Economic and Financing Instruments

A Strategic Programme of the Global Mechanism

THE GLOBAL MECHANISM

UNITED NATIONS CONVENTION TO COMBAT DESERTIFICATION

Introduction

International resource allocation patterns are shifting towards country leadership and country-driven identification of development priorities. This is why governments need to identify sustainable land management (SLM) as a national priority and allocate national budget resources for SLM, if they intend to attract donor support for United Nations Convention to Combat Desertification (UNCCD) implementation.

The Global Mechanism (GM)'s *Strategic Programme on Economics and Financing Instruments* focuses on economic issues and financing for SLM. The Programme has been designed to facilitate country Parties' understanding of the changes in the financial environment following the *Paris Declaration on Aid Effectiveness*, highlight the opportunities it offers, and illustrate how UNCCD focal point institutions can work with it to their advantage.

The Programme promotes the development and implementation of national financing strategies (NFSs). A NFS is used to identify national priorities, bottlenecks and opportunities, and national and international sources of financing. It is a tool for designing and conducting a broad process leading to investment frameworks for SLM financing.

These fact sheets have been compiled with the intention of providing basic information 'at your fingertips' on key resource mobilization issues for UNCCD implementation. They cover a range of topics, drawing on authoritative sources. Clearly, the issues examined are continuously evolving. For instance, at the time of going to print, negotiations on the 15th Replenishment of the International Development Association (IDA15) of the World Bank are in progress and their outcome will have major implications on SLM financing.

This poses a challenge which the GM addresses through regular publication updates, e-newsletters on hot topics including the latest studies and papers and its state-of-the-art knowledge base available on its website: www.global-mechanism.org.

The GM believes knowledge management plays a crucial role in generating a deeper understanding of the financing instruments available for upscaling resources for SLM and poverty reduction, so that countries can safeguard natural resource availability for present and future generations.

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The World Bank's International Development Association

Background

The World Bank is made up of two development institutions owned by its 185 member countries: the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). IBRD focuses on middle-income and creditworthy poor countries, while IDA is the concessional lending arm of the World Bank, which supports the efforts of the world's poorest countries to reduce poverty, improve living conditions and boost economic growth. As the world's largest provider of financial resources to low-income countries with limited or no access to market-based financing, IDA helps such countries achieve their development objectives. IDA places special emphasis on Africa, aiming to direct half of its assistance there, subject to performance.

BOX 1: IDA at a glance [1]

- an international agreement between 165 governments
- part of the World Bank Group and administered by its staff
- mostly soft loans plus some grants, to support growth and reduce poverty
- finances social services such as health and education but also infrastructure, agriculture and general budget support
- largest borrowers in 2005/6: Pakistan, Viet Nam, Ethiopia, India and Bangladesh
- country funding limits based on population, income, staff-assessed performance
- regular loans paid back over 40 years, including a 10-year grace period
- administration charge of 0.75% per year levied in lieu of interest
- more than 35 donors replenish IDA funds by donating every three years
- 70% of donations come from G7 countries
- other resources: loan repayments, investments, World Bank net income

Sources of IDA funding

While IBRD raises most of its funds on the world's financial markets, IDA is funded largely by contributions from the governments of the richer member countries. Additional funds come from IBRD's income, investment income and repayments of earlier IDA credits. Donors meet every three years to replenish IDA's funds and review its policies.

[1] Adapted from ODI (2005).

Who is eligible for IDA funding?

Three criteria are used to determine which countries are eligible for IDA resources:

- **relative poverty**, defined as gross national product (GNP) per capita below USD1025; [2]
- **lack of creditworthiness** to borrow on market terms and therefore a need for concessional resources to finance the country's development programme; and
- **good policy performance**, defined as the implementation of economic and social policies that promote growth and poverty reduction.

The 14th replenishment

The most recent replenishment, IDA14, began in February 2004 in Paris, and concluded in February 2005 in Washington. Under IDA14, USD34 billion will be made available to the world's 82 poorest countries between 2006 and 2008, of which USD18 billion are from new contributions from 40 donor countries. This represents an increase of nearly 25% in overall resources compared with the previous replenishment, and is the largest expansion of IDA resources in two decades.

Under the 14th replenishment, IDA's financial support to poor countries will take systematic account of vulnerability to debt. The countries facing the toughest debt problems – most of which are in sub-Saharan Africa – will receive all support in the form of grants. Less debt-burdened countries will receive IDA's highly concessional, long-term loans (interest-free credits with a maturity period of 40 years and a grace period of 10 years), or in some cases, a mixture of grants and credits. It is expected that 30% of total IDA support during this period will take the form of grants.

Grant eligibility: debt distress

A central element of IDA14 is the new system for allocating IDA grants on the basis of countries' risk of debt distress. The objective is to support low-income countries in their efforts to achieve the Millennium Development Goals (MDGs) without creating future debt problems, and to keep countries that have received debt relief under the Highly Indebted Poor Countries (HIPC) Initiative on a sustainable track. [3] The analytical basis for this system is the Debt Sustainability Framework (DSF).

According to the DSF, countries are at greater risk of debt distress, the lower their debt capacity thresholds (because of poor policies, greater vulnerability to shocks and, to a lesser extent, income levels) and the higher their actual or projected debt levels. In order to assess whether a country's current borrowing strategy may lead to future debt-servicing difficulties, a debt sustainability analysis (DSA) is conducted by World Bank country teams in close collaboration with the International Monetary

[2] As of 1 July 2006.

[3] Those countries that face an unsustainable debt situation (debt–to–export levels above a fixed ratio of 150%) and are eligible only for highly concessional assistance from IDA and IMF can join the HIPC Initiative. The Multilateral Debt Relief Initiative (MDRI), which became effective 1 July 2006, provides debt cancellation by IDA, IMF and the African Development Fund to countries that reach the "completion point" of the HIPC Initiative. It is expected to provide USD37 billion in debt relief over 40 years.

Fund (IMF). The country is then classified according to its risk of debt distress. The greater a country's risk of debt distress, the larger the share of financing (0%, 50% or 100%) it receives as grants. IBRD/IDA blend countries, and hardened-term (or "gap") countries are excluded from access to grants irrespective of their external debt situation.

Performance-based allocation

One of the aims of the IDA resource allocation system is to ensure that good performers get a higher share of IDA's available resources. The IDA14 grant allocation system has a direct relationship with the Performance-Based Allocation (PBA) system, which determines the grant amount (per capita) based on the country's performance and needs. Resources are allocated on the basis of the IDA Country Performance Rating (CPR), population, and gross national income (GNI) per capita.

IDA countries' performance is assessed annually using the Country Policy and Institutional Assessment (CPIA) tool. The CPIA assesses each IDA country's present policy and institutional framework for fostering poverty reduction, sustainable growth and ability to effectively use development assistance. The system has evolved over time and now comprises 16 criteria grouped into four equally weighted clusters: (i) economic management; (ii) structural policies; (iii) policies for social inclusion and equity; and (iv) public sector management and institutions (Box 2).

Box 2: Revised CPIA criteria [4]

A. Economic management
1. Macroeconomic management
2. Fiscal policy
3. Debt policy

B. Structural policies
4. Trade
5. Financial sector
6. Business regulatory environment

C. Policies for social inclusion/equity
7. Gender equality
8. Equity of public resource use
9. Building human resources
10. Social protection and labour
11. Policies and institutions for environmental sustainability

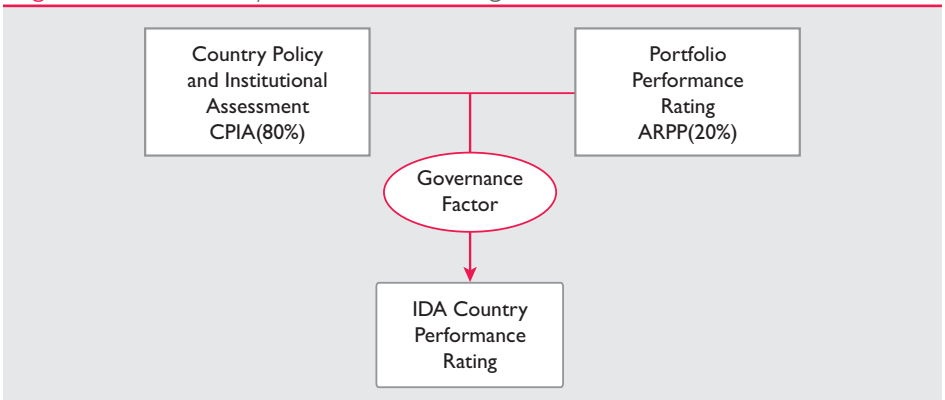
D. Public sector management and institutions
12. Property rights and rule-based governance
13. Quality of budgetary and financial management
14. Efficiency of revenue mobilization
15. Quality of public administration
16. Transparency, accountability and corruption in the public sector

[4] IDA14 Replenishment Report (Annex 1).

Two additional process steps are added to the CPIA to capture the dimension of quality of development project and programme management (Portfolio Performance Rating) and the quality of governance (the Governance Factor). This determines the Country Performance Rating (CPR) (see Figure 1).

In addition to their performance-based allocations, all countries are allotted a basic allocation of SDR3.3 million[5] (which in per capita terms benefits small states in particular), on terms that are in accordance with the grant allocation system for IDA14. Country allocations vary over time with changes in a country's performance, changes in other countries' performances, changes in eligibility for IDA resources and for IDA grants and IDA resource availability.

Figure 1: IDA Country Performance Rating [6]



IDA establishes a Country Assistance Strategy (CAS) based on the Poverty Reduction Strategy Paper (PRSP) of each country. The country poverty reduction goals that IDA is best placed to contribute to are selected from the PRSP, such as policy reform, capacity enhancement, demonstrated effects and learning. Each IDA country is expected to adapt the MDGs to country circumstances using the PRSP as an instrument and taking appropriate account of such factors as poverty profile, fiscal situation and administrative capacity.

What does IDA fund?

IDA lending goes to a range of programmes and projects, from basic health and education provision, water supply and sanitation to economy-wide adjustment operations and oil, gas and mining projects. Adjustment lending has accounted for 16% to 27% of IDA annual commitments over the last ten years. The bulk of IDA lending supports individual investment projects. IDA has increased its investment lending in social sectors, from around 20% of overall commitments in the late 1980s to around 40% by the mid-1990s. In recent years, IDA has targeted 50 percent of its new commitments to countries in Africa. [7]

[5] The SDR is an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies. (IMF website).

[6] IDA14 Replenishment Report (Annex 1).

[7] World Bank Information Center website.

The role of IDA at the country level

IDA's approach to reducing poverty has evolved over the years. Its key strength lies in its country programmes and in its emphasis on country-led development, as manifested by its support for PRSPs. IDA aims to work with the governments of recipient countries to support the priorities that emerge from their own development strategies. It seeks to provide an integrated package of finance, policy advice and institutional support to its clients, and works in collaboration with the rest of the World Bank Group (WBG), other development institutions, the private sector and civil society.

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Public expenditure reviews

Background

In recent decades, more attention has been focused on the allocation of public expenditures in national and international development policy, for several reasons. In developing countries, negative macroeconomic balances have underscored the importance of cutting aggregate spending and deficits. At the same time, governments have had to make difficult choices about where to cut spending or how to allocate scarce resources to achieve growth and poverty alleviation objectives. Donors have realized that their earlier focus on lending for individual projects ignored larger spending priorities and have therefore increasingly focused conditionality for grants and concessional loans on restructuring public expenditure priorities.

Steps have been taken to harmonize development assistance and align it with national priorities, as illustrated by the Monterrey Consensus (2002), the Rome Declaration on Harmonization (2003), the Joint Marrakech Memorandum (2004) and the Paris Declaration on Aid Effectiveness (2005). Donors and partner countries have made commitments to improve aid delivery and contribute to the achievement of development results at the country level. Multilateral and bilateral donors and partner countries are working to harmonize their operational policies, procedures and practices, and to align their support with country-owned poverty reduction strategies or other development frameworks.

The work being done to implement the Paris Declaration involves collective efforts to identify elements that all agree are good practices, and subsequently individual efforts by each country/institution to align policies and procedures to these good practices. In other words, much more attention is being paid to enhancing country systems for all development expenditures. This practical reform agenda covers a broad range of activities and includes analytical work in general and analysis of public expenditures in particular. [1]

In recent years there has also been an increase in the share of Official Development Assistance (ODA) provided through national budgets (budget support) - emphasizing the importance and relevance of robust public financial management (PFM) systems in developing countries. Consequently, donor conditionality in grants and concessional loans has increasingly focused on restructuring public expenditure priorities. Sound public spending, in particular pro-poor spending, has been placed at the centre of the debate on aid harmonization, effectiveness and accountability.

[1] Aid Harmonization and Alignment (2007) (www.aidharmonization.org/ah-overview/secondary-pages)

Why public expenditure reviews?

The relatively recent focus on public expenditures has led the donor community, in particular the World Bank(WB), to devote substantial resources to economic and sector work to assist developing partners in seeking potential solutions to development challenges. This work includes public expenditure reviews (PERs). A PER is a tool for analysing public sector issues in general and public expenditure issues in particular. PERs aim to help countries establish effective and transparent mechanisms to allocate and use available public resources in a manner that promotes economic growth and poverty reduction. At the same time, they are used to inform the WB's country assistance strategies.

Most PERs are essentially comprehensive macro reports (macro PERs) that focus on the efficiency and efficacy of resource allocation. Topics covered include analysis and projection of revenue, determination of level and composition of public spending, inter- and intra-sectoral analysis, involvement of financial and non-financial public sector enterprises, structure of governance and functioning of public institutions. PERs may also be used as an input to a country's budget process, providing analytical underpinnings for decision making and priority setting.

Sectoral PERs are specific to a given sector and provide a framework for analysing whether sector priorities and spending are consistent with overall macroeconomic policies and development objectives. They analyse a country's development issues, existing policies, expenditure priorities and how public institutions in the specific sector are managed. One shortcoming of sector reviews is that they rarely address the issue of resource fungibility across sectors - an issue more effectively analysed through a PER covering the entire national budget.

For the WB, the PER is at the heart of the lending process, since the Bank's lending programme supplements public spending in the borrower country and it uses PER recommendations to develop loan conditionalities through project- or policy-based loans. Today, the World Bank's strategy, particularly in Africa, is to undertake highly focused annual reviews covering a few topics, rather than major reviews with broad coverage every three years. One result is that several African countries have begun to shift towards annual, single focused PERs and more concise reporting formats are replacing large, all-comprehensive reports. [2]

What constitutes a good PER?

The main functions of a PER are to analyze the allocation and management of public expenditure and to assist the country in reforming public expenditures. A high-quality, comprehensive macro PER is often a very useful document for government, especially for the Ministry of Finance. In many developing countries the PER is the only mechanism for a systematic analysis of public sector issues.

PERs may cover all government expenditures or focus on a few priority sectors

[2] World Bank (2007) (www.worldbank.org)

(e.g. health, basic education, agriculture, water). PERs can be used to inform strategic planning and budget preparation and to identify ways of improving the efficiency and effectiveness of resource allocation. PERs also review expenditure management systems and institutions, in recognition that the allocation and management of public expenditures is determined by the institutional framework, organizational capacity, and everyday expenditure management practice of government.

Ideally, a PER analyses past performance in terms of resource allocation and service delivery in order to make a realistic assessment of what can be achieved in the future. The table below illustrates the type of questions to be answered by a PER. [3]

Issue	Past performance	Future performance
Fiscal discipline	Did expenditure correspond to budget allocations?	What can/cannot be done with the resources available? (and why/why not?)
Strategic priorities	Did expenditure correspond to strategic objectives?	How can expenditure be made to conform more closely to strategic objectives? What changes in resource allocation will make the greatest difference?
Operational efficiency	Did expenditure deliver value for money or could other providers have delivered the same output for less? Did publicly financed activities make a difference?	How can value for money be improved? Can some services be financed privately without efficiency or effectiveness loss?

A typical analytical framework for a PER comprises:

- analysis of the provision of an appropriate public-private mix of goods and services in the economy once the rationale for public intervention in terms of market failure (efficiency) and redistribution (equity) has been identified;
- analysis of whether adequate revenue is being generated in a non-distorting, equitable and sustainable manner, and whether fiscal deficits are sustainable and consistent with economic growth, inflation and other macro objectives;
- evaluation of public expenditure priorities, given the resource constraints and distributional objectives;
- examination of the link between expenditure inputs and outcomes (not necessarily based on complex statistical techniques – convincing anecdotes can work well where data is unreliable or insufficient); and
- focus on the public sector institutional arrangements (including political incentives), with suggestions for reforms to improve the effectiveness of public spending.

There is no set prescription for the level or composition of public spending. The design and implementation of public spending programmes are dependent on the country context and therefore require detailed assessment and tailoring on a country-by-country basis. [4]

PERs have been - and to a great extent still are - driven by donors and divorced from governments' decision–making processes. Attempts are being made to improve the process by asking: How can country ownership be ensured? What topics should be covered? How should the findings be disseminated? How can in-

[3] Oxford Policy Management (2007) (www.opml.co.uk/services/public expenditure reviews/index.html)

[4] World Bank (2007) (www.worldbank.org)

country capacity to undertake PERs be enhanced? PER reform proposals cannot be imposed on a country or government. Fostering the participation of high-level politicians and key civil servants is likely to increase the chances of success of the proposed reforms. Training in public expenditure issues can be helpful in breaking deadlocks and developing capacity.

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Sector-wide approaches

Background

International cooperation agencies are increasingly promoting programme-based approaches (PBAs) to avoid fragmented development assistance, enhance coordination of financial aid and promote cooperation. These agencies place strong emphasis on ensuring that recipient countries have local ownership of development programmes and receive support for their institutional development - aims not fully achieved by a project-based approach. The most significant PBA is the sector-wide approach (SWAp). [1]

What is a SWAp?

A SWAp is not a lending mechanism but rather an approach whereby sector funding – whether from donors or internal sources – supports a single policy and expenditure programme, under government leadership. Common methods are adopted across the sector, and are generally accompanied by efforts to strengthen government procedures for disbursement and accountability. Ideally a SWAp involves broad stakeholder consultation in the design of a coherent sector programme at micro, meso and macro levels, and strong coordination among donors and government actors.

Common characteristics of a SWAP

Since their emergence in the 1990s, SWAps have been continuously evolving. The first SWAps were developed for health and education, while more recently they have been adopted in agriculture and rural development, environment, water, youth, small- and medium-sized enterprise sectors, and in the context of decentralization.[2] SWAps tend to share the following characteristics:

- **country leadership and ownership:** in a SWAp, development partners come together to support the government's development programme for a given sector. The government plays a key role in this process – directing the programme and mobilizing and coordinating the different sources of financial and technical support for sector development.
- **collaborative process:** SWAps require partnership and close coordination between the government, development partners and other stakeholders, plus the

[1] UNESCO-UNEVOC (2004).

[2] Farrington and Lomax (2001).

commitment of all parties to openness, consultation, and information sharing.

- **common sector-wide policy framework:** the existence of a single, comprehensive sector policy framework, agreed to by government, the development partners and all other key stakeholders, is fundamental to a SWAp. This policy framework describes the current sectoral setting and constraints, and defines the overall goals, principles and priorities for the sector. These are then translated into a medium-term (typically, five-year) sector strategy, which outlines the sector objectives and the means of achieving them. The medium-term strategy is articulated as a programme of specific interventions over a given period of time. Annual activity programmes are reviewed each year and adjusted accordingly.

Two additional elements are often present in SWAps:

- a medium-term expenditure framework (MTEF) or budget that supports the policy framework; and
- commitment to moving towards greater reliance on the recipient government's financial management and accountability systems.

The combination of these elements in a SWAp varies according to the sector concerned, the development partners involved, the associated risks and local capacity.

How is a SWAp funded?

The government and all development partners agree on the proportion of the programme that each will finance. By agreeing to support a common sector programme, development partners agree in principle, not to finance expenditures outside the programme, thereby ensuring that resources are concentrated on the agreed priorities. SWAp funding may consist of pooled (or basket) funding, non-pooled funding, or a combination of both. For pooled funding the government and/or development partners use a common account, and all participants are required to use common procurement, financial management and disbursement procedures. Non-pooled funds are placed in dedicated donor-specific accounts - as is customary for traditional investment loans - and the disbursement, procurement and financial management rules and procedures of the donor concerned are applied.

The role of SWAps in the new architecture of development assistance

For the countries participating in the Heavily Indebted Poor Countries (HIPC) Initiative, poverty reduction strategies (PRSs) are now the basis for World Bank and International Monetary Fund (IMF) concessional lending and aid. Many donors have agreed that PRSs should be one of the conditions for development assistance. MTEFs are being formulated to link budgets to development priorities and overcome year-to-year discontinuities. Despite many practical shortcomings, PRS processes are expected to draw heavily on consultative approaches such as participatory poverty assessments, and to be cross-sectoral in scope. They may also aim to devolve responsibility for implementation to the level closest to the community, and to engage private (commercial and civil society) organizations in both preparation and implementation of the strategy.

The challenges in using SWAps in this new context include achieving consistency in what is planned within a sector (SWAp) and across sectors (PRS processes). Cross-cutting issues must be taken into account within the SWAp. Developing basic SWAp documents and consulting donors and stakeholders can be a lengthy, complicated process. Consensus must also be sought for implementation, monitoring and improved accountability. However, as long as PRS processes and SWAps are broadly consistent, SWAps may provide an opportunity to attract a wider range of donor interest than would occur in the absence of a PRS process, and SWAps may themselves become a mechanism to implement PRS processes. [3]

[3] ODI (2001).

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Domestic budgeting processes

Background

There have been major shifts in thinking and practice on development assistance in the recent past. Signs of a new approach and broad commitment to enhanced coherence among donors are reflected, *inter alia*, in the Paris Declaration on Aid Effectiveness. Resource allocation patterns at both the national and international levels are evolving towards country leadership and country-driven identification of development priorities, often through Poverty Reduction Strategy (PRS) processes. This approach is also evident in the agreement of the 14th replenishment of the World Bank's International Development Association (IDA) resources, whereby an increasing amount of the aid provided will be on grant terms, thus increasing recipient countries' autonomy in use of their budget funds and in the implementation of their national development frameworks.

As donors increasingly align their priorities with those of recipient countries, the importance of domestic public budget allocations increases, and new approaches such as basket funding and direct public budget support come into play. Sector programmes and budget support are placing new emphasis on coordination, complementarity and integration with government systems and procedures. Resource allocation is increasingly subject to national-level negotiations within government and between the recipient government and the international community. Domestic budgeting processes are becoming an increasingly important element of development finance, because it is through these processes that decisions central to allocation of both national and international financial resources are made.

As public expenditure becomes the privileged means for delivering services and reducing poverty levels, and an ever greater percentage of aid funds flows through national budgets, concerns about efficiency, transparency and accountability in the budget process are bound to grow.

What is a budget?

A budget determines the origin and application of public financial resources and therefore plays a central role in the process of government - fulfilling economic, political, legal and managerial functions. An annual budget sets out a government's intentions for raising and using resources during a given year.

As a tool of economic policy, the budget is the means by which the government seeks to achieve three key economic policy goals: (i) fiscal discipline, by controlling aggregate expenditure in line with macroeconomic constraints; (ii) the allocation of resources in line with the government's policy priorities; and (iii) the economic, efficient and effective use of resources in achieving policy goals.

The way public resources are used is a determining factor in the achievement of public policy objectives. Two important characteristics of budgeting processes in poor countries are scarcity and uncertainty. These conditions often force public policy choices and trade-offs to be made. Sometimes proposed budgets cannot be financed, or can only be financed in ways that pose risks to fiscal stability. Shifting priorities and taking ad hoc measures in response to shocks and crises can lead to actual budget outcomes that are very different from the original budget proposed. In such circumstances, the budget has a limited role as an economic policy tool and guide. [1]

Budget formulation

The budget formulation process forces a government to make choices regarding the financing of public expenditure (through revenues, aid, debt, etc.) and the allocation of available resources to programmes and institutions. Budgets can therefore provide a very clear statement of intent of a government's priorities. Indeed, budgets are often more accurate than the policies or plans on which they are based.

Since resources are limited, budgets determine the winners and losers in the resource allocation process. While choices and trade-offs in the budgeting processes are sometimes based on technical considerations, they are more often the result of complex interactions between various stakeholders, ranging from government actors to economic lobbies to civil society groups. They often involve compromise between 'optimal technical solutions' and the political reality and interests within the country. This is why well-formulated strategies and plans based on strong rationale and fully aligned with overarching national development frameworks do not necessarily receive adequate budget allocations.

Budget implementation

While drafting policies and plans often absorbs much of policy-makers' time, it is, in fact, the allocation of resources for these plans that determines the implementation of activities. Budget implementation is the transformation of the numbers in the budget into delivery of outputs and the potential achievement of government objectives. Ensuring that public funds are spent in a way that enables objectives to be met, and higher degrees of efficiency and effectiveness to be achieved requires the interaction of a range of actors: government agencies at various levels; contractors; clients; and service providers including non-governmental organizations (NGOs) and private sector firms. These interactions are governed by complicated systems of rules, procedures and incentives. [2]

[1] ODI (2004).

Budget implementation, like budget formulation, is the outcome of a combination of political and technical processes. These include: (i) the extent to which the budget figures are realistic, which is dependent on the government's capacity to accurately forecast variables such as growth and inflation rates and revenue levels, and on its capacity to implement programmes; (ii) the degree to which the budget is free from manipulation due to political pressure or lack of transparency; and (iii) the capacity of the budget to amortize shocks, and its flexibility in adjusting to sudden changes in priorities or availability of resources due to external circumstances. [3]

Domestic budgets and aid

Developing countries are often heavily dependent on external aid which, in some cases, constitutes the source of financing for more than half the national budget. This can put strain on the budget formulation process, which must take donor priorities into account, and on budget implementation - where multiple financing sources may require separate implementation and reporting procedures and multiple accountability.

The new aid agenda focuses on country-led approaches, moving away from project assistance to more government-friendly processes. This not only means that budgets become more important to donors, but it makes donor behaviour a critical factor in the budget process, further increasing the relevance of the alignment and harmonization agenda.

Several donor governments have committed to doubling aid to Africa by 2010. This could bring in extra foreign exchange, investment resources and government revenues. However, a macroeconomic shock on this scale poses real challenges in terms of balance of payments, monetary and fiscal management and wise spending of the additional resources through existing allocation frameworks and domestic budgeting processes. There is a risk of large, rapid increases in aid being wasted - unless they are provided in the context of carefully prepared plans. Moreover, governments may have a limited capacity to utilize rapidly increasing budgets effectively. There is therefore a risk that donor disillusion will develop, leaving African governments with the familiar problem of the short-term benefits of an aid increase being negated by destabilizing difficulties, as they try to run expanded services and infrastructures with less assistance than anticipated. [4]

[2] ODI (2004).

[3] ODI (2004).

[4] ODI (2006).

Initiatives that address performance budgeting and management in low-income countries often play a vital role in the successful implementation of PRSs. With donor support, medium-term expenditure frameworks (MTEFs) have been introduced, with donor support, in a number of countries, to bridge the gap between policy measures championed by politicians, and the availability of financial resources – with mixed results.

Although the introduction of MTEFs has focused attention on policy priorities and poverty reduction, PRSs, MTEF and budget processes require broad participation in order to ensure ownership and credibility. Consultations on PRS priorities need to be timed so as to feed into the MTEF/budget process, and parliament must be involved in the budget process to ensure credibility and predictable budget implementation.

A lesson to be learned from these experiences is the need to focus on developing coherent, integrated policy-making, planning and budgeting processes. This lesson brings home, once again, the importance of domestic budgeting processes for development finance.

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THE GLOBAL MECHANISM
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Medium-term expenditure frameworks

Background

Low-income countries' budgeting processes often result in the allocation of resources on a historical, incremental basis. Programmes may be cut at the last minute in an arbitrary manner, in order to maintain budgets within existing resource ceilings. Overly optimistic assumptions about government revenues, and weaknesses in financial management systems, may mean that budgeted allocations are not fully disbursed or are not disbursed in a timely and predictable manner. Links between development and recurrent budgets are often weak or non-existent. Such undisciplined, piecemeal budget processes lack credibility and provide little basis or incentive for sound planning, even when technical capacity exists. This severely limits the feasibility of developing approaches based on sector or budgetary support.

Medium-term expenditure frameworks (MTEFs) are one way of breaking this vicious cycle. MTEFs are designed to allow policy-makers to shift from short-term expenditure allocation and arbitrary budget cuts, to reassessment of resources based on national priorities, by providing a framework that gives some scope for resource shifts, while offering a degree of continuity even in the case of redeployment of key personnel. [1]

MTEFs are therefore regarded as a central element of public expenditure management (PEM) reform.

What is an MTEF?

An MTEF is a tool to reconcile the costs of implementing government strategy with aggregate resources available for public expenditure. It aims to reduce the imbalance between what government can afford and what sectors and line ministries request, by charting out future resource requirements for existing services, and assessing resource implications of policy changes and new programmes. In practical terms, the MTEF sets the ceilings used in the annual budgeting process for each of the sectors/line ministries.

MTEF development can be divided into three steps:

(i) the development of a medium-term fiscal framework (MTFF), which typically states the fiscal policy objectives and contains a set of integrated medium-term macroeconomic and fiscal targets and projections;

(ii) the development of a medium-term budget framework (MTBF), which builds on the MTFF by developing medium-term budget estimates for sectors/line ministries; and

[1] DFID (2002).

(iii) the formulation of the MTEF based on (i) and (ii) and further enriched with elements of output-based budgeting. [2]

While practices vary between countries, a 'model' MTEF is:

- **Realistic.** Public expenditure is set at a level consistent with macroeconomic stability. Allocations to the various sectors are then made according to national strategic priorities.
- **Set in a medium-term perspective** (usually 3 to 5 years). Figures for year 1 of an MTEF are the same as the annual budget. For subsequent years, the implications of existing commitments are projected throughout the planning period and include the financial implications of any policy changes and new programmes.
- **A rolling programme**, updated on an annual basis. The annual budget is fixed and subject to 'hard budget constraints'. The figures projected for subsequent years are merely best estimates for planning purposes.
- **Comprehensive**, covering all public expenditure and revenues from all sources (including external development partners).
- **Centred on broad participation** in decisions related to sectoral allocations, intra-sectoral allocations and sector policy.
- **Designed using conservative cost and revenue estimates**, including the provision of contingencies to cover changes in economic circumstances such as inflation and new policy commitments.
- **Clear in terms of accountability and responsibilities.** To enhance credibility, ideally, it is approved by the Cabinet and published (not just adopted as a working document). [3]

The value of MTEFs

MTEFs are receiving renewed attention in the context of the formulation of Poverty Reduction Strategy Papers (PRSPs). As the PRSP becomes the strategic document for national development in many countries, the MTEF can be the ideal vehicle translating PRSPs into public expenditure programmes within a coherent, multi-year, macroeconomic and fiscal framework.

It is important to emphasize that the key driver of the success of an MTEF is policy change – with resource reallocation playing a largely supportive role. Without commitment to policy change, shifting resources around the system will not produce the desired results. A successfully implemented MTEF is not only strategically useful, but can also bring considerable benefits to policy implementation, in terms of: [4]

- **enhancing the efficiency of public expenditure** by committing countries to a process that eventually channels resources toward higher-value uses and helps ensure that key services are adequately funded. Unlike the annual budget approach,

[2] Oxford Policy Management (2000).

[3] World Bank (2002).

[4] DFID (2002).

it allows the future implications of policy decisions to be fully assessed and their affordability considered.

- **increasing the predictability of resource flows** by basing estimates on more realistic assumptions about revenue. This can improve efficiency, given that shortfalls are often borne disproportionately by non-salary items, seriously reducing operational efficiency.
- **promoting more outcome-focused approaches** by requiring line departments to be more explicit about what they propose to do, why they want to do it, and what it will cost.
- **improving accountability** by encouraging consideration of the medium- and long-term financial implications of policy choices. Emphasis is shifted away from the identification of new programmes towards issues such as expenditure control and resource allocation.
- **promoting inter-sectoral approaches**, by asking questions such as, "How can land management practices be best improved?" rather than "Which agriculture sector interventions are best at improving land management practices?" The process of developing an MTEF and the questions it raises are critical aspects of the tool.

The MTEF in a national planning context

The MTEF has become a standard item in the World Bank's public expenditure management toolkit. As a national planning tool the MTEF must relate to and interact with other national policy and planning initiatives, including:

- **Sector-wide approaches (SWAps).** The MTEF is particularly important in a SWAp context. The MTEF significantly increases the credibility of a SWAp by providing it with a broad financial framework, while sector strategy reviews and annual performance reviews associated with SWAps can support MTEFs. Donors can undermine the MTEF process if they provide additional support outside an MTEF. Therefore donor buy-in of the MTEF is an important step in negotiations.
- **Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI).** These initiatives release additional resources to ministries of finance, which can be used to fund more public expenditure or reduce debt. This affects the revenue projections to be included in the MTEF and may imply significant increases in expenditure on social sectors because these initiatives are conditional on PRSPs.
- **PRSPs.** The PRSP process affects the MTEF by increasing revenue flows, influencing sectoral allocations and identifying policy issues and new programmes required to achieve social objectives. The MTEF must quantify the financial consequences and viability of such issues and programmes.
- **Public expenditure review** (PER). A PER assesses the effectiveness of public expenditure and makes recommendations as to how spending of public funds can be improved. The findings of a PER need to be built into the MTEF. The decision to adopt and implement an MTEF is often the result of a PER. [5]

[5] World Bank (2002).

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Aid harmonization and effectiveness

Background

In the consensus reached at the Monterrey Conference on Financing for Development (March 2002), the global community affirmed the importance of development for the world's well-being. The Monterrey Consensus calls upon developing countries to strengthen their commitment to policies and institutions that work to stimulate growth, reduce poverty and achieve the Millennium Development Goals (MDGs). It also calls upon developed countries to provide more and better aid and improve trade and debt policies. One year later, in Rome (February 2003), further commitments were made to align development assistance with partners' strategies, improve systems, harmonize donor policies and procedures and implement principles of good practice in development cooperation. Donors and recipient governments committed to taking action to improve the management and effectiveness of aid and to take stock of progress before meeting again in Paris in February 2005 for the High-Level Forum on Joint Progress towards Enhanced Development and Effectiveness: Harmonization, Alignment and Results.

The challenge facing donors and partner countries is to harmonize their operational policies, procedures and practices, and align their support with country-owned poverty reduction strategies or other development frameworks. This involves joint efforts to identify elements that all agree are good practices, followed by individual efforts on the part of the institutions or countries concerned to align their policies and procedures, as far as possible, with those good practices, enhancing country systems for all development expenditures. This practical reform agenda covers a broad range of activities: analytical work, technical assistance, country strategies and operations and regional and global activities. [1]

Rome High-Level Forum on Harmonization (2003)

In February 2003, the major multilateral development banks and international and bilateral organizations met donor and recipient country representatives in Rome for the High-Level Forum on Harmonization, with the objective of planning how to apply the principles of good practice at the country level. The concluding statement - the Rome Declaration on Harmonization - highlighted the importance the international development community attaches to a country-based approach, emphasizing country ownership and government leadership. The Declaration also recognized the diversity of aid modalities, and committed donors and partner countries to an ambitious programme of action comprising:

- streamlining and harmonizing donor policies, practices and procedures;

[1] www.aidharmonization.org/ah-overview/secondary-pages

- aligning development assistance with partner countries' national development strategies, priorities and systems;
- implementing good practice principles in development assistance delivery, including through delegated cooperation;
- increasing the flexibility of country-based staff to manage country programmes; and
- developing incentives within donor agencies to foster internal recognition of the benefits of harmonization.

Marrakech 2nd International Roundtable on Managing for Development Results (2004)

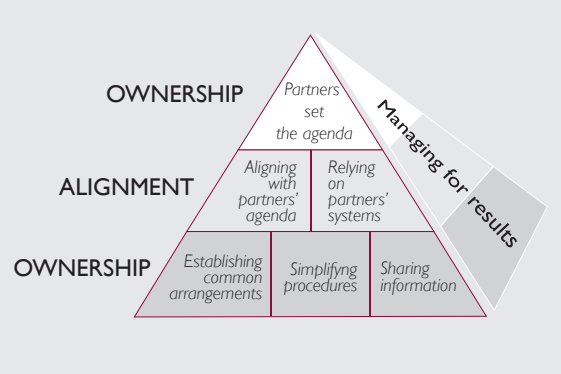
In February 2004, delegates from over 50 countries and 20 international organizations met in Marrakech, to reach a common understanding of principles and discuss ways to build on progress achieved. The resulting Joint Marrakech Memorandum complemented the Rome Declaration, by placing results at the centre of the development community's work, including in the areas of harmonization and alignment. The commitments made in Rome and Marrakech can be grouped into four broad areas: ownership, alignment, harmonization and managing for results (Table 1). [2]

Table 1: Commitments made in Rome and Marrakech

Ownership	The development community will respect the right and responsibility of partner countries to establish their own development agendas, setting out their strategies for poverty reduction and growth.
Alignment	Donors will align development assistance with the development priorities and results-oriented strategies set out by partner countries. In delivering this assistance, donors will progressively depend on partner countries' own systems, providing capacity-building support to improve these, rather than establishing parallel ones. Partner countries will undertake the reforms needed to enable donors to rely on country systems.
Harmonization	Donors will implement good practice principles in development assistance delivery. They will streamline and harmonize their policies, procedures and practices; intensify delegated cooperation; increase the flexibility of country-based staff to manage country programmes/projects more effectively; and develop incentives within their agencies to foster recognition of the benefits of harmonization.
Managing for results	The Marrakech commitments emphasize that partner countries embrace the principles of managing for results, starting with their own results-oriented strategies and then focusing on results at all stages of the development cycle, from planning through implementation to evaluation. Donors will rely on and support partner country priorities, objectives and results. They will work in coordination with other donors to strengthen partner country capacity to plan and implement projects and programmes, report on results and evaluate their development processes and outcomes, avoiding parallel, donor-driven mechanisms.

[2] World Bank(www1.worldbank.org/harmonization/Paris/ReviewofProgressChallengesOpportunities.pdf, p. 12.)

Figure 1: Aid effectiveness pyramid [3]



These four areas can be represented graphically as a pyramid describing the harmonization and alignment agenda (Figure 1). Whether read top-down or bottom-up, the pyramid illustrates the need for partner countries to set clear priorities (ownership) and establish common approaches (harmonization). It also highlights the importance of closing the gap between these two aspects of international development cooperation (alignment).

Paris High-Level Forum on Aid Effectiveness (2005)

The agreements in Rome and Marrakech were followed by the Paris High-Level Forum on Aid Effectiveness (28 February–2 March 2005), attended by development representatives from 91 governments, 26 donor organizations, civil society organizations and the private sector. In the concluding Paris Declaration on Aid Effectiveness, the government ministers and the heads of multilateral and bilateral development institutions committed to far-reaching and monitorable actions to increase aid effectiveness. The partnership commitments from the Paris Declaration build upon the Rome and Marrakech agreements, focusing on:

ownership: developing countries will exercise effective leadership over their development policies, strategies and coordination of development actions;

alignment: donors will base their overall support on partner countries' national development strategies, institutions and procedures;

harmonization: donor countries will work to make their actions more harmonized, transparent and collectively effective;

managing for results: management and implementation of aid will be linked to results, using information to improve decision-making; and

mutual accountability: donor and developing countries will be mutually accountable for development results;

The progress indicators for the Paris Declaration[4] are to be measured nationally and monitored internationally using tools such as the Country Implementation Tracking Tool (CITT), which is an updated catalogue of detailed information on country-level harmonization initiatives and activities. It provides overviews of donor coordination and harmonization, details government–donor activities around an agreed focus and lists components of the country harmonization programme, progress monitoring indicators, timeframes and partners involved.

[3] OECD/DAC

[4] www.aidharmonization.org

Potential costs of harmonization

Avoidance of fragmentation and reduction of the overlap and government costs of dealing with many different donors are often cited as benefits of harmonization. One risk of harmonization is that by moving towards a more coordinated approach, some of the healthy diversity inherent in individualized approaches may be lost. Smaller donors may end up relying on larger donors for major policy decisions, resulting in one dominant model being used for all development assistance.

Country-level implications of the Paris and Rome Declarations

Strong government leadership has resulted in many countries developing harmonization programmes or specific harmonized transactions such as sector-wide approach programmes, budget support commitments and basket funding arrangements. The Rome and Paris commitments have bolstered these efforts, which inevitably affect cooperation modalities between governments and donor institutions and between donors at the country level. One consequence is that both multilateral and bilateral support from international development partners must be designed within and coordinated through national aid harmonization frameworks, such as Joint Assistance Strategies, to a much greater degree than before.

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Budget support

Background

Financial aid as a donor contribution to the overall budgets of recipient countries has taken a variety of forms over the last 50 years. During the 1970s and 1980s, it took the form of 'balance of payments support' to help countries manage external financing constraints. During the 1990s, the emphasis shifted towards relieving recipient countries' internal fiscal constraints to addressing poverty reduction. The sector-wide or SWAp approach (a consensual framework, coordinated by the government, which major donors agree to support) emerged in the mid-1990s, in recognition of the weaknesses of stand-alone projects. More importantly, the 1990s saw a major shift towards increased country ownership of development programmes based on a set of core poverty reduction strategy (PRS) principles. This generated greater concern to provide assistance that enhanced government ownership of reform programmes and government accountability, developed sustainable capacity and provided transparency and predictability of resource flows. This assistance was to be provided in a way that maximized value for money and minimized transaction costs.

What is budget support?

Budget support is financial aid in the form of a direct contribution to a partner government's budget. If channelled to the recipient government's central treasury, it is often termed 'direct budget support' or 'poverty reduction budget support' (PRBS). Budget support may also be channelled into a specific sector as 'sector budget support'. Project aid funds more specific and limited sets of activities.

Why use budget support?

Budget support is designed to achieve the following objectives:

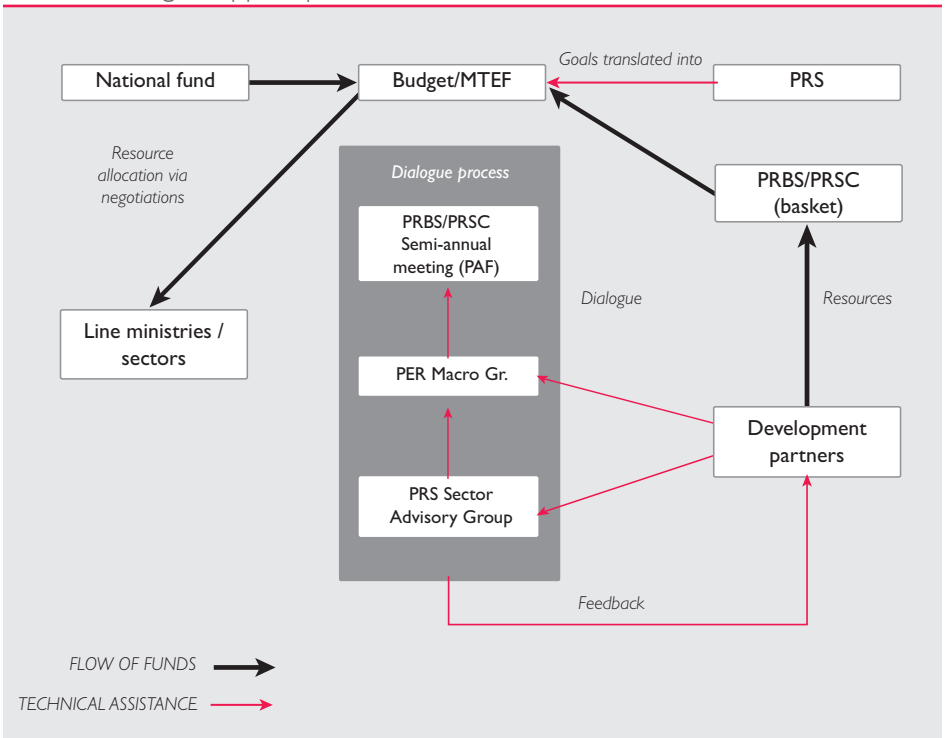
- **Link the provision of external funds to development results.** This underlines the importance of a sharper focus on policy outcomes.
- **Increase local ownership.** By integrating external assistance into the national budget, aid is allocated according to local priorities. A partner government may redirect funds from one area to another. The final distribution of funds will reflect the preferences of recipient governments. It is expected that by having greater

[1] European Centre for Development Policy Management

discretion over the use of funds, partner governments will be more committed to spending priorities and will use aid more effectively.

- **Improve public finance management.** The provision of budget support is tied to progressive improvements in public finance management, monitored according to jointly agreed indicators.
- **Develop coherent and comprehensive national planning and budgeting processes.** Budget support allows for rational allocation of resources between investment and recurrent costs.
- **Enhance government accountability.** Budget support involves regular reporting to national stakeholders (parliament in particular, but also civil society) and external partners.
- **Increase the predictability of funding flows.** Funds are distributed regularly, on the condition that results are achieved.
- **Strengthen national systems.** Budget support requires monitoring, assessment and control of how public funds are utilized, in particular through public audit institutions. Partner governments increase their capacity to make allocation decisions and engage in long-term financial management. Incentives exist for donors and recipients to enhance the effectiveness of government systems and institutions.
- **Improve the efficiency of aid.** Budget support incurs lower transaction costs than project support, which involves a more piecemeal approach. It also requires greater coordination and harmonization of donor approaches.

Box 1: A budget support process [1]



[1] European Centre for Development Policy Management

How is budget support implemented?

The steps in a typical process budget support process are as follows:

(i) Meetings are held on PRBS and poverty reduction strategy credits (PRSC) to identify pledges from development partners.

(ii) Resources flow through the PRBS/PRSC process into the national budget.

(iii) The objectives formulated in the PRS and the resources provided are coordinated and prioritized, in large part through the mid-term expenditure framework (MTEF). Resources are allocated to line ministries and sectors.

(iv) A PRBS/PRSC semi-annual meeting is held during which the government and its development partners discuss issues of assistance in the context of the performance assessment framework (PAF).

(v) The government and its development partners meet for the poverty expenditure review (PER) and at the Macroeconomic Policy Dialogue and Cooperation Group, to cooperate technically on the PRBS/PRSC process. Technical assistance (TA) supports this process.

(vi) PRS sector advisory groups assist the line ministries in improving their planning and budget processes, with TA support.

What are the potential risks of direct budget support?

- The disbursement of budget support is often tied to numerous conditions.
- The donor community can potentially exert greater influence over the policy-making of the partner country and government ownership may become a mere 'window-dressing' exercise geared towards satisfying donor demands.
- While the recipient country gains a better overview of the resources available, the allocation of funds is tuned to the needs of individual ministries and the treasury. Although funds are earmarked for poverty reduction, procedures could lead to institutions with little experience and concern for development (such as the treasury) determining the agenda, which could result in the domination of financial issues over social ones.
- The most alarming risks within the context of budget support are corruption, fiduciary risk and bad financial management. According to a study by the International Monetary Fund (IMF),[2] the efficiency of budget support depends to a large extent on the institutional framework and democratic structures prevailing in the recipient country. In order to increase the efficiency of budget support measures in countries with high levels of corruption, the IMF recommends tying budget aid to institutional reforms.
- Ownership and transparency require control to be steadily transferred to local

[2] AGEZ (2005)

government structures and local civil society. Access to relevant information is crucial in this process, as are efficient democratic structures and robust civil society organizations. Such conditions are lacking in many recipient countries.

- Results can only be monitored and sustained with the involvement of a strong and independent civil society. Non-governmental organizations (NGOs), traditionally relied on to promote a civil society agenda, can become mere contractors. Civil society must be empowered to assess and influence government budget planning and policies.

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Financial aid instruments and modalities: an overview

Background

New aid approaches emerged in the 1990s as a way of overcoming the weaknesses of existing aid modalities, which were typically stand-alone projects and structural adjustment operations such as balance of payment support. General budget support (GBS), sector budget support (SBS) and pooling fund arrangements under the sector-wide approach (SWAp), were introduced alongside the development of Poverty Reduction Strategy Papers (PRSPs) and the related institutional frameworks such as performance assessment frameworks (PAF) and medium-term expenditure frameworks (MTEF).

Enthusiasm for a programmatic approach to aid delivery at either sector or general budget support level, has obscured the wide array of aid modalities that can be drawn upon to achieve balance in aid programmes.

Major aid modalities

Project aid: Project aid finances specific activities with a limited objective, budget and timeframe to achieve specific results, with inputs linked to outputs. A specific area of intervention for donor involvement is identified, the objectives and outputs are defined, and funds are targeted for specific activities. A variety of options exist for procedural arrangements. The donor-supported project can be part of the government budget, it can be subject to the policy conditions of the project and the sector in which it is situated, and/or the donor can disburse funds into a bank account maintained by the recipient government and entrust the government to organize procurement.

Project aid using parallel systems: This refers to spending proposals where the donor takes the lead in design and appraisal, decides on its inputs and uses its own disbursement and accountability procedures. This type of approach is often criticized for bypassing government systems.

Balance of payment support: Balance of payment support provides finance for a programme of policy reform measures, usually agreed to by the Government with the International Monetary Fund (IMF) and the World Bank. In the 1980s, balance of payment support aimed primarily at correcting problems of debt unsustainability, trade imbalances, and exchange rate overvaluation.

Basket funding/pooling funds: Donor funds are pooled and pass through the government's accounts. The government manages and accounts for the funds, preferably using standard budgeting procedures such as those used for government revenues. Funds are earmarked for activities in a specific sector.

Budget support: A form of financial aid that channels donor funds directly into the partner government's budget and uses the government's own allocation and accounting systems. Conditionality, where it exists, focuses on policy measures related to growth, poverty reduction, fiscal adjustment, and strengthening institutions, especially budgetary processes. Budget support can be general budget support (GBS) or sector budget support (SBS).

- *general budget support:* Under GBS, financial assistance is provided as a general contribution to the overall budget. Any conditionality is linked to policy measures related to overall budget priorities. Within this category, there is no formal limitation on the sector in which funds are actually spent.
- *sector budget support:* Under SBS, support is normally subject to conditions requiring the execution of agreed policy and expenditure plans for the sector, through a sector approach supported by the government and major donors. SBS is not, in practice, the same as support to a sector wide approach (SWAp), described in Box 1.

Aid-funded debt relief: The main effect of debt relief is to reduce the stock of obligations a government is expected to meet in future. Relief is given subject to conditions, but once granted, it cannot be revoked, leaving the government free to decide how to allocate the resources that are no longer earmarked for debt repayment. Under the Heavily Indebted Poor Countries (HIPC) Initiative, debt relief is conditional on governments putting in place a participatory process to establish and monitor a poverty reduction strategy (PRS), giving greater accountability to local stakeholders. Other funding sources can be leveraged to ensure that the poverty reduction objectives supported by the HIPC Initiative are not abandoned once relief is obtained.

[1] Foster and Leavy (2001).

BOX 1: SWAp [1]

A SWAp is not a so much a modality as an approach to increase donor alignment with government policy and expenditure frameworks. The approach calls for all significant public funding for a sector to support a single sector policy and expenditure programme under government leadership. It progresses towards relying on the government to disburse and account for all public expenditure. A SWAp can encompass a wide range of instruments, from a set of coordinated projects to the provision of sectoral budget support and sector pooled funding arrangements. It usually includes three components: (i) an approved sectoral policy document and overall strategic framework, which define government priorities; (ii) an MTEF for the sector; and (iii) a coordinated process among donors in the sector, led by government).

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The Heavily Indebted Poor Countries (HIPC) Initiative

Background

By the 1990s, the external debt situation for a number of low-income countries - mostly in Africa - had become extremely difficult, weakening the prospects of economic development. Even if these countries had made full use of the traditional mechanisms of rescheduling, debt reduction and concessional financing, coupled with sound economic policies, they would not have attained sustainable external debt levels without additional external support.

In 1996, the International Monetary Fund (IMF) and the Word Bank defined a group of 41 countries in this situation, to be considered for special treatment under the Heavily Indebted Poor Countries (HIPC) Initiative.

The HIPC Initiative aims to reduce the external debt burden of these countries to sustainable levels, through coordinated action by the international financial community, including multilateral institutions. The HIPC Initiative was enhanced in 1999 to provide more comprehensive and faster relief and to strengthen links between debt relief and poverty reduction.

The HIPC process

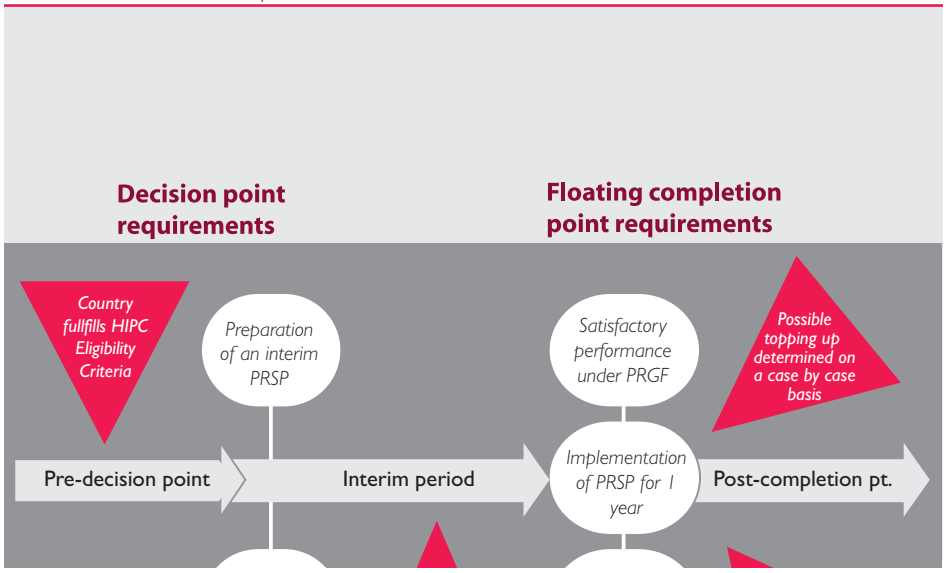
To be eligible for the HIPC Initiative a country must:

- face an unsustainable debt situation[1] even after receiving Naples Terms[2] treatment;
- be eligible only for highly concessional assistance from the World Bank's International Development Association (IDA) (be an 'IDA-only' country) and the IMF's Poverty Reduction and Growth Facility (PRGF); and
- enact certain reforms and develop a Poverty Reduction Strategy Paper (PRSP), with broad participation.

[1] A country's debt level is considered unsustainable if debt-to-export ratio exceeds 150% or if the country has a very open economy in which the exclusive reliance on external indicators may not adequately reflect the fiscal burden of external debt, and the debt-to-government revenue ratio exceeds 250%.

[2] Naples Terms allow a 67% debt reduction of eligible non-Official Development Assistance credits and stock treatments on a case-by-case basis. Only certain countries are eligible (www.clubdeparis.org).

FIGURE 1: The HIPC process [3]



Stage one

Stage one is a three-year period (starting once the country receives Naples Terms service treatment under the Paris Club Agreement), during which a country enacts economic reforms prescribed by the IMF and the World Bank, including changing its economic policy in line with the PRGF and consistently implementing poverty reduction programmes. This often requires deregulation and privatization of state enterprises, reform of the taxation system and changes in the way the public sector operates. Countries must also prepare PRSPs, with support from the IMF and World Bank, through consultation with civil society, donors and the regional development banks.

Decision point

At the end of Stage one, a country reaches its decision point. The IMF and the World Bank conduct a debt sustainability analysis of each loan to determine the country's level of indebtedness and the amount of debt relief it may receive. If they decide that the country's debt is still unsustainable - notwithstanding traditional debt relief - a small portion of that debt is cancelled. At this point, the country may begin receiving interim relief on a provisional basis.

Stage two

Stage two is the subsequent three-year phase, during which the country receives up to 90% debt reduction from creditors, and undertakes further reforms. Requirements include maintaining macroeconomic stability under a PGRF-supported programme, carrying out structural and social reforms as agreed upon at the decision point, and implementing a PRSP satisfactorily for one year.

Completion point

If a country complies with these requirements, it reaches completion point and can receive full, irrevocable debt relief. The period between decision and completion points may be more than three years and varies according to how rapidly a country

[3] The World Bank.

can implement its poverty reduction strategy and maintain macroeconomic stability. The framework also includes a provision whereby in exceptional cases, additional debt relief ('topping-up') may be committed at the completion point, for example when external factors such as natural disaster or conflict cause fundamental changes to the country's economic circumstances.

The expected contribution from each multilateral creditor is proportional to its individual share in end-1999 present value (PV) multilateral debt. Assistance from Paris Club and non-Paris Club bilateral creditors is based on their respective shares in overall end-1999 debt in PV terms, after the full application of traditional debt relief mechanisms. Many Paris Club creditors have announced that they will also provide debt relief over and above HIPC Initiative assistance, particularly on ODA debt.

In 2005, to assist those countries that had completed the HIPC Initiative in working towards the Millennium Development Goals (MDGs), the HIPC Initiative was supplemented by the Multilateral Debt Relief Initiative (MDRI), which allows for full relief on some debts from the IMF, the World Bank's IDA and the African Development Fund (AfDF).

FIGURE 2: Main characteristics of the HIPC Initiative and the MDRI [4]

	HIPC INITIATIVE	MDRI *
Country coverage	IDA-only, PRGF-eligible countries with debt indicators above the HIPC Initiative thresholds, and engaged in qualifying IMF-and IDA-supported programmes.	HIPC countries that have reached completion point.
Participating creditors	All multilateral, official bilateral and commercial creditors.	International Development Association (IDA), International Monetary Fund (IMF), African Development Fund (AfDF), and Inter-American Development Bank(IADB).
Debt relief provided	External public and publicly guaranteed debt is reduced to the HIPC Initiative thresholds, as calculated at the time of the decision point.	Debt discussed before end-December 2004 (IMF and AfDF) and end-December 2003 (IDA) and still outstanding at the time of qualification (after HIPC Initiative debt relief) is cancelled.
Total cost of committed debt relief	USD 41.9 billion in end-2005 NPV terms. USD 62.2 billion in nominal terms.	USD 19.3 billion in end-2005 NPV terms. USD 37.6 billion in nominal terms.
Countries that have benefited from relief	30 decision-point and completion-point HIPCs.	22 completion-point HIPCs.
Remaining potentially eligible HIPCs	10 pre-decision-point HIPCs.	18 decision-point and pre-decision-point HIPCs.

* MDRI-related estimates do not include IADB.

Annex 1 provides a more detailed outline of the stages and timing of the HIPC Initiative and what the debt relief countries can expect to receive at each point. Annex 2 shows the status of the HIPC Initiative as of March 2007.

[4] HIPC at-a-glance guide, World Bank 2007.

Box 1: HIPC debt strategy and analysis capacity-building programme

In the context of the HIPC Initiative, the Governments of Austria, Denmark, Sweden, Switzerland and the United Kingdom fund the HIPC debt strategy and analysis capacity-building programme (HIPC CBP). The aim of the programme is to allow HIPC governments to develop full independent capacity to undertake their own debt strategy analysis, to maximize their ownership and leadership of national debt strategy and to demonstrate to the donor and creditor community their commitment to a high level of debt management during and beyond the HIPC Initiative.

(For more information, www.hipc-cbp.org)

Criticisms of the HIPC Initiative

The most common criticisms of the HIPC Initiative are concerned with:

Stringency of conditions for debt relief. For countries to be eligible for debt relief under HIPC, they must meet stringent macroeconomic conditions imposed by the IMF under the PRGF (including tight fiscal management, tax reforms, financial sector reform, governance reforms, economic liberalization and privatization). Failure to conform to IMF structural adjustment conditionalities is a major reason why countries do not to reach the completion point. This not only delays the reduction of their debt stocks, but also results in the suspension of the reduction in debt service payments that they receive between decision and completion points. It can also result in delays in delivery of aid by other bilateral donors.[5] Moreover, many equally poor, indebted countries are excluded due to the criteria applied. [6]

Limits on poverty reduction expenditure. The debt-to-export ratio approach means that many governments cannot risk borrowing to fund poverty reduction initiatives (even at concessional levels), since the debt could push them over the 'sustainability' thresholds and send them off track with an IMF programme. This was the case in **Rwanda**, where the government maintained it should have the freedom to contract more debt in order to invest in basic agriculture for future economic growth, even at the risk of increasing its fiscal deficit and pushing its debt-to-export ratio higher. However, the IMF resisted strongly. Similarly, in **Ethiopia**, when a fall in coffee prices raised the debt-to-export ratio to 217%, the government was barred from taking loans and could accept only grants, which restricted its capacity to invest in initiatives to reduce poverty and enhance growth. [7]

Vulnerability to shocks. While modifications have been made in the HIPC structure over the years, many argue that HIPC does not take into sufficient account factors such as the vulnerability of developing country economies to external economic shocks (*e.g.* volatile commodity prices, exchange rate devaluations and variable donor aid flows) and non-economic shocks (*e.g.* natural disasters, desertification, conflicts and political instability).

Growth rates. The World Bank and the IMF may have overestimated growth and future revenue in recipient countries when they projected average gross domestic

[5] European Network on Debt and Development (2005) and Trocaire (2005).

[6] G-24 (2003).

[7] Jubilee Research (2005) and Trocaire (2005).

product (GDP) growth rates of 5.5% for 2000–2010. (Between 1990 and 1999, these countries averaged 3% GDP growth.) Overestimating future revenue could mean the countries may have to allocate relatively larger shares of government budgets to debt servicing, which would limit financing for development priorities.

Potential implications of the HIPC Initiative for UNCCD implementation

UNCCD priorities and the PRSP. Under the enhanced HIPC Initiative, resources freed through debt relief are to be used to support poverty reduction strategies through PRSPs. For the UNCCD to benefit from the Initiative, its priorities must be adequately reflected in the PRSP, and the linkages between sustainable land management and poverty alleviation made clear.

UNCCD objectives and the use of HIPC relief. The UNCCD Focal Point should be involved in the HIPC pre-decision point process since it is at this stage that the government, the IMF and the World Bank set the floating completion point conditions that have to be met prior to completion and the release of the debt relief package. A decision point document that specifies use of the interim HIPC relief provided between decision point and completion point is also drafted. UNCCD objectives should be considered in this document in order for interim funds, including from the Paris Club creditors, to be directed towards UNCCD implementation.

Debt-for-environment swaps. Under the Paris Club Agreement the government of each participating creditor country may sell or exchange, in the framework of debt-for-nature, debt-for-aid, debt-for-equity swaps or other local currency debt swaps. Bilateral discussions with creditor countries should be held on the potential for developing debt-for-environment swaps within the context of the HIPC Initiative. Potential entry points for such discussions are meetings with donors to determine bilateral programming priorities. Agreements should be reached prior to the decision point and subsequently at the Paris Club Meeting on the interim relief to be provided to the country. Additional meetings should be convened during the period leading up to the completion point to ensure that debt-for-environment swaps are included as a source of financing for UNCCD initiatives.

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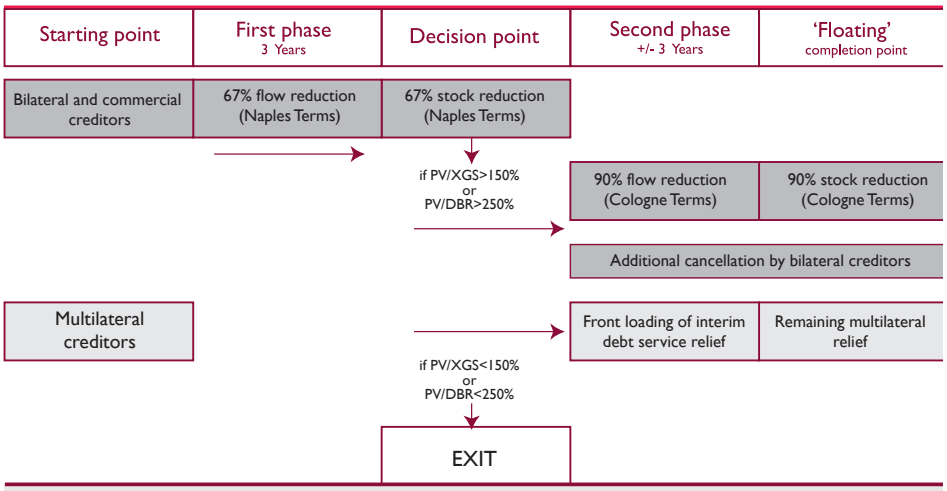
ANNEX 1: The HIPC Initiative



PV/XGS: Debt - Export ratio
PV/DBR: Debt - Governement budget revenue ratio

SOURCE: Debt relief international (2001)

ANNEX 2: Status of HIPC Initiative as of March 2007

List of countries that have qualified for, are eligible or potentially eligible for and may wish to receive HIPC Initiative assistance (as of end March 2007)

Post-completion point countries (22)		
Benin	Honduras	Niger
Bolivia	Madagascar	Rwanda
Burkina Faso	Malawi	São Tomé & Príncipe
Cameroon	Mali	Senegal
Ethiopia	Mauritania	Sierra Leone
Ghana	Mozambique	Tanzania
Guyana	Nicaragua	Uganda
		Zambia
Interim countries (between decision and completion points) (8)		
Burundi	Democratic Republic of the Congo	Guinea-Bissau
Chad	The Gambia	Haiti
Republic of Congo	Guinea	
Pre-decision point countries (10)		
Central African Republic	Kyrgyz Republic	Sudan
Comoros	Liberia	Togo
Côte d'Ivoire	Nepal	
Eritrea	Somalia	

Source: IMF website (2007)

ANNEX 3: Glossary

Appropriate market rate. An interest rate defined in a bilateral agreement implementing the Paris Club Agreed Minutes, based upon standard interest rates of the currency concerned, plus a management fee. This rate may be fixed or variable and does not include a country risk premium.

Cologne Terms. In November 1999, the Paris Club creditor countries, in the framework of the HIPC Initiative and in follow-up to the Cologne Summit, accepted to raise the level of cancellation for the poorest countries to 90% or more if necessary.

Completion point. The date at which a country completes the key structural reforms agreed at the HIPC decision point, including implementation of its poverty reduction strategy. The country then receives the bulk of HIPC debt relief without further policy conditions.

Debt-for-environment swaps/debt-for-nature swaps. Agreements under which a proportion of a country's debts are written off in exchange for a commitment by the debtor country to undertake environmental protection projects.

Decision point. The date on which HIPC debt relief is committed and begins on an interim basis, followed by the HIPC completion point.

The Evian approach. In the run-up to the G8 Summit in Evian in 2003, finance ministers agreed to support a more flexible approach in the Paris Club whereby agreements would not be based on predefined terms, but would be adapted to countries' individual circumstances. The key innovation was that the Paris Club began to look at the sustainability of debtor countries' long-term debt positions, not just their short-term cash needs.

Flow treatments. A standard Paris Club agreement that provides a way of assisting a debtor country through temporary balance of payment difficulties. There is usually a consolidation period when the IMF programme shows a financing gap that can only be covered by debt rescheduling. Payments due to Paris Club creditors in this period and covered by the Paris Club agreement are consolidated and the payment of these debts is then rescheduled.

International Development Association (IDA). IDA is the concessional lending arm of the World Bank Group that provides interest-free loans and grants to low-income developing countries.

Naples Terms. In December 1994, Paris Club creditors agreed to implement a new treatment on the debt of the poorest countries (to be implemented on a case-by-case basis). The level of reduction and the conditions of treatment of the debt were initially set at 50% to 67% of eligible non-ODA credits. (In September 1999, creditors agreed that all Naples Terms treatments would carry a 67% debt reduction.) Stock treatments may also be implemented on a case-by-case basis. [8]

Paris Club. The Paris Club is an informal group of official creditors whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by debtor nations. Paris Club creditors agree to reschedule debts. Rescheduling is

[8] www.clubdeparis.org

a means of providing a country with debt relief through postponement and, in the case of concessional rescheduling, a reduction in debt service obligations.

Poverty Reduction and Growth Facility (PRGF). The PRGF is the IMF's low-interest lending facility for low-income countries. PRGF-supported programmes are underpinned by comprehensive country-owned poverty reduction strategies. The targets and policy conditions in a PRGF-supported programme are taken from the country's PRSP.

Poverty Reduction Strategy Paper (PRSP). Countries prepare PRSPs every three years, through a participatory process involving civil society and other domestic stakeholders, with the involvement of the World Bank and the IMF. PRSPs describe the country's macroeconomic, structural and social policies and programmes to promote growth and reduce poverty, associated external financing needs and major sources of financing.

Present Value (PV) of debt. The discounted sum of all future debt service at a given rate of interest. If the rate of interest is the contractual rate of the debt, by definition, PV equals the nominal value, whereas if the rate of interest is the market interest rate, then PV equals the market value of the debt.

Stock treatment. Some Paris Club treatments apply not only to payments falling due during a particular period of time, but also to the entire stock of debt from which these payments derive. An agreement that deals with the stock of debt in this way provides a country with a Paris Club treatment called 'exit rescheduling'. In the context of the HIPC Initiative, Paris Club creditors provide their share of the effort through a Cologne Terms stock treatment at completion point. Stock treatments generate higher interest on the consolidation than in the case of flow treatments. As a consequence, stock treatments provide long-term debt relief, but debt service relief is lower in the short term than for flow treatments.

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