AFRICAN DEVELOPMENT FUND

BANK GROUP EXPERIENCE IN USE OF BUDGET SUPPORT AND SECTOR-WIDE APPROACHES (SWAps): ISSUES AND CHALLENGES

ADF-X MID TERM REVIEW
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OPERATIONS POLICY AND COMPLIANCE DEPARTMENT

I. INTRODUCTION

1.1 This paper is prepared with the objective of informing the ADF Deputies and seeking their guidance about the experiences, challenges and issues that the ADF continues to encounter with respect to Budget Support Operations (BSOs), and the Sector-wide Approaches (SWAps) operations.

1.2 This Note reviews the evolution of Bank Group's budget support lending, including the SWAps, and discusses the current issues and challenges. Based on the review, recommendations on the way forward are made for consideration by the Deputies. This paper particularly highlights the constraints posed by the Article 15(4) of the Agreements establishing the African Development Fund (ADF) when resources are co-mingled in a basket by donors as the preferred modality of financing SWAp operations. It is worth noting that Management has consulted the ADF Board of Directors on issues and challenges pertaining to BSOs and SWAp operations.. It was agreed that Management should prepare and submit a discussion paper to the Deputies for their guidance during the ADF-X mid-term review.

II. EVOLUTION OF BUDGET SUPPORT INSTRUMENTS AND SECTOR-WIDE APPROACHES

2.1 **Policy Based Lending (PBL)**: The Bank introduced PBLs in the 1980s in response to demand by its client RMCs. The PBLs involve the provision by the Bank of development assistance to countries directly through their fiscal budgetary systems. The PBLs were originally designed primarily as balance of payments or as Structural Adjustment Operations (SAOs) financed through soft loans or grants that primarily focus on assisting the RMCs implement their macroeconomic and structural reforms. They support the implementation of policy reforms using the government's own financial management systems and implementation modalities. An important variant of the PBLs is the Sector Adjustment Loans (SECALs) that focus on addressing reforms in specific sectors of the economies of RMCs.

2.2 As RMCs completed the first generation of reforms, the emphasis of the PBL shifted from medium to the longer-term structural and institutional reforms, both across and within the various sectors of the economy. It is in response to this demand that the Bank Group introduced the Policy Based Lending (PBL) for Governance (PBLG)[1] and joined other donors in using the Development Budget Support Lending Instrument (DBSL) in 2003. Both ADF and ADB eligible countries use the PBL instrument.

2.3 There is no doubt that PBLs have been largely successful in assisting RMCs implement crucial stabilization and structural policy reforms focused on creating the enabling environment for private sector activities, which is of critical importance in addressing poverty and unemployment in the RMCs. Based on the findings of the Bank Group's Operations Evaluation Department (OPEV)[2], PBLs have provided the Bank with a forum for engaging in policy dialogue with regional member countries especially on the important issues of macroeconomic and structural reforms, including strengthening various aspects of good governance. In addition, implementations

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[1] See African Development Bank, *Guidelines for Policy-Based Lending on Governance*, Operations Policy and Review Department, April 2004.

[2] See ADB/ADF "*An Evaluation of Bank Group Policy-Based Lending Operations, 1986-97*" Operations Evaluation Department, November 1997 (Ref: ADB/ADF/OPEV/97/41)

of PBLs by RMCs have been quite effective in strengthening the collaboration and coordination between the Bank and other development partners.

2.4 **Prerequisites for PBLs**: A fundamental prerequisite that RMCs must fulfill, prior to qualifying for, and in the course of implementing the Bank Group's PBLs, is that they must maintain sound macroeconomic stability. This stability is proxied by the smooth implementation, by the RMC, of the IMF's Poverty Reduction and Growth Facility (PRGF) program. In the absence of an IMF program, the Bank has been requesting for an Assessment Letter from the IMF that focuses on the country's macroeconomic situation and prospects over the medium term. The requirement for RMCs to maintain sound macroeconomic policy framework is a clear indication that the Bank Group's PBLs are implemented in very close collaboration and coordination with other development partners, principally the World Bank and the IMF.

2.5 The Bank does also require that the proceeds of PBLs are subjected to sound financial management practices and that yearly auditing is undertaken in line with the Bank Group's auditing practices and procedures. Besides the yearly audit, the Bank does insist that procurement of goods and services funded by the PBLs are undertaken in accordance with the Bank Group's Rules for Procurement of Goods and Services. This requirement implies that the RMC recipient of the PBL has to comply with the limitations imposed by Article 15 (4) of the Agreement establishing the African Development Fund (ADF)[3].

2.6 The limitation in Article 15 (4), commonly referred to as the "Rule of Origin**"** restricts procurement of goods and services to States participants or members, or to States that provide resources to ADF. Management's experience with respect to this limitation is that it has tended to create additional burden to countries of justifying all the procurements undertaken from proceeds of PBLs. The justification is unnecessary, given the yearly audit that must be undertaken, and involves the submission to the Bank, for verification with respect to the sources of origin, all the import records or invoice bills for procurement undertaken using the proceeds of a country's PBL.

2.7 **Development Budget Support Lending (DBSL)**: The Note defines BSOs as the method of financing a partner country's fiscal budget through the transfer of resources from an external development financing agency, principally bilateral or International Finance Institutions (IFIs) to the partner government's national treasury. The funds thus transferred are managed in accordance with the recipient country's systems, including the budgetary, accounting and procurement processes. For a number of donors, the budget support instrument is becoming a tool for greater alignment and harmonization, particularly with respect to the implementation of the priority areas and concerns of a country's Poverty Reduction Strategies. Budget support instrument contributes to strengthening human and institutional capacity, particularly in critical areas of public financial management. The instrument contributes also to a country's accountability by underscoring the budget's role as the statement and tool of government policy. The credibility of this role is dependent on the emergence, in a country, of an open and transparent public financial and accounting system, with efficient internal safeguards for managing government's revenues and expenditures. This outcome is consistent with the donors' expectations of the role of budget

[3] See details in Annex I, African Development Fund (ADF) *"Legal Note on the Application of Article 15 (4) of the Agreement Establishing the African Development Fund"* March 2005.

support instrument as underscored in the Paris Declaration on Harmonization, Alignment and Managing for Results (OECD-DAC)[4].

2.8 The Bank introduced Development Budget Support Lending (DBSL) in 2001, with the first beneficiaries being Benin, Burkina Faso and Uganda. Since then, the instrument has been utilized by several RMCs, including Cape Verde, Ghana, Malawi, Mozambique, Rwanda, and Tanzania. The specific goal of the DBSL, as outlined in the 2004 Bank Group's Guidelines on Development Budget Support Lending[5] is to assist in the implementation of the country's Poverty Reduction Strategies (PRS). Accordingly, the use of the DBSL in various RMCs focus on: i) improving the environment for economic, social and human development and consolidating the implementation of governments' PRS; ii) addressing the governments' concerns for harmonization and alignment; iii) creating the necessary synergy among development partners; iv) putting in place an efficient public financial management system; and v) building the management capacities of sector ministries. The Bank operationalizes the DBSL instrument in two modes, the general Macro-support and the Sector budget support. Both modes involve the transfer of financial resources to the country's fiscal budget.

2.9 **Sector-Wide Approaches (SWAps) operations**: SWAps are not aid delivery instruments but processes in support of country-owned sector wide programs or investment projects based on a country's long-term development plan. SWAps are a way of working under a coordinated and harmonized approach. The SWAps emerged in response to the disadvantages inherent in the traditional donor-driven project-based approach[6]. Such disadvantages include the high transactional costs and the unpredictable flow of resources that characterize the project-based approach. The SWAps involve providing support that has the following characteristics: i) a clear sector policy with targets defined in qualitative and quantitative terms; ii) a formalized process of donor co-ordination, with agreed roles and rules; and iii) a medium-term expenditure program, matching sources and uses of funds. In addition, the SWAps are implemented through common implementation system that involve the harmonization of disbursements, common procurement procedures, and reporting, using the Performance Assessment Frameworks (PAFs). Overall, the Bank Group's experience over the years is that SWAps can facilitate harmonization and alignment on the ground across a wide range of different development actors engaged in RMCs.

2.10 Various financing instruments can be used to support SWAps, such as, project lending, technical assistance, sector budget support and general budget support. There are, in general, three financing modalities : (i) pooled funds in single basket or trust fund which is referred as co-mingled funds **;** (ii) pooled funds with separate partner banking accounts and ; (iii) parallel funding where opportunity is offered to other donors, outside the pool, to fund the program using separate projects (classical project instruments) and earmarked funds. All these financing modalities could coexist. Participants (donors, government and other partners) to the SWAps operations decide usually in a Memorandum of understanding (MOU) or other agreements whether the funds should

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[4] See for High Level Forum of March 2005, "*Joint Forum: Effort Towards Enhanced Aid Effectiveness*" OECD-DAC, the World Bank, African Development Bank (ADB) and the European Bank of Reconstruction and Development
OECD-DAC, "*Good Practices in Budget Support, Sector Approaches and Capacity Development in Public Financial Management*"

[5] See African Development Bank, "*Guidelines on Development Budget Support Lending*" Operations Policies and Review Department (POPR), April 2004.

[6] See African Development Bank "*Revised Guidelines for Bank Group Operations Using Sector-Wide Approaches (SWAps)*", Operations Policies and Review Department (POPR), April 2004.

be managed by a leading donor, the sector ministry or an implementation unit. In the pooled financing option, all pooling partners would use a common implementation system, which involves a unified and coordinated planning cycle, the harmonization of disbursements as well as common procurement procedures including the use of country systems. The choice of the pooled funding with separate donor banking accounts may be justified by the need for some donors to respect the "Rule of Origin" constraint when universal procurement rules, at donors level, do not prevail and to track the use of the proceeds of their financing. Using in a pool funding, separate accounts for financing specific activity/ies in the sector is assimilated to "ring-fencing" or "segregated" funding. SWAp operations are normally computed in the government consolidated operation account (GCOP). They could be implemented either through or outside of country's fiscal budget system. SWAps operations implemented through the country fiscal budget are mainly supported through the sector budget support or the general budget support instrument and mainly focus on sector policy or investment programs. SWAps operations involving the management and control of the fund by an implementation unit are normally implemented outside of country's fiscal budget system.

2.11 **Prerequisites for Accessing BSOs and SWAps**: The financial safeguards used by the Bank and other development partners to ensure that proceeds from BSOs and SWAps are utilized effectively include the prerequisites stipulated in the Guidelines that RMCs have to meet for accessing the instruments. The country should have first established a strong track-record of accomplishment of good macroeconomic performance and implemented sound Public Financial Management (PFM) systems, including procurement. The PFM systems should be comprehensive and transparent enough to allow for the monitoring of the implementation of the entire fiscal budget of the country. As is the case with PBLs, macroeconomic performance is proxied through the PRGF or an Assessment Letter from the IMF.

2.12 The country should further show commitment to reduce fiduciary risks based on the findings and recommendations that could arise from the ex-ante assessment of its PFM systems. The assessment is done through the preparation by Government with assistance of development partners, including the Bank, of the Country's Financial Accountability Assessment (CFAA), the Country's Procurement Assessment (CPAR) and the annual Public Expenditure Reviews (PERs). In addition, countries should have implemented the Medium Term Expenditure Framework (MTEF) that links their fiscal budgets to the priority areas identified in the Poverty Reduction Strategy Papers (PRSPs). The approval of the DBSL to any RMC is therefore more of a vote of confidence with the Bank Group trusting the country with the proven track record to allocate untied resources consistent with the implementation of its PRS priorities and programs. It is to be noted that these prerequisites also apply and guide the Bank's involvement in SWAps. The primary objective of these prerequisites is to reduce fiduciary risks.

III. BANK GROUP EXPERIENCES, CHALLENGES AND ISSUES IN BUDGET SUPPORT LENDING AND SWAps.

3.1 BANK GROUP EXPERIENCES

3.1.1 Since 2001, the Bank has gained experience in BSOs and the SWAps. The Bank Group's experiences are in line with those of other development partners engaged in RMCs. Overall, SWAps and BSOs can be effective in contributing to country ownership and reducing transaction costs. More specifically, the BSOs and SWAps have contributed to:

- Scaling up the donor funded programs and projects implemented through the country fiscal budgetary process. Such programs and projects have tended to be supportive of, and consistent with, the country's economic and sectoral policies that aim at accelerating sustainable economic growth and poverty reduction;

- Strengthening the country's public financial management and accountability systems by providing funds directly to the budget to be utilized through government's own systems and by using national accounting, auditing and procurement systems;

- Contributing to donor harmonization and alignment. Development partners involved in budget support or SWAps have to harmonize their programs or projects with those of other, must align their support processes with that of the country's PRS and the country's budgetary cycles;

- Promoting a coherent planning process, consolidating the resources available to the country, harmonizing disbursements and improving the predictability of the inflow of external resources to the country; and

- Assisting in enhancing development dialogue between the country and development partners, and within development partners themselves.

3.2 CHALLENGES AND ISSUES

3.2.1 Despite their contribution to the development process, the BSOs and the SWAps do present considerable challenges, both at the donor and country levels. The impact and effects of these challenges in preparing and implementing BSOs and SWAps in RMCs vary from donor to donor.

3.2.2 With respect to the Bank Group, the first set of challenges include the enhancement of field presence with adequate staffing and increased delegation of authority to these offices. To address these, the Bank Group, in the framework of its on going decentralization policy, will soon complete the establishment of a significant number of field offices in RMCs. The Bank will have 25 field offices by end 2007. Fourteen country and regional offices are already operational and 8 are planned to be opened before the end of 2006 with another 3 field offices planned for 2007. A strategy for enhancing country offices that addresses issues including adequate staffing and operating delegation of authority to country offices is being considered by the Boards. This will progressively boost the Bank's participation in the preparation and implementation of its programs and projects, including the BSOs and SWAps operations.

3.2.3 The second challenge relates to the weak public financial management (PFM) systems in various RMCs. These weaknesses are increasingly being brought out through the PRSPs being prepared by RMCs and through the Country Financial Accountability Assessment (CFAA), the Country Procurement Assessment (CPAR) and the Governance Profiles. In response to these weaknesses, RMCs have been designing comprehensive capacity building programs focused on improving their entire PFM systems, including procurement procedures and the establishment of public sector institutions to deal with corruption. The overriding objective of these programs is to promote accountability and transparency in public financial management system, thus transform the country's budgetary system into an effective and efficient tool for implementing the ambitious pro-poor policies and programs contained in the PRSPs. The Bank will continue to work closely with all RMCs with the view of strengthening all aspects of their PFM systems. The support is crucial in reducing opportunities for corruption and non-transparent budgetary transactions, and in ensuring that more RMCs strengthen their public financial management system to a point where they could qualify for BSOs and SWAps.

3.2.4 Finally, though the budget support instrument has contributed towards enhancing coordination, harmonization and alignment, thus strengthening aid effectiveness and dialogue between the countries and their development partners, it can also increase the volatility of aid flows to a country, thus triggering-off costly fiscal adjustments when disbursements are suspended or delayed, due to issues related to political governance. This unfortunate eventuality could occur if donors agree on a common position linked to the disbursement of their assistance.

3.2.5 A number of other issues continue to limit the Bank Group's effective participation in BSOs and SWAps. The most critical include:

i) Prerequisites that RMCs have to meet for accessing BSOs or SWAps; and

ii) The Fund's procurement rule, as contained in Article 15 (4) of the Agreement establishing the African Development Fund (ADF Agreement).

Prerequisites for Accessing BSOs or SWAps

3.2.6 Owing to the financial safeguards and prerequisites that RMCs have to meet to qualify for BSOs or SWAps, only a few countries have access to these instruments. Such RMCs tend to have high quintile ranking in the Bank Group's Country Performance and Institutional Assessment (CPIA) and continue to show solid performance and commitment to implementing an effective social and economic reform program. This situation has tended to create difficulties for many RMCs that would like to access the instruments, but have not fully met the required prerequisites. The most affected of such countries include the fragile regional member states, particularly those in the early stages of their post-conflict phases, and those more prone to sudden exogenous shocks, such as natural calamities (e.g., droughts) or those experiencing sharp swings in their terms of trade.

3.2.7 Management is in the process of reviewing the Bank Group's current operational practices, policies and procedures, along with assessing the effectiveness of its role in providing assistance to fragile regional member states. In the context of the new policy currently being prepared to enhance its assistance to fragile states, the Bank will emphasize building institutions and capacity in the areas of public financial management and governance. This will contribute towards strengthening their public financial management systems so they eventually meet the Bank Group's prerequisites for BSOs and SWAps.

Constraints Imposed by Article 15 (4) of the ADF Agreement

3.2.8 The Article 15(4) of the ADF Agreement poses certain challenges with respect to the implementation of SWAp operations that involve the co-mingling of donor resources in a basket (basket funding). The problem arises because Article 15(4) limits procurement to State participants or members, or to States providing resources to ADF. The above-stated provisions, referred to colloquially as the "Rules of Origin" limit the use of ADF resources to procuring goods and services in State participants, member states of the Bank and other States which contribute resources to the ADF under Article 8 of the ADF Agreement. A State that contributes resources under Article 8 becomes an eligible supplier of goods works or services in respect of such resources, or generally from such other funds received under Article 8 as the ADF Board of Directors decides. The provisions of Article 15(4)(a), in effect, tie procurement to participation in the Fund or membership in the Bank. The rationale for this is that procurement is one of the expected benefits of participation in the ADF. Consequently, it is becoming increasingly difficult for the Fund to participate effectively in some SWAp operations that involve basket funding or the co-mingling of funds in a trust fund.

3.2.9 In addition to the “Rules of Origin” limitation, Article 15(4) poses a further challenge because the SWAp operations entail the use of procurement procedure(s) that are applicable to all donors participating in such SWAp operation(s). The practice is that usually, the recipient country’s procurement procedures or those of the lead donor playing the lead role are adapted. Such procurement procedures may not be fully compatible with those of the Bank Group, as outlined in Article 15(4) of the ADF Agreement. This statutory constraint cannot be resolved by requesting waivers from the Board of Directors, as the Article 15 (4) limitation imposed by the ADF Charter cannot be waived.

3.2.10 The alternative options of “ring-fencing” and parallel financing have not been effective or have been cumbersome owing to the fact that the principle and expected benefits of harmonization are lost. In addition, experience has shown that in cases where the Fund has adopted ring-fencing as a solution, implementation has sometimes been delayed and participating donors and borrowing governments have been dissatisfied, and thereby resisted the Fund’s practice. Other donors and RMCs have therefore appealed to the Bank Group to consider harmonizing its procurement rules with those of other donors.

Approaches of other sister institutions

3.2.11 The World Bank and the Inter-American Development Bank (IADB) have adopted universal approach to eligible procurement and therefore do not have similar statutory limitations. The Asian Development Bank (AsDB) has similar provisions to those of the ADF but uses the “importation to eligible member country formula” to address the difficulty posed by co-mingled funding in SWAps. In this approach, the Fund manager is responsible for ensuring, from import documents, that an amount at least equal to the grant/loan is used for the procurement of goods and services from Eligible countries. However the application of this approach to ADF’s member countries many of which have weak custom management capacities may be cumbersome and difficult..

IV. CONCLUSION AND RECOMMENDATION

4.1 **Conclusion**. The Bank Group will continue to participate in BSOs and SWAps on a case by case basis in conformity with the Guidelines approved by the Boards of Directors. Management will also continue to strengthen the Bank’s field presence through effective implementation of an effective decentralization strategy with the view of ensuring that newly established country and regional offices are adequately staffed and can engage constructively with development partners and governments in BSOs and SWAps preparation and implementation. The Bank will keep on providing support for capacity building to RMCs focusing specifically on strengthening their public financial management systems, widely defined to include fiscal budgetary system, procurement processes and procedures, national auditing, and the capacity to combat corruption.

The successful implementation of these good governance reforms will contribute towards reducing fiduciary risks. However, Article 15 (4) of the ADF Agreement continues to constrain the ADF'*s* full participation in SWAp operations, particularly those involving basket funding or the co-mingling funds.

4.2 To overcome this challenge, Management seeks guidance from Deputies on the following three options:

Option 1**: Amendment of Article 15(4) of the ADF Agreement.** To overcome the procurement limitations imposed by Article 15 (4) of the Agreement Establishing the ADF, and harmonize the Fund's involvement in SWAp operations, Management recommends the amendment of Article 15(4) by removing the procurement limitations contained therein and permit universal procurement.

Option 2: **Deletion of Article 15(4) of the ADF Agreement thereby permitting universal procurement**.

It should be noted that the implications of adopting options 1 and 2 above, is that for operations financed by the ADF, including the financing of projects , beneficiaries or recipients will not be required to adhere to rules of origin with respect to procurement for goods and services.

Option 3: **Reformulation of the Procurement Restriction in Article 15(4) of the ADF Agreement (to conform to the provisions in Article 17(1)(d) of the ADB Agreement)** as follows:

Proposed Article 15(4):

"The proceeds of any loan, investment or other financing undertaken in the ordinary operations of the Bank shall be used only for procurement in member countries of goods and services produced in member countries, , except in any case in which the Board of Directors determines to permit procurement in a non-member country or of goods and services produced in a non-member country in special circumstances making such procurement appropriate, as in the case of a non-member country in which a significant amount of financing has been provided to the Bank."[7]

[7] See Original text of Article 17(1)(d) of the ADB Agreement.