Position Paper
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Direct **budget support**

NORAD
DIREKTORATET FOR UTVIKLINGSSAMARBEID
NORWEGIAN AGENCY FOR DEVELOPMENT COOPERATION

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1 Introduction

In order to ensure that resources freed as a result of debt reduction[1], and loans are utilised for poverty reduction in development countries, the World Bank and the IMF require countries to develop a strategy for poverty reduction (Poverty Reduction Strategy Paper, PRSP). Norway has decided to base its development co-operation in main partner countries on national strategies for poverty reduction. The objective of combating poverty also remains very central to Norway's cooperation in other partner countries.

Direct budget support represents just one of several means of achieving poverty reduction. The Norwegian Government has stated in its Action Plan for Combating Poverty in the South towards 2015 – 'Fighting Poverty' (March 2002) – that Norway intends continuing the process of shifting project assistance to various types of budget and programme support. Public financial management will remain an area of focus.

This document reviews some of the key issues related to direct budget support and public financial management[2]. In addition, some advice is being provided on how NORAD ought to handle and deal with direct budget support.

2 The objectives of direct budget support and its advantages compared to project assistance

Among the problems related to project assistance one can mention:

- A lack of responsibility on the part of the recipient
- A lack of completeness in plans for achieving poverty reduction
- A lack of long-term project sustainability, e.g. if the recipient has not given priority to the project, it might consequently not be followed up in the future
- Large administrative costs of both donor and recipient

Such problems have caused a shift in focus from project assistance to programme and direct budget support. However, project assistance continue as one of the central forms of development aid in the foreseeable future, if for no other reason that reorganisation takes time.

Should a partner country's strategies for reducing poverty as well as its governance prove satisfactory, then generally backing up these strategies with direct budget support rather than attempting to direct financial support in every detail by way of project assistance may prove to be more goal-oriented and effective.

Public financial management is unlikely to be completely satisfactory. General direct budget support will not only allow for a follow-up of the planning and budgetary procedures but also for discussions about developing democratic institutions, private sector development, improving tax revenue, reforming public administration, and about the procedures surrounding the government budget etc. In part these could also imply contributing to combating corruption in a goal-oriented and effective manner.

The level of requirements that must be met in these and other areas needs to be weighed against what has been considered as one of direct budget support's important advantages compared to project assistance, namely providing the authorities in a partner country with a real sense of 'owning' its own development plans. For example a sector minister will find it easier to plan within

[1] Under the procedures for Heavily Indebted Poor Countries (HIPC)

[2] In part this document is based on a discussion memorandum produced by Dag Aarnes in September 2001 entitled 'Budsjettstøtte som bistandsform' (Direct Budget Support as a Form of Development Aid). This was previously distributed to all embassies and internally within NORAD, Oslo.

his/her own sector in the case of direct budget support instead of dealing with too many donor dominated individual projects.

Additionally, direct budget support better allows for the development of comprehensive development aid plans since the support is not earmarked for specific purposes. Through the use of direct budget support Norway can assist its partner countries to achieve an improved overview of available resources, not least so that they can be incorporated in the government budget. This will also give the country's national assembly the opportunity of conducting a complete assessment of how resources are being utilised. This is an important part of the effort to achieve better systems of governance and the strengthening of democracy.

Direct budget support can create positive incentives as a partner country itself will give priority to using the funds in ways that provide high rates of return; this will most likely stimulate the provision of further aid once donors note that results are being achieved. In the case of project assistance the opposite is generally the rule with regard to incentives; the recipient has learnt that donors finance good projects which can result in a recipient seeking incentives for not having to fund these themselves, preferring to use the money in ways that provide lower rates of return. Regardless of whether funds are earmarked for specific projects or not, it will prove difficult in practice to attain solid financial management of a project; funds related to one area of the economy, for example a school, can release money for use in other areas, e.g. weapons. This can also be referred to as fungibility (please see below).

There is reason to believe that direct budget support can, in the long run, lead to lower total administrative costs, especially if several donors are co-ordinating the support. A recipient is faced with fewer procedures, has fewer reports to draw up, there are fewer transfers to make etc. If several donors are responsible for coordinating direct budget support, then these advantages will be boosted even more.

3 Fungibility and monitoring systems

In recent years a number of studies have been conducted looking at the extent to which aid is fungible, i.e. functions in the same way as other resources in the economy of the recipient country. This question is important in connection both with the choice of partner countries and the use of direct budget support as a form of aid. Some of the results have been presented in the study entitled 'Assessing Aid' published by the World Bank and are relatively clear. Aid increases the resources available in the economy of a recipient country yet it does not increase that portion of the resources allocated for investment. This means that the proportion of every Norwegian aid Krone directed to investments is the same as for other resources in the economy. A donor earmarking funds for investment, education etc. via project or programme assistance is of limited effect since the authorities in the recipient country can counteract the donor's priorities by reallocating resources within its own budget.

Fungibility is of importance not only for how aid funds are actually used but also for the effect of aid. World Bank analyses indicate that economic policies and institutions in the partner countries must function reasonably well (that is, the countries' resources are employed well) if aid is going to have a positive effect on economic development. Given this experience, the World Bank has recommended that aid should be extended to countries that have developed fairly good policies and where there is a high level of poverty in the population. Through its analyses the World Bank has made important contributions to the understanding the relationship between aid and development. However, weaknesses have been highlighted in the Bank's analyses with regard to problems of methodology and the choice of indicators for what constitutes good governance. A review of the situation in each individual country is required in order to reach a conclusion as to whether aid can be expected to play a role and how it achieves this.

If one provides support to countries that pursue satisfactory development policies, fungibility is not a key donor concern, as both donor and partner will share concurrent priorities to a great degree. Given certain prerequisites, direct budget support will then act as an extremely effective form of aid. Aid will have little effect in those instances where a country does not pursue policies that contribute to development; such countries should not be given priority when the choice of partners is made. The information available concerning fungibility indicates that donors will be unable to force development on countries by way of project assistance.

Acknowledging the fact that aid funds are fungible and that one is increasingly providing direct budget support will have consequences for one's procedures for reporting the effects of aid. It has been normal practice for Norway to follow each development aid Krone as far as possible. We have attempted to maintain as much control over financial aid as possible by developing systems that require a lot of resources, not least on the part of the partner countries. In reality such control mechanisms are of rather limited value, given that funds are fungible. Effective –yet probably expensive – control mechanisms over a small part of a country's economy tells us little, for example, about the degree to which partner countries follow up their own development strategies or actually reduce poverty.

As far as the use of direct budget support as a form of aid is concerned, the monitoring mechanisms used will to a great degree be systems that cover the whole economy, for example the Auditor General, national accounting systems, parliamentary supervision, freedom of access to public administration. Just minor improvements to these national systems can be of greater importance than a nearly perfect system that merely covers a limited aid project.

4 Mode of operation

Budget support can be provided as direct assistance to a government budget, i.e. foreign currency is converted in the local currency, as balance of payments support in the shape of foreign currency, i.e. these funds do not enter the domestic economic system, or as debt relief. The aim is to contribute to improvements in a country's financial situation and its external balance of payments. As a result investment will increase in areas such as road construction, new buildings, increased know-how, or a more effective workforce, all of which leads to an increase in economic growth. The intention is not to contribute directly to an increase in consumption, i.e. a rise in imports or current expenditures. Providing aid as a means of increasing consumption will imply spending accumulated savings obtained from donors on consumption. A better use of transferred capital would be investing in other kinds of capital, for example a reduction in the nation's debt, human resources (education etc), physical assets or (in principle) natural resources, all of which can provide a rate of return the next time round. In turn this can be spent on increased consumption. These arguments are equally applicable to project assistance.

The ultimate effects of increased aid on investment, consumption and foreign trade will depend on how the funds are utilised and on how a country's economy is actually functioning. In countries where a small proportion of public or private sector resources is invested or placed in investments giving low rates of return, aid will also make a limited contribution to productive investment because of fungibility. Development assistance will therefore probably serve the best purposes in countries with a high degree of poverty and a large proportion of investments (with high rates of return) compared to consumption.

In addition we would refer you to the appendix entitled 'How Development Assistance Can Contribute to Economic Stabilisation and Growth'.

5 Norwegian direct budget support

Budget support offered as direct assistance to a government budget can either be general in nature and not earmarked for any particular purpose, or sector support earmarked for a specific section of the government budget. Additionally, direct budget support can be given bilaterally or via the multilateral system. Norwegian bilateral budget support may either take the form of an arrangement involving only Norway and the recipient country or be provided through a common system incorporating other bilateral donors. Yet another way of organising Norway's budget support is to co-finance with the World Bank's Poverty Reduction Support Credit (PRSC).

As of April 2002 Norway provides general bilateral budget support to the following countries:

- Tanzania, where focus is being directed at implementing poverty reduction programmes and the reform of government systems.
- Mozambique: direct budget support (provided in cooperation with nine other donor countries) is intended to support the implementation of Mozambique's poverty reduction strategy (PARPA/PRSP) and improvements in public financial management and tax systems.
- Malawi: cooperation on direct budget support (provided together with other donor countries) is meant to increase the predictability of aid, reduce the number of consultations, establish common administrative procedures for distributing assistance, and lead to dialogue with regard to improved financial management.

Direct budget support as a possible form of aid from Norway is also under discussion in some other countries, e.g. Uganda, Bangladesh, Nepal.

6 Important elements in working with direct budget support

There are several factors decisive in making direct budget support an appropriate and effective form of aid. The following factors should therefore be assessed:

- Does a strategy covering several years exist for reducing the poverty level?
- Is there a credible link between this strategy and the government budget so that the strategy can in fact be implemented?
- Are there already systems in place making the authorities accountable for the results? It would be best not to insist that these systems are completely perfect before direct budget support is provided; rather, the authorities should have thoroughly thought through their approach and be able to show that the situation develops in the right direction.
- Are efforts being made to increase the country's own tax revenues?
- Are improvements in public financial management being undertaken? This will include fighting corruption.
- Would coordinating both bilateral and multilateral donors be relevant if several donors were to agree to participate?

These issues will have to be dealt with in addition to any other criteria for bilateral cooperation - for example the poverty level and governance situation in the recipient country. Furthermore, the Norwegian embassy must possess the relevant knowledge and capacity to follow up any direct budget support granted, or be represented by another country with regard to the follow-up process[3].

The fact that other countries are also willing to provide direct budget support does not need to be a prerequisite for Norway doing so. In practice there will most likely be other donors providing direct budget support to countries where Norway considers such assistance. As already mentioned, coordination between the various donors is important for reducing administrative costs. At the same time donor cooperation can lead to disequilibrium in the balance of power between partner countries on the one hand and donors on the other. This can result in reduced recipient responsibility.

[3] NORAD has developed a two-day course in macroeconomics held at the Foreign Ministry's Training Centre in Oslo. NORAD also works together with SIDA on developing a course in public financial management.

In practice the assessments carried out by other countries, the IMF or the World Bank will act as relevant background information when Norway considers what action to take. Nevertheless, one could imagine that Norway might in principle produce a different assessment or choose to maintain direct budget support in a situation where other countries have decided not to provide this type of aid. It is important to be aware that coordinated direct budget support can represent a risk for the recipient since a coordinated reduction in or withholding of aid would have severe consequences.

In addition, it is important that the provision of aid is as predictable as possible. Direct budget support can represent a sizeable portion of a recipient country's government budget, especially when several donors are providing such support. Consequently partner countries may experience difficulty in making good plans and budgets if the amount of aid fluctuates severely from year to year. In practice direct budget support might be regarded as having closer links with the country's political development than might other types of aid. In situations where development has taken a negative turn participating donors will be able much more quickly to raise questions related to budget support than would be the case for other types of country-to-country assistance.

The above-mentioned factors also imply a need for a certain amount of predictability with regard to the system of governance and to developments in the recipient country's society in order for direct budget support to act as an appropriate form of development aid. As with all kinds of development cooperation Norway's choice of partner for the provision of budget support will be of great importance.

Other factors that might be central to implementing budget support are as follows:

- In the case of several donors participating in an agreement on budget support, one should strive for the establishment of common systems for implementing the aid arrangement. This will include shared methods for transferring funds, drawing up reports, maintaining contact with the authorities in the recipient country etc.
- The division of work between the donors should also be given consideration.
- From experience certain challenges can prove relevant and ought therefore to be given as much thought as possible in advance, such as:
    - What are the critical limits for a partner country not fulfilling the requirements for direct budget support? The long-term trends in a country's development are important since cooperation with Norway's partner countries should itself be robust and long-term in nature.
    - If the prerequisites have not been fulfilled, might the relevant response be to assess a gradual, planned reduction in assistance in consultation with other donors rather than to halt disbursements completely?
    - How should possible disagreement within the group of donors be dealt with?
    - How should one handle the country assessments produced by the IMF and the World Bank?
    - What improvements in the system of managing public finances should specifically be focused on? This should be based on the experience and analyses found in Public Expenditure Reviews (PER), Country Financial Accountability Assessments (CFAA) etc (please refer to section 7).

7 Increased focus on public financial management

The quality of the management of public finances in a partner country is not only decisive for whether or not public funds are being utilised effectively but also for the effectiveness in achieving reduced poverty levels. This will include the quality of the whole budget process; and the routines for payments, accounting and auditing at both local and central levels of public administration, and not least how well the whole system actually functions. For some time now focus has been directed at the quality of the management of public finances within the area of development assistance. The procedures for managing public finances in individual countries have been assessed in order to check for and ensure the effective utilisation of aid funding, while professional support and institutional development have been employed in strengthening financial management in partner countries.

There will be an even greater need to possess adequate knowledge of the functioning of financial management systems if aid is going to be provided in the form of direct budget support channelled through national systems either at macro or sector level. Debt relief also has a budget support effect, a fact that makes the quality of the country's financial management even more decisive in ensuring that the funds released due to debt relief are utilised in such a way that they will assist in reducing the level of poverty. When dealing with sector programmes one will also be faced with severe challenges with regard to understanding how a country's public administration actually functions; the relationship between central government and the local authorities; the methods that donors should use for channelling aid funding into the system in an appropriate manner; reporting systems; auditing etc.

Various reviews are undertaken in order to assess public financial management in development countries – Public Expenditure Reviews (PER), Country Financial Accountability Assessments (CFAA). Such reviews are conducted by bilateral donors (please refer to Norway's participation in Joint Donor Review/Mozambique or Common Approach to Budget Support/Malawi), the World Bank, the IMF and others. They do not always coordinate their work which then often becomes overlapping. This lays claim to a good deal of capacity in partner countries that are required in some instances to respond to the same questions from different donors. Greater cooperation in conducting such surveys and assessments is therefore needed. Participation in such reviews is of importance not only for obtaining the necessary insight into how public financial management works but also as the basis for formulating reform programmes and capacity building within public financial management systems.

Apart from following up the public financial management systems generally and government budgets of partner countries specifically, NORAD is faced with the challenge of ensuring that as much development funds as possible – both budget support and other types of assistance – is clearly reflected in recipient countries' published budgets. An as accurate as possible estimate of the total amount of development assistance granted is required before one is able to draw up satisfactory plans concerning the use of public funds; in addition this will help in arriving at the most accurate estimate of a country's economic development. Moreover, insisting that all development aid funding be clearly and openly detailed in a nation's budget may act as a form of deterrent against corruption. At the same time this will require that donors publish an accurate budget forecast for the subsequent year.

Furthermore, reform programmes, capacity building and technical assistance will be required in areas as macro-economic planning, statistics, auditing, local government, procurement etc.

Statistics Norway is already a partner in this regard; contact has also been established with the Norwegian Ministry of Finance, the Norwegian Tax Administration, the Norwegian Customs and Excise, and the Norwegian Banking, Insurance and Securities Commission in order to initiate co-operative measures. The Central Bank of Norway may also prove to be a potential partner.

MEMORANDUM

APPENDIX

To: All participants in the meeting with the Director General Our Ref:

From: UE Your Ref:

Desk Officer: KNT File No:

Copy to: The finance network

Date: 11th January 2002

HOW DEVELOPMENT ASSISTANCE CAN CONTRIBUTE TO ECONOMIC STABILISATION AND GROWTH

As the changeover from project based assistance to direct budget support continues to grow, organisations providing development aid will increasingly be faced with new and important problems. This memorandum highlights some of these problems and more generally discusses the ways in which assistance affects the economies of recipient countries and which means of distribution it utilises.

The different aspects of development assistance

Development assistance itself possesses several characteristics. It is capable of making contributions to the transfer of technology and to creating a dialogue between donor and recipient. Three important characteristics are:

- Development assistance is representative of *the transfer of revenue* from rich to poor countries and, to start with, increases the recipient's disposable revenue by an amount equivalent to the assistance provided.
- The increase in disposable revenue as a result of development assistance can *promote investment* that in turn increases the economy's capacity to produce goods.
- Development assistance (and any changes made thereto) can have an effect on the proportion of production capacity in a country's economy *by increasing demand*. Little attention has been directed at this aspect of development aid so far.

Development aid as a transfer of revenue
Development aid represents a transfer of revenue to the recipient country. It directly increases that country's disposable income in exactly the same way that social security payments and benefits increase the disposable income of Norwegian households. What is so special about development aid is the fact that it is paid out in foreign currency. As such it can only be utilised in making way for an increase in imports, either directly or indirectly by leaving room for increased overseas economic activity leading to greater imports.

Development aid as investment
Donors wish the greatest possible percentage of increased revenue resulting from development aid in the recipient's economy to be invested such that economic production capacity increases. The long-term objective in this instance is economic growth. However, development aid funding is in reality put to use in the economy just like

any other economic resource because of fungibility (or the exchangeability of resources). Consequently development aid funding is most effective in countries with high levels of investment that are applied productively, i.e. the country runs reasonably satisfactory institutions and pursues a sound economic policy. Nevertheless, countries with unsatisfactory policies have historically received equally large amounts of development aid as have those countries demonstrating sound policies. On average development aid has not, therefore, had any effect on economic growth. This of course does not imply that those transfers of revenue received by development countries in the form of development assistance have not increased living standards.

Development aid as a way of creating economic demand
Increased development aid allows for an increase in imports equivalent to the increase in aid. This leaves room in the recipient country's foreign trade balance for stepping up economic activity; in turn this leads to a rise in imports. The extent of any increase in economic activity due to the injection of higher levels of development aid into the recipient country's economy will depend to a large degree on the general business conditions prevailing at the time. When domestic production capacity is more or less being utilised to the full, there will be a greater tendency to import goods (as is the case today in Norway). Furthermore, increased demand caused by a rise in the development aid received will not result in an overall increase in economic activity worth noting, but rather in higher imports generally speaking.

On the other hand, if a good deal of slack exists in the means of production, e.g. during a depression, higher levels of development aid probably can expand GDP by the equivalent of 2 to 3 times the amount of aid funding.

The mechanics of the process are as follows. The injection of development aid into an economy results in some of these funds being used for direct imports, while the remainder serves to create a demand for idle domestic manpower and resources that are then brought into play; GDP will also increase accordingly. The owners of these sources of labour and domestic resources will enjoy a commensurate rise in profits. Some of the earnings will be turned into savings, some will be used to pay taxes, while the remainder satisfies increased demand, partly in the form of imports but principally in the shape of domestic production. Moreover, GDP expands by an equivalent amount. This results in higher revenue/profits and increased demand. Every successive cycle produces a lesser effect than the previous one due to leakages in each part of the process, namely in increased income converted into savings or taxes paid and in the demand for imports.

Higher economic activity leads to governments receiving greater amounts in taxation and having a more balanced budget. This in turn allows for demand to be further stimulated through increased public expenditure. In that respect development aid plays a role in mobilising a country's own resources. It can act as an effective economic stabiliser especially if it has been increased in times of economic shock or depression. However, a reduction in aid funding under such circumstances may severely exacerbate a country's economic situation.

A new report issued by the World Bank's research department (Collier & Dehn: 'Aid, Shocks, and Growth', Working Paper, October 2001) indicates that:

- A severe drop in the price of exports causes production (GDP) to fall by an amount equivalent to twice the revenue lost from the drop in prices over a four-year period.
- An increase in development aid can counteract the negative effects of a price shock. The effect of such an increase on GDP is great relative to the usual growth-promoting effects of development aid. In addition, it is

proportionately greater so far as improvements to the effectiveness of development aid are concerned, when this is specifically directed at recipient countries with satisfactory policies.

- Both the policies of a recipient country and the negative shock of export prices ought to influence aid distribution, yet this has not so far been the case. The apportionment of aid funding would become more effective in reducing poverty levels if this were taken into consideration.

Should more emphasis be placed on economic stabilisation in relationship to development assistance?
As far as it goes, it is relatively surprising that the question of counter-cyclical policies in relationship to development assistance has not been accorded much attention so far. The absence of such policies may lead to a large fall in GDP and play a part in a country declining into a low-growth situation. Stabilising GDP is a central point in the economic policies of industrialised countries. Developing countries are exposed to more severe macro-economic shocks than industrialised countries because of the large fluctuations in export prices and in agricultural yields.

The reason for little attention having been paid to this problem partially lies in the fact that it has been regarded as a domain of action for the IMF (which requires its loans to be repaid) and that one has principally been preoccupied with stabilising a country's external account and its finances. This may result in cuts that further promote any downswing in GDP when viewed in isolation. Collier and Dehn point out that the make-up of current IMF programmes presupposes any development assistance beyond that already planned for a specific programme must be accumulated in the form of foreign currency reserves. This would apparently seem to be intended as an incentive for donors not to provide development aid as a counter to an economic shock.

Bilateral development assistance organisations have for their part spread aid thinly over several countries by way of project assistance and have thus been confronted with macro-economic problems only to a small degree. These problems are about to become of greater current interest:

- Administering development assistance aimed at countries that have developed satisfactory policies can be conducive to a reallocation of funds between countries to an ever-increasing degree. This can act as a stimulus in the trade cycle of countries that have experienced rises and falls in funding. A greater amount of coordination among donors has considerably more influence on a country's macro-economy.
- The transition from project to direct budget assistance will result in donors being confronted more and more by questions concerning macro-economic stabilisation. At the same time the potential for contributing to this stabilisation will grow since direct budget assistance works as a more effective means than project assistance in this instance.
- This question may well arise should one of the countries that has a PRSP and has developed effective policies for reducing poverty levels suffer a sudden, serious drop in its export prices. Its bilateral donors are then faced with the following dilemma – should they continue on a 'business as usual' basis or provide more active emergency financial assistance on a temporary basis?

One should already have set a high threshold limit on actively applying development aid funding as a counter-cyclical policy during a period of depression, that is by increasing public expenditure. One of the arguments against such a policy would be the ease with which one can get the timing of it wrong. A more cautious approach would be to assist in filling the gaps in a country's government budget caused by recession. One would then avoid the need for cutbacks in the government budget that simply intensifies a recession.

Conclusions

The effectiveness of development assistance can be increased by the ongoing transition to direct budget assistance and by donors concentrating their efforts more and more on countries with policies that promote development. This will result in development assistance organisations facing challenges that have been waiting for them in the recipient countries, but which have so far confronted them to only a small degree, e.g. stabilisation policies and to a certain extent the regulatory framework for business. Dealing positively with these challenges will increase the effectiveness of development aid.

First and foremost NORAD must develop a long-term investment perspective on development assistance in relationship to working in partnership. However, new types of aid will have an effect on the make-up of this perspective. The transition to more and more direct budget assistance will move our focus away from domestic Norwegian priorities and priority programmes. Simply injecting funds into a larger state budget previously drawn up by the recipient country will contribute towards reaching this aim. Furthermore, taking part in discussions about the budget will direct one's focus more towards concrete problems to be found in the recipient country related to economic policy and regulatory frameworks and which at the same time prevent speedy economic growth and a reduction in poverty levels.