



Tools and Methods Series

Working document

BUDGET SUPPORT

GUIDELINES

*Programming, Design and Management
- A modern approach to Budget Support*

September 2012

Budget Support Guidelines
Programming, Design and Management
A modern approach to Budget support

EuropeAid Development and Cooperation Directorate-General
European Commission

Brussels, September 2012

**Europe Direct is a service to help you find answers
to your questions about the European Union.**

Freephone number*: 00 800 6 7 8 9 10 11

*Certain mobile telephone contractors do not allow access
to 00 800 numbers or these calls may be billed.

More information on the European Union is available on the Internet (<http://europa.eu>).

© European Union, 2012

Reproduction is authorised provided the source is acknowledged.

Printed in Belgium

PRINTED ON ELEMENTAL CHLORINE-FREE BLEACHED PAPER (ECF)

ACKNOWLEDGEMENTS

These Guidelines have been prepared by unit DEVCO “Budget Support, Public Finance and Macroeconomic Analysis” of the EuropeAid in close collaboration with all DEVCO Directorates and the EEAS and has benefited from many discussions and contributions received from staff in Headquarters and EU Delegations.

In light of the experience in using these Guidelines, it is planned to make modifications and adaptations as and when necessary. To help in this work, comments, questions and suggestions are welcomed and should be sent to unit DEVCO/A4 at europaaid-a4@ec.europa.eu starting from the 01/01/2013.

Structure of the Guidelines

The Guidelines are structured in three parts as follows:

Part I: Executive Guide

Part II: Programming, Design and Management of Budget Support

Part III: Annexes – Thematic topics and procedural requirements

The Executive Guide is designed to provide an overview for the decision makers of how the new policy will be implemented. Each section of the Executive Guide corresponds to a companion chapter of the second part “Programming, Design and Management of Budget Support” of the guidelines, where further policy and technical guidance can be found for a wider audience: EU staff, EU Member States, partner countries, other donors, parliaments, civil society organizations. A number of Annexes provide guidance on thematic topics and procedural requirements, including annotated templates for programme preparation and implementation, for the EU staff dealing directly with budget support operations.

TABLE OF CONTENTS

ACKNOWLEDGEMENTS	1
STRUCTURE OF THE GUIDELINES	1
CHAPTER 1: PURPOSE, RATIONALE AND SCOPE	5
1.1. Structure of the guidelines	7
CHAPTER 2: RATIONALE FOR BUDGET SUPPORT AND POLICY CONTEXT	9
2.1. What is Budget Support?	11
Platform for Dialogue	11
Financial Support to Public Policies Using Country Systems	11
Performance & Results Assessment	11
Capacity Development	11
2.2. Policy Context	12
EU Coordinated Approach	13
2.3. Objectives of EU Budget Support	13
Good Governance and Development Contracts (GGDCs)	13
Sector Reform Contracts (SRCs)	13
State Building Contracts (SBCs)	14
2.3.1. The Choice of Contract	14
2.3.2. Budget Support and Decentralisation	14
2.3.3. Budget support: an intervention logic	15
CHAPTER 3: NEW GOVERNANCE FOR EU BUDGET SUPPORT	19
3.1. Introduction	21
3.2. Headquarters	21
Budget Support Steering Committee	21
3.3. EU Delegations in the Region	22
Regional Budget Support Teams	22
3.4. Key Tasks of the new governance structures	23
3.4.1. Assessment of the pre-conditions for Good Governance and Development Contracts	23
3.4.2. Risk Management Framework	23
3.4.3. Ensure quality and policy coherence of budget support	23
3.4.4. Conduct the necessary Budget Support dialogue	24
CHAPTER 4: FUNDAMENTAL VALUES AND BUDGET SUPPORT	25
Principles	27
Scope	27
Promotion and protection of fundamental values via Budget Support	27
Structures and Mechanisms	28
EU coordination on fundamental values and GGDC (General budget support)	29
Gradualism and proportionality of the responses to be considered by the EU	29
CHAPTER 5: DESIGN AND IMPLEMENTATION OF BUDGET SUPPORT	31
5.1. Eligibility Criteria for Approval & Disbursement	33
5.1.1. Public Policies [National/sector development strategy]	34
5.1.2. Stable Macroeconomic Framework	35
5.1.3. Public Financial Management	37
5.1.4. Transparency and Oversight of the Budget	39
5.2. Budget Support Dialogue	42
5.3. Risk Management Framework	42

5.3.1. Introduction	42
5.3.2. Risk Assessment	43
5.3.3. Risk Responses and Mitigation	45
5.3.4. Risk monitoring and reporting	46
5.4. Performance, Variable Tranche Design, Ownership & Predictability	46
5.4.1. Introduction	46
5.4.2. Size and phasing of variable tranches.	47
5.4.3. Variable tranche indicator selection	47
5.4.4. Determining variable tranche payments	48
5.5. Domestic Revenue Mobilisation	48
5.6. Accountability	49
5.7. Fraud and corruption	50
5.8. Capacity development	50
CHAPTER 6: THE PROGRAMME CYCLE	51
6.1. Introduction	53
6.2. Identification	53
6.2.1. Whether to Provide Budget Support	53
6.2.2. How Much Budget Support	54
6.2.3. Identification	55
6.3. Formulation	55
6.4. Commitments	56
6.5. Implementation and Disbursements	56
6.6. Evaluation and Audit	57
6.7. Visibility	57
BUDGET SUPPORT CONTRACTS: SUMMARY TABLE	58
ANNEXES	61
DETAILED TABLE OF CONTENTS OF THE ANNEXES	63
ANNEX 1: GLOSSARY OF TERMS	67
ANNEX 2: OBJECTIVES AND INTERVENTION LOGICS OF BUDGET SUPPORT	72
ANNEX 3: ASSESSING PUBLIC POLICY ELIGIBILITY	78
ANNEX 4: ASSESSING MACROECONOMIC ELIGIBILITY	83
ANNEX 5: ASSESSING PUBLIC FINANCIAL MANAGEMENT ELIGIBILITY	95
ANNEX 5: ASSESSING PMF ELIGIBILITY – PART II: ANNUAL MONITORING REPORT	105
ANNEX 6: ASSESSING ELIGIBILITY ON TRANSPARENCY AND OVERSIGHT OF THE BUDGET	116
ANNEX 7: RISK MANAGEMENT FRAMEWORK	126
ANNEX 8: PERFORMANCE ASSESSMENT AND VARIABLE TRANCHE DESIGN	135
ANNEX 9: STATE BUILDING CONTRACTS FOR FRAGILE SITUATIONS	141
ANNEX 10: BUDGET SUPPORT IN SMALL ISLAND DEVELOPING STATES (SIDS) AND OVERSEAS COUNTRIES AND TERRITORIES (OCTS)	151
ANNEX 11: DOMESTIC REVENUE MOBILISATION (DRM)	156
ANNEX 12: ASSESSMENT OF FUNDAMENTAL VALUES	163

Chapter 1

PURPOSE, RATIONALE AND SCOPE

1. PURPOSE, RATIONALE AND SCOPE

The **purpose** of these Guidelines is, firstly, to contribute to improving the quality of European Commission budget support programmes by providing guidance to those who programme, design and implement them. They aim to promote consistency and clarity of approach, while allowing for the necessary operational flexibility required in the face of dynamic and diverse situations. Secondly, the Guidelines are intended to provide a basis for a more coordinated EU approach to the provision of budget support.

The **rationale** for this particular revision is to ensure that new budget support programmes comply with the new policy direction set out in the budget support Communication and corresponding Council Conclusions.

The **scope** of the Guidelines covers all budget support programmes provided by the European Commission to “third countries” (that is countries other than the Member States, Acceding countries, candidate countries, and potential candidate countries of the European Union). The Guidelines do not cover the requirements for the provision of Macro-Financial Assistance (MFA), which is managed by DG ECFIN on the basis of its own operational procedures⁽¹⁾.

1.1. Structure of the guidelines

The main body of these guidelines is designed to provide a comprehensive overview of how the new Communication will be operationalised, summarising why and how the EU will provide budget support.

The Guidelines are structured as follows. **Chapter 2** summarises the basic definitions, policy context and objectives of budget support. **Chapter 3** describes new budget support governance arrangements, while **Chapter 4** sets out how the fundamental values are to be used and assessed as preconditions for budget support, and during implementation. **Chapter 5** outlines key themes that need to be considered throughout the programme cycle, focusing on eligibility criteria, policy dialogue, risk assessment and management, performance assessment, domestic revenue mobilisation, accountability, fraud and corruption, and capacity development. **Chapter 6** summarises the programme cycle and outlines what analysis and documentation needs to be prepared at each stage. A number of **Annexes** provide further guidance on thematic topics and procedural requirements, including annotated templates used during programme preparation and implementation.

⁽¹⁾ Macro Financial Assistance is managed by ECFIN and provides balance of payments support to beneficiary countries on a short-term and exceptional nature, managed under the so-called “Genval Criteria” and requiring an explicit decision by the Commission in accordance with Article 308 of the Treaty. However strong coordination is foreseen with DG ECFIN in countries where the Commission provides both Macro-Financial Assistance and Budget Support in order to ensure coherence and synergies between the two programmes.

Chapter 2

RATIONALE FOR BUDGET SUPPORT AND POLICY CONTEXT

This chapter summarises basic definitions, policy context, and objectives of budget support.

2. RATIONALE FOR BUDGET SUPPORT AND POLICY CONTEXT

2.1. What is Budget Support?

Budget support is an aid modality. It should not be seen as an end in itself, but as a means of delivering better aid and achieving sustainable development results. It involves dialogue, financial transfers to the national treasury account of the partner country, performance assessment and capacity development, based on partnership and mutual accountability. Therefore, it is important to distinguish between the **budget support aid modality**, which incorporates all four elements of this package, and **budget support funds**, which relates only to the financial resources transferred to the partner country. Budget Support is not a blank cheque, nor is it provided to every country. Eligibility criteria have to be met before and during the programme and conditions need to be fulfilled before payments are made. Budget support is fully aligned with the principles and commitments made in the Paris Declaration on Aid Effectiveness (2005), the Accra Agenda for Action (2008) and the Busan Partnership for Effective Development Co-operation (2011).

Platform for Dialogue

Budget support offers a platform for dialogue with the partner country (Government, national control bodies and civil society) on policies and their financing, objectives and results, consistent with the principles of ownership, transparency and accountability. A major step to reinforce dialogue and manage risk is the governance structure of budget support (chapter 3).

Financial Support to Public Policies Using Country Systems

EU budget support involves the transfer of financial resources *to the National Treasury of a partner country, following the respect by the latter of agreed conditions for payment*. Transfers are made in EURO to a Government account held at the Central Bank and then converted into local currency to the National Treasury Account⁽²⁾. The Delegation must ensure that the beneficiary government provide the documentary evidence that the relevant Treasury Account has been credited by the amount equivalent to the foreign exchange transfer at the appropriate day's exchange rate as outlined in the Financing Agreement. Budget support funds must be accounted as government revenues and included in the State budget of the beneficiary country, if predictable enough, in the executive budget proposal and the enacted budget, otherwise in the year-end report of the budget, according to the principles of the IMF's Government Finance Statistics. Any transfer is always made *after* the agreed conditions for payment have been respected. Once this transfer has taken place, budget support funds are used in accordance with the partner country's own public financial management (PFM) systems, and responsibility for the management of these transferred resources rests with the partner government. The Commission's responsibilities when accounting for and auditing its resources are therefore limited to ensuring that the conditions have been met and that resources are transferred to the national treasury in accordance with the agreement. However, EU Delegations and HQ services should be aware of and seek to avoid any reputational risk for the EU caused by a major dysfunction of the country systems or by corruption and fraud. The risk management framework (section 5.3) is an important tool to manage such risk.

Performance & Results Assessment

Budget support is focused on development results. This implies good country systems to collect information and provide statistics, monitor progress, evaluate impact, ensure sound results-focused public financial management, transparent reporting and public accessibility of information. The system should be developed under the ownership of the government with the support from donors if need be. Clarity in choices of indicators and targets as well as on resources requirements and institutional set up are important elements for the reliability of the system. The system should contribute to strengthening the voice and legitimacy of national stakeholders in the partner country's budgetary process, to structuring the policy dialogue between the government and donors and to ensuring that factual and verifiable information on development results is placed in the public domain.

Capacity Development

Capacity development needs should be assessed systematically to promote effective institutions and to enhance government's capacity to design and implement policies and deliver services to final beneficiaries; to promote the active engagement of all domestic stakeholders and to strengthen the national statistical system. The Commission

⁽²⁾ The Consolidated Fund, National Revenue Account, "le compte du Trésor" or equivalent – normally held by the government in the Central Bank. Transfers that are made to accounts held by parties other than the government, held in commercial banks (even if held by government agencies or agents), or held outside the National Treasury system cannot be considered to be budget support funds.

provides support to capacity development based on demand, linked to clear outputs, and through harmonised and aligned initiatives. These guidelines provide an enhanced treatment of institutional analysis and capacity development, emphasising the need for a contextual and country specific analysis of institutions and capacity, focusing on underlying incentives and performance, and avoiding the superficial “add-on” approach which has often led to supply-driven prescriptions of technical assistance.

2.2. Policy Context

The policy context has changed significantly since the previous 2007 Guidelines. Questions about the quality, value for money and impact of budget support were increasingly being raised by a range of stakeholders, and led to the publication of a Green Paper on the future of EU Budget Support in October 2010⁽³⁾. These consultations and other developments – notably reports from the European Court of Auditors concerning the Commission’s management of budget support⁽⁴⁾ – informed the subsequent preparation of the new Communication on Budget Support, adopted on 13 October 2011. The Communication was adopted together with a new Development Policy framework (the “Agenda for Change”⁽⁵⁾) outlining the EU Development policy and laying down the priorities and guiding principles that will underpin all future programming exercise. Council Conclusions on both Communications were approved in May 2012.

The Communication sets out a modern approach to budget support that aims at *strengthening the contractual partnership on EU budget support between the EU and partner countries in order to build and consolidate democracies, pursue sustainable economic growth and eradicate poverty. This approach must be based on mutual accountability and shared commitment to fundamental values of human rights, democracy and the rule of law. It should enable greater differentiation of budget support operations, allowing the EU to respond better to the political, economic and social context of the partner country.* Budget support is provided as a “**vector of change**” to address five key development challenges:

- Promoting human rights and democratic values;
- Improving financial management, macroeconomic stability, inclusive growth and the fight against corruption and fraud;
- Promoting sector reforms and improving sector service delivery;
- State building in fragile states, and addressing the specific development challenges of small island development states (SIDS) and overseas countries and territories (OCTs);
- Improving domestic revenue mobilisation and reducing dependency on aid.

In order to respond to those challenges, the European Commission provides three forms of budget support programmes⁽⁶⁾:

- **Good Governance and Development Contracts** to provide budget support to a national development or reform policy and strategy.
- **Sector Reform Contracts** to provide budget support in order to address sector reforms and improve service delivery.
- **State Building Contracts** to provide budget support in fragile and transition situations⁽⁷⁾.

There are no targets for EU budget support at either national or global level. Rather, the appropriate mix between different aid modalities should be decided as part of a portfolio approach that comprises several financing modalities in response to a partner country’s specificities and agreed development objectives⁽⁸⁾.

⁽³⁾ COM(2010) 586; 19 October 2010

⁽⁴⁾ “The Commission’s Management of General Budget Support in ACP, Latin American and Asian Countries”, ECA Special Report No.11, 2010.

⁽⁵⁾ COM(2011) 637; 13 October 2011

⁽⁶⁾ MDG-Contracts, provided to 8 good performing countries in the 10th EDF as a longer-term, more predictable form of general budget support, will not be continued as a separate form of budget support. However, their principle features may be applied to both GGDCs and SRCs.

⁽⁷⁾ For the purposes of DAC coding, GGDCs and SBCs can be considered as general budget support, whereas SRCs are sector budget support.

⁽⁸⁾ Distinctions can also be drawn between untargeted and targeted budget support (depending on whether funds are linked to a defined set of eligible expenditures or budget lines). In the majority of cases, Commission support will and should be provided as untargeted budget support. In some cases, for example State Building Contracts or in the presence of serious Treasury/Budgetary process constraints, support may be targeted in order to better safeguard Commission assistance. Budget support may also be used for arrears clearance or to assist countries affected by exogenous shocks (eg VFlex in 2009 and 2010), but will remain subject to the provisions in these Guidelines.

EU Coordinated Approach

The Council Conclusions renew the EU commitment to use budget support effectively to support poverty reduction and the use of country systems, make aid more predictable and strengthen partner countries' ownership of development policies and reforms. They endorse the policy and the objectives set out in the Communication and acknowledge the need to apply a dynamic approach to eligibility, focusing on progress in the implementation of credible and relevant reforms, to maximise the impact on the ground. They highlight the importance of strengthening the contractual and reciprocal nature of partnership between the EU and partner countries and point out that the commitment and record of partner countries to democracy, human rights and the rule of law is one of the key determinants of EU development cooperation, including general and sector budget support, and should be assessed to determine if using budget support is appropriate.

The Council Conclusions also highlight the need for a more EU coordinated approach to increase the effectiveness of this modality for development results and reforms, and to provide coordinated and consistent EU responses. This more coordinated approach shall be conducted within existing procedures and decision-making processes, in country and headquarters, and shall be based upon the principles of sovereign decision making by Member States.

2.3. Objectives of EU Budget Support

The **general objective** common to the three forms of budget support, which are coherent with the “Agenda for Change”, is to contribute to:

- Poverty eradication
- Sustainable and inclusive economic growth
- Consolidation of democracies

The **specific objectives** of individual budget support programmes should be defined in line with two important principles:

- Alignment with partner countries own development policies, priorities and objectives (and thus harmonised and coordinated with other aligned donors)
- Consistency with EU development policy, particularly the “Agenda for Change”.

These specific objectives should also reflect the five development challenges, the relative importance of which will vary according to country context and the form of budget support (see annex 2).

Good Governance and Development Contracts (GGDCs)

GGDCs are to be used whenever the specific objectives are focused on fostering domestic accountability and strengthening national control mechanisms (an important basis for improving governance and adherence to fundamental values); or on strengthening core government systems and supporting broader reforms, such as macroeconomic management, public financial management (including procurement and the fight against corruption), domestic revenue mobilisation and public sector reform, and addressing constraints to sustained and inclusive growth. Improved government systems should lead to improved MDG indicators and cross-cutting service delivery aspects, which may therefore also be reflected in the specific objectives of GGDCs.

Sector Reform Contracts (SRCs)

SRCs should be used when the specific objectives are more narrowly focused on supporting sector policies and reforms, improving governance and service delivery in a specific sector or set of interlinked sectors. When providing SRC, emphasis should be on the equitable access to and quality of public service delivery, particularly to the poor, on the promotion of gender equality and children's rights, and the capacity to absorb and use sector research results, as well as creating conditions at sector level for inclusive and sustainable growth. Financial additionality may be a key feature of many SRC programmes – as it is of other forms of external support – but SRC programmes may also have objectives that do not necessarily imply significant increases in sector expenditure. The value added of a SRC is often in supporting an acceleration of reforms, in improving efficiency and effectiveness of sector expenditures, in knowledge sharing or capacity development. When SRC objectives imply an increase in sector expenditure,

EU Delegations should start early to prepare for a structured dialogue with the national authorities and other partners, particularly the IMF, on budgetary allocations and sector expenditure path, focusing on realistic and fiscal sustainability expenditure projections that should underpin the sector programme (see annex 2).

In providing budget support under SRC to Small Island Developing States (SIDS) and Overseas Countries and Territories (OCTs) the EU should pay particular attention to address in an efficient way the complex and cross-cutting development challenges, including structural vulnerability and climate change (Annex 10).

State Building Contracts (SBCs)

SBCs should be used when situations of fragility or transition require action to support transition processes towards development and democratic governance, including sustainable changes in transition societies, to help partner countries to ensure vital state functions and to deliver basic services to the populations. Assessments of eligibility for SBCs will focus more on forward looking political commitment and institutional reforms than backward looking track record, but will require stronger political and policy dialogue and, if necessary, closer monitoring and possible targeting of EU funds.

2.3.1. The Choice of Contract

The appropriate form of budget support contract should be determined by the specific objectives and expected results of the programme. The use of conditions, dialogue and performance indicators should be tailored to address those specific objectives and expected results. While the provision of a GGDC may be considered as signalling endorsement of a country's commitment and path towards the fundamental values, SRCs will in many contexts remain the more appropriate option and should not be seen as a second class form of budget support.

It makes sense to be pragmatic and take into account the country specific context when identifying "interlinked sectors" to be supported by a "multi-sector" SRC. Such linkages should be underpinned by a coherent policy and institutional coordinating framework covering the interlinked sectors or areas, and the existence of complementarities and synergies in the implementation of the activities under a "multi-sector" programme. It is also important to consider whether the "multi-sector" SRC reaches a critical mass at country level in terms of support to the "interlinked sectors" or human resources (including capacity in EU Delegations for policy dialogue) in order to generate significant results. The effectiveness of the programme will suffer if the same instrument is used to support different specific objectives that are not connected as explained.

GGDCs and SRCs may both be provided in parallel to the same country as they can mutually reinforcing each other. GGDC provides a unique platform to support broader policy reforms and objectives of the partner country and should not be overloaded with a multiplicity of objectives at sector level. When provided in parallel, SRC can benefit from a concomitant GGDC, mainly by deferring to the GGDC the assessment and dialogue of macroeconomic policies and PFM reforms, as well as the support to the partner country national development policy and, therefore, providing a sound basis for implementing sector policies. In contrast, a SRC can reinforce a GGDC by providing a unique platform to support specific sector priorities embedded into the country national development policy and for which a SRC can drill down into the specifics of the sector, including a comprehensive range of indicators (input, process, output, outcome and impact) reflecting different dimensions of the sector.

SBCs would *not* generally be combined with other forms of budget support. It should prepare the ground for GGDC or SRCs by supporting the formulation of national/sector development policies, consolidating the macroeconomic and PFM framework or ensuring a better phasing and smoothing transition from short to medium/long term partner country's objectives and commitments.

2.3.2. Budget Support and Decentralisation⁽⁹⁾

Many budget support operations, particularly Sector Reform Contract, tend to support significant service delivery mechanisms or reforms, which need to be decentralised geographically in order to reach the target population or institutions, for example in health, education, water, sanitation, agriculture, roads or the process of decentralisation itself.

EU Delegations can come across different situations in providing budget support in a decentralised context, as the

⁽⁹⁾ Further elements are developed in the EuropeAid reference document "Supporting Decentralisation and Local Governance in Third Countries" 2007.

decentralisation normally originates from a rich variety of public administration, cultures, traditions and history specific to each country. As regards to budget support, the approach should be based on the EU guidance on decentralisation process (see reference document in footnote 11), which is to focus on the three functional dimensions of decentralisation, i.e. i) **Political** which involves a range of political powers, including the formulation and adoption of public policies; ii) **Administrative** which involves resources and responsibilities for the delivery of a select number of public services or “functions”, and iii) **Fiscal** which involves a high degree of autonomy and discretion for the decision and management of an important share of revenues and/or expenditures by sub-national governments. Therefore, EU Delegations should follow a pragmatic approach for budget support in a decentralised context, taking into account the following elements:

- **Budget Support for the decentralisation of public services:** In situations where normally the sub-national government has extensive administrative powers but very limited political and fiscal autonomy, SRC can be provided to support the geographic decentralisation of services, for example, in sectors such as health, education, water & sanitation, justice and security, generally related to a sector policy or reform framed and financed at national level. The design and implementation of the SRC, including the eligibility criteria and budget support dialogue, has to take into account both central and sub-national government levels.
- **Budget support to a decentralisation process⁽¹⁰⁾:** In situations where the decentralisation process from central to sub-national levels is itself the specific objective of the programme, SRC can be provided to support the decentralisation policy. The programme should focus on the reforms and institutional aspects of the decentralisation process and, according to the country own policy, could cover the three functional dimensions above political, administrative and fiscal. Similar to the previous case, the design and implementation of the SRC, including the eligibility criteria and budget support dialogue, has to take into account both central and sub-national government levels.
- **Budget support to a sub-national government:** In situations where a sub-national government enjoys extensive political, administrative and fiscal powers (e.g. Federal system), a fully-fledged SRC can be provided to support a sector policy or reform. Although the central government can still play a role (national authorising officer, some central aspects of the eligibility criteria), the design and implementation of the SRC, including the eligibility criteria and budget support dialogue, should focus on the sub-national level. However, GGDC is not advisable even in those cases, as main features of the GGDC, such as the pre-condition on fundamental values, are by nature an essential function of the central government.

2.3.3. Budget support: an intervention logic

The intervention logic can be considered in two parts⁽¹¹⁾. The first part covers the effects of the budget support operation (including associated policy dialogue and capacity development) on public policy, institutions, spending and service delivery (the first three levels of the framework: budget support inputs (level 1); direct outputs (level 2) and induced outputs (level 3)), recognising that these “induced outputs” will be determined by government actors and policies beyond the budget support package. The second part considers changes in outcomes (level 4) and impacts (level 5) *expected* from Government policies, strategies and spending, but also influenced by a range of other factors (including other government policies, private sector and civil society initiatives, other aid programmes and external factors) which need to be assessed during evaluation.

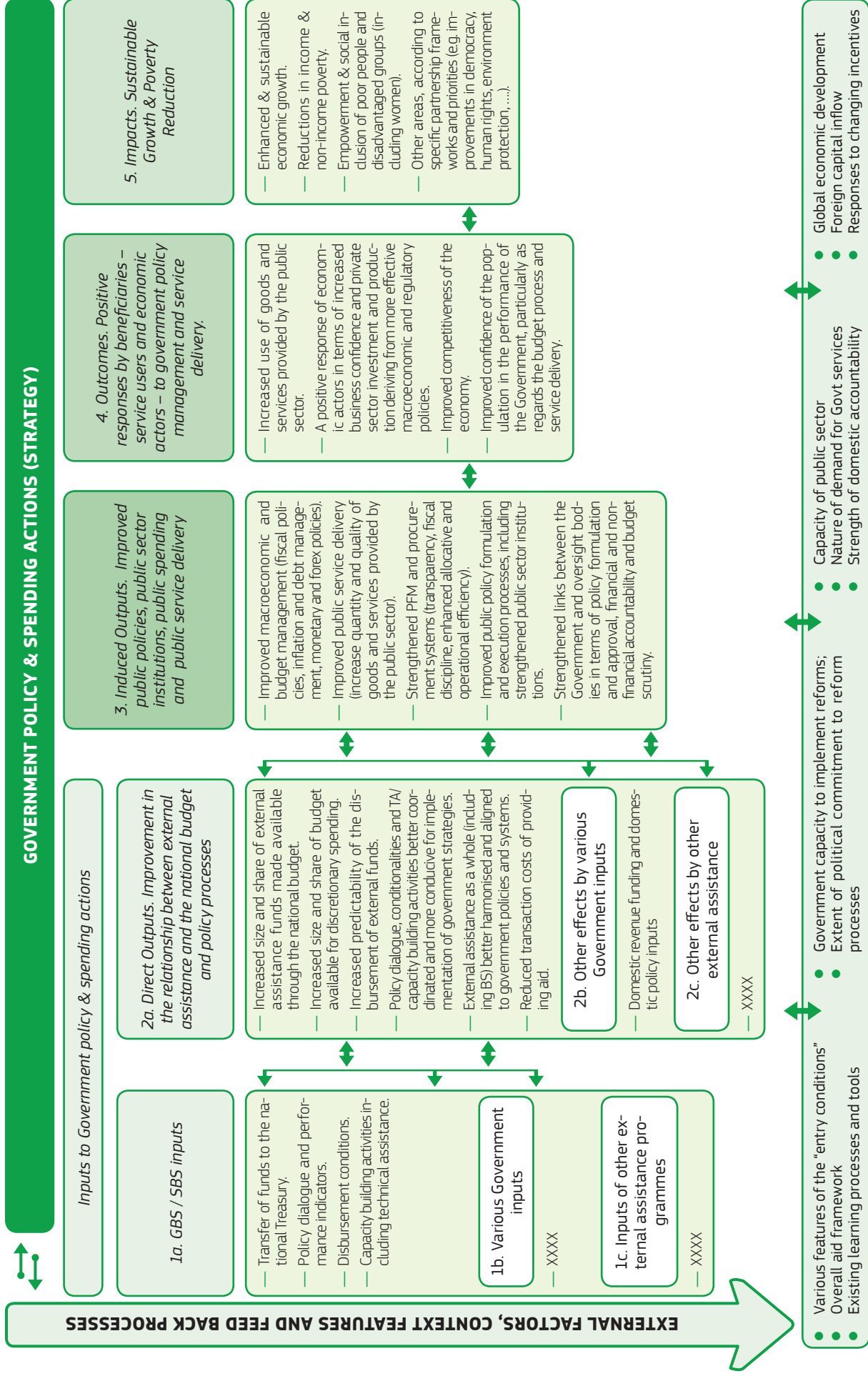
It is these elements, particularly those at levels 2 and 3 where the effects of budget support are more direct, that represent the expected benefits of budget support as an aid modality. These are likely to be particularly significant in heavily aid dependent countries where budget support will contribute to capacity development to enable the use of country systems and support the development of coherent policies by partner governments.

The general objectives outlined above (eradicate poverty, sustainable economic growth, consolidate democracies) are reflected in level 5 of the framework (impacts). The specific objectives and expected results will vary more widely between individual budget support programmes, but will generally be focused on level 3 (induced outputs) and 4 (outcomes). Thus while acknowledging that budget support aims at making a contribution to the achievement of

⁽¹⁰⁾ This would be consistent with the sectors identified in the Communication “Agenda for Change” under “Democracy, human rights and the rule of law” or “Public Sector Management”.

⁽¹¹⁾ Figure 1 sets out the comprehensive evaluation framework recently piloted in the budget support evaluations for Tunisia, Mali and Zambia, and accepted with some revisions as the basis for future evaluation work. This framework effectively provides the **intervention logic** for budget support, through which budget support transfers, coupled with policy dialogue, technical assistance and capacity development, contribute to improved outputs, outcomes and ultimately impacts. Evaluations of BS operations are joint donor exercises and therefore cover all BS operations within a specified period. The details of the Comprehensive Evaluation Framework therefore relate to the entire package of BS operations in a country and, thus, needs to be adapted if applied to specific BS operations.

Figure 1 – Comprehensive Evaluation Framework for budget support evaluations



the general objective reflected on the impact indicators such as sustainable growth and poverty reduction, the focus should be on what budget support (and its complementary activities) can contribute to more directly, i.e. the specific objectives and results.

Some example “intervention logics” that set out overall and specific objectives, as well as expected results and main activities, for a GGDC, SRC and SBC can be found in Annex 2 to illustrate this more clearly. Expected results (linked to the specific objectives and to be achieved by the end of the programme) should be as specific as possible in order to better assess and report on progress during implementation, support completion of an end of programme review, and facilitate ex-post evaluation.

Chapter 3

NEW GOVERNANCE FOR EU BUDGET SUPPORT

3. NEW GOVERNANCE FOR EU BUDGET SUPPORT

3.1. Introduction

The Communication on “The Future Approach to EU Budget Support to Third Countries” approved by the Commission on 13 October, with the full support of the EEAS, foresees the reinforcement of the capacity of the Commission to manage budget support. It states that:

“In order to engage in a genuine high-level political and policy dialogue with countries eligible for budget support in general, and for Good Governance and Development Contracts in particular, staff resources at EU Delegations will have to be reviewed nationally and regionally, both in terms of level and expertise.

To this end, the Commission will set up senior regional teams, at Headquarters and in EU Delegations, with the participation of relevant Commission services and the EEAS. These teams will also consult with Member States as appropriate”.

This mechanism will be complemented by appropriate management tools, in particular a risk management framework. In this regard, the Communication states that:

“Commission services and where appropriate the EEAS will develop an improved risk management framework adapted to the specific risk profile of budget support... This framework will be an important complementary tool in programming, designing and implementing programmes and to inform policy dialogue... Risk response and mitigating measures will be proposed according to the balance between risks and benefits”.

Therefore, it has been agreed to set up the new governance structure foreseen by the Communication, at Headquarters and EU Delegations, in charge of monitoring and implementing Budget Support. The objectives of these proposals are to:

- 1) **Strengthen continuous policy steering at Senior Management and Commissioner level.**
- 2) **Enhance and ensure coherence of the EU budget support dialogue with partner countries, as agreed in the Communication.**
- 3) **Ensure policy coherence across countries and regions.**
- 4) **Reinforce the risk management and risk mitigation mechanisms**
- 5) **Support EU Delegations and HQ in programming, design and implementation of budget support programmes.**

The new governance structure will include new/strengthened structures both at Headquarters and in EU Delegations.

3.2. Headquarters

The Geographical Directors in DEVCO are, and will remain, directly responsible, in their role of Sub-Delegated Authorising Officer, for the management of all budget support programmes in their region.

There will be no change in the current financial circuits, neither in HQs nor in EU Delegations. Relevant DEVCO services, including thematic experts, will continue to provide technical advice and support to the Geographical Directorates through the quality support group or upon request.

Budget Support Steering Committee

In order to **further involve the Director General** in the decision making-process early enough to provide necessary strategic guidance, as well as to consult the Commissioners for Development, Neighbourhood, and the HR/VP as appropriate, a **“Budget Support Steering Committee”** will be created, chaired by the Director General of DEVCO.

The Steering Committee will include:

- The responsible Geographical Director
- Representatives of the EEAS (geographic/horizontal, for programming and political and fundamental values aspects)

- Relevant Thematic/Horizontal Directors
- Representatives of the Geographical services
- Representatives of the thematic services (for the sectors concerned)
- One representative from DG ECFIN (for macroeconomic/financial aspects)
- One representative of unit DEVCO A2 (secretariat)

The “**Budget Support Steering Committee**” (BSSC) will meet as regularly as is necessary. Its frequency will be determined by the timing of commitments and disbursements with every effort made to avoid delays in the decision making process.

The Steering Committee will discuss Budget Support programmes to be presented to the relevant Management Committee of EU Member States, as well as disbursements of ongoing programmes, where there are **substantial or high political and policy implications** that need to be brought to the attention of, and formally engage, the senior management and, as appropriate, the Commissioners (Development, Neighbourhood) and the HR/VP.

It is the **responsibility of the Geographical Directors** to include in the agenda of the BSSC such budget support programmes and disbursement decisions. Directors A, C or D and the EEAS may also request referral of a BS operation to the Steering Committee.

A decision in principle to engage in Budget support, particularly in high risk environments, as well as the decision to suspend budget support operations will be taken by the Director General (as chair of the Steering Committee) after agreement, as appropriate, of the Commissioners (Development, Neighbourhood) and the HR/VP. Disagreements on issues of political governance, including fundamental values, will lead to consultation at Commissioner and/or HR/VP level.

3.3. EU Delegations in the Region

The Heads of Delegation and Delegation staff are, and will remain, directly responsible, in their respective Sub-Delegated roles, for the management of all budget support programmes in their Delegation.

Regional Budget Support Teams

The regional teams will have an **advisory and support role to Geographical Directorates, HoD and EU Delegations** in the region, in close cooperation with the relevant thematic experts. **The Senior Regional Advisor will work under the instructions of the Geographic Director (SDAO)** and in full cooperation with the Heads of EU Delegations in the region.

The regional teams **location** will be decided by the Director General, after a proposal from the Geographic Director and in agreement with the EEAS taking into account the administrative and budgetary capacity of EU Delegations to host the regional teams.

The regional teams structure and specific mandate will be decided by the Director General, after a proposal from the Geographic Director and consultation with the EEAS.

The role of the Regional Teams will be to enhance the capacity of EU Delegations and Geographical Directorates to prepare, oversee and implement high quality budget support programmes by:

- 1) Providing **advice and support to EU Delegations** in Budget support operations;
- 2) Providing **advice to the respective Geographical Directorate** on issues related to Budget support in the region;
- 3) Being fully associated with the **Heads of Delegation in the budget support dialogue** with the partner country, following instructions from the DEVCO Geographical Director, and with participation of relevant Commission services and the EEAS.

The regional budget support teams will be chaired by a **senior official designated by DEVCO** (to be called Senior Regional Advisor) and will comprise a number of officials, contract and local agents. They will also benefit from the support of DEVCO staff in the Delegation where they are based, if deemed necessary.

The Chair and staff of the regional teams will work as a team in close cooperation with thematic experts, HODs and with all other relevant staff in EU Delegations and HQ and the EEAS under the supervision of the Geographical Director.

As a rule, the Regional teams will be involved in **Good Governance and Development Contracts and State Building Contracts** dialogues, unless the Geographic Director or the BS Steering Committee decides otherwise. They will also be involved in Sector Reform Contracts dialogues in cases considered by the Geographic Director or the BS Steering Committee as presenting substantial or high risks.

3.4. Key Tasks of the new governance structures

3.4.1. Assessment of the pre-conditions for Good Governance and Development Contracts

With a view to ensure full respect of the preconditions and other criteria and before starting the identification phase, the Director General of DEVCO, following discussions in the Budget Support Steering Committee and taking into account the MIPs and the assessment made of the preconditions for budget support by the HoD, will identify which countries fulfil all the conditions and eligibility criteria for Good Governance and Development Contracts, and will seek the agreement as appropriate of the Commissioners for Development, Neighbourhood, and the HR/VP.

The Geographical Director will provide the necessary information, the opinions of the Head of Delegation, the EEAS as well as the advice of the Regional teams to inform this decision.

Once this decision has been taken, the identification and formulation of GGDC programmes will start in line with the currently existing decision-making procedures,

3.4.2. Risk Management Framework

The Director General of DEVCO is responsible for the risk management strategy and its effectiveness. The Geographical Directors are responsible for the implementation and monitoring of the risk management in their region.

The Geographical Directorates, with support from EU Delegations and Regional Teams, shall provide country specific information and propose alternative options for decision-making, including in response to deteriorating situations.

The EEAS leads on the political risks involved in budget support and instructs, as required, the Head of Delegation, on the line to take in relation to political dialogue. The HOD will ensure consistency at the country level between the budget support dialogue and the political dialogue.

Regional Teams will support the EU Delegations and the Geographical Directorates in implementing the risk management strategy and framework in a consistent and effective way across countries by providing inputs that will help:

- a) to inform decisions on the risk level; and balancing risks and benefits of providing budget support (or not);
- b) to formulate mitigating measures and risk responses as part of a risk strategy and to reflect these in the dialogue on budget support;

The implementation of the Risk Management Framework will inform the Geographical Directorates on where additional policy and dialogue efforts should be deployed.

3.4.3. Ensure quality and policy coherence of budget support

Quality and policy coherence of budget support programmes across countries and regions will be ensured at two levels:

- Geographical, Thematic and Policy Directorates: will ensure quality and policy coherence between countries in the same region, with the support of the Regional BS teams and thematic hubs.
- Budget Support Steering Committee: will ensure quality and policy coherence across regions.

3.4.4. Conduct the necessary Budget Support dialogue

Under instructions given by the Geographical Directors (sometimes after discussions in the BSSC), the HoDs chair the policy dialogues, as first interlocutors with local authorities. The Senior Regional advisor and the Regional Teams will be fully associated to these dialogues. When the Geographical Director decides to visit the partner country, s/he chairs the dialogues, in full association with the HoD and the regional teams.

There will be close coordination with the EEAS, in charge of the overall political dialogue, as well as with EU Delegations and geographic services, in charge of the continuous policy dialogue with the beneficiary country.

The dialogue will be intensified and more strategic in countries receiving Good Governance and Development Contracts or those showing substantial or high political and policy risk levels and in the context of State Building Contracts.

Chapter 4

FUNDAMENTAL VALUES AND BUDGET SUPPORT

This chapter describes how issues relating to fundamental values are to be considered in the framework of Good Governance and Development Contracts (General Budget support) programmes in third countries. It reviews the principles to be followed, the scope of the assessment, how fundamental values link to different contexts of Good Governance and Development Contracts (General Budget support), the process to assess and monitor the fundamental values and finally discuss the wider process of EU coordination in this area.

4. FUNDAMENTAL VALUES AND BUDGET SUPPORT

Principles

Article 21 of the Treaty on European Union defines democracy, rule of law and the universality and indivisibility of human rights and fundamental freedoms as guiding principles of the EU's action on the international scene. A positive and pro-active approach is required to implement these guiding principles, which requires coherence between the EU development policy and the EU CFSP.

As stated in art. 208 TEU, development cooperation shall be conducted in the framework of the principles and objectives of the Union's external action and its **primary objective is poverty reduction and eradication**.

In addition to the primary objective of poverty reduction, there is the general EU commitment and adherence to the fundamental values of human rights, democracy and rule of law, which are essential elements of all the EU's partnerships and cooperation agreements with third countries.

In this context, **Good Governance and Development Contracts** (General Budget support) could be provided where there is trust and confidence that state budget funds will be spent pursuant to the fundamental values that the EU and the partner country share, and for the respect of which partner countries commit to move forward.

Scope

Article 21 of the Treaty defines as guiding principles of the EU external action:

“democracy, the rule of law, the universality and indivisibility of human rights and fundamental freedoms, respect for human dignity, the principles of equality and solidarity, and respect for the principles of the United Nations Charter and international law.”

The scope of assessment shall refer inter alia to international instruments, ratification, transposition into domestic laws, the relevant institutional framework and effective implementation. It shall build on the relevant EU Human Rights Country Strategies and the analyses they contain on country situations.

It may include corruption in so far as there may be fundamental breaches in the rule of law, but concerns around the strength of public financial management systems and the fiduciary implications of corruption should be considered as part of the public financial management eligibility criterion.

The assessment will determine the extent to which the government of a third country concerned is committed to the effective protection and promotion of these fundamental values, as well as changes and trends over time, in a dynamic process, based on minimal standards, e.g. in terms of ratification of the core international instruments that express the shared commitments to fundamental values. This exercise should build on, and fully take into account, existing mechanisms, documents, instruments and dialogues, including output of UN and regional human rights mechanisms.

Promotion and protection of fundamental values via Budget Support

With **Good Governance and Development Contracts (GGDCs)**, the EU aims at fostering domestic accountability and strengthening national systems and control mechanisms, as a basis for **promoting broad reforms leading to poverty reduction and improving governance**, including adherence to fundamental values.

Delivering assistance through GGDC is to be seen as an implicit recognition that the partner country's overall policy stance and democratic governance is on track, or moving in the right direction. Therefore, GGDC (General budget support) could be provided where there is trust and confidence that state budget funds will be spent while the partner country continues to be committed to make fundamental values move forward.

The GGDC is an instrument to support broad reforms that lead to poverty reduction, improved governance, while signalling a mutual and shared commitment to universal fundamental values. Therefore, the commitment to fundamental values needs to be assessed as a pre-condition for any GGDCs, and subsequently monitored during implementation (to identify slippage, policy reversals and deterioration).

When Sector Reform Contracts are selected as the most appropriate support modality, adherence to fundamental values should be taken into account. In general, Sectoral budget support is geared at promoting sectoral policy reforms and delivering basic services to the people.

Sector Budget support remains a useful tool even where the conditions do not exist to permit the use of GGDC, because it often remains the best delivery mechanism, and can be used as a vector to improve governance. Assessing EU sector budget support in the light of political governance will need to be carefully balanced against the need to serve and protect the population. However, where political governance has severely deteriorated, the EU should reassess its overall development cooperation with the partner country, including sector budget support.

Particular care should be taken when supporting sectors which have a direct link with fundamental values, such as justice and security.

In case of **State Building Contracts**, the assessment of the government's commitment to fundamental values as well as the political response to address them in a comprehensive way are aspects to be considered, inter alia, when deciding to engage with these countries. In the context of a fragile or conflict affected situation, the EU should adopt a forward looking approach accompanied by reinforced political and Budget support dialogues. The risk of inaction should be balanced with the development and basic needs implications of not engaging in fragile states.

Structures and Mechanisms

There are already a number of relevant mechanisms in place which enable the EU to monitor trends in the situation as regards human rights and other fundamental values:

- Regular, **political reporting from the Heads of the EU Delegation** (and/or of EU Heads of Mission when appropriate), provide continuous information and assessments of political developments, also in terms of fundamental values, and recommendations are formulated as appropriate.
- The ongoing **political dialogue between the EU and the partner country** is a key forum to address concerns and challenges relating to fundamental values, including human rights issues.
- The **EU Human Rights country strategies** are very useful tools, and represent comprehensive assessments covering the principles defined in Article 21 and also identify the activities envisaged to attain the objectives. They take into account, and link, to the Universal Periodic Reviews undertaken in the United Nations context. They do not need to be replicated for this purpose.

They should be fed in the discussions of the **Budget Support Steering Committee** and in the **Budget Support dialogue**, which addresses all issues related to Budget support operations (with the participation of the EEAS and the Head of the EU Delegation).

When proposing the MIP including the EU response strategy during the programming phase, the **Head of Delegation could propose as a priority sector "Good Governance and Development"**. In such cases, the HoD will provide his assessment on:

- whether the **preconditions in terms of fundamental values**, are met for providing GGDC (General budget support), and – if appropriate – what conditions would need to be met, or which development would need to take place, for the EU to be able to initiate or resume support through GGDC (General budget support);
- which areas of fundamental values, and other aspects, are likely to be raised in the **political and Budget Support dialogues** with the partner country in the short and medium term.
- A brief identification of the political risks, to be considered for the **"risk management framework"** for the country.

The Budget Support Steering Committee will take into account existing information and documentation on fundamental values, including HRs country strategies, as provided by the EEAS, as well as the opinion of the Head of Delegation and the advice of Regional teams and the Geographic services.

The Director General of DEVCO, following discussions in the Budget Support Steering Committee, **will identify which countries fulfil the pre-conditions for Good Governance and Development Contracts**, and will seek the agreement of the competent Commissioners (Development or Neighbourhood) and the High Representative/Vice-President, as appropriate.

Four types of situations can emerge, insofar as fundamental values are concerned

- 1 Mostly **stable or positively progressing** situation. The situation with regard to fundamental values allows the EU to continue to deploy activities planned with GGDC (General budget support), including its disbursements. Minor modifications or adaptations can be made to the GGDC (General budget support) operations to better provide for promoting fundamental values, but overall the situation is deemed as being on track in this respect.
- 2 Some **concerns arising**, but an overall respect of fundamental values is nevertheless still observed. The Commission (Geographic Director), following the advice of the EU Head of Delegation, EEAS and the Regional Budget Support teams may propose mitigation measures, changes to activities and approach to follow in relation to disbursements, to the Budget Support Steering Committee. DEVCO and the EU Delegation then undertake the necessary financial or contractual adjustments or measures, as appropriate.
- 3 **Significant deterioration of fundamental values**. The EEAS and the EU Delegation, with support from the Budget Support regional teams, will provide a report, including an analysis of the political impact on the budget support operations, and their recommendations for action to the Geographic Director, who then refers this BS programme, with his recommendation, to the Budget Support Steering Committee for decision. The Budget Support Steering Committee will then decide on the re-orientation of the planned budget support aid towards other delivery modalities, and/or the adoption, of precautionary measures. The Development or Neighbourhood Commissioners, and the HR/VP will be consulted, as appropriate.
- 4 In the **extreme cases where overall cooperation needs to be suspended** (ex art 96 of Cotonou agreement, and similar procedures normally based on art 1 of Agreements in the DCI and Neighbourhood regions), appropriate measures are decided by the EU Institutions, which can include a reallocation of funds to non-governmental channels.

EU coordination on fundamental values and GGDC (General budget support)

The EU is aiming at a close coordination in the assessment and monitoring of fundamental values, both at local and capitals levels, including by means of the EU Human Rights country strategies and the political follow-up of the country provided by the EU Delegations. EU coordination in the appreciation of the situation of the fundamental values is desirable to face the consequences of decisions to be taken, which can include a decision by some EU Member States or by the Commission to suspend budget support.

Gradualism and proportionality of the responses to be considered by the EU

Any EU response to a significant/serious deterioration in the situation of fundamental values **should be progressive and proportionate**, except in the very serious cases where immediate suspension may be necessary. There are a number of contingency measures which can be considered to promote fundamental values and allow for a balanced response from the EU so as to achieve the best outcome in terms of defending and promoting fundamental values:

1. **Enhanced dialogue** should be the first response either to allay the concern and/or to agree on a roadmap for restoring confidence.
2. When dialogue fails, the Budget Support Steering Committee may consider different options, including **delaying disbursements** (to provide time to clarify the situation and agree on appropriate action), **reallocating** (General budget support) funds to other aid delivery modalities or a **reduction** of General budget support
3. **Suspension** of GGDC (General budget support), as a measure of last resort,

Short term conditions agreed to by the partner country, including for example a **roadmap** for alleviating concerns, can be put in place setting, new terms for resuming GGDC (General budget support), reallocating temporarily funds to other delivery modalities or providing, if necessary, funds for enabling correction of problem areas that were identified as critical

Use can be made of the **Article 23 of the Financing Agreements, which are jointly signed by the Commission and the beneficiary country**, and that provides for formal ways for suspending budget support. This can be: a) Gradual, by means of a reduction of the value of planned disbursements in order to provide a clear signal that changes are needed, as the situation is deteriorating., b) Temporary suspension as part of precautionary measures, c) Complete, full and formal suspension of budget support to make it clear that the situation in terms of fundamental values is no longer compatible with providing General budget support to the country.

Where conditions allow it and subject to the eligibility criteria, a reallocation to a Sector reform contract or sector programme can be made. Alternatively, a reallocation can be made to project aid. **The choice between alternative aid delivery modalities in case of deterioration should be carefully assessed**, so as to balance the need to continue responding to development and people's needs and the respect and promotion of fundamental values, using the available instruments in a strategic and coherent way.

Chapter 5

DESIGN AND IMPLEMENTATION OF BUDGET SUPPORT

This chapter sets out the key issues that need to be considered throughout the programme cycle. The chapter begins by considering eligibility, and also summarises the approaches to policy dialogue, risk assessment and management, performance assessment and domestic revenue mobilisation, accountability, fraud and corruption, and capacity development. Further details are in Annexes 3-8.

5. DESIGN AND IMPLEMENTATION OF BUDGET SUPPORT

5.1. Eligibility Criteria for Approval & Disbursement

Budget support programmes are subject to the following four eligibility criteria covering:

- National/sector policies and reforms (“public policies”)
- Stable macro-economic framework
- Public financial management
- Transparency and oversight of the budget

These criteria need to be met both when a programme is approved, and at the time of each budget support disbursement. The assessment of the eligibility criteria generally involves:

- 1) Assessment, during identification and formulation, of the **relevance** and **credibility** of the partner country policy and strategy related to each eligibility criterion:
 - *Relevance*: refers to extent to which key constraints and weaknesses are being addressed by the government’s strategy to reach the objectives of the policy.
 - *Credibility*: refers to the quality of the reform process regarding its realism, institutional arrangements, track record and political commitment to the reforms.
- 2) Assessment, during implementation, of **progress** made in implementing the policy and strategy and achieving the objectives:
 - *Satisfactory progress*: it should be based on a **dynamic approach**, looking at past and recent policy performance benchmarked against reform commitments, but allowing for shocks and corrective measures and refining the objectives and targets if necessary. For some criteria (notably PFM), progress against initial reform milestones is particularly important; for others (macroeconomic, for example), maintaining stability-oriented policies is sufficient to confirm eligibility. The setting of targets and assessment of progress should take into account the initial starting point. In countries with already strong performance and systems the assessment should focus on maintaining the quality of the systems. The continued relevance and credibility of any strategy should be confirmed.

Eligibility criteria during formulation and implementation

For approval (end of formulation):

A country may be considered eligible when:

- *Public policy*: There is a credible and relevant national/sector development strategy that supports the objectives of poverty reduction, sustainable and inclusive growth, and democratic governance.
- *Macroeconomic*: There is a credible and relevant programme to restore and/or maintain macroeconomic stability.
- *PFM*: There is a credible and relevant programme to improve public financial management.
- *Budget transparency*: the government has published either the Executive’s Proposal or the Enacted Budget within the previous or current budget cycle.

During implementation (suggested wording for General Conditions):

- *Public policy*: satisfactory progress in the implementation of [cite appropriate public policy/strategy document] and continued credibility and relevance of that or any successor strategy.
- *Macroeconomic*: maintenance of a credible and relevant stability-oriented macroeconomic policy or progress made towards restoring key balances.
- *PFM*: satisfactory progress in the implementation of its programme to improve public financial management.
- *Budget Transparency*: satisfactory progress with regard to the public availability of accessible, timely, comprehensive, and sound budgetary information.

Assessments should be reasonably short (avoiding lengthy descriptions of the policy) and analytical, providing a clearly argued and justified recommendation regarding eligibility. A reform programme may not always be encapsulated into a single, comprehensive and coherent policy or strategy document. In such cases, the analysis will be based on the different measures and reform process followed by the government to strengthen the system.

The four eligibility criteria apply to all three forms of budget support⁽¹²⁾, although the focus may vary according to the specific objectives of the programme. Further details covering the scope, rationale and methodology for assessing each eligibility criterion are set out below. Annotated templates for the necessary documentation, and further references or background information, are contained in Annexes 3–6.

Three general points are relevant to assessment of each criterion:

- The first is that assessing eligibility should always be put in the context of alignment with partner countries' policies and cycles and, while policy dialogue or performance incentives should be part of the budget support operation, ownership is of prime importance.
- Second, coordination with development partners should be sought although full harmonisation of conditions might not always be necessary or relevant. Minimizing transaction costs for the beneficiary country and maximizing aid effectiveness should remain the guiding principles when deciding on the best coordination mechanism to choose.
- Third, decisions on eligibility to budget support and subsequent payment decisions will remain at the discretion of the Commission in coordination with the EEAS and in accordance with the applicable legal framework and the present guidelines. These decisions will be informed by available and if possible joint assessments or reviews of policy implementation, but ultimately the Commission remains responsible for its own decision.

5.1.1. Public Policies [National/sector development strategy]

Scope and rationale

Budget support is provided in support of a public policy to contribute to achieving the general objective of poverty eradication, sustainable and inclusive economic growth, and consolidation of democracies. The effectiveness of a budget support operation is therefore dependent on the relevance and credibility of the policy it supports. The term 'public policy' refers to national, sector or transversal⁽¹³⁾ policies or strategies. Depending on the form of budget support, the policies to be assessed will differ. For GGDCs, national policy should be assessed with a particular focus on governance and broad sustainable development and poverty eradication policies. Similarly, for SBCs eligibility refers to the national policy or a "transition compact"⁽¹⁴⁾. In countries in situation of fragility there might not always be a fully-fledged national policy. In such cases, the EU Delegations can refer to the process and progress of formulation and monitor the national policy or a "transition compact" developed under the "New Deal for Engagement in Fragile States" endorsed in Busan by the EU and its Member States⁽¹⁵⁾, focusing on the great importance of restoring vital state functions, security, justice, economic foundations and basic social services. With SRCs, sector policies for the concerned sector (or interlinked sectors) should be assessed, focused on sector reforms, improving sectoral governance and service delivery, including transversal policies that have an impact on the sector. A sector policy can be a stand-alone policy or encapsulated into a national policy. In the last case, EU Delegations should clearly identify the sectoral components of the national policy that the SRC is supposed to support with the range of indicators and elements for dialogue and capacity building.

Assessment of eligibility will consider the relevance and credibility of the partner country's policy, and during implementation, progress against its stated objectives. The analysis will provide a baseline and confirm that a well-defined policy and strategy that responds to the challenges and problems faced by the partner country is in place or, in case by case bases for SBC, in preparation or a "transition compact" is agreed. Such an assessment can draw on the analysis provided for the sectoral concentration selected during the Programming exercise of EU assistance. It is important to bear in mind that budget support being an aid modality, the eligibility to budget support must still be demonstrated during the identification and formulation phases in accordance with the guidance provided below as well as in section 6.2.2. A satisfactory conclusion of this assessment should be that budget support is the most appropriate aid modality to support the partner country within the selected sector.

⁽¹²⁾ SRCs are also subject to these criteria, rather than the "seven areas of assessment" (which are substantially reflected within these four criteria) used previously for sector policy support programmes.

⁽¹³⁾ For example public sector reform policies.

⁽¹⁴⁾ See Annex 9 for guidance on transition compacts and budget support to countries in situations of fragility or transition.

⁽¹⁵⁾ See Council Conclusions on the Communication on Budget Support (May 2012) para. 11, Doc. 9371/12

Methodology

Eligibility for programme approval

In the baseline assessment EU Delegations should assess to what extent the policy response is relevant to the overall objectives of poverty reduction, sustainable and inclusive growth, and democratic governance. The specific objectives identified in the public policy and in the budget support programme also need to be relevant in relation to the country context.

The assessment of policy credibility depends on several factors. A country's track record is expected to show a positive trend in overall performance and policy implementation. Where this is not the case, EU Delegations should assess whether this undermines the credibility of the policy, taken into consideration external factors that may have negatively affected performance. The analysis of policy financing should focus on the consistency between the policy and the budgetary framework while verifying budget comprehensiveness, value for money, financial sustainability, and where relevant, fiscal decentralisation aspects. Partner country governments are characterised in many cases by important institutional capacity constraints. EU Delegations should assess to what extent institutional capacity is considered sufficient to implement the policy, combined with a view on the degree of ownership of the policy. Likewise, EU Delegations should appraise whether weaknesses in statistical systems or policy analysis significantly undermine the validity of the objectives and targets stated in the policy.

Finally, the baseline assessment should describe the policy framework, and the basis for monitoring the public policy eligibility criterion during implementation. Normally, such basis is provided by the policy monitoring or performance assessment framework (PAF) and its review documents, issued by the responsible authority, often jointly with development partners and in consultation with non-state actors. EU Delegations can refer to these review documents to monitor eligibility without the need to carry out an additional analysis but should express a justified opinion on the validity of its conclusions. Particularly, which are the key issues that will be assessed in order to monitor eligibility and what progress is expected before the first disbursement? At the same time, emphasis should be on ensuring that the policy is strengthened with a quality monitoring and evaluation framework, which can provide the basis for future policy dialogue and budget support conditions.

Eligibility during implementation

When submitting payment files, EU Delegations should appraise whether the public policy eligibility criterion continues to be satisfied. Specifically, does the policy continue to be sufficiently relevant and credible, and has there been satisfactory progress in policy implementation since the last eligibility check, taken into account external factors or exogenous shocks? Again, EU Delegations should refer to the public policy monitoring framework or the PAF, but other relevant information sources such as survey results can also be taken into consideration to reach an informed and justified conclusion on progress rather than a mechanistic calculation based on the number of indicators met. Where overall progress is limited or substantially less than planned, EU Delegations should assess to what extent this may be explained by external factors or overambitious planning, and conclude whether eligibility continues to be satisfied.

The focus should be on progress in policy implementation. However, in case of a new policy framework during implementation, the baseline assessment needs to be revisited⁽¹⁶⁾. Where existing policies are subject to substantial budgetary revisions or revisions in indicators or targets in the PAF, these should equally be considered.

5.1.2. Stable Macroeconomic Framework

Scope and rationale

Promoting stability requires creating or maintaining the conditions for governments, enterprises and individuals to plan, invest and to anticipate changing circumstances. It particularly means avoiding unsustainable external and internal deficits, swings in economic activity, high and/or volatile inflation, and excessive volatility in exchange rates and financial markets which often result in loss of jobs and reduced wealth. Macroeconomic stability is therefore key for pursuing inclusive and sustainable growth, one of the objectives of budget support. It also contributes to more effective and efficient budget management. In the absence of a stable macroeconomic framework, budget outcomes are more likely to diverge significantly from forecasts, undermining the programmes that budget support intends to support.

⁽¹⁶⁾ The existence of a gap between the formal end date of one policy document and the final adoption of a successor need not be an impediment to eligibility if the process of revision is sufficiently participatory, and the emerging policy orientations are reasonably clear.

The assessment should therefore:

- analyse the main macroeconomic aggregates and identify potential sources of instability that would endanger the strength and the persistence of growth, or the return to a stable macroeconomic frame and debt sustainability;
- assess macroeconomic and fiscal policies in place and their contribution to stabilize the macroeconomic framework over the short and medium term;
- assess efforts to strengthen domestic revenue mobilisation;
- assess vulnerability to external shocks and efforts to strengthen macroeconomic resilience.

Methodology

Eligibility has to be demonstrated applying the same methodology from the approval of the programme and for each disbursement. The eligibility assessment will be based on the relevance and credibility of the policies in place and announced, both at the formulation and during implementation of the budget programme. The assessment of the macroeconomic policies will be based on the analysis of the economic frame, including GDP growth and other relevant variables of the real sector, inflation, public and external accounts and their compatibility with debt sustainability, and financial sector stability as well as the resilience of the country to external shocks.

Policy relevance refers to the extent to which key macroeconomic imbalances are being addressed by the government's macroeconomic and fiscal policies. The specific objectives of these policies need to be assessed⁽¹⁷⁾. These policies will also depend on the main weaknesses and risks, the institutional framework and the capacities of the country. Policy credibility refers to the realism of the strategy, political commitment, the adequacy of institutional arrangements and track record of effective implementation.

At each disbursement progress made towards restoring key balances will be assessed taking account of the fulfilment of policy commitments and changes in the macroeconomic environment. Furthermore, special attention has to be given to fiscal policy and targets; and more particularly to domestic revenue mobilisation.

An important tool for the assessment is the existence in the partner country of Medium Term Frameworks (MTFF, MTEF) as instruments for strengthening the fiscal-macroeconomic policy link and the consistency of projections and scenarios concerning economic, fiscal and financial aggregates over the medium term. EU Delegations should also assess whether the country has fiscal responsibility rules, particularly on debt and deficit thresholds, to enforce aggregate fiscal discipline consistent with macroeconomic stability.

Central for assessing the stability of the macroeconomic framework and the policy response is the relation of the country with the IMF and the analysis provided by this institution. The assessment may therefore benefit from a pro-active and continuous dialogue with IMF before and during a planned budget support operation (for all contracts), and indicate the nature of the country's relationship with the IMF.

Satisfactory implementation of an IMF financial programme in support of a medium term adjustment and reform programme⁽¹⁸⁾, or of a Policy Support Instrument, will generally provide a good assurance that the macroeconomic framework is stability oriented. On the other hand, the absence of an IMF programme need not automatically imply that the macroeconomic eligibility criterion is not met. In some cases, no programme exists because the country does not need IMF support, which is generally a positive indicator of eligibility. In such cases, the Commission should make its own judgement drawing on the analysis and conclusions of the latest IMF Article IV report. Where implementation is unsatisfactory or there is no IMF programme in place because of difficulties to agreed one with the IMF, a country may still be eligible if the budget support programme objectives are not at risk⁽¹⁹⁾, particularly for SRC. If there is no such programme, an assessment letter of the IMF confirming that a policy supporting or restoring the country's macroeconomic stability is in place may be considered an important element for deciding on eligibility. Those cases should be discussed in the BSSC.

⁽¹⁷⁾ For example, the objective may be acting counter cyclically at a time of a deterioration of external demand while respecting public and external debt sustainability ratios, or redressing unsustainable imbalances, or simply ensuring a rule based predictability of the fiscal and monetary policy.

⁽¹⁸⁾ In 2012, such programme are: Extended Fund Facility, Stand-By Arrangement and Flexible Credit Line, as well as Extended Credit Facility and Stand-By Credit Facility for Low Income Countries

⁽¹⁹⁾ For example, if due to delays in implementing structural reforms that may not be central to the achievement of the programme's macroeconomic or sectoral targets and objectives.

It will be important that the absence of an automatic link between the implementation of an IMF program and the fulfilment of this eligibility criterion is well understood by the authorities of the country to make sure that the EU preserves complete independence to take its own decision.

5.1.3. Public Financial Management

Scope and rationale

“Public Financial Management (PFM) is the system by which financial resources are planned, directed and controlled to enable and influence the efficient and effective delivery of public service goals”⁽²⁰⁾. The public financial management system comprises the full budget cycle including: revenue administration, budget preparation, budget execution with cash management, procurement systems, internal controls and internal audit, accounting and reporting, external audit and scrutiny.

A sound PFM system is essential for the implementation of policies and the achievement of development objectives. A sound PFM system should collect resources from the economy, integrate them into the budget, allocate them, and use them in an efficient, effective, economic, equitable and accountable manner. Government public financial management systems are critical to implement policies and deliver public services and, therefore, a key criterion for eligibility to budget support.

The Commission uses the PEFA-PFM Performance Measurement Framework⁽²¹⁾ as the preferred tool to assess the quality of the PFM system in a country. The PEFA-PFM Framework measures the operational performance of the PFM system using 28 indicators spread over six core dimensions, and evaluates the likely impact of PFM weaknesses on three levels of PFM budgetary outcomes in the medium-term (see table below).

Structure of the PEFA-PFM Performance Measurement Framework

BUDGETARY OUTCOMES	
Aggregate fiscal discipline	Effective controls of the budget totals and management of fiscal risks contribute to maintain fiscal discipline
Strategic allocation of resources	Planning and executing the budget in line with government priorities contributes to implementation of government's objectives
Efficient service delivery	Managing the use of budgeted resources contributes to efficient service delivery and value for money
CORE DIMENSIONS OF PFM PERFORMANCE	
Credibility of the budget	The budget is realistic and is implemented as intended
Comprehensiveness and transparency	The budget and the fiscal risk oversight are comprehensive, and fiscal and budget information is accessible to the public
Policy-based budgeting	The budget is prepared with due regard to government policy
Predictability and control in budget execution	The budget is implemented in an orderly and predictable manner and there are arrangements for the exercise of control and stewardship in the use of public funds
Accounting, recording and reporting	Adequate records and information are produced, maintained and disseminated to meet decision-making control, management and reporting purposes
External scrutiny and audit	Arrangements for scrutiny of public finances and follow-up by executive are operating

The framework is not a prescriptive tool for the formulation of a PFM reform strategy. The country PFM reform strategy depends on a complex network of interrelated systems and sub-systems, within an institutional framework at central government, regional, national and sub-national levels, as well as check and balances between the executive, legislative and judiciary.

⁽²⁰⁾ See CIPFA (The Chartered Institute of Public Finance & Accounts) “PFM a Whole System Approach”, August 2010.

⁽²¹⁾ “Public Financial Management Performance Measurement Framework”, PEFA (Public Expenditure and Financial Accountability), revised January 2011.

The assessment should also include other important information and reports, not or partially covered by the PEFA-PFM, particularly when assessing financial compliance, legal framework, budgetary standards and rules, corruption and sector PFM specificities (see PFM annex for more details).

Special attention should be given to government efforts to mobilise domestic revenues, the centre-piece for sustainable financing of development. Domestic revenues include both tax and non-tax revenues. Government reforms aiming at fostering revenue administration should be supported through dialogue and technical cooperation and should be monitored by the programme. In resource-rich countries, the EU should reinforce support for comprehensive reform programmes promoting enhanced natural resources governance, transparency and accountability (see Annex 11).

Budget transparency and oversight has become an eligibility criterion on its own (section 5.1.4), although the relevance and role of oversight bodies will continue to be assessed within this PFM eligibility criterion. The analysis of fiscal policies and the budget (e.g. budget allocations, medium term fiscal perspectives) will be done respectively within the macro-economic stability and public policy criteria (section 5.1.2 and 5.1.1 respectively of this Guide).

Methodology

Eligibility for programme approval

Programme approval requires the existence of a relevant and credible government PFM reform programme. Relevance relates to the extent to which key weaknesses are being addressed by the strategy. Credibility relates to the quality of the reform process regarding the appropriateness of its sequencing, institutional arrangements, political commitment to the reforms and implementation track record.

The analysis of the reform programme should be based on the assessment of the weaknesses and strengths of PFM system, including at the sub-national level when relevant (see PFM annex for more details). For the three types of budget support contract, the assessment should recognise that the above core dimensions of PFM performance are interconnected and the PFM system will be more efficient and effective if there is a balance across them. The scope of each assessment should therefore cover the whole PFM system to ensure consistency across programmes in the same country using typically national PEFA assessments. When specific sectors are covered by the programme (i.e. in SRCs), any sector specific PFM arrangements (eg covering procurement systems or 'off-budget' funds) should also be analysed⁽²²⁾ using available sources of information on the performance of the sector such as sector audits from the Supreme Audit Institution or Public Expenditure Tracking Surveys.

On the basis of the assessment, it is important to define the PFM dialogue agenda with the partner country by identifying the key weaknesses, reform milestones and performance measures to monitor up during implementation in order to optimise the above core dimensions and budgetary outcomes (see table above). Nevertheless, the principles of appropriate sequencing of reforms should be respected, making sure that basic compliance systems are in place before more advanced reforms take place.

- **For Good Governance and Development Contracts** the monitoring could embrace the whole core dimensions of the PFM performance and other issues such as corruption in order to achieve a good balance across the full range of budgetary outcomes (aggregate fiscal discipline, strategic allocation of resources and efficient service delivery) as well as financial compliance.
- **For Sector Reform Contracts**, in complement to an overall assessment of PFM performance, the monitoring should focus on a selected number of core dimensions of the PFM performance while tackling the weaknesses specific to the management of the public finances in the sector in order to optimise the budgetary outcome related to "efficient service delivery" of the sector and recognising that the effective management of funds can differ across sectors.
- **In the case of State Building Contracts**, establishing core dimensions of the PFM system with a special attention to the budget cycle in order to ensure vital State functions and delivery of basic services to the populations should be the focus. This emphasis will be aimed at ensuring that some level of financial compliance is progressively put in place and further strengthened. This will then allow that aggregate fiscal discipline could be achieved over the medium term.

⁽²²⁾ It is important that the assessment covers the entire PFM system, and sector-specific PEFA diagnostics and PFM reform plans are therefore generally not acceptable.

In certain PFM environments it may be necessary to require short term measures, selected from the partner country's own PFM reform strategy. Such environments may be characterised by the absence of key core functions within the budget cycle, notably covering budget availability, a Treasury system, or a mechanism for reporting on budget execution. In the absence of one or more of these core functions, budget support will not be considered. Where such core functions exist but are weak, typically in fragile situations supported through State Building Contracts, additional safeguards would generally be required in the form of specific conditions that would need to be fulfilled prior to the disbursement of the first tranche. In addition, the targeting of disbursements to specific expenditure lines such as civil service salaries or arrears clearance may also be appropriate in this context. The need for complementary support required in the form of technical assistance should also be considered in order to address these specific weaknesses.

Eligibility during implementation

The programme proposal will present the framework against which the reform strategy will be monitored. It will comprise a baseline of key weaknesses of the PFM system and realistic annual reform and performance objectives against which progress will be measured annually. The framework will also contain medium-term targets of the reforms in the areas covered by the baseline consistent with the three PFM budgetary outcomes, as well as financial compliance, against which the direction of change will be measured. This framework will structure the monitoring of the eligibility criterion as well as the policy dialogue.

During programme implementation, demonstration of eligibility will require a positive assessment of i) the **progress** achieved in terms of performance against *annual* milestones and benchmarks defined in the monitoring framework at the end of the formulation of the programme (and updated annually) and ii) the **direction of change** taken with regard to the *medium-term* targets for achieving the three budgetary outcomes (fiscal discipline, strategic allocation of resources and efficient service delivery), as well as financial compliance. This assessment will need to consider current levels as well as trends in performance. In cases of limited progress in achieving agreed milestones, an explanation and justification will be necessary to justify continued eligibility.

It is possible that different conclusions (in line with chosen milestones) may be reached during implementation with regard to PFM eligibility for different budget support contracts in the same country, even though each assessment should cover all dimensions and budgetary outcomes. This might arise, for example, if there is evidence of significant differences in the quality of management of public funds in sectors covered by a SRC (e.g. from sector level public expenditure reviews (PERs) and public expenditure tracking surveys (PETS), or audit reports), resulting in different conclusions regarding PFM eligibility if two SRCs (or a GGDC and SRC) are running in parallel. However if a SRC and a GGDC are running in parallel, a SRC cannot be judged PFM eligible if PFM eligibility for the GGDC is not met.

5.1.4. Transparency and Oversight of the Budget

Scope and rationale

Budget transparency is defined as the full disclosure of all relevant fiscal information in a timely and systematic manner. It is a key element of good governance, as the public availability of comprehensive, accessible, useful, and timely budgetary information is a prerequisite for domestic accountability. With more and better budgetary information, national control bodies like parliament, auditors, local authorities, civil society organisations, and media, can scrutinize the budget and hold decision makers to account for collecting and using public funds effectively and efficiently and to call for policies that improve service delivery.

Budget transparency is a necessary, but not sufficient condition for the oversight and scrutiny of the budget. The systematic integration of programmes to support national legislative and oversight bodies as well as internal control structures is key in this regard in order to address capacity weaknesses. In addition, domestic accountability mechanisms may also be strengthened by a participatory budget support approach. Good practices are, for example, the inclusion of national control bodies in the annual reviews or the use of audit reports for the policy dialogue (see chapter 5.6).

The eligibility criterion on transparency and oversight of the budget focuses on the timely availability of comprehensive and sound budgetary information. It covers the definition of an entry point for budget support operations and the assessment of progress based on a dynamic approach. The Commission applies this dynamic approach by identifying a baseline during the formulation phase, and by monitoring progress in the medium term focusing on:

- key budget documents to be produced,
- key budget documents to be made available and accessible to the public,
- timeliness of release of budgetary information,
- comprehensiveness of budgetary information (content), and
- quality, integrity and accuracy of budgetary information.

The relevance and role of oversight bodies will be covered by the public financial management assessment (see chapter 5.1.3) in order to avoid duplications.

Methodology

Eligibility for programme approval

The entry point requires that the government must have published its budget within the previous or current budget cycle (either the Executive's budget proposal or the enacted budget). This information should be available to the general public in printed form or on an external website. Under certain circumstances, programme approval will depend on the commitment of the partner country to meet the entry point before the first disbursement. This needs to be reflected in the Financing Agreement. This rule applies

- during the transition period in 2012 for all budget support contracts,
- for State Building Contracts in general, and
- for budget support contracts in SIDS/OCTs in exceptional and justified cases.

Eligibility during implementation

Besides this entry point to be met before each disbursement, the Commission will assess and monitor comprehensively the progress of disclosure. The country needs to show satisfactory progress with regard to the baseline and medium term objectives on budget transparency identified during the formulation phase.

The establishment and assessment of reform expectations needs to be adapted to country circumstances. In cases where the baseline is already close to international benchmarks, the eligibility criterion is met if there is at least no significant deterioration⁽²³⁾ during implementation. As structural reforms of budget transparency and oversight of the budget take time, medium term objectives should be based on realistic expectations, in particular regarding the production or comprehensiveness of key budgetary documents. However, the timely publication of such documents that are already produced should be a "quick win" and attainable in the short term.

However, the Executive's Budget Proposal and the Year End Report or the Audit Report are crucial for domestic accountability, as the Executive's Budget Proposal is the key document for the domestic budget debate and the Year End Report or Audit Report will help citizens to know about the results achieved. These should therefore be given particular attention when setting medium term reform expectations as the basis for measuring satisfactory progress. In case of a more short term budget support programme (less than three years), a state building contract or an engagement in SIDS/OCTs, more flexibility may be justified regarding these key budgetary documents.

The disclosure of budgetary information will be assessed by focusing on 6 key budgetary documents⁽²⁴⁾:

⁽²³⁾ For example, the non-publication of a key budget document that was previously made public, or the reduction in comprehensiveness of a previously comprehensive document.

⁽²⁴⁾ The disclosure of budgetary information means that the respective document are produced and made available to the public, so that the public can easily access the documents. Additional reports (e.g. citizens' budgets and pre-budget statements) may be added to the assessment depending on the specific circumstances of partner country.

Key Budget Document	Description	Release benchmarks	Comprehensiveness
Executive's budget proposal	The executive's budget proposal is the government's draft budget that should be submitted to the legislature.	Should be made available to the public when it is first presented to the legislature or, at a minimum, before the legislature approves it.	Should be presented within a medium-term macroeconomic and fiscal policy framework, include all budgetary activities of the government and detailed commentary on each revenue and expenditure programme.
Enacted Budget	The enacted budget refers to the budget that has been passed by the legislature.	Should be released to the public no later than three month after the legislature approves it.	See executive's budget proposal.
In-year report	In-year reports (also Monthly Reports or Quarterly Reports) show progress in implementing the budget. These reports can be issued for the entire government or issued by different agencies.	Should be released to the public no later than three months after the reporting period.	Should show the executive's progress in implementing the budget.
Mid-year report	The mid-year report provides a more comprehensive update on the implementation of the budget.	Should be released no later than three month after the reporting period.	Should include an update on the implementation of the budget, a review of economic assumptions, and an updated forecast of the budget outcome for the current fiscal year.
Year-end report	The year-end report is one of the key accountability documents. It shows compliance with the level of revenue and expenditures authorised by the legislature.	Should be released no later than one year after the end of the fiscal year (the reporting period).	Should include the reconciliation with the approved budget and compliance with the revenue and expenditures authorised by the Parliament.
Audit report	This report covers the year-end report audited by an independent Supreme Audit Institution.	Should be released no later than two years after the end of the fiscal year (the reporting period).	Should cover all activities undertaken by the executive following the adherence to appropriate auditing standards, and to the principle of interdependence of the external audit institution. Should focus on significant and systematic PFM issues and on performance such as reliability of financial statements, regularity of transactions, functioning of internal control and procurement systems ⁽²⁵⁾ .

International assessments such as the Open Budget Index, PEFA, and IMF Reports on the Observance of Standards and Codes (ROSCs) on fiscal transparency, should be used as guideposts for the independent assessments of the EU Delegations, in particular for the identification of key weaknesses and the definition of a country specific baselines during the formulation phase. Further resources on best practices and principles are the OECD Best Practices for Budget Transparency, and the Lima Declaration of Guidelines on Auditing Precepts of the International Organization of Supreme Audit Institutions (INTOSAI).

⁽²⁵⁾ The assessment should also cover the timely and effective follow-up by the legislature and executive on the main recommendations of the Audit Report.

5.2. Budget Support Dialogue

Budget support dialogue is a core element of the package and a centre piece for mutual accountability. First, it provides a framework to take stock of the implementation of the partner country's policies and reforms as well as of donors' commitments and to assess progress on both sides on the basis of different information, criteria and indicators as well as extensive discussions with the Government. Second, budget support dialogue can be used as a forward-looking tool to identify policy slippages and to reach a common understanding with the authorities on corrective measures to meet policy objectives and refining the objectives and targets if necessary. Chapter 3 details the structures that the EU has put in place to strengthen budget support dialogue.

Budget support dialogue covers both process (including formal meetings with different stakeholders, reviews, etc, but also informal contacts which may be at least as important in influencing and adding value to the development process) and content/substance (e.g. education policy, performance indicators). It should address not just the specific policy elements of the budget support operation, but also the wider development context, in order to support the achievement of the programme's objectives.

Effective dialogue should draw on the eligibility and risk assessments. It requires a clear understanding of the **national and sector coordination framework**, as part of a broader context analysis, to better understand actors, rules and mechanisms of the decision making-process in the partner country. Similarly, the **country-donor coordination framework** needs to be understood, covering both central and sub-national levels of government and non-government stakeholders. The analysis should show which donor discusses what with whom and with what effect. Finally, there must be a good understanding of the role of donors (who are the main donors, e.g. financially and degree of influence) and how **donor coordination** works.

A rolling **dialogue strategy** should use this analysis to identify the most effective dialogue methods and platforms, and a programme of action. Given the difficulties of attributing the achievement of specific development results to the provision of budget support funds, it is particularly important that the dialogue is properly documented to help demonstrate the contribution that budget support is making⁽²⁶⁾. This will ease the problems caused by staff turnover, and enable subsequent evaluations to better assess the impact of budget support.

The dialogue should be based on the specific objectives and performance framework of each type of budget support contract. GGDC provides a platform to engage in a dialogue with the partner country on a wide range of policies and reforms; on resources mobilisation and allocation across the whole government expenditure; improving the efficiency and effectiveness of core government systems, thus creating the basis for accountability and better implementation of reforms and improving service delivery; promoting good governance including democratic values. SRC provides a platform to engage in a dialogue with the partner country on sector specific issues covering the whole range of key performance indicators (KPI) of the sector from input, process, output to outcome; tackling access and quality of service delivery; contributing to improving the efficiency and effectiveness of the government's sectoral delivery structures and systems. Finally, SBC provides a platform to engage in a dialogue with the partner country on a global, coherent and coordinated response to restore the vital State functions and provide basic services to the population; on transition towards development and democratic governance; contributing to avoid negative spill over effects and security problems at regional level.

5.3. Risk Management Framework

5.3.1. Introduction

The development of an improved risk management framework adapted to the specific risk profile of budget support operations is a key element of the Communication on the "Future Approach to EU Budget Support to Third Countries". The framework aims at identifying in a structured way, mostly on the basis of existing assessments (e.g. human rights strategies, eligibility criteria) the significant risks related to budget support operations, and at making sure that they are managed in line with the Commission's guidelines on risk management⁽²⁷⁾. It is an important tool during the identification, formulation and implementation of budget support operations whilst also informing policy and political dialogue. By identifying risks the tool helps to come to more informed decisions on the use of budget support by comparing the risks with the cost of non-intervention (potential benefits)⁽²⁸⁾.

⁽²⁶⁾ In addition to key documents such as financing agreements, MoUs, official minutes and other official communications, reports or studies (which should generally be maintained by the chair of the budget support donor group), EU Delegations should also systematically file their own internal briefing notes, back to office and mission reports, and substantive email exchanges with government and with HQ.

⁽²⁷⁾ Risk Management in the Commission, Implementation Guide, Updated Version-October 2010

⁽²⁸⁾ The benefits of a budget support programme will be assessed separately and are not part of the risk assessment framework.

The Risk Management Framework provides the basis for the decision making process⁽²⁹⁾ by:

- 1) identifying the specific risks linked to the general objectives of budget support,
- 2) identifying mitigating measures and risk responses as part of a risk strategy,
- 3) informing budget support dialogue,
- 4) monitoring the identified risks and the mitigating measures during implementation,
- 5) identifying the framework to react to immediate deteriorations of a partner country's situation.

The risk management framework is an internal assessment and comprises the following key steps:



5.3.2. Risk Assessment

The Commission defines a risk as “any event or issue that could occur and adversely impact the achievement of the Commission’s political, strategic, and operation objective. Lost opportunities are also considered as risks.”⁽³⁰⁾

The Risk Management Framework for budget support operations is focusing on the country system and framework in order to identify the risks that may impede achieving the general objectives of budget support: Eradicate poverty, sustainable and inclusive economic growth, and consolidate democracies. Therefore, the EU identifies five risk **categories**: Political governance, developmental risks, macroeconomic risks, public financial management, and corruption / fraud. Each risk category comprises one or several **risk dimensions**.

RISK MANAGEMENT FRAMEWORK	
Risk Category	Dimensions
Political	<ul style="list-style-type: none"> ● Human Rights ● Democracy ● Rule of Law ● Insecurity and Conflict
Macroeconomic	<ul style="list-style-type: none"> ● Macroeconomic Policy & Financial Sector ● Debt Sustainability ● Vulnerability & Exogenous Shocks
Developmental	<ul style="list-style-type: none"> ● Public Policy ● Government Effectiveness

⁽²⁹⁾ See Chapter 3 on new governance for EU budget support regarding the role of the Budget Support Steering Committee, the Geographic director and the regional teams.

⁽³⁰⁾ Idem.

PFM	<ul style="list-style-type: none"> • Comprehensiveness of the Budget • Controls in Budget Execution • Procurement • External Audit
Corruption/Fraud	<ul style="list-style-type: none"> • Corruption & Fraud

All the risk categories are applied for different budget support contracts. As the risks are assessed according to the general objectives of budget support in a country, it is not necessary to provide different assessments for different contracts.

The assessment of risk will be part of the **identification, formulation and implementation** phase and will follow the Budget Support Cycle Management (see section 6).

The risks and risk levels are identified and defined by a short questionnaire. It is based on existing assessments, in particular of the eligibility criteria, the fundamental values and the human rights strategies. It is also based on an excel sheet that is easy to use and will guide the risk identification.

Each question of the risk questionnaire has to be judged in terms of four risk ratings (low, moderate, substantial, high), capturing both the likelihood and impact of a risk with regard to the general objectives of budget support. The decision on the risk level for each question has to be justified through a very short narrative comment. As the risk assessment is a forward-looking exercise and the general objectives have a medium-term perspective, this should take into account the whole contract period of a budget support programme.

The risk ratings for each question are averaged to generate risk levels for each risk dimension (e.g. human rights, rule of law, etc.), for each risk category (e.g. political governance, macroeconomic risks, etc.), and for overall country risk. The scoring is an important part of the assessment, as it supports the definition of a risk level for decision-making. However, the questionnaire may not cover all risks and important risks may be hidden by referring to averages. In exceptional and well justified cases, the Delegation has, therefore, the discretion to change the risk rating and score for each risk dimension based on a more qualitative assessment. In such cases, the Delegation has to present a comprehensive narrative to explain the situation.

It is also crucial that the risk level is accompanied by a narrative assessment highlighting the major risks identified by the questionnaire. This part of the assessment may also provide the necessary discretion to the Delegation to highlight the major risks that may not be covered by the questionnaire or be hidden by risk score averages.

Risk Level	Description
LOW	The country's situation involves a low risk for budget support, as the risk is unlikely to occur due to the systems and institutional structures in place. Should the risk occur the impact will be limited with regard to the attainment of the programme objectives.
MODERATE	The country's situation involves a moderate risk for budget support operations. Country systems and institutional structures should prevent the occurrence, but additional monitoring will be necessary. Should the risk occur the impact will be limited in the sense of a delayed attainment or a partial achievement of objectives.
SUBSTANTIAL	The country's situation involves a substantial risk for budget support operations. Country systems and institutional structures are not sufficiently robust to guard against key risks. Should the risk occur the impact would significantly disrupt the programme or the achievement of results.
HIGH	The country's situation involves a high risk for budget support operations. Country systems and institutional structures are too weak to prevent the occurrence of risks. Should the risk occur the impact would result in a quasi failure of the programme objectives and may seriously damage the EU's image and reputation.

5.3.3. Risk Responses and Mitigation

Depending on the assessment of risks, an appropriate risk response has to be defined by the following steps:

1. Identification of mitigating measures,
2. Assessment of residual risks (after mitigating measures), and
3. Decision on the final response: risk acceptance or risk avoidance.

Mitigating risks means joint efforts of the partner country and donors to respond to the identified risks, for example, by identifying safeguards, reform needs, or short term measures. Mitigating measures may cover the whole contract period and may include specific measures for a shorter time period. Mitigation should be the most common risk response.

If the risk level of a risk dimension is substantial or high, mitigating measures need to be discussed and identified with the partner government in order to address the respective risk dimensions. This implies the definition and implementation of a clear and comprehensive **action plan**, which clearly allocate responsibility for and timing of implementation. Satisfactory progress of the mitigating measures is essential during the implementation of the budget support programme.

If the political risk is substantial or high in case of a Good Governance and Development Contract, mitigating measures will cover clear and comprehensive action plans based on a **policy matrix**. The policy-matrix is a forward-looking exercise to set clear milestones and benchmarks for implementation and for measuring progress. As part of the risk response, **contingency plans** are necessary aiming at increasing the capacity to react immediately in cases of further deteriorations. They outline the actions to be undertaken if there is a significant deteriorating trend in the partner country's risk assessment. This could include making adjustments to the size of any tranche and/or reallocating funds to sector programmes, channelling funds to target groups via non-governmental organisations or reinforcing other aid modalities.

The risk register is the main tool in identifying risks and monitoring the identified mitigating measures and to inform the decision making process in different phases of the budget support cycle management.

The following list proposes several mitigating measures:

- **Further analyses and surveys** may be necessary in order to shed light on the systemic weaknesses leading to specific risks. The Public Expenditure and Financial Accountability (PEFA) assessments, Public Expenditure Tracking Surveys and Public Expenditure Reviews may be useful in order to identify reform needs and capacity constraints.
- **Capacity development and technical cooperation** could be used to mitigate risks in cases where there is a strong commitment for reform, but a lack of capacity to improve country systems/frameworks.
- **Enhancing transparency, accountability and participation in the budget process** is important to strengthen nationally owned safeguard and oversight mechanisms. Transparency and openness are prerequisite for accountability and participation. Internal and external accountability mechanisms provide opportunities for enhanced scrutiny and monitoring. The involvement of citizens and civil society is also essential in budget processes from decisions about resources to monitoring of service delivery.
- **Conditions for the disbursement of variable tranches** could be used to set incentives for reform and to enter into policy dialogue. This approach may allow addressing key risks without jeopardizing predictability.
- **Requirements** to implement specific controls, legislations and reform steps to address specific weaknesses may be appropriate to deal with substantial or high risks.
- **Further adaptations regarding the design of a budget support programme**, by shortening the duration of a programme in environments with substantial risks, use targeted aid to reduce reputational risk, etc.

The risk mitigation measures differ depending on the identified inherent risks. Some risks can be mitigated, other risks cannot be managed at all. Therefore, the EU will assess the possible impact of the mitigating measures for the duration of the budget support contract in order to conclude on the **residual risk** that remains after mitigation (assessed by geographical directorates in DG DEVCO and the EEAS). It is an important part of the risk management framework in order to decide on the final risk strategy, i.e. risk acceptance or risk avoidance.

In addition to the inherent and residual risks, a **risk trend** is identified (by HQ). The risk trend compares the current residual risk level with the level of the past assessment. Looking backwards, the risk trend aims at assessing the development of risks over time and at identifying deteriorating trends.

The risk management framework comprises as well an **early warning system**. If there is an immediate and severe deterioration of the situation or the occurrence of an event identified as risk that has a major impact on the programme objectives, the EU Delegations should report in these cases immediately to Headquarters.

5.3.4. Risk monitoring and reporting

Chapter 3 explains how the EU monitors the risk framework. The monitoring of risks and their mitigating measures is crucial in order to check that identified risks are adequately managed, the identified mitigating measures are implemented and new risks or changes in circumstances are taken into account. During the implementation phase, the risk management register will be updated in January/February. It will be up-dated if necessary in June/July or as part of the disbursement file. If the inherent risk level of one of the risk categories is substantial or high, the budget support programme, its mitigating measures and residual risks as well as the potential benefits need to be discussed in the BSSC leading to a decision on the budget support programme (commitment or disbursement). In case of a deterioration of a risk category from a previously lower assessment to substantial or high during implementation, the budget support contract should be re-discussed in the BSSC before a disbursement decision. The Risk Management Framework is an internal document.

5.4. Performance, Variable Tranche Design, Ownership & Predictability

5.4.1. Introduction

The establishment of the performance monitoring system and related disbursement criteria is at the heart of a budget support operation, providing the framework for conditionality and for policy dialogue. Base (or fixed) tranches are linked to eligibility (section 5.1), and performance or variable tranches are additionally linked to progress against specific indicators.

The partner country should have a well-functioning system in place for monitoring progress and performance. It is important to bear in mind that progress and, therefore, disbursements are assessed against results/data that should be reliable. If weaknesses are identified actions should be agreed with the beneficiary Government to strengthen the system. EU Delegations will pay particular attention to the following elements:

- Institutional setup of the system.
- Existing Performance Assessment Framework (PAF) linked to policy objectives and key processes.
- Quality, regularity and reliability of data, including official statistics, information systems, indicators (input, process, output and outcome) and reporting documents.

This section sets out how budget support programmes may be designed using variable tranches to incentivise and respond to specific performance issues measured by an indicator framework.

Such tranches have several advantages: i) creating incentives for improved performance through partial payment for partial performance; ii) reducing damaging “stop-go” volatility in aid disbursements; iii) enhancing the credibility of disbursement conditions by providing an alternative to the “extreme option” of blocking the entire payment. The remainder of this section focuses on determining the size and phasing of variable tranches, the selection of variable tranche indicators, and methods for determining variable tranche payments.

5.4.2. Size and phasing of variable tranches.

There is some evidence⁽³¹⁾ that larger variable tranches may have a stronger incentive effect, particularly in weak policy environments and where there is some stability over time in the indicators used, although a large number of factors are likely to influence performance. There are equally indications that the incentive effect is dependent on the alignment of objectives between donors and partner countries, and that countries are sensitive to the signalling effect of any reduction in payments, regardless of size. **A balance needs to be struck between creating incentives and avoiding excessive unpredictability or volatility in disbursements, particularly in more aid dependent contexts.** EU budget support programmes on average have had a variable tranche of about 40 percent. However, the variable share might be expected to be larger in the following circumstances: the smaller the budget support programme's share of the partner country's budget; the weaker its track record of budget support implementation; the weaker the country's commitment to reform and poverty reduction; the higher the risk assessment. **Therefore, EU Delegations should follow a pragmatic approach taking into account the above elements, as** no clear rules regarding the appropriate share of base and variable tranches can be defined. **GGDCs and SRCs** would typically cover commitments for 3 years, or more in countries with an established positive track record across the eligibility criteria and low risk profile. For **SBCs** with duration of only 1 year, there may be no variable tranche, with a focus instead on satisfying the eligibility criteria and preparing for future budget support operations with longer duration and variable tranches. Examples of different options are provided in Annex 8. In all cases, EU Delegations should co-ordinate decisions on the size and phasing of variable tranches with other development partners.

5.4.3. Variable tranche indicator selection

Indicator types

Input and process indicators measure the financial resources provided and the policy and regulatory actions taken (e.g. adoption of a regulation), *output indicators* measure the immediate and concrete consequences of the resources used and measures taken (e.g. schools built), *outcome indicators* measure the results at the level of beneficiaries (e.g. proportion of children vaccinated), *impact indicators* measures the consequences of the outcomes in terms of wider objective (e.g. literacy rates).

The Commission gives particular attention to outcomes, because:

- 6) *it is these results that ultimately matter;*
- 7) *it encourages evidence-based policy making;*
- 8) *it protects political space for beneficiary countries to choose their own policies and strategies for achieving them;*
- 9) *it promotes domestic accountability; and*
- 10) *it stimulates demand for high quality statistical information.*

EU Delegations should select, in agreement with the authorities and in co-ordination with other development partners, a number of indicators from the Performance Assessment Framework (PAF) for variable tranche conditionality. In exceptional cases where no PAF exists, particularly in fragile or transition situations, EU Delegations should agree with the authorities on a number of performance indicators derived from the public policy or "transition compact", in consultation with other stakeholders. The following principles should be applied:

- There should be **coherence** between the programme objectives, the diagnosis of the problem, and the selected indicators and targets,
- A combination of **indicator types** can be selected. The greater the willingness of the partner country to be held accountable for such outcomes, and the greater the confidence in the government's ability to deliver and in the

⁽³¹⁾ 'Conditionality, Predictability and Performance: A Study of EDF 9 General Budget Support Programmes', 2012, Andreas Eberhard and Jonathan Beynon.

quality of such performance data, the more emphasis should be placed on outcome indicators. In less aid-dependent countries, it may be more appropriate to focus on agreed policy actions using process indicators;

- The **number of indicators should generally be limited** to a maximum of 8 per tranche (and could in some cases be much less) in order to avoid a loss of policy focus. The more focused the objectives of the programme and the smaller the size of the variable tranche, the fewer the recommended number of indicators;
- **Indicators and targets should be agreed during the formulation phase** and indicators, targets, and assessment methodology should be **precisely and unambiguously defined** in the Technical and Administrative Provisions attached to the Financing Agreement. The data source should be clearly identified and the quality of the data assessed. Changes to the indicators should be avoided where possible but may be necessary. Policy targets might be adapted to take account of policy progress during programme implementation. Financing Agreements should therefore include an explicit clause stating that any subsequent revision of indicators or targets can take place upon the request of the Government and subsequent agreement of the responsible Commission Authorising Officer.

5.4.4. Determining variable tranche payments

This involves attributing a score for each selected indicator, and then aggregating these scores in some manner to determine the variable tranche disbursement. The two main options involve a **pro-rata** disbursement or the use of broader aggregate **performance categories**⁽³²⁾ (see annex 8 for guidance).

As noted in the public policy section, **performance assessments should be an inclusive process** led by the government, whereby performance results are also subject to stakeholder consultations and are made publicly available and feed into domestic accountability mechanisms. The results for variable tranche indicators can then be extracted from the overall policy review process, subject to EU Delegation views on the accuracy of the information. Where serious doubts exist about the quality of the data provided, **data verification exercises** should be carried out to inform payment decisions.

In order to **enhance predictability** and respect the country's budgetary and planning cycles, conditions, criteria, procedures and timing for disbursement should be clear defined with and understanding by the partner country. This is a core element of the budget support contract between the EU and the partner country. Assessments and decisions regarding disbursements should take place timely to support the budget execution for the fiscal year into which the funds are to be disbursed. **Floating tranches, i.e. without a decision date defined in the Financing Agreement, should generally be avoided.**

EU Delegations should agree with the authorities and in consultation with other budget support development partners on an appropriate and transparent methodology. In general, **undisbursed funds should not be 'recycled' in later tranches** as this can reduce the initial incentive effect of variable tranches. They should be de-committed and where possible returned to the country's multi-annual indicative programme. However, where circumstances exist to encourage the partner government through dialogue to gear up performance, undisbursed funds can be re-assessed in the following year (N+1) against the original target if there is a positive trend in the indicator and the government did not reach the target because of external factors.

5.5. Domestic Revenue Mobilisation

Domestic revenue mobilisation (DRM) plays a determinant role in fostering sustainable and inclusive growth, good governance and poverty reduction. In the Communication on "Tax and Development: Cooperating with Developing Countries on Promoting Good Governance in Tax Matters" (April 2010), the European Commission has set out its policy to help developing countries in this area. In addition, domestic revenue mobilisation was given increased prominence in both Communications on "Agenda for Change" and "Budget Support".

Within budget support contracts, DRM will be considered within the macroeconomic (fiscal policy) and public financial management (tax administration) eligibility criteria, and it should be given greater attention in policy dialogue and capacity development. Tax/GDP ratio, tax effort and tax policy should be part of the macroeconomic assessment, including tax exemptions and incentives. This will provide an overview of the amount of

⁽³²⁾ Suggested categories: 'unsatisfactory' (score 0-29 and no variable tranche disbursement), 'limited progress' (score 30-49 and 40% variable tranche disbursement), 'satisfactory' (score 50-79 and a 70% variable tranche disbursement), and 'strong performance' (score 80-100 and full disbursement).

tax revenues in relation to GDP (with and without oil), of the extent to which the country exploits its tax potential, and of the composition, level and relevance of the various taxes in the country and other sources of domestic revenues. Furthermore, the assessment needs to analyse how the country intends to compensate tax losses due to trade liberalisation and lower trade taxes (fiscal transition). The assessment of public financial management with regard to revenues should cover inter alia the areas of access to information and transparency (particularly in resource-rich countries), good governance, anti-corruption, administrative structure, oversight and civil society involvement.

As regards to policy dialogue and capacity development, budget support contracts will be important in:

- Assisting in tax reforms and strengthening tax administration
- Promoting domestic accountability and public financial management
- Managing natural resources wealth and promoting revenues from natural resources
- Promoting a transparent, cooperative and fair international tax environment
- Enhancing the participation of developing countries in relevant international fora
- Supporting adoption and implementation of international standards

5.6. Accountability

Domestic accountability refers to a partner government being accountable to its citizens and institutions (parliament, audit and judiciary institutions) on policy choices, revenue collection, budget allocations and outcomes. It is a two-way relationship between citizen and state institutions, as citizens must also be able to hold their government answerable and accountable for its actions and to check abuses.

Mutual accountability refers to the relationship between donors and partner countries. From the donor's perspective, mutual accountability is important so that donor governments can demonstrate to their stakeholders that public funds for development are used effectively and efficiently. For partner countries, it is important to receive credible donor commitments and timely, predictable, transparent and comprehensive information on aid flows aligned with the budget cycle, to prepare and implement budgets that deliver agreed policy objectives and outcomes.

In principle, budget support provides opportunities to strengthen domestic accountability as it is subject to parliamentary and audit scrutiny in a way that project support is often not. However, progress in domestic accountability takes time and supporting national accountability institutions and systems is a major challenge for donors involved in budget support. The best incentives for change of government actions derive from the actions undertaken by domestic accountability bodies. Therefore, accountability will be further enhanced by:

- Strengthening the openness, transparency, and accountability of the budget process, for example by the new eligibility criterion on budget transparency (section 5.1.4);
- Supporting a participatory budget support approach by reinforcing and promoting the participation of national control bodies and other domestic stakeholders in the policy dialogue and the annual performance reviews related to budget support;
- Supporting national legislative and oversight bodies, internal audit and control institutions as well as sub-national authorities and civil society organizations. Capacity constraints often impede the effective operation of national oversight bodies⁽³³⁾ and civil society organisations⁽³⁴⁾ even in a more open and transparent environment. Therefore, it is recommended to systematically assess capacity development needs of such bodies and

⁽³³⁾ Guidance on the link between parliaments and budget support is available in "Engaging and Supporting Parliaments Worldwide" European Commission, Reference Document No. 8, October 2010.

⁽³⁴⁾ Guidance on how to engage non-state actors in new aid modalities is available in "Engaging Non-State Actors in New Aid Modalities For Better Development Outcomes and Governance" European Commission, Reference Document No. 12. January 2011. The document highlights the role of civil society organisations in contributing to the formulation of national and sector policies; policy dialogues, sector coordination, mid-term and joint reviews; performance and budget monitoring, including users' consultation; budget implementation and service delivery; and the provision of capacity development, in particular for budget literacy and public expenditure tracking.

to integrate programmes of support – either as a component of a budget support financing agreement or as a separate project – wherever appropriate⁽³⁵⁾.

- Increasing transparency by publishing relevant information on budget support Financing Agreements and performance reviews as part of its commitment to increased mutual accountability (see also section 6.6 on visibility).

5.7. Fraud and corruption

The fight against fraud and corruption is a key element that should have greater prominence in budget support, particularly when assessing the PFM eligibility criterion. The Commission will pay particular attention to these issues and will promote a stronger use of anti-fraud and corruption provisions. Partner countries need to be actively engaged in the fight against fraud and corruption and be equipped with appropriate and effective mechanisms covering the whole “anti-fraud and corruption cycle” (prevention, detection, investigation and sanctioning) as well as adequate inspections authorities and judicial capacity. The Commission will also promote capacity development in this area. In this context the Commission will promote the cooperation between the European Anti-Fraud Office (OLAF) and the inspection and judicial authorities of the partner countries⁽³⁶⁾.

5.8. Capacity development

Capacity development⁽³⁷⁾ refers to a change process that aims at strengthening the ability of people, organisations and networks to develop and use their resources in an effective and efficient way. In line with the Busan declaration “Partnership for Effective Development Co-operation” effective institutions and policies are indispensable for country ownership and the delivery of sustainable development results.

Capacity development is a key part of the budget support modality, as it supports effective and efficient organisations, enhances government’s capacity to implement policies and deliver services to final beneficiaries, and promotes the active engagement of all domestic stakeholders. Support for capacity development implies a facilitation role of the European Commission, such as supporting the partner to define realistic capacity development targets, developing a partnership based on trust and shared views on key constraints and opportunities, and playing a catalytic role by building on demand for change, providing access to knowledge and facilitating dialogue between stakeholders.

Capacity development needs are assessed systematically and should be provided based on the following key quality criteria: support programmes should fit to the context and existing capacity, be based on adequate demand, ownership and commitment, be linked to results and expected outcomes, be provided through harmonized and aligned approaches, particularly in the context of the EU coordinated approach to budget support and division of labour with Member States, and rely on appropriate programme implementation arrangements.

With regard to budget support, the following capacity development areas are of particular importance:

- Public financial management,
- Tax reforms, tax administration, and management of natural resources,
- Public expenditure reviews and tracking surveys,
- Public sector reforms and public administration,
- Quality and capacity of statistical systems,
- Capacity of national control bodies, such as parliaments, supreme audit institutions, judiciary bodies, internal audit and control institutions, civil society organisations, local authorities and media⁽³⁸⁾.

⁽³⁵⁾ The collaboration of the European Commission with the International Organisation for Supreme Audit Institutions (INTOSAI) is one example of an engagement to strengthen the support to Supreme Audit Institutions and to recognise their role in supporting accountability and poverty reduction.

⁽³⁶⁾ The excellent collaboration between OLAF and FIGE (Forum for General Inspections of State of Africa and Similar Institutions) is a good example of such engagement.

⁽³⁷⁾ Further guidance is available in the PPCM.

⁽³⁸⁾ Various pilot projects have shown that the capacity of stakeholders for collaborative governance can be enhanced through information and communication technologies (ICT) (e.g. ICT mediated participatory budgeting, visualisation of budget expenditure data, etc.).

Chapter 6

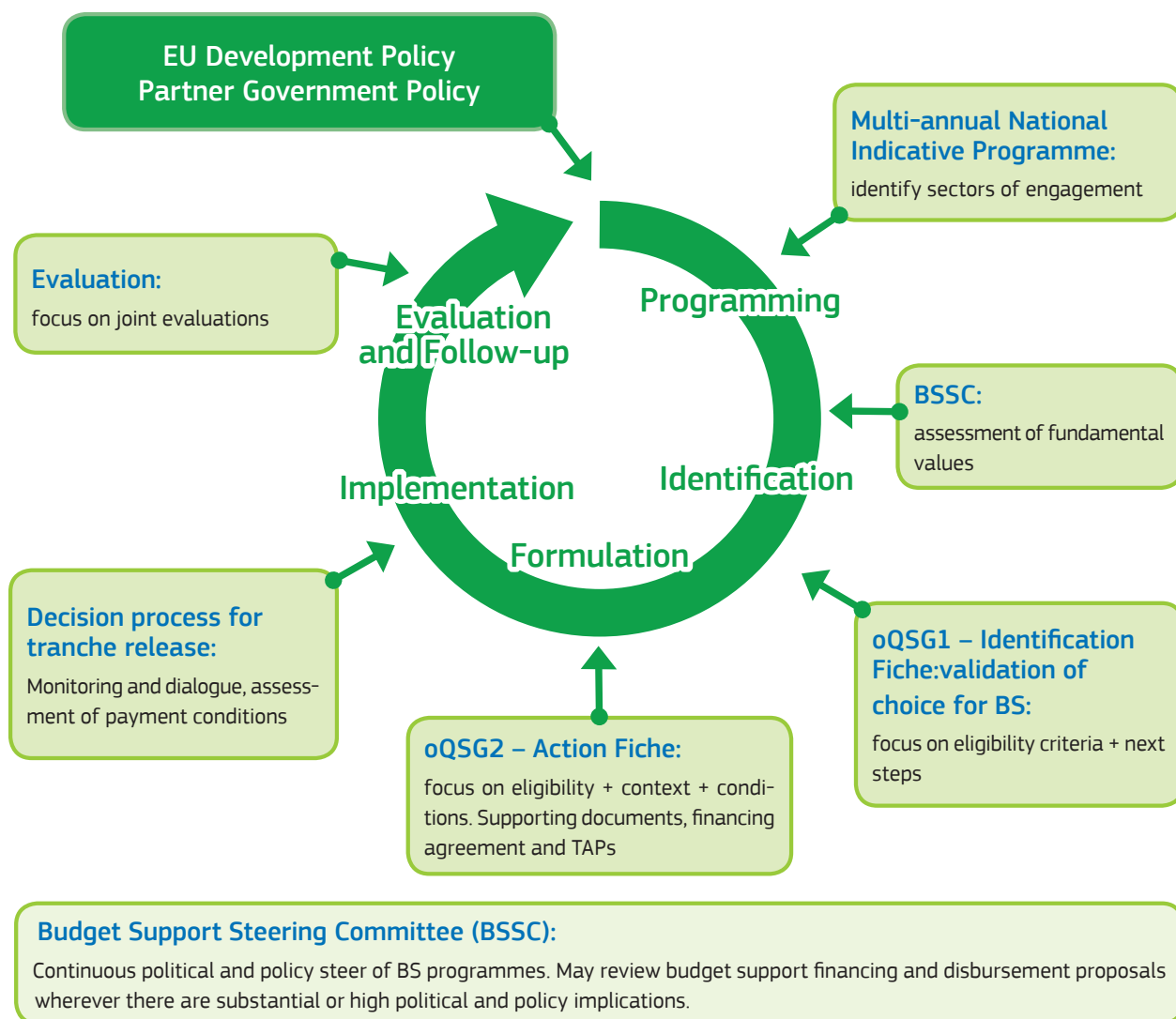
THE PROGRAMME CYCLE

6. THE PROGRAMME CYCLE

6.1. Introduction

The cycle of management for budget support programmes is summarised in the diagram below, and follows the same steps as for all other modalities, with the exception of the fundamental values pre-condition assessment. This chapter reviews those steps and outlines what needs to be prepared at each stage.

Budget Support Cycle Management



6.2. Identification

6.2.1. Whether to Provide Budget Support

The process for reaching this decision is set out in Chapters 3, 4 and 5. This involves the following steps:

First, an assessment of a country's commitment to the fundamental values of human rights, democracy and rule of law. For any GGDC the commitment to fundamental values is a pre-condition and will be assessed during the programming phase when Good Governance and Development is selected as an equivalent to a sector, and subsequently monitored during the identification, formulation and implementation phases using the risk framework. For SRC and SBC no assessment of the pre-condition is required. The assessment of fundamental values will be done within the risk management framework (political risk category) during the identification phase and subsequently monitored during the formulation and implementation phases using the risk framework. Proposed SRC and

SBC during the identification phase with substantial or high political risk will be submitted to the Budget Support Steering Committee who will balance any concerns related to the political risk with the need to provide and protect the provision of vital services, including other potential benefits, in order to decide whether a SRC or a SBC are appropriate aid modalities.

Second, an assessment of the eligibility against the four criteria. This assessment will be done for all budget support contracts during the identification and formulation phases for approval and during the implementation, in addition to variable tranche performance, for disbursement. During the identification phase, countries may be categorised into strong candidates (expected to meet and maintain eligibility), potential candidates (where eligibility is less certain), and weak candidates (where eligibility is highly unlikely).

Third, an assessment of the risks and whether these are likely to be outweighed by the mitigate measures and expected benefits during the identification, formulation and implementation phases.

6.2.2. How Much Budget Support

Decisions on how much budget support will be based on a broad qualitative assessment of the following needs and performance criteria:

- *Financing needs of the partner country assessed on the basis of its medium term fiscal framework and/or the national/sector development strategies:* this will take into account both the partner country's current and projected levels of domestic revenues, expenditures, fiscal deficit and financial needs, including aid (and budget support) dependency, and the country's own stated preferences for choice or mix of aid modalities. The greater its current and projected reliance on budget support, and the stronger its own preferences for budget support, the larger the share of the programme would be provided as budget support.
- *Commitment of the partner country to allocate national budget resources in line with development strategy and objectives:* this should consider both the process of budget formulation, and its outcome in terms of budget allocations in line with development strategies and objectives and execution rates. The greater the confidence we have in both the process and outcome of the partner country's budget allocation system, the greater the share of the country programme should be provided as budget support.
- *Effectiveness, value for money and impact of the specific added value that budget support will bring in achieving the partner country's policy objectives:* assessment will specifically aim to consider the potential impact of budget support relative to other modalities, while also taking into account the likely influence of the EU based on indicators covering relations with the government, human resource capacity, and financial leverage. The greater the impact, the larger the share to be provided as budget support. Similarly, the stronger the quality of policies and institutions in partner countries (likely to impact positively on aid effectiveness), the larger the share to be provided as budget support.
- *Track record and absorption capacity of past disbursements and how effectively agreed objectives were achieved with budget support operations:* the greater the rate and timeliness of previous disbursements of both fixed and variable tranches, the greater the share of the country programme should be provided as budget support.
- *Result orientation in the partner country's development strategy including a monitoring system:* the stronger the monitoring system and the greater the willingness of the partner country to incorporate key reform and result indicators in budget support operations, the greater the share of the country programme should be provided as budget support.

Each criterion may be judged as high, medium or low, allowing an overall assessment regarding the appropriate share of a programme to be provided as budget support: high (more than two thirds), medium (between one and two thirds), or low (less than one third). The approach should not be mechanistic as the significance of each criterion will differ, and risks and benefits need to be taken into account. This therefore combines a reasonably structured approach to define broad categories, with flexibility within those categories to choose an appropriate mix of modalities that best fits the country context.

6.2.3. Identification

The identification allows for a preliminary proposal – summarised in the preparation of an “Identification Fiche” – to be prepared that sets out the proposed objectives and expected results of the operation; the proposed scale (€m) and form (GGDC⁽³⁹⁾, SRC, SBC or other aid modalities); the likelihood of meeting and maintaining the eligibility criteria and, if necessary, identification of possible prior actions that may need to be taken (either prior to formulation or as specific conditions for the first disbursement) and supporting measures (notably to build capacity and domestic accountability); some preliminary proposals for design and implementation; the main risks; and next steps. It should be accompanied by a first rough draft of the risk management framework.

The Identification Fiche is discussed at QSG 1. **The fiche is not expected to be too detailed or have all the answers, indeed, other aid modality options should be included as a basis for discussion.** It provides an opportunity for EU Delegations to communicate with Headquarters on progress being made in programme preparation, and to seek advice where appropriate from the Regional Teams; and for Headquarters and the Regional Teams to ensure the coherence and consistency of the approaches being adopted in the area of budget support, notably with respect to eligibility conditions.

Although there is no procedural requirement to prepare a “road map”, this can be a useful way to support the planning process. Templates for both can be found in Annex 12.

6.3. Formulation

Following the Identification Fiche and in accordance with the decision following QSG 1, formulation will lead to the preparation of the Action Fiche and draft Technical and Administrative Provisions to be reviewed by QSG 2. All budget support contract Action Fiches should follow the same format (see links in Annex 12), covering the following main sections:

- Rationale, objectives and expected benefits of the budget support programme constitute the key lines of the strategic framework.
- Assessment of country context and budget support eligibility, summarizing the main issues and results of the assessment of the four eligibility criteria (set out more fully in separate supporting documents).
- Risk Management covers the main issues identified in the risk management framework focusing on a description of the major risks and mitigating measures.
- Design of the programme covers the implementation issues, including the expected benefits and results, whether targeted or not targeted, budget and calendar (total budget, indicative calendar for disbursements), stakeholders and donor coordination, performance monitoring, criteria for disbursement, complementary measures (in particular for capacity development, evaluation and audit, communication and visibility).

The draft Action Fiche, when transmitted by the EU Delegation to Headquarters, should be accompanied by supplementary documents that cover each of the four eligibility criteria as well as the Risk Management Framework (following the annotated templates contained in Annexes 3-7), as well as a draft set of Technical and Administrative Provisions (TAPs) and the Capacity Development quality grid⁽⁴⁰⁾. The TAPs form part of the legal agreement with the partner country, and spell out in detail the general and specific disbursement conditions.

After approval by the geographic Director and, if necessary, review by the Budget Support Steering Committee when there are substantial or high political and policy implications, the Annual Action Programme / Action Fiche is submitted for approval to the relevant Committee of EU Member States for each instrument, before the European Commission takes a financing decision. The Financing Agreement including TAPs will be signed with the partner country after the financing decision. It is the legal agreement with the partner country that consists of three parts: (1) Special Conditions (2) Annex I the General Conditions; (3) Annex II, the Technical and Administrative Provisions.

⁽³⁹⁾ This will be based on the prior recommendations of the Budget Support Steering Committee and decision by the Director General: see section 6.2.1 and chapter 3.

⁽⁴⁰⁾ The Capacity Development grid is an internal tool to help the delegation in making sure that the action contributes to the objective of developing institutional capacity.

6.4. Commitments

Budget support financing agreements constitute legal commitments which may give rise to payments without the conclusion of additional legal commitments. In this case, the individual budgetary/financial commitment is recorded immediately after the financing agreement is signed by the two parties, on the basis of the total of the payment instalments (tranches) provided for in the financing agreement (with the exception of the funds intended for audit, evaluation, technical assistance and contingencies). The relevant financial circuits and check-lists for such commitments are provided in annex to the Step by Step Guide⁽⁴¹⁾.

6.5. Implementation and Disbursements⁽⁴²⁾

Regular monitoring and dialogue will be key elements of all budget support operations, and should generally follow the structure and principles laid down in chapters 3 and 4 as well as section 5.2. Promoting domestic ownership and accountability, strengthening team working within EU Delegations and across all budget support providers, and paying attention to appropriate communication and visibility activities will all be important. The Regional Teams will have an important role to play in supporting EU Delegations (see chapter 3).

Disbursements require the following steps:

- Request for tranche release by the beneficiary country: this should be duly justified, but in many cases this may simply take the form of a short covering letter with the relevant annual review or other appropriate supporting documents annexed.
- Analysis of tranche release request and preparation of a “payment dossier” by the EU Delegation: this should analyse whether conditions for payment have been fulfilled.
- The visa circuit in the Delegation prior to submission of the dossier to headquarters entails i) operational initiation (GESTOPE); ii) operational verification (RESPOPE); iii) financial initiation (GESTFIN) and iv) financial verification (RESPFIN). In this context it is essential that the Delegation ensures that the dedicated check-list for budget support payments is applied and provided in the dossier with full supporting documentation for all checks made.⁽⁴³⁾
- The dossier should conclude with a clear statement by the Head of Delegation on the compliance with each of the eligibility criteria and include a recommendation on whether and how much should be disbursed. Analysis of eligibility and risk should follow the templates in Annexes 3-7. Support from the Regional Teams will again be important.

DEVCO Geographical services prepare a dossier for the approval of the relevant Director, in line with the procedure agreed in the budget support Governance arrangements and, where appropriate, involving the Budget Support Steering Committee (chapter 3). The Director formalizes his/her agreement by providing his/her visa (DIRGEO). This visa remains valid for 2 weeks only. In this context the Director may also convey key messages to the Delegation to be taken up in dialogue with the partner country.

- Upon receipt of the approval from Headquarters the Head of Delegation can he proceed to provide his/her authorising officer visa (ORDO). This should be accompanied by a formal letter with the key messages arising from assessment to be taken up in dialogue.
- Verification of payments (including confirmation that the appropriate exchange rate has been applied) by the Delegation.

Timeliness of payment is critical, and every effort should be made to adhere to the indicative disbursement timetable set out in the Financing Agreement and/or disbursement schedule agreed subsequently between the partner country and its budget support partners. This may require the Delegation to be proactive in soliciting the request from the partner country well ahead of the due payment date, and for all parties to respect agreed approval times. Further details are set out in Annex 12.

⁽⁴¹⁾ For full details refer to Financial Circuits: Step by Step on the DEVCO Intranet. For direct link see page 60

⁽⁴²⁾ For full details refer to Financial Circuits: Step by Step *ibid*.

⁽⁴³⁾ Checklist for budget support available on the DEVCO Intranet. For direct link see page 60

Where, subsequent to payment, the assessment that formed the basis for payment was found to be characterised by serious irregularities such as substantive misreporting by partner countries, EU Delegations should duly inform Headquarters with a recommended action to take, which can include a request for full or partial reimbursement.

At the end of a budget support programme, a final report needs to be formulated. These final programme reviews will highlight the initial objectives of the programme, progress and results achieved during implementation, as well as lessons learnt. The reviews are not formal evaluations, but aim at providing input for future budget support operations and at improving the communication and visibility of results, e.g. for the purpose of the DG's annual report.

6.6. Evaluation and Audit

In principle budget support evaluations should be carried out every 5 to 7 years jointly with the other donors utilising this aid modality in the country to be evaluated, using the refined methodological approach developed within the framework of the OECD/DAC Steering Group for BS evaluations (chapter 2.4). Donors need to work closely with evaluation departments of governments throughout the process leading to and during evaluations. The TAPs of Financing Agreements and Memoranda of Understanding should include provisions on when and how BS evaluations should take place, and ensure that proper monitoring and data collection systems (including household and other required surveys) are in place.

The key features of the methodological approach are: a) the Comprehensive Evaluation Framework (see section 2.3.1) which sets out the hypothetical sequence of effects for BS programmes across 5 analytical levels included in and interacting with the overall national context within which BS is provided, and b) the Three Steps Approach, whereby; i) Step one encompasses the assessment of BS inputs, their outputs and their contribution to induced outputs, i.e. public policies, institutions, spending and service delivery of BS, ii) Step two encompasses the identification of the development results (economic and social outcomes and impact at macro and micro level) supported by BS programmes and the factors which have caused and/or contributed to these outcomes and impacts, both internal, i.e. linked to government policies, and external, iii) Step three entails an exploration of whether there is a link between the induced Outputs identified in Step one and the determining factors of the outcomes and impacts. A positive link implies that BS has made a contribution to the achievement of the outcomes and impacts.

As regards to audits, reliance should be placed on the audited national accounts prepared by the country's own Supreme Audit Institution, since once transferred into the partner country's Treasury account the European Commission's budget support funds become inseparable from the general revenues of government and the budget support inflows from other donor agencies. Strengthening this function, as well as the internal audit and control institutions, is typically a significant part of any policy dialogue and capacity development connected with budget support. There are two caveats to be made to this principle. The first is that an audit can and should be carried out to confirm that the transfer of funds into the Treasury account has respected the terms of the Financing Agreement. The second is that in the case of targeted budget support funds are intended to finance a specific and agreed set of budget lines. In this case, a procedural audit to verify that expenditures at least equivalent to the size of the Commission disbursements should be made prior to disbursement (i.e. the disbursement is effectively a reimbursement of verified eligible spending).

6.7. Visibility

As part of promoting mutual accountability and transparency as well as enhancing the visibility of its support, the EU will publish relevant information on budget support financing agreements and performance reviews (including disbursement conditions and assessments in agreement with the partner country). This should also include publication of press releases – jointly with other budget support donors wherever possible – regarding budget support payments made and results achieved (and reasons for non or only partial payment where applicable). Such information will increasingly be incorporated in the Commission's annual reports on development assistance.

Budget Support Contracts: Summary Table

	GGDC Good Governance and Development Contract	SRC Sector Reform Contract	SBC State Building Contract
Overall objective	Eradicating poverty, promoting sustainable and inclusive growth, and consolidating democracies		
Specific Objectives	<ul style="list-style-type: none"> ● Improve financial capability of govt to achieve policy objectives; ● Foster domestic accountability and strengthen national control mechanisms to improve governance; ● Strengthen core government systems and supporting broader reforms (macro, PFM, PSR, DRM...); ● Address constraints on sustained and inclusive growth; ● Improve MDGs and cross-cutting service delivery aspects 	<ul style="list-style-type: none"> ● Improve financial capability of govt to achieve sector policy objectives; ● Promote sector policies and reforms ● Improve service delivery at sector level; ● Address basic needs of the population ● Improve governance at sector level. 	<ul style="list-style-type: none"> ● Improve financial capability of govt to restore peace, macro-economic stability and to achieve short-term policy objectives; ● Foster a transition process towards development and democratic governance; ● Ensuring vital state functions (notably the provision of peace and security, payment of civil service salaries, provision of core administrative functions and minimum basic services);
Precondition	Positive assessment of country's adherence and commitment to Fundamental Values (FV)	Fundamental values matter, but no specific precondition (Particular care should be taken when supporting sectors that have a direct link to the FVs, e.g. justice and security sector)	Fundamental values matter, but no specific precondition
Eligibility	<ul style="list-style-type: none"> ● Credible and relevant national development strategy ● Stability oriented macro-economic policy ● Credible and relevant overall PFM reform programme ● Publication of the budget 	<ul style="list-style-type: none"> ● Credible and relevant sector development strategy ● Stability oriented macro-economic policy ● Credible and relevant overall PFM reform programme, assessment of progress to focus in particular on sector PFM issues and performance ● Publication of the budget 	<ul style="list-style-type: none"> ● Credible and relevant national development strategy or «transition compact» ● Stability oriented macro-economic policy ● Credible and relevant overall PFM reform programme, assessment of progress to focus in particular on fiscal compliance and discipline ● Publication of the budget

	GGDC Good Governance and Development Contract	SRC Sector Reform Contract	SBC State Building Contract
Expected results	<ul style="list-style-type: none"> • Improvements in the quality of public financial management • improvements in the business environment • a more transparent and accountable planning and budgeting system • improvements in key indicators of MDGs and cross-cutting service delivery • the maintenance of macroeconomic stability and economic resilience to shocks 	<ul style="list-style-type: none"> • Improved design and implementation of sectoral policies and reforms • improvements in key indicators of sector service delivery • improvements in the quality of PFM, across the entire PFM system but particularly with regard to the management of funds in the sector 	<ul style="list-style-type: none"> • Peace and security maintained, transition to democracy and development; • sufficient financial allocation to cover at least the provision of a minimum level of basic services and public administration; • improved efficiency of public financial management systems, • a more transparent and accountable planning and budgeting system • the restoration of macroeconomic stability
Design Features	<ul style="list-style-type: none"> • 3-6 year commitments; • FT+VT • untargeted 	<ul style="list-style-type: none"> • 3-6 year commitments; • FT+VT • untargeted 	<ul style="list-style-type: none"> • 1-2 year commitments (this could include the possibility to renew it for a similar period); • FT only if 1 year (may have process VT indicators if 2 years) • targeted (<i>if necessary</i>); • more specific conditions, closer monitoring and more significant dialogue, more TA

For EU staff only: Intranet links to the “Financial Circuit: Step by Step Guide” and the check-list for budget support payments

“Financial Circuit: Step by Step Guide”

For Commission active staff:

http://myintracomm.ec.europa.eu/dg/devco/finance-contracts-legal/financing-contracting-guides/companion/Documents/financial_circuits/2011_3_circuits_etapes_en.pdf

For OP active staff and staff in DELEGATIONS:

https://myintracomm-ext.ec.europa.eu/dg/devco/finance-contracts-legal/financing-contracting-guides/companion/Documents/financial_circuits/2011_3_circuits_etapes_en.pdf

For other EU Institutions & Agencies (including EEAS):

http://myintracomm.ec.testa.eu/dg/devco/finance-contracts-legal/financing-contracting-guides/companion/Documents/financial_circuits/2011_3_circuits_etapes_en.pdf

Check-list for budget support payments

For Commission active staff:

http://myintracomm.ec.europa.eu/dg/devco/finance-contracts-legal/financing-contracting-guides/companion/Documents/checklists/2009_checklist_demandes_paiement_appui_budgetaire_en.xls

For OP active staff and staff in DELEGATIONS:

https://myintracomm-ext.ec.europa.eu/dg/devco/finance-contracts-legal/financing-contracting-guides/companion/Documents/checklists/2009_checklist_demandes_paiement_appui_budgetaire_en.xls

For other EU Institutions & Agencies (including EEAS):

http://myintracomm.ec.testa.eu/dg/devco/finance-contracts-legal/financing-contracting-guides/companion/Documents/checklists/2009_checklist_demandes_paiement_appui_budgetaire_en.xls

Annexes

THEMATIC TOPICS AND PROCEDURAL REQUIREMENTS

TABLE OF CONTENTS

ANNEX 1: GLOSSARY OF TERMS	67
ANNEX 2: OBJECTIVES AND INTERVENTION LOGICS OF BUDGET SUPPORT	72
1. Good Governance and Development Contract: Intervention Logic	72
1.1. Objectives	72
1.2. Expected results and main activities	72
2. Sector Reform Contract: Intervention Logic	73
2.1. Objectives	73
2.2. Expected results and main activities	74
2.3. Financial additionality in Sector Reform Contracts	74
2.3.1. When an increase in sector expenditure is not the key constraint to achieve Sector Reform Contract objectives	75
2.3.2. When an increase in sector expenditure is an important element to achieve Sector Reform Contract objectives	75
3. State Building Contract: Intervention Logic	76
3.1. Objectives	76
3.2. Expected results and main activities	76
ANNEX 3: ASSESSING PUBLIC POLICY ELIGIBILITY	78
Part I – Eligibility assessment during design	78
1. Policy framework	78
2. Policy relevance	79
3. Policy credibility	79
3.1. Track record in policy implementation	80
3.2. Policy financing	80
3.3. Analytical basis and data quality	81
4. Conclusion: Appreciation of Eligibility	81
5. Expected progress in policy implementation	81
Part II – Eligibility during implementation	81
ANNEX 4: ASSESSING MACROECONOMIC ELIGIBILITY	83
I. Introduction	83
II. Template for the supplementary document to the action fiche and payment dossier	84
1. Introduction	84
Context	84
Relation with the IMF	84
2. Key macroeconomic indicators and potential source of instability	85
Short term performance and outlook	85
3. Assessment of macroeconomic policies and stabilisation of the macroeconomic framework	85
4. Domestic revenue mobilisation	86
5. Assess vulnerability to external shocks and efforts to strengthen resilience	87
6. Conclusions of the analysis	87
At end of identification or formulation:	87
Implementation phase/Disbursement decision	87
Appendix 1: Assessing external accounts	88
Appendix 2: Debt sustainability(57)	89
Appendix 3: External price shocks on food and energy, control of inflation and fiscal policy	90
Appendix 4: IMF lending instruments to Low Income Countries	91
STANDARD TABLES	92
ANNEX 5: ASSESSING PUBLIC FINANCIAL MANAGEMENT ELIGIBILITY	95
Annex 5: Assessing PMF Eligibility – Part I: Supplementary Document to the Action Fiche	96
1. Key features [1 page]	96
2. A snapshot of the analysis [1 page]	96

3. Diagnosis of the system [2-3 pages]	96
Summary of public financial management assessments [1 page]	96
Scope of the assessment	97
Comprehensiveness of assessments and of data	97
Findings of Supreme Audit Institution reports [1/2 page]	98
Sector issues [1/2 page]	98
Identifying key weaknesses [1/2 page]	99
The Government's PFM Reform Programme [1/2 page]	99
4. Eligibility to budget support [3-4 pages]	100
Assessment of relevance of the strategy	100
Assessment of the credibility of the strategy	100
Conclusions on Eligibility	102
5. PFM dialogue and capacity building [1 page]	102
6. List of annexes to the Supplementary Document to the Action Fiche	103
Annex 5: Assessing PMF Eligibility – Part II: Annual Monitoring Report	104
1. Key features [1 page]	104
2. Main highlights in developments over the past year [2 pages]	104
3. Progress in improving public financial management [5 pages]	105
Summary and analysis of quantifiable progress	105
Other evidence of progress	106
Recent annual audit reports, implications and follow up	106
Follow-up of audit reports	106
4. Assessment of continued relevance of the strategy [1 page]	106
Recent diagnostic work: key issues	106
Implications for the reform programme	107
5. Assessment of continued credibility of the strategy [2 pages]	107
Corruption, fraud and PFM	107
Coordination, capacity building and coherence	107
Coherence in supporting PFM weaknesses	107
6. Conclusions on eligibility [1/2 page]	107
7. Quality of the dialogue [1/2 page]	107
8. List of annexes to the annual monitoring report on public finance management	108
Annex 5: Assessing PMF Eligibility – Part III: Additional Guidance	109
Guidance for the completion of the table	111
General	111
Appendix 3: List of background documents consulted	114
ANNEX 6: ASSESSING ELIGIBILITY ON TRANSPARENCY AND OVERSIGHT OF THE BUDGET	116
1. Assessing the entry point	117
2. Identification of the key weaknesses on transparency and oversight of the budget	117
3. Identification of the baseline and medium term objectives	119
4. Assessing the entry point	121
5. Assessing progress	121
6. Conclusion	122
Appendix A: Assessment Grid for Key Budget Documents(80)	123
Appendix B: Useful Key References	124
Public Expenditure and Financial Accountability Framework (PEFA)	124
IMF Code of Good Practices on Fiscal Transparency (2007)	124
Open Budget Survey / Open Budget Index	124
OECD Best Practices for Budget Transparency (2002)	124
ANNEX 7: RISK MANAGEMENT FRAMEWORK	126
1. Management of risks in budget support operations	126
2. Risk assessment	127

2.1. Definition of risk and risk categories	127
2.2. Risk Dimensions, Risk Questionnaire, and the Definition of Risk Levels	128
2.3. Templates of the Risk Management Framework	130
3. Risk response and mitigation	130
3.1. Risk response and residual risks	130
3.2. Early warning system	132
3.3. Overview on the risk responses	132
4. Risk Monitoring and reporting	133
ANNEX 8: PERFORMANCE ASSESSMENT AND VARIABLE TRANCHE DESIGN	134
1. Introduction	134
2. Programme duration, size and phasing of variable tranches	134
3. Use of an Annual Performance Tranche (APT)	136
4. Selection of Performance Indicators	137
5. Options for calculating variable tranche payments	139
Step 2: Aggregating scores to determine the variable tranche disbursement	140
Useful references	140
ANNEX 9: STATE BUILDING CONTRACTS FOR FRAGILE SITUATIONS	141
1. Introduction	141
2. Rationale for State building Contracts	141
3. Key issues when assessing the case for State building contracts	141
3.1. Which situations	141
3.2. Opportunity of intervention	142
3.3. Enhanced political and policy dialogue	144
4. Preparation of the action fiche and supplementary documents	144
4.1. Eligibility criteria	144
4.1.1. National/sector policies and reforms	145
4.1.2. Stability oriented Macro-economic framework	145
4.1.3. Public Financial Management (see Section 5.1.3 and Annex 5 of the Guidelines)	146
4.1.4. Transparency and oversight of the Budget	147
4.2. Design of State Building Contracts	147
4.2.1. Duration of the programme	147
4.2.2. Risk Mitigation	148
4.2.3. Disbursement profile	148
4.2.4. Performance indicators	149
4.2.5. Annual review of the programme	149
4.2.6. Additional technical support	149
Key references:	150
ANNEX 10: BUDGET SUPPORT IN SMALL ISLAND DEVELOPING STATES (SIDS) AND OVERSEAS COUNTRIES AND TERRITORIES (OCTS)	151
I. Introduction, background and rationale	151
II. Key Challenges facing SIDS/OCTs	151
III. How to make EU budget support suitable to SIDS/OCTs	152
IV. Design Features	153
V. On Establishing Eligibility	154
VI. Risk Management Framework	155
ANNEX 11: DOMESTIC REVENUE MOBILISATION (DRM)	156
1. Policy Context / Background	156
2. EU's Efforts in support of DRM	156
3. What to promote through Budget Support and how to assess efforts in domestic revenue mobilisation	157
4. Overview of diagnostic tools and conclusion	161

ANNEX 12: ASSESSMENT OF FUNDAMENTAL VALUES 162

1. Good Governance and Development Contracts 162

2. Sector Reform Contracts 166

3. State Building Contracts 166

Annex 1: Glossary of Terms

Accountability	<p><i>Domestic accountability</i> refers to a partner government being accountable to its citizens and institutions (parliament, audit and judiciary institutions) on policy choices, revenue collection, budget allocations and outcomes. It is a two-way relationship between citizen and state institutions, as citizens must also be able to hold their government answerable and accountable for its actions and to check abuses.</p> <p><i>Mutual accountability</i> refers to the relationship between donors and partner countries. From the donor's perspective, mutual accountability is important so that donor governments can demonstrate to their stakeholders that public funds for development are used effectively and efficiently. For partner countries, it is important to receive credible donor commitments and timely, predictable, transparent and comprehensive information on aid flows aligned with the budget cycle, to prepare and implement budgets that deliver agreed policy objectives and outcomes.</p>
Annual Performance Tranche (APT)	A special form of variable tranche, first introduced with the MDG-Contract, limited to 10% of the yearly budget support tranche and either disbursed or withheld in full on basis of an overall qualitative assessment, informed by selected performance indicators and other relevant performance information. Unless there are specific and significant concerns it should be disbursed in full, but it allows for disbursement decisions to take into account all relevant information in cases where there is a potential need to respond to and signal significant concerns about performance.
Alignment	Where donor support is brought into alignment with those of the partner country. Donors will base their overall support on partner countries' national development or reform policies and strategies, institutions, and procedures.
Base tranche	See fixed tranche
Beneficiaries	<p>Beneficiaries are those who benefit in whatever way from the implementation of the programme. Distinction may be made between:</p> <ul style="list-style-type: none"> (i) Target group(s): the group/entity who will be immediately positively affected by the programme at the level of the programme purpose (specific objective); (ii) Final beneficiaries: those who benefit from the project in the long terms at the level of the society or sector at large; eg «children» due to increased spending on health and education, or «consumers» due to improved agricultural production and marketing.
Budget Support	<p>Budget support involves dialogue, financial transfers, performance assessment and capacity development. The financial transfer is the transfer of financial resources to the National Treasury of a partner country, following the respect by the latter of agreed conditions for payment. The financial resources thus received are part of the global resources of the partner country, and consequently used in accordance with the public financial management system of the partner country.</p> <p><i>Method of Implementation:</i> centralised direct</p>
Budget Support Steering Committee	Established in 2012 to review budget support financing proposals and disbursement decisions wherever there are substantial or high political and policy implications.
Capacity Development	Capacity Development is the process by which people and organisations create and strengthen their capacity over time. <i>Capacity is defined as the ability to perform tasks and produce outputs, to define and solve problems, and make informed choices.</i>
Complementary Support	The support that is complementary to the main budget support operation, such as monitoring, evaluation, audit, and capacity development (including technical assistance). The Financing Agreement template for budget support includes a section which allows for a specific mention for complementary support.

Counterpart funds	Local currency equivalent of a foreign currency transfer. Most commonly used in the context of indirect budget support
Direct Budget Support	When domestic currency is convertible into foreign currency budget support is direct because the domestic currency equivalent of the foreign currency is generated or created directly through the usual channels of the banking system. The foreign exchange is simply transferred to the Central Bank which then credits the equivalent amount of domestic currency in the partner government's National Treasury account.
EC Procurement, grant award, and payment procedures	Where EC procurement, grant award, and payment procedures are used in project and programme implementation. Some of these procedures may be decentralised to third parties, but there will always be some ex-ante or ex-post control in the process. <i>Method of Implementation:</i> centralised or decentralised.
Eligibility criteria for budget support	A country may be considered eligible when: <ul style="list-style-type: none"> i) There is a credible and relevant national/sectoral development strategy that supports the objectives of poverty reduction, sustainable and inclusive growth, and democratic governance. ii) There is a credible and relevant programme to restore and/or maintain macroeconomic stability. iii) There is a credible and relevant programme to improve public financial management. iv) the government has published either the Executive's Proposal or the Enacted Budget within the past or current budget cycle.
Financing Modality	The manner in which finance is provided. There are three financing modalities used in EC projects and programmes: (i) EC procurement and grant award procedures; (ii) Common pool (or basket) funds; and (iii) budget support.
Fixed tranche	Fixed tranches have a fixed value, specified in advance within the Financing Agreement. They are either disbursed in full (if all conditions are met) or not at all (if one or more conditions are not met). May also be called a «base tranche».
Floating tranche	Floating tranches: a tranche is considered to be floating, when the date by which its disbursement condition(s) need(s) to be met can vary – in effect there is no fixed “cut-off” date for meeting the disbursement condition. An indicative date will normally be specified in the Financing Agreement – but the actual date will “float” depending on when the conditions for disbursement have been met (although, of course, there needs to be a final date governed by the Financing Agreement)
Fundamental values	The fundamental values of human rights, democracy and the rule of law are essential elements of all of the EU's partnerships and cooperation agreements with third countries. GGDCs will only be provided where there is trust and confidence that state budget funds will be spent pursuant to these fundamental values that the EU and the partner country share, and for the respect of which partner countries commit to move forward.
General Budget Support (GBS)	A transfer to the National Treasury in support of a national development or reform policy and strategy that may provided in the form of a Good Governance and Development Contract (GGDC) or State Building Contract (SBC) <i>Method of Implementation:</i> centralised direct
General Conditions	These are conditions that apply to the disbursement of all tranches. These conditions will in most cases be those related to the eligibility criteria for receiving budget support. There may be additional general conditions (for example, availability of documents, but these should be kept to a minimum).
Good Governance and Development Contract (GGDC)	To provide (general) support to a national development reform policy and strategy

Harmonisation	Where donors implement, among themselves, common arrangements to support a national development or reform policy and strategy
Indirect Budget Support	When domestic currency is not freely convertible into foreign currency, budget support is indirect because the local currency equivalent of the foreign currency is generated indirectly outside the usual channels of the banking system. The foreign exchange is converted into a domestic currency equivalent typically through the sale of foreign exchange on a foreign exchange auction, or through allocations of foreign exchange through a general or sectoral import programme, or through the sale of aid in kind, or the use of a currency facility.
Impact	Measures the consequences of the outcomes in terms of wider objectives; for example, literacy rates, unemployment rates; The definition covers the wider effects of the outcomes; but there might also be higher level impacts, related to broader objectives – growth and income poverty
Input	Measures the financial resources provided, and the administrative and regulatory measures taken; for example, resources allocated, resources used, measures taken, laws passed. The definition of inputs can be treated as very broad covering in some cases what is often called process indicators
Interlinked sectors	Sector Reform Contracts (SRCs) can support several interlinked sectors if they are closely interlinked through a coherent policy, budgetary and institutional framework (for example, agriculture and rural roads as part of a common rural development strategy)
Macro Financial Assistance	The macro financial assistance provided by the Commission and management by ECFIN in accordance with the “updated Genva” criteria of 8 November 2002 (see Annex 1 to the 2453rd meeting of the Council (Economic and Financial Affairs), 8 October 2002)
MDG Contract	A longer term, more predictable form of general budget support launched in 2008 and applied in 8 ECP countries during EDF 10. No longer applied as a distinct form of budget support, but its key design features may be incorporated within new GGDCs and SRCs in good performing countries.
Non-floating tranche	Non-floating tranches: a tranche is non-floating when the date by which its disbursement condition(s) need(s) to be met cannot vary – in effect there is a fixed “cut-off” date for meeting a disbursement condition. A fixed date will be specified in the Financing Agreement by which the disbursement condition is to be met; if the disbursement condition is not met by this date, the partner country will, in principle, be ineligible for support
On-budget	Aid is said to be on-budget when it is included in the budget documents presented for (parliamentary) approval. Other terms such as on-plan (when aid is included in planning documents); on-procurement (aid uses the partner country’s procurement procedures); on-payment/accounts (aid uses the payment procedures and is included within the accounting system of the partner country); on-reporting (aid is included in expenditure reports); and on-audit (where aid is audited by the supreme audit institution) are terms used to describe the extent to which aid is included in the public financial management system of a country.
Output	Measures the immediate and concrete consequences of the resources used and measures taken; for example, schools built, teachers employed, nurses trained; the definition of output covers those goods and services “produced” by the public sector
Outcome	Measures the results at the level of beneficiaries; For example, gross enrolment rates, vaccination; The definition covers the outcomes (or results) from the use and satisfaction of the goods and services produced by the public sector – it is where supply comes face-to-face with demand
Overall Objective	The overall objective explains why the programme is important to society, in terms of the longer-term benefits to final beneficiaries and the wider benefits of other groups. The overall objective will be derived from national policy and strategy and will not be achieved by the programme alone.

Ownership	Partner countries exercise effective leadership and show commitment to their national development or reform policies and strategies, and coordinate development actions
Pooled Fund	Where EC funds are transferred to an account in which the resources of more than one development partner and possibly the partner country are “pooled” in one fund. The resources so transferred are then used in accordance with the financial management procedures of the pooled fund. A trust fund is a form of pooled fund <i>Method of Implementation: shared (with Member States), decentralised (with partner countries), or joint (with international organisations).</i>
Purpose	The purpose should address the core problems or particular aspects of overall national policy and strategy. The purpose will be derived from national policy and strategy and will not be achieved by the programme alone. Sometimes known as a specific objective.
Quality Support Group	The Quality Support Group is used within DEVCO to examine projects and programmes at the stage of both end of identification (QSG1) and end of formulation (QSG2). The QSG within DEVCO is organised separately for each geographic directorate.
Results – Logical Framework definition	In the EC’s Logical Framework Matrix hierarchy of objectives, results are the tangible products/services delivered as a consequence of implementing a set of activities. In the indicator typology used in EC programmes these «results» are known as «outputs».
Results – Indicator Typology	Two possible interpretations exist: (i) In the EC Indicator Typology «results» are known as «outcomes» – see outcomes. (ii) In the OECD-DAC evaluation framework «results» refers to «outputs», «outcomes» and «impacts»
Sector Approach	A way of working together between government and development partners with the aim of broadening Government ownership over public sector policy and resource allocation decision within the sector, to increase the coherence between policy, spending and results, and to reduce transaction costs. It involves progressive development of a comprehensive and coherent sector policy and strategy, of a unified public expenditure framework for local and external resources and of a common management, planning and reporting framework.
Sector Budget Support	A transfer to the National Treasury in support of a sector programme provided in the form of a Sector Reform Contract. <i>Method of Implementation: centralised direct</i>
Sector Policy Support Programme (SPSP)	The programme of European Commission by which financial support is provided to the partner Government’s Sector Programme
Sector Programme	A sector policy and action plan covering: (i) an approved sector policy document and overall strategic framework; (ii) a sectoral medium term expenditure framework (though not an eligibility criterion for budget support) and an annual budget; and (iii) a coordination process amongst the development partners led by the government. A sector programme is a result of following a <i>sector approach</i> , in which governments in consultation with development partners and other stakeholders may develop a sector policy and action plan. It may be supported through a Sector Reform Contract or other modality (eg. pooled funding arrangement).
Sector Reform Contract (SRC)	A form of (sector) budget support order to address sector reforms and improve service delivery

Specific Conditions	These are conditions that apply to the disbursement of individual tranches, whether fixed or variable. These conditions will normally be those related to performance criteria and indicators established in each of the areas of focus of the GBS programme. In setting these performance criteria and indicators attention will normally be giving to ensuring that they are “result/outcome-based”, particularly in the case of variable tranches.
Specific Objective	See purpose
Stakeholders	Any individuals, groups of people, institutions or firms that may have a relationship with the programme are defined as stakeholders. They may – directly or indirectly, positively or negatively – affect or be affected by the process and the outcomes of the programme. Usually different sub-groups have to be considered.
State Building Contract (SBC)	A form of (general) budget support to provide budget support in fragile situations.
Targeted Budget Support	Targeted budget support involves the transfer of EC funds to the national treasury as ex-post “financing” of specific expenditures within the budget or of specific budget lines. Its use will involve auditing those expenditures for which budget support is to be provided, and then making a transfer to the national treasury for an amount equal to that for which the audit report has concluded that expenditures are eligible for EC financing. A satisfactory audit report becomes a condition for the disbursement of funds in the case of targeted budget support.
Target Groups	See beneficiaries
Tied Aid	Aid that must be spent on works/goods/services originating from the donor country or other specified origins (for example from a pre-specified list of countries).
Untargeted Budget Support	Untargeted Budget Support involves the transfer of EC resources to the national treasury of the partner country, where they are “mixed” with domestic revenues and other sources of finance and used to finance activities of the government’s budget. There is no tracking by the EC of the use of the resources so transferred; rather any follow-up takes place in the context of the overall system of public financial management of the partner country
Variable Tranche	Variable tranches have a maximum value, specified in advance within the Financing Agreement. They are either disbursed in full or in part, with the amount being disbursed being based on performance achieved in relation to pre-specified targets or designated performance indicators (provided that at the same time the general conditions are all met).

Annex 2: Objectives and Intervention Logics of Budget Support

This Annex sets out some example intervention logics to illustrate how the overall objectives, specific objectives, expected results and main activities might be described for the three forms of budget support contracts. They are purely illustrative (although the overall objective should be broadly common to all), with the precise formulation necessarily differing according to country context. Reference should also be made to the evaluation framework set out in the main text of this Guide. Expected results (linked to the specific objectives and to be achieved by the end of the programme) should be as specific as possible in order to better assess and report on progress during implementation, support completion of an end of programme review, and facilitate ex-post evaluation (recognising that budget support evaluations will generally be undertaken every 5-7 years and will assess all budget support jointly).

1. GOOD GOVERNANCE AND DEVELOPMENT CONTRACT: INTERVENTION LOGIC

1.1. Objectives

The **overall objective** of this Good Governance and Development Contract is to assist the Government of [X] in eradicating poverty, promoting sustainable and inclusive growth, and consolidating and improving democratic and economic governance.

The **specific objectives** are to:

- improve the financial capability of the government to achieve its policy objectives;
- strengthen core government systems and supporting broader reforms covering macroeconomic management, public financial management, public sector reform and Domestic Revenue Mobilisation;
- address constraints on sustained and inclusive growth;
- foster domestic accountability and strengthening national control mechanisms to improve governance;
- improve cross-cutting service delivery aspects.

1.2. Expected results and main activities

The **expected results** of this intervention are:

- the maintenance of macroeconomic stability and resilience to shocks, notably through improved fiscal discipline, increase in domestic taxation and/or improvements in tax administration, and/or reduction in the levels of external and domestic debt; (specify key fiscal targets)
- improvements in the quality of public financial management, notably with respect to (...list key areas of focus, which may include: include improvements in budget execution, public procurement, internal and external audit, and specify key targets where possible);
- improvements in the business environment, notably through [...specify key results expected];
- a more transparent and accountable planning and budgeting system, notably with respect to the more timely and comprehensive publication of key budget reports and more effective functioning of the public accounts committee (list some specific targets where possible);
- improvements in key indicators of cross-cutting service delivery, notably with respect to (...identify key sectors of interest/focus), and also with respect to reduced geographical and gender disparities of access and quality, in particular:... [specify main targets to be achieved. These may be selected from the set of VT indicators/targets

for the outer year of the programme, although it should be emphasised that budget support will be only a contributory factor at this level (4) of the evaluation framework].

- Improvements in the business environment

Main activities in this respect will include:

- transfer of €Xm over the period (specify partner country fiscal years over which disbursements expected);
- continued political and policy dialogue with the Government with a particular focus on areas reflected in the programme's objectives, as well as wider issues concerning the country's commitment to the fundamental values;
- a continued effort to reinforce Government's capacities in the area of PFM in the context of existing complementary support programmes;
- continued dialogue between the EU Delegation and other donors to coordinate and further align our development cooperation with a view to avoiding duplication of activities and relieving the Government from multiple reporting duties;
- regular monitoring of budget support eligibility criteria:
 - Monitoring of achievement of the national development strategy's priority objectives will be undertaken on the basis of annual progress reports and other EU or development partners' reviews, supported by regular briefings for and discussions in the relevant technical working groups;
 - Monitoring of macro-economic developments will be performed in the context of the IMF missions and other relevant assessments;
 - Monitoring of PFM eligibility will be done on the basis of the reviews of the government's PFM reform strategy and associated assessments;
 - Monitoring of budget transparency will be undertaken through verifying public availability of appropriate documentation.

2. SECTOR REFORM CONTRACT: INTERVENTION LOGIC

2.1. Objectives

The overall objective of this Sector Reform Contract is to assist the Government of [X] in eradicating poverty, promoting sustainable and inclusive growth, and consolidating and improving democratic and economic governance.

The specific objectives are to:

- improve the financial capability of the government to achieve sector policy objectives;
- Promote sector policies and reforms;
- Improve service delivery in the X sector;
- Improve governance at sector level.
- [Support the partnership agenda in neighbourhood countries]
- Address basic needs of the population (...identify key elements)

2.2. Expected results and main activities

The **expected results** of this intervention are:

- improved design and implementation of sectoral policies, notably with respect to (give examples of specific policy reforms expected);
- improvements in key indicators of service delivery, notably with respect to (...identify main areas of interest/focus), and also with respect to reduced geographical and gender disparities of access and quality, in particular:... [specify main targets to be achieved. These may be selected from the set of VT indicators/targets for the outer year of the programme, although it should be emphasised that budget support will be only a contributory factor at this level (4) of the evaluation framework].
- improvements in the quality of public financial management, notably with respect to (...list key areas of focus, which may include: include improvements in budget execution, public procurement, internal and external audit, and specify key targets where possible), but particularly with regard to the management of funds in the sector (specify some key targets where possible);

Main activities in this respect will include:

- transfer of €Xm over the period (specify partner country fiscal years over which disbursements expected);
- continued political and policy dialogue with the Government with a particular focus on areas reflected in the programme's objectives;
- a continued effort to reinforce Government's capacities in the area of PFM in the context of existing complementary support programmes;
- continued dialogue between the EU Delegation and other donors to coordinate and further align our development cooperation with a view to avoiding duplication of activities and relieving the Government from multiple reporting duties;
- regular monitoring of budget support eligibility criteria:
 - monitoring of achievement of the sector's priority objectives will be undertaken on the basis of annual progress reports and other EU or development partners' reviews, supported by regular briefings for and discussions in the relevant sector working group;
 - monitoring of macro-economic developments will be performed in the context of the IMF missions and other relevant assessments;
 - monitoring of PFM eligibility will be done on the basis of the reviews of the government's PFM reform strategy and associated assessments or ad-hoc analysis from the IMF and other DPs, including sector specific analysis (eg through PETS and PERS);
 - monitoring of budget transparency will be undertaken through verifying public availability of appropriate documentation.

2.3. Financial additionality in Sector Reform Contracts

Financial additionality may be a key feature of many SRC operations – as it is of other forms of external support – but it is not necessarily the objective of such programmes. Applying a rigid requirement for financial additionality in the use of SRC may overlook many other important issues that need to be addressed when examining a sector. Additionality should be defined in relation to the plausibility of the sector expenditure path⁽⁴⁴⁾. Here we can consider two main scenarios – first, where an increase in sector expenditure is not the prime objective of the SRC; and second, where it is an important objective of the SRC.

⁽⁴⁴⁾ The term "sector expenditure path" refers to current and projected sector expenditures. When the time horizon for projected expenditures covers a period of two or more years, this will require the development of a medium term perspective on resource availability, and indeed in ideal form a medium term expenditure framework integrated into the budgetary process (see section Annex 3, Section 3.2).

2.3.1. When an increase in sector expenditure is not the key constraint to achieve Sector Reform Contract objectives.

In providing SBS, the concern is to see an impact in sector results but not necessarily in the level of sector spending. In this context, SRC may add value in other ways and *will not necessarily have increasing levels of sector expenditure as a requirement*. For example, effectiveness and efficiency of a given level of sector expenditure could be raised with a reallocation of resources from capital to recurrent expenditure, from tertiary to primary level of service delivery or from central to decentralised entities. Improving rates of execution of existing sector budgets can also have a significant positive impact on sector outcomes. The value added of SRC could also be in supporting an acceleration of reforms, in knowledge sharing or capacity development.

In this context, SRC effectively provides additional fiscal space to the government at a macro level whilst focusing dialogue on results at sector level. This should enhance the prospects for fully executing existing sector expenditure plans as set out in the budget. It is therefore important to ensure that there is a full understanding of the financial nature of the programme between the EU, the Ministry of Finance and the sectoral ministry/ministries concerned.

A clear understanding on the appropriate approach to such programmes should therefore be reached with all parties during the formulation of such programmes. This may also require agreement on how the SRC is to be treated in the budget documents. In particular, the identification of the SRC resources as assigned revenue (appropriations-in-aid/revenue affecté) in line ministries budgets should be avoided.

2.3.2. When an increase in sector expenditure is an important element to achieve Sector Reform Contract objectives.

The assessment of the sector policy, the budget allocated, and its implementation may reveal that the main constraint to achieving the sector goals is that the sector is under-funded. In these cases *increases in the levels of sector spending are desirable and among the main objectives* of the SRC programme, especially in underfunded sectors. It is preferable to focus on realistic expenditure projections that should underpin any sector programme. It is also important to start early to prepare for dialogue on the sector expenditure path. To build a picture for looking at the sector expenditure path the following steps are proposed:

- **Focus on historical trends to identify a meaningful baseline.** The starting point of any process looking at the sector expenditure path should be a thorough analysis of past trends of sector budget allocation. A focus on actual levels of sector financing has several advantages: it reduces the impact of variations in government financing that respond to changes in project aid and it promotes a more complete and realistic picture of current and past levels of sector expenditure.
- It is crucial that this exercise involves all members of the sector coordination, the minister of finance in addition to the concerned line minister and all donors involved in the sector.
- **Choose how to express the baseline.** Current and past levels of actual sector expenditure constitute a baseline that could usefully be presented in per capita terms. Other options are to express current and past levels of sector expenditure as percentage of GDP, government overall expenditure or domestic revenue. However, great care is needed in using such percentages as targets, since they may be affected by factors outside the control of the sector.
- **Discuss expected increases in sector spending.** It is recommended to review with government the magnitude of desirable levels in sector spending. In certain cases maintaining real per capita expenditure can be sufficiently ambitious. In others the objective will be positive increase in real per capita expenditure. A medium term perspective is important as it links SBS commitments to agreed projections of total and sector expenditure. This can be a useful subject of dialogue between government and the entire donor group.
- **Assess the fiscal sustainability of expected increases in sector spending.** The expected increases in sector spending should take into account the results of preliminary assessments and be consistent with the government medium-term fiscal framework. Crucial in this process is the role of the Minister of Finance and, where appropriate, the IMF. The consistency of spending shifts between sectors with the partner country national policy should also be assessed.

- Where appropriate translate any requirement into disbursement conditions. In exceptional circumstances the programme could define conditions in the Financing Agreement around critical levels of expenditure for certain key budget items.

3. STATE BUILDING CONTRACT: INTERVENTION LOGIC

3.1. Objectives

The **overall objective** of this State Building Contract is to assist the Government of [X] in eradicating poverty, promoting sustainable and inclusive growth, and consolidating and improving democratic and economic governance.

The **specific objectives** are to:

- improve the financial capability of the government to restore peace, macro-economic stability and to achieve short-term policy objectives;
- Foster a transition process towards development and democratic governance;
- support the Government efforts in ensuring vital state functions (notably the provision of peace and security, payment of civil service salaries, provision of core administrative functions and minimum basic services to the populations);

3.2. Expected results and main activities

The **expected results** of this intervention are:

- Peace and security maintained, progress towards transition to democracy and development
- sufficient financial allocation to cover at least the provision of a minimum level of basic services in (identify one or two key sectors) and public administration;
- improved efficiency of public financial management systems, processes and capacities. It is also expected that probity in the management of public resources is strengthened while the efficiency and effectiveness of the public administration will improve;
- a more transparent and accountable planning and budgeting system allowing the implementation of medium to long term development strategy and reforms;
- Restore macroeconomic stability.

Main activities in this respect will include:

- transfer of €Xm over the period (specify partner country fiscal years over which disbursements expected);
- continued political and policy dialogue with the Government with a particular focus on areas reflected in the programme's objectives;
- a continued effort to reinforce Government's capacities in the area of PFM in the context of existing complementary support programmes;
- continued dialogue between the EU Delegation and other donors to coordinate and further align our development cooperation with a view to avoiding duplication of activities and relieving the Government from multiple reporting duties.
- regular monitoring of budget support eligibility criteria:
 - monitoring of macro-economic developments will be performed in the context of the IMF half-yearly missions and other relevant assessments, as well as a sustained dialogue with the IMF.

- fiscal discipline and budget execution performance will be assessed on a regular basis in order to ascertain that it does not deviate substantially from agreed targets or does not threaten overall macroeconomic stability. This will be done through regular meetings between Government and donors, including the IMF.
- monitoring of the PFM performance will be done on the basis of the PFM-PEFA analysis, the IMF FAD reports, in accordance with the national roadmap for PFM reforms, and other regular or ad-hoc analysis from the IMF, other DPs or relevant bodies.
- monitoring of achievement of national development priority objectives will be undertaken on the basis of annual progress reports and other EU or development partners' reviews. [This budget support programme also includes an institutional support component which will contribute to reinforce the monitoring capacity of key sector ministries and more globally the capacity of the Government to develop its monitoring framework].
- monitoring of budget transparency will be undertaken through verifying public availability of appropriate documentation.

Annex 3: Assessing Public Policy Eligibility

This Annex provides guidance on how to assess eligibility with regards to national or sector policies or strategies, hereafter simply referred to as *policies*, both during the design and implementation of budget support programmes. Such an assessment can draw on the analysis provided for the assessment of national/sector plans as a basis for the programming of EU assistance bearing in mind that budget support contracts may refer only to a subset of national plans and that eligibility must still be demonstrated in accordance with the guidance provided here. A satisfactory conclusion regarding the use of national/sector development plans as a basis for EU programming does not automatically imply public policy eligibility for budget support operations. In assessing public policy eligibility, it should be specified that budget support is the most appropriate aid modality to support the partner country within the selected sector. Part I sets out an annotated template for the supplementary document to be submitted together with the identification fiche or at the latest with the Action Fiche. Part II deals with eligibility updates to be provided with payment requests.

Depending on the form of budget support, the policies to be assessed will differ. For GGDCs, national policy should be assessed with a particular focus on governance and broad sustainable development and poverty eradication policies. Similarly, for SBCs eligibility refers to the national policy or a “transition compact”. In countries in situation of fragility there might not always be a fully-fledged national policy. In such cases, the EU Delegations can refer to the process and progress of formulation and monitor the national policy or a “transition compact” developed under the “New Deal for Engagement in Fragile States” endorsed in Busan by the EU and its Member States, focusing on the great importance of restoring vital state functions, security, justice, economic foundations and basic social services. With SRCs, sector policies for the concerned sector (or interlinked sectors) should be assessed, focused on sector reforms, improving sectoral governance and service delivery, including transversal policies that have an impact on the sector. A sector policy can be a stand-alone policy or encapsulated into a national policy. In the last case, EU Delegations should clearly identify the sectoral components of the national policy that the SRC is supposed to support with the range of indicators and elements for dialogue and capacity building.

Eligibility is assessed on the basis of the relevance and credibility of the policy. Relevance refers to the overall objectives of poverty reduction, sustainable and inclusive growth and democratic governance, as well as the specific challenges and objectives identified in the public policy and budget support programme in relation to the country context. Where possible, particular attention should also be given to social protection and employment in accordance with the EU Agenda for Change. Policy credibility will depend on the track record in policy implementation, policy financing, institutional capacity and ownership, and the quality of data and analysis underlying the policy.

PART I – ELIGIBILITY ASSESSMENT DURING DESIGN

A supplementary document of approximately 6-8 pages (or less where existing policy assessments are available and can be referred to) should be provided with budget support Action Fiches or before during identification where possible. This template provides under each heading an indicative list of issues to be covered with guiding questions. Supporting information and key reference documents such as multi-donor Joint Review documents should be annexed.

1. POLICY FRAMEWORK

Before assessing policy relevance and credibility, delegations should provide a short description of the policy framework:

- **Policy Content and Formulation:** What are (very briefly) the main elements of the policy? Where is the policy defined⁽⁴⁵⁾? What is the period covered and how does it correspond with political cycles or other policy processes? What has been the approval process? To what extent were different national and sub-national public and private stakeholders involved in the policy formulation process?
- **Monitoring and Evaluation framework:** does the policy contain such a framework that clearly reflects the policy priorities, has SMART indicators and yearly targets that can provide the basis for policy reviews? Is the framework aligned with domestic processes, and subject to local accountability mechanisms (e.g. parliament)? Is it publicly

⁽⁴⁵⁾ Policies are usually formulated in a formal strategic document, approved by the Executive. However, other documents such as manifestos can provide complementary information. Where the policy gives little information on its financing, this might be obtained from other sources such as the budget or MTFF, or even budget speeches.

available? What is the process for updating the framework? Does a **Performance Assessment Framework**⁽⁴⁶⁾ (PAF) exist that is drawn from the Monitoring and Evaluation framework and forms the basis for budget support conditionality? More guidance can be found in Annex 8, “Performance Measurement and Programme Design”.

- **Review mechanisms and donor coordination:** is there an inclusive and regular review process led by the Government and governed by specific arrangements such as a Memorandum of Understanding? Is the review published and to what extent does it feed into domestic accountability mechanisms? Are development partners and non-state actors involved in the review process and do they support the results of the policy review?
- **Is the policy coherent with other government policies?** Is there coherence between national and the sectoral or subnational policies targeted for budget support? Are intra-sectoral policies coherent? Does the policy take into account decentralisation reforms and devolution of powers?

2. POLICY RELEVANCE

Delegations should **assess to what extent the policy is relevant to the overall objectives of poverty reduction, sustainable and inclusive growth, and democratic governance, as well as the specific challenges and objectives identified** in the public policy and the budget support programme in relation to the country context. Specific objectives will differ depending on the country context and the public policy the budget support programme is in support of. In general terms, SBCs are expected to focus on state-building, SRCs on sector reforms and public service delivery, and GGDCs on broader reforms of governance systems.

Reference can be made to existing review documentation, which should be annexed together with the policy document(s). Some guiding questions to assess relevance are provided here:

- What is the policy’s contribution to **sustainable and inclusive growth**? Such an impact can be more directly targeted, through a focus on the business environment, employment and productivity, but also indirectly, for example through social policies that have a longer term impact on inclusive growth. Examples of relevant questions for GGDCs, SBCs and for SRCs that directly target the growth objective are: is the policy likely to influence the poverty incidence of growth? Does it include specific social protection measures to ensure growth is inclusive? Will the policy contribute to the protection and sustainable use of natural resources and energy efficiency⁽⁴⁷⁾? Will the policy reduce economic vulnerability, by strengthening resilience to economic shocks or natural disasters? Are expenditure allocations and domestic revenue mobilisation policies consistent with the sustainable and inclusive growth objective?
- SRCs, but also relevant GGDCs and SBCs, aim at supporting **sector reforms and public service delivery**. To what extent does the policy aim at improving inclusive access and use of quality services with a particular focus on frontline service delivery for vulnerable groups?
- To what extent does the policy aim at strengthening **domestic accountability and national control mechanisms** as a basis for improving governance?
- Will the policy contribute to further progress in **crosscutting areas** such as gender and youth?
- Other Annexes provide further guidance on specific policy objectives related to **state building in fragile situations**, addressing the particular development challenges of **SIDs and OCTs**, and strengthening **domestic revenue mobilisation**.

3. POLICY CREDIBILITY

Policy credibility will depend on the track record in policy implementation, policy financing, institutional capacity and ownership, and the quality of data and analysis underlying the policy. Note that there may be cases where a policy is broadly credible except that it lacks realism in terms of the time it will take to reach the policy objectives and specific targets. This should be clearly noted in the eligibility assessment and reflected in section 5, which deals with expected progress.

⁽⁴⁶⁾ A PAF refers to a summary table which brings together the policy objectives, activities, expected results and indicators (with their targets and source of verification) that form the basis for budget support donors to monitor progress. A variable tranche indicator framework is usually drawn from the PAF.

⁽⁴⁷⁾ Include reference to PPCM guide on sustainable development analysis (SDA) when available.

3.1. Track record in policy implementation

The main instrument for verifying policy implementation is the monitoring or performance framework, or key policy issues identified previously (cf. section 5), policy reviews and budget execution reports. However, where important other information sources are available, such as surveys, these should also be considered. Delegations should appraise progress in the area(s) covered by the policy. Have lessons learned been taken into account for the formulation of this policy? **Is there a positive trend in overall performance?** If not, does this undermine the credibility of the policy, or were important external factors at play?

3.2. Policy financing

Costing or budget analysis should be undertaken on the basis of the available budget classifiers (cf. box 1). A budgetary analysis should then include the following aspects:

- **Policy costing:** were appropriate cost estimates prepared for the policy, based on outputs or programmes? Was costing applied in an incremental logic or through more complex methodologies analysing cost drivers? Have the recurrent-cost implications of investments been taken into account? Were any potential savings considered? Reference can also be made to dimensions 3 and 4 of PEFA indicator 12 on the existence of sector strategies with multi-year costing of recurrent & investment expenditure, and linkages between investment budgets and forward expenditure estimates.
- **Policy financing: consistency between the policy and the budget/MTEF⁽⁴⁸⁾:** based on cost estimates of the policy, are the budget/MTEF sectoral and intra-sectoral allocations considered appropriate for a successful implementation of the policy and do they reflect the targeted outputs of the policy performance assessment framework? Do the allocations reflect 'value for money'? Does the investment budget reflect policy priorities? Is there an appropriate balance between recurrent and investment expenditure, and between wage and non-wage expenditure? Have policies and their expenditure needs been prioritised appropriately to deal with financing shortfalls? Finally, based on past budget execution, is the budget a reliable indication of expected spending in the policy area?
- **Budget comprehensiveness:** do estimates exist of the extent of off-budget expenditure (e.g. aid-financed expenditure) and revenues (e.g. ODA, fees...) and have these been considered in the policy? References to the latest PEFA assessment (Indicators D1-D2-D3) may be made if relevant.

Box 1: The use of budget classifiers

The three primary classifications are administrative, economic, and functional/programmatic. The administrative/organisational classification is essential for accountability purposes and identifies the administrative entity responsible for managing the resources allocated to it for implementing specific policy objectives, such as ministries or, at a lower level, schools and hospitals. The economic classification includes classification of revenue, expenditure, assets and liabilities, and forms the basis for preparing Government Finance Statistics (GFS). Functional/programmatic classifiers relate to the function of government or the programmes the government wants to deliver. They allow for a more direct link between budget lines and policy objectives. In the absence of such classifiers administrative classifiers are often used as a broad proxy for costing government policies. There may be a need for other classifiers, for example territorial, depending on IFMIS capacity and stakeholder needs.

- **Financial sustainability:** is there a risk that an important part of the policy will not continue to be financed in the future? Is projected expenditure consistent with the macroeconomic budget constraint? Could contingent liabilities or arrears affect financial sustainability? Are external financing projections credible, particularly for aid dependent countries?

⁽⁴⁸⁾ In the absence of a MTEF, which is not a formal eligibility requirement, the credibility of existing sector financial projections or policy costings should be verified based on past budgetary allocations and expenditure, and expected revenues. If the policy is not costed, delegations can still appraise consistency between the policy and the recent budget allocations based on rough estimations and whether the partner country has a positive track record in financing its policies.

- Where relevant, **fiscal decentralisation**: does an allocation and transfer mechanism exist consistent with decentralisation policy? Is there consistency between budgetary allocations to sub-national entities and their functional mandates in accordance with the legal framework underpinning fiscal decentralisation?

Sources of information to inform the analysis above are budget documents, including (sector) MTEFs and Public Investment Plans, as well as PEFA reports and Public Expenditures Reviews.

- Institutional capacity and ownership: **To what extent is institutional capacity considered to be sufficient to implement the policy?** Do capacity assessments exist for the ministries or agencies in charge of the policy and/or for the national civil service as a whole⁽⁴⁹⁾? Are policies in place to strengthen public sector capacity, for example in public sector reform or capacity development strategies? In cases where a substantial part of the policy response is implemented by sub-national entities, are these considered to have sufficient implementation capacity? **What indications exist that the policy is sufficiently owned by the institutions that have to implement the policy and their political leaders?** Delegations can include elements of political economy analysis as a basis for reaching a conclusion on ownership.

3.3. Analytical basis and data quality

Before starting budget support operations based on a series of performance indicators, delegations should appraise the quality of national statistical systems⁽⁵⁰⁾ including the institutional set-up, and if applicable, sector statistical units. What is the degree of data availability, reliability, and timeliness? Does the institution responsible for statistics concur with the PAF indicator data produced? **Are the weaknesses affecting statistical systems significantly undermining the validity of the objectives and targets stated in the policy?** Are weaknesses being addressed?

What analysis or studies informed the policy? **Is the quality of the analytical basis underlying the policy sufficient not to undermine the credibility of the policy?**

4. CONCLUSION: APPRECIATION OF ELIGIBILITY

On the basis of this assessment, the Delegation concludes that the policy is considered [sufficiently/insufficiently] relevant and credible for budget support programme objectives to be largely achieved. Therefore the policy [can/cannot] be supported by the Commission with the proposed budget support programme.

5. EXPECTED PROGRESS IN POLICY IMPLEMENTATION

This section should specify the main basis for monitoring progress in policy implementation. Normally, such basis is provided by the **policy monitoring or performance assessment framework** and its review documents, issued by the responsible authority, often jointly with development partners. Delegations can refer to these review documents to monitor eligibility but should express a justified opinion on the validity of its conclusions.

Where the quality of the existing monitoring framework is considered insufficient, delegations should in this section spell out how eligibility will be monitored, in agreement with the partner country and in coordination with other donors. Particularly, which are the key issues that will be assessed in order to monitor eligibility and what progress is expected before the first disbursement? At the same time, emphasis should be on ensuring that the policy is strengthened with a quality monitoring and evaluation framework, which can provide the basis for future policy dialogue and budget support conditions.

PART II – ELIGIBILITY DURING IMPLEMENTATION

When submitting disbursement files, delegations should appraise whether the public policy eligibility criterion continues to be satisfied. Specifically, **does the policy continue to be sufficiently relevant and credible, and has there been satisfactory progress in policy implementation** since the last eligibility check, taken into account external

⁽⁴⁹⁾ Relevant information can also be found in Civil Service Commission (or equivalent) reports on headcounts, qualifications and structures to give an overview of current HR capacity.

⁽⁵⁰⁾ More guidance on the assessment of statistical systems can be found in the Eurostat *Guide to Statistics in European Commission Development*: http://epp.eurostat.ec.europa.eu/portal/page/portal/international_statistical_cooperation/thematic_activities/communication_and_coordination/guide_to_statistics

factors or exogenous shocks? The length of this supplementary document will depend on the number of policy changes and the availability of existing policy reviews. It should not be more than 6-8 pages, annexes not included.

The same template can be used as in part I with a particular **focus on progress in policy implementation** (section 3.1). Attachments should include a summary table of progress against selected performance indicators (cf. section 5). Delegations should refer to the policy monitoring or performance framework, but other relevant information sources such as survey results should also be taken into consideration to reach an informed and justified conclusion on progress rather than a mechanistic calculation based on the number of indicators met. Delegations can refer to existing review documents to monitor eligibility but should express a justified opinion on the validity of its conclusions.

In other sections, reference can be made to the previous eligibility assessment where there has been no significant change (in which case overall length may be shorter). However, where a new policy is in place, the initial assessment needs to be redone. Where existing policies are subject to substantial budgetary revisions or revisions in indicators or targets in the monitoring framework or PAF, these should equally be considered, especially those indicators selected for the variable tranche.

Annex 4: Assessing Macroeconomic Eligibility

I. INTRODUCTION

This Annex to the Budget Support Guide provides a template for setting out a structured assessment of the macroeconomic eligibility criterion that assess the relevance and credibility of the macroeconomic policies being pursued by the authorities. Additional background information is contained in a number of Appendices.

The assessment should:

- analyse the main macroeconomic aggregates and identify potential sources of instability that would endanger the strength and the persistence of growth, or the return to a stable macroeconomic frame and debt sustainability;
- assess macroeconomic and fiscal policies in place and their contribution to stabilize the macroeconomic framework over the short and medium term;
- assess efforts to strengthen domestic revenue mobilisation;
- assess vulnerability to external shocks and efforts to strengthen macroeconomic resilience.

The template below provides analytical tools and proposals for indicators on which to base the assessment of eligibility. The analysis should also underpin the risk assessment. The analysis should be based on national documents, on IMF analysis as well as on analysis from other international financial institutions. The assessment should take in consideration that there is no “single” stability-oriented macroeconomic policy in a given situation and that the authorities generally have to face conflicting objectives. The benchmarks are, however, that the Government’s capacity to finance the fiscal and external deficits is not jeopardized in the short- and the medium term, and that inflationary pressures are brought under control. Furthermore, efforts to enhance domestic revenue mobilisation should be effective in order to strengthen the resilience of the economy. The country context, in particular in fragile or transition situations, including available financial resources, administrative capacities and short term social and economic priorities, shall be taken in account when assessing those medium term oriented efforts.

The assessment of the macroeconomic eligibility criterion during implementation follows the same logic as during the preparation phase, and the same template should therefore be used. However, the analysis at the time of decision on payment of a tranche should in particular include answers to the following questions: have the authorities respected their commitments towards a stability oriented macroeconomic policy? Have unexpected domestic or external events required a macroeconomic policy adjustment? If so, what has been the reaction of the authorities? And, is the new policy stance still stability oriented?

II. TEMPLATE FOR THE SUPPLEMENTARY DOCUMENT TO THE ACTION FICHE AND PAYMENT DOSSIER

NB: No data and no analysis are required to fill in this template that are not easily available in national official documents, if any, and by default in documents by the IMF, the World Bank or other international organisations documents. The relation of the country with the IMF and the analysis of this institution of the macroeconomic policy orientation is key to assess the eligibility criterion. The economic analysis, in particular the assessment of the credibility of the policy stance, should also be strengthened by regular contact at technical and policy level between the Delegation and the national authorities, as well as with the IMF mission and the Resident Representative and other relevant stakeholders. The document should in general not exceed 6 pages plus tables and graphs. It should aim at a synthesis of the main issues while referring (positively or negatively) to the analysis provided in documents by other institutions.

1. INTRODUCTION

Context

Brief overview of key structural indicators of the economy: Income per capita (LIC/MIC?), past medium term growth performances, source of GDP (agriculture, natural resources) and diversification, poverty/inequality, qualities of institutions and business environment, openness. The delegation is encouraged to use its local knowledge and judgement to identify and briefly present on the base of few indicators **the few most pressing economic and social challenges and risks** faced by the government and that could jeopardise medium term growth and development prospects⁽⁵¹⁾, recognising that economic transformation is never socially or environmentally neutral. Indicators of inclusiveness that can be provided include (i) absolute poverty and inequality (Gini coefficient, income lowest to highest quintile/decile, people under poverty line, ...) (ii) pattern of economic growth and social development: persistent contrast between main sectors (traditional agriculture vs. export oriented); (iii) rapid urbanisation with pressing deficit in public infrastructure and service provision; (iv) unemployment, in particular youth; land and water access as emerging issues as a result of the transformation of property rights. Cross references may be made where appropriate to the analysis of the assessment of public policy eligibility.

Source: National publications, World Bank and IMF on line data bank and data bank of other international financial institutions and bodies⁽⁵²⁾ (e.g. International Energy Agency, ...), MDG and UN Human Development statistics.

Relation with the IMF

The mandate of the IMF is to *advise and help member countries in implementing macroeconomic and financial policies that promote stability, reduce vulnerability to exogenous shocks, and encourage sustained growth and high living standards as well as poverty reduction*. The quality of the relation of the country with IMF is therefore of first importance, while not necessarily decisive, for assessing the eligibility of the country to a budget support operation. The link to be established between the relation of the country with the IMF and this eligibility is described in the main part of the text.

The relationship with the IMF should be described⁽⁵³⁾, including: Current credit arrangement or Policy Support Instrument or Staff monitored programme: when available/relevant, date of conclusion of last review, planned date of next review or of IMF mission, expiry date, amounts; main conclusion of last staff report and of the last Board meeting; or, date of last Article 4 consultation and summary of staff appraisal and of commitments/announcements by the authorities in this context (diverging views, e.g. on forecasts or policy recommendations, shall be mentioned and as possible explained); expected date of next programme review or Article 4 consultation. As relevant, this description can be usefully complemented by a description of the relationship of the country with the World Bank and Regional Development Banks.

Source: IMF country webpage. World Bank or Regional Development Bank country webpage; see appendix 3

⁽⁵¹⁾ There is, in particular, growing evidence that inequalities jeopardize growth prospects in the medium term. See for example: Inequalities and Unsustainable Growth: two sides of the same coin, IMF, 2011, <http://www.imf.org/external/pubs/ft/sdn/2011/sdn1108.pdf>

⁽⁵²⁾ For example: http://www.worldenergy.org/publications/energy_efficiency_policies_around_the_world_review_and_evaluation/1230.asp

⁽⁵³⁾ For the various IMF lending instruments see: <http://www.imf.org/external/np/exr/facts/howlend.htm>

2. KEY MACROECONOMIC INDICATORS AND POTENTIAL SOURCE OF INSTABILITY

Short term performance and outlook

This section focuses on the presentation of key imbalances to be addressed by the Government. The main indicators to be used should be presented in an analytical table (see template below) and complemented as necessary. Imbalances may for example relate:

- to a significant weakening of real GDP growth compared to long/medium term trend as a result of a sudden and unexpected weakening of internal or external demand or supply factors (including natural shocks or events like rain fall), and/or
- to pressures on prices and/or competitiveness that could jeopardise prospects for moderate inflation and currency stability; inflation rates need to be assessed in their historical dimension (persistently high, acceleration). Changes in prices induced by an exogenous price shock and the policy response to it shall be carefully assessed (see appendix 3) and/or
- to a deterioration of the external accounts, for example as a result of changes in terms of trade, weakening of external demand, reduced aid, or domestic demand pressure that jeopardizes the capacity to finance the balance of payments and/or keep the level of reserves at a sufficient level, or would result in an unsustainable evolution of debt levels (see appendix 1), and/or
- to an evolution of public expenditures, for example as a result of social pressures, food security crisis, political cycle, or of revenues (change of prices of natural resources, unexpected shortfall in tax revenues) that jeopardizes the capacity to finance in the short run the fiscal deficit or would result in an unsustainable evolution of public debt levels, and/or
- to weaknesses in the financial or banking sectors (accumulation of bad loans, difficulties to refinance). Indicators can in general be found in IMF Review documents (Table “Financial Soundness Indicators”).

Source: National accounts, National Budget, Central Bank report, IMF last Program review or Article IV review, IMF country web page.

3. ASSESSMENT OF MACROECONOMIC POLICIES AND STABILISATION OF THE MACROECONOMIC FRAMEWORK

The relevance of macroeconomic policies shall be assessed in view of the macroeconomic imbalances identified in the previous section and of the debt sustainability analysis. The overall orientation of the macroeconomic policy stance in a short and medium term perspective is in general outlined in the letter of intent signed by the authorities in the context of credit arrangements with the IMF, in other national public documents (Budget, Central Bank announcements) or in IMF documents (Article IV review, Review of Credit arrangements). Appendix 4 provides examples of formulations for the diagnostic and the macroeconomic response as reflected in IMF Review documents.

The main quantitative indicators of the fiscal policy stance are included in the Analytical Table. They include the fiscal deficit, the primary deficit (overall deficit excluding interest payments), the level and change of public debt as a percentage of GDP. Based on these indicators, the fiscal policy stance shall be assessed taking account of the cyclical position of the economy, the desirability of a short term expansive stimulus or of a deceleration of demand, as well as of debt sustainability considerations (see appendix 2).

The credibility of expected tax revenues may be measured by verifying the coherence of the change in tax ratios with recent tax policy changes and efforts to strengthen administrative capacities (see below assessment of efforts for strengthening domestic revenue mobilisation). For natural resources, the underlying extraction volume and price hypothesis may be taken into consideration. For expenditures, underlying assumptions for salaries and staff and social expenditures (including the political impact), expected interest payments related to debt stock, as well as changes in public investment volume, are determinant for assessing the credibility.

The method of assessing the contribution of macroeconomic policies to price stability very much depends on the monetary policy instruments, the exchange rate, and the capital movement regime, which may differ widely from

country to country. The Delegation will, in general, rely on the analysis of the IMF for this purpose. An explanation should also be provided of the quality of banking supervision, the path of financial sector reforms, because of the high relevance of these aspects for assessing risks.

Source: National Budget, multi-year programming documents (Medium-Term Fiscal and Expenditure Frameworks – MTFF, MTEF), Budget Execution reports, Balance sheet of the Central Bank, other Central Bank reports, National Accounts, the national statistics institute's financial statistics, the International Financial Statistics (from the IMF), IMF last Program review or Article IV review, IMF country web page

4. DOMESTIC REVENUE MOBILISATION

Measuring domestic revenue mobilisation as a share of tax revenues to GDP shows two features. For developing countries, higher per capita revenue tends to go hand in hand with relative higher public revenues without saying anything on the nature and direction of causality. The variance of this ratio is high within each income group.

Table: Key Indicators on Domestic Revenue Mobilisation⁽⁵⁴⁾

Year 2010	Size of the sample	Tax ratio (% of GDP)			Estimated effort (Effective tax revenue in % of estimated potential)		
		Median	Maximum	Minimum	Median	Maximum	Minimum
LICs	12	13,9	22,4	8,1	77,6	92,4	41,0
Lower MICs	24	16,5	36,6	9,5	63,2	87,1	38,1
Upper MICs	20	26,8	45,7	14,3	77,2	98,4	48,3

The table provides only a very broad indication for situating the efforts of a developing country for its domestic revenue mobilisation⁽⁵⁵⁾. However, the assessment of efforts made to enhance domestic revenue mobilisation needs to be put in the country context. The annex on Domestic Revenue Mobilisation provides a detailed background to this end.

Many oil and resource-rich countries have relatively high revenue-to-GDP ratios. These countries, however, need to improve the efficiency of their tax systems to reduce reliance on natural resource revenues. In such countries, indicators to be analysed should include ratio of revenues from natural resources to GDP, and from tax revenues to GDP (excluding natural resource revenues).

Basically, efforts made to enhance revenues can be assessed on the base of the answers to following questions:

- Does the Medium Term Financial Framework foresee a progressive increase of coverage of public expenditures by tax revenues? An assessment would have to take in consideration the per capita income level of the country, its development needs and the existence of natural resources;
- Tax policy: Did the authorities take any significant tax policy measures in the period under consideration? What is the objective of these measures and the expected impact on tax revenues? A particular attention needs to be given to the transparency and consistency of tax incentives as well as to their coherence with well defined public policy objectives. A quantification of the overall costs of tax exemptions shall be sought.
- Tax administration: Did the authorities take any measure to build up an effective and efficient tax administration promoting tax compliance and strict enforcement of tax codes?
- How are the specific problems arising for taxing natural resource, especially in natural resource rich countries, addressed (transparency, commitment to EITI, ...).
- Did the authorities take any measure to contribute to international tax cooperation?

⁽⁵⁴⁾ Source: IMF, 2011, Revenue Mobilisation in developing countries, P. 60. The potential has been estimated by the IMF on the base of a simple regression retaining most pertinent determinants (tax base, level of development,...). Samples include natural resource rich and poor countries. LIC = Low Income Countries; MIC = Middle Income Countries

⁽⁵⁵⁾ These numbers need to be interpreted with caution, including because the quality of GDP estimates may vary strongly from one country to another.

- Can visible progresses be demonstrated in the collection of one or more specific taxes compared to the relevant tax base as result of policy or administrative measures? Compared to the average increase of tax revenues?

Dialogue with the authorities, with donors and agencies providing assistance to fiscal reforms, contact with the IMF and the PFM assessment provide in particular the base for answering these questions. The assessment shall be put in a medium term perspective recognising that tax reforms are difficult endeavours and that their successes is contingent to several factors. However, based on the answers to previous questions, a repeated and obvious lack of commitment by the authorities to take serious measures for enhancing domestic revenue mobilisation shall result in a negative assessment of the macroeconomic eligibility criterion.

Source: National documents, IMF reports; TA reports; NGOs reports

5. ASSESS VULNERABILITY TO EXTERNAL SHOCKS AND EFFORTS TO STRENGTHEN RESILIENCE

Developing countries are particularly vulnerable to exogenous shocks, e.g. a sharp decline in international trade, a shift in terms of trade, volatile external flows, or climatic changes. In the face of an increasingly uncertain global environment, macroeconomic stability over the medium term therefore depends on building economic resilience to future shocks. The assessment of efforts made to strengthen economic resilience has to be brought in relation with the vulnerability of the economy to shocks (commodity prices, world demand of main export products). Evidence on vulnerability includes volatility of economic growth, of exports values as well as of fiscal and natural resource revenues as a result of external shocks. It is therefore strongly country dependent. Experience accumulated over the last decade, in particular in the wave of the 2007-08 food prices and financial crisis shows that economic resilience depends on three important factors: external and fiscal buffers, a well-targeted and efficient social safety net, and over the medium/long run capacity to diversify production. Efforts to strengthen economic resilience should be assessed alongside these three dimensions.

6. CONCLUSIONS OF THE ANALYSIS

This section should draw a basic conclusion on the relevance and credibility of the macroeconomic framework and hence eligibility for budget support. The assessment of eligibility may take the following form⁽⁵⁶⁾:

At end of identification or formulation:

“Based on the analysis above [and the latest IMF review dated MM YY][with the following caveats...] it is concluded that the authorities pursue a credible and relevant stability oriented macroeconomic policy aiming at restoring fiscal or external stability and sustainability.

Implementation phase/Disbursement decision

Based on the analysis above it is concluded that there is a stability-oriented macroeconomic framework in the country or progress is made towards restoring key balances.

⁽⁵⁶⁾ For illustrative purposes

APPENDIX 1: ASSESSING EXTERNAL ACCOUNTS

Two tables are central to assessing external accounts: the standard Balance of Payments table and the summary table “External financing requirements and sources” as calculated by the IMF from the Balance of Payments.

Assessing the balance of payments cannot be limited to the size of the trade balance or of the current account. Firstly, the vulnerability of the current account depends on structural factors, e.g. geographical and product diversification of exports, size and origin of remittances, vulnerability of import values to raw material prices. It also depends on changes in price competitiveness. Secondly, a current account deficit corresponds to national investment in excess of national saving. Such a deficit going for example hand in hand with a high investment ratio and rapid growth will be the consequence of a successful growth oriented development strategy as long it is financed on a sound basis; by contrast, a deficit in the context of low growth and low investment or low investment efficiency will tend to generate an unsustainable external debt. Thirdly, the source of financing matters. Indicators include reliance on official versus private flows, change and level of external reserves and the respective share of FDI, long term and short term capital flows in private capital flows.

The “external financing requirements” (requirement: -) as defined in the summary table include the current account balance (deficit: -), the increase or intended change of international reserves (increase: -) and the financing requirement stemming from debt amortization (debt repayment: -). There are two types of external financing: private flows (inflows: +), subdivided into forecast FDI minus reversible investment in productive capital and other private flows, representing investments in short, medium and long term financial assets; and the contribution of the IMF and other official flows. As EU budget support falls into of this latter category, it makes sense to compare yearly disbursements under EU budget support to the overall amount of official capital flows.

An agreed IMF programme always presents a “closed” overall balance of payment, i.e. equality of financing requirements and sources. Before an agreement is reached, the presentation of a “residual financing gap” by the Fund specifically raises the question of the contributions of official donors and multilaterals already included under “other official flows”. If the Fund deems expected official flows insufficient to “close the gap”, it will have to renegotiate the macroeconomic framework, with specific regard to the fiscal policy stance, with the Government. This will in general result in reduced public expenditures or a more restrictive monetary policy stance.

APPENDIX 2: DEBT SUSTAINABILITY⁽⁵⁷⁾

Debt sustainability relates to debt and debt service relative to measures of repayment capacity. A debt and related debt service obligation growing persistently faster than the revenue base underpinning repayment will unavoidably result in a liquidity or solvency crisis. A current deficit – either external or fiscal – shall therefore be in a first step be assessed in relation to the existing level of debt and the change of the debt it will mechanically induce compared to the expected growth rates in revenues (debt to revenue ratio). Debt sustainability put a constraint on the acceptable size and desirable evolution of the current deficit under consideration. For example, an increased of the fiscal deficit that may appear to be desirable for sustaining activities in the case of an adverse shock may have to be rejected because of debt sustainability concerns.

For most Low Income Countries the first indicator to be looked at is the sustainability of public external debt. However, as more and more countries have access to a domestic capital market, attention needs to be given to the overall public debt

The information to be provided in all cases should be based on the joint analysis by the IMF and the World Bank. These institutions undertake such analyses for most of the LICs on a regular basis (three year cycle with yearly update). They are published on the IMF website (<http://www.imf.org/external/pubs/ft/dsa/lic.aspx>). In some cases, a debt sustainability analysis is undertaken for middle income countries with access to capital markets, though using a somewhat different methodology.

Debt stock indicators provide a useful measure of the total future debt-service burden of existing debt. Debt-service indicators provide a measure of the immediate burden that debt imposes on a country by crowding out other uses of scarce resources. Repayment capacity is measured by GDP, exports of goods and services, or Government revenues. The most relevant measure of repayment capacity depends on the constraints that are most binding on an individual country. Present Value debt ratios are summary indicators of the burden represented by the future obligations of a country and thus reflect long-term risks to solvency, while the time path of debt-service ratios provides an indication of the likelihood and possible timing of liquidity problems.

IMF/World Bank debt sustainability analysis is based on “realistic” macroeconomic scenarios intended to “provide safeguards against excessive borrowing and return to debt distress, without constraining justified optimism about the effective use of external resources to promote growth, reduce poverty and achieve MDGs” (IMF, 2010). It includes base line, alternative and stress test scenarios. Increasingly, the attempt is made to take consideration of the efficiency of public investment.

It relates to Debt Burden Thresholds (Debt and debt burden as % of Exports, GDP and fiscal revenue) taking account of the institutional capacity of the country to manage debt on a sound basis (IMF, 2010, P. 9). It classifies countries in low, moderate, high risk of debt distress or in debt distress. Particular attention should also be given the accumulation of arrears.

⁽⁵⁷⁾ Source: Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability, IMF, 2010, <http://www.imf.org/external/np/pp/eng/2010/012210.pdf>; see also the Framework for Low-Income Countries: <http://www.imf.org/external/pubs/ft/dsa/index.htm>

APPENDIX 3: EXTERNAL PRICE SHOCKS ON FOOD AND ENERGY, CONTROL OF INFLATION AND FISCAL POLICY

In the absence of external price shocks, the objective of a moderate and stable inflation rate is generally pursued mixing interest rate policy, control of domestic credit and exchange rate stability. An external shock on food and/or energy prices may give rise to substantial challenges for the authorities of several developing countries, in particular of LDCs. The average share of food in the consumer basket of LDCs is around 45% and of fuel 6%. Price shocks affect mostly the poorest households, but the middle class may also be significantly affected. Capacity to partially absorb the price shock through reduced saving or depletion of savings is limited or inexistent. The poverty incidence is therefore high. Small enterprises with limited access to credit may be hit by an excessive volatility of energy prices, resulting in liquidity problems.

As a result, full passing through of food and energy price shocks to the final users in absence of an effective social safety net targeting the poorest and where credit market access is weak, is often not a sustainable solution. Price subsidy schemes appear as a second-best, but expensive solution, and need to be carefully designed to meet the needs of the poorest in a cost-effective manner, taking account of the fiscal space. Reversibility of such schemes is also a key issue.

Moreover, monetary policy is challenged. The “standard” advice is to accommodate first round effects on prices whilst opposing to further “second round” spill over effect on domestic prices that would trigger an inflationary dynamic. However, countries which had international reserve problems and/or inflationary pressures before the shock may have to pursue an even more restrictive stance to oppose immediate effects of the price shock.

This underlines the importance of strengthening resilience over the medium term through effective and well-targeted social safety nets as well as through international reserve and fiscal buffers for ensuring medium term macroeconomic stability.

APPENDIX 4: IMF LENDING INSTRUMENTS TO LOW INCOME COUNTRIES

The IMF has overhauled its instruments for low-income countries *since the beginning of the global economic crisis to address their greater vulnerability and exposure to the ups and downs of the global economy needs for short-term and emergency support. Lending instruments include:*

The Extended Credit Facility (ECF), replacing the *Poverty Reduction and Growth Facility, (PRGF)*

- Provides sustained engagement over the medium- to long-term, in case of medium-term balance of payments needs;
- Offers more flexibility than before on programme extensions, the timing of structural reforms, and formal poverty reduction strategy document requirements.

The Standby Credit Facility (SCF), which supersedes the Exogenous Shocks Facility's High Access Component, is similar to the Stand-By Arrangement for middle-income countries. It

- Provides flexible support to low-income countries with short-term financing and adjustment needs caused by domestic or external shocks, or policy slippages;
- Targets countries that do not face protracted balance of payments problems but may need help from time to time;
- Can also be used on a precautionary basis to provide insurance.

The Rapid Credit Facility (RCF),

- Provides rapid financial support in a single, up-front payout for low-income countries facing urgent financing needs, and offers successive drawings for countries in post-conflict or other fragile situations;
- Provides flexible assistance without programme-based conditionality when use of the other two facilities is either not necessary (limited nature of need) or not possible (institutional or capacity constraints).

All these facilities allow for significantly higher access to financing and offer more concessional terms than previously. Low-income countries will receive exceptional forgiveness through end-2011 on all interest payments due to the IMF under its concessional lending instruments. Thereafter, concessionality will be reviewed every two years.

STANDARD TABLES

The tables below include core information required to make a macroeconomic assessment. They come on top of the information to be provided as suggested in the text (notably development indicators, size of EU aid in relation to macroeconomic variables, tax policy parameters, medium term macroeconomic framework of the debt sustainability analysis ...). They may have to be adapted to take account of country specificities. The calendar years are exemplary provided for an elaboration in the second half of 2011 and first half of 2012.

Table 1: National accounts and prices

	2000-08	2009	2010	2011 (est.)	2012 (proj.)	2013 (proj.)
Real GDP (% change p.a.)						
Real (nonoil) GDP (% change p.a.)						
Real GDP per capita (% change p.a.)						
Population (size end of period)	-					
GDP (US \$ or €)						
Gross investment (percent of GDP)						
— Private						
— Public						
Consumer price index (% change annual average)						
Nominal effective exchange rate (% change end of period)						
Real effective exchange rate (%change end of period)						

Table 2: Financial sector

Net domestic assets of the banking sector (% annual changes)						
Net foreign assets of the banking sector (% annual changes)						
Indicator(s) of capital adequacy (for details see IMF table «Financial soundness indicators».)						
Indicator(s) of asset quality (idem)						

Table 3: External accounts (in Mio \$ or €)

	2008	2009	2010	2011 (est.)	2012 (proj.)	2013 (proj.)
Current balance (including grants)						...
Trade balance						...
— Exports						
• Of which (indicate the export value of the first main export product(s))						
— Imports						
• Of which Oil						
Balance on services and income						...
— Of which interest payments						
Balance on transfers						
— Of which official transfers (net)						
Capital and financial account						
Capital account (net)						
Financial account (net)						
— Official financing (Long and medium term loans)						
— Private capital						
— Short term capital						
Errors and omissions						
Overall balance						
Memorandum items (% of GDP unless otherwise indicated)						
Net international reserves (-, incr.)						
Current balance, including official transfers						
Total donor support						
— Of which official transfers						
• Of which EU aid (disbursed)						
External debt						
External debts service paid						
Gross international reserves in US\$						
Gross international reserves in months of prospective imports						
Export volume (% change p.a.)						
Import volume (% change p.a.)						
Terms of Trade (%change p.a.)						

Table 4: Fiscal policy indicators (% of GDP resp. % of non oil GDP)

	2000-08	2009	2010	2011 (est.)	2012 (proj.)	2013 (proj.)
Total revenue and grants						
Revenue						
— Oil revenue						
— Nonoil revenue						
— Tax revenue						
• Direct taxes						
• Indirect taxes						
• Trade related taxes						
— Nontax revenue						
Grants						
— Of which EU budget support (disbursement)						
Total expenditure						
Current expenditure						
— Current Non-interest expenditure						
• Wages and salaries						
• Goods and services						
• Other						
— Interest payments						
• domestic						
• foreign						
Capital expenditure (total)						
Domestic						
Foreign						
Arrears clearance (clearance -)						
Domestic primary balance						
						<
Overall balance (after arrears clearance)						
Memorandum items (% of GDP resp. % of non oil GDP)						
Total poverty spending (social protection, health, education)						
Tax exemptions						
Outstanding domestic payments arrears						
Total government debt						
— Domestic debt						
— External debt						

Annex 5: Assessing Public Financial Management Eligibility

This Annex contains two annotated templates to be used for any type of the three types of budget support contracts. The first template ([Part I of this Annex](#)) is the **Supplementary Document** that has to be submitted along with the Action Fiche for Budget Support Operations at the end of the formulation. The second template ([Part II of this Annex](#)) is the **Annual Monitoring Report** that has to be prepared to support the disbursement request. This annex also include a final section ([Part III of this Annex](#)) with additional guidance, templates and useful references on PFM.

The Commission considers a country to fulfil the PFM eligibility criterion for *programme approval* when a credible and relevant programme to improve public financial management can be demonstrated to be in place. *For tranche disbursement*, the general condition on PFM will be fulfilled when there is satisfactory progress in the implementation of the public financial management reform. The demonstration will include a positive assessment of two aspects i) the **quantitative progress** against the targets defined in the monitoring framework and ii) the **direction of change** of the public financial management reform towards achieving the medium term budgetary outcomes. Relevance and credibility of the programme should also be maintained⁽⁵⁸⁾.

The **Supplementary Document** therefore sets out the initial expectations of progress in PFM over the lifetime of the budget support programme and sets the **baseline** against which progress should be assessed during implementation in the **Annual Monitoring Report**. A core element of the templates is the **monitoring framework** which defines baselines along with both short term (one year) and medium term (end of the programme) targets (see in Part III annex 1).

⁽⁵⁸⁾ Since PFM reform programmes typically take a medium-term perspective (e.g. 3 to 5 years or more), it is not expected that the judgment on the relevance and credibility of such programmes will change on an annual basis. In the case of countries where budget support programmes are committed on an annual basis, this means that the same analysis of a PFM reform programme could effectively be used to justify eligibility at the end of formulation over a number of years. In such cases, however, it would still be necessary to update the monitoring framework by specifying the appropriate baseline and reform expectations to be used during implementation.

ANNEX 5: ASSESSING PMF ELIGIBILITY – PART I: SUPPLEMENTARY DOCUMENT TO THE ACTION FICHE

1. KEY FEATURES [1 PAGE] ⁽⁵⁹⁾

Financial year:	e.g. July/June
Last PEFA/ Diagnostic Study:	Date of publication and financial year referenced
Last annual accounts submitted to Auditor General / Court of Auditors:	Date of submission and financial year of reference
Last annual audit report:	Date of submission and financial year referenced
(Audit of financial statements of consolidated funds /"compte de gestion")	Date of last discharge or equivalent report by the Parliament
Basis/Forum of PFM dialogue	Level of representation and date of last formal level meeting
Reform Programme:	Title of strategy document or equivalent , date of government endorsement, period covered ⁽⁶⁰⁾

2. A SNAPSHOT OF THE ANALYSIS [1 PAGE]

The focus of this Supplementary Document is on a comprehensive overview of the entire PFM system and determining the framework of monitoring of weaknesses. Demonstration of eligibility should focus on analysing the relevance and credibility of the public finance management reform in place. This section should be brief and only include the main highlights using the box below.

- Main weaknesses in the PFM system
- Assessment of relevance of government's PFM reform strategy
- Assessment of credibility of government's PFM reform strategy
- Delegation's conclusion on PFM eligibility
- Main issues for dialogue in PFM

3. DIAGNOSIS OF THE SYSTEM [2-3 PAGES]

Summary of public financial management assessments [1 page]

The first step in the preparation of the supplementary document will be to **briefly summarise the main findings from recent assessments and diagnostics** of the Public Financial Management systems in place. This will typically have

⁽⁵⁹⁾ All mentions in brackets "[]" are to be deleted when filling in this template.

⁽⁶⁰⁾ A single reform strategy document may not always be in place. It is common to see the external audit reforms or the revenue reforms treated separately. In such cases, the different reforms should be listed.

been undertaken using standard diagnostic tools such as PEFA, complemented where appropriate, by additional assessments⁽⁶¹⁾. All the source materials should be clearly referenced in the Appendix 5 to the Supplementary Document.

This section is not meant to reproduce wholesale the findings of the various diagnostics. Where a PEFA has been done, a summary of the scores should be made and presented in full in Appendix 3, including repeat exercises.

Scope of the assessment

Within the PFM systems all the sub-systems (including revenue administration, budget preparation, budget execution with cash management, procurement systems, internal controls and internal audit, accounting and reporting, external audit and scrutiny) are strongly linked and thus have all to be analysed for any type of budget support contract selected.

Two areas require special attention, consistently with the 2011 Commission's Communication on Budget Support, namely the **revenue administration and the budget transparency and oversight**. As regards revenue administration, the analysis should provide an assessment of government capacities to mobilise domestic revenues (both tax and non-tax). A specific annex to the budget support guide provides the details on how to support this area.

On budget transparency and oversight, the availability of budgetary information is the core elements of the analysis to demonstrate fulfilment of a fourth and separate eligibility criterion as explained in the separate and specific annex to the budget support guide. The analysis and monitoring of the relevance and role of oversight bodies should however be included as part of this Supplementary Document under section 3.2 below.

Comprehensiveness of assessments and of data

Two important considerations in this section relate to the comprehensiveness of assessments and of data.

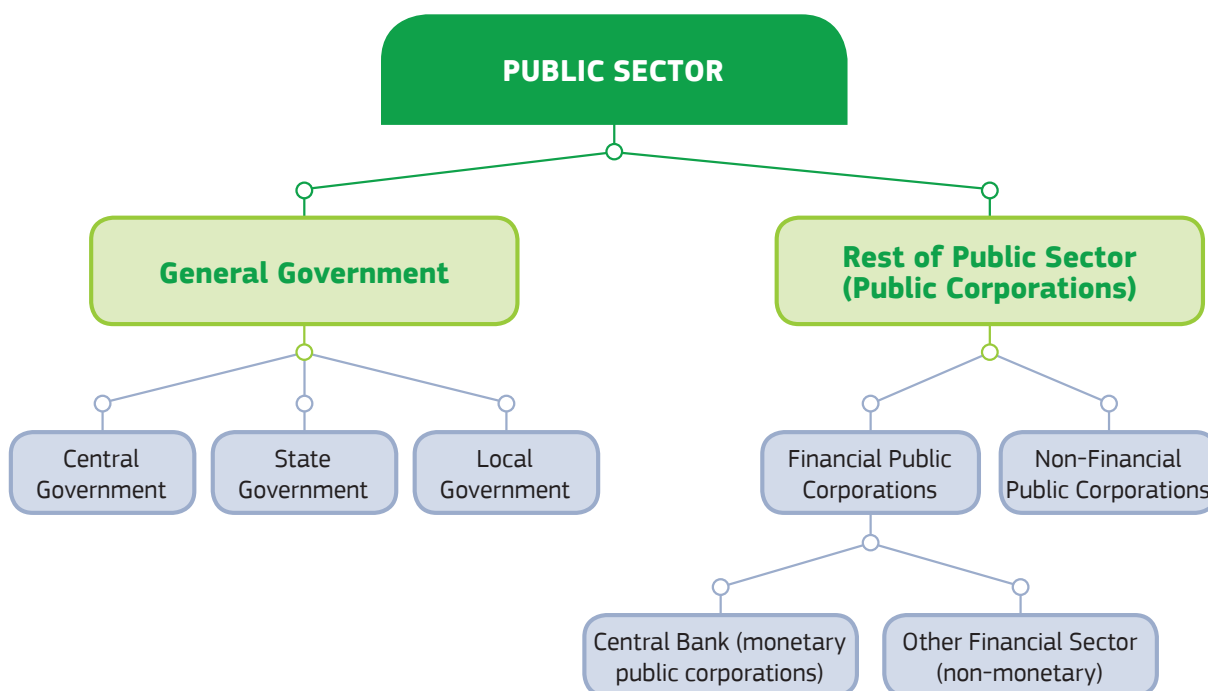
Regarding the **assessments** some questions for the analysis include the following: are the assessments restricted to central government alone or include sub-national government, off-budget expenditures and the wider public sector (parastatals and agencies). In general those ministries and other agencies that play the most critical role in the PFM system should be covered, in particular those channelling the largest amounts of funds. Any significant gaps should be highlighted and considered for future diagnostic work. This may be the case, for example, when significant service delivery responsibilities are devolved to federal levels through block grants. In addition, the sub-national level should also be analysed in cases of a high degree of fiscal decentralisation, i.e. high autonomy and discretion for the management of an important share of revenues and/or expenditures by sub-national governments. PEFA PI-8 indicator would be an important source of information but a complementary PEFA at sub-national level should be considered when programmes focus on specific regions or states.

Regarding the related **data** for public finance, they should be accessible for all levels of governments (see below figure 1). In practice it is often difficult to access sub-national government data in countries with a high level of fiscal decentralisation. This section should include the share of budgetary resources outside the control of the government using the information available in the PEFA report. Where sub-national data may not be available, a dialogue based on the Government Financial Statistics⁽⁶²⁾ reporting standards may lead to measures to overcome the problems.

⁽⁶¹⁾ An important aspect of dialogue on PFM is agreeing on what the programme of diagnostic work should be. While the PEFA offers a comprehensive overview of the functioning of the PFM system as a whole, there may be specific areas where more detailed work is considered necessary. This may lead to further diagnostics to 'drill down' in a particular area. In view of the importance of its role in managing public funds, the procurement system is one area where additional diagnostics are often undertaken to provide a more complete picture of the functioning of the PFM system.

⁽⁶²⁾ The 2001 Government Financial Statistics manual is available in IMF's website: <http://www.imf.org/external/pubs/ft/gfs/manual/>

Figure 1 – The structure of the public sector



Findings of Supreme Audit Institution reports [1/2 page]

A second essential element to this section is a brief report of **highlights of the findings of the most recent supreme audit institution (SAI) audit reports**⁽⁶³⁾ with implications for the overall PFM system. The emphasis should be placed on compliance issues as they give an indication of the performance of the system as a whole. As a first step, the timing and availability of audit reports in line with statutory provisions should be summarised in the table in Appendix 2 with associated comments provided in this section. Furthermore, the **response of government** to the recommendations and findings should be summarised.

Sector issues [1/2 page]

Where the proposed budget support operation focuses on a **sector**, the financial management specificities of the sector should also be analysed and when relevant they should be included in the monitoring table (Appendix 1). Examples of sources of information include Public Expenditure Reviews, Public Expenditure Tracking Surveys although these are heavy assessments which cannot be conducted annually. Thus it would also be important to highlight **the findings of the annual audit report** in the sectors concerned and the government's response, when available.

The analysis of the sector specificities is of particular importance when the financial management within the sector: i) includes specific systems, ii) systems with some variations or iii) systems which differ significantly from the standards of financial governance across government. Examples of critical issues to be addressed in sector assessments of PFM include:

- (a) **Procurement systems** when separate systems have been set up such as drugs in health or with particular importance such as construction contracts in infrastructure taking into account in the analysis their consistency with the national procurement system that should remain the reference.
- (b) **Payroll performance** which is critical for human resource intensive sectors, typically education or health taking into account in the analysis their consistency with the national procurement system that should remain the reference.

⁽⁶³⁾ Audit of financial statements of consolidated funds or "compte de gestion" for francophone countries.

- (c) **'Off-budget' funds** such as road funds, social security funds, and other earmarked funds that may be financed outside the mainstream tax system, or which may be financed from general taxation but earmarked for specific use.
- (d) **Level of fiscal decentralisation.** In countries where a critical share of the budget is directly under the responsibility of local governments, PFM at the sub-national level should be analysed separately. Note that some governments present only central government accounts, while others may present consolidated general government accounts which include provincial and local authority expenditures.

Identifying key weaknesses [1/2 page]

Based in the above diagnostic reviews, audit findings and sectoral challenges, the main short-term and medium term challenges to the PFM system should be briefly outlined in a paragraph.

Building on the brief summary, the next key issue is to **identify the critical weaknesses of the PFM system and the baseline against which progress will be monitored.** This section should identify what the Commission considers to be the main weaknesses in the national PFM system and sector or sub-national system for sector reform contracts when relevant. **In order to prepare the way for the subsequent analysis of the strategy, the key weaknesses addressed should be reproduced in Column 2 of the monitoring framework in Appendix 1.**

Key reforms to be monitored as part of the PFM dialogue often emerge quite naturally from the dialogue that takes place in the wake of PFM assessments and results in a shared appreciation of the most important weaknesses. Importance should be given at the medium term expected results the annual PFM reform actions are expected to achieve. Tracking the medium term direction of change will be done by using as benchmarks the three budgetary outcomes measured through the 28 indicators of the PEFA PFM performance framework, namely: i) aggregate fiscal discipline, ii) strategic allocation of resources and iii) efficient service delivery. In addition, in order to meet these objectives, financial compliance with laws and regulations is necessary by having core PFM functions in place.

Within these areas attention should focus on reforms which are of critical importance in improving PFM budgetary outcomes over the expected duration of the budget support operation and according to the type of contract while ensuring a good balance across the outcomes and a respect of the appropriate sequencing of reforms for each country. On the latter, before moving to any advanced reform, basic compliance systems or core PFM systems should be operational as this is necessary for all three budgetary outcomes. A suggested differentiation for the monitoring of each type of contract, taking into account that the effective management of funds can differ across sectors, could be as follows:

- For Good Governance and Development Contracts all three budgetary outcomes as well as financial compliance should be covered keeping the focus on strengthening the core systems to improve governance and tackle corruption.
- For sector reform contracts, while monitoring key weaknesses of the overall PFM system, focus should be on achieving efficient service delivery by targeting weaknesses specific to the sector.
- Finally for State Building Contracts, restoring core PFM functions should be the priority to ensure that some level of financial compliance can progressively be achieved.

In cases where there is the absence of a budget, a rudimentary treasury system⁽⁶⁴⁾ or a mechanism for budget execution reporting⁽⁶⁵⁾, budget support will not be considered. Where such core functions exist but are weak, typically in fragile situations supported through State Building Contracts, specific short term measures and additional safeguards would generally be required in the form of specific conditions that would need to be fulfilled prior to the disbursement of the first tranche. In addition, the targeting of disbursements to specific expenditure lines such as civil service salaries or arrears clearance may also be appropriate in this context. The need for complementary support required in the form of technical assistance should also be considered in order to address these specific weaknesses.

The Government's PFM Reform Programme [1/2 page]

This section should summarise past, present and planned government initiatives to strengthen PFM. Where there is a comprehensive and fully articulated PFM reform strategy document this can be briefly summarised in terms of its

⁽⁶⁴⁾ In this case a treasury system would be a system that oversees and accounts for the principal Government revenues, and disbursements whilst also taking responsibility for cash management and government bank accounts.

⁽⁶⁵⁾ A mechanism for budget execution reporting should be in place to allow some control over spending at least on an annual basis.

coverage, activities, and objectives. In countries where such a unified strategy document does not exist but a range of discrete reforms are nevertheless being pursued then these should also be described in terms of the problems that they seek to address and their objectives. Attention should also be given to organisational aspects such as institutional leadership, coordination issues and broader ‘political economy’ aspects of the nature of the reform programme (see section 3.2.4).

In order to prepare the way for the analysis of the relevance and credibility of the strategy, the objectives of the reform programme should be reproduced in the monitoring framework in Appendix 1. This should cover both short-term objectives (columns 3) and medium term objectives (column 6).

4. ELIGIBILITY TO BUDGET SUPPORT [3-4 PAGES]

Assessment of relevance of the strategy

This section should arrive at a reasoned judgement as to the relevance of the PFM reform strategy.

The key criterion for assessing the relevance of the reform programme is the extent to which key weaknesses are being addressed by the strategy. In terms of the monitoring framework in Appendix 1, this means that there is a meaningful set of objectives that can be monitored (columns 3 and 6) set against each of the key weaknesses identified (Column 2).

Where there is a gap, i.e. a key weakness is not subject to reform measures, reinforced dialogue and/or further explanation are needed. It may be acceptable for a key weakness to remain unaddressed over the short term due to sequencing issues (see section 3.2 below). In such cases a full explanation should be provided justifying the apparent ‘gap’ in the reform programme. Alternatively, the existence of such a gap may be considered by the Commission to be an important omission that warrants further dialogue and should be addressed before moving forward with the assessment of eligibility.

Assessment of the credibility of the strategy

The credibility of the strategy is determined by various factors⁽⁶⁶⁾ **that will influence the success or failure of reforms** including the appropriate sequencing, appropriate institutional arrangements, donor coordination, allocation of resources, political ‘buy in’, links to anti-corruption efforts and the reform track-record when relevant etc. An assessment of these aspects should be taken together, along with considerations of relevance, to arrive at the judgement of eligibility.

■ Sequencing issues

In this section Delegations should explain how priorities have been set, how the sequence has been determined and whether the “basics first” principle, explained below, has been applied, and, finally express a view as to how appropriate they are judged to be in the light of the key weaknesses identified. A brief overview of the sequencing approaches is provided below but for more details on the different reform sequencing approaches please refer to the sequencing literature⁽⁶⁷⁾.

It is important to keep in mind that PFM sub-systems are strongly linked and failure in any of them can have a negative impact on the other sub-system, undermining the effectiveness of the whole budget system. Weaknesses identified in the PEFA PFM report and from other sources will be the starting point for the design of a reform in a given country. Together with the specific external factors (i.e. political, organisational, institutional) they will determine the required optimal country-specific prioritisation and sequencing.

It should be noted however that the approach to simply take the aspects of the PFM system that rate the lowest in the most recent PEFA assessment is an anti-strategic approach that ignores relations between the overall system. The recommended approach⁽⁶⁸⁾ should be rather to prioritise the core PFM systems and analyse whether the “PFM basics”

⁽⁶⁶⁾ The set of issues to be analysed in this section are very close to the framework for analysing the non-PFM factors determining success or failure of reforms currently under development. J. Diamond in “The Non-Technical Context of PFM Reform (draft July 2011) proposes a three tier framework for their analysis including i) the conditioning factors (political environment, economic development, social governance and technological and capacity), ii) Institutional structure of the PFM system (including relationships of MOF with other relevant government stakeholders and iii) Internal organisation of PFM processes.

⁽⁶⁷⁾ Tommasi D. (2008) Strengthening Public Expenditure Management in Developing Countries Sequencing Issues.

⁽⁶⁸⁾ The European Commission and the IMF are working on a guidance note on the Sequencing to PFM reforms expected to be available by mid-2012.

as popularised by Allen Schick are already in place. Ensuring reliable accounting and financial reporting would for instance be part of these essential systems. If the core PFM systems are already in place efforts should be to go beyond.

■ Political buy-in

Successful reforms in public financial management systems are more likely to occur when there is a high level of political commitment to reforms and leadership. Some of the key issues to look at when analysing this aspect include indicatively: level of commitment to reforms within the government, level of appointee in charge and his power (i.e. Minister of Finance, President, director of department), references to reform agenda (i.e. in speeches, international events, and parliamentary auditions), degree of turnover of reform leaders and local incentives systems towards change and improvements. Reforms are also influenced by the context in which the PFM system evolves such as power of ministry of finance, its relationship with other line ministers where the reforms have to be rolled out, relationship with the Parliament, structure of government, role of the Supreme Audit Institution and its ability in scrutinising, role of citizens and civil society organisations and strength of domestic accountability systems.

The political dimension to reform is not only a risk to mitigate but also an opportunity to seize. Demand for better governance and greater accountability is a key driver of change in budgetary systems. This demand emerges from both the formal institutions (parliaments or supreme audit institutions) and informal mechanisms (civil society, media and citizens). **With these considerations in mind, this section should identify the key political opportunities and constraints to the reform process.** Attention should therefore be given to the existence of champions, entrenched resistance, sectoral interests, conflicts etc.

■ Corruption, fraud⁽⁶⁹⁾ and Public Financial Management

The issue of corruption and fraud extends beyond the public finances and their management. At the same time, it is recognised that strengthened PFM systems are a key plank of any credible programme for preventing and controlling corruption. In this respect, certain aspects of the PFM system are critical, such as public procurement, internal control, and the role of external scrutiny and domestic accountability.

Corruption is a complex issue affecting public institutions and citizens as well as different processes in a society, and can be a major obstacle to achieve development objectives. **In this respect there are two broad sets of issues within corruption:**

The first is where public policy, including fiscal policy, is influenced in the legislature or by the executive for personal or group gain; for example, influencing tax policy to favour powerful groups, or directing public expenditure for sectional interests using illegal means. This aspect of corruption could negatively impact the achievement of the objectives of a policy and if arising should be taken into account for the risk management assessment (see annex 7).

The second is corruption related to weaknesses in the PFM system resulting from leakages in procurement, for instance; often most acute in the capital budget or from weaknesses in payroll management.

This section should therefore only focus on identifying the second aspect and explaining anti-corruption efforts within the PFM reforms which will affect the eligibility for PFM. While specific attention should be paid to grand corruption cases and more particularly to the follow up ensured by the Government and the judicial system, systemic and low-level corruption should not be ignored. Where there is information, some indication of the scale and type of corruption should be provided. Where the Commission and other actors are involved in anti-corruption measures, these should be recorded.

■ Institutional arrangements and coordination

In this section, Delegations should briefly describe the institutional and coordination arrangements for the delivery of PFM reforms, highlighting any challenges and addressing the considerations below.

In view of the complexity and sensitivity of PFM reforms, the degree to which they are coordinated and managed has an important bearing on their potential for success. PFM reforms potentially involve major shifts in responsibility

⁽⁶⁹⁾ In criminal law, a fraud is an intentional deception made for personal gain or to damage another individual. However the specific legal definition varies by legal jurisdiction. Fraud is commonly understood as dishonesty calculated for advantage. For the European Union the definition can be found in Article 1 of the Convention drawn up on the basis of Article K.3 of the Treaty on European Union, on the protection of the European Communities' financial interests (OJ C 316, 27/11/1995, p. 49).

from the ministry of finance to line ministries; substantial changes in the incentives and power relations within ministries; and implications for recruitment and retention.⁽⁷⁰⁾ Moreover, the involvement of independent areas of government such as parliament and supreme audit institutions in the PFM system also presents potential coordination problems. The involvement of donor support also adds to the complexity.

A further consideration in this context is the availability of staff and other resources. The allocation of well skilled personnel and the availability of technical expertise is a key factor in determining the potential success of PFM reforms. The role of donors in this context is often important. A key criterion in assessing credibility is therefore the domestic budgetary and donor resources allocated to key reforms.

■ Institutional weaknesses and capacity building

Linked to the previous point, a matrix should be presented (see suggested format in Appendix 5) recapitulating, by area and donor, the main institutional support actions in PFM field. Comments should be made, whenever relevant, on those projects which have serious implementation issues likely to negatively impact on the success of reforms. Success stories might also be flagged.

This section should draw the links between the key areas of PFM weaknesses, the key priorities for reform and the capacity building and technical support being provided. The matrix presented in appendix 5 should be used as a reference. **Any gaps should be highlighted with proposals on how to address them.** Where such support is envisaged as part of the budget support operation, this should be set out in section 4.

■ Reform track-record

The performance record in implementing the reform when reforms have been ongoing should be analysed. If reforms have been unproductive in the past, explain the changes made that could make a difference this time around. Refer also when relevant to areas being politically sensitive in your country. This question will not be relevant for countries in fragile state situation particularly after a conflict when there is no recent track record of the reform.

Conclusions on Eligibility

This section should draw a basic conclusion on relevance and credibility by explicitly addressing the following:

- (i) The PFM reform strategy is considered sufficiently [/insufficiently] **relevant** because.... (a key consideration here is the matching of key weaknesses and the objectives of the reform programme).
- (ii) The PFM reform strategy is considered sufficiently [/insufficiently] **credible** because.... (here a balance of the main factors in section must be explicitly weighed to arrive at a judgement).

Where there are concerns about relevance and/or credibility these should be highlighted for further dialogue with the authorities.

5. PFM DIALOGUE AND CAPACITY BUILDING [1 PAGE]

This section will be used to set up the dialogue agenda regarding PFM issues for the Delegation underlining the issues of particular focus for the Delegation (possibly with other donors) for the first year of programme implementation or, if different, by the first expected payment. It should be drawn on the short-term objectives in appendix 1. This section should also explain what are the short term measures needed in very weak systems during the first year.

A critical part of the dialogue is agreeing a coordinated approach to diagnostics that avoids overloading government and respects national priorities.

Finally, the specific capacity development support foreseen should be explained in this section. Links with the gaps identified in section 3.2 should be made.

⁽⁷⁰⁾ This section draws on Harmonising Donor Practices for Effective Aid Delivery, Volume 2: Budget Support, Sector Wide Approaches and Capacity Development in Public Financial Management, OECD, Paris, 2006.

6. LIST OF ANNEXES TO THE SUPPLEMENTARY DOCUMENT TO THE ACTION FICHE (Templates included in part III of this annex)

- 1) Summary table of PFM performance and reform programme monitoring (with stylised example)
- 2) Timing and availability of annual external audit reports
- 3) Summary of PEFA scores
- 4) Matrix of donor support to PFM
- 5) List of background documents consulted (with list of possible sources of diagnostic information)

ANNEX 5: ASSESSING PMF ELIGIBILITY – PART II: ANNUAL MONITORING REPORT

1. KEY FEATURES [1 PAGE]

Financial year:	e.g. July/June
Last PEFA/ Diagnostic Study:	Date of publication and financial year referenced
Last annual accounts submitted to Auditor General / Court of Auditors:	Date of submission and financial year of reference
Last annual audit report:	Date of submission and financial year referenced
(Audit of financial statements of consolidated funds /"compte de gestion")	Date of last discharge or equivalent report by the Parliament
Basis/Forum of PFM dialogue	Level of representation and date of last formal level meeting
Reform Programme:	Title of strategy document or equivalent, date of government endorsement, period covered⁽⁷¹⁾

2. MAIN HIGHLIGHTS IN DEVELOPMENTS OVER THE PAST YEAR [2 PAGES]

The focus of this report is not a comprehensive overview of the entire PFM system such as with the Supplementary Document to the Action Fiche. Rather, the focus should be on reporting key developments that have emerged during the past year and since the previous report, consistently with the dynamic approach. Demonstration of eligibility should focus on how key priorities are being addressed and results achieved and on how key weaknesses are being addressed using in the monitoring framework defined. In cases of more than one budget support in a country, where significant weaknesses in the management of public funds and lack of progress is experienced in a specific sector, a different conclusion on the PFM eligibility could be reached for the given programme.

As mentioned in the introduction to this PFM annex, it is not expected that the judgement on the relevance and credibility of such programmes will change on an annual basis since PFM reform programmes typically take a medium-term perspective (e.g. 3 to 5 years or more). In the case of countries where budget support programmes are committed on an annual basis, this means that the same analysis of a PFM reform programme could effectively be used to justify eligibility at the end of formulation over a number of years. In such cases, however, it would still be necessary to update the monitoring framework by specifying the appropriate baseline and reform expectations to be used during implementation.

⁽⁷¹⁾ A single reform strategy document may not always be in place. It is common to see the external audit reforms or the revenue reforms treated separately. In such cases, the different reforms should be listed.

This section should be brief and only include the main highlights using the box below. It should be completed once the main report is finalised as this is a summary of the assessment.

1. Main developments in the implementation of the PFM reforms

1.1. Key quantitative progress in addressing PFM weaknesses (against annual targets)

-
-

1.2. Negative developments

-
-

1.3. Overall direction of change (including processes, plans and commitments)

1.4. Availability and key findings of latest supreme audit institution report

2. Assessment of relevance of government's PFM reform strategy

2.1. Main outstanding challenges faced by the PFM system

- Short term (next 12 months)
- Medium to long term

2.2. Adjustments of the strategy if any

3. Assessment of credibility of government's PFM reform strategy (including efforts to tackle corruption)

4. Delegation's conclusion on PFM eligibility

5. Quality of the dialogue in PFM (substance and process)

3. PROGRESS IN IMPROVING PUBLIC FINANCIAL MANAGEMENT [5 PAGES]

Summary and analysis of quantifiable progress

This section is **the core of the PFM Annual Monitoring Report**. It should take as its starting point the articulation of the system improvements and reform expectations as set out prior to the approval of the programme. This should have been detailed in the monitoring matrix included in the Supplementary Document on Public Financial Management which was submitted with the Action Fiche.

The baseline for this assessment should be the summary table (or annex 1 included in Part III) which sets out progress achieved and expectations in terms of both **performance** and **reform measures and actions**. As significant improvements in PFM systems can take time to show improved outcomes, and hence to engender movements across PEFA scores (e.g. from C to B), PEFA scores cannot be used for this purpose.

PFM **performance** should be monitored through quantitative data on PFM outputs e.g.: aggregate expenditure out-turn compared to budget (PEFA PI-1), reduced delays in external audit reports etc. Findings of annual audit reports from partner countries' Supreme Audit Institutions will also provide useful information regarding the budget execution performance, particularly on sector management of funds.

The second element is the **progress in the implementation of the strategy**. This section should therefore analyse the progress in individual measures and actions that were planned for the reporting period, comparing expectations with progress and highlighting emerging issues relating to the implementation or coherence of the strategy.

In the case of absence of progress in addressing a weakness in sector, affecting severely the implementation of the sector budget, this could lead to a decision of non fulfilment of the criterion for the respective sector only.

Other evidence of progress

It is not always possible to track progress in quantitative terms. For this reason, processes, plans and even commitments are also relevant in giving an indication of the direction of change and inform a judgement as to whether the PFM reform strategy is on track. This section should detail these additional factors.

At the same time, **institutional factors and power structures** also have a significant influence on the prospects for reform. These issues should also be addressed taking the material initially presented in the Supplementary Document to the Action Fiche (Section V covering political economy issues) and updating as appropriate.

Recent annual audit reports, implications and follow up

■ Timing and availability of audit reports

Explain briefly the **timing and availability of audit reports** in line with statutory provisions and summarise them in the table in appendix 3.

■ Key findings

Summarise the **key findings** of the report which are of relevance to European Commission's budget support reporting setting out the details of how this process has evolved since formulation or the last PFM report. The report should cover the two aspects as follows:

Overall PFM system: Report on highlights of the findings of the most recent audit report with implications for the overall PFM system. The emphasis should be placed on how **compliance issues** that may emerge give an indication of the performance of the system and the direction of change.

An issue to be borne in mind is that a judgement may have to be made as to whether more critical findings are the result in deterioration in compliance (performance of the PFM system) or the increased capacity and independence of the audit authority.

Sector issues: Report on specific highlights of the findings of the annual audit report in the sectors where the Commission is engaged in budget support. This analysis is of particular importance where the sector follows specific public financial management rules that depart from overall public financial management systems. This is the case, for example, of Road Funds, public agencies, parastatals or local governments (see section 5.7 of part I).

Follow-up of audit reports

This section should set out how the issues identified in (3.3.1) and (3.3.2) above are being followed up through both:

- **Response from government** to audit findings, including responses to previous reports. Describe the formal statutory process for treating audit reports (parliamentary scrutiny, parliamentary reports, executive response e.g. Treasury letter) and provide an account of the recent cycle of such reports, focusing on government's action.
- **Response of Delegation and other donors through the PFM dialogue.** Describe the process and substance of dialogue between government and donors on the key findings of the recent audit reports and the responses by Parliament and government.

4. ASSESSMENT OF CONTINUED RELEVANCE OF THE STRATEGY [1 PAGE]

Recent diagnostic work: key issues

Do not cut and paste from the available diagnostic work e.g. PEFA, CFAA, CPAR etc but provide a *very brief* summary of the process and findings of the most recent diagnostic work since the last report. Where a repeat PEFA has been done, a brief summary of the comparative scores should be made (drawing on annex 2 included in Part III of this annex). The main short-term and medium term challenges to the PFM system should also be briefly outlined.

Implications for the reform programme

In the light of the latest review, the continued relevance of the current strategy should be re-assessed and any implications for a revision highlighted.

5. ASSESSMENT OF CONTINUED CREDIBILITY OF THE STRATEGY [2 PAGES]

Corruption, fraud and PFM

This section should report on the efforts to tackle corruption within the PFM reforms monitoring the issues presented in the initial PFM eligibility assessment at the programme formulation. It is recognised that strengthened PFM systems are a key plank of any credible programme for preventing and controlling corruption. In this respect, certain aspects of the PFM system are critical, such as public procurement, payroll management, internal control, and the broader domestic accountability nexus.

This section should document the most notable recent cases of alleged corruption, the government's response and positions taken by donors. However the focus should be on the cases with implications for the quality of the PFM system e.g. procurement, oversight bodies, internal control should be highlighted.

The broader corruption issues not strictly linked to PFM should be taken into account in the risk assessment as explained in Part I of this Annex (see Risk Management annex 7 to the budget support guide).

Coordination, capacity building and coherence

■ Donor coordination

Describe briefly the quality of the coordination, between donors and with government, of institutional support planning and monitoring covering PFM and anti-corruption issues.

What degree of harmonisation has been reached by the Donors in the PFM field, especially in the area of diagnostics?

■ Capacity building

Update the table "Development Partners' Interventions in PFM" prepared with the Supplementary Document to the Action Fiche, using the template in appendix 4 which recapitulates by area and donor the main institutional support actions in the PFM field.

Comment, *whenever relevant*, on those projects which have serious implementation issues likely to negatively impact on the success of reforms (IFMIS, basket fund etc). Success stories might also be flagged.

Coherence in supporting PFM weaknesses

This section should draw the links between the key areas of PFM weaknesses, the key priorities for reform and the capacity building and technical support being provided. The matrix presented in annex 1 in Part III should be used as a reference. Any gaps should be highlighted with proposals on how to address them.

6. CONCLUSIONS ON ELIGIBILITY [1/2 PAGE]

On the basis of the analysis above confirm whether the eligibility criterion is fulfilled. The assessment of satisfactory progress in improving public finance management systems should take into account i) quantitative progress achieved against annual targets and ii) positive direction of change.

7. QUALITY OF THE DIALOGUE [1/2 PAGE]

This section should detail the *substance* and *process* of the dialogue on PFM issues. Key issues discussed should be recorded in column 4bis of annex 1 in Part III. The frequency of meetings and the level at which they are held (on both government and donor sides) should be made explicit. Issues which may warrant discussion in political dialogue should be highlighted.

Further questions to be considered include:

- Does it cover new issues on PFM which were not addressed before?
- Does it have any linkage with policy dialogue on crosscutting issues like corruption and the reform of public sector?
- Has it contributed to the definition and/or implementation of a (revised) PFM improvement strategy or reform programme?
- Does the dialogue include all arms of the PFM system (executive, parliament, auditor general)?
- What is the role of civil society organisations in the reform process?

8. LIST OF ANNEXES TO THE ANNUAL MONITORING REPORT ON PUBLIC FINANCE MANAGEMENT (Templates included in part III of this annex)

- 1) Summary table of progress against performance and reform expectations
- 2) Timing and availability of annual external audit reports
- 3) List of background documents consulted

ANNEX 5: ASSESSING PMF ELIGIBILITY – PART III: ADDITIONAL GUIDANCE

- I. **Appendices to the Supplementary Document to the Action Fiche and to the Annual Monitoring Report on Public Finance Management**
 - 1) Summary table of PFM performance and reform programme monitoring (Stylised examples for formulation and for annual monitoring report provided)
 - 2) Timing and availability of annual external audit reports
 - 3) List of background documents consulted (List of possible sources of diagnostic information provided)
- II. **Template for Cover Letter from Head of Delegation to Director for submission of Public Financial Management Report**

Progress to be monitored during the lifetime of the current programme.					
1	Dimensions of PFM system where key weaknesses have been identified	2	Baseline: Key specific weaknesses identified in diagnostic work (PEFA etc)	3	Short term reform expectations (one year) as set out at formulation stage. (To be updated subsequently by subsequent annual reports from previous year's column 5)
Accounting, Recording and Reporting		4	Evolution since formulation or last Annual Monitoring Report: a) Performance b) Reform process Source of verification	4 ^{bis}	Summary of policy dialogue
		5	Revised objectives to be monitored for the next year (Becoming next year's column 3)	6	Medium term targets of the PFM reform programme
				Fully comprehensive financial statements prepared within the statutory deadline	

Progress to be monitored during the lifetime of the current programme.								
1 Dimensions of PFM system where key weaknesses have been identified	2 Baseline: Key specific weaknesses identified in diagnostic work (PEFA etc)	3 Short term reform expectations (one year) as set out at formulation stage. (To be updated successively by subsequent annual reports from previous year's column 5)	4			6		
			Evolution since formulation or last Annual Monitoring Report: a) Performance b) Reform process Source of verification			Medium term targets of the PFM reform programme		
Accounting, Recording and Reporting	Major delays and quality issues in annual financial statements	Annual financial statements include decentralised arms of government.	4 ^{bis}			5		
			Summary of policy dialogue			Revised objectives to be monitored for the next year (Becoming next year's column 3)		
						Fully comprehensive financial statements prepared within the statutory deadline		

GUIDANCE FOR THE COMPLETION OF THE TABLE

General

The stylised example is for illustrative purposes only in order to give an idea of the type of possible reform areas that could be monitored. The actual contents of the table will be determined on a country-by-country basis drawing on the weaknesses identified in the PEFA and other diagnostics, and the priorities of government reform programme.

■ Column (1): Dimensions of PFM system where key weaknesses have been identified

This column is simply a broad categorisation of the PFM system and follows the 6 areas retained in the PEFA. In each of these 6 areas of the national PFM system one could expect a number of reform expectations. Some of areas may not be covered depending on the priorities and sequencing set out in the PFM Reform Strategy.

■ Column 2: Key specific weaknesses identified in diagnostic work (PEFA etc)

This column should list those areas that have been identified in the available diagnostic work as key weaknesses of the PFM system. It is the baseline therefore should remain the same during the programme implementation. In addition, specific weaknesses in the management of funds of a sector or sub-national level should be added in the case of sector reform contracts when relevant (see section 3.3 of Part I of this PFM annex).

■ Column 3: Short term (one year) reform expectations as set out at formulation stage and revised successively by subsequent annual reports

This column should be derived from the government's reform plans and ongoing actions. It should therefore set out reforms that are expected to be achieved over the lifetime of the budget support programme both in the first year as well as for the medium term. After the first year, this column will have to be revised in the light of progress and evolving priorities; this is to be addressed in the PFM Annual Monitoring Report. The material to be included should then be drawn from the previous year's Annual Monitoring Report (AMR) column 5 i.e. the forward looking element of the AMR which indicates the immediate reform expectations.

■ Column 4: Evolution since formulation/last Annual Management Report

This section should be left blank at the formulation stage and be filled in at successive PFM Annual Monitoring Reports setting out actual progress. PFM **performance** should be monitored through quantitative data on PFM outputs (see section 3.1 of part I)

■ Column 4 bis: *Summary of policy dialogue*

This column will be used to keep a record of the key points discussed with the government regarding each identified weakness.

■ Column 5: Revised objectives to be monitored for the next year

This is the forward looking element of the AMR which indicates the immediate reform expectations in the light of progress made and reported in column 4. In this way the AMR effectively becomes a rolling monitoring tool that is sufficiently flexible to adapt to actual progress and/or revised strategic goals.

■ Column 6:

The column recalls the medium term goals of the reform programme as presented at the end of formulation. The medium term reform horizon may, and often will, extend beyond the timeframe of a typical three year budget support programme and is included here to show the longer term context within which PFM reforms operate.

“Stylised example for ANNUAL MONITORING REPORT” – Summary table of PFM performance and reform programme monitoring.

Progress to be monitored during the lifetime of the current budget support programme.					
1	2	3	4	4 bis	5
Dimensions of PFM system where key weaknesses have been identified	Baseline: Key specific weaknesses identified in diagnostic work (PEFA etc)	Annual objectives: a) quantitative performance b) reform expectations: (set out at formulation stage). (To be updated successively by subsequent annual reports from previous year's column 5)	Evolution since formulation or last Annual Monitoring Report: a) Performance b) Reform process Source of verification	Summary of policy dialogue discussions	Revised objectives to be monitored for the next year (Becoming next year's column 3)
Accounting, Recording and Reporting	Major delays and quality issues in annual financial statements	Annual financial statements include decentralised arms of government	a) Compliance of lower tiers of government with accounting standards and deadlines improved b) Reorganisation of Accountant General's Office and accounting cadre in line ministries with a view to more effectively meeting statutory requirements.		Further progress in compliance by lower tiers of government.
					Fully comprehensive financial statements prepared within the statutory deadline

Appendix 2 – Timing and availability of annual external audit reports

Latest year for which an audit report is available (N)				Year N-1				Year N-2			
Annual accounts		Audit report		Annual accounts		Audit report		Annual accounts		Audit report	
Due date*	Date of sub-mission to SAI	Due date*	Date of sub-mission to Parlmt.	Due date*	Date of sub-mission to SAI	Due date*	Date of sub-mission to Parlmt.	Due date*	Date of sub-mission to SAI	Due date*	Date of sub-mission to Parlmt.

*Due date for submission to Supreme Audit Institution (accounts) and Parliament (audit report) in accordance with national legislation.

APPENDIX 3: LIST OF BACKGROUND DOCUMENTS CONSULTED (with list of possible sources of diagnostic information)

This appendix should reference all source materials consulted to prepare this supplementary document. Below an indicative and non-exhaustive list of possible sources of information on PFM is provided. This appendix should reference all source materials consulted to prepare this supplementary document.

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

The following provides a non-exhaustive list of possible sources of information on PFM. A critical part of the dialogue is in fact agreeing a coordinated approach to diagnostics that avoids overloading government and respects national priorities.

- (a) Public Expenditure and Financial Accountability (PEFA) Performance Measurement Framework: The PEFA Performance Measurement Framework is the preferred tool of assessment of the EC and typically serves as the basis of the development of a common information pool for donors and governments. Such assessments provide the basis for determining key weaknesses and the priorities for the eventual reform plan.
- (b) OECD/DAC Methodology for Assessing Procurement Systems (MAPS): Common tool which developing countries and donors can use to assess the quality and effectiveness of national procurement systems. The assessment should provide a basis upon which a country can formulate a capacity development plan to improve its procurement system.
- (c) Public Expenditure Reviews (PER): They analyse the allocation and management of public expenditure. They may cover all government expenditure or focus on a few priority sectors (e.g. health, basic education, agriculture, water, roads). Increasingly, PERs also review expenditure management systems and institutions, in recognition of the fact that it is the institutional framework, organisational capacity, and everyday expenditure management practice of government which determines the allocation and management of public expenditures. A PER should analyse past performance in terms of resource allocation and service delivery in order to be able to make a realistic assessment of what the sector should be aiming to achieve in the medium term.
- (d) Public Expenditure Tracking Surveys (PETS): PETS have emerged as a popular tool for identification of problems with the flow of resources between different levels of public administration and frontline service providers. Public Expenditure Tracking Surveys, or PETS, are recognised as an effective tool to improve accountability in public finance and service delivery. A Ugandan success with PETS is one of the most cited anti corruption success stories. Expenditure tracking has also become a popular activity among civil society organisations engaged in accountability issues at the local level.
- (e) Reports on the Observance of Standards and Codes (ROSC): The IMF conducts ROSC exercises in a number of areas but the relevant module for PFM assesses performance against the Code of Fiscal Transparency (Fiscal Transparency ROSC). This Code identifies a set of principles and practices to help governments provide a clear picture of the structure and finances of government.
- (f) Supreme Audit Institution audit reports: The Supreme Audit Institution (SAI) should submit reports on an annual basis to the legislature.
- (g) Government documentation: the government may have undertaken its own assessment of reform performance, and identified weaknesses that need to be addressed.
- (h) Civil society groups, independent fiscal research institutions, universities, think tanks, NGOs, business associations and others may have published assessments of PFM.

III. Template for Cover Letter from Head of Delegation to Headquarters

Note to the Attention of XXX

Director [DEVCO geographical directorate]

Subject: Transmission of Annual Public Finance Management Report for Country X

Programme Reference (CRIS decision number):

Please find attached the Delegation's Public Financial Management Annual Monitoring Report. I hereby confirm that on the basis of the following key assessments, COUNTRY X is making **satisfactory/unsatisfactory** progress in improving its PFM systems and therefore remains **[is no longer]** eligible for budget support. This conclusion is based on the following⁽⁷²⁾:

Executive Summary and Main Conclusions

Continued relevance of PFM reform strategy

Does the reform programme still respond to the key challenges? If not, is dialogue underway to address this?

Dialogue on PFM reform

How frequently and at what level has dialogue on PFM issues been conducted with the government in the last year? Does this include all arms of the PFM system (executive, parliament, auditor general)? What is the role of civil society organisations in the reform process?

How regularly have PFM issues been discussed with government and at what level? Are Heads of Mission involved? Are there issues relating to the findings of this report that warrant inclusion in the political dialogue with the country?

Progress in PFM performance

Do the main developments in the report justify a conclusion of progress in performance?

Progress in the PFM reform programme

Do the main developments in the report justify a conclusion of progress in reform implementation?

Publication and findings of the latest supreme audit institutions reports

Does the timing and availability of accounts and audit reports give confidence that the budget is subject to timely oversight and scrutiny?

Are the findings sufficiently serious to raise questions about financial management risk of government funds?

Are the findings being addressed by the government? Is this done in a systematic manner?

Do the findings suggest the need for possible risk mitigating measures to be considered in the future implementation of budget support programmes (e.g.: enhanced dialogue, launching of expenditure tracking surveys, establishing agreed short-term specific action plans in PFM etc.).

Efforts to tackle corruption and fraud

Is the government demonstrating commitment to tackling corruption and fraud? This question should be answered with reference to institutional changes to the anti-corruption bodies and the governments' response to any possible cases of corruption or fraud.

[Head of Delegation's signature]

⁽⁷²⁾ The Executive Summary and Conclusions should form the basis of the Head of Delegation's cover letter.

Annex 6: Assessing eligibility on Transparency and Oversight of the Budget

1. This Annex provides the templates for assessing the eligibility criterion on transparency and oversight of the budget, first, when formulating a budget support programme (**initial eligibility**), and, second, when deciding on the disbursements (**ongoing eligibility**).
2. For that purpose, this Annex consists of two templates. The first one proposes an annotated template for the supplementary document to be submitted together with the **Action Fiche** for programme approval. This document aims at assessing the initial eligibility by deciding whether the entry point is met (initial eligibility). In addition, the assessment identifies key weaknesses, the baseline, and the **medium** term objectives on budget transparency for the implementation of the budget support programme, including policy dialogue and capacity development measures to strengthen accountability.
3. The second template aims at preparing the disbursement decision by assessing whether the entry point is met and by monitoring progress (**ongoing eligibility**). Beside the entry point, the country needs to show satisfactory progress with regard to the baseline and objectives on budget transparency identified during the formulation phase. As most of these reforms take time, it is not required to show annual progress, but to focus on medium term reform expectations.

TEMPLATE A: SUPPLEMENTARY DOCUMENT TO THE ACTION FICHE

1. ASSESSING THE ENTRY POINT

In this section, the delegation is asked to assess if the entry point is met. The entry point is defined as following: The government must have published its budget within the past or current budget cycle (either the Executive's budget proposal or the enacted budget). That means that the government had to publish the budget of the past budget cycle within the respective fiscal year. In order to have the possibility to reward progress in budget transparency from the last to the current fiscal year at the time of the assessment, the publication of the current budget within the current fiscal year may also lead to the fulfilment of this criterion. In general, the budget should be available to the general public in printed form or on a website. Under certain circumstances, the programme approval will depend at least on the commitment of the partner country to meet the entry point before the first disbursement. This needs to be reflected in the Financing Agreement by setting a specific condition. This rule applies

- during the transition period in 2012 for all budget support contracts,
- for State Building Contracts in general, and
- for budget support contracts in SIDS/OCTs in exceptional and justified cases.

This section should draw a conclusion on the fulfilment of the entry point by referring to the release of the respective budget document: "The entry point is considered to be met, as the Executive's budget proposal / the enacted budget were published on the [date] at [website, if applicable]."

2. IDENTIFICATION OF THE KEY WEAKNESSES ON TRANSPARENCY AND OVERSIGHT OF THE BUDGET

This section should identify the key weaknesses and challenges of the partner country regarding the transparency and oversight of the budget. As a first step, the EU delegation is asked to give a short summary of the available international data on budget transparency and oversight of the budget, focusing on the Open Budget Index and PEFA framework.

It is recommended to use the following table (if applicable):

Open Budget Index					
OBI (year)		OBI (year)		OBI (year)	
Public Expenditure and Financial Accountability (PEFA) Framework					
Indicator	Description	Score (year)		Score (year)	
PI-6	Comprehensiveness of information included in budget documentation				
PI-10	Public access to key fiscal information				
PI-24	Quality and timeliness of in-year budget reports				
PI-25	Quality and timeliness of annual financial statements				
PI-26	Scope, nature and follow-up of external audit				
PI-27	Legislative scrutiny of the annual budget law				

These indicators and scores are used to inform headquarters on indicators and trends. However, the compilation of data cannot replace the identification of key weaknesses and challenges on a narrative basis that should be the main focus of this section.

The key weaknesses will be assessed by focusing on

- key budget documents to be produced,

- key budget documents to be made available and accessible to the public,
- timely release of budgetary information,
- comprehensiveness of budgetary information (content), and
- quality, integrity, and accuracy of budgetary information.

The relevance and role of oversight bodies will be covered by the public financial management assessment (see chapter 5.1.3) in order to avoid duplications.

In general, budgetary documents should be **available** at minimal costs to any person who wishes to **access** the document. It should be relatively easy to make budgetary documents widely available for free if governments simply publish them on their website. Countries could also make hard copies of budget documents available in national and local libraries and in information desks maintained in government offices.⁽⁷³⁾

The **timeliness and comprehensive** of information are prerequisites for national control bodies playing their role as watchdogs. The budget documents should allow a complete picture of central government fiscal forecasts, budget proposals and out-turn of the previous year. They should include among other macro-economic assumptions, fiscal deficits, deficit financing, debt stocks, financial assets, prior year's outturn, current year's budget, and summarized budget data for revenue and expenditure.⁽⁷⁴⁾ In some cases, the state-owned enterprises and extra-budgetary operations expenditures needs to be looked at as well. The table on page 10 may help to identify the key weaknesses and the baseline, as it aims at describing international good practice benchmarks with regard to the timeliness and comprehensiveness of budgetary information.

The **quality, integrity, and accuracy of budgetary information** are an essential part of the assessment. Good practices in this regard relates to the realism of budget data, accounting standards, data consistency, and reconciliation with other data. As these issues are difficult to assess, it is recommended to rely on information provided by the PEFA and the international finance institutions, in particular the IMF.⁽⁷⁵⁾

The disclosure of budgetary information will be examined by focusing on **six key budgetary documents**⁽⁷⁶⁾ covering the different stages in the budget cycle: The Executive's budget proposal, enacted budget, in-year (monthly/quarterly) reports, mid-year report, year-end report, and the audit report. Depending on the country's circumstances, the Delegation may also look on additional budgetary documents such as the citizens' budget⁽⁷⁷⁾ and pre-budget statements⁽⁷⁸⁾. The disclosure of budgetary information means that the respective documents are produced and made available to the public, so that the public can easily access the documents.

Depending on the country framework, the key weaknesses should be presented by the Delegation using the following table (see table in the appendix A as guidepost):

Key Budget Document	Description	Produced (yes/no)	Published (date; website)	Timeliness of Publication (yes/no)	Comprehensiveness & Quality (narrative on key issues)
Executive's budget proposal	The executive's budget proposal is the government's draft budget that should be submitted to the legislature.				
Enacted Budget	The enacted budget refers to the budget that has been passed by the legislature.				

⁽⁷³⁾ See International Budget Partnership: Open Budgets. Transform Lives. The Open Budget Survey 2010, p. 7

⁽⁷⁴⁾ Compare PEFA assessment, PI-6 on comprehensiveness of information included in budget documentation.

⁽⁷⁵⁾ The IMF Manual on Fiscal Transparency (2007) includes some criteria on assurances of integrity. The IMF Reports on the Observance of Standards and Codes (ROSCs) may cover these issues. Another source of information is the PEFA assessments, in particular with regard to PI-24 and PI-25.

⁽⁷⁶⁾ The Open Budget Survey / Index looks at two additional key budgetary documents: The Pre-Budget Statement and the Citizens Budget.

⁽⁷⁷⁾ A Citizens Budget provides simplified budget data that is easily accessible for a broad audience.

⁽⁷⁸⁾ A pre-budget report should be released before the executive's budget proposal and stress the government's long-term economic and fiscal policy objectives, including the total level of revenue, expenditure, deficit or surplus, and debt.

Key Budget Document	Description	Produced (yes/no)	Published (date; website)	Timeliness of Publication (yes/no)	Comprehensiveness & Quality (narrative on key issues)
In-year report	In-year reports (also Monthly Reports or Quarterly Reports) show progress in implementing the budget. These reports can be issued for the entire government or issued by different agencies.				
Mid-year report	The mid-year report provides a more comprehensive update on the implementation of the budget.				
Year-end report	The year-end report is one of the key accountability documents. It shows compliance with the level of revenue and expenditures authorised by the legislature.				
Audit report	This report covers the year-end report audited by an independent Supreme Audit Institution.				

3. IDENTIFICATION OF THE BASELINE AND MEDIUM TERM OBJECTIVES

Based on the key weaknesses in chapter 2, this section should identify a baseline of the key weaknesses that can be potentially addressed by the budget support programme. The baseline approach should also be used to identify and include accompanying capacity development measures to strengthen accountability mechanisms. The baseline and the definition of realistic reform objectives (medium term) on budget transparency and oversight of the budget against which progress will be measured during of the implementation of budget support programme are essential.

As structural reforms of budget transparency and oversight of the budget take time, the assessment needs to set objectives based on realistic expectations, in particular in particular on the production or comprehensiveness of key budgetary documents. However, the timely publication of already produced budgetary document should be a “quick win” and attainable on the short term.

*In cases where **the Executive’s Budget Proposal, and the Year End Report or Audit Report** are not published, the medium term reform expectations as the basis for measuring satisfactory progress must take these key documents into account. In case of a state building contract, a short term budget support programme (less than 3 years) and the engagement in SIDS/OCTs, more flexibility may be justified regarding these key budgetary documents. However, the more transparent the system is initially, the more modest should the Commission be in defining medium term reform expectations. In cases where the baseline is already close to international benchmarks (see Appendix A), the European Commission may only focus on monitoring whether there is no significant deterioration during implementation.⁽⁷⁹⁾ In addition, it should be highlighted, how and by which means the objectives are supposed to be supported, e.g. by policy dialogue, by conditions for the variable tranche, by supporting a participatory budget support approach (e.g. participation of national control bodies at the Annual Reviews), by accompanying capacity development measures.*

⁽⁷⁹⁾ According to the Open Budget Index 2010, some partner countries score better on budget transparency than some EU Member States (e.g. South Africa, Sri Lanka, India, Peru, Mongolia, etc.). As it will not be credible to engage in a dialogue on medium term reform expectations in these cases, ongoing eligibility is met if there is at least not significant deterioration during implementation. A significant deterioration could be, for example, a non-publication of a key budget document that was published in earlier years (Executive’s Budget Proposal, Enacted Budget, Year-End Report, Audit Report) or the significant reduction of the comprehensiveness of a previously comprehensive document.

Baseline, objectives, and the means, are of utmost importance in order to monitor progress as part of the dynamic approach. Therefore, it is recommended to use the following table for structuring the assessment:

Key budgetary document	Specific weaknesses/ baseline	Medium term reform expectation (including timing)	Means

TEMPLATE B: PAYMENT FILE FOR THE PROGRAMME

4. ASSESSING THE ENTRY POINT

In this section, the delegation is asked to assess if the entry point is met. The entry point is defined as following: The government must have published its budget within the past or current budget cycle (either the Executive's budget proposal or the enacted budget). That means that the government had to publish the budget of the past budget cycle within the respective fiscal year. In order to have the possibility to reward progress in budget transparency from the last to the current fiscal year at the time of the assessment, the publication of the current budget within the current fiscal year may also lead to the fulfilment of this criterion. In general, the budget should be available to the general public in printed form or on a website.

This section should draw a conclusion on the fulfilment of the entry point by referring to the release of the respective budget document: "The entry point is considered to be met, as the Executive's budget proposal / the enacted budget were published on the [date] at [website, if applicable]."

5. ASSESSING PROGRESS

This section assesses the ongoing eligibility of a partner country for the criterion on transparency and oversight of the budget. As a first step, the delegation is asked to give a short up-dated summary of the available international data on budget transparency and oversight of the budget, focusing on the Open Budget Index and PEFA framework.

It is recommended to use the following table:

Open Budget Index					
OBI (year)		OBI (year)		OBI (year)	
Public Expenditure and Financial Accountability (PEFA) Framework					
Indicator	Description	Score (year)		Score (year)	
PI-6	Comprehensiveness of information included in budget documentation				
PI-10	Public access to key fiscal information				
PI-24	Quality and timeliness of in-year budget reports				
PI-25	Quality and timeliness of annual financial statements				
PI-26	Scope, nature and follow-up of external audit				
PI-27	Legislative scrutiny of the annual budget law				

These indicators and scores are used to inform headquarters on indicators and trends. However, decisions on the ongoing eligibility of a partner country are not based on the data and scores, but on the following narrative part of the assessment. In this regard, the baseline defined by the key weaknesses and the short- and medium term objectives on budget transparency identified at the outset of the programme are the key essentials against which progress will be measured in this section

During implementation, ongoing eligibility requires satisfactory progress on budget transparency. As most of these reforms take time, it is not required to show annual progress. The demonstration of eligibility will rather require progress with regard to the baseline and the identified medium term reform expectations.

It is recommended to use the following table for structuring the assessment. This table should be based on the table supplemented to the Action Fiche during the formulation phase. The baseline, medium term objectives and the means are already set by the initial assessments and it is only needed to add a column on monitoring progress (evolutions since the last assessment). In the columns "means", the results of the policy dialogue should be documented.

In exceptional cases where the key weaknesses / baseline, objectives, or means have changed significantly, the table should be updated, even though changes should be stressed and justified by a short additional comment.

Key budgetary document	Specific weaknesses/ baseline	Medium term reform expectation (including timing)	Means	Evolutions since last assessment

6. CONCLUSION

The analysis should also provide a conclusion on the ongoing eligibility: “Satisfactory progress is considered to be made because of ... (narrative conclusion on the basis of the table reflecting the confirmation of the entry point and progress with respect to the identified medium-term reform expectations.”

APPENDIX A: ASSESSMENT GRID FOR KEY BUDGET DOCUMENTS⁽⁸⁰⁾

Key Budget Document	Description	Release benchmarks	Comprehensiveness
Executive's budget proposal	The executive's budget proposal is the government's draft budget that should be submitted to the legislature.	Should be made available to the public when it is first presented to the legislature or, at a minimum, before the legislature approves it.	Should be presented within a medium-term macroeconomic and fiscal policy framework, include all budgetary activities of the government and detailed commentary on each revenue and expenditure programme.
Enacted Budget	The enacted budget refers to the budget that has been passed by the legislature.	Should be released to the public no later than three month after the legislature approves it.	See executive's budget proposal.
In-year report	In-year reports (also Monthly Reports or Quarterly Reports) show progress in implementing the budget. These reports can be issued for the entire government or issued by different agencies.	Should be released to the public no later than three months after the reporting period.	Should show the executive's progress in implementing the budget.
Mid-year report	The mid-year report provides a more comprehensive update on the implementation of the budget.	Should be released no later than three month after the reporting period.	Should include an update on the implementation of the budget, a review of economic assumptions, and an updated forecast of the budget outcome for the current fiscal year.
Year-end report	The year-end report is one of the key accountability documents. It shows compliance with the level of revenue and expenditures authorised by the legislature.	Should be released no later than one year after the end of the fiscal year (the reporting period).	Should include the reconciliation with the approved budget and compliance with the revenue and expenditures authorised by the Parliament.
Audit report	This report covers the year-end report audited by an independent Supreme Audit Institution.	Should be released no later than two years after the end of the fiscal year (the reporting period).	Should cover all activities undertaken by the executive following the adherence to appropriate auditing standards, and to the principle of interdependence of the external audit institution. Should focus on significant and systematic PFM issues and on performance such as reliability of financial statements, regularity of transactions, functioning of internal control and procurement systems. ⁽⁸¹⁾

⁽⁸⁰⁾ The benchmarks are based on the Open Budget Survey / Index, the Public Expenditure and Financial Accountability Framework, the IMF Code of Good Practices on Fiscal Transparency, and the OECD Best Practices for Budget Transparency

⁽⁸¹⁾ The assessment should also cover the timely and effective follow-up by the legislature and executive on the main recommendations of the Audit Report.

APPENDIX B: USEFUL KEY REFERENCES

Public Expenditure and Financial Accountability Framework (PEFA)

The PEFA Performance Measurement Framework (PEFA Framework) has been developed to assess and develop essential PFM systems, by providing a common pool of information for measurement and monitoring of PFM performance progress, and a common platform for dialogue. PEFA framework covers budget transparency and oversight of the budget by several indicators, in particular

PI-6 Comprehensiveness of information included in budget documentation,

PI-10 Public access to key fiscal information,

PI-24 Quality and timeliness of in-year budget reports,

PI-25 Quality and timeliness of annual financial statements,

PI-26 Scope, nature and follow-up of external audit,

PI-27 Legislative scrutiny of the annual budget law.

Information on the methodology and the recent PEFA assessment reports are available on the following website: www.pefa.org

IMF Code of Good Practices on Fiscal Transparency (2007)

The Code identifies a set of principles and practices to help governments provide a clear picture of the structure and finances of government. It underpins the voluntary program of fiscal transparency assessments called fiscal transparency modules of Reports on the Observance of Standards and Codes (or fiscal transparency ROSCs), that summarize the extent to which countries observe certain internationally recognized standards and codes. The code and additional information are available on the IMF website:

<http://www.imf.org/external/np/fad/trans/index.htm>

The Reports on the Observance of Standards and Codes are available on the following website:

<http://www.imf.org/external/NP/rosc/rosc.aspx>

Open Budget Survey / Open Budget Index

The **Open Budget Survey** was developed by the International Budget Partnership to collaborate with civil society to undertake budget analyses. It assesses the availability of eight key budget documents, the comprehensiveness of the data contained in these documents, the extent of effective oversight provided by legislatures and supreme audit institutions, and the opportunities available to the public to participate in national budget decision-making processes. The Survey uses internationally accepted criteria to assess each country's budget transparency and accountability. Scores assigned to certain Open Budget Survey questions are used to compile scores and ranking of each country's transparency. These scores constitute the Open Budget Index. Information on the methodology and the recent Open Budget Index are available on the website of the International Budget Partnership: <http://internationalbudget.org>

OECD Best Practices for Budget Transparency (2002)

The best practices are drawn together by the OECD Secretariat based on OECD Member States experiences. The best practices are designed as a reference tool for Member and non-member countries to use in order to increase the degree of budget transparency in their respective countries. They comprise a list of principal budget reports that governments should produce, including their content, a description of specific disclosures to be contained in the reports, and practices for ensuring the quality and integrity of the reports. The document is available on the OECD website:

<http://www.oecd.org/dataoecd/33/13/1905258.pdf>

The Lima Declaration of Guidelines on Auditing Precepts (1977)

The Lima Declaration of Guidelines on Auditing Precepts contains a comprehensive list of principles and standards for government auditing relevant for all Supreme Audit Institutions grouped in INTOSAI, the International Organization for Supreme Audit Institutions. It refers to the importance of audits for a legal, effective and efficient public financial management and calls for an independent government auditing guaranteed by law.

<http://www.intosai.org/documents/intosai/general/declarations-of-lima-and-mexico/lima-declaration.html>

Annex 7: Risk Management Framework

1. MANAGEMENT OF RISKS IN BUDGET SUPPORT OPERATIONS

The development of an improved risk management framework adapted to the specific risk profile of budget support operations is a key element of the Communication on the “Future Approach to EU Budget Support to Third Countries”. The Risk Management Framework aims at identifying in a structured way, mostly based on existing assessments (e.g. human rights strategies, eligibility criteria) the significant risks related to budget support. In addition, the Risk Management Framework makes sure that these risks are managed in line with the Commission’s guidelines on risk management⁽⁸²⁾.

This annex presents the framework for the risk management based on the communication and the recommendations of the European Court of Auditors. It is also inspired by the existing tools of some EU Member States, in particular of Denmark, France, Germany, Netherlands, and the United Kingdom.

The risk management framework is an important tool during the identification, formulation and implementation of budget support operations whilst also informing policy and political dialogue. By identifying risks the tool helps to come to more informed decisions on the provision of budget support by comparing the risks with the cost of non-intervention, i.e. the potential benefits of a budget support programme⁽⁸³⁾.

Therefore, the Risk Management Framework aims at

1. identifying the specific risks linked to the provision of budget support,
2. identifying mitigating measures and risk responses as part of a risk strategy,
3. informing budget support dialogue,
4. monitoring the identified risks and the mitigating measures during implementation,
5. identifying the framework to react to immediate deteriorations of a partner country’s situation.

The European Commission defines **risk management** as: “a continuous, proactive and systematic process of identifying, assessing and managing risks in line with the accepted risk levels, carried out at every level of the Commission to provide **reasonable assurance** as regards the achievement of the objectives”⁽⁸⁴⁾.

The EU identifies the following five risk categories: political governance risks, macroeconomic risks, developmental risks, public financial management, and corruption / fraud. The specific risk profile of budget support operation is related to the use of country system, as budget support involves a transfer of financial resources to the National Treasury. In addition, there is a specific reputational risk for Good Governance and Development Contracts, as general budget support is seen as an overall endorsement of the political stance of a partner country in a way in which other forms of budget support may not be.

The Risk Management Framework for budget support operations is focusing on the country system in order to identify the risks that may impede achieving the general **objectives** of budget support: Eradicate poverty, sustainable and inclusive economic growth, and consolidate democracies. It is carried out for each country that may receive or is receiving budget support in the form of a Good Governance and Development Contract and/or Sector Reform Contract or State Building Contract. As risks are assessed according to the general objectives of budget support in a country, it is not necessary to provide different assessments for different contracts.

⁽⁸²⁾ Risk Management in the Commission, Implementation Guide, Updated Version-October 2010

⁽⁸³⁾ The benefits of a budget support programme will be assessed separately and are not part of the risk assessment framework.

⁽⁸⁴⁾ idem

In general, the framework comprises the following key steps:



2. RISK ASSESSMENT

2.1. Definition of risk and risk categories

The Commission **defines a risk** as “any event or issue that could occur and adversely impact the achievement of the Commission’s political, strategic and operational objective. Lost opportunities are also considered as risks”⁽⁸⁵⁾.

Understanding and analysing the risk environment is an important step towards the identification of mitigating measures and risk monitoring. The identification of risks with regard to the general objectives of budget support is, therefore, the first step of a risk management approach.

The assessment of risk will part of the **identification, formulation and implementation** phase. During identification, the delegation will be asked to prepare a first “rough” draft of the risk management framework that will be sent to the regional teams and Headquarters (DG DEVCO and EEAS), including the budget support unit (**bottom-up approach**), in order to check coherence and consistency across countries and regions. The draft will be provided by the EU Delegation except for the assessment of the impact of the mitigating measures and the risk trends that will be added by Headquarters (geographical directorates in DG DEVCO and EEAS).

During formulation, the risk management framework will be revised by the delegation taking into account the feedback from the Headquarters and the regional teams on the first draft (**top-down approach**) and based on a more in depth analysis assessment of the eligibility criteria. This second draft will be sent to the regional teams and Headquarters, including the budget support unit, in order to check coherence and consistency across countries and regions and, if necessary, to revise the assessment of the mitigating measures. The EEAS geographic directorates will validate the political risks in consultation with DEVCO geographical directorates.

In order to assess the risks, the EU identifies five **risk categories**:

- **Political risks** refer to the universal values, fundamental rights, conflict and insecurity. The risk framework is used to regularly monitor the commitment and adherence to the fundamental values of human rights, democracy and rule of law. The risk of conflict and insecurity, including political and social destabilisation, regional tensions and the support of policies and powers that may exacerbate tensions, are also part of the political risk assessment, as they also need to be carefully analysed.
- **Macroeconomic risks** refer to the possibility that the macroeconomic policies cease to be stability-oriented. In addition, the framework will take into account the risk of external shocks that are outside the immediate influence of the partner country, e.g. impact of global economic crises and volatility in commodity prices.
- **Developmental risks**: This includes the risk that the policies put in place by the government will not be continued or may not attain the desired outcomes, in particular with regard to poverty reduction and inclusive economic growth. A variety of factors may lead to developmental risks, including inadequate policy design, lack of ownership for policies, lack of participatory consultations with stakeholders, insufficient institutional capacities and capabilities with regard to implementation and monitoring of policies and programmes.

⁽⁸⁵⁾ Idem

- **Public Financial Management (PFM)** refers to the risks that weaknesses in the government's regulatory framework, financial compliance and controls systems may lead to inappropriate management of public funds. This risk is assessed in terms of the comprehensiveness of the budget, controls in revenue collection / budget execution, procurement and external audit. In principle, PFM risks are assessed on the basis of the PEFA that provides a snapshot of the current situation. However, the risk assessment should also take into account the government PFM reform measures that may (not) address the respective key weakness of the PFM system and its associated risks.
- **Corruption and Fraud** refers to risks that resources diverted away and power is abused for private gain. Large scale corruption and fraud constitute a major obstacle to development objectives. Risks of corruption and fraud are linked to public financial management and developmental risks, but by having a separate risk category, the Commission puts increased emphasis on corruption and fraud. The specific risk category focuses, therefore, on the perceived risk level, the legal, regulatory and institutional framework as well as government responsiveness and enforcement.

Reputational risks and the **going concern risks** are not covered by a separate risk category due to their cross-cutting nature. The going concern risks refer to a possible insolvency or bankruptcy of a sovereign government and to risks linked to changes in policy direction.⁽⁸⁶⁾ These risk dimensions are covered by the macro-economic and developmental risk assessment.

2.2. Risk Dimensions, Risk Questionnaire, and the Definition of Risk Levels

Each risk category comprises the following risk dimensions:

RISK MANAGEMENT FRAMEWORK	
Risk Category	Dimensions
Political	<ul style="list-style-type: none"> ● Human Rights ● Democracy ● Rule of Law ● Insecurity and Conflict
Macroeconomic	<ul style="list-style-type: none"> ● Macroeconomic Policy & Financial Sector ● Debt Sustainability ● Vulnerability & Exogenous Shocks
Developmental	<ul style="list-style-type: none"> ● Public Policy ● Government Effectiveness
PFM	<ul style="list-style-type: none"> ● Comprehensiveness of the Budget ● Controls in Budget Execution ● Procurement ● External Audit
Corruption/Fraud	<ul style="list-style-type: none"> ● Corruption & Fraud

Table 1: Risk categories and risk dimensions of the framework

The risks and risk levels are identified and defined by a short questionnaire. The questionnaire is mostly based on existing assessments, in particular of the eligibility criteria, the fundamental values, and the Human Rights Country Strategies. It is also based on an excel sheet that is easy to use and will guide the risk identification.

⁽⁸⁶⁾ See International Standards of Supreme Audit Institutions (ISSAI) 1570: Going Concern. Financial Audit Guidelines. INTOSAI

The questionnaire takes into account:

- **a set of qualitative criteria** focusing on the **quality of policies and institutions**, supplemented by publicly available **quantitative data and indicators**, such as the Corruption and Government Effectiveness Indicators, Public Expenditure and Financial Accountability Framework (PEFA), etc.;
- **the will and commitment for reform and the quality of the reform agenda**, as budget support implies incentives for structural reforms, and
- **observations and judgments** that are based on country knowledge of the European Delegation and the missions of EU Member States.

Each question has to be judged in terms of four risk ratings (low, moderate, substantial, high) capturing both, the likelihood and impact of a risk with regard to the general objectives of budget support (eradicate poverty, sustainable and inclusive economic growth, consolidate democracies). The decision on the risk rating for each question has to be justified through a very short narrative comment. As the risk assessment is a forward-looking exercise and the general objectives have a medium-term perspective, the assessment should take into account the whole contract period of a budget support programme.

The risk ratings for each question are averaged to general risk levels for each risk dimension (e.g. human rights, rule of law, etc.), for each risk category (e.g. political governance, macroeconomic risks, etc.) and for the overall country risk. The rating is an important part of the assessment, as it supports the definition of risk levels for decision-making. However, the questionnaire may not cover all risks and important risks may be hidden by referring to averages. In exceptional and well justified cases, the Delegation has, therefore, the discretion to change the risk rating and risk score for each risk dimension based on a more qualitative assessment.

It is also crucial that the risk level assessment is accompanied by a narrative assessment highlighting the major risks identified by the questionnaire. This part of the assessment may also provide the necessary discretion to the Delegation to highlight the major risks that may not be covered by the questionnaire or be hidden by averages. All the questions assessed as high or substantial in the questionnaire need to be named as major risks.

The risk levels and the narrative part of the assessment will provide the necessary overview of a partner country's situation. The following table gives a short description of each risk level and may help to identify the adequate risk rating for each question and to cross-check the results of the questionnaire. However, the risk level takes into account both, the likelihood and the impact of a risk. That is why the descriptions should be seen as a "guidepost", as, for example, a moderate risk level may be a result of a substantial likelihood, but a low impact.

Risk Level	Description
LOW	The country's situation involves a low risk for budget support, as the risk is unlikely to occur due to the systems and institutional structures in place. Should the risk occur the impact will be limited with regard to the attainment of the programme objectives.
MODERATE	The country's situation involves a moderate risk for budget support operations. Country systems and institutional structures should prevent the occurrence, but additional monitoring will be necessary. Should the risk occur the impact will be limited in the sense of a delayed attainment or a partial achievement of objectives.
SUBSTANTIAL	The country's situation involves a substantial risk for budget support operations. Country systems and institutional structures are not sufficiently robust to guard against key risks. Should the risk occur the impact would significantly disrupt the programme or the achievement of results.
HIGH	The country's situation involves a high risk for budget support operations. Country systems and institutional structures are too weak to prevent the occurrence of risks. Should the risk occur the impact would result in a quasi failure of the programme objectives and may seriously damage the EU's image and reputation.

Table 2: Description of risk levels

2.3. Templates of the Risk Management Framework

The Risk Management Framework consists of the following excel templates:

- The **Risk Questionnaire** is used to identify and assess the risks leading to the definition of risk levels.
- A **Risk Management Register** (see excel template) is created in order to provide information on the risk level, risk score, residual risk and risk trend as a result of the questionnaire. In addition, the register describes the major risk and the mitigating measures for each risk dimension. It is also a tool to inform policy dialogue on budget support and monitor the identified risks during implementation.
- As a second register, a **country risk profile for budget support** (see excel template) will be created to highlight on one page all the important information of the risk assessment of each country. The country risk profile for budget support responds to the need to have a less complex tool to support informed decision-making. It indicates the overall risk levels and risk scores for inherent and residual risks as well as risk trends for each risk category and the whole country. In addition, the profile provides a summary on the risk of non-intervention (expected benefits of budget support⁽⁸⁷⁾), on the major risks and on the major mitigating measures. As a result of the risk assessment, a recommendation is given according to the risk level (see table 2 & 3). The country risk profile is used to inform the decision making process in Headquarters (management tool) and to balance risks and benefits in order to decide on the provision of budget support.

The questionnaire and the narrative assessment in the risk register provide the necessary discretion to each delegation to assess country specific risks. However, in order to ensure the consistency and quality across countries and regions, the regional teams, the geographical directorates in DG DEVCO, and the EEAS in coordination with the budget support unit needs to guide the risk assessment and to ensure coherence and consistency.

3. RISK RESPONSE AND MITIGATION

3.1. Risk response and residual risks

Given the fact that risks are inevitable in all aid operations the aim is not to avoid risks at all costs. Reducing risks to zero is, in most cases, practically unfeasible and rarely cost effective. A certain degree of risk acceptance is necessary, as non-engaging can cause risks and higher costs in the long run. A higher risk may be acceptable in contexts where the expected impact and benefit of budget support operations is higher than the potential risk. This is of particular relevance for budget support under the “State Building Contract”. Situations of fragility tend to be characterized by higher risks, but also call for action to ensure vital state functions, to support the transition towards development, to promote governance, human rights and democracy, and to deliver basic services to the populations.

Depending on the assessment of risks, an appropriate risk response has to be defined by the following steps:

1. Identification of mitigating measures,
2. Assessment of the impact of the mitigating measures in order to conclude on the residual risk (risk after mitigation), and
3. Decision on the final response: risk acceptance or risk avoidance.

Mitigating risks means joint efforts of the partner country and donors to respond to the identified risks, for example, by identifying safeguards, reform needs, or short term measures. Mitigating measures may cover the whole contract period and may include specific measures for a shorter time period. Mitigation should be the most common risk response.

If the risk level of a risk dimension is substantial or high, mitigating measures need to be discussed and identified with the partner government in order to address the respective risk dimensions. This implies the definition and implementation of a clear and comprehensive **action plan**, which clearly allocate responsibility for and timing of implementation. Satisfactory progress of the mitigating measures is essential during the implementation of the budget support programme.

⁽⁸⁷⁾ The potential benefits of budget support programmes are described in the relevant formulation documents i.e. Action Fiche and associated supplementary documents.

If the political risk is substantial or high in case of a Good Governance and Development Contract, mitigating measures will cover clear and comprehensive action plans based on a **policy matrix**. The policy-matrix is a forward-looking exercise to set clear milestones and benchmarks for implementation and for measuring progress. As part of the risk response, **contingency plans** are necessary aiming at increasing the capacity to react immediately in cases of further deteriorations. They outline the actions to be undertaken if there is a significant deteriorating trend in the partner country's risk assessment. This could include making adjustments to the size of any tranche and/or reallocating funds to sector programmes, channelling funds to target groups via non-governmental organisations or reinforcing other aid modalities.

The risk register is the main tool in identifying risks and monitoring the identified mitigating measures and to inform the decision making process in different phases of the budget support cycle management.

The following list proposes several mitigating measures:

- **Further analyses and surveys** may be necessary in order to shed light on the systemic weaknesses leading to specific risks. The Public Expenditure and Financial Accountability (PEFA) assessments, Public Expenditure Tracking Surveys and Public Expenditure Reviews may be useful in order to identify reform needs and capacity constraints.
- **Capacity development and technical cooperation** could be used to mitigate risks in cases where there is a strong commitment for reform, but a lack of capacity to improve country systems/frameworks.
- **Enhancing transparency, accountability and participation in the budget process** is important to strengthen nationally owned safeguard and oversight mechanisms. Transparency and openness are prerequisite for accountability and participation. Internal and external accountability mechanisms provide opportunities for enhanced scrutiny and monitoring. The involvement of citizens and civil society is also essential in budget processes from decisions about resources to monitoring of service delivery.
- **Conditions for the disbursement of variable tranches** could be used to set incentives for reform and to enter into policy dialogue. This approach may allow addressing key risks without jeopardizing predictability.
- **Requirements** to implement specific controls, legislations and reform steps to address specific weaknesses may be appropriate to deal with substantial or high risks.
- **Further adaptations regarding the design of a budget support programme**, by shortening the duration of a programme in environments with substantial risks, use targeted aid to reduce reputational risk, etc.

The risk mitigation measures differ depending on the identified inherent risks. Some risks can be mitigated; other risks cannot be managed at all. Therefore, the EU will assess the possible impact of the mitigating measure for the duration of the budget support contract in order to conclude on the **residual risk** that remains after mitigation. It is an important part of the risk management framework in order to decide on the final risk strategy, i.e. risk acceptance or risk avoidance. Residual risks will be assessed by Headquarters (geographical directorates in DG DEVCO and EEAS).

In addition to the inherent and residual risks, a **risk trend** is identified. The risk trend compares the current residual risk level with the level of the past assessment. Decisive for the risk trend is the change of the risk level (e.g. from moderate to substantial). Looking backwards, the risk trend aims at assessing the development of risks over time and at identifying deteriorating trends.

Based on the residual risk, a risk response can lead to risk acceptance or risk avoidance. The **risk acceptance** corresponds to a certain level of risk that is acceptable. **Risk avoidance** means that the risk is too high leading to the rethinking of budget support operations. In most cases, the decision on the risk response is taken by the Budget Support Steering Committee (BSSC; see chapter 3.2).

3.2. Early warning system

The **early warning system** will be activated in cases where there is an **immediate and severe deterioration of the situation** or the occurrence of an event identified as risk that has a major impact on the programme objectives. In these cases, the EU needs to react immediately in order to avoid a serious damage of the EU's image and reputation. This may be, for example, a result of a major corruption or fraud case or a breach of the fundamental values. The EU Delegations should report on these cases immediately to Headquarters (DG DEVCO and EEAS).

3.3. Overview on the risk responses

Risk Level	Risk Strategy	Recommendation for the identification/ formulation phase	Recommendation during implementation
LOW	Acceptance	The provision of budget support is feasible without additional safeguards.	The budget support dialogue is pursued on a regular basis.
MODERATE	Acceptance / Mitigating	The provision of budget support is feasible without additional safeguards. Mitigating measures, if necessary, may be identified for the respective risk category or risk dimension.	The budget support dialogue is pursued on a regular basis. If necessary, monitoring of the mitigating measures.
SUBSTANTIAL	Mitigating / Avoidance	<p>Budget support operations are only recommended when appropriate mitigating measures are agreed with the partner country. This needs to be reflected in the Action Fiche and the Financing Agreement.</p> <p>If the risk level of one of the categories is substantial, the budget support programme needs to be discussed in the BSSC.</p> <p>In case of a substantial risk of one of the political risk dimensions, a GGDC should be linked to progress in addressing the root causes and be used to promote the fundamental values by policy and political dialogue. In this context, a contingency plan should be developed in order to increase the capacity to react immediately in cases of further deteriorations. Any decision on the provision of a GGDC will be taken by the BSSC.</p>	<p>Monitoring of the mitigating measures (satisfactory progress of the mitigating measures during implementation).</p> <p>In case of a deterioration of a risk category from low/moderate to substantial, the budget support contract should be discussed in the BSSC before a disbursement decision.</p>
HIGH	Avoidance / Mitigating	<p>Budget support operations are only recommended when appropriate mitigating measures, including safeguards and specific requirements, are agreed with the partner country. This needs to be reflected in the Action Fiche and the Financing Agreement.</p> <p>If the risk level of one of the categories is high, the budget support programme needs to be discussed in the BSSC in order to provide a final decision on the risk response (risk avoidance / risk acceptance).</p> <p>In case of a high risk of one of the political risk dimensions, a GGDC should be linked to progress in addressing the root causes and be used to promote the fundamental values by policy and political dialogue. In this context, a contingency plan should be developed in order to increase the capacity to react immediately. Any decision on the provision of a GGDC will be taken by the BSSC.</p>	<p>Monitoring of the mitigating measures (satisfactory progress of the actions plans; safeguards/ specific requirements are met).</p> <p>In case of a deterioration of a risk category from low/moderate/ substantial to high, the budget support contract should be discussed in the BSSC before a disbursement decision.</p>

Table 3: Overview on the risk responses

4. RISK MONITORING AND REPORTING

The risk management framework will also be used to monitor the risks and their mitigation measures for all contracts on a periodical basis in order to:

- Check that identified risks are being adequately managed,
- Assess the implementation progress of the mitigating measures, and
- Identify any new risks or changes in circumstances.

Most monitoring of the identified risks can be done as an inherent part of good management of budget support programmes by Delegations and HQ. Other information should flow naturally from developing close relationships with partner governments, civil society organisations, and other donors in country, particularly EU Member States and IFIs.

The risks and mitigating measures are identified as part of the identification and formulation phase on the basis of the questionnaire and the risk register. During the implementation phase, the risk management register will be updated in January/February and, if necessary in June/July or as part of the disbursement file. The geographical directorates (DG DEVCO and EEAS for political risks), with support from Delegations, regional teams and thematic directorates, have the responsibility for ensuring consistency and coherence across countries in their regions and the implementation of the risk management framework. Questions of intra- or inter-regional consistency may be referred to the BSSC. **In case of a deterioration of a risk category from a previously lower assessment to substantial or high, the budget support contract should be re-discussed in the BSSC before a disbursement decision.**

The Risk Management Framework is an **internal** document. It is not foreseen to jointly assess the risks together with the partner country.

Annex 8: Performance Assessment and Variable Tranche Design

1. INTRODUCTION

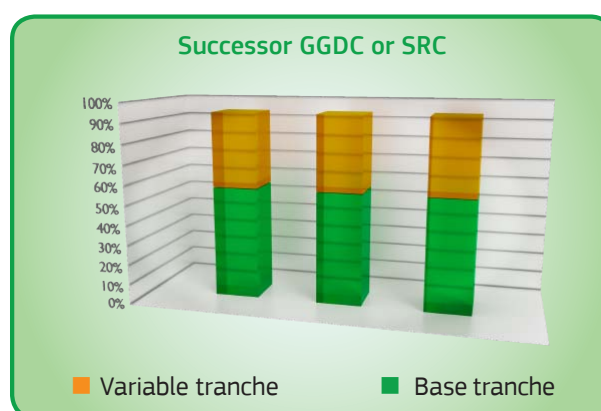
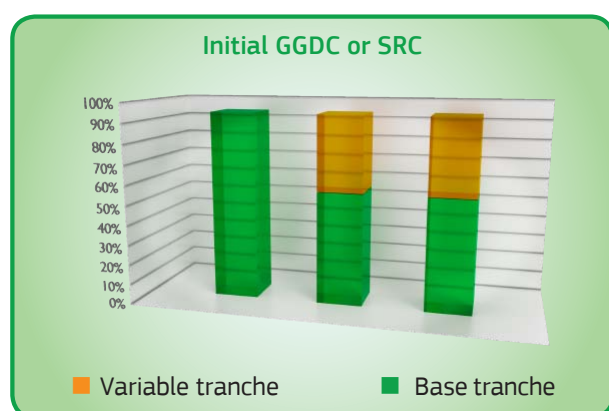
This annex aims to set out how budget support programmes may be designed using variable tranches to incentivise and respond to specific performance issues measured by an indicator framework. Specifically, it provides guiding examples around the size and phasing of such tranches, principles for the selection of indicators, and methods for determining variable tranche payments.

2. PROGRAMME DURATION, SIZE AND PHASING OF VARIABLE TRANCHES.

A recent study⁽⁸⁸⁾ showed some evidence that larger variable tranches may have a stronger incentive effect, particularly in weak policy environments and where there is some stability over time in the indicators used. However, a large number of factors are likely to influence performance, and there are equally indications that the incentive effect is dependent on the alignment of objectives between donors and partner countries and that countries are sensitive to the signalling effect of any reduction in payments, regardless of size.

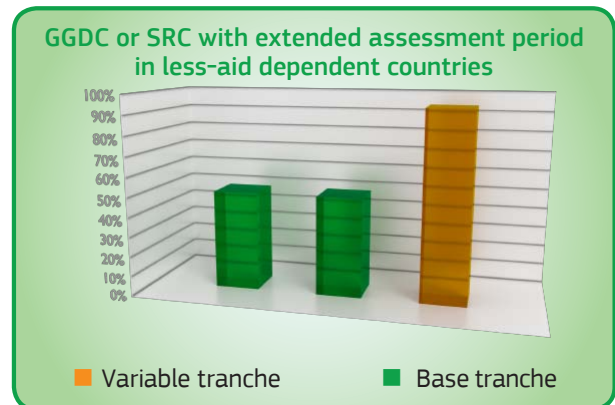
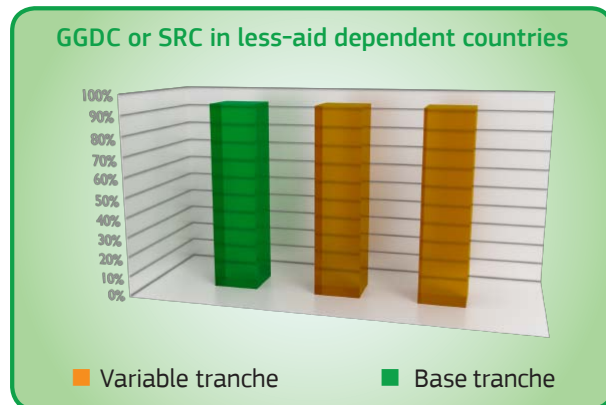
A balance needs to be struck between creating incentives and avoiding excessive unpredictability or volatility in disbursements, particularly in more aid dependent contexts, and **no definite rules regarding the appropriate share of fixed and variable tranches can be defined**. The following examples can nevertheless be used as a reference point that forms the initial basis for discussion. **The variable share might be expected to be larger in the following circumstances:** the smaller the budget support programme's share of the partner country's budget; the weaker its track record of budget support implementation; the weaker the country's commitment to reform and poverty reduction; the higher the risk assessment. Country context matters, and the possibility of 100% fixed or 100% variable programmes remains open. In all cases, delegations should co-ordinate decisions on the size and phasing of variable tranche with other development partners.

- **Standard GGDCs and SRCs would typically cover commitments for 3 years with a possible base and variable tranche ratio of about 60/40.** In order to facilitate a partner country's budgetary planning particularly in aid dependent countries, the first year of a new budget support programme (without predecessor) should normally only have a base tranche. This also allows for a reasonable amount of time between the agreement on the indicator targets, and their evaluation. However, where a successor programme is being prepared, the design should aim to include a variable tranche in the first year in order to maintain continuity of assessment. This implies formulating a successor programme sufficiently in advance.



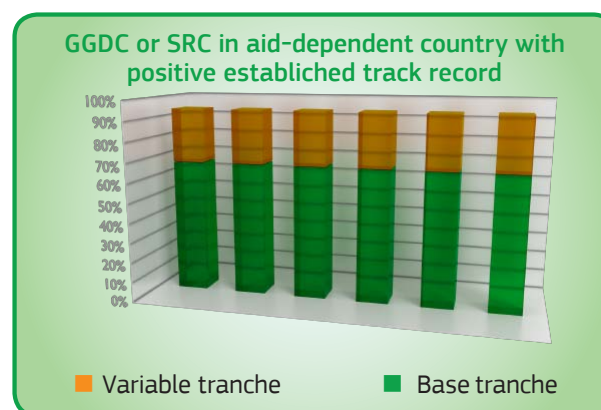
⁽⁸⁸⁾ 'Conditionality, Predictability and Performance: A Study of EDF 9 General Budget Support Programmes', 2012, Andreas Eberhard and Jonathan Beynon

- **Less aid-dependent countries** leave flexibility for concentrated variable tranches, possibly based on extended assessment periods, where more timing flexibility is given to reach targets:

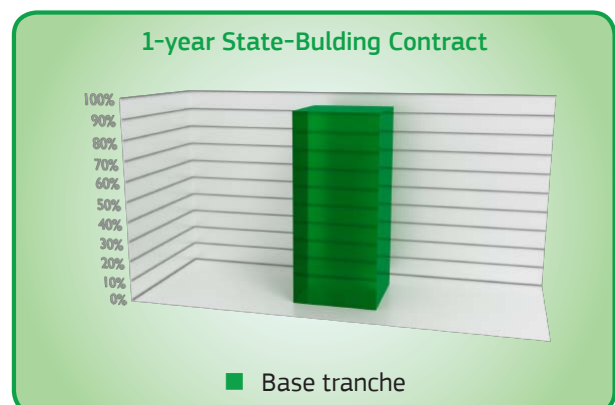
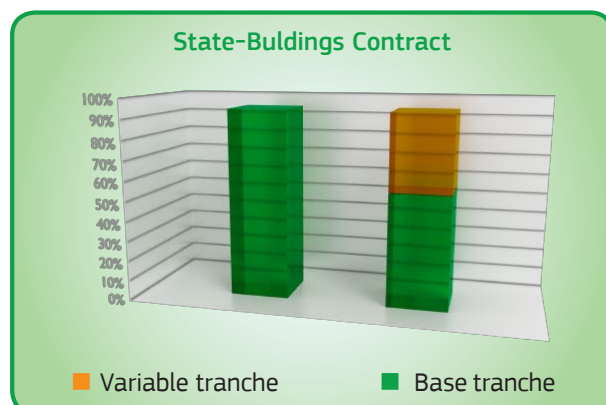


The second example has a variable tranche in the final third year only, based on a 2 year assessment period. Either end-of-period or average performance can be used. The former leaves scope for compensating poor year 1 performance by catching up in year 2, but the lack of conditionality over year 1 performance may affect the policy dialogue although this can be compensated by introducing an annual performance tranche (cf. below).

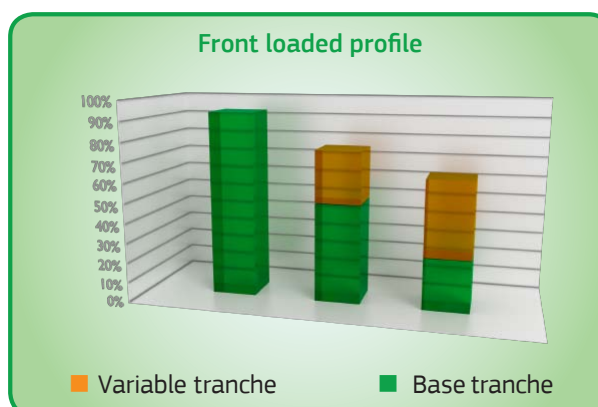
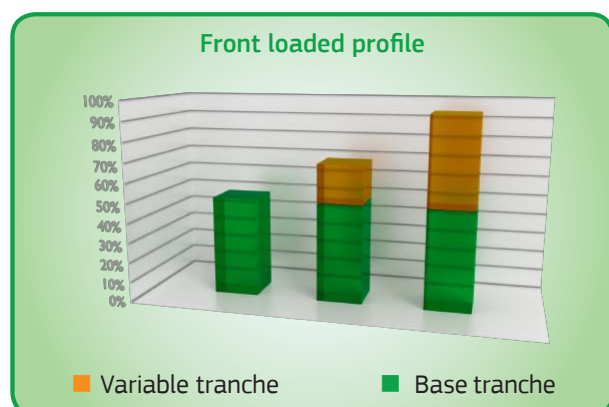
- **For aid-dependent countries with an established positive track record** across the eligibility criteria and a low risk profile, a longer programme duration and higher base tranche ratio can be used:



- **SBCs will typically have a duration of 1-3 years.** A higher risk profile and possibly limited track record would imply a higher variable tranche. However, the short duration, the importance of predictability in what are often highly aid-dependent countries, including for essential services, can mean that overall the variable tranche is not generally higher than with the other contracts. For 1 to 2 year operations, there may be no variable tranche with a focus on satisfying the eligibility criteria and preparing for future budget support operations with longer duration and variable tranches. See Fragile states annex for more detail.



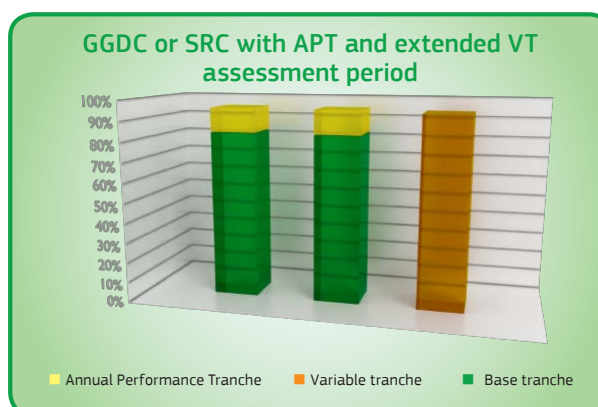
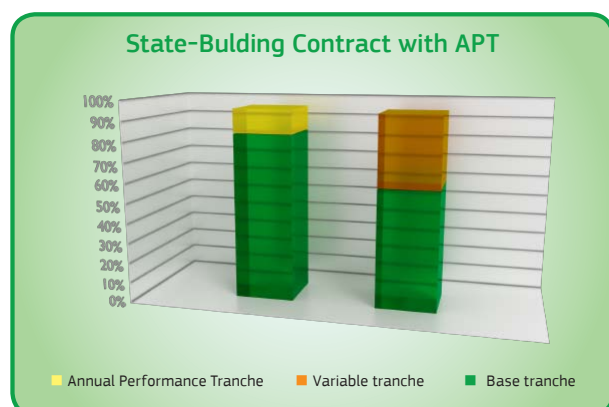
- Finally, independent of the variable tranche profile, **total disbursement profiles can vary.**



The choice of profile should be based on the targeted incentive structure and, particularly for aid-dependent countries, the following factors: (i) analysis of the macroeconomic financing gap, (ii) other donors' disbursement plans, (iii) partner country's absorptive capacity, (iv) partner country's preferences.

3. USE OF AN ANNUAL PERFORMANCE TRANCHE (APT)

The APT was introduced as part of the MDG-Contract. **It can be used to complement the base tranche for years where there is no variable tranche.** It is limited to 10% of the yearly budget support tranche and is either disbursed or withheld in full. Because it is based on an overall qualitative assessment informed by selected performance indicators *and* other relevant performance information, it allows for disbursement decisions to take into account all relevant information in cases where there is a potential need to respond to and signal significant concerns about performance. This can be useful, for example, for State Building Contracts with higher risks. Another example is where a variable tranche outcome indicator set in the outer year of the programme is complemented with intermediate input or process indicators linked to an APT in order to facilitate the monitoring of yearly progress. These two examples are illustrated here:



In principle, if performance is judged to be satisfactory taking into account an overall assessment informed by performance indicators and other relevant performance information, then the whole APT would be disbursed. The following specific language is suggested for inclusion in the financing agreement: *"Disbursement of the Annual Performance Tranche will be based on the conclusions of the Annual Review, with particular attention paid to the following issues: [list 2-5 key issues/indicators of special importance for each APT]. Unless there are specific and significant concerns, the APT will be disbursed in full. The areas of particular attention will be agreed and confirmed each year in writing in the light of each annual review"*

4. SELECTION OF PERFORMANCE INDICATORS

As indicated in the public policy annex, delegations should select, in agreement with the authorities and in co-ordination with other development partners, a number of indicators from the public policy's performance assessment framework (PAF) for variable tranche conditionality. The selected indicators should be coherent with programme objectives and the diagnosis of the problem. Where no PAF exists, delegations should agree with the authorities on a number of performance indicators derived from the public policy, in consultation with other stakeholders. Indicators and targets should be agreed during the formulation phase. Changes to the indicators should be avoided where possible but may be necessary. Policy targets might be adapted upwards or downwards to take account of policy progress during programme implementation. Financing Agreements should therefore include an explicit clause stating that any subsequent revision of indicators or targets can take place upon the request of the Government and subsequent agreement of the responsible Commission Authorising Officer.

The **number of indicators should generally not exceed 8** per tranche (and could be much less) in order to avoid a loss of policy focus. The more focused the objectives of the programme and the smaller the size of the VT, the fewer the recommended number of indicators. Indicators can have targets disaggregated by gender or geography, which may be particularly relevant where there are major disparities in the provision of key services by gender or region.

There are **different indicator types**. Input and process indicators measure the financial resources provided and the policy and regulatory actions taken (e.g. adoption of a regulation), output indicators measure the immediate and concrete consequences of the resources used and measures taken (e.g. schools built), outcome indicators measure the results at the level of beneficiaries (e.g. proportion of children vaccinated), impact indicators measures the consequences of the outcomes in terms of wider objective (e.g. literacy rates).

The **Commission supports the use of outcome indicators**, because (i) it is these results that ultimately matter; (ii) it encourages evidence-based policy making; (iii) it protects political space for beneficiary countries to choose their own policies and strategies for achieving them; (iv) it promotes domestic accountability; and (v) it stimulates demand for high quality statistical information. The greater the willingness of the partner country to be held accountable for such results, and the greater the confidence in the government's ability to deliver and in the quality of such performance data, the more emphasis should be placed on outcome indicators. In less aid-dependent countries, it may be more appropriate to focus on agreed policy actions using process indicators.

Outcome indicators can focus on quantity, for example school enrolment, but **attention should also be given to indicators measuring quality**. For that purpose, proxy indicators can be used that give an indication of quality. Examples are the pupil teacher ratio, school completion rates, attendance or utilisation rates for public services, absenteeism rates of public service providers, indicators measuring provider skills (qualifications or actual measured skills), stock-out rates (absence) of essential drugs in health facilities, share of pharmaceutical sales that consist of counterfeit drugs. Particularly in the area of governance and regulatory frameworks, attention should also be given to indicators that measure or verify de facto practice vs. de jure regulations. Finally, subjective survey data have value in complementing objective measures, for example by pointing out inconsistencies, but should not be used for conditionality purposes.

Input or output indicators may play a useful role, particularly when the programme targets the regulatory framework, or when outcome statistics are not considered sufficiently reliable. **Public financial management indicators** additional to the PFM eligibility monitoring framework can be used, but poor performance against such variable tranche indicators should not put into question eligibility, which should be based on a broader assessment.

Impact indicators are not considered appropriate for conditionality purposes given the potential importance of external factors and the possible time lags involved.

Different sets of criteria exist to assess **indicator quality**: SMART indicators are Specific, Measurable, Achievable, Realistic and Time-limited. CREAM criteria refer to indicators that are Clear, Relevant, Economic, Adequate and Monitorable. EUROSTAT indicator guidance focuses on logic, relevance, the possibility of setting a target, frequency of data collection, appropriateness and possibility of estimating precision. RACER indicators refer to indicators that are Relevant, Accepted, Credible, Easy, and Robust. Box x lists suggested specific questions to ask when evaluating the quality of a performance assessment framework indicator.

Box 1– Seven questions to ask oneself in front of a performance assessment framework indicator

1. Does the indicator have quantified targets or, for process indicators, result-oriented formulations?
2. Do baseline and trend data exist?
3. Is the definition, the responsible institution or ministry and the reference document that will serve as source of verification mentioned?
4. Are the periodicity of publication, the type of data collection, the timing for the production, the quality assurance processes and the dependence from external funding known for each indicator?
5. What are the driving factors for the indicator and to what extent is it sensitive to exogenous factors? Is there any dependence on the availability of donor funding or donor technical assistance?
6. Are the statistical aspects (e.g. precision; confidence interval; expected coverage or completeness; potential change of methodology) known for each indicator?
7. Is the indicator disaggregated whenever relevant and to the extent possible by gender, location or population groups?

Targets should get the balance right between being over-ambitious or excessively prudent. Where Delegations conclude that the government's targets are either too ambitious or too prudent, this should be addressed by modifying the approach to VT assessment (see below) rather than through adjusting the targets themselves. Targets disaggregated by gender or geography may be particularly relevant where there are major disparities in the provision of key services by sex or region.

DOCUMENTATION SHEET

Indicator	Title	
Programme	Reference to the government programme	
Objective	Reference to the relevant objective within the programme	
Action	Reference to the relevant action within the objective	
Department responsible	Name of the department making use of the indicator within the programme	
Description of the Indicator		
Measurement unit		
Periodicity of measurement		
Last known result	Year	Value
Development and quality of the Indicator		
Nature of basic data	Numerator, denominator, field covered.	
Method of data collection	Survey, administrative collection	
Departments and bodies responsible for collection	State the body/bodies responsible for collection	
Method of calculation	State the formula	
Means of Interpretation		
Known limits and bias	State the limits of use (significance) or, in the case of a proxy, the bias with regard to the desired indicator	
Means of interpretation	Specify its significance in relation to the area – What, precisely, is the indicator measuring?	
Direction of interpretation	Decrease or increase	
Documentation schedule		
Delivery date	Date on which the document containing the value appeared	
Improvement in progress	State whether the department producing the indicator intends to alter the calculation or collection method.	
Comments		

Selected indicators, targets, and assessment methodology should be **precisely and unambiguously defined** in the Technical and Administrative Provisions. The data source should be clearly identified and the availability of quality data verified. Delegations can use the template shown here for a description of the selected indicators.

Finally, delegations should apply these principles not only to the variable tranche indicators but also **support the partner country to reflect these principles in the overall public policy monitoring framework**. Clearly defined indicators and assessment methodology, a prioritisation of indicators⁽⁸⁹⁾ to reflect policy objectives and identified challenges, and an appropriate mix of indicator types are all equally relevant to the overall PAF or public policy monitoring framework, which, where available, will be used to monitor the public policy eligibility criterion.

5. OPTIONS FOR CALCULATING VARIABLE TRANCHE PAYMENTS

This involves attributing a score for each selected indicator, and then aggregating these scores in some manner to determine the variable tranche disbursement. An example is provided below. As noted in the public policy chapter and annex, **performance assessments should be an inclusive process** led by the government but whereby performance results are also subject to stakeholder consultations, and whereby **performance results are made publicly available and feed into domestic accountability mechanisms**. The results for variable tranche indicators can then be extracted from the overall policy review process, subject to EU Delegation views on the accuracy of the results.

Variable tranche calculation example using 0-0.5-1 scores and performance categories

Sector development objectives	Indicator	Baseline	Target	Result	Assessment	Financial weight	Score
1. Education – Access	Indicator A	a (x0)	a (y1)	a (z1)	1	20%	20%
2. Education – Quality	Indicator B	b (x0)	b (y1)	b (z1)	1	20%	20%
3. Education – Governance	Indicator C	c (x0)	c (y1)	c (z1)	0,5	20%	10%
4. Public finance – Internal control	Indicator D	d (x0)	d (y1)	d (z1)	1	20%	20%
5. Public finance – Procurement	Indicator E	e (x0)	e (y1)	e (z1)	0,5	20%	10%
1. Overall score:							80%
2. Variable tranche disbursement:							100%

Performance categories: ‘unsatisfactory’ (score 0-29 and no variable tranche disbursement), ‘limited progress’ (score 30-49 and 40% variable tranche disbursement), ‘satisfactory’ (score 50-79 and a 70% variable tranche disbursement), and ‘strong performance’ (score 80-100 and full disbursement)

Step 1: Attributing a score to each indicator

In this example, each indicator is scored 0, 0.5 or 1 depending on whether there was (i) no or insignificant progress, (ii) significant but partial progress, or (iii) target met. Alternative options are to have just 2 categories (0 or 1 for met or not met), or a pro-rata score in accordance with progress made⁽⁹⁰⁾. However, these options can lead to reduced payments even with solid progress across the indicators. If used appropriately, **the option used in the example is therefore the preferred option in most cases**.

Where serious doubts exist about the quality of the data provided, a **data verification exercise** should be carried out to inform payment decisions. An external expert could be recruited to verify data claims on a sample basis, verifying data directly where possible or through cross-checking data with other, typically non-governmental, stakeholders.

⁽⁸⁹⁾ Public Policy PAFs can obviously have more than 10 indicators but the principle of prioritisation remains valid and with PAFs that more than 50 indicators policy makers can lose sight of priorities.

⁽⁹⁰⁾ This would be $(z-a)/(y-a)$ in the example. Only applicable to quantitative targets.

Step 2: Aggregating scores to determine the variable tranche disbursement

The two main options involve a **pro-rata** disbursement (the sum of weight-adjusted scores for individual indicators) **or the use of broader aggregate performance categories**. The example above gives an equal weighting to each indicator to arrive at an overall score of 80%. Rather than disbursing 80% of the variable tranche (the pro-rata disbursement option), disbursement in the example is 100% based on the use of four performance categories (more performance categories can be used). Compared with the pro-rata disbursement option, this allows for full payment in cases of strong, but not 100%, performance, and the withholding of variable tranche payment when performance may not be 0% but is still highly unsatisfactory. It is particularly useful in the case of quantitative targets where it avoids an overly mechanistic focus on individual scores and a 'ticking boxes' approach in favour of a broader view. The use of performance categories is therefore recommended. However, where the variable tranche consists of a limited number of key policy measures and reforms the pro-rata option is preferable to ensure policy focus on each of the policy actions.

In exceptional cases, where exceptional events or changing circumstances have prevented meeting previously agreed targets, it may be possible to **waive or neutralise an indicator condition**. In this case, the related amount can either be transferred to the next tranche or reallocated to the other indicators of the same tranche.

In order to enhance predictability and respect budgetary and planning cycles, indicator assessments should normally take place at the time foreseen covering a time period that coincides with the country's budgetary cycle. A typical review calendar would be to assess fiscal year $n-1$ performance in year n , in order to provide disbursement commitments for disbursement early in year $n+1$. This is the **$n-1/n/n+1$ principle**. In less aid dependent countries where predictability is less of a concern, disbursement could take place if needed immediately after the assessment, the **$n-1/n/n$ option**.

Floating tranches, i.e. tranches without a defined decision date in the financing agreement, should generally be avoided.

In general, undisbursed funds should not be 'recycled' in later tranches, the so-called '**tranche balai**', as this can reduce the initial incentive effect of variable tranches. Rather, they should be decommitted and where possible returned to the country's multi-annual indicative programme. However, in exceptional and duly justified cases financing agreements can allow for a re-assessment of certain unmet targets in the following year against the original target if there is a positive trend and the government did not reach the target because of external factors.

Useful references

- ADM support, The Role and Use of Performance Measurement Indicators: http://capacity4dev.ec.europa.eu/macro-eco_pub-fin/document/guide-performance-measurementenglish;
- Eurostat, Guide to Statistics in European Commission Development Co-operation (http://epp.eurostat.ec.europa.eu/portal/page/portal/international_statistical_cooperation/thematic_activities/communication_and_coordination/guide_to_statistics)
- Learning from Experience with Performance Assessment Frameworks for General Budget Support; November 2005; Andrew Lawson, Richard Gertser, and David Hoole: http://www.gersterconsulting.ch/docs/synthesis_paf_report.pdf
- European Commission, "EC Budget DSupport: An Innovative Approach to Conditionality", DG Development, February 2005.
- "Conditionality, Predictability and Performance: A Study of EDF 9 General Budget Support Programmes", A.Eberhard and J.Beynon, J. European Commission, DG DEVCO, 2012 (forthcoming).

Annex 9: State Building Contracts for Fragile Situations

1. INTRODUCTION

This annex aims at highlighting aspects specific to budget support in situations of “fragility” and “transition”, namely: the rationale, key issues when assessing the case for a State Building Contract (SBC), and the specificities of design and implementation. The purpose of this document is therefore to provide guidance on the conditions in which the EU would consider implementing budget support in situations of fragility and to give some indication of the measures to be taken for its implementation. The State Building Contract is not limited to fragile States however and situations of fragility may arise, inter alia, in partner countries during political transition to democracy and establishment of the rule of Law.

The aim is to ensure the consistency of the EU’s activities in this field, against a background of enhanced coordination with other donors and a deep commitment to the principles of ownership of aid by beneficiary countries.

It could be useful, for broader background information on situations of fragility, to refer to the work of the International Network on Conflict and Fragility (INCAF) and to the New Deal for Engagement in Fragile States adopted in Busan in 2011.

2. RATIONALE FOR STATE BUILDING CONTRACTS

In certain situations of fragility the provision of budget support may be the most appropriate aid modality to support partner countries ensure vital state functions. It can prevent serious deterioration of both the political and economic situation, by underpinning stabilisation measures, and strengthening the State’s limited capacity to provide at least basic services to the population. The lack of basic service delivery is often a cause for perpetuation of social tensions and may lead to lack of credibility and trust in public institutions. State building in these contexts is essential to build up social cohesion, state legitimacy, human security and stability.

Budget support can therefore support the transition towards stability and development and enables the promotion of improvements in governance, human rights and democracy and basic service delivery.

In order to better reflect these objectives, EU budget support operations in fragile situations are now referred to as “State Building Contracts” (SBCs). More than a simple change of name, State Building Contracts reflect greater differentiation of budget support operations and a specific approach to fragile situations, which entails a commitment to developing the capacity of such states. Indeed, countries in fragile situations face a lot of challenges and are, by definition, high risk environments. Therefore, the decision to provide budget support, the eligibility criteria assessment, the design and the implementation modalities require specific features: quick intervention, taking account of the institutional and capacity weaknesses in applying the eligibility criteria and performance results, but also stronger political and policy dialogue, technical assistance, the possible earmarking of EU funds, and close monitoring of risks through the risk management framework.

This however requires a holistic approach with budget support seen as complementary to other means of intervention (humanitarian aid, pooled funds, project aid, and technical assistance).

3. KEY ISSUES WHEN ASSESSING THE CASE FOR STATE BUILDING CONTRACTS

3.1. Which situations

State building contracts should be provided exclusively in fragile situations on a case by case basis. They should not be used as a means of avoiding the requirements for Good Governance and Development or for Sector Reform Contracts. Furthermore, any country in fragile situations is not automatically eligible for State building Contracts. Thus, EU Delegations should start the identification phase with determining whether the potential beneficiary state can be considered “fragile” or in fragile situations/in transition.

In its conclusions of November 2007, the Council of the EU acknowledges that “fragility refers to weak or failing structures and to situations where the social contract is broken due to the State’s incapacity or unwillingness to deal with its basic functions, meet its obligations and responsibilities regarding the rule of law, protection of human rights and fundamental freedoms, security and safety of its population, poverty reduction, service delivery, the transparent and equitable management of resources and access to power”.

The concept of fragility covers a wide range of situations and circumstances, including countries emerging from crisis and armed conflict, reconstruction, humanitarian crises and natural disasters, and situations of extreme poverty, and also underlines the issue of prevention.

The concept of transition refers here to a variety of situations that can lead to a transition from authoritarian rule to democracy. This can be a long process of societal transformation where policymaking institutions need to adapt to new challenges of a more democratic and equitable society. The transition may be peaceful or crisis-driven. In these situations, elaboration of medium term development strategies may not be feasible as long as the situation remains fragile.⁽⁹¹⁾ These countries may face economic and social pressures and need more effort and international support to deepen and make reform work in practice and become sustainable.

EU Delegations are required to make an assessment of fragility, based on criteria related to consideration of fragility by international organisations and in relation to the above EU definition of fragility. Reference can also be made to characteristics used by the Commission in its 2007 Communication “Towards an Action Plan on Fragility”.

From a viewpoint of the potential provision of budget support, the analysis must naturally address whether fragility is related to unwillingness or (following e.g. a peace / transition agreement) it is more related to incapacity (as per the above mentioned council conclusions). In case of fragility due to unwillingness, there may be little scope for budget support. In practice, the assessment may often not be so black and white, and a judgement must be made.

Although there is no automaticity for the purposes of a state building contract, it can be useful to refer to the list of countries for which a declaration of crisis has been taken by the Director General of DEVCO, for the application of flexible procedures. This goes the same for the World Bank list of fragile states or territories. If a state or territory is not on one of these lists, then it can still be considered fragile or in fragile situation for the purposes of the state building contract if sufficient evidence can be provided.

A country’s emergence from crisis is a long and non-linear process from the beginning of the post crisis phase to the stabilisation phase which each offers a window of opportunity for deciding whether to grant budget support. The post crisis period presents the higher risks but getting the state functioning again (financing of officials’ salaries and other current expenditure) and consolidating a weak and sometimes broken state apparatus can in some cases play a decisive role in building trust and preventing a country from slipping back into crisis. During the transition phase, appropriate development and growth strategies become possible in order to reduce the causes of fragility or conflict on a lasting basis. In this context, SBC may contribute directly to macroeconomic stabilisation by increasing the revenue available to meet, in particular, social needs (wages, health, education), or other peace and state building goals, facilitate cash flow management, reduce the internal debt, etc. This phase can be relatively long, as long as there remains a major risk of backsliding.

3.2. Opportunity of intervention

The assessment of the opportunity to provide budget support will depend on whether budget support could support essential elements of state building that consolidate the process of stabilisation and a country’s emergence from crisis. The decision will be based on the political and economic analysis of the situation of fragility which should be part of the analysis of the risks and benefits expected. These analyses will be conducted by the EU Delegations, in close coordination with Member States and other donors in the field. They should lead to an enhanced political and policy dialogue with the partner country.

The decision to grant budget support may entail the prior adoption of additional arrangements to provide the requisite funding. In order to speed up the decision-making process, these analyses should be conducted rapidly.

Risks and benefits analysis / political and security situation

⁽⁹¹⁾ Communication on “Supporting sustainable change in transition societies” (to be adopted in mid-2012)

The decision to provide EU budget support in fragile situations “should be taken on a case by case basis and supported by an assessment of the expected benefits and potential risks. The Commission will ensure that these decisions take into account the overall political and security situation, the financial risks, and the potential cost of non intervention”⁽⁹²⁾. This decision of opportunity is therefore a preliminary step before assessing the country eligibility to budget support.

Risk analysis will inform the decision making process. It will help to identify the specific risks linked to the provision of budget support, to develop a risk response strategy, that covers mitigating measures like safeguards and specific conditions, and to inform the political and policy dialogue.

Annex 7 of the Budget support guidelines develops an improved risk management framework adapted to the specific risk profile of budget support operations. Risks must be analysed according to the five following categories: political governance, developmental risks, macroeconomic risks, public financial management and corruption and fraud. This risk analysis framework applies to state building contracts as well but some guidance are given hereafter to highlight specific issues related to fragile situations that may be part of the narrative assessment within the risk management framework.

A good basis for assessing the risks and opportunities would be a specific conflict or fragility / political economy assessment. In many fragile states, such analyses are carried out as part of joint-donor cooperation and – ideally jointly with or even lead by the government. Where no up to date and authoritative analysis is available, the Delegation may choose to conduct its own analysis. It would typically consist of an analysis of key factors and actors playing a role in the conflict / situation of fragility, and their relations, often complemented by some form of scenario analysis. Separate guidance on conflict and political economy analysis will be forthcoming⁽⁹³⁾.

Engagement in fragile situations involves high risks, but also offers opportunities for a high return on investment, as the non-engagement in a fragile situation may cause higher costs in the long run. Spill over effects to neighbouring countries, directly through conflict, crime, and disease, but also through economic linkages, are to be taken into account⁽⁹⁴⁾. A higher risk may be acceptable in these contexts where the expected benefit of a state building contract is higher than the potential risk. However, the risk management framework is also a tool to monitor risks and the implementation of mitigating measures. This is crucial for an engagement in an environment of substantial and high risks in order to safeguard the Commission's interests and reputation. To analyse the risk, the same risk management framework is applied, even though the specific risk profile of a State Building Contract will be considered in the narrative part of the assessment, in particular by taking into account the relevance and credibility of a policy for transition, debt analysis, and financing gaps as part of the macroeconomic risk, and the overall institutional capacity. Balancing risks and benefits of a State Building Contract are crucial in order to decide on a budget support programme on a case by case basis. The risk management tool will therefore provide a summary of the expected benefits (the risk of non-intervention) of a budget support programme in a fragile situation.

To summarise, the decision to move ahead with development of a state building contract includes the following components:

- an assessment of whether the state can be considered fragile or in a fragile situation/in transition
- an assessment of the risks and benefits(risk of not providing budget support) including the identification of mitigating measures
- a clear purpose linked to state building objectives
- an indication of the government strategy to be supported by the SBC
- an indication of wider international support for the provision of budget support notably from the World Bank and IMF

The above assessment will be shared with EU MS represented in the country and in particular with those already engaged in budget support operations. An appropriate level of consultation with non EU partners, in particular IFIs, will also be sought.

⁽⁹²⁾ Communication on the “Future Approach to EU Budget Support to Third Countries”

⁽⁹³⁾ Delegations may also contact both DEVCO's Fragility and Crisis Management unit (A5) as well as the EEAS Conflict Prevention, Peace Building and Mediation Division (VI.C1).

⁽⁹⁴⁾ The cost to the typical fragile state and its neighbours, over the entire history of its fragility, has been estimated to be about \$100 billion: Collier (2007) and Chauvet and Collier (2005)

A note summarising this assessment should be sent for decision to the relevant geographical director. On approval, the Delegation is free to move ahead with preparing the action fiche and the supplementary documents. In order to speed up the intervention, an identification fiche will not be required. The Delegation may however choose to submit an identification fiche – for example to facilitate wider discussion on the options (inclusion of institutional support, design of the programme etc.).

3.3. Enhanced political and policy dialogue

The political will of the government would merit special attention in itself as well as its capacity and/ willingness to commit to state building objectives/goals (cf. but not exclusively the five Peacebuilding and Statebuilding goals as defined in the New Deal approach endorsed in Busan⁽⁹⁵⁾) and good governance principles. As for countries in democratic transition, they should have started the process towards democratic and governance reform (e.g. free elections, establishment of a Constituent Assembly) and should have demonstrated their willingness to incorporate fundamental rights into their legal frameworks. The experience of the Arab Spring shows that a successful transition towards democracy is not possible without broad public support and a wide popular understanding of the various issues involved, including the related political, governance and economic reforms and their implications. Thus, the political dialogue will aim at evaluating the stabilisation strategies for meeting the challenges of fragility or instability and attention will also be given to the ownership and inclusiveness of the national political dialogue.

Budget support in a situation of fragility is part of an overall EU approach. It is not an isolated instrument and the political and policy dialogue related to BS needs to be fully integrated into the EU's approach and to seek potential synergies with other EU interventions.

Indeed, the issues involved when a country emerges from crisis (e.g. demilitarisation and reintegration of ex-combatants, security sector reform, etc.) will also be closely related to the country's budget. Issues of economic governance such as the management of natural resources (EITI, mining and petroleum agreements, forest exploitation/FLEGT, taxes and other charges) or public sector management are related issues that will be discussed in the broader political dialogue with the authorities. Indeed, all too often, the countries in Africa that nature has endowed with the most plentiful economically valuable resources such as oil, diamonds, minerals and timber have been the same countries that have struggled with instability and conflict. The dialogue on budget support enables the EU, through the EU Delegation, to take a stance on key development issues (governance reform, economic, budget, development policy).

Making the most of this dialogue calls for a high-level commitment, especially at the time of the identification/formulation phase as well as during the annual review of budget support. However, it must be underlined that both political and policy dialogues must be an ongoing process, informed by the constant monitoring of the budget support programme as well as the broader political developments. **Dialogue must be coordinated among EU member states** and other donors in order to provide coherent and consistent responses to challenges encountered.

4. PREPARATION OF THE ACTION FICHE AND SUPPLEMENTARY DOCUMENTS

4.1. Eligibility criteria

Instrument: Road map budget support in a situation of fragility

Where emergency allocations are used (e.g. B Envelope in the case of the EDF), the identification and formulation stages could be run together.

Once the decision of opportunity to provide SBC has been taken, the preparation of the road map involves a preliminary analysis of the country's situation with regard to eligibility for budget support. The road map is the instrument used to identify whether a country is eligible or to identify the steps by which it could become eligible. These steps, if sufficiently predictable, could take place alongside the formulation process (identification/formulation). The road map will define the roles of the different actors (governments, IMF, group of donors, EU) in the process and, where relevant, chart the identification / formulation phases, including the timetable, right up to the financing decision.

In order to get the dialogue with the authorities under way as soon as possible and to inform them of the steps and

⁽⁹⁵⁾ The New Deal for engagement with fragile states defines 5 Peacebuilding and Statebuilding goals: i) legitimate politics (foster inclusive political settlements and conflict resolution) ii) security (establish and strengthen people's security) iii) justice (address injustices and increase people's access to justice) iv) economic foundations (generate employment and improve livelihoods) v) revenues and services (manage revenue and build capacity for accountable and fair service delivery).

conditions leading to eligibility, it is recommended that the road map be shared with them. It is also recommended that the road map be discussed with partners, especially the IMF, World Bank, development banks and Member States involved in budget support and/or support for economic governance in the country. This coordination will verify the feasibility of the steps and conditions planned and will ensure the consistency of the different partners' approaches.

As for all budget support programmes, SBC are subject to eligibility criteria in the following four areas:

- Public policies
- Macro-economic framework
- Public financial management
- Transparency and oversight of the budget

The general principles to assessment of eligibility criteria described in the guidelines for Budget support also apply to SBC. However, when assessing the eligibility and the fulfilment of general conditions during implementation, the focus will vary in order to adapt on a case by case basis to the weaknesses inherent to situations of fragility. This annex focuses to these specificities.

4.1.1. National/sector policies and reforms

The overall purpose of SBC is to support the activities deployed by a Government to ensure its vital State function and implement a development strategy addressing the challenges of fragility and poverty reduction as well as strengthening democratic processes.

However, in countries of situation of fragility there might not always be national development plans. In such cases, the EU Delegation can refer to frameworks approved by the international community, such as transition compacts developed to avoid aid fragmentation and ensure coherent approaches in state building. Other government strategies can also be used such as Presidential plans especially where these are more recent than a national development plan which might predate a crisis or conflict.

The eligibility assessment will aim to demonstrate that the policy response is **relevant** and **credible** for the particular country and the particular situation of fragility. During implementation, the assessment will focus on progress against its stated objectives.

The first step will be to look at the process for formulating and monitoring the national development plan (or related strategy), taking due account of the institutional and financial obstacles to achieving that goal. Particularly in fragile situations, where institutional capacity is limited, care should be taken to ensure government ownership. Risk for donor-driven reforms is high but experience proves that ownership is critical for policy success.

The policy should not be overambitious, at the risk of creating unrealistic expectations that could further damage the legitimacy of the state. However, even embryonic, it should address the challenges of fragility (governance issues, stable macroeconomic framework, economic resilience, PFM reforms, basic service delivery).

The country's eligibility will be analysed in the light of the government's commitment to integrating its priorities into the state budget and to conducting regular joint reviews involving the development partners (the international community and the authorities) and, as far as possible, civil society.

During the implementation of the programme, as the policy response is implemented, the eligibility assessment will aim to demonstrate that progress is achieved against its objectives.

4.1.2. Stability oriented Macro-economic framework

According to an IMF study, in fragile LICs, on average, per capita GDP is roughly 60 percent lower than that of other LICs, while domestic revenues lag behind by some 5 percentage points of GDP⁽⁹⁶⁾. Economic development is thus a key component of transition out of fragility. This requires a stable macroeconomic environment in order to reduce

⁽⁹⁶⁾ Based on IMF data for 2009 and excluding oil producing LICs, Somalia, and Solomon Islands.

economic vulnerabilities over the longer term. Reliable program support and technical assistance are critical elements in this effort.

The IMF has an essential role to play in helping countries' efforts in this area and particular importance will be accorded to the studies and analyses of the IMF, with which the beneficiary governments draw up their budgets and macroeconomic frameworks and negotiate funding to meet urgent balance of payments needs.

In line with the guidelines on Budget support (Section 5.1.2), for the purposes of demonstrating eligibility, particular attention will be given to the following aspects:

- The nature of the country's relations with the IMF and the type of programme in place: the road map will show that a programme (an Extended Credit Facility) or at least a Rapid Credit Facility with the IMF is in place and will specify the type and characteristics (especially quantitative and structural benchmarks). It is a necessary condition. If there is no such programme, the IMF will be asked to provide an assessment letter confirming that a policy supporting or restoring the country's macroeconomic stability is in place; this may, for example, be the case when negotiations are under way for an IMF programme.
- Analysis of the macroeconomic situation (balance of payments, inflation, deficit with and without grants, level of foreign reserves, internal and external debt, etc.) and the sustainability of the debt, including management capacity.
- Existence of a revenue and expenditure framework and an identified financing gap.
- Outlook for the next two to three years and identification of variables in the event of shocks (e.g. accumulation of internal or external arrears).

4.1.3. Public Financial Management (see Section 5.1.3 and Annex 5 of the Guidelines)

Public financial management system is an essential part of the development process. Its performance is key to the achievement of public policy objectives and to ensure the appropriate use and effectiveness of donor assistance.

Therefore, assessment of eligibility will consider the credibility and relevance of the partner country's PFM reform programme. However, a reform programme may not always be encapsulated into a single, comprehensive and coherent strategy document, particularly in countries with weak systems, as fragile states. In such context, as stated in the Common Approach Paper on Coordination on BS in fragile states, *"Improved public financial management performance may be an outcome, rather than a pre-condition, of budget support, if the country has committed itself to an adequate program of PFM improvement and there is reasonable evidence that improvements are occurring in a timely manner."*

However, the eligibility assessment needs to ensure, as a minimum, that basic elements of a PFM system are met. To this end, a rapid diagnosis of the PFM system should be conducted to provide a frame of reference for analysing the baseline situation and identifying main weaknesses that will need to be addressed (for example a PEFA or a diagnosis by the IMF's Fiscal Affairs Department, the World Bank or other donors can be used). Where these diagnostics do not exist already, a report conducted by the Delegation can be considered sufficient provided it gives evidence of conclusions reached and reflects views of other respected organisations.

In a particularly weak PFM environment it may be necessary to require short term measures, selected from the partner country's own PFM reform strategy. These would generally be in the form of specific conditions that would need to be fulfilled prior to the disbursement of the first tranche. The need for complementary support required in the form of technical assistance should be considered in order to address these specific weaknesses. Additional safeguards such as accounting and bank reconciliations, clearance of suspense accounts and targeting disbursements to specific expenditure lines such as civil service salaries or arrears clearance may be considered. A particularly weak PFM system would be one characterised by very weak core functions within the budget cycle, notably covering budget availability, Treasury system⁽⁹⁷⁾, as well as a mechanism for reporting on budget execution⁽⁹⁸⁾, all of which are necessary in order to allow fiscal discipline and provide some basic assurance that money is being spent in line with stated objectives. In the *absence* of one or more of these core functions, budget support will not be considered.

⁽⁹⁷⁾ In this case a treasury system would be a system that accounts for all Government revenue collections and disbursements and ensures some control of cash balances through for instance the implementation of a treasury plan and the consolidation of government bank accounts

⁽⁹⁸⁾ A mechanism for budget execution reporting should be in place to allow some control over spending at least on an annual basis through for instance budget execution reports

On the basis of the diagnosis, the government, with the support of the donors if necessary, will draw up (or update its existing reform plan) a realistic action plan with appropriate prioritised reforms. Failing that, the measures agreed with the government and monitored by the IMF under its programme, or contained in a letter of intent, will be used as a basis. Due account will be taken of progress in public-financial management in the framework of the IMF programme, and in some cases in the framework of the HIPC initiative.

4.1.4. Transparency and oversight of the Budget

The new eligibility criterion on transparency and oversight of the budget, detailed in annex 6 of the guidelines, focuses on the timely availability of comprehensive and sound budgetary information.

Eligibility for programme approval: The government must have published its budget before the first disbursement (either the Executive's budget proposal or the enacted budget). This information should be available to the general public in printed form or on an external website. This would then become a specific condition for the first disbursement if not already met. The eligibility assessment will therefore evaluate if there is a clear commitment on the part of the partner country to meet this criterion.

Eligibility during implementation: The Commission will assess and monitor more comprehensively the disclosure of budgetary information. In this regard, the Commission will focus on the implementation of a credible reform programme and will take into account

- key budget documents to be produced and published (notably: the executive's budget proposal, the enacted budget, in-year report, mid-year report, year-end report, audit report),
- timeliness of release of budgetary information,
- comprehensiveness of budgetary information, and
- quality, integrity and accuracy of information

International assessments such as the Open Budget Index, the PEFA assessments, and the IMF Reports on the Observance of Standards and Codes (ROSCs) on fiscal transparency, can be used as a guidepost for the assessment, including for the definition of a country specific baseline during the formulation phase. The definition of reform milestones, however, must be realistic in the context of fragile states (see Annex 6 of the Budget Support Guide for more detail).

4.2. Design of State Building Contracts

Experience shows that effective support to countries in fragile situations means engaging at an early stage and being prepared to stay engaged over the long haul, embracing a philosophy of carefully sequenced reforms tailored to improvements in capacity, helping country authorities deliver "quick wins" to the population, and, in this process, building the legitimacy of the state. Such an approach implies to take account of what a fragile state or a state in transition can realistically achieve in a given timeframe. The design of the program will therefore be tailored, on a case by case basis, in view of managing and minimizing the risks identified.

4.2.1. Duration of the programme

A short-term programme (1-2 year) will be used to adapt support to the pace of reforms and the short-term financing gap (e.g. accumulation of domestic arrears).

This will not, however, in dealings with the country, stand in the way of flagging the intention to continue budget support in the years ahead if conditions continue to be met (and if funds are available) and if longer term projections can be made; the country can be given an idea of the amounts planned over a two or three-year period. An annual programme review may be organised to evaluate the results of budget support and develop the dialogue with the authorities and partners.

Recourse to short programmes can also help take on board the country's own political agenda, where, for example following elections, there may be a deadline for continuing or adjusting reforms with a risk of a return to instability.

It will be possible in due circumstances, and when the transition to SRC or GGDC is not yet feasible, to renew the SBCs for a similar period.

4.2.2. Risk Mitigation

The risk management framework (see Annex 7) is used to identify risks as part of the identification and formulation phase, and to propose appropriate measures to address them, in particular for the risk dimensions that face substantial or high risk levels.

Mitigating measures could include possible financial safeguards/deployment of TA in line position (including with signing authority) of fiscal management and oversight. When this is the case, a transition plan towards the reintegration of those functions sustainably into government structures will need to be established. Other mitigating measures are set out in Annex 7).

■ Targeting of budget aid

In an environment where the risks associated with public financial management seems considerable (lack of monitoring of budget implementation and cash flow, accumulation of arrears in particular), but where these weaknesses do not exclude a beneficiary country from receiving budget support, budget support could be targeted as a safeguard measure.

■ Specific conditions

Depending on what has been agreed during the identification/formulation phase, the action fiche will set out the type of mitigating measures to be included in the technical and administrative provisions.

Systematically, these measures and conditions must have been the object of a dialogue with the authorities and, as far as possible, a consensus with the other budget support donors and the IMF. Additional to the four eligibility criteria, they should focus inter alia on the key elements which will bring about an improvement, particularly in the public financial management system.

■ Preconditions for disbursement

Depending on the context, it may be necessary to obtain the adoption of a particular measure before the programme can be implemented (ie before the first disbursement). This may concern the budget transparency, the improvement of some weaknesses identified in the PFM as well as the legislative, regulatory or institutional framework for financial administration.

Examples include a decree establishing a treasury committee, payroll control (e.g. audit of education expenditure), a reduction in the number of government accounts with commercial banks, limitation of the number of accounts at the Central Bank, preparation or adoption of legislation/rules on public procurement, etc. Preconditions could also be related to the state building purpose of the SBC.

4.2.3. Disbursement profile

The disbursement profile must be discussed with the government, the budget support donors and the IMF to make sure the planned timetable satisfies cash flow needs.

In situations of fragility, in order to increase the predictability of the programme and simplify its management both for the EC and the national authorising officer, the presumption should be that there will be just one disbursement a year. It will be timed to facilitate cashflow management and budget implementation in relation to the purpose of the SBC, which in most cases will be in the first half of the budget year.

For a two or three-year programme, a variable tranche will be introduced of generally not more than 30%, with the possibility of stepping up the proportion of the variable tranche over the lifetime of the programme. For the first year of the programme, if no appropriate VT indicator has yet been identified, a single fixed tranche disbursement will be planned. The use of an Annual Performance Tranche (see Annex 8) may also be useful as a signalling device to respond to poor performance.

4.2.4. Performance indicators

Indicators should be carefully chosen to provide initial leverage for certain reforms necessary for successful implementation of the SBC without imposing further conditions.

In situations of fragility, there should be a limited number of indicators for a variable tranche (if possible each indicator should represent a significant amount of funding). They will serve to focus the dialogue on certain key points relating to the state building objectives supported by the programme, including in many cases public-financial management reform. As far as possible, they should be drawn from the national strategies and action plans or transition compacts. These will mainly be process indicators and/or, if possible, indicators linked to the budget (rate of budget implementation, ideally for the social sectors).

4.2.5. Annual review of the programme

Whatever the duration of the budget support programme, the initial analysis of the risk and benefits must be regularly updated to facilitate risk management and identify possible slippages (early warning system), e.g. in macro-economic policy, economic governance (public procurement, corruption) or public financial management (delays in reform, etc.). An annual review will be organised for this purpose. It will go beyond issues around disbursement requests and will involve pursuing deeper dialogue with the authorities and partners on broader issues relating to development and governance policies.

The annual review of the EU budget support programme conducted by the Commission and the government (ideally involving other multilateral donors and Member States in the country) will ideally be timed to coincide with the review of the national development strategy or equivalent document, the budget support review (if provided for by a joint monitoring mechanism) or the IMF review in order to permit an exchange of views on the EU programme. Reviews of the stabilisation framework may also be taken into account in the analysis. The review will cover: the four eligibility criteria and the specific conditions, the indicators for the variable tranches for years n and $n+1$, disbursement forecasts and any other relevant issue (institutional support for public financial management, economic governance, stabilisation reforms with a major budget impact (DDR, SSR, etc.), donor coordination, etc.).

The annual review will enable a decision to be taken on whether to continue the programme, if need be in an amended form, and the conditions for the next year to be validated (specific conditions, indicators).

4.2.6. Additional technical support

Given the institutional/system weakness of countries in fragile situations, it will be necessary in many cases, to include additional technical support either in the budget support programme or alongside it, for instance as part of a governance support project.

Additional technical support should support for example public financial management reform, PRSP (or equivalent) process, public administration reform, or support for the implementation of budget support. The scale of this support will depend on the country's initial situation, the needs identified and the support offered/planned by the other partners in the context of the division of labour.

In the countries concerned, Delegations can mobilise a variety of support, technical assistance, support to transparency (e.g. web tools) and democratic accountability (e.g. CSOs), twinning and public expertise notably from EU Member States for the Neighbourhood region. As strengthening public-financial management systems is one of the core functions of the IMF, Delegations can for example also mobilise the IMF expertise (Fiscal Affairs Department) through the framework agreement signed with the IMF.

Similarly, the EU, in consultation with the partners involved in the PRSP process, for example the UNDP and the World Bank, could plan support for the PRSP process focusing on the drafting of the monitoring matrix, the choice of indicators and support for statistics.

Lastly, the EU could intervene to help the beneficiary country set up an appropriate system for monitoring its partners' budget support, including public-finance reforms, in association with strengthening coordination between donors (CAP approach).

Key references:

- **Providing Budget Aid in Situations of Fragility: A World Bank–African Development Bank Common Approach Paper:** <http://www.afdb.org/fileadmin/uploads/afdb/Documents/Project-and-Operations/CAP%20Budget%20Aid%20in%20Fragile%20Situations%20English.pdf>
- **Fourth High-Level Forum on Aid Effectiveness in Busan – A New Deal for Engagement in Fragile States:** http://www.oecd.org/document/22/0,3746,en_21571361_43407692_49151766_1_1_1_1,00.html

Annex 10: Budget support in Small Island Developing States (SIDS) and Overseas Countries and Territories (OCTs)

I. Introduction, background and rationale

The Communication on the Future Approach to Budget Support to Third Countries⁽⁹⁹⁾ makes special reference to SIDS/OCTs:

The EU will also pay attention to SIDS (Small Island Developing States) and overseas countries and territories (OCTs). There, budget support can have an important impact, given

the strong level of accountability and commitment to addressing their structural vulnerability and climate change issues, including the decline of biological diversity and other environmental shocks. Budget support can offer an efficient way of addressing these crosscutting, long-term and structural challenges and threats.

The need to adapt budget support design to SIDS/OCTs rises from the specific conditions and challenges facing these countries and territories. The question, however, is not about reducing requirements. The impact of aid has been limited in SIDS/OCTs, partly because of the structural challenges faced by these countries, but also because of the relatively limited effectiveness of aid delivery⁽¹⁰⁰⁾.

II. Key Challenges facing SIDS/OCTs

The challenges facing SIDS/OCTs can be summarised under four headings; vulnerability, volatility, natural resources wealth, and institutional capacity:

- 1) **Vulnerability:** Most SIDS/OCTs are highly vulnerable to natural disasters, economic/terms of trade shocks and aid volatility. Moreover, high levels of debt might reduce the resilience capacity to shocks of SIDS or of OCTs. For instance, according to the composite vulnerability index of the Commonwealth Secretariat, the level of economic vulnerability of SIDS is among the highest in the world⁽¹⁰¹⁾. In that respect, it is generally recognised that reducing vulnerability to hazards through mitigation and adaptation is critical and should be a key component of SIDS development strategies and of OCTs efforts for a sustainable development. This vulnerability is increasingly exacerbated by the negative impacts of climate change, which disproportionately affect SIDS/OCTs, distance and energy constraints. These effects have important and direct impacts on the MDGs concerning the SIDS, and on the objectives of the association of the OCTs with the Union outlining the close links between climate change adaptation and development strategies in SIDS/OCTs.
- 2) **Volatility:** International evidence shows that small states are no poorer or slower growing than larger states, especially when they are close to large markets and have relatively high population densities. Small states, including SIDS/OCTs, have overcome obstacles of scale by increasing trade and specializing in a small number of exports to a selected number of large markets, as well as in tourism. But this reliance on specialization has increased their vulnerability to rapid shifts in the terms of trade and changes in economic conditions in the world markets. As a corollary, they experience also greater volatility in growth. Combined with their vulnerability, this extreme volatility makes development planning particularly challenging in SIDS/OCTs and calls for strategies that take these uncertainties into account and builds an element of flexibility.

⁽⁹⁹⁾ COM(2011) 638; 13 October 2011

⁽¹⁰⁰⁾ See for example Simon Feeny and Mark Rogers, *Public Sector Efficiency, Foreign Aid and Small Island Developing States*, Journal of International Development, Volume 20, 526-546 (2008)

⁽¹⁰¹⁾ J.P. Atkins, C. Easter and S. Mazzi (2000), 'A Commonwealth Vulnerability Index for Developing Countries: The Position of Small States', *Commonwealth Secretariat Economic Paper* 40, January 2000, pp.viii + 64. London: Commonwealth Secretariat. ISBN 0 85092 637 8

- 3) **Natural resources management:** There are strong similarities in the means by which high growth rates have been achieved in SIDS/OCTs. Tourism and natural resources play an important role in the growth experience of most strongly performing SIDS/OCTs. But good outcomes from natural resource investment are not automatically assured. The presence of natural resource wealth can be an opportunity for rapid growth and, therefore, for poverty eradication or for the achievement of sustainable development in the OCTs. But many studies show that reliance on abundant and high profitable point-source, non-renewable natural resource, linked with a high level of export dependence on these may not necessarily result in good economic performance due to distortion of incentives for sound fiscal management. Consequences are crowding out, i.e. expansionary fiscal policy reducing investment spending in other sectors, notably the private one, and the phenomena coined “natural resource curse” that ultimately reduce growth prospects. Contests over ownership and access to natural resources can lead to conflict, corruption and ineffective governance. In that respect, building capacity for managing natural resource wealth its governance, and its environmental and social impact, are essential in SIDS/OCTs.
- 4) **Institutional Capacity:** Many SIDS/OCTs are characterized by very small administrations, weak institutional capacity and weak core state or local government functions. However, by comparison, public sector expenditures tend to be relatively high. Broad and generalized reform agendas are unlikely to be successful, because they cannot overcome such constraints. SIDS/OCTs must adopt strategies that reflect their usually limited administrative and political capacity as to strike a balance between the level of ambition, the available capacity and competence.

Many issues have a regional dimension and opportunities and constraints faced by SIDS/OCT are often similar. To that respect, regional organisations can play a key role in providing sector policy advice and technical expertise. Strengthened regional organisations allow for economies of scale which is of particular interest in SIDS/OCT. Where regional organisations are considered efficient, ownership from SIDS/OCT in promoting regional integration and sharing competencies at regional level should be promoted and monitored.

III. How to make EU budget support suitable to SIDS/OCTs

Budget support can be an appropriate tool to help SIDS/OCTs to address the cross-cutting nature of the above four challenges, as it can contribute to inclusive and sustainable growth by helping foster a more strategic approach to adaptation to climate changes and resilience to vulnerability/volatility and to promote enhancing sector policies and reforms, including management of natural resources and development capacity.

A follow-up question that arises is how to make EU budget support as effective as possible to the SIDS/OCTs context. It should be clear that the answer is no creation of an additional category of BS contract for SIDS/OCTs, in addition to Good Governance and Development Contracts (GGDC), Sector Reform Contract (SRC) and State Building Contract (SBC). The objective is rather to assess how the overall guidelines for budget support should be interpreted and specified for SIDS/OCTs, by narrowing them down and making them more context-relevant, and thus ultimately increasing the effectiveness of budget support programmes in SIDS/OCTs.

Paradoxically, while budget support could unleash some of its greatest potential in those difficult policy environments, establishing eligibility to the instrument and setting the adequate dialogue and monitoring framework in place may be the most challenging. Often, eligibility difficulties are not a result of not meeting the eligibility criteria for budget support as such (in fact analyses show that these countries or territories are not doing worse from an economic governance perspective than recipients of budget support in other parts of the world). It is rather more the consequence of having limited capacity to undertake the necessary “administrative” processes towards assessing eligibility, as well as, conducting the dialogue and monitoring the programme, from both the recipient side and the EU side.

However, even if, in general, SIDS/OCTs share the same above four challenges, there is no one-size-fit all approach. The following three major parameters should be taken into account to adjust budget support operations to the specific SIDS/OCTs context.

■ Size of the Population

Budget support programmes should take into account the important differences within this group, which includes nations, on one side, of several million inhabitants, such as the Dominican Republic and Papua New Guinea and, on the other side, very isolated and far-flung micro- and nano-countries, sometimes with less than a thousand inhabitants.

■ Association of the Overseas Countries and Territories with the Union

OCTs are associated to the European Union by a specific “Overseas Association Decision”. They are not sovereign countries but have special links with four EU Member States: Denmark, France, the Netherlands and the United Kingdom. Within their constitutional relations with the four Member States, the OCTs enjoy wide ranging autonomy and power covering the three dimensions of decentralisation: i) political, ii) administrative and iii) fiscal. In this context, budget support to OCTs may have similar features as to budget support to a sub-national government (see guidelines main text section 2.3). As regards to the fundamental principles of human rights, democracy and rule of law built in the Communication of Budget Support, they are common to the OCTs and the Member States to which they are linked. Consequently, the fundamental values condition need not be assessed for OCTs within the budget support framework, as they are part of the “Overseas Association Decision” and monitored within the association framework.

■ Capacity Development and Size of the Administration

Some SIDS/OCTs have more opportunities to develop a fully-fledged institutional and administrative frameworks and capacities than others, the latter being often smaller and more isolated economies in this group. In such SIDS/OCTs the standard considerations and assessments should be made when budget support programmes are being designed. This applies to SIDS/OCTs with capacity to design and implement public policies and reform strategies, and which have institutions and instruments to be able to manage macro-economic policy (e.g. they would have an autonomous Central Bank).

SIDS/OCTs with a more limited institutional and administrative framework and that do not meet the above criteria will need to be assessed accordingly. Expectations in terms of macro-economic eligibility cannot be the same for a country with a small economy without adequate capacity and instruments to manage such policies. The same would apply to PFM and public policies. Moreover, for OCTs, PFM assessment can benefit, where applicable, from the audit report of the Supreme Audit Institution or other oversight controls of the Member State to which they are linked.

IV. Design Features

- a. In SIDS/OCTs it will be more appropriate to provide budget support under SRC as most SIDS/OCT are characterised by a few – if not a single one – dominant sector(s). SRCs in support of key sectors may be used in order to focus reform objectives and facilitate policy dialogue and monitoring. Such SRCs should take into account and incorporate key cross-cutting areas related to the above four challenges; vulnerability, volatility, institutional capacity and, where appropriate, natural resources management. Sector budget support, and in particular the policy dialogue that surrounds it, can contribute fostering a more strategic approach to adaptation to climate change.
- b. In small SIDS/OCTs there should be a preference for fixed tranches only, with a specific focus in the assessments of general conditions on a limited number of key measures and outcome indicators. Most small SIDS/OCTs do not have the capacity as well as the institutional and administrative framework to monitor performance as required by the Variable Tranche approach. However, for small SIDS/OCTs, results should be assessed every 5 to 7 years jointly with the donors utilising this aid modality in the country or territory to be evaluated.
- c. Linked to the above, a policy dialogue and review process with a strong focus, from the EU side, on a few key and country-owned measures, and a close alignment/integration of the broader budget support assessment framework with other partners (if it exists), including the definition of triggers and disbursement conditions. If circumstances permit, this could take the form of delegated cooperation agreements.
- d. In many SIDS/OCTs, it may be unrealistic to envisage a frequent and in depth dialogue as requested elsewhere. A more opportunistic and ad-hoc approach may be applied, using opportunities as they become available (such as regional meetings, video-conference) as channels for dialogue. Nevertheless, the association of the OCTs with the Union constitutes a partnership that provides the framework for an enhanced policy dialogue.
- e. Greater reliance on EU Member States (in the case of OCTs), multilateral and regional players/donors, in particular ADB, Australia, New-Zealand, IABD, WB and IMF (with its Regional Technical Assistance Centers) for assessments around PFM, Macroeconomic and Public policy issues, and experience with similar funding mechanisms (for example with the US Compact for Micronesia and Marshall Islands).

V. On Establishing Eligibility

■ Public Policy

Most SIDS/OCTs have a development policy or strategy under implementation. However, in very small government administrations, there may not be a separate fully fledged sector policy. In such cases, the national or local policy can be used to assess the public policy eligibility criterion for a SRC, as long as the national or local policy addresses sector issues in a sufficiently detailed manner. When assessing policy relevance, particular attention should be paid to the four key issues (vulnerability, volatility, natural resources and development capacity) outlined above. In most cases, these issues should be integrated into or addressed, at least to some extent, in sector policies. For OCTs, Member States' Multiannual Investment National Plans or Government Multiannual Programmes discussed in Parliaments can be used to assess eligibility to SRC. As long as it addresses sector issues in a sufficiently detailed manner.

■ Stability-oriented Macro-economic Framework

This eligibility assessment warrants particular attention given SIDS/OCTs vulnerability to macroeconomic shocks. Moreover, where no funded IMF programme is present⁽¹⁰²⁾, EU delegations will have to base their assessment on IMF article IV report or on one of the regional development banks reports (IADB for Caribbean, ABD for Pacific). For small economies, the assessment will take into account of the institutional framework in terms of capacity and policy instruments (eg: a Central Bank). For most of the OCTs macroeconomic stability is supported by the Member States to which they are linked.

Fiscal policy can be particularly critical in SIDS/OCTs given the dominant role of the state and the need to develop resilience against shocks. In SIDS/OCTs, the public sector tends to have a relatively dominant role in the economy. Higher public expenditure in smaller economies can reflect a higher share of 'fixed' minimum costs required to operate a government, or the need for more government interaction with the economy in response to a narrower economic base. This higher level of expenditure also tends to result in larger budget deficits (excluding grants). Foreign aid, together with debt financing, plays a major role in financing some of these deficits, and thus can have an important macroeconomic impact. The high degree of vulnerability creates a need for fiscal policy space in order to give policymakers flexibility to respond counter-cyclically to shocks or downturns⁽¹⁰³⁾. Weak fiscal discipline may exacerbate economic volatility by, for example, causing bouts of fiscal expansion and contraction. Fiscal discipline can help reverse the crowding out of private investment and spur private-sector led growth.

■ Public Financial Management

Sound public financial management is essential for a successful development process in SIDS/OCTs, as it is for developing countries. There are however important differences to bear in mind when analysing the relevance of the strategy and when supporting and setting expectations for PFM reforms in SIDS/OCTs, specifically the annual and medium term reform expectations included as part of the monitoring framework for programme implementation.

The focus in small SIDS/OCTs should not be overly on the too complex PFM reforms, but rather on whether key PFM processes, particularly related to financial compliance and aggregate fiscal discipline, are effectively implemented. Small SIDS/OCTs may not necessarily require PFM systems as sophisticated as in other countries.

Many SIDS/OCTs, in particular in the Pacific have been testing-grounds for complex PFM techniques and systems, with insufficient attention paid to sustainability and relevance. In 2001, the IMF, referring to such systems in the Pacific Islands, was recognising that *...implementation on the ground has remained a considerable problem primarily because the reforms were in most cases introduced without sufficient regard to local capacity constraints, notably in management and accounting*.⁽¹⁰⁴⁾ A particular risk factor is often the reliance on costly external expertise.

Against this background, in small SIDS/OCTs particular attention should be given to the analysis of shortcomings of existing systems and practices and then the establishment of priorities for reform identification of resource constraints and development of coherent and well-paced implementation plans. In reasonably well performing SIDS/OCTs, the focus of the eligibility will as a result be more about assessing progress towards advanced reforms to achieve high PFM standards that can deliver, in addition to financial compliance and aggregate fiscal discipline, efficient and effective service delivery.

⁽¹⁰²⁾ While the IMF is present in most Caribbean countries, few Pacific Islands and none of the OCTs have Fund programmes. However, regional donors or organisations (PFTAC, ADB, IADB, CARTAC,...) may also have macroeconomic assessments which can be a source of information.

⁽¹⁰³⁾ Stéphanie Medina Cas and Rui Ota, *Big Government, High Debt, and Fiscal Adjustment in Small States*, IMF Working Paper WP/08/39.

⁽¹⁰⁴⁾ Klaus-Walter Riechel, *Public Financial Management: Principal Issues in Small Pacific Island Countries*, IMF Policy Discussion Paper, February 2002

Eligibility assessments of PFM for OCTs will depend also on the fiscal autonomy and powers from the Member States to which they are linked. Therefore, attention should be paid to their the fiscal autonomy.

■ Transparency and Oversight of the Budget

The new guidelines outline how this criterion should be assessed for SIDS/OCTs (see Guidelines section 5.1.4.). The criterion covers the definition of an entry point for budget support operations and the assessment of progress based on a dynamic approach.

For eligibility during implementation, which focuses on disclosure of six key budgetary documents, the guidelines state that more flexibility can be applied for SIDS, in particular with regard to the publication of the Executive's Proposal and the Year End Report or Audit Report.

Budget transparency in OCTs should be, in principal, identical to that of the Member State to which they are linked. If any difference can be observed, an assessment of eligibility should be made.

VI. Risk Management Framework

In principle, the Budget Support Risk Management Framework is also applied for SIDS/OCTs, except the political risk, which is not applied for OCTs (see above). However, the specific circumstances of SIDS/OCTs needs to be reflected when the risk management framework is used. As an example, the vulnerability, volatility, and capacity constraints in SIDS/OCTs may imply specific risks that are not covered by the standard risk questionnaire. In these cases, the narrative part of the risk register and the country risk profile should be used to highlight the specific circumstances and risks.

Annex 11: Domestic Revenue Mobilisation (DRM)

This annex provides background information on Domestic Revenue Mobilisation (DRM) in the context of budget support. It is complementary to the specific guidance on DRM, which is provided in the annexes on public financial management and macroeconomic analysis. Section 1 outlines the policy context of the EU approach to mobilise domestic resources and Section 2 describes EU's efforts in supporting DRM. Section 3 provides an overview of crucial areas and measures with regard to tax policy and tax administration. This overview aims to provide a basis to assess taxation systems and to discuss domestic revenue mobilisation in the policy dialogue with partner countries. Section 4 describes existing diagnostic tools, their advantages and disadvantages to analyse taxation systems and a conclusion.

1. POLICY CONTEXT / BACKGROUND

In many developing countries, the sustainable provision of public services that is necessary to achieve and maintain the Millennium Development Goals (MDG) requires substantial increase in resources beyond what can be funded by external resources. So far, though, domestic revenue mobilisation in developing countries is relatively low in comparison to developed countries. The tax ratio in low income countries is around 10 – 20%, whereas it averages 36% in OECD countries. Therefore, already in 2002 the United Nations Monterrey Consensus on Financing for Development acknowledged the necessity to increase domestic revenue mobilisation in developing countries. This was reinforced at the United Nations Doha Declaration on Financing for Development in 2008. Moreover, the Paris Declaration (2005), the Accra Agenda for Action (2008), the G 20 Summit in Cannes in 2011, and most recently, the 4th High-Level Forum on Aid Effectiveness in Busan, (Korea) all highlighted the importance of domestic revenue mobilisation for economic development and sustainable growth. The impact of the financial crisis on developing countries has not only sharpened the awareness regarding the importance of good governance in tax matters but also made it even more urgent to take up the call for action to increase much needed tax revenues in developing countries.

Increasing domestic revenue not only creates additional space for supporting MDG-related spending, but it also allows a country to assume ownership of its development policy choices and reduced dependency on aid. Therefore the communication "Future Approach to EU Budget Support to Third Countries" emphasise the importance of increased domestic revenue mobilisation in cooperation with partner countries. The African Economic Outlook 2011 highlighted that development success stories go hand in hand with an increased domestic revenue mobilisation and less dependency on aid and other foreign finances. Domestic revenue mobilisation and in particular taxation have a positive impact on the relationship between the state and its citizens. The latter are more likely to hold the government accountable on the use of public expenditures and public service delivery when they support the government through taxation. In other words, taxes are central to the social contract between a state and citizens and hence increase domestic accountability. In the long-term, domestic revenue mobilisation provides partner countries with sustainable and more predictable public revenues and reduces aid dependency. Efficient and effective tax systems can contribute to tackle corruption by reducing possibilities for poor governance and illegal behaviour due to intransparent and inefficient tax systems. Strengthening partner countries' tax systems is therefore a necessary step in enabling long term financing of their development strategies and programmes, ensuring fiscal stability, promoting economic growth, strengthening anti-corruption efforts, as well as compensating for possible negative incentives to DRM from budget support.

Yet, reforms in taxation are medium- to long-term measures and therefore domestic revenue mobilisation cannot be seen as a substitute for, but as complementary to, foreign aid. Domestic revenue mobilisation, including revenues from natural resources, needs to be an essential component of countries' public finance reform programmes and a fundamental part of the policy dialogue between the EU and partner countries. It is in this regard that domestic revenue mobilisation is an integral part of the eligibility criteria on both Macro and Public Financial Management.

2. EU'S EFFORTS IN SUPPORT OF DRM

In 2010 the Commission adopted a communication on "Tax and Development: Cooperating with Developing Countries on Promoting Good Governance in Tax Matters". It aims at improving synergies between tax and development policies by suggesting ways in which the EU could assist developing countries in building efficient, fair and sustainable

tax systems and administrations with a view to enhancing domestic revenue mobilisation in a changing international environment. It emphasises the need for domestic revenue mobilisation to be supported by the EU in the context of its broader efforts to strengthen good governance and public financial management in its partner countries based on a comprehensive approach, in the sense that reforms are seen from a governance, state building and growth perspectives. Therefore, emphasis is to be placed on a better understanding of the political environment and growth implications of tax reforms to ensure their sustainability, as well as on addressing governance issues undermining tax reforms and ensuring increased governmental accountability to strengthen the relationship between the taxpayer and the state. In this context support to partner countries should also focus on improving tax administrations to enhance efficiency and effectiveness of tax collection and to tackle corruption in the area of taxation.

Developing countries often finance an important share of their budget from activities in the extractive industry. Therefore, the increase in domestic revenues in resource rich countries is often based on an increase in public revenues from natural resources. Thus, the Communication highlights the role of the global Extractive Industries Transparency Initiative (EITI) as a way to promote transparency, domestic accountability and thus enhancing public and corporate governance in resource-rich countries.⁽¹⁰⁵⁾

In line with the Communication, the Commission has strengthened its cooperation with developing countries on tax matters. With the help of a dedicated budget line recently created to that effect by the European Parliament, the Commission cooperated during the last years with regional tax centres in Africa (African Tax Administration Forum, ATAF) and Latin America (Inter American Centre of Tax Administrations, CIAT) to support regional capacity building activities on various tax issues such as auditing of multinational companies, taxation and state building, tax governance, transfer pricing, electronic invoicing and tax burden amongst others. In 2010 the European Commission launched a study on “Transfer Pricing and Developing Countries” which led to a Tripartite Initiative with the World Bank and the OECD to enhance the capacity on transfer pricing in partner countries. Furthermore, the European Commission is contributing to the IMF Topical Trust Fund on Tax Policy and Administration, to the IMF Regional Technical Assistance Centres, to the IMF Topical Trust Fund Managing Natural Resource Wealth and to the World Bank EITI Trust Fund. Furthermore, the Commission supports EITI activities as well as developing countries’ efforts to adhere to and comply with EITI rules. The European Commission is also a member of international initiatives such as the International Tax Compact (ITC) and International Tax Dialogue (ITD).

3. WHAT TO PROMOTE THROUGH BUDGET SUPPORT AND HOW TO ASSESS EFFORTS IN DOMESTIC REVENUE MOBILISATION

In contrast with other areas of public financial management, no specific tool to provide a sound analysis exists yet to adequately assess tax policies and tax administration capacities. However, several tools and indicators can be used to gather insights on tax regimes. In particular, to assess a country’s performance in terms of their ability to mobilise domestic revenues, the tax ratio, tax effort and tax system can provide a good indication. They provide an overview of the amount of tax revenues in relation to GDP (which should be computed with and without oil and gas resources), of the extent to which the country exploits its tax potential, of the composition, level and relevance of the various taxes in the country, and how the country intends to compensate losses from increased trade liberalisation and lower tax rates. Furthermore, an analysis of the tax incentives a country accords to taxpayers provides an overview on the tax expenditures a country faces as well as of their costs and benefits.

■ Tax Policy

Through revenue raising, tax policy has a strong impact on macroeconomic stability, income distribution and economic growth. The decision on the type of taxes a country adopts and the overall mix of tax types, tax incentives (tax exemptions, tax holidays, tax credits, tax reductions, tax free zones, etc.) and tax rates have an effect on the size of revenues a country can collect. In turn, this influences choices on economic activities, ways of investment and consumption, the potential to attract foreign direct investments, the economy’s growth rate and the beneficiaries from that growth.

The **tax ratio**, calculated as the total of all collected tax revenues as a percentage of Gross Domestic Product (GDP), is one indicator of a countries’ tax collection. It gives an indication of the amount of tax revenues that are available in relation to the size of the economy (e.g. if the economy grows faster than the tax revenues it means that the tax ratio will decline). Although the average tax ratio has been increasing over the last years in developing countries, it is still low for low income countries.

⁽¹⁰⁵⁾ The Extractive Industries Transparency Initiative (<http://eiti.org/>) is a global standard that promotes extractive industry revenue transparency in resource-rich countries, requesting companies to publish payments to governments and governments to publish the revenues effectively received from companies.

A low tax ratio can be caused by various reasons. Nevertheless, if the tax ratio is below the average of comparable countries the reasons behind the low tax ratio need to be examined to support the country in implementing reforms to increase revenue collection in relation to the size of the economy (GDP). In addition, many resource-rich countries have a high tax ratio due to revenues from oil and gas. In these cases it is necessary to calculate the tax ratio with and without revenues from oil and gas to assess the countries performance in revenue collection with regard to more traditional taxes (income taxes, VAT).

A related indicator of the countries' tax system is **taxes per capita**. It is defined as the total of all collected tax revenues divided by the population. It shows the average amount of taxes collected from the countries' inhabitants and in a way it measures its tax effort. Yet, a better index of **tax effort** can be obtained by measuring how well a country is doing in terms of tax collection in relation to its economic potential. Tax efforts indicate the extent to which each country exploits its tax potential. It is calculated by dividing the actual tax collection by the potential tax collection of the country based on the structure of its economy (indicated by per capita income, ratio of trade to GDP, share of agriculture to GDP)⁽¹⁰⁶⁾. The tax effort is generally increasing with the development of the economy. For example it is lower if the share of the agricultural sector of the economy is high. This is due to the generally low level of monetisation in this sector and the difficulty of taxing agriculture directly. A tax effort below one indicates that the country is collecting less tax than predicted, while a tax effort about one means tax collection is as expected from the structural characteristics. The tax effort is, in most cases, difficult to calculate due as much to lack of data availability regarding the economy as to the sophisticated calculation process involved. Hence, whether the tax effort can be used as an indication of the tax performance in a country depends on the quality and availability of country data.

The **tax system** shows the composition and relevance of various taxes in the country. The main distinction of taxes is between direct and indirect taxes. Direct taxes are levied on income of individuals and on corporate profits, regardless of use. Whereas indirect taxes are levied on consumption (e.g. Value Added Taxes, sales taxes, excise duties, import tariff) that means when the income is allocated to consumption and the assets are transferred. In addition, revenues from the extraction of natural resources (activities in oil, gas and mining) are becoming an important source of revenues for resource-rich countries.

While every country has its own specific tax system, some general observations can be made about the current state of tax systems and tax reform in the developing world. Countries with a high per capita income tend to rely more on direct taxes (in OECD countries their average is 15.6% of GDP), while in Latin America direct taxes account for only 5% of GDP. Trade taxes (such as import tariffs and export duties) account for 24% of tax revenues in the lower-income group compared to only 1% in the higher-income group.⁽¹⁰⁷⁾ Tax collection requires comparatively low administrative capacity at the borders and this explains their more intensive use by countries with low domestic capacities. For the same reason, lower-income countries are also more likely to rely strongly on excises (fuel, alcohol, tobacco) taxes.⁽¹⁰⁸⁾ As for taxes from natural resources, they are less predictable, thus making budget planning more difficult.

The relative importance of the various types of taxes has changed in the last decades with revenues from consumption taxes increasing, mostly because of the widespread introduction of VAT' schemes⁽¹⁰⁹⁾. This form of taxation has been frequently introduced to compensate for tax losses due to trade liberalization and lower trade taxes. In Middle Income Countries, 45% to 60% of tax losses from trade liberalization were thus recovered. In Low Income Countries, revenue recovery was much weaker, with about only 30% of lost revenue. When introducing VAT schemes in low income countries to replace losses from other taxes, the vast informal sector in these countries needs to be taken into account. Other consideration to be taken into account is that VAT usually has a negative impact on the welfare of poorer citizens and might increase the gap between the formal and informal sector. According to prevailing view, indirect taxes affecting consumption produce regressive effects. As the propensity to consume grow less proportional to the grow of income, indirect taxes on consumer income weigh more on the income of the poor than on rich ones with obvious regressive effects.

An analysis of the tax system gives an insight of the tax rates of the various taxes in the country, their importance with regard to total revenue collection and their impact on the economy, growth projections and social inequalities. Besides nominal rates the analysis should consider the structure of tax incentives and tax deductions effecting the tax base or tax payable. In countries where multinational companies operate the analysis should also include

⁽¹⁰⁶⁾For more information on estimating tax efforts and an overview of estimated tax efforts for various countries see: IMF (2011) *Revenue Mobilization in Developing Countries*.

⁽¹⁰⁷⁾Zolt Eric M. and Bird Richard M. *Introduction to Tax Policy Design and Development*. Draft paper prepared for World Bank course on practical issues of tax policy in developing countries. (2003)

⁽¹⁰⁸⁾Zolt, Eric M. and Bird, Richard M., *Tax Policy in Emerging Countries. Environment and Planning C: Government and Policy*, Vol. 26, 2008; UCLA School of Law, Law-Econ Research Paper No. 08-18.

⁽¹⁰⁹⁾In some countries such as Mozambique debt relief under the HIPC programme was conditioned to the introduction of a VAT.

assessments of the discipline of Transfer Pricing. Furthermore, it should provide an overview of the countries' efforts to compensate the revenue losses from trade.

Developing countries seem to be particularly vulnerable to the increasing mobility of capital, the competition for which has significantly reduced corporate tax rates in both developed and developing countries. Revenues from corporate taxes decreased by 20% in developing countries, due to falling statutory rates and the increasing use of **tax incentives** in many countries.⁽¹¹⁰⁾ These tax incentives are used to encourage investment and attract foreign direct investment. Nevertheless, the actual effect of tax incentives on investment is subject to much debate. Normally companies' decision-making process is based on various factors and not on tax incentives alone⁽¹¹¹⁾. Other factors are access to markets and profit opportunities, a predictable and non-discriminatory legal and regulatory framework, macroeconomic stability, skilled and responsive labour markets and a well-developed infrastructure. It is often argued that these factors are weighted higher than tax incentives and that the effect of tax incentives on investment and foreign direct investment is relatively low in low income countries.

The ongoing international debate on tax incentives does not focus on their elimination but, rather, on ways to govern them in a transparent and consistent manner. Further challenges lay in the governance aspect of these incentives and in respecting national sovereignty. An analysis of the fiscal, social and environmental impact of decisions on incentives (cost-benefit analysis), avoidance of a "race to the bottom" competition, identification of alternatives and non-fiscal incentives should be considered in this regard, and the decision to accord tax incentives should be transparent to the public. Transparency on tax incentives should cover policy, legislation, information gathering, reporting, cost-benefit analysis, social and environmental assessments and periodic reviews to ensure they continue to meet desired policy objectives.

To conclude, efficient and equitable tax policies are crucial for growth and poverty reduction. They provide domestic revenues and can reduce reliance on natural resources and external aid. When correctly used, they can decrease inequality and stimulate more competitive economies. In particular, the nexus between tax policies and the improvement of the business environment is critical. Successful reformers have focused on reinforcing this nexus by conducting tax reforms in tandem with regulatory changes that make it easier for businesses to invest, to trade and to create jobs, without necessarily increasing average tax rates. Such an approach leads to higher revenues through higher economic growth and broader tax bases, inter alia by bringing in the informal economy and reducing corruption, waste and tax evasion.

■ Tax Administration

Taxes can become a reliable and sustainable source of development finance if the taxation regime in place facilitates revenue collection, curbs tax evasion and abusive tax avoidance and, at the same time, ensures equity and encourages entrepreneurship. This effort is intrinsically linked to the build-up of effective and efficient tax administrations promoting both tax compliance and ensuring the strict enforcement of tax codes. An increase in the capacity to collect taxes should be accompanied by strengthening social legitimacy of a country's governing institutions, including the possibility for taxpayers to appeal decisions from revenue authorities before court, and it should be compatible with the promotion of an environment-encouraging investment.

In a nutshell, an environment which promotes the rule of law, good governance in the public sector, sound economic policies and effective multi-stakeholder involvement fosters successful taxation systems. In that respect, the integration of tax reforms within broader governance and public sector reforms enables to better address the political economy factors that often hinder tax reform efforts, and lead in particular to large tax exemptions.

Tax reform is not only about the introduction of the "right taxes". It also needs to consider a country's specific institutional environment. Appropriate policy and legal frameworks, focused capacity building, sufficient financial and competent human resources are necessary to guarantee that the complex and intertwined tasks of tax policy formulation, implementation, monitoring and enforcement are addressed in a comprehensive and effective manner. Equally important are administrative improvements such as standardizing and simplifying procedures to reduce compliance time for investors and ease tax collection for authorities. Establishment of special departments and specialized officers dealing with large taxpayers and high risk taxpayers, income from natural resources, fraud investigations and cooperation with the police and judiciary apparatus, both at home and internationally, allow a specialisation for complex areas that can facilitate compliance and raise revenues.

⁽¹¹⁰⁾ Keen, M. and Simone A. (2004), *Tax policy in developing countries: Some lessons from the 1990s, and some challenges ahead*, in Gupta, S., Clements B. and G. Inchauste (Eds.), *Helping countries develop: the role of fiscal policy*, Washington, D.C.: International Monetary Fund.

⁽¹¹¹⁾ UNCTAD (2000), *Tax Incentives and Foreign Direct Investment – A Global Survey*, ASIT Advisory Studies No 16.

In sum, country-specific tax reforms will have to address the challenge of finding a conducive policy mix in which structure, type and level of applicable taxes will have to take into account efficiency and administrative simplicity in tax collection. A stable legal framework and simplified procedures result in significantly reduced transaction costs in tax compliance for enterprises and encourage investment. In contrast, the complexity of the tax system tends to be a strong disincentive for investment.

The analysis of tax administrations should cover the areas of access to information and transparency (particularly in resource-rich countries), good governance, anti-corruption, administrative structure, oversight and civil society involvement. Especially, Chapter 1 of DG TAXUD's EU Fiscal Blueprints⁽¹¹²⁾, although developed mainly for candidate countries, can provide useful guidance on how to assess tax administrations of developing countries, even if they might need to be adapted and redesigned to that effect.

With regard to transparency, the assessment should further take into account publicly available tax legislations and regulations, publication of revenue collection, exchange of information between tax authorities, and publicly available information on tax incentives. With the liberalisation of financial markets, cross border tax evasion becomes easier. To ensure the administration and enforcement of countries' tax laws, international cooperation in tax matters is crucial. To that effect, the OECD Task force on Tax and Development initiated the Global Forum on Transparency and Exchange of Information in Tax Matters. More than 90 countries have already committed to the internationally agreed tax standard. The main principles of this standard are the following: availability, access and exchange of information⁽¹¹³⁾. If a country has signed up to this standard, it clearly indicates its willingness to transparency and exchange of information.

■ The Special Case of Revenues from Natural Resources

Only a handful of developing countries have managed resource revenues in a way that promotes sustainable economic growth and poverty alleviation. In all too many cases, the discovery of hydrocarbon or mineral resources has been associated with devastating political conflict and economic setbacks, as referred to in the literature under the term of "resource curse"⁽¹¹⁴⁾.

Some key factors can hamper domestic revenue collection by triggering rent-seeking behaviour of involved stakeholders with harmful effects on poverty, corruption and conflicts. In particular, a lack of transparency in allocating and negotiating terms for extractive projects, combined with the asymmetric distribution of information, experience and competence between companies and governments, can favour corruption and lead to unbalanced rent distributions from resource extraction. Transparency in payments from extractive industries to governments and in contracts increases domestic accountability, decreases corruption opportunities, facilitates revenue collection and sets incentives for stakeholders to negotiate more balanced deals.⁽¹¹⁵⁾

Much of the increase in the tax ratio of developing countries in recent years is due to natural resource taxes, mainly income from production sharing and royalties or corporate income tax on oil and mining companies. For instance, in Sub-Saharan Africa the tax-to-GDP ratio improved from less than 15% in 1980 to more than 18% in 2005 mainly due to revenues from natural resources. Although these natural resource taxes have generated domestic revenues in many developing countries, this type of income is highly volatile and hard to predict (non-resource related revenue rose by less than 1% of GDP). Moreover, they have often failed to ensure a better pro-poor allocation of state revenues. A challenge for developing countries is to ensure that funds stemming from extractive activities are duly redistributed (including inter-generationally) and devoted to the promotion of the MDGs and the reduction of poverty as well as to overall economic growth.

In sum, in resource-rich countries, these are particularly areas that need to be addressed in the analysis of their taxation regimes and their transparency. Further information regarding the licences, contracts, investment agreements and permits governing the exploration, exploitation, transportation and export of natural resources; the documentation of the awarding process, social and environmental impact assessments, audited accounts of state controlled companies operating in these sectors; payments due and made by independent companies operating in these sectors to government and monitoring reports should be publicly available. In general, a country should show an overall commitment to good governance and anti-corruption. In line with United Nations Convention Against Corruption

⁽¹¹²⁾http://ec.europa.eu/taxation_customs/resources/documents/common/publications/info_docs/taxation/fiscal_blueprint_en.pdf

⁽¹¹³⁾For more information: <http://www.oecd.org/dataoecd/32/45/43757434.pdf>

⁽¹¹⁴⁾This term has been used first by Richard M. Auty in 1993. Auty, Richard M. *Sustaining Development in Mineral Economies: The Resource Curse Thesis*. London: Routledge (1993). Many Sub Saharan African-resource rich countries are scoring relatively low on the Human Development Index (HDI), for example Nigeria (HDI Rank 2009: 158) Angola (143), Sudan (150), Cameroon (153), Chad (175) with the slight exceptions of Botswana (125) and Gabon (103)

⁽¹¹⁵⁾Rosenblum, P. Maples, S (2009): *Contracts Confidential: Ending Secret Deals in the Extractive Industries*

(UNCAC), the government should have in place an anti-corruption legislation which clearly defines and forbids conflicts of interest on the part of public officials. Furthermore, the ownership of companies in the natural resource sector by these officials or their immediate family members need to be effectively prohibited. Of similar importance is the adherence to existing legislations with clear sanctions and penalties, and the existence of an independent oversight mechanism. The questions provided in the EU-Fiscal Blueprint on the independence and oversight of tax administrations can be used for the natural resource sectors accordingly. Furthermore, the government should endorse the oversight by independent third parties and the engagement of civil society organisations at all stages of the resource value chain, including the award process and monitoring.

A number of promising international initiatives supported by the EU have emerged to address these challenges by promoting good governance and transparency in the hydrocarbon and mining sector. In particular, the EITI initiative has been instrumental in supporting improved governance and accountability through the verification and full publication of company payments and government revenues from oil, gas and mining. A country's commitment to the EITI signals its openness and transparency efforts.

With regard to the extractive sector the policy dialogue in the context of budget support operations must focus increasingly on good economic governance in this sector, also by using instruments such as Governance Action Plans, PFM annual reviews and PEFA assessments. Examples of good practice for mainstreaming raw materials governance into the budget support dialogue are the Performance Assessment Frameworks used in the EU budget support operations in Ghana and Cambodia, which imply concrete and time-bound output indicators on improving the collection, management and/or transparency of natural resource revenues as budget support disbursement triggers.

4. OVERVIEW OF DIAGNOSTIC TOOLS AND CONCLUSION

Existing tools to assess taxation were examined by a recent study commissioned by the PEFA Secretariat. It presented the following table on the various tools available. Three of the tools are databases which are publicly available and provide useful data for assessment purposes. The other five tools are frameworks to undertake individual country assessments. However, none of these tools were considered to be sufficiently comprehensive, evidence-based or driven by performance indicators. Yet, even if not fully adequate to assess a developing country's taxation system, the tools in question can provide some guidance for the assessment.

Overview of the tax administration diagnostic tools⁽¹¹⁶⁾

Tool	Brief description
Databases	
OECD Comparative Information Series	Provides tax administration information for 44 countries related to organization, management, tax filing and payment, administrative powers, tax burden, and operational performance
USAID Collecting Taxes Database	Provides global coverage on 31 different indicators covering 200+ countries. It gives a country-level view as well as regional, income group and international benchmarks against which to assess a country's tax system.
GDI Tax Performance Assessment (Under development)	Using 2007-08 as a base year, provides a comparative overview of the tax performance of different countries, based on aggregate historical data and country-specific information. Data from more than 175 countries is being analyzed.

⁽¹¹⁶⁾PEFA Feasibility Study *Developing a tool to assess tax administration performance*, 2011

Tool	Brief description
Frameworks for making individual country assessments	
PEFA Tax Administration Indicators	<p>Tax administration in the PEFA framework is covered by four indicators that assess: aggregate revenue outturn compared to forecast; clarity and comprehensiveness of legislation and procedures, taxpayer access to information, and the existence and functioning of an appeals mechanism; tax payer registration, penalties for non-registration and non-filing, and planning and monitoring for audits and investigations; and the collection ratio, the effectiveness of transfers to the treasury, and the frequency of reconciliations. This is done for countries that have used the full PFM Evaluation Framework.</p> <p>So far the PEFA tax indicators do not provide a full and clear picture of the status of domestic revenue systems and their administration. To identify the main constraints of revenue systems and to set reform priorities ample and additional information in the report is needed. However, the third indicator of the PEFA Assessment can be related to other macro and development indicators. It is a rather general measure of budget planning compliance for domestic revenues.</p> <p>Whereas the PEFA assessments, as regards tax matters, can provide some valuable information at country level but further refining of the tax indicators would be necessary to get a fuller picture of the performance of a countries taxation system.</p>
EU Fiscal Blueprints	<p>The fiscal blueprints are designed to be used as a self-assessment tool that provides an overall framework and benchmarks related to the technical and organizational aspects of a tax administration. The blueprints are organized in five groups that comprise 14 separate blueprint chapters. Each blueprint has the same structure: an <i>aim</i> or broad statement of overall purpose; <i>strategic objectives</i>, i.e. statements that identify crucial issues, expected achievement, and measureable results; a <i>scoring</i> system, including a weighting of each strategic objective; <i>key indicators</i>, which express the strategic objectives in technical and practical terms; and <i>definitions</i>.</p>
WB – Handbook for Tax Administration	<p>The handbook is intended for policy makers as the basis to assess a tax system in its entirety, measure its various parameters and how it is administered and define best practice for tax administration and tax policy. Topics range from policy considerations to templates for implementing policy and measuring the effectiveness of reforms.</p>
WB – Diagnostic Framework for Revenue Administration	<p>The framework outlines a relatively complicated approach of calculating various indicators, using a congruence model of effective organization, and preparing a detailed list of organizational, management and technical tasks. The indicators and tasks are then assessed against the environment of the revenue administration, and its resources, history, strategy, and outputs.</p>
IMF – Diagnostic missions	<p>These missions identify shortcomings in tax administration performance (gaps) compared to international good practice, and develop strategies to close the identified gaps. The assessments and recommendations are documented in formal diagnostic reports that are utilized by governments and donors as roadmaps for reform efforts.</p>

Policy dialogue should focus on tax policy, tax administration and revenues, including from natural resources. They are crucial to increase domestic revenue mobilisation, to enhance good governance and to allow a positive effect on the economy. However, there is no tax regime which is right for all countries. The specific country circumstances need to be taken into account to find the solution suitable for the specific country. Integral part of the dialogue should be the discussion on revenues from natural resources to ensure their sustainable and efficient use for inclusive economic growth.

In general the discussion on the tax regime in partner countries should be based on information available and further assessments in the areas discussed above. The assessments should be discussed and coordinated in a harmonised way with other donors to ensure compliance with the Paris Declaration regarding donor harmonisation. The sensitivity of the topic should be taken into account.

Annex 12: Assessment of Fundamental Values

This annex provides guidance on assessing fundamental values for Good Governance and Development Contracts (GGDC), State Building Contracts (SBC) and Sector Reform Contracts.

Section A provides guidance on GGDC, Section B on SRC, and Section C on SBC.

Why an assessment of fundamental values?

The commitment and record of partner countries to democracy, human rights and the rule of law is one of the key determinants of EU development cooperation, including general and sector budget support, and should be assessed to determine if using budget support is appropriate.

- The **GGDC** is an instrument to support broad reforms that lead to poverty reduction, improved governance, while signalling a mutual and shared commitment to universal fundamental values. Therefore, the commitment to fundamental values needs to be assessed as a *pre-condition* for any GGDCs, and subsequently monitored during implementation. For GGDC's the commitment to fundamental values is assessed on the basis of the actual situation, including ongoing reforms, and past track record.
- When **Sector Reform Contracts** are proposed as the most appropriate support modality, adherence to fundamental values should be *taken into account*. Assessing if EU sector budget support should proceed in the light of political governance will need to be carefully balanced against the need to serve and protect the population. Particular care should be taken when supporting sectors which have a direct link with fundamental values, such as justice and security.
- In case of **State Building Contracts**, the assessment of the government's commitment to fundamental values as well as their political response to uphold them in a comprehensive way are aspects to be *considered interalia* when deciding whether to engage with these countries. In the context of a fragile or conflict affected situation, the EU should adopt a forward looking approach accompanied by reinforced political and Budget support dialogues. Risks should be balanced against the implications of not engaging in a fragile state.

1. GOOD GOVERNANCE AND DEVELOPMENT CONTRACTS

When to assess fundamental values?

For any GGDC the commitment to fundamental values as a pre-condition needs to be assessed by delegations during the **programming phase** when Good Governance and Development is proposed as a sector (cf. programming instructions) and the assessment submitted to the BSSC. The assessment of the pre-condition for GGDC will be prepared by the Delegations *and reviewed by the EEAS in consultation with DEVCO before submission to the BSSC*.

The assessment should be brief (4 pages). Action Fiches will have a section summarising the conclusion on the pre-condition.

Subsequently, commitment to fundamental values will be monitored during the identification, formulation and implementation phases using the risk framework.

How to assess fundamental values when a GGDC is considered?

This analysis should be based on the updated Human Rights Country Strategies, EU Election Observation Missions' reports, Delegations' political reporting, UN open sources, including UN Human Rights Council's Country Resolutions, CSO reports and testimonies, other relevant sources (e.g. World Governance Indicators, Amnesty International, Human Rights Watch, Freedom House, Transparency International).

This assessment should take into account the political analysis undertaken during programming phase and will also be used to answer the questions in the risk management framework.

EU MS should be consulted in the process and especially MS who are also providing budget support to ensure coordination and coherence.

The assessment of Fundamental Values should be completed in two steps (in total 4 pages):

Step one

The first step is a screening of the extent to which the country meets the core benchmarks on human rights, democracy, and the rule of law.

Assess the country's stand on the following core benchmarks:

1. **International commitments** (signing, ratification, transposition and implementation of core international conventions and their protocols⁽¹¹⁷⁾, UPR recommendations, treaty monitoring bodies, special rapporteurs' recommendations, etc.)
2. **Human Rights** (death penalty, torture and other cruel, inhumane and degrading treatment, slavery and servitude);
3. **Democracy** (credibility of the electoral process, balance of power, space for civil society and media independence);
4. **Rule of Law** (independence of the judiciary, access to justice, law enforcement system).

When the assessment under Step one is not satisfactory, the country concerned will not be eligible for a GGDC. Therefore, a more detailed analysis in Step two is not needed.

Step two

If the assessment in step one on the core benchmarks is satisfactory, a more detailed analysis shall be carried out in Step two. The assessment should be guided by the following questions:

(The assessment should be in line with HR Country Strategy)

1. Democracy

- How does Parliament exercise its main powers? (legislative functions, power to decide the national Budget, oversight of the executive/government's action and capacity to dismiss the executive, oversight of military)?
- Are there democratic political parties that can operate freely and is there a pluralist party system?
- Are there a viable media and an independent civil society and is the government receptive?
- What are the main challenges for civil society? (in respect of legislation and practice, access to funding, including from abroad, restrictions to legal registration, restrictions to freedom of assembly).
- Are there national security or other restrictive laws in place that inhibit public debate?
- Are women represented across decision-making institutions?

⁽¹¹⁷⁾ E.g; in the human rights field, the International Covenant on Civil and Political Rights (ICCPR), the International Covenant on Economic, Social and Cultural Rights (ICESCR), the International Convention on the Elimination of all forms of Racial Discrimination (ICERD), the Convention on the Elimination of all forms of Discrimination against Women (CEDAW), the Convention Against Torture and other Cruel, Inhuman or Degrading Treatment (CAT), the Convention on the Rights of the Child (CRC) and the Convention on the Prevention and Punishment of the Crime of Genocide. In the field of International Humanitarian law, additional protocol 1 and 2 to the Geneva Conventions and the Ottawa convention prohibiting anti-personnel land mines.

2. The Rule of Law

- Is the current system conducive to a performing judiciary? Is corruption an impediment?
- Does the judicial system guarantee the right to a fair trial?
- Is access to justice reasonably ensured and Court decisions enforced?
- Is the system for appeal effective?
- In the exercise of its functions, does the law enforcement system guarantee security of citizens and respect of law, while respecting human rights? Do prison conditions respect human dignity?

3. Human Rights

- Do the national institutions (Ombudsman, Human Rights Commission), in case they exist, have problems in exercising their power?
- Is the principle of non-discrimination based on sex, race, language, religion, political or other opinion, national or social origin, or similar status (as foreseen by the law) effectively guaranteed? If not what are the main problems?
- Are the rights of women and children recognized and effectively protected? What are the main controversial issues? (in particular violence against women)
- Are the rights of persons belonging to minorities and indigenous peoples effectively protected? What are the main controversial issues (land and environmental rights, political rights, etc)?

Country's commitment/political willingness

On the basis of the above analysis this section should set-out an assessment of the partner country's commitment and willingness to address the situation.

- Is the partner country's government taking actions through relevant reform programmes, action plans etc. that address key constraints and weaknesses identified above?
- Are these actions credible in terms of political commitment, quality of the reform process, and realistic in terms of implementation?
- What is the country's track-record and has there been satisfactory progress taking into account the resources and capacity of the country?
- How do you assess the likelihood that violent conflict could undermine the adherence to fundamental values?

Overall recommendation

This section should set-out the Delegation's recommendation whether the pre-condition for a GGDC is met and define any issues which:

- need particular monitoring in the risk management framework;
- should be discussed in the budget support dialogue or the political dialogue;
- should be taken into consideration during identification and formulation in order to strengthen the GGDC in its objective of fostering domestic accountability, strengthening national systems and control mechanisms, and as a basis for improving governance, including adherence to fundamental values.

2. SECTOR REFORM CONTRACTS

For proposed SRCs the overall adherence to fundamental values of the country is reviewed as part of the risk management framework (political risk category) and a short summary is provided in the identification and action fiches. No separate assessment of fundamental values as a pre-condition is required. If the framework points to substantial or high political risks, a BSSC submission is required whereby the BSSC will balance any fundamental values concerns with the need to provide and protect the provision of vital services, including other potential benefits, in order to decide whether a SRC is an appropriate aid modality.

During the identification and formulation phases, the sector analysis should take into account the human rights based approach, as described below. The most critical issues relevant to the sector and arising from the sector analysis should be highlighted in the identification and action fiches and addressed by the SRC.

The human rights based approach at sector level should focus on the following issues:

1. An indication of the extent to which the country addresses human rights issues at sector level, based on the country's adherence to the International Covenant on Economic, Social and Cultural Rights (ICESCR), the International Convention on the Elimination of all forms of Racial Discrimination (ICERD), the Convention on the Elimination of all forms of Discrimination against Women (CEDAW), The Convention on the Rights of Persons with Disabilities and its Optional Protocol.
2. In cases where the treaty bodies have provided recommendations to the country concerned how have these been followed up at sector level?
3. For the sector concerned, how is equality and non-discrimination addressed in laws, sector policies and practices, distribution and delivery of resources and public services (equal opportunities)?
4. How is access to services in the sector assured for minority groups, indigenous peoples, women, children, poor, disadvantaged and disabled people (availability and accessibility)?
5. How is the concerned population (target group) consulted and able to express their views; are they entitled to participate in decisions that directly affect them, such as the design, implementation and monitoring of sector interventions (participation and inclusion)?
6. How is the decision making process within the sector transparent and is accountability ensured? In case of grievances, is judicial or administrative redress available (right to remedy/compensation)?
7. What is the quality of sector services for the people? (user's rights to quality improvement process)

Overall recommendation

As a result of this analysis, Delegations should conclude on how fundamental values should be addressed in cases of SRC.

- Issues to be monitored in the risk management framework;
- Issues that should be discussed in the budget support dialogue or the policy dialogue;
- Issues to be addressed in the design of the programme.

3. STATE BUILDING CONTRACTS

The assessment of fundamental values for State Building Contract should adopt a forward looking approach, to inform the opportunity of intervention (Annex 9, section 3.2.) and subsequent programme identification / formulation. The assessment should be concise and no more than 5 pages and a summary should be provided in the identification and action fiches. A forward looking assessment should inquire into the presence of clear and concrete signs of real (renewed) commitment to improve the situation. These clear signs could e.g. be a peace accord, or other form of political settlement that is assessed as genuinely expressing political commitment.

Not all fragile states have just emerged from crisis or just starting the path of transition. The path out of fragility through peace building and state building is a long one, and can become protracted. In such cases, the likelihood of real improvements could be demonstrated by a positive track record. Where this is not the case, the analysis must carefully assess whether there are clear and convincing (re)new(ed) signs of commitment to future improvement (restore peace and foster transition towards democratic governance – see Annex 2).

How to assess fundamental values when a SBC is considered?

A forward looking approach

For this type of contract, special attention should be paid to the following issues:

1. What are the partner country's government's commitments to improving the situation regarding democracy, human rights and rule of law?
2. What are the sources / background of these commitments, the credibility of the government's commitment as well as broader support for this agenda from society?
3. Are there concrete (confidence building) measures that have been undertaken that demonstrate real willingness to improve the situation?
4. In case of protracted fragility: Is there a positive track record?
 - a. If yes, please provide a short assessment;
 - b. If no, please assess whether there are still credible (re)new(ed) commitments to improve the situation, that merit support or not.
5. How do you assess the risk of the resumption or emergence of violent conflict?

To assess the current situation, as a baseline for monitoring and as an input to the risk management framework and programme formulation, the questions formulated as part of section A should guide the analysis.

Overall recommendation

This section should set-out the Delegation's recommendation whether:

- the assessment of fundamental values confirms or not the opportunity of intervention through a State Building Contract;
- there are specific issues which:
 - need particular monitoring in the risk management framework;
 - should be discussed in the budget support dialogue or the political dialogue;
 - should be taken into consideration during identification and formulation in order to strengthen the SBC in its objectives to restore peace and foster transition towards democratic governance.

This document belongs to the **“Tools and Methods series”** launched by EuropeAid in 2007. This collection aims to structure the presentation of the methodological documents produced by Directorate on “Quality of Operations”. The collection includes three sub-collections: Guidelines, Reference Documents and Concept papers. Other titles in this collection include:

Guidelines

- Guidelines (n°1) – “The Programming, Design and Management of General Budget Support”
- Guidelines (n°2) – “EC Support to sector programmes: covering the three financing modalities: Sector budget support, Pool funding and EC procurement and EC project procedures” – 2007
- Guidelines (n°3) – “Making technical cooperation more effective” – 2009
- Guidelines (n°4) – “Guidelines on the Integration of Environment and Climate Change in Development Cooperation” – 2009

Reference documents

- Reference document (n°1) – “Institutional Assessment and Capacity Development – Why, what and how?” – 2005
- Reference document (n°2) – “Supporting decentralisation and local governance in third countries” – 2008
- Reference document (n°3) – “Strengthening project internal monitoring: How to enhance the role of EC task managers” – 2009
- Reference document (n°4) – “Analysing and Addressing Governance in Sector Operations” – 2009
- Reference document (n°5) – “Sector Approaches in Agriculture and Rural Development” – 2009
- Reference document (n°6) – “Toolkit for Capacity Development” – 2009
- Reference document (n°7) – “Water Sector Development and Governance: Complementarities and synergies between Sector-wide Approach and Integrated Water Resource Management” – 2009
- Reference document (n°8) – “Engaging and Supporting Parliaments Worldwide – Strategies and methodologies for EC action in support to parliaments” – 2010
- Reference document (n°9) – “Support for judicial reform in ACP Countries” – 2010
- Reference document (n°10) – “Trade and Private Sector Policy and Development – Support programmes financed by EU external assistance” – 2010
- Reference document (n°11) – “Emerging good practice on Codes of Conduct, Partnership Principles and Memorandums of Understanding in the Water Sector” – 2010
- Reference document (n°12) – “Engaging Non-State Actors in New Aid Modalities – For better development outcomes and governance” – 2011
- Reference document (n°13) – “Addressing undernutrition in external assistance – An integrated approach through sectors and aid modalities” – 2011
- Reference document (n°14) – “Social transfers in the fight against hunger: A resource for development practitioners” – 2012
- Reference document (n°15) – “Support for Justice and the Rule of Law – Review – Review of past experience and guidance for future EU development cooperation programmes” – 2012

Concept papers

- Concept paper (n°1) – “Public Sector Reform: An Introduction” – 2009
- Concept paper (n°2) – “Supporting Anti-Corruption Reform in Partner Countries – Concepts, Tools and Areas for Action” – 2011

European Commission

**Programming, Design and Management
– A modern approach to Budget support**

2012 — 172 p. — 21x29.7 cm

How to obtain EU publications

Free publications:

- via EU Bookshop (<http://bookshop.europa.eu>);
- at the European Union's representations or delegations.
You can obtain their contact details on the Internet (<http://ec.europa.eu>) or by sending a fax to +352 2929-42758.

Priced publications:

- via EU Bookshop (<http://bookshop.europa.eu>).

Priced subscriptions (e.g. annual series of the *Official Journal of the European Union* and reports of cases before the Court of Justice of the European Union):

- via one of the sales agents of the Publications Office of the European Union (http://publications.europa.eu/otherstagentslindex_en.htm).

