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Guidelines on the Programming, Design & Management of General Budget Support

AIDCO DEV RELEX

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Guidelines on the Programming, Design & Management of General Budget Support

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In light of the experience in using this guide it is planned to make modifications and adaptations as and when necessary. Indeed, the annexes will be regularly updated to take account of new thinking and lessons learnt. To help in this work, comments, questions, and suggestions on this guide are therefore warmly welcomed and should be sent to unit AIDCO/E1 at: **EuropeAid-E1-macro-economic-support@ec.europa.eu**

Abbreviations

AAP	Annual Action Programme
ACP	Africa, Caribbean, Pacific countries (signatories to the Cotonou agreement)
ADM	Aid Delivery Methods
AF	Action Fiche
ALA	Asian and Latin American countries
BSTN	Budget Support Thematic Network
BWI	Bretton Woods Institutions
CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment Review
CRIS	Common Relex Information System
CSP	Country Strategy Paper
DAC	Development Assistance Committee (of OECD)
DCI	Development Cooperation Instrument
DG	Directorate-General
DG DEV	Directorate-General for Development
DG RELEX	External Relations Directorate-General
EC	European Commission
ECFIN	Directorate General for Economic and Financial Affairs
EDF	European Development Fund
ENPI	European Neighbourhood and Partnership Instrument
EPRD	European Programme for Reconstruction and Development (South Africa)
EU	European Union
DG AIDCO	EuropeAid Co-operation Office (AIDCO)
FA	Financing Agreement
ENP	European Neighbourhood and Partnership
FP	Financing Proposal
GBS	General Budget Support
GIP	General Import Programme
HQ	EC Headquarters in Brussels
IfS	Instrument for Stability
IPA	Instrument for Pre-Accession Assistance
i-QSG	Inter-service Quality Support Group
IF	Identification Fiche
IMF	International Monetary Fund
INTOSAI	International Organisation of Supreme Audit Institutions
MDG	Millennium Development Goals
MEDA	Mediterranean countries (signatories to the Barcelona process)
NIP	National Indicative Programme
o-QSG	Office Quality Support Group
OECD	Organisation for Economic Co-operation and Development
OFS	Order for Service
PCM	Project Cycle Management
PEFA	Public Expenditure & Financial Accountability
PEM	Public Expenditure Management
PER	Public Expenditure Review
PETS	Public Expenditure Tracking Survey
PFM	Public Finance/Financial Management
PFM-PMR	Public Financial Management Performance Measurement Report
PRS	Poverty Reduction Strategy
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
PSI	Policy Support Instrument
OECD	Organisation for Economic Cooperation and Development
QSG	Quality Support Group
QSG(1)	Office Quality Support Group at the end of Identification
QSG(2)	Office Quality Support Group at the end of Formulation

SBS	Sector Budget Support
SIP	Sector Import Programme
SMP	Staff Monitored Programme
SP	Sector Programme
SPA	Special Partnership with Africa
SPSP	Sector Policy Support Programme
TAPs	Technical and Administrative Provisions
UNDP	United Nations Development Programme
WB	World Bank

1 INTRODUCTION

For many years the European Commission has promoted the use of budget support as a way of delivering aid. To support this process a *Guide for the programming and implementation of Budget Support for Third Countries,* March 2002, was prepared by the Commission services in order to promote a harmonised and coherent approach to the use of budget support. These new *Guidelines on the Programming, Design and Management of General Budget Support* represent the first major revision of the earlier guidelines.

1.1 Purpose of the Guidelines

The purpose of these *Guidelines* is to contribute to improving the quality of EC Budget Support[1] programmes by providing guidance to those who prepare and implement these programmes.[2] They aim to promote consistency and clarity of approach, while allowing for the operational flexibility required in the face of dynamic and diverse situations. To achieve this purpose, these guidelines provide information and guidance on:

- The rationale and definitions for using budget support as a financing modality (Chapter 2)
- The importance of eligibility criteria for budget support programme throughout all the stages of the cycle of operations from programming through to implementation (Chapter 3)
- How the programming, identification, formulation, implementation and evaluation of General Budget Support (GBS) is carried out (Chapters 4-8)
- How the procedures of the European Commission are used in the preparation and implementation of GBS operations (Chapter 9) (Although providing some guidance on procedural matters, this guide does not describe in detail the financial procedures and circuits, which are addressed separately in other official EC documents dealing with Financial Regulations of the Community budget and the European Development Fund.[3])
- Annexes provide supporting guidance in three areas (i) further guidance on thematic topics; (ii) model terms of reference; (iii) procedures and budget support, including templates used during programme preparation and implementation.

1.2 Coverage of these guidelines

The Guidelines are focused on the requirements for **General Budget Support**, provided by the European Commission to "third countries", that is countries other than the Member States, Acceding countries, candidate countries, and potential candidate countries of the European Union.

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[1] These operations have been referred to as Budget Aid (BA), although Budget Support is now the generally accepted term and used throughout these guidelines. "Budget Aid" and "Budget Support" are synonymous.

[2] These guidelines therefore focus in the first instance on the needs of EC officials, although colleagues in partner governments and other donors may benefit from a better understanding of the EC's approach to budget support that these guidelines provide.

[3] See Notes on Financial Circuits relating to transactions management by AIDCO, as well as the *Practical Guide to Contract Procedures for EC External Actions*, *Finance Guide applicable to external actions financed from the General Budget of the European Communities* (for the budget), and *Guide to the Financial Procedures of the 9th European Development Fund*, (for the EDF) see:
http://www.cc.cec/EUROPEAID/contfin/budget_procfincont_en.htm (for the budget) and
http://www.cc.cec/EUROPEAID/contfin/fed_procfincont_en.htm (for the EDF)

Many of the requirements for General Budget Support are applicable to the provision of Sector Budget Support. **Sector Budget Support** (SBS) can be provided to support the implementation of a Sector Programme of a partner government. Much of what is contained in these Guidelines is applicable to Sector Budget Support. However, as one of the financing modalities for an EC Sector Policy Support Programme (SPSP), it is the *Guidelines on EC Support to Sector Programmes* which provide the relevant operational guidance on the design and management of Sector Policy Support Programmes that use budget support as the financing modality.

It should be noted that **these Guidelines do not cover the requirements for the provision of Macro-Financial Assistance (MFA)**, which is managed by DG ECFIN on the basis of operational procedures determined by DG ECFIN itself.[1]

1.3 The policy context

These guidelines have been prepared to take account of the policy context as well as practical orientations in the area of providing budget support. Most notable in this regard are:

- *The Millennium Development Goals and the EU's commitments*. The Millennium Development Goals, adopted by 189 nations in September 2000, have set eight goals, eighteen targets, and 48 indicators for measuring progress. For the EU they have been complemented by the Barcelona Commitments made in March 2002 which includes eight commitments, most notably on increased aid commitments, and improved harmonisation and coordination.

- *The Paris Declaration on Aid Effectiveness,* March 2005, which includes twelve indicators of progress on ownership, alignment, harmonisation, managing for results, and mutual accountability.[2] Many of these indicators of progress implicitly lend support to the use of budget support, and encourage the use of partner country public financial management systems. Linked to the Paris Declaration the EU has made four additional commitments, one of which also has implications for budget support[3].

- *The European Consensus* Joint Statement by the Council and the representatives of the Governments of the Member States meeting within the Council, the European Parliament and the Commission on European Union Development Policy, 22 November 2005. This statement of development policy includes many commitments to the use of budget support.

- *OECD Good Practice Guidance on Budget Support*, in "Harmonising Donor Practices for Effective Aid Delivery", Volume 2, 2006 which puts forward certain guiding principles in the areas of ownership, PFM systems, transaction costs, and predictability.

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[1] Macro Financial Assistance is managed by ECFIN and provides balance of payments support to beneficiary countries on a short-term and exceptional nature, managed under ths so-called "Genval Criteria" and requiring an explicit decision by the Commission in accordance with Article 308 of the Treaty.

[2] See Part III of the *Paris Declaration on Aid Effectiveness: Ownership, Harmonisation, Alignment, Results and Mutual Accountability*, Paris February 28 – March 2, 2005.

[3] One of the four additional EU indicators states: "To channel 50 per cent of government-to-government assistance through country systems, including by increasing the percentage of our assistance provided through budget support or SWAP arrangements" See *Statement by the EU Presidency on behalf of the European Union, Second High Level Forum on Aid Effectiveness.*

- *Evaluation of General Budget Support,* May 2006, which, from an evaluation of seven countries[1] conducted under the auspices of the OECD-DAC, found that budget support had been a relevant response to certain problems in aid effectiveness, and that it can be an efficient, effective, and sustainable way of supporting national poverty reduction strategies, as well as strengthening capacity, especially in the area of public financial management.

- *European Court of Auditor's Special Report No 2/2005 concerning EDF budget aid to ACP Countries: the Commission's management of public finance reform aspect.* This report made a number of recommendations in the area of public financial management and budget support to which the Commission has made replies. This report follows two earlier reports by the Court of Auditors, one on ACP countries, and the other on MEDA countries as well as the use of the MFA instrument.[2]

This guidance does not make a restatement of the orientations, guidance and recommendations made in these reports. However, where appropriate, references are made to these documents, in particular the OECD Good Practice Guidance on Budget Support, because of its practical orientation.

1.4 What is new in these guidelines

These guidelines contain a number of new features when compared to the earlier guidelines of March 2002.

- *Clearer definitions and coherence with other guidance.* An effort has been made in this guide to provide clear definitions of some of the key phrases used in budget support programmes so that there can be a shared language. Furthermore, attention has been paid to ensure coherence with other EC guidance on projects[3] and sector programmes.[4]

- *General Budget Support replaces Macroeconomic Budget Support*. The phrase macroeconomic budget support used in the March 2002 guidance has been replaced with the more widely used phrase "General Budget Support" (GBS)

- *General Budget Support can have medium-term <u>or</u> short-term objectives*. The March 2002 guidance gave GBS (or macroeconomic budget support) three objectives of "support to economic reforms"; "ad-hoc complementary support" and "emergency aid for stabilisation and rehabilitation". In this guide the objectives have been simplified to cover either medium-term objectives (to support a development or reform policy and strategy) or short-term objectives (to support stabilisation and rehabilitation).

- *Extended discussion of the potential benefits and risks of budget support.* This guide includes a detailed presentation of some of the potential benefits as well as the risk associated with budget support. It aims to ensure that those preparing and implementing budget support programmes are

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[1] Burkina Faso, Malawi, Mozambique, Nicaragua, Rwanda, Uganda, Vietnam.

[2] Special Report No 5/2001 on counterpart funds from structural adjustment support earmarked for budget aid (seventh and eighth EDFs); and Special Report No 1/2002 concerning macro-financial assistance (MFA) and structural adjustment facilities (SAF) in the Mediterranean countries.

[3] *Project Cycle Management Guidelines*, European Commission, March 2004

[4] *Guidelines for EC Support to Sector Programmes,* European Commission, February 2003

aware of the context and issues surrounding budget support, and are therefore better placed to deal with the challenges that arise.

- *Much greater attention to Eligibility Conditions for budget support*. In the previous March 2002 guidance there was only a very brief reference to eligibility. In this guide, much greater attention is given to these eligibility conditions in an effort to focus attention, especially during programming and identification, on key elements that should be in place if budget support is to be used.

- *Guidance focuses on practicalities related to preparation and implementation*. An effort has been made to ensure that the guidance is as practical as possible. In particular the guidance on programme preparation follows the current format of a Financing Proposal/Action Fiche[1] to ensure that the main issues are covered.

- *Much greater guidance on assessing public financial management.* This guide includes extensive discussion of assessments of public financial management (Chapter 6 and a number of annexes), based for the most part of work arising from the Public Expenditure and Financial Accountability (PEFA) initiative. This work should give much greater coherence and clarity to the assessment of public financial management as an eligibility conditions for the use of budget support.

- *Much greater guidance on the use of performance indicators.* As part of the international agenda to encourage results-based approaches to managing and monitoring aid, more guidance is given on the use of "results/outcome oriented" performance indicators.

[1] The term *Financing Proposal* is used for actions financed under the 9th EDF, and the term *Action Fiche* is used for all other actions, whether financed from the DCI, ENPI, or other instruments. Although the names differ the areas and sub-areas covered in each document are for all practical purposes the same.

2 RATIONALE AND DEFINITIONS

This chapter:

⇒ Explains what is meant by budget support and provides key definitions used in budget support operations

⇒ Explains the potential benefits of budget support, the results/outcome-oriented approach, and the use of variable tranches, as well as some of the associated risks

⇒ Presents a stylised intervention logic for budget support

⇒ Summarises why direct untargeted budget support is a favoured modality for delivering aid

2.1 What is budget support?

The definition of budget support that is adopted in this guidance is as follows:

*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*[1].

There are a number of important points in this definition (see Figure 2.1 below):

- First, the transfer of resources is, in the first instance, made to the foreign exchange reserves of the Central Bank. It is then the Central Bank that credits the National Treasury of the partner country.

- Second, the transfer of resources must be to the National Treasury Account – this may be the Consolidated Fund of the Government, National Revenue Account, "le compte du Trésor" or equivalent – normally held by the government in the Central Bank[2]. Transfers that are made to accounts held by parties other than the government, held in Commercial banks (even if held by government agencies or agents), or held outside the National Treasury system cannot be considered to be budget support.

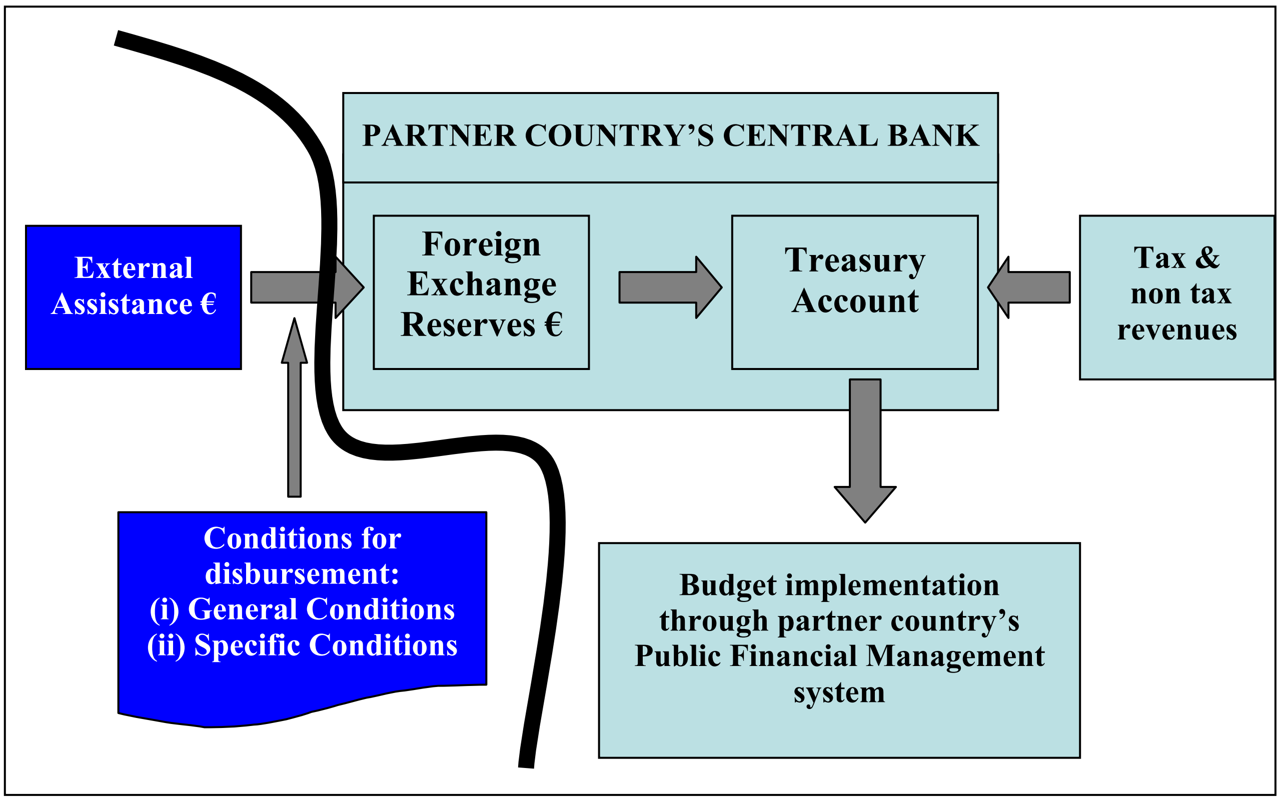
- Third, any transfer is always made after the agreed conditions for payment have been respected, and once the transfer is made these resources are used, along with other government resources, in accordance with the public financial management systems of the partner government. That is they

[1] The OECD-DAC uses similar definitions: (i) the Creditor Reporting Systems codes 2005, defines General Budget Support as "un-earmarked contributions to the government budget; support for the implementation of macroeconomic reforms (structural adjustment programmes, poverty reduction strategies); transfers for the stabilisation of the balance-of-payments (e.g. STABEX, exchange rate guarantee schemes); general programme assistance (when not allocable by sector)" and (ii) the OECD-DAC booklet, *Harmonising Donor Practices for Effective Aid Delivery, Volume 2,* states that "…budget support is defined as a method of financing a partner country's budget through a transfer of resources from an external financing agency to the partner government's national treasury"

[2] The concept of the "National Treasury Account" should be interpreted in the broadest sense so that it covers all the accounts held in the Central Bank through which pass all government receipts and payments. It will therefore include any "*comptes special*" or equivalent.

are planned for, budgeted, spent, reported on, accounted for, and audited through the procedures of the partner government. In this respect the Commission's responsibility consists of ensuring that the conditions have been met and that resources are transferred to the national treasury in accordance with the agreement.[1] Once this transfer has taken place, the responsibility for the management of these transferred resources rests with the partner government. There is no follow-up by the EC through, for example the clearance of accounts, or subsequent accounting for the use of these funds (hence the thick black line that separates what the EC does from what a partner country does in Figure 2.1 below).[2] Any follow-up is undertaken in accordance with the mandate of the authorities of the partner country which are responsible for the supervision, control, and auditing of public funds.

Figure 2.1: Flow of Funds of Budget Support



This (procedural or administrative) definition of budget support avoids ambiguity over what is and what is not budget support. However, it overlooks key features of a budget support operation. Because it contributes to financing the totality of a country's budget and not any specific subset of budgeted expenditures, it will be accompanied by dialogue on the overall policy and strategy, and on the functioning of public financial management. By virtue of contributing to a partner country's budget it will involve alignment with government systems, and be accompanied with harmonisation with other donors. Furthermore, dialogue frequently leads to agreement on support for capacity development as an important accompanying measure.

[1] Under the EC's financial regulations this method of implementation is known as "centralised direct" – see Chapter 9 for further details

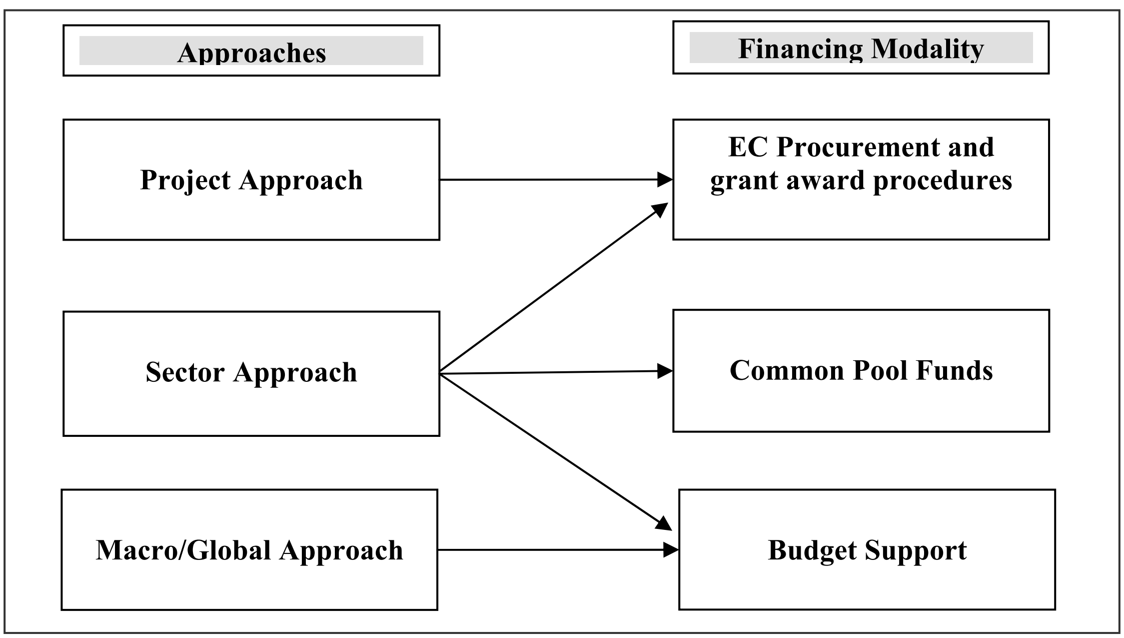
[2] There is one exception to this rule, and that is that the EC Delegation in the beneficiary country is expected to verify the arrival of the funds in the relevant Treasury account.

Given the features mentioned above, a more holistic view of budget support would be to see it *as "provision of* ***money*** *on the basis of the fulfilment of* ***conditions*** *in a context of* ***dialogue, harmonisation, alignment****, and* ***capacity development****"*.

2.2 Budget Support and Aid Delivery Methods

It is also useful to recall that budget support should be seen as a financing modality within the framework of "Aid Delivery Methods" (ADM) used by the European Commission.[1] In this framework it is common to refer to three *approaches* – the project approach, the sector approach, and the macro or global approach. At the same time it is common to refer to three *financing modalities*[2] – the use of EC procurement and grant award procedures, the use of a common pool funds, and the use of budget support. The clearest way in which this distinction between "approach" and "financing modality" can be seen is in the case of a Sector Policy Support Programme (SPSP) which can be financed either through the use of EC procurement and grant award procedures, or through the pooling of funds, or through the use of budget support. Figure 2.2 below illustrates this way of looking at Aid Delivery Methods.

Figure 2.2: The Aid Delivery Methods used by the European Commission



2.3 The language of budget support

Understanding the definition of budget support is just a start. But there are other key terms essential for implementation of budget support operations. Table 2.1 below gives a general overview of some of the key terms employed when using budget support. It classifies this language according to the objectives of

[1] See "Aid Delivery Methods: Project Cycle Management Guidelines", European Commission, March 2004

[2] In the *Guidelines for European Commission Support to Sector Programmes,* February 2003 the phrase "operating modality" was used instead of "financing modality" (see page 41) In these guidelines the phrase "financing modality" is preferred since it better conveys the idea of a method of channelling finance

budget support, the manner in which the local currency equivalent of foreign currency aid is generated, and the different language used for different disbursement methods. The rest of this section outlines what is meant by these key phrases (a glossary of terms is at Annex 1.1).

Table 2.1: The Language of Budget Support

Type of Budget support	Broad Objectives of budget support	Generation of local currency equivalent of foreign currency transfer	Disbursement Methods			
General Budget Support	Medium Term	Direct or Indirect	General Conditions and Specific conditions	Untargeted or Targeted	Fixed Tranches and/or Variable tranches	Floating conditions and Non-floating conditions
	Short-term					
Sector Budget Support	Medium Term					

2.3.1 General Budget Support and Sector Budget Support

Budget support as described above may be provided as either:

- **General Budget Support**, representing a transfer to the national treasury in support of a national development or reform policy and strategy; or

- **Sector Budget Support**, representing a transfer to the national treasury in support of a sector programme policy and strategy.

Both General Budget Support (GBS) and Sector Budget Support (SBS) involve a transfer of funds to the National Treasury of a partner country, and there is therefore no procedural distinction between GBS and SBS. But they are distinct to the extent that they have **different objectives**. GBS aims to support a national development policy and strategy; SBS aims to support a sector policy and strategy. In many respects GBS is an approach to providing aid that has evolved out of balance of payments support, whereas SBS, in contrast, is an approach to delivering external assistance that has evolved out of project support. The difference in objectives will be reflected in the conditions and dialogue.

In supporting a national policy and strategy, GBS should be built around the fundamental goals the Commission wishes to support. In the case of ACP and DCI countries these goals will in most cases be based upon poverty reduction (including non-income poverty related issues such as education and health), and in ENPI countries on construction of a zone of shared prosperity and economic convergence with the European Union. Even if it supports a country's overall priorities, GBS should not be built as a "multi-sectoral" operation, since this would weaken the focus on supporting national development policy and strategy in coherence with the fundamental goals of the Commission. It would also weaken the deeper technical dialogue with a broader range of stakeholders on a specific sector that would normally be achieved with a SPSP using budget support as the financing modality. Table 2.2 below summarises these main distinctions.

Table 2.2: General Budget Support and Sector Budget Support

Area	General Budget Support	Sector Budget Support[1]
Financing Modality	Budget support: the transfer of resources to the National Treasury, where these financial resources are used in accordance with the public financial management system of the partner country.	
Objectives	Support to the national development or reform policy and strategy	Support to a sector programme policy an strategy
Policy Dialogue	Focus on the national development or reform policy and strategy. For example, support to an Association Agreement, or a PRSP	Focus on the sectoral development and reform policy and strategy. For example, support to an education sector programme
Typical features	Focus on: (i) national objectives which can cover key sectoral objectives in so far as they are fundamental to the national development or reform policy and strategy; (ii) improving or maintaining macroeconomic stability; (iii) improving overall public financial management; (iv) improving the budgetary framework to address national policy and strategy objectives (iv) oriented to the use of "results/outcome based" performance indicators	Focus on: (i) improving sector performance; (ii) improving overall public financial management, but paying particular attention to sector specific issues (iii) macroeconomic framework in so far as it is important for the achievement of sectoral objectives; (iv) improving the budgetary framework for the sector (iv) the use of "results/outcome" based performance indicators, but also paying attention to the results chain from "inputs" to "outputs" to "results/outcome"

2.3.2 Objectives of general budget support – medium-term and short-term

The way in which General Budget Support can achieve its objectives of supporting a national development or reform policy and strategy depends upon the specific country context (see Figure 2.3).

The two main categories can be identified as follows:

- **Short-term support for stabilisation and rehabilitation**[2] can be provided to support the establishment (or the preservation) of the conditions allowing the implementation of a medium-term or long-term development or reform policy and strategy. Thus, for instance, budget support may be supplied within a short-term programme, for example in post-crisis countries which are emerging from internal or external conflict or natural disaster, or for countries affected by crises and difficulties elsewhere[3]. Fluctuations in export earnings, particularly from the products of the

[1] Further information on definitions of the "sector approach", a "sector programme" are provided in the *Guidelines for European Commission Support to Sector Programmes, February 2003*

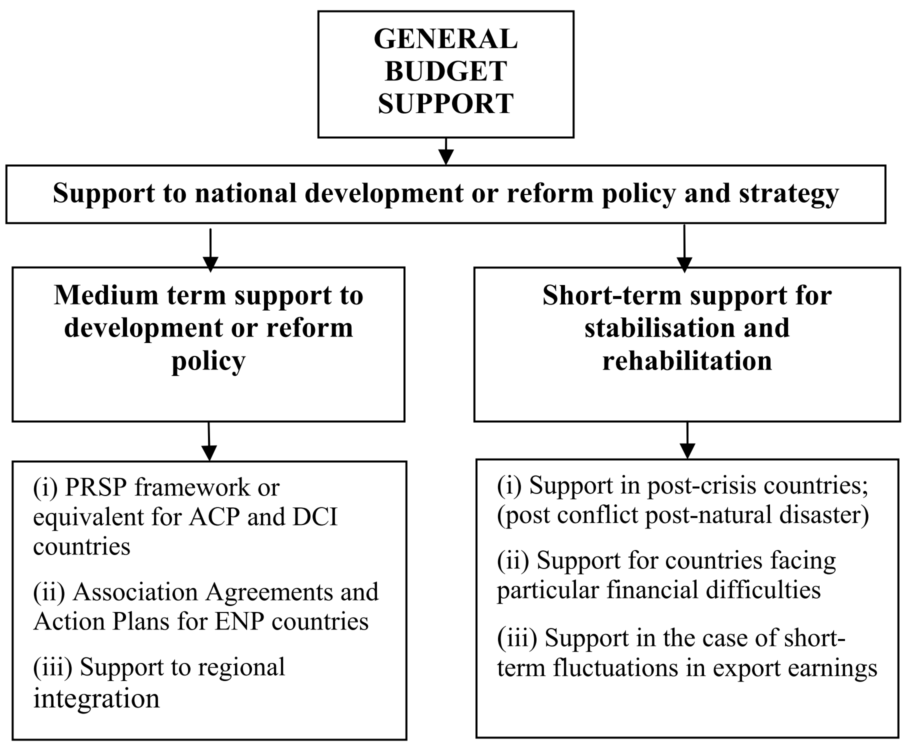
[2] This support should be distinguished from Macro Financial Assistance (MFA) managed by ECFIN, which is also of a short-term nature but is also of an exceptional nature requiring an explicit decision by the Commission in accordance with Article 308 of the Treaty.

[3] In such situations it would be inappropriate to expect the partner country to have a fully developed national policy and strategy; but nevertheless it would be right to expect a commitment to reform as well as some capacity to plan and implement key measures of a more limited policy and strategy document. Often this type of support takes the

agricultural and mining sectors, may compromise the ability of partner countries to achieve their development goals. For ACP countries, arrangements are therefore foreseen to provide support in the event of short-term fluctuations in such earnings.

- **Medium term support to development or reform policies and strategies.** In this more common case, GBS programmes will be designed to provide support for the implementation of a country's national policy and strategy focusing on economic and social reforms. In ACP and DCI countries this will usually involve support for Poverty Reduction Strategies (PRS); and in the case of ENPI countries involve support for the objectives of association and economic convergence with the European Union set out in Association and Cooperation Agreements and Action Plans. Regional integration objectives may also be assisted with budget support.

Figure 2.3: Objectives of General Budget Support



2.3.3 Direct and Indirect Budget Support

Budget support refers to the financing of a partner country's budget through the domestic currency equivalent ("generated" or "created" by the conversion) of the foreign currency resources transferred by the EC to the partner country's central bank. The foreign currency regime of the recipient country determines whether budget support is direct or indirect.

- **Direct Budget Support**. When the domestic currency equivalent of the foreign currency transfer is generated or created *directly* through the usual channels of the banking system. The foreign

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form of an annual programme, possibly involving just a single tranche payment based on agreement to a financial stabilisation and economic recovery plan so as to provide timely support to meet external and internal financing needs. Such support would normally also be the first step in preparing a medium-term programme of support.

exchange is simply transferred to the Central Bank which then credits the equivalent amount of domestic currency in the partner government's National Treasury account. When domestic currency is convertible[1] into foreign currencybudget support is provided in this *direct* manner.

- **Indirect Budget Support**. When domestic currency equivalent of the foreign currency transfer is generated or created *indirectly* outside the usual channels of the banking system. The foreign exchange is converted into a domestic currency equivalent typically through the sale of foreign exchange on a foreign exchange auction, or through allocations of foreign exchange through a general or sectoral import programme, or through the sale of aid in kind, or the use of a currency facility. When domestic currency is not convertible[2] into foreign currency, budget support is *indirect* because the local currency

2.3.4 General and Specific Conditions for disbursements

GBS disbursements are made after verification that certain conditions for payment are met. These conditions are usually classified as general or specific.

- **General conditions**. These are conditions that apply to the disbursement of *all* tranches. These conditions will be those related to the eligibility criteria for receiving GBS, namely (i) that a national development or reform policy and strategy is in place or under implementation; (ii) that a stability-oriented macroeconomic policy is in place or under implementation; and (iii) that a credible and relevant programme to improve public financial management is in place or under implementation. There may be additional general conditions (for example, availability of documents, but these should be kept to a minimum). The general conditions should be drafted in a way that ensures verifying the conditions without introducing formalistic rigidities that may lead to unnecessary "stop and go"[3] during programme implementation.

- **Specific conditions**. These are conditions that apply to the disbursement of *individual* tranches, whether fixed or variable. These conditions will normally be those related to performance criteria and indicators established in each of the areas of focus of the GBS programme In setting these performance criteria and indicators attention will normally be given to ensuring that they are "result/outcome-oriented", particularly in the case of variable tranches.

2.3.5 Untargeted and Targeted Budget Support

Budget support can be disbursed to the national treasury either in a untargeted or targeted manner.

- **Untargeted Budget Support** involves the transfer of EC resources to the national treasury of the partner country, where they are "mixed" with domestic revenues and other sources of finance and used to finance activities of the government's budget. There is no tracking of the use of the resources so transferred. Untargeted budget support is favoured because it focuses attention on overall performance as established in disbursement conditions, recognises that with the fungibility (see Annex 1.1) of resources there is little to be gained in aid effectiveness with targeting, and avoids the high transaction costs of targeting.

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[1] The exchange arrangements and exchange restrictions agreed between the partner country and the IMF under either Article VIII or Article XIV of the IMF's Articles of Agreement will be used to arrive at a conclusion on whether the domestic currency is convertible or not.

[2] See footnote (1) above.

[3] "Stop and go" or "stop-go" is used to describe a situation over time in which there are repeated disbursements followed by non-disbursements. For example, one year budget support might be disbursed, the following year it might be stopped, and then in the following year it might be restarted.

- **Targeted budget support**[1] involves the transfer of EC funds to the national treasury of an amount equal to eligible expenditures clearly identified within the budget. The transfer of EC funds will be ex-post[2], taking place after an audit to verify the actual execution of eligible expenditures. The amount transferred to the national treasury will be equal to the amount certified as eligible for EC financing in the audit (subject to the agreement of EC services)[3,4] (see section 8.2.2 for futher details).

Box 2.1: OECD Good Practice Guidance: refrain from targeting budget support

OECD Good Practice Guidance states "Refrain from targeting budget support – As a norm, there should be no restrictions on the use of funds once these are transferred to a partner country's treasury account following the fulfilment of agreed conditionality. Given resource fungibility, the earmarking of resources would have little or no positive impact on the effectiveness of aid, but it would increase transaction costs. Exceptions to the general rule should be limited to cases that are clearly justified, eg when significant risks of severe liquidity constraints raise the possibility of cuts in priority spending. Generally, however, the factors that seemingly justify the targeting of resources are better addressed through adopting an alternative aid modality such as sector or project support"

Source: *Harmonising Donor Practices for Effective Aid Delivery, Volume 2,* OECD-DAC, para 11

2.3.6 Fixed and Variable Tranches

GBS disbursements are made through the use of either fixed or variable tranches.

- **Fixed tranches** have a fixed value, specified in advance within the Financing Agreement. They are either disbursed in full (if all conditions are met) or not at all (if one or more conditions are not met). In other words, partial disbursement is not possible.

- **Variable tranches** have a *maximum* value, specified in advance within the Financing Agreement. They are either disbursed in full or in part, with the amount being disbursed being based on performance achieved in relation to pre-specified targets or designated performance criteria and indicators (provided that at the same time the general conditions are all met).

2.3.7 Floating and Non-floating tranches

It is often useful in budget support operations to make a distinction between floating and non-floating tranches.

- **Floating tranches**: a tranche is considered to be floating, when the date by which its disbursement condition(s) need(s) to be met can vary – in effect there is no fixed "cut-off" date for meeting the disbursement condition. An indicative date will normally be specified in the Financing Agreement – but the actual date will "float" depending on when the conditions for disbursement have been

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[1] In many Member States targeted budget support is referred to as "earmarked" budget support.

[2] The reference to "ex-post" here is because the previously widely used approach of making an advance to a double-signature account (government and EC), which is then subsequently transferred to a partner country account in accordance with the conclusions of the audit, is no longer foreseen in the financial regulations (Budget and EDF)

[3] Sometimes targeting is treated as the same as using a sectoral allocation (budgeted or expenditures) as a condition for disbursement. However, targeting only requires an audit to the value of the amount of budget support provided, and is therefore qualitatively different from a disbursement condition that requires a total budget allocation or expenditure outturn to be equal to (or greater than) a certain amount

[4] In addition it should be noted that in this definition, targeting refers to the *financial resources* provided, and not to whether the *conditions* for disbursement are targeted on a particular sector.

met[1]. Floating tranches would most commonly be used when certain measures such as passing legislation or taking a particular decision are necessary for disbursement.

- **Non-floating tranches**: a tranche is non-floating when the date by which its disbursement condition(s) need(s) to be met *cannot* vary – in effect there is a fixed "cut-off" date for meeting a disbursement condition. A fixed date will be specified in the Financing Agreement by which the disbursement condition is to be met; if the disbursement condition is not met by this date, the partner country will, in principle, be ineligible for support. Where performance indicators are to be met in a given year these would normally be non-floating (for example if a gross enrolment target for year X is not met, there would not be the possibility of disbursement in year X+1 should the target be met in that year).

2.4 The potential benefits of budget support

In recent years the European Commission and other donors have pointed to a series of potential benefits from the use of budget support as a financing modality. There are many ways of presenting the potential benefits of budget support (and indeed in the list below they are not necessarily mutually exclusive), and although the list below may appear especially wide, it needs to be recognised that not all potential benefits may arise at the same time, and that any potential benefits will depend on country context. Some of these many potential benefits are mentioned below:

- *Increased ownership*. Since budget support is based on the principle of supporting a partner country's policies and strategies through its budget, it can be expected to increase ownership of the development process by partner countries.

- *A more stable macroeconomic framework*. Since budget support provides resources to the budget and the balance of payments, it contributes to helping a country establish and/or preserve a stability-oriented macroeconomic framework. On the internal (budget) side this is seen either through increased expenditures that are fully financed, or through a reduction in financing needs (or some combination of the two) and an improvement in the net position of the government at the central bank. Similarly, on the external (balance of payments) side it is seen through increased imports that are fully financed, or through a reduction in financing needs for imports (or some combination of the two) and a building-up of foreign exchange reserves.

- *A better framework of public policy and public expenditure*. Budget support by integrating donor support into the budget of a country offers the potential for improving the framework of public policy and public expenditure, notably through its focus on public financial management. This improved framework may be felt in all areas – public financial management, tax policy, regulatory environment, and macroeconomic management.

- *Higher potential for overall impact*. The integration of budget support within the budget enables donors to focus on the big picture – the whole budget which they are directly or indirectly supporting. By focusing on the overall picture we avoid the possibility of creating "islands of perfection" without addressing more systemic and fundamental issues, such as ensuring

[1] An example of conditions which "float" comes from the HIPC initiative, where the date of the "completion point" for full eligibility for stock of debt reduction is not fixed in time, but is instead flexible – the "completion point" floats and depends on the date on which the conditions are met. With the EC, even with floating tranches there will, of course, be a limit to how much the tranche can "float" driven by the life of the financing agreement. In the case of budget support all requests for tranche release have to be made before the end of the "operational implementation period" as specified in the financing agreement; if this condition is not fulfilled, then the beneficiary country is no longer eligible for tranche release

prioritised, results-oriented, national programmes. The potential for having a greater overall impact is therefore present.

- *Increased coherence*. Budget support, by bringing “on-budget” what was often “off-budget”, increases the potential for achieving a more coherent mix between sectors; between capital and recurrent spending; and within recurrent spending between salaries, and non-salary costs. In contrast with a multiplicity of donor projects, those managing public expenditure often do not have information on expenditures taking place and the liabilities being created.

- *Lower transaction costs*. Without the need for project management units, by putting money through national processes, and by adopting common reporting procedures the transaction costs[1] of delivering aid as budget support are potentially lower than other forms of aid. The costs associated with delivering aid in terms of identifying, negotiating, and implementing budget support will in most cases be lower than supplying aid in other forms.

- *Greater harmonisation of donor practices and alignment with government procedures.* Budget support by focusing support on national or sectoral policies and strategies creates incentives for harmonisation amongst donors. Furthermore, by its use of the partner country’s procedures it leads to alignment with those procedures.

- *Improved capacity development*. Budget support does not rely on the use of parallel and often costly management structures outside, with their own staffing arrangements and management procedures, which are outside government structures. Instead it focuses on using existing government structures and procedures, especially those in the area of public financial management. Use of government systems may not always be easy, but budget support focuses the attention of partner countries and donors on improving these systems, so that once donor support diminishes, or indeed is no longer available, the improvements to capacity that come from using government procedures remain.

- *Improved domestic accountability*. Since budget support funds flow through the government accounts and budget, governments can in principle be held to account for the use made of these resources. The availability of information on the budget as the whole has the potential of increasing domestic accountability, especially with respect to results/outcomes (see below). This accountability comes from the increased transparency in the budget, the role of parliament in the budget (in particular finance committees), and the internal and external control associated with the budget.

- *Increased efficiency and sustainability*. The fact that budget support is integrated into the public financial management procedures of a country improves the possibility of a lasting effect of the aid. One can expect that the effect comes through the increased ownership, efficient use of resources (including the fact that budget support is *de facto* untied aid), increased coherence, and improved capacity development mentioned above.

[1] Transaction costs may be defined as the extra costs – beyond that of the aid itself – of delivering aid. These costs may be born by the recipient, the donor, or by both. It may cover, for example, the money, time, inconvenience of identifying, negotiating, implementing, monitoring and evaluating aid delivery.

2.5 The potential benefits of results/outcome-oriented budget support

In many of its programmes using budget support as a financing modality the Commission and the international community has encouraged a "results/outcome-oriented" approach.[1] In the Commission's "Input-Output-Outcome-Impact" typology, a result corresponds to the "outcome" level where typically access to, use of, and satisfaction with public service provision is measured (see Annex 1.9, and Box 2.2).

Box 2.2: RESULTS: What are they and why use them?

What do we mean by "Results"?

There is the potential for confusion over what is meant by a "result". In the Commission's "input-output-outcome-impact" typology it would correspond to an "outcome", such as primary school enrolment; whereas the amount spent on primary education would be classified as an "input"; the number of primary teachers trained would be an "output", and literacy rates would be an "impact". It is for this reason that the terms "results" and "outcomes" should be treated as synonymous. In this text you will find the reference "results/outcomes" frequently used.

However, it should be noted that others sometimes give a different definition to what is meant by a result. For example, the OECD-DAC refers to a result as being the "output, outcome, or impact…of a development intervention" (see *Glossary of Key Terms in Evaluation and Results Based Management",* OECD, 2002).

Why focus on results/outcomes?

In the "Input-Output-Outcome-Impact" typology mentioned above, inputs and outputs correspond to what can be more or less *"controlled directly"*; outcomes correspond to what can be *"influenced directly"*; and impacts refer to what can be *"influenced indirectly".* Thus, outcomes may not be fully controlled, but governments can have a very strong direct influence on what can happen, often over a short time period (for example vaccination rates and school enrolment). Although it is impact that we may wish to change, it would be unrealistic to seek short-term changes at this level; in contrast focusing on outcomes ensures that changes can take place in those areas where governments can have a direct influence.

Encouraging the use of results/outcome indicators is expected to be beneficial for a number of reasons:

- *Results matter.* Traditional policy-based conditionality has frequently not looked at what is happening to potential beneficiaries and target groups. Linking budget support to what is happening in terms of results shifts the policy dialogue and encourages both donors and beneficiary countries to look at the actual results of their actions, thus taking their commitments on aid effectiveness seriously. Furthermore, this focus on results is consistent with agreed policy including the internationally agreed Millennium Development Goals. Focusing on results also avoids payment of budget support against what can easily become symbolic acts such as passing legislation or completing a study, that do not necessarily reflect the genuine intentions of partner countries.

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[1] For example, in *The European Consensus,* Joint Statement by the Council and the representatives of the Governments of the Member States meeting within the Council, the European Parliament and the Commission on European Union Development Policy, 22 November 2005, it is stated (para 115) that "The Community will consistently use an approach based on results and performance indicators". Furthermore, this approach has found expression in the Paris Declaration on Aid Effectiveness, March 2005, where in particular one of the twelve "Indicators of Progress" on "Managing for Results" calls for "results-oriented frameworks…with transparent and monitorable performance assessment frameworks to assess progress against (a) the national development strategies and (b) sector programmes.

- *Encourage "evidence-based" policy making.* The focus on results when providing budget support is expected to encourage donors and beneficiary countries to analyse carefully the consequences of any given policy on the outcomes. In some cases it can be expected to lead to an enhanced policy dialogue focusing on outcomes rather than means.

- *Protect political space of beneficiary countries.* Using results/outcome-based indicators instead of policy conditions protects the policy space of the government to make what it considers are the right policy decisions needed to meet a particular objective. Country context varies a great deal and it is perhaps advisable, even when giving advice during policy dialogue, to refrain from being prescriptive in terms of policy conditions[1].

- *To promote domestic accountability*. Using results/outcome-oriented indicators has the potential to encourage greater transparency by Ministries, cabinet, parliament, and the public in general over the use of public funds.

- *Stimulate demand for high quality data and data that supports evidence based decision making*. One of the potential strengths of the focus on results is that it helps identify potential weaknesses in national statistical systems in terms of the quality of statistical information. Naturally the identification of these weaknesses should lead to corrective measures to improve the quality of statistical information.

2.6 The potential benefits of using variable tranches

Although in practice the Commission uses variable tranches in combination with "results-based" indicators, the validity of using variable tranches is applicable whether "results-based" indicators are or are not used.[2] In particular they can be beneficial for a number of reasons

- *Partial payment for partial performance*. It seems more "just" or appropriate to recognise progress that has been made on certain conditions, even when progress has not been made in all areas. In effect a "reward" for some performance seems more appropriate than not making any payment at all (see Box 2.3).

- *Avoid damaging "stop-go" in aid disbursements*. The idea that all tranches should be disbursed on the basis of "all or nothing" can be particularly damaging to macroeconomic and budget management. The opportunity of providing a partial disbursement opens up the possibility of avoiding these potentially volatile and damaging swings in support.

- *Enhanced credibility of disbursement conditions.* Often because of the damaging "stop-go" effects mentioned above, donors are tempted to overlook under-performance by granting waivers, thus ensuring that the whole amount of a tranche payment can be made rather than blocking the payment. There is a risk in this approach - if it becomes too frequent it will undermine the credibility of conditionality. This credibility can be maintained by making partial payment for partial performance.

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[1] Experience, for example, on user fees, suggests that donors should be more modest in their policy recommendations.

[2] It is worth observing that other donors often use a *de facto* variability in their tranches, through a process of altering commitments and disbursement that are set on an annual basis. This is the approach adopted, for example, by the World Bank in its programmatic lending where "in the case of uneven country performance, the Bank has typically reacted either by delaying the next operation or reducing its amount" (see *Review of World Bank Conditionality: Modalities of Conditionality,* World Bank, June 2005, para 18)

Box 2.3: OECD Good Practice Guidance: Allow partial disbursement in cases of partial fulfilment

The OECD Good Practice Guidance, states "Allow partial disbursements in cases of partial fulfilment. Such a mechanism can reduce the volatility of budget support by establishing an intermediate option between withholding all funds and releasing them. One method currently applied to provide for graduated response is the fixed and variable tranche mechanism utilised by some donors. Another possible arrangement would be to devise budget support as a set of multiple flows, each subject to its own specific array of conditions. In the simplest of cases, this would twin a macroeconomic and a sectoral tranche. While some funds could then, for example, be withheld in the case of a delay in an IMF programme review, the remaining funds could still be disbursed if sectoral conditionality was being met, thus allowing the continued financing of a sector despite the existence of some problems at the macroeconomic level.

Source: *Harmonising Donor Practices for Effective Aid Delivery, Volume 2,* OECD-DAC, para 27

2.7 Realising the potential benefits of budget support by minimising the risks

The risks attached to the use of any aid modality can be defined as "anything that may stand in the way of achieving the objectives".[1] Given this definition, risks should be assessed in the light of stated objectives, ambitions, and aims. Furthermore, there is no *a priori* reason to believe that the risks associated with budget support are greater or smaller that those associated with other aid modalities, although there may be a change in the nature of the risks (See Box 2.4).

Box 2.4: Main Risks related to Budget Support

Risks associated with budget support are not a priori greater or smaller than those associated with other instruments. Rather, there is a change of risk profile as one moves from project assistance to budget support. Some risks, like those related to public finance management and fiduciary risks might become more important while others such as weak policy environment and lack of ownership, lack of co-ordination and weak result culture diminish as they are directly addressed by using budget support. The changing risk profile implies adaptations in the risk management approach. In general, budget support leads to an increased involvement of donors upstream of the political process, when government policies and budgets are decided. This involvement can by itself become domineering when governments are weak, and this poses a different risk, [which] donors may need to address collectively and jointly with the partner government.

While discussing risks associated to budgetary support it is important to remember that the instrument is considered to be a response to risks which could affect external assistance based on project assistance. Budgetary support offers an entry point and leverage to foster improvements in the management of public finances in beneficiary countries. Budget support also allows operations to be conducted within a single framework facilitating a more complete and consistent analysis of government policy. It is conducive to a country's government taking ownership of the policies, thus ensuring the sustainability of measures and reforms, improving the performance of domestic and assistance resources, and the collective effort of governments and donors. Budget support encourages broader dialogue with a government, makes it easier to co-ordinate operations with other donors around national procedures and increases a country's absorption capacity (because there is a single procedure).

Source: *Commission Staff Working Paper: Outline of Risks linked to External Aid,* 12 March 2004

The Commission manages the risks associated with budget support by having conditions associated with the preparation and implementation of budget support programmes. These include the eligibility criteria set out in the legal bases and assessed in the programming documents and in the Financing Proposal/Action Fiche. Both the programming documents and the Financing Proposal/Action Fiche will include conditions for disbursement designed to address risks. These conditions will for the most part

[1] *Commission Staff Working Paper: Outline of Risks linked to External Aid,* 12 March 2004, SEC(2004)318

focus on the eligibility criteria, but may cover other particular risks. The conditions may cover start-up conditions (usually in the Financing Proposal/Action Fiche), and disbursement conditions (in the Financing Agreement), which enable the EC to decide whether or not to provide budget support, suspend disbursement during implementation, or to increase or reduce the amount involved. In addition, the conditions for disbursement set out in the Financing Agreement are there to ensure respect for the method of implementation of budget support – namely "centralised direct" – through verification of disbursement conditions followed by disbursement to the national treasury account.

During all phases of a budget support operation as well as maximising the potential benefits discussed earlier, attention needs to be paid to minimising risks. Some risks may simply be seen as the "opposite" of a potential benefit, whilst other risks may "stand alone". From this point of view of the main risks concern: (i) respect for the eligibility conditions – national policy and strategy, macroeconomic stability, and improvements in public financial management; (ii) predictability of budget support; (iii) the ownership of national policies and strategies; (iv) setting an appropriate pace and timing of reforms; (v) implementing capacity; (vi) not overloading budget support with issues that are not necessarily central to its objectives (see Box 2.5); (vii) absorption capacity in its many dimensions; and (viii) adjusting policy and strategy in the light of results achieved.

Box 2.5: Joint Evaluation of General Budget Support: Risk of Overloading Budget Support

On the specific risk of overloading budget support the Joint Evaluation of General Budget Support made the following comments: "Our review of the GBS record so far indicates that there are many things that it can (help to) do. But its potential range is itself a risk: there is a serious danger of overloading one instrument, expecting it to achieve too many things and too quickly. There are both conceptual and practical aspects to this. There are some things that an instrument such as GBS is inherently unlikely ever to achieve. In particular it is unrealistic to expect it to effect radical institutional transformations, or change the political foundations of states and governments. Setting unrealistic objectives is a recipe for failure, and could distract from less grand, but still useful, things that GBS can help towards. Even when focusing on what is practical, it is important not to attempt too much at once. It is important to learn from experience with the instrument before extending its scope. There are limits to the absorptive capacity for reform; overloading GBS with targets and conditions could overwhelm even a willing government…In prioritising the reform focus of PGBS, it is important to remember that its ability to strengthen PFM systems is fundamental to its other effects."

Source: *Evaluation of General Budget Support: Synthesis Report,* May 2006, para 6.29

2.8 An intervention logic for General Budget Support

As mentioned earlier, budget support is a financing modality (see section 2.1), with general budget support focusing on supporting the implementation of a national development or reform policy and strategy. Within this very broad framework, it is useful to consider the way in which general budget support is expected to meet its objectives.

The intervention logic in Figure 2.4 presents a stylised view of the way in which budget support is expected to be able to support national development and policy objectives, by helping improve the functioning of a public sector "causality" or "production chain". The description that is presented in Figure 2.4 should be self-explanatory[1]. It gives a stylised view of the way in which at one end inputs in the form of GBS lead to changes in the way that donors and partner countries work together, which in turn lead to a better performing government and public sector, and onward through the causality chain to higher level impact on key areas related to growth, stability, security, and good neighbourliness. For this

[1] This intervention logic uses the terminology found in the indicator framework (see *Guidelines for the use of Indicators in Country Performance assessment,* DG DEV, December 2002). As such the causality chain does not use the terminology found in the logical framework - in particular there is no reference to "activities" which would normally be found in a logical framework and which need to be undertaken to convert "inputs" (or means) into "outputs".

causality chain to function effectively certain best practices shown in the diagram are expected to be practiced.[1] From this presentation it should be clear that the potential benefits of GBS rely upon the soundness of a pre-existing national policy and strategy.

This stylised view of the way in which budget support is expected to improve the government and public sector causality (or production) chain, is clearly a simplification of what in reality is a much more complex picture. For example, budget support does not operate in an environment in which there is a simple linear causality chain. In fact we can expect there to be many feedback loops, and in some circumstances certain elements at a "higher" level might be necessary to carry out activities at a "lower" level. Furthermore, as we move along the causality chain the possibility of bringing about changes is clearly weakened since other external factors become much more important. Finally, realising the potential benefits requires effort and respect for good practices such as those identified by the OECD-DAC (see Box 2.6). It should be clear from this overview that there is no "GBS logical framework" of the type that you would find in a project. Instead GBS should be seen as contributing to ensuring the better functioning of an overall framework that has been established by the partner country.

Box 2.6: OECD Good Practice Guidance

The OECD Good Practice Guidance offers some principles for realising the potential benefits of budget support. They may be summarised around four principles combined with a number of good practices.

1: Budget Support should reinforce partner countries' ownership

- Refrain from targeting budget support
- Reflect partner country priorities
- Focus on results

2: Budget Support should help to enhance the performance and accountability of partner counties' Public Financial Management systems

- Follow good practices in PFM diagnostic and assessment work
- Directly support the capacity development of partner PFM systems
- Avoid undermining country systems

3: Transaction costs incurred by budget support should be minimised

- Streamline conditionality
- Rationalise fiduciary assessments
- Align processes with partner countries national budgetary cycles
- Tap the potential of joint donor frameworks
- Time disbursements to facilitate the smooth execution of budgetary payments

4: Budget support should be delivered in a way that enhances the predictability of resources and reduces their volatility

- Programme budget support over several years
- Align support with partner country budget cycles
- Design conditionality to enhance the predictability of disbursements
- Time disbursements in a predictable manner
- Avoid stop-and-go cycles and allow for graduated responses
- Build public support

Source: *Harmonising Donor Practices for Effective Aid Delivery, Volume 2,* OECD-DAC

[1] For more detail on best practices see for example, *Harmonising Donor Practices for Effective Aid Delivery, Volume 2,* OECD DAC, which includes a section on Guidelines on the use of budget support

Figure 2.4: A stylised intervention logic for (medium term) general budget support

Global Impact

Contribute to global objectives of national policy and strategy, such as
- Sustainable growth
- well-being
- stability, security and good neighbourliness
- integration into the world economy, economic partnership

Intermediate Impacts

Contribute to intermediate objectives of national policy and strategy, such as
- income poverty
- literacy rates
- unemployment rates

Outcomes/Results

Contribute to a better access to, use of, and satisfaction with public services, such as
- enrolment rates in schools
- exam pass rates
- vaccination rates
- user and customer satisfaction
- private sector "outcomes"

Outputs (2)

Contribute to improved supply of goods and services by the public sector, such as
- government services effectively delivered
- macroeconomic stability
- domestic political accountability improved

Outputs (1)

Contribute to improved framework for public policy and public expenditure, such as
- increased ownership by partner country
- improved capacity development
- public financial management improved
- regulatory environment improved
- tax environment improved
- macroeconomic management improved (fiscal policy, monetary policy, exchange rate policy)
- performance measurement improved

Inputs/Means

Financial and human resources
- Finance – general budget support that by its nature is integrated into national treasury and budgetary systems
- Disbursement criteria
- Dialogue
- Harmonisation and Alignment
- Capacity Development

Policy and legal context
- Policy: MDGs, Paris Declaration, European Consensus, OECD-DAC Good Practices, Evaluation recommendations, Court of Auditors Recommendations
- Legal: Financial Instruments, Financial Regulations

Eligibility Criteria
- National policy and strategy in place or under implementation
- Stability-oriented macroeconomic policy in place or under implementation
- Credible and relevant programme to improve Public Financial Management is in place or under implementation

Assumptions for the logic to materialise effectively

Follow Best Practices for providing Budget Support

1. Reinforce partner countries' ownership
- refrain from targeting budget support
- reflect partner country priorities
- focus on outcomes/results

2. Enhance the accountability of partner countries' PFM systems
- follow good practice in PFM diagnostic and assessment work
- directly support the capacity development of partner PFM systems
- avoid undermining country systems

3. Support reductions in transaction costs
- streamline conditionality
- rationalise fiduciary assessments
- Align processes with partner countries national budget cycle
- Tap the potential of joint donor frameworks
- time disbursements to facilitate the smooth the execution of budgetary payments

4. Enhance predictability and reduce volatility
- programme budget support over several years
- align support with partner country budget cycles
- design conditionality to enhance the predictability of disbursements
- time disbursements in a predictable manner
- avoid stop-and-go cycles and allow for graduated responses
- build public support

Source: *Harmonising Donor Practices for Effective Aid Delivery, Volume 2,* OECD-DAC

2.9 Conclusion - using direct untargeted budget support

Although there are many potential ways of implementing budget support that will depend upon country context, in practice there is one approach is used pre often than others– *the use of direct, untargeted budget support*[1]*, making use of fixed and variable components, with floating cut-off dates for payments. Furthermore programmes will tend to have general and specific conditions for making payments.*

This approach is favoured, with few exceptions because:

- most countries now have convertible and freely transferable currencies - hence direct budget support;
- it focuses attention on overall performance rather than “islands of (presumed) perfection” - hence untargeted budget support;
- links between performance and payment could lower volatility - hence the possible use, of variable tranches side-by-side with fixed tranches;
- being flexible on timing encourages ownership - hence the use of floating cut-off dates for meeting disbursement conditions[2];
- there is a need to monitor eligibility conditions - hence the general conditions for all tranches - as well as pursuit of specific objectives of individual tranches - hence the specific conditions for each tranche.

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[1] To avoid any potential confusion the concept of targeting refers to the *financial resources* and not to the *conditions* that may be targeted on a particular sector.

[2] However, if the disbursement condition refers to meeting a particular performance indicator in a particular year, then this disbursement condition is unlikely to “float” (although the actual date by which information has to be supplied would normally be flexible, within a certain time period). Floating cut-off dates are most frequently used when the disbursement condition refers to a “measure” to be taken – such as passing a new law, or taking a particular decision. Even then, there may be cases when fixed cut-off dates are appropriate to support a climate of reform.

3 ELIGIBILITY AND THE CYCLE OF OPERATIONS

This chapter:

⇒ Sets out the eligibility criteria for budget support – their legal basis and their logical importance

⇒ Provides an overview of the cycle of operations, showing that eligibility criteria are regularly present

⇒ Presents a "flow-chart" on the main issues to be addressed in preparing a GBS operation

3.1 Introduction

Budget support has the potential to give many development benefits (see Chapter 2). But at the same time it does involve risks. In order to deal with these risks and ensure that they are properly addressed at all stages of the cycle of operations from programming through to implementation, certain legal provisions have been put in place for the use of budget support. These explicit legal references and their interpretation are taken as the basis for establishing what are generally referred to as "eligibility criteria". This chapter therefore introduces these eligibility criteria – in the three areas of national policy and strategy, macroeconomic stability, and public financial management - and provides a justification for why these criteria have been established. It then goes on to show how these eligibility criteria are relevant in the cycle of operations, as well as providing an overview of other issues examined during this cycle.

3.2 The legal basis for eligibility criteria

EC cooperation with third countries is currently organised around geographical and thematic programmes which determine the objectives and scope of budget support. Provisions for budget support exist in the Cotonou Agreement for ACP countries, and existed in the pre-2007 legal frameworks for EC cooperation with MEDA and ALA regions, as well as with South Africa and for Food security. The relevant legal texts and references to key clauses related to the eligibility criteria are set out in Table 3.1 below.

Table 3.1: Pre-2007 legal basis for the eligibility criteria

Instrument	Legal Text	National development or reform policy and strategy	Macroeconomic context	Public Financial Management	Comments
ACP/Accord de Cotonou	Cotonou Agreement, 23 June 2000	Article 67	Article 61(2)(b)	Article 61(2)(a) and (c)	
ALA (Asia and Latin America)	Council Regulation No 443/92 of 25 February 1992	Council Resolution 18 May 2000	Council Resolution 18 May 2000	Council Resolution 18 May 2000	No explicit reference to eligibility, but Council Resolution encourages same approach as in ACP countries
Food Security	Council Regulation No 1292/96 if 27 June 1996	Article 2(5)	Article 2(5)	Article 2(5)	
MEDA (South and East	Council Regulation No 2698/2000 of 27	Annex II(b)	Annex II(b)		No explicit reference to matters

Mediterranean & the Middle East)	November 2000				related to public financial management
South Africa	Council regulation (EC) No1726/2000 of 29 June 2000	Article 4(2.b)		Article 4(2.b)	No explicit reference to macroeconomic context

However, whilst Table 3.1 above sets out the pre-2007 legal status, with the exception of the ACP region, the legal bases for EC support were replaced on 1st January 2007. From this date onwards a number of new instruments were introduced, including three main instruments that include budget support as a financing modality: the Development Cooperation Instrument (DCI), the European Neighbourhood and Partnership Instrument (ENPI), the Pre-Accession Instrument (IPA), and the Instrument for Stability (IfS)

The key provisions with respect to budget support operations for the DCI, ENPI, IPA and the IfS are shown in Table 3.2 below.

Table 3.2: Legal basis as of 1st January 2007[1]

Instrument	Regions concerned	Proposed legal text	Clause on Eligibility criteria
ACP-EU Partnership Agreement (Cotonou)	African, Caribbean and Pacific countries (78 countries)	Article 61(2)	*Direct budgetary assistance in support of macroeconomic or sectoral reforms shall be granted where: (a) public expenditure management is sufficiently transparent, accountable, and effective; (b) well defined macroeconomic or sectoral policies established by the country itself and agreed to by its main donors are in place; and (c) public procurement is sufficiently open and transparent*
Development cooperation Instrument (DCI)	Latin America (18 countries) Asia (19 countries) Central Asia (5 countries) Middle East (5 countries) South Africa + thematic actions in all countries covered by ENPI and EDF	Article 25(b)	*"Community financing may take the following forms...budget support if the partner country's management of public spending is sufficiently transparent, reliable and effective, and where it has put in place properly formulated sectoral or macroeconomic policies positively assessed by its principal donors, including where relevant, the international financial institutions. The Commission shall consistently use an approach based on results and performance indicators and shall clearly define and monitor its conditionality and support efforts of partner countries to develop parliamentary control and audit capacities and to increase transparency and public access to information. Disbursement of budget support shall be conditional on satisfactory progress towards achieving the objectives in terms of impact and results"*
European Neighbourhood and Partnership Instrument	Seventeen countries	Article 15(2)(e)	*"Community assistance may also be used…for sectoral and general budget support if the partner country's management of public spending is sufficiently transparent, reliable and effective, and where it has put in place properly*

[1] Includes ACP countries, under the Cotonou Agreement for which there was no change in the legal basis as of 1st January 2007

(ENPI)			*formulated sectoral or macroeconomic policies approved by its principal donors, including where relevant, the international financial institutions"*
Instrument For Pre-Accession Assistance (IPA)	Seven countries in Western and Eastern Balkans, and Turkey	Article 15(1),	*"Budgetary support shall be exceptional, with precise objectives and related benchmarks, and be contingent on the administration of public finances of the beneficiary country being sufficiently transparent, reliable and efficient, and on well-defined sectoral or macroeconomic policies approved in principle by international financing institutions having been put in place. Disbursement of budgetary support shall be conditional on satisfactory progress towards achieving the objectives in terms of impacts and results"*
Instrument for Stability	No restrictions on geographical coverage	Article 11(b)	"Community financing may take the following forms…sectoral or general budget support, where the partner country's arrangements for managing public finds are sufficiently transparent, reliable and effective, and where proper sectoral or macro-economic policies have been put in place by the partner country and approved by its main donors, including international financial institutions where applicable. Budgetary support may in general be one of several instruments. It shall be allocated with precise objectives and related benchmarks. Disbursement of budgetary support shall be conditional on satisfactory progress towards achieving the objectives in terms of impact and results.

3.3 The justification for the use of the three eligibility criteria

3.3.1 National policy and strategy

The first eligibility criterion is that a well defined national policy and strategy is in place or under implementation. This eligibility criterion is justified because:

- *Legal basis.* In the case of ACP countries there is reference to "reform programmes", and the new legal instruments as of 1st January 2007, whilst making no explicit reference to national reform programmes, can be interpreted as requiring this condition by the very nature of the support to be provided. However, there is explicit reference to sectoral policies.

- *Support to national policy and strategy is at the heart of General Budget Support programmes.* All GBS operations have at their heart the objective of supporting the implementation of a national development or reform policy and strategy. Therefore, as a first step, this policy and strategy needs to be positively assessed.

- *GBS is built around support to a country-owned national policy and strategy (for example, a PRSP, Association Agreement, or agreed National Action Plan).* Experience suggests that it is domestic political considerations which drive reform processes and that "ownership" of these reforms is critical for their successful implementation. If GBS is to realise its potential benefits a first step is to assess the extent of commitment and ownership to the declared national policy and strategy.

3.3.2 Macroeconomic framework

The second eligibility criterion is that a stability-oriented macroeconomic policy is in place or under implementation. This eligibility criterion is justified because:

- *Legal basis* Legal instruments either directly or by implication make reference to "well-defined", "approved", "properly formulated", "proper" or "positively assessed" macroeconomic policies.

- *Macroeconomic stability is a pre-condition for growth and poverty reduction.* A stability oriented macroeconomic environment that avoids volatility and promotes sustainability in key economic aggregates is going to reduce uncertainty and risk, encourage investment and confidence in the future, and thereby contribute to growth, a necessary condition for poverty reduction.

- *Stability oriented macroeconomic policies contribute to ensuring that budgeted expenditures conform to budget allocations.* A budget that is prepared within a stable macroeconomic framework of revenue and expenditure forecasts will greatly contribute to ensuring the conformity of actual expenditures with budget allocations. In contrast, in the absence of a stable macroeconomic framework, outcomes are likely to diverge significantly from forecasts, and the risk of crisis or a sudden change in fortunes is likely to lead to significant changes in actual expenditures, undermining the programmes that budget support intends to support.

3.3.3 Public Financial Management

The third eligibility criterion is that a credible and relevant programme to improve public financial management is in place or under implementation. This eligibility criterion is justified because:

- *The legal basis.* Existing instruments include references to public financial management, using the phrase, "sufficiently transparent, reliable and effective (DCI, ENPI, IfS), or "sufficiently transparent, accountable, and effective" (ACP), or "sufficiently transparent, reliable, and efficient" (IPA). Under the pre-2007 instruments, similar phrases existed for the Food Security instrument, South Africa, and by implication the ALA instrument. There was an exception in the case of the MEDA instrument. However, even under this previous instrument the Commission has responded positively to proposals of the Court of Auditors that PFM issues should be addressed in budget support programmes[1] and incorporated such requirements in the Project Fiche that was used at that time.

- *Success or failure of implementation of national policies and strategies is strongly affected by the quality of the public financial management system*. A PFM system should collect resources from the economy, integrate them into a budget, allocate them, and use them in an efficient, effective, economic, equitable and accountable manner. In view of this strategic role, the PFM system is regarded as a key criterion for eligibility to budget support.

- *Improvements in PFM systems, rather than thresholds, are important for developmental objectives.* Even if a PFM system is regarded as weak, this does not automatically exclude a beneficiary country from receiving budget support. Indeed, one of the objectives of budget support is to support the achievement of the goals of national policy and strategy by strengthening the PFM system through which such a policy and strategy is implemented.

[1] See *Special Report No 1/2002 concerning macro-financial assistance (MFA) to third countries and structural adjustment facilities (SAF) in the Mediterranean countries together with the Commission's replies*, Court of Auditors, 2002; as well as Commission Staff Working Paper, *Follow-up to the Council Conclusions regarding the recommendations by the Court of Auditors concerning macro-financial assistance and structural adjustment facilities,* 9 September 2003, SEC(2003)1003.

What matters, therefore, is the existence of a credible commitment by the partner country to implement policies providing pertinent answers to the identified weaknesses, as shown by actual implementation and improvements over time.[1]

3.4 A dynamic and rigorous interpretation of eligibility criteria

Whenever looking at the eligibility criteria, it is always important to take into account the direction of change. In the use of budget support there are no absolute "thresholds" in the sense that certain static minimum conditions in the area of national policy and strategy, macroeconomic policy, and public financial management have to be met. Instead, the key factor in deciding whether eligibility criteria are met is the direction and magnitude of change against the background of the initial quality of the national development or reform policy and strategy, the macroeconomic framework, and public financial management. It is this dynamic interpretation of the eligibility criteria, the case-by-case approach to which it leads, and the rigour of the diagnostic assessments used, that helps ensure that budget support can contribute to wider development objectives.[2]

Furthermore, the three eligibility criteria should be seen as part of a coherent and interdependent whole. It would be inappropriate to judge non-performance in one area as being offset by good performance in another area. Instead, performance in all areas is seen as key to ensuring eligibility for budget support.

3.5 General Budget Support and the Seven Areas of Assessment

The seven areas of assessment used in the preparation of Sector Policy Support Programmes (SPSP), are also used in the case of General Budget Support through their inclusion at different stages of the cycle of operations. However, unlike the preparation of a SPSP, there is no requirement with a GBS operation to carry out a general "seven assessments" diagnostic at the programming/identification stage. Instead, in order to give focus to the preparation of a GBS operation, the use of the seven areas of assessment varies throughout the cycle of operations, with a different focus depending on where you are in the cycle. At each stage in the cycle different areas are examined:

- *Programming:* during programming emphasis is placed on three of the seven assessments corresponding to the eligibility criteria "national policy and strategy", "macroeconomic framework", and "Public Financial Management".

- *Identification:* during identification emphasis is placed not only on the three areas corresponding to the eligibility criteria, but also on a further two of the seven areas: "donor coordination" and "performance measurement". More specifically, a view has to be taken on the partner country's willingness to take the lead on "donor coordination" and to use "performance measurement" for the disbursement of budget support funds.

- *Formulation:* during formulation all of the seven areas of assessment are covered in their respective chapters within the Financing Proposal/ction Fiche, and annexes covering the three eligibility criteria as well as performance measurement are expected to be prepared.

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[1] Clearly at the start of a programme of reform or improvement it will not be possible to show that implementation has taken place or that over time there have been improvements. In this case – which will frequently arise in a country where budget support is being used for the first time or after a long delay – the focus will be on the establishment of a credible programme of improvement, and we can expect to see more implementing conditions used to manage the resulting risk.

[2] As the Court of Auditors has stated "Many other donors including the Bretton Woods Institutions, similarly take account of the prospect of improving public finance management systems, rather than referring to a threshold value or absolute qualitative level" *Special Report No 2/2005 concerning EDF budget aid to ACP countries: the Commission's management of the public finance reform aspect, together with the Commission's replies",* Court of Auditors, 7 October 2005, para 28

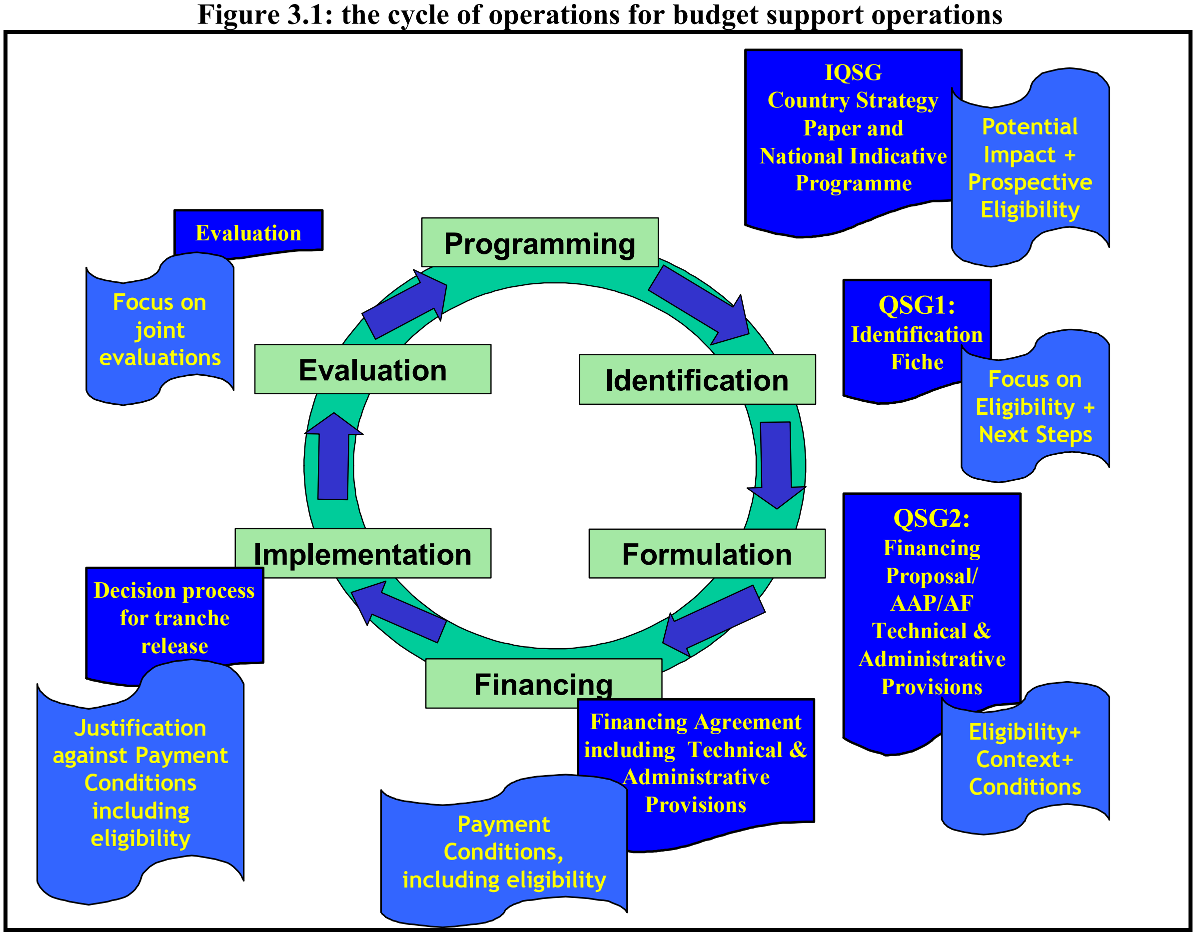
- *Implementation:* When it comes to implementation, the focus will be on the assessments corresponding to the three eligibility criteria which are normally included as general conditions. In addition follow-up to any complementary support may be provided to ensure progress in other areas, notably on "capacity development".

Annex 1.12 provides further information on the seven areas of assessment and their use in GBS programmes and their correspondence with the seven areas of assessment used in the preparation of SPSP.

3.6 The cycle of operations in General Budget Support

The cycle of operations for budget support is presented in Figure 3.1 below. The process described in Figure 3.1 shows the standard cycle of operations used by the European Commission.[1] In following the steps from programming through to evaluation, it does not differ from the approach adopted for projects.

Figure 3.1: the cycle of operations for budget support operations



What is clear from Figure 3.1 is that the eligibility conditions are present at each step in the cycle of operations. They are found at the stage of programming (Chapter 4), at identification (Chapter 5), at formulation (Chapter 6) and during implementation (Chapter 7).

[1] See *Aid Delivery Methods: Project Cycle Management Guidelines,* European Commission, March2004

In addition throughout the cycle of operations other features and themes not shown here will also be important. For example, dialogue will be a recurring theme, although the nature of the dialogue and with whom will change according to each specific stage of the cycle. There are many potential interlocutors, and during the early stages of preparing a budget support operation it can be useful to consider all the potential organisations with whom discussions should take place.[1] Topics for discussion will vary over the cycle from discussing prospective eligibility and risk during programming; the amount of money (and its timing), conditions attached to disbursement, and any accompanying measures during identification and formulation; and possible reasons for under- or over-performance during implementation.

Furthermore, throughout the cycle of operations attention has to be paid to international commitments, in particular the Paris Declaration on Aid Effectiveness,[2] March 2005 (including its twelve indicators to measure progress), and the EU's additional commitments in it Aid Effectiveness Package, March 2006 (including four additional indicators to measure progress).[3] [4]

3.7 Key steps in the decision making process for general budget support

Whilst Figure 3.1 provides an overview of the cycle of operations and the use of the eligibility criteria throughout the cycle, Figure 3.2 below provides further detail on some of the key issues that will be addressed at each stage. Further detail on all these matters is provided in subsequent chapters.

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[1] Organisations involved will vary from country to country, but are likely to include Prime Minister's Office, Ministry of Finance, line ministries, Supreme Audit Institutions, Parliament (including the finance committee or equivalent), the Central Bank, national statistical authorities, Member States, the Bretton Woods Institutions, other donors, non-state actors. In ACP countries the National Authorising Officer will be particularly important. Identifying all the relevant organisations may be analogous to a stakeholder analysis (see "Aid Delivery Modalities: Project Cycle Management Guidelines, European Commission, March 2004).

[2] *Paris Declaration on Aid Effectiveness: Ownership, Harmonisation, Alignment, Results and Mutual Accountability*, Paris February 28 – March 2, 2005.

[3] On the EU Aid Effectiveness Package see: (i) Communication from the European Commission to the Council and the European Parliament, *Financing for Development and Aid Effectiveness – the challenges of scaling up EU Aid 2006-2010*, 2 March 2006, COM(2006)85; (ii) Communication from the European Commission, *EU Aid: Delivering more, better and faster*, 2 March 2006, COM(2006)87; and (iii) Communication from the European Commission to the Council and the European Parliament, *Increasing the impact of EU Aid – A common framework for drafting country strategy papers and joint multi-annual programming,* 2 March 2006, COM(2006)88.

[4] The four additional EC indicators cover (i) provide all capacity building assistance through coordinated programmes with an increasing use of multi-donor arrangements; (ii) to channel 50% of government-to-government assistance through country systems, including by increasing the percentage of our assistance provided through budget support or sector-wide approaches; (iii) to avoid the establishment of any new project implementation units; and (iv) to reduce the number of un-coordinated missions by 50%

Figure 3.2: Key steps in the decision making process of General Budget Support

Programming *I-QSG*	**Assess potential impact of GBS**	**Focus on key issues** (i) importance of dialogue on overall policy and strategic priorities (ii) importance of contributing to increased expenditure or financing of the budget (iii) scope and depth of reforms and policies that could be supported by GBS (iv) importance of promoting improvements in PFM (v) willingness of partner country to use results/outcome indicators (vi) importance of advancing harmonisation and alignment
	Assess prospective eligibility for GBS	**Focus on eligibility conditions** (i) National policy and strategy (i) Macroeconomic Stability (ii) Public Financial Management **Four main categories** (i) Strong candidates: risk of non-utilisation of budget support is very limited (ii) Potential candidates: some risk of non-utilisation of budget support (iii) Weak candidates: high risk of non-utilisation of budget support
	Include key orientations for steps to be taken after programming	**Four main categories** (i) *Strong candidates*: establish financial envelope; specific objectives and expected results; recall eligibility conditions; mention possible performance indicators; establish indicative timetable for preparation, overall commitments and disbursement *(ii) Potential candidates*: as for strong candidates but indicate the possible measures needed to strengthen the prospects for future eligibility *(iii) Weak candidates*: as for strong candidates, but indicate the possible measures needed to strengthen the prospects for future eligibility
Identification *QSG-1*	**Establish Road Map for programme preparation**	(i) Key issues to be addressed (ii) Actions to be taken to address the issues (studies, missions, joint work) (iii) responsibilities of different parties (iv) timetable
	Preliminary identification of objectives, purpose, and results	(i) Objectives, purpose, and expected results of the GBS programme (ii) Objectives, purpose, and expected results of any complementary support
	Reconfirm Eligibility conditions	(i) National policy and strategy (ii) Macroeconomic stability (iii) Public Financial Management

	Confirm government "willingness" on donor coordination and performance measurement →	(i) Donor coordination – the partner country is willing to take a leading role (ii) Performance Measurement – the partner country is willing to use performance measurement as a means for disbursing funds
	↓ **Identify preliminary implementation modalities** →	(i) Operating Modalities – how the "non-financial" aspects of the GBS programme are going to be organised and monitored (ii) Disbursement modalities and procedures – amounts, modalities, monitoring, possible conditions for tranche release, calendar
	↓ **Identify Next Steps** →	(i) Next steps including where decisions need to be taken, where further work needs to be carried out, especially in dialogue with the partner country (ii) work plan and time schedule of activities (iii) Highlight – those areas where advice and guidance is needed from HQ, where timing depends on others, and any particular risks that could affect preparation of the programme
Formulation*[1]** ***QSG-2 *(Including consultation DEV/RELEX)*	**Rationale – Why?** →	(i) Strategic framework (in Annual Action Programme) (ii) Lessons learnt (iii) Complementary actions of EC and other donors (iv) Donor coordination, including obligation on Delegations to consult HQ on joint donor agreements
	↓ **Country Context – Why?** →	(i) *Economic and social situation* (ii*) Development/Cooperation Policy and Strategy of beneficiary country*: national development and reform policy and strategy, the macroeconomic framework, and performance measurement (iii) *Sector Policies*: policies for the sectors where support might be focused (iv) *Public Finance*: public financial management; and the budget and MTEF
	↓ **Description – What?** →	(i) Objectives and purpose (ii) Expected Results and main activities (iii) Stakeholders (iv) Risks and assumptions (v) Crosscutting issues
	↓	

[1] The four areas mentioned here – rationale, country context, description, and implementation issues are mentioned in the *Financing Proposal* format used in ACP countries under the 9th EDF (see Note 28944 of 13 August 2004). However, for other regions, as of 1st January 2007, the *Action Fiche* format is to be used, and with one exception all the sub-areas mentioned here under "rationale" and "country context" are grouped into one section called "Rationale and Country Context". The one exception is that the issues related to the strategic framework will appear in the separate overall *Annual Action Programme* (see Note No 31179 of 21 December 2006).

	Implementation Issues – How and When?	→	**Disbursement methods for GBS** (i) *Budget and calendar*: amounts and timing of programme review and tranche release decisions; (ii) *Modalities* - Normally direct, untargeted, making use of fixed and variable tranches (iii) *Performance Measurement and criteria for disbursement:* - *General conditions* (applicable to all tranches, usually related to eligibility criteria);and - *Specific conditions* (choice of performance criteria and indicators, including hoice of targets; choosing the method of performance evaluation) (iv) *Procurement and grant award procedures* (only for complementary support) (v) *Evaluation and audit* (vi) *Communication and visibility*
Financing	**EC Decision making process**	→	**Key steps for a decision** (i) Inter-Service Consultation (ii) Management Committee (iii) European Parliament (where required) (iv) Financing Decision (v) Budgetary/financial commitment (vi) Financing Agreement
Implementation	**Action during implementation**	→	**Implementation** (i) Policy and monitoring implementation: promote use of joint donor assessments and joint donor agreements; promoting ownership and accountability; team work… (ii) tranche release decisions according to "justification against payment conditions" (iii) ensuring visibility (iv) Monitoring reports (economic, public financial management, early warning) (v) Implementation of Complementary Support
Evaluation	**Joint Evaluations of GBS**	→	**Key features:** (i) Evaluation should be joint with other donors providing budget support (ii) The Evaluation should be based around a hypothesised causality framework and relevant "evaluation questions" (iii) Emphasis must be placed on evidence to support any judgements made

4 PROGRAMMING

4.1 Programming and general budget support

Programming is the first stage in the cycle of operation and consists in the preparation of multi-year country strategies and indicative programmes. Based on the country diagnosis, lessons learned from past and present cooperation, the comparative advantage of donors, the response strategy will define how the EC (and Member States in case of joint programming) will support the partner country's efforts to achieve its development objectives.

Since GBS can provide a unique opportunity to have a dialogue on the overall policy priorities of the partner country and to support its broad reform process, it can be included in the Country Strategy Papers (CSP). **The decision to programme GBS is based on a comparison between the expected benefits and risks for the objectives set out in the CSP.**

The results of this comparison will crucially depend on the specific country context and the financial size of the potential GBS envelope (relative to partner country's budgetary aggregates). As mentioned in Chapter 2, risks should be assessed in the light of the stated ambitions and aims bearing in mind how they can be managed by appropriately designing implementation modalities. In deciding whether to programme GBS or not, there are two steps – one related to the expected impact of GBS; the other covering prospective eligibility based on the eligibility criteria. Detailed guidance on programming and GBS will be provided to supplement this information by DG DEV/RELEX.

4.2 Two steps in programming General Budget Support

4.2.1 The expected impact of General Budget Support

The first step required during the programming exercise is to appreciate the **expected impact of GBS** and its potential contribution to the objectives of the response strategy. Generally speaking, by providing financial resources to the partner country's national budget, GBS can support the implementation of a national development or reform policy and strategy (PRSP in ACP countries, or National Action Plans in ENPI countries) while contributing to macroeconomic stability. Through dialogue and conditionality GBS supports goals of national policies and strategies, stability-oriented macroeconomic policies, and improvements in public financial management as captured by selected indicators, in particular results/outcome oriented indicators.

It is therefore important to assess in the specific case of the country in question:

- The significance of being involved in a dialogue on the overall policy and strategic priorities of the partner country;
- The importance of contributing to increased expenditure or the financing of the budget;
- The scope and depth of reforms and policies that could be supported with GBS (including those that would be necessary to establish eligibility)
- The importance of promoting improvements in public financial management;
- The readiness of the partner country in using results/outcome indicators to monitor progress towards its development or reform objectives;
- The importance of advancing harmonisation and alignment through the use of the partner country's systems and the participation in joint donor groups.

As a result of this first assessment, it should be possible to rank the **potential contribution of GBS** to the objectives of the response strategy from **high to low**.

4.2.2 The prospective eligibility for General Budget Support

The second step required during the programming exercise is the assessment of the country **prospective eligibility** for budget support and the **risk of difficulty during implementation** that could result in non-utilisation of budget support resources. This analysis will typically be based on the country's previous experience with GBS and its track record and likely evolution with respect to the eligibility criteria (see Chapter 3). As a result of this second assessment, countries are likely to be divided into:

- *Strong candidates:* countries for which the risk of non utilisation of budget support is very limited. These would typically be those countries that have received and successfully managed GBS under the previous programming cycle and whose prospects of remaining eligible remain very good.

- *Potential candidates*: countries for which there is some risk of non utilisation of budget support. These would typically be countries for who the prospects of becoming or remaining eligible is fair but somewhat uncertain, such as for instance countries that have received GBS in the past but encountered some difficulties in implementation or countries that have not yet received GBS and whose eligibility needs to be assessed.

- *Weak candidates*: countries for which there is a high risk of non-utilisation of budget support. These would typically be countries that have received but failed to implement GBS in the past and countries that have not yet received GBS and whose prospects of complying with the eligibility criteria during the programming period are poor or very poor. In this case it is clear that including allocations for GBS would be highly risky and can be justified only if the benefits expected from the support are considered critical.

4.3 Including General Budget Support in the programming documents

Assuming a country requests GBS[1], the decision to programme it should then be taken as the joint result of the two assessments mentioned above. Different justifications may apply. GBS could be included for strong candidates whenever it contributes to the objective of the CSP. It can also be included for potential candidates when its expected benefits justify the risk of difficulties during implementation. Finally, GBS can also be programmed for weak candidates when the expected benefits are considered critical to the response strategy. In the latter two cases, it will be important to include in the response strategy an indication of the eventual measures necessary to correct remaining weaknesses and to strengthen the prospects for future eligibility. In addition, it is clear that, in these cases, the design of the budget support operation will also have to take into particular account how to manage potential risks.

Countries that include GBS in their response strategy and indicative programme will have to clearly indicate the bases of this decision in terms of the expected benefits of GBS, prospective eligibility and risk of non-utilisation of budget support resources. Where future eligibility is uncertain, applicable measures necessary to ensure or maintain eligibility will need to be clearly indicated. The indicative programmes of these countries, will define amounts, main objectives, timeframe for commitment and implementation and possible areas for indicators.

For countries that do not include GBS in their strategy, it is in any case recommended to insert the following clause in their response strategy: "Countries who improve their compliance with eligibility

[1] It is clear that GBS should not be included in the strategies of those countries that do not demand it.

criteria, or who did not need GBS from the Community when the support strategy was drafted but subsequently develop the need for, have the possibility of using part of the A-envelope[1] for GBS at a later stage, by agreement between the National Authorising Officer and the Commission's services to be reached in the context of an annual, mid-term or end-of term review. The agreement of the reallocation of funds to GBS would take the form of an addendum to the CSP"

Eligibility of countries that include GBS in their country strategy in addition to the focal areas will be re-assessed and confirmed by a more in-depth analysis during the identification and formulation phase. If a serious deterioration of country conditions undermines eligibility, GBS funds could be reallocated to other focal areas subject to agreement between the partner country and the Commission to be reached in the context of an annual and mid-term review, or end-of term review. The agreement on the reallocation of funds from GBS would take the form of an addendum to the CSP.

[1] The reference to the A envelope would have to be modified in the context of non-ACP countries.

5 IDENTIFICATION – THE START OF PROGRAMME PREPARATION

5.1 Identification and its links with formulation

Identification is usually presented as being distinct from formulation, with identification focusing on discussion of "project ideas" and formulation focusing on preparation of a "detailed project design" based on the proposed and agreed project idea.[1]

However, in the case of GBS the *identification and formulation stages should be seen as part of a continuous process of programme preparation addressing similar issues*. The distinction between identification and formulation is to some extent an administrative one based on the presentation of an Identification Fiche (at the end of "identification") and the presentation of a Financing Proposal or Annual Action Programme/Action Fiche (at the end of "formulation"). Nevertheless, the identification process will tend to focus on the eligibility criteria, whilst formulation will tend to go beyond the eligibility criteria to also focus on the practical procedures for implementation.

During this continuous process of identification and formulation, attention will be given to the eligibility criteria (national policy and strategy, macroeconomic framework, public financial management), to the wider analysis of the context (the budget, donor coordination, performance measurement, capacity development), whilst at the same time drawing upon the policy orientations of the EU, the lessons learnt from previous experience, and other planned interventions. All this information and analysis is expected to feed into the setting of appropriate conditions and indicators for disbursement.

This analysis and understanding of the country context will also need to find expression in a clear description of the programme (its objectives), and on the implementation modalities (the choice of performance criteria and indicators and their targets for disbursement, as well as the practical modalities of programme implementation). It is often the establishment of the implementation modalities where much of the practical work takes place during the preparation of a GBS programme.

Given the substantial amount of work involved in preparing a GBS programme it is important that Delegations ***start early*** in the process of identification and formulation. In addition, although the cycle of operations (Figure 3.1) presents a process that is sequential in time, in practice one stage may overlap with another in order to ensure that an overall timetable for preparation and implementation can be respected.

5.2 A GBS Road Map – a starting point for programme preparation

At the start of the process of identification and formulation it may be appropriate for the Delegation to prepare a GBS Road Map[2] setting out the issues to be addressed and the proposed timing in the preparation of the GBS programme. Such a GBS Road Map should build on and be consistent with the general objectives, priorities, and conditions mentioned in the programming documents. Without going into all the details it should set out, maybe in draft form, some of the main issues to be addressed during identification and formulation. It would also include an indicative timetable of

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[1] See *Aid Delivery Methods, Project Cycle Management Guidelines,* EC March 2004

[2] A "GBS road map" might also be usefully prepared at regular intervals – say once a year - in order to ensure that there is a shared understanding with the partner country and EC headquarters on the work that needs to be undertaken to ensure the smooth implementation of the GBS programme.

actions to be taken in order to respect the agreed timetable established in the programming documents (a model GBS Road Map is at Annex 3.1).

There is no procedural requirement for such a GBS road map, but it can be a useful and practical instrument to move programme preparation in the right direction by both ensuring that the partner country, the Delegation, and Headquarters, are each aware of their role and the issues to be addressed in the preparation of a GBS programme. If such a road map is produced it should be communicated to the responsible services (AIDCO and DEV/RELEX).

5.3 The Identification Fiche – are we on the right track?

Although identification and formulation can be seen as part of a continuous process, it is nevertheless a requirement that some stock taking of the progress in formulation of a GBS programme be made. This step is justified by the need for Delegations and Headquarters to make a formal "check" that programme preparation is moving in the right direction and that key issues are being addressed. It provides an opportunity for Delegations to communicate with Headquarters on progress being made in programme preparation, and to seek advice where appropriate; and for headquarters to ensure the coherence and consistency of the approaches being adopted in the area of budget support, notably with respect to eligibility conditions.

Box 5.1: The Structure of an Identification Fiche for General Budget Support

There are seven main sections to the Identification Fiche for General Budget Support, as summarised below;

1. *Summary description:* proposed objectives, purpose, and expected results of the proposed GBS programme and any complementary support..

2. *Consistency with EC Policy, programming framework and the aid effectiveness agenda.* Consistency with EC programming documents, as well as Commission policy in the use of GBS.

3. *Eligibility*. A requirement to state clearly whether the partner country either meets the eligibility criteria or is reasonably be expected to meet them before the end of formulation.

4. *Implementation issues.* Covers issue of organisation of the programme, the disbursement modalities and procedures, mentioning any lessons learnt or risks associated with the proposed implementation modalities.

5. *Issues and state of play.* This section covers the "seven areas of assessment", with special emphasis placed on national policy and strategy; macroeconomic stability; and public financial management:

(i) National development or reform policy and strategy
(ii) Macroeconomic context
(iii) Budget and Medium Term Expenditure Framework (MTEF)
(iv) Public Financial Management
(v) Donor Coordination
(vi) Performance Measurement
(vii) Institutional assessment and capacity development

6. *Risks and assumptions:* main assumptions and risks likely to affect the implementation of the proposed GBS operation..

7. *Next Steps, workplan, and time schedule*. Identify the next steps, including work to be carried out whilst highlighting those areas where advice and guidance from HQ is required.

This stock taking is made through a presentation to the QSG(1) of the identification fiche in accordance with the instructions on identification of GBS operations (see Annex 3.2 for the GBS Identification Fiche and guidance for its use, as well as the accompanying Checklist and Quality Frame). The identification fiche besides looking at issues related to objectives, implementation, and risks, also includes a section based on the "seven areas of assessment". However, in looking at these areas there is a focus on three of these areas, namely the eligibility criteria. In line with this guidance on identification, the main issues to be addressed are:

- *Provide a preliminary description of objectives, purpose and results* of both the budget support and any complementary support. Attention should be drawn to any issues relating to the consistency of the proposed programme with the Paris Declaration and EU commitments on the aid effectiveness agenda.

- *Confirm that the eligibility conditions for General Budget Support will be met before the end of formulation*[1], that is in the areas of National development or reform policy and strategy, Macroeconomic framework, and Public Financial Management.

- *Demonstrate the willingness of the partner country* to use performance criteria and indicators for disbursements, and to take the lead on donor coordination.

- *Make preliminary proposals on implementation issues*: the type of budget support (normally direct, untargeted, making use of fixed and variable tranches); and the disbursement methods proposed (general conditions applicable to all tranches, and specific conditions applicable to individual tranches, as well as the overall budget and proposed timing of disbursements).

- *Set out the next steps for formulating the GBS programme,* highlighting those areas where advice and guidance is sought from headquarters, those steps where timing is conditioned by other stakeholders; and particular areas of risk that could affect the preparation of the programme.

It is often the case that a good "Identification fiche" is the product of good communication between the Delegation and Headquarters during the period leading-up to the finalisation of the Identification Fiche for the QSG(1). With good communication, misunderstandings, unhelpful advice from headquarters, or blockage of programmes can be avoided, and overall quality improved.

Furthermore, although the "identification fiche" discussed at the QSG(1) focuses on a number of key issues, it does not mean that the other issues, such as performance criteria and indicators, budget analysis, or donor coordination, are put on hold. Rather, these issues should be addressed at the same (or similar) time as all other issues within a continuous process of programme preparation. However, it is not necessary at the time of identification to have arrived at well developed conclusions.

[1] The end of formulation is in most cases the date of the *Financing Decision* taken by the Commission. However, in some exceptional cases, where it is judged useful as a means for encouraging positive steps, it might be taken as the date of *signature of the Financing Agreement*. In these cases, although a financing decision has been taken by the Commission, signature of the Financing Agreement would depend upon certain prior actions being taken.

6 FORMULATION – THE DESIGN OF THE GBS PROGRAMME

The end-point of formulation will be the preparation of: (i) the "Financing Proposal or Annual Action Programme/Action Fiche" [1] followed by (ii) a Financing Agreement including the Technical and Administrative Provisions (TAPs) to be signed with the partner country.

The coverage of each of these documents may vary. For example, the TAPs, which are part of the legal agreement with the partner country, are likely to be much more detailed on the legal arrangements, whereas the Financing Proposal or Annual Action Programme/Action Fiche is likely to be more detailed in explaining the context of a particular country. Annex 3.3 provides the format of the Financing Proposal/Action Fiche, and Annex 3.4 the format for the Technical and Administrative Provisions. The text below follows the structure of a Financing Proposal/Action Fiche, including the suggested annexes (see box 6.1 below).[2]

When preparing a Financing Proposal/Action Fiche, use should be made of any work that has already been undertaken, in particular joint diagnostics that may have been carried out in collaboration with the partner country and other donors. The use of one-off "EC studies" should be kept to a minimum. Instead work should be prepared well in advance, and so far as possible in collaboration with other parties.

Box 6.1: The Structure of a Financing Proposal/Action Fiche

The main sections to a Financing Proposal or Annual Action Programme/Action Fiche, as summarised below;

1: Rationale, covering the strategic framework (in the Annual Action Programme); lessons learnt; complementary actions (by the partner country, the EC, and other donors); and donor coordination;

2: Country context, covering the economic and social situation; development or cooperation related policy and strategy of the beneficiary country; sector policies where appropriate; and public financial management;

3: Description, covering the objectives; expected results and main activities; stakeholders; risks and assumptions; and cross-cutting issues;

4: Implementation Issues, covering the budget and calendar; modalities; procurement and grant award procedures; performance monitoring and criteria for disbursement; and evaluation and audit.

5. Annexes: Annexes are included as appropriate, where specific analysis is required. In the case of GBS, the annexes should cover:

- (i) Description and assessment of national policy and strategy
- (ii) Description and assessment of macroeconomic policy
- (iii) Description and assessment of public financial management
- (iv) Description and assessment of performance criteria and indicators used for disbursements
- (iv) Modalities for disbursement (performance criteria and indicators, and timing)

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[1] The term "Financing Proposal" is used for actions for ACP countries financed under the 9th EDF; and the term "Action Fiche" is used for actions financed under the DCI, ENPI, IPA, IfS.

Although the names differ the areas covered in each document are, for all practical purposes, the same.

[2] The format of the Financing Proposal (used for actions financed under the 9th EDF) and the Action Fiche (AF – used for other actions) differs slightly, but both cover the same areas. With one exception all the sub-areas mentioned here under "rationale" and "country context" in the *Financing Proposal* are grouped into one section called "Rationale and Country Context" in the *Action Fiche (AF)*. The one exception is that the issues related to the strategic framework will appear in the separate overall *Annual Action Programme (AAF)* (see Note No 31179 of 21 December 2006). Annex 3.5 shows the links between the format of the Financing Proposal and the format of the AAP/AF.

6.1 Rationale

The "rationale" section of a Financing Proposal/Action Fiche for a GBS operation contains four sections: the strategic framework; lessons learnt; complementary actions; and donor coordination.

6.1.1 Strategic framework

Any budget support operation should be justified in part by the strategic development and/or cooperation framework established by the European Union. In this respect it is important to ensure during programme preparation, and to recall in the financing proposal/Annual Action Programme, that the GBS programme is consistent with: (i) the Country Strategy Paper, Indicative Programme, Action Plan, Mid-Term Review, or other relevant documentation; (ii) broader policy documents of the European Union and the European Commission such as the EU Development Policy Statement, the "European Consensus", 22 November 2005[1] (which makes a large number of references to the use of budget support as a favoured modality for aid delivery), the Barcelona Declaration, the "European Neighbourhood Policy"[2], and the "EU Strategic Partnership with the Mediterranean and the Middle East", June 2004. This section will be included in the Annual Action Programme for actions financed outside the 9th EDF.

6.1.2 Lessons learnt

In preparing a budget support programme, the experience of previous programmes, and those of other donors should be used to guide the design of the programme. If lessons are to be learnt, it requires early analysis in the process of preparing the programme. Monitoring reports and (joint) evaluations of budget support can be used to guide the programme. Practical experience with previous EC financed programmes should be used to help formulate future programmes.

In general there will be both positive and negative experiences from previous budget support programmes, but attention should be paid in particular to:

- *Respect of eligibility criteria.* The partner country's ability in the past to maintain continued respect of the eligibility criteria – in particular the progress that has been made in terms of improving public financial management;

- *Harmonisation but not uniformity.* The capacity of donor coordination to provide a an overall framework from which, in agreement with the partner country, donors can select those objectives and performance criteria and indicators which it wishes to support. Such an approach can be described as "*harmonisation but not unanimity*" (see below under donor coordination, and Box 6.2 for further information);

- *Timely availability of information.* Experience on the availability and timeliness of information on performance criteria and indicators used for the disbursement of budget support;

- *Timing of tranche release decisions.* The time needed to ensure smooth implementation of tranche release decisions from the request of the partner country to the transfer of budget support funds;

- *Predictability.* The predictability of budget support flows to the National Treasury.

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[1] *The European Consensus*, Joint Statement by the Council and the representatives of the Governments of the Member States meeting within the Council, the European Parliament and the Commission on European Union Development Policy, 22 November 2005 (see paragraphs: 26, 31, 32, 50, 59, 95, 107, 112, 113, 114, 117, 124)

[2] *The European Neighbourhood Policy, Strategy Paper*, European Commission, 12 May 2004, COM(2004)373

6.1.3 Complementary actions

In this context, complementary actions refer to those actions undertaken by the partner country, the EC, and other donors that are complementary to the budget support being provided by the EC. When the Commission provides GBS, it is providing support to a national development or reform policy and strategy and therefore expects to co-finance this support. Therefore, the Financing Proposal/Action Fiche of a GBS programme should mention:

- *Complementary Actions by the partner country,* in particular, any financial support being provided by the partner country in the area of capacity development, with indicative timing over the life of the GBS programme.

- *Complementary Actions by other donors*, in particular any financial support being provided by other donors in the form of budget support or capacity development, with indicative timing over the life of the GBS programme.

- *Complementary Actions by the EC,* in particular any similar budget support activities (for example, sector budget support, or other similar programmes) and actions related to capacity development that, over the life of the GBS programme, are relevant to budget support.

6.1.4 Donor coordination

Closely related to having a clear vision of the complementary actions of all those involved in supporting the national development or reform policy and strategy, is an analysis of the arrangements for donor coordination. Donor coordination will aim to achieve *harmonisation* in donor practices, and *alignment* of donor practices with the national procedures of the partner country.[1] In both respects special attention needs to be paid to the role of the IMF and the World Bank. During the process of programme preparation it will normally be necessary to cover four main areas (see Annex 1.10 for details):

- *Assess the nature of donor coordination*. For example: does the partner country take the lead? Has donor coordination been formalised in a joint donor agreement (such as a Memorandum of Understanding)? What is the relationship between the mechanisms of donor coordination and wider consultation with non-state actors? Is donor coordination providing a basis for improving aid effectiveness? What is the role of the World Bank and the IMF in donor coordination? In particular, are the World Bank and IMF playing a role that encourages donor coordination?

- *Does the framework for donor coordination provide a framework for harmonisation without unanimity*? The issue of harmonisation without unanimity is important. One way in which it might be addressed is through donors agreeing with the partner country on a single framework of reforms and performance criteria and indicators, but with each donor free to make its own financing decision. For example, each donor within a common framework can choose, in agreement with the government, those features of the single framework that it wishes to support. This approach is also consistent with what as been recently proposed by the OECD-DAC (see Box 6.2 below).

- *Making donor-partner coordination work*. For example: (i) promoting the establishment of a "Budget Support Group" or improvements in the functioning of an existing group (such as the participation of key organisations such as the IMF and World Bank); (ii) support

[1] These issues are particularly important in the light of the Paris Declaration on Aid Effectiveness, March 2005; and the EU Aid Effectiveness Package, March 2006. The Paris Declaration on Aid Effectiveness includes indicators of progress on the "percent of aid provided as programme-based approaches" and "percent of (a) field mission and/or (b) country analytic work, including diagnostic reviews that are joint"; the EU has an additional indicator "to reduce the number of un-coordinated missions by 50%"

Government leadership – for example, if there is a secretariat for coordination it should be firmly under the control of the lead government ministry, so that domestic accountability is not undermined; (iii) using the donor coordination framework to promote predictability in funding through rolling multi-year commitments that can feed into the Medium-Term Expenditure Framework; (iv) promoting a common performance assessment framework for disbursement decisions; (v) avoiding "ganging-up" by ensuring that all donors do not have the same criteria for disbursement and that there is complementarity rather than uniformity (see comments above on harmonisation without unanimity – see Box 6.2 below); (vi) promoting joint training between donors, government officials, and non-state actors.

- *Making donor-donor coordination work*. For example: (i) sharing information, for instance by relying on common diagnostics (for example, in the area of PFM), or establishing a common website; (ii) promoting the effective division of labour between different development partners; (iii) avoiding complex discussions over common donor procurement procedures – for example for technical assistance; (iv) making use of the "operational coordination"[1] with EU Member States to encourage greater harmonisation of approach between the Commission and Member States.

Box 6.2: OECD Good Practice Guidance: streamline conditionality and allow for graduated responses

The OECD Good Practice Guidance states: "Partners should have a single, comprehensive national budget and a single national strategy and budget support providers should link funding to a single framework of conditions and/or reduced set of indicators. This does not mean that all donors should have identical conditions; rather that each donor's conditions should be derived from a common operational framework"

It also states that donors should "avoid institutionalising the principle of unanimous donors' agreement. Harmonisation is different from unanimity. Whether formalised or not, joint processes should preserve the space for different donors to make different decisions on the basis of the same evidence. Donors participating in joint-donor frameworks should reach agreement on the circumstances under which their support would be individually or collectively adjusted or reduced, as well as the modalities of such adjustments"

Source: *Harmonising Donor Practices for Effective Aid Delivery, Volume 2,* OECD-DAC, para 17 and para 27

In taking actions during the period of programme preparation, and indeed during programme implementation, care must be taken to not enter into legal commitments (such as signing a Memorandum of Understanding or agreeing a Performance Assessment Framework) that run counter to the legal obligations established by the Commission in other texts such as the Financial Regulations, Practical Guide, or the Financing Agreement providing budget support; or indeed pre-judge the content of a Financing Agreement that has not yet been signed. **For these reasons, as a precautionary measure, Delegations should consult headquarters (AIDCO and DEV/RELEX) before any Memorandum of Understanding or agreed framework for donor coordination is signed by the Head of Delegation.**

6.2 The Country Context

An analysis and understanding of the country context is important for designing a GBS programme that properly addresses the problems faced. The main areas covered when looking at the country context are not only the eligibility conditions (national policy and strategy, macroeconomic framework, and public financial management), but also other important areas such as the orientations contained in the budget and the national system of performance measurement. The country context section of the financing proposal/Action Fiche contains four sections: economic and social situation;

[1] Reference to Council Resolution, January 1999

the development/cooperation policy[1] and strategy of the beneficiary country (that covers, national policy and strategy, the macroeconomic framework, and the national budget); sector policies (where appropriate); and public finances (that covers issues of public financial management).

6.2.1 Economic and social situation

The format for the financing proposal/Action Fiche (see Annex 3.3) describes adequately the information that is required by requesting information in two areas – the macroeconomic situation; and the profile and trends in poverty. In describing poverty in this section it is important to be clear what is meant by poverty – are we talking about income poverty (and the many ways this might be measured), or non-income poverty (covered for example by the social indicators in MDG 2 to 7). The section below explains how the issues related to the macroeconomic situation should be approached.

- ***The macroeconomic framework***

One of the eligibility criteria is that a stability-oriented macroeconomic policy is in place or under implementation. Making an assessment in this area relies on three main elements:

- *A summary of the main past and expected trends in macroeconomic variables.* Use can be made of a *standard analytical framework* summarising the main expected trends in key macroeconomic variables,[2] including data for the past two years and forecasts/projections for the current and following two years (see Annex 1.4 for further details). The partner country's track record on macroeconomic management, as well as the prospects for a good track record being maintained or a poor track record being improved should be mentioned. In examining these issues, in all but exceptional cases, it is not expected that a separate macroeconomic analysis be carried out, but that a judgement on stability-oriented macroeconomic policies be made on the basis of existing documentation, using as starting point information from the IMF.

- *Description of the relationship between the partner country and the IMF* In looking at the macroeconomic eligibility criteria above one of the key issues will be the relationship between the partner country and the IMF[3]. For example, is there a programme? How long will it last? Is a successor programme in preparation? The nature of this relationship can serve as a tool at the disposal of the EC to assess eligibility. Indeed, satisfactory implementation of a financial or non-financial programme with the IMF will be sufficient assurance of a stability-oriented macroeconomic policy. However, the absence of a programme with the IMF is not itself reason for non-eligibility. In such a situation it is important to examine why there is no programme with the IMF (is it because there are difficulties with the IMF? Or does the partner country not need support from the IMF?) In some circumstances reliance can be placed on the conclusions of Article IV consultations, in particular where there is a strong track record of stability. In exceptional cases it may be necessary for the Commission to carry out its own assessment (See Annex 2.6 for model terms of reference).

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[1] The ACP documents refer to "development policy and strategy of beneficiary country"; whilst the Action Fiche for other countries refers to "cooperation related policy and strategy of beneficiary country"

[2] Such as the overall growth rate, the balance of payments deficit, the government deficit, the rate of inflation, the shares of the social sectors in the overall budget, employment growth, the level of reserves, the level of external indebtedness and the exchange rate

[3] A country has a programme with the IMF when it has an agreement between the IMF on a set of macroeconomic and structural policies whose implementation may either be financially supported by the IMF (such as a PRGF or stand-by agreement); or a non-financial programme with the IMF (SMP, PSI); or a country's policies may not be agreed together with the IMF, but may simply be assessed by the IMF under an Article IV cycle of consultations. An overview of the possible scenarios is presented in Annex 1.4.

- *Are there any special topics of macroeconomic interest that might need to be addressed?* Depending on the country context, there may be particular areas that deserve special attention. Focus should be on those areas where the risks concerning the preservation of eligibility are greatest and where the provision of budget support may itself create a set of macroeconomic challenges. Such areas may include the challenges of "scaling-up" of external aid (to meet the MDG objectives, for example), the timing of the spending and absorption of external assistance, the relevance (or not) of Dutch disease, debt sustainability issues, the macro impact of state owned enterprises, and the level of tax revenue.

In examining the above issue the text in the Financing Proposal/Action Fiche should describe, summarise and comment on the main information, with further supporting information provided in an annex. The aim is that this section of the Financing Proposal/Action Fiche, along with the annexes, should summarise both the EC's assessment of the macroeconomic eligibility criterion as well as the key issue that could be taken forward in the dialogue with Government and other donor partners.

The main text of this section in the Financing Proposal/Action Fiche should conclude with a statement confirming the fulfilment of the relevant eligibility criterion that a stability oriented macroeconomic policy is in place or under implementation and that this macroeconomic policy should be supported by the EC. Box 6.6 contains a suggested wording.

6.2.2 Development/Cooperation Policy and Strategy of beneficiary country

This section should cover three main areas – the national development and reform policy and strategy; the macroeconomic context; and given the importance of indicators in monitoring national objectives, the performance measurement system.

In making a description and analysis in this section it is expected that existing documentation will be exploited, rather than drawing upon specific studies financed by the EC.

- ***National development and reform policy and strategy***

One of the eligibility criteria is that a well-defined national development or reform policy and strategy is in place or under implementation. The key issues that can help inform an assessment here include the following areas:

- *Are the main features of a national development and reform policy and strategy present?* Desirable elements of a policy and strategy are: a description and analysis of the current situation, problems and challenges; a clear, coherent, and comprehensive statement of policy and strategy[1] for meeting objectives; an action plan for implementing the strategy; a medium-term financial perspective and annual budget framework; time-bound performance indicators to measure achievement of objectives and results (this point is developed further below); and monitoring and evaluation arrangements.

- *Is the national development and reform policy and strategy credible and relevant?* Many factors will be involved in assessing the credibility of a national policy and strategy, including whether it presents a coherent set of policies, and whether there are weaknesses. In considering these questions certain issues might be examine, for example:

[1] The strategy refers in particular how it is expected that we move from the position today, to the desired position in the future.

- *Growth and poverty reduction*. It is very often the case that growth objectives will be at the heart of any national policy and strategy,[1] and in particular the impact that growth might have on poverty reduction[2]. Are the plans in this area quantified and realistic given the country context? Where is growth and poverty reduction to come from? Are there any possible weaknesses?

- *The strategic orientations*. Frequently a national development policy and strategy will identify a number of "axes" or "pillars" or "key sectors" where actions are to be taken. Are these areas sufficiently comprehensive? Within these key sectors is their an appropriate role for the government (at its different levels) and for the private sector? Is the approach to international trade addressed? (This area is particularly important as part of the approximation process in the ENP countries, but it is also relevant in ACP countries through the process of Economic Partnership Agreements.) Are the key areas in which action is proposed coherent with the overall strategy for growth and poverty reduction? Are there any possible weaknesses? Is there capacity to implement the programme?

- *cross-cutting issues and national policy and strategy*.[3] Are cross-cutting issues covered in the national policy and strategy? (see para 6.3.5 below). Are the proposals coherent with the overall strategy for growth and poverty reduction? Are there any possible weaknesses.

➢ *Is the national development and reform policy and strategy owned by the partner country?* Professional judgement informed by the Delegation's specialist knowledge of the partner country political situation and dynamics must be used to answer this key question. In some cases it may be important to accept "good enough" policies because they are in some sense "owned" rather than "best" technical policies for which there is no real political commitment.[4]

In examining these areas analysis rather than description is needed so as to arrive at a soundly based judgement. It is important to go beyond the (all too frequent) descriptions that a country is poor because it has no money; or to improve output, productivity must increase; or to raise growth investment must be increased - without in any of these cases stating why there is no money, or why productivity is too low, or why investment is lower than desired. It is important to look beyond statements such as these to see if there is an accompanying diagnosis.

The main text of this section in the Financing Proposal/Action Fiche should conclude with a statement confirming the fulfilment of the relevant eligibility criteria that a well defined national development or reform policy and strategy is in place or under implementation, and that this policy and strategy should be supported by the EC. Box 6.6 contains a suggested wording. In the case that weaknesses are identified, an appropriate strategy of dialogue combined with appropriate disbursement conditions should be put in place.

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[1] In this respect it is always very salutary for low income countries to ask how many years it will take to double GDP per person. Use the "rule of 70". Take the growth of GDP per person, say 3 per cent and divide into 70, giving about 23 – thus it will take about 23 years to double GDP per head say from EUR 200 to EUR 400.

[2] It is also useful when looking at income poverty to consider the extent to which changes in poverty are sensitive to growth on the one hand, and to changes in income distribution.

[3] Although there is a separate section in the Financing Proposal or Annual Action Programme/Action Fiche that covers cross-cutting issues, it will mainly be through the analysis of the national policy and strategy that some form of assessment will be made of cross-cutting issues

[4] The Paris Declaration on Aid Effectiveness, March 2002, pays particular attention to ownership, notably in one of its "Indicators of Progress"

Box 6.3: Joint Evaluation of General Budget Support: Growth and poverty reduction in national policies and strategies

The Joint Evaluation on General Budget Support made some comments and recommendation s on growth and poverty in GBS operations: "Concerning the balance between expansion of social services and policy measures to address income poverty, GBS reflects the strengths and the weaknesses of the PRSPs [national policies and strategies] that it supports. It helps to support a macroeconomic environment which provides prerequisites for poverty-reducing growth, but the charge of imbalance between public service expansion and a focus on growth and income-poverty reduction is a forceful one…Many of the things that a growth strategy requires (better business environment) depend on government actions and/or policy changes (rule of law. deregulation, anti-corruption measures). These are often cross-agency issues that can usefully be raised in cross-agency partnership forums, and supported by GBS dialogue and conditionality…Governments and international partners should pay more explicit attention to the income poverty and growth implications of public policy and expenditures, and to the ways in which GBS may complement other modalities in this area"

Source*: Evaluation of General Budget Support: Synthesis Report,* May 2006*,* para 6.12-6.14

- ***Performance Measurement***

Performance measurement is important for any country pursuing its own development or reform policy. International commitments and the EC's own policies also stress the importance of performance measurement, with an accent on results/outcomes.[1] Some aspects that should be mentioned include:

- *The existence of a matrix of performance indicators to measure the achievement of objectives which is coherent with national and sectoral policies.* It is important to ensure that any strategic orientations set out in a national policy and strategy find their expression in a matrix of performance indicators. In some countries the use of a "Performance Assessment Framework" (PAF) has become common, and in such cases it should be analysed, including the extent to which it is results/outcome oriented.[2]

- *The coherence with the Millennium Development Goals*: The MDGs, which have been internationally agreed, place an emphasis on results/outcomes. It is therefore natural to consider the extent to which the country is able to monitor these objectives

- *The existence of a programme to ensure the quality of the performance indicators used to measure the achievement of objectives*. Frequently there are difficulties in collecting all the relevant information needed to monitor performance of national policy and strategy. Mention should be made of any programme, including capacity development support, designed to rectify this situation.

6.2.3 Sector Policies

In a GBS programme designed to support a national policy and strategy, there will nevertheless be key sectors or areas where particular attention will be given. These sectors will be those judged to be of particular importance to the support to the national strategy. They might in some cases cover

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[1] See for example the *Paris Declaration,* March 2005, which includes "Managing for Results" as one of its twelve indicators of progress, which covers "number of countries with transparent and monitorable performance assessment frameworks to assess progress against (a) the national development strategies and (b) sector programmes. The *European Consensus,* November 2005 states "the Community will consistently use an approach based on results and performance indicators".

[2] This issue is particularly important given the intention to use performance criteria and indicators that arise from a partner country's own strategy as disbursement conditions. Sometimes performance indicators are absent, not sufficiently results-oriented, or are not presented on an annual basis, making it difficult to judge on a regular basis whether a country is meeting its objectives. Furthermore, this area forms part of the "Indicators of Progress" in the Paris Declaration on Aid Effectiveness, March 2006.

sectors where other donors are not particularly active, but which form an important part of the national policy and strategy. In those countries where support is being given to PRSPs it is normal to focus on the social sectors of education and health as being key elements in reducing income and non-income poverty. In this part of the Financing Proposal/Action Fiche it would be important to describe the key elements of the sector policies and strategies that are the focus of attention within the GBS operation. In addressing these areas it will be particularly important to consult with sector specialists within the Delegation.

6.2.4 Public Finance

The section on public finance should cover two main areas: public financial management (PFM) and the national budget (and MTEF, where it exists). Looking at PFM is different from looking at the budget. PFM is concerned with the planning, implementing, reporting, and auditing of public money as well as assessing the extent to which plans are fulfilled, and whether a budget is comprehensive and transparently prepared and implemented. As such it covers issues that deal with the "mechanics" of the budgetary process. In contrast looking at the budget is motivated by a wish to examine whether a budget is in some sense "good", or "appropriate"[1] or "moving in the right direction". As such is covers issues that deal with the validity of the budget allocations.

- ***Public financial management***

One of the eligibility criteria is that a credible and relevant programme to improve public financial management (PFM) is in place or under implementation.[2] Making an assessment in this area relies on two essential elements:

- *An assessment of the quality of the PFM system* using, as the EC's favoured tool of choice[3], the "Public Financial Management – Performance Measurement Framework" (PFM-PMF) of the PEFA (Public Expenditure and Financial Accountability) initiative. Some key features of this assessment are:
    - The PFM-PMF consists of the analysis of 28 indicators covering six essential dimensions of PFM systems: (i) credibility of the budget, (ii) comprehensiveness and transparency of the budget, (iii) policy-based budgeting, (iv) predictability and control in budget execution, (v) accounting, recording and reporting, and (vi) external scrutiny and audit. It also includes three indicators on donor practices.
    - This analysis is developed and synthesised in a "PFM Performance Report" which also contains additional complementary elements (for example, a statement on the legal and institutional framework) so as to provide an overall evaluation of the performance of the public financial management of the country under review.

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[1] Sometimes the metaphor is used to describe PFM as the "engine of the car", and the budget/MTEF as the "direction of the car".

[2] The *Paris Declaration on Aid Effectiveness* also covers issues related to PFM with indicators of progress in three areas. First, "Number of partner countries that have procurement and public financial management systems that either (a) adhere to broadly accepted good practices or (b) have a reform programme in place to achieve these". Second, "Percent of donors and of aid flows that use partner country procurement systems which either (a) adhere to broadly accepted good practices or (b) have a reform programme in place to achieve these. Third, "Percent of donors and of aid flows that use public financial management systems in partner countries which either (a) adhere to broadly accepted good practices or (b) have a reform programme in place to achieve these". These indicators make a distinction between "public financial management" and "country procurement systems" – a distinction that is not used in this text and does not exist in the PEFA PFM-PMF, where country procurement systems are seen as part of PFM.

[3] Taking into account that coordination with other donors is important, the Commission whilst promoting the use of the PEFA diagnostic, can accept to be part of, or contribute to, other initiatives to examine the quality of PFM systems.

- o Delegations, in collaboration with other donors, are expected to use and promote the PFM-PMF in their work, and discourage the use of a variety of diagnostic tools[1] that have existed to present. Indeed the PFM-PMF has been designed to ensure more effective monitoring through donor coordination around coherent and harmonised diagnostic appraisals.

The logic underlying the PFM-PMF, a description of its main elements, and guidance and practical instructions for its use are at Annex 1.5. An outline of terms of reference for carrying out an assessment of PFM according to the PEFA methodology is at Annex 2.1.

- *An assessment of the PFM reform process.* The "PFM Performance Report" mentioned above contains a section on the government reform process which briefly summarises recent and ongoing reforms and improvements. However, in order to encourage the partner country's ownership of the reform process, the report does *not* include any recommendations for reforms or assumptions as to the potential impact of ongoing reforms on PFM performance. This type of appreciation is left to the stage of policy dialogue between the partner country and the donors. It is therefore necessary to complement the information provided by the PFM performance report, with an assessment of the programme designed to improve or reform public financial management. Such an assessment should focus on:

  - o evidence of the national authorities' political will, commitment and endeavours to improve PFM performance.
  - o the relevance and degree of implementation of the reform strategy (and related action plan);
  - o the relevance and degree of coordination and implementation of the capacity development programmes that may be financed by the donors to support the reform of public financial management; and

  Such an assessment will be based on the PFM reform reviews organised by the governments (for example in the framework of the annual reviews of the implementation of poverty reduction strategies), or on studies/evaluations/audits financed by donors and, whenever possible, on the reports of the national Parliament and Supreme Audit Institution.[2]

The main text of this section in the Financing Proposal/Action Fiche should conclude with a statement confirming the fulfilment of the relevant eligibility criterion that a credible and relevant programme to improve Public Financial Management is in place or under implementation and that this programme should be supported by the EC. Box 6.6 provides a suggested wording.

In arriving at the conclusion to support the programme to improve public financial management it should be stated that applicable legal provisions[3] have been met, notably that the analysis has shown that public financial management is "sufficiently transparent, reliable, and effective"[4] always taking into account that "sufficiently" is given a dynamic interpretation (see Chapter 3) An annex to the Financing Proposal/Action Fiche must provide detailed comments on this section on public financial

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[1] In the past a wide array of different diagnostic tools for assessing PFM (CFAA, PER, HPIC tracking exercise and others) has been used. It was against this backdrop that the Commission and other Donors (World Bank, IMF, France, UK, Norway, and Switzerland) undertook to elaborate, through the PEFA initiative, a common Performance Measurement Framework which was adopted in June 2005 and approved by the OECD/DAC.

[2] Clearly, at the start of a PFM reform process it will not be possible to address issues related to implementation of PFM reform or of capacity development issues. In this case the assessment will not cover issues related to implementation.

[3] See section 3.2 for the applicable legal provisions.

[4] This is the phrase that exists in the DCI, ENPI, and IPA, whilst in Cotonou Agreement uses the phrase "sufficiently transparent, *accountable*, and effective"

management, for which Annex 6 includes a model format covering the analysis of both the performance and the PFM reform process.

Given the central role of PFM in budget support operations, it is also important that the Financing Proposal/Action Fiche clearly highlights the linkage between the diagnosis of the PFM situation and the conclusions drawn in terms of PFM performance criteria and indicators used as conditions for tranche release, and the PFM related institutional and capacity development support foreseen (see sections 6.5 below). If any weaknesses are identified, an appropriate strategy of dialogue combined with appropriate disbursement conditions should be put in place. Furthermore, it is important to demonstrate the extent to which these indicators/conditions/support are adequate responses to at least some of the key weaknesses identified by the diagnosis. If, for any reason, some major weaknesses are not tackled by the EC this should be explained - for example, other donors are addressing them in their own budget support programmes.

Box 6.4: Joint Evaluation of General Budget Support: Corruption and Budget Support

The issue of corruption is frequently raised in the context of budget support. Although it is a subject that goes beyond the area of budget support, it nevertheless needs to be addressed. It is often assumed that budget support is more susceptible to corruption than other forms of aid. However, as the Joint Evaluation on General Budget Support states, this view is "…not in fact self-evident…"[1]. Even if aid funds are earmarked for specific purposes, they may be offset by the allocation of government revenues to other uses – earmarking through projects does not avoid corruption. Other forms of aid are vulnerable to corruption in quite subtle ways – opportunities for corruption exist throughout the project cycle from project selection, through design, and procurement; tax exemptions often associated with donor financed projects and programmes are rarely conducive to "correct" practices; and the adoption of separate disbursement systems can undermine accountability within the public sector system.

Nevertheless, the fact that public financial management is assessed in the preparation and implementation of GBS programmes, naturally opens-up the possibility of looking at one of the more visible areas where corruption may have an effect on public affairs. In practice this issue is addressed first, through the eligibility criterion related to public financial management; and second, through the requirement to provide information on the government's efforts to fight corruption in the annex to the Financing Proposal/Action Fiche on Public Financial Management. In this annex one section is expected to cover "The Government's efforts to fight corruption" through (i) identifying those PFM reforms that have a particular anti-corruption dimension; (ii) assessing the extent to which the fight against corruption is on the political agenda; (iii) specifying whether there are particular public entities set up to deal with corruption; and (iv) mentioning any complementary activities of the Commission in supporting the partner country's fight against corruption.

Finally, it should be stressed that even if fighting corruption goes beyond the objectives of GBS, it nevertheless contributes to tackling one of the channels of corrupt practices by targeting the strengthening of PFM systems.

- ***National budget and medium term financial perspectives***

Looking at the budget and the medium term financial perspectives (if they exist)[2] is motivated by the fact that a satisfactory national policy and PFM system are not sufficient to guarantee the achievement of objectives. Budgets and medium-term allocations and expenditures should be assessed – the budget is the instrument used to promote change and achieve the policy and strategic objectives. Although this issue is complex, there are a number of issues that could be examined. For example:

- *What is the size of budget support in relation to the budget?* It is important to describe the size of budget support in relation to key budget figures. For example, the size of forecast

[1] *Evaluation of General Budget Support: Synthesis Report*, IDD and Associates, May 2006

[2] The phrase "medium term financial perspectives" is used here to try and keep the concept as general as possible. Various formulations exist. For example, "Medium Term Expenditure Framework", "Medium Term Budgetary Framework", "Medium Term Financial Framework", or "Medium Term Fiscal Framework". The choice of term and its coverage will depend on the country context.

annual budget support as a percentage of total revenues, or total expenditure, or as a percentage of the fiscal deficit. The size of EC budget support should also be placed in context in relation to the size of external aid, either in the form of grants, or as a percentage of grants and loans.

- *What type of budget are we looking at?* Line item (incremental budget), or programme and performance based budgets. What is the coverage of the budget – which level of government does it cover – central government, general government, or the public sector? Does the budget just cover Treasury financed activities, or does it include donor financed activities?[1] What is the structure of budget income (tax revenue, non-tax revenue, grants), expenditure (economic and functional classification, including debt interest), and financing (domestic, external, amortisation)?
- *Are budget allocations and budget outturns consistent with national policy and strategies?* For example, what is the overall structure or sectoral and sub-sectoral composition of public expenditures? What is the division between capital and recurrent expenditure, and within recurrent expenditure between wage and non-wage costs? What is the revenue composition? What are the trends in these budgetary aggregates? Is it possible to assess whether the sectoral and sub-sectoral compositions are consistent with national policy? If there are differences, what reasons explain these differences – is there lack of clarity in defining strategic objectives to guide budget allocations? What main areas need to be addressed to bring allocations into line with national policy and strategy?

Box 6.5: Joint Evaluation of General Budget Support: Budget strategy and pro-poor public expenditure

The Joint Evaluation on General Budget Support made some comments and recommendations on growth and poverty in GBS operations: "The "pro-poor expenditure" approach to allocation of additional budget resources can be dangerously simplistic…Donors with an instinctive preference to support primary services need to consider more deeply the implications of sustainable long-term strategies – e.g. the demand for basic secondary education that is inevitable when the universal primary education cohorts start to complete the primary cycle, and the need for university education also to feature in a balanced growth and poverty reduction strategy…International partners and governments need to move on from simplistic "pro-poor expenditure" based expenditure allocation approaches to deeper analysis of sector and sub-sector strategies and their expenditure implications"

Source: *Evaluation of General Budget Support: Synthesis Report,* May 2006, para 6.10-6.11

- *What budgetary strategy is being pursued by the partner country?* In examining the evolution of the budget over time, and the forecasts for the future, it should be possible to describe the budgetary strategy of the country (for example, through an examination of the statement of government operations). Issues include: (i) *the existence of budget rules.* Some countries have guidelines or rules on the size of the wage bill, the capital budget, and fiscal deficits, or even on the amount of money that should be allocated for particular purposes; (ii) *the budget financing strategy:* does the budget rely on domestic or external borrowing for financing purposes? Within domestic borrowing is the focus on the banking or non-banking sectors? Does the partner country need grants for investment costs,[2] or is the budget

[1] The *Paris Declaration on Aid Effectiveness* includes an indicator of progress related to this area on "percent of aid flows to the government sector that is reported on partners' national budget"

[2] This issue can be examined by looking at the extent to which tax ("own") resources are greater than recurrent expenditures. If this is the case, it strongly suggests that the counterfactual of the absence of grants in the form of budget support would have an impact on investment or financing rather than recurrent expenditure. Indeed, it has been stated that "…budget support should seamlessly complement domestic revenues and allow the financing of all types of expenditures. In practice, however, it rarely does. MDG attainment requires higher recurrent expenditures but prudent fiscal management discourages financing such an increase through volatile and ultimately uncertain source of funds such as budget support" *New aid modalities for the MDGs – Issues and questions,* DG DEV, 11 May 2005.

dependent on grants to pay for recurrent costs, including wages and salaries? To what extent do tax and non-tax revenue cover total expenditure? Examining these issues on the basis of past performance and future plans often gives a guide as to where priorities and constraints lie within the budget and where budget support can be most effective.

- *Is any work being undertaken to examine whether the budget is providing value for money?* It would also be useful to comment on any work that is being undertaken to look at whether the budget is providing value for money. For example, are there any audits by the Supreme Audit Institution examining this issue? Are there comparisons between Ministries, other state bodies, or between regions on value for money? Are steps being taken to examine this issue, and does the government have a strategy for ensuring value for money in the use of public funds?

Box 6.6: Is the Country Context ready for General Budget Support?

In all the areas discussed in the section on country context within the Financing Proposal/Action Fiche it is important to be able to make clear statements about whether the specific areas related to country context provide an appropriate or sufficient basis for providing General Budget Support. In this respect, a number of standard terms are suggested below.

On *national policy and strategy*: "The analysis of national policy and strategy set out above and in more detail in […specify the annex…] , confirms that a well defined national policy and strategy that responds to the challenges and problems faced by the partner country is in place/under implementation. As a result this national policy and strategy is an appropriate basis for providing EC general budget support.

On the macroeconomic framework. The analysis of the macroeconomic framework, [and in particular the support provided by the IMF through its […state the programme…]] set out above and in more detail in […specify annex…] shows that the macroeconomic policy is conducive to maintaining macroeconomic stability over the coming years. As a result this stability oriented macroeconomic policy is an appropriate basis for providing EC general budget support.

On public financial management. "The analysis of public financial management set out above and in more detail in […specify the annex…] shows that the partner country has established [or is implementing] a credible and relevant programme of improvement in public financial management and that the evidence from the PFM diagnostic and the PFM reform process shows that trends in PFM justify the allocation of budget support with respect to the legal requirements concerning the eligibility criteria for budget support" […the appropriate reference to the legal basis may be included here, for example Article 61(2) of the Cotonou Agreement for ACP countries…]

- *Is anything happening on the preparation of a medium term financial perspectives?* Is there an MTEF or equivalent? If not, is there a plan to introduce a medium term expenditure framework? Does it focus on the capital budget, or does it cover both capital and recurrent spending? Does the existing or planned medium term expenditure framework provide sufficiently detailed coverage to allow for the orientation/reorientation of budget allocations in line with national policy and strategy? In this area the extent of discretionary and non-discretionary expenditure in the budget[1] is important, because it is only over time that budget and expenditure reorientation can take place. Are revenues covered in the projections? *In examining this area, attention should be paid to ensuring that any plans are not overly ambitious*. Often there are more pressing problems in organising public finances – good macroeconomic projections, and indeed a satisfactory annual budget – than establishment of a MTEF. It may be much more important to get these basic issues right before turning to medium-term financial perspectives.

[1] Non-discretionary expenditure is expenditure that cannot be avoided, at least in the short-term (for example, debt and salary payments). Discretionary expenditures are those expenditures that can be avoided in the short term (for example, asset maintenance). Over time more and more expenditure categories become discretionary as it becomes possible to avoid the associated costs (for example, not replacing staff upon retirement).

In looking at all these areas related to the budget and medium-term financial perspectives it is important that the Delegation identifies in the Financing Proposal/Action Fiche whether there are any particular challenges in bringing budget allocations into line with national policies and strategies. In the case that weaknesses are identified, an appropriate strategy of dialogue would need to be initiated, combined if appropriate with disbursement conditions.

6.3 Describing the GBS operation

Within any GBS programme the overall objective, purpose, expected results and activities will need to be defined. This whole area should be driven by an analysis of the country context, lessons learnt, and the planned activities of other donors, and complementary activities of the EC. The objectives should derive from the national development or reform policy and strategy of the country, and not be distinct "EC objectives". Any description of overall objective, purpose, results, and activities could draw upon the "intervention logic" of GBS (see chapter 2), but careful analysis is needed in each specific case to ensure that the logic is widely accepted and agreed, taking into account country specific circumstances rather than relying on the use of any given blueprint.

When preparing the objectives, purpose, results, and activities, it is also important to have time-bound quantified targets. For example, it should not be sufficient to refer to an objective of poverty reduction without referring to the current situation and the objective over the coming years. Similarly, if there is a reference to reducing inequality, the objective in this area should be quantified.

6.3.1 Overall objectives and purpose

Overall objectives – derived from the national policy and strategy – will usually cover a contribution to broad cooperation objectives, such as growth, poverty reduction (in its various dimensions), well-being, security and good neighbourliness, integration into the world economy, economic partnership, which broadly cover issues related to wider developmental objectives.

Beyond the overall objectives, it is necessary to clearly define the *purpose* (or specific objective) of the budget support intervention. The purpose – derived from the national policy and strategy – should refer to particular aspects of the overall strategy. It is often related to improving macroeconomic stability, public financial management, and improvements in the performance, access to, use of, and satisfaction with government and social services, measured with performance indicators.

It is important when stating the overall objectives and purpose to ensure that they are consistent with the stability-oriented macroeconomic policy.[1]

6.3.2 Expected results and main activities

Results[2] will often be related to the better functioning of the public or general government sector and the goods and services it supplies, as well as improvements in the framework for public policy and public expenditure. These goods and services would be those that contribute towards the overall objectives, such as those related to poverty reduction.

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[1] For example, it would be inappropriate to suggest that an objective is to increase public expenditure in certain sectors when the stability-oriented macroeconomic policy allows for the progressive spending and absorption of aid over time in order to smooth the expenditure path.

[2] It is worth stating here that the "results" concept here can cause some confusion. Here the word results corresponds to that used in the EC's Logical Framework is not the same at the "results" concept used by the EC in the indicator typology or by other donors (see Box 1).

Activities will cover the issues related to policy dialogue and partnership based on best practice principles, capacity development activities, but above request for disbursement of budget support by the partner country and the subsequent verification of the conditions for disbursement. Means (or inputs) will refer mainly to the financial support provided by GBS, indicating clearly the size of this support in relation to key macroeconomic variables (such as the percentage of GDP, percentage of public expenditure, percentage of total revenue, percentage of fiscal deficit, the percentage of current account revenue and percentage of current account balance).

6.3.3 Stakeholders and beneficiaries

All Financing Proposals/Action Fiches require some description of main stakeholders[1], including beneficiaries[2]. In a GBS operation the beneficiaries are usually identified at two levels:

- *Broad sections of the community*, for example "the poor", "the population in general" that are expected to be the beneficiaries of a national development or reform policy and strategy that aims to reduce the (income) poverty rate or to reduce inequality (this area corresponds to the "final beneficiaries" – see footnote below)

- *Targeted sections of the community*, when target groups are identified through the use of performance indicators for the disbursement of tranches. For example, women receiving health treatment, girls in school.

When considering the issue of stakeholders and beneficiaries, contacts with non-state actors should be encouraged. There is often a temptation in GBS operations to focus attention on discussion and dialogue with governments, overlooking the potential for discussions and consultation with organisations and groups outside of government, such as NGOs, professional associations, and trade unions. Consultations with these groups can be used to better formulate the GBS operation, assist in implementation, as well as help in improving understanding of the EC's approach to giving budget support.

6.3.4 Risks and assumptions

As a result during programme preparation, and in the Financing Proposal/Action Fiche it is important to ensure that the diagnosis has clearly identified the areas of risk, and that the conditions established in the programme are designed to address those risks. Normally, risks would be addressed through:

- *thorough assessment* before finalisation of programme preparation, notably with respect to the eligibility criteria, but also other contextual issues such as donor coordination and performance measurement;
- *use of general and specific* conditions to ensure that the risks, most notably those concerning public financial management, are addressed during programme implementation.

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[1] Stakeholders are any individuals, groups of people, institutions or firms that may have a relationship with the programme. They may – directly or indirectly, positively or negatively – affect or be affected by the process and the outcome of projects and programmes.

[2] Beneficiaries are those who benefit in whatever way from the implementation of the programme. A distinction may be made between: (i) target group(s) that will be immediately positively affected by the programme at the programme purpose level; and (ii) final beneficiaries that will benefit from the programme in the long-term at the level of society or sector at large, eg "children" due to increased spending on health and education or "consumers" due to improved agricultural production and marketing.

6.3.5 Cross-cutting issues

There are a number of critical cross-cutting issues[1] which should be addressed during programme preparation. A GBS operation has to be coherent with the Country Strategy Paper and the general dialogue with the government. In this context, GBS supports implementation of a national policy and strategy and an assessment of the quality of that policy and strategy makes it possible to judge whether cross-cutting issues are being properly addressed. However, it is important not to overload the GBS tool with too many issues, and ensure that it can focus on a number of key aspects. In this respect gender issues, good governance, and the environment are particularly important:

- ***Gender.*** Taking into account the fact that MDG 3 has as its goal to "promote gender equality and empower women" it is important to address this issue. There are many tools for looking at gender issues in the budget[2] and gender budgeting is increasingly promoted as a tool for gender mainstreaming[3] where PFM capacity has reached the required level. Depending on the country context these issues will be examined to varying degrees in the formulation of a budget support programme. Very specifically, it is possible to see gender issues being taken into account in the choice of performance criteria and indicators for the disbursement of tranches.

- ***Good Governance.*** The economic, social, and political dimensions of good governance[4] have been grouped into six clusters by the EC, one of which focuses on "public administration reform, management of public finances and civil service reform".[5] Although the six clusters of good governance will regularly occur in the policy dialogue with partner governments which accompanies GBS, it is the question of the management of public finances that naturally has greater prominence. This area will be addressed in the actions taken on public financial management.

- ***Environment***. Environmental protection and sustainable management of natural resources are crucial for lasting poverty alleviation and economic growth. Ensuring environmental

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[1] Cross-cutting themes or issues change over time as they are updated. For example in the Cotonou Agreement they are labelled: (i) gender issues; (ii) environment and natural resources; (iii) institutional development and capacity building (Articles 31-33). More recently, in the *European Consensus,* 22 November 2005, cross-cutting issues are referred to as "…the promotion of human rights, gender equality, democracy, good governance, children's rights and indigenous peoples, conflict prevention, environmental sustainability and combating HIV/AIDS."

[2] For example: gender aware policy appraisal, beneficiary assessment, incidence analysis, budget statements. See the *Toolkit on mainstreaming gender equality in EC Development Cooperation,* 2004; and *Gender Budgeting: its usefulness in programme-based approaches to aid,* Briefing Note, EC Gender Help Desk, 2006, for more information.

[3] Gender budgeting has been described as "…an application for gender mainstreaming in the budgetary process. It means a gender-based assessment of budgets, incorporating a gender perspective at all levels of the budgetary process and restructuring revenues and expenditure in order to promote gender equality" (Group of Specialists on gender budgeting, Council of Europe, 2005)

[4] Described as "The transparent and accountable management of human, natural, economic and financial resources for the purposes of equitable and sustainable development, in the context of a political and institutional environment that upholds human rights, democratic principles and the rule of law" in the EC Handbook on Good Governance.

[5] The other areas cover: (i) support to democratization including support to electoral processes and electoral observation; (ii) promotion and protection of Human Rights (as defined in the international covenants and conventions, respects of norms and non-discrimination); (iii) Reinforcement of the rule of law and the administration of justice (as to the legal framework, legal dispute mechanisms, access to justice, etc); (iv) enhancement of the role of civil society and its capacity building (as a partner in public policy making and implementation); and (v) decentralisation and local government reform/capacity building (to promote and institutionalise participation at the local level with a focus on local power structures and resources).

sustainability[1] is one of the Millennium Development Goals (MDG-7) and the Commission has made a number of commitments on the environment.[2] It is important to underline that the national policy and strategy being supported and the resulting macroeconomic policies, trade policies, tax regime, and budget allocations may have significant environmental impacts affecting the livelihood of the poor or the sustainability of economic growth. It is thus important to consider the extent to which the national policy and strategy being supported addresses key environmental and sustainability concerns, such as those identified in the Country Environmental Profile (CEP) or the Strategic Environmental Assessment (SEA) and whether it may lead to detrimental environmental externalities, resource exhaustion, or damaging distortions through, for example, tax, expenditure, and regulatory policies.

If appropriate, and in line with the overall objectives and purpose of the budget support programme, the Financing Proposal/Action Fiche should make it clear how they are covering cross cutting issues, most notably in the assessment of the national policy and strategy being supported, without overloading the instrument.

6.4 Establishing the implementation modalities

It is in establishing the financial implementation modalities that all the previous analysis, diagnosis, and agreement on objectives, finds concrete expression in the conditions linked to tranche disbursement.

6.4.1 Budget and Calendar

The Financing Proposal/Action Fiche should clearly present and specify: (i) the amount of budget support to be disbursed by type of tranche (fixed or variable); and (ii) the indicative disbursement calendar as well as the timing of the key steps to be taken in meeting that calendar; (iii) key references to procedural matters such as the operational implementation period in months from the date of signature of the Financing Agreement

With respect to the ***budget and tranches*** the following points should be taken into account:

- *Aim for an appropriate mixture of fixed and variable tranches.* In many budget support programmes it is useful to make use of fixed and variable tranches. The two types of tranches should be kept distinct in a Financing Proposal/Action Fiche and in the Financing Agreement. To avoid difficulties in implementation the use of "mixed" tranches (when a single instalment is made up of a fixed and variable amount) should be avoided. Further guidance on the amounts to allocate to fixed and variable tranches is provided in Annex 1.13.

- *Aim for an appropriate disbursement of funds over the life of the GBS programme*. Different options tend to be adopted in this area, of which there are two main approaches – equal disbursements in each year of the programme; or larger up-front disbursement in the first year followed by equal disbursements in each of the subsequent years. Which approach is adopted will depend upon the country context. Equal disbursements throughout the programme will generally be favoured when the programme is part of an uninterrupted sequence of payments. A larger up-front payment might be favoured if the operation follows a period without budget support or forms part of a short-term programme.

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[1] Sustainability refers to the capacity to meet the needs of the present without compromising the ability of future generations to meet their own needs.

[2] See, for example, the *European Consensus*, on the environment and the sustainable management of natural resources (para 74-75), and the strengthened approach to mainstreaming para (100-102).

With respect to the ***calendar*** the following elements should guide the description in the Financing Proposal/Action Fiche:

- *Aim for a programme of <u>at least</u> three years.* On the duration of the programme it is important to find a balance between a time period long enough to allow for greater predictability in the flow of aid and the measurement of performance; and short enough to allow for the preparation of new programmes that respond to changing circumstances. There is also a need to ensure coherence with the time period of any partner country programme being supported and the activities of other donors. Within this framework it has been most common to prepare a programme to cover a three year period. However, given the pressing concerns about the predictability of budget support consideration should also be given to programmes that are longer than three years.

- *Annual Reviews should be carried out jointly with other donors.* It would be normal practice to have an annual review carried out jointly with other donors – for example, the annual review of the PRSP. The annual review should ideally link into other established milestones within the national planning and budgeting calendar, for example the annual review of the government programme. In this way, and through careful planning, linking in to existing government planning and review mechanisms, and coordinating closely with other external financing agencies, it is possible to increase ownership and transparency and reduce transaction costs. Annual reviews could nevertheless be supplemented with other forums of dialogue if needed.

- *Aim for coherence between the disbursement calendar and the budget calendar.* The starting point is to have a clear view of the budget calendar for a particular country, and then integrate the timing of the reviews, discussions and decisions into that calendar. In general, this would imply an annual review 6-7 months before the start of the subsequent fiscal year, with firm decisions on disbursements being communicated at least 5-6 months in advance of the fiscal year, with funds then disbursed at the start of the subsequent fiscal year. It is important in preparing the timetable for reviews, requests for tranche release, to be extremely prudent in the timing needed to make decisions.

Box 6.7: OECD Good Practice Guidance: time disbursements to facilitate smooth execution

The OECD Good Practice Guidance states: "Time disbursements to facilitate the smooth execution of budgetary payments. Donors should agree with a partner country's budgetary authorities on the most appropriate timing for the planned release of budget support resources, particularly if there are significant fluctuations in the country's budgetary cash flows during the year. If deemed relevant, seasonal macroeconomic patterns should also be taken into account. When more than one donor is providing budget support, donors and partners' budgetary authorities should coordinate to spread individual disbursements across the fiscal year in the most appropriate way. This information should be taken into account in the design of the macroeconomic and monetary programmes for the coming year"

Source: *Harmonising Donor Practices for Effective Aid Delivery, Volume 2,* OECD-DAC, para 21

With respect to ***procedural*** aspects:

- *Ensure that the operational implementation period is properly specified.* It is important given that there may be slippages in programme implementation to specify an operational implementation period in the Financing Proposal/Action Fiche that is substantially in excess of the programme period of say three years. In this case, an operational implementation period of around five years should be specified, ensuring that should delays arise there is sufficient time for the partner country to make its request for disbursement without requiring a rider to the Financing Agreement. Furthermore it is important to ensure that the operational implementation period is specified in months as from the date of signature of the Financing Agreement in order to avoid difficulties in implementation that might arise as a result of delays in signature of this agreement.

It would be normal for the Financing Proposal/Action Fiche, either in the text of in the annex, to set out a detailed table of the budget and calendar for implementation. Annex 1.13 includes a model table as well as suggestions for the manner in which the timing of tranche release might be structured.

6.4.2 Modalities of support

The Financing Proposal/Action Fiche and Financing Agreement needs to clearly state whether direct or indirect budget support is being used and whether targeted or non targeted budget support is being used (see Chapter 2 for definitions). In designing the modalities of support for the GBS operation the following points should be taken into account:

- *Direct budget support is used as the norm.* Direct budget support is used when the foreign currency is considered convertible, and in this case no justification is normally required for the use of the foreign currency since the foreign exchange forms part of the partner country's reserves and is freely available in line with the rules on convertibility. With the progressive liberalization of the current account transactions of the Balance of Payments, most of the EC's partner countries now have convertible currencies. In this context, there is no longer a justification for indirect budget support[1].

  Indirect budget support is used when foreign exchange is not convertible, in which case it is normal to require a justification for the use of foreign currency, (for example through the auditing of supporting documents in principle based on national procedures. However, some specific procedures may be necessary – respect of a "negative list" of military items and some luxury goods; respect for rules of origin; free and open competition for the award of contracts requiring foreign exchange; proof of contract often through a Letter of Credit; proof of import from the customs authorities. The need for any EC specific procedures should be ascertained before using this approach). The transfer of foreign currency and the conversion into local currency should take place *after* the documentary evidence for the use of foreign currency has been audited.

- *Untargeted budget support is used as the norm*. Untargeted budget support is the favoured approach, because of the advantages it offers in terms of focusing on *overall* performance, improvements in public financial management as a whole, and focusing on results. It also avoid some of the weaknesses associated with targeted budget support (see Annex 1.14 for the main points on experience with targeted budget support).

  In exceptional cases, the use of "targeted" budget support does, however, remain possible. For example, in those countries with significant cash-flow and budget execution problems, where there may be particular problems that require a more targeted response:

  - *Risk of non-execution of the budget.* Where there is a high risk of non-execution of the budget, with spending on priority items in the budget hampered by a combination of financing constraints and prior calls on the budget from spending items of a "non-discretionary" nature. This problem often goes by the name of "treasury tensions";

  - *Domestic Arrears*. Where there is a particular need to address a domestic arrears problem, such as an overhang of arrears of payments to government suppliers or a high level of domestic debt which is undermining budget programming and

[1] The one exception is where budget support operations have been financed under the Food Security budget line, where the relevant regulation is framed in such a way that there is a requirement to follow both the commodities and/or foreign currency sold or made available to the partner country.

management. This scenario is closely linked to that mentioned above, since it involves a high risk of non-execution of the budget.

- *External Arrears.* In countries eligible for the Highly Indebted Poor Countries (HIPC) initiative, budget support has been targeted on the clearance of external arrears. Among the key objectives of the initiative is the regularisation of relations between creditors and debtors, which cannot be achieved without the solution of the problem of arrears. The EC's policy is that arrears clearance within the HIPC initiative is generally agreed: (i) on a exceptional case-by-case basis to preserve the preferred creditor status of EC/EDF loans; (ii) within an internationally agreed clearance scheme to ensure fair burden sharing; (iii) from country allocations, if sufficient leverage can be demonstrated; and (iv) with disbursement clearly linked to the HIPC Decision Point, to reduce problems of moral hazard.

In all cases the disbursement of targeted budget support takes place after carrying out the relevant audit, and therefore requires careful consideration in terms of the timing of the audit and disbursements if it is required that funds be disbursed in the same fiscal year for which budget payments were made.

6.4.3 Performance monitoring and criteria for disbursement

The establishment of the performance monitoring system and the criteria for disbursement is at the heart of a budget support operation. It represents the "conditions" part of the overall view of budget support (see Chapter 2); but also sets the stage for the dialogue on the reasons for underperformance and/or the ambition of possible targets.

One sensitive issue in setting criteria for disbursement is the role of political conditionality. All Financing Agreements for General Budget Support include a clause for the suspension (Article 21 of the General Conditions). In addition the legal bases for cooperation may contain provisions for dialogue and suspension (for example, Article 8, 96 and 97 of the Cotonou Agreement). Normal practice would be to treat such political issues as touching on the overall cooperation programme, and not as specific to any particular aid delivery modality. See Box 6.8 below for the OECD/DAC guidance in this area.

Box 6.8: OECD Good Practice Guidance: Political Conditionality

The OECD Guidance states: While prohibited in the case of the international financial institutions, political conditionality can be legitimate for other donors. Political sensitivities are also likely to be more intense in the case of budget aid since some constituencies may see the provision of budget support as an endorsement of the partner country's overall policy stance. However, the vary nature of political conditionality makes it difficult to formulate clearly defined conditions that leave very little margin for interpretation. Accordingly, 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.

Source: *Harmonising Donor Practices for Effective Aid Delivery, Volume 2,* OECD-DAC, para 25

- ***General Conditions for disbursement***

It is normal to establish general conditions for disbursement that apply to all tranche release decisions. These general conditions will always include those related to eligibility criteria for budget support – national policy and strategy, macroeconomic stability, and improvements in public financial management. There might also be other general conditions, that would have to be prepared in accordance with the country context (for example, ensuring the availability of key budgetary documents and accounts). However, whatever the general conditions it is important to be clear about the factors that will be taken into account when arriving at a judgement of performance in these areas. Box 6.9 includes some suggested wording.

Box 6.9: General Conditions for General Budget Support: suggested wording

A suggested wording for the general conditions for GBS is as follows: So that the EC can evaluate the fulfilment of the general conditions, the [specify the authority in the partner country] shall communicate by [specify date – take into account that there will be more than one date given that the general conditions will apply to more than one tranche] information on the following:
(i) satisfactory progress in the implementation of the partner country national development or reform policy and strategy as evidenced by […provide details of information to be supplied by the partner country in their request for tranche release, …];
(ii) satisfactory progress in the maintenance of a stability-oriented macroeconomic policy as evidenced by […provide details of information to be supplied by the partner country in their request for tranche release…][For example, "continued implementation of a macroeconomic programme supported by the IMF". Where the review of an IMF programme is delayed or temporarily suspended or lapses, the EC may still take the decision to disburse budget support if it judges that stability-oriented macroeconomic policy is still being implemented, following communications as appropriate with the partner country and the IMF.]
(iii) satisfactory progress in the implementation of its programme to improve public financial management, as evidenced *inter alia* by […provide details of information to be supplied by the partner country in their request for tranche release…][For example, "the joint annual government-donor review or the public financial management reform programmes scheduled for…*name of month…*each year and the subsequent implementation of agreed measures"/"the conclusions of the PFM-PMF diagnostics planned for…*month and year…*"]
(vi) The Government of […*name of country*…] shall use its best efforts to supply the EC in a timely manner with all the necessary information needed to formulate an assessment based on (i), (ii) and (iii) above, as well as ensure dialogue around the objectives supported by this General Budget Support programme, such as […participation in/information on the IMF mission discussions, consultations on budget preparation and execution, add list of relevant information as appropriate…].

On the basis of the information supplied, the EC shall formulate a positive assessment before the disbursement of all tranches of budget support.

- ***Specific Conditions for disbursement***

Specific conditions are those that are applied to individual tranches (whether fixed or variable) in addition to the general conditions mentioned above. These specific conditions are related to very specific performance criteria and indicators and should be designed so that they are limited in number with limited room for interpretation. It is in the establishment of appropriate indicators that the "results/outcome-oriented" approach to providing budget support can be promoted.

- ***The choice of performance criteria and indicators***

Although it is not an eligibility criteria for budget support, a partner country's capacity to measure performance criteria and indicators used for disbursement purposes is particularly important. Furthermore, these performance criteria and indicators are likely to become the focus of subsequent dialogue, and will therefore in many respects determine the nature of the budget support programme.

In general the use of performance criteria and indicators requires a thorough understanding of the typology of indicators. Sometimes the discussion and dialogue in this area is confused because of misunderstandings over the terminology being used. In this respect, to have a fruitful dialogue with the partner country it is important that there is a common understanding of what is meant by input, output, outcome, and impact (Annex 1.9 provides detail on the terminology used in the context of EC budget support).

In all cases, whatever type of performance criteria or indicator is being used for disbursement purposes, the choice of criteria or indicator should be justified, and the responsibilities and sources of verification provided. It is particularly important to ensure that there is coherence between the diagnosis and the performance criteria and indicators used in the programme. The annex to the Financing Proposal/Action Fiche on the "Description and assessment of performance criteria and indicators used for disbursements" (see Box 6.1) should include the relevant information.

If performance indicators are used for disbursement purposes, then to ensure that any dialogue can take place on a sound basis, the quality of the information used needs to be assessed. As a result, **all budget support operations, which use performance indicators as a basis for disbursement, should carry out a prior (ex ante) diagnosis[1] of the indicators that it is proposed to use for disbursement purposes.** (Annex 2.5 includes model terms of reference for such a diagnosis). An annex to the Financing Proposal/Action Fiche should provide further information on this subject.

In making a prior diagnosis and choosing performance indicators a number of key steps need to be followed:

- *identification of the areas* for which specific conditions for disbursement of individual tranches will be defined (for example, the health sector or education sector);

- *identification of the performance indicators to be used* - in general it is recommended that the number of performance indicators is limited.[2] – a maximum of six per sector or area in a tranche is suggested; and

- *choice of the performance targets for each indicator*. The performance targets would normally be established on an annual basis for each year of the programme, for a period of at least three years.

In making the choice of indicators and their targets, attention should be paid to avoiding many of the common problems that exist in using performance indicators – the absence of precise and unambiguous definitions; lack of coherence between the calendar of the Financing Agreement (for assessment of performance) and that of national processes (including availability of data) which may result in delayed disbursement as compared with the planned agenda ; and lack of comparability of the indicators from one year to the next. The choice of indicators and targets should therefore pay attention to the following factors (further details can be found in Annex 1.9):

- *Link between indicators and national policies*
    - *Indicators should be drawn from the national policy and strategy*. Indicators should not be imposed. If however it is agreed that indicators not present in the national policy and strategy should be used, they should at a later stage be incorporated into the national policy and strategy;
    - *Indicators chosen for disbursement purposes should be coherent with the analysis in the country context.* In the section on country context there is likely to be discussion of problems faced – notably in the area of public financial management. The choice of performance indicators used for disbursement should be coherent with this analysis and address the problems identified;

- *The technical characteristics of the indicators*
    - *Clear and unambiguous definition* of the indicators so as to avoid errors and misunderstandings in interpretation at a later date;
    - *Source of indicators should be clearly identified* and as much as possible be drawn from the data produced by the National Statistical System, avoiding ad hoc or project related indicators;
    - *Methodology used to calculate the indicator should be clearly described*, including that of metadata so that the reliability of the indicators from one year to the next are comparable;

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[1] In addition an (ex-post) diagnosis should be undertaken each time a disbursement is made on the basis of performance indicators (see section 7)

[2] Within the ACP region it is suggested that in most cases there should be a *maximum* of 20 indicators per tranche, which would cover in general three main areas – education, health, and public financial management, an orientation broadly consistent with the guidance of a maximum of six indicators pre sector or area.

   - *Sensitivity of the indicator to policy changes* should be assessed given that annual monitoring of indicators will take place;
   - *Timing of the availability of the indicators should be known* so as to ensure consistency with the planned disbursement calendar;

- *Choosing targets for the indicators*
   - *Targets should be set so as to get the balance right* between being over-ambitious or excessively prudent. The targets should be drawn from national and/or sectoral strategies; should be coherent with international objectives, notably the MDGs; should be set for each year of the programme; should take account of previous performance as well as the resources available in the relevant area to meet the agreed targets. In this respect there needs to be a clear baseline.
   - *Choose indicators and targets with the maximum transparency* both in consultations with government, other donors, and with non-state actors. This transparency is a tool also for establishing the suitability and reliability of the chosen indicators and their targets (this aspect could equally be classified under the "link between indicators and national policies" – see above).

The annex to the Financing Proposal/Action Fiche on the "Description and assessment of performance criteria and indicators used for disbursements" should address the points above so as to assess the performance indicators used, paying attention to showing the link between indicators and national policies, the technical characteristics of the indicators, and the chosen targets for the indicators. It should also, so far as possible, provide information on past trends, in principle, for the three years before the current year.

If technical weaknesses are identified these weaknesses should not be used as grounds for excluding the use of indicators; rather special attention should be paid to seeking appropriate solutions, through for example, using proxy indicators, absolute numbers rather than ratios, and in extreme cases complementary data collection. Every effort should be made to ensure some form of performance indicators are used in the programme. In addition, on a short to medium-term basis an appropriate response would also be to identify what capacity development needs may exist to ensure that sufficiently high quality indicators can be produced, either within a short time period or at an appropriate point in the future.[1]

With respect to choosing the targets for indicators, it is recommended to use past trends as a basis, drawing upon a sufficiently long time span. It is important that the Financing Proposal/Action Fiche specifies the targets for each year of the programme, or at least for next three years. The information should be set out in a table, either within the main text or within an annex stating clearly, for example, that the vaccination rate target for year 200X, 200Y, and 200Z are A%, B%, and C% respectively. **Information limited to stating that the targets are to be agreed at a future date and in a separate document should be avoided except in exceptional cases, since absence of agreement in this area usually leads to delays**. In addition it is important in the Financing Agreement to include an explicit clause stating that any subsequent revision of indicators can take place upon the request of the Government and subsequent agreement of the responsible Commission Authorising Officer. Box 6.10 includes a suggested wording.

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[1] It may also be appropriate, to go beyond an analysis focusing on the performance indicators that might be used as a basis disbursement, and undertake a diagnosis of the National Statistical System in order to better judge overall performance of national policy and strategy. Such an approach might form part of a capacity development programme designed to complement not only a GBS programme but also other programmes. In effect, given that analysis of the National Statistical System touches areas that are of particular importance to all aid financing modalities, it is important to ensure coordination with other donors, and have a focus that is not limited solely to the interests of budget support (see Annex 2.4).

Box 6.10: Agreeing indicators and targets

Financing Agreements should be explicit about performance measurement systems and the targets that have been agreed for performance indicators used for the disbursement of tranches for at least a period of three years.

With respect to *performance measurement systems* the aim should be that the Financing Proposal/Action Fiche should include a phrase such as "The analysis of the proposed performance indicators set out above and in more detail in […specify the annex…] shows that they are of sufficient quality to provide a basis for using them as criteria for the disbursement of budget support"

With respect to *changes to agreed targets and indicators* the following text is suggested: “The Performance indicators and targets set out in […specify the Table(s)…] will apply for the duration of the programme. However, in exceptional and duly motivated cases, a request for modifications of targets may be made by […name of the partner country body responsible for making such a request…] to the responsible Commission Authorising Officer and the exchange of letters between the two parties shall give effect to any agreed modification in indicators and targets”

- ***The method of performance evaluation***

Once the indicators have been chosen, and the targets established, it is important to set out the method for performance evaluation. It is in the establishment of the method of performance evaluation that will determine whether a fixed tranche is disbursed in whole or not at all; or in the case of a variable tranche, the amount of the variable tranche that is disbursed.

In the case of a **fixed tranche** it will be normal to require all conditions to be met for the tranche to be disbursed. In the case of a fixed tranche that involves carrying out certain measures it should be clearly stated whether the measures need to be fulfilled by a given date, or whether the date of fulfilment "floats", thereby giving time to the partner country to fulfil the conditions.

In the case of a **variable tranche**, the approach involves combining two factors:

- an “individual performance score” based on the degree of performance of a given indicator; and
- a weight given to the same indicator in relation to the overall set of indicators used in the variable tranche (the sum of all weights being equal to one).

Figure 6.1: Determining the Overall Performance Score

Overall Performance Score = **SUM OF** { **Individual performance Score** X **Weight of indicator in all indicators** }

The sum of these two factors will give the “overall performance score” which is then used to determine the percentage of the available variable tranche that will be disbursed. Figure 6.1 above presents this approach. There are many ways in which this approach might be used in practice, and Annex 1.13 provides further information. However, it is suggested that the scoring system be kept as simple as possible in order to avoid difficulties in understanding and interpretation.

Whether using fixed or variable tranches, there are often unexpected or unanticipated events that are beyond the control of the partner country which could adversely affect the fulfilment of the conditions for disbursement. Given this possibility it would be reasonable to include in any Financing Proposal/Action Fiche a reference to the fact that partner countries can make requests for the "neutralisation" or "waiver" of performance criteria and indicators in cases where exceptional events or changing circumstances have prevented meeting previously agreed targets. The nature of these exceptional events or changing circumstances might be mentioned, taking into account the particular specificities of each country.

6.5 Complementary support to the budget support operation

Complementary support covers issues such as audit, monitoring and evaluation, and institutional and capacity development. This section only considers the issue of institutional and capacity development, whereas audit, monitoring, and evaluation are considered in Chapter 8.

It has to be recognised that achieving sustainable results it the area of institutional and capacity development is amongst one of the most difficult aspects in development cooperation. Institutional and capacity development[1] must be seen as a country-led, endogenous and long-term process. Donor support to such processes is only likely to produce significant and sustainable results as long as there is sufficient domestic political leadership and commitment to change.

Box 6.11: OECD Good Practice Guidance: directly supporting the capacity development of partner PFM systems

The OECD Guidance states: Budget support should directly encourage improvements in partners' PFM systems, including transparency and accountability to partner countries' legislature and civil society at large. This can be done in alignment with countries' reform strategies through the inclusion of specific conditionality and the provision of targeted technical assistance. Increasing the involvement of a partner country's auditing institution in PFM assessments and conducting *ex post* audits may also prove useful.

Source: *Harmonising Donor Practices for Effective Aid Delivery, Volume 2,* OECD-DAC, para 15

To limit the risk of an approach focused on a shopping list of "needed" inputs, it is therefore recommended that a structured dialogue and a phased approach involving all main stakeholders be undertaken in the country so as to reach broad agreement on the nature of any institutional and capacity development support. Some key steps in assessing institutional and capacity development include the following[2]:

- *What are the organisations and actors to be supported?* Based on the objectives of the budget support programme, the organisations and actors can be identified. In the case of budget support this might include the Ministry of Finance, the Supreme Audit Institutions, the National Statistical Organisations, Parliament and its finance committee, organisations in charge of PRSP monitoring, and non-state actors involved in public financial management issues. Focus should be on existing organisations, and support to ad-hoc organisations to meet the specific needs of donors should be avoided.

- *What specific key outputs are required in priority?* What specific outputs and what change in outputs (products and services) could any required support bring about within the specified timeframe.

- *What is the institutional and regulatory framework?* A necessary steps includes the analysis and evaluation of the institutional and regulatory framework, looking at for example at the overall constitutional, legal, and regulatory framework within which organisations have to

[1] *Capacity development* denotes the *process* by which a country manages to make better use of existing capacities and to further develop capacities of its people and institutions to perform functions, to solve problems, and to set and achieve objectives.

[2] See *Institutional Assessment and Capacity Development – Why, what and how?*, European Commission, September 2005

function. In addition at the level of the organisation it is necessary to understand the organigramme and mission statement.

Box 6.12: Using audits of internal control systems as a tool for capacity development

When the upgrading of internal control systems is on the PFM reform agenda and the partner country expresses their need to be supported in this area, the EC can provide finance for an audit limited to an analysis of the internal control systems since this can be a useful tool for capacity development.

An audit of internal control systems gives an opinion on the quality and effectiveness of the internal control systems put in place by the audited entity, documented in particular by means of *tests of control*[1] This type of audit will determine the extent to which the internal control systems of the audited entity are: (i) conceived so as to provide protection against the risk of mismanagement and fraud identified in different areas (such as financial management, accounting, and safeguarding of assets), and (ii) operating effectively, continuously and consistently. In other words this audit tells us whether the internal control systems are properly conceived and functioning – they do not give an opinion on the financial statements produced by the audited entity.

As internal control systems touch on many issues related to public financial management,[2] their strengthening is habitually high on the agenda of PFM reforms in partner countries. Normally the reflection on internal control systems should be driven by the Ministry of Finance and particularly the entity in charge of supervising the internal audit function (for example, the "*Inspection Générale des Finances"* in Francophone Africa or Internal Auditor in many Anglophone countries), but also by the Supreme Audit Institution (SAI) which has an obvious interest in seeing the internal control systems upgraded. In many of those countries, however, the Internal Auditor as well as the SAI frequently lack the necessary capacity and resources to conduct an in depth reflection on the reform of internal control systems. If it is the case, an externally financed audit of internal control has the potential of being a tool which can help to strengthen and spur the reflection of the partner country in this field. This positive perception will be strengthened if the audit, taking into account the local context, involves the Internal Auditor and/or the SAI. Annex 2.2 gives further information.

- *What resources do the organisations and actors have at the moment?* Amongst the first analyses, and before considering spending additional financial resources, it is recommended that a comprehensive review of all funds (recurrent expenditure including wage bill, capital expenditure, and revenue sources) available to the organisations be conducted, and that an assessment on the use of such resources be obtained from and discussed with the main stakeholders/users as well as with internal and external auditors.

- *What is the existing organisational capacity?* The assessment should look at the implementation capacity of the organisations to deliver on existing commitments (for example, as established in mission statements), and the capacity of its staff, to sustain such results as well as take on new roles and responsibilities.

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[1] An audit of internal control systems is in fact the first stage of a financial audit carried out according to the system based approach (SBA) to audit and does *not* lead to give an opinion on the financial statements (reliability of accounts and legality and regularity of underlying transactions). The INTOSAI auditing standards foresee two types of approach to carry out a financial audit : (i) the systems based approach (SBA) which includes two stages: an evaluation of the conception and effectiveness of the internal controls, based on tests of controls + an opinion on the financial statements based on substantive testings, (ii) the direct substantive testing approach (DST) whereby the auditor reduces to the minimum the analysis of the internal control systems, does not carry out tests of control and resorts directly to substantive testing to give an opinion on the financial statements.

[2] Internal control systems deal with every key aspect of PFM: management of the chain of expenditures, personnel , accounting and reporting, assets…

In any GBS operation, the examination of PFM weaknesses is likely to lead to the development of actions in the area of public financial management and related capacity development needs. These could touch on the Ministry of Finance, sector ministries, the Supreme Audit Institution, or Parliament. Wherever actions are planned it is important of the effectiveness of the intervention to ensure that they form part of an overall programme.[1] One possible way to help move from an identified general weakness[2] to concrete capacity development plans it the use of system audits of internal control systems. Box 6.12 below provides further information on this possible approach.

In the Financing Proposal/Action Fiche it is important to demonstrate that **any proposed actions of support for institutional and capacity development are consistent with the diagnosis undertaken and that the support, in coherence with the support and actions of others, is designed to address the priority issues identified**. Furthermore, in considering any proposed actions careful thought needs to be given to deciding whether it would be more appropriate to prepare a separate "capacity development" project or programme, in coherence with, but outside the main GBS operation (see Annex 1.11 for further details).

6.6 Conclusion

In conclusion, based on the information above, and taking into account that circumstances vary from country to country so it is always difficult to specify the main features of a good Financing Proposal/ Action Fiche and Financing Agreement, but some pointers include the following:

- *Eligibility criteria are met.* It should be clearly shown that the country meets the eligibility criteria related to national policy and strategy, macroeconomic framework,, and public financial management;
- *Link between diagnosis and disbursement criteria and indicators.* There should be a clear link between any diagnosis and the indicators chosen for disbursement of tranches. For example, indicators chosen in the area of public financial management should be related to the diagnosis of problems in the area of public financial management.
- *Link between diagnosis and support to capacity development.* There should be a clear link between any diagnosis and any capacity development and institutional support to be provided. For example, the actions proposed in terms of public financial management should reflect the analysis of the problems in this area.
- *Clear and unambiguous general and specific conditions for disbursement.* Conditions for disbursement, whether general or specific, should be clearly and unambiguously stated.
- *Clear definitions for performance criteria and indicators.* The definition, sources, methodology, timing, of any performance criteria or indicator used for disbursement purposes should be clearly stated
- *Clear method of performance evaluation.* The methodology for deciding whether disbursement can proceed should be clearly stated, with scoring systems and weighting of performance indicators clear.
- *Timing of programme should be realistic.* The timing of the steps to be followed should be clear and realistic – avoid short time periods between supply of information and disbursement, and allow sufficient time for decision to be taken
- *Be clear on who does what.* It should be clear who does what and when, and with what resources. For example, that the partner country is responsible for supplying information required to assess whether disbursement criteria and indicators have been met.

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[1] The *Paris Declaration on Aid Effectiveness* has a number of indicators of progress in this area. First, "Percent of donor capacity-development support provided through coordinated programmes consistent with the partners' national development strategies". The EU has an additional commitment "to provide all capacity building assistance through coordinated programmes with an increasing use of multi-donor arrangements"

[2] As identified, for example, in the relevant PEFA PFM-PMF indicators.

7 IMPLEMENTATION

Implementation will usually concern two main areas: (i) monitoring and pursuing dialogue during implementation on key areas such as national policy and strategy, the macroeconomic framework, and public financial management; and (ii) reporting to headquarters on these issues. Recommendations and decisions on tranche releases which are key actions in the implementation are covered in chapter 7 below.

7.1 Monitoring and Dialogue with partner country during implementation

All GBS operations will include both formal and informal processes of policy dialogue which are essential for the proper monitoring of the progress in implementing national policies and strategies, the macro-economic framework, and improvements in public financial management. As mentioned above the choice of performance criteria will very much influence the nature of the dialogue and its possible focus on some specific issues. There is no simple recipe or standard formula on how this dialogue with national authorities and other donors should be managed but some good practice principles that have emerged in recent years include:

- *Monitor and assess disbursement criteria.* The Financing Agreement will contain the general and specific conditions that are used as disbursement criteria. Key actions will include:

    - *Monitoring* the disbursement criteria, and on the basis of information supplied by the partner country, make an assessment as to whether those disbursement criteria have been respected. Much dialogue will focus around the disbursement criteria, so they also provide an opportunity to ensure a wider debate – with the partner country, other donors, and non-state actors – on the issues addressed by these criteria.

    - *Assessing performance indicators:* carry out an **ex-post diagnosis of the indicators that are being used for disbursement purposes** (see Annex 2.5)

    - *Joint diagnostics:* make use of joint diagnostics to help monitor and assess performance in relation to disbursement criteria. Joint diagnostics can be particularly useful in promoting dialogue around key issues of national policy and strategy.

- *Coordinate actions with national procedures and timetables*. In the process of monitoring the implementation of a programme and in the process of dialogue with the partner country it is important to ensure that the process builds on existing national procedures and timetables. Thus key points in monitoring and dialogue will be built around the annual budget calendar – For example, on the basis of a planning phase, the implementation phase, and the reporting and accounting phase leading to accounts closure. For each of these phases there are likely to be key dates set out in a budget law or equivalent, and they provide the framework for ensuring that the monitoring and dialogue associated with a GBS operation is aligned with the partner country's own procedures.

- *Use a Joint Donor Agreement to structure dialogue with partner country and other donors*. Such joint donor agreements are currently in place in a number of countries. Their main objective is usually to have a formal agreement between donors and beneficiary governments on the structure, timing and content of the dialogue, to clarify respective expectations against key objectives, to strengthen donors' coordination, foster their alignment on national processes, and to harmonise conditions for disbursement. Most arrangements are not legally binding and can never overrule the provisions of donors' bilateral formal agreements such as the EC's financing agreement. A study carried out in the context of the SPA framework has identified a number of best practices in this field (see annex 1.10 for further information).

- *Promote a virtuous cycle of ownership and accountability.* Ownership involves government responsibility and therefore pressure to produce results, which should over time produce better policies, better spending, and better government so as to meet those results. The fulfilment of this objective implies the gradual promotion of participation by other key stakeholders such as Parliament, local governments or non-state actors all along the process of implementing budget support and at key moments in the joint government/donors reviews of budget support. Ownership calls for promoting domestic processes or accountability related to budget preparation, implementation, and accountability, such as discussion of National audit office reports through public hearings within parliament or its specialist committees. In addition ownership calls for choosing relevant performance criteria and indicators, and selecting only those officially monitored by the government itself in the implementation of its national policy and avoid creating a parallel monitoring system by alignment of joint reviews on domestic monitoring process (PRSP or sectors reviews).

- *Develop team work within and outside the Delegation.* Good communication and team work is required for all projects and programmes, but perhaps more so for budget support operations since they are likely to touch on a number of issues that are frequently addressed separately. The need for teamwork will be especially important for sector dialogue during annual reviews, where those working on general budget support can take advantage of work usually followed by others. The use of the "Road Map" (see section 5.2) could be particularly useful for strengthening teamwork within Delegations and between Delegations and headquarters. Frequently, drawing on the Delegation's own human resources may not be necessary to cover all relevant issues and in these circumstances good collaboration with other donors, in particular Member States, may provide useful information, especially at the time of sector dialogue during annual reviews.

- *Pay attention to visibility.* It is important when implementing a budget support programme to ensure that sufficient visibility is given to the approach and work of the EC. However visibility in the case of budget support is bound to take on different aspects when compared to visibility in the case of projects, since it is difficult to attach an EC flag to any particular physical investment. Elements of an approach to visibility might include:

    - *define your audience* – for example, is it citizens of the partner country, donors, the public in Europe?

    - *define the act/event that creates the visibility* - for example, a signing ceremony, press conference at an annual review or tranche release decision, visits to facilities "supported" by budget support, documents, brochures, displays, that try to popularise and provide information on the budget in the country;

    - *put in place complementary/medium term actions* that build understanding of the EC approach - for example, creating involvement around the process of programme preparation and implementation through consultations with Non-state actors, donors, and parliament.

7.2 Mobilising and implementing Complementary Support

Long- and short-term technical advice to support and complement the institutional and capacity development in the beneficiary country can be provided using EC procurement procedures. Good preparation in this area, and close follow-up of all the procedural matters is important to ensure successful use of the funds available. The areas normally covered by different forms of technical advice include:

- advice on specific design features of a budget support operation mostly during the preparation process;

- assessment of public financial management (PFM), to be undertaken in advance of the drafting of the Financing Proposal/Action Fiche and updated during implementation, notably the use of the PEFA PFM-PMF;

- assessment of performance monitoring systems, and if appropriate National Statistical Systems;

- annual assessment of progress made in the area of public financial management;

- technical support to for capacity development, for example: public financial management, national statistical authorities, supreme audit institutions, parliament, including, where appropriate, via twinning arrangements.

It is strongly advised that in designing support to institutional and capacity development that the discussion on the modalities of support follow the shared undertaking of an analytical process already highlighted in section 6.5 above and reviewed further in Annex 1.11.

7.3 Reporting to Headquarters

As with any other aid programme, GBS operation will call for due reporting by the Delegation to HQ. Delegations will be expected to make the regular reports on their activities – for example the “Implementation Report” in CRIS and the External Assistance Monitoring Report, for which guidance has been issued. In addition to these two general reporting tools, Delegations are expected to provide HQ with timely and accurate information on the overall macro-economic and PFM evolution

7.3.1 Economic Reports

Delegations are already expected to produce on a regular basis – at least quarterly – economic reports (and send them to AIDCO and RELEX/DEV) which cover the country's macro-economic situation and outlook, as well as structural changes and other major economic, financial, and social developments.[1] For these reports, good use should be made of existing information in this area. For example, IMF and World Bank missions and reports, economic reports produced by the Ministry of Finance, the budget as well as reports on budget implementation, economic reports produced by the Central Bank, economic statistics produced by the Ministry of Finance or Statistical Authority, multilateral surveillance reports for countries involved in economic integration, economic reports produced by other donors, economic reports produced by local academic and research bodies. The results of this monitoring work should be summarised in an economic report that should assess the macroeconomic situation and outlook, by looking at major economic and social indicators, the performance of the budget, and structural changes. It is suggested that Delegations should take advantage of these reports to cover

7.3.2 Annual Report on Public Financial Management.

The Delegation has an obligation to produce an “Annual Report on Public Financial Management”[2] which must be sent to AIDCO and DEV/RELEX. The report should respect the following features:

- *Produced once a year.* In principle it should be produced in line with the country calendar – for example, following an annual review of programme implementation. In the absence of such a calendar the report should be produced by end-February each year.

[1] The Quarterly Economic Report is a requirement set out by the RELEX Directors General “Guidelines for Reporting”, Note No 111160 of 20 June 2002

[2] This annual report is the only additional report that Delegations are expected to produce on a systematic basis when budget support is being used.

- *Use to monitor and ensure a structured dialogue around PFM.* This report is required because it is important that Headquarters and Delegations, after the signature of Financing Agreement, maintain a regular structured dialogue on the PFM situation in the partner country. Its main purpose is to check whether the PFM situation of the country shows a satisfactory trend so as to confirm its continued eligibility to budget support. In this respect the Delegation must take a clear position in the report.

- *Format is based on Annex to the Financing Proposal/Action Fiche.* Beyond this key aspect, the report is, from a practical point of view, an update of the PFM information which has been included in the Financing Proposal/Action Fiche (and subsequent Financing Agreement). The format to be followed, apart from some details, will be similar to that used for the annex on PFM of the Financing Proposal/Action Fiche (see Annex 1.7 for further details). The report can use many sources of information: for example, a new PEFA PFM-PMF assessment, the annual review of the PFM performance indicators of a variable tranche, results of an audit, or regular policy dialogue on PFM.

- *Valid for at least six months.* Once the Annual Report on Public Financial Management has been prepared **it is considered as valid for at least six months for all disbursements that require satisfactory trends in public financial management** (for example, a SPSP using budget support as the financing modality). Should the period of six months be exceeded, then it will **not** be necessary to produce another report on PFM, however supplementary comments and observations on any pertinent developments since the last Annual Report on PFM will be necessary.

7.3.3 Early Warning System

As part of the process of monitoring, the Head of Delegation should report if any major problems arise, or are likely to arise, that could impede the smooth implementation of the GBS programme. For example, slippages on national policy and strategy, macroeconomic management, budget implementation, and public financial management. The Head of Delegation should not wait for the quarterly Economic Report, or the annual Public financial management report to draw the attention of AIDCO and DEV/RELEX to any particularly important issues. The use of the early warning system is especially important should issues come to light between the recommendation by the Delegation for a tranche release decision, and the approval by the relevant Director.

8 EVALUATION AND AUDIT

8.1 Evaluation

One of the major difficulties with evaluating budget support is that, by virtue of the fact that budget support resources are "mixed" with other resources in the treasury account of a government, it is not possible to identify or attribute certain "outputs" with certain "inputs", as is the case when using EC procurement procedures. There is consequently an "attribution" problem with evaluating budget support (although attribution problems also exist with projects – notably when looking at "results/outcomes" and "impacts").

Evaluation is concerned with the extent and under what circumstances budget support is relevant, efficient, and effective in contributing to achieving sustainable impacts in the areas which are the focus of the objectives of budget support (typically national policy and strategic objectives such as poverty reduction, growth, but also other objectives such as improvements in public financial management).[1]

An evaluation will be expected to identify evidence, best practice, lessons, and recommendations regarding to what extent, how, why, and when budget support has either contributed to reaching and/or could contribute to reaching intended objectives. As such an evaluation goes beyond monitoring of implementation, which aims to identify whether budget support inputs have been delivered as expected and in accordance with the calendar and conditions set.

The results of an evaluation are expected to feed into (i) the implementation of future budget support operations; (ii) possible changes in policy, approach, and/or methods; and (iii) to support decisions on the circumstances when/where budget support is an appropriate and relevant instrument. Therefore the most suitable time to undertake an evaluation would be the programming phase following the implementation of a series of budget support programmes, or whenever any actor involved (EC, partner country, other donors) feels that there is a need to review policy, methods or approach.

In spite of some of the complications of evaluation and budget support, there are nevertheless many evaluation questions that can be addressed. Evaluations often revolve around a series of "evaluation questions". In the case of budget support many plausible answers can be given to these evaluation questions. For example on relevance, harmonisation and alignment, on increases in public expenditure, on public financial management, on policy making, on macroeconomics, and on service delivery.

No specific, widely recognised, standard methodology for the evaluation of budget support operations has been developed. An evaluation framework was, however, prepared in 2004 and refined in 2005, on the basis of the standard OECD DAC criteria (relevance, efficiency, effectiveness, sustainability, and impact). It presents successive level of inputs, intermediate effects, outputs, outcomes, and impacts, so that causal assumptions can be spelled out and tested. It has been applied and tested on budget support provide to seven countries as part of a joint evaluation of general budget support. As for methodology of evaluation, a number of conclusions can be drawn [section to be modified in light of Note on Approach and Methods still to be produced by the evaluation team]:

- *Budget Support by its very nature call for joint evaluations.* The logic of budget support that in effect pools a donors resources in the treasury account with the resources transferred by other donors, as well as the government's resources suggests that evaluation should be carried

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[1] See the "Evaluation in the European Commission", Evaluation Unit, AIDCO, March 2001; see also "Evaluating EU Activities: a practical guide for the Commission services", DG Budget, July 2004

out not only in close collaboration with other donors, but also in close collaboration with the partner country, as well as non-state actors

- *Causality links need to be examined on the basis of evidence.* The evaluation needs to consider the causality links between the inputs up to impacts. It is important to rely on evidence to ensure objectivity and difficulties in this area mean that expectations need to be realistic.

- *Preparation of the terms of reference and identification of an experienced evaluator* are important steps. The evaluation should be initiated by the partner country, the EC Delegation, or by another lead donor and be carried out by independent evaluators. The Delegation should work closely with the thematic and evaluation units of AIDCO in preparing the terms of reference.

- *The timing of an evaluation should allow for conclusions to be taken on board.* Evaluations need to be timed in advance of the conclusion of an existing budget support operation and before the start of a subsequent operation. Careful consideration needs to be given to the timing of such evaluations to ensure that any conclusions can be taken into account as soon as possible in the design of a subsequent programme.

8.2 Audit

The use of traditional audits in budget support operation will depend on the disbursement method being used – whether the budget support is targeted or untargeted. By traditional audits is meant "financial" audits, as distinct from the wider class of audits that are frequently used, such as performance audit, value for money audit, and organisational audit.

8.2.1 Audits in the framework of targeted budget support programmes

Traditional audits are, so to speak, “consubstantial” with targeted budget support as the Financing Agreements generally make them mandatory by including them in the disbursement conditions. In this sense the requirement to carry out an audit is a condition for disbursement.

The main purpose of these audits is as a criterion for the disbursement of targeted budget support. The audit should be carried out ex ante (before the disbursement of EC funds is made) and the amount of budget support will be determined by the results of the audit[1]. The use of targeted budget support will involve the following steps:

- the identification, jointly with the partner government, of the budget lines to be targeted;

- the verification of spending against these agreed budget lines through a formal financial and procedural audit of expenditure data and supporting documentation necessary for the auditor to give an *opinion* on the amount of targeted budget support to be provided;

- disbursement of budget support, using the conclusions of the audit as the justification for making the budget support payment (this can also be seen as a reimbursement of verified spending).

Annex 2.3 provides standard Term of Reference for the planning and execution of audits in the framework of targeted budget support.

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[1] In the past it was possible to “clear” advances of budget support against supporting documents. However, in accordance with the new financial regulations this possibility no longer exists since the method of implementation of budget support is “centralised direct” leading to no further checks on the use of funds once transferred.

8.2.2 Audits and untargeted budget support

The use of financial audits in the context of untargeted budget support is a more complex issue. It needs to be recalled that the objectives of a financial audit are: (i) to assess the accuracy and completeness of the financial statements of the audited entity; and/or (ii) to ascertain whether the transactions underlying the financial statements are legal and regular.[1] In other words the purpose is, on the basis of substantive testing, to formulate *an opinion* on the financial statements. In this context three principles can be stated:

- *The EC does **not** carry out financial audits of untargeted budget support*. Once disbursed to the national Treasury, these funds are fungible and it is no longer possible to trace the "use" of EC funds. It is therefore not possible to carry out an audit of "EC funds".

- *Audit of national accounts should be carried out by the Supreme Audit Institution* or equivalent of the partner country. It is the responsibility of the authorities of the partner country to carry out audits of national accounts, whatever the source of revenue/financing – tax, non-tax, and grants or loans. Formulating an opinion on the accounts of a partner country is by its nature an eminently political act that can only be carried out by a national institution endowed with the necessary legal and political legitimacy, in practice the Supreme Audit Institution (SAI) or equivalent.

- *EC audits of budget support operations are possible up to the point where the funds are transferred to the national treasury of the partner country.* It is quite normal given the "centralised direct" method of implementation of budget support (See Chapter 9), that audits should be carried out to ensure that the EC has respected the financial and procedural rules laid down in its regulations and in the Financing Agreement, *up to the point* where funds are disbursed to the national treasury account. This is the mandate of the European Court of Auditors as part of its worked linked to its annual declaration of assurance.[2]

8.2.3 Audits and PEFA

Audits might sometimes be used to examine internal control systems to provide evidence on PEFA scores. PEFA assessments deal, through some indicators (for example PI-18, PI-20, PI-22) with internal control systems. In its Special Report 2/2005 the European Court of Auditors has stressed the fact that to conclude that internal control related PEFA indicators are not only strong on paper but also strong in practice, can only rest on the findings of tests of controls (which are actually the last step of an audit of internal control systems). In other words a positive note (A or B) given to these indicators should be justified by tests of controls aiming at giving evidence of the effectiveness of these systems.

Consequently this means that, if this positive note is not backed by tests of controls, the EC could envisage different courses of action, such as: (i) carry out a specific exercise in between the PEFA assessments; or (ii) to include tests of control as part of the contract of a subsequent PEFA assessment. Whichever option is adopted, they would have to be agreed in consultation with the partner country, the SAI, and other donors involved in the PEFA assessment.

Finally is worth recalling that, whatever course of action is envisaged, the financing of an external audit of internal control systems is an option which requires in all cases the agreement of the partner country and should preferably be carried out in collaboration with the SAI. Such an audit will be financed under the "complementary support" section which is normally included in any Financing Agreement (see Section 6.5).

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[1] See *European Implementing Guidelines for the INTOSAI Auditing Standards,* European Court of Auditors, 1998

[2] Commonly referred to by the French acronym, DAS – Déclaration d'assurance

9 PROCEDURES FOR PREPARING AND IMPLEMENTING BUDGET SUPPORT

9.1 Responsibilities throughout the cycle of operations

Following completion of programming, it is the responsibility of Delegations to organise the identification and formulation of GBS programmes (see Annex 1.2 for the division of responsibilities between headquarters and Delegations). There may be the opportunity of missions of support from headquarters, but these would need to be planned in advance and should not be assumed. In contrast support from headquarters on particular issues that arise during the process of identification and formulation should be expected. This process of preparation by Delegations is backed up by two formal steps whereby documentation form the Delegation goes through the AIDCO Quality Support Group – QSG(1) for the Identification Fiche, and QSG(2) for the Financing Proposal or Annual Action Programme/Action Fiche[1]

9.2 Identification and Formulation: procedures

The manner in which most procedural questions are approached projects/programmes does not differ between budget support and other aid instruments. The interservice agreement, June 2001, between AIDCO, DEV and RELEX sets out the framework of responsibilities on procedural matters covering: (i) identification (point 2.2); (ii) financing (point 2.4); and (iii) and implementation (point 2.5). The area of disbursement is one area where budget support is treated differently from other projects and programmes: point 2.5.3 states that "…the proposal or decision to disburse or not would be made by AIDCO after prior consultation of DG RELEX/DEV…". In other areas there is no requirement for prior consultation with DG RELEX/DEV.

9.2.1 Road Map

There is no procedural requirement to have a Road Map, but a well prepared Road Map can be very practical instrument to move programme preparation in the right direction (see Chapter 5 for details). It might also be appropriate to establish each year a "road map" of activities that need to be undertaken over the coming years in the area of budget support.

9.2.2 The Identification fiche

For each programme an identification fiche is to be prepared (see Annex 3.2). Programming documents will normally include a date or time period for the establishment of the identification fiche and the finalisation of the Financing Proposal/Action Fiche. The information in the Identification fiche would normally cover issues related to the proposed objectives, consistency with programming objectives and EC policy, eligibility criteria, the amount foreseen and indicative timetable, and other information available according to the state of programme preparation, and next steps to complete formulation.

The identification fiche is also important because it forms the first document that is shown to the QSG(1) (organised by AIDCO, but with the participation of RELEX and DEV) for discussion and approval. The QSG(1) could decide, if necessary, to require the re-submission of the Identification Fiche before agreeing to the proposed GBS programme.

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[1] The term "Financing Proposal" is used for actions financed under the 9th EDF; for other actions the terms used are Annual Action Programme/Action Fiche. Although the names differ the areas covered in each document are for all practical purposes the same. See Note No 28944 of 13 August 2004 for actions financed under the 9th EDF; and Note No 31179 of 21 December 2006 for other actions.

9.2.3 The Financing Proposal/Action Fiche – essential elements of the Commission decision

Following the identification fiche and in accordance with the agreements reached in the QSG(1), formulation will lead to the preparation of a financing proposal to be submitted for "avis" to the Management Committees of each instrument[1] (see Annex 3.3).

- **For the ACP countries** a *Financing Proposal* is prepared for *each individual programme* at the time when the programme is sufficiently mature to be presented to the Member States in the respective Financing Committee. Proposal for financing are therefore presented at different times during the year.

- **For other countries covered by the DCI and ENPI,** the practice is the presentation once a year of an *Annual Action Programme* which for each country summarises in particular the strategic framework. In addition for each project or programme an *Action fiche* is also prepared.

There is a distinct format for the Financing Proposal/Action Fiche for general budget support (see Annex 3.3 for further details)

In line with the principle that the Financing Proposal/Action Fiche should form the basis for a financing decision (and is attached to the financing decision), it should contain only the "essential elements" (see section on financing decision below), and it is not necessary to provide all the detailed information on all aspects of the programme.

However, in the area establishing indicators and setting target, particular care must be taken to ensure that not only the indicators and targets are specified (for example that the "vaccination rate target for year 200X, 200Y, and 200Z will A%, B%, and C% respectively"), but also that a clause is included that allows modifications to be made to these indicators and targets should an agreement be reached between the partner country and the responsible Commission Authorising Officer.

9.2.4 The Financing Decision

Following the "approval" of the proposal for financing by the relevant Management Committee, the Financing Proposal/Action Fiches serve as the basis for a Financing Decision adopted by the Commission.[2] In principle, the Financing decision should contain only the "essential elements"[3] of a programme. As the Financing Proposal/Action Fiche contains at least these elements (due to the fact that the Financing Proposal/Action Fiche is attached as an annex to the financing decision), no additional programme related information is provided in the Financing Decision beyond that already provided in the Financing Proposal/Action Fiche considered by the Financing Committee[4].

At the moment (March 2006) the financing decision is taken in accordance with the empowerment procedure for ALA, EDF, and EPRD; and by written procedure for MEDA. (In some cases it may be appropriate to delay the financing decision, on the basis of an agreement with the financing committees that a decision will only be made if some prior actions are carried out.) In general, the

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[1] See http://www.cc.cec/dgintranet/europeaid/special/financial_perspectives/overview_instruments_en.htm for further details.

[2] See http://www.cc.cec/dgintranet/europeaid/special/financial_perspectives/overview_instruments_en.htm for further details.

[3] See Article 90 of the Implementing Rules of the Financial Regulation, Commission Regulation No 2342/2002 of 23 December 2002, where it is states that "The financing decision shall determine the essential elements of an action involving expenditure from the budget"

[4] Additional information required for making a financing decision is however provided such as the legal basis for the decision, the budgetary implications of the decision, and the opinion of the Financing Committee.

Financing Decision is adopted in the two weeks following the submission of the Financing Proposal/Action Fiche to the appropriate committee.

9.2.5 The Financing Agreement – the legal agreement with the partner country

Following the Financing Decision a budgetary or financial commitment for the funds involved is made.[1] Such a commitment is a precondition to the signing of the Financing Agreement.

The Financing Agreement itself consists of three parts: (i) the Special Conditions; (ii) Annex I the General Conditions; and (ii) Annex II, the Technical and Administrative Provisions. For the Special Conditions and the General Conditions a standard format is to be used for all instruments, whether the resources come from the Budget or the EDF[2] (see Annex 3.4 for further details). Key features of the Financing Agreement format are:

- Budget Support Financing Agreements will usually include, at the same time, two ways of providing financial support: (i) budget support itself (which will be the main part of funds made available); and (ii) "complementary support" covering capacity development and institutional support, monitoring, evaluation and audit.

- For the application of the financial regulations[3] to the use of budget support[4]:

    - the method of implementation budget support is "centralised direct" for both the budget and the EDF;
    - the financing agreement constitutes the individual legal commitment for making payments of budget support;
    - the rule D+3 (date + 3) that specifies that all contracts implementing a financing agreement (except audit and evaluation contacts) must be concluded not later than three years following the date of the budgetary commitment does not apply to budget support operations since there is no additional implementing contract with the Financing Agreement constituting such a contract[5] as such in budget support operations;
    - all requests for the disbursement of tranches of budget support must be made before the end of the "operational implementation phase" as specified in the financing agreement.

- Exchange rate to be used is specified in the Special Conditions. It is important that there should be no ambiguity about the exchange rate to be used.

- Within the TAPs or in an annex to the TAPs it is important to specify in full the criteria for disbursement. The Financing Agreement is the legal contract between the Commission and the beneficiary country and therefore it is appropriate that the Financing Agreement contain these provisions (see below on implementation for modifications).

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[1] For the Budget the term "budgetary commitment" is used; whereas for the EDF the term "financial commitment" is used.

[2] See the Deputy Director General's letter No 12890 of 10 May 2004

[3] *Financial Regulation applicable to the general budget of the European Communities and its Implementing Rules* (As of October 2006, Council Regulation No 1605/2002 of 25 June 2002 and Council Regulation No 2342/2002 of 23 December 2002, as modified by *Commission Regulation 1248/2006 of 07 august 2006* amending Regulation 2342/2002 of 23 december 2002, and *Financial Regulation applicable to the 9th European Development Fund*, 27 March 2003.

[4] See annex to the Deputy Director General's letter No 12890 of 10 May 2004

[5] Nevertheless in the accounting system, the individual financial or budgetary commitment(s), allowing payments to be made must be entered within the period "D+3"

- In some cases it may be the case that signature of the Financing Agreement can only take place once a number of preconditions for signing have been met

Box 9.1: Exchange Rates for budget support
Usually the following provision is inserted in Article 9 of the Special Conditions: "The State of the Beneficiary undertakes to apply its national foreign exchange regulations in a non-discriminatory manner to the payments made under this financing agreement. The foreign exchange transfers will be accounted for under the value date of the notification of credit to the account of the Central Bank opened for this purpose. The exchange rate will be the average rate of the interbank foreign currency market on the value date of the notification of credit"[1].

9.3 Implementation: procedures for making a payment of budget support

Payments of budget support tranches are based on the principle that partner countries make analysis and requests, Delegations analyse these requests and prepare the consequent payment dossier; and that headquarters assess the request and the Delegation's analysis. If the conditions are confirmed to be fulfilled the AIDCO Director concerned signs the payment decision and instructs the Delegation to proceed with payment. At the end of the process, the Delegation makes the payment. In detail the process can be described in the following steps:[2]

- **Request for tranche release by the beneficiary country**. On the basis of the conditions for disbursement set out in the Financing Agreement the benefiary country has to make a formal request to the EC Delegation for tranche release covering:
    - the fullest possible analysis and justification for the release of funds, including supporting documentation which should be annexed;
    - a duly signed *Financial Identification Form* in order to facilitate subsequent payment (see below for further details).[3]

- **Analysis of tranche release request and preparation of "payment dossier" by the EC Delegation.** The Delegation should analyse the request and prepare the "payment dossier" on whether the conditions set out in the Financing Agreement for tranche release have been fulfilled. The analysis by the Delegation should be as full and complete as possible and **the Head of Delegation should state clearly their recommendation on disbursement, or otherwise**. The "payment dossier" would normally include:
    - copy of request by the beneficiary country (including any annexes);
    - analysis by the Delegation of the request made by the beneficiary country. For this purpose the Delegation must set out clearly the "conditions for disbursement", "Analysis of the situation in relation to each condition" and "sources of information" including cross-referencing to relevant annexes. For each individual condition for

[1] This standard wording may be adapted in agreement with the practices of the Central Bank of the Beneficiary country. In case of indirect budgetary aid, targeted or non targeted, and of a currency facility, in a country where the local currency is not convertible, an ad-hoc wording will replace the second sentence of article 8.2.2 and will be based on the modalities of functioning of the foreign exchange market in the Beneficiary country and the practices of the Central Bank of the country

[2] **The procedures set out below may be subject to change, so it is always important to consult the latest information on the Financial Circuits applicable to the budget and to the EDF**. See: http://www.cc.cec/EUROPEAID/contfin/budget_procfincont_en.htm (for the budget) and http://www.cc.cec/EUROPEAID/contfin/fed_procfincont_en.htm (for the EDF)

[3] The Financial Identification Form should be provided whenever there is a change in bank account to which funds are to be transferred. If during a single programme, the same bank account is used, it would be sufficient to provide a photocopy of the original Financial Identification Form.

disbursement the Delegation should state in an unambiguous manner whether, in their view, the condition has or has not been met.
  - the "payment decision" signed by the operational initiator and the operational verificator.

- **AIDCO Geographical services prepare a dossier for the approval of the relevant Director**. On the basis of the documentation from the beneficiary country and the analysis and recommendation of the Delegation, AIDCO prepares a dossier for the approval of the relevant AIDCO Director with a recommendation for disbursement or not. This dossier will include:
  - The three elements mentioned above in the "payment dossier" prepared by the Delegation;
  - Note to the File prepared by the AIDCO Geographical Unit responsible for the country in question with their analysis and proposal on the disbursement of funds;
  - A draft letter of reply from the Director to the beneficiary country setting out the Commission's views on disbursement;

  The payment dossier receives the visa of either DG DEV or DG RELEX in line with their respective geographical responsibilities; if necessary the payment dossier receives the visa of the relevant operations support services of AIDCO.[1]

- **AIDCO Director signs the "payment decision" and sends to the Delegation**. On the basis of the "proposal" dossier prepared by the AIDCO services, the Director signs the "Payment Decision" and the "Letter of Reply" to the beneficiary country, and sends to the Delegation:
  - the "payment decision"
  - the "Letter of reply" to the beneficiary country
  - the "Note to the File" prepared by AIDCO
  - the "fiche de circulation" of the "payment decision" dossier

- **Payment by the Delegation.** In accordance with usual procedures the Delegation makes the payment:
  - Financial Initiation visa on the payment decision
  - Financial verification visa on the payment decision
  - Authorisation by the Head of Delegation, who may authorise the expenditure only after receiving the payment decision signed by the concerned AIDCO Director (this payment order is sent electronically to DG BUDG through the accounting system and DG BUDG carries out the money transfer within a short delay – see below)

  Financial Identification Form. For the execution of a payment order involving budget support, DG BUDG must be in possession of a Financial Identification Form[2]. This form contains the address and details of the account holder (in general the Ministry of Finances of the partner country) and the bank account (at the Central Bank). This document signed and stamped both by the account holder and the Bank's representative **must be validated by DG**

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[1] At present (May 2006) the relevant services are AIDCO/E1

[2] The Financial Identification Form is used so that a bank account can be created and validated in the *Bank Account File (BAF)*, which is a database containing banking details. Each bank account in the BAF must be linked to a previously created and validated "Legal Entity" in the *Legal Entity File (LEF)* which is a database of all third parties with which the European Commission conducts revenue and expenditure transactions. For further detail on Legal Entity Files and Bank Account Files, see *The Finance Guide* (for the Budget) http://www.cc.cec/EUROPEAID/contfin/budget_procfincont_en.htm
and the *Guide to the financial procedures of the 9th European Development Fund (EDF)*
http://www.cc.cec/EUROPEAID/contfin/fed_procfincont_en.htm (for the EDF)
In addition http://www.cc.cec/budg/imp/contractors/imp-100_contractors_en.html contains information on the LEF and BAF

BUDG[1] before the payment can be carried out. DG BUDG recommends that in the part "remarks" of the form that the name, the country of location, and the swift code of the Intermediary Bank be indicated. This information, although not necessary, facilitates the payment.

- **Verification of payments by the Delegation**. Following confirmation by the Commission that payment has been made, the Delegation shall obtain confirmation, that the relevant Treasury account has been credited by an amount equivalent to the foreign exchange transfer. The Delegation is responsible for obtaining evidence that the Treasury account has been credited and documentary evidence from the Central Bank on the day's exchange rate.

9.4 Implementation: procedures for complementary support

The approval Financing Proposal/Action Fiche or the signature of a Financing Agreement is usually the opening of the procedure for the recruitment of the technical assistance that has been planned as part of the programme. Given the time period for the preparation and implementation of complementary support, which must conform to the D+3 rule[2], a number or simple rules should be followed in the preparation of complementary support:

- *Tender documents including Terms of reference* should be ready to be launched without further discussion at the moment of signature of the Financing Agreement

- *Tender documents* could be launched before the signature of the Financing agreement if there is approval for using the suspensive clause applicable in these cases[3]

[1] This validation could take **three to four weeks**.

[2] The D+3 rule states that all individual contracts and agreements which implement a financing agreement "shall be concluded no later than three years" following the date of the budgetary commitment (budget Article 166.2 of the Budget Financial Regulation) or financial commitment (Article 53 of EDF Financial Regulation). This rule will change under the revised Budget Financial Regulations where the D+3 will be countered fro the date of the conclusion of the financing agreement.

[3] See para 2.4.13 of the "Tender Procedures with suspension clause" of the Practical Guide to Contract Procedures for EC External Relations (Feb 2006).