



Federal Ministry  
for Economic Cooperation  
and Development

STRATEGIES 181

# Budget Support in the Framework of Programme-Oriented Joint Financing (PJF)



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# Abbreviations

CIM	Centre for International Migration and Development
DC	Development Cooperation
DED	German Development Service
FC	Financial Cooperation
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
HIPC	Heavily Indebted Poor Countries
IMF	International Monetary Fund
Inwent	Inwent – Capacity Building International, Germany
KfW	KfW Bankengruppe
MDBS Programme	Multi-Donor Budget Support Programme
MDGs	Millennium Development Goals
MoU	Memorandum of Understanding
MTEF	Medium-term Expenditure Framework
NGO	Non-governmental organisation
PBA	Programme-Based Approach
PFM	Public Financial Management
PJF	Programme-oriented Joint Financing
PRSC	Poverty Reduction Support Credit (World Bank)
PRSP	Poverty Reduction Strategy Paper
SMEs	Small and Medium-sized Enterprises
SWAp	Sector-Wide Approach
TA	Technical Assistance
TC	Technical Cooperation

# 1. Introduction

In the international debate about ways of enhancing the effectiveness of development cooperation, programme-based approaches (PBAs) have acquired considerable importance in recent years. Programme-oriented joint financing (PJF), and budget support in particular, are specific forms of PBA constituting an innovative modality to implement new principles and procedures, and have evolved into a key instrument in German development policy as well. This paper deals with **budget support as an instrument within the PJF framework** and only touches peripherally on the broader PBA approach.

PJF, and especially budget support, is channelled through the partner country's own political system and institutions. PJF provides joint financing for locally developed and owned sectoral, cross-sectoral or macroeconomic reform programmes in the partner country by several donors, who agree the shared objectives and harmonised procedures with the partner. Joint financing takes the form of general budget support at macro level, sectoral budget support, and basket funding. Bilateral funding is provided via financial cooperation (FC), but basket funding can also be channelled through technical cooperation (TC) via the pooling of technical assistance (TA pooling).

This Strategy presents the updated position of the Federal Ministry for Economic Cooperation and Development (BMZ) on German development policy towards and participation in PJF and replaces the 2001 position paper<sup>1</sup>. The objectives, criteria and fundamental principles underlying the Strategy, described below, also provide a frame of ref-

erence for the policy dialogue with other bilateral donors, the World Bank, the regional banks, the European Commission and the United Nations. The Strategy focuses on **general and sectoral budget support**, but draws attention, where relevant, to specific aspects of **basket funding** as well (see Annex 1: Types and basic principles of PJF).

The Federal Ministry for Economic Cooperation and Development (BMZ) views budget support as complementary to other types of programme-based approaches (PBA) and project-related measures. These approaches are not in competition with each other but have different functions and to some extent operate at different political levels. In practice, the approaches should be linked so as to complement each other and generate synergies. It is particularly important to consider the adoption of accompanying advisory measures within the framework of technical cooperation.

The present Strategy advocates the expansion of the existing instruments (project investment, basket funding, advisory services) with budget support and endorses effective linkage between these instruments and budget support. This **mix of instruments** embodies the basic philosophy behind Germany's contribution to budget support. With a mix of instruments, the aim is to achieve development policy synergies and leverage effects through the combination of projects/programmes and budget support while minimising implementation and portfolio risks. Strengthening the partner country's institutional capacities and combining political dialogue with partnership-based advisory services are priorities here.

<sup>1</sup> Position paper on "Participation in Joint Financing with Other Donors within the Framework of Programme-oriented Development Cooperation", BMZ, November 2001.

## 2. Development Policy Context

### 2.1 The Paris Declaration: the international context

In the international debate, PJF falls within the broad context of programme-based approaches (PBAs) defined in the **Paris Declaration on Aid Effectiveness (2005)**<sup>2</sup>. PBAs include budget support, basket funding and project-related parallel financing, support measures and advisory services, as long as these accord with the defining characteristics of programme-based approaches and are embedded in the partner countries' national programmes, e.g. sector-wide approaches (SWAs). PBAs<sup>3</sup> are defined as modalities for engaging in development cooperation based on the principles of coordinated support for a locally owned programme. Here, programmes are defined as a national development strategy (macro-programme), a sector programme, a thematic programme of a **partner country**, or a programme of a specific (regional) organisation). To qualify as PBAs, projects must meet the following **four criteria**<sup>4</sup>:

1. Leadership by the partner country/organisation;
2. Use of a comprehensive programme and budget framework;
3. Formalised processes for donor coordination and harmonisation of donor procedures for **at least two** of the following systems: i) reporting, ii) budgeting, iii) financial management and iv) procurement.

4. Use of **at least two** of the following partner systems: i) programme design, ii) implementation, iii) financial management, iv) monitoring and evaluation.

Bilateral programmes must generally meet all these essential criteria in order to qualify as PBA measures. As an international donor, Germany has committed to **provide 66% of bilateral aid flows** through programme-based approaches by 2010<sup>5</sup>. PJF, including budget support, is thus a key element of PBA and plays an extremely important role in the bilateral expansion of programme-based aid.

Germany has also committed to implement the **five principles enshrined in the Paris Declaration**, which provide a binding frame of reference for the bilateral development of PJF:

- **Ownership:** Donors boost partner countries' capacities to exercise effective leadership over their development process.
- **Alignment:** Donors base their overall support on partner countries' national development strategies, institutions and procedures, strengthening country structures and systems such as national budget processes, harmonising donor practices, and with alignment to the partner country's national procedures and institutions.
- **Harmonisation:** Donor actions are more harmonised and transparent with a view

2 The Paris Declaration on Aid Effectiveness was adopted by 60 partner countries and 40 bilateral and multilateral organisations in March 2005, with a view to enhancing the effectiveness of development cooperation.

3 cf. OECD/DAC (2006), *Harmonising Donor Practices for Effective Aid Delivery*, Volume 2.

4 cf. OECD/DAC 2008 Survey on Monitoring the Paris Declaration, *Definitions and Guidance for the Questionnaires*

5 See also *Handreichung zum Operationsplan zur Erreichung der MDGs und zur Umsetzung der Paris Declaration* (2006), Indicator 9.

to enhancing effectiveness; donors implement common arrangements; transaction costs for donors and partner countries are reduced.

- **Managing for Development Results:** This means managing and implementing aid in a way that focuses on the desired results and impacts, and
- **Mutual and Domestic Accountability:** This focuses on shared and mutual accountability of partner countries and donors, and strengthening the role of parliaments and the public.

## 2.2 Comparative advantages and risks

Budget support programmes differ significantly from project-related measures in terms of their partner country orientation and risk profile. The comparative advantages and risks of budget support are described below, in order to allow this instrument to be located more precisely in the development toolbox:

In particular, **budget support** offers the following **comparative advantages**:

- In essence, it operates through **national systems, structures and institutions in the partner country**. There is no risk that it will bypass the partner country's budget and create any parallel structures or unofficial budgets. It thus strengthens partner country **ownership** of the reform programme because it is part of government policy and is integrated into national budget processes. This means that budget support is subject to national **parliamentary**

**scrutiny** and is more transparent for **civil society** and the **media**.

- It offers **incentives to introduce political reforms or new practices in the partner country** as the provision of significant volumes of external funding creates new policy space for action. This unleashes local creativity and fosters the development of reform concepts which are adapted to local conditions. The prerequisite, however, is, firstly, that budget support is understood and implemented as a **long-term instrument**, and secondly, that **clear, realistic and mutually agreed conditions and objectives** support, and do not undermine, the incentives provided.
- It offers the prospect of a **reduction** in both sides' **transaction costs** in the medium to long term (e.g. through harmonisation of procedures). It thus has the potential to be implemented more efficiently than project-related measures<sup>6</sup>.
- It **strengthens the national budget process** during the stages of budget planning, preparation, implementation and control (public financial management – PFM) via the transfer of resources to the budget. It facilitates **budgetary coherence** between internal and external resources, and permits **comprehensive planning** and allocation of funds while avoiding distortions between individual sectors (e.g. through relative under- or over-funding due to bias in donor preferences).
- It **promotes harmonisation of donor practices**, i.e. coordination of procedures, content and objectives. The progress made

<sup>6</sup> Currently, these costs are decreasing on the partner countries' side and increasing on the donor side due to the increased requirements for donor dialogue at field level. This must be accepted as part of the adaptation process.

here radiates out to other instruments such as project-based aid. It also **raises** the joint **policy dialogue** between donors and the partner country's government to a **higher level** and focuses it more strongly on key issues relating to political and economic management.

However, these comparative advantages of budget support must be set against a number of **fiduciary, macroeconomic and political risks**:

- **Fiduciary risks** result from the direct payment of donor funds into partner countries' national budgets, especially if public financial and control systems (including courts of audit, parliament, civil society and the media) are inadequate. It is also important, in this context, to mention so-called "**fungibility risks**" which may arise because it is no longer possible to trace the path of each individual euro of donor funding and attribute it to specific expenditure<sup>7</sup>.
- **Macroeconomic risks** cannot be ruled out as a result of the substantial flows of funding associated with budget support. With these large financial inflows and the ensuing rise in domestic demand, national currencies may come under upward pressure ("Dutch disease" effects). Possible disincentives, such as a decrease in the partner country's own efforts to boost government revenue, or the misallocation of public resources, are other potential risks.
- **Political risks** can arise if the budget support focuses solely on the partner country's spending policy to the detriment of the revenue side, reinforcing or even increasing the partner country's dependence on external aid. Other political risks can result from

an expected and dramatic worsening of governance in the partner country. In this case, the suspension of payments or termination of budget support for countries that rely heavily on external donor funding can greatly restrict the state's capacities to function effectively and further jeopardise political and macroeconomic stability.

- **Implementation risks** can occur if there are sufficient capacities in the partner country's systems at national level but operational weaknesses exist at lower tiers of government. There is then a danger that public funding will not be targeted sufficiently towards disadvantaged sectors of society, e.g. in the form of improved government services.

The risks associated with budget funding cannot be evaluated on a generalised basis. They depend on the country context and therefore always require case-by-case analysis. They can also be influenced and managed by means of an appropriate system of **risk management**. For risk management, procedural criteria, including standards that are harmonised to the maximum possible extent, are key. This Strategy is intended to foster an understanding of Germany's procedural criteria.

The procedures described here are based on the view that an effective risk management system must address several levels, e.g. the selection of countries, design of conditionalities, accompanying measures under technical cooperation, monitoring and evaluation, and, not least, the level of political dialogue. **Basket funding** is thus a special case, for although it is budget-oriented in focus (the funding is generally reported on-budget), it is usually not channeled directly through the budget and therefore entails significantly fewer fiduciary risks.

<sup>7</sup> NB: "Classic" development projects are also not exempt from fungibility risks as they may release budget funds which can then be spent on other items which are not subject to scrutiny by donors.

### 3. Objectives and Profile of German Development Policy in the Context of Budget Support

#### 3.1 Objectives of German development policy

In providing budget support, Germany pursues the following **three objectives**:

- **Governance objective:** Budget support programmes contribute to reform processes in the partner country that aim to build functioning public institutions on a sustainable basis and, in particular, improve transparency, accountability, and the effectiveness and efficiency of **public administration** and **public financial management**. Budget funding helps to improve **specialised and democratic control** of expenditure and policy objectives by improving accountability to parliament and civil society. Budget support programmes also promote political dialogue on respect for and realisation of **human rights, democratic participation, the rule of law and gender equality**.
- **Effectiveness and efficiency objective:** Budget support programmes facilitate consistent implementation of the principles enshrined in the Paris Declaration. By participating in and shaping budget funding programmes involving several donors, German development policy can support partner countries' reform processes more effectively while minimising potential risks. As the positive bilateral experiences to date have shown, budget support measures can generate significant impetus for comprehensive reforms of the sectoral, macroeconomic and budget frameworks in

the partner countries, beyond the capacities of Germany or other single donor, for example.

- **Financing objective:** Budget support measures contribute to the attainment of the partner country's development objectives by providing financial resources and accompanying technical cooperation measures that facilitate implementation of the country's pro-poor strategies and programmes, which play a key role in achieving the Millennium Development Goals (MDGs).

#### 3.2 Target countries and operational objectives

Budget support programmes are applied **selectively**:

- **Target countries:** German development policy will focus its **budget support programmes** primarily on **low-income countries with dynamic reform processes** (mainly PRSP countries) that rely heavily on external donor funding and are demonstrating ownership for implementing their national poverty reduction strategy (or similar development strategies). The fundamental prerequisites are an adequate level of good governance and trustful cooperation with the partner country's government. If the reform dynamic is inadequate, **the preferred option is generally basket funding or other forms of pro-**



**programme-based aid, e.g. parallel funding within the SWAps framework.**

Within the budget support framework, German development policy pursues the following **operational objectives**:

- German budget support takes a long-term perspective which means that budget support programmes are significant contributions (relative to the overall German portfolio and contribution of other donors). This is intended. Through appropriate conditionality and through the provision of advisory services, it supports the country's own efforts to strengthen its internal financing capacities. The partner country is informed in time of the amount of financial support to be provided and when it will be disbursed, so that this information can be taken into account in the partner country's annual budget and financial planning. The partner country's absorptive capacities and debt sustainability are considered when granting budget support.
- German budget support takes a **long-term perspective** which means that budget support programmes are significant contributions (relative to the overall German portfolio and contribution of other donors). This is intended to support complex, long-term reform processes in the partner countries, boost the steering capacity of the German contribution and create financial incentives, thereby justifying the higher transaction costs associated with the management of budget support in the country concerned (field structure). As part of this long-term orientation, importance is attached to strengthening the partner country's own financing capacities.
- German budget support should be implemented efficiently and effectively and

should be visible in a donor-harmonised coordination framework. German development policy will therefore link budget support to a specific **thematic profile** (see also Section 3.3).

### **3.3 Thematic profile of German budget support**

German development policy will aim to link budget support to a specific thematic profile to signal to other donors and the partner country what the German contribution to budget support stands for.

On a **country basis**, the German profile builds on **two levels**, with both of these levels mainly drawing on bilateral experience. In order to operationalise the profile, there must be a linkage between the various instruments of bilateral development cooperation (GTZ, KfW, DED, Inwent, CIM), and consideration of the specific conditions in the individual countries must also be taken (including current positioning of other donors). A **flexible response** to the given conditions in-country is required. The **two profile levels** are:

- 1) The **sector-specific profile**, which already exists on a **country-specific** basis in the form of bilateral development programmes in the priority area and must be taken into account in future too.
- 2) The **cross-cutting profile**, which is relevant to **all countries** and includes the following topics:
  - a) **promoting a functioning public financial management (PFM) system with a particular focus on governance and gender objectives;**
  - b) **improving the economic infrastructure and the economic policy environment for private sector activity;**

c) **enhancing impact monitoring and evaluation systems.**

1) **The sector-specific profile**

Budget support aims to capitalise on German know-how as a key priority: as a rule, German development policy has been engaged at the various political levels (micro, meso, macro) via its various instruments (KfW, GTZ, DED, Inwent, foundations, etc.) for many years and has acquired considerable country-specific sectoral/sub-sectoral expertise. The new focus on a smaller number of priorities and the conceptual linkage between the bilateral instruments (policy coherence in development cooperation) help strengthen the dialogue capacities of German development policy. **As part of the division of labour between donors, German development cooperation will position itself selectively and on a differentiated basis; as a rule, it should be able to act as lead donor in the various priority sectors.** The *sector-specific profile* applies both to sectoral budget support and to general budget support with sectoral relevance.

2) **The cross-cutting profile**

Within the framework of budget support, German development policy also focuses on cross-cutting topics that play a key role in terms of operational implementation by partner countries and as part of the overall reform agenda. The *cross-cutting profile* includes, in particular, topics such as public financial management, the creation of an enabling environment for private sector development, and impact monitoring and evaluation. Integrating the **cross-cutting topics** into the policy matrix is a key issue for German development cooperation. However, these topics do not have to be actively represented by Germany in every case if other donors can take on a lead role here. This is also a matter of maximising the efficient use of Germany's available resources and supporting the international agenda for the division of labour in development cooperation.

a) **Public financial management**

Public financial management – a key field of action for good financial governance – plays a major role in the context of budget support as it reflects the partner country's capacity to deploy public resources in a transparent and appropriate manner, with proper accountability and with a view to gender and distributive justice. The style of financial management is also a reflection of whether sustainable external funding is feasible, which means that budget support-induced disincentives are avoided. For German development policy, key objectives are **improving domestic accountability in the partner country**, which means accountability to the public and civil society (as opposed to donor-oriented external accountability) and **strengthening the partner country's own financing capacities**. These are complementary objectives and are intended to safeguard the long-term success of budget support through structural reforms; scrutiny by the country's own public is more effective than scrutiny by donors, and donor funding is no substitute for own revenue, in the long term.

Within the framework of budget support and the associated mix of instruments, we focus especially on:

- **The revenue side: strengthening the partner country's own financing capacities by modernising tax revenue systems (tax policy and administration), user fees and levies.** The revenue side of the public budget is crucially important if PJF, and especially budget support, are to have a sustainable impact (see also Section 4.3).
- **The expenditure side: this means gearing public finances more strongly towards poverty reduction like pro-poor growth**, in order to optimise allocations towards meeting the Millennium Development Goals. **Human rights issues and gen-**

**der equality** are actively pursued within the framework of policy dialogue and introduced in the budget planning process, especially at sector level.

- **Budget management: this means practical improvements in budget preparation and implementation in the finance and sector ministries.** For German development policy, a well-structured system for the preparation of the budget on a sound legal basis, a regulated system of budget administration, especially in the cooperation between the finance and sector ministries and in the sector ministries themselves, alignment of budget planning and implementation, and compliance with proper accounting standards are key prerequisites for improvements in budget processes.
  - **Procurement: this means increasing efficiency and effectiveness in budget implementation through the introduction of transparent guidelines for the award of contracts on the basis of competition, and ensuring that they are applied in practice** (reform of public procurement).
  - **Fiscal decentralisation: promotion of fiscal decentralisation through the development of local financial management capacities.** Budget support approaches initially start at central political level. However, the lower tiers of government and administration play a very important role in the vertical implementation of poverty reduction strategies, especially the delivery of basic public services. Well-functioning lower tiers also act as a counterweight to possible centralisation trends at central political level, which may impede development. Strengthening the local authorities' role vis-à-vis the institutions of central government is therefore an important task.
  - **Increasing accountability and public scrutiny: this means boosting financial control by promoting the role of the courts of audit, internal audit bodies, budget committees in national parliaments and cooperation with civil society.** Strengthening these democratic control functions vis-à-vis the executive branch is very important in terms of improving scrutiny of public finances and increasing citizens' democratic participation. In the parliamentary sphere and in relation to civil society, the aim is to foster close cooperation with German non-governmental organisations (NGOs) and the political foundations, the churches and other private agencies.
  - **Strengthening civil society participation in the context of budget support:** a strong civil society plays a key role in the context of budget support, notably in scrutinising the utilisation of public resources and building more democratic structures in public administration ("watchdog role"). As part of the implementation of the *Accra Agenda for Action* (2008), civil societies in our partner countries must therefore be involved to a greater extent in monitoring national budget processes. Above all, appropriate dialogue forums must be created between governments, donors and civil society, and key stakeholders from civil society must be given access to information and a chance to have a say. We are working together with partner governments and other relevant donors to ensure that appropriate dialogue forums are established and that the content of joint budget funding agreements, policy implementation matrices and annual review processes are opened up to broad social debate.
- Wherever possible and necessary, German development policy will participate

in building the capacities of civil society organisations in the partner countries. The aim is to facilitate independent participation of civil society actors in the political dialogue and enable them to contribute to and monitor national budget processes.

**In granting budget support, German development policy offers appropriate and flexible financing options to strengthen civil society participation,** mainly via official development assistance (ODA) in the form of technical and financial cooperation. However, other funding options may be considered in future in the context of non-governmental development cooperation.

**Other fields of action** to improve pro-poor budgetary and fiscal policy and promote reforms of public finance can be incorporated into the bilateral programme in line with the partner country's priorities.

**b. Improving the economic infrastructure and the enabling environment for private sector development**

The impacts of budget support on income poverty can still be improved. This is mainly because budget support programmes have largely focused on social sectors until now, with the result that sectors of direct relevance to growth have been neglected. There is a concern here that public allocations and the policy focus (macroeconomic environment) are proceeding at the expense of the private sector, (pro-poor) growth and income generation. In order to address this concern, German development policy intends to make improving the economic infrastructure and the enabling environment for private sector development a key issue in **policy dialogue**, with a view to achieving more balanced policies. In addition, **specific advisory and investment offers** can be made:

- **Boosting infrastructural investment, especially in sub-Saharan Africa:** In this context, budget support can help to improve the institutional and legal framework for the sustainable operation and maintenance of infrastructure. To enhance programme- and project-based approaches (infrastructural investment via financial cooperation), maintenance and running costs must be factored into the financial management framework of budget support programmes.
- **Expanding political dialogue in order to achieve pro-poor growth:** Many fields of activity of relevance to the implementation of a sustainable growth strategy are less about finances and costs than about policy focus and political reforms (e.g. legal certainty, deregulation, anti-corruption measures). The relevant dialogue should be conducted, and accompanying advisory services provided, with a view to gearing poverty reduction strategies (including PRSPs) more strongly towards growth in a process involving non-governmental actors (profit and non-profit sectors) as well.
- **Boosting economic development with selected economic policy analysis and advisory services at macro and sector policy level:** These advisory services are to be considered if they can be linked to the existing (sectoral) priority areas.

**c. Enhancing impact monitoring and evaluation systems**

For partner countries and donors, reliable monitoring data and impact analyses are crucially important for the successful management of complex reform and budget support programmes. In line with the Paris Declaration, the objective which must be pursued to strengthen the partner country's monitoring structures (and not donor-owned systems), as responsibility for veri-

fyng goal achievement and effectiveness must lie with the partner countries (domestic accountability). In the majority of partner countries, however, there are still considerable capacity bottlenecks here. German development cooperation has considerable expertise and experience in this

complex and challenging field, based on numerous advisory programmes. It will therefore participate on a case-by-case basis in joint donor approaches that aim to improve monitoring and evaluation systems.

## 4. Formulation of and Participation in Budget Support: The Role of German Development Cooperation

### 4.1 Conditions (eligibility criteria)

Germany will only participate in **budget support programmes** in countries which meet certain **minimum requirements** and where the donor harmonisation process (implementation of the Paris Declaration) already provides an adequate coordination framework, including political dialogue. The **selection of countries** is based on an analysis of the

- 1) **political**
- 2) **fiduciary and**
- 3) **macroeconomic environment.**

These minimum requirements serve as **eligibility criteria**. They are intended to facilitate a viable selection of countries in order to **minimise po-**

**litical risks**, simplify the formulation of **disbursement criteria** and facilitate **long-term engagement**. The eligibility criteria discussed below relate to general and sectoral budget support, and are more stringent than those applicable to basket funding, which entails lower fiduciary risks.

Deviation from these eligibility criteria may be considered in **specific cases** for **fragile states** or countries with conflict/crisis potential.

#### 1) **The political environment**

German participation in budget support prioritises countries with **good governance**, i.e. countries which deal responsibly with the exercise of political power and public resources and show respect for human rights<sup>8</sup>. The core elements of good governance are assessed and evaluated using the comprehensive **catalogue of criteria**

<sup>8</sup> The characteristics of good governance are state institutions and an administration that handle political power and public resources responsibly and with respect for human rights. A well-governed state is at pains to fulfil its functions efficiently, transparently and on a participatory basis, to guarantee equality and non-discrimination, and to fulfil its accountability obligations towards the general public; cf. BMZ Strategies 153, Development-Oriented Transformation in Conditions of Fragile Statehood and Poor Government Performance).

### Assessment framework for budget support: overall score is the deciding factor

In general, Germany only provides budget support to countries which comply with all the stated criteria that demonstrate **medium standards of governance** and which show a **positive development trend**. The latter is regarded as an indicator of the reform momentum and the partner country's efforts to progressively fulfill the criteria being applied. There must, however, be an **above-average** level of **political commitment**. Where the general environment is less satisfactory with a low level of confidence – in other words, where the governance level is generally low, with bad government and a lack of commitment to reform – German participation in budget support is not an option due to the political and fiduciary risks. Any development cooperation regarded as necessary should take place via other instruments instead.

developed by the BMZ (see Annex 2<sup>9</sup>). All the criteria set forth in the catalogue are used for evaluation purposes, especially those relating to the political environment, as the granting of budget support is conditional on compliance with reliable minimum standards of human rights, the rule of law, democracy and peace.

Budget support is highly sensitive to **political risks**, which creates tensions in terms of its longer-term predictability. This field of tension can only be resolved satisfactorily in relation to reform-oriented countries. For that reason, the analysis of the political environment and the application of **stringent benchmarks** are of key importance. The analysis should not only form the basis for eligibility for PJF and the choice between budget support and basket funding; in particular, it should also determine the amount and proportion of budget support in the mix of instruments.

A **viable choice of country ex ante**, based on medium to high eligibility criteria, takes account of the political, economic and institutional environment, especially the political commitment to reform and poverty reduction, the capacities of the public budgetary administration, and evidence

of dynamic reform based on past performance. The selective approach to the choice of countries helps to **minimise political risks** and thus **safeguard long-term engagement** with predictable financial contributions.

#### 2) The fiduciary environment

Whereas the fungibility risks<sup>10</sup> remain the same for both project-based funding and budget support, the **fiduciary risk** increases in the case of budget support, compared with project-based aid, as the funding is channelled directly into the partner country's budget, so no distinction can be made between resources from external and internal sources, and resource utilisation and scrutiny are generally undertaken by the partner country's own institutions.

Minimising fiduciary risks takes place at several levels of control – the selection of countries, the choice of financial mechanism (budget support vs. basket funding, see also Section 4.2) and through improvements in public financial management as an integral and accompanying component of budget support (see also Section 3.3).

<sup>9</sup> This is the BMZ's updated catalogue of criteria (2006) which has been expanded to include specific PJF-relevant issues and indicators. The catalogue is used for all country programming and for the allocation of funding.

<sup>10</sup> Development cooperation is said to be fungible if, as a result of the aid provided, the partner country is able to reduce its own expenditure on the stated item. This releases resources which, in principle, could then be used for another purpose. Fungibility also cannot be ruled out in the case of project-based approaches.

### Dealing with fiduciary risks

With regard to public financial management structures as a key criterion for budget support, it would generally be desirable for a level beyond medium standards of governance to be in place, but this is rarely the reality in partner countries. The task, then, is to weigh up whether identified weaknesses can be overcome in the budget support programming framework if addressed by the partner country and accompanied by capacity-building measures by donors (and German technical cooperation). In cases where the political environment is PJF-compliant but public financial structures do not yet meet adequate standards (e.g. if too many deficits have been identified in the PEFA assessment, see **Annex 2**, paragraph 4), and these shortcomings cannot be rectified through targeted capacity development, basket funding should be the preferred option.

### 3) The macroeconomic environment

A stable macroeconomic environment in the partner countries is an **essential prerequisite for eligibility for budget support**. It promotes economic growth and offers scope for fiscal policy responses. Coordination and dialogue between budget support donors and the International Monetary Fund (IMF) therefore play a key role. In particular, if the macroeconomic situation worsens, intensive dialogue about possible responses is essential. However, although the IMF's assessment is important as a reference, German development cooperation should not tie in systematically with IMF responses. **The suspension of IMF tranches should not automatically trigger suspension of bilateral budget support contributions**, as there is two-way interaction between budget support and macroeconomic stability, and a massive interruption of budget support can have a direct and negative impact on macroeconomic stability.

### 4) PJF in fragile states or countries with conflict/crisis potential

#### Fragile states: a special case

There are some countries, e.g. some **post-conflict countries**, which are undergoing a promising but politically risky transformation, and which have a substantial requirement for funding to cover the running costs of basic social provision for poor

and disadvantaged sectors of society. These countries' access to PJF is considered on a **case-by-case basis** with reference to the BMZ Strategy on "Development-Oriented Transformation in Conditions of Fragile Statehood and Poor Government Performance". In principle, PJF can be granted to this group of countries as well, provided that – notwithstanding their low governance levels – they show a clear and positive trend in government performance (development orientation, political commitment to reform, readiness to engage in dialogue). In practice, Germany's preferred option in these cases is generally **basket funding**, or **basket funding via multi-donor trust funds**. Due to the higher risks posed by this group of countries, a policy decision in favour of **budget support** would only be taken in an exceptional case. The prospect of budget support can be used as an incentive for partner countries to improve their governance level and institutional capacities.

#### Countries with conflict/crisis potential: a special case

**In partner countries** where an increased or acute need for prevention has been identified due to conflict and crisis potential, budget support can be deployed on a **case-by-case basis** provided that the country meets the governance criteria described above. However, particular account must be taken of the increased political risks associated with the crisis potential. With this group

of countries, Germany aims to address the conflict relevance within the framework of political dialogue with the partner country concerned, in order to ensure that the budget support contribution is conflict-sensitive. The dialogue is conducted in accordance with the BMZ's Sector Strategy for Crisis Prevention, Conflict Transformation and Peace-building in German Development Cooperation (2005).

#### 4.2 Structuring PJF: optimising the financial mechanism

The choice of the appropriate financial mechanism for PJF (which, below, will explicitly include basket funding as well) must be taken in light of the country context and public financial management capacities. The PJF Strategy – i.e. the use of **general and/or sectoral budget support** and/or **basket funding** – must be tailored to the individual partner country. The **share of budget support in a country portfolio** reflects the **specific conditions in the country concerned**. The more stable and sustainable the reform process, and the greater the reform momentum in institutional capacity-building, the larger the share of budget support in the country quota can be.

In terms of optimising the financial mechanism, the following principles apply:

- **Integration into multilateral initiatives: participation in the PRSC and MDBS frameworks**

German PJF contributions are always made jointly with other donors, in order to mobilise a critical mass of financial resources and gain influence in conjunction with other donors, but also to spread the risks among a wider group. The World Bank and/or the European Commission (and, if appropri-

ate, the United Nations) generally form the nucleus around which bilateral budget support contributions, including those made by German development cooperation, are grouped. When comparing the World Bank's cofinancing activities (poverty reduction support credits – PRSCs) and multi-donor budget support (MDBS) programmes, **German development policy will in future give preference to participation in MDBS programmes**, as these programmes generally allow bilateral donors to have a greater say in policy dialogue. As part of donor coordination at local level, German development policy will advance the position to the World Bank that the World Bank programmes (PRSCs) should be closely aligned to the MDBS programmes, and that both types of programme should be coordinated in terms of their content.

- **Respecting national ownership of the budget**

By using a PJF approach, Germany supports partner governments' efforts to establish a **coherent budget** which reflects the strategic priorities set out in the **poverty reduction strategy** (generally a PRSP). Moreover, in any application of PJF, the partner country's **national budget principles**, established in law, must be complied with – alongside the government's objectives – provided that they meet international standards. This means that the funds allocated through German budget support are not directly earmarked for a specific purpose; in general, **earmarking**<sup>11</sup> should only take place in exceptional and justified cases.

- **General vs. sectoral budget support**

The comparative advantages of German

<sup>11</sup> Earmarking means giving preference to coverage of specific expenditure. This violates the budgetary principle of total coverage, according to which all revenue can be used to cover any expenditure.



development cooperation traditionally lie in its **sector know-how** (priority and profile areas). From a German perspective, this is an argument in favour of Germany's sectoral budget support commitment taking on a more defined identity as well. In practice, a clear distinction cannot always be made between general and sectoral budget support: often, budget support operates along a fluid spectrum in a mix of macro-economic and sectoral conditions. In light of this situation, and given that sectoral and general budget support have a complementary role (see below), **German development policy will therefore be open to both approaches**. The decision on the type of budget support to be granted must be taken on a case-by-case basis, taking account of the options for Germany to exert influence and shape developments in the individual case.

Germany's "both/and" approach is in line with the current international debate in which a shared understanding is developing that **sectoral budget support should always play a complementary role to general budget support**. The arguments in favour of this approach are: 1) that policy dialogue at macro level within the framework of general budget support and policy dialogue at sector level can be more focused on relevant core topics ("unburdening" effects at the macro/sectoral level<sup>12</sup>; discussion of subsidiary topics) while offering opportunities for linkage; 2) the delinking of conditionalities at macro and sector level can help to improve the predictability of external resource transfers; and 3) vertical funds (health, education etc.) can be integrated more easily into the budget.

- **Budget support at sub-national level**  
Budget support at sub-national level (e.g. at state/provincial level) is a new form of budget support, and is one which Germany can also make available in **individual cases**. The prerequisite is that it must be an appropriate measure to promote decentralisation processes and can take place in line with, or is compatible with, national budget processes. As a rule, support is provided for regional allocations from the national budget to the sub-national level (based on a regional allocation formula), e.g. in order to promote the delivery of basic social services. Here too, the partner country's national budgetary principles must be complied with, with continued importance being attached to political dialogue at the central level. Fiscal policy advisory services are then delivered primarily at the sub-national level.
- **Role of basket funding**  
When embarking on PJF under more challenging conditions, a **gradual entry process** should be selected, in order to ensure that positive contributions to reforms and capacity-building can be made at a relatively early stage. As a rule, the trend which can be observed in the context of PJF is a progressive shift from basket funding within an individual sector to sectoral budget support and, finally, general budget support. This trend goes hand in hand with increased public financial management capacities. **Basket funding** should therefore be used when there is still little PJF experience to draw on with the partner country concerned and fiduciary risks need to be controlled due to capacity weaknesses. Basket funding can also **prepare the way** for a

<sup>12</sup> For example, stable macroeconomic conditions generally form part of the funding criteria for sectoral budget support as well.

move into sectoral/general budget support. The overarching goal of basket funding should therefore be to create the institutional conditions for budget funding via targeted support measures.

#### 4.3 Conditionality of budget support: promoting reform

Conditionality is a central aspect of budget support. Within the framework of **policy dialogue**, German development cooperation defines the conditions for budget support in collaboration with the partner country and other donors. Conditionality now accords with a **new understanding** of budget support: it is now agreed that bud-

if political dialogue fails to produce viable solutions.

Conditionality has the following **steering functions**:

- Conditions **act as an incentive** for the continuation of political reforms;
- They fulfill a **signal and control function** by making the reform process and its successes more transparent and facilitating impact monitoring (see also Section 4.4);
- Fulfillment of the conditions is a **prerequisite for the disbursement of German financial contributions**.

The **prerequisites for disbursement** of funds are agreed within the framework of a donor-harmonised procedure together with the partner country, and should be limited to a few key political reform measures in order to avoid overloading the process. Outside the **policy matrix** that is mutually defined with the partner country, no specific German conditions are agreed. The prerequisites for disbursement are based on mutually agreed political objectives, indicators and timeframes, and are intended to create **positive performance incentives** and support predefined goals.

get support should be provided on the basis of **common reform objectives** which support-ownership by the partner country. These reform objectives are derived from the partner country's poverty reduction strategy and shared human rights commitments; the Millennium Declaration and the MDGs also form a shared and binding basis. Good governance, respect for human rights and a commitment to poverty reduction, as the political basis for trustful cooperation in the realm of budget support, are explicitly enshrined as **underlying principles** in joint agreements with the partner country and donors concerned (**Memorandum of Understanding – MoU**). Substantial violation of the core elements of this agreement may result in the immediate and complete cessation of cooperation on budget support

The following **principles** should be applied by Germany when defining policies on conditionality:

- **Promoting ownership**  
German budget support underpins the key objectives of national poverty reduction policies and shared human rights principles and obligations, such as increasing participation and promoting the empowerment of disadvantaged sectors of society, especially women and young people. The partner country owns the process to achieve these objectives. As it develops options for action, including policy impact assessment, German development cooperation can support the partner country with advisory measures.

- **Rewarding performance, creating incentives**

The conditions set by Germany are generally geared towards supporting the partner country's reform efforts. To this end, **appropriate performance indicators** are selected in conjunction with the partner country and the donors concerned (see also Section 4.4).

Additional performance incentives can be created through differentiation between fixed and variable tranches. The variable tranche supplements the fixed tranche, and its disbursement is entirely dependent on fulfillment of additional performance indicators. Although there is a **preference for fixed tranches** in German development cooperation in principle, **fixed and/or variable disbursement mechanisms** may be appropriate in some circumstances (see Annex 3 for an overview of the individual criteria). German budget support contributions can thus be tailored flexibly to the country context, whereby the most important objective, in terms of policy design, is to **maximise harmonisation, as far as possible, through the adoption by all donors of a clear, simple and effective conditionality policy** and generally avoiding negative effects on the predictability of disbursements.

- **Defining effective conditions, supporting harmonisation**

German budget support helps to reduce the transaction costs of budget support as German conditions are aligned to a mutually defined **policy matrix** and the number of conditions and indicators is restricted to priority areas of reform. In the past, a proliferation of bilateral conditions impeded the effective implementation of budget support (watering down of priori-

ties, overstretching of the partner country, unpredictable disbursements). German development policy therefore supports the new policy orientation, which focuses on achieving agreement on **a small number of substantive conditions**, and is encouraging other donors to follow suit.

For German development cooperation, this means setting **clear policy priorities at field level** so that these priorities can be integrated and embedded in a joint policy matrix during the negotiating process. German budget support does not agree any further conditions outside this framework. German development cooperation thus draws on and contributes its own experience and expertise as part of a coordinated approach.

**Evaluation of compliance with the conditions** also takes place, as far as possible, as part of a joint process, although harmonisation in this case does not mean that each donor must draw the same conclusions. German budget support strives to achieve shared conclusions, but retains its bilateral scope for decision-making, e.g. if there are fundamentally different views among donors.

- **Making disbursements predictable and incentive-compatible**

Tying disbursements to conditions does not guarantee that all the funds pledged will be disbursed in full. From the partner country's perspective, this impairs medium- to long-term predictability and limits its scope for action. If aid is highly unpredictable, long-term investment programmes cannot be realised to their full extent or are may be at risk altogether. **Short-term volatility** of budget support should therefore be **mitigated**, as far as possible, by a

transparent and rules-based disbursement policy.

Disbursements of budget support must also be **incentive-compatible**, with a view to ensuring that long-term commitments do not result in a decrease in partner countries' own efforts (rent-seeking), e.g. in the mobilisation of own resources. "**Mobilising domestic revenue**" is a **key topic** in the policy dialogue in order to prevent budget support from creating **possible disincentives in relation to the collection of tax revenue** and in order to facilitate the adoption of sustainable pro-poor, pro-investment policies over the long term by the partner country concerned.

- German budget support will help to increase financial predictability and ensure incentive compatibility through the adoption of various **measures**, e.g. by **working towards increasing tax revenue** in the partner country; **aligning disbursements to the national budget cycle**, and **avoiding negative stop-go cycles** (see also Annex 4 on the individual steering mechanisms).

#### 4.4 Results orientation, monitoring and evaluation

Development cooperation faces various **methodological challenges** in terms of verifying progress on the agreed objectives and particularly the

long-term impacts of budget support. The challenges lie, firstly, in the selection of appropriate indicators to measure reform progress and, secondly, in the continuous improvement of evaluation methodologies (measuring clear correlations over longer time periods, improving the data situation in partner countries). In general, the evaluation criteria and procedures developed on the basis of the OECD/DAC Criteria for Evaluating Development Assistance (relevance, effectiveness, efficiency, impact, sustainability)<sup>13</sup> are applied. German development policy will respond to these challenges, in particular through:

- participation in the development and joint application of performance indicators; the indicators applied should be increasingly disaggregated by poverty status, sex, age, ethnic, social and/or geographical group, and should take account, as far as possible, of the core elements of human rights<sup>14</sup>;
- participation in the development and joint application of arrangements for impact analysis, in order to assess impact mechanisms (development of methodologies);
- joint conduct of impact studies (independent joint evaluations with other donors); and
- regular production of monitoring reports on individual countries and publication of reform trends in individual countries (reporting).

<sup>13</sup> See also *Evaluierungskriterien für die deutsche bilaterale EZ* [Evaluation Criteria for German Bilateral Development Cooperation], BMZ, July 2006.

<sup>14</sup> The core elements of human rights (also known as the "4As") comprise the following, according to the definitive interpretation by the UN Committee on Economic, Social and Cultural Rights: Availability, Accessibility (physical and economic accessibility, without discrimination), Adaptability, and Acceptability (relevant, culturally appropriate and of good quality); see, for example, General Comment No. 13 of the Committee on Economic, Social and Cultural Rights: The right to education (Article 13 of the Covenant), 8 December 1999, UN Doc. E/C.12/1999/10.

Notwithstanding the steering responsibility and accountability of donors, partner countries have a key role and responsibility in assessing the effectiveness of budget support, as it is channelled entirely through the partner country's own systems and development successes cannot be attributed, in any meaningful way, to individual donor contributions. Indicators which provide information about reform progress, development trends and compliance with target corridors therefore form an important shared basis for control and accountability.

### Managing the indicators

The policy matrix contains a range of indicators to measure goal achievement; as a rule, these indicators are based on the partner country's poverty reduction strategy. German budget support focuses not only on the overall result but especially on those indicators of particular relevance to it, i.e. those which play a key role in measuring compliance with disbursement criteria, the attainment of Germany's objectives, and topics at field level.

German budget support focuses on **results and impacts**, i.e. on the partner country's *outputs* (goods and services delivered, e.g. the number of schools that have been built), *outcomes* (direct benefits of development policy in the short and medium term, including the use of the goods and services delivered, e.g. an increase in school enrolment rates) and *impacts* (longer-term and broader impacts, such as an increase in the num-

ber of children achieving higher school-leaving qualifications and thus improving their income status). The introduction of policy processes can be shown in the short term via *inputs* (provision of resources) (e.g. abolition of school fees).

A realistic **mix of indicators** should be aimed for in the policy matrix for the purposes of the annual review of goal achievement. This should focus especially on agreed **outputs and outcomes** as the specific **prerequisites for disbursement ("triggers")**<sup>15</sup>. Where necessary, indicators on **inputs** should be used as **management aids ("benchmarks")** in the overall process<sup>16</sup>. German budget support does not apply **impact conditionality** – although this is in line with the overarching goal of German development policy – due to the numerous problems with measuring (availability of data) and attribution (plausible impact chains) and also due to the substantial time lag until impacts can be observed. Long-term impacts cannot be recorded as part of annual monitoring but are the subject of comprehensive evaluations undertaken at longer (multiannual) intervals.

For the collection and utilisation of the specified indicators, organisational and institutional capacity-building in the relevant sector ministries and statistical systems is essential. In particular, the generation of data and further development of analytical methodologies to monitor impacts is an important but long-term task for the partner countries and international technical cooperation. Wherever possible, German development cooperation will contribute to this process.

<sup>15</sup> The indicators applied should be increasingly disaggregated by sex, age, ethnic, social and/or geographical group, and should take account, as far as possible, of the core elements of human rights (see above).

<sup>16</sup> However, conditionality of processes (inputs) cannot always be avoided, e.g. because the definition or monitoring of outcome indicators can be difficult (e.g. in public budgets) or because specific inputs are particularly important. For example, the abolition of school fees can also be regarded as the key criterion for free access to basic education.

### Participation in monitoring

German development cooperation participates in the annual joint **performance assessments** of PJF which allow conclusions to be drawn about the annual implementation status of the reform process and are a crucial factor in donors' disbursement decisions. It is important to ensure, in this context, that the performance assessment in the partner countries is viewed as a policy management instrument and is supported by the national courts of audit, and if necessary by independent external audit organisations. Furthermore, German development policy is working towards a transparent process which involves civil society. The results of the performance assessment in the individual countries are utilised to step up public relations work.

Separate from these annual reviews, independent **joint evaluations** (by the partner country and donors) are carried out at longer intervals in order to assess the long-term impacts. German development policy attaches great importance to these joint evaluations and will participate in them on a regular basis. Within this framework, German development cooperation will contribute to the further development of methodologies and continued harmonisation of this analytical tool and, in particular, will work pro-actively for the joint application of the OECD/DAC Criteria for Evaluating Development Assistance, mentioned above.

#### 4.5 Criteria for discontinuation: response mechanisms and crisis management in German development policy if political conditions deteriorate

The basic principles pertaining to good governance are agreed between Germany, the other donors and the partner country, and are set out inter alia in Memoranda of Understanding. This creates rights and obligations for the stakeholders, and also creates **transparency and predict-**

**ability** in relation to the various legitimate response mechanisms which can be applied in the event of a dispute or crisis. If the political environment deteriorates (and especially if there is a worsening of government performance), the donor community can react, but should do so **gradually** with various political and financial response mechanisms.

German development policy envisages that **PJF (and especially budget support)** may be **reduced, suspended or discontinued** depending on the extent to which the political environment has deteriorated. The political environment is regarded as having deteriorated if the partner country violates fundamental principles such as the rule of law, democracy, human rights and peaceful conduct, departs permanently from the agreed reform agenda, or if public financial management significantly worsens. Before any decision is taken, the political crisis, crisis management and possible German responses are discussed in the political dialogue with the partner country and other donors.

German development cooperation provides for the following graduated mechanisms:

1. **Discussion in the framework of political dialogue**
2. **Gradual suspension (immediately or deferred)**
3. **Complete suspension (immediately or deferred)**
4. **Withdrawal from the budget support programme**
5. **Reprogramming after withdrawal, or**
6. **Repayments in the event of verifiable misappropriation of funds.**

The responses should be formulated in a **constructive negotiating process**. First, it is important to inform the partner country at an early stage about Germany's observations, concerns and possible consequences and agree on a more intensive dialogue that focuses on crisis management (intensified political dialogue). Wherever possible, this dialogue should be **coordinated with**, or involve, other donors. An intensive exchange with bilateral donors who provide a high proportion of budget support and with multilateral organisations and the European Commission is necessary here. Civil society representatives in the country concerned should also be consulted.

Governance crises, such as a clear departure from the reform course or violation of the underlying principles, prompt a direct response. Germany's reaction should be clear but also **proportionate** and **gradual** and should take account of possible long-term impacts on the programme as a whole. As far as is justified by the scale of the cri-

sis, the German response should not take effect immediately but should be **deferred** until subsequent fiscal years in order to **avoid political over-reactions**, monitor domestic policy trends in the country concerned, and avert further destabilising effects that would be triggered by an immediate suspension of budget support. In the event of extraordinary political events such as massive political unrest or a coup d'état, German development policy can suspend budget support in full with immediate effect. **Complete withdrawal** from budget support is the appropriate response if the political environment (especially government performance) has worsened to such an extent that trustful cooperation is no longer considered possible for the foreseeable future, e.g. in the event of a lasting break with rule-of-law principles or departure from the agreed reform agenda. In this case, it is important to assess whether there is scope to deploy other instruments of German development cooperation or whether the general suspension of bilateral development cooperation must be considered.

## 5. Preparation of Budget Support Programmes and the Division of Labour within German Development Cooperation

Participation in budget support programmes steps up the requirements for effective cooperation between the German development institutions. The boundaries between technical/specialised and political dialogue are sometimes fluid, and this increases the need for coordination and a division of labour between the BMZ, the German Federal Foreign Office (AA) and its missions abroad, and the implementing organisations in relation to donor coordination, programme support and monitoring. The BMZ and the Federal Foreign Office/its missions abroad also need more and different advisory services from KfW and GTZ in the case of budget support. A detailed description of the **tasks** involved follows:

### 5.1 Tasks involved in the policy dialogue

Development policy dialogue on budget support is one of the most important fields of activity in terms of the management by the **BMZ's** regional divisions. They are supported in this task by the German missions abroad. The **BMZ, the Federal Foreign Office and its missions abroad** cooperate closely to ensure that the German government has a consistent profile in the partner country. The content of the dialogue ranges from the general framework conditions in the partner country to the individual policy areas of budget support (policy matrix). The following issues are of key importance:

- during the **preparation of budget support**: whether and to what extent the political criteria for the granting of budget sup-

port are being met, how overall conditionality should be structured in cooperation with other donors and the partner country, which bilateral disbursement conditions (e.g. fixed/variable tranches, performance indicators) should apply, and which conditionality-related negotiation criteria should be applied by KfW at project appraisal;

- during the **implementation of budget support**: political participation in the annual performance assessments and close coordination within the group of donors to ensure that the political signals sent out to the partner country are as clear as possible.

For Germany, **development policy dialogue** requires a joint approach – in accordance with the division of labour principle – between the BMZ, the German Federal Foreign Office/its missions abroad, KfW and GTZ. In cases where German development policy takes on a lead role in the context of international donor coordination (e.g. chairing the entire budget support coordination process), the implementing organisation – in agreement with the BMZ – provides appropriate support to the mission in the country concerned.

Within the framework of the division of labour within the country team and in the specific areas of responsibility, participation in the various working groups can be passed (delegated) to the implementing organisations. There is close liaison between the economic cooperation officers at the missions abroad, the priority area coordinators and the PJF managers. Any difficulties and



problems identified, which are of fundamental importance but cannot be resolved at specialised level, are brought to the political level and dealt with there. When required, the political level in a country can range from the economic cooperation officer up to ambassadorial level and, on the partner's side, up to ministerial and also presidential level. The interventions are carried out in coordination with the BMZ.

## 5.2 Tasks involved in budget support implementation

KfW plays a key role in the management of Germany's financial contributions and is usually commissioned with implementing budget support measures. It is **responsible for contracts and cooperation** which entails appraising and implementing the German budget support contribution. To that end, it liaises closely with the BMZ and the embassies (see above), and also involves GTZ. The implementation process includes the associated development policy dialogue at specialist level, the preparation of disbursement decisions (assessing whether conditions have been met and providing recommendations to the BMZ in the event of non-fulfillment) and the actual disbursement (after close liaison with the BMZ and the embassies in the event of any uncertainty regarding compliance with the conditions). The same procedure applies for GTZ where PJF is administered through technical cooperation, as with TA pooling and, in exceptional cases, contributions to sectoral budgets.

Budget support (and the continuing implementation of the Paris Declaration) has highlighted the need for capacity-building in the partner countries' administrations. Fragmented approaches, inadequate coordination of donors' contributions via technical cooperation, and the lack of government strategies to implement capacity development measures in the countries themselves are all indicative of the current need for action.

German technical cooperation, in conjunction with other donors, will therefore help the partner countries to develop **integrated and comprehensive capacity development programmes at sectoral and national level** and, on that basis, present **donor-coordinated proposals** for implementation of technical cooperation. Entry points for German technical cooperation contributions arise, in particular, from the **thematic profile** described above (see also Section 3.3) and the experiences gained by technical cooperation in shaping reform processes and policies and delivering sector-specific and macroeconomic advisory services.

In terms of PJF, the following aspects are important for the provision of German development cooperation in the future:

- **The combination of financial with technical cooperation:** Accompanying advisory services through technical cooperation at sectoral and national level create a more conducive environment for the implementation of budget financing. Combined country-specific financial and technical cooperation measures complement one another and create synergies, and should be increased. When participating in any budget support measure, therefore, German development cooperation always appraises whether and how **strategic components of technical cooperation** can be developed in line with the above thematic profile (see also Section 3.3) and in accordance with the partner country's needs. The needs analysis considers whether other donors are already covering relevant areas as part of the division of labour. Advisory services via German technical cooperation are implemented in consultation with the other donors.
- **Contributions under technical cooperation in the form of TA pooling:** TA pool-

ing offers a new opportunity to deliver technical cooperation services within the PJF framework. It refers to the pooling of several donors' resources in "baskets" that are administered by partner countries or donors, with most of the resources being used for the financing or delivery of technical cooperation services. Partner countries testing this model expect certain advantages from separating the financing from the provision of advisory services, e.g. lower transaction costs, increased transparency and more specific alignment to the partner's own preferences. TA pooling will be particularly important in countries in

which the partner's management capacities are already more advanced, and which primarily require short-term advisory services and expertise to resolve clearly defined technical problems.

What is needed, therefore, is for future contributions through technical cooperation to be delivered flexibly within each country context in accordance with local demand. Besides technical cooperation in the form of direct contributions, participation in joint TA pools will be another possible way of providing technical cooperation services. Improving flexibility by combining approaches is also envisaged.

# Annexes

## Annex 1: Programme-oriented Joint Financing (PJF): types and basic principles

### 1. PJF in the context of macro- and sector programmes

#### (1) Macro-programmes

Macro-programmes are intended to support the implementation of national poverty reduction strategies and cross-sectoral economic, regulatory and institutional reform. These programmes often include selected sector-specific issues in the policy dialogue as well. In this context, conditions are imposed as an instrument of policy dialogue, donor coordination and as payment triggers. In a policy matrix or performance assessment framework, the donor and partner countries jointly decide on the objectives, measures, monitoring indicators and triggers, and the funding provided by the donors is channelled into the general budget. **Macro-programmes are financed through general budget support.**

**There are two types of macro-programmes in which German development cooperation participates in the form of general budget support:**

- **Poverty Reduction Support Credits (PRSCs) (World Bank)**<sup>17</sup>: These are macro-programmes to support economic, social and institutional reforms.
- **Multi-Donor Budget Support Programmes (MDBS)** from other donors (especially bilateral donors, the European Commission, and regional development banks).

<sup>17</sup> PRSCs come under the World Bank's Development Policy Lending instruments. They support the implementation of PRSPs as a general budget support instrument.

These are macro-programmes with a primary, but not exclusive, focus on social sectors, e.g. education, health and water and governance issues (e.g. public financial management).

#### (2) Sector programmes (Sector-Wide Approaches – SWAs)

Sector programmes are intended to support reforms and help finance expenditure within a specific sector. Broadly speaking, they can be implemented in all priority areas of development cooperation. They have traditionally played a key role in the education, water/wastewater management, health, transport and agriculture sectors (frequent priorities in PRSPs). They can also include cross-cutting issues such as decentralisation/local governance or cover several selected sectors. SWAs do not constitute an instrument in themselves but form a joint political framework at sector level and establish the rules for joint action by donors. The SWAp contribution can therefore be made through various types of funding (however, parallel-financed individual projects within the SWAp framework do not count as PJF).

**There are two PJF instruments for financing sector programmes:**

- **Sectoral budget support**: donor funds are channelled into the general budget and can be earmarked for sectoral use<sup>18</sup>. No individual measures are defined.
- **Basket funding**: donors jointly finance a spending plan to implement a specific set

<sup>18</sup> This means that the expenditure in a particular sector has to reach a specific, predefined (high) level (principle of "additionality" of donor funds for a specific sector).

of measures as part of a sector strategy<sup>19</sup>. The funds are earmarked for the agreed measures. The basket can be administered by either the partner country or a donor commissioned with the task. The funds are paid into a special account and are generally reported on-budget. The administration of the donor contributions is in most cases not subject to the regular budgetary procedures of the partner country.

## 2. Basic principles governing programme-oriented joint financing

The following **basic principles** apply to PJF:

- Development cooperation is shifted from the individual project level to the **programme and political level**;
- Donors and the partner country's government engage in a **joint policy dialogue** about reforms, with support for the implementation of a **binding reform strategy** (national poverty reduction strategy, generally in the form of a Poverty Reduction Strategy Paper – PRSP). The partner country takes on the lead role and **owns** the process of programme management and financing (including resource utilisation);
- **Several donors** reach agreement with the partner country on the **joint financing of a spending plan** (e.g. as part of the medium-term expenditure framework (MTEF)) or on **joint budget financing** (general budget, sectoral budget, basket);
- **Uniform procedures** are adopted (e.g. financing modalities, reporting, allocation

procedures), and the **partner country's own allocation, procurement, accounting and monitoring systems are used** wherever possible<sup>20</sup>;

- The payments are made contingent upon **disbursement conditions** (triggers), which define the common goals and reinforce stakeholders' commitment.

In the context of budget support, basket funding is a special case, for although it is budget-oriented in focus, it does not form part of the country's national budget, and thus entails **fewer fiduciary risks**.

## Annex 2: Good Governance and Budget Support: the eligibility criteria

The fact-finding and evaluation of good governance, required for PJF when delivered in the form of budget support, are **based on the catalogue of criteria developed by the BMZ (2006)** to assess the development orientation of a partner country. In addition to the catalogue of criteria, some issues (indicators) have been enlarged upon, and **minimum qualitative benchmarks** have been defined for the implementation of instrument-based budget support. The evaluation framework ranges from a standard of governance of low (a score of 1 or 2), to medium (3) and high (4 and 5).

### The individual budget support eligibility criteria are:

1. **Pro-poor and sustainable policies:** Are the policies geared towards the Millennium Development Goals (MDGs) and towards gender justice and economic and environmental sustainability?

<sup>19</sup> Basket funding can, in individual cases, also operate at sub-sectoral level (thematic approach).

<sup>20</sup> This feature clearly differs from traditional parallel financing in which German development cooperation, in coordination with other donors, administers part of the overall project in accordance with its own procedures, which have been agreed with the project executing organisation.

- Is the policy based on a **national poverty reduction strategy** (e.g. a PRSP or comparable development strategy) and is it being implemented? All in all, does this strategy demonstrate serious political commitment to reducing income poverty, realising the right to education, health, water and food, improving basic social services, fostering pro-poor growth, and achieving the MDGs? Does this strategy contain specific objectives, interim targets and specific indicators, whose attainment is being measured? Is this strategy jointly supported by the country's parliament and all the key civil society actors? Is combating poverty at the heart of the macroeconomic or sectoral reform programme? Is visible progress being made with the implementation of the strategy? Is there evidence of any initial impacts on the poor target groups, e.g. in the form of improvements in the availability, appropriateness and quality of, as well as access to, basic social services, or in the form of positive effects on income poverty? **Minimum benchmark: no serious constraints (medium standard of governance) with development on an upward trend.** The poverty reduction strategy is a key element of the policy dialogue and indicators should be derived from it.
  - What percentage of the overall budget goes on **military expenditure**? What is the political justification for relatively high military expenditure? **Minimum benchmark: justifiable expenditure.** In certain circumstances it may be necessary to agree specific indicators for the policy dialogue.
  - Is the **macroeconomic environment** stable? Is a stability-oriented monetary, fiscal and exchange rate policy in place? Is there a reform programme supported by the Bretton Woods institutions (usually the IMF)? **Minimum benchmark: no serious constraints (medium standard of governance) with development on an upward trend.** Orientation towards IMF assessments, e.g. Article IV consultations, programme reviews, assessment letters, "on track" status. An IMF programme is generally preferable but is not an essential prerequisite for Germany's decision to participate in PJF.
2. **Human rights:** Are all human rights respected, protected and fulfilled? (See also individual questions in the catalogue of criteria). **Minimum benchmark: no serious constraints (medium standard of governance) with development on an upward trend.** In some partner countries it may be necessary to agree specific human rights indicators for the policy dialogue. These should be based on existing policy commitments, such as poverty reduction strategies, human rights action plans or laws, and also objectives for the realisation of human rights that have been agreed between the relevant treaty bodies and states within the framework of the reporting process for States Parties to the International Covenant on Civil and Political Rights. To that end, the treaty bodies are increasingly developing human rights indicators which are closely aligned to the MDGs.
  3. **Democracy and the rule of law:** Are democratic participation and the rule of law guaranteed to all sectors of society on an equal basis? (See also individual questions in the catalogue of criteria). **Minimum benchmark: no serious constraints (medium standard of governance) with development on an upward trend.** In some

circumstances it may be necessary to include specific rule-of-law indicators in the policy dialogue.

4. **Efficiency and transparency:** Is governance efficient and transparent?

- Does the government possess the **political commitment and ownership** to implement reforms? **Minimum benchmark: above-average, efforts clearly visible (high standard of governance).** There must also be clear ownership of difficult reforms. The World Bank's Governance Rating provides a frame of reference here.
- Is the government being proactive and effective in its efforts to combat **corruption**? **Minimum benchmark: no serious constraints (medium standard of governance) with development on an upward trend.** A frame of reference is provided by anti-corruption programmes, programmes to reform public services, anti-corruption overviews, parliamentary control reports, Transparency International's Corruption Perception Index, external audit reports and the absence of corruption scandals in the government sector. In some circumstances, it may be necessary to agree specific anti-corruption indicators for the policy dialogue.

- Is the administration's **public financial management** (budget planning, preparation, implementation and control) sufficiently efficient in terms of transparency, gender justice, conflict sensitivity, fiscal discipline, the strategic allocation of resources, and value for money? Is there a willingness to improve and is development visibly on an upward trend? Does PJF constitute an incentive to improve public financial management? Are any identified weaknesses in the public financial administration being addressed within the PJF framework, e.g. through technical cooperation measures to build administrative capacities? **Minimum benchmark: no serious constraints in the implementation (medium standard of governance) with development on an upward trend:** The political commitment exists without restrictions, and support measures to build the partner country's administrative capacities are available. Frame of reference: A positive overall assessment from the **PEFA-PFM performance report**<sup>21</sup> or other analytical tools, e.g. from the World Bank or Transparency International<sup>22</sup>. **A positive evaluation of the fiduciary risks by KfW.** It is also important to draw on the partner country's own data wherever possible, e.g. annual financial statements, external audit reports, par-

21 PEFA (Public Expenditure and Financial Accountability) is a new tool developed by a group of donors (the World Bank, the EU, bilateral donors) to evaluate public financial management (PFM) reforms using selected indicators (PEFA PFM measurement framework). The result of the country analysis will in future be included in PFM performance reports. German development cooperation should draw on these reports for its own evaluations.

22 World Bank analysis tools include, for example, World Bank Country Financial Accountability Assessments, Country Procurement Assessment Reviews and Public Expenditure Reviews. Transparency International publishes National Integrity Studies. German development cooperation should draw on these studies wherever possible. Independent diagnostic work should remain the exception and, if it is carried out, should take place within a donor-coordinated framework.

liamentary oversight committee reports, progress reports on public financial management, studies and reports on gender responsive budgeting initiatives.

#### 5. Stance within the international community

Is there a cooperative stance within the international community? (See also individual questions in the catalogue of criteria). **Minimum benchmark: no serious constraints (medium standard of governance) with development on an upward trend.** The country also behaves constructively in regional and international settings and is pro-reform. It is not embroiled in any conflicts and does not constitute a security risk.

### Annex 3: Criteria for the Use of Variable Tranches

The basic difference between fixed and variable tranches is as follows:

Whereas the fixed tranche is always paid out, provided there has been no violation of the underlying principles, the disbursement of the variable tranche depends on the extent to which the agreed objectives of the previous period (n-1) have been achieved. The advantage of this differentiation is that the basic funding is secure, on the one hand, and special performance incentives (a performance bonus) can be set, on the other.

**In German budget support, the variable tranche approach is considered under the following conditions:**

- In the case of a **significant German contribution**: Variable tranches are only of political relevance when Germany's total contri-

bution for the applicable financing period accounts for a significant proportion of the budget support of all donors. Contributions below this threshold should be made solely by means of fixed tranches.

- In the case of **joint, coordinated tranches**: German budget support should not develop any specific variable tranches for harmonisation reasons (e.g. transaction costs). Instead, it should only advocate the use of variable tranches in conjunction with a group of donors and in coordination with the partner country. The preferred route here would be for **Germany to tie in with the European Commission's variable tranche**.
- When **the variable tranche is focused on a small number of performance indicators**: Due to its key importance, public financial management should be the focus of general budget support measures. Besides managing expenditure, an important condition from a German perspective would be measures to achieve a long-term improvement in the partner country's own financing capacities (especially through tax revenues). Transparency, accountability, participation and gender justice are important principles here. In sectoral budget support, selected performance indicators from the sector concerned can be the main focus.
- **In the case of high-performing countries**: Variable tranches should play a subsidiary role in countries with a very good and consistent reform dynamic. Predictability should be the focus here. The contributions should be managed according to the level of commitments agreed in the government negotiating cycle.
- When budget support is accompanied by **technical cooperation measures**

**from Germany or other donors:** Whenever necessary (or called for), the performance-related variable portion should be accompanied by specific support contributions within the technical cooperation framework, in order to rectify any deficits promptly.

#### **Annex 4: Measures to Boost Predictability and Incentive Compatibility**

German budget support helps to **strengthen financial predictability and ensure incentive compatibility**. The following **measures** serve as a basic frame of reference:

- **Long-term improvement in state revenue:** To safeguard the sustainability of budget support in the long term, agreements concerning a medium to long-term increase in tax revenues are made with the partner countries. Budget support is linked to tax reform measures from the outset.
  - **Orientation to the budget cycle:** The German commitments are structured in such a way that the funds can be included in the budget plan of the fiscal year concerned at an early stage (in the ongoing fiscal year n for the subsequent fiscal year n+1). The partner country must therefore ensure that the documentation forming the basis of the decision is submitted on time (goal achievement in fiscal year n-1, targets for fiscal year n+1).
  - **Budget-oriented interventions:** The German commitments for fiscal year n are met in principle; this means that outgoing funds may not be varied in the ongoing fiscal year n. Unless the underlying principles (as laid down in the joint MoUs) of the budget support measure are breached, reductions can only be made for future periods
- (from n+1 onwards). Current budget support programmes do not provide for the re-programming of budget support commitments in favour of other instruments. Re-programming generally only takes place if German development cooperation decides to withdraw from the budget support programmes of a partner country.
- **Gradual responses are the basic pattern:** German budget support is geared towards avoiding negative stop-go cycles (all or nothing payments) in which the partial performance and implementation weaknesses of a partner country lead to the complete suspension of an entire budget support programme. To this end, the following **gradual steering mechanisms** can be considered:
    - (1) **No systematic tie-ins to the IMF and the World Bank:** Use of the greater opportunities to influence policy offered by MDBS programmes (together with close coordination with World Bank programmes).
    - (2) **A holistic view of the reform process:** Evaluating overall goal achievement, taking a flexible and balanced approach within the conditionality matrix, considering external factors that influence the process, assessing the political consequences of reducing payments (e.g. using the Poverty and Social Impact Analysis (PSIA) of major political changes).
    - (3) The transparency of the German disbursement policy should be ensured, especially through the participation in **payment procedures** (including MoUs) **agreed** with other donors and the partner country.



- (4) **The complete and immediate suspension of payments should only occur in the event of fundamental contraventions of the policy framework under the terms of the underlying principles agreed with the partner country.** The core elements of the underlying principles are the country's commitments to peace, free democratic processes, the independence of the judiciary, the rule of law, respect for human rights, accountability to its citizens, combating corruption and poverty, attainment of the Millennium Development Goals and a commitment to sound public financial management and macroeconomic stability.
- (5) **Sanction-oriented supplements or reductions should always be made as part of a deferred response in the subsequent period (n+1) or within the framework of the two- to three-year government negotiation cycle in which commitments are agreed;** the level of the commitments can be used to send out a political signal here (to express satisfaction or dissatisfaction with the reform process). The variability should be noticeable but should not lead to excessive volatility (+/- 20 per cent is a guide). The preferable route is to use the variability within the framework of the government negotiation cycles in order to avoid excessively short-term interventions and facilitate a better assessment of the reform process dynamic. The prospect of increased budget support contributions in the medium term should be used as an incentive mechanism in the policy dialogue.
- (6) **Germany's participation in the World Bank and the EU should be used as further leverage to ensure the compatibility of the bilateral and multilateral budget support.**
- (7) **Fixed and variable tranches in line with the European Commission's basic model are a further option for German budget support and can be used under certain circumstances (cf. Annex 3).**

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