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The Choice of Financial Aid Instruments

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1. Objectives and Coverage

This paper sets out an approach to deciding what forms of aid are appropriate in specific country circumstances. It does not address how much aid a country should receive. The focus is on the choice between different types of financial aid, though some of the principles are also relevant to technical assistance. The focus is on Government to Government aid. It considers briefly the circumstances in which there may be a case within country programmes for direct support to NGOs or private sector partners, but does not pretend to offer an adequate treatment of emergency aid, nor of the approach to financial support where normal Governance has broken down.

The attached matrix tables and flow chart set out a taxonomy of different aid instruments, and when they might be used. These are the main operational tool which country teams are invited to use. The text provides additional explanation and justification.

2. Types of Financial Aid

The taxonomy in Table 1 characterises different types of aid according to the reciprocal obligations which are laid on the recipient in return for the aid. These are of three types:-

- Conditionality: Policy measures which the partner Government agrees to implement as a condition of the aid.
- Earmarking: Limitations placed on what the aid must be spent on.
- Disbursement channels and accountability: Agreement on how the funds will be disbursed, accounted for, and audited.

The table characterises the main aid forms in use by aid donors in terms of these three criteria. The following paragraphs give a fuller description of each aid type. For simplicity of exposition, the descriptions are in terms of pure types, though in practice there are hybrid forms also in use which exhibit only some of the features.

2.1 Balance of payments support

Balance of payments assistance provides finance in support of a programme of policy reform measures, usually agreed by Government with the IMF and the World Bank. The growth of balance of payments support in the 1980s was aimed primarily at correcting problems of debt unsustainability, trade imbalances, and exchange rate over-valuation. In the early years of structural adjustment, donor balance of payments support financed specific imports. As Governments liberalised their foreign exchange markets, it made less sense to identify donor flows with specific purchases. The emphasis shifted almost entirely to the policy actions which Government had agreed to undertake, with little if any attention to how the specific donor foreign exchange would be used. In its purest form, no restrictions are placed on the use of the foreign exchange, and there is no formal accounting for how the aid is used. IMF financial support takes this form: it is paid into the Central Bank, and there is no formal accountability beyond reviewing the macro programme which will include targets for the foreign exchange reserves. World Bank structural adjustment support using the new procedures also dispenses with formal accounting, other than a cursory check that eligible imports exceed the value of the aid. For DFID formal accounting has often been limited to reimbursement of payments which would have been made in any case, and the effect of the aid is to make available free foreign exchange.

2.2 General budget support

Structural adjustment programmes are also financed using general budget support. This can be thought of as a sub-category of balance of payments support, which differs only in so far as it focuses attention on the local currency counterpart to the foreign exchange, rather than the foreign exchange itself. When a donor provides foreign exchange to support the balance of payments, the counterpart to the foreign exchange deposited in the Central Bank is an increase in the domestic currency bank balance of the Government. This is in principle available to the Government budget, and can be used to raise spending, reduce borrowing, or reduce taxes. Where there is an IMF programme in place, the balance between these choices will in practice be determined by IMF conditionality, and an understanding of how commitments of budget support will be absorbed is a key element in appraising such assistance.[1]

Examples of general budget support would include the World Bank poverty reduction support credit for Uganda,[2] or the general budget support provided by DFID to Uganda and Tanzania. The main focus of conditionality is again on an agenda of policy measures which central Government departments have agreed to implement. In the case of general budget support, the conditions typically include agreement to the overall budget priorities, as set out in for example a medium term budget and expenditure framework. With agreement on the budget as a whole, there is no need to earmark to specific expenditures (though in practice, some largely nominal earmarking is often used for reasons discussed later). The funds are disbursed into the Government account (in Commonwealth countries, the Consolidated Fund). For the budget as a whole, accountability is based on Government producing audited accounts on Government revenues and expenditures. Donors such as DFID have in practice also asked for nominal accounting against specific budgetary expenditures.

2.3 Aid funded debt relief

Debt relief is not treated in detail in this guidance note, but key points relevant to the choice of aid instrument are that:-

- The critical difference is that debt relief has its main effect by reducing the stock of obligations which Government is expected to meet in future. Reducing a large debt stock, especially one which Government is presently unable to service in full, has a positive effect on economic incentives. A large debt stock can discourage private sector investment, because of fears that Government will eventually be forced to raise taxes in order to service the debt, and because a Government which has no capacity for additional borrowing is vulnerable to external shocks and dependent entirely on the continuing goodwill of donors and creditors. Conversely, Government itself may be discouraged from efforts to increase tax revenues by fears that extra revenues will simply provoke extra demands from creditors whose loans are not currently being serviced. On the other hand, writing off the debt carries a moral hazard problem of discouraging other countries from servicing their debts to the financial institutions on which low income countries depend, while a climate in which debt relief is expected may delay the access of low income countries to private sector flows which could potentially make a significant contribution to growth and poverty reduction.
- The effect on the net flow of resources to the country depends on whether the Government would have serviced the debt in the absence of debt relief, and whether the debt relief is additional to the aid which would otherwise have been available. Judgements on both points are difficult to make. It can not necessarily be assumed that Government has more money available to it as a consequence of debt relief.
- Assuming that Government does plan to service the debt, the effect of debt relief is to irrevocably increase the financial resources available to Government, with benefits stretching many years into the future. Granting the relief can be the subject of conditionality but, once granted, it can not be reversed, and the Government is free to decide how to allocate the additional resources. In reaction to this problem, HIPC debt relief was made conditional on Governments putting in place a participatory process for establishing and

[1] This is equally the case for balance of payments support, and for sector budget support, but may not be the case for off-budget project commitments. For fuller discussion, see Foster and Naschold, 2000.

[2] For World Bank procedural reasons, the Uganda PRSC is nominally accounted for as an adjustment operation against imports. However, the emphasis of monitoring and of many of the undertakings is on the execution and accountability of the Government budget.

monitoring a poverty reduction strategy, with strengthened accountability to local stakeholders. The hope is that this will be more difficult to reverse than stroke of a pen conditions agreed with external stakeholders. The PRSP process has also become the basis for World Bank and IMF lending. Although the HIPC support is irrevocable, the leverage of other funding sources is to be used to ensure that the poverty reduction objectives supported by HIPC are not abandoned once relief is obtained.

- The size of the debt burden is not a good indicator of relative need. A poor country which borrowed less may have a less developed infrastructure of schools and clinics, and may need relatively larger net resource transfers to reach the international development targets. The existence of an unsustainable debt service burden may argue in favour of providing financial support in the form of debt relief, but the overall allocation of concessional support (aid and debt relief) needs to take account of relative need and the prospects for achieving poverty reduction given the policies in place.
- Subject to the above points, the resources released from debt relief can in principle be subject to choices on conditionality, can be earmarked to specific expenditures, and can be accounted for against foreign exchange or against budgetary expenditures, in exactly the same way as other forms of structural adjustment support.

2.4 Sectoral budget support

Sectoral budget support is provided normally with sector conditions requiring agreement and execution of an agreed policy and agreed expenditure plan for the sector, normally through a sector approach supported by Government and the major donors. The aid is earmarked to help finance the agreed sector expenditure plan, and is disbursed and accounted for through Government systems, possibly with some additional sectoral reporting. Sector earmarked support is similar, but limits the donor aid to specific expenditures or expenditure categories within the sector, for example so called 'basket funding' in some health sector programmes has focused on supporting primary health spending at district level.

Sectoral Budget Support is not in practice the same as support to a sector wide approach, defined in Box 1. The SWAp aims to coordinate all Government and donor assistance to a sector in support of a common expenditure programme, and may aim to eventually reach a stage where all sector finance goes through the budget and uses the same procedures. However, for the moment, SWAp financing typically includes a range of donor budget support, project aid, and technical assistance, which may or may not be earmarked to specific expenditures and may or may not be disbursed using Government management arrangements.

It needs to be recognised that even in sectors like health and education, a large part of sector activity is financed by non-Government sources, and delivered by non-Government providers, while the sector is also influenced by many cross-sectoral issues. The SWAp needs to recognise the importance of defining the Government role, thinking through how Government relates to non-Government actors and to related sectors, and ensuring that putting money through the budget does not result in non-Government options being given lower priority than they deserve.

Box 1: Definition of Sector Wide Approach

The defining characteristics of a SWAp are that all significant public funding for the sector supports a single sector policy and expenditure programme, under Government leadership, adopting common approaches across the sector, and progressing towards relying on Government procedures to disburse and account for all public expenditure, however funded. The working definition focuses on the intended direction of change rather than just the current attainment.

Source: Adapted from Brown, Foster, Norton and Fozzard (2001), The Status of Sector Wide Approaches, ODI Working Paper 142, January.

2.5 Project aid using government systems

Project aid provides more specific earmarking of expenditures to a discrete set of activities for which coherent objectives and outputs and the inputs required to achieve them can be defined. The donor supported project can still be part of the Government budget, can be subject to policy conditions related to the project and the sector in which it is situated, and the resources can be disbursed and accounted for using Government systems. World Bank projects are often implemented in this way, though additional statements of expenditure and specific project accounts may need to be added to standard Government financial procedures. DFID projects make limited use of Government systems, mainly in cases where UK funding is reimbursing local cost expenditures by Government.

2.6 Project aid using parallel systems

Project Aid using parallel systems refers to those spending proposals where the donor has taken the lead in design and appraisal, has decided the inputs which will be provided, and uses its own disbursement and accountability procedures. In these circumstances, the donor is usually in a weaker position for insisting on project or sectoral conditionality, and the donor project operates as an enclave not fully integrated in the budget. This is likely to be true so long as the donor retains management control, even if log frame workshops and other techniques have been used to develop ownership and participation.

2.7 Project aid through NGO/private providers

In principle, in a good policy environment, Government would define its own role in relation to the private and not for profit sectors and, if there is a case for subsidising an activity carried out via these non-Government routes, the resources could be financed via the budget. In practice, Government Departments often resist resources being spent on outside organisations, while NGOs may be undertaking activities which, though important, do not map neatly onto the budget responsibilities of specific public sector organisations. There can therefore be a strong case for direct support to non-Government actors even in good policy environments, whereas the non-Government route may be the only feasible one in weak environments.

The rationale for donor involvement would need to be based on some form of market failure or on a distributional argument. The distributional case would be that the proposed project is a cost-effective way to provide better access by the poor to a socially desirable service. That is, a specific poor and vulnerable population requires subsidy before a service will be provided, and the proposed project is a cost-effective way to reach them. Issues of sustainability and of exit strategy will be especially important in looking at the case for subsidising goods or services provided by bodies outside Government, for whom the growth of taxation revenues does not provide a clear pathway to eventually reducing reliance on donors.

For support via the private sector, a critical issue is to ensure that the competitive market is not undermined as a result of the involvement of concessional finance. This implies using competition and good procurement practice to ensure that any subsidies benefit the end user rather than accruing as 'rent' to private sector operators. Where a long term case for subsidised provision by non-Government service providers exists, there is a strong case for engaging Government in dialogue on eventually providing the necessary funding via the Government budget.

2.8 Multilateral aid

This guidance does not directly address providing aid via multilateral channels. However, it is important to recognise the important linkages between bilateral and multilateral aid. The major objective in moving towards more direct support for the budget process has been to support more effective poverty reduction, and the major vehicle for achieving this is the poverty strategy paper which receives formal endorsement by the boards of both the IMF and the World Bank. Formal endorsement of the PRSP determines access to Fund lending, and to HIPC debt relief for eligible countries, while it is also a major influence on the level and priorities of World Bank support. Poverty Reduction Support Credits, the main World Bank vehicle for supporting PRSPs, have some of the features of budget support, as described above, and will set the donor agenda for dialogue on structural policies and budget priorities.

The existence of very much larger sums of multilateral aid provides an opportunity for bilateral donors to benefit from the analysis and co-ordination efforts of the multilaterals, and an opportunity for well directed bilateral support to influence much larger multilateral flows. It is also an important constraint. There can and should be only one policy dialogue, and the leadership on the donor side in negotiating agreements on policies and expenditure programmes will be with the Fund on macro-economics, and usually the World Bank on most structural issues. The bilateral donors will wish to make their own assessments of Government policies, commitment, and capacity, but will also need to ensure that their views are taken into account by the Bank and the Fund in both the content of the policy dialogue, and in the process of dialogue. It is important to ensure that the approach taken by the international financial institutions allows space for participation and dialogue with all stake-holders, which can improve both the content of policies, and the commitment to implementing them.

2.9 Types of aid and the design of country programmes

All of these aid types are stylised, but they illustrate the main differences. In practice, there are many more combinations and hybrid forms which are feasible. Because there are many different ways to combine conditionality, earmarking, and disbursement channels, the bulk of this guidance note is concerned with analysis of the factors to be taken into account when deciding how to treat each of these aspects in specific circumstances. However, before diving into the detail, Figure 1 offers a framework for deciding which types of financial support may be relevant to a particular country. It also brings out some of the linkages between financial aid and technical assistance.

Different aid instruments are suitable for supporting different objectives, and interventions at macro, sector, sub-national, and project level may be needed. However, this does not imply that individual donors should be involved at all levels in a particular country. There is a strong case for donors to specialise, in order to avoid the problems caused by donors crowding into supporting the same activities. Each donor must decide how to allocate its own funding depending on what others are doing, where the gaps are, and depending on its own policy preferences and capacity to provide what is needed. The reasoning and analysis underlying the choices made and the future strategic directions should be made explicit within country programme documents.

Figure 1 suggests that the appropriate mix of aid instruments depends mainly on the degree of consensus on policies and the capacity of the recipient to implement them, with policy understood to refer to actions rather than merely words, and with capacity understood to encompass not just technical capacity but the ability to adhere to standards of financial management and respect for human rights. The flow chart aims to telescope a complex range of issues on a single page. Some of them will be further elaborated below.

Starting from the top left hand corner of Figure 1, general budget support should only be considered where three sets of conditions are met.

Firstly, there should be a formal agreement between the donor community and the central budget authorities on policies and expenditure priorities. The policy agreement needs to cover not just the budget but also broader aspects of the policy environment for private sector growth and poverty reduction. The budget proposals need to consider the appropriate roles in financing and service provision of Government, private sector, and not for profit organisations.

Secondly, the case for budget support must rest on specific benefits. In aid dependent countries, reliance on project approaches causes a range of problems which budget support can help to address. Projects impose high management costs through the burden of donor missions, reporting requirements, and differing procedures; the proliferation of poorly co-ordinated projects taking different approaches leads to uneven service provision and poor sustainability, exacerbated by donor induced biases towards spending on offshore capital and technical assistance costs. The lack of a hard budget constraint undermines prioritisation, while donor willingness to pay staff supplements and fund training and vehicles distorts incentives and encourages rent seeking and patronage. In these circumstances, budget support can have significant benefits in the form of better co-ordination of support to a more coherent policy and expenditure programme, and lower aid management costs. However, circumstances differ, and benefits need to be assessed rather than assumed. Factors leading to low or even negative net benefits from general budget support include high costs of negotiating and maintaining policy agreements, relative to low potential for reducing aid management costs. These are characteristic of countries where aid dependence is low, where negotiation costs are high because of lack of consensus on policy within and between Government and the donor community, and where significant donors resist reforming their approach.

Thirdly, if there are weaknesses in public expenditure management, additional safeguards may need to accompany the budget support, in the form of conditionality, earmarking of support to specific expenditures, or additional accountability provisions.[3] Support may be linked to TA to overcome specific problems.

If Government is addressing the main impediments to poverty reduction through an effective planning and budget process linked to incentives for Ministries and local Government to strengthen their performance, it may be appropriate for general budget support to be the main or exclusive aid instrument, probably alongside TA support co-ordinated with other donors and linked to the support of overall Government reform. More usually, central authorities will be well placed to influence budget allocation to sectors and overall reform strategies such as pay and performance

[3] DFID readers are referred to the separate guidance which has been prepared on DFID fiduciary requirements for more detail: Meeting DFID's Fiduciary Requirement when providing budgetary or sector support, Governance Department, July 2001

management, but there will also be a need for support to develop the policy and implementation capacity at sector or sub-national level. Donors may also therefore be involved in dialogue and technical assistance at these levels. This may need to be complemented by financial support to the sector to add credibility to the donor voice. Financial support to a sector should be part of an overall Government budget, and in one sense should not change the financial resources available to the sector. If there is a unified budget, involvement in sector dialogue and TA should not require earmarking of budget support to the sector. However, if financial leverage on sector managers is thought to be needed, a separate sector level instrument may be useful: we return to this issue in discussing earmarking.

If there is no formal agreement on Government policies and priorities, general budget support will not be appropriate. Donors should then assess whether there is scope for reaching agreement on policies and priorities at sector or sub-national level, and whether budget support at that level makes sense given the overall policy and institutional environment within which sectors and sub-national Government operate. The lack of overall agreement may simply reflect good macro management not requiring Bank or Fund endorsement, or Government reluctance to accept donor intrusion in policy, or a difference in view on specific issues which should not prevent progress being made at sectoral or sub-national level. However, management of the macro economy is weak and generating low growth, high inflation and unreliable budgets, then budget support at lower levels will face a high risk of failing to achieve and sustain sufficient benefits to justify the costs. Risks will vary by sector, and sectors investing in long-lived infrastructure, or having their own sources of revenue, may have more scope for operating with success in a hostile macro policy environment.

The sector wide approach involves reaching agreement on policies, management arrangements, and expenditure programmes within a sector. Not all Government activity will fit neatly into ‘sectors’, and many sectors are institutionally complex, with more than one Government Ministry involved, plus local Government, and both private sector and NGO participation. Ideally, Government, donors, and other stakeholders would agree an effective framework of policies, expenditure proposals, and management arrangements, recognising the contributions of all stakeholders in the sector, and allocating Government and donor resources in order to maximise their impact. In these circumstances, all financial support to the sector could be used to finance a common sector expenditure programme which would be jointly monitored. In practice, for reasons of manageability, sector programmes have often defined themselves around the area of responsibility of a lead Ministry, and have not been comprehensive in meeting sector needs. It has sometimes proved difficult to use the SWAp mechanism to fund activities by NGO or private actors, or activities requiring inputs from other Government departments.

The sector wide approach is normally a hybrid of funding forms. Irrespective of how the money is disbursed and accounted for, the defining characteristic is a requirement to reach agreement with donors on sector policies and spending plans, and to assess progress through regular joint reviews. These arrangements should be subject to the same assessment of additionality of benefits as has been proposed for general budget support. Where aid dependence is low, policy consensus is costly to achieve, and donors reluctant to offer budget support, Government may prefer to keep donors at arms length, and continue to rely on project finance.

Exactly as with general budget support, the decision whether to provide support to a sector wide approach in the form of sector budget support will require an assessment of the capacity of the sector institutions to plan and execute the agreed policies and programmes, and to account for the resources. Where significant weaknesses exist, Government and donors would work towards sector budget support (if Government so desires), but financing in the interim may be mixed, with some funding earmarked to specific purposes or projects forming part of the sector programme, while any pooled funding might be subject to additional provisions to strengthen accountability.

Even where there is scope for significant savings in aid management costs through common appraisal, reporting, monitoring, and use of pooled funding, Government authorities may prefer to continue to rely on a mix of budget support and project finance. For example, Government may value donor appraisal and management skills for undertaking complex investments, and it may be more cost-effective to manage their provision through projects rather than as part of sector financing.

Governments will themselves implement projects, and there is no reason in principle why project investments, pilot projects, or technical assistance should not be financed as part of general or sector budget support. Nevertheless, there are a number of situations in which project forms of finance remain relevant.

Where the policy environment is weak, a major priority for the donor community will be to encourage Government to modify policies and build the capacity to implement them. If the problems reflect a difference of view, then technical assistance, policy research, and pilot projects may be successful in changing opinions. More usually, the problems stem at least in part from weak Governance. Donors can help civil society organisations to press for more accountable and responsive Government even where official channels for policy dialogue are not effective.

In addition to policy influencing, projects may be the only way to provide support to poor populations unfortunate enough to live within weak policy and institutional environments. Whether working with public sector bodies, NGOs, or the private sector, project interventions in these circumstances may struggle to meet tests of viability, and the accent is likely to be on interventions which are not reliant on Government policy for their success.

In countries with low aid dependence, projects may be the best way for donors to contribute ideas and expertise to a Government reluctant to engage explicitly in policy dialogue. Even in countries which are adopting budget support and sector wide approaches, some sectors are less advanced than others, and there continues to be a role for projects while they develop their policies and capacity.

Some cross-cutting issues or issues best addressed by non-Government providers may be under-resourced if left to funding allocated through line ministry budgets. The Government can of course decide to set up new structures or budget lines to address this problem, but budget and political pressures can make this difficult, and earmarked donor support can be helpful, especially in circumstances (such as the HIV/AIDS epidemic) when action is urgent.

It is worth emphasising that:-

- The greater the consensus on policy, and the greater the capacity of Government, the more donors can leave it to Government to decide where and in what form it wishes to receive aid. Restrictions will be mainly for presentational reasons for the donor. On the other hand, Government should not be made to accept budget support if they prefer, and can manage, projects.
- General budget support requires policy consensus with the central economic authorities. In the absence of such consensus, sector or project commitments should only be made after assessing the risks to aid effectiveness if central issues are not tackled.
- Significant financial support to a sector, whether through a SWAp or through stand-alone projects, requires some degree of consensus on sector policies. Policy dialogue, technical

assistance, or projects might be used in part to bring about more effective sector level policies.

- General budget support can also be used to encourage stronger sector policies, by supporting reforms to the budget process that improve the incentives for sound policies, and by using conditionality and earmarking to more directly influence allocations towards higher priority programmes.
- Where capacity is weak, and aid dependence is high, it becomes all the more important to use aid channels which minimise the strains on Government management. Technical assistance needs to be coordinated around a strategy for building capacity, donors need to coordinate their support to a coherent Government plan and budget, and there is a stronger case for providing support using Government channels, strengthened as necessary.

The remaining tables of the matrix take each type of restriction in turn (conditionality, earmarking, and accountability), and examine the circumstances in which different degrees of restriction are appropriate.

3. Conditionality

3.1 Objectives of conditionality

Conditionality has two possible objectives:-

- To give Government an incentive to implement, during the time period specified in the programme, a different set of policy measures than it would otherwise have chosen.
- To record the understanding between Government and donor partners on those policy measures which will be undertaken by Government, and which are regarded as essential to the continued success of the aid.

The first objective assumes that Government values the aid sufficiently to change behaviour to reflect donor preferences. At the most extreme, this can take the form of 'bribing' a Government to undertake policy measures with which it actively disagrees. This is a form of conditionality which can only be used in highly aid dependent countries and probably only in times of financial crisis, when Governments have few options. More typical is the use of conditional offers of aid as an incentive to Government to advance the timing of policy measures which the donor regards as critical, to help reinforce the position of those who support the measure in the face of domestic opposition, or to encourage increased management attention to implementation in order to secure release of the funds.

Conditionality is negotiated in a setting in which there are likely to be multiple views within the Government and within broader civil society, and the donor voice is one among many influences. Conditionality can be helpful to reformers in maintaining commitment to a policy which faces opposition, but heavy-handed negotiation by donors can equally undermine reformers by making them appear to be the servants of the donors. Within a democracy, Government may have decisions entered in good faith reversed in Parliament, or in elections. Killick and others have pointed to the problem that Governments and donors have their own reasons for colluding to avoid interrupting disbursements, and hence the credibility of threats of withdrawing aid may be undermined.

Even if the dependence of Government on aid gives donors the necessary leverage to force policy change through conditionality, the evidence from evaluations of structural adjustment suggests that policy measures taken from conviction are more sustainable and more effectively implemented than policy changes introduced through coercive conditionality. Ethical arguments would also suggest that donors should not use their financial leverage to impose policy changes for which there is little domestic support. The emphasis on wide consultation, broad ownership, and assessing actions rather than promises reflect the difficulties. Other than in conditions of short-term crisis, the most effective instruments to support policy change will be policy dialogue and technical assistance.

A general principle is that conditional aid should benefit the budgets of the departments with the power to ensure that the conditions are met. This will differ depending on the nature of the policy agenda which is being supported. It is appropriate to use different aid forms for different development objectives.

3.2 Unconditional financial support?

Financial support is never entirely 'unconditional.' However, a less prescriptive approach to future policy reforms may be appropriate where there is strong policy consensus within Government and between Government and donors, and there is a strong track record of implementation. Government ability to plan with confidence could be assisted by donors making longer term commitments, with probable funding levels indicated for the next several years, but subject to annual confirmation based on assessment of past performance against a range of criteria. The donor could vary the level of commitment annually based on performance and relative need, but annual funds once committed would not be dependent on specific future measures to trigger their release. This ensures that the donor resources programmed into each annual budget are secure by the time the budget is finalised.

Although the literature talks of moving to a form of assessment which is unconditional in the sense of rewarding past actions rather than buying future promises, in practice the distinction is more apparent than real. If Government and donors are in a long-term relationship, then Government will wish to know the future policy actions which donors will be assessing when making next year's judgements on the level of budget support, and future plans as well as past actions will need to be part of the assessment. The main difference is likely to be that, in strong performers, the future programme indicates the areas where policy progress is required, but may leave Government more latitude on the nature and timing of actions to resolve identified policy issues. This more flexible approach requires close communication between Government and donors throughout the year, in order to ensure that Government does not base budget plans on incorrect assumptions as to what it needs to do in order to secure funding for the year ahead.

3.3 Macro and structural conditions

Macro level conditionality will be appropriate in circumstances where overcoming binding constraints to sustained poverty reduction requires action by the central, cross-cutting departments of Government. Actions at sector or project level can not yield sustained benefits if critical problems are not addressed by the central departments. For example:-

- The Ministry of Finance must produce the conditions in which growth will generate increasing incomes for the poor, and predictable and growing revenues for sustaining public services in the longer term.
- Public spending must be allocated and spent in line with national priorities, through a sound budget management system which encourages realistic planning and enforces accountability for how public resources are used.
- Public sector pay policy must balance incentives and affordability, and be consistent with improvements in public sector performance.

The World Bank and the IMF generally lead the negotiation of conditionality on these overall economic policy issues, on behalf of all donors supporting the reforms, and with their participation to a greater or lesser degree. This may change as increased emphasis is placed on the development of poverty strategy which Government owns, through a process with broad participation, and with more open dialogue around the annual budget cycle. As the dialogue becomes more open, it is possible to envisage a process in which Government presents its own strategy and donors make individual decisions on whether to support it. This is what happened in effect in Uganda, where DFID committed to provide general budget support for the poverty strategy in advance of the World Bank finalising their negotiation of the poverty reduction support credit.

There will never be total agreement on policy, nor total satisfaction with implementation, nor complete agreement on every allocation within the budget. The judgement which donors need to make is whether the final outcome following dialogue is sufficiently beneficial to the poor to be worth supporting, which includes a judgement on whether the allocation of resources is moving in favour of increased and more effective spending on poverty reduction. This assessment will include a judgement on the adequacy of financial management arrangements to deliver poverty reduction.

A key judgement concerns how best to achieve a pro-poor allocation of Government and donor expenditure. One approach is for both Government and donor resources to be jointly planned as a single expenditure programme, which is subject to negotiation and agreement on the allocation of expenditure between different priorities. This comprehensive approach requires sufficient consensus for agreement to be feasible, raises issues of sovereignty and accountability, and implies a level of donor intrusion into the budget process which may not be acceptable. It also requires some procedure for deciding how to react to the inevitable divergences between planned budgets and actual expenditure. Where comprehensive agreement on the budget can not be reached, more partial undertakings related to Government commitment to specific spending priorities are feasible. In the absence of an overall budget framework which is consistent with the available resources, partial conditions can risk over-committing the budget, especially if there is a proliferation of budget conditionalities related to individual donor activities.

Where conditionality on the Government budget is not feasible, donors may seek to influence the allocation of budget resources through earmarking their own support. If aid is fungible (Box 2), this might achieve no net increase in spending on the designated poverty programmes.[4] We return to this issue in the discussion on earmarking.

Where Government management is competent and there is agreement on the medium term and annual budget, it may seem appealing to provide all financial support as general budget support. The main problem with this approach is that the risks to Government are substantially increased if a very large share of total resource flows are subject to the same conditionality. It will be important to ensure that sanctions associated with budget support are measured, and there can be a case for separate operations with separate conditionality relating to performance within a particular area of the overall policy and programme agenda. This argument is reinforced by the need to address issues which are the concern of sector level authorities. General budget support inevitably focuses mainly on the issues of concern to the central economic ministries who lead the negotiation, but many of the most critical issues for achieving poverty reduction require action by sector ministries who are responsible for delivering the services on which the poor depend.

[4] Meeting DFID's Fiduciary Requirement when providing budgetary or sector support, Governance Department, July 2001

Box 2: Fungibility, Conditionality, and Earmarking

Aid is said to be *Fungible* when Government offsets donor spending on a particular purpose by reducing its own expenditure on the same purpose. For example, donor funding earmarked to health will not increase total health spending if Government reduces its own health spending, and uses the funds thus released for some other purpose.

Fungibility means that total public spending (both Government and donor financed) is adjusted to reflect the priorities of the national Government rather than the uncoordinated preferences which emerge from large numbers of donor projects. If Government and donors are in agreement on budget priorities, then fungibility is welcome, and ensures that the agreed budget priorities can be implemented.

If donors disagree with Government spending priorities, they can try to influence them through policy dialogue, through conditionality, or by earmarking their aid. Depending on the stage in the budget cycle at which earmarking takes place and Government reactions to it, it may be capable of changing allocations between or within sectors, or the extent to which aspects of the finally approved budget are actually executed. It requires strong assumptions regarding the efficiency of the budget process and the relative power of the finance ministry before donor earmarking is rendered entirely impotent.

3.4 Sectoral and sub-national conditionality

It may be appropriate to use sector level policy conditions to support policy and institutional change within the power of sectoral departments, such as health or education. This will only be appropriate if other macro level or cross-cutting issues which are critical to the success of reforms at sector level are being addressed. It is not essential that each donor be involved in supporting such reforms, but donors need to confirm that adequate measures are being taken and progress is being monitored by other means. This needs to include ensuring that realistic policies are in place in areas which are key to the private sector growth on which poverty reduction and sustaining social services ultimately depends: financial sector reforms, trade measures, and policies in transport, energy and communications sectors.

The appraisal of proposals for sector level support, we have argued, needs to assess whether key macro and cross-cutting issues are being addressed. However, once the sector programme is approved, continued financial support should be dependent primarily on sector level conditions. If the macro economy comes badly adrift, it is highly probable that this will manifest itself in difficulties within individual sectors, which will require adjustments to the programme. However, it is undesirable to amplify the effect of macro shocks to the economy, even self inflicted ones, by also interrupting support for sector programmes. An increasing share of external assistance is provided as sector support, easy to interrupt and with all donors applying virtually the same conditionality. In earlier periods, much of the funding would have been committed to projects, and would not have been subject to policy conditions. Donors need to exercise restraint, to avoid the risk that every minor interruption to sound economic management could otherwise be amplified into donor-induced disruption of expenditure programmes.

A key cross-cutting issue concerns the allocation of financial resources to the sector. Donors should only lend their leverage in support of a Sector Ministry campaign for a larger budget if their judgement is informed by an overall review of public expenditure allocation: it can not reasonably be considered in isolation from other spending priorities.

When conditions are applied at sector level, the distinction between conditionality and earmarking becomes difficult to sustain. In principle, the amount of finance offered need have no specific link to the budget of the sector. In practice, it usually does, for the practical reason that there is no incentive for the sector managers to implement the reforms if their budget is unchanged as a result of the aid commitment.

Conditionality linked to sectoral finance is only likely to be effective where an overall increase in expenditure to the sector is envisaged. In sectors such as agriculture, where a reduced Government role and budget may be appropriate, the necessary reforms need to be achieved before embarking on a sector wide approach with external funding. The conditionality should be focused on the Ministry of Finance, to insist on a smaller budget reflecting a reduced role.

Sector wide approaches typically include conditionality related to agreeing and implementing an overall strategy and operational plans for the sector. There are also often agreed targets, and agreed 'rules of the game' setting out how Government and donors agree to behave in implementing the sector wide approach. Only the Government obligations have so far proved enforceable. They typically include matters such as agreement to a defined procedure for reviewing and modifying the sector plan and budget, including monitoring and reporting requirements, and may include specific undertakings agreed in the initial sector planning documents, or in subsequent joint reviews.

The feasibility of sector level conditionality is limited to cases where donor flows represent a significant share of public funding for the sector, and where the major donors providing the bulk of such funding are able to reach agreement with Government on the policies, plans and expenditure programmes to be implemented within the sector.

What is a significant share of spending? This is a matter of judgement, informed by experience of the Government willingness to allow a constructive policy dialogue. Some aid dependent countries may nevertheless be very resistant to allowing donor policy influence, especially if sector managers do not share donor policy preferences. Others may in practice welcome the technical support and improved coordination which the sector approach can in principle help to achieve. A relatively small share may make a significant difference in a system where Government funds are tied up in salaries, with little left for implementing programmes. A relatively large commitment may carry less leverage if capacity constraints in practice make it difficult to spend.

The same principles apply to support to sub-national levels of Government , with the need for judgement on whether the overall policy environment is strong enough for sub-national level interventions to be effective. States in India, for example, have a large measure of autonomy, and achieving results for poverty reduction requires undertakings to be agreed with State level Government, an argument analogous to the case for sector level interventions to solve problems which are the concern of sector ministries. The most critical additional issue is to ensure that donor support for a specific sub-national Government does not contribute to inequities in the geographical allocation of public spending. Even if technical assistance is focused on specific sub-national Governments, there may be a case for ensuring that financial support respects national allocation formulas, just as support for the education sector should be part of a national budget in which the competing claims of health and roads have also been considered. The problem with this approach of course is that the prospect of additional funding is the main attraction from the viewpoint of a local Government. The justification for a donor in effect colluding in providing a specific region with a larger share of public spending than it would otherwise get needs to rest on arguments of equity and/or effectiveness. Additional support to a specific State Government in a federal country may be justified to improve a currently inequitable allocation of resources. It could alternatively or additionally be justified where specific sub-national Governments have sufficient autonomy and commitment to tackle key problems receiving insufficient attention in national programmes, and where the support can have a useful lesson-learning and demonstration effect.

3.5 Project conditions

Donors may have no leverage over sector policy in situations where aid dependence is low, or where Government has such different policy views that there is no basis for dialogue, or where the donors themselves are unable to agree a coordinated position to permit some leverage on policy. In these circumstances, conditionality will be limited to attempting to ensure that necessary conditions exist for the project to meet its specific objectives. There are three main circumstances in which conditionality limited to project level may be appropriate:-

- Although donors have no leverage over sector policy, the sector policy environment is sufficiently supportive for the project to achieve sustainable and replicable benefits, subject to conditions on purely project specific matters.
- Government agreement to implement the specific project forms part of a longer term strategy to achieve policy change, by demonstrating the effectiveness of alternative approaches, or supporting policy analysis or capacity building. The realism of this rationale needs to be carefully tested. The prospects for innovative approaches being subsequently adopted will be increased to the extent that Government policymakers and officials are involved in design, implementation, and evaluation of the experience.
- Finance which is conditional on specific projects may not always be fungible, and may succeed in bringing about a change in the allocation of resources, though the desirability and sustainability of such changes needs to be assessed.

4. Earmarking

Box 2 argues that earmarking to specific expenditures only changes the pattern of spending if Government does not fully adjust its own spending to achieve its desired spending priorities, i.e. fungibility is incomplete. In practice, complete fungibility requires quite strong assumptions. In most aid dependent countries, donor flows are not fully integrated within the budget overall or at sector level. Ministries of Finance do not always reduce line ministries budgets to offset every donor project they manage to negotiate, indeed the Ministry of Finance often has incomplete knowledge of project expenditures. This absence of fungibility implies that donor earmarking can influence the pattern of spending, but the consequences can be uneven development and poor sustainability. The problems caused by this absence of fungibility, such as a proliferation of project investments which can not be adequately staffed or operated, were part of the rationale for moving towards providing support to an agreed overall budget or to a sector-wide approach. If all sources of funding help support the same, agreed budget, then all spending is fungible, and donor influence comes through participation in the negotiation of budget priorities.

4.1 No earmarking

If Government spending allocations are accepted by donors, earmarking is unnecessary, and general budget support could be provided. Even if donors have reservations about Government public expenditure priorities, earmarking may still be rendered ineffectual if Government planning and budgeting processes ensure fungibility. In these circumstances, donors may nevertheless wish to preserve some nominal earmarking for presentational reasons, in order to distance themselves from expenditures of which they disapprove. There may also be a case for earmarking if it facilitates donor influence in sector level dialogue (see 'sector earmarking' below).

4.2 Poverty earmarking

Uganda has developed an approach to earmarking which channels HIPC debt relief and some donor commitments towards additional expenditures on poverty related spending. The main elements of the approach are:-

- Government poverty strategy identifies components of the budget which represent high priority for poverty reduction. For example, in the case of Uganda, they include primary education, the delivery of an essential package of primary and preventive health services, clean water and sanitation, rural feeder roads, some agricultural services, and expenditures on monitoring and evaluation of poverty programmes.
- The baseline level of spending on these budget lines is identified, in the case of Uganda the baseline was defined as the level of spending in the year before the programme started.
- Donor and HIPC funds are earmarked to finance **additional** spending beyond the base level, and are not available for any other purpose. Government guarantees to release budgeted amounts in full, any funding not disbursed within the budget year can not be reallocated but has to be carried forward.

This approach has the advantage that, unlike conditionality, the incentives and disincentives are non-discretionary: the funds will be spent in full if and only if Government fulfils obligations to increase spending on poverty. No political decision is required. This avoids the difficulties which have in practice made donors reluctant to actually impose sanctions when conditions are not met.

The approach requires careful definition of the ‘without aid’ baseline to ensure that earmarked aid is genuinely additional, and will only be effective where donor funds represent a significant share of the budget. The danger is that the earmarking can make poverty spending appear to be the concern of the donors rather than the Government, and the level of donor commitments can become a limitation on the expansion of such spending rather than a stimulus. It is important to ensure that dialogue on budget priorities and management does not become confined solely to the poverty earmarked spending, but retains an interest in overall reform of budget prioritisation and management. The approach is likely to work best where donors and reformers in the Ministry of Finance share the desire to protect poverty spending from pressures to increase other spending on for example defence. In the case of Uganda, Government has provided additional funding for the poverty lines from its own budget resources in addition to the donor earmarking, and has afforded equal protection from cuts to domestic and foreign financed poverty spending.

4.3 Sector earmarking

A donor with particular interest and expertise within a specific sector may believe that earmarking funds to that sector gives added influence on sector policy and management.

Donor influence on a sector may derive from the perceived power to grant or deny funds to the sector dependent on sector performance in implementing the agreed programme. In principle, Ministry of Finance can allocate increases or cuts in spending as it sees fit: if earmarked funds to the health sector are denied, Government can make up the shortfall from its own funds, making cuts in other sectors instead. If the budget process is effective, earmarking funds to a specific sector will only achieve changes in total funds available to the sector if supported by conditionality on the Government share.

The corollary is that sanctions and rewards for achieving change at sector level require the cooperation of the Ministry of Finance. The Ministry of Finance has the power to reward high performing ministries, and sanction poor performers with lower budget allocations. Donor decisions can achieve little without the agreement of Finance. Donors have a legitimate role in influencing budget allocations, but once the budget is agreed they should support Ministry of Finance efforts to implement it as approved, including ensuring that budget ceilings are respected.

In practice, there are few countries where the budget process is sufficiently developed to render sector earmarking powerless. Government budgets are often tied up in commitments to wages, debt service, counterpart contributions to donor projects, with very limited discretionary resources available. Experience of budget bids subject to arbitrary cuts, and budget releases unpredictable in timing and amount, undermines managers commitment to the planning and budget process. Donor earmarking, especially if supported by conditions on the Government contribution, can result in a more reliable flow of resources to the sector, and can restore the conditions in which planning and budgeting can begin to regain their credibility. A key consideration, however, is that increased budget certainty in one sector implies that any external shocks are concentrated on sectors without donor protection. Government and donors need to be convinced that the sector is important enough to merit special treatment.

In summary, if the main focus of donor interest is on reforms which are within the power of sector managers and policymakers, it will normally make sense to earmark the funding to that sector, even if only nominally.

4.4 Earmarking to projects or specific expenditures within a sector

The sector approach attempts to reach agreement on the policies and plans for the sector. Complete agreement on spending priorities may not always be achieved. Even where agreement is achieved in principle, sector managers may come under pressure to approve investments for political or corrupt reasons, they may face pay pressures which risk eating up the non-salary recurrent budget, they may lack the management systems to encourage decentralised budget centres to respect sectoral priorities. For any or all of these reasons, donors may choose to earmark their funding to critical expenditures within the sector, because of fears that Government may otherwise fail to ensure that those categories of spending receive adequate priority.

Earmarking within a sector approach in this way should be seen as a transitional stage. It may need conditions to support the baseline level of Government spending and ensure additionality, it will also need to be supported by sector dialogue and institutional reform to ensure that the benefits can be sustained in the longer term without being dependent on donor finance or conditionality.

Earmarking to projects may also be a necessary interim stage towards sector support, especially in situations where Government in the short term simply lacks the institutional capacity to deliver the strategy, for example in post-conflict countries such as Mozambique.

Earmarking to projects may have a more permanent role in situations where Government may value project aid and the related technical and management support, but may be uncomfortable with policy dialogue. This is arguably the situation in China.

Sector programmes will themselves include projects, and those projects will require technical and management support. However, this need not imply earmarked project aid. It may be more effective and sustainable to provide the finance and the technical support as a fully integrated part of the sector programme, without specific earmarking of donor funding.

5. Disbursement and Accountability

The underlying principle when considering disbursement and accountability choices is that achieving the development targets will require all sources of finance to be managed and accounted for effectively, minimising waste and corruption and maximising value for money. Donors should contribute to achieving this by using Government financial management arrangements wherever possible, using any leverage they may have to reinforce pressures for action to achieve improved financial management.[5] This is a larger prize than simply securing accounting discharge for donor funds, especially if accounting for donor funds distracts attention from the overall task of improving public sector financial management.

5.1 Donor funds disbursed and accounted for through standard government arrangements

The matrix is fairly self explanatory. The basic principle is that a comprehensive assessment will be made of procurement and financial management arrangements for each country in receipt of significant financial aid. This is best done in collaboration with other donors. The World Bank country financial accountability and country procurement assessments could perform this role. Where material weaknesses are found, Government will be expected to agree an action plan to overcome them, to be monitored together with the donors.

It may also be appropriate to agree additional ‘comfort’ measures to reassure donors pending the achievement of necessary improvements. For example, additional independent audit or pre-audit checks could be added pending strengthening of the Government auditor. Independent financial tracking studies can be used to reveal the extent and nature of problems in financial management arrangements, and feed in to the monitoring of the action plan. Measures can be put in place to strengthen the ability of the media, the NGOs, and most importantly users of Government services, to hold Government officials and politicians to account for their stewardship of Government funds. Publicity can be quite powerful in ensuring that resources reach their intended destination, while other civil society campaigns have had some success in controlling Government behaviour through exposing scandals and ‘naming and shaming’ those who misuse Government funds.

5.2 Disbursement through government systems, but accounted for against specific expenditures

DFID has made extensive use of this approach, disbursing programme aid and budget support through Government systems, but accounting for it against specific items of public expenditure, usually on a reimbursement basis. This is simple to do, and causes few problems for the recipient. However, it does incur TA costs for an exercise which has no effect on the pattern of spending, since the funds have already been spent. The original rationale was that the exercise of accounting for UK funds would yield information on overall standards of financial accountability and could be used to reinforce pressures for change. There may have been some merit in this argument to begin with, and early budget support was for example associated with action to eliminate ghost workers or improve financial record keeping. In more recent cases, the accountability has been entirely nominal, an expenditure with purely presentational benefit. The presentational benefits are not insignificant: a recent case enabled DFID to argue that UK aid had not helped pay for Mercedes

[5] In the case of India, an added complication is that the federal Government itself uses a range of parallel funding routes for funding the States, by-passing its own systems where they are recognised to be dysfunctional, but too difficult to change.

cars bought at great cost for Government officials. However, the presentational argument would not withstand much scrutiny, and alternative approaches (such as explicitly reducing the next tranche by an amount related to the cost of the dubious expenditure) might carry more conviction.

There can be a case for associating donor flows with specific expenditures in order to reinforce the pressures for improved accountability. A number of sector programmes and programmes of financial support to local Government have made effective use of financial accountability conditions in the form of criteria which must be met before particular spending units can receive funds. For example, they may be required to appoint appropriate accounting staff, submit accounts for the previous quarter, prepare workplans, all as a requirement to receive funds. There is a danger that this approach can become inequitable, since the better off local government areas are also best able to meet the requirements. Various ways around this problem have been tried. For example, Ghana health ensured that funds were still allocated and spent, but would be managed at the next highest level (e.g. regional instead of district) until the conditions were satisfied. In other cases, failure to meet the criteria has triggered intense capacity building support.

5.3 Procurement using parallel systems

Major international procurement can often be subject to risks of corruption and of poor value for money. Procurement requires technical skills which may be lacking, and it may not necessarily make sense in all cases for Government to establish the necessary skills in-house, especially for specialist procurement where staff could not be continually occupied. International procurement is arguably the aspect of public expenditure where the risks of relying purely on Government systems are greatest, and where the benefits of doing so may be lowest. Donor support may well add value through reduced corruption risk, and more cost-effective procurement. Similar arguments could be applied to the award and subsequent supervision of large and complex international contracts related to infrastructure projects or to the privatisation of complex state enterprises.

Transparency over costs and decision criteria should be universal, and should apply equally to funds managed by the donor, including technical assistance contracts, where Government should know the costs, and have a role in choice of supplier. There is no reason in principle why TA should not also be integrated within general budget support, if necessary with safeguards to earmark spending to ensure that it receives sufficient priority, and possibly with some provision for independent scrutiny and approval of the choice of consultant in order to prevent cronyism and protect the quality of advice available.

Direct project procurement may be appropriate for minor items of expenditure needed to support TA projects. Though undesirable in principle, the importance of avoiding delays may make it sensible to be pragmatic in ensuring that TA projects are not delayed while waiting for Government to procure necessary tools of the trade.

However, there is no long term role for project procurement and TA imprest accounts as a means of transferring financial resources to support Government service provision. Project units are costly, unsustainable and not replicable, and may not even succeed in avoiding financial abuses, given that technical advisors controlling imprest accounts have limited time, and may have limited skills and interest, in financial management. It is precisely in the provision of budgetary resources to support decentralised service provision that it is most urgent to build Government systems and capacity to disburse and account for financial resources.

One last option concerns direct donor support to non-Government service providers. This may be the only realistic option where Government services are ineffective or where Government can not be relied on to pass on resources efficiently to Government and non-Government providers. In the interests of supporting innovation and diversity of consumer choice, there can be good reasons for supporting NGO providers. However, in countries where resources are insufficient to meet basic needs, it is important that non-Government service providers coordinate their activities with those of Government, and there can be a case for channelling funds to them via Government for provision of specific services as part of a coordinated sector strategy.

Figure 1: Decision Tree for Choosing Aid Instruments

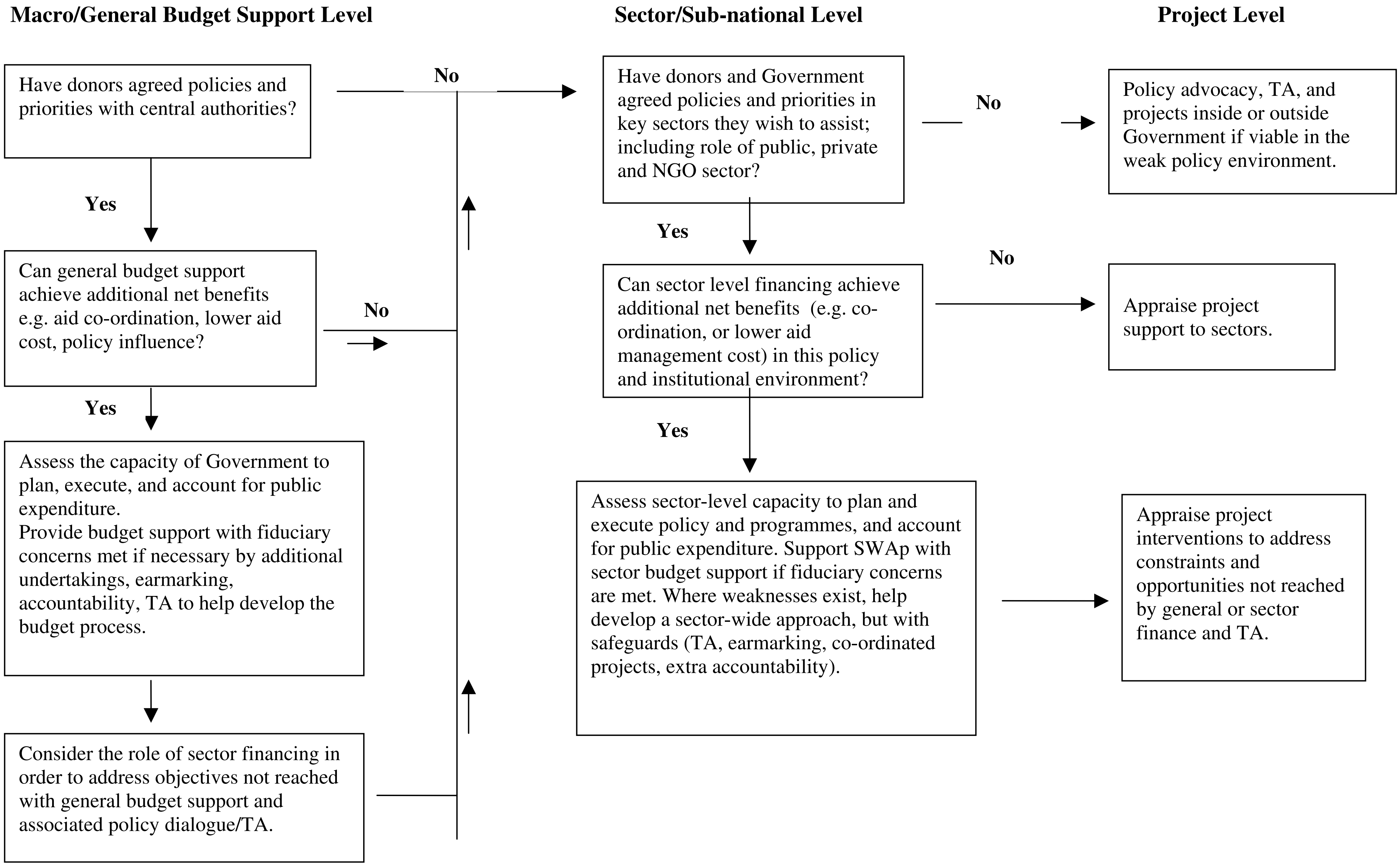

Table 1: Characteristics of Main Aid Forms

Aid Form	**Conditionality**	**Earmarking**	**Accountability**
Balance of Payments support	Macro	None	None
General Budget Support	Macro and budget	None or nominal	Govt systems
Aid financed debt relief	Macro & budget	None or poverty virtual fund (Uganda)	Govt systems
Sector Budget Support	Sectoral	To sector	Govt systems
Sector earmarked	Sectoral	Within sector	Govt systems
Projects using Govt systems	(Sector and) Project	Project	Govt systems
Projects using parallel systems	Limited by low ownership?	Total	Donor

Table 2: Matrix for Choice of Aid Instruments

The choice of aid instrument: 1. Conditionality	
Alternatives to consider	**When to use them**
A. Conditionality Choices	All conditionality assumes Government values aid sufficiently to change policy or increase commitment to reflect donor preferences, and that similar results would not be achieved by policy dialogue and TC not linked to concessional funds.
None	• No significant disagreement with Govt policy, resource use, commitment to institutional reform; • Strong track record; • Still need dialogue, confirm level of support to budget each year based on assessment of need and performance.
Macro/structural	• Main concerns are cross-cutting, central department issues. • Strategy is generally appropriate (or dialogue has reached an acceptable compromise) • Resource allocation is agreed, moving in right direction, and donors judge they achieve more leverage through conditionality than through earmarking (fungibility)
Sectoral	• Cross-cutting issues that affect sector progress are being addressed and progress monitored by other means • Sector strategy and operational plans agreed, consistent with resources • Allocation to the sector is reasonable, given other priorities (or the leverage of sector commitments can achieve change- but in setting targets, inter-sectoral issues must be considered). • Agreed targets, rules of the game for partners, process for monitoring and review
Project Conditions	• Low aid dependence, no sector leverage, but sustainable & replicable project benefits achievable • Demonstration role where sector programme priorities need reform • Resource allocation role where fungibility is imperfect

The choice of aid instrument: 2. Earmarking	
Alternatives to consider	**When to use them**
B. Earmarking Choices	Earmarking aid to specific expenditures only changes the pattern of spending if Government does not adjust its own spending to achieve desired spending priorities (i.e. incomplete fungibility)
No earmarking	• Government spending allocations are accepted by donors, **or** • Government planning and budgeting process ensures fungibility rendering earmarking pointless, **and** • Donors accept inability to say how their aid was (or was not) used
Poverty earmarking (e.g. Uganda PAF)	• If baseline poverty expenditures are identified in the budget, earmarking to additional spending can protect allocations and releases • Less discretionary than conditionality, therefore more effective as incentive • Assumes donors are significant share • Requires careful definition of 'without aid' alternative baseline • Works best where donors and reformers share desire to protect poverty spending from e.g. defence
Sector Earmarking	• Donors want voice in sector policy forums (might be achieved anyway through general budget support) • Additionality is desirable given other priorities, and achievable (which requires earmarking to be supported by conditionality on Govt share) • Donor earmarking ensures reliable flow of resources, encourages more serious planning and budgeting
Earmarking to projects or specific expenditures within a sector	• If partners agree, earmark if Govt fails to prioritise critical expenditures. May need conditions to ensure additionality, sector dialogue to sustain benefits after donor exit. • Govt may value project aid and related technical & management support, but refuse policy dialogue. • Interim donor projects while Govt sector implementation capacity is built. • Sustainable non-Govt. projects addressing gaps

The choice of aid instrument: 3. Disbursement Channel	
Alternatives to consider	**When to use them**
C. Choice of Disbursement Channels	If possible, build sustainable capacity by using Government financial management arrangements, strengthening and adapting as necessary to contain accountability risks to donor.
Donor funds disbursed through standard Government disbursement and accounting arrangements.	• Procurement and financial management are assessed as satisfactory (e.g. by World Bank procurement and country financial accountability assessments), **or** • Govt has agreed an action plan and monitoring arrangements to overcome weaknesses, **and** • Sufficient extra checks & controls are in place to meet donor accountability concerns (e.g. independent audit or pre audit, tracking studies, strengthening of user and civil society accountability).
Donor funds disbursed through Government systems, subject to the conditions specified in Row 2, plus additional accounting for donor flows against specific budget expenditures.	• Notional accounting and reimbursement causes few problems, and distances donor from controversial spending decisions, but it incurs TA costs, and achieves only spurious accountability. • Financial support to local Governments who meet planning, monitoring, reporting, accountability requirements, capacity building for those who don't, support accountability to users.
Offshore procurement using parallel systems	• Few benefits of extending direct budget support to major international tenders if procurement expertise is lacking, or corruption is prevalent. Donor support may save costs and improve results; • Transparency over costs and decision criteria should be universal, Govt should have a role in choice of supplier, including for TC. • If donors fear Govt will underspend on TC, they can earmark funds.
Local project procurement using parallel systems, TC imprests	• Costly, unsustainable, not replicable • May not prevent abuses • Not part of the long-term solution

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Annex 1: Country Examples for Applying the Guidance

These country examples follow the general chain of logic of the decision tree at Figure 1.

1. Aid dependent country with good policies

Can we agree policies and priorities with central Government authorities?

Country A is a low-income country in which Government and donors have been able to reach agreement with central authorities on policies and expenditure priorities. There is a long track record of sound economic management and public sector reform although some important structural reforms have yet to be undertaken. A poverty reduction strategy is in place, linked to a medium term budget process which has increased allocations to poverty programmes. There is good dialogue with government on a wide range of policy issues including budgetary process, and the Poverty Reduction Support Credit (PRSC) and annual policy dialogue on the budget provides a mechanism for co-ordinated support to the budget.

Aid dependency is high, which reinforces the case for working with other donors through common procedures in order to minimise the burdens on Government. Govt has produced partnership principles for donors which call for all support to be integrated within Govt budget plans. Govt plans to extend the sector approach to all areas of Government spending. There is a case for phasing out project support to Government activities as the sector approach gathers pace

Is budget process strong enough to plan, execute and account for public spending?

There are some concerns over corruption, control of government funds, poor public service pay and performance, internal peace and security and external border conflicts, otherwise governance is relatively good. General budget support is therefore accompanied by undertakings aimed at strengthening financial management and accountability for results and inputs. An effective mechanism has been established, through the Poverty Reduction Support Credit, for monitoring progress on the key cross-cutting policy concerns, and efforts are being made to better co-ordinate TA support. Given the long track record, conditionality recognises progress made and the quality of the dialogue, and aims to minimise the buying of future promises. Budget support is committed annually in time to facilitate budget planning, with indications of longer term funding levels assuming the programme continues to make progress in implementing the poverty action plan, addressing accountability and expenditure effectiveness concerns while maintaining sound macro management.

Serious weaknesses in accountability are being addressed through the Poverty Reduction Support Credit process, an action plan is in place. Pending improvements in the overall accountability environment, DFID has continued to rely on notional accounting for budget support in terms of budgetary expenditures which can be readily accounted for through pre-audit by Crown Agents.

Can poverty concerns be sufficiently addressed by supporting central budget and reform processes?

There are weaknesses at Ministry and local Government level in the capacity to implement effective programmes, and to account for the results achieved and the resources used. The PRSC and central TA addresses cross-cutting issues together with other donors. Sector strategies and operational plans are consistent with MTEF estimates of resources, and there is good dialogue on developing and monitoring them. Conditions at sector level are addressed both through SWAps and through PRSC, Govt agrees that PRSC donors should also have access to sector dialogue. Central authorities have welcomed some donor earmarking of budget support, both to protect key poverty spending, and to use donor leverage to increase pressure for sector level reforms. Govt has channelled HIPC, donor, and some additional own funds into protected Poverty Action Fund spending.

Is sector (and sub-national) capacity strong enough to plan, execute, account for resources?

DFID continues to be involved in capacity-building projects for maintenance of basic infrastructure in transport and power sectors. These should eventually be subsumed into sector programmes when they are developed, as should residual project activities in health, education and Livelihoods improvement (including land reform). Meanwhile, they should be fully integrated within the MTEF.

There is continuing tension between the budget support-sector programme approach, and the need for capacity building support at local Government level, where services are delivered. The approach presently being taken involves working with government to ensure an appropriate policy framework for sustainable livelihoods is established at centre, to be supported via national programmes for local Government and for agricultural modernisation.

2. Aid dependent country, policy and governance concerns

Can we agree policies and priorities with central Government authorities?

Country B receives significant flows of aid but aid dependence has fallen (down to 45% of development budget from 85% ten years ago).

Poor governance, weak institutions, and a dominant elite mean that neither national interests nor those of the poor are adequately addressed. In the absence of a stronger domestic voice for the poor, the influence of donors and external players is not enough to counteract the detrimental effect of the strong elite on policy and implementation.

Human rights performance is variable, democracy is fragile, and corruption widespread. In the absence of a more effective and accountable government, dialogue with donors can make only limited progress. WB and ADB would expand assistance but only with evidence of Government commitment and capacity to propose and implement appropriate policies more rapidly. There is no agreement to the major reforms needed before progress on addressing poverty can be attained. Resource allocation is weak, too much budget goes to finance untargeted subsidies and investment projects and losses of poorly managed SOEs. Government has not yet demonstrated political commitment to governance reforms.

Elite domination at all levels can not be addressed by top-down reform, but needs empowerment of the poor and vulnerable. Projects through major domestic NGOs help support long-run prospects of improved Governance, strengthening the voice of the poor and vulnerable through wider education, micro-credit and employment of women.

Can sub-national or sector level interventions achieve worthwhile impact despite weaknesses in central policies?

Despite overall constraints on which WB are leading dialogue, DFID judges that worthwhile scope exists to pursue poverty reduction objectives at sector level e.g. in support of health and population SWAp. A clear process is in place for agreeing sector strategy and plans with donors, a regular review process, dialogue to improve poverty targeting through linked TA.

Additionality of sector commitments is desirable given low Government commitment to poverty spending, but needs to be supported by conditionality to avoid fungibility (e.g. there is evidence of lower Government spending on health and population sector in reaction to donor commitments). It is difficult for a single donor to have impact, by earmarking, but there may be some scope within broader donor partnerships with conditionality on Govt share, provided the threat of reduced donor spending is perceived as credible (which it has not been hitherto).

Can Government and donors reach agreement on policies and priorities in key sectors?

Government remains a key provider/purchaser of services for the poor but needs greater effectiveness which in turn will require enhanced accountability as well as commitment to improved performance and responsiveness to the public. The current DFID programme focuses on poverty reduction and strengthening governance and institutions (a central theme of DFID strategy), through projects in key sectors (health, education, micro-credit, livelihoods in agriculture and fisheries, infrastructure) with much co-financing.

Preparation has started to extend a sector wide multi donor approach to more sectors, facilitating formulation of coherent sector plans through a participatory process. There is no overall government strategy for dealing with poverty elimination so DFID's interest in working with Government and donors at sector level to encourage development of a sector-wide approach where possible will go some way towards filling the gap in policy, though it will be important to ensure that the process does not run ahead of the development of Government ownership.

Is sector capacity strong enough to plan, execute, account for resources?

Within the health sector, despite agreement to a joint health and population sector programme, the perception that resource allocation remains weak has influenced DFID to retain some earmarking, e.g. to NGOs and to health economics.

The lack of transparency and accountability in use of public funds, the existence of institutionalised corruption, the lack of a strategy to overcome long established problems, make donors reluctant to rely on Government systems, leading to insistence on additional safeguards for pooled funding. The health sector support uses a WB style project office, conventional WB project disbursement procedures relying on statements of expenditures to be funded from HPSP funds, with a focus on the development budget.

A TA project is strengthening aspects of financial management and accountability, though the problems of political economy and bureaucratic systems are more of a constraint than lack of skills, hence 'technical fix' TA can have limited impact.

Concerns about delays and difficulties with government resources, decisions and commitment, as well as widespread corruption, together with the lack of a credible Government strategy to address these problems, mean that bypassing government financial systems is currently seen as the most sensible option if substantial financial resources are to be provided in support of public expenditure.

3. Large federal country, substantial state autonomy

Can we agree policies and priorities with central economic authorities?

Country C is a low income, federal country, but with low aid dependence (aid is 3-4% of the national budget). DFID assessment is of 'Relatively good economic and social policy and institutional environment in recent years', but the Government continues to struggle with fiscal problems, misallocation of resources to poorly targeted subsidies and to SOEs, a slow pace of reform, and corruption concerns. These problems have weakened the capacity if not the commitment to providing adequate resources for basic social services. The constraints lie in the political difficulty of implementing reforms rather than in any lack of technical awareness or capacity to do so, and the influence of donors on the national policy dialogue is inevitably (and appropriately) limited.

Can sub-national or sector level interventions achieve worthwhile impact despite weaknesses in central policies?

Cross-cutting policy issues are of central importance, but with negligible leverage, policy conditionality is unacceptable to national Govt. However, DFID judges that States have scope to address many cross-cutting reform issues independently, within a federal policy framework which is sufficiently positive for State reform efforts to yield significant benefits. .

DFID would like bilateral grants to specific States to be additional. Though too weak an incentive to promote reforms where ownership is absent, DFID judge that bilateral aid (especially alongside the World Bank) can be significant enough to positively influence the probability, timing, design and prospects of successful implementation of reforms at State level. DFID therefore is proposing macro structural adjustment support with the WB at State level.

An unresolved issue concerns the terms on which such support is passed on to the States. It could be argued that the principle of a donor deciding bilaterally on additional support to selected States undermines the efforts of the national Government to prioritise the use of scarce resources, and runs counter to the very principles of rational allocation of resources on which the movement towards budget support is predicated. This argument might be countered if the donor allocations were offsetting other biases in allocation, but Govt have argued that this is not the case, and that other States (possibly less well managed ones) receive a disproportionately small share of funding. Because Govt funds are allocated based on politically contentious formulas, it is difficult for Government to fully offset donor allocations and render them fungible.

Within States, DFID recognises that cross-cutting issues of resource allocation must be addressed, and is contemplating supporting an overall reform agenda with the WB, by providing a form of general budget support conditional on implementation of reforms. It is recognised that the scope for increasing currently low levels of expenditure on services most relevant to the poor will only be increased if action is taken to restrain the burden of poorly targeted subsidies to power, fertiliser, and general food rations.

Can poverty concerns be sufficiently addressed by supporting central budget and reform processes? Do donors agree with policies and priorities in key sectors they wish to assist?

The poverty agenda at State level also requires complementary action at sector level. Sectors need to develop strategies and operational plans, and DFID is helping to facilitate this with the aim of moving towards sector support. Allocations to primary services are so low in percentage terms that increasing them is not a major factor in the wider problem of the fiscal deficit. Sector support will aim to leverage increased Govt. spending on basic services, while the wider fiscal problems are addressed through the state level adjustment programme which DFID plan to support with the World Bank.

DFID also support project interventions not linked to the preparation of sector programmes. Given the low leverage & large size of the country, projects risk achieving limited local impact at high administrative cost. Conditions need to focus on ensuring that they support broader reform objectives, and are embedded in institutional processes which enable benefits to be sustained and replicated, e.g. support to state level public sector management reform.

Is sector capacity strong enough to plan, execute, account for resources?

The capacity to plan, execute and account for sector spending is currently weak at State level, and time will be needed to put in place sector strategies which could be supported with un-earmarked budget support. In the meantime, support will in practice be earmarked to specific parts of the programme. Because of the fragmented budget responsibilities, fungibility is arguably far from complete, and earmarking can help to leverage additional resources for the sector. For example, the existing Govt commitment to provide staff and operating budgets for primary schools means project investments in new classrooms can leverage additional Government spending. The extent to which this is a responsible strategy depends on keeping under review the practical capacity of Government to honour this commitment.