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Directorate-General for Neighbourhood and Enlargement Negotiations

# **BUDGET SUPPORT**

## **GUIDELINES**

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# Table of Contents

<b>1. PURPOSE, SCOPE, AND STRUCTURE .....</b>	<b>4</b>
<b>2. RATIONALE FOR BUDGET SUPPORT AND POLICY CONTEXT .....</b>	<b>5</b>
2.1 WHAT IS BUDGET SUPPORT? .....	5
2.2 WHY BUDGET SUPPORT? .....	6
2.3 POLICY CONTEXT .....	7
2.4 OBJECTIVES OF EU BUDGET SUPPORT .....	10
2.5 THE CHOICE OF CONTRACT .....	12
2.6. BUDGET SUPPORT: AN INTERVENTION LOGIC .....	13
<b>3. FUNDAMENTAL VALUES AND BUDGET SUPPORT .....</b>	<b>15</b>
3.1 PRINCIPLES.....	15
3.2 SCOPE.....	15
3.3 PROMOTION AND PROTECTION OF FUNDAMENTAL VALUES VIA BUDGET SUPPORT .....	16
3.4 STRUCTURES AND MECHANISMS .....	17
3.5 GRADUALISM AND PROPORTIONALITY OF THE RESPONSES TO BE CONSIDERED BY THE EU .....	19
3.6 EU COORDINATION ON FUNDAMENTAL VALUES.....	19
<b>4. DESIGN AND IMPLEMENTATION OF BUDGET SUPPORT.....</b>	<b>20</b>
4.1 ELIGIBILITY CRITERIA FOR APPROVAL & DISBURSEMENT.....	20
4.1.1 <i>Public policies [National/sector policies and reforms]</i> .....	22
4.1.2 <i>Stable macroeconomic framework</i> .....	24
4.1.3. <i>Public financial management</i> .....	26
4.1.4. <i>Transparency and oversight of the budget</i> .....	32
4.2. POLICY DIALOGUE IN THE CONTEXT OF BUDGET SUPPORT .....	35
4.3 RISK MANAGEMENT FRAMEWORK .....	37
4.3.1 <i>Introduction</i> .....	37
4.3.2 <i>Risk assessment</i> .....	38
4.3.3 <i>Risk responses and mitigation</i> .....	39
4.3.4 <i>Risk monitoring and reporting</i> .....	40
4.4 VARIABLE TRANCHE DESIGN AND PERFORMANCE INDICATORS .....	41
4.4.1. <i>Introduction</i> .....	41
4.4.2. <i>Size and phasing of variable tranches</i> .....	41
4.4.3. <i>Variable tranche indicator selection</i> .....	42
4.4.4 <i>Determining variable tranche payments</i> .....	43
4.5 DOMESTIC REVENUE MOBILISATION.....	44
4.5.1. <i>International dimension</i> .....	44
4.5.2. <i>National tax policy</i> .....	46
4.5.3. <i>National tax administration</i> .....	46
4.6. ACCOUNTABILITY .....	46
4.7. CIVIL SOCIETY PARTICIPATION .....	47
4.8. CORRUPTION AND FRAUD .....	48
4.9. BUDGET SUPPORT IN A DECENTRALISED CONTEXT .....	51
4.10. INVESTMENT AND THE BUSINESS ENVIRONMENT .....	52
<b>5. THE PROGRAMME CYCLE.....</b>	<b>54</b>
5.1 INTRODUCTION.....	54
5.2 IDENTIFICATION .....	54
5.2.1 <i>Whether to provide budget support</i> .....	54
5.2.2 <i>How much budget support</i> .....	55
5.2.3. <i>Financial additionality or earmarking</i> .....	56
5.2.4. <i>Duration of the contracts</i> .....	56
5.2.5. <i>Identification</i> .....	56
5.3. THE BUDGET SUPPORT/FINANCIAL ASSISTANCE STEERING COMMITTEE .....	57
5.4. FORMULATION .....	57
5.5. COMMITMENTS.....	58
5.6. IMPLEMENTATION AND DISBURSEMENTS.....	58
5.7. MONITORING.....	60

5.8. EVALUATION .....	60
5.9. AUDIT .....	62
5.10. COMMUNICATION AND VISIBILITY .....	62
<b>ANNEXES .....</b>	<b>67</b>
ANNEX 1 – GLOSSARY OF TERMS .....	68
ANNEX 2 – OBJECTIVES AND INTERVENTION LOGIC .....	76
ANNEX 3 – ASSESSING PUBLIC POLICY ELIGIBILITY .....	81
ANNEX 4 – ASSESSING MACROECONOMIC ELIGIBILITY .....	89
ANNEX 5 – ASSESSING PUBLIC FINANCE MANAGEMENT ELIGIBILITY .....	95
ANNEX 6 – ASSESSING ELIGIBILITY ON BUDGET TRANSPARENCY AND OVERSIGHT .....	117
ANNEX 7 – RISK MANAGEMENT FRAMEWORK .....	129
ANNEX 8 – VARIABLE TRANCHE DESIGN AND PERFORMANCE INDICATORS .....	138
ANNEX 9 – STATE AND RESILIENCE BUILDING CONTRACTS FOR FRAGILE SITUATIONS .....	147
ANNEX 10 – BUDGET SUPPORT IN SMALL ISLAND DEVELOPING STATES (SIDS) AND OVERSEAS COUNTRIES AND TERRITORIES (OCTs) .....	164
ANNEX 11 – DOMESTIC REVENUE MOBILISATION .....	170
ANNEX 12 – ASSESSMENT OF FUNDAMENTAL VALUES .....	186
ANNEX 13 – POLICY DIALOGUE IN THE CONTEXT OF BUDGET SUPPORT .....	192

## 1. Purpose, scope, and structure

These guidelines constitute an update to the 2012 DG DEVCO guidelines<sup>1</sup> and the 2014 DG Enlargement sector budget support guidelines<sup>2</sup> and merge both into one document. The **purpose** of these guidelines is, first, to contribute to improving the quality of EU budget support contracts by providing guidance to those who programme, design and implement them, in line with the policy direction set out in the 2011 budget support Communication 'The Future Approach to EU Budget Support to Third Countries', and corresponding Council Conclusions<sup>3</sup>. Second, the guidelines are intended to provide a basis for a coordinated EU approach to the provision of budget support. EU Member States are therefore encouraged to use the guidelines and the various tools therein. The aim of this document is to promote consistency and clarity, while allowing for the operational flexibility required in the face of dynamic and diverse situations.

The **scope** of the guidelines includes all EU budget support contracts to partner countries. The guidelines do *not* cover the provision of Macro-Financial Assistance, which is managed by DG ECFIN on the basis of its own operational procedures<sup>4</sup>.

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

It is recommended to always consult the on-line version of the guidelines instead of the printed version so as to take account of any specific update or clarification<sup>5</sup>.

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<sup>1</sup> See [https://ec.europa.eu/europeaid/sites/devco/files/methodology-budget-support-guidelines-201209\\_en\\_3.pdf](https://ec.europa.eu/europeaid/sites/devco/files/methodology-budget-support-guidelines-201209_en_3.pdf).

<sup>2</sup> Reference: DG Enlargement Sector Budget Support Guidelines, January 2014.

<sup>3</sup> See COM(2011) 638; 13 October 2011; 3166<sup>th</sup> Foreign Affairs Council meeting, Brussels, 14 May 2012 ([http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/EN/foraff/130241.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/EN/foraff/130241.pdf)).

<sup>4</sup> Macro Financial Assistance provides balance of payments support to beneficiary countries on a short-term and exceptional nature, managed under the so-called "Genval Criteria" and requiring an explicit decision by the Commission in accordance with Article 308 of the Treaty. However strong coordination is foreseen with DG ECFIN in countries where the Commission provides both Macro-Financial Assistance and Budget Support in order to ensure coherence and synergies between the two programmes.

<sup>5</sup> Refer to [https://ec.europa.eu/europeaid/policies/budget-support-and-dialogue-partner-countries\\_en](https://ec.europa.eu/europeaid/policies/budget-support-and-dialogue-partner-countries_en).

## **2. Rationale for budget support and policy context**

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

### **2.1 What is budget support?**

Budget support is a means of delivering effective aid and durable results in support of EU partners' reform efforts and the Sustainable Development Goals (SDGs). It involves (i) dialogue with a partner country to agree on the reforms or development results which budget support can contribute to; (ii) an assessment of progress achieved; (iii) financial transfers to the treasury account of the partner country once those results have been achieved; and (iv) capacity development support. It is a contract based on a partnership with mutual accountability. As stated in the Financial Regulations (General Budget and European Development Fund) and the related Implementation and Application Rules, the use of budget support is subject to conditions. Eligibility criteria have to be met before signing a contract and maintained during its implementation before payments are made.

#### **Platform for dialogue**

Budget support offers a valuable platform for dialogue with the partner country (Government, national oversight bodies, civil society, private sector, and other stakeholders) on policies and their financing, objectives and results, consistent with the principles of ownership, transparency and accountability. The EU direct contribution to the state budget provides the legitimacy and the opportunity to enter in this dialogue, allowing a comprehensive view on a country's development or reform strategy and ways to achieve it.

#### **Financial transfers**

Budget support involves the transfer of financial resources to the National Treasury of a partner country, following the fulfilment by the latter of the agreed conditions for payment set out in the contract. Transfers are made in euros to a Government account held at the Central Bank and then converted into local currency to the National Treasury Account<sup>6</sup>. Budget support funds must be included in the State budget and fiscal accounts as grants.

Once the transfer has taken place, budget support funds are used in accordance with the partner country's own public financial management (PFM) systems. The responsibility for the management of these transferred resources rests with the partner government. The Commission's responsibility when accounting for and auditing its resources is to ensure that the stipulated conditions have been met and that resources are transferred to the national treasury in accordance with the financing agreement<sup>7</sup>. EU Delegations and HQ monitor PFM systems closely as part of the general conditions and through the risk management framework. Guidance on addressing major corruption or fraud cases is given in section 4.8.

#### **Performance & results assessment**

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<sup>6</sup> The Consolidated Fund, National Revenue Account, "le compte du Trésor" or equivalent – normally held by the Government in the Central Bank. Transfers that are made to accounts held by parties other than the government, held in commercial banks (even if held by government agencies or agents), or held outside the National Treasury system cannot be considered to be budget support funds.

<sup>7</sup> Guidance on the establishment of an exchange rate for budget support contracts is provided hereafter.

Budget support is directly linked to reforms and developmental results. This implies the existence or building of effective country systems to collect information and statistics on results, to monitor progress, and evaluate impact. Performance monitoring systems should be further developed by the government with the support of international partners if needed. Clarity on the choices of indicators, realistic targets, resource requirements and institutional set up, are all important elements for the reliability of the system. The system should also contribute to strengthening the voice and participation of different stakeholders in the partner country's budgetary process, structuring the policy dialogue between the government and partners, and ensuring that relevant, reliable and timely information on development results is placed in the public domain.

### **Capacity development support**

Budget support aims to strengthen the capacity of partner countries in a sustainable way by using the country's policy and public finance systems, improving the accountability of the government towards its citizens, rather than creating parallel structures administered outside the budget by third parties. In addition, specific actions can be designed to strengthen key institutions and policy-making processes. Capacity development needs should be assessed for that purpose and support provided to (i) promote effective, accountable and inclusive institutions, (ii) enhance the government's capacity to design, implement, monitor, evaluate policies and deliver better services to final beneficiaries (rights holders); (iii) promote the active engagement of all relevant domestic stakeholders in policy design, implementation and monitoring; (iv) strengthen the national monitoring and evaluation framework, including statistical systems; and v) integrate gender equality measures in planning, budgeting and monitoring. The Commission provides support to capacity development based on identified needs and demand, linked to clear results, and through harmonised and aligned initiatives.

## **2.2 Why budget support?**

Budget support is fully aligned with the principles and commitments of the aid effectiveness agenda outlined in the Paris Declaration (2005), the Accra Agenda for Action (2008), the Busan Partnership for Effective Development Co-operation (2011) and the 2<sup>nd</sup> High Level Meeting of Global Partnership in Nairobi (2016). Reasons for using the budget support modality include the following:

- **Budget support is results-based.** Whereas other assistance modalities are mostly disbursed against eligible expenditures, budget support is disbursed according to the results achieved. Overall progress regarding policy implementation must be satisfactory, the macroeconomic, public finance, and budgetary transparency eligibility criteria must be met, and variable tranches are linked to specific performance indicators.
- **Alignment with country policies and systems together with partner country ownership render the results achieved more sustainable.** Budget support finances reforms and activities that are an integral part of a country's policy-making, planning, budgeting, and execution system. Therefore it is easier to maintain results, ensuring for example continued funding for infrastructure maintenance, teacher salaries or learning material. It also leaves policy space for the country to determine the way to achieve the desired results.
- **Budget support links assistance to reforms and improvements in the policy environment.** Financial resources are important but need to be complemented with progress in creating an enabling policy environment and effective institutions. Investment in energy,

for example, to be effective requires a supportive regulatory framework. Budget support contracts are specifically designed to support policy reforms and institutional strengthening.

- **Budget support recognises that developmental progress and sustainable growth hinges on sound macroeconomic and fiscal management.** The eligibility criteria ensure that budget support is provided in the context of a stability-oriented macroeconomic framework with a sufficient degree of progress in the management of public finances and domestic revenue mobilisation.

- **Budget support improves accountability and helps to tackle corruption.** Strengthening accountability requires transparency, with a focus on oversight institutions such as supreme audit institutions and parliament, and also civil society participation in the shaping and monitoring of government policies. Eligibility criteria for budget support focus on progress in public finance management and budgetary transparency and oversight. The financing provided through budget support becomes part of the state budget and therefore subject to external audit and parliamentary control. The participation of civil society is encouraged for example through support to 'citizen budgets' by encouraging governments to involve civil society more systematically in policy-making and monitoring processes (see section 4.7).

- **Budget support can lower the transaction cost of delivering assistance.** It does not require the establishment of parallel systems with separate management, staffing, planning, budgeting, accounting and reporting procedures. Budget support funds are an integral part of a country's state budget. For example, budget support funds can be integrated in the single treasury account.

- **Evaluations have pointed to significant developmental results of budget support contracts.** These include important contributions to economic growth, improved public financial management and an expansion of service delivery to the population<sup>8</sup>.

## 2.3 Policy context

In October 2011, a Commission Communication on Budget Support<sup>9</sup> was adopted to reflect the findings of a Green Paper on the future of EU Budget Support (2010), reports from the European Court of Auditors concerning the Commission's management of Budget Support<sup>10</sup> and the Development Policy Framework (*Agenda for Change*). The May 2012 Council Conclusions<sup>11</sup> on *"The future approach to EU budget support to third countries"* provide the policy framework for these guidelines.

While the above-mentioned Council Conclusions still constitute the framework for these guidelines, the policy context has continued to evolve. In September 2015, the international community adopted the UN 2030 Agenda for Sustainable Development. This was a response to continued changes to the geography of poverty and inequality, global demographic shifts, emerging economic, social and environmental changes and challenges, diversification of developing and emerging countries, the changing approach to global development and the expanding development landscape encompassing new stakeholders and innovative solutions.

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<sup>8</sup> All European Commission evaluations can be found at [https://ec.europa.eu/europeaid/node/80199\\_en](https://ec.europa.eu/europeaid/node/80199_en).

<sup>9</sup> See <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52011DC0638&from=EN>.

<sup>10</sup> See *The Commission's Management of General Budget Support in ACP, Latin American and Asian Countries*, ECA Special Report No.11, 2010.

<sup>11</sup> See [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/EN/foraff/130241.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/EN/foraff/130241.pdf).



The Addis Ababa Action Agenda adopted in July 2015, is an integral part of the 2030 Agenda and sets a comprehensive framework for its implementation. In response to the 2030 Agenda and to reflect the EU commitment to lead by example in its implementation, a new European Consensus on Development was adopted in 2017 by the European Commission, Member States and the European Parliament. The Consensus provides a framework for a common approach to development and cooperation policy for the EU and its Member States. These budget support guidelines are in line with the new Consensus and the 2030 Agenda.

This European Consensus on Development frames the implementation of the 2030 Agenda in partnership with all partner countries, taking due account of the framework provided by the Lisbon Treaty. In addition, the Global Strategy for the EU's Foreign and Security Policy (the Global Strategy) provides an overall vision for a joined-up, credible and responsive engagement in the world. The Joint Communication on *A Strategic Approach to Resilience in the EU's External Action*<sup>12</sup> sets out a series of guiding considerations for programme design designed to sustain progress towards development goals in a context of a more fluid global risk environment. Budget support is also considered a key modality to further the implementation of the EU Gender Action Plan<sup>13</sup>.

As regards the countries of the **European neighbourhood**, EU policy is set out in the EU Global Strategy of 2016 (with a dedicated chapter on investing in state and societal resilience in the neighbouring countries of the EU) and the review of the European Neighbourhood Policy of 2015 (with a political priority of further stabilisation of the region). Political priorities for the coming years are agreed jointly by the EU with partner country governments in Partnership Priorities, or similar jointly agreed documents. These documents directly frame the formulation of priorities for EU assistance, such as on reform agendas or approximation with EU legislation and regulatory frameworks.

As for candidate countries and potential candidates for EU membership, the **enlargement policy** focuses on reforms in the areas of rule of law, fundamental rights, the strengthening of democratic institutions and public administration reforms, as well as economic development and competitiveness. The objective of the EU's assistance is to support those countries in their progressive alignment with the EU law, standards, policies and practices and to build their capacity to adopt and implement those rules and standards. The Enlargement Strategy and reports take account of the progress towards meeting the accession criteria and set the political priorities to be considered in the programming of EU assistance.

In line with the above commitments and to support the implementation of the 2030 Agenda, budget support aims to strengthen the contractual partnership between the EU and partner countries in order to promote **sustainable development, inclusive growth and job creation, poverty eradication, inequality reduction**, and build and **consolidate democracies and peaceful societies**. This approach must be based on mutual accountability and **shared commitment to fundamental values of human rights, democracy and the rule of law**. It should enable greater differentiation of budget support contracts, allowing the EU to better respond to the political, economic and social context of the partner country. In the enlargement context more specifically, these objectives support the progressive alignment of

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<sup>12</sup> See <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52017JC0021> – JOIN (2017) 21 final.

<sup>13</sup> See *Gender Equality and Women's Empowerment: Transforming the Lives of Girls and Women through EU External Relations 2016-2020* ([https://ec.europa.eu/europeaid/sites/devco/files/staff-working-document-gender-2016-2020-20150922\\_en.pdf](https://ec.europa.eu/europeaid/sites/devco/files/staff-working-document-gender-2016-2020-20150922_en.pdf)).



candidate countries and potential candidates with the European Union's rules, standards, policies and practices in the perspective of EU accession.

Budget support complements partner countries' efforts to 'collect more and spend better' in support of sustainable development. The Commission considers domestic revenue mobilisation and effective spending, as key ingredients to achieving the 2030 Agenda<sup>14</sup>.

Budget support is provided as a '**vector of change**' for:

- Improving public financial management, macroeconomic stability, sustainable and inclusive growth, and the fight against corruption and fraud;
- Promoting sector reforms and improving sector service delivery;
- State and resilience building in situations of fragility, and addressing the specific development challenges of Small Island Development States (SIDS) and Overseas Countries and Territories (OCTs);
- Improving domestic revenue mobilisation and reducing dependency on aid;
- Promoting human rights, democratic values, peaceful societies, and gender equality.

In the enlargement context and in the perspective of EU membership, budget support is used to apply the Copenhagen criteria in candidate countries and potential candidates, together with strengthening the civil society dialogue, enhancing market economies and supporting approximation to the EU acquis<sup>15</sup>.

In order to fulfil these objectives, the Commission provides three forms of budget support<sup>16</sup>:

- **Sustainable Development Goals Contracts**<sup>17</sup> to support national policies and strategies in progressing towards the SDGs;
- **Sector Reform Performance Contracts**<sup>18</sup> to support sector reforms and improve service delivery; and
- **State and Resilience Building Contracts**<sup>19</sup> in fragile and transition situations.

All three budget support forms are subject to the following four eligibility criteria covering:

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

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<sup>14</sup> See <https://ec.europa.eu/europeaid/sites/devco/files/swd-collect-more-spend-better.pdf>.

<sup>15</sup> The acquis is the body of common rights and obligations that is binding on all the EU member states.

<sup>16</sup> For the purpose of DAC coding, SDG-Cs and SRBCs are considered as general budget support and SRPCs as sector budget support.

<sup>17</sup> The Sustainable Development Goal Contract replaces the Good Governance and Development Contract in view of the 2030 Agenda, but it will abide by the same principles spelled out in the Communication on Budget Support (2011) and the related Council Conclusions (2012), notably as regards fundamental values.

<sup>18</sup> The Sector Reform Performance Contract replaces the Sector Reform Contract. This underlines the importance of improving the monitoring and evaluation systems, including the performance reporting, to foster informed decision making by the partner countries and the Commission. It will abide by the same principles spelled out in the Communication on Budget Support (2011) and the related Council Conclusions (2012).

<sup>19</sup> The State and Resilience Building Contract replaces the State Building Contract to emphasise that it contributes to increasing state and social resilience. It will abide by the same principles spelled out in the Communication on Budget Support (2011) and the related Council Conclusions (2012). It is also in line with the Communication for A Strategic Approach to Resilience in the EU's External Action (2017).

The Commission does not set specific targets for the use of budget support at either national or global level. However, budget support should be used in a manner which is consistent with the principles of development effectiveness and where the conditions are right. More generally, the appropriate mix between different aid modalities should be decided as part of a portfolio approach that comprises several financing modalities in response to a partner country's specificities and agreed development or reform objectives<sup>20</sup>.

### **What if the conditions for budget support are not currently met?**

Where there are indications that budget support might be a possibility in the short to medium term, the dialogue should be initiated with the government (possibly involving also EU Member States and other partners) and appropriate capacity development support measures planned in support of key institutions and reforms. In addition a risk management framework should be prepared (see section 4.3) and submitted together with a narrative which summarises the key issues to be addressed to enable a potential budget support contract.

### **EU coordinated approach**

The 2012 Council Conclusions highlight the need for a more EU coordinated approach to increase the effectiveness of this aid modality for development results and reforms, and to provide coordinated and consistent EU responses. This more coordinated approach shall be conducted in respect of existing procedures and decision-making processes, both in country and at headquarters. A coordinated approach can be facilitated by and take place in the context of joint programming, joint analysis and joint implementation.

A coordinated approach is not limited to budget support providers. Other interventions, for example in the area of capacity strengthening or through policy dialogue, can complement and reinforce EU budget support contracts, particularly in relation to risk mitigation. The 2017 European Consensus on Development reiterates that coordinated work by the EU and its Member States on budget support will help to support partner countries' efforts to implement the 2030 Agenda. It further underlines the commitment of the EU and its Member States to implement a rights-based approach to development cooperation, including women's and girls' rights, and to promote gender equality and the empowerment of women and girls.

## **2.4 Objectives of EU budget support**

The **general objective**, which is in line with the 2017 European Consensus on Development, is to contribute to:

- Poverty eradication and inequality reduction;
- Sustainable development, inclusive economic growth and job creation;
- Consolidation of democracies and peaceful societies, and promotion of gender equality; and
- Sectoral impacts.

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<sup>20</sup> Distinctions can also be drawn between untargeted and targeted budget support (when it refunds the Government for a pre-defined list of eligible expenditures or budget lines, after goods or services have been delivered, payments made by the treasury and transactions verified by an audit). In the majority of cases, Commission support will be provided as untargeted budget support. In some cases, for example, with State and Resilience Building Contracts or in the presence of serious Treasury/Budgetary process constraints, support may be targeted in order to better safeguard funding for key expenditures. Budget support may also be used for arrears clearance or to assist countries affected by exogenous shocks but it remains subject to these Guidelines.

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

- Alignment with partner countries' own development policies, priorities and objectives (and thus harmonised and coordinated with other aligned donors); and
- Consistency with the EU external action policy, particularly the 2017 European Consensus on Development and the EU's enlargement and neighbourhood policies.

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

### **Sustainable Development Goals Contracts (SDG-C)**

SDG-Cs should be used to support the attainment of the Sustainable Development Goals (SDGs) to end poverty, protect the planet and ensure prosperity for all by 2030. The purpose of the SDG Contract is to provide a flexible way to support the achievement of selected SDGs, in line with the country context and the preferences of the partner Government. The policy supported can be the national development plan (or an equivalent policy) or a part of it which can be linked to the SDGs. It is expected that SDG-Cs support higher level, strategic development objectives which require a comprehensive and crosscutting approach. This will differentiate it from a Sector Reform Performance Contract which focuses on a particular sector policy. A SDG-C will typically cover enabling areas such as macroeconomic management, public finance, including domestic revenue mobilisation, public sector/administration reform, investment climate, inequality and domestic accountability. A satisfactory assessment and trend analysis of the Government's commitment to Fundamental Values is a pre-condition for a SDG-C (see chapter 3 and annex 12).

### **Sector Reform Performance Contract (SRPC)**

SRPCs should be used when the specific objectives are more narrowly focused on supporting sector policies and reforms, improving governance and service delivery in a specific sector or set of closely interlinked sectors. When providing SRPCs, and in line with the pledge to leave no one behind stated in the 2030 Agenda, emphasis should be on the equitable access to and the quality of public service delivery, particularly to the poor and vulnerable, and the promotion of gender equality and children's rights. It should also enhance the capacity to absorb and use sector research results, as well as creating conditions at sector level for inclusive and sustainable growth and job creation. Adherence to fundamental values should be taken into account.

Financial additionality may be a key feature of many SRPCs – as it is of other forms of external support – but SRPCs may also have objectives that do not necessarily imply significant increases in sector expenditure. The involvement of the Ministry of Finance, along with the supported sector Ministry(ies), as well as relevant civil society organisations should be strongly promoted. The value added of a SRPC is often in supporting an acceleration of reforms and in improving efficiency and effectiveness of sector expenditures. When SRPC objectives imply an increase in sector expenditure, EU Delegations should start early to prepare for a structured dialogue with the national authorities and other partners, particularly the IMF, as well as with civil society organisations, on budgetary allocations and the sector expenditure path. This should focus on realistic and fiscally sustainable expenditure projections that should underpin the sector programme (see annexes 2 and 13).

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

In the enlargement context, SRPCs assist the partner countries in implementing the political, institutional, legal, administrative, social and economic reforms required to bring the countries closer to European Union values, and to progressively align with the Union's rules, standards, policies and practices in the path towards EU membership.

### **State and Resilience Building Contracts (SRBC)**

SRBCs should be used when situations of fragility or transition require action to support transition processes towards recovery, development and democratic governance, and addressing structural causes of fragility, to help partner countries to ensure vital state functions and to deliver basic services to the populations. This will also be done from a perspective of supporting societal and state resilience, in line with the Joint Communication on Resilience. SRBCs can furthermore support specific gender equality objectives (e.g. in constitution-making, women's political participation in national parliaments and local authorities or for a gender-responsive security sector reform).

Assessments of eligibility for SRBCs will focus on forward-looking political commitment and institutional reforms rather than on track record. SRBCs require stronger political and policy dialogue and, if necessary, safeguard measures such as joint treasury committees to ensure close monitoring of cash management, targeting whereby disbursements reimburse verified eligible expenditures, or specific conditions. The assessment of government's commitment to fundamental values, as well as their political response to uphold them in a comprehensive way, are aspects to be considered when deciding whether to engage with these countries.

## **2.5 The choice of contract**

The decision on the appropriate form of budget support contract should be based on the specific objectives and expected results of the contract. The use of incentives, policy dialogue and performance indicators should be tailored to address these specific objectives and expected results. In the enlargement context, only SRPCs are concluded<sup>21</sup>.

SDG-Cs and SRPCs may both be provided in parallel to the same country as they can mutually reinforce each other. SRPCs can benefit from a concomitant SDG-C, mainly by deferring to the SDG-C the assessment and dialogue about the country national development policy, its macroeconomic policies and its main PFM reforms, providing a sound basis for implementing sector policies. A SRPC can in turn reinforce a SDG-C by providing an additional platform to support specific sector priorities embedded into the country national development policy and for which a SRPC can drill down into the specifics of the sector, including sector PFM, sector policies and a comprehensive range of indicators (input, process, output, outcome and impact) reflecting different dimensions of the sector.

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<sup>21</sup> This is in line with the explanatory Memorandum of the Commission's proposal for the IPA II Regulation. Other forms of budget support are not applicable for the candidate countries and potential candidates.

SRBCs are expected to prepare the ground for a SDG-C or SRPC by supporting the formulation of national/sector development policies and their integration into the budget, by consolidating the macroeconomic and PFM framework or by phasing and smoothing the transition from short to medium/long term partner country's objectives and commitments. If appropriate, SRBCs can be combined with a SRPC when a sector policy is in place.

Depending on the context, a SRBC may focus on short-term elements linked to the transition process or on structural/longer-term aspects linked to fragility and on resilience building.

## **2.6. Budget support: an intervention logic**

In line with the revised OECD-DAC methodology used for evaluating budget support programmes<sup>22</sup>, the intervention logic identifies five levels of budget support effects: inputs (level 1); direct outputs (level 2); induced outputs (level 3); outcomes (level 4) and impacts (level 5). These five levels are then grouped in two parts (see Figure 1).

The first part groups the first three levels of the framework and covers the effects of budget support (including associated policy dialogue and capacity development) on public policy, institutions, spending and service delivery, recognising that “induced outputs” will be determined by the government and its policies beyond the budget support package. The second part considers changes in outcomes (level 4) and impacts (level 5) expected from Government policies, strategies and spending, but also influenced by a range of other factors (including other government policies, private sector and civil society initiatives, other aid programmes and external factors) which need to be assessed during evaluation.

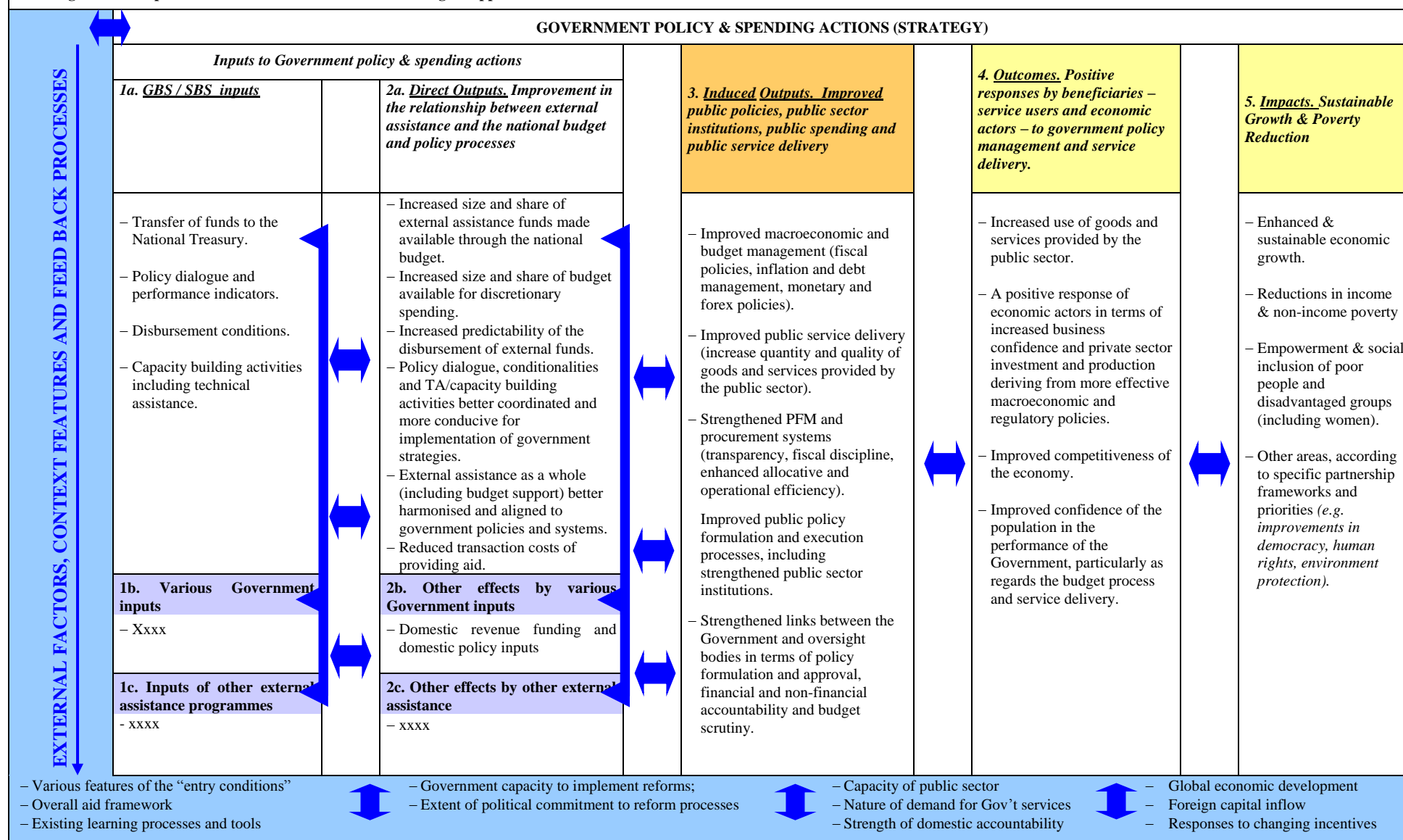
The evaluation will then combine part 1 and part 2 in a third step, which explores whether there is a link between the induced outputs and the determining factors of the outcomes and impacts, whereby a positive link implies that budget support has made a contribution to the achievement of the outcomes and impacts. Elements at levels 2 and 3, where the effects of budget support are more direct, represent the expected benefits of budget support as an aid modality. These are likely to be particularly significant in heavily aid dependent countries where budget support will contribute to capacity development to enable the use of country systems and to support the development of coherent policies by partner governments.

The overall objectives outlined above are reflected in level 5 of the framework (impacts). The specific objectives will vary more widely between individual budget support contracts, but will generally be focused on level 4 (outcomes), but can include, if appropriate, induced outputs. Thus, while acknowledging that budget support aims to make a contribution to the achievement of the general objective (impacts) such as sustainable and inclusive growth or poverty reduction, the focus should be on what budget support (and its complementary activities) can contribute to more directly, i.e. the specific objectives and results (outcomes and induced/direct outputs). The expected results should be as specific as possible in order to better assess and report on progress during implementation, to support the completion of the final report for each budget support contract, and to facilitate the ex-post evaluation.

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<sup>22</sup> The revised approach was adopted by the OECD-DAC Network on development evaluation in 2012. Evaluations of budget support operations are joint donor exercises and therefore cover all budget support operations within a specified period. The details of the Comprehensive Evaluation Framework therefore relate to the entire package of budget support operations in a country and, thus, needs to be adapted if applied to specific budget support operations. Refer to section 5.8 for further background or consult <http://www.oecd.org/dac/evaluation/evaluatingbudgetsupport.htm>.

Figure 1 - Comprehensive Evaluation Framework for Budget Support evaluations





### 3. Fundamental values and budget support

This chapter describes how issues relating to fundamental values are to be considered in the different types of budget support contracts. It reviews the principles to be followed, the scope of the assessment, how fundamental values link to different contexts the process to assess and monitor the fundamental values, and the wider process of EU coordination in this respect.

#### 3.1 Principles

As stated in Article 208 of the Treaty on the Functioning of the European Union (TFEU), development cooperation shall be conducted in the framework of the principles and objectives of the Union's external action and its **primary objective is poverty reduction and eradication**.

As regards relations with candidate countries and potential candidates for EU membership, the accession criteria reflect the values on which the EU is founded as set out in Article 2 of the Treaty on European Union (TEU). These essential conditions which all candidate countries must satisfy to become a member state notably include: the stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities.

In addition, Article 21 of the TEU defines democracy, the rule of law, the universality and indivisibility of human rights and fundamental freedoms, respect for human dignity, the principles of equality and solidarity as guiding principles of the EU's external actions. The Union shall seek to develop relations and build partnerships with third countries which share these principles. A positive and pro-active approach is required to implement these guiding principles, which requires coherence between the EU external action, the EU development policy and the EU Common Foreign and Security Policy.

For these reasons, all the EU's partnerships, association and cooperation agreements with third countries (e.g. Cotonou Partnership Agreement, the Association and Partnership agreements with Neighbourhood countries or the Stabilisation and Association agreements with candidate countries and potential candidates in the Western Balkans) incorporate the mutual **commitment to the fundamental values of human rights, democracy and rule of law**. These are essential elements of these agreements. The European Consensus on Development 2017 reiterates the EU and its Members States' commitment to implement a rights-based approach, encompassing all human rights, to development cooperation, and to promote gender equality and the empowerment of women and girls.

On the basis of these commitments, a fundamental values assessment needs to be undertaken when budget support contracts are proposed.

#### 3.2 Scope

The scope of the fundamental values assessment on partner countries' commitments shall refer inter alia to international instruments, ratification, transposition into domestic laws, the relevant institutional framework and effective implementation. It shall build on the analysis in relevant **EU Human Rights and Democracy Country Strategies and implementation reports**, and on a robust country gender analysis.



In the enlargement context, reforms are prioritised in the areas of rule of law, fundamental rights, the strengthening of democratic institutions, including public administration reform, as well as economic development and competitiveness. The countries' progress towards meeting the accession criteria notably as regards "the fundamentals" is covered in depth in the **European Commission's Enlargement strategy and reports**. In the case of the countries of the European Neighbourhood Policy, reforms are prioritised according to jointly agreed documents with partner country governments, such as Partnership Priorities. The countries' progress towards meeting the agreed priorities, including fundamental values, is covered in regular **EU horizontal and country reports**.

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

### 3.3 Promotion and protection of fundamental values via budget support

**Sustainable Development Goals Contracts** can be agreed where there is trust and confidence that state budget funds will be spent pursuant to the fundamental values that the EU and the partner country share, and which partner countries commit to move forward. Delivering assistance through a SDG-C is seen as an implicit recognition that the partner country's overall policy stance and democratic governance is moving in the right direction. Therefore, the commitment to fundamental values needs to be assessed as a **pre-condition for any SDG Contract** as described in annex 12, and monitored during implementation.

**When Sector Reform Performance Contracts are selected as the most appropriate support modality, adherence to fundamental values is taken into account as part of the risk management framework (political risk category)**. In addition, as described in annex 12, the sector analysis should take into account the human rights based approach. The most critical issues relevant to the sector and arising from such sector analysis should be highlighted and addressed by the SRPC.

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

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

and Resilience Building Contract should therefore adopt a forward looking approach; the assessment should be concise and a summary should be provided in the action document to serve as a baseline. **The overall adherence to fundamental values should be taken into account as part of the risk management framework (political risk category).**

### 3.4 Structures and mechanisms

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

- Regular **political reporting from the Head of the EU Delegation** (and/or of EU Heads of Mission when appropriate). This provides continuous information and assessments of political developments, also in terms of fundamental values, and recommendations are formulated as appropriate.
- The ongoing **political dialogue between the EU and the partner country** is a key forum to address concerns and challenges relating to fundamental values, including human rights issues.
- The **political dialogue in the enlargement context** reflects the specific nature of relations with partners in the Western Balkans and Turkey. As part of the Enlargement process and the Stabilisation and Association process (SAAs), the European Commission monitors the candidate countries' and potential candidates' progress in applying EU legislation and meeting the accession criteria. In this context, the Commission monitors and holds regular dialogue on the candidates' compliance with the political criteria to have stable institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities.
- The **EU Human Rights and Democracy country strategies** and their implementation reports are very useful tools. They provide comprehensive assessments covering the principles defined in Article 21 and also identify activities envisaged to attain the objectives. They take into account, and link, to the Universal Periodic Reviews and other human rights assessments undertaken in the United Nations context and by regional human rights mechanisms. They incorporate as annexes the Civil Society Road Maps that are a key indicator of civil society space in the country and the Democracy Action plans. In the case of candidate countries and potential candidates for EU membership, the assessment of compliance with the political criteria to have stable institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities is contained in the **European Commission's Enlargement Strategy and reports**.

These inputs feed into the risk management framework and policy dialogue, the assessment of the pre-conditions, and discussions of the **Budget Support Steering Committee (BSSC) or of the Financial Assistance Steering Committee (FAST)**.

When a SDG-C is planned during the identification phase, the EU Delegation will provide an assessment on:

- whether the **preconditions in terms of fundamental values** are met for providing a SDG-C (as per annex 12), and - if appropriate - what conditions would need to be met,

or which developments would need to take place, for the EU to be able to initiate or resume support through a SDG-C;

- the areas of fundamental values, and other aspects, which are likely to be raised in the **political and policy dialogue** with the partner country in the short and medium term; and
- the identification of the political risks, to be considered for the "**risk management framework**" for the country.

It is important to involve locally the Heads of Mission of EU Member States as early as possible in this assessment, in particular in countries with joint programming.

The assessment is submitted to the Budget Support/Financial Assistance Steering Committee by the geographic directorate. The committee takes into account all relevant existing information and documentation on fundamental values, including but not limited to the EU Human Rights and Democracy Strategies and their implementation reports, the Civil Society road maps and the Democracy Action Plans, as well as the opinion of the Head of the EU Delegation and relevant geographic and thematic units of DEVCO, NEAR and EEAS<sup>23</sup> as relevant. The Director General of DEVCO/NEAR, following discussions in the Committee, **will confirm whether the country fulfils the pre-condition**, seeking the agreement of the competent Commissioner and the High Representative/Vice-President, as appropriate.

### **Monitoring of fundamental values during implementation**

During implementation, the fundamental values are consistently monitored, including through the risk management framework. Four types of situations can emerge:

1. **Mostly stable or positively progressing** situation. The situation with regard to fundamental values allows the EU to continue to deploy activities planned with budget support, including its disbursements. Minor modifications or adaptations can be made to the budget support contracts to better provide for promoting fundamental values, but overall the situation is deemed as being on track.
2. Some **concerns arising**, but an overall respect of fundamental values is nevertheless still observed. Mitigation measures and/or changes to activities and approach to follow in relation to disbursements can be proposed.
3. **Significant deterioration of fundamental values**. The EU Delegation, with support from the relevant geographic and thematic units in DEVCO/NEAR and EEAS, will provide a report, including an analysis of the political impact on the budget support contracts, and their recommendations for action to the geographic director. He/she then refers this budget support contract, with his/her recommendation, to the Budget Support/Financial Assistance Steering Committee for decision. The Committee will then decide on a potential re-allocation of the funds set aside for the planned budget support and/or the adoption of precautionary measures. The Development or Neighbourhood Commissioner and the High Representative/Vice President (HR/VP) will be consulted, as appropriate.

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<sup>23</sup> The Council decision 2010/427/EU of 26 July 2010 establishing the organisation and functioning of the EEAS indicates in art 9(2) the list of external assistance instruments where the EEAS has a specific role in the programming and management cycle. The IPA regulation is not included in this list.

4. In the **extreme cases where overall cooperation needs to be suspended** (e.g. Art. 96 of Cotonou agreement, and similar situations), appropriate measures are decided by the EU Institutions, which can include a reallocation of funds to non-governmental channels.

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

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

1. **Enhanced dialogue**, including at political level where reform commitments are taken, should be the first response either to allay the concern and/or to agree on a roadmap for restoring confidence;
2. When dialogue fails, the Budget Support/Financial Assistance Steering Committee may consider different options, including **delaying disbursements** (to provide time to clarify the situation and agree on appropriate action), **reducing** Budget Support, or **suspending** Budget Support, as a measure of last resort; and
3. The BSSC/ FAST could also recommend reallocating budget support funds to other types of assistance.

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

Use can be made of the relevant **Article(s) of the financing agreements, which are jointly signed by the Commission and the partner country**, and that provides for formal ways for altering/suspending Budget Support.

**The choice between alternative assistance modalities in case of deterioration should be carefully assessed**, so as to balance the need to continue responding to development and people's needs and the respect and promotion of fundamental values, using the available instruments in a strategic and coherent way.

### 3.6 EU coordination on fundamental values

The EU aims to closely coordinate the assessment and monitoring of fundamental values, both in-country and at headquarters, including by means of the political follow-up of the country by the EU Delegations. EU coordination in the appreciation of the situation of the fundamental values is needed, also to face the consequences of decisions taken, which can include decisions to delay payments and/or to re-orient assistance.

## 4. Design and implementation of budget support

This chapter sets out the key issues to be considered throughout the programme cycle.

### 4.1 Eligibility criteria for approval & disbursement

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

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

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

1) Assessment, during identification and formulation, of the **relevance** and **credibility** of the partner country policy and strategic framework related to each eligibility criterion:

- *Relevance*: refers to the extent to which key constraints and weaknesses are being addressed by the government's strategy to reach the objectives of the policy.
- *Credibility*: refers to the quality of the reform process regarding implementation track record, financing, institutional capacity and political commitment to the reforms.

2) Assessment, during implementation, of **progress** made in implementing the policy and strategy and achieving the objectives:

- *Satisfactory progress*: it should be based on a **dynamic approach**, looking at past and recent policy performance benchmarked against reform commitments, but allowing for shocks and corrective measures and refining the objectives and targets if necessary. For some criteria (notably PFM), progress against initial reform milestones is particularly important; for others (macroeconomic, for example), maintaining stability-oriented policies is sufficient to confirm eligibility. The setting of targets and assessment of progress should take into account the initial starting point. In areas where performance and systems are already robust, the assessment should focus on maintaining the quality of the systems. The continued relevance and credibility of any strategy should be confirmed.

#### Eligibility criteria during formulation and implementation

##### *For approval (end of formulation)*

A country may be considered eligible when:

- *Public policy*: There is a credible and relevant national/sector policy that supports the overall objectives of poverty eradication and inequality reduction, sustainable and inclusive growth and job creation, the consolidation of democracies and peaceful societies, and the promotion of gender equality.
- *Macroeconomic*: There is a credible and relevant programme to restore and/or maintain macroeconomic stability.
- *PFM*: There is a credible and relevant programme to improve public financial management.
- *Budget transparency*: the government has published either the executive's proposal or the enacted budget within the previous or current budget cycle.

***During implementation (suggested wording for general conditions)***

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

**Structured and focussed assessments by EU Delegations of each of the four criteria are essential to effectively monitor eligibility.** Governments should be encouraged to provide progress reports as a basis for these assessments<sup>24</sup>. However such reports or other external information sources cannot replace the EU Delegation's own analysis. A clearly argued and justified recommendation regarding eligibility must be provided. It is also important to mobilise the expertise of different sections of the EU Delegation in the eligibility assessment as part of a collaborative effort.

The four eligibility criteria apply to all forms of budget support, although the focus may vary according to the specific objectives of the contract. Details on the scope, rationale and methodology for assessing each eligibility criterion are set out below. Annotated templates to document the assessment and background information are provided in annexes 3-6<sup>25</sup>.

Three general points are relevant to the assessment of each criterion:

- The first is that the cycle of eligibility assessment should be aligned with partner countries' policy reporting and budget cycles.
- Second, coordination with cooperation partners should be sought, although full harmonisation of conditions might not always be necessary or relevant. Minimising transaction costs for the country and maximising aid effectiveness should remain the guiding principles when deciding on the best coordination mechanism.
- Third, decisions on eligibility to budget support and subsequent payments will remain at the discretion of the Commission in coordination with the EEAS as appropriate<sup>26</sup> and in accordance with the applicable legal framework and the present guidelines. These decisions will be informed by (if possible joint) assessments or reviews of policy implementation. Ultimately the Commission remains responsible for its decision.

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<sup>24</sup> Note that a reform programme may not always be encapsulated into a single, comprehensive and coherent policy or strategy document. In such cases, the analysis will be based on the different documents, measures and reform processes followed by the government to strengthen the system.

<sup>25</sup> DEVCO/NEAR intranet should be consulted for the most up-to-date templates.

<sup>26</sup> The Council decision 2010/427/EU of 26 July 2010 establishing the organisation and functioning of the EEAS indicates in Article 9(2) the list of external assistance instruments where the EEAS has a specific role in the programming and management cycle. The IPA regulation is not included in this list.

### 4.1.1 Public policies [National/sector policies and reforms]

#### **Scope and rationale**

Budget support is provided in support of a public policy and to contribute to achieving the overall objectives. The effectiveness of a budget support contract is therefore dependent on the relevance and credibility of the policy it supports.

The term 'public policy' refers to national, sector or transversal<sup>27</sup> policies or strategies. Depending on the form of budget support, the policies to be assessed will differ.

For SDG-Cs, the national policy should be assessed with particular attention to the selected areas of focus.

For SRBCs eligibility refers to the national policy or a 'transition compact'<sup>28</sup>. In countries in situation of fragility there might not always be a fully-fledged national policy. In such cases, the EU Delegations can refer to the process and progress of formulation and monitor the national policy or a "transition compact" developed under the *New Deal for Engagement in Fragile States* endorsed in Busan by the EU and its Member States<sup>29</sup>, focusing on the great importance of restoring vital state functions, security, justice, economic foundations, basic social services, and addressing sources of vulnerability.

With SRPCs, sector policies for the concerned sector (or subsector or interlinked sectors) will be assessed, focusing on sector governance, sector reforms, service delivery and results for beneficiaries, including transversal policies that have an impact on the sector. A sector policy can be a stand-alone policy or encapsulated into a national policy. In the last case, EU Delegations should clearly identify the sectoral components of the national policy that the SRPC will support, also considering indicators and targets which can be drawn from that policy and aspects which call for policy dialogue and capacity building.

Assessment of eligibility will consider the relevance and credibility of the partner country's policy, and during implementation, progress against its stated objectives. The analysis will provide a baseline and confirm that a well-defined policy/strategy that responds to the challenges faced by the partner country is in place and, thereafter, implemented.

#### **Methodology**

##### *Eligibility for contract approval*

In the baseline assessment, the *policy relevance* is assessed both in terms of whether the country's public policy is in line with the EU objectives in the country and whether the public policy responds appropriately to the identified problems and weaknesses. The quality and comprehensiveness of the underlying problem analysis, including the assessment of expected socio-economic, fiscal and/or environmental impacts, is crucial to form an opinion on the relevance of the policy response. Coherence with cross-cutting reforms, especially with public administration reforms, and other policy agendas also needs to be assessed to ensure consistency and to avoid support for conflicting objectives.

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<sup>27</sup> For example, policies for public administration and public finance management reforms or against corruption.

<sup>28</sup> See annex 9 for guidance on transition compacts and budget support in situations of fragility or transition.

<sup>29</sup> See Council Conclusions on the Communication on Budget Support (May 2012), paragraph 11.



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

The EU Delegations should also provide an overview of the partner country's monitoring and evaluation arrangements. The country monitoring framework is important as it is expected to inform the assessment of the public policy eligibility criterion during the contract implementation. Consequently, EU Delegations should appraise whether weaknesses in statistical systems, availability of data and policy analysis significantly undermine the validity of the objectives and targets, as well as monitoring of the policy overall. The country monitoring systems should aim to produce annual progress reports to support informed policy dialogue with stakeholders, to provide information for the national accountability mechanisms, and to feed evidence-based decision making. Development of the progress report should be done to the extent possible in a consultative process. While drawing on these documents to monitor the eligibility to budget support, the Delegations should still express a justified opinion on the validity of their conclusions.

Where the quality of the existing monitoring framework is considered insufficient, EU Delegations should spell out how eligibility will be monitored, in agreement with the partner country and other cooperation partners. In particular, which are the key issues that will be considered when monitoring eligibility? At the same time, EU Delegations should ensure that the performance assessment and policy monitoring is strengthened, also with the view of providing the basis for future policy dialogue and budget support conditions. Complementary support for capacity development can be foreseen for that purpose.

#### **Performance assessment and policy monitoring frameworks**

Monitoring and evaluation (M&E) of public policies are often the weakest phases of the policy cycle. A monitoring system is usually created gradually, whereby in the first phase a country starts to produce progress reports on the implementation of policies, preferably measuring progress towards targets with indicators. Progressively the quality of information generated by the monitoring system improves (along with improvements in statistical data) and in the last phase this information is effectively used in decision making and policy development.

Countries adopt different approaches to M&E. The whole of government approach establishes a broad-based and comprehensive M&E across the government. In practice, different sectors tend to have varying capacities and systems in place for collecting, storing, analysing and using data. While the statistical office is part of the system, it does not necessarily produce comprehensive results information for all public sectors. Consequently, when a budget support contract is designed, the existing systems in place for the country in general (and the sector in particular for a SRPC) need to be assessed. The strategy supported should be accompanied by an action plan, and results indicators with baselines and targets, as well as a transparent review process. The responsibilities and timing of harvesting the information from the sector data collection systems, and producing the progress report will need to be clarified during the design of the contract. Where progress reports exist, their quality in

terms of reporting against the result targets need to be analysed. Robust progress reports on the supported strategy increase the space for informed policy dialogue between the stakeholders, transparency and accountability of the public service, awareness-raising about the reforms and results, and assessing the conditions and performance indicators for budget support. Improving countries' M&E systems also helps to respond to difficulties during the policy implementation. Where weaknesses in the country's M&E systems are identified during the contract design, governments should be supported to improve them.

In countries with a number of budget support donors, a joint performance assessment framework (PAF) can be agreed. A PAF refers to a summary table drawn from the country's strategy. It brings together the policy objectives, activities, expected results and indicators that form the basis for budget support partners to monitor progress over time. Using a PAF can help structure the areas for dialogue and creates transparency on mutual expectations and commitments. It should be result oriented or include an appropriate mix of process and result indicators.

The use of a PAF from the Commission's perspective is twofold. First, it helps monitor results as described in the intervention logic and the results matrix annexed to the action document. Second, it informs the eligibility assessments and the selection/evaluation of variable tranche performance indicators. However it should not undermine countries' efforts and investment towards strengthening their own M&E systems, for domestic purposes primarily.

### *Eligibility during implementation*

EU Delegations should appraise whether the policy continues to be sufficiently relevant and credible, and whether there has been satisfactory progress in policy implementation since the last eligibility check, taking into account external factors or exogenous shocks. Where overall progress is limited or substantially less than planned, EU Delegations should assess to what extent this may be explained by external factors or overambitious planning, and conclude whether eligibility continues to be satisfied.

The focus should be on progress in policy implementation. However, in case a new policy framework is put in place during contract implementation, the baseline assessment will need to be revisited<sup>30</sup>. Where existing policies are subject to substantial budgetary revisions or revisions in indicators or targets, such an update should equally be considered.

#### *4.1.2 Stable macroeconomic framework*

##### *Scope and rationale*

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

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<sup>30</sup> The existence of a gap between the formal end date of one policy document and the final adoption of a successor need not be an impediment to eligibility if the process of revision is sufficiently participatory, and the emerging policy orientations are reasonably clear.

Partner countries also need to have the necessary tools and institutions to steer macroeconomic stability and enforce policy responses. In other words, an effective framework of economic governance is important. For example, an unexpected decrease of revenues (for example, due to a commodity price shock) or a sudden increase of expenditures (for example, due to a spiralling wage bill) has severe consequences on macroeconomic stability and call for the authorities to adjust swiftly their fiscal policy.

The assessment should therefore:

- Summarise the evolution of the main macroeconomic aggregates and stress the potential sources of instability that would endanger the strength and the persistence of growth, or the return to a stable macroeconomic outlook, including debt sustainability;
- assess macroeconomic and fiscal policies (both revenues and expenditures) in place and their contribution to maintaining or achieving macroeconomic stability over the short and medium term; and
- assess the country's vulnerability to external shocks and efforts to strengthen macroeconomic resilience.

### ***Methodology***

Eligibility has to be demonstrated by applying the same methodology from the approval of the contract and for each disbursement. The eligibility assessment will be based on the relevance and credibility of the policies in place and announced, both at the formulation and during implementation of the budget support contract. The assessment of the macroeconomic policies will be based on the analysis of the economic framework, including gross domestic product growth and its composition, or other relevant variables (i.e. real sector, fiscal developments, inflation and monetary accounts, external balances) and their compatibility with debt sustainability, financial sector stability as well as the resilience of the country to external shocks.

Policy relevance refers to the extent to which key macroeconomic imbalances are being addressed by the government's macroeconomic and fiscal policies. The specific objectives of these policies need to be assessed<sup>31</sup>. These policies will also depend on the main weaknesses and risks, the institutional framework and the capacities of the country. Policy credibility refers to the realism of the strategy, political commitment, the adequacy of institutional arrangements and track record of effective implementation.

For each disbursement progress made towards restoring key balances will be assessed taking account of the fulfilment of policy commitments and changes in the macroeconomic environment. Furthermore, special attention has to be given to fiscal policy and targets, notably to domestic revenue mobilisation, and on how fiscal developments may impact the implementation of public policies.

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<sup>31</sup> For example, the objective may be acting counter cyclically at a time of a deterioration of external demand while respecting public and external debt sustainability ratios, or redressing unsustainable imbalances, or simply ensuring a rule based predictability of the fiscal and monetary policy.

A central tool for the assessment is the existence in the partner country of medium term fiscal/expenditure<sup>32</sup> frameworks (MTFF/MTEF) or equivalent tools for medium-term budget planning as instruments for strengthening the fiscal-macroeconomic policy link and the consistency of projections and scenarios concerning economic, fiscal and financial aggregates over the medium term. EU Delegations should also assess whether the country has fiscal responsibility rules, particularly on debt and deficit thresholds, to enforce aggregate fiscal discipline consistent with macroeconomic stability.

**An important element for assessing the stability of the macroeconomic framework and the policy response is to consider the relationship of the country with the IMF and the analysis provided by this institution.** The assessment will therefore benefit from a proactive and continuous dialogue with the IMF before and in the course of a budget support contract (for all three types of contracts).

**Satisfactory implementation of an IMF financial programme in support of a medium term adjustment and reform programme<sup>33</sup> or of a Policy Support Instrument, will generally provide a good assurance that the macroeconomic framework is stability oriented.** On the other hand, the absence of an IMF programme does not automatically imply that the macroeconomic eligibility criterion is not met. In some cases, no programme exists because the country does not need IMF support, which is generally a positive indicator of eligibility. In such cases, the Commission should make its own judgement drawing on the analysis and conclusions of the latest IMF Article IV report. Where implementation is unsatisfactory or there is no IMF programme in place because of difficulties agreeing one with the IMF, a country may in certain cases still be eligible if the objectives of the budget support contract are not at risk<sup>34</sup>. If there is no such programme, an assessment letter of the IMF confirming that a policy supporting or restoring the country's macroeconomic stability is in place may be considered an important element for deciding on eligibility. Those cases should be discussed at the BSSC/FAST.

For countries with an EU macro-financial assistance programme and for all candidate countries and potential candidates having an on-going Economic Reform Programme, the assessment of macroeconomic stability by ECFIN is equally important. In the enlargement context, a satisfactory assessment of macroeconomic stability by the Commission under the Economic Reform Programme would provide this assurance.

In the case of SRBCs, where budget support is provided in substantial or high risk environments, the Commission will aim at very close coordination with the IMF, in particular where risks and fragility of the macro-fiscal context are high and a lack of experience or track record in budget support can be observed.

#### *4.1.3. Public financial management*

##### *Scope and rationale*

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<sup>32</sup> The main difference between the two frameworks lies in the fact that a medium-term fiscal framework (MTFF) will consider both revenues and expenditures, while a medium-term expenditure framework (MTEFs) will focus on spending projections, usually with far more detail notably in the case of sector MTEFs.

<sup>33</sup> See <http://www.imf.org/external/np/exr/facts/howlend.htm> for further details about IMF instruments.

<sup>34</sup> For example, if due to delays in implementing structural reforms that may not be central to the achievement of the programme's macroeconomic or sectoral targets and objectives.

The Commission considers that a country fulfils the Public Financial Management (PFM) eligibility criterion for a budget support contract approval when a credible and relevant programme to improve PFM can be demonstrated to be in place. For tranche disbursements, eligibility will be fulfilled when there is satisfactory progress in the implementation of the PFM reform. Relevance and credibility of the reform programme should also be maintained. The Commission defines PFM in a comprehensive manner which includes all aspects of domestic revenue mobilisation as part of the PFM eligibility criterion and its assessment.

The following sections address i) the rationale and scope of this eligibility criterion; ii) the assessment methodology; and iii) reporting arrangements. Annex 5 provides a template of the PFM and Transparency report and detailed guidance notes. Annex 11 provides additional guidance on domestic revenue mobilisation and Annex 6 provides guidance on transparency and oversight.

The Public Financial Management system is the set of procedures and institutions by which financial resources and expenditures are planned, directed and controlled<sup>35</sup>. The PFM system covers both revenue and expenditure management and should be supporting the achievement of three main outcomes: aggregate fiscal discipline, strategic allocation of resources and efficient use of resources for services delivery. A sound PFM system is essential for the implementation of policies and the attainment of country's objectives. Active government commitment to improve PFM performance as proven by the existence of a reform programme and a satisfactory track record of progress is therefore a key criterion for eligibility to budget support.

The PFM eligibility criterion focuses on financial operations managed by the central government<sup>36</sup>. The public financial management system comprises the full budget cycle: budget preparation and budget execution of both revenues and expenditures, accounting and reporting and external audit and scrutiny. This includes key functions as revenue administration, payroll management, cash management, procurement, internal controls and internal audit, investment and debt management.

The table below defines budgetary outcomes and presents the characteristics of an open and orderly PFM system. PFM activities are clustered into seven functional areas (or pillars) as proposed by the Public Expenditure and Financial Accountability (PEFA) framework<sup>37</sup>. Aspects of revenue administration are covered throughout these areas through a series of indicators.

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<sup>35</sup> See *PFM: a Whole System Approach* by CIPFA (The Chartered Institute of Public Finance & Accountancy), August 2010 (<http://www.cipfa.org/policy-and-guidance/reports/whole-system-approach-volume-1>).

<sup>36</sup> Central Government definition is based on the classification structure of the IMF's Government Finance Statistics 2014 (<http://www.imf.org/external/pubs/ft/gfs/manual/gfs.htm>) Subnational governments and other public sector components could also be considered whenever their PFM weaknesses substantially affect the overall PFM performance.

<sup>37</sup> See PEFA Framework for assessing public financial management, revised February 2016 (<https://pefa.org>).

**Table – Budgetary outcomes and PEFA pillars**

<b>Budgetary Outcomes</b>	
Aggregate fiscal discipline	Effective controls of the budget totals and management of fiscal risks contribute to maintaining fiscal discipline
Strategic allocation of resources	Planning and executing the budget in line with government priorities contributes to implementation of government's objectives
Efficient service delivery	Managing budgeted resources to achieve the best levels of public services within available resources
<b>Pillars of performance of a PFM system</b>	
Budget reliability	The budget is realistic and is implemented as intended
Transparency of public finances	Information on PFM is comprehensive, consistent and accessible to users
Management of assets and liabilities	Public investment provides value for money, assets are recorded and managed, fiscal risks are identified and debts and guarantees are prudently planned, approved and monitored
Policy-based strategy and budgeting	The fiscal strategy and the budget are prepared with due regard to government fiscal policy, strategic plans and adequate macroeconomic and fiscal projections
Predictability and control in budget execution	The budget is implemented in an orderly and predictable manner and there are arrangements for the exercise of control and stewardship in the use of public funds
Accounting and reporting	Accurate and reliable records are maintained and information is produced and disseminated at appropriate times to meet decision-making, management and reporting needs
External scrutiny and audit	Public finances are independently reviewed and there is external follow-up on the implementation of recommendations for improvement of the executive

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

For any type of budget support contract, each eligibility assessment should cover the entire PFM system, including Domestic Resource Mobilisation (DRM), to ensure consistency across contracts in the same country. However, special attention could be devoted to progress in the following aspects:

- Sustainable Development Goal Contracts should address progress in the entire PFM system and highlight cross-cutting issues to ensure a good balance across all three budgetary outcomes as well as financial compliance.
- For Sector Reform Performance Contracts, in complement to an overall assessment of PFM performance, the monitoring should tackle the weaknesses specific to the management of the public finances in the sector in order to improve the *efficiency of service delivery* of the sector. The effective management of funds can differ across sectors. Sector-specific PFM arrangements to be analysed include revenue sources, budget allocation processes, internal control set-up, dedicated procurement systems or off-budget funds.
- State and Resilience Building Contracts should aim at establishing the core functions of the PFM system to ensure vital state activities and delivery of basic services to the population. Core functions include the preparation of an annual budget, a mechanism for regular treasury management and basic budget execution reporting. The priority is to ensure that minimal standards of financial compliance are enforced and then progressively strengthened. This will contribute to *aggregate fiscal discipline* over the medium term. Particular attention should also be paid to the control of corruption.

Budget transparency and oversight is an eligibility criterion in its own right (see section 4.1.4), although the relevance and role of oversight bodies is assessed within this PFM eligibility criterion. The analysis of fiscal policies and the budget (e.g. budget allocations, medium term fiscal perspectives) will be done respectively within the macro-economic stability and public policy eligibility assessment (see respectively sections 4.1.2 and 4.1.1).

## ***Methodology***

### ***Eligibility for contract approval***

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

The analysis of the relevance of the reform programme should be based on a diagnosis of the weaknesses and strengths of the PFM system. The Commission uses the PEFA Framework as the preferred tool to assess the operational performance of the PFM system in a country. A PEFA assessment provides a thorough, consistent and evidence-based analysis at a specific point in time using 31 performance indicators. The PEFA methodology can be reapplied in successive assessments to track changes over time.

The assessment of eligibility should also build on other available diagnostics and reports, which complement and deepen higher-level PEFA assessments, particularly when assessing



financial compliance, legal framework, budgetary standards and rules, corruption and sector PFM specificities. This covers diagnostic tools on specific PFM areas, such as TADAT for tax administration assessments<sup>38</sup>; PIMA for public investment management<sup>39</sup>, MAPS for public procurement<sup>40</sup>, DEMPA for debt management<sup>41</sup> or OECD/SIGMA baseline assessments against the principles of public administration (including PFM), in the enlargement and neighbourhood contexts<sup>42</sup>. Sector-specific sources of information are sector audits from the Supreme Audit Institution, Public Expenditure Reviews (PER) or Public Expenditure Tracking Surveys (PETS)<sup>43</sup>. In the enlargement context, key documents to consider are the available screening reports and subsequent monitoring especially under the negotiation Chapter 5 (public procurement) and Chapter 32 (Financial control, which addresses public sector internal control, internal audit and external audit).

On the basis of the available diagnoses, the partner country will define a reform programme which spells out the key weaknesses, reform milestones and performance measures in order to achieve the budgetary outcomes. The PEFA Framework is not a prescriptive tool for the formulation of a PFM reform programme. Such comprehensive assessment should be followed by the analysis of the underlying causes of underperformance (supported by specific diagnosis tools when relevant), an evaluation of the various reform options and finally a careful formulation of the reform programme, including its monitoring framework. PFM reforms should be appropriately sequenced, making sure that basic compliance systems are in place before more advanced reforms are initiated. The Commission should support this stepped approach with policy dialogue and support for capacity development.

For budget support contract approval, in some PFM environments, it may be necessary to require short term measures, selected from the partner country's own PFM reform strategy. Such environments may be characterised by the absence of key core functions within the budget cycle, notably covering budget availability, revenues and expenditure monitoring, a treasury system, or a mechanism for reporting on budget execution. In the absence of one or more of these core functions, budget support will not be considered.

Where such core functions exist but are weak, typically in fragile situations, additional safeguards would generally be required in the form of specific conditions that would need to be fulfilled prior to the disbursement of the first tranche. In addition, the targeting of disbursements to specific expenditure lines such as civil service salaries or arrears clearance may also be appropriate in this context. The need for complementary support required in the form of technical assistance should also be considered in order to address these weaknesses.

### *Eligibility during implementation*

Budget support contracts should rely, to the extent possible, on the country's PFM monitoring framework used to assess progress in reform implementation domestically. This framework is to be summarized in a PFM monitoring table which will structure reporting on PFM in the context of budget support. This table comprises a baseline of key PFM weaknesses and realistic annual reform and performance objectives against which progress can be measured

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<sup>38</sup> For TADAT, refer to <http://www.tadat.org>.

<sup>39</sup> For PIMA, refer to <http://www.imf.org/external/np/fad/publicinvestment>.

<sup>40</sup> For MAPS, refer to <http://www.oecd.org/governance/ethics/commonbenchmarkingandassessmentmethodologyforpublicprocurementsystemsversion4.htm>.

<sup>41</sup> For DEMPA, refer to <http://www.worldbank.org/en/topic/debt/brief/dempa-2015>.

<sup>42</sup> For SIGMA, refer to <http://www.sigmaweb.org/publications/public-governance-monitoring-reports.htm>.

<sup>43</sup> For PETS, see <http://www.worldbank.org/en/topic/governance/brief/public-expenditure-tracking-system-pets>.

annually. The framework also contains medium-term targets of the reforms in the areas covered by the baseline consistent with the three PFM budgetary outcomes, as well as financial compliance, against which the direction of change will be measured. This table structures the monitoring of the eligibility criterion as well as the policy dialogue.

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

It is possible that different conclusions with regard to PFM eligibility (in line with chosen milestones) may be reached for different budget support contracts under implementation in the same country, even though each assessment should cover all PFM core dimensions and budgetary outcomes. This may arise if a SRPC runs parallel with another SRPC, for example, and there are significant differences in the quality of management of public funds in the two sectors (e.g. evidenced by sector public expenditure reviews, public expenditure tracking surveys or audit reports), resulting in different conclusions regarding eligibility. However, if a SRPC runs parallel with a SDG-C or SRBC, PFM eligibility cannot be considered met for the SRPC, if it is not considered met for the SDG-C or SRBC.

### ***Reporting arrangements***

Delegations should report their conclusions on PFM eligibility in the action document and disbursement notes as instructed in the respective templates. These documents should provide the *essential* and *most up to date* evidence and present a reasoned conclusion on eligibility.

These summarised updates for each budget support contract should build on the complete analysis of eligibility conveyed in the EU Delegation's **PFM Report**. The PFM report combines reporting on the PFM as well as transparency and oversight eligibility criteria. PFM eligibility concerns both expenditure and revenue management. At the core of the PFM report is the **monitoring table**, which sets out the baselines, targets and the results achieved. PFM weaknesses affecting budget support priority sectors should be highlighted. The Report also helps to identify PFM priorities for policy dialogue (see annex 13).

Delegations should *submit* their latest PFM Report as:

- a supplementary document to the action document for the formulation of each new contract, as well as
- an annex to each disbursement note by the Head of Delegation.

However, the frequency of the *update* of the PFM Report is not determined by the individual budget support contract cycles. It depends on the PFM risks reported in the latest country's Risk Management Framework, as follows:

- Every year, if PFM risks are substantial or high.
- Every three years, if PFM risks are low or moderate.

#### *4.1.4. Transparency and oversight of the budget*

##### ***Scope and rationale***

Budget transparency is defined as the full disclosure of all relevant fiscal information in a timely and systematic manner. It is a key element of good governance as the public availability of comprehensive, accessible, useful, and timely budgetary information is a prerequisite for domestic accountability.

With more and better budgetary information, national independent oversight bodies – like parliament, Ombudspersons, supreme audit institutions as well as other stakeholders such as local authorities, civil society organisations and media – can scrutinise the budget and hold decision makers accountable for collecting and spending public funds efficiently and effectively. They can call for policy changes that improve service delivery and achieve results.

Budget transparency is a necessary, but not sufficient condition for the oversight and scrutiny of the budget. The systematic inclusion of actions and support measures to support national legislative and oversight bodies as well as internal control structures is instrumental to address capacity weaknesses.

In addition, domestic accountability mechanisms may also be strengthened by opening up policy or budget reviews, and taking a participatory approach to relevant civil society organisations. Good practices also include inviting the oversight bodies to take part in the annual reviews or to use the audit reports for the policy dialogue (see sections 4.6 and 4.7).

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

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

The relevance and actions of the oversight bodies themselves will be covered by the public finance management assessment in order to avoid duplication (see section 4.1.3).

##### ***Methodology***

###### ***Eligibility for contract approval***

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

### *Eligibility during implementation*

Besides this entry point to be met before each disbursement, the Commission will assess and monitor comprehensively the progress in terms of budgetary transparency. The country needs to show satisfactory progress with regard to the baseline and medium term objectives identified.

Expectations in this respect need to be set and assessed according to country circumstances and be drawn from the country plans and strategies. For example, improving budget transparency and oversight may be included in the PFM reform programme of the Ministry of Finance. Finally, civil society and private sector are sometimes involved in this area, e.g. by producing easily understandable assessments of the national budget information.

In cases where the baseline is already close to international benchmarks, the eligibility criterion is met, if there is at least no significant deterioration during implementation<sup>44</sup>. As structural reforms of budget transparency and oversight of the budget take time and cover several aspects, medium-term objectives should be based on realistic expectations, in particular regarding the production or comprehensiveness of key budgetary documents. Particular attention should be given to accessibility (in terms of format and content) of the information for citizens, as well as an enabling environment for dialogue around budgetary processes. However, the timely publication of such documents, that are already produced, should be a quick win and attainable in the short term.

However, the Executive's Budget Proposal and the Year-End Report or the Audit Report are crucial for domestic accountability, as the Executive's Budget Proposal is the key document for the domestic budget debate and the Year End Report or Audit Report allows citizens to know about fiscal figures and achieved results. These dimensions of budget transparency and oversight should therefore be given priority.

In case of shorter budget support contracts (less than three years), of a State and Resilience Building Contract, or of a budget support contract in SIDS/OCTs, more flexibility may be justified as regards the progress to be expected for these key budgetary documents.

### *Evaluation of transparency and oversight of the budget*

The evaluation assesses the respect of the entry point and progress made in relation to key weaknesses. Essential information is summarised in the action document or disbursement note. A more in-depth analysis is included in the public finance management report (chapter on transparency and oversight). The disclosure of budgetary information is assessed with a particular focus on six key budget documents and other sources described below.

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<sup>44</sup> For example, the non-publication of a key budget document that was previously made public, or the reduction in comprehensiveness of a previously comprehensive document.

## Key Sources of Budget and Expenditure Management Information

Key Budget Document	Description	Release benchmarks	Comprehensiveness
Executive's budget proposal	The executive's budget proposal is the government's draft budget that should be submitted to the legislature.	Should be made available to the public when it is first presented to the legislature or, at a minimum, before the legislature approves it. The legislature and the public should have enough time to examine it.	Should be presented within a medium-term macroeconomic and fiscal policy framework, include all budgetary activities of the government and detailed commentary on each revenue and expenditure programme.
Enacted Budget	The enacted budget refers to the budget that has been passed by the legislature.	Should be released to the public no later than three months after the legislature approves it.	See executive's budget proposal.
In-year reports	In-year reports (also Monthly Reports or Quarterly Reports) show progress in implementing the budget. These reports can be issued for the entire government or issued by different agencies.	Should be released to the public no later than three months after the reporting period.	Should show the executive's progress in implementing the budget.
Mid-year report	The mid-year report provides a more comprehensive update on the implementation of the budget.	Should be released no later than three months after the reporting period.	Should include an update on the implementation of the budget, a review of economic assumptions, and an updated forecast of the budget outcome for the current fiscal year.
Year-end report	The year-end report is one of the key accountability documents. It shows compliance with the level of revenue and expenditures authorised by the legislature.	Should be released no later than one year after the end of the fiscal year (the reporting period).	Should include the reconciliation with the approved budget and compliance with the revenue and expenditures authorised by the Parliament.
Audit report	This report covers the year-end report audited by an independent Supreme Audit Institution.	Should be released no later than two years after the end of the fiscal year (the reporting period).	Should cover all activities undertaken by the Executive in accordance with appropriate auditing standards and be produced in full independence by the supreme audit institution. Should focus on significant and systematic PFM issues and on performance such as reliability of financial statements, regularity of transactions, functioning of internal control and procurement systems <sup>45</sup> .

<sup>45</sup> The assessment should also cover the timely and effective follow-up by the legislature and the executive on the main recommendations of the audit report.

Other documents such as citizens budget or medium term budgetary framework	A citizens' budget is defined as an easy-to-understand summary of the main features of the Executive's budget proposal. It should be a self-contained document that explains what is in the annual budget proposals and what their effects are expected to be. It can also reflect the enacted budget or the annual budget report.	At the same time as its corresponding budgetary document.	It should briefly set out the key role the budget plays in public financial management, in the constitution or in the budget law. The guide should very briefly describe the budget process, including the roles of the executive branch in preparing the budget and of the legislature in authorising government taxation, borrowing and expenditure.
	A macro-budgetary medium term framework presents the strategic and budgetary orientations and medium term economic perspectives	Available before the 30th of June (or mid-year for any other fiscal year).	The macroeconomic and fiscal outlook is a starting point. Economic forecasts for at least the budget year should be presented. Medium-term projections of fiscal aggregates (revenues, spending, deficit) should also be presented if available.

International assessments such as the PEFA-PFM Performance Measurement Framework, the OECD/SIGMA baseline assessments, the IMF Fiscal Transparency Code<sup>46</sup> and the International Budget Partnership, which publishes the Open Budget Survey<sup>47</sup>, should be used as guideposts for the independent assessments by EU Delegations, in particular for the identification of key weaknesses and the definition of baselines. Further resources on best practices and principles are the OECD Best Practices for Budget Transparency<sup>48</sup>, and the Lima Declaration of Guidelines on Auditing Precepts of the International Organisation of Supreme Audit Institutions (INTOSAI)<sup>49</sup>. Delegations can also refer to self-assessment tools developed by the country or regional organisations (e.g. for monitoring the transposition of regional directives).

## 4.2. Policy dialogue in the context of budget support

Policy dialogue between beneficiaries and cooperation partners is an essential activity under budget support. It constitutes one of the main inputs of budget support contracts, alongside the transfer of funds and capacity strengthening. Policy dialogue is part of the budget support intervention logic, and is expected to contribute to the objectives of budget support contracts. Policy dialogue is typically also one of the measures used to mitigate risks.

Policy dialogue provides a framework to take stock of the implementation of the partner country's policies and reforms, as well as of donors' commitments, and it can be used as a forward-looking tool to identify policy slippages and to reach a common understanding with the authorities on corrective measures to meet policy objectives and on refining the objectives and targets if necessary.

Policy dialogue should be coherent with the political dialogue in the country. Political dialogue – in line with the Lisbon Treaty, the Cotonou Agreement, the Stabilisation and

<sup>46</sup> Refer to <http://blog-pfm.imf.org/files/ft-code.pdf>.

<sup>47</sup> Refer to <http://www.internationalbudget.org/opening-budgets/open-budget-initiative/open-budget-survey>.

<sup>48</sup> Refer to <https://www.oecd.org/gov/budgeting/Best%20Practices%20Budget%20Transparency%20-%20complete%20with%20cover%20page.pdf>.

<sup>49</sup> Refer to <http://www.intosai.org/issai-executive-summaries/view/article/issai-1-the-lima-declaration.html>.



Association Agreements, Association Agreements and other legal bases – covers all EU external policies be they development, neighbourhood (in particular ENP sector dialogues), or enlargement policies. Political dialogues take place with a fixed sequence (pre-negotiated agendas) and on a regular basis and are usually held at ministerial level in Summits (prepared at Senior Official and expert level meetings). In the post-Lisbon context, the High Representative is in charge of conducting political dialogue with third parties on the Union's behalf (article 27.2 of the Treaty on the European Union) and is assisted by the European External Action Service in fulfilling his/her mandate (article 27.3)<sup>50</sup>. In ACP countries, the Article 8 political dialogue usually takes place between the EU Head of Mission accredited in the country and ministerial/presidential level for the ACP country.

Political dialogue in the enlargement context takes place at the Association Councils held once a year and usually chaired by the High Representative. They are prepared by the Association Committee meetings at senior official and expert levels.

Policy dialogue covers the sectors of EU cooperation and supports the partner country's reform efforts to achieve the objectives laid down in its strategies. In practice, it may be difficult to make a clear distinction between the two. Some political dialogue platforms can include extensive policy dialogue. On the other hand, policy dialogue often carries a political dimension. Policy coherence implies a coordination of EU developmental and political objectives, which should be mutually reinforcing. Close coordination within cooperation sections, particularly thematic and economic/governance sections, should also be ensured.

As explained in annex 13, an effective dialogue requires a pro-active, strategic, structured and documented approach, and a number of enabling factors. A sound knowledge base is essential to make the dialogue more efficient and to bring added value for partner countries. The dialogue should not be limited to the monitoring of disbursement conditions, but include a focus on supporting partner countries with policy solutions. Dialogue objectives should be focussed on a small number of key issues, and the dialogue should be appropriately resourced. Partner countries may need support with the coordination of the dialogue and the EU can play a key role in facilitating stakeholder participation.

An effective policy dialogue is inclusive, involves the right mandated actors, builds on trust and respects the principles of ownership, and is aligned with existing policy and budgetary cycles. To be effective, it requires a clear understanding of the national and sector coordination framework, as part of a broader context analysis, to better understand stakeholders, rules and mechanisms of the decision making-process in the partner country. Alignment and harmonisation between cooperation partners, particularly EU Member States, reduces transaction costs for partner countries and strengthens the policy messages. It is therefore important to understand the country-donor coordination framework and improve it, when necessary.

Policy dialogue is a continuous process, taking place both in formal and informal contexts. Formal dialogue benefits from a clear agreement with partner countries on a dialogue framework. The starting point, whenever possible, should be the sector/national coordination, monitoring and reporting mechanisms, which the budget support aims to strengthen in order to ensure more sustainable results beyond the duration of budget support. Based on the objectives and framework, the dialogue should be adequately resourced. The setting up of a

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<sup>50</sup> Guidelines for handling Political Dialogue meetings with third Countries are available in the EEAS intranet <http://intragate.ec.europa.eu/eeas/eeaszone/general/political-dialogues>.



dialogue facility can provide complementary support for example for technical assistance, workshops, coordination tasks or joint missions.

Finally, in order to learn from the dialogue, and for accountability and evaluation purposes, it is advisable that policy dialogue is recorded and reported upon.

## 4.3 Risk management framework

### 4.3.1 Introduction

The development of a sound risk management framework adapted to the specific risk profile of budget support contracts is a central element of the EU policy on budget support set out by the 2011 Communication and the related 2012 Council conclusions.

The framework aims at identifying in a structured way, mostly on the basis of existing assessments (e.g. Human Rights and Democracy Country Strategies, eligibility criteria), the most significant risks related to budget support contracts, and at making sure that they are managed in line with the Commission's guidelines on risk management<sup>51</sup>.

It is an important tool during the identification, formulation, implementation, and evaluation of budget support contracts, whilst it can be a useful tool also to inform and help prioritise policy and political dialogue and the design of complementary support. Furthermore, it allows for a simplification of reporting requirements on budget support contracts in countries where the risk level is low or moderate (see annexes 5 and 6). Annex 7 provides more details on the management of risks in budget support contracts.

By identifying risks, the tool helps to come to more informed decisions on the use of budget support comparing risks with potential benefits<sup>52</sup> or the cost of non-intervention. The risk management framework informs the decision making process by:

1. identifying the specific risks linked to the overall objectives of budget support;
2. identifying mitigating measures and risk responses as part of a risk strategy;
3. informing budget support policy dialogue and the design of complementary support; and
4. monitoring the identified risks and the mitigating measures during implementation.

The risk management framework is an internal tool which comprises the following steps:



<sup>51</sup> Risk Management in the Commission, Implementation Guide, Version updated in November 2015 (2016 edition), available on the intranet.

<sup>52</sup> The benefits of a budget support contract are assessed separately and are not part of the risk assessment framework.

### 4.3.2 Risk assessment

The Commission defines a risk as any event or issue that could occur and adversely impact the achievement of the Commission's political, strategic, and operational objectives. Lost opportunities are also considered as risks.

The risk management framework for budget support contracts is focusing on the country risks in relation to the overall objectives of budget support. Specifically, the EU identifies five risk **categories**: political, developmental, macroeconomic, public financial management and corruption/fraud risks. Each risk category comprises one or several **risk dimensions**

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

Risks are assessed in relation to the objectives of budget support in a country. There is only one risk management framework per country, but sector-specific developmental risks can be differentiated. The risks and risk levels are identified, defined and rated through a questionnaire. It is based on existing assessments, in particular the eligibility criteria, fundamental values assessments, and the human rights and democracy country strategies. Each question of the risk questionnaire has to be judged in terms of four risk ratings (low, moderate, substantial, high), capturing both the likelihood and impact of a risk. The decision on the risk level for each question has to be justified through a short narrative comment.

The risk ratings for each question are averaged automatically to generate risk levels for each risk dimension (e.g. human rights or rule of law), for each risk category (e.g. political governance or macroeconomic risks) and for the overall country risk. In exceptional circumstances, the Delegation can adjust the risk rating for a risk dimension (e.g. to give certain questions more weight or to reflect risks not covered among the questions). In such cases, the Delegation must present a short justification in the narrative. Lastly, the risk profile provides a summary of the risk management framework. The major risks section should include any potential reputational risks for the EU.

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

#### *4.3.3 Risk responses and mitigation*

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

1. Identification of mitigating measures,
2. Decision on the final response: risk acceptance or risk avoidance.

Mitigating risks means joint efforts of the country and cooperation partners to respond to the identified risks. Mitigating measures may include short-term actions but also more medium-term structural measures such as strengthening accountability institutions and actors. Mitigation should be the most common risk response and is a key element of budget support contracts.

If the risk level of a risk dimension is substantial or high, mitigating measures need to be identified with the government and other cooperation partners in order to address the respective risk dimensions. Progress in the implementation of the mitigating measures must subsequently be monitored in the risk management framework.

If the political risk is substantial or high in case of a SDG-Contract, mitigating measures will cover clear and comprehensive action plans and a reinforced dialogue with the partner country in accordance with the principle of gradualism and proportionality (see section 3.5.).

#### **List of potential mitigating measures**

- **Further analyses and surveys** may be necessary to shed light on the systemic weaknesses leading to specific risks. For example, Public Expenditure and Financial Accountability assessments, Public Expenditure Tracking Surveys and Public Expenditure Reviews may identify reform needs and capacity constraints. Political economy or drivers of change analysis can help identifying dynamic factors behind reform needs.

- **Capacity development and technical cooperation** could be used to mitigate risks in cases where there is a strong commitment for reform, but a lack of capacity to improve country systems/frameworks.
- **Enhancing transparency, accountability and participation in the budget process** is important to strengthen nationally owned safeguard and oversight mechanisms. Transparency and openness are prerequisites for accountability and participation. Internal and external accountability mechanisms provide opportunities for enhanced scrutiny and monitoring. The involvement of citizens and civil society is also essential in budget processes from decisions about resources to monitoring of service delivery.
- **Policy dialogue** should take into account identified risks and can give more prominence to key risk areas and the need for related reforms.
- **Performance indicators of the variable tranches** could be used to set incentives for reform and to support policy dialogue. This approach may allow addressing key risks without jeopardizing predictability.
- **Requirements** to implement specific controls, legislation changes and reform steps may be appropriate to address specific weaknesses and deal with substantial or high risks.
- **Further adaptations** that may be considered in the design of a budget support contract include shortening the duration of a contract in environments with substantial/high risks, adjusting the disbursement profiles or opting for targeted aid to reduce reputational risk.
- **Adopting proactive communication strategies** with a view of raising awareness amongst stakeholders, addressing concerns and increasing public acceptance of the reforms.

In addition to risk levels, it is important to monitor risk trends. They may be an indication of evolving underlying dynamics which may not translate immediately in changes of risk categories but, if sustained, can substantially alter the overall risk level.

#### *4.3.4 Risk monitoring and reporting*

Risks and their mitigating measures are monitored with a view of ensuring that identified risks are adequately managed, that the identified mitigating measures are implemented and that new risks or changes in circumstances are taken into account.

The risk management framework should be updated once a year, except when new circumstances lead to deterioration in at least one of the risk categories to substantial or high. In such cases, an updated risk management framework should be submitted as soon as possible.

The risk management framework is an internal management tool which is not published. However, collaboration with interested EU Member States to update the framework is encouraged, where appropriate.

## 4.4 Variable tranche design and performance indicators

### 4.4.1. Introduction

The budget support intervention logic and disbursement criteria provide a basis for policy dialogue. Fixed tranches are linked to the general conditions and variable tranches are linked to progress against agreed performance indicators, in addition to the general conditions<sup>53</sup>.

The partner country should have a well-functioning system in place for monitoring progress and reporting on performance. Progress is assessed against results data that should be reliable as it triggers disbursements. Where weaknesses are identified, actions should be agreed with the government and other cooperation partners to strengthen statistical, monitoring, and reporting systems. EU Delegations should pay particular attention to the following elements:

- the institutional setup and the functioning of statistical systems in the country and more particularly in the sector(s) covered by the contract;
- the monitoring and evaluation systems and/or the performance assessment framework linked to the policy; and
- the timeliness, regularity, quality and reliability of official statistics, public data and reporting documents as well as the extent of publication and dissemination<sup>54</sup>.

This section sets out how budget support contracts may be designed using variable tranches and performance indicators. Such tranches have several advantages: i) creating incentives for improved performance through payment proportional to performance; ii) reducing damaging 'stop-go' volatility in disbursements; and iii) enhancing the credibility of disbursement conditions by providing an alternative to the extreme option of blocking the entire payment. The remainder of this section focuses on the size and phasing of variable tranches, the selection of indicators, and methods for determining variable tranche payments.

### 4.4.2. Size and phasing of variable tranches

While many factors are likely to influence performance, larger variable tranches are expected to have a stronger incentive effect. This is particularly true in weak policy environments and where there is some stability in the indicators used over time. There are equally indications that the incentive effect is dependent on the alignment of objectives between cooperation partners and countries, and that countries are sensitive to the signalling effect of any reduction in payments, regardless of size.

No clear rules regarding the appropriate share of fixed and variable tranches can be defined. A balance needs to be struck between creating incentives and avoiding excessive unpredictability or volatility in disbursements, particularly in more aid dependent contexts. As a starting point, a fixed component of 60% and a variable component of 40% could be considered, but this ratio will eventually depend on the country context and the possibility of 100% fixed or 100% variable contracts remains open. The variable share might be expected to be larger in the following circumstances: the smaller the budget support contract's share of the partner country's budget; the weaker its track record of budget support implementation; the weaker the country's commitment to reform; and/or the higher the risk. EU Delegations should follow a pragmatic approach taking into account the above elements. EU Delegations

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<sup>53</sup> The use of specific conditions, in addition to general conditions and variable tranche indicators, is usually not recommended.

<sup>54</sup> Refer to annex 8 for more guidance as regards performance indicators.

should also co-ordinate decisions on the size and phasing of variable tranches with other cooperation partners in the country.

#### *4.4.3. Variable tranche indicator selection*

EU Delegations should select, in agreement with the authorities and in co-ordination with other cooperation partners, a limited number of performance indicators for variable tranche disbursement, from the country's monitoring and evaluation systems or from the performance assessment framework. Where no such a framework exists, particularly in fragile or transition situations, EU Delegations should agree with the authorities on a number of performance indicators derived from the policy's priorities or the transition compact, in consultation with other stakeholders and according to the following principles:

- There should be coherence between the contract objectives, the diagnosis of the problem, and the selected indicators and targets;
- Preference should be given to induced output or outcome indicators but different types of indicators could also be combined. The greater the willingness of the partner country to be held accountable for outcomes, and the greater the confidence in the government's ability to produce reliable data, the more emphasis should be placed on outcome indicators. Depending on country contexts, it may be more appropriate in some cases to focus on agreed reforms or policy actions using process indicators;
- The number of indicators of a variable tranche should generally range from 3 to 10. The more focused the objectives of the contract and the smaller the size of the variable tranche, the fewer the recommended number of indicators.

Indicators, baselines, targets and assessment methodology should be agreed during the formulation phase and defined – precisely and unambiguously – in the financing agreement. The data source should be clearly identified and the quality of the data assessed. Changes to the indicators and their targets should be avoided where possible but may be necessary to take account of progress or changes during contract implementation. A minimum time-lapse is however required between the moment the target is set and the moment the result is assessed, in order to avoid undermining the incentive for performance. Financing agreements should therefore include an explicit clause stating that any subsequent revision of indicators or targets can take place upon the request of the Government and subsequent agreement by the responsible Commission Authorising Officer. Note that any change to the targets should be agreed ex-ante or at the latest by the end of the first quarter of the assessed year.

#### **Indicator types**

**Input and process** indicators measure the financial resources provided and the policy and regulatory actions taken (e.g. adoption of a regulation); **output** indicators measure the immediate and concrete consequences of the resources used and measures taken (e.g. schools built); **outcome** indicators measure the results at the level of beneficiaries (e.g. proportion of children vaccinated); and **impact** indicators measures the consequences of the outcomes in terms of wider objective (e.g. poverty level or growth rate). The Commission gives particular attention to outcomes, because (i) it is the change that ultimately matters; (ii) it encourages evidence-based policy making; (iii) it protects political space for partner countries to choose their own policies and strategies for achieving them; (iv) it promotes domestic accountability; and (v) it stimulates demand for high quality statistical information.



#### *4.4.4 Determining variable tranche payments*

This involves attributing a score for each selected indicator, and then aggregating these scores according to a clear methodology to determine the variable tranche disbursement. The two main options involve an indicator-by-indicator disbursement or the use of aggregate performance categories<sup>55</sup>.

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

Conditions, criteria, procedures and timing for disbursement should be clearly defined with and understood by the partner country in order to enhance predictability and respect the country's budgetary, planning and reporting cycles. Mutual understanding is a core element of the budget support contract between the EU and the partner country. To the extent possible, assessments and decisions regarding disbursements should take place in a timely manner to support the budget execution for the fiscal year into which the funds are to be disbursed. Floating tranches, i.e. without a decision date defined in the financing agreement, should be avoided.

EU Delegations should agree with the authorities and in consultation with other cooperation partners on an appropriate and transparent methodology. Undisbursed funds should not be 'recycled' in later tranches as this can reduce the initial incentive effect of variable tranches. They should be de-committed and where possible returned to the country's national/multi-annual indicative programme according to the applicable rules, or, if relevant and feasible, allocated to the complementary support component of the contract.

Nonetheless, the financing agreement may allow for the possibility to waive or neutralise a variable tranche indicator in exceptional and/or duly justified cases, e.g. where unexpected events, external shocks or changing circumstances have made an indicator or its target irrelevant. In these cases, the related amount could either be reallocated to the other indicators of the variable tranche the same year or be transferred to the next variable tranche the following year. The financing agreement may also provide for the possibility to re-assess an indicator the following year against the original target, if there was a positive trend and the authorities did not reach the target because of factors beyond their control.

Such potential provisions in the financing agreement should not substitute for constant monitoring of the conditions and indicators applicable to disbursements at any time of contract implementation. Problems of this kind must be anticipated to the extent possible and, when needed, be taken into account through an amendment to the financing agreement, early enough not to undermine the incentive effect of variable tranches.

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<sup>55</sup> See annex 8 for guidance as regards variable tranche disbursement.

## 4.5 Domestic revenue mobilisation

Domestic revenue mobilisation (DRM) is by far the **most important source of the fiscal space** required to achieve sustainable development. On average, developing countries raise less than 20% of GDP in taxes, as compared with 30-45% in OECD countries. Around half of all low- and lower-middle-income countries (LICs and LMICs) still have tax-to-GDP ratios of below 15%. There is **considerable room for improvement** in many partner countries to fill this tax gap. **Illicit financial flows (IFF)** are also a matter of great concern.

Domestic revenue mobilisation is at the heart of the Addis Ababa Action Agenda on Financing for Development as well as the 2030 Agenda for Sustainable Development. Consequently, DRM plays an important role in the new European Consensus on Development. With a view to supporting partner countries to establish efficient, effective, fair and transparent tax systems, to implementing international tax standards, and, by doing so, to increasing domestic revenue mobilisation, the European Commission and several EU Member States have signed the **Addis Tax Initiative**, which includes a commitment to collectively double support to DRM by 2020. The EU approach to domestic revenue mobilisation is outlined in the **‘Collect More – Spend Better’** staff working document, which addresses both the revenue and expenditure side of domestic public finance and which is fully aligned with the principles of the Communication on 'Tax and Development' from April 2010.

The approach is twofold: first, the EU is introducing important improvements in **EU regulation**. A number of reform proposals have been put forward under the Anti-Tax Avoidance Package, including an analysis of the impact of these proposals on third countries. Second, the EU has been establishing **'Global Partnerships'** with key international development institutions, **notably UN, IMF, WB and OECD<sup>56</sup>**, in order to support partner countries in their efforts to increase domestic revenue mobilisation. Countries rich in natural resources deserve special attention since revenues from natural resources are generally highly volatile. In addition, the current budget support guidelines aim at strengthening EU support to DRM through budget support contracts.

Budget support is a key modality in addressing and supporting DRM reform processes. As stated in the 2017 report by the European Court of Auditors on the relation between Budget Support and Domestic Revenue Mobilisation in Sub-Saharan Africa<sup>57</sup>, further emphasis should be put on strengthening the ties between budget support and DRM when it comes to analysis and reporting, policy dialogue, capacity strengthening, and conditions and indicators. DRM should receive full attention under the PFM eligibility criterion. In addition, some aspects are also covered in the macroeconomic eligibility criterion. A more detailed description and guidance on how to strengthen these ties in practice is provided in the DRM annex. Improvement in DRM requires progress in three areas: the international dimension, national tax policy and administration.

### 4.5.1. International dimension

The two main international drivers of the tax gap are **illicit financial flows** and **harmful tax competition** between countries.

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<sup>56</sup> UN, IMF, WB and OECD work on DRM is coordinate through the Platform for collaboration on tax (PCT - <http://www.oecd.org/tax/platform-for-collaboration-on-tax.htm>)

<sup>57</sup> Special report no 35/2016: The use of budget support to improve domestic revenue mobilisation in sub-Saharan Africa - <http://www.eca.europa.eu/en/Pages/DocItem.aspx?did=40763>



**Illicit financial flows (IFF)** – Despite the fact that there is no official definition of this concept, the 'Mbeki Report on illicit financial flows from Africa'<sup>58</sup> defines IFF as “money that is illegally earned, transferred or utilized”. It notes that these funds typically originate from three sources: i) commercial tax evasion, trade mis-invoicing and abusive transfer pricing; ii) criminal activities, including the drug trade, human trafficking, illegal arms dealing, and smuggling of contraband; and iii) bribery and theft by corrupt government officials.

The role of national revenue systems in tackling illicit financial flows is made more difficult by the increasing international mobility of taxpayers, the globalisation of economic activities, high volumes of trade and capital flows, new technologies, uncooperative tax jurisdictions and aggressive tax planning, including multinational enterprises' abusive transfer pricing and trade mis-invoicing practices. Illicit financial flows transcend national borders and affect a multitude of countries.

At EU level, a listing process of non-cooperative (third country) tax jurisdictions is underway. A first list is envisaged by the end of 2017. This listing is based on a three step process of a scoreboard exercise, a screening process including a dialogue and the final listing. This process is conducted as an intergovernmental activity of EU Member States in the Council in relation to tax policy. At the Commission, DG TAXUD is in the lead.

When it comes to Anti-Money Laundering, it is necessary to follow closely the work by the Financial Action Task Force (FATF) and whether the country concerned is willing and able to implement the FATF recommendations and reforms. At EU level, listing under the FATF is in essence the trigger to be listed as well under the EU Anti-Money Laundering Directive. DG JUST, as the responsible line DG, is periodically producing updated briefings and lines to take for Delegations concerned, in collaboration with EEAS, DEVCO and NEAR.

The listing process is highly sensitive as it may have important implications on the EU external assistance, including budget support. Close monitoring is required and any concerns should be highlighted in the relevant analytical and reporting tools such as the Risk Management Framework, PFM reporting and the assessment of the PFM and Macro eligibility criteria. Mitigating measures should be envisaged, including policy and political dialogue, technical assistance and strengthening institutions.

**Tax competition** – While taxation takes place at national level and improving DRM is primarily the responsibility of each country according to its own context and choices, external changes also have a significant impact on the effectiveness and fairness of DRM. Tax competition creates spillover effects that arise from the interactions of national tax policies. The potential economic impact of international spillover effects goes well beyond tax revenues, with wider implications for the distribution of welfare across nations. Developing countries are particularly negatively affected due to the fact the revenues they collected rely generally on a small number of large companies.

Among the means to fight international tax evasion, specific attention should also be given to the implementation of international standards for transparency and the exchange of information under the umbrella of the Global Forum on Transparency and Exchange of Information for Tax Purposes<sup>59</sup>. The implementation of this standard contributes to providing tax administrations with a much more comprehensive picture of the full spectrum of their

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<sup>58</sup> See *Report of the High Level Panel on Illicit Financial Flows from Africa* ([http://www.uneca.org/sites/default/files/PublicationFiles/iff\\_main\\_report\\_26feb\\_en.pdf](http://www.uneca.org/sites/default/files/PublicationFiles/iff_main_report_26feb_en.pdf)).

<sup>59</sup> See <http://www.oecd.org/tax/transparency>.

taxpayers' international activities. This enables them to enforce their own tax laws and address public concerns about the fairness and equity of the international tax system.

#### *4.5.2. National tax policy*

Part of the domestic revenue mobilisation challenge is linked to the gap between the tax due under an optimal tax policy and that due under current tax policy. The focus is on tax policies to broaden the tax base where appropriate, close loopholes and fight tax avoidance. Closing this part of the tax gap requires an in-depth analysis of tax policies. The IMF is developing a Tax Policy Assessment Framework (IMF TPAF).

These issues are all the more important when they concern the natural resource sector. Revenues from extractive industries (oil, gas, mining and forestry) have important macroeconomic and fiscal implications, since they generally account for over half of government revenue in petroleum-rich countries and for over 20% in mining countries. Most countries have adopted special fiscal regimes for the natural resource sector, which is dominated by a few multinational enterprises.

#### *4.5.3. National tax administration*

The three main challenges to tax administration reform are political, administrative, and economy related. Political constraints arise from special interest groups lobbying for tax incentives or a favourable treatment. Transparency and strong political backing are necessary for the design and implementation of fair tax rules. Administrative challenges arise from tax administrations in partner countries facing capacity constraints, staff retention issues, and a weak tax-collection infrastructure. Economic constraints are typically linked to a narrow tax base, to a high proportion of the population living in poverty, to a large portion of the economic activity in the informal and agricultural sectors, to a heavy dependence on natural resources and to tax rules aimed to attract investors with little justification. These result in substantial amounts of domestic revenue given away by governments in the form of tax incentives (also called tax expenditures). Such incentives, when poorly designed, are ineffective, inefficient and linked to abuse and corruption.

Closing this administration part of the tax gap requires an in-depth analysis. The Tax administration diagnostic assessment tool (TADAT<sup>60</sup>) is the dedicated tool for such an analysis. Reforms can be planned as part of Medium-Term Revenue Strategy (MTRS<sup>61</sup>).

### **4.6. Accountability**

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

Mutual accountability refers to the relationship between cooperation partners and countries. For cooperation partners, mutual accountability is important so to report to their constituencies that public funds for cooperation and development are used effectively and

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<sup>60</sup> See <http://www.tadat.org>.

<sup>61</sup> On MTRS see also the Platform for collaboration on tax concept note: <http://www.taxfordevelopmentevent.org/files/2017/04/MTRS-Draft-concept-note-Feb-6-2017.pdf>.

efficiently. For partner countries, it is important to receive credible commitments from cooperation partners and timely, predictable, transparent and comprehensive information on assistance flows, to allow them to prepare and implement budgets that deliver agreed policy objectives and outcomes.

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

- Strengthening the openness, transparency, and accountability of the budget process, for example by the eligibility criterion on budget transparency (section 4.1.4) or by integrating gender-responsive budgeting tools;
- Supporting a participatory and inclusive approach to budget support by reinforcing and promoting the participation of domestic stakeholders in the policy dialogue and the monitoring of reforms, especially during the annual performance reviews;
- Supporting national oversight bodies, sub-national authorities and civil society organizations as capacity constraints often impede the effective operation of parliaments<sup>62</sup>, Supreme Audit Institutions<sup>63</sup>, and civil society organisations<sup>64</sup>, even in more open and transparent environments. The mandate of oversight bodies should include commitments to gender equality, and the composition of the democratic and civil oversight bodies should be representative of the population.
- Increasing transparency by publishing relevant information and communicating on public policy implementation and performance reviews (in the context of budget support contracts and beyond) as part of a commitment to increased mutual accountability. Assisting the government in its own communication and sensitisation campaigns may also be relevant<sup>65</sup>.

#### 4.7. Civil society participation

Budget support contracts can directly or indirectly strengthen civil society participation in policy and budgetary processes by informing and facilitating the dialogue with civil society, by increasing transparency and accountability, or by strengthening participation through complementary support activities.

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<sup>62</sup> Guidance on the link between parliaments and budget support is available in "Engaging and Supporting Parliaments Worldwide", Reference Document No. 8. See [https://ec.europa.eu/europeaid/sites/devco/files/study-engaging-supporting-parliaments-worldwide-201010\\_en\\_2.pdf](https://ec.europa.eu/europeaid/sites/devco/files/study-engaging-supporting-parliaments-worldwide-201010_en_2.pdf).

<sup>63</sup> The collaboration with the International Organisation for Supreme Audit Institutions demonstrates the Commission's commitment to strengthen Supreme Audit Institutions and recognises their role for accountability.

<sup>64</sup> Guidance on how to engage non-state actors is available in *Engaging Non-State Actors in New Aid Modalities for Better Development Outcomes and Governance*, Reference Document No. 12. The document highlights the contribution of civil society organisations to the formulation of policies; policy dialogue, sector coordination, mid-term and joint reviews; performance and budget monitoring, including users' consultation; budget implementation and service delivery; and the provision of capacity development, in particular for budget literacy and public expenditure tracking. See [https://ec.europa.eu/europeaid/sites/devco/files/methodology-tools-and-methods-engaging-non-state-actors-new-aid-modalities-201101\\_en\\_2.pdf](https://ec.europa.eu/europeaid/sites/devco/files/methodology-tools-and-methods-engaging-non-state-actors-new-aid-modalities-201101_en_2.pdf).

<sup>65</sup> See section 5.10 on communication and visibility.

Citizen's informed participation in public life, notably in discussions on policy choices, revenue collection, budget allocations and outcomes enables a two-way relationship between citizen and state institutions. An empowered civil society is a crucial component of any democratic system and is the prerequisite for social accountability. For citizens and civil society, access to information is a key requirement to be able to influence policy and budget processes and to provide effective oversight, along with freedom of association, assembly and expression. By fostering access to timely information, the eligibility criterion on transparency and oversight of the budget will allow Civil Society Organisations (CSOs) to strengthen domestic accountability.

CSOs can play an important role also at grassroots and local level in keeping politicians and officials accountable for responsive and efficient delivery of public services. Citizens and civil society need to have meaningful opportunities for participating actively in agenda setting and decision-making.

In some countries, national strategies or frameworks have been developed to define standards for the involvement of civil society in policy development and monitoring processes. Participatory budgeting is another method for involving the local population directly in making decisions on the spending priorities. CSOs can play a key role in aggregating and presenting demands on behalf of constituents contributing with advocacy and constructive dialogue about people's needs and priorities. Experience with participatory budgeting is, however, still limited and it has mostly been applied at municipal or spending unit level, where the engagement of citizens groups is related to specific expenditures associated with people's everyday life.

There are a number of ways the CSOs can get involved. A CSO, or a coalition of CSOs, may for example decide to submit a shadow budget, a policy proposal, or conduct independent studies to provide evidence for advocacy. CSOs can also use networks and platforms, demand access to information and influence on decisions. Information and communication technologies have greatly enhanced the ability of CSOs to hold authorities accountable through evidence-based advocacy.

#### **4.8. Corruption and fraud**

Corruption can be defined as "the abuse of entrusted power for private gain"<sup>66</sup>. Corruption distorts markets, hampers economic growth, prevents development and compromises the government's ability to meet its human rights obligations (e.g. access to justice and fair trials) or deliver on basic services (e.g. health or education). The prevalence of corruption creates discrimination in access to public services in favour of those able to influence the authorities to act in their personal interest. The economically and politically disadvantaged suffer disproportionately from the consequences of corruption, because they are particularly dependent on public services.

Fraud may be understood to mean the acquisition of another person's property by deception<sup>67</sup>. The fight against fraud and corruption is a key element that requires close attention in budget support contracts, particularly in terms of corruption and fraud risk assessment and mitigation, when assessing the PFM eligibility criterion and in relation with the fundamental values assessment. The partner country's commitment and approach towards fighting corruption is

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<sup>66</sup> See <https://www.transparency.org/what-is-corruption>.

<sup>67</sup> See <https://stats.oecd.org/glossary/detail.asp?ID=4781>.

assessed not only when a new budget support contract is being designed but also during the implementation phase. The Commission pays particular attention to these issues and promotes a stronger use of anti-fraud and corruption provisions. Partner countries need to be actively engaged in the fight against fraud and corruption and be equipped with appropriate and effective mechanisms covering the whole "anti-fraud and corruption cycle": prevention, detection, investigation and sanctioning.

As part of its long-term strategy in partner countries, the Commission fights corruption with a number of measures which include the following:

- Support to establishing a robust legal framework in line with European or international standards on preventing and fighting corruption;
- Support to establishing and strengthening specialised anti-corruption bodies;
- Support to reform of public administration and to the management of public finances;
- Support to improvements in the business and investment climate and customs reform;
- Support to fight against economic/financial crime (capacity-building for law enforcement and judicial authorities, as well as specialised bodies such as anti-corruption commissions), as well as support to Justice and Security reforms (including police reform);
- Support to civil society and media as watchdogs, as well as Supreme Audit Institutions and Parliaments in exercising their oversight and control functions; and
- The Commission also promotes the cooperation between the European Anti-Fraud Office (OLAF) and the inspection and judicial authorities of the partner countries<sup>68</sup>.

## Diagnostic tools

A range of international indices are available to measure the extent of the corruption problem, such as Transparency International's Corruption Perception Index and the World Bank's Worldwide Governance Indicator on Control of Corruption. Most are based on *perception* or on citizens/companies' surveys, rather than measuring corruption directly, which remains a challenge. In areas particularly vulnerable to corruption, indicators have been developed (e.g. on risks in public procurement<sup>69</sup>). These should also be actively promoted in the dialogue with partner countries. More specific and more objective anti-corruption indicators are often difficult to construct, but as an example, indicators related to independence, impartiality and performance of the justice sector can be proposed and discussed with partner countries.

Transparency and rigour around the selection procedures of large public investment projects and public procurement also offer very good entry points to address potential corruption. General assessments of transparency in public finances are also relevant, such as the IMF's Fiscal Transparency Evaluations based on the Fiscal Transparency Code<sup>70</sup>. Tighter controls and transparency increase the level of **detection** of corruption cases. Consequently, as detection tools improve, **incidence** seems to increase, until a certain point when additional controls and sanctions (if effective) will start making an impact to decreasing incidence.

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<sup>68</sup> The collaboration between OLAF and FIGE (Forum for General Inspections of State of Africa and Similar Institutions) is a good example of such engagement.

<sup>69</sup> See [https://ec.europa.eu/home-affairs/sites/homeaffairs/files/what-we-do/policies/organized-crime-and-human-trafficking/corruption/experience-sharing-programme/docs/fazekas\\_presentation\\_30032017\\_en.pdf](https://ec.europa.eu/home-affairs/sites/homeaffairs/files/what-we-do/policies/organized-crime-and-human-trafficking/corruption/experience-sharing-programme/docs/fazekas_presentation_30032017_en.pdf).

<sup>70</sup> See <http://www.imf.org/external/np/fad/trans/> for more information.

## Response strategy to major corruption cases

While highlighting the need to have a case-by-case approach, the following framework provides some guidance on how to deal with major corruption cases. From the moment a major corruption case is identified, the Delegation should keep HQ informed.<sup>71</sup> Imminent budget support decisions should be referred to the Budget Support/Financial Assistance Steering Committee, and it may be necessary to revise the risk management framework. The following process should be followed:

- 1) From early on, facts should be established in the most objective way, to try and define the **nature** of the corruption case, i.e. distinguishing between fraudulent cases (simple theft/fraud by individual officials) and systemic failures that allowed the case to take place (e.g. systematic non-compliance with internal control mechanisms; PFM weaknesses).
- 2) It is important to know **who** brought the case to the light: Government, the press, civil society or whistle-blowers. This would give an indication of the integrity and credibility of the country's accountability system.
- 3) An assessment of the **financial impact** of the corruption case, and what it means in terms of the budget finances, is important as well as assessing potential harm to the Commission's financial interests.
- 4) To overcome major corruption scandals (and avoid a breach of eligibility criteria or Fundamental Values), it is essential to assess the credibility of the **Government's response**. When dialogue is effective and well-coordinated with all stakeholders (other cooperation partners, but also domestic actors such as parliament and civil society), the Government is expected to formulate a relevant and credible response to the revealed corruption case, possibly in the form of an action plan (preferably including a performance measurement framework). Such a plan would typically include short and medium-term measures, dealing with the revealed case, preventing similar misuse in the future by strengthening systems, and generally fighting corruption and strengthening accountability institutions. The actions identified should not create a parallel accountability process, but should rely as much as possible on national systems (Parliament, external audit, judiciary system or anti-corruption bodies). However the EU reserves the right to demand further corrective measures.

Experience shows that some partners can be very vulnerable to a sudden loss of budget support. It emphasizes therefore that cooperation partners should be reliable partners, should use government/donor dialogue as the first step in dealing with wrongdoing, and that, if any additional donor response is necessary (such as suspending budget support or delaying or reducing a disbursement), the response should be proportionate to the problem. Immediately stopping all budget support can interrupt the government/donor dialogue just when it might be particularly useful. A letter or even a visit by a high-level Commission official might be a way to emphasize the seriousness the EU attaches to fighting corruption.

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<sup>71</sup> This is already a requirement set out in annex 7 on the early warning system as part of the risk management framework.



As soon as enough information is available, it can be useful to summarise the entire incident and the response of the various actors, to learn from it, to strengthen dialogue, to promote the continuous fight against corruption and to strengthen the accountability systems<sup>72</sup>.

#### 4.9. Budget support in a decentralised context

Decentralised contexts in partner countries constitute complex environments for budget support. Each country context is different and depends on the constitutional realities, traditions and local political economy. When assessing budget support in a decentralised context, particular attention should be paid to the legal framework, mandates, institutional capacities at the local level and the articulation between central and local government responsibilities and resources.

The overall EU approach to decentralization is set out in the EU guidance on decentralisation processes<sup>73</sup> and the Commission Communication “*Empowering Local Authorities in partner countries for enhanced growth and more effective development outcomes*”<sup>74</sup>. A specific methodological note provides the principles and approaches for the formulation and implementation of budget support contracts in decentralized contexts<sup>75</sup>. The focus for budget support lies on the three functional dimensions of decentralisation, i) **political** which involves a range of political powers for subnational governments, including the formulation and adoption of public policies as well as accountability mechanisms towards citizens; ii) **administrative** which involves responsibilities for the delivery of a select number of public services or functions, and iii) **fiscal** which involves the formal assignment of expenditure functions and revenues to subnational governments, usually implying a high degree of autonomy and discretion for the decision and management of public funds.

Three main types of operations can be distinguished:

- **Budget support for decentralised public service delivery:** budget support is provided within a given decentralisation framework to support decentralised multi-level service delivery, in particular in situations where normally the sub-national government has extensive administrative powers but limited political and fiscal autonomy. Support could target sectors such as health, education, water & sanitation, justice and security, generally related to a sector policy or reform framed and financed at national level. Typically, support would be provided in the form of an SRPC or in fragile situations an SRBC with a view to ensuring continued service delivery to the local population. Design and implementation, including the eligibility criteria and policy dialogue, have to take into account both central and sub-national government levels.

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<sup>72</sup> Further guidance on how to mainstream anti-corruption in European Commission development assistance can be found in Concept Paper No 2, *Supporting Anti-Corruption Reforms in Partner Countries- Concepts, Tools and Areas for Actions* ([http://ec.europa.eu/europeaid/sites/devco/files/methodology-tools-and-methods-series-anti-corruption-reform-201110\\_en\\_2.pdf](http://ec.europa.eu/europeaid/sites/devco/files/methodology-tools-and-methods-series-anti-corruption-reform-201110_en_2.pdf)).

<sup>73</sup> See *Supporting Decentralisation, Local Governance and Local Development through a Territorial Approach*, DEVCO Tools and Methods Series no 23, November 2016 (<https://ec.europa.eu/europeaid/sites/devco/files/mn-bb-16-005-en-n.pdf>).

<sup>74</sup> Refer to COM (2013)280 of 15/05/2013 (see [https://ec.europa.eu/europeaid/sites/devco/files/communication-local-authorities-in-partner-countries-com2013280-20130515\\_en\\_4.pdf](https://ec.europa.eu/europeaid/sites/devco/files/communication-local-authorities-in-partner-countries-com2013280-20130515_en_4.pdf)).

<sup>75</sup> See *Providing EU budget support in decentralised contexts*, Methodological Note, 2016 (<https://myintracomm.ec.europa.eu/dg/devco/eu-development-policy/budget-support-public-finance-management/Pages/guidelines.aspx>)



- **Budget support to decentralisation reforms:** In situations where the decentralisation process from central to sub-national levels is itself the specific objective of the contract, budget support can be provided to support the decentralisation policy and strengthen local authorities systems. The contract should focus on the reforms and institutional aspects of the decentralisation process and, depending on the country's own policy, could cover the three functional dimensions - political, administrative and fiscal. Support would typically take the form of an SRPC or as a component of a SDG-C. In certain cases of structural fragility and a pre-existing institutional basis at subnational level a decentralisation component may be considered within an SRBC to strengthen the presence of the State at the periphery. Design and implementation, including the eligibility criteria and policy dialogue, have to take into account both central and sub-national government levels.
- **Budget support to sub-national authorities' territorial policies:** In situations where a sub-national government enjoys extensive political, administrative and fiscal powers and capacities (e.g. in a federal system), an SRPC could help design, finance and implement location-specific policies through sub-national governments' own strategic territorial development plans. While the central government still plays an important role (contracting partner for the financing agreement, recipient of tranche payments, some central aspects of the eligibility criteria), the design and implementation of the SRPC, including the eligibility criteria and policy dialogue, should primarily focus on the sub-national level. Therefore, the use of a SDG-C is not advisable. Note that budget support under this option should be only be undertaken in exceptional cases and should be submitted to the Steering Committee for guidance. It would be feasible only in more advanced contexts that allow managing fiduciary and other risks that accompany the advanced level of decentralized responsibility. Preferably, a sub-national PEFA would have been undertaken<sup>76</sup> and reform measures are being implemented.

Budget support in decentralised contexts should be decided on a case-by-case basis. EU Delegations should carefully examine the opportunities and risks involved, including of possible default of sub-national governments. They should also examine the implications of an intervention at the decentralised level on policy dialogue with the central government and on the EU Delegation's human resource capacities.

#### 4.10. Investment and the business environment

Investment, whether it is public, private, through a public-private partnership or 'blending' operation under the forthcoming External Investment Plan, requires a number of enabling factors. Budget support can play an important role, particularly in relation to the macroeconomic and budgetary framework, the investment and business environment, and sector policies and institutions.

The macroeconomic and budgetary framework should provide a predictable, stable and sustainable basis for investment planning. Sound macroeconomic policies promote growth by providing a more secure environment for public and private sector investment decisions. At the same time, investments can have a macroeconomic impact, particularly where they involve direct or contingent liabilities for the public sector. Support to investment needs to keep in mind public debt sustainability, given that the public debt/GDP ratio has risen significantly in many countries since 2011 due to expansive investment policies, the

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<sup>76</sup> See related PEFA guidance at [http://www.pefa.org/sites/pefa.org/files/attachments/SNG-Supplementary-Guidelines-eng001%20\(Jan%2017\).docx](http://www.pefa.org/sites/pefa.org/files/attachments/SNG-Supplementary-Guidelines-eng001%20(Jan%2017).docx) .pdf.

emergence of new donors and relatively favourable conditions on financial markets. A sound Medium Term Fiscal Framework is crucial to avoid unsustainable debt accumulation. It is also important to consider the structure of public debt and the capacity of the country to serve it over the medium term.

Strengthening public finance management can address critical issues which directly affect investment. Public investments or blending operations should be aligned with partner country policies, i.e. included in Public Investment Plans (PIP), prioritized and costed properly. An effective and rule-based selection of projects with a realistic project pipeline is essential to avoid implementation disruptions due to a shortage of funds. Similarly a well-functioning expenditure chain and the capacity to manage large complex projects is needed. A competitive and transparent procurement system is crucial to ensure investment quality and value for money. At the same time, public procurement offers business opportunities to the private sector. Proper maintenance systems need to preserve the quality of public assets over time and avoid premature deterioration. Policy dialogue can make sure that the maintenance of investments is included in national budget planning and that appropriate asset monitoring is being performed. Good quality of public accounting systems are a basic requirement for effective asset monitoring. Diagnostic tools such as the PEFA and PIMA (Public Investment Management Assessment) can be used.

Budget support can also address issues related to the investment climate at national, sub-national or sector level, particularly business policies, regulations and their enforcement. Budget support can address sector-specific issues, including subsidy policies, licensing and regulations, strengthening markets and competition, or developing expertise in understanding, minimizing and allocating risks (e.g. project risks, demand risks, macroeconomic risks or renegotiations risks) to the public or private party best placed to bear them.

Budget support represents a key tool to leverage and promote investment by directly addressing market failures and market risks that affect the investment climate. It is therefore important to exploit synergies and complementarities with other tools such as blending, in order to increase the effectiveness of EU assistance. Following the experience under the EU blending framework<sup>77</sup> and in particular in view of the launching of the proposed integrated approach External Investment Plan (EIP), these synergies shall be reinforced. The EIP aims to ensure coherence between financing operations and other aid modalities such as budget support under its proposed third pillar which promotes a conducive investment climate in partner countries.

Investments under the EIP create incentives for sound sector policies and create opportunities for dialogue with the private sector. Budget support can complement this through a combination of financing, policy dialogue and capacity building, complemented by specific performance indicators for variable tranches, to address impediments to investments and blending and improve sector policies and the business environment of the partner country. To harness these synergies, the parallel use of budget support and blending instruments in focal sectors should be encouraged where feasible, and coordination between Delegations and finance institutions should take place at an early stage.

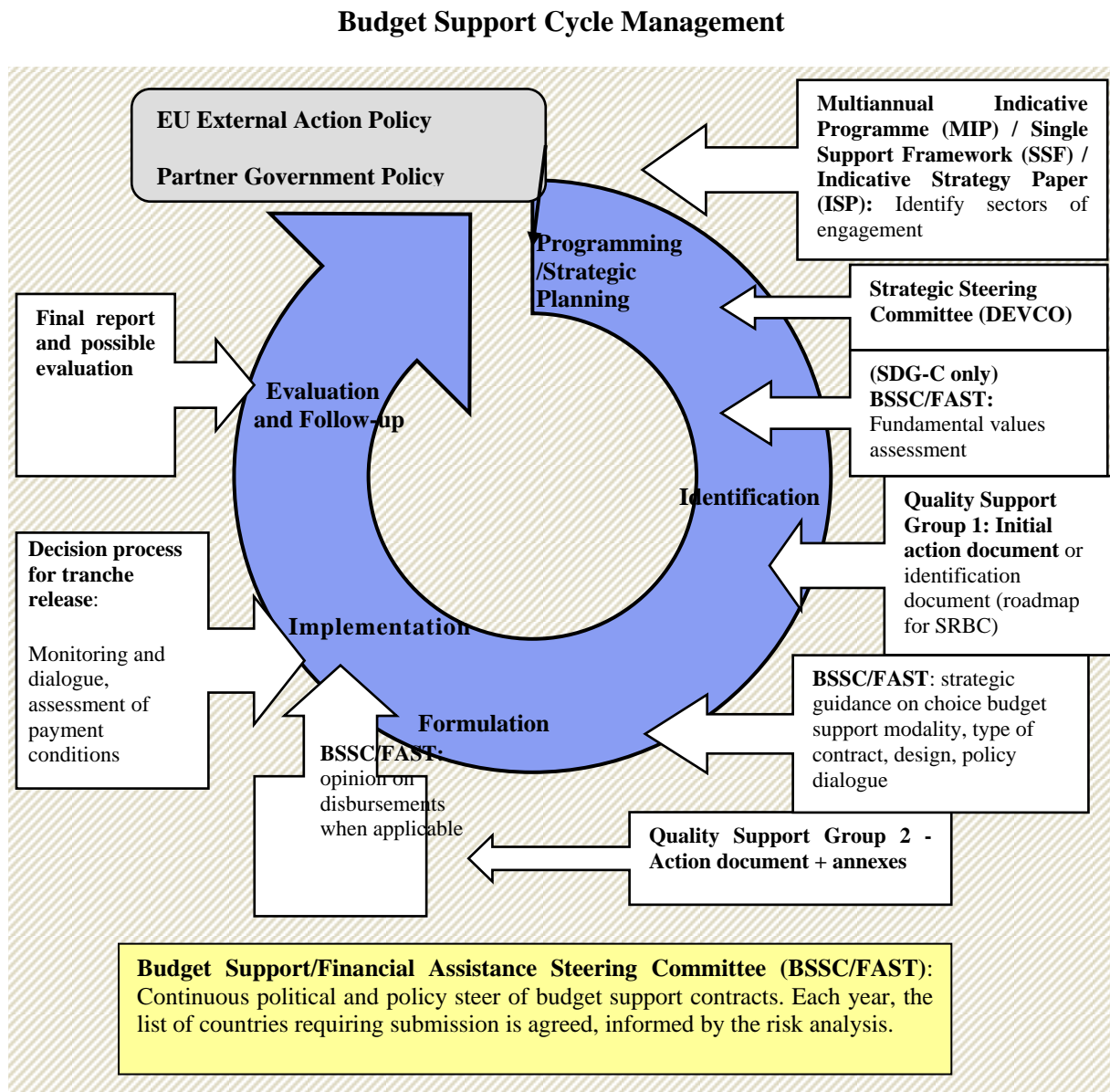
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<sup>77</sup> See [https://ec.europa.eu/europeaid/evaluation-blending\\_en](https://ec.europa.eu/europeaid/evaluation-blending_en).

## 5. The programme cycle

### 5.1 Introduction

The cycle of management for budget support contracts is summarised in the diagram below. This chapter reviews those steps and outlines what needs to be prepared at each stage.



### 5.2 Identification

#### 5.2.1 Whether to provide budget support

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

**First**, an assessment of the risks should be carried out using the risk management framework, and whether risks are likely to be outweighed by the mitigating measures and expected benefits. This includes an assessment of a country's commitment to the fundamental values of

human rights, democracy and rule of law (political risk category). The BSSC/FAST will balance any concerns related to political risk with the need to provide and protect the provision of vital services, and other potential benefits, in order to decide whether a SRPC or a SRBC are appropriate assistance modalities.

For SDG-Cs the commitment to fundamental values is a pre-condition and will be assessed separately to the risk management framework (see annex 12) and subsequently monitored during the formulation and implementation phases using the risk framework.

**Second**, a preliminary assessment of the eligibility against the four criteria should be performed in the initial action or identification document. This assessment will be done for all budget support contracts during the identification and formulation phases and during implementation. During the identification phase, countries may be categorised into strong candidates (expected to meet and maintain eligibility), potential candidates (where eligibility is less certain), and weak candidates (where eligibility is highly unlikely).

As highlighted in chapter 2, if the conditions for budget support are not currently met but there are indications that budget support is intended and may be a possibility in the short to medium term, a dialogue should be initiated with the government. This provides the scope to agree on a roadmap towards a budget support partnership, a risk management framework should be prepared, and appropriate capacity development support measures should be initiated in support of key institutions and reforms.

### **5.2.2 How much budget support**

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

- *Financing needs of the partner country assessed on the basis of its medium term fiscal framework and/or the national/sector development and reform strategies:* this will take into account both the partner country's current and projected levels of domestic revenues, expenditures, fiscal deficit and financial needs, including aid (and budget support) dependency, and the country's own stated preferences for choice or mix of assistance modalities. The greater its current and projected reliance on budget support, and the stronger its own preferences for budget support, the larger the share of the programme would be provided as budget support.
- *Commitment of the partner country to allocate national budget resources in line with the national/sector reform strategy objectives:* this should consider both the process of budget formulation, and its outcome in terms of budget allocations in line with development strategies and objectives and execution rates. The greater the confidence in both the process and outcome of the partner country's budget allocation system, the greater the share of the country programme that can be provided as budget support.
- *Effectiveness, value for money and impact of the specific added value that budget support will bring in achieving the partner country's policy objectives:* assessment will specifically aim to consider the potential impact of budget support relative to other modalities, while also taking into account the likely influence of the EU based on indicators covering relations with the government, human resource capacity, and financial leverage. The greater the impact, the larger the share to be provided as budget support. Similarly, the stronger the quality of policies and institutions in partner

countries (likely to impact positively on aid effectiveness), the larger the share to be provided as budget support.

- *Track record and absorption capacity of past disbursements and how effectively agreed objectives were achieved with budget support contracts:* the greater the rate and timeliness of previous disbursements of both fixed and variable tranches, the greater the share of the country programme that can be provided as budget support.
- *Result orientation in the partner country's national/sector policy including a monitoring system:* the stronger the monitoring system and the greater the willingness of the partner country to be held accountable for key reforms and outcomes in budget support contracts, the greater the share of the country programme should be provided as budget support.

### 5.2.3. Financial additionality or earmarking

All budget support funds are additional to a partner country's domestic revenues in the budget. At sector level, a certain degree of additionality or earmarking may be a prime objective of the budget support contract. In such cases, an increase in (sub) sector allocations and expenditure should be agreed with the partner country in the context of the medium-term expenditure framework. As budget support is a results-based financing mechanism, conditions are normally framed in relation to results rather than budgetary inputs. Hence, such an agreement would normally not be translated in a specific disbursement condition but rather be assessed as part of the public policy eligibility assessment (policy financing chapter). Second, it should be considered whether the increase is appropriate given the existing macroeconomic and budgetary framework and whether it may undermine strategic resource allocation. Third, the financial sustainability of the proposed increase should be appraised, particularly if the increase concerns recurrent expenditure. Finally, note that this option does not entail any targeting, i.e. the specification of specific expenditure items, which once executed and audited, can be reimbursed by budget support.

In other cases, the emphasis of budget support contracts will be on the effectiveness and efficiency of sector policies and expenditure. In this context, the budget support contract provides additional fiscal space at macro level whilst focussing the dialogue, incentives, and conditions on results at sector level.

### 5.2.4. Duration of the contracts

The duration of a SDG-C or SRPC should be between 3 to maximum 6 years. A contract of 3-4 years should be the preferred option, given the difficulties in anticipating the design, context and prospects for a longer period. The duration of a SRBC should be comprised between 1 to 3 years (longer durations are especially relevant in the case of structural fragility situations). The more the situation is volatile, the shorter the duration of the contract should be.

### 5.2.5. Identification

The identification allows for a preliminary proposal to be prepared that sets out the proposed objectives and expected results of the contract; the proposed scale and form (SDG-C, SRPC, SRBC or other assistance modalities); the likelihood of meeting and maintaining the eligibility criteria and, if necessary, identification of possible prior actions that may need to be taken (prior to formulation or the decision) and supporting measures (notably to strengthen

capacity and domestic accountability); preliminary proposals for design and implementation; the main risks; and next steps. It should be accompanied by the latest validated risk management framework, or a first draft for new budget support countries.

### 5.3. The Budget Support/Financial Assistance Steering Committee

The top management is engaged in the decision making-process to provide strategic guidance, as well as to consult the Commissioners for International Cooperation and Development, European Neighbourhood Policy & Enlargement Negotiations and the HR/VP as appropriate, through two Steering Committees: a Budget Support Steering Committee (BSSC), chaired by the Director-General of DEVCO, and a Financial Assistance Steering Committee (FAST Committee) chaired by the Director-General of NEAR. The two committees are attended by EEAS and ECFIN as appropriate. Line DGs may be invited for consultation on matters pertaining to their specific expertise. The BSSC Secretariat is ensured by the budget support central unit in DEVCO; the FAST Secretariat is placed in the Financial Assistance, Policy and Strategy unit in DG NEAR.

Subject to BSSC/FAST decisions following the annual validation of the risk management frameworks, new contracts are submitted for strategic guidance to ensure, with support from thematic and policy directorates and the EEAS<sup>78</sup>, quality and policy coherence across regions, and consistency in the political and policy dialogue priorities for the partner country.

### 5.4. Formulation

Following the identification phase and in accordance with the decision following the first Quality Support meeting and strategic guidance from the BSSC/FAST, formulation will lead to the preparation of the Action document and of the relevant annexes to the Financing agreement to be reviewed by the second quality support meeting. All budget support action documents should follow the same format, covering the following main areas<sup>79</sup>:

- Rationale, objectives and expected benefits of the budget support contract constitute the key elements of the strategic framework;
- Assessment of country context and budget support eligibility, summarising the main issues and results of the assessment of the four eligibility criteria;
- Risk Management covers the main issues identified in the risk management framework focusing on a description of the major risks and mitigating measures;
- Design of the contract covers the implementation issues, including the expected benefits and results, budget and indicative disbursement calendar, stakeholders and donor coordination, performance monitoring, criteria for disbursement, complementary measures (in particular for capacity development), domestic accountability, and crosscutting objectives particularly in relation to gender, the rights-based approach, and the environment; and

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<sup>78</sup> The Council decision 2010/427/EU of 26 July 2010 establishing the organisation and functioning of the EEAS indicates in art 9(2) the list of external assistance instruments where the EEAS has a specific role in the programming and management cycle. The IPA regulation is not included in this list.

<sup>79</sup> The format of the action document is subject to changes over time. Always use the latest template which is made available on DEVCO/NEAR intranet, as per instructions.



- Evaluation and audit, communication and visibility.

The draft action document, when transmitted by the EU Delegation to Headquarters, should be accompanied by the latest validated Risk Management Framework and the relevant supplementary assessments. It should also include the annexes to the financing agreement (which spell out in detail the general/specific disbursement conditions and the performance indicators attached to variable tranches).

After approval by the geographic director, the contract is submitted for approval to the relevant Committee of EU Member States for each instrument, before the European Commission takes a financing decision. The financing agreement including relevant annexes will be signed with the partner country after the financing decision and forms the legal agreement with the partner country.

## 5.5. Commitments

Budget Support financing agreements constitute legal commitments which may give rise to payments without the conclusion of additional legal commitments. In such cases, the single individual budgetary/financial commitment is recorded immediately after the financing agreement is signed by the two parties, on the basis of the total of the payment instalments (tranches) to be provided under the financing agreement (with the exception of the funds intended for audit, evaluation, complementary support and contingencies).

## 5.6. Implementation and disbursements

Regular monitoring and dialogue will be key elements of all budget support contracts, and should generally follow the structure and principles laid down in chapters 3 and 4 as well as in sections 5.2, and 6.6. It is important to promote domestic ownership and accountability, strengthen team working within EU Delegations and across all budget support providers, and pay attention to appropriate communication and visibility activities.

Disbursements require the following steps:

1. Request for tranche release by the partner country: this may take the form of a covering letter with the relevant annual review or policy monitoring report and other appropriate supporting documents annexed. The letter should provide evidence and a justified conclusion on eligibility. EU Delegations should engage in dialogue with national authorities about the content of a reform progress report and also share the relevant templates that Delegations use to support the disbursement decisions, in order to guide the partner countries on the information required.
2. Analysis of tranche release request and preparation of a disbursement file by the EU Delegation: this should analyse whether conditions for payment have been fulfilled and provide a justified opinion. The disbursement note should be drafted in accordance with the annotated template and conclude with a clear statement by the Head of Delegation on the compliance with each of the eligibility criteria and include a recommendation on whether and how much should be disbursed. When applicable, the note should be copied to the EEAS geographical directorate for information. The note should also inform headquarters of any changes to the variable tranche indicators and/or targets related to the release of next tranches. These changes are subject to a written amendment to the financing agreement, which may be made through an exchange of



letters between the signatories of the financing agreement. The changes should be negotiated no later than the end of the first quarter of the implementing year to which the result targets refer.

3. DEVCO/NEAR Geographical services prepare the disbursement file for the approval of the relevant Director, and, as instructed, involve the Budget Support /Financial Assistance Steering Committee and units with a thematic and budget support lead. The Director instructs payment and may also convey key messages to the Delegation to be taken up in dialogue with the partner country.
4. Upon receipt of the approval from Headquarters the Head of Delegation proceeds to provide his/her authorising officer visa. This should be accompanied by a formal letter with the key messages arising from the assessment to be taken up in dialogue.
5. The Delegation undertakes verification of payments (including confirmation that the appropriate exchange rate has been applied).

Timeliness of payment is critical, and every effort should be made to adhere to the indicative disbursement timetable set out in the Financing agreement and/or disbursement schedule agreed subsequently between the partner country and its Budget Support partners. This will require the EU Delegation to be proactive in soliciting the request from the partner country well ahead of the due payment date, and for all parties to respect the agreed timetable.

#### **Exchange rate verification**

Budget Support involves the transfer of financial resources to the National Treasury of a partner country. The Delegation must ensure that the beneficiary government provides the documentary evidence that the relevant Treasury Account has been credited by the amount equivalent to the foreign exchange transfer at the exchange rate prevailing that day. Budget Support funds must be accounted as government revenues and included in the State budget of the beneficiary country.

The exchange rate of the budget support payments has to be clearly stated and recorded in order to make sure that the whole amount in Euros is converted to the local currency and is credited in a timely fashion to the appropriate treasury account. This should prevent the risk that a non-transparent exchange rate results in funds that might be unaccounted for. For a few countries it is even necessary to pass through a third currency (USD). The Special Conditions in the budget support financing agreements explicitly acknowledge that the wording of the relevant clauses concerning exchange rates should be adapted according to the beneficiary's Central Banking practices and regulations. At the same time there is a clear requirement that these practices are applied in a non-discriminatory way.

It is strongly suggested that, during the formulation of the budget support contract, the EU Delegation contacts the Central Bank to clarify acceptable definitions for the exchange rate and to better inform the Central Bank about the obligations entailed by the Financing agreement. Based on this, good practice employed in some countries has been to obtain written confirmation from the Central Bank of the exchange rate arrangements to be included in the Financing agreement. More information can be found on the DEVCO budget support unit's intranet page.

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

## 5.7. Monitoring

The provision of budget support requires monitoring that the implementation of the contract is consistent with the provisions of the financing agreement at any time of the year, and not only when preparing disbursement files<sup>80</sup>. This includes verifying regularly the provisions of the financing agreement and particularly:

- the intervention logic and related objectives and indicators of the contract;
- the timelines of the contract (e.g. expiry of the financing agreement, cut-off dates, expected dates for reviews or submission of the payment request by the Government);
- the general conditions as they are formulated in the financing agreement;
- the variable tranche indicators as they are stated in the financing agreement and any development that could affect their assessment (potentially requiring changes in their scope or targets);
- the documentation and the nature of evidence expected from the government, as formulated in the financing agreement;
- the arrangements foreseen for policy dialogue, as agreed in the financing agreement.

This constant and rigorous monitoring, both by implementing partners and the EU, aims at ensuring the success of the contract and at anticipating any factor that could derail its implementation. Corrective measures, reinforced policy dialogue and, when needed, amendments to the financing agreement, could then be enforced well ahead of payment.

**Following the last budget support disbursement, a brief final report needs to be prepared** by the delegation and submitted to headquarters. These final reviews are meant to remain internal, to assess the results achieved during the implementation of the contract and to draw lessons for future contracts<sup>81</sup>. Such reviews are not formal evaluations (see next section), but aim at providing input for future budget support contracts and at improving the communication and visibility of results, e.g. for the purpose of the Commission's external assistance report or other dedicated publications. The report should be sent to headquarters no later than three months after the disbursement of the last tranche.

## 5.8. Evaluation

Regular and timely evaluation of its programmes, activities, instruments, legislation and non-spending activities is a priority of the European Commission in order to demonstrate accountability, to promote lesson learning to improve policy and practice, and to comply with evaluation commitments<sup>82</sup>.

Budget support evaluations determine to what extent and under which circumstances the budget support has enhanced the policies, strategies and spending actions of the partner government. They can, in addition, assess the contribution of budget support to sustainable national and/or sector level development outcomes and impacts.

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<sup>80</sup> DEVCO decided that the Results-Oriented Monitoring (ROM) does not apply to its budget support contracts.

<sup>81</sup> A template is available on the intranet page.

<sup>82</sup> See DEVCO/NEAR intranet for guidance in this respect.

Delegations should ensure with the partner country that monitoring and data collection systems (including household and other required surveys) are being strengthened. These monitoring and data systems are crucial not only for the evaluation of budget support contracts but also for the follow up and evaluation of the partner country's public policies. The information included in final reports, which are a key monitoring tool, can constitute valuable inputs for external evaluations.

Two types of evaluation can apply to budget support: strategic and programme(s) evaluations.

**1. Strategic evaluations of budget support** are comprehensive as they include all (or most) budget support contracts implemented in a country during a relatively long period of time (usually around 7 to 10 years) irrespective of the donor (e.g. EU, Member States or development banks) The aim is to have a complete overview of the contribution of budget support to the changes in the livelihoods of the final beneficiaries.

They are managed and financed by DG DEVCO's and DG NEAR's evaluation services under a specific Framework Contract available only to these units. They are usually joint evaluations with other cooperation partners. These evaluations are included in the DG DEVCO/DG NEAR Work Programmes for Strategic evaluations<sup>83</sup>, approved by the respective Commissioners and the High Representative of the Union for Foreign Affairs and Security Policy where applicable.

The key features of the methodological approach are: a) the Comprehensive Evaluation Framework (see section 2.6) which sets out the hypothetical sequence of effects for budget support contracts across five analytical levels included in and interacting with the overall national context within which budget support is provided; and b) the Three Steps Approach, whereby; i) Step one encompasses the assessment of budget support inputs, their outputs and their contribution to induced outputs, i.e. public policies, institutions, spending and service delivery, ii) Step two encompasses the identification of the development results (outcomes and impact) and the factors which have caused and/or contributed to these outcomes and impacts, both internal, i.e. linked to government policies, and external, iii) Step three entails an exploration of whether there is a link between the induced Outputs identified in Step one and the determining factors of the outcomes and impacts. A positive link implies that budget support has made a contribution to the achievement of the outcomes and impacts.

2. Whereas strategic evaluations are managed by the evaluation services of both DGs, EU delegations can launch and manage **programme(s) evaluations of budget support**. As in the case of strategic evaluations, they also respond to learning and accountability purposes and should be used when a strategic evaluation is not planned (or not in due time). It usually focuses on one or a few budget contracts, only financed by the EU. When they cover several budget support contracts, this implies that these contracts may be evaluated at different stages of implementation.

These evaluations are launched under a Framework Contract. They cover a shorter evaluation period than strategic evaluations. They can be undertaken every 3-5 years. Programme(s) budget support evaluations use a simplified version of the Methodological Approach used for strategic evaluations as the focus is more on the programme(s)' process and on the results (outputs and outcomes) of the partner country's policies than on the impact for final

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<sup>83</sup> The 5-year rolling Work Programmes for Strategic evaluations can be consulted on the evaluation websites of the two concerned DGs.

beneficiaries. Thus, the *programme(s) evaluations* of budget support do not use the full OECD methodology for strategic evaluations<sup>84</sup>. They focus on step 1, partially on step 2 (outcome level only, not impact), and do not undertake step 3.

When including a provision for a budget support *programme(s) evaluation* in the financing agreement of a budget support contract, flexibility should be sought so as to accommodate the possibility that different budget support contracts are covered by the same evaluation.

## 5.9. Audit

Reliance is placed on the audited national accounts prepared by the country's own Supreme Audit Institution, since once transferred into the partner country's Treasury Account the European Commission's budget support funds become inseparable from the general revenues of government and the budget support inflows from other donor agencies. Strengthening this function, as well as the internal audit and control institutions, is typically a significant part of any policy dialogue and capacity development connected with budget support.

Nevertheless a verification by the EU Delegation is required to confirm that the transfer of funds into the Treasury Account has respected the terms of the financing agreement (see box on the exchange rate). Complementary support activities included in the financing agreement may also require auditing. In the case of targeted budget support, where funds are intended to finance a specific and agreed set of budget lines, an audit is required to verify the amount of eligible expenditure which has been made in those budget lines. The budget support payment is made ex-post to reimburse the eligible expenditure in line with the audit findings.

## 5.10. Communication and visibility

Good communication is essential both in relation to specific budget support contracts and to promote the budget support instrument overall. Communication should be planned strategically as the contract is being designed and its objectives defined, in line with the overall objectives of cooperation agreed between the EU and the partner country<sup>85</sup>. An update on the communication strategy and communication activities should also be provided regularly during contract implementation or, when relevant, in the context of EAMR or other relevant reporting arrangements.

Effective communication results in visibility. It helps raise awareness and gain support for EU actions by serving transparency and accountability vis-à-vis the Commission's constituencies. These principles apply to all assistance modalities<sup>86</sup> but communication as regards budget support can be more challenging or sensitive due to the nature of the instrument. Messaging around budget support should be framed accordingly and the guiding principles below should be adapted to the country context, to the nature of the partnership with the EU and to the media environment. The reputational risk for the EU should not be overlooked either but it should not refrain for carrying out communication activities.

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<sup>84</sup> The template terms of reference for programme(s) evaluations can be found on DEVCO/NEAR intranet.

<sup>85</sup> For visibility purpose, it may be more relevant to have one single communication contract at the level of the delegation whereby the EU budget support activities and results may be promoted together with other actions in a more strategic manner, rather than a piecemeal approach project by project with their own (and smaller) budget and distinct communication material each time.

<sup>86</sup> Refer to the general guidance as regards visibility and communication for external assistance on the intranet.

Furthermore, communication about budget support cannot be considered in isolation of the policy or public administration reforms that the contract is supporting. A budget support contract is successful when the policy itself is successful and when EU support contributes to effective reforms and sustainable change in the country. To some extent, the success of policies and reforms depends on the communication efforts made by the government itself to promote and explain its plans. Such efforts include both internal communication, for example by sensitising government staff implementing the policy, and external communication, for example by running media campaigns, briefing journalists, holding public events and engaging with stakeholders in any other manner.

Communication can have different objectives, such as informing the public debate about the changes at stake, securing public acceptance of the proposed reforms, raising awareness about the expected gains for the beneficiaries, explaining the challenging aspects of the reforms or eventually reporting of their results. Investing in communication is a critical way to mitigate implementation risks. As the policy is implemented, communication plays an equally important role in reporting about results, remaining challenges and remedying measures. It contributes to transparency and accountability. On the contrary, the absence of communication around a policy may jeopardise its implementation and also involve a reputational risk for the EU, if the most controversial aspects of the reforms which are supported through budget support are not communicated adequately and proactively.

Communication should therefore be considered an integral part of the dialogue with partner countries, and any progress or setback be reported by delegations as part of the policy assessment. If deemed necessary, dedicated support for capacity development in this respect could be envisaged. In any case, it would be important to monitor that information about the policy itself and its implementation is published on ministry's or agency's website, in a timely, accurate and accessible manner. EU delegations could also engage with the authorities to support the preparation and implementation of a reform communication strategy, advising on target audiences, the key messages, the methods and the timelines. A communications audit may be a useful tool, so as to identify an organisation's strengths and weaknesses in terms of internal and external communication. It would generally screen the organisation's communication practices, measure how well the target stakeholders are informed, assess how far its communication activities achieve impact and make recommendations for improvements. Surveys may also be required to understand the perceptions and attitudes of the public towards the reform in question.

In principle, communication efforts by the government and the EU delegation in the context of a budget support contract should be coordinated and complement each other. EU delegations should consider the following three dimensions for any communication action around budget support.

First, the **target** audience should be clearly identified. Communication could be directed at the stakeholders in the partner country and equally be relevant to European Union stakeholders. Communication would typically focus on results, and not on budget support itself with its technicalities (e.g. how the contract is designed) or related processes (e.g. how the review was carried out). Messages should be kept simple and catchy. Story-telling would be the preferred approach<sup>87</sup>. The story would typically start with testimonials from beneficiaries<sup>88</sup> of the

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<sup>87</sup> See intranet or Capacity4dev for concrete and recent examples.

<sup>88</sup> The challenge of measuring and quantifying the contribution of budget support to the results achieved by partner countries make it difficult to identify direct 'beneficiaries' of budget support contracts, but

government policy and thereafter highlight how the budget support contract contributes to this progress in partnership with the government. Results against performance indicators and other quantitative evidence, arising from reviews or evaluations, would further substantiate the progress thereby presented.

Second, the *timing* of communication activities should be considered in relation to the implementation cycle of each budget support contract but also to the political calendar of the country. For instance, communication activities may be carried out at the end of each annual review but it may make more sense, from a domestic point of view and for local stakeholders, to promote the budget support contribution when, for instance, the budget proposal is tabled by the government or the budget approved by the parliament. Coordination with government's communication plans should be sought, whenever relevant, and joint communication with other budget support providers favoured, whenever possible. Delegations should nonetheless be mindful of interference or clash with political developments in the country and of any potential misuse of messages for electoral purposes.

Third, the communication around budget support should take full advantage of all available *tools*. Communication activities may include publication of press releases, jointly with other budget support donors if possible. Press conferences could also be organised with a press kit distributed to journalists. Events may also have potential to attract TV or radio channels. Teaming up with civil society organisations<sup>89</sup> or academia often proves to be very effective, considering that public intervention from a third party may reinforce messages from the authorities or from the Delegation. Printed material (e.g. brochures or leaflets) could also be used on specific occasions (e.g. events where they can be distributed to a large number of participants at once).

Digital tools are the most cost-efficient and the easiest to monitor in terms of outreach, as they come with metrics. News items or stories should be posted on the website and social media accounts of EU Delegations. Online material would typically be directed at a wide audience so messages should be straightforward and catchy (e.g. short videos, animations, infographics or filmed interviews). Elaborated content, such as reports or case studies, made available on a website should always be introduced with short posts summarising the main messages of the reports, in a simple language and with visual material (e.g. pictures or illustrations).

The tools and the breadth of dedicated communication activities by the EU around budget support should be chosen according to the target audience, the local conditions and the capacities of the EU Delegation, weighing up the expected impact in relation to the costs and the investment in terms of workload. An update on the communication strategy and communication activities should be provided regularly.

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communication objectives should not be confused with evaluation objectives. Beneficiaries should be considered in this context as individuals, groups of individuals or organisations having benefited from a government policy that the EU supports through a budget support contract.

<sup>89</sup> An example of such partnership in the area of public administration reforms can be found in the Western Balkans, where the EU is supporting a regional network WeBER to strengthen civil society and media participation in public administration reforms. See <http://www.par-monitor.org>.

## BUDGET SUPPORT CONTRACTS – SUMMARY TABLE

	<b>SDG-C Sustainable Development Goals Contract</b>	<b>SRPC Sector Reform Performance Contract</b>	<b>SRBC State and Resilience Building Contract</b>
<b>Overall objective</b>	Eradicating poverty and reducing inequality, promoting sustainable and inclusive growth and job creation, and consolidating democracies, promoting human rights and peaceful societies, and applying sector impact indicators as appropriate		
<b>Specific Objectives</b>	<ul style="list-style-type: none"> <li>- Promote reforms and progress towards selected SDGs and cross-cutting service delivery aspects in a rights-based and gender-sensitive manner;</li> <li>- Address constraints on sustained, inclusive and equitable growth;</li> <li>- Foster economic governance and domestic accountability by strengthening core government systems and supporting broader reforms (macro, PFM, PSR, DRM...)</li> </ul>	<ul style="list-style-type: none"> <li>- Promote sector policy reforms;</li> <li>- Improve service delivery at sector level;</li> <li>- Address basic needs of the population with a particular focus on gender equality and reaching marginalised groups;</li> <li>- Improve governance at sector level.</li> </ul>	<ul style="list-style-type: none"> <li>- Restore macro-economic and fiscal stability;</li> <li>- Build on state and societal resilience;</li> <li>- Foster a transition process towards development and democratic governance;</li> <li>- Promote reforms that address sources of vulnerability</li> <li>- Ensure vital state functions (notably the provision of peace and security, payment of civil service salaries, provision of core administrative functions and minimum basic services)</li> </ul>
<b>Precondition</b>	Satisfactory assessment and trend analysis of country's commitment to Fundamental Values (FV)	Fundamental values matter, but related risks are balanced against the need to protect basic service delivery	Fundamental values matter, but related risks are balanced against the risks of non-intervention
<b>Eligibility</b>	<ul style="list-style-type: none"> <li>- Credible and relevant national development strategy</li> <li>- Stability oriented macro-economic policy</li> <li>- Credible and relevant overall PFM reform programme</li> <li>- Budgetary transparency</li> </ul>	<ul style="list-style-type: none"> <li>- Credible and relevant sector development strategy</li> <li>- Stability oriented macro-economic policy</li> <li>- Credible and relevant overall PFM reform programme, assessment of progress to focus in particular on sector PFM issues and performance</li> <li>- Budgetary transparency</li> </ul>	<ul style="list-style-type: none"> <li>- Credible and relevant national development strategy or "transition compact"</li> <li>- Stability oriented macro-economic policy</li> <li>- Credible and relevant overall PFM reform programme, assessment of progress to focus in particular on fiscal compliance and discipline</li> <li>- Budgetary transparency</li> </ul>



<b>Expected results</b>	<ul style="list-style-type: none"> <li>- Progress toward selected SDGs with well-defined policies and effective implementation, in a gender-sensitive manner;</li> <li>- Improvements in the quality of PFM</li> <li>- A more transparent and accountable planning and budgeting system;</li> <li>- The maintenance of macroeconomic stability and economic resilience to shocks.</li> </ul>	<ul style="list-style-type: none"> <li>- Improved design and implementation of sectoral policies and reforms;</li> <li>- Improvements in key indicators of sector service delivery;</li> <li>- Improvements in the quality of PFM, across the entire PFM system but particularly with regard to the management of funds in the sector</li> </ul>	<ul style="list-style-type: none"> <li>- Peace and security maintained, transition to democracy and development;</li> <li>- Sufficient financial allocation to cover at least the provision of a minimum level of basic services and public administration;</li> <li>- Improved efficiency of public financial management systems;</li> <li>- A more transparent and accountable planning and budgeting system;</li> <li>- The restoration of macroeconomic stability;</li> <li>- Measures/reforms initiated to address structural fragility</li> </ul>
<b>Design Features</b>	<ul style="list-style-type: none"> <li>- 3-6 year commitments;</li> <li>- FT+VT</li> </ul>	<ul style="list-style-type: none"> <li>- 3-6 year commitments;</li> <li>- FT+VT</li> </ul>	<ul style="list-style-type: none"> <li>- 1-3 year commitments, (especially for situations of structural fragility), which can be renewed;</li> <li>- FT only if 1 year. It may have process VT indicators if 2-3 years or if renewed;</li> <li>- Safeguards such as pre- or specific conditions, treasury committees or targeting may be required;</li> <li>- Closer monitoring and significant capacity strengthening.</li> </ul>

## **ANNEXES**

## Annex 1 – Glossary of terms

<b>Accountability</b>	<p><i>Domestic accountability</i> refers to a partner government being accountable to its citizens and institutions (parliament, audit and judiciary institutions) on policy choices, revenue collection, budget allocations and outcomes. It is a two-way relationship between citizen and state institutions, as citizens must also be able to hold their government answerable and accountable for its actions and to check abuses.</p> <p><i>Mutual accountability</i> refers to the relationship between donors and partner countries. From the donor's perspective, mutual accountability is important so that donor governments can demonstrate to their stakeholders that public funds for development are used effectively and efficiently. For partner countries, it is important to receive credible donor commitments and timely, predictable, transparent and comprehensive information on aid flows aligned with the budget cycle, to prepare and implement budgets that deliver agreed policy objectives and outcomes.</p>
<b>Acquis</b>	The acquis is the body of common rights and obligations that is binding on all the EU member states.
<b>Alignment</b>	Where donor support is aligned to partner country systems, donors will base their overall support on partner countries' national development or reform policies and strategies, institutions, and procedures.
<b>Base tranche</b>	See fixed tranche
<b>Beneficiaries</b>	<p>Beneficiaries are those who benefit in whatever way from the implementation of the programme. Distinction may be made between:</p> <p>(i) Target group(s): the group/entity who will be immediately positively affected by the programme at the level of the programme purpose (specific objective) and at the level of direct/induced outputs;</p> <p>(ii) Final beneficiaries: those who benefit from the project in the long terms at the level of the society or sector at large (e.g. children due to increased spending on health and education, or consumers due to improved agricultural production and marketing, or entrepreneurs, due to better business climate).</p>
<b>Budget Support</b>	<p>Budget support involves dialogue, financial transfers, performance assessment and capacity development. The financial transfer is the transfer of financial resources to the National Treasury of a partner country, following the respect by the latter of agreed conditions for payment. The financial resources thus received are part of the global resources of the partner country, and consequently used in accordance with the public financial management system of the partner country.</p> <p><i>Method of Implementation:</i> centralised direct</p>

<b>Budget Support Steering Committee (BSSC)</b>	A senior management committee in DG DEVCO to review budget support financing proposals and disbursement decisions wherever there are substantial or high political and policy implications.
<b>Capacity Development</b>	The process by which individuals, groups and organisations, institutions and countries develop, enhance and organise their systems, resources and knowledge; all reflected in their abilities, individually and collectively, to perform functions, solve problems and achieve objectives (OECD definition).
<b>Complementary Support</b>	<p>The support that is complementary to the main budget support contract. This will typically include one or more of the following components:</p> <ul style="list-style-type: none"> <li>i) capacity development measures (technical assistance and other forms of capacity building, including twinnings, and, whenever appropriate, supplies and works) aimed at strengthening the capacity of the public institutions to coordinate, implement, monitor, evaluate and communicate the public policy in question or related aspects (e.g. public finance management or macroeconomic reforms);</li> <li>ii) capacity development measures aimed at strengthening the capacity of civil society to contribute to the implementation and monitoring of public policies and/or grants to civil society organisations to promote their involvement in oversight functions;</li> <li>iii) technical assistance to support the monitoring or the evaluation of the EU contract; and</li> <li>iv) support for the design and implementation of a government-led visibility and communication strategy.</li> </ul> <p>The financing agreement template for budget support includes a section to provide for complementary support, if relevant.</p>
<b>Counterpart funds</b>	Local currency equivalent of a foreign currency transfer. Most commonly used in the context of indirect budget support.
<b>Direct Budget Support</b>	When domestic currency is convertible into foreign currency budget support is direct because the domestic currency equivalent of the foreign currency is generated or created directly through the usual channels of the banking system. The foreign exchange is simply transferred to the Central Bank which then credits the equivalent amount of domestic currency in the partner government's National Treasury account.
<b>European Commission's procurement, grant award and payment procedures</b>	<p>Where European Commission's procurement, grant award and payment procedures are used in project and programme implementation. Some of these procedures may be decentralised to third parties, but there will always be some ex-ante or ex-post control in the process.</p> <p><i>Method of Implementation:</i> centralised or decentralised.</p>

<b>Eligibility criteria for budget support</b>	<p>A country may be considered eligible when:</p> <ul style="list-style-type: none"> <li>i) There is a credible and relevant national/sector policy that supports the overall objectives of poverty eradication and inequality reduction, sustainable and inclusive growth and job creation, the consolidation of democracies and peaceful societies, and the promotion of gender equality.</li> <li>ii) There is a credible and relevant programme to restore and/or maintain macroeconomic stability.</li> <li>iii) There is a credible and relevant programme to improve public financial management.</li> <li>iv) The government has published either the Executive's Proposal or the Enacted Budget within the past or current budget cycle.</li> </ul>
<b>Financial Assistance Steering Committee (FAST)</b>	A senior management committee in DG NEAR to review budget support financing proposals and disbursement decisions wherever there are substantial or high political and policy implications.
<b>Financing Modality</b>	The manner in which finance is provided. There are three financing modalities used in European Commission's projects and programmes: (i) European Commission's procurement and grant award procedures; (ii) Common pool (or basket) funds; and (iii) budget support.
<b>Fixed tranche</b>	Fixed tranches have a fixed value, specified in advance within the financing agreement. They are either disbursed in full (if all conditions are met) or not at all (if one or more conditions are not met). May also be called a 'base tranche'.
<b>Floating tranche</b>	A tranche is considered to be floating, when the date by which its disbursement condition(s) need(s) to be met can vary – in effect there is no fixed “cut-off” date for meeting the disbursement condition. An indicative date will normally be specified in the financing agreement – but the actual date will “float” depending on when the conditions for disbursement have been met (although, of course, there needs to be a final date governed by the financing agreement). The use of floating tranches is not recommended.
<b>Fundamental values</b>	The fundamental values of human rights, democracy and the rule of law are essential elements of all of the EU's partnerships and cooperation agreements with third countries. SDG-C will only be provided where there is trust and confidence that state budget funds will be spent pursuant to these fundamental values which the EU and the partner country share, and for the respect of which partner countries commit to move forward.

<b>General Budget Support (GBS)</b>	<p>A transfer to the National Treasury in support of a national development or reform policy and strategy that may be provided in the form of a Sustainable Development Goal Contract (SDG-C) or State and Resilience Building Contract (SRBC)</p> <p><i>Method of Implementation:</i> centralised direct</p>
<b>General Conditions</b>	<p>These are conditions which apply to the disbursement of all tranches of a contract. These conditions will in most cases be those related to the eligibility criteria for receiving budget support. There may be additional general conditions or specific conditions (see hereafter), but these are not recommended and, if decided otherwise, they should be kept to a minimum.</p>
<b>Sustainable Development Goal Contract (SDG-C)</b>	<p>A budget support contract aimed at providing (general) support to a national development reform policy and strategy to achieve the SDGs</p>
<b>Harmonisation</b>	<p>Where donors implement, among themselves, common arrangements to support a national development or reform policy and strategy</p>
<b>Indirect Budget Support</b>	<p>When domestic currency is not freely convertible into foreign currency, budget support is indirect because the local currency equivalent of the foreign currency is generated indirectly outside the usual channels of the banking system. The foreign exchange is converted into a domestic currency equivalent typically through: i) the sale of foreign exchange on a foreign exchange auction; ii) allocations of foreign exchange through a general or sectoral import programme; or iii) through the sale of aid in kind, or the use of a currency facility.</p>
<b>Impact</b>	<p>The expected long-term and intermediate changes leading to the achievement of the country's strategic goals endorsed by the EU and coherent with its country / regional strategy. They are the consequences/effects of the outcomes in the society at large; for example, improvement in literacy; improvement of employment rates; At a higher level of impact, they can relate to broader objectives, such as growth and income poverty.</p>
<b>Input</b>	<p>Measures the financial resources provided, and the administrative and regulatory measures taken; for example, resources allocated, resources used, measures taken, laws passed. The definition of inputs can be treated as very broad covering in some cases what is often called process indicators.</p>
<b>Inputs of budget support</b>	<p>The inputs necessary to create direct outputs: funding, policy dialogue between the partner country public institutions and the EU, disbursement conditions, complementary support measures. (refer to Annex 2)</p>

<b>Interlinked sectors</b>	Sector Reform Performance Contracts (SRPCs) can support several sectors if they are closely interlinked through a coherent policy, budgetary and institutional framework (for example, agriculture and rural roads as part of a common rural development strategy).
<b>Intervention Logic</b>	The logical structure and sequence of the expected results underlying a budget support contract.
<b>Macro Financial Assistance</b>	The macro financial assistance provided by the Commission and management by ECFIN in accordance with the “updated Genval” criteria of 8 November 2002 (see Annex 1 to the 2453rd meeting of the Council (Economic and Financial Affairs), 8 October 2002)
<b>Non-floating tranche</b>	A tranche is non-floating when the date by which its disbursement condition(s) need(s) to be met cannot vary – in effect there is a fixed “cut-off” date for meeting a disbursement condition. A fixed date will be specified in the financing agreement by which the disbursement condition is to be met; if the disbursement condition is not met by this date, the partner country will, in principle, be ineligible for support
<b>On-budget and related terms</b>	Assistance is said to be on-budget when it is included in the budget documents presented for (parliamentary) approval. Other terms used to describe the extent to which assistance is included in the public financial management system of a country include: on-plan (when assistance is included in planning documents); on-procurement (assistance uses the partner country's procurement procedures); on-treasury (assistance uses the payment procedures and is included within the accounting system of the partner country); on-reporting (assistance is included in expenditure reports); and on-audit (where assistance is audited by the supreme audit institution).
<b>Direct output</b>	The country opportunities that are expected to improve as a direct consequence of the deployment of budget support inputs, e.g.: the new fiscal space created by the transfer of funds; increased predictability of funds, reduced transaction costs, a more aligned and coordinated policy dialogue and capacity strengthening activities conducive to reforms; improved monitoring of reforms; the products or services delivered by the complementary support measures.
<b>Induced output</b>	Policy and institutional changes that should facilitate the achievement of outcomes. Some examples are an increase in the number and quality of schools, the improvement of the institutional and legislative framework on prevention and repression of corruption, improved PFM systems and improved business environment (e.g. related legal, regulatory and institutional frameworks, and new services). The focus is on institutional improvements and not on their use by the final beneficiaries, which is part of the outcomes.



<b>Outcome</b>	Changes in the behaviour of the targeted beneficiaries, where supply meets demand (for example, in the education sector, these could be improvements in enrolment, dropout, repetition and completion rates) and which are supposed to pave the way for longer-term impacts (for example, in the education sector, learning achievements and literacy rates). Other examples of outcomes include increased business confidence and private sector investment, or an improvement in corruption perception. In certain cases, outcomes can also include behavioural changes at the organisational level constituting a response by institutional actors (for example, for public administration reforms, these could be the increase in prosecution of corruption cases, that would pave the way for longer-term impacts, such as the decrease of corruption incidence).
<b>Output</b>	Measures the immediate and concrete consequences of the resources used and measures taken; for example, schools built, teachers employed, nurses trained; the definition of output covers those goods and services “produced” by the public sector
<b>Overall Objective</b>	The overall objective explains why the contract is important to society, in terms of the longer-term benefits to final beneficiaries and the wider benefits of other groups. The overall objective will be derived from national policy and strategy and will not be achieved by the contract alone.
<b>Ownership</b>	Partner countries exercise effective leadership and show commitment to their national development or reform policies and strategies, and coordinate development actions
<b>Performance indicators</b>	Indicators used to determine the amount of the variable tranches to be disbursed, according to specific scoring and assessment modalities to be defined in the financing agreement. In principle such indicators must be drawn from the policy document and monitoring framework from the partner country.
<b>Performance tranche</b>	See variable tranche.
<b>Pooled Fund</b>	Where EC funds are transferred to an account in which the resources of more than one development partner and possibly the partner country are “pooled” in one fund. The resources so transferred are then used in accordance with the financial management procedures of the pooled fund. A trust fund is a form of pooled fund. <i>Method of Implementation:</i> shared (with Member States), decentralised (with partner countries), or joint (with international organisations).
<b>Quality Support Group</b>	The Quality Support Group within DEVCO/NEAR to reviews projects and programmes at the stage of both end of identification (QSG1/QR1) and end of formulation (QSG2/QR2). The QSG/QR within DEVCO/NEAR is organised separately for each geographic directorate.

<b>Sector Approach</b>	A way of working together between government and development/cooperation partners with the aim of broadening government ownership over public sector policy and resource allocation decision within the sector to increase the coherence between policy, spending and results. It involves progressive development of a comprehensive and coherent sector policy and strategy, of a unified public expenditure framework for domestic and external resources and of a common management, planning and reporting framework.
<b>Sector Budget Support</b>	A transfer to the National Treasury in support of a sector programme/policy provided in the form of a Sector Reform Performance Contract. <i>Method of Implementation:</i> centralised direct
<b>Sector Programme</b>	A sector policy and action plan covering: (i) an approved sector policy document and overall strategic framework with a monitoring and evaluation system in place; (ii) a sector medium term expenditure framework (though this is not an eligibility criterion for budget support) and an annual budget; (iii) a coordination process amongst the development/cooperation partners led by the government; A sector programme is a result of following a <i>sector approach</i> , in which governments, in consultation with development/cooperation partners and other stakeholders, may develop a sector policy and action plan. It may be supported through a Sector Reform Performance Contract or other modality (e.g. pooled funding arrangement).
<b>Sector Reform Performance Contract (SRPC)</b>	A form of (sector) budget support order to address sector reforms and improve service delivery
<b>Specific Condition</b>	This is a condition applying to the disbursement of individual tranches in a specific year, in addition to the general conditions and to variable tranche performance indicators. The use of specific conditions is usually not recommended. It may however be necessary in the context of State and Resilience Building Contracts.
<b>Stakeholders</b>	Any individuals, groups of people, institutions or firms that may have a relationship with the programme are defined as stakeholders. They may – directly or indirectly, positively or negatively – affect or be affected by the process and the outcomes of the programme. Usually different sub-groups have to be considered.
<b>State and Resilience Building Contract (SRBC)</b>	A form of (general) budget support to provide support in fragile and transition situations.

<b>Targeted Budget Support</b>	Targeted budget support involves the transfer of EU funds to the national treasury to refund the Government for a pre-defined list of eligible expenditures or budget lines (i) after goods or services have been delivered, (ii) payments made by the treasury and (iii) transactions verified by an audit. Budget support is provided up to the amount of expenditures certified as eligible by the audit. A satisfactory audit report therefore becomes a condition for the disbursement of funds in the case of targeted budget support.
<b>Target Groups</b>	See beneficiaries
<b>Tied Aid</b>	Aid that must be spent on works/goods/services originating from the donor country or other specified origins (for example from a pre-specified list of countries).
<b>Untargeted Budget Support</b>	Untargeted Budget Support involves the transfer of financial resources to the national treasury of the partner country, where they are “mixed” with domestic revenues and other sources of finance and used to finance activities of the government’s budget. There is no tracking by the European Commission of the use of the resources so transferred; rather any follow-up takes place in the context of the overall system of public financial management of the partner country
<b>Variable Tranche</b>	Variable tranches have a maximum value, specified in advance within the financing agreement. They are either disbursed in full or in part, with the amount being disbursed being based on performance achieved in relation to pre-specified performance indicators and targets (provided that at the same time the general conditions are all met). They may also be designated as performance tranches.

## Annex 2 – Objectives and intervention logic

The intervention logic (IL) is a useful tool to present in a concise manner the budget support contract rationale – i.e. the logical structure and sequence of the expected results, over the implementation period and in a longer perspective – and the underlying theory of change<sup>90</sup> that supports it. The IL tells the story of a budget support contract and is a fundamental tool, not only for monitoring and evaluation, but also for the design, policy dialogue and communication to a large number of stakeholders.

The intervention logic consists of a narrative, reflected in the action document, and a results matrix which is included in the appendix to the action document. The results matrix is a formal representation of the results-chain underlying the processes of change that are induced by the policy interventions. Those changes can be observed along the results-chain represented by the sequence of inputs-outputs-outcomes-impacts. It also informs the general (or overall) and specific objectives. The overall objectives are normally set at impact level. The specific objectives will generally be outcomes, but can include, if appropriate and on an exceptional basis<sup>91</sup>, induced outputs which make the link with outcomes.

The IL also communicates the expected outputs (both induced and direct outputs). During the design and conception phase of a budget support contract, it allows structuring the result chain which the programme is expected to trigger.

During implementation, the IL becomes a reference to monitor progress and guide the policy dialogue and performance assessments. At the end of implementation, in the final report, the IL is a reference point for reviewing the results achieved. Evaluations, using the agreed OECD DAC framework, refer to the intervention logic. The IL therefore constitutes an important accountability tool.

The budget support IL differs from that of a standard project because budget support is not a programme or policy in itself, but a means, by interacting with others, to enhance the formulation and implementation of a policy by a partner country. One consequence is that the results matrix appendix of the action document does not constitute a rigid reference for evaluations to determine whether a budget support contract was successful.

The basis for the IL is usually the country's policy monitoring framework for the public policy concerned. The framework is used both for conditionality purposes (to inform the general and, when applicable; the specific conditions) and for monitoring purposes through the intervention logic. In practice there will be overlaps between both uses, but there are important differences and the intervention logic is not used for conditionality purposes. Conditionality assumes a sufficient degree of government control and influence at least in the short to medium term. Hence, indicators are normally not impact related. Monitoring results implies an additional focus on the final impact of government actions also in the longer term. It is important to focus the policy dialogue not exclusively on conditions, but rather, using the IL, on the whole chain of results (see also annex 13). Finally, note that where the quality of the existing performance monitoring framework is considered insufficient, delegations should

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<sup>90</sup> Compared to a logical model represented through either a diagram or a table matrix, the theory of change presents a wider and more complex understanding of the process that -from the inputs- should lead to the outcomes and impacts, including the assumptions, the context and the non-programme factors (both policy and non-policy related factors) that are expected to interact with - and contribute to - the process.

<sup>91</sup> For example, in the case of public finance management or public sector reform programmes where outcomes may be less directly identifiable.

use the identification and formulation phases to look for opportunities to improve the performance framework<sup>92</sup> and agree on the key expected results (see also annexes 3 and 8).

### The Budget Support Intervention Logic levels

The IL is based on the OECD DAC comprehensive evaluation framework for budget support evaluations as presented in the intervention logic chapter of the guidelines (see section 2.6). Based on the expected longer term impact (or ‘overall objectives’) foreseen by the partner country in their respective strategy, the IL identifies the necessary steps to which budget support intends to contribute.

The **impact** or overall objectives relate to the intermediate and longer term changes in the socio-economic environment, to which budget support is expected to contribute.

The intermediate steps include:

- i) the **outcomes**, i.e. a number of positive changes in the living conditions and behaviour of the targeted beneficiaries (for example in the education sector these could be improvements in enrolment, pass, dropout, repetition and completion rates, qualified labour force...), which are likely to lead to longer term impacts (for example in the education sector, learning achievements and literacy rates). In the health sector, examples include percentage of births in health facilities or immunization coverage. Other examples of outcomes include increased business confidence, private sector investment, number of businesses registered, or an improvement in corruption perception. In certain cases, outcomes can also include behavioural changes at the organisational level constituting a response by institutional actors (for example in the public administration reform area these could be the increase in prosecution of cases of corruption, that would open the way toward longer-term impacts, such as the decrease of corruption perception);
- ii) the **induced outputs**, i.e. a number of policy and institutional changes that should facilitate the achievement of such outcomes. Some examples are an increase in the number and quality of schools; pupil/teacher or pupil/textbook ratio, health facilities coverage; the improvement of the institutional and legislative framework on prevention and repression of corruption; improved PFM systems; degree of supreme audit institution independence; and improved business environment (e.g. related legal, regulatory and institutional frameworks, and new services). The focus is on institutional improvements and not on their use by the final beneficiaries, which is part of the outcomes;
- iii) the **direct outputs**, i.e. the country opportunities that are expected to improve as a direct consequence of the deployment of budget support inputs, e.g.: the new fiscal space created by the transfer of funds; increased predictability of funds, reduced transaction costs, a more aligned and coordinated policy dialogue and capacity strengthening activities conducive to reforms; improved monitoring and reporting of reforms; the products or services delivered by the complementary support measures; and
- iv) the budget support **inputs** necessary to create such opportunities: funding, policy dialogue, disbursement conditions<sup>93</sup> and complementary support measures<sup>94</sup>.

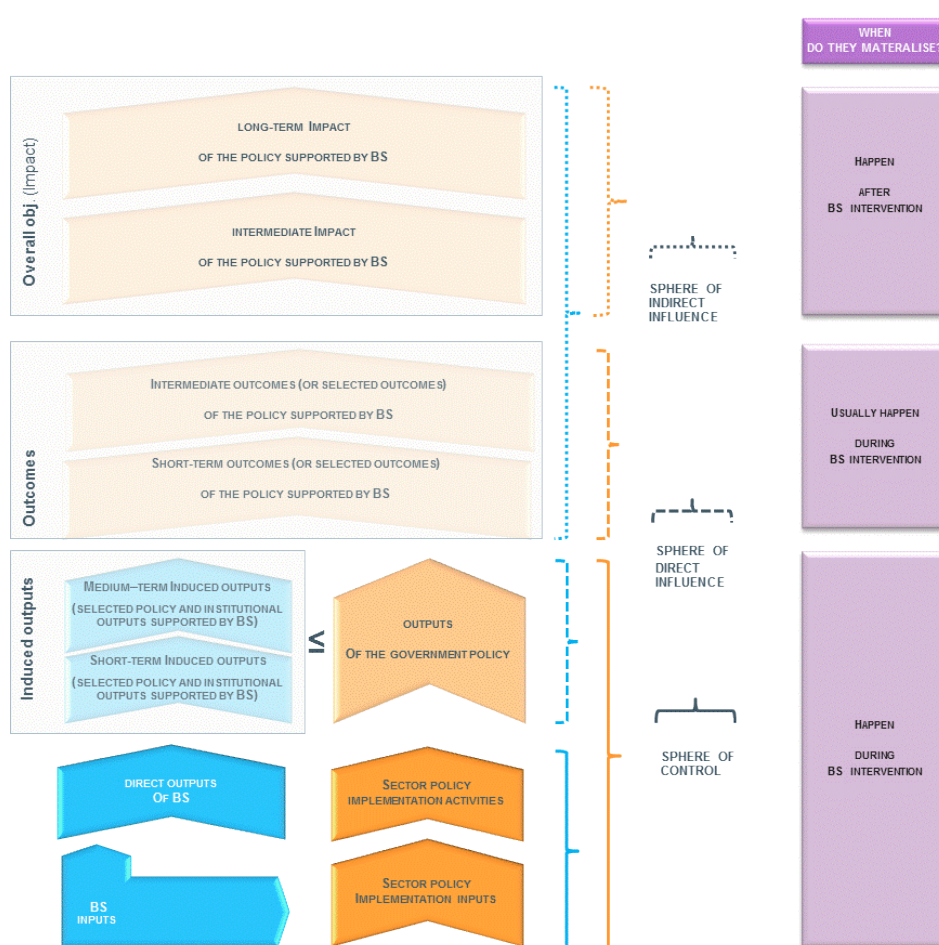
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<sup>92</sup> This can be done for example by including one or more conditions related to the set-up and functioning of government-led sector monitoring systems in the variable tranches and/or by providing complementary support in the form of capacity development measures in this area.

The IL narrative should highlight the results chain but also the assumptions and the expected interaction with other institutional processes, including contextual and external factors. The design of the intervention logic of a budget support has a number of specific features to reflect the fact that **budget support is not a programme or policy in itself, but a means among others to enhance the implementation of a policy by a partner country**. This has a number of conceptual and practical implications in terms of:

i) The introduction of an additional layer of results obtained by splitting the level of outputs into direct outputs and induced outputs in order to distinguish between (a) the direct outputs of the budget support contracts, and (b) the induced effects of these direct outputs on government's policies and spending actions. This distinction emphasises the fact that there are two key categories of actors, development and country partner(s), each of which exercises a linked but different degree of control and influence over each level of results.

### Budget support partners' intervention logic levels & spheres of control and influence



*Legend: The brackets in blue refer to control and influence of budget support external partner on the budget*

<sup>93</sup> Conditions are classified among the inputs as they are part of the dialogue framework, and define the financial incentive mechanism of a contract.

<sup>94</sup> This will typically include one or more of the following: i) capacity development measures aimed at strengthening the capacity of the public institutions to coordinate, implement, monitor, evaluate and communicate the public policy in question; ii) capacity development measures aimed at strengthening the capacity of civil society to contribute to the implementation and monitoring of public policies; iii) monitoring, evaluation and supervision TA of the EU-funded action; and iv) support for the design and implementation of a visibility and communication strategy.

*support results chain (the left one). The brackets in orange refer to control and influence of budget support country partner on the sector policy results chain, including budget support. A budget support contract should be aligned with the strategy of the partner country's institution(s), with which it shares the outcomes and impacts, and with which it coordinates the inputs and the different levels of outputs, so as to ensure the maximum synergy of action.*

ii) The strategic relevance of the budget support results' chain which must be aligned with that of the partner country (and coherent with the objectives of the EU strategy in the region/country), in particular at the higher levels.

This means that the overall and specific objectives (impacts and outcomes) of the contract must reflect the broad development goals and/or sector specific objectives of the governments' policies which are supported by the EU, as they are coherent with the EU regional/country strategy and are adapted to the context. In practical terms, the intervention logic of each budget support intervention will reflect a broader or narrower selection of the partner government's policy objectives depending on whether the intervention is geared to support a specific sub-sector policy or a broader national development policy.

iii) The overarching importance of the analysis of the context and of the various stakeholders involved, as these will not only influence the design of the budget support contract but will also affect and be affected by the whole sequence of effects across the results' chain.

iv) The importance of the assumptions, i.e. the basic conditions that are supposed to exist and remain in place (or be put in place) during the implementation of the budget support contract for the IL to materialise according to its original design. When designing budget support contracts, the general conditions are made explicit and are the subject of systematic monitoring and reporting. Other assumptions may be added according to the specific contracts.

v) The need for a strategic approach to risk management to mitigate risks in a comprehensive way (see annex 7).

## **Presentation of the Intervention Logic**

The different levels of the intervention logic reflect the basic structure for the narrative in a dedicated section in the action document. This section should highlight the mechanisms which allow moving from one level to the next in the results chain, including the main challenges and the possible unintended effects. It should also identify some key assumptions, including the persistence of the mutual political commitment and the flexibility to respond to changes in the external context.

The appendix of the action document (AD) contains the results matrix which should provide in table format the chain of results from direct output to impact and related indicators, with baselines, targets and their relevant sources and means of verification. Indicators should be gender disaggregated whenever possible. By providing a clear and concise summary of the programme, including indicators, it supports monitoring/reporting on results, as well as management and evaluations thereby fulfilling obligations vis-à-vis the EU institutions (implementing regulations) and commitments at corporate level.



The budget support Intervention Logic as presented in the AD appendix indicative results matrix					
	Results chain	Indicators	Baselines (year)	Targets (year)	Sources & means of verification
Overall objective: Impact					
Outcome(s)					
Induced outputs					
Direct outputs					

Note that a description of inputs is not requested here as budget support inputs are considered relatively standard. It is important to note that the initial results matrix is purely indicative and may be updated. The budget support final report will present an update of the situation in terms of results. Evaluations will use the intervention logic structure and make use of an evaluation matrix with a set of evaluation questions and related indicators which is also likely to expand on the existing set of indicators depending on the specific needs.

In the case of NEAR, the diagram format is also stressed as it places the emphasis on the chain of the results, including the linkages between results within the same level and/or between levels and allows to better frame the contract within the broader context through a clear graphic reference to the main factors of the context / opportunity framework (enabling and hindering factors), together with risks and assumptions.

## Annex 3 – Assessing public policy eligibility

### 1. Introduction

This Annex provides guidance on how to assess eligibility with regards to national or sector policies or strategies, hereafter simply referred to as *policies*, both during the design and implementation of budget support contracts. Such an assessment can draw on the analysis provided for the assessment of national/sector plans as a basis for the programming of EU assistance bearing in mind that budget support contracts may refer only to a subset of national plans and that eligibility must still be demonstrated in accordance with the guidance provided here. A satisfactory conclusion regarding the use of national/sector development plans as a basis for EU programming does not automatically imply public policy eligibility for budget support. In assessing public policy eligibility, it should be specified that budget support is the most appropriate modality to support the partner country within the selected sector.

Depending on the form of budget support, the policies to be assessed will differ. For SDG-Cs, the national policy and budget should be assessed with a particular focus on the areas linked to the specific objectives. Similarly, for SRBCs eligibility refers to the national policy or a "transition compact". In fragile countries, there might not always be a fully-fledged national policy. In such cases, the EU Delegations can refer to the process and progress of formulation of such a policy or a "transition compact" developed under the "New Deal for Engagement in Fragile States"<sup>95</sup>. With SRPCs, sector policies and sector budget should be assessed, with a focus on sector reforms, improving sector governance and service delivery, including transversal policies that have an impact on the sector. A sector policy can be a stand-alone policy or encapsulated into a national policy. In the last case, EU Delegations should clearly identify the sectoral components of the national policy that the SRPC is supposed to support with the range of indicators and elements for dialogue and capacity building.

Eligibility is assessed on the basis of the relevance and credibility of the policy. Relevance refers to the overall objectives and how the policy responds to the specific challenges identified. Policy credibility depends on the track record in policy implementation and service delivery, policy financing, institutional capacity and ownership, and the quality of data and analysis underlying the policy.

### 2. The Eligibility assessment during design

The eligibility assessment should closely follow the template and guidance provided below.

#### 2.1. Policy framework

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

- **Policy Content and Formulation:** What are (very briefly) the main elements of the policy? Where is the policy defined<sup>96</sup>? What is the period covered and how does it

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<sup>95</sup> The New Deal approach was endorsed in Busan by the EU and its Member States, focusing on the importance of restoring vital state functions, security, justice, economic foundations, basic social services and addressing vulnerabilities.

<sup>96</sup> Policies are usually formulated in a formal strategic document, approved by the Executive. However, other documents such as manifestos can provide complementary information. Where the policy gives little information on financing, this might be obtained from other sources such as the budget or MTFF, or even budget speeches.

correspond with political cycles or other policy processes? What has been the approval process and who could credibly implement planned reforms? To what extent have different national and sub-national public and private stakeholders been involved in the policy formulation process?

- **Monitoring and Evaluation system:** does the policy document include SMART indicators and yearly targets which can provide the basis for monitoring progress? Is there a system for collecting, processing and analysing the information and the data produced during the review process? Is the monitoring of the policy consistent with monitoring of other policies within a country monitoring and evaluation system? Are the policy, its objectives and the progress reports publicly available and subject to domestic accountability (e.g. parliament)? Who has the responsibility for drafting, approving and publishing the monitoring reports? How often are they produced? What is their quality? Do they give clear account of the progress achieved against objectives and target indicators in the action plan?
- **Reform coordination mechanisms, including donor coordination:** is there an inclusive reform coordination structure that meets regularly? Does the reform coordination structure accommodate participation of cooperation partners or are other fora dedicated for coordination with cooperation partners? Does the structure incorporate an inclusive review of progress led by the Government? Are non-state actors actively involved in the reform monitoring process?
- **Is the policy coherent with other government policies?** Is there coherence between national and the sectoral or subnational policies targeted for budget support? Are intra-sectoral policies coherent? If country is undergoing public administration reform, especially reform of the overall policy planning system, how is the policy that is supported by budget support consistent with these horizontal reform efforts? Does the policy take into account decentralisation reforms and devolution of powers?
- **Is there a communication plan/strategy** to support the implementation of the strategy? How is coordination and coherence ensured between the government, EU and other donor communication activities?

#### Public administration reform and public policies

All countries, which have committed to the Sustainable Development Goal 16 and its targets, have *de facto* committed to public administration reform at some level. Especially the targets of reducing corruption and bribery, developing effective, accountable and transparent institutions at all levels, ensuring responsive, inclusive, participatory and representative decision-making at all levels. This also entails ensuring public access to information cannot be met without addressing necessary reforms in different aspects of public administration – its civil service, policy planning and policy-making procedures, accountability structures, service delivery capacity and the public financial management system.

OECD/SIGMA has developed the Principles of Public Administration<sup>97</sup> in cooperation with the European Commission. They are being used in the enlargement context and in many European Neighbourhood Policy countries as a benchmark for improving the different aspects of public administration. The gap assessments (baseline assessments) against the Principles of Public

<sup>97</sup> See <http://www.sigmaweb.org/publications/principles-public-administration.htm>.

Administration have provided the basis for a number of countries to develop public administration reform strategies and for engaging in more comprehensive and sequenced reforms.

In line with the targets of SDG 16 and as further defined by the Principles of Public Administration (Policy development and coordination area), national and sector public policies should be developed in an inclusive and evidence-based process by ensuring a participatory approach that involves concerned stakeholders. In practice, draft policies should be subject to inter-ministerial and public consultations in the right time of the process. The policies should be developed on the basis of evidence through fiscal and regulatory impact assessments. Also, in order to be responsive, public policies should be regularly monitored, and appropriate action should be taken by authorities to ensure that policies are meeting their intended purpose. Public policies should also be communicated both internally and externally.

Capacity of civil service and accountability structures within public administration and towards citizens also impact the quality of public policies. Unclear accountability lines between institutions (especially ministries and agencies) contribute to fragmented policies. Also, policies are fragmented where the civil service has weak capacity and lacks the necessary skills for proper policy formulation in line with the inclusive and evidence-based approach, policies are fragmented.

In those countries where the horizontal public administration reform efforts address accountability of administration, professionalisation of the civil service and an inclusive and participatory policy development system, the designers of budget support should verify that the planned support to national or sector public policy is fully in line with horizontal reform efforts. In those countries where there is no comprehensive public administration reform strategy but where there is a commitment to meeting the SDG 16 targets, the designers of budget support should promote a more inclusive and evidence-based approach to development of public policies, including having a coherent country monitoring and evaluation system.

## **2.2. Policy relevance**

Delegations should **assess to what extent the policy is relevant to the overall objectives, as well as the specific challenges and objectives identified** in relation to the country context. Specific objectives will differ depending on the country context and the public policy the budget support contract is in support of. In general terms, SRBCs are expected to focus on state building and strengthening societal resilience, SRPCs on sector reforms and public service delivery, and SGD-Cs on selected priority areas in the national policy.

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

- What is the policy's contribution to **sustainable and inclusive growth**? Such an impact can be more directly targeted, through a focus on the business environment, employment and productivity, but also indirectly, for example through social policies that have a longer term impact on inclusive growth. Is the policy likely to influence the poverty incidence of growth? Does it include specific social protection measures to ensure growth is inclusive? Will the policy contribute to the protection and sustainable use of natural resources and energy efficiency? Will the policy reduce economic vulnerability, by strengthening resilience to economic shocks or natural disasters? Are expenditure allocations and domestic revenue mobilisation policies consistent with the sustainable and inclusive growth objective?

- SRPCs, but also relevant SDG-Contracts and SRBCs, aim at supporting **sector<sup>98</sup> reforms and public service delivery**. To what extent does the policy aim at improving inclusive access and use of quality services with a particular focus on frontline service delivery for vulnerable groups?
- To what extent does the policy aim at strengthening **domestic accountability and national oversight mechanisms** as a basis for improving governance?
- To what extent does the policy contribute to the adaptability of states, societies, communities and individuals to political, economic, environmental, demographic or societal pressures, in order to strengthen resilience and sustain progress towards national development goals?
- Will the policy contribute to further progress in **crosscutting areas** such as gender and youth?
- In the **enlargement context**, does the policy support the partner countries in implementing the political, institutional, legal, administrative, social and economic reforms required to bring the countries closer to EU values and to align to EU rules, standards, policies and practices with a view to EU membership?

Other Annexes provide further guidance on specific policy objectives related to **state building in fragile situations**, addressing the particular development challenges of **SIDs and OCTs**, and strengthening **domestic revenue mobilisation**.

### 2.3. *Policy credibility*

Policy credibility will depend on realistic planning and: (i) the track record in policy implementation and service delivery; (ii) policy financing; (iii) institutional capacity and ownership; and (iv) the quality of data and analysis underlying the policy. Note that there may be cases where a policy is broadly credible except that it lacks realism in terms of the time it will take to reach the policy objectives and specific targets. This should be clearly noted in the eligibility assessment and reflected in section 4 hereafter, which covers expected progress.

#### 2.3.1. *Track record in policy implementation*

The basis for verifying policy implementation is expected to be the progress report produced by the partner country, the related monitoring or performance framework, and budget execution reports. However, where important other information sources are available, such as surveys, evaluations or NGO reports, these should also be considered. Delegations should appraise past progress in the area(s) covered by the policy. Have lessons learned been taken into account for the formulation of this policy? **Is there a positive trend in overall performance** and are the results sustainable? If not, does this undermine the credibility of the policy, or were important external factors at play?

#### 2.3.2. *Policy financing*

Costing or budget analysis should be undertaken on the basis of the available budget classifiers (see below). Reference can be made to the PEFA pillar on policy-based fiscal

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<sup>98</sup> Note that the scope of a sector can vary from a more complex cross-ministerial or multi-institutional setting to a narrower "sub-sector" focus.

strategy and budgeting. Other sources include the budget documentation (including MTEFs, Public Investment Plans) and Public Expenditure Reviews. A budgetary analysis should include the following aspects:

- **Policy costing:** were appropriate cost estimates prepared for the policy, based on outputs or programmes? Was costing applied in an incremental logic or through more complex methodologies analysing cost drivers? Have the recurrent-cost implications of investments been taken into account? Were any potential savings considered? Do sector strategies have multi-year costing of recurrent & investment expenditure, and linkages between investment budgets and forward expenditure estimates?
- **Policy financing: consistency between the policy and the budget/MTEF<sup>99</sup>:** based on cost estimates of the policy, are the budget/MTEF sectoral and intra-sectoral allocations considered appropriate for a successful implementation of the policy and do they reflect the targeted outputs of the policy performance assessment framework? Do the allocations reflect 'value for money'? Does the investment budget reflect policy priorities? Is there an appropriate balance between recurrent and investment expenditure, and between wage and non-wage expenditure? Have policies and their expenditure needs been prioritised appropriately to deal with financing shortfalls? Based on past budget execution, is the budget a reliable indication of expected spending in the policy area?
- **Budget comprehensiveness:** references to the latest PEFA assessment should be made in this context. In particular, does the budget cover only central government or are local government and other funds (e.g. social security) also included? To what extent is the exclusion of other sectors of general government critical (e.g. share of total expenditures or GDP). What is the role of State Owned Enterprises? Do estimates exist of the extent of off-budget expenditures (e.g. aid-financed expenditures) and revenues (e.g. development assistance or user charges) and have these been considered in the policy?
- **Financial sustainability:** is there a risk that an important part of the policy will not continue to be financed in the future? Is projected expenditure consistent with the macroeconomic budget constraint? Could contingent liabilities or arrears affect financial sustainability? Are external financing projections credible, particularly for aid dependent countries? Are the recurrent cost implications of capital expenditure taken into account in medium-term projections?
- Where relevant, **fiscal decentralisation:** does an allocation and transfer mechanism exist consistent with decentralisation policy? Is there consistency between budgetary allocations to sub-national entities and their functional mandates in accordance with the legal framework underpinning fiscal decentralisation?

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<sup>99</sup> In the absence of a MTEF, which is not a formal eligibility requirement, the credibility of existing sector financial projections or policy costings should be verified based on past budgetary allocations and expenditure, and expected revenues. If the policy is not costed, delegations can still appraise consistency between the policy and the recent budget allocations based on rough estimations and whether the partner country has a positive track record in financing its policies.

### **The use of budget classifiers**

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

#### *2.3.3. Institutional capacity and ownership*

Sound context analysis of policies and institutions is an important element, including relevant stakeholders outside the government's sphere. Who are the main stakeholders for the implementation of the policy in question? While the key formal interlocutors relevant to policy reform are the ministries in charge of implementing the reform, they should also include the Ministry of Finance, which provides the link between the budget and the strategic budget allocations, and the key institutions responsible for the overall public administration reform in the country (i.e. Centre of Government institutions and Ministry of Public Administration or similar). These institutions are usually responsible for setting the framework for the overall reform/reinforcement of strategic planning, human resource systems, accountability systems and the monitoring and evaluation frameworks. Other stakeholders include oversight and accountability institutions (parliament, State Audit Institution, independent regulatory bodies, Ombudsperson), civil society organisations, political parties, other donors/cooperation partners, international organisations present in the country, private sector organisations, academia and subnational government entities.

**To what extent is institutional capacity considered to be sufficient to implement the policy?** Do capacity assessments exist for the ministries or agencies in charge of the policy and/or for the national civil service as a whole<sup>100</sup>? Are policies in place to strengthen public sector capacity? In cases where a substantial part of the policy response is implemented by sub-national entities, are these considered to have sufficient implementation capacity? EU Delegations should not only look into the number and capabilities of the human resource capacities of specific institutions, but should also consider the governance structures for the specific policy, especially whether unclear accountability and supervision lines between institutions (especially ministries and agencies) result into fragmentation of supported policy. Another aspect is the quality of inter-institutional coordination.

**What indications exist that the policy is sufficiently owned by the institutions that have to implement the policy and their political leaders?** Delegations may include elements of Political Economy Analysis (PEA) as a basis for reaching a conclusion on ownership.

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<sup>100</sup> Relevant information can also be found in Civil Service Commission (or equivalent) reports on headcounts, qualifications and structures to give an overview of current human resource capacities.



#### 2.3.4. Analytical basis and data quality

Before starting budget support contracts based on a series of performance indicators, delegations should appraise the quality of national statistical systems including the institutional set-up, and if applicable, sector statistical units. What is the degree of data availability, reliability, and timeliness? Does the institution responsible for statistics concur with the data produced during the policy review? **Are the weaknesses affecting statistical systems significantly undermining the validity of the objectives and targets stated in the policy?** Are weaknesses being addressed? What analysis or studies informed the policy? **Is the quality of the analytical basis underlying the policy sufficient not to undermine the credibility of the policy?**

#### 2.4 Expected progress in policy implementation

This section should specify the main basis for monitoring progress in policy implementation. Normally, such basis is provided by the **monitoring and evaluation system and/or the review of the performance assessment framework**, led by the responsible authority, in coordination with development/cooperation partners. Delegations are expected to refer to the documents produced in this context so as to monitor eligibility but should express a justified opinion on the validity of its conclusions.

**Where the quality of the existing monitoring framework is considered insufficient, delegations should in this section spell out how eligibility will be monitored**, in agreement with the partner country and in coordination with other donors. Particularly, which are the key issues that will be assessed in order to monitor eligibility and what progress is expected before the next disbursement? In this case, complementary measures should ensure that the policy is strengthened with a quality monitoring and evaluation framework, and ability of the partner country to produce good quality progress reports which can facilitate informed policy dialogue between the stakeholders, support the national accountability processes and serve as the bases for evidence based decision making.

#### 2.5 Conclusion: Appreciation of eligibility

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

### 3. The eligibility assessment during implementation

In the public policy chapter of each disbursement note (see intranet for template) delegations should appraise whether the public policy eligibility criterion continues to be satisfied. Specifically, **does the policy continue to be sufficiently relevant and credible, and has there been satisfactory progress in policy implementation** since the last eligibility check, taken into account external factors or exogenous shocks?

Analysis of budget allocation and execution (recurrent, capital) with regard to the sector or national policy in question should assess whether budgeted expenditure is adequate for the attainment of policy objectives and to which degree budgeted expenditure has actually been implemented. In case of significant deviations between initially approved and actually

executed expenditure the underlying reasons have to be identified. Sources of information can be the approved budget and budget execution reports.

The basis of the assessment should be progress report produced by the partner country, where possible. Where available, attachments to the disbursement note should include a summary table of progress against selected performance indicators (cf. section 5). Delegations should refer to the progress report and performance assessment framework where applicable, but other relevant information sources such as survey results, evaluations, or NGO reports should also be taken into consideration to reach an informed and justified conclusion on progress rather than a mechanistic calculation based on the number of indicators met. Delegations can refer to existing review documents to monitor eligibility but should express a justified opinion on the validity of its conclusions.

**In case of a new policy framework, the initial assessment of the policy relevant and credibility needs to be performed again.** Where existing policies are subject to substantial budgetary revisions or substantial revisions in indicators or targets, these should equally be considered, especially affecting the indicators selected for the variable tranche.

## Annex 4 – Assessing macroeconomic eligibility

### 1. Introduction

This annex provides guidance for setting out a structured assessment of the macroeconomic eligibility criterion for budget support, with regard to the relevance and credibility of the macroeconomic policies pursued by the partner country. Additional background on some specific macroeconomic dimensions is provided in three appendices hereafter.

The assessment should:

- summarise the evolution of the main macroeconomic aggregates and stress the potential sources of instability that would endanger the strength and the persistence of growth, or the return to a stable macroeconomic outlook, including debt sustainability;
- briefly describe the macroeconomic and fiscal policies in place and their contribution to maintaining or achieving macroeconomic stability over the short and medium term; and
- assess the country's vulnerability to external shocks and efforts to strengthen macroeconomic resilience.

The analysis by the Delegation should make use of national documents, of the latest IMF assessment (e.g. Article IV report or programme review document), of the Economic Reform Programmes (ERP) and related Commission assessment in the case of the Instrument for Pre-Accession Assistance (IPA) beneficiaries, as well as the assessment of DG ECFIN for countries having an EU macro-financial assistance programme. If there was no recent IMF assessment or this assessment was deemed insufficient, the Delegation should look for assessments by other international financial institutions (e.g. World Bank) with information in relation to the following questions:

- Are the authorities implementing policies aimed at macroeconomic stability?
- Have domestic or external factors required a macroeconomic policy adjustment?
- If so, what has been the policy response? Is the new policy stance still stability-oriented?

The assessment should take into consideration that there is no 'single' stability-oriented macroeconomic policy in a given situation and that the authorities generally have to face conflicting objectives. The country context (in particular in fragile or transition situations and small island developing states), the available resources and institutional capacities to implement the macroeconomic policy and other short term social and economic priorities should be taken in account when assessing those medium term oriented efforts.

### 2. Information expected in the action document and in the disbursement note<sup>101</sup>

*NB: Required data is normally available in national official documents, if any, in the ERP for the IPA beneficiaries and by default in documents produced by the IMF, the World Bank or other international organisations. The relation of the country with the IMF and the analysis by this institution of the macroeconomic policy orientation are essential aspects to consider when assessing the eligibility criterion. The analysis, in particular the assessment of the credibility of the policy stance, should also be informed by regular dialogue between the Delegation and the national authorities, as well as with the IMF, any other relevant international organisation or local stakeholder. In the context of middle-income countries, the*

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<sup>101</sup> Refer to the latest templates of action document and of disbursement note on the intranet.

*assessment by rating agencies may also be helpful. For countries with an EU macro-financial assistance programme and for all candidate countries and potential candidates having an on-going Economic Reform Programme, the assessment of macroeconomic stability from DG ECFIN should be the main reference document.*

- ***Relations with the IMF***

The mandate of the IMF is to advise and help member countries in implementing macroeconomic and financial policies that promote stability, reduce vulnerability to exogenous shocks, and encourage sustained growth and high living standards as well as poverty reduction. The quality of the relationship with the IMF is of primary importance, while not necessarily decisive, for assessing the eligibility of the country to budget support.

The relationship with the IMF<sup>102</sup> should therefore be described (regular consultation as per Article IV, credit arrangement, policy support instrument or staff monitored programme<sup>103</sup>).

The analysis by the Delegation would typically provide information such as:

- the completion date of the last programme review, Article IV consultation or technical mission and the planned date for the next review;
- if relevant, details about the IMF programme (e.g. timeframe, amount, last instalment);
- the main conclusions of last IMF staff report and last IMF Board meeting;
- the commitments and announcements by the authorities in this context;
- diverging views, if any, between the IMF and the authorities (e.g. forecasts or measures).

As relevant, this analysis could be complemented by similar information about the assessments and activities of other financial institutions (e.g. World Bank or Regional Development Bank). For countries with an EU macro-financial assistance programme and for all candidate countries and potential candidates having an on-going ERP, the assessment and schedule of reviews by ECFIN would be equally important.

- ***Key macroeconomic indicators***

The following key indicators should be presented in a summary table to provide an overview of the latest macroeconomic developments and describes the macroeconomic outlook<sup>104</sup>. They would substantiate the analytical narrative developed thereafter to assess the eligibility.

**Indicative list of key indicators (to be adapted to the country context)**

Indicator	Year n-3	Year n-2	Year n-1	Year n	Year n+1 (forecast)	Year n+2 (forecast)
Real GDP (% change)						
GDP per capita (% change)						
Inflation rate (Consumer Price Index)						
Unemployment rate (if available)						
Investment (% GDP)						
Total revenue (% GDP)						

<sup>102</sup> Such information is provided on the country page on the IMF website (<http://www.imf.org/external/country/index.htm>).

<sup>103</sup> For details about the various instruments, consult the IMF website (<http://www.imf.org/external/np/exr/facts/howlend.htm>).

<sup>104</sup> The table is requested for the disbursement note. However, in the action document, it may be more appropriate to provide a narrative only due to space constraints. Other indicators may be added, if relevant.

- Tax revenue (% GDP)						
- Non-tax revenue (%GDP)						
- Oil revenue (if relevant)						
Total expenditures (% GDP)						
- primary expenditures						
- interest payments						
- capital expenditures						
- social transfers (if relevant)						
Net lending/borrowing (% GDP)						
Gross debt (% GDP)						
External debt or debt in foreign currencies, [public/private] (% GDP)						
Debt Sustainability Analysis (DSA) rating (if available)						
Exports (% change)						
Current account balance (% GDP)						
Reserve coverage (months of imports)						
Remittances (% GDP)						

- ***Assessment of the macroeconomic framework, key vulnerabilities and efforts towards greater macroeconomic stability***

The relevance of macroeconomic policies should be assessed with respect to macroeconomic imbalances<sup>105</sup> and debt sustainability<sup>106</sup>. The overall orientation of the macroeconomic policy stance, in a short and medium term perspective, is outlined in national public documents. These include medium term fiscal/expenditure financial framework, budget statements, budget execution reports, or central bank announcements, the letter of intent signed by the authorities in the context of credit arrangements with the IMF, the IMF reports (Article IV consultation or review of credit arrangements), the Economic Reform Programmes in the enlargement context and often in reports by other international financial institutions.

The analysis is expected to focus on fiscal policy, including debt sustainability. The assessment should also cover real sector developments (growth, employment), monetary sector (price stability, interest rates), and external sector (balance of payments, exchange rates)<sup>107</sup> and the interactions between these. An analysis of the financial sector may also be provided, including banking supervision and the path of financial sector reforms, because of the high relevance of these aspects for assessing macroeconomic risks and also for the fiscal side. The Delegation would, in general, rely on the IMF analysis for this purpose.

The Delegation should also pay attention to the policy track record and the capacities of the key economic governance institutions – such as the Ministry(ies) of Finance and Economy, the Central Bank, the Revenue Agencies, the Fiscal Council and the Statistical Office – as well as their abilities to work in a coordinated manner to ensure macroeconomic stability.

- ***Conclusion***

**Based on the analysis, it is concluded that the authorities are [are not] pursuing a stability-oriented macroeconomic policy.**

<sup>105</sup> Refer to Appendix A for some considerations as regards fiscal policy, shocks and inflation.

<sup>106</sup> Refer to Appendix B for further background on debt sustainability.

<sup>107</sup> Refer to Appendix C for some explanations about external accounts.

## Appendix A

### Considerations on fiscal policy, external price shocks and control of inflation

Fiscal policy should be analysed with the view of ensuring macroeconomic stability and for its resource allocation purpose. Expenditure composition can have implications for sustained broad based growth, fiscal sustainability, efficiency and distributional aspects. The assessment could include the following questions: is the existing fiscal policy stance consistent with stabilization purposes (e.g. for external imbalances or inflation)? Is fiscal policy adequately coordinated with monetary policy? What are the recent revenue and expenditure trends? Are expenditure and revenue policies and public debt on a sustainable path? Is the overall fiscal policy consistent with medium term growth and other key development objectives? Does fiscal policy contribute to fighting inequalities, addressing geographic disparities and promoting gender equality?

The revenue side must be considered according to its structure, recent dynamics and potential medium term implications. Relevant tax policy shortcomings, tax expenditure and arrears could be discussed. Recent or planned tax policy reform initiatives may be highlighted in the context of the broader fiscal strategy being pursued by the authorities. Regional integration and trade liberalisation processes or, on the contrary, protectionist measures should also be considered with respect to duties and taxes (e.g. VAT and excises) perceived by customs. The equity of revenue/tax policy is also of high importance<sup>108</sup>.

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

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

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

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

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<sup>108</sup> For further background on domestic revenue mobilisation, refer to Annex 11.

## Appendix B

### Debt sustainability

Debt sustainability relates to debt and debt service levels relative to country's repayment capacity. Debt stock indicators provide a useful measure of the total future debt-service burden of existing debt. Debt-service indicators provide a measure of the immediate burden that debt imposes on a country by crowding out other uses of scarce resources. Repayment capacity is measured against GDP, exports of goods and services, or government revenues. For most low-income countries, the analysis focuses on the public external debt but, as domestic capital markets are expanding, the overall public debt must also be considered.

Measuring repayment capacity depends on the constraints which are the most binding on each country. Present value debt ratios are indicators of the burden represented by the future obligations of a country and thus reflect long-term risks to solvency, while the time path of debt-service ratios provides an indication of the likelihood and possible timing of liquidity problems<sup>1</sup>. If the debt stock and debt service grow persistently faster than the revenue base underpinning repayment, this will unavoidably result in a liquidity or solvency crisis.

A current deficit – either external or fiscal – should therefore be assessed in relation to the existing level of debt and the change of the debt that it will mechanically induce compared to the expected growth rates in revenues (debt to revenue ratio). Debt sustainability puts a constraint on the acceptable size and desirable evolution of the current deficit. An increase of the fiscal deficit, that would look desirable to sustain activities, in the case of an adverse shock, may have to be rejected because of debt sustainability concerns.

The information to be provided by the Delegation should draw on the assessment by the IMF and the World Bank<sup>109</sup> and on the Economic Reform Programmes in the enlargement context. IMF/World Bank debt sustainability analysis (DSA) assesses the outlook for debt sustainability based on current policies (baseline). The DSA includes sensitivity analysis to a set of standard shocks. Risks stemming from public investment and contingent liabilities (e.g. state-owned enterprises, public-private partnerships) are also considered. The DSA covers total public debt, i.e. both external debt and domestic debt. Arrears are explicitly taken into account. The DSA differentiates market-access countries, that typically have significant access to international capital markets, and low-income countries, which meet their external financings needs mostly through concessional resources. The assessments of public and external debt sustainability are conducted in the context of IMF surveillance.

The analysis leads to an informed opinion about debt burden thresholds (debt and debt-service burden as % of exports, GDP and revenue) taking account of the institutional capacity of the country to manage debt on a sound basis<sup>110</sup>. It classifies countries in low, moderate, high risk of debt distress or in debt distress.

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<sup>109</sup> Refer to IMF website (<https://www.imf.org/external/pubs/ft/dsa>).

<sup>110</sup> The Debt Performance Assessment tool (DEMPA) can analyse government capacities in this respect (see <http://www.worldbank.org/en/topic/debt/brief/dempa-2015>).



## **Appendix C**

### **Assessing external accounts**

Two tables are central to assessing external accounts: the standard 'Balance of Payments' table and the summary table 'External Financing Requirements and Sources' as calculated by the IMF.

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

The 'external financing requirements (requirement: -) include the current account balance (deficit: -), the increase or intended change of international reserves (increase: -) and the financing requirement stemming from debt amortization (debt repayment: -). There are two types of external financing: private flows (inflows: +), subdivided into forecast FDI minus reversible investment in productive capital and other private flows, representing investments in short, medium and long term financial assets; and the contribution of the IMF and other official flows.

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

## Annex 5 – Assessing public finance management eligibility

The Commission considers a country to fulfil the Public Financial Management (PFM) eligibility criterion for budget support *contract approval* when a credible and relevant programme to improve PFM (including domestic revenue mobilisation/DRM) can be demonstrated to be in place. For tranche *disbursements*, eligibility will be fulfilled when there is satisfactory progress in the implementation of the PFM reform. Relevance and credibility of the reform programme should also be maintained.

Delegations should report their conclusions on the PFM and Budget Transparency and oversight eligibility criteria in the **action documents** and **disbursement notes** as instructed in the respective templates. These documents should provide the *essential* and *most up to date* evidence and present a justified conclusion on eligibility.

These summarised updates for each budget support contract should build on the complete analysis of eligibility conveyed in the Delegation's **PFM and Transparency Assessment Report**. PFM eligibility concerns both expenditure and revenue management. PFM weaknesses affecting budget support priority sectors should be highlighted. The Report also helps to identify PFM priorities for policy dialogue (see annex 13).

Delegations should *submit* their latest PFM and Transparency Report as:

- A supplementary document to the Action document for the formulation of each new contract; or
- An annex to each disbursement note of the Head of Delegation.

At the core of the PFM and Transparency Assessment Report are the **monitoring tables**, which set out the baselines, targets and the results achieved. The PFM monitoring table contains a selection of the country's PFM reform plan priorities, chosen by the Delegation for the purposes of monitoring budget support eligibility and steering policy dialogue. Progress in reform implementation should be assessed against that set of targets *as a whole*. Columns 4 and 5 should be updated regularly to convey the progress also reported in the relevant sections of the Action document and Disbursement notes to justify eligibility. The monitoring tables should be updated annually. It is recommended to align that update with the timing of the country's PFM reform plan (annual) monitoring review.

However, the frequency of the *update* of the full narrative of the PFM and Transparency Assessment Report is not determined by the individual budget support program cycles. It depends on the PFM risks reported in the latest country's Risk Management Framework, as follows:

- Every year, if overall PFM risk is substantial or high; or
- Every three years, if overall PFM risk is low or moderate.

If, in case of low and moderate risks, a new PFM strategy is produced before the end of the three year period, a new PFM report is required. If no new budget support contract is formulated, the PFM report can remain valid during the implementation phase beyond 3 years.

This annex of the Guidelines provides:

- A. A template of the PFM and transparency assessment report;
- B. Guidance on public finance management to fill in the template; and
- C. Background information on gender-responsive budgeting.

Specific guidance on domestic revenue mobilisation is provided in annex 11. Guidance on Transparency and Oversight is provided in annex 6. Those annexes explain key concepts, describe the scope of the eligibility assessment, list sources of information and suggest priorities for policy dialogue. Delegations should use them to build up their assessment and draft the action document and the disbursement notes, the Monitoring tables and the RMF as well as the PFM and transparency assessment report (although annexes 6 and 11 are not fully organised along the structure of the template below).

When filling in the template please be brief and analytical and avoid lengthy descriptions.

## A – Template of the public finance management and transparency assessment report<sup>111</sup>

### PUBLIC FINANCE MANAGEMENT AND TRANSPARENCY

#### ASSESSMENT REPORT [Country, Date]

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[Delegations should refer to the DEVCO/NEAR Intranet for the latest version of this template. Guidance on how to fill the template is provided **in this annex on overall PFM issues, in annex 6 on budget Transparency and in annex 11 on DRM**. The report should be concise and analytical. Indicative length is 12-15 pages (excluding monitoring tables and appendices). Sections 2 and 3 are devoted to PFM (covering both revenues and expenses). Section 4 is on Transparency. These sections first *describe* observed performance and then *assess* reforms against the criteria of relevance and credibility. Sections 1 and 5 convey the messages to be reflected in the Action document, Disbursement notes and policy dialogue. The Monitoring tables in Section 6 schematically show current performance and reform expectations, as a road map for future assessment of eligibility and policy dialogue.]

#### 1. Executive summary [1 page]

[Eligibility should be demonstrated by describing 1) how key weaknesses are being addressed and 2) results achieved since previous PFM and Transparency Report (as in the Monitoring Tables)]

#### 2. Diagnosis of the PFM system (including DRM) [2-3 pages]

--- Transparency will be dealt with under chapter 4 ---

##### 2.1 Key weaknesses [1 page]

[A limited number of weaknesses (as evidenced by the cited sources of information)]

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

[*Current* priorities as reflected in the authorities' key strategic and operational documents]

##### 2.3 Results since previous PFM Report [1 page]

[Progress in key outputs and measures against targets set in the previous monitoring table]

#### 3. Assessment of the Relevance and Credibility of PFM reforms [5-6 pages]

##### 3.1 Relevance [1 page]

[Demonstrate that each key weakness highlighted in section 2.1 is addressed by clearly identified reform objectives. Mention 'gaps' in the reform programme]

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<sup>111</sup> All mentions in brackets "[ ]" are to be deleted when filling in this template.

### **3.2 Credibility [2 pages]**

[Demonstrate that conditions exist to achieve the expected results (action plan with adequate sequencing and prioritization, resources, political 'buy in', institutional and monitoring arrangements). Address risk of corruption and fraud and capacity strengthening needs]

### **3.3 PFM sectorial aspects [1/2 -1 page]**

[Only as relevant, in case of specific PFM challenges in priority sectors not covered by the analysis of the overall PFM system]

### **3.4 Domestic revenue mobilisation**

## **4. Budget transparency and oversight [3-4 pages]**

### **4.1 Assessing the entry point**

**4.2 Key weaknesses in transparency and oversight of the budget** (including Table 1: Notes PEFA and OBI –see annex 6).

### **4.3 Objectives**

### **4.4 Budget transparency and oversight: baseline, objectives table**

## **5. Conclusion on eligibility [1 page]**

[Clearly state whether eligibility is met, with a brief justification]

### **5.1 Public Finance Management (including DRM)**

### **5.2 Budget transparency and oversight**

## **6. Monitoring table**

## **7. List of annexes to the PFM and transparency assessment report**

Annex 1. List of background documents consulted

Annex 2. Timing and availability of external Audit reports

Annex 3. Summary of PEFA scores

Annex 4. Matrix summarizing, by area and donor, the main institutional support actions.

## B – Guidance on public finance management

This note presents guidance to draft the PFM and Transparency Assessment Report following the structure of its template.

### 1. Executive summary [1 page]

Eligibility should be demonstrated by describing how key weaknesses are being addressed and results achieved (as reflected in the Monitoring Tables) *since the previous Report*. It is important to focus on the issues implying higher risks for the achievement of the budgetary objectives. It should be also highlighted what progress are expected in the short term (i.e. until next scheduled update of the Report). It should clearly and explicitly cover both expenditures and revenues (DRM) aspects. See below a list of recommended contents:

- Main weaknesses in the PFM system;
- Progresses in the implementation of PFM reforms *since the previous update of the Report* (including progress against annual targets, negative developments, overall direction of change, findings of the latest audits and assessments);
- Assessment of continued relevance of government's PFM reform program (including main outstanding challenges, and adjustments of the strategy if any);
- Assessment of credibility of government's PFM reform strategy;
- Delegation's conclusion on PFM eligibility;
- Delegation's conclusion on Transparency and Oversight eligibility; and
- Progress expectations (as detailed in the Monitoring Table).

### 2. Diagnosis of the system [2-3 pages]

The following subsection should clearly and explicitly cover both expenditures and revenues (DRM) aspects.

#### 2.1 Key weaknesses [1 page]

**This section should briefly outline a limited number (ideally less than ten) of weaknesses of the PFM system that appear to be affecting in the short-term and/or the medium-term the overall achievement of the three main fiscal and budgetary outcomes i.e. aggregate fiscal discipline, strategic allocation of resources and efficient use of resources for service delivery.** Lack of compliance with laws and regulations should also be highlighted. It should also explain why those weaknesses should be a concern.

The key weaknesses identified should be reproduced in Column 2 of the annexed Monitoring Table. Their description constitutes the baseline for future monitoring of progress.

In cases where there is absence of a budget, of a rudimentary treasury system<sup>112</sup> or of a mechanism for annual budget execution reporting, budget support will not be considered. Where such core functions exist but are weak, typically in fragile situations supported through State and Resilience Building Contracts, specific short term measures and additional safeguards would generally be required (see annex 9 of the guidelines).

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<sup>112</sup> Such a treasury system oversees and accounts for the main government revenues, and disbursements whilst also taking responsibility for cash management and government bank accounts.

## *Sources*

The findings from recent PFM assessments (using PEFA or other diagnosis tools such as TADAT, PIMA, MAPS, DEMPA or SIGMA baseline assessments) and from Supreme Audit Institutions reports (including the response from the government, legislative or oversight bodies) must be used as reference. However, the aim is not to replicate all conclusions from those assessments. Data source should be also mentioned, specifying whether it complies with international reporting standards<sup>113</sup>. The timing and availability of audit reports in line with statutory provisions should be summarised in Annex 2. All sources should be referenced in Annex 3. A summary of PEFA scores should be presented in Annex 4, including repeat exercises in order to show trends.

## *Scope*

Within the PFM system all sub-systems should be considered for any type of budget support contract: revenue administration, budget preparation, budget execution with cash management, procurement systems, investments, debt management, internal controls and internal audit, accounting and reporting, external audit and scrutiny. Links between the performance of those sub-systems should be also considered.

**Domestic revenue mobilisation** requires special attention, consistently with the 2011 Commission's Communication on Budget Support. This section should briefly outline the main weaknesses of revenue administration (both tax and non-tax). Section 3.4 of the template will evaluate the relevance and credibility of specific reforms in this area, based on guidance provided in Annex 6.

The analysis should address the central government's weaknesses. Where data is available, and there are considered major weaknesses, it should also cover off-budget expenditures and the wider public sector (parastatals and agencies) operations. In addition, the sub-national level should also be analysed in cases with a high degree of fiscal decentralisation<sup>114</sup>.

Where the Commission implements a **Sector Reform Performance Contract** or where the specific weaknesses of the financial management of a SRBC or SDG-C **priority sector** hinders the efficient use of resources for service delivery, those challenges should be outlined in section 4.3 below and included in the PFM monitoring table.

## **2.2 The Government's PFM Reform Programme priorities [1/2 page]**

This section outlines the *current* reform priorities as reflected in the authorities' key strategic and operational documents. Where there is a comprehensive and fully articulated PFM reform strategy document this can be briefly summarised in terms of its coverage, activities, and objectives. In countries where such a unified strategy document does not exist but a range of sub-system reforms are nevertheless being pursued then these should also be described in terms of the challenges that they seek to address and their objectives. It should be mentioned whether the PFM Reform Programme addresses Transparency and Oversight weaknesses as well as DRM initiatives. This section should be descriptive and brief. The assessment of the quality of the reform programs (relevance and credibility) is covered by section 3 below.

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<sup>113</sup> See, for instance, Government Financial Statistics reporting standards (see <https://www.imf.org/external/pubs/ft/gfs/manual/pdf/all.pdf>).

<sup>114</sup> This refers to high autonomy and discretion for the management of an important share of revenues and/or expenditures by sub-national governments.



A selection of the objectives of the reform programme addressing the weaknesses identified in section 2.1 above should be reproduced in the PFM monitoring table. This should cover both short-term objectives (columns 3) and medium term objectives (column 5).

### **2.3 Results since previous PFM Report [1 page]**

Consistent with the dynamic approach, this section is **the core of the PFM Report**. It should take as its starting point the articulation of the system improvements and reform expectations as set out in the previous PFM Report. The baseline for this assessment should be the previous PFM Monitoring Table which set out expectations in terms of both **performance** and **reform measures and actions**. If reforms have been unproductive, briefly explain why. Outline corrective actions or changes in the strategy adopted by the government during the period.

**PFM performance** should be monitored through **quantitative data on PFM outputs against annual targets**. As significant improvements in PFM systems can take time to show improved outcomes, and hence to engender movements across PEFA scores (e.g. from C to B), PEFA scores cannot be normally used for this purpose. However some of them can be monitored annually (e.g. aggregate expenditure outturn compared to budget PEFA PI-1. Budget execution performance (execution rates, particularly on sector management of funds) are reported by the Executive and audited by the country's Supreme Audit Institutions. Other examples of quantitative outputs are delays in external audit reports, extent of arrears or timeliness of bank reconciliation.

The second element is the **progress in the implementation of the strategy**. This section should therefore analyse the progress in individual measures and actions that were planned for the reporting period, comparing expectations with progress and highlighting emerging issues relating to the implementation or coherence of the strategy. Processes, plans and even commitments are also relevant in giving an indication of the direction of change. The analysis should link with updated information of section 3.2 as institutional factors, power structures and coordination arrangements have a significant influence on the implementation of reforms.

Report on highlights of the findings of the most recent audit report with implications for the overall PFM system. The emphasis should be placed on how **compliance issues** that may emerge give an indication of the performance of the system and the direction of change. A judgement may have to be made as to whether more critical findings are the result in deterioration in compliance (performance of the PFM system) or the increased capacity and independence of the audit authority. The **response from government** to audit findings should be reported. Describe the formal statutory process for treating audit reports (parliamentary scrutiny, parliamentary reports, executive response e.g. Treasury letter) and provide an account of the recent cycle of such reports, focusing on government's action.

### **3. Relevance and Credibility of reforms [3-4 pages]**

The following subsections should clearly and explicitly cover both expenditures and revenues (DRM) aspects.

#### **3.1 Assessment of relevance of reforms**

This section should arrive at a reasoned judgement as to the relevance of the PFM reform strategy (or joint relevance of a set of sub-system reform strategies). The continued relevance

of the current strategy should be re-assessed and any implications for a revision highlighted with every new evidence of progress in the implementation of reforms, such a PEFA assessment or government's annual PFM monitoring reports.

The key criterion for assessing the relevance of the reform programme is the extent to which key weaknesses are being addressed by the strategy. In terms of the PFM monitoring table, this means that there is a meaningful set of objectives that can be monitored (columns 3 and 5) set against each of the key weaknesses identified (Column 2).

Where there is a gap, i.e. a key weakness is not subject to reform measures, reinforced dialogue and/or further explanation are needed. It may be acceptable for a key weakness to remain unaddressed over the short term due to sequencing issues. In such cases a full explanation should be provided justifying the apparent 'gap' in the reform programme. Alternatively, the existence of such a gap may be considered by the Commission to be an important omission that requires further dialogue and should be addressed before moving forward with the assessment of eligibility. This decision should be reported in section 5 (overall conclusions on eligibility).

### **3.2 Assessment of the credibility of the strategy**

The credibility of the strategy is determined by various factors<sup>115</sup> **that will influence the success or failure of reforms** including the existence of an action plan with appropriate sequencing and prioritization, enough resources allocated, institutional and monitoring arrangements, donor coordination and political 'buy in'. Attention to specific issues such as anti-corruption efforts or gender responsiveness should be also evaluated. An assessment of these aspects should be taken together, along with considerations of relevance and the past reform track-record as described in section 2.3 above to conclude on the judgement of eligibility.

#### ***Action plan***

An action plan is an annual or multi-year summary of tasks, timeframes, resources and responsibilities. Plans analyse the activities to be conducted as well as the expected outputs and outcomes. It translates the overall strategic vision spelled out in the reform strategy or program into operational terms on an annual basis. This section should state whether such an action plan exists, evaluate its coherence with the strategy's medium-term vision, and whether it is regularly updated so that it remains an effective operational tool. In those countries where there is not a comprehensive PFM reform action plan, it should be stated whether reforms are adequately included in the ministries annual action plans, or to the contrary, there is no indication on how they will be implemented.

#### ***Monitoring arrangements***

PFM reforms strategies and action plans should include monitoring arrangements to keep under systematic review progress achieved over the lifetime of the reform. Its purpose is to

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<sup>115</sup> The set of issues to be analysed in this section are very close to the framework for analysing the non-PFM factors determining success or failure of reforms currently under development. J. Diamond in "The Non-Technical Context of PFM Reform (draft July 2011) proposes a three tier framework for their analysis including i) the conditioning factors (political environment, economic development, social governance and technological and capacity), ii) Institutional structure of the PFM system (including relationships of MOF with other relevant government stakeholders and iii) Internal organisation of PFM processes.

determine if the activities, outputs, and schedules planned have been reached so that action can be taken to correct the deficiencies as quickly as possible. It typically involves the drafting of annual reports by the reform coordination entity. This section should describe the monitoring arrangements set by the government, by briefly outlining the main actors involved (with their role and responsibilities), timing and frequency of monitoring reports, the existence and quality of a set of indicators with baselines and targets, sources and data, and whether the authorities undertake follow-up actions.

### ***Sequencing and prioritization of reforms***

In this section Delegations should explain how priorities have been set, how the sequence has been determined and whether the “basics first” principle, explained below, has been applied, and, finally express a view of its appropriateness in light of the key weaknesses identified.

PEFA assessment scores highlight strengths and weaknesses of a PFM system and thus constitute an important input to a priority setting and sequencing of PFM reforms. But PEFA scores are only one – of several – inputs to the reform formulation process. Many other important factors must be considered simultaneously, such as political economy, cultural, legal, administrative and resource factors as well as capacity to initiate reform in each area.

PEFA indicator scores should not be used simplistically in reform formulation. A low indicator score is not in itself enough justification for making reform for the system element a priority. The relative importance of the subject, the complexity and timeframe for improving the system element and its interdependence with the performance of other system elements all need to be taken into consideration.

PEFA assessments need to be complemented by detailed analysis of the underlying causes and capacity factors (institutional, organizational and human resource factors) that result in unsatisfactory performance. Such complementary analysis may be restricted to only areas identified as priority and part of the first stage in a sequence. Other, more subject specific diagnostic tools are available for this type of detailed analysis.

The Commission and the IMF have provided guidance on PFM reform sequencing through the *Good practice note on Sequencing PFM reforms*<sup>116</sup>. The note recommends a high-level ordering when undertaking reforms, beginning with establishing some key or “core” functions (stressing control over public finances) and then moving to more sophisticated reforms—establishing instruments for medium-term fiscal management and ultimately reforms aimed at improving efficiency and effectiveness in resource use.

The first priority in PFM reform is to establish a minimum operational level of core PFM functions. These core PFM functions primarily focus on financial compliance (compliance with budgetary legislation, financial regulations and procedures) and fiscal control. A realistic (or credible) budget is fundamental to financial control, therefore implementing a realistic budget can, together with financial compliance, be considered as part of the “core” functions.

Before advancing to reforms aimed beyond core PFM functions, it is important to establish an adequate IT basis, accounting system, and regulatory framework, on which to anchor subsequent reforms. The benchmarks for attaining this PFM operational level are the establishment of a financial management information system, an accounting system that can

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<sup>116</sup> Good practice note on Sequencing PFM reforms. J. Diamond. Background papers on PFM sequencing and core PFM functions and PEFA indicators papers by J. Diamond and D. Tommasi January 2013.

at least meet International Public Sector Accounting Standards (IPSAS), cash reporting standards for central government operations, and budget legislation that meets critical control standards and is adequately enforced. With this as a platform, subsequent PFM reforms should be sequenced along three tracks: further improving compliance; a progressive move from annual to medium-term budget planning; and a staged move from traditional line-item budgeting to program, and eventually performance budgeting. With sequencing priorities set in this order, the exact choice of reform actions and pace of moving along these three tracks should be determined by specific country circumstances and preferences.

However, this in no way implies defining a universal reform path that all countries should follow. Rather, the note emphasizes that choice within broad reform categories should be country-specific, especially since all countries face different non-technical determinants external to PFM that are recognized in the note as critical to the success of reform. It is also recognized that typically reforms are not undertaken from a zero base, but must in some way accommodate on-going reforms.

### ***Political buy-in***

This section should identify the key political opportunities and constraints to the reform process. Attention should be given to the existence of reform champions, entrenched resistance and issues politically sensitive, sectoral interests or conflicts.

Successful reforms in public financial management systems are more likely to occur when there is a high level of political commitment to reforms and leadership. Reforms are also influenced by the context in which the PFM system evolves such as the authority of the Ministry of Finance, its relationship with other line ministers where the reforms have to be rolled out, relationship with the Parliament, structure of government, role of the Supreme Audit Institution and its ability in scrutinising, role of citizens and civil society organisations and strength of domestic accountability systems.

The political dimension to reform is not only a risk to mitigate but also an opportunity to seize. Demand for better governance and greater accountability is a key driver of change in budgetary systems. This demand emerges from both the formal institutions (parliaments or supreme audit institutions) and informal mechanisms (civil society, media and citizens).

### ***Corruption, fraud<sup>117</sup> and Public Financial Management***

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

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

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<sup>117</sup> In criminal law, a fraud is an intentional deception made for personal gain or to damage another individual. However the specific legal definition varies by legal jurisdiction. Fraud is commonly understood as dishonesty calculated for advantage. For the European Union the definition can be found in Article 1 of the Convention drawn up on the basis of Article K.3 of the Treaty on European Union, on the protection of the European Communities' financial interests (OJ C316, 27/11/1995, p. 49).

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

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

This section should therefore only focus on identifying the second aspect and explaining anti-corruption efforts within the PFM reforms which will affect the eligibility for PFM. While specific attention should be paid to grand corruption cases and more particularly to the follow up ensured by the Government and the judicial system, systemic and low-level corruption should not be ignored. However, the focus should be on the cases with implications for the quality of the PFM system. Where there is information, some indication of the scale and type of corruption should be provided. Where the Commission and other actors are involved in anti-corruption measures, these should be recorded. The broader corruption issues not strictly linked to PFM should be taken into account in the risk assessment (see annex 7).

### ***Institutional arrangements, resources allocated and coordination***

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

In view of the complexity and sensitivity of PFM reforms, the degree to which they are coordinated and managed has an important bearing on their potential for success. PFM reforms potentially involve major shifts in responsibility from the Ministry of Finance to line ministries; substantial changes in the incentives and power relations within ministries; and implications for recruitment and retention.<sup>118</sup> Moreover, the involvement of independent areas of government such as parliament and supreme audit institutions in the PFM system also presents potential coordination problems. The involvement of donor support also adds to the complexity.

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

Describe briefly the quality of the coordination, between donors and with government, of institutional support planning and monitoring covering PFM and anti-corruption issues. What degree of harmonisation has been reached by the partners in PFM, especially for diagnostics?

### ***Institutional weaknesses and capacity strengthening needs***

This section should draw the links between the key areas of PFM weaknesses, the key priorities for reform and the capacity building and technical support being provided.

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<sup>118</sup> This section draws on *Harmonising Donor Practices for Effective Aid Delivery*, Volume 2: Budget Support, Sector Wide Approaches and Capacity Development in Public Financial Management, OECD, Paris, 2006.

Reference can be made to the Risk Management Framework risk mitigating measures in terms of capacity strengthening. Any gaps should be highlighted.

### ***Gender issues***

Government policies, implemented through a budget, should aim at eliminating all sorts of harmful disparities. If the government aims at achieving greater gender equality it is important to analyse the extent to which the current PFM reforms would render the budget more gender responsive. Additional guidance on how to analyse and report on Gender-responsive Budgeting is provided in the background note at the end of this annex 5.

### **3.3 PFM sectoral aspects**

Where the Commission is engaged in SRPC **or** where the specific weaknesses of the financial management of a **priority sector** covered by a SDG-C or SRBC hinders the efficient use of resources for service delivery, those challenges should be outlined here and included in the PFM monitoring table. Examples of sources of information are Public Expenditure Reviews or Public Expenditure Tracking Surveys. Note that these are heavy assessments which cannot be conducted regularly. Thus it would also be important to highlight **the findings of the annual audit report** in the sectors concerned and the government's response, when available.

The analysis of the sector specificities is of particular importance when the financial management within the sector includes sector-specific systems, particularly where these systems differ significantly from the standards of financial governance across government. This is the case, for example, of road funds, public agencies, parastatals or local governments.

Examples of critical issues to be addressed in sector assessments of PFM include:

- a) **Procurement systems** when separate systems have been set up such as for buying drugs in the health sector, or with particular importance such as construction contracts in infrastructure. The assessments should address the consistency with the national procurement system that should remain the reference.
- b) **Payroll performance** which is critical for human resource intensive sectors, typically education or health. The assessment should address the consistency with the national payroll system that should remain the reference.
- c) **‘Off-budget’ funds** such as road funds, social security funds, and other earmarked funds that may be financed outside the mainstream tax system, or which may be financed from general taxation but earmarked for specific use.
- d) **Level of fiscal decentralisation.** In countries where a critical share of the sector budget is directly under the responsibility of sub-national governments, PFM at the sub-national level should be analysed separately<sup>119</sup>. Note that some governments present only central government accounts, while others may present consolidated general government accounts which include provincial and local authority sector expenditures.

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<sup>119</sup> For specific guidance, consult: *Providing EU budget support in decentralised contexts*, 2016 (<https://myintracomm.ec.europa.eu/dg/devco/eu-development-policy/budget-support-public-finance-management/Pages/guidelines.aspx>).

- e) **Investment.** Where the capital budget of the sector is managed through specific processes and institutions and accounts for large amounts of the resources available for the sector, it is important to evaluate the performance of this specific system and the potential risks associated to the appraisal, selection, costing and monitoring of the projects. The assessment can build on the findings of specific diagnosis such as PIMA (see appendix C) or dedicated audits. Attention should be paid to investment implemented through structured financing instruments notably public-private partnerships (PPP) or blending.

### **3.4 Domestic Revenue Mobilisation**

Annex 11 provides guidance on how to complete this section.

## **4. Budget Transparency and Oversight**

Annex 6 provides guidance on how to complete this section.

## **5. Overall conclusion on Eligibility**

### **5.1 Public Finance Management (including DRM)**

**This section should draw a conclusion on relevance and credibility by explicitly stating the following:**

- (i) **The PFM reform strategy is considered sufficiently [/insufficiently] relevant because...** (a key consideration here is the matching of key weaknesses and the objectives of the reform programme).
- (ii) **The PFM reform strategy is considered sufficiently [/insufficiently] credible because...** (main factors in sections 3.2, 3.3 and 3.4 should be balanced to draw a judgement).

Where there are concerns about relevance and/or credibility these should be highlighted for further dialogue with the authorities<sup>120</sup>.

Where evidence, such as recent audit reports, has exposed critical failures in the system challenging a positive assessment of the eligibility criteria, the process and substance of dialogue, the response of the Delegation and other donors, the Parliament and the Executive should be described here. This section should also explain what short-term measures are needed in very weak systems.

### **5.2 Budget Transparency and Oversight**

Annex 6 provides guidance on how to complete this section

#### **List of annexes to the PFM and transparency assessment report**

Annex 1: PFM monitoring table

Annex 2: Timing and Availability of annual external audit reports

Annex 3: List of sources of information

Annex 4: Summary of PEFA scores

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<sup>120</sup> A critical part of the dialogue is agreeing a coordinated approach to diagnostics that avoids overloading government and respects national priorities.



*Template of the annex 1 to the PFM and transparency assessment report –PFM monitoring table (with stylised example)*

(1) Dimensions of the PFM system where key weaknesses have been identified	(2) Baseline:  Key specific weaknesses identified in diagnostic work (e.g. PEFA)	(3) Short term reform expectations (one period) To be updated successively by subsequent reports from previous period's column 5	Progress to be monitored			
			(4) Evolution since last Report (date):  a) Performance  b) Reform process  Source of verification	(4 bis) Priorities for policy dialogue	(5) Revised objectives to be monitored for the next period (Becoming next period's column 3)	(6) Medium term targets of the PFM reform programme
Accounting and Reporting	Major delays and quality issues in annual financial statements	Annual financial statements include decentralised arms of government.				Fully comprehensive financial statements prepared within the statutory deadline

## *How to fill the monitoring table*

### **General**

The monitoring table is a key element of the PFM and Transparency Report. The table schematically sets the baseline against which progress should be assessed, along with both short term and medium term targets. Through subsequent updates, the table conveys the evidence for the positive assessment of satisfactory progress in the implementation of reforms. The stylised example is for illustrative purposes only. The actual contents of the table will be determined on a country-by-country basis drawing on the weaknesses identified and the priorities of government's reform programme.

### **Column (1): Dimensions of the PFM system where key weaknesses have been identified**

This column helps to group weaknesses by using a broad categorisation of the functions of a PFM system (as for example the 7 pillars retained in the PEFA Framework). Some areas may not be covered depending on the priorities and sequencing set out in the PFM Reform Strategy.

### **Column 2: Key specific weaknesses identified in a diagnostic assessment (e.g PEFA)**

This column should list a *limited* selection of the key weaknesses of the PFM system highlighted by the most recent diagnostic assessments. A comprehensive assessment such as PEFA is the preferred reference but other specific diagnosis tools, audits, or evaluations can also be used as sources for each area. The date of the assessment should be clearly stated and, as a baseline, it should remain the same until a later assessment provides updated evidence. Several weaknesses can be listed for each area, but it is important to limit the total number of entries to the most critical issues affecting overall performance (indicatively, ten entries). In addition, specific weaknesses in the management of funds of a sector or sub-national level should be added in the case of Sector Reform Performance Contracts when relevant.

### **Column 3: Short term reform expectations, revised successively by subsequent PFM reports**

This column should be derived from the government's immediate reform plans and ongoing actions addressing the weaknesses listed in column 2. It should therefore set out reforms that are expected to be achieved over the short term (i.e. until the next update of the PFM report, depending on the level of risk) as well as for the medium term. Column 3 will be revised in the light of progress and evolving priorities with each update of the PFM report by transposing the column 5 from the previous period's table. Please mention the reference (e.g. government PFM reform plan, relevant ministries annual management plans).

### **Column 4: Evolution since last PFM Report**

PFM **performance** should be monitored through quantitative data on PFM outputs. Progress in the PFM **reform process** should be monitored by the effective realisation of the government's planned reform activities (as described in column 3). The date of the last PFM report should be mentioned as well as the source of verification (typically government reports produced according to the PFM reform strategy monitoring arrangements).

### **Column 4 bis: Summary of policy dialogue**

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

**Column 5: Revised objectives to be monitored for the next period**

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

**Column 6:**

The column recalls the medium term goals of the partner country's reform programme. The medium term reform horizon may, and often will, extend beyond the timeframe of a typical three year budget support contract and is included here to show the longer term context within which PFM reforms operate.

*Template of the annex 2 to the PFM and transparency assessment report – Timing and availability of annual external audit reports*

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

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

### ***Annex 3 to the PFM and transparency assessment report - Sources of information***

Annex 3 of the PFM and transparency assessment report should reference all source materials consulted during the drafting of each report.

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

(a) Public Expenditure and Financial Accountability (PEFA) Performance Measurement Framework: The PEFA Performance Measurement Framework is the preferred tool of assessment of the European Commission and typically serves as a common information pool for donors and governments. Such assessments provide the basis for determining key weaknesses and the priorities for the eventual reform plan.

(b) Government documentation: Other than assessing the information disclosed in budgetary documents, the government may have undertaken its own assessment of PFM reform performance, and identified weaknesses that need to be addressed.

(c) Supreme Audit Institution (SAI) audit reports: The SAI should submit reports on an annual basis to the legislature.

(d) Legislative reports providing budget oversight.

(e) The IMF's Fiscal Transparency Code and Evaluation which includes a set of principles built around four pillars: (i) fiscal reporting; (ii) fiscal forecasting and budgeting; (iii) fiscal risk analysis and management; and (iv) resource revenue management.

For each principle, the Code differentiates between basic, good, and advanced practices to provide countries with clear milestones toward full compliance with the Code and ensure its applicability to the broad range of IMF member countries.

Fiscal Transparency Evaluations (FTEs) are the IMF's fiscal transparency diagnostic. FTEs provide countries with a comprehensive assessment of their fiscal transparency practices against the differentiated standards set by the Code.

(f) SAI Performance Measurement Framework (INTOSAI). The SAI PMF provides SAIs with a framework for voluntary assessments of their performance against the International Standards for Supreme Audit Institutions (ISSAIs) and other established international good practices for external public auditing. It is important for those SAIs that have adopted, aspire to adopt, or wish to benchmark themselves against, the ISSAIs and other international good practices.

(g) The Tax Administration Diagnostic Assessment Tool (TADAT). This is a new instrument to help governments gauge the performance of their tax administrations and identify priorities for reform. TADAT is designed to deliver an objective and standardized assessment of the most critical outcomes of any country's system of tax administration, focused on nine key performance outcome areas. The assessment of these performance outcome areas is based on 26 high-level indicators that are themselves built on 54 measurement dimensions.

TADAT is suitable for countries at all stages of development and helps to:

- Identify a tax administration's relative strengths and weaknesses;
- Facilitate a shared view among all stakeholders;
- Set the reform agenda;
- Facilitate management and coordination of external support; and
- Monitor and evaluate reform progress through repeat assessments.

(h) Civil society groups, independent fiscal research institutions, universities, think tanks, NGOs, business associations and others may have published assessments of PFM.

(i) OECD/DAC Methodology for Assessing Procurement Systems (MAPS): Common tool which countries and cooperation partners can use to assess the quality and effectiveness of national procurement systems. The assessment should provide a basis upon which a country can formulate a capacity development plan to improve its procurement system.

(j) Methodology for Assessing Procurement Systems (MAPS II): ongoing process led by OECD to revise and finalise the methodology of this diagnostic tool aimed at promoting high quality procurement in order to spend efficiently and maximize the value and impact of purchased public works, goods and services. MAPS II is currently (2017) being pilot tested before being rolled out to a larger number of partner countries.

(k) Public Expenditure Reviews (PER): They analyse the allocation and management of public expenditure. They may cover all government expenditure or focus on a few priority sectors (e.g. health, basic education, agriculture, water, roads). Increasingly, PERs also review expenditure management systems and institutions, in recognition of the fact that it is the institutional framework, organisational capacity, and everyday expenditure management practice of government which determines the allocation and management of public expenditures. A PER should analyse past performance in terms of resource allocation and service delivery in order to be able to make a realistic assessment of what the sector should be aiming to achieve in the medium term.

(l) Public Expenditure Tracking Surveys (PETS): PETS have emerged as a popular tool for identification of problems with the flow of resources between different levels of public administration and frontline service providers. PETS are recognised as an effective tool to improve accountability in public finance and service delivery.

(m) Public Investment Management Assessment (PIMA): diagnostic tool developed by the IMF to evaluate a country's institutional arrangements for planning, allocating, and executing public investment projects. It provides a sound basis for countries to develop priorities for reform action. Improving public investment management should ease fiscal pressures in the context of rising debt levels and important financing needs for infrastructure investments.

(n) Debt Management Performance Assessment (DEMPA) which is useful to assess the administration's capacities to manage debt agreements and also informs assessments of the debt sustainability or of the risks to embark into large or innovative investment deals.

(o) OECD/SIGMA gap assessments (baseline assessments) against the principles of public administration (including public finance management) which are used in the enlargement context and by many European neighbourhood countries as a benchmark for improving performance.

## C – Background information on gender-responsive budgeting<sup>121</sup>

**Promoting gender equality is beneficial to society on the grounds of human rights, economic growth and fairness.** Progress has been made in recent years but the potential economic contribution from women remains largely untapped, especially with respect to an unequal access to labour markets<sup>122</sup>.

Tracking progress for both men and women is needed to help policy makers understand the effects of the gender gaps for social-economic development. Gender analysis and sex-disaggregated data can visualize the different constraints and obstacles that are faced by women and men, and the different impact of resource allocations on their social-economic position and performance.

The notion of gender-responsive budgeting (GRB) refers to policies and to particular PFM techniques for promoting gender equality. GRB implicitly acknowledges that there is no gender-neutral government budget: reducing the budget allocation for water and sanitation will affect women (who traditionally collect water for the household) more than men; reducing tax credits for healthcare will place the burden on women who tend to stay home and take care of children. Although this is a general problem (government policies, implemented through a budget, should aim at eliminating all sorts of harmful disparities), it is particularly relevant to gender and age issues<sup>123</sup>.

**The adoption of the Sustainable Development Goals paved the way for a wider use of 'Gender Responsive Budgeting', i.e. public finance management, fiscal policy and administration to promote gender equality in partner countries.**

**Gender budgeting already exists in a large number of countries but at various degrees of intensity and scope.** A systematic analysis reveals the large variation of gender budgeting efforts, reflecting the country-specific circumstances, the status of women, but also the political choices that are made and the capacity of the administration. In some cases this has resulted in adjustments to public and fiscal policies and programs to explicitly reduce gender gaps; advances in collecting data on women's conditions and needs; changes in spending ministries administration. In some cases there has been a virtual status quo except for a few administrative changes and some lip service.<sup>124</sup>

**All government agencies can potentially play a role in the implementation of gender oriented policies but not all should necessarily be activated concurrently.** In countries with limited capacity, it is important to focus the effort where the returns are likely to be higher. Identifying appropriate priorities, especially for public investment would be critical to maximize the chances of success. This would require the recruitment of staff able to articulate

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<sup>121</sup> This text follows closely the views and recommendations of Kochhar et. Al. (2017) and Stotsky (2016). Additional references can be found in the EU Resource package on gender mainstreaming (<http://eugender.itcilo.org>) and in the Toolkit on Mainstreaming Gender Equality in EC Development Cooperation ([http://ec.europa.eu/europeaid/toolkit-mainstreaming-gender-equality-ec-development-cooperation\\_en](http://ec.europa.eu/europeaid/toolkit-mainstreaming-gender-equality-ec-development-cooperation_en)).

<sup>122</sup> On the many benefits of reducing gender inequality, see World Bank (2011), Duflo (2012), and Elborgh-Woytek et al. (2013). For a text with special reference to SSA, see Hakura et al. (2015).

<sup>123</sup> For more thoughts about the integration of gender sensitive issues in PFM, see [http://eugender.itcilo.org/toolkit/online/story\\_content/external\\_files/TA\\_Public\\_COMBAZ.pdf](http://eugender.itcilo.org/toolkit/online/story_content/external_files/TA_Public_COMBAZ.pdf).

<sup>124</sup> There are many country examples. In Rwanda, spending aimed at keeping girls in school—such as providing basic sanitation—has led to higher enrolment; In South Korea a lack of child care has forced women to choose between work and family. Both female labour-force participation and fertility rates are low—a poor formula for growth in an ageing country. Gender budgeting helped the government design programmes to reduce the burden of care on women. For example, when Uganda first looked at its budget through a gender lens, it discovered that little of the spending on agriculture was going to support women farmers, though they did most of the work.



gender oriented priorities in the overall investment program, assess from the gender equality point of view the specific sector chosen for action, evaluate existing gender oriented programs, and compile the relevant information for government and public consumption. Often, staff is placed in the Ministry of Finance that necessarily takes the lead in providing guidance to spending ministries (e.g. Morocco and Rwanda). The spending ministries must play an important role in making gender impact assessments of their policies and plans, incorporating gender oriented policies in their programs and reporting them according to relevant accounting standards and this requires capacity development. The revenue side should not be neglected as tax policy is often not gender-neutral (in particular in the characteristics of the revenue source). Finally, the role of sub-national governments in addressing gender related inequalities can be very important, depending on the specific inter-governmental arrangements within the country.

**For gender-budgeting (as for other critical social goals), it is important that the objectives are set in a realistic, meaningful and measurable manner.** In education for example, the goals of spending programs can be set in terms of number of newly built/refurbished schools having separate latrines for girls and boys, (outputs), or by student performance (i.e. how many girls completed the primary/secondary school = outcomes). This is why program budgeting is important in terms of integrating gender-oriented objectives into the budget process. Monitoring the inputs also provides important information but can be misleading. For example, tracking a special line item related to education for girls may paint a picture of progress that does not reflect realities if the rest of the education budget unduly favours boys (or is 'gender blind')<sup>125</sup>. In all cases, the costs and benefits of gender-oriented budget policies can only be assessed in the medium term. Most of these policies play a role through an accumulation of capital that indeed increases human productivity, but only over the medium and long term.

**Finally, the main implications from the discussion above and the abundant literature that exists on the topic can be summarized as below (from Stotsky, 2016).** Note that the focus here is on the policy components. These should be supported by administrative actions that can take various forms.

- Align gender budgeting efforts to goals in national development plans, including those related to the Sustainable Development Goals. Countries should ensure that their gender-oriented objectives are clear, ambitious, and fit into the budget process.
- Improve access of girls to secondary and tertiary education, and their participation in science, technology, and math education. Equal access of girls and boys to primary education across the world is within reach.
- Keep gender-oriented health goals as priorities. These goals include bringing down high rates of maternal mortality and sexually transmitted diseases, including HIV/AIDS, and providing contraception services.
- Remove obstacles that prevent girls and women from participating in educational and economic activities, such as inappropriate sanitary and hygiene facilities and unsafe transportation.
- Improve the supply of electricity and water to households as well as cooking technologies to reduce girls' and women's time demands for domestic work.

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<sup>125</sup> See Kochhar, 2017 in the list of useful references.

- Assess key sectors of the economy in which women could participate more productively, identify the constraints to their participation, and develop fiscal policies to help address these constraints. Governments can extend fiscal incentives to individuals and employers, and to financial institutions to encourage greater women's participation in economic activities.
- Ensure that subsistence agriculture remains a focus of fiscal policies and programs, including through enhanced training of farmers, in sub-Saharan Africa and other regions where women continue to play a predominant role.
- Eliminate gender-based inequalities in tax, financial, civil, and other laws, and ensure that women's rights to ownership and control of property are equal to men's rights.
- Improve the administration of justice, law, and order, to reduce violence against girls and women.
- Review recruitment policy and career management, starting with the public sector and use affirmative action.
- Increase awareness by the general public, especially of the positive role that women can play in the economy, while avoiding portraying women as a group that is dependent on public aid or transfers.

### **Useful references**

- Duflo, Esther, 2012, "Women Empowerment and Economic Development", *Journal of Economic Literature*, Vol. 50, pp. 1051-79.
- Elborgh-Woytek, Kristin, Monique Newiak, Stefania Fabrizio, Kalpana Kochhar, Kangni Kpodar, Philippe Wingender, Benedict Clements, and Gerd Schwartz, 2013, "Women, Work, and the Economy: Macroeconomic Gains from Gender Equity", IMF Staff Discussion Note 13/10 (Washington, DC: IMF).
- Hakura, Dalia, Christine Dieterich, et al. 2015, "Inequality and Economic Outcomes in Sub-Saharan Africa", *African Development Regional Economic Outlook: Dealing with the Gathering Clouds*, pp. 55-76.
- Kalpana Kochhar, Sonali Jain-Chandra, and Monique Newiak, 2017, *Women, Work, and Economic Growth: Leveling the Playing Field*, IMF, Washington DC
- Janet Stotsky (2016), "Gender Budgeting: Fiscal Context and Current Outcomes", IMF Working Paper No. 16/149, Washington DC.
- World Bank, 2011, *World Development Report 2012: Gender Equality and Development* (Washington DC: World Bank).

## Annex 6 – Assessing eligibility on budget transparency and oversight

This annex provides guidance to assess the eligibility criterion on transparency and oversight of the budget when formulating a budget support contract (initial eligibility) and when deciding on disbursement (continued eligibility). It has to be understood in full complementarity with annex 5, since reporting on this eligibility criterion is combined with the assessment of public finance management within a single template.

The assessment of the eligibility as regards budget transparency and oversight is made through two documents:

### **- Chapter on budget transparency and oversight in the PFM and transparency assessment report<sup>126</sup>**

This chapter is included in the PFM and transparency report. It includes an assessment of initial eligibility by confirming whether the “entry point” is met. In addition, the assessment sets out key weaknesses, the baseline, and the medium term objectives on budget transparency including policy dialogue and capacity development activities to strengthen accountability.

This in-depth analysis on transparency has to be updated regularly and similarly to the public finance management assessment: every year if the risk related to PFM is substantial or high, every three years in the other cases. This document is submitted together with the action document for contract approval and disbursement notes.

The action document itself includes a section on transparency and oversight of the budget. In the action document, the Delegation is asked to assess if the entry point is met and to summarise the current situation on budget transparency and oversight.

### **- Transparency section in the disbursement note<sup>127</sup>**

This section in the note provides the necessary information to inform the disbursement decision, as regards the eligibility criterion on budget transparency and oversight (initial eligibility confirmed or not). The document aims at assessing whether the entry point is still met and at monitoring progress (ongoing eligibility).

The relevance and the effectiveness of oversight bodies are covered by the PFM assessment to avoid repetition (refer to section 4.1.3 or annex 5 for further background).

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<sup>126</sup> See reporting template in annex 5.

<sup>127</sup> The template of disbursement note is made available on DEVCO/NEAR intranet.

## 1. Chapter on budget transparency and oversight in the PFM and transparency assessment report

### 1.1. Assessing the entry point

In this section, the Delegation is asked to assess if the entry point is met. The entry point is defined as follows: the government must have published its budget within the past or current budget cycle (either the Executive's budget proposal or the enacted budget).

That means that the government had to publish the budget of the past budgetary cycle within the respective fiscal year. In order to have the possibility to reward progress in budget transparency from the last to the current fiscal year at the time of the assessment, the publication of the current budget within the current fiscal year may also lead to the fulfilment of this criterion. In general, the budget should be available to the general public in printed form or on a website. Under certain circumstances, the contract approval will depend at least on the commitment of the partner country to meet the entry point before the first disbursement. This needs to be reflected in the financing agreement by setting a specific condition.

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

### 1.2. Identifying the key weaknesses on transparency and oversight of the budget

This section should identify the key weaknesses and challenges of the partner country regarding the transparency and oversight of the budget. As a first step, the EU delegation is asked to give a short summary of the available international data on budget transparency and oversight of the budget, focusing on the Open Budget Index (OBI) and PEFA framework. It is recommended to use the following indicators, as in the table hereafter.

**Table 1 – PEFA and OBI scores<sup>128</sup>**

PEFA Assessment (2016 indicators)	Match with PEFA 2011	Year	Year	Year	Monitoring of progress
PI-5 Budget documentation	PI-6				
PI-6 Central government operations outside financial reports	PI-7				
PI-9 Public access to fiscal information	PI-10				
PI-28 In-year budget reports	PI-24				
PI-29 Annual financial reports	PI-25				
PI-30 External audit	PI-26				
PI-31 Legislative scrutiny of audit reports	PI-27				
		<b>Year</b>	<b>Year</b>	<b>Year</b>	<b>Progress</b>
Open Budget Index					

According to the country's context, two other PEFA indicators may be used: PI-7 Transfers to subnational governments and PI-8 Performance information for service delivery.

<sup>128</sup> See appendix B of this annex 6. Another useful reference is the IMF Code of Good Practices on Fiscal Transparency.

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

The key weaknesses will be assessed by focusing on:

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

The relevance and role of oversight bodies will be covered by the public financial management assessment in order to avoid duplications (see section 4.1.3 or annex 5).

In general, budgetary documents should be available at minimal costs to any person who wishes to access the document. It should be relatively easy to make budgetary documents widely available for free if governments simply publish them on their website. Countries could also make hard copies of budget documents available in national and local libraries and in information desks maintained in government offices<sup>129</sup>.

The **timeliness and comprehensiveness of budgetary information** are prerequisites for national control bodies playing their role as watchdogs. The budget documents should allow a complete picture of central government fiscal forecasts, budget proposals and out-turns of the previous year. They should include among other macro-economic assumptions, fiscal deficits, deficit financing, debt stocks, financial assets, prior year's outturn, current year's budget, and summarized budget data for revenue and expenditure<sup>130</sup>. In some cases, the state-owned enterprises and extra-budgetary operations expenditures needs to be looked at as well. Appendix A may help to identify the key weaknesses and the baseline, as it describes international good practice benchmarks with regard to the timeliness and comprehensiveness of budgetary information.

The **quality, integrity, and accuracy of budgetary information** are essential aspects of the assessment. Good practices in this regard relates to the realism of budget data, accounting standards, data consistency and reconciliation with other data. As these are issues difficult to assess, it is recommended to rely on information provided by the PEFA and international financial institutions, notably the IMF<sup>131</sup>, but also on internal evaluations by the countries<sup>132</sup>.

The **disclosure of budgetary information** will be examined by focusing on six key budgetary documents<sup>133</sup> covering the different stages in the budget cycle: (i) the Executive's budget proposal; (ii) the enacted budget; (iii) in-year (monthly/quarterly) reports; (iv) mid-year report; (v) year-end report; (vi) the audit report. According to the country's circumstances, the Delegation may also look on additional budgetary documents such as the

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<sup>129</sup> See International Budget Partnership, *Open Budgets. Transform Lives: The Open Budget Survey 2010*, p.7.

<sup>130</sup> Refer to PEFA assessment, PI-5 on budget documentation.

<sup>131</sup> The IMF Manual on Fiscal Transparency (2007) includes some criteria on assurances of integrity. The IMF Reports on the Observance of Standards and Codes (ROSCs) may cover these issues. Another source of information is the PEFA assessments, in particular with regard to PI-28 and PI-29.

<sup>132</sup> Regional Committees (West African Economic and Monetary Union, UEMOA, and Economic and Monetary Community of Central Africa, CEMAC) have developed monitoring and evaluation tools to measure progress in the implementation of the public finance guidelines and aspects directly related to transparency.

<sup>133</sup> The Open Budget Survey / Index looks at two additional key budgetary documents: The Pre-Budget Statement and the Citizens Budget.

citizens' budget<sup>134</sup> and pre-budget statements<sup>135</sup>. Finally, annexes to the budget law may be required to enhance the information to parliament, and in this case a specific follow-up is encouraged (e.g. an annual report on tax expenditures would typically constitute an annex to the main budget document). The disclosure of budgetary information implies that the respective documents are produced and made available to the public, so that the public can easily access the documents. The production of relevant and simplified budgetary information is also encouraged, for example in the form of a citizens' budget.

Depending on the country context, this section is expected to set a baseline with regard to the key weaknesses that can be potentially addressed by a public finance management reform program with a component on transparency issues. The Delegation is invited to present key weaknesses and short and medium term reform expectations on budget transparency using the following table. The baseline defined and the objectives identified at the outset of the contract will be used to monitor progress as part of the dynamic approach.

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<sup>134</sup> A Citizens Budget provides simplified budget data that is easily accessible for a broad audience.

<sup>135</sup> A pre-budget report should be released before the executive's budget proposal and stress the government's long-term economic and fiscal policy objectives, including the total level of revenue, expenditure, deficit or surplus, and debt.

**Table 2 – Publication of key budget documents**

(See appendix A to this annex 6 for further background on each key budget document)

Key budget document	Description	Produced (yes/no)	Published (date, website)	Timeliness of publication (yes/no)	Comprehensiveness & quality (narrative on key issues)	Specific weaknesses / baseline	Short and medium term objectives / reform expectation
<b>Executive's budget proposal</b>	The executive's budget proposal is the government's draft budget that should be submitted to the legislature.						
<b>Enacted Budget</b>	The enacted budget refers to the budget that has been passed by the legislature.						
<b>In-year reports</b>	In-year reports (also Monthly Reports or Quarterly Reports) show progress in implementing the budget. These reports can be issued for the entire government or issued by different agencies.						
<b>Mid-year report</b>	The mid-year report provides a more comprehensive update on the implementation of the budget.						
<b>Year-end report</b>	The year-end report is one of the key accountability documents. It shows compliance with the level of revenue and expenditures authorised by the legislature.						
<b>Audit report</b>	This report covers the year-end report audited by an independent Supreme Audit Institution.						
<b>Other documents such as citizens budget, medium-term budgetary framework, annual report on tax expenditures</b>	<p>A citizens' budget is defined as an easy-to-understand summary of the main features of the Executive's budget proposal. It should be a self-contained document that explains what is in the annual budget proposals and what their effects are expected to be. It can also reflect the enacted budget or the annual budget report.</p> <p>A macro-budgetary medium term framework presents the strategic and budgetary orientations and medium term economic perspectives</p>						



### ***1.3. Medium-term objectives for budget transparency and oversight***

Based on the analysis of the situation, this section should set a baseline of the key weaknesses. The baseline approach should also identify and include accompanying capacity development measures to strengthen accountability mechanisms. The baseline and the definition of realistic reform objectives (medium term) on budget transparency and oversight, against which progress will be measured during the implementation of the budget support contract, are essential.

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

In addition, the narrative should highlight how the objectives are supposed to be supported within the budget support contract, e.g. by policy dialogue, through performance indicators in the variable tranches, by supporting a participatory budget support approach (e.g. participation of national oversight bodies or of civil society organisations in the annual policy reviews) and by accompanying capacity development measures.

In cases where the executive's budget proposal, and the year-end report or the audit report are not published, the medium-term reform expectations would typically focus on these key documents, as the basis for measuring progress. In the case of a State and Resilience Building Contract, a short-term budget support contract (less than 3 years) or a contract implemented in SIDS/OCTs, more flexibility may be justified regarding these key budgetary documents.

This differentiated approach is justified also for countries where the entry point is met, where the main budget documents are regularly published and the margins for progress are therefore more limited. For these countries, it is necessary to further analyse the quality and comprehensiveness of the documentation in particular with regard to the annexes to the budget proposal or to budget execution reports.

Depending on the specific country context, this part could also develop public finance management topics, analysed in sections 2 and 3 of the PFM and transparency assessment report, where one of the main weaknesses identified is directly linked to transparency (such as natural resources or procurement).

However, the more transparent the system is initially, the more modest should the Commission be in setting medium term reform expectations. In cases where the baseline is already close to international benchmarks (see appendix A), the European Commission may only focus on monitoring whether there is no significant deterioration during implementation.

## 2. Transparency section in the disbursement note

### 2.1 Key budget documents

In this section, the delegation is asked to assess if the entry point is met (initial eligibility) and to give a short up-date summary of the available budget document. The delegation is asked to use the following Table (see appendix A for further background on each document).

Key Budget Document	Produced (yes/no)	Published (yes/no)	Timeliness of Publication	Comprehensiveness & Quality	Latest developments (if relevant)
Executive's budget proposal					
Enacted Budget					
In-year reports					
Mid-year report					
Year-end report					
Audit report					
Other document if relevant (e.g. citizens budget, medium-term budgetary framework, annual report on tax expenditures)					

Conventional key budget documents can be complemented with other budget documents, such as the citizens' budget, the macro-budgetary framework or an annual report on tax expenditures.

The last column on the right is intended to assess concrete progress, in particular for countries where room for improvement is significant.

## 2.2 Assessing transparency

This section assesses the ongoing eligibility of a partner country as regards transparency and oversight of the budget. As a first step, the delegation is asked to summarize the available international data on budget transparency and oversight of the budget focusing on the Open Budget Index (OBI) and the PEFA framework. This summary will update the table produced when formulating a new contract (section 1.2 of this annex 6). Other indicators may be included (e.g. PI-7 Transfers to subnational governments and PI-8 Performance information for service delivery), particularly if they had been for the initial assessment.

PEFA Assessment (2016 indicators)	Match with PEFA 2011	Year	Year	Year	Progress
PI-5 Budget documentation	PI-6				
PI-6 Central government operations outside financial reports	PI-7				
PI-9 Public access to fiscal information	PI-10				
PI-28 In-year budget reports	PI-24				
PI-29 Annual financial reports	PI-25				
PI-30 External audit	PI-26				
PI-31 Legislative scrutiny of audit reports	PI-27				
		Year	Year	Year	Progress
Open Budget Index					

Like for the initial assessment, these indicators and scores are used to update headquarters on indicators and trends. However, decisions on the ongoing eligibility of a partner country are not based on the data and scores, but on the following narrative part of the assessment.

During implementation, ongoing eligibility requires satisfactory progress on budget transparency and oversight. Demonstrating eligibility will require evidencing progress with regard to the baseline and the identified medium-term reform expectations. It is important to demonstrate a positive trend, while recognising that there may be a temporary setback in transparency which does not necessarily undermine eligibility, provided a clear justification can be provided. The baseline – defined by the key weaknesses and the short-term and medium-term objectives on budget transparency– is the reference against which progress will be measured (see table 2 in previous section).

A focus may be given to aspects requiring close monitoring and dedicated policy dialogue with the government as regards the reforms initiated or to be initiated. This will be particularly the case where the weaknesses reported are important. For PEFA performance indicators which are rated D, close monitoring is proposed. For example, the quality and comprehensiveness of the budget documents, in particular with regard to the annexes to the budget proposal, should be closely analysed if the indicator PI 5 is rated D.

## 2.3 Conclusion on eligibility as regards budget transparency and oversight

The analysis should provide a conclusion on the ongoing eligibility: **“Progress is considered satisfactory because ... (narrative conclusion based on the table reflecting the confirmation of the entry point and progress with respect to the identified medium-term reform expectations)”**.

## Appendix A – Assessment grid for key budget documents<sup>136</sup>

Key Budget Document	Description	Release benchmarks	Comprehensiveness
<b>Executive's budget proposal</b>	The executive's budget proposal is the government's draft budget that should be submitted to the legislature.	Should be made available to the public when it is first presented to the legislature or, at a minimum, before the legislature approves it. The legislature and the public should have enough time to examine it.	Should be presented within a medium-term macroeconomic and fiscal policy framework. Include all budgetary activities of the government and detailed commentary on each revenue and expenditure programme.
<b>Enacted Budget</b>	The enacted budget refers to the budget that has been passed by the legislature.	Should be released to the public no later than three months after the legislature approves it.	See executive's budget proposal.
<b>In-year reports</b>	In-year reports (also Monthly Reports or Quarterly Reports) show progress in implementing the budget. These reports can be issued for the entire government or issued by different agencies.	Should be released to the public no later than three months after the reporting period.	Should show the executive's progress in implementing the budget.
<b>Mid-year report</b>	The mid-year report provides a more comprehensive update on the implementation of the budget.	Should be released no later than three months after the reporting period.	Should include an update on the implementation of the budget, a review of economic assumptions, and an updated forecast of the budget outcome for the current fiscal year.
<b>Year-end report</b>	The year-end report is one of the key accountability documents. It shows compliance with the level of revenue and expenditures authorised by the legislature.	Should be released no later than one year after the end of the fiscal year (the reporting period).	Should include the reconciliation with the approved budget and compliance with the revenue and expenditures authorised by the Parliament.
<b>Audit report</b>	This report covers the year-end report audited by an independent Supreme Audit Institution.	Should be released no later than two years after the end of the fiscal year (the reporting period).	Should cover all activities undertaken by the Executive in accordance with appropriate auditing standards and be produced in full independence by the supreme audit institution. Should focus on significant and systematic PFM issues and on performance such as reliability of financial statements, regularity of transactions, functioning of internal control and procurement systems <sup>137</sup> .

<sup>136</sup> The benchmarks are based on the Open Budget Survey/Index, the Public Expenditure and Financial Accountability Framework, the IMF Code of Good Practices on Fiscal Transparency and the OECD Best Practices for Budget Transparency.

<sup>137</sup> The assessment should also cover the timely and effective follow-up by the legislature and the executive on the main recommendations of the Audit Report.

<b>Other documents such as citizens budget or medium term budgetary framework, annual report on tax expenditures</b>	<p>A citizens' budget is defined as an easy-to-understand summary of the main features of the Executive's budget proposal. It should be a self-contained document that explains what is in the annual budget proposals and what their effects are expected to be. It can also reflect the enacted budget or the annual budget report.</p> <p>A macro-budgetary medium term framework presents the strategic and budgetary orientations and medium term economic perspectives</p>	<p>At the same time as its corresponding budgetary document.</p> <p>Available before the 30th of June (or mid-year for any other fiscal year).</p>	<p>It should briefly set out the key role the budget plays in public financial management, in the constitution or in the budget law. The guide should very briefly describe the budget process, including the roles of the executive branch in preparing the budget and of the legislature in authorising government taxation, borrowing and expenditure.</p> <p>The macroeconomic and fiscal outlook is a starting point. Economic forecasts for at least the budget year should be presented. Medium-term projections of fiscal aggregates (revenues, spending, deficit) should also be presented if available.</p>
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## **Appendix B – Useful references**

### **Public Expenditure and Financial Accountability Framework (updated in 2016)**

The PEFA Performance Measurement Framework has been developed to assess and develop essential PFM systems, by providing a common pool of information for measurement and monitoring of PFM performance progress as well as a common platform for dialogue. PEFA framework covers budget transparency and oversight through several indicators. Information on the methodology and the recent PEFA assessment reports are available at [www.pefa.org](http://www.pefa.org).

### **IMF Code of Good Practices on Fiscal Transparency (2007, updated in 2016)**

The Code identifies a set of principles and practices to help governments provide a clear picture of the structure and finances of government. It underpins the voluntary program of fiscal transparency assessments called fiscal transparency modules of Reports on the Observance of Standards and Codes (or fiscal transparency ROSCs), that summarize the extent to which countries observe certain internationally recognized standards and codes. The code and additional information are available on the IMF website: <http://www.imf.org/external/np/fad/trans/index.htm>. The Reports on the Observance of Standards and Codes are available at <http://www.imf.org/external/NP/rosc/rosc.aspx>

### **Open Budget Survey / Index**

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

### **OECD Best Practices for Budget Transparency (2002)**

The best practices are drawn by the OECD Secretariat based on OECD Member States experiences. The best practices are designed as a reference tool for member and non-member countries to use in order to increase the degree of budget transparency in their respective countries. They comprise a list of principal budget reports that governments should produce, including their content, a description of specific disclosures to be contained in the reports, and practices for ensuring the quality and integrity of the reports. The document is available on the OECD website: <http://www.oecd.org/dataoecd/33/13/1905258.pdf>.

### **The Lima Declaration of Guidelines on Auditing Precepts (1977)**

The Lima Declaration contains a comprehensive list of principles and standards for government auditing relevant for all Supreme Audit Institutions grouped in INTOSAI, the International Organization for Supreme Audit Institutions. It refers to the importance of audits for a legal, effective and efficient public financial management and calls for an independent government auditing guaranteed by law. See: <http://www.intosai.org/issai-executive-summaries/view/article/issai-1-the-lima-declaration.html>.

## **SAI Performance Measurement Framework (SAI-PMF)**

The framework for Performance Measurement of Supreme Audit Institutions has been developed by the Development Initiative of the International Organisation of Supreme Audit Institutions (INTOSAI). This tool could become the international standard for assessing the performance of SAIs. See: <http://www.idi.no/en/sai-pmf/sai-performance-measurement-framework>.

## **Tool to measure progress in public finance management UEMOA and CEMAC**

Delegations can use the new evaluation tools developed by the Regional Committees of UEMOA (*Union Economique et Monétaire Ouest-Africaine*) and CEMAC (*Communauté Economique et Monétaire de l'Afrique Centrale*) to take stock of the implementation of the public finance directives and notably of aspects directly related to transparency. The Regional Committees carry out evaluations.

This monitoring and evaluation guide is a relevant source of information for the analysis of budget transparency in UEMOA/CEMAC Member States. The indicators are monitored by the UEMOA/CEMAC Commissions and are self-assessed by the States. Some indicators can feed into Delegations' analysis and be used to assess progress in those countries such as:

- I5: contracts between public administration and all categories of enterprises are published;
- I7: the text defining the annual budget calendar is published;
- I9: quarterly publication of data on the level and composition of public indebtedness, financial assets and other non-debt obligations and annual publication of data relating to its natural resource assets;
- I10: detailed presentation in a finance law of the nature and budgetary cost of tax exemptions;
- I12: publication on the website and in at least two general circulation newspapers of the reports of the Court of Auditors;
- I13: organization of public debates on the preparation and execution of the state budget.

## Annex 7 – Risk management framework

### 1. Management of risks in budget support contracts

The development of an improved risk management framework adapted to the specific risk profile of budget support contracts is a key element of the Communication on the "Future Approach to EU Budget Support to Third Countries". The Risk Management Framework (RMF) aims at identifying in a structured way, mostly based on existing assessments (e.g. Human Rights and Democracy Country Strategies, eligibility criteria) the significant risks related to budget support. In addition, the Risk Management Framework makes sure that these risks are managed in line with the Commission's guidelines on risk management<sup>138</sup>.

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

The RMF is an important tool during the identification, formulation, implementation, and evaluation of budget support contracts whilst also informing policy and political dialogue and the design of complementary support. Furthermore, it simplifies PFM reporting requirements where risks are low or moderate<sup>139</sup>.

By identifying risks, the tool allows more informed decisions on the provision of budget support considering the risks, potential mitigating measures and the cost of non-intervention<sup>140</sup>.

Therefore, the RMF aims to:

1. Identify the specific risks linked to the provision of budget support;
2. Identify mitigating measures and risk responses as part of a risk strategy;
3. Inform the policy dialogue and the design of complementary support;
4. Monitor the identified risks and the mitigating measures during implementation,

The European Commission defines risk management as: "a continuous, proactive and systematic process of identifying, assessing and managing risks in line with the accepted risk levels, carried out at every level of the Commission to provide reasonable assurance as regards the achievement of the objectives"<sup>141</sup>.

In this framework, the following five risk categories are identified: political governance risks, macroeconomic risks, developmental risks, public financial management, and corruption / fraud. The specific risk profile of budget support contracts is related to the use of country systems, as budget support involves a transfer of financial resources to the National Treasury. Any reputational risks to the EU should also be highlighted.

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<sup>138</sup> Risk Management in the Commission, Implementation Guide, Version updated in November 2015 (2016 edition), available on the intranet.

<sup>139</sup> Refer to annex 5 for further guidance on PFM eligibility assessment.

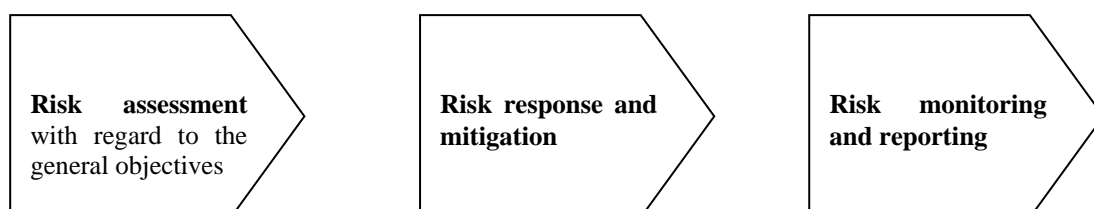
<sup>140</sup> The benefits of a budget support contract will be assessed separately and are not part of the risk assessment framework.

<sup>141</sup> See SEC(2005)1327 *Towards an effective and coherent risk management in the Commission services*.



The Risk Management Framework for budget support contracts is focusing on the country system in order to identify the risks that may impede achieving the overall objectives of budget support. It is carried out for each country that may receive or is receiving budget support in the form of a Sustainable Development Goals Contract, State and Resilience Building Contract and/or Sector Reform Performance Contract. Risks are assessed in relation to the objectives of budget support in a country. There is only one risk management framework per country but sector specific developmental risks can be highlighted.

In general, the framework comprises the following key steps:



## 2. Risk assessment

### 2.1 Definition of risk and risk categories

The Commission defines a risk as "*any event or issue that could occur and adversely impact the achievement of the Commission's political, strategic and operational objective. Lost opportunities are also considered as risks*"<sup>142</sup>.

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

The assessment of risk should inform the identification, formulation, implementation, and evaluation phases. Risk Management Framework updates are scheduled to take place once a year following an instruction note from the Director General, except when new circumstances lead to a deterioration in at least one of the risk categories to substantial or high. In such a case, an updated risk management framework should be submitted to the BSSC/FAST by the relevant geographical directorate as soon as possible. When budget support is planned in a country and no RMF is yet in place, it should be prepared during identification, reviewed in Quality Support (Group), and submitted to the BSSC/FAST subsequently.

The process for preparing or updating an RMF is as follows. EU Delegations submit a first draft to geographic directorates, who then have the responsibility to coordinate a review process, in consultation with EEAS<sup>143</sup>, ECFIN and DEVCO/NEAR thematic services as relevant. With the exception of the enlargement context, the EEAS geographic directorates lead on the validation of political risks assessment, in consultation with DEVCO/NEAR thematic and geographical directorates. Reviewed RMFs are subsequently submitted to the BSSC/FAST for final approval.

<sup>142</sup> *Ibid.*

<sup>143</sup> The Council decision 2010/427/EU of 26 July 2010 establishing the organisation and functioning of the EEAS indicates in art 9(2) the list of external assistance instruments where the EEAS has a specific role in the programming and management cycle. The IPA regulation is not included in this list.

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

- **Political risks** refer to the universal values, fundamental rights, conflict and insecurity. The risk framework is used to regularly monitor the commitment and adherence to the fundamental values of human rights, democracy and rule of law. The risk of conflict and insecurity, including political and social destabilisation, regional tensions and the support of policies and powers that may exacerbate tensions, are also part of the political risk assessment and carry a particular importance in that a country entering into violent conflict could quickly overturn the rest of the RMF.
- **Macroeconomic risks** refer to the possibility that the macroeconomic policies cease to be stability-oriented. In addition, the framework will take into account the risk of external shocks that are outside the immediate influence of the partner country, e.g. impact of global economic crises and volatility in commodity prices.
- **Developmental risks**: This includes the risk that the policies put in place by the government will not be continued or may not attain the desired outcomes, in particular with regard to poverty reduction and sustainable and inclusive economic growth. A variety of factors may lead to developmental risks, including weak policy design, poor baseline assessments, lack of ownership for policies, lack of participatory consultations with stakeholders, insufficient institutional capacities and capabilities with regard to implementation and monitoring of policies and programmes. The risk management framework also allows the assessment of sector-specific developmental risks in focal sectors.
- **Public Financial Management** refers to the risks that weaknesses in the government's regulatory framework, financial compliance and controls systems may lead to inappropriate management of public funds. This risk is assessed in terms of the comprehensiveness of the budget, controls in revenue collection / budget execution, procurement and external audit. PFM risks are assessed on the basis of information available from different diagnostic tools (e.g. PEFA, TADAT, SIGMA or others<sup>144</sup>), government reports and any other sources of information from international organisations or consultancy reports. If diagnostic assessments have not been carried out recently, other information sources may be used in order to present the most recent situation.
- **Corruption and Fraud** refers to risks that resources diverted away and power is abused for private gain. Large scale corruption and fraud constitute a major obstacle to development objectives. Risks of corruption and fraud are linked to public financial management and developmental risks, but by having a separate risk category, the Commission puts increased emphasis on corruption and fraud. The specific risk category focuses, therefore, on the perceived risk level, the legal, regulatory and institutional framework as well as government responsiveness and enforcement.

**Any reputational risks** can be reflected in various risk categories and can be described in the major risks section if appropriate.

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

Each risk category comprises the following risk **dimensions**:

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<sup>144</sup> Refer to annex 5 for further background on PFM diagnostics tools.

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

The risks and risk levels are identified and assessed through a questionnaire. The questionnaire is mostly based on existing assessments available for the country in question, in particular of the eligibility criteria, the fundamental values, the Human Rights Country Strategies, the single country assessments envisaged in the Resilience Joint Communication (when and where these exist), and the relevant reports in the enlargement context. It is based on an excel sheet that guides the risk identification.

**Replies to the questionnaire should be consistent with other EU assessments carried out regularly in the areas covered.** In the case of **neighbourhood countries** these are: human rights (& democracy) annual reports, democracy country profiles, ENP country reports for Association Councils, assessment for the ENI Umbrella Programme ('more for more'), replies to the conflict prevention/early warning questionnaire.

The questionnaire takes into account:

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

Each question is judged in terms of four risk ratings (low, moderate, substantial, high) capturing both, the likelihood and impact of a risk with regard to the overall objectives of budget support. The decision on the risk rating for each question has to be justified through a very short narrative comment based on the most recent available information. The risk assessment is a forward-looking exercise and should take a medium term perspective.

For Small Island Developing States (SIDS) and Overseas Countries and Territories (OCTs), a simplified Risk Management template will be applied, with 14 questions, one per each risk dimension. This reflects the specific nature of these states and territories, but still allows comparison with other countries by keeping the rating for the 14 dimensions (see annex 10).

The risk ratings for each question are averaged to general risk levels for each risk dimension (e.g. human rights or rule of law), for each risk category (e.g. political risks or macroeconomic risks) and for the average country risk. The rating is an important part of the assessment, as it supports the definition of risk levels for decision-making. However, the questionnaire may not cover all possible risks and averages may not reflect the actual risk level at an aggregate level, such as in the case of the risk of insecurity and conflict. In exceptional and well justified cases, the Delegation has, therefore, the discretion to change the risk rating for each risk dimension based on a more qualitative assessment.

It is therefore crucial that the risk rating is accompanied by a narrative assessment highlighting the major risks identified by the questionnaire. This part of the assessment also provides the possibility for Delegations to highlight the major risks that may not be covered by the questionnaire.

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

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

## 2.3 Risk Management Framework template

The Risk Management Framework consists of the following elements:

- The **Risk Questionnaire** is used to identify and assess the risks leading to the definition of risk levels.
- The **Risk Profile** highlights all the important information of the risk assessment of each country. The country risk profile for budget support responds to the need to have a summary tool to support informed decision-making. It indicates the risk trends for each risk category. In addition, the profile provides a summary on the risk of non-intervention (expected benefits of budget support<sup>145</sup>), on the major risks, including in particular reputational risks, and on the key mitigating measures. Based on the risk assessment, an overall recommendation is presented on the use of budget support, setting out the necessary key mitigating measures or a roadmap which creates the conditions for its use. The eligibility for budget support is not assessed in the Risk Management Framework.
- For Sector Reform Performance Contracts, a separate part of the questionnaire covers sector-specific developmental risks for a maximum of four sectors. The same questions as for the country developmental risks apply, but risk levels can be differentiated in accordance with the perceived risks in different sectors.

## 3. Risk response and mitigation

### 3.1 Risk response

Given the fact that a degree of risk is inevitable in all aid operations, the aim is not to avoid risks at all costs. Reducing risks to zero is, in most cases, practically infeasible and rarely effective. A certain degree of risk acceptance is necessary, as non-engagement can cause higher risks and developmental costs in the long run. A higher risk may be acceptable in contexts where the expected impact and benefits of budget support contracts is higher than the potential risk. This is of particular relevance for State and Resilience Building Contracts. Situations of fragility tend to be characterized by higher risks, but also call for action to ensure vital state functions, to support transitions, to promote governance, human rights and democracy, and to deliver basic services to the populations.

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

1. Identification of mitigating measures; and
2. Decision on the response: risk acceptance or risk avoidance.

**Risks may be mitigated** by joint efforts of the country and cooperation partners to respond to the identified risks, for example, by identifying safeguards or reform needs. Mitigating measures may include short term measures but also longer term structural measures such as the strengthening of accountability institutions and actors. Mitigation should be the most common risk response and it is a critical element of budget support contracts.

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<sup>145</sup> The potential benefits of individual budget support contracts are described in the relevant formulation documents, i.e. in the action document and associated supplementary documents.

If the risk level of a risk dimension is substantial or high, mitigating measures need to be discussed and identified with the government and other cooperation partners in order to address the respective risk dimensions. Progress in the implementation of mitigating measures must subsequently be monitored.

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

Risk mitigating measures and the progress with their implementation should be documented on the **Risk Questionnaire** after each risk category and on the **Risk Profile sheet**, in the major risks section.

**The following list proposes potential mitigating measures:**

- **Further analyses and surveys** may be necessary in order to shed light on the systemic weaknesses leading to specific risks. For example, the Public Expenditure and Financial Accountability (PEFA) assessments, Public Expenditure Tracking Surveys, Public Expenditure Reviews and public administration assessments can usefully identify reform needs and capacity constraints. Political economy or drivers of change analysis can help identifying catalysts behind reform needs.
- **Capacity development and technical cooperation** could be used to mitigate risks in cases where there is a strong commitment for reform, but a lack of capacity to improve country systems / frameworks.
- **Enhancing transparency, accountability and participation in the budget process** is important to strengthen nationally owned safeguard and oversight mechanisms. Internal and external accountability mechanisms provide opportunities for enhanced scrutiny and monitoring.
- **Policy dialogue** should take into account identified risks and can give more prominence to key risk areas and the need for related reforms.
- **Performance indicators of the variable tranches** could be used to set incentives for reform and to support policy dialogue. This approach may allow addressing key risks without jeopardizing predictability.
- **Requirements** to implement specific controls, legislations and reform steps may be appropriate to address specific weaknesses and deal with substantial or high risks.
- **Further adaptations that may be considered in the design of a budget support contract** include shortening the duration of a contract in environments with substantial/high risks, adjusting the disbursement profiles or opting targeted aid to reduce reputational risk.
- **Adopting proactive communication strategies** with the view of raising awareness amongst stakeholders, addressing concerns and increasing public acceptance of the reforms.

In addition to risk levels, it is important to monitor risk trends. They may be an indication of evolving underlying dynamics which may not translate immediately in changes of risk categories but, if sustained, can substantially alter the overall risk level.

Based on the analysis of risks and mitigating measures, a risk response will lead to risk acceptance or risk avoidance. The **risk acceptance** corresponds to a certain level of risk that is acceptable. **Risk avoidance** means that the risk is too high leading to the rethinking of on-going or potential budget support contracts.

As mentioned above, when new circumstances lead to a deterioration in at least one of the risk categories to substantial or high, an updated risk management framework should be submitted to the BSSC/FAST by the geographic directorate as soon as possible.

### 3.2 Overview risk response

Risk Level	Risk Strategy	Recommendation for the identification/formulation phase	Recommendation during implementation
LOW	Acceptance	The provision of budget support is feasible without additional safeguards.	The budget support dialogue is pursued on a regular basis.
Moderate	Acceptance / Mitigating	The provision of budget support is feasible without additional safeguards. Mitigating measures, if necessary, may be identified for the respective risk category or risk dimension.	The budget support dialogue is pursued on a regular basis. If necessary, monitoring of the mitigating measures.
Substantial	Mitigating / Avoidance	Budget support contracts are only recommended when appropriate mitigating measures are agreed with the partner country. In case of a substantial risk of one of the political risk dimensions, a SDG-C should be linked to progress in addressing the root causes and be used to promote the fundamental values through policy and political dialogue. In this context, a contingency plan should be developed in order to increase the capacity to react immediately in cases of further deteriorations. Any decision on the provision of a SDG-C will be taken by the BSSC/FAST.	Monitoring of the mitigating measures (satisfactory progress of the mitigating measures during implementation).
High	Avoidance / Mitigating	Budget support contracts are only recommended when appropriate mitigating measures, including safeguards and specific requirements, are agreed with the partner country. In case of a high risk of one of the political risk dimensions, a SDG-C should be linked to progress in addressing the root causes and be used to promote the fundamental values by policy and political dialogue. In this context, a contingency plan should be developed in order to increase the capacity to react immediately. Any decision on the provision of a SDG-C will be taken by the BSSC/FAST.	Close monitoring of the mitigating measures (satisfactory progress of the actions plans; safeguards/ specific requirements are met). In case of a deterioration of a risk category from low/moderate/substantial to high, the budget support contract should be discussed in the BSSC/FAST before a disbursement decision.

### **3.3 Risk Monitoring and reporting**

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

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

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

The risks and mitigating measures are identified as part of the identification and formulation phase on the basis of the questionnaire and the risk profile. During the implementation phase, risk mitigating measures will be updated regularly in risk management template as often as necessary, but at least once a year. The geographical directorates (DG DEVCO/NEAR and, except in the enlargement context, EEAS for political risks), with support from Delegations and thematic directorates, have the responsibility for ensuring consistency and coherence across countries in their regions and the implementation of the risk management framework. Questions of intra- or inter-regional consistency may be referred to the BSSC/FAST. **In case of a deterioration of a risk category from a previously lower assessment to substantial or high, the budget support contract should be re-discussed in the BSSC/FAST before any disbursement decision.**

The risk management framework is an internal management tool. It should not be shared widely and its content should not be copied as such in the Action document. However, collaboration with interested EU Member States in the country to fill in or update the risk management framework is encouraged, where appropriate and in particular in the countries where Joint Programming is used.



## Annex 8 – Variable tranche design and performance indicators

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

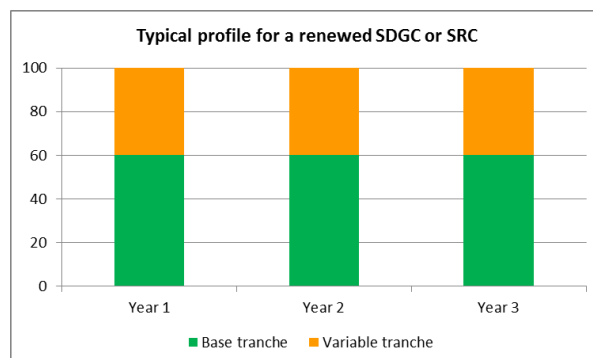
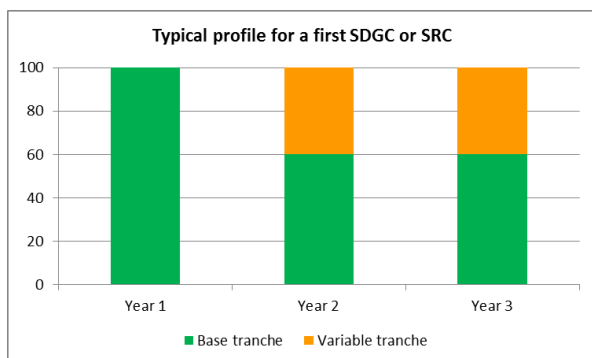
### 1. Contract duration, size and phasing of variable tranches

A balance needs to be struck between creating incentives and avoiding excessive unpredictability or volatility in disbursements, particularly in more aid dependent contexts, but **no definite rules regarding the appropriate share of fixed and variable tranches can be defined**. Larger variable tranches may have a stronger incentive effect, particularly in weak policy environments and where there is some stability over time in the indicators used. However, a large number of factors are likely to influence performance, and there are equally indications that the incentive effect is dependent on the alignment of objectives with partner countries and that countries are sensitive to the signalling effect of reduction in payments, regardless of size.

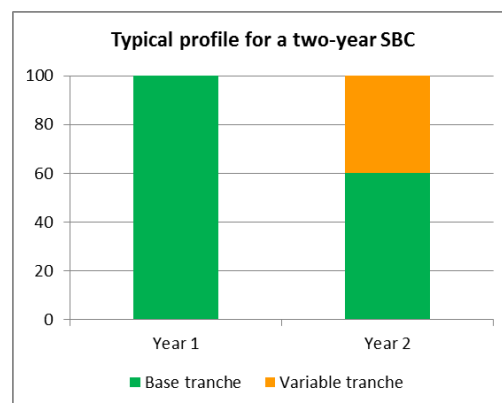
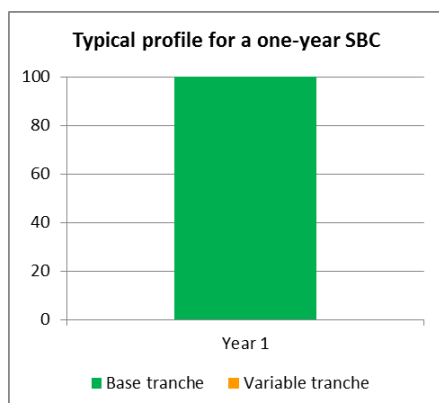
The following examples can nevertheless be used as a reference point that forms the initial basis for discussion. **The variable share might be expected to be larger in the following circumstances:** the smaller the budget support contract's share of the partner country's budget; the weaker its track record of budget support implementation; the weaker the country's commitment to reform; the higher the risk assessment. Country context matters, and the possibility of 100% fixed or 100% variable contracts remains open. In all cases, Delegations should co-ordinate decisions on the size and phasing of variable tranche with other cooperation partners and international financial institutions.

**SDG-Cs and SRPCs would typically cover commitments for 3-4 years with a possible fixed and variable tranche ratio of about 60/40.** The duration of a SDG-C or a SRPC may be longer but, in any case, both the political and policy timeframe of the partner country should be duly considered when deciding on the duration of the contract.

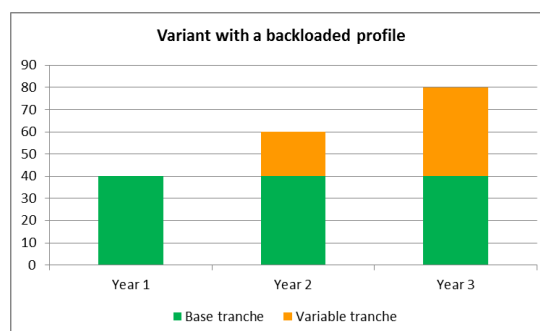
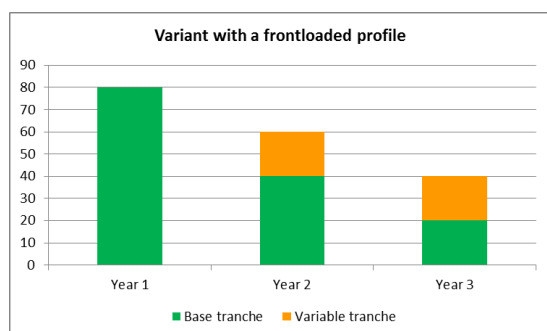
In order to facilitate partner country's budgeting particularly in aid dependent countries, the first year of a new budget support contract (without predecessor) should normally only have a fixed tranche. This also allows for a reasonable amount of time between the agreement on the indicator targets, and their evaluation. However, where a successor contract is being prepared, the design should aim to include a variable tranche in the first year to ensure continuity of assessment. This implies formulating a successor contract sufficiently in advance to ensure predictability.



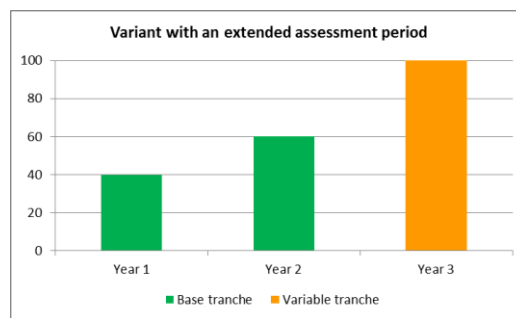
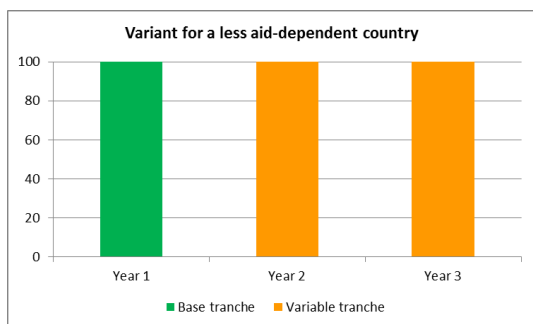
**SRBCs will typically last 1 to 3 years.** The shorter duration and the importance of predictability in highly aid-dependent countries, including for essential services, can mean that overall the variable tranche is not generally higher than with the other contracts, despite a higher level of risks. For 1 to 2 year contracts, there may be no variable tranche with a focus on satisfying the eligibility criteria and preparing for a future SDG-C or SRPC.



Independent of the share of variable tranches, the **disbursement profiles** may vary in volume and be either frontloaded or backloaded (see two examples below).



**Less aid-dependent countries** leave flexibility for larger variable tranches and possibly for variable tranches based on extended assessment periods, where a longer time-lapse is given to reach targets and performance is measured over several years. In the example on the right below, the contract has a variable tranche in its third year only, based on a 2-year assessment period. Either end-of-period or average performance can be used. The former leaves scope for compensating poor year 1 performance by catching up in year 2, but the absence of a variable tranche with performance indicators may affect the policy dialogue.



The **choice of profile** should take into account, particularly for aid-dependent countries: (i) the macroeconomic financing gap, (ii) other donors' disbursement plans, (iii) partner country's absorptive capacity, (iv) partner country's preferences, (v) the sequencing and the challenges arising from the reforms; (vi) the incentives for change in the policy environment; and (vii) the time-sensitivity of the selected indicators and their targets.

## 2. Selection of Variable Tranche Indicators

For variable tranche disbursements, delegations should select – in agreement with the authorities and in co-ordination with Member States and other cooperation partners – a number of indicators, amongst those used by the country within its own monitoring and evaluation system or through the performance assessment framework agreed with the authorities. The indicators must come with baseline and targets, as per the policy which is supported through budget support.

Where no such a system or framework exists, Delegations should agree with the authorities on a number of indicators derived from the policy, in consultation with other domestic and external stakeholders. The selected indicators should be coherent with policy objectives and the diagnosis of the situation. Once agreed locally, indicators and targets are to be approved by headquarters, when the action document and the draft financing agreement are reviewed.

Indicators, baselines and targets must be agreed during the formulation phase and set in the financing agreement. Changes to the indicators should be avoided but may be necessary. Targets might have to be amended or adjusted upwards/downwards during contract implementation (e.g. to reflect new circumstances, an update of the baseline or a change of measurement methodology). Such changes should be agreed by the beginning of the year which is assessed, or at the latest by the end of its first quarter. Financing agreements should include an explicit clause stating that any revision of indicators or targets can take place upon request by the authorities and subsequent agreement by the EU Authorising Officer<sup>146</sup>.

**The number of indicators for a variable tranche would generally range from 3 to 10.** The more focused the objectives of the contract and the smaller the size of the variable tranches, the fewer the recommended number of indicators. Indicators may have targets disaggregated by sex or geography, which are particularly relevant where there are disparities in the provision of key services.

<sup>146</sup> Such a revision requires a written amendment to the financing agreement. This amendment would typically be processed through an exchange of letters between the signatories of the financing agreement, after approval by headquarters. Refer to the financial Companion for further guidance on the procedure to apply.

There is no predefined set of indicators which can suit all countries. Indicators must be drawn from the policy document, be in line with the Sustainable Development Goals, with the EU reference policies and be chosen amongst the usually accepted indicators in the sector<sup>147</sup>.

There are **different types of indicators for public policies**<sup>148</sup>. Input and process indicators measure the financial resources provided and the policy/regulatory actions taken (e.g. adoption of a regulation), output indicators measure the immediate and concrete consequences of the resources used and measures taken (e.g. schools built); outcome indicators measure the results for beneficiaries (e.g. proportion of children vaccinated); and impact indicators measures the consequences of the outcomes in terms of the wider objective (e.g. reduced poverty).

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

Outcome indicators can focus on quantity, for example school enrolment, but **attention should also be given to indicators measuring quality**. For that purpose, proxy indicators can be used that give an indication of quality. Examples are the pupil teacher ratio; school completion rates; attendance or utilisation rates for public services; absenteeism rates of public service providers; indicators measuring public provider skills; stock-out rates of essential drugs in health facilities and share of pharmaceutical sales that consist of counterfeit drugs. Particularly in the area of governance and regulatory frameworks, attention should also be given to indicators that measure or verify *de facto* practices vs. *de jure* regulations, to monitor the enforcement of these regulations and their effects. Subjective data (e.g. perception or satisfaction survey) has value in complementing objective measurement but is not recommended for variable tranche disbursement, as they may not be embedded in the regular statistical production, may not use stable methodologies or may not be comparable over years.

**Input, process or output indicators may play a useful role**, particularly when the policy aims at changes in the regulatory framework, or when outcome statistics are not considered sufficiently reliable. It may also be the case that the annual sensitivity of an outcome indicator is low, or even that this outcome is not measured on an annual basis<sup>149</sup>. When opting for process indicators, measuring qualitative aspects still matters. Therefore, such indicators should not focus on processes only (e.g. if a bill is to be passed, what is this bill expected to cover and address? If an entity is to be set up, what is required to make it functional?).

**Public financial management indicators** in addition to eligibility monitoring may also be used, but poor performance against such indicators should not lead to question eligibility,

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<sup>147</sup> See, for instance, UNESCO website for education (<http://uis.unesco.org>), the WHO website for health ([http://www.who.int/gho/indicator\\_registry/en](http://www.who.int/gho/indicator_registry/en)), ILO website for employment (<http://www.ilo.org/global/statistics-and-databases/lang--en/index.htm>), FAO website for agriculture (<http://www.fao.org/faostat/en/#home>) and similarly the other recognized organisations in their respective fields.

<sup>148</sup> For further guidance on indicators in the context of budget support, refer to the Annex 2 'Intervention Logic'.

<sup>149</sup> In such a case, it may be relevant to opt for input or process indicators in the earlier years of a programme and use outcome indicators, only later. The former would be deemed necessary conditions to achieve the latter.

which is based on a broader assessment. Finally, when using input indicators, consistency with the medium-term fiscal framework should be checked.

It is important to monitor **impact indicators** in relation to the overall objectives, but such indicators are not considered appropriate for disbursement purposes, given the numerous external factors to which they are subject and the time-lapse required to evidence change.

In order to support countries' efforts towards a result-based approach, the strengthening of national statistical systems and monitoring frameworks should be a critical component of policy dialogue and may call for capacity development. Sound, timely and publicly available statistics and progress reports are not only necessary to inform policy making, they are also instrumental for domestic accountability.

Various sets of criteria exist to assess **indicator quality** (e.g. SMART for Specific, Measurable, Achievable, Realistic, Time-limited; CREAM for Clear, Relevant, Economic, Adequate, Monitorable; RACER for Relevant, Accepted, Credible, Easy, Robust). Eurostat guidance focuses on logic, relevance, the possibility of setting a target, frequency of data collection, appropriateness and possibility of estimating precision. The box below suggests specific questions to ask when evaluating the quality of a performance indicator.

**Ten aspects to consider when assessing a performance indicator**

1. Is the indicator used by the country for its own policy monitoring and reporting? If not, why?
2. Does the indicator have quantified targets or, for process indicators, a result-oriented formulation?
3. Does the indicator come with baseline and time series? What is the average variation over years?
4. Are the definition, the department responsible for the indicator (both data collection and reporting), the reference document to serve as source of verification and its publication date fully clear?
5. Are statistical aspects known for each indicator (e.g. precision, confidence interval, expected coverage or completeness)?
6. Are methodological aspects known for each indicator (e.g. periodicity, data collection and reporting responsibilities, timeframe for processing and publication, quality assurance, recent or forthcoming methodological changes)?
7. What are the drivers for indicator variation and to what extent is it sensitive to exogenous factors?
8. When relevant, are demographic factors taken into account by the indicator and the targets?
9. Is the indicator disaggregated whenever relevant and to the extent possible by sex, geographic area or population groups?
10. Is the indicator dependent on the availability of external funding or technical assistance and is the target at risk of not being achieved, should this external support not materialise? Is the data collected through an ad hoc survey which is financed by external assistance?

**Targets** should get the balance right between being over-ambitious or excessively prudent. At the time of formulation, where Delegations conclude that the government's targets are either too ambitious or too prudent in the policy document, this should be addressed by modifying the approach to variable tranche assessment (see hereafter the various options for calculating variable tranche payments) rather than through adjusting the targets themselves, thereby departing from the government's policy and the domestic accountability processes.

Indicators, baselines, targets and assessment methodology should be **precisely and unambiguously defined** in the financing agreement to avoid different interpretations

afterwards. The data source should be clearly identified and the availability of quality data verified. Delegations should use the template below to describe the selected indicators.

### **Indicator documentation sheet**

<b>Indicator no. X</b>	<b>Title</b>
<b>Policy</b>	<i>Reference to the partner country's policy</i>
<b>Objective</b>	<i>Reference to the relevant objective within the policy</i>
<b>Department</b>	<i>Department making use of this indicator within this policy</i>
<b>Indicator type</b>	<i>Process / input / output / outcome</i>
<b>Measurement unit</b>	<i>e.g. %, national currency, km and other units</i>
<b>Calculation method</b>	<i>Exact formula (e.g. numerator and denominator for a ratio)</i>
<b>Disaggregation</b>	<i>e.g. by sex, geographic area or population groups</i>
<b>Data collection method</b>	<i>e.g. administrative collection or survey</i>
<b>Measurement periodicity</b>	<i>e.g. monthly, annual or every 3 years</i>
<b>Department responsible</b>	<i>Department(s) in charge of data collection, processing and publication</i>
<b>Delivery date</b>	<i>Timeline for the publication of data and related documentation</i>
<b>Limitations and bias</b>	<i>Methodological weaknesses, statistical features (e.g. precision; confidence interval; expected coverage or completeness) or, in case of a proxy, the bias with regard to the desired indicator</i>
<b>Means of interpretation</b>	<i>Significance in relation to the policy – what is actually measured? What can other indicators tell in connection with this indicator?</i>
<b>Change in methodology</b>	<i>State whether the department responsible for the production of the indicator intends to change the calculation or data collection method.</i>
<b>Baseline</b>	<i>Year &amp; value (or state of play for process indicators)</i>
<b>Targets</b>	<i>Years &amp; values (or expected progress for process indicators)</i>

Finally, delegations should apply these principles not only to the variable tranche indicators but also **support the partner country to reflect these principles in its own monitoring and evaluation system, when the policy is formulated and during progress reviews**. Clearly defined indicators and assessment methodology, a prioritisation of indicators<sup>150</sup> to reflect policy objectives and identified challenges, and an appropriate mix of indicator types are all equally relevant to public policy monitoring, which, where available, will be used to monitor the public policy eligibility criterion.

### **3. Options for calculating variable tranche payments**

<sup>150</sup> The principle of prioritisation applies first of all to policy documents. With too many indicators, policy makers may lose sight of priorities and the quality of result monitoring may be undermined accordingly.

This involves attributing a score for each selected indicator, and aggregating these scores to determine the amount of the variable tranche to be disbursed. An example is provided below. **Policy monitoring and performance assessment should be an inclusive process** led by the government but whereby performance results are also subject to stakeholder consultations and whereby **results are made publicly available and feed into domestic accountability mechanisms**. Government's reports should include data on progress against indicators and these reports should be published. In this context, results for variable tranche indicators can be drawn from the policy review, subject to Delegation's views on the accuracy of the results.

***Example of a variable tranche of EUR 10 M based on 3 policy objectives and 8 indicators***

Policy objective		Indicator	Assessment	Score (0-0.5-1)	Amount per indicator	Decision (option 1)	Amount per policy objective	Decision (option 2)	Amount of the tranche	Decision (option 3)
Objective 1	Indicator 1	≈ ☹	0.5	2 M€	1 M€	4 M€	score of 1/3 - <i>unsatisfactory</i> - 0 M€	10 M€	overall score of 5.5/10 - <i>satisfactory</i> – 6.5 M€	
	Indicator 2	✖ ☹	0	1 M€	0 M€					
	Indicator 3	≈ ☹	0.5	1 M€	0.5 M€					
Objective 2	Indicator 4	✖ ☹	0	1 M€	0 M€	3 M€	score of 2/3 - <i>satisfactory</i> - 1.5 M€			
	Indicator 5	✓ ☺	1	1 M€	1 M€					
	Indicator 6	✓ ☺	1	1 M€	1 M€					
Objective 3	Indicator 7	✓ ☺	1	1 M€	1 M€	3 M€	score of 1.5/2 - <i>strong</i> - 3 M€			
	Indicator 8	≈ ☹	0.5	2 M€	1 M€					
Total amount to be disbursed					Option 1	5.5 M€	Option 2	4.5 M€	Option 3	6.5 M€
					Indicator by indicator		Per policy objective		Overall	

**Option 1 – indicator by indicator:** each indicator is considered individually. *In the example, the respective amounts to be disbursed add up to 5.5 M€.*

**Option 2 – performance per policy objective:** the indicators are considered per policy objective and progress is assessed accordingly, with categories such as 'unsatisfactory' (aggregated score below 35% of the maximum possible for the objective – no disbursement), 'satisfactory' (aggregated score for the objective of 35% to 70% – half-disbursement) and 'strong' (aggregated score for the objective of 70% and more – full disbursement). *In the example, progress against policy objective 1 is 'unsatisfactory' withholding this share of the variable tranche. Progress against objective 2 is 'satisfactory' triggering half-disbursement. Progress against objective 3 is 'strong' and the respective share of the variable tranche is disbursed in full. As a result, 4.5 M€ is disbursed.*

**Option 3 – overall performance:** all indicators are considered together and the assessment is based on the overall progress, with categories such as 'unsatisfactory' (overall score below 3 – no disbursement), 'limited' (overall score from 3 to 4.5 – disbursement of 35%), 'satisfactory' (overall score from 5 to 7.5 – disbursement of 65%) and 'strong' (score from 8 to 10 – full disbursement). *In the example, the overall score is 5.5, it falls into the 'satisfactory progress' category and 65% of the variable tranche is disbursed or 6.5 M€.*

***Step 1 – Assessing performance and attributing a score to each indicator***

In this example, each indicator is scored 0, 0.5 or 1 depending on whether there was (i) no or insignificant progress, (ii) significant but partial progress<sup>151</sup>, or (iii) target met. This is the preferred option but alternative options may be proposed, for instance to have only 2 categories (0 or 1 for met or not met), an exact pro-rata score in accordance with progress made<sup>152</sup> or a target which would be set in terms of range<sup>153</sup> instead of a precise figure in order

<sup>151</sup> The target assigned to the intermediate score (0.5) would typically be set midway between the baseline and the full target, but it may also be defined differently. This is particularly true for process-indicators which may not be quantified. In any case, this has to be spelled out precisely in the financing agreement.

<sup>152</sup> It would only be applicable to quantified targets and this would be calculated as follows: (Result – Baseline) / (Target – Baseline). In the case of an indicator for which an increase by 4 percentage points was targeted and a progress by 3 percentage points actually achieved, the exact pro-rata score for this indicator would be 75% (3/4) and the amount attached to this specific indicator be disbursed to the extent of 75%.

to take account of confidence intervals and make the performance assessment less mechanistic or subject to statistical flaws, for instance. Whatever the scoring methodology is, all the calculation details and the various scenarios need to be spelled out explicitly in the financing agreement with their unambiguous conclusions for the disbursement decision.

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

### *Step 2 – Aggregating scores to determine the variable tranche disbursement*

The scores may be aggregated **indicator by indicator** (adding up weight-adjusted amounts for individual indicators) **or through the use of broader performance categories** (two possibilities are presented above, but others could be proposed as long as they are adequately spelled out and substantiated). In the example, the three options lead to different results:

- a disbursement of 55% of the variable tranche (indicator by indicator);
- a disbursement of 45% of the variable tranche (performance per policy objective);
- a disbursement of 65% of the variable tranche (overall performance).

Compared with the indicator-by-indicator option, the use of performance categories allows for a broader assessment (e.g. a full payment in case of strong but not 100% performance, or the tranche withholding when performance may not be 0% but is still unsatisfactory).

It is particularly useful in the case of quantitative targets where it avoids an overly mechanistic focus on individual scores and a 'ticking boxes' approach in favour of a broader analysis. Aggregating scores around each policy objective may also prove to be effective to assess progress in a more structured manner with greater attention to the consistency of results against several indicators for the same objective. However, where the variable tranche is based on a limited number of policy measures, the indicator-by-indicator option may be preferable to ensure focus on each reform.

In all cases, **the financing agreement must spell out explicitly the chosen aggregation methodology, the various possible cases with their unambiguous conclusions for the disbursement decision.** Ultimately it needs to make sense in view of the policy objectives, of the country context and to be understandable by the partner country.

The performance assessment and the related decision about variable tranche disbursements depend on the availability of the results information, which will need to be assessed and specified during the design of the budget support contract. In order to enhance predictability, the disbursements should normally coincide with the country's budgetary cycle. A typical review calendar would be to assess fiscal year n-1 performance in year n, in order to provide disbursement commitments for disbursement early in year n+1. This is the **n-1/n/n+1**

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<sup>153</sup> For instance, the target for an indicator to be considered 'met' could be set at '75% with an accepted deviation down to 74.5%' [and/or] 'up to 75.5%' should an increase, a decrease or a continued rate be sought. Accepted deviations could also apply to absolute numbers (often input or output indicators). Opting for a range and accepting slight deviations allows taking into account statistical imprecision or slight changes in coverage or completeness of statistics over years. However opting for a range instead of an exact number would still require (i) setting exactly the lowest and/or greatest accepted values of the range in the financing agreement and (ii) demonstrating progress over years to trigger disbursement against the indicator.



**principle.** In less aid dependent countries where predictability is less of a concern, disbursement could take place if needed immediately after the assessment, the **n-1/n/n option**.

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

In general, **undisbursed funds** should not be 'recycled' in later tranches as this could reduce the incentive effect of variable tranches and undermine the credibility of policy dialogue and performance measurement in the context of budget support. Rather, where possible and according to the applicable rules, they should be decommitted and either re-committed for capacity building actions within the financing agreement or returned to the country's multi-annual indicative programme.

Nonetheless, the financing agreement may allow for the possibility to **waive or neutralise a variable tranche indicator** in exceptional and/or duly justified cases, e.g. where unexpected events, external shocks or changing circumstances have made the indicator or the target irrelevant. In these cases, the related amount could either be reallocated to the other indicators of the variable tranche the same year or be transferred to the next variable tranche the following year. The financing agreement may also provide for the possibility to re-assess an indicator the following year against the original target, if there was a positive trend and the authorities did not reach the target because of factors beyond their control.

Such provisions in the financing agreement should not substitute for **constant monitoring of the conditions and indicators** applicable to disbursements at any time of contract implementation. Problems of this kind must be anticipated to the extent possible and, when needed, be taken into account through an amendment to the financing agreement, early enough not to undermine the incentive effect of variable tranches.

## Useful references

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## **Annex 9 – State and Resilience Building Contracts for fragile situations**

This annex aims at highlighting aspects specific to budget support in situations of "fragility" and "transition", namely: the rationale, key issues when assessing the case for a State and Resilience Building Contract (SRBC), and the specificities of design and implementation. The purpose of this document is therefore to provide guidance on the conditions in which the EU would consider implementing budget support in situations of fragility and to give some indication of the measures to be taken for its implementation. The SRBC is adapted to situations of fragility that may arise, inter alia, in partner countries during political transition to democracy and establishment of the rule of law.

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

The SRBC concept is in particular informed by the work of the International Network on Conflict and Fragility (INCAF), by the EU's engagement in the International Dialogue on Peace- building and State-building (IDPS) and its commitment to the New Deal for Engagement in Fragile States (New Deal) adopted in Busan in 2011 and its reaffirmation in the "Stockholm Declaration" on Addressing Fragility and Building Peace in a Changing World of April 2016. The Joint Communication on Resilience sets out a number of methodological considerations, reproduced in Appendix.

### **1. Rationale for State and Resilience Building Contracts**

In certain situations of fragility the provision of budget support may be the most appropriate aid modality to support partner countries in ensuring vital state functions. By channeling financial resources through the state's budget, it can prevent serious deterioration of the economic situation, by underpinning stabilisation measures, and strengthening the State's capacity to provide basic services to the population. The lack of basic service delivery is often a cause for an aggravation of social tensions and may lead to a loss of trust in public institutions. Therefore it is essential to strengthening the capacity of a state to build, maintain or restore its core functions, and basic social and political cohesion, in a manner that ensures respect for democracy, rule of law, human and fundamental rights and fosters inclusive long-term security and progress. In line with the Joint Communication on Resilience, attention should also be given to the capacity of societies, communities and individuals to manage opportunities and risks in a peaceful and stable manner, and to build, maintain or restore livelihoods.

Budget support can help the transition towards stability and development and promote improvements in governance, human rights and democracy and basic service delivery.

In order to reflect these objectives, EU budget support contracts in fragile situations are referred to as State and Resilience Building Contracts (SRBCs). Countries in fragile situations face considerable challenges and are, by definition, high risk environments. Therefore, the decision to provide budget support, the eligibility criteria assessment, the design, and the implementation modalities require specific features: quick intervention, conflict analysis, taking account of the institutional and capacity weaknesses in applying the eligibility criteria and performance results, but also identification of positive factors of resilience, stronger political and policy dialogue, technical assistance, additional safeguards, close monitoring of risks through the risk management framework and considering the risks of non-intervention.

This requires an integrated approach where budget support is complementary to other means of intervention (humanitarian aid, pooled funds, project aid, and technical assistance) and diplomatic and political efforts.

## **2. Key issues when assessing the case for State and Resilience Building Contracts**

### ***2.1 Analysis of the fragility situation***

State and Resilience Building Contracts should be provided exclusively in fragile situations on a case by case basis. However, countries in fragile situation are not automatically eligible for SRBCs. EU Delegations should start the identification phase by determining whether the potential beneficiary state can be considered to be in a fragile situation/in transition (taking into account information from EU internal and relevant external sources, including the OECD's 2016 multi-dimensional framework).

In its conclusions of November 2007, the Council of the EU addressed the state – citizens relationship and the aspect of the State's political will by stating that "fragility refers to weak or failing structures and to situations where the social contract is broken due to the State's incapacity or unwillingness to deal with its basic functions, meet its obligations and responsibilities regarding the rule of law, protection of human rights and fundamental freedoms, security and safety of its population, poverty reduction, service delivery, the transparent and equitable management of resources and access to power".

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

The concept of transition refers here to a variety of situations that can lead to a transition from conflict to sustained peace often accompanied by a transition from authoritarian rule to democracy. This can be a long process of societal transformation where policymaking institutions need to adapt to the demands of a more democratic and equitable society. The transition may be peaceful or crisis-driven. In these situations, elaboration of medium term development strategies may not be feasible as long as the situation remains fragile<sup>154</sup>. Countries in transition may face economic and social pressures and need more effort and international support to make reforms work in practice and become sustainable.

The EU Global Strategy identifies strengthening state and societal resilience in EU partner countries as part of the strategic response. The support to resilience at all levels is also an integral part of the new European Consensus on Development, which promotes a dynamic and multidimensional approach to resilience, to deal with vulnerability to multiple inter-related risks. The Global Strategy as well as the Consensus recognise the need to move away from crisis containment to a more structural, long-term non-linear approach to vulnerabilities, with an emphasis on prevention. This requires the integration of efforts by EU political, development and humanitarian actors.

A better understanding of the factors of risk and resilience in a given context is a prerequisite for responding to pressures in a more effective manner. To do so requires a proper understanding of the linkages between different parts of the complex systems that govern and

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<sup>154</sup> See Communication on Supporting sustainable change in transition societies (SWD(2012)282).

sustain states, societies and communities, as well as their response to sudden-onset shocks, and recurrent or long-term stresses. A possible tool for this analysis are the single country assessments envisaged in the Joint Communication on Resilience, and the Risk and Resilience Assessment developed by the World Bank<sup>155</sup>.

EU Delegations are required to make an assessment of fragility, based on criteria related to consideration of fragility by international organisations and in relation to the above EU definition of fragility.

From a viewpoint of the potential provision of budget support, the analysis must address whether fragility is related to unwillingness or lack of capacity (as per the above mentioned council conclusions). In case of fragility due to unwillingness, there may be little scope for budget support. In practice, the assessment may often not be so clear-cut and a judgement must be made.

Although there is no automatic eligibility for the purposes of a State and Resilience Building Contract, it can be useful to refer to the list of countries for which a declaration of crisis has been made for the application of flexible procedures. The same applies to the World Bank harmonised list of fragile situations. However, even if a state or territory is not on one of these lists, then it can still be considered fragile or in fragile situation for the purposes of the State and Resilience Building Contract if sufficient evidence can be provided.

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

In the case of a transition situation, the SRBC should support short-term stabilisation through an integrated approach to prevent or manage crises. In the case of more structural fragility, it should accompany longer-term, state-building objectives, be conflict sensitive, and also aimed at addressing the sources of vulnerability.

## **2.2 Opportunity of intervention – risks and benefits analysis**

The decision to provide EU budget support in fragile situations *"should be taken on a case by case basis and supported by an assessment of the expected benefits and potential risks. The Commission will ensure that these decisions take into account the overall political and security situation, the financial risks, and the potential cost of non-intervention"*<sup>156</sup>. This assessment of opportunity is therefore a preliminary step before assessing the country eligibility to budget support.

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<sup>155</sup> , The use of these World Bank assessments is promoted in the declaration on the occasion of the World Bank and European Commission Deep Dive in June 2016

<sup>156</sup> See Communication on the Future Approach to EU Budget Support to Third Countries.

The assessment of the opportunity to provide budget support seeks to establish whether budget support could potentially promote essential elements of state building that consolidate the process of stabilisation and a country's emergence from crisis. The decision will be based on the political and economic analysis of the situation of fragility which should be part of the analysis of the risks and benefits expected. These analyses will be conducted by the EU Delegations, in close coordination with headquarters, member states and other donors in the field. In countries with joint programming, the joint analysis should be used, where available, to inform the preparation of the roadmap. This should lead to enhanced political and policy dialogue with the partner country.

The decision to grant budget support may require the prior adoption of specific policy measures before disbursements in order to limit risks. In order to speed up the decision-making process, this analysis should be conducted rapidly.

The risk management framework will inform the decision making process. It will help to identify the specific risks linked to the provision of budget support, to develop a risk response strategy, that covers mitigating measures such as capacity strengthening activities, safeguards and specific conditions, and to inform the political and policy dialogue.

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

A good basis for assessing the risks and opportunities should be a specific conflict or fragility / political economy assessment. In many fragile states, such analyses are carried out as part of joint-donor cooperation and – ideally jointly with the government. Where no up to date or credible analysis is available, the Delegation may choose to conduct its own analysis with the support of conflict analysis experts from headquarters. It would typically consist of an analysis of key factors and actors playing a role in the conflict/situation of fragility<sup>157</sup>, and their relations, often complemented by some form of scenario analysis.

Engagement in fragile situations involves high risks, but also offers opportunities for a high returns, as the non-engagement in a fragile situation may lead to higher costs in the long run. Spill over effects to neighbouring countries, directly through conflict, crime, and disease, but also through economic linkages, are to be taken into account<sup>158</sup>. A higher risk may be acceptable in these contexts where the expected benefit of a State and Resilience Building Contract is higher than the potential risk. The risk management framework is also a tool to monitor risks and the implementation of mitigating measures. This is crucial for an engagement in an environment of substantial and high risks in order to safeguard the Commission's interests and reputation. To analyse the risk, the same risk management framework as for other budget support contracts is applied, whereby the specific risk profile of a State and Resilience Building Contract will be reflected in the narrative part of the assessment, in particular by taking into account the relevance and credibility of a policy for

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<sup>157</sup> Guidance note on the use of Conflict Analysis in support of EU external action (29 October, 2013); Delegations may also contact DEVCO's Resilience and Fragility unit and the PRISM division in the EEAS.

<sup>158</sup> The cost to the typical fragile state and its neighbours, over the entire history of its fragility, has been estimated to be about \$100 billion – Collier (2007); Chauvet and Collier (2005).

transition, debt analysis, and financing gaps as part of the macroeconomic risk, and the overall institutional capacity. Balancing risks and benefits of a State and Resilience Building Contract are crucial for the decision on a budget support contract on a case by case basis. The risk management tool will therefore provide a summary of the expected benefits (the risk of non-intervention) of a budget support contract in a fragile situation alongside the risks associated with the intervention.

The decision to provide a SRBC is based on the political, economic and social situation of the partner country, and includes the following steps:

- Assessment of whether the partner country can be considered fragile or in a fragile/transition situation;
- A clear purpose linked to state building and democratic transition objectives;
- Assessment of the partner country commitment and stabilisation strategy to be supported by the SRBC;
- Assessment of the eligibility criteria for SRBC;
- Assessment of risks including the political risk, the mitigation measures and benefits; and
- An indication of the role of wider international support, notably from the EU member states, World Bank, IMF and Regional Development Banks.

The above assessment will be shared with EU MS represented in the country and in particular with those already engaged in budget support contracts or other stabilisation efforts. An appropriate level of consultation with non EU partners, in particular IFIs, will also be sought.

A note summarising this assessment (called the SRBC Road Map) will be prepared by the Delegation with an enhanced support of HQ, given the complexity and level of risk involved. It should be sent for decision to the relevant geographical director in DEVCO/NEAR. In order to speed up the intervention, an initial action document will not be required. The Delegation may however choose to submit an initial action document – for example to facilitate wider discussion on the options (inclusion of institutional support or design of the contract), instead of the SRBC Road map (see section 2.4 in this annex).

### ***2.3 Enhanced political and policy dialogue***

The political will of the government merits special attention as well as its capacity and/declared commitment to state building objectives/goals (cf. but not exclusively the five peace-building and state-building goals as defined in the New Deal<sup>159</sup>) and good governance principles. As for countries in democratic transition, they should have started the process towards democratic and governance reform (e.g. free elections or establishment of a Constituent Assembly) and should have demonstrated their willingness to incorporate fundamental rights into their legal frameworks. A successful transition towards democracy is not possible without broad public support and a wide popular understanding of the various issues involved, including the related political, governance and economic reforms and their implications. Thus, the political dialogue will aim at evaluating the stabilisation strategies for

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<sup>159</sup> The New Deal for engagement with fragile states defines 5 peace-building and state-building goals: i) legitimate politics (foster inclusive political settlements and conflict resolution) ii) security (establish and strengthen people's security) iii) justice (address injustices and increase people's access to justice) iv) economic foundations (generate employment and improve livelihoods) v) revenues and services (manage revenue and build capacity for accountable and fair service delivery).

meeting the challenges of fragility or instability and particular attention will also be given to the ownership and inclusiveness of the national political dialogue.

Budget support in a situation of fragility is part of an integrated EU approach. It is not an isolated instrument and the political and policy dialogue related to budget support needs to feed into the EU's overall approach, seeking synergies with other EU interventions<sup>160</sup>.

The challenges faced by a country emerging from crisis (e.g. demilitarisation and reintegration of ex-combatants or security sector reform) will have an impact on the country's budget. Issues of economic governance such as the management of natural resources (Extractive Industries Transparency Initiative (EITI), mining and petroleum agreements, forest exploitation/Forest Law, Enforcement, Governance and Trade (FLEGT), taxes and other revenues) or public sector management should be addressed in the broader political dialogue with the authorities. Indeed, all too often, countries endowed with natural resources such as oil, diamonds, minerals and timber have been the same countries that have struggled with instability and conflict. The dialogue on budget support enables the EU, through the EU Delegation, to take a stance on key development issues (governance reform, economic, domestic revenues, efficiency and effectiveness of spending, development policy).

Making the most of this dialogue calls for a high-level commitment, especially at the time of the identification/formulation phase as well as during the annual review of budget support. However, it must be underlined that both political and policy dialogues must be an ongoing process, informed by the constant monitoring of the budget support contract as well as the broader political developments. **Dialogue must be coordinated among EU member states** and other strategic partners to provide coherent and consistent responses to the challenges encountered.

## ***2.4 Eight steps leading to a road map for fragile or transition countries***

### **1. Assessment of the fragility situation**

Before providing a State and Resilience Building Contract, the situation of a partner country needs to be analysed focusing on its fragile or transitional nature, taking into account and complementing country led fragility assessments wherever they exist. It is important to ensure that SRBCs respond to the conditions on the ground and country specific challenges. It needs to be explained why a country is considered as being in a fragile situation or in a process of a democratic transition. The focus should be put on the capacity of the Government to fulfil its core functions and to deliver basic services to the population.

### **2. Clear purpose linked to state building objectives**

SRBCs generally aim at fostering a transition process towards development and democratic governance, and supporting vital state functions, including the delivery of basic services to the most vulnerable with a specific focus on women<sup>161</sup>, and reforms addressing the sources of vulnerability. Any State and Resilience Building Contract needs to reflect these objectives and be complementary to other means of intervention (humanitarian aid, pooled funds, and projects).

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<sup>160</sup> Council conclusions on the EU's comprehensive approach, 12 May 2014.

<sup>161</sup> Including actions such as cash transfers or social accountability measures, for instance.

### 3. Assessment of the partner country commitment and stabilisation strategy to be supported by the SRBC

Attention should be paid to Government's capacity and willingness, as well as its credibility to commit to state building objectives and goals<sup>162</sup> and/or to the democratisation process. The political/policy dialogue will play a vital role. It will aim at evaluating the stabilisation strategies and conflict sensitive planning for meeting the challenges of fragility or transition towards development and democratic governance. It will be continuously monitored through the Risk Management Framework during contract implementation.

### 4. Assessment of the eligibility criteria for SRBC

The eligibility criteria for SRBCs are adapted to specific circumstances of fragility and transition and take into account the capacity constraints of the partner country. The design of the contract should make an extensive use of the Council Conclusion on the Communication on Budget Support, which states *"In all forms of budget support the EU will apply a tailor-made and dynamic approach to eligibility [...] to maximise the impact on the ground"*.

Some short-term measures and support, particularly on Public Finance Management (PFM) and institutional capacity, may be required during the identification and formulation phase of the contract to prepare the country to be eligible for SRBC, in some cases more intensively and over a longer period of time than in others.

### 5. Assessment of the risks, including the political risk, the mitigation measures and benefits

The risk management framework is a very important tool in particular in fragile and transitional situations by their very nature. The analysis should be forward-looking oriented, as in most cases of fragility and transition track records are very poor. In order to propose a SRBC, the risk management framework needs to be used to prepare informed decisions of the Budget Support Steering Committee balancing the risks with the expected results/risks of non-intervention and to identify risk response strategies including mitigation measures and capacity development needs. Depending on a case-by-case decision, higher risks may be acceptable by the Commission, if expected results may outweigh the identified risks.

### 6. Indication of wider international support, notably from the EU-MS, World Bank, IMF and Regional Development Banks

Engaging in a dialogue with other international partners is crucial to ensuring better coordination between institutions at both HQs and country levels, notably in preparing and implementing budget support contracts in fragile/transition situations by sharing assessments and by developing joint road maps.

However, this approach should not restrict the autonomy of the Commission in deciding on special conditions for SRBC and assessing them during contract implementation.

### 7. Specific design features applied to SRBCs

SRBC should be part of an integrated approach and a long-term strategy of engagement with fragile/transition countries but should be monitored on a short term basis. In principle each contract should cover a period of 1-3 years. For SRBCs of short duration, in countries with a

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<sup>162</sup> Such as the five peace-building and state-building goals defined in the New Deal approach in Busan.



high financing gap with a need for more predictable aid, it is recommended to have larger base tranches. Indicators for variable tranches should be simple and realistic and focus on reforms and output indicators rather than outcome indicators.

This is due to the fact that often statistic capacities and monitoring frameworks are too weak to produce reliable outcome indicators. Moreover, the contract duration may be too short to achieve important improvements at outcome level. The indicators should relate to vital state functions, addressing sources of vulnerabilities, and, in case of countries in democratic transition, to democratisation processes as well. Close monitoring of treasury operations (e.g. through joint treasury committees) or targeted budget support (disbursements against verified expenditures) can be an option in case of very weak PFM systems.

## 8. Development of a road map

The SRBC Road maps will be developed following the sequence presented below. Road maps will identify and address key challenges for the design of a SRBC in a specific country. They will also aim at framing the policy dialogue, including capacity development, with the partner country to allow for, and strengthen the use of country systems, "making the case" for SRBC.

In order to speed up the intervention, an initial action document or identification fiche will not be required in principle. Road maps should be developed under the leadership of the geographic directorates and in close collaboration with Delegations and the participation of relevant HQs services (in coordination with ECFIN when macro-financial assistance is foreseen or is already on-going). The road maps will be submitted by geographic directors to the BSSC/FAST for approval. Subsequently, the action document and supplementary documents will be prepared by Delegations in accordance with the applicable procedures.

The road map is the instrument used to identify whether a country is likely to be eligible for budget support or to identify the steps by which it could become eligible. These steps, if sufficiently predictable, could take place alongside the formulation process. The road map will define the roles of the different actors (governments, IMF, group of donors, EU) in the process and, where relevant, chart the formulation phase, including the timetable, up to the financing decision. The road map should also be conflict sensitive.

In order to get the dialogue with the authorities under way as soon as possible and to inform them of the steps and conditions leading to eligibility, it is recommended that the road map be shared with them. It is also recommended that the road map be discussed with other partners, especially EU Member States, the IMF, World Bank, and development banks involved in budget support and/or support for economic governance in the country. This coordination will verify the feasibility of the steps and conditions planned and will ensure the consistency of the different partners' approaches.

## **3. Preparation of the action document and supplementary documents**

### ***3.1 Eligibility criteria***

As for all budget support contracts, SRBCs are subject to the four same eligibility criteria:

- Public policies;
- Stable macro-economic framework;
- Public financial management; and

- Transparency and oversight of the budget.

The general principles for the assessment of budget support eligibility described in these guidelines also apply to SRBC. However, when assessing the eligibility and the fulfilment of general conditions during implementation, the focus will vary to adapt on a case by case basis to the weaknesses inherent to situations of fragility. This annex addresses these specificities.

### 3.1.1 National/sector policies and reforms

The overall purpose of the SRBC is to support the activities deployed by a Government to ensure its vital State function and implement a development strategy addressing the challenges of fragility and poverty reduction as well as strengthening democratic processes.

However, in countries of situation of fragility there might not always be national development plans. In such cases, the EU Delegation can refer to frameworks approved by the international community, such as transition compacts developed to avoid aid fragmentation and ensure coherent approaches in state building. Other government strategies can also be used such as Presidential plans especially where these are more recent than a national development plan which might predate the crisis or conflict.

In line with section 4.1.1, the eligibility assessment will aim to demonstrate that the policy response is relevant and credible for this country and this particular situation of fragility. During implementation, the assessment will focus on progress against its stated objectives.

The first step will be to look at the process for formulating and monitoring the national development plan (or related strategy), taking due account of the institutional and financial obstacles to achieving that goal. Particularly in fragile situations, where institutional capacity is limited, care should be taken to ensure country ownership. Risk for donor-driven reforms is high but experience proves that ownership is critical for policy success.

The policy should not be overambitious, to avoid creating unrealistic expectations that could damage the legitimacy of the state. It should also support state and societal resilience. However, even embryonic, it should address the challenges of fragility (governance issues, stable macroeconomic framework, economic resilience, PFM reforms, basic service delivery) and be conflict sensitive.

The country's eligibility will be analysed in the light of the government's commitment to integrating its priorities into the state budget and to conducting regular joint reviews involving the authorities, the cooperation partners and, as far as possible, civil society.

During the implementation of the contract, as the policy response is implemented, the eligibility assessment will aim to demonstrate that progress is achieved against its objectives.

### 3.1.2 Stability oriented macro-economic framework

In Low Income Countries (LICs) experiencing fragility, on average, per capita GDP is roughly 60 percent lower than that of other LICs, while domestic revenues lag behind by some 5 percentage points of GDP<sup>163</sup>. Economic development is thus a key component of transition out of fragility. This requires a stable macroeconomic environment in order to

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<sup>163</sup> Based on IMF data for 2009 and excluding oil producing LICs, Somalia, and Solomon Islands.

reduce economic vulnerabilities over the longer term. Reliable program support and technical assistance are critical elements in this effort.

The IMF has an essential role to play in helping countries' efforts in this area and particular importance will be accorded to the studies and analyses of the IMF, with which the beneficiary governments draw up their budgets and macroeconomic frameworks and negotiate funding to meet urgent balance of payments needs. In Neighbourhood countries, the Commission, through ECFIN and macro-financial assistance, also provides analysis, advice and support to reforms geared towards macro-economic stabilisation.

In line with the guidelines on budget support (see section 4.1.2), for the purposes of demonstrating eligibility, particular attention will be given to the following aspects:

- The nature of the country's relations with the IMF and the type of programme in place: the analysis will show that a programme (an Extended Credit Facility) or at least a Rapid Credit Facility with the IMF is in place and will specify the type and characteristics (especially quantitative and structural benchmarks). It is a necessary condition. If there is no such programme, the IMF will be asked to provide an assessment letter confirming that a policy supporting or restoring the country's macroeconomic stability is in place; this may, for example, be the case when negotiations are under way for an IMF programme.
- The relations with the Commission in cases where there is a foreseen or on-going macro-financial assistance operation financed by the EU.
- Analysis of the macroeconomic situation (i.e. balance of payments, inflation, deficit with and without grants, level of foreign reserves, internal and external debt and fiscal policy), including management capacity.
- Existence of a revenue and expenditure framework and an identified financing gap.
- Outlook for the next two to three years and identification of variables in the event of shocks (e.g. accumulation of internal or external arrears).

### 3.1.3 Public Financial Management (see section 4.1.3 and annex 5 of the Guidelines)

Public financial management system is an essential part of the development process. Its performance is critical to achieve the public policy objectives and to ensure the appropriate use and effectiveness of donor assistance.

Therefore, assessment of eligibility will consider the credibility and relevance of the partner country's PFM reform programme. However, a reform programme may not always be encapsulated into a single, comprehensive and coherent strategy document, particularly in countries with weak systems, as fragile states. In such context, as stated in the Common Approach Paper on Coordination on BS in fragile states, *"Improved public financial management performance may be an outcome, rather than a pre-condition, of budget support, if the country has committed itself to an adequate program of PFM improvement and there is reasonable evidence that improvements are occurring in a timely manner."*

However, the eligibility assessment needs to ensure, as a minimum, that basic elements of a PFM system are met. To this end, a rapid diagnosis of the PFM system should be conducted

to provide a frame of reference for analysing the baseline situation and identifying main weaknesses that will need to be addressed (for example a PEFA or a diagnosis by the IMF's Fiscal Affairs Department, the World Bank or other donors can be used). Where these diagnostics do not exist already, a report conducted by the Delegation can be considered sufficient provided it gives evidence of conclusions reached and reflects views of other respected organisations.

In a particularly weak PFM environment it may be necessary to require short term measures, selected from the partner country's own PFM reform strategy. These would generally be in the form of specific conditions that would need to be fulfilled prior to the disbursement of the first tranche. The need for complementary support required in the form of technical assistance should be considered in order to address these specific weaknesses. On a case by case basis, additional exceptional safeguards may be considered such as joint treasury committees, accounting and bank reconciliations, clearance of suspense accounts, targeting disbursements to specific expenditure lines such as civil service salaries or for arrears clearance, or deployment of TA in line position with direct authority in relation to fiscal management and oversight. A particularly weak PFM system would be one characterised by very weak core functions within the budget cycle, notably covering budget availability, treasury system<sup>164</sup>, as well as a mechanism for reporting on budget execution, all of which are necessary in order to allow fiscal discipline and provide some basic assurance that money is being spent in line with stated objectives. In the *absence* of one or more of these core functions, budget support will not be considered.

Particular attention should also be paid to domestic revenue mobilisation as a key element in the sustainability of state building. Annex 11 provides additional guidance on this analysis.

On the basis of the diagnosis, the government, with the support of partners if necessary, will draw up (or update its existing reform plan) a realistic action plan with appropriate and prioritised reforms. Failing that, the measures agreed with the government and monitored by the IMF under its programme, or contained in a letter of intent, will be used as a basis. Due account will be taken of progress in public finance management reported by the IMF.

#### 3.1.4 Transparency and oversight of the Budget

The eligibility criterion on transparency and oversight of the budget<sup>165</sup>, detailed in annex 6 of the guidelines, focuses on the timely availability of comprehensive and sound budgetary information.

*Eligibility for contract approval:* The government must have published its budget before the first disbursement (either the Executive's budget proposal or the enacted budget). This information should be available to the general public in printed form or on an external website. This would be a specific condition for the first disbursement if not already met. The eligibility assessment will therefore evaluate if there is a clear commitment on the part of the partner country to meet this criterion.

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<sup>164</sup> In this case, a treasury system would be a system that accounts for all Government revenue collections and disbursements and ensures some control of cash balances through for instance the implementation of a treasury plan and the consolidation of government bank accounts.

<sup>165</sup> Refer to annex 6 for more details.

*Eligibility during implementation:* The Commission will assess and monitor more comprehensively the disclosure of budgetary information. In this regard, the Commission will focus on the implementation of a credible reform programme and will take into account:

- key budget documents to be produced and published (e.g. executive's budget proposal, the enacted budget, in-year reports, mid-year report, year-end report, audit report);
- timeliness of release of budgetary information;
- comprehensiveness of budgetary information; and
- quality, integrity and accuracy of information.

International assessments such as the Open Budget Index, the PEFA assessments, and the IMF Reports on the Observance of Standards and Codes (ROSCs) on fiscal transparency, can be used as a guidepost for the assessment, including for the definition of a country specific baseline during the formulation phase. The definition of reform milestones, however, must be realistic in the context of fragile states<sup>166</sup>.

### **3.2 Design of State and Resilience Building Contracts**

Experience shows that effective support to countries in fragile situations means engaging at an early stage and being prepared to stay engaged over the long haul, embracing a philosophy of carefully sequenced reforms tailored to improvements in capacity, supporting state and societal resilience, helping country authorities deliver “quick wins” to the population, and, in this process, building the legitimacy of the state. Such an approach implies to take account of what a fragile state or a state in transition can realistically achieve in a given timeframe. The design of the program will therefore be tailored, on a case by case basis, in view of managing and minimizing the risks identified.

#### **3.2.1 Duration of the contract**

Short-term SRBCs (1-2 years) should aim at supporting the short-term financing gap (e.g. to avoid an accumulation of domestic arrears), while SRBCs up to 3 years should be used to support more structural reforms, often in relation to the causes of vulnerability. Recourse to short contracts can help to consider a country's political agenda. However, many of the fragile countries show signs of long term, structural fragility. In these cases, with proper justification, SRBCs can be renewed, as long as the fragility persists. However, when conditions allow, an exit strategy towards a SDG contract or a SRPC should be pursued. A SRBC may be combined with an SRPC to support this transition.

#### **3.2.2 Risk Mitigation**

The Risk Management Framework (RMF)<sup>167</sup> is used to identify risks as part of the identification and formulation phase, and to propose appropriate measures to address them, in particular for the risk dimensions that face substantial or high risk levels. Experience with SRBCs suggests that a particular emphasis should be given to mitigating risks related to corruption as corruption in fragile countries continues to be a significant challenge. Contracts should also be conflict sensitive. Non-intervention risks are crucial for SRBCs and have to be highlighted in the decision making process.

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<sup>166</sup> Refer to annex 6 for more details.

<sup>167</sup> Refer to annex 7 for more details.

Mitigating measures could also include possible financial safeguards as described above (specific conditions, joint treasury committees to closely monitor treasury operations, accounting and bank reconciliations, clearance of suspense accounts, deployment of technical assistance in line position for fiscal management and oversight, or targeting)<sup>168</sup>.

#### *Specific conditions*

Depending on what has been agreed during the identification/formulation phase, the action document sets out the type of mitigating measures to be included in the financing agreement.

Systematically, these measures and conditions must have been the object of a dialogue with the authorities and, as far as possible, a consensus with the other budget support donors and the IMF. Additional to the four eligibility criteria, they should focus on the key elements to bring about overall improvement, particularly in the public financial management system.

#### *Preconditions for disbursement*

Depending on the context, it may be necessary to obtain the adoption of a particular measure before the contract can be implemented (i.e. before the first disbursement). This may concern the budget transparency, the improvement of some weaknesses identified in the PFM as well as the legislative, regulatory or institutional framework for financial administration.

Examples include a decree establishing a treasury committee, payroll control (e.g. audit of education expenditure), a reduction in the number of government accounts with commercial banks, limitation of the number of accounts at the Central Bank, preparation or adoption of legislation/rules on public procurement or strengthening external audit). Preconditions could also be related to the state building purpose of the SRBC.

### 3.2.3 Disbursement profile

The disbursement profile must be discussed with the government, the budget support donors and the IMF to make sure the planned timetable satisfies cash flow needs.

In situations of fragility, in order to increase the predictability of the contract and simplify its management both for the EU and the national authorities, the presumption should be that there will be just one disbursement a year. It will be timed to facilitate cash-flow management and budget implementation in relation to the purpose of the SRBC, which in most cases will be early in the budget year.

For a two or three-year contract, a variable tranche (VT) will be introduced of generally not more than 30%, with the possibility of stepping up the proportion of the variable tranche over the lifetime of the contract. For the first year of the contract, if no appropriate VT indicator has yet been identified, a single fixed tranche disbursement will be planned. In case of renewal, a variable tranche can be used already in the first year.

### 3.2.4 Performance indicators

Indicators should be carefully chosen to focus the policy dialogue and incentivise key reforms for the successful implementation of the SRBC without imposing further conditions.

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<sup>168</sup> Refer to annex 7 for more examples.

In situations of fragility, there should be a limited number of indicators for a variable tranche. They will serve to focus the dialogue on key points relating to the state building objectives supported by the contract, including in many cases public-financial management reform. As far as possible, they should be drawn from the national strategies and action plans or transition compacts. These will mainly be process indicators and/or, if possible, indicators linked to the budget (rate of budget execution, ideally for the social sectors).

In this complex environment, it is suggested that indicators be developed under the leadership of the HQ geographical directorate and in close cooperation with relevant HQ services (budget support unit, resilience and fragility unit and other thematic units).

### 3.2.5 Annual review of the contract

Whatever the duration of the budget support contract, the initial analysis of the risk and benefits must be regularly updated to facilitate risk management and identify possible slippages (early warning system), e.g. in macroeconomic policy, economic governance (e.g. public procurement, corruption) or public financial management (e.g. delays in reform). An annual review will be organised for this purpose. It will go beyond issues around disbursement requests and will involve pursuing deeper dialogue with the authorities and partners on broader issues relating to development and governance policies.

The annual review of the EU budget support contract conducted by the EU and the government (involving other multilateral donors and Member States in the country) will ideally be timed to coincide with the review of the national development strategy or equivalent document, the budget support review (if provided for by a joint monitoring mechanism) or the IMF review in order to permit an exchange of views on the EU contract. Reviews of the stabilisation framework may also be taken into account in the analysis. The review will cover: the four eligibility criteria and, if any, the specific conditions, the performance indicators for the variable tranches for the following year, disbursement forecasts and any other relevant issue (e.g. support for public financial management, economic governance or stabilisation reforms and donor coordination).

The annual review will enable a decision to be taken on whether to continue the contract, if need be in an amended form, and the conditions for the next year to be validated (specific conditions, if any, and performance indicators).

### 3.2.6 Additional technical support

Given the institutional/system weakness of countries in fragile situations, it will be necessary in many cases, to include additional technical support either in the budget support contract or alongside it, for instance as part of a governance support project.

Additional technical support should support for example public financial management reform, policy formulation and implementation, public administration reform, stabilisation, anti-corruption measures, or support for the implementation of budget support. The scale of this support will depend on the country's initial situation, the needs identified and the support offered/planned by the other partners in the context of the division of labour.

In the countries concerned, Delegations can mobilise a variety of support, technical assistance, support to transparency (e.g. web tools) and democratic accountability (e.g. CSOs), twinning and public expertise notably from EU Member States. As strengthening

public-financial management systems is one of the core functions of the IMF, Delegations can also mobilise the IMF expertise (Fiscal Affairs Department), in particular through the framework agreement signed between the IMF and DEVCO. Similarly, the EU, in consultation with the partners involved in the national policy process, for example the UNDP and the World Bank, could plan support for policy formulation and implementation, focusing on the drafting of the monitoring matrix, the choice of indicators and support for statistics.

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## **Appendix – 10 guiding considerations for A strategic approach to resilience from A Strategic Approach to Resilience in the EU's External Action – Ref.: JOIN (2017) 21**

**1. Strengthening resilience is a means not an end.** The EU's strategic approach to resilience is about building upon underlying institutional and societal strengths in partner countries in order to achieve long term sustainable development or security goals. It is about securing progress towards these goals by addressing vulnerabilities and underlying structural risks. It recognises that development, and progress towards democracy, peace and security, is not a linear process, and that sectoral approaches, on their own, are not always enough to ensure sustainable results.

**2. Understanding the factors of resilience in a given context can help us plan against pressures and contingencies in a more effective manner.** To do so requires a proper understanding of the linkages between different parts of the complex systems that govern and sustain states, societies and communities, as well as of how they respond when faced with sudden-onset shocks, recurrent or long-term stresses.

**3. Resilience is context-specific, and requires tailor-made approaches.** Although there are a number of common characteristics of resilient systems, it will be for practitioners and local actors to develop context-specific working definitions. The role of the EU and other external actors is to support this process and to foster societies better empowered to identify and solve their own problems. It requires policy makers and development partners to adopt a long-term approach that tolerates the necessary adaptability as approaches are tested and refined.

**4. Identifying and building upon existing positive sources of resilience is as important as tracking and responding to vulnerabilities.** Such factors may take the form of institutionalised or informal democratic and good governance or justice systems, non-state institutions and organisations, embedded cultural norms and practices or ad hoc community-driven solutions that complement state capacities or compensate for their absence. **Resilience has to be addressed at multiple levels – state, society and community.** Local governments and civil society are often the basis on which resilience can take root and grow at community level. Women have a specific and essential role that needs to be recognised and acted upon, while addressing the structural causes of gender inequality.

**5. Resilience is about transformation not preserving the status quo.** If resilience is about sustaining the core identity and capabilities of states, societies and communities in the face of disruptive pressures, it is also about ensuring their ability to adapt and reform to meet new needs. Harnessing the transformative dimension of resilience is key.

**6. Resilience requires a political approach.** Governments have primary responsibility for catering for the needs of their populations, and international assistance should not be a substitute for local responsibility and political action. All countries have committed to the Sustainable Development Goals, which include specific references to strengthening resilience. Thus the primary responsibility for integrating resilience into national and local policy frameworks lies within each country. However, the EU and its Member States can support the strengthening of resilience through raising the issue as an integral part of its political dialogue, including at the highest level.

**7. Resilience requires risk-informed programming.** Action to address the underlying diverse causes of fragility should be accompanied with risk management measures to protect

populations from shocks and stresses, limit their impact through early response and assist a quick recovery.

**8.** It will not always be possible to address sustained pressures at their point of origin, or to escape the consequences of a sudden-onset crisis. But addressing problems at the point of failure is disproportionately costly. That means **building flexibility and adaptability to change into programme design from the outset**. It also means thinking about the possible stresses that strengthening or weakening one part of a system can place on another.

**9. Early warning needs to be linked to early action.** It is not possible to avoid all risks, so an effective resilience approach requires decision makers to be able to identify and assess pressures in the long, medium and short term, and to take effective early action. This means that a complete assessment has to be linked to appropriate decision-making processes. This is not just about shocks (as in the case of natural disaster, inter-state conflict or economic crisis), it is also about slow-onset crises, recurrent pressures, or cumulative long-term pressures that can reach a tipping point (demographic, environmental degradation, climate change, migratory and other chronic stresses).

**10. The operational starting point is a broader analysis of strengths, vulnerabilities and pressures.** States and societies are built around complex interdependencies between political and security actors, the private sector, civil society, communities and individuals. Traditional sectoral policy approaches may not identify all vulnerabilities, their interconnections, or anticipate how a system as a whole will respond when it comes under pressure, including possible consequences for other States. That means that for any given outcome, risk – and the ability to cope – needs to be analysed at multiple levels, particularly at the points at which one factor of resilience, or one set of actors is dependent on the resilience of others, or where power relations between different levels of society play an important role. Typically this will mean an "all-hazard" approach, bringing together analysis at regional, state, organisational, community and individual level.

## Annex 10 – Budget support in Small Island Developing States (SIDS) and Overseas Countries and Territories (OCTs)

### 1. Introduction, background and rationale

The Communication on Budget Support makes special reference to SIDS/OCTs:

*The EU will pay special attention to SIDS (Small Island Developing States) and Overseas Countries and Territories (OCTs). There, budget support can have an important impact, given their strong commitment to addressing their structural vulnerability and climate change issues, including the decline of biological diversity and other environmental shocks. Budget support can offer an efficient way of addressing these cross-cutting, long-term and structural challenges and threats.*

The need to adapt budget support design to SIDS/OCTs rises from the specific conditions and challenges facing these countries and territories. The question, however, is not about reducing requirements. The impact of aid has been limited in SIDS/OCTs, partly because of the structural challenges faced by these countries, but also because of the relatively limited effectiveness of aid delivery<sup>169</sup>.

### 2. Key Challenges facing SIDS/OCTs

The challenges facing SIDS/OCTs can be summarised under four headings; vulnerability, volatility, natural resources wealth and institutional capacity:

1) Vulnerability: most SIDS/OCTs are highly vulnerable to natural disasters, economic/terms of trade shocks and aid volatility. Moreover, high levels of debt might reduce the resilience capacity to shocks. In that respect, it is generally recognised that reducing vulnerability to hazards through mitigation and adaptation is critical and should be a key component of SIDS development strategies and of OCT's efforts for a sustainable development. This vulnerability is increasingly exacerbated by the negative impacts of climate change, which disproportionally affect SIDS/OCTs, distance and energy constraints. These effects have important and direct impacts on the SDGs.

2) Volatility: international evidence shows that small states are no poorer or slower growing than larger states, especially when they are close to large markets and have relatively high population densities. Small states, including SIDS/OCTs, have overcome obstacles of scale by increasing trade and specializing in a small number of exports to a selected number of large markets, as well as in tourism. But this reliance on specialization has increased their vulnerability to rapid shifts in the terms of trade and changes in economic conditions in the world markets. As a corollary, they experience also greater volatility in growth. Combined with their vulnerability, this extreme volatility makes development planning particularly challenging in SIDS/OCTs and calls for strategies that take these uncertainties into account and builds an element of flexibility.

3) Natural resources management: There are strong similarities in the means by which high growth rates have been achieved in SIDS/OCTs. Tourism and natural resources play an important role in the growth experience of most strongly performing SIDS/OCTs. But good outcomes from natural resource investment are not automatically assured. The presence of

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<sup>169</sup> See for example Simon Feeny and Mark Rogers, *Public Sector Efficiency, Foreign Aid and Small Island Developing States*, Journal of International Development, Volume 20, 526-546 (2008).

natural resource wealth can be an opportunity for rapid growth and, therefore, for poverty eradication or for the achievement of sustainable development in the OCTs. However, reliance on abundant, highly profitable and non-renewable natural resources, linked with a high level of export dependence on these may not necessarily result in good economic performance due to distortion of incentives for sound fiscal management. Consequences are crowding out, i.e. expansionary fiscal policy reducing investment spending in other sectors, notably the private one, and the phenomena coined "natural resource curse" that ultimately reduce growth prospects. Contests over ownership and access to natural resources can lead to conflict, corruption and ineffective governance. In that respect, building capacity for managing natural resource wealth its governance, and its environmental and social impact, are essential in SIDS/OCTs.

4) Institutional Capacity: many SIDS/OCTs are characterized by very small administrations, weak institutional capacity and weak core state or local government functions. However, by comparison, public sector expenditures tend to be relatively high. Broad reform agendas are unlikely to be successful, because they cannot overcome such constraints. SIDS/OCTs must adopt strategies that reflect their usually limited administrative and political capacity as to strike a balance between the level of ambition, the available capacity and competence.

Many issues have a regional dimension and opportunities and constraints faced by SIDS/OCT are often similar. To that respect, regional organisations can play a key role in providing sector policy advice and technical expertise. Strengthened regional organisations allow for economies of scale which is of particular interest in SIDS/OCT. Where regional organisations are considered efficient, ownership from SIDS/OCT in promoting regional integration and sharing competencies at regional level should be promoted and monitored.

### **3. How to make EU budget support suitable to SIDS/OCTs**

Budget support can be an appropriate tool to help SIDS/OCTs to address the cross-cutting nature of the above four challenges. It can contribute to inclusive and sustainable growth by helping to foster a more strategic approach to adaptation to climate changes and resilience to vulnerability/volatility and to promote enhancing sector policies and reforms, including management of natural resources and development capacity.

This justifies adapting budget support to the SIDS/OCTs context. It implies assessing how the overall guidelines for budget support should be interpreted and specified for SIDS/OCTs, by narrowing them down and making them more context-relevant, and thus ultimately increasing the effectiveness of budget support contracts in SIDS/OCTs.

Paradoxically, while budget support could unleash some of its greatest potential in those difficult policy environments, establishing eligibility to the instrument and setting the adequate dialogue and monitoring framework in place may be the most challenging. Often, eligibility difficulties are not a result of failing to meet the eligibility criteria for budget support as such (in fact analyses show that these countries or territories are not doing worse from an economic governance perspective than recipients of budget support in other parts of the world). It is rather the consequence of having limited capacity to undertake the necessary "administrative" processes towards assessing eligibility, as well as, conducting the dialogue and monitoring the contract, from both the recipient side and the EU side.

However, even if, in general, SIDS/OCTs share the same four challenges listed above, there is no one-size-fit all approach. The following three major parameters should be taken into account to adjust budget support contracts to the specific SIDS/OCTs context.

#### *Size of the Population*

Budget support contracts should take into account the important differences within this group, which includes nations, on one side, of several million inhabitants, such as the Dominican Republic and Papua New Guinea and, on the other side, very isolated and far-flung micro- and nano-countries, sometimes with less than a thousand inhabitants.

#### *Association of the Overseas Countries and Territories with the Union*

OCTs are associated to the European Union by a specific 'Overseas Association Decision'. They are not sovereign countries but have special links with certain EU Member States. Within their constitutional relations with those Member States, the OCTs enjoy wide ranging autonomy and power covering the three dimensions of decentralisation: i) political, ii) administrative and iii) fiscal. In this context, budget support to OCTs may have similar features as budget support to a sub-national government (see section 2.3 in the guidelines). As regards to the fundamental principles of human rights, democracy and rule of law built-in the Communication of Budget Support, they are common to the OCTs and the Member States to which they are linked. Consequently, the fundamental values condition need not be assessed for OCTs within the budget support framework, as they are part of the 'Overseas Association Decision' and monitored within the association framework.

#### *Capacity Development and Size of the Administration*

Some SIDS/OCTs have more opportunities to develop a fully-fledged institutional and administrative frameworks and capacities than others, the latter being often smaller and more isolated economies in this group. In such SIDS/OCTs the standard considerations and assessments should be made when budget support contracts are being designed. This applies to SIDS/OCTs with capacity to design and implement public policies and reform strategies, and which have institutions and instruments to be able to manage macro-economic policy (e.g. they would have an autonomous Central Bank).

SIDS/OCTs with a more limited institutional and administrative framework and that do not meet the above criteria will need to be assessed accordingly. Expectations in terms of macro-economic eligibility cannot be the same for a country with a small economy without adequate instruments to manage such policies. The same would apply to public policies and PFM. Moreover, PFM assessment can draw, where applicable, on the audit report of the Supreme Audit Institution or other oversight bodies of the Member State to which they are linked.

## **4. Design Features**

a) In SIDS/OCTs, in most cases, the Sector Reform Performance Contract will be the most appropriate form of budget support, as most SIDS/OCT are characterised by a few – if not a single one – dominant sector(s). SRPCs in support of key sectors may be used in order to focus reform objectives and facilitate policy dialogue and monitoring. Such SRPCs should take into account and incorporate key cross-cutting areas related to the above four challenges; vulnerability, volatility, institutional capacity and, where appropriate, natural resources management. A SRPC, and in particular the policy dialogue that surrounds it, can contribute

fostering a more strategic approach to adaptation to climate change. This does not exclude the use of SDG- Cs or SRBCs in relevant contexts.

b) In SIDS/OCTs there should be a preference for fixed tranches only, with a specific focus in the assessments of general conditions on a limited number of key measures and outcome indicators. Most SIDS/OCTs have neither the capacity nor the institutional and administrative framework to monitor performance as required by the Variable Tranche approach. For the same reasons, the number of tranches (fixed or variable) should ideally be limited to one per year. If variable tranches are used, they should be applied towards the end of the contract, when it is more likely that results can be observed and assessed.

c) Linked to the above, the policy dialogue and the review process should focus on a few key country-owned measures and a close alignment/integration of the broader budget support assessment framework with other partners (if possible), including the definition of triggers and disbursement conditions. If circumstances permit, this could take the form of delegated cooperation agreements.

d) In many SIDS/OCTs, it may be unrealistic to envisage a frequent and in depth dialogue as requested elsewhere. A more opportunistic and ad-hoc approach may be applied, using opportunities as they become available (such as regional meetings, video-conference) as channels for dialogue. Nevertheless, the association of the OCTs with the Union constitutes a partnership that provides the framework for an enhanced policy dialogue.

e) Greater reliance on EU Member States (in the case of OCTs), multilateral and regional players/donors, in particular ADB, Australia, New-Zealand, IABD, WB and IMF (with its Regional Technical Assistance Centres) for assessments around PFM, macroeconomic and public policy issues, and experience with similar funding mechanisms (for example with the US Compact for Micronesia and Marshall Islands).

## **5. Risk Management Framework**

The Budget Support Risk Management Framework (RMF) is also applied for SIDS/OCTs. However, the specific circumstances of SIDS/OCTs needs to be reflected when the risk management framework is used. As an example, the vulnerability, volatility, and capacity constraints in SIDS/OCTs may imply specific risks that are not covered by the standard risk questionnaire. In these cases, the narrative part of the risk register and the country risk profile should be used to highlight the specific circumstances and risks.

For OCTs, the RMF will be conducted in close consultation and coordination with the EU Member State to which they are linked. Due to their special status, the RMF analysis will exclude political risks and will cover macro-economic risks, developmental risks, public finance management risks and aspects related to corruption and fraud.

In order to reflect the specificities of SIDS and OCTs, a simplified Risk Management Framework is applied. Rather than completing the full Risk Questionnaire with 44 questions, a simplified RMF template is applicable for SIDS/OCT, where only the 14 risk dimensions (see Annex 7) have to be rated and justified. This helps to focus on the most important issues and to reduce reporting requirements. Since risk ratings will still be available for the 14 risk dimensions, comparison with all other budget support countries and trend analysis will continue to be possible. The list of SIDS, which will apply the simplified RMF template, will be discussed once a year by the BSSC.

## 6. Evidencing eligibility

Simplified reporting requirements apply to SIDS and OCTs in the same way as to all budget support countries. This includes the possibility to prepare the Public Finance Management Report only every three years for countries and OCTs with overall low or moderate PFM risk. In addition, the specificities of SIDS and OCTs, described below, have to be taken into account when assessing eligibility.

### *Public Policy*

Most SIDS/OCTs have a development policy or strategy under implementation. However, in very small government administrations, there may not be a separate fully fledged sector policy. In such cases, the national or local policy can be used to assess the public policy eligibility criterion for a SRPC, as long as the national or local policy addresses sector issues in a sufficiently detailed manner. When assessing policy relevance, particular attention should be paid to the four key issues (vulnerability, volatility, natural resources and development capacity) outlined above. In most cases, these issues should be integrated into or addressed, at least to some extent, in sector policies. For OCTs, Member States' Multiannual Investment National Plans or Government Multiannual Programmes discussed in Parliaments can be used to assess eligibility as long as it addresses sector issues in a sufficiently detailed manner.

### *Stability-oriented Macro-economic Framework*

This eligibility assessment warrants particular attention given SIDS/OCTs vulnerability to macroeconomic shocks. Moreover, where no funded IMF programme is present<sup>170</sup>, EU delegations will have to base their assessment on IMF article IV report or on one of the regional development banks reports (e.g. IADB for Caribbean; ADB for Pacific). For small economies, the assessment will take into account of the institutional framework in terms of capacity and policy instruments (e.g. a Central Bank). For most of the OCTs macroeconomic stability is supported by the Member States to which they are linked.

Fiscal policy can be particularly critical in SIDS/OCTs given the dominant role of the state and the need to develop resilience against shocks. In SIDS/OCTs, the public sector tends to have a relatively dominant role in the economy. Higher public expenditure in smaller economies can reflect a higher share of 'fixed' minimum costs required to operate a government, or the need for more government interaction with the economy in response to a narrower economic base. This higher level of expenditure also tends to result in larger budget deficits (excluding grants). Foreign aid, together with debt financing, plays a major role in financing some of these deficits, and thus can have an important macroeconomic impact. The high degree of vulnerability creates a need for fiscal policy space in order to give policymakers flexibility to respond counter-cyclically to shocks or downturns<sup>171</sup>. Weak fiscal discipline may exacerbate economic volatility by, for example, causing bouts of fiscal expansion and contraction. Fiscal discipline can help reverse the crowding out of private investment and spur private-sector led growth.

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<sup>170</sup> While the IMF is present in most Caribbean countries, few Pacific Islands and none of the OCTs have Fund programmes. However, regional donors or organisations (e.g. PFTAC, ADB, IADB or CARTAC) may also have macroeconomic assessments which can be a source of information.

<sup>171</sup> Stéphanie Medina Cas and Rui Ota, *Big Government, High Debt, and Fiscal Adjustment in Small States*, IMF Working Paper WP/08/39.

## *Public Financial Management*

Sound public financial management is essential for a successful development process in SIDS/OCTs, as it is for all partner countries. There are, however, important differences to bear in mind when analysing the relevance of the strategy and when supporting and setting expectations for PFM reforms in SIDS/OCTs, specifically the annual and medium term reform expectations included as part of the monitoring framework for contract implementation.

The focus in SIDS/OCTs should not be overly on the too complex PFM reforms, but rather on whether key PFM processes, particularly related to financial compliance and aggregate fiscal discipline, are effectively implemented. SIDS/OCTs may not necessarily require PFM systems as sophisticated as in other countries.

Many SIDS/OCTs, in particular in the Pacific have been testing-grounds for complex PFM techniques and systems, with insufficient attention paid to sustainability and relevance. In 2001, the IMF, referring to such systems in the Pacific Islands, was recognising that *...implementation on the ground has remained a considerable problem primarily because the reforms were in most cases introduced without sufficient regard to local capacity constraints, notably in management and accounting*".<sup>172</sup> A particular risk factor is often the reliance on costly external expertise.

Against this background, in SIDS/OCTs particular attention should be given to the analysis of shortcomings of existing systems and practices and then the establishment of priorities for reform identification of resource constraints and development of coherent and well-paced implementation plans. In reasonably well performing SIDS/OCTs, the focus of the eligibility will as a result be more about assessing progress towards advanced reforms to achieve high PFM standards that can deliver, in addition to financial compliance and aggregate fiscal discipline, efficient and effective service delivery.

Assessments of OCTs will depend also on the fiscal autonomy and powers from the Member States to which they are linked. Therefore, attention should be paid to their fiscal autonomy.

### *Transparency and Oversight of the Budget*

The guidelines outline how this criterion should be assessed for SIDS/OCTs (see Guidelines section 5.1.4.). The criterion covers the definition of an entry point for budget support contracts and the assessment of progress based on a dynamic approach.

For eligibility during implementation, which focuses on disclosure of six key budgetary documents, the guidelines state that more flexibility can be applied for SIDS and OCTs, in particular with regard to the publication of the Executive's Proposal and the Year End Report or Audit Report.

Nevertheless, budget transparency in OCTs should be, in principle, identical to that of the Member State to which they are linked. If any difference can be observed, an assessment of eligibility should be made.

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<sup>172</sup> Klaus-Walter Riechel, *Public Financial Management: Principal Issues in Small Pacific Island Countries*, IMF Policy Discussion Paper, February 2002



## Annex 11 – Domestic revenue mobilisation

This annex provides background information on domestic revenue mobilisation (DRM) in the context of budget support. It complements the guidance on DRM included in the annexes on public financial management and macroeconomic analysis. It is structured as follows:

- Section 1. The global and policy context for the EU approach to DRM support;
- Section 2. EU efforts in support to DRM;
- Section 3. How to promote domestic revenue mobilisation through budget support;
- Section 4. The special case of natural resources for taxation and revenue management; and
- Section 5. Overview of DRM databases and diagnostic tools.

### 1. The global and policy context for the EU approach to DRM support

The improvement of domestic revenue mobilisation lies at the heart of the Addis Ababa Action Agenda on Financing for Development<sup>173</sup> as well as the 2030 Agenda for Sustainable Development<sup>174</sup>. It is also a priority of the international G20<sup>175</sup> and G7<sup>176</sup> agenda. To finance and implement successfully the global commitments of the international community and the development aspirations of its citizens, more domestic revenues are needed.

One aspect has received particular attention globally. This is the loss of tax revenues due to tax avoidance, tax evasion and the related illicit financial flows. The importance and magnitude of the problem have been highlighted in several scandals. The impact is significant in countries with high dependency on revenues from corporate income tax. The 'Mebeki Report'<sup>177</sup> estimates that illicit financial flows from Africa could be as much as US\$50 billion per annum.

At domestic level, despite often strong growth rates and abundant natural resources, many partner countries still lag behind their full potential in DRM with a world average of tax/GDP of less than 20%, although there is no standard as regards the level of taxation. When natural resources are abundant, this wealth can even undermine DRM efforts<sup>178</sup>.

DRM and, in particular, fair and efficient taxation are at the core of the social contract between a state and its citizens. Domestic accountability, understood as the ability to hold the government accountable on the use of public expenditures and public service delivery, is more likely to thrive when citizens fund the government through taxation.

Efficient and effective tax systems contribute to tackling corruption and illicit financial flows by reducing possibilities for poor governance and illegal behaviour. Strengthening partner countries' tax systems is therefore a necessary step in ensuring fiscal stability, promoting equitable economic growth, reducing inequality, strengthening anti-corruption efforts, as well as enabling long term financing of their own strategies and programmes. Domestic revenue mobilisation, including revenues from natural resources, needs to be an essential component

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<sup>173</sup> See [http://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA\\_Outcome.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf).

<sup>174</sup> See <https://sustainabledevelopment.un.org>.

<sup>175</sup> See G20 Leaders' Communiqué Hangzhou Summit, 4-5 September 2016.

<sup>176</sup> G7 Ise-Shima Leaders' Declaration, G7 Ise-Shima Summit, 26-27 May 2016.

<sup>177</sup> Refer to *Illicit Financial Flows*, Report of the High Level Panel on Illicit Financial Flows from Africa Commissioned by the AU/ECA Conference of Ministers of Finance, Planning and Economic Development (see [http://www.uneca.org/sites/default/files/PublicationFiles/iff\\_main\\_report\\_26feb\\_en.pdf](http://www.uneca.org/sites/default/files/PublicationFiles/iff_main_report_26feb_en.pdf)).

<sup>178</sup> Refer, for instance, to IMF Working Paper WP/14/5, *Resource Blessing, Revenue Curse? Domestic Revenue Effort in Resource-Rich Countries* (<https://www.imf.org/external/pubs/ft/wp/2014/wp1405.pdf>).

of countries' public finance reform programmes and part of the policy dialogue between the EU and partner countries, especially in the framework of a budget support program.

## 2. EU efforts in support of DRM

The EU promotes the principles of transparency, information exchange and fair tax competition, which have gained traction worldwide. Major improvements have been made in tax governance within the EU internal market, while taking into account implications for third countries and ensuring policy coherence for development. The *Anti-Avoidance Tax Package* adopted in January 2016 includes a dedicated communication on the *External Strategy for Effective Taxation*<sup>179</sup>.

In terms of development policy, the Commission approach towards DRM has been outlined in the *Collect More – Spend Better* Staff Working Document in 2015<sup>180</sup>. This document addresses both the revenue and expenditure side of public finance. It builds upon the 2010 *Communication Tax and Development* and is consistent with the 2011 *Communication on Budget Support*. In addition, the relevance of DRM as a driver for development is highlighted in the EU development policy, the New European Consensus<sup>181</sup>.

The EU is increasingly supporting countries' reform efforts to mobilise domestic revenues as well as their efficient and effective use. A collective commitment by development and cooperation partners to doubling the support to DRM efforts by 2020 was adopted in 2015 under the Addis Tax Initiative (ATI)<sup>182</sup>. Action is taking place at national, regional and international level to help countries mobilise domestic revenues, tackle illicit financial flows and ensure that all taxpayers pay their fair share of taxes. Support for transparent and fair tax systems plays an important role in all EU budget support contracts as well as in dedicated projects to develop capacities in this respect.

At global level, the Commission collaborates mostly but not exclusively with the four Institutions that form the *Platform for Collaboration on Tax*<sup>183</sup> (IMF, WB, UN and OECD).

- The EU supports the G20/OECD initiatives on *Base Erosion and Profit Shifting (BEPS)*<sup>184</sup> and *Exchange of Information (EOI)*<sup>185</sup>. It promotes the involvement of partner countries in international fora and standard setting processes, such as the BEPS Action Plan and its inclusive framework, to ensure that all countries' concerns may be taken into consideration.
- The EU collaborates with the OECD on the *Revenue Statistics Initiative*<sup>186</sup> that focuses on the production of reliable and comparable data on revenue mobilisation.
- The EU provides assistance to the UN Tax Committee<sup>187</sup> with the objective to enable participation of partner countries in its sub-committee.

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<sup>179</sup> See [http://ec.europa.eu/taxation\\_customs/business/company-tax/anti-tax-avoidance-package\\_en](http://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en).

<sup>180</sup> See <https://ec.europa.eu/europeaid/sites/devco/files/swd-collect-more-spend-better.pdf>.

<sup>181</sup> See [https://ec.europa.eu/europeaid/sites/devco/files/european-consensus-on-development-20170602\\_en\\_0.pdf](https://ec.europa.eu/europeaid/sites/devco/files/european-consensus-on-development-20170602_en_0.pdf).

<sup>182</sup> See <https://www.addistaxinitiative.net>.

<sup>183</sup> See <http://www.oecd.org/tax/platform-for-collaboration-on-tax.htm>.

<sup>184</sup> See <http://www.oecd.org/ctp/beps>.

<sup>185</sup> See <http://www.oecd.org/tax/transparency>.

<sup>186</sup> See <https://www.oecd.org/tax/revenue-statistics-in-africa-9789264253308-en-fr.htm> for Africa, <http://www.oecd.org/tax/revenue-statistics-in-asian-countries-2016-9789264266483-en.htm> for Asia and <http://www.oecd.org/ctp/revenue-statistics-in-latin-america-and-the-caribbean-24104736.htm> for LAC.

- Through the Pan African Program<sup>188</sup>, in collaboration with the **German International Cooperation (GIZ)**, the EU supports the work of the *International Tax Compact (ITC)* which includes assistance to the secretariat of the *Addis Tax Initiative (ATI)*.
- The EU is engaged in a tripartite initiative together with the **OECD** and **World Bank** to support partner countries, notably through capacity building, to prevent profit-shifting through misuse of transfer pricing by transnational corporations.
- The EU closely worked with the **IMF and other partners** on the development and roll out of the *Tax Administration Diagnostic Assessment Tool (TADAT)*<sup>189</sup>. TADAT plays a critical role in complementing the PEFA instrument on tax-related aspects.
- In the context of the **DEVCO-IMF Strategic Partnership Framework**<sup>190</sup>, EU efforts to mobilize domestic revenues are promoted through the technical assistance provided by IMF topical trust funds which benefit from a substantial financial EU contribution and political support at the highest level. The *Revenue Mobilisation Trust Fund*<sup>191</sup> provides direct assistance to partner countries in strengthening their tax policies and administrations. In a similar approach, the *Management of Natural Resource Wealth Programme*<sup>192</sup> focuses on revenue mobilisation in natural resource rich countries.
- To promote transparency in revenues coming from the exploitation of natural resources, the EU is also engaged in the promotion and implementation of the *Extractive industries Transparency Initiative (EITI)*<sup>193</sup>. The EITI has helped to discourage corruption and tackle illicit financial flows by disclosing information about the revenues coming from extractive industries. Support to countries for implementing the EITI Standard is provided by the World Bank through the Extractives Global Programmatic Support<sup>194</sup> Multi-Donor Trust Fund with an important EU financial contribution.
- In the neighbourhood and enlargement contexts, the EU provides technical assistance through agreements with “Support for Improvement in Governance and Management” (SIGMA) OECD, with the IMF and with the World Bank. SIGMA supports country strategies formulation, monitoring and evaluation systems based on baseline assessments. It also integrates tax administration and PFM reforms in the framework of public administration reforms looking for a more efficient and effective approach that takes into account key issues like human resource management and civil service, information technologies, policy-making and service delivery. IMF provides technical assistance in medium term budget frameworks, fiscal strategy and tax administration (e.g. compliance risk management, IT systems conceptual framework and change management). World Bank helps with complementary technical assistance.

**At regional level**, the EU supports through the Pan African Programme regional network organisations in Africa such as the *African Tax Administration Forum (ATAF)*<sup>195</sup>, the *African Organisation of Supreme Audit Institutions (AFROSAI)* and the *Collaborative African Budget*

<sup>187</sup> See <http://www.un.org/esa/ffd/ffd-follow-up/tax-committee.html>.

<sup>188</sup> See <https://www.giz.de/en/downloads/giz2015-gfg-article-eu-and-giz.pdf>.

<sup>189</sup> Refer to <http://www.tadat.org>.

<sup>190</sup> See <https://myintracomm.ec.europa.eu/dg/devco/notice-board/Pages/20161220c.aspx>.

<sup>191</sup> See <https://www.imf.org/external/np/ins/english/rmtf.htm>.

<sup>192</sup> See <http://www.imf.org/en/Capacity%20Development/trust-fund/MNRW-TTF>.

<sup>193</sup> See <https://eiti.org>.

<sup>194</sup> See <http://www.worldbank.org/en/programs/egps>.

<sup>195</sup> See <http://www.ataftax.org/en/Pages/default.aspx>.

*Reform Initiative (CABRI)* and the *African Public Accounts Committees (AFROPAC)* through a joint programme with Germany.

In addition, collaboration is sought with the *Centro Interamericano de Administraciones Tributarias (CIAT)*<sup>196</sup> and the *Centre de Rencontre et d'Etudes des Dirigeants des Administrations Fiscales (CREDAF)*<sup>197</sup>.

At regional level, the IMF managed Regional Technical Assistance Centres (RTACs)<sup>198</sup> provide targeted technical assistance in tax reform alongside other reform areas.

All these actions take place in the **international** context and are **complementary to the EU direct assistance** provided to developing countries through budget support and through bilateral technical assistance programmes in support to the reform of economic governance.

While DRM has been an important aspect in the design of budget support contracts, the new global context together with the relevance of DRM as a key contributor to financing the achievement of the Sustainable Development Goals, makes it necessary to further strengthen the position of DRM in the design of the future budget support contracts.

Throughout the document *Special report no 35/2016: The use of budget support to improve domestic revenue mobilisation in sub-Saharan Africa*<sup>199</sup> the European Court Of Auditors examined the European Commission's use of budget support contracts to support revenue mobilisation in nine low-income and lower-middle-income countries in sub-Saharan Africa: Cape Verde, the Central African Republic, Mali, Mauritania, Mozambique, Niger, Rwanda, Senegal and Sierra Leone. They concluded that, while the Commission's approach led to better needs assessment requirements, weaknesses in implementation prevented budget support contracts' potential from being fully exploited.

In line with their recommendations, the present annex spells out a more coherent and systematic approach to DRM through strengthened analysis and reporting; intensified policy dialogue and better inclusion in the design of budget support contracts.

The dual nature of DRM (domestic reforms – tax policy and tax administration - and wide ranging global tax governance processes) makes it necessary to address this matter not exclusively as a development issue but rather as a complex topic including aspects such as trade, investment, financial sector, economic governance, taxation, money laundering and illicit financial flows. This is especially pertinent in the light of the ongoing EU process of establishing listings of non-cooperative third country tax jurisdictions and of third countries showing strategic deficiencies in their regimes on Anti-Money Laundering (AML) and Countering Terrorist Financing (CTF). Hence a broader approach through economic diplomacy is required, cognisant of the implications of revenue mobilisation reforms, including policy coherence for development.

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<sup>196</sup> See <https://www.ciat.org/?lang=en>.

<sup>197</sup> See <http://credaf.org/fr/actualites>.

<sup>198</sup> See <http://www.imf.org/en/About/Factsheets/Sheets/2016/07/27/17/12/Regional-Technical-Assistance-Centers>. These are also supported by the EU.

<sup>199</sup> See [http://www.eca.europa.eu/lists/ecadocuments/sr16\\_35/sr\\_revenue\\_in\\_africa\\_en.pdf](http://www.eca.europa.eu/lists/ecadocuments/sr16_35/sr_revenue_in_africa_en.pdf).

### 3. How to promote domestic revenue mobilisation through budget support

Domestic revenue mobilisation has to feature prominently in the public finance management analysis. This chapter provides guidance for that purpose and has to be applied selectively according to the country context. It is not to be considered a template<sup>200</sup>.

Promoting DRM does **not only mean to increase the volume**, i.e. the level of revenues collected, **but also to improve the quality, i.e. equity, transparency, fairness and efficiency of the whole process and system**. DRM is directly linked to the 'social contract' between the relevant stakeholders and a sovereign country. Assisting a DRM reform process therefore requires a good understanding of the surrounding political economy. It is inherently a sensitive issue, hence the importance to respect country ownership in DRM reform, identify the political champions who promote these reforms, build a strong policy dialogue with the identified partners and align support to a country driven reform agenda.

The establishment of a **medium-term revenue strategy (MTRS)**<sup>201</sup> could be particularly relevant as a framework for medium-term planning, reform and assistance. A MTRS is a high-level road map of the tax system reform over 4 to 6 years – with its policy, administration, and legal components. It embodies a government's strategy to mobilize resources through a tax system which can finance its spending needs and secure macroeconomic sustainability, while reflecting distributional considerations and creating appropriate incentives for economic and social development. A MTRS should be a public document, since wide consultation with the tax system's stakeholders is desirable in its development, including promoting accountability of all parties. A MTRS thus becomes a government-led and country-owned effort, supported at the highest political level. This proves to be critical, given the broad reach of the tax system. Some countries may wish to have external support with development and implementation of their MTRS. The development and implementation of the MTRS may obviously be supported by cooperation partners, as long as it remains aligned with the government-led strategy (including in terms of sequencing).

Areas of engagement can range from revenue policy to revenue administration and the relevant legal framework, including the fight against tax avoidance or evasion, both at internal and international level, also tackling illicit financial flows that derive from tax evasion.

DRM and tax reforms are structural and long-term issues, for which external factors have significant influence (e.g. fluctuation of international commodity prices). Often improvements do not immediately translate into measurable results but are rather medium to long-term processes. These are aspects which need to be taken into consideration when designing budget support contracts. In particular, the choice of indicators needs to rely on measurable improvements and follow a reasonable timeframe.

Considering this background, support to partner country for domestic revenue mobilisation improvement through budget support will be articulated around the followings steps:

- Assessing DRM in a country;
- DRM when designing a budget support contract; and
- DRM when implementing a budget support contract.

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<sup>200</sup> Refer to reporting requirements applying to public finance management, to budget transparency and oversight and to macroeconomic policies in this respect.

<sup>201</sup> See <http://www.taxfordevelopmentevent.org/files/2017/04/MTRS-Draft-concept-note-Feb-6-2017.pdf> and [http://www.un.org/esa/ffd/wp-content/uploads/2017/04/ICTM2017\\_Presentation\\_Verhoeven-et-al.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2017/04/ICTM2017_Presentation_Verhoeven-et-al.pdf).

### 3.1 Assessing DRM in a country

In order to identify and potentially support critical reforms like to fuel a sound and substantial policy dialogue, a thorough understanding of the DRM situation is needed. To get to this stage, constant engagement with relevant actors (e.g. revenue authority, ministry of finance, supreme audit institution, parliament, civil society, private sector or other cooperation partners) is required to formulate a well-informed analysis.

There is no one size fits for all diagnosis. The information collected will have diverse implications in each context. Assessing DRM is country-specific and the dialogue with authorities is particularly important to feed into this analysis. A TADAT assessment on the strength and weaknesses of the tax administration would generally be a good starting point to set out an objective and informed base for support and dialogue. Like for PEFA and with due consideration of the sequencing between the two assessments, the use of TADAT is recommended to all delegations.

A DRM analysis should cover a broad range of issues, including taxes, customs and revenues from natural resources. Ideally, it should be structured around three main dimensions: **national tax/revenue policy, national tax/revenue administration and international dimension**. Such an assessment should also take place in the context of or in close connection with assessment with respect to public finance management or macroeconomic policies in general. It may for instance address the following points<sup>202</sup>:

#### *National tax policy*

- Identifying who are the local counterparts and how they interact among them (e.g. national/local administration for tax, customs, mines or forests; dedicated agencies and civil society organisations active in that field);
- Compiling available official public information (general information on taxes as well as more disaggregated information such as tax to GDP ratios, direct/indirect taxes, or national/local breakdowns). Assessing the existing facilities to ease the payment of taxes or duties (e.g. e-administration) and provide accessible/public information (e.g. on types of taxes, legal bases, payment schedule or contact points within the administration through the ministry of finances' or revenue administration's website) should also be tested. Determining also whether some public programs to improve tax payer compliance/education are implemented and if there is a public communication policy;
- Assessing whether tax/revenue regulations are regularly updated and this information is easily accessible to taxpayers. Assessing whether it is comprehensive and some tax regimes are defined in other codes, such as for example the investment code or the mining code? Are they also up-to-date and consistent with each other?;
- Assessing the level of cooperation and information-sharing between tax administrations, notably as regards taxpayers' information;
- Reviewing the tax incentives (also designated as tax expenditures) and assess these are regularly assessed and this assessment is published (if there is a 'free zone' in the country, and can the authorities clearly identify its beneficiaries?); and
- Examining if DRM tax/revenue policies are discussed at parliament and the degree of involvement of the members of parliament in this respect.

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<sup>202</sup> This is an indicative and non-exhaustive list of issues for consideration, to be adapted to the country context.



So far, no standard tool is available for the analysis of tax policy but a Tax Policy Assessment Framework (TPAF) is under development by the IMF and the World Bank.

#### *National tax administration*

- Verifying if recent assessments covering the revenue administration have been carried out such as the Tax Administration Diagnostic Assessment Tool (TADAT), the Revenue Administration Gap analysis (RA-GAP), the Revenue Administration Fiscal Tool (RA-FIT), and/or a Public Expenditure and Financial Accountability (PEFA). Listing the main weaknesses identified and reviewing the action plans prepared accordingly.
- Determining the size and structure of the tax administration (for example, the segmentation between large/medium/small taxpayers) and also the broad structure of revenues collected (for example, the share of total revenues provided by the 50 or 100 largest companies, and the share of VAT in the total amount of revenues collected).
- Finding out if the administration benefits from capacity building support delivered by international institutions, other partners and/or private entities. Determining if the country is getting EU-financed technical assistance on tax or customs issues, such as the one provided by the IMF Revenue Mobilisation Topical Trust Fund, IMF Management of Natural Resources Wealth Topical Trust Fund, the World Bank Extractives Global Programmatic Support, or the relevant IMF Regional Technical Assistance Centre.
- Identifying if the country is involved in the OECD Revenue Statistics Initiative to provide reliable and comparable data on tax collected.

#### *International dimension*

- Assessing how the administration is structured to work on international tax issues and deal with international/regional tax treaties (e.g. through a dedicated service or not);
- Verifying whether the country is listed by the EU and/or by the OECD as a non-cooperative jurisdiction or whether is present in the Financial Action Task Force (FATF) list<sup>203</sup>;
- Assessing the level of fulfilment with regard to the Global forum on transparency and exchange of information for tax purpose<sup>204</sup>;
- Verifying whether the country is participating in the OECD Base Erosion and Profit Shifting (BEPS) inclusive framework<sup>205</sup>;
- Assessing how the authorities work on revenues issues with regional organisations such as the Regional Economic Commissions (e.g. ECOWAS, COMESA, SADC);
- Assessing how far there is a dialogue between the revenue administration and, on the one hand, the different regional fora (e.g. African Tax Administration Forum, *Centre de Rencontre des Dirigeants d'Administrations Fiscales* or *Centro Interamericano de Administraciones Tributarias*) and, on the other hand, the international partners; and
- Determining whether the country signed up to the Addis Tax Initiative.

A dedicated Cross Border Diagnostic Tool (CBDT) is under development by the OECD to assess the degree of international involvement on tax matters.

#### *Engagement with partners and others*

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<sup>203</sup> See <http://www.fatf-gafi.org/home>.

<sup>204</sup> See <http://www.oecd.org/tax/transparency>.

<sup>205</sup> See <http://www.oecd.org/tax/beps>.

- Reviewing the dialogue on DRM between donors and relevant administration/official bodies, if any, and also assessing if DRM is regularly discussed in any coordination cluster of cooperation partners (e.g. public finance management, transparency, private sector, trade or public service reform).
- Finding out if there was any assessment by the national Court of Auditors concerning tax issues.
- Assessing if the national/international civil society is actively involved in revenue monitoring or accountability and, if it is, what the focus is (e.g. taxation, customs or extractive industries).

### **3.2 *DRM when designing a budget support contract***

Domestic revenue mobilisation has to be analysed as part of the **eligibility assessment** for budget support contracts.

**Macroeconomic stability** – Domestic revenue mobilisation has a strong influence on macroeconomic stability. The country capacity to rely on predictable revenue is crucial. It has a direct link to public service delivery and public investment. As illustrated by any commodity crisis, the countries which heavily dependent on natural resources revenues do not always take advantage of the expansion phase of cycles to improve domestic revenue mobilisation and often face severe shocks negatively affecting their macroeconomic stability, when international prices drop. Updated information on this topic should be found notably in the IMF article IV report or in IMF program reviews.

**Public finance management** – Public finance management covers both expenditure and revenue. A sound PFM assessment must include a dedicated part on domestic revenue mobilisation. This broad assessment should rely on the collection of available information from national sources, on diagnosis tools (such as TADAT or PEFA), technical assistance reports as well as on dialogue with authorities. Reports from the IMF (Article IV consultation or program reviews) usually include information in this respect as well.

**Transparency and oversight** – Revenue forecast is a crucial part of the budget (and of revised budgets). It has to be published for the coming fiscal year. It should be realistic. Likewise figures about the actual revenue collection should be subject to external audit and publication.

The use of **performance indicators on domestic revenue mobilisation** in budget support contracts is also encouraged. However, setting broad quantitative revenue targets (e.g. revenue to GDP) may not be relevant and may overlook specific issues to tackle. Indeed, such targets could be heavily influenced by external factors or could be reached by introducing temporary measures (in particular, an increase in tax audits) which would not reflect a real and sustainable effort by the administration to widen the tax base and therefore allow for the collection of revenues in a fair and transparent manner.

Indicators should be selected from country owned and agreed medium-term revenue strategies or similar comprehensive plans, where they exist. The targets would need to be realistic, achievable within the rather short timeframe of budget support contracts and measurable through relevant, reliable and accessible information. Such indicators must be identified together with the administration, as data might be available internally but not published.



The relevance of indicators will depend on the local context and the information gathered through any DRM assessment, in particular the TADAT, but here is an indicative list of indicators which might be relevant in the context of budget support:

- Tax payer identification number data base – The tax identification number database is at the core of the work of tax administrations. This database should be comprehensive and updated to make sure that taxpayer activities are registered. The updating of the database can target a geographical area as well as a cluster of tax payers (e.g. medium-size companies). Reliable data is also needed to follow each taxpayer and to make crosscutting analyses, for example with the customs administration. Such crosscutting analysis should be encouraged, as it can help to detect discrepancies between the volume of imports declared by companies to the customs administration and the amount of revenues declared to the tax administration.
- Regular assessments and publication of tax expenditures – Tax expenditures are incentives that significantly impact the authorities' budget, insofar as they voluntarily relinquish part of their tax revenues to support the productive or social sectors. It can be about tax exemptions for new enterprises or free zones, for example. These preferential measures are a major burden on the public budget. Yet, in lots of countries no figures are available for a detailed understanding of their costs and the benefits which can be expected in return. It is therefore necessary for the authorities to ensure full clarity and transparency on the exemptions granted and their impact on public finance. The assessment of tax expenditures should be done and published regularly for the sake of transparency and accountability, and to contribute to improving their effectiveness.
- Value added tax (VAT) – VAT is often the biggest source of revenue for public authorities. As this tax requests frequent submission of declarations and frequent payments by businesses which collect the tax (and repayment of VAT credits), the regularity of declaration and payment could be monitored through an indicator.
- Tax audit indicators – It is essential to ensure, at the beginning of the auditing process, an accurate selection of the taxpayers to be audited in order to improve efficiency and to avoid overloading services with less productive audits.

### **3.3 *DRM when implementing a budget support contract***

Since DRM is not only a technical matter but in its core both a policy and political one, this dimension should be thoroughly enshrined in the policy dialogue organised in the context of a budget support contract. Such a thorough dialogue should be based on the analytical reports and assessments of the DRM situation, identifying the most critical aspects of DRM.

Policy dialogue should focus on tax policy, the legal framework, tax administration and revenues, including from natural resources, to ensure their sustainable and efficient use for inclusive economic growth. These aspects are crucial to increase domestic revenue mobilisation, to enhance good governance and to allow for a positive effect on the economy. However, there is no tax regime which is right for all countries. In addition, the implementation of the global tax governance agenda – notably the Global Forum on Transparency and Exchange of Information, the Base Erosion Profit Shifting (BEPS) agenda or issues raised by the Financial Action Task Force (FATF) when it comes to money laundering – need to be taken into account, as well as the potential listing process under EU legislation when it comes to 'non-cooperative tax jurisdictions' and anti-money laundering.

The specific country circumstances need to be taken into account to find the relevant points to address in a given context and to support through the different assistance modalities.

To facilitate reporting on what the EU and other partners do for DRM in the context of budget support or capacity development projects, a new code has been created by the OECD Development Assistance Committee (DAC) to monitor DRM, separately from the PFM code, in order to be able to report specifically on external assistance in this respect and to monitor the commitment of doubling support to DRM by 2020, as stated in the Addis Tax Initiative.

#### **4. The special case of natural resources for taxation and revenue management**

Only a handful of countries have realized the full development potential of their natural resources. This is particularly challenging for countries with significant extractive industries – oil, gas and mineral resources. In principle, the enlarged fiscal space from these resources can provide large revenues for the government, and in turn finance the public goods and services needed to support sustainable development and poverty reduction. However, in practice, governments often fail to address the institutional and policy challenges that come with natural resources. As a consequence, development outcomes for these countries have often been disappointing, a phenomenon known as "resource curse"<sup>206</sup>. In addition to the possible adverse impact on growth, resource riches have been seen as a major contributor to corruption and social unrest. In a number of countries, oil, diamonds, other minerals and timber have been associated with civil war, with devastating social and economic implications.

The reasons for this shortfall are manifold and range from weak national administrations, defective laws and regulations, inadequate policies or lack of expertise of governments to deal with international extractive industries companies. Domestic revenue collection is often negatively affected by the rent-seeking behaviour of involved stakeholders. In particular, a lack of transparency in allocating and negotiating terms for extractive projects, combined with the asymmetric distribution of information, experience and competence between companies and governments, can favour corruption and lead to unbalanced rent distributions from resource extraction. Transparency about payments from extractive industries to governments (and of the related contracts) would increase domestic accountability, decrease corruption opportunities, facilitate revenue collection and set incentives for stakeholders to negotiate more balanced deals<sup>207</sup>.

Extractive revenues, mainly income from production sharing and royalties or corporate income tax on oil, gas and mining companies, might dominate countries' revenues. Many of these are low-income and middle-income countries in which resource revenue (principally in petroleum-rich countries) accounts for over 50 percent of government revenue or export proceeds. The high sensitivity of countries to resource price volatility has often led to well documented boom and bust cycles. Recently again, the fall in commodity prices has significantly worsened resource-rich countries fiscal positions and forced them to reform their revenue systems in order to cope with a significant reduction of their fiscal space<sup>208</sup>.

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<sup>206</sup> There is vast literature on the impact of natural resource wealth. Comprehensive reviews are provided by Van der Ploeg (2011), Ross (2012) and Venables (2016). Many papers highlight the complex fiscal and political economy problems that countries need to solve so as to beneficially use natural resource wealth for development.

<sup>207</sup> See Rosenblum/Maples (2009): *Contracts Confidential: Ending Secret Deals in the Extractive Industries*.

<sup>208</sup> For instance, it has been estimated that the recent reduction of around 50 percent in international crude prices between August 2014 and end-2016 will eventually depress the level of GDP per capita in oil and gas producing countries in the Latin America and Caribbean region by 5–6 percent on average.

Countries have embarked, with a variable degree of ambition and success rate on reforms related to tax design, revenue administration, macroeconomic management, and public transparency of revenues from natural resources. These issues deserve specific attention when addressing the domestic revenue mobilisation efforts of developing/emerging countries.

Efforts made by vulnerable resource-rich countries towards institutional strengthening to improve transparency usually provided ample pay-off for a relatively modest investment. In particular, public exposure, regarding the licences, contracts, investment agreements and permits governing the exploration, exploitation, transportation and export of natural resources; the documentation of the awarding process, social and environmental impact assessments, audited accounts of state controlled companies operating in these sectors; payments due and made by independent companies operating in these sectors to governments, and beneficial ownership of companies, can help establish and maintain credibility in regard to the collection and distribution of resource revenue.

A number of promising international initiatives supported by the EU have emerged to address these challenges by promoting good governance and transparency in the hydrocarbon and mining sector. In particular, the Extractive Industries Transparency Initiative (EITI) has been instrumental in supporting improved governance and accountability through the reconciliation and full publication of company payments and government revenues from oil, gas and mining. A country's commitment to the EITI signals its openness to comply with a global transparency standard<sup>209</sup>. The EITI seeks to strengthen government and company systems, inform public debate, and enhance trust among stakeholders in extracting countries, including civil society organisations (CSOs). Protecting the space of CSOs to effectively participate in oversight mechanisms and on decision-making processes in all stages of the value chain should be encouraged and actively promoted<sup>210</sup>.

Promoting the responsible behaviour of companies operating in conflict-affected or high-risk areas can have a powerful and positive socio-economic impact in these areas. The 2014 joint Communication by the European Commission and the High Representative on *Responsible sourcing of minerals originating in conflict-affected and high-risk areas*<sup>211</sup> presents an integrated approach to reduce opportunities for armed groups to trade in tin, tantalum, tungsten and gold in conflict affected areas; to improve the ability of EU operators – especially in the downstream section of the supply chain – to comply with existing due diligence frameworks; and to reduce distortions in global markets for the aforesaid four minerals sourced from conflict-affected and high-risk areas (e.g. the Great Lakes Region).

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<sup>209</sup> The EITI Standard is implemented by 51 countries and supported by over 90 extractive companies and 900 civil society organizations. Implementing countries publish annual EITI reports which include information about government revenues, production, licenses and the legal and fiscal provisions applicable to state-owned enterprises. Increasing transparency in extractive industries brings about better governance and economic, environmental and social sustainability and thus contains the resource curse.

<sup>210</sup> Oversight bodies can detect and prevent corruption in the oil, gas and mining sectors if they ask the right questions. Corruption schemes can be complex and opaque, yet clear patterns and similar signs of problematic behavior do exist across resource-rich countries. The Natural Resource Governance Institute has developed a list of 12 red flags of corruption in extractive sector license and contract awards (see <https://www.resourcegovernance.org/sites/default/files/documents/corruption-risks-in-the-award-of-extractive-sector-licenses-and-contracts.pdf>).

<sup>211</sup> *Responsible sourcing of minerals originating in conflict-affected and high-risk areas- Towards an integrated EU approach* – JOIN(2014) 8 final, <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014JC0008&from=EN>.

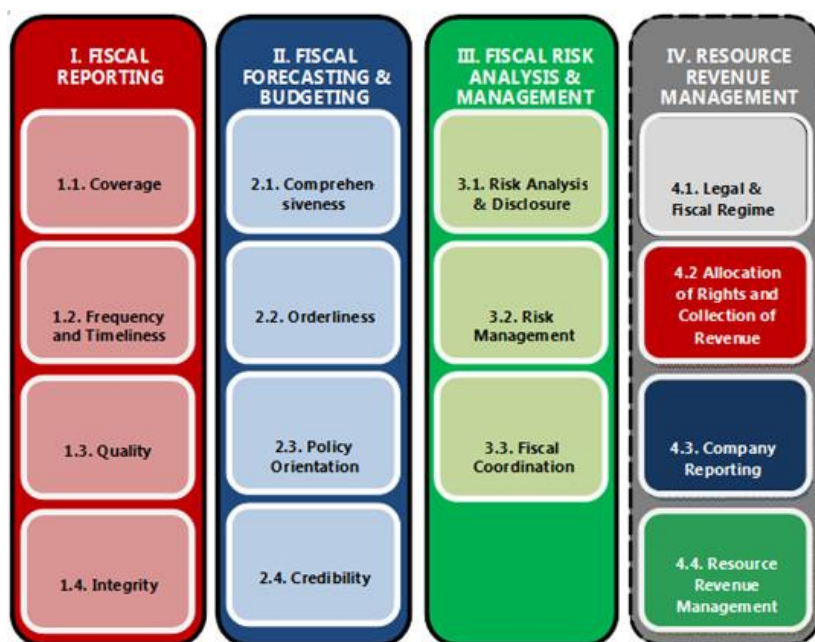
With regard to the extractive sector, the policy dialogue in the context of budget support must focus increasingly on good economic governance in this sector. It should make use of instruments such as Governance Action Plans, PFM annual reviews, PEFA assessments, TADAT assessments, EITI country reports, and mission reports from technical assistance missions by the IMF and the WB in the framework of the Management of Natural Resource Wealth Topical Trust Fund (MNRW-TTF), the Revenue Mobilisation Trust Fund (RM-TF), and the Extractive Global Programmatic Support Multi-Donor Trust Fund (EGPS-MDTF)<sup>212</sup>.

The identification of concrete and time-bound targets on improving the collection, management and/or transparency of natural resource revenues, as budget support performance indicators should be increasingly encouraged.

A simple way to start addressing good economic governance in the extractive sector is to assess **how transparent is a country in managing natural resources**. By simply checking whether the country is implementing the EITI Standard and what is its status in the EITI report, it is possible to assess: i) whether your country is making efforts towards improving the collecting and reporting on natural resource revenue flows; ii) whether the country is applying the new IMF template for reporting and compiling national accounts statistics for the resource sectors; iii) whether it is pursuing efforts on identifying the ownership of extractive companies operating in the country; and iv) what are the ongoing efforts to set up saving mechanisms such as sovereign wealth funds or stabilisation funds allowing to country to mitigate the impact of commodity price volatility.

In addition, this assessment should check whether the country is applying the **IMF Natural Resource Fiscal Transparency Code**<sup>213</sup> which includes now a new pillar IV on Resource Revenue Management and provides a transparent framework for the ownership, allocation, taxation, and management of natural resources.

### Natural Resource Fiscal Transparency Code Pillars



<sup>212</sup> Other private instruments and diagnostic tools take form, such as the Resource Governance Index from the Natural Resource Governance Institute (see <https://resourcegovernance.org>).

<sup>213</sup> See <https://www.imf.org/external/np/exr/consult/2016/ftc/index.htm>.

The revised draft Code now includes augmented versions of Pillars I, II and III, covering issues related to reporting, budgeting, and risk management of natural resources. Pillar IV emphasizes specific transparency issues associated with the legal and fiscal regime governing the extraction of natural resources, the allocation of resource rights holdings, reporting by companies engaged in resource extraction activity, and the governance and operation of natural resource funds.

## 5. Overview of DRM databases and diagnostic tools

Existing resources tools to assess taxation are described in the table below. The first set consists of databases which are publicly available and provide useful data for assessment.

The second set is about diagnostic tools and frameworks to undertake individual country assessments. Indicators used in that context would not necessarily make relevant indicators in for budget support, but these are definitely useful for policy dialogue and monitoring.

<b>Databases</b>	
OECD Revenue statistic initiative	Provides reliable and comparable data on revenues collected in Africa, Asia and Pacific, Latin America and the Caribbean: - revenue statistics in Africa ( <a href="https://www.oecd.org/tax/revenue-statistics-in-africa-9789264253308-en-fr.htm">https://www.oecd.org/tax/revenue-statistics-in-africa-9789264253308-en-fr.htm</a> ); - revenue statistics in Asia ( <a href="http://www.oecd.org/tax/revenue-statistics-in-asian-countries-2016-9789264266483-en.htm">http://www.oecd.org/tax/revenue-statistics-in-asian-countries-2016-9789264266483-en.htm</a> ); - revenue statistics in LAC ( <a href="http://www.oecd.org/ctp/revenue-statistics-in-latin-america-and-the-caribbean-24104736.htm">http://www.oecd.org/ctp/revenue-statistics-in-latin-america-and-the-caribbean-24104736.htm</a> ).
OECD Comparative Information Series	Provides tax administration information for a number of countries related to organization, management, tax filing and payment, administrative powers, tax burden, and operational performance. <a href="http://www.oecd.org/ctp/administration/tax-administration-23077727.htm">http://www.oecd.org/ctp/administration/tax-administration-23077727.htm</a>
USAID Collecting Taxes Database	Provides global coverage on 31 different indicators covering 200+ countries. It gives a country-level view as well as regional, income group and international benchmarks against which to assess a country's tax system. <a href="https://www.usaid.gov/data/dataset/cdeb8a1b-3440-4e88-b6cb-81b2428f8cea">https://www.usaid.gov/data/dataset/cdeb8a1b-3440-4e88-b6cb-81b2428f8cea</a>
GDI Tax Performance Assessment	Using 2007-08 as a base year, it provides a comparative overview of the tax performance of 175+ countries, based on aggregate historical data and country-specific information – <i>Under development</i> .

<b><i>Frameworks for making individual country assessments</i></b>	
TADAT – Tax Administration Diagnostic Assessment Tool	<p>The TADAT provides an objective assessment of the health of key components of a country’s system of tax administration. This framework covers most tax administration functions, processes and institutions. The assessment of these performance outcome areas is based on 28 high-level indicators that are each built on 1 to 4 dimensions that together add up to 47 measurement dimensions, making TADAT a comprehensive but administrable diagnostic tool. The TADAT assessments are particularly helpful in:</p> <ul style="list-style-type: none"> <li>• identifying the relative strengths and weaknesses in tax administration systems, processes, and institutions;</li> <li>• facilitating a shared view on the condition of the system of tax administration among all stakeholders (e.g., country authorities, international organizations, donor countries, and technical assistance providers);</li> <li>• setting the reform agenda, including reform objectives, priorities, initiatives, and implementation sequencing;</li> <li>• facilitating management and coordination of external support for reforms, and achieving faster and more efficient implementation; and</li> <li>• monitoring and evaluating reform progress by way of subsequent repeat assessments.</li> </ul>
IMF Revenue Administration – Gap Analysis Program (RA-GAP)	<p>The Revenue Administration Gap Analysis Program assists revenue administrations in monitoring taxpayer compliance through tax gap analysis for VAT or excise.</p> <p><a href="http://www.imf.org/en/Publications/TNM/Issues/2017/04/07/The-Revenue-Administration-Gap-Analysis-Program-Model-and-Methodology-for-Value-Added-Tax-Gap-44715">http://www.imf.org/en/Publications/TNM/Issues/2017/04/07/The-Revenue-Administration-Gap-Analysis-Program-Model-and-Methodology-for-Value-Added-Tax-Gap-44715</a></p> <p><a href="http://www.imf.org/en/Publications/TNM/Issues/2017/04/20/An-Analytical-Framework-for-Excise-Duty-Gap-Estimation-Excise-Gaps-in-Tax-Administration-44720">http://www.imf.org/en/Publications/TNM/Issues/2017/04/20/An-Analytical-Framework-for-Excise-Duty-Gap-Estimation-Excise-Gaps-in-Tax-Administration-44720</a></p>
IMF Revenue Administration Fiscal Information Tool (RA-FIT) / International Survey on Revenue Administration (ISORA)	<p>RA-FIT/ ISORA is a data-gathering initiative designed to collect tax and customs information. The data gathered include both quantitative and qualitative information and encompass a mixture of tax administration baseline and profile data, inputs, and performance-related data.</p> <p><a href="https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2016/12/31/Understanding-Revenue-Administration-An-Initial-Data-Analysis-Using-the-Revenue-42951">https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2016/12/31/Understanding-Revenue-Administration-An-Initial-Data-Analysis-Using-the-Revenue-42951</a></p>
IMF/WB Tax policy assessment tool (TPAF)	<p>The Tax Policy Assessment Framework (TPAF) aims at providing diagnostic information to countries’ tax policy including modules on international tax issues and sector specific (extractives in particular) – <i>Under development</i>.</p>
Cross Boarder Diagnostic tool (OECD)	<p>The tool aims at including the economic perspective in the analysis of tax administration and policy to better understand the vulnerabilities, the transnational interactions and thereby avoid a silo approach – <i>Under development</i>.</p>

PEFA Tax Administration Indicators	<p>Revenues issues in the PEFA framework (<a href="https://pefa.org">https://pefa.org</a>) are covered mainly by the following indicators:</p> <p>PI-3. Revenue out-turn</p> <p>PI-5. Budget documentation</p> <p>PI-9. Public access to fiscal information</p> <p>PI-14. Macroeconomic and fiscal forecasting</p> <p>PI-15. Fiscal strategy</p> <p>PI-17. Budget preparation process</p> <p>PI-18. Legislative scrutiny of budgets</p> <p>PI-19. Revenue administration</p> <p>PI-20. Accounting for revenue</p>
EITI (Extractive Industries Transparency Initiative) country reports	<p>The EITI promotes open and accountable management of natural resources by setting a global transparency standard. The EITI seeks to strengthen government and company systems, inform public debate, and enhance trust among stakeholders in extracting countries. Implementing countries have to publish annual EITI reports which include information about government revenues, production, licenses and the legal and fiscal provisions applicable to state-owned enterprises (<a href="https://eiti.org/countries/reports">https://eiti.org/countries/reports</a>).</p>
IMF Fiscal Analysis of Resource Industries (FARI)	<p>The analysis performed in FARI is carried out from the perspective of a foreign investor, i.e. in a very usual situation for many resource-rich developing/emerging countries which depend on foreign investment to develop their extractive sectors. The model helps determine how the net cash flows generated over the full life cycle of a project are shared between such an investor and the host government according to the fiscal regime in place.</p> <p><a href="http://www.imf.org/external/pubs/ft/tnm/2016/tnm1601.pdf">http://www.imf.org/external/pubs/ft/tnm/2016/tnm1601.pdf</a></p>
IMF – Handbook for Administering Fiscal Regimes for Extractive Industries	<p>This handbook focuses on the effective administration of revenues from extractive industries. It provides policymakers and officials support in developing and emerging economies with guidelines to establish a robust legal framework, organization, and procedures for administering revenue from these industries. It suggests actions to strengthen managerial and technical capacity of countries. It also touches upon transparency and how to promote it.</p> <p><a href="https://www.imf.org/en/Publications/Books/Issues/2016/12/31/Administering-Fiscal-Regimes-for-Extractive-Industries-A-Handbook-41040">https://www.imf.org/en/Publications/Books/Issues/2016/12/31/Administering-Fiscal-Regimes-for-Extractive-Industries-A-Handbook-41040</a></p>



<p>WB – Sourcebook How to improve Mining Tax Administration and Collection Frameworks</p>	<p>This sourcebook focuses on mineral royalties and on other taxation measures that are specific to mining activities. The legislative framework establishing these taxes in partner countries is in most cases relatively modern and largely adequate, but the supporting administrative capability, procedures, and systems have tended to lag behind. This sourcebook presents a practical overview of how to analyse and improve the administrative frameworks and systems for mineral royalties and other taxes specific to mining.</p> <p><a href="http://documents.worldbank.org/curated/en/576391468330004326/How-to-improve-mining-tax-administration-and-collection-frameworks-a-sourcebook">http://documents.worldbank.org/curated/en/576391468330004326/How-to-improve-mining-tax-administration-and-collection-frameworks-a-sourcebook</a></p>
<p>IMF – Diagnostic missions, including mission reports from the Management of Natural Resource Wealth Topical Trust Fund (MNRW-TTF) and from the Revenue Mobilisation Trust Fund (RM-TF)</p>	<p>These mission reports identify shortcomings in tax policy and tax administrations' performance (compared to international good practice) and develop strategies to close the identified gaps. The assessments and recommendations are documented in formal diagnostic reports that are utilised by governments and donors as roadmaps for reform efforts.</p> <p><a href="http://www.imf.org/en/Capacity%20Development/trust-fund/MNRW-TTF">http://www.imf.org/en/Capacity%20Development/trust-fund/MNRW-TTF</a></p> <p><a href="http://www.imf.org/external/np/ins/english/rmtf.htm">http://www.imf.org/external/np/ins/english/rmtf.htm</a></p>
<p>WB – Diagnostic missions, including mission reports from the Extractive Global Programmatic Support Multi-Donor Trust Fund (EGPS-MDTF)</p>	<p>These mission reports identify shortcomings in tax regimes in the extractives sector and tax administration's performance (compared to international good practices) and help develop strategies to close the identified gaps.</p> <p><a href="http://www.worldbank.org/en/programs/egps">http://www.worldbank.org/en/programs/egps</a></p>



## Annex 12 – Assessment of fundamental values

This annex provides guidance on assessing fundamental values for Sustainable Development Goals Contracts (SDG-C), Sector Reform Performance Contracts (SRPC) and State and Resilience Building Contracts (SRBC).

Section B provides guidance on SDG-C, Section C on SRPC, and Section D on SRBC.

### A. Why an assessment of fundamental values?

The commitment and record of partner countries in relation to the key values set out in the EU Treaty that the EU commits itself to promote in its foreign policy – democracy, the rule of law and respect for human rights – is one of the key determinants of EU external assistance, including general and sector budget support. It should be assessed to determine if using budget support is appropriate. In addition, the findings of the fundamental values analysis shall guide the rights-based design and implementation of budget support. Fundamental values assessment is closely linked to the working principles of the Rights-Based Approach (RBA) of “applying all rights”, and reinforced and complemented by the RBA and gender mainstreaming applicable to all budget support contracts.

The **SDG Contract** is an instrument to support selected SDGs and broad reforms that lead to poverty reduction, improved governance, and inclusive growth, while signalling a mutual and shared commitment to universal fundamental values. Therefore, the commitment to fundamental values needs to be assessed as a pre-condition for any SDG-C, and subsequently monitored during implementation. For SDG-Cs the commitment to fundamental values is assessed on the basis of the actual situation, including ongoing reforms, and past track record.

When **Sector Reform Performance Contracts** are proposed as the most appropriate support modality, adherence to fundamental values should be taken into account. Assessing if EU sector budget support should proceed in the light of political governance will need to be carefully balanced against the need to respect, protect and fulfil human rights, assuming the agreed reforms will be implemented and the EU funds reach the population through improved quality public services.

In case of **State and Resilience Building Contracts**, the assessment of the government's commitment to fundamental values as well as their political response to uphold them in a comprehensive way are aspects to be considered inter alia when deciding whether to engage with these countries. In the context of a fragile or conflict affected situation, the EU should adopt a forward looking approach accompanied by reinforced political and budget support dialogues. Risks should be balanced against the implications of not engaging in a fragile state.

### B. Sustainable Development Goal Contracts

#### *When to assess fundamental values?*

For any SDG-C, the commitment to fundamental values as a pre-condition needs to be assessed by delegations before the identification phase and the assessment submitted to the BSSC/FAST. The assessment will be prepared by the Delegations and reviewed by the EEAS in consultation with DEVCO/NEAR before submission.

The assessment should be brief (4 pages). Action documents will have a section summarizing the conclusion on the pre-condition.

Subsequently, commitment to fundamental values will be monitored during the formulation and implementation phases using the risk management framework.

### *How to assess fundamental values when a SDG Contract is considered?*

This analysis should be based on the updated Human Rights and Democracy Country Strategies and their implementation reports, as well as sources such as EU Election Observation Mission reports, Delegation political reporting, Civil Society Road Maps, UN open sources, including UN Human Rights Council Country Resolutions, Special Rapporteur reports and Concluding observations by treaty bodies. It should also draw on country gender analysis studies, reports from monitoring bodies and other information from regional human rights systems and National Human Rights Institutions, where applicable, civil society reports and testimonies and other relevant sources (e.g. World Governance Indicators, Amnesty International, Human Rights Watch, Freedom House, Transparency International).

This assessment should take into account the political analysis undertaken during programming phase and will also be used to answer the questions in the Risk Management Framework.

EU MS should be consulted in the process and especially MS who are also providing budget support to ensure coordination and coherence.

The assessment of fundamental values should be completed in two steps (in total 4 pages).

#### **Step one**

The first step is a screening of the extent to which the country meets the core benchmarks on human rights, democracy, and the rule of law.

Assess the country's stand on the following core benchmarks:

- 1. International commitments**<sup>214</sup>, including on human rights (i.e. signing, ratification, transposition and implementation of core international or regional conventions and their protocols', Universal Periodic Review recommendations, treaty monitoring bodies, special rapporteurs' recommendations) as well as cooperation with international and regional human rights bodies;
- 2. Democracy:** credibility and transparency of the electoral process, balance of power, enabled space for civil society, freedom of expression online and offline, association and assembly and media independence;
- 3. Rule of Law:** independence of the judiciary, access to justice for all, including right to a fair trial and due process, law enforcement system, transitional justice, impunity;
- 4. Human rights** (death penalty, torture and other cruel inhumane and degrading treatment, slavery and servitude, women and children rights, non -discrimination).

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<sup>214</sup> For instance, in the human rights field, the International Covenant on Civil and Political Rights (ICCPR), the International Covenant on Economic, Social and Cultural Rights (ICESCR), the International Convention on the Elimination of all forms of Racial Discrimination (ICERD), the Convention on the Elimination of all forms of Discrimination against Women (CEDAW), the Convention Against Torture and other Cruel, Inhuman or Degrading Treatment (CAT), the Convention on the Rights of the Child (CRC) and the Convention on the Prevention and Punishment of the Crime of Genocide. In the field of International Humanitarian law, additional protocol I and 2 to the Geneva Conventions and the Ottawa convention prohibiting anti-personnel land mines.

When the assessment under Step one is not satisfactory, the country concerned will not be eligible for a SDG-C. Therefore, a more detailed analysis in Step two is not needed.

## **Step two**

If the assessment in step one on the core benchmarks is satisfactory, a more detailed analysis shall be carried out in Step two. The assessment should be guided by the following questions:

*(The assessment should be in line with Human Rights and Democracy Country Strategy and its implementation reports)*

### **Democracy**

- Are there democratic political parties that can operate freely and is there a pluralist party system?
- Is there a viable media and an independent civil society and is the government receptive?
- Are there national security or other restrictive laws in place that inhibit public debate?
- Are women represented across decision-making institutions?
- How does Parliament exercise its main powers? (legislative functions, power to decide the national Budget, oversight of the executive/government's action and capacity to dismiss the executive, oversight of military)?
- What are the main challenges for civil society? Is freedom of expression, and freedom of association and assembly guaranteed? Is there space for human rights defenders to promote and protect their rights and fundamental freedoms? Do duty bearers have the capacity to respect, protect and fulfil their human rights?
- More generally, are the rights to freedom of expression and freedom of assembly respected?
- Are there national security or other restrictive laws in place that inhibit public debate?
- Do women's organizations and their actors face context-specific challenges? (in respect of legislation and practice, access to funding, including from abroad, restrictions to legal registration, restrictions to freedom of assembly).

### **The Rule of Law**

- Is the current system conducive to a performing judiciary? Is corruption an impediment? If yes, is it properly addressed?
- Does the judicial system guarantee the right to a fair trial and due process?
- Is access to justice reasonably ensured and Court decisions enforced?
- Is the system for appeal effective?
- In the exercise of its functions, does the law enforcement system guarantee security of citizens and respect of the rule of law, while respecting human rights? Do prison conditions respect human dignity? Is the system gender sensitive?
- Is impunity addressed?

### **Human Rights**

- Are the national institutions (Ombudsman, Human Rights Commission), in case they exist, independent in carrying out their work? Is their advisory authority recognized?

- Is the principle of non-discrimination based on sex, race, language, religion, political or other opinion, national or social origin, or sexual orientation, age and disability or other status (as foreseen by the law), effectively guaranteed? If not what are the main problems?
- What are the main issues identified in terms of social, economic and cultural rights?
- Are the rights of women and children recognized and effectively protected? What are the main issues (in particular sexual and reproductive health and rights, ownership of property, inheritance, family law and violence against women)?
- Are the rights of persons belonging to minorities and indigenous peoples effectively protected? What are the main controversial or problematic issues (e.g. land and environmental rights, political rights)?

#### Country's commitment/political willingness

On the basis of the above analysis this section should set-out an assessment of the partner country's commitment and willingness to address the situation.

- Is the partner country's government taking actions through relevant reform programmes or action plans that address key constraints and weaknesses identified above?
- Are these actions **credible** in terms of political commitment, quality of the reform process, and realistic in terms of implementation?
- What is the country's **track-record** and has there been satisfactory progress taking into account the resources and capacity of the country?
- How do you assess the likelihood that violent conflict could undermine the adherence to fundamental values?

#### Overall recommendation

As a result of this analysis, the Delegation should assess whether the pre-condition for a SDG-C is met and should state any issues which:

- need particular monitoring in the risk management framework;
- should be discussed within the policy dialogue or the political dialogue framework;
- should be taken into consideration during formulation in order to strengthen the SDG-C in its objective of fostering domestic accountability, strengthening national systems and control mechanisms, and as a basis for improving governance, including adherence to fundamental values.

### **C. Sector Reform Performance Contracts**

For proposed SRPCs the overall adherence to fundamental values is reviewed as part of the risk management framework (political risk category) and a short summary is to be provided in the action document. No separate assessment of fundamental values as a pre-condition is required. If the framework points to substantial or high political risks, a BSSC/FAST submission is normally required whereby the BSSC/FAST will balance any fundamental values concerns with the need to provide and protect the provision of vital services, for the population, including other potential benefits, in order to decide whether a SRPC is an appropriate aid modality.

During the identification and formulation phases, the sector analysis should take into account the human rights based approach, as described below. The most critical issues **relevant to the**

**sector** and arising from the sector analysis, including sector specific gender analysis, should be highlighted in the action document and addressed by the SRPC.

The human rights based approach at sector level should focus on the following issues:

1. An indication of the extent to which the country addresses human rights issues at sector level, based on the country's adherence to the International Covenant on Economic, Social and Cultural Rights (ICESCR), the International Convention on the Elimination of all forms of Racial Discrimination (ICERD), the Convention on the Rights of the Child (UNCRC), the Convention on the Elimination of all forms of Discrimination against Women (CEDAW), the Convention on the Rights of Persons with Disabilities and other relevant international and regional instruments.
2. In the case of IPA beneficiaries, an assessment of the extent to which the beneficiary is implementing the political, institutional, legal, administrative, social and economic reforms required to bring the country closer to EU values and to progressively align to European rules, standards, policies and practices on rule of law, fundamental rights and democracy, with a view to EU membership.
3. In cases where the treaty bodies and other human rights monitoring mechanisms have provided recommendations to the country concerned how have these been followed up at sector level?
4. For the sector concerned, how is equality and non-discrimination addressed in laws, sector policies and practices, distribution and delivery of resources and public services (equal opportunities)?
5. How is access to services in the sector assured for women, children and vulnerable groups including LGBTI (Lesbian Gay Bisexual Transgender and Intersex) people, persons with disabilities, indigenous peoples, people belonging to ethnic and minority groups, people affected (availability and accessibility)?
6. How are rights holders consulted and able to express their views; are they entitled to participate in and influence decisions that directly affect them, such as the design, implementation and monitoring of sector interventions (participation and inclusion)?
7. Is the decision making process within the sector transparent and is accountability ensured? In case of grievances, is judicial or administrative redress available (right to remedy/compensation)?
8. What is the quality of sector services for the people (user's rights to quality improvement process)?

#### Overall recommendation

As a result of this analysis, Delegations should assess whether and how fundamental values should be addressed within the SRPC:

- Issues to be monitored in the risk management framework;
- Issues that should be discussed in the budget support dialogue or the policy dialogue; and
- Issues to be addressed in the design of the contract.

#### **D. State and Resilience Building Contracts**

For proposed SRBCs the overall adherence to fundamental values is reviewed as part of the risk management framework (political risk category) and a short summary is provided in the Action document.

The assessment of fundamental values for State and Resilience Building Contract should adopt a forward looking approach, to inform the opportunity of intervention (Annex 9, section 3.2.). A forward looking assessment should inquire into the presence of clear and concrete signs of real (renewed) commitment to improve the situation. These clear signs could e.g. be a peace accord, or other form of political settlement that is assessed as genuinely expressing political commitment.

Not all fragile states have just emerged from crisis or just starting the path of transition. The path out of fragility through peace building and state building is a long one, and can become protracted. In such cases, the likelihood of real improvements could be demonstrated by a positive track record. Where this is not the case, the analysis must carefully assess whether there are clear and convincing (re)new(ed) signs of commitment to future improvement (restore peace and foster transition towards democratic governance - see Annex 2).

How to assess fundamental values when a SRBC is considered?

#### Forward-looking approach

For this type of contract, special attention should be paid to the following issues:

1. What are the partner country's government's commitments to improving the situation regarding democracy, human rights and rule of law?
2. What are the sources / background of these commitments, the credibility of the government's commitment as well as broader support for this agenda from society?
3. Are there concrete (confidence building) measures that have been undertaken that demonstrate real willingness to improve the situation?
4. In case of protracted fragility, is there a positive track record?
  - a. If yes, provide a short assessment:
  - b. If no, assess whether there are still credible (re)new(ed) commitments to improve the situation, that merit support or not.
5. How do you assess the risk of the resumption or emergence of violent conflict?

To assess the current situation, as a baseline for monitoring and as an input to the risk management framework and contract formulation, the questions formulated as part of section A should guide the analysis.

#### Overall recommendation

As a result of this analysis, the Delegation should assess whether the assessment of fundamental values confirms or not the opportunity of intervention through a State and Resilience Building Contract, and whether there are specific issues which:

- need particular monitoring in the risk management framework;
- should be discussed in the budget support dialogue or the political dialogue;
- should be taken into consideration during identification and formulation in order to strengthen the SRBC in its objectives to restore peace and foster transition towards democratic governance.

## Annex 13 – Policy dialogue in the context of budget support

Policy dialogue between the EU and partner country governments and other stakeholders is an essential activity under budget support. It constitutes one of the main inputs of budget support contracts, alongside the transfer of funds and capacity strengthening. Policy dialogue is part of the budget support **intervention logic**, and is expected to contribute to the objectives of budget support contracts. Policy dialogue is typically also one of the measures used to mitigate some of the risks inherent to budget support. The policy dialogue should also seek synergies with complementary instruments such as blending where the dialogue can help to address specific bottlenecks for investments, previously identified by the EU Delegation through a local structure dialogue with the private sector.

The objective of this annex is to help EU staff become more aware of the range of opportunities for policy dialogue, and to enable them to run an effective policy dialogue.

### **EU dialogue must be coherent**

For the sake of efficiency and effectiveness, all EU dialogue with the country needs to be coherent and in line with the agreed objectives. The objectives of the EU dialogue are directly related to the overall objectives of EU external policies, including development policy, trade, foreign and security policy, European neighbourhood policy, enlargement policy or migration policy. The contents of the dialogue are therefore often related to 'essential elements'/'fundamentals' of the partnership (e.g. an area mentioned under Article 8 of the Cotonou Agreement, one of the fundamentals of the EU accession process<sup>215</sup>, or the Partnership Priorities, or equivalent jointly agreed documents with partner country governments under the European Neighbourhood Policy).

Two types of dialogue may be distinguished: **political dialogue**, which in line with the Lisbon Treaty or other legal bases covers all EU external policies be they development, neighbourhood or enlargement, foreign and security, or migration policies. Formal political dialogues take place on the basis of legal and/or political commitments with a fixed sequence (pre-negotiated agendas) and on a regular basis. In addition, prior information and reporting to Member States are obligatory. Their participation can also be foreseen in some specific formats. They are usually held at ministerial level in Summits (and prepared at senior official and expert level meetings). In the post-Lisbon context, the High Representative (HR) is in charge of conducting political dialogue with third parties<sup>216</sup> on the Union's behalf (article 27.2 of the Treaty on the European Union) and is assisted by the European External Action Service in fulfilling his/her mandate (article 27.3). In ACP countries the Article 8 political dialogue usually takes place between EU HoMs, on one side, and ministerial/presidential level on the ACP side<sup>217</sup>. Political dialogue in the enlargement context takes place at the Association Councils held once a year and usually chaired by the High Representative. They are prepared by Association Committee meetings at senior official and expert levels.

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<sup>215</sup> Including the conditions for membership, as set down in the Copenhagen criteria, and/or the fundamentals set out in the "Enlargement Strategy and Main Challenges 2014-2015", notably rule of law, fundamental rights, strengthening democratic institutions, including public administration reform, as well as economic development and competitiveness.

<sup>216</sup> Guidelines for handling Political Dialogue meetings with third Countries are available in the EEAS intranet <http://intragate.ec.europa.eu/eeas/eeaszone/general/political-dialogues>.

<sup>217</sup> Specific Guidance for conducting Article 8 political dialogue with ACP countries is also being elaborated.

**Policy dialogue** covers the specific sectors of EU cooperation and supports the partner country's efforts to achieve the objectives laid down in their strategies. Some political dialogue platforms can include extensive policy dialogue, where reforms represent a key EU interest towards the partner country, e.g. in order to strengthen resilience or achieve stabilisation. On the other hand, policy dialogue may carry a political dimension (e.g. when difficult reforms are politically costly) and political dialogue can be used as an additional leverage to promote certain reforms or resolve questions that have not been resolved at the policy dialogue level. In conclusion, policy coherence requires coordination of EU developmental and political objectives, which should be mutually reinforcing.

The Commission's budget support policy introduced in 2012 makes the connection between political and policy dialogue explicit by strengthening the link between budget support and the fundamental values (see annex 12). Close coordination within delegations between the cooperation and political sections is important. Consultation with headquarters is also necessary, particularly when the political process is largely led by headquarters, for example in the case of the European Neighbourhood Policy and the enlargement process. The Head of Delegation and Head of Cooperation will ensure consistency between policy and political dialogue in the partner country, in close cooperation with the relevant Commission/EEAS geographical Directors and Heads of Unit.

### **Conditions for effective budget support policy dialogue**

**Results of budget support evaluations have shown that there is a danger of budget support policy dialogue being perceived by the partner country as a 'transaction cost' with limited added value.** A fruitful dialogue requires a set of enabling conditions: dialogue only works well if the circumstances are characterized by trust between the government and its cooperation partners, and where there is agreement between all parties on the framework within which the policy dialogue is taking place. Budget support evaluations conclude that three issues in particular have led to disappointing results: (1) Unrealistic expectations and overloading the dialogue process by the international partners; (2) Tension between an open 'problem solving' dialogue on one hand, and the overly restrictive target setting and results monitoring related to disbursement conditionality on the other hand; and (3) The high level of transaction costs associated with the assessment of the contract conditions and with the dialogue processes.

**Effective policy dialogue under budget support is typically characterised by a government led, pro-active, strategic, structured and documented approach, and it is based on robust monitoring and evaluation data ideally generated by the beneficiary** (for example annual implementation reports). It consists of four steps: (1) An adequate analysis of the country and sector context; (2) a precise definition of the objectives of the policy dialogue; (3) the establishment of an agreed framework and resources for the dialogue; and (4) the maintenance of adequate records and reporting on the policy dialogue.



## **Step 1. Analysing country and sector context:**

- **Identification of formal institutions: public policies, coordination and dialogue structures, state budgets, reform lead**
- **Identification of informal institutions & dynamic factors, informal dialogue structures**

### **Tools:**

- Eligibility assessments
- Risk management framework
- Political Economy / Drivers of change assessments
- Stakeholder analysis
- Budget analysis and diagnostic tools
- Assessment of the fundamental values
- Partner country human rights commitments
- Capacity assessments
- Civil society assessments
- Sector baseline assessments
- Structured dialogue with the private sector to identify key obstacles to investment
- Assessments of the M & E systems
- Communication audits
- Mapping and assessment of the existing policy coordination and dialogue structures
- Relevant country & sector documentation or field visits

**A prerequisite for credible policy dialogue is an adequate knowledge of the country and the sector context.** This includes the relevant actors (also non-state actors), institutional framework, and the existing cooperation, dialogue, and monitoring and evaluation structures. In-depth sector knowledge is necessary in order to define the technical content of the policy dialogue. This sector knowledge should include a dynamic perspective in order to understand the drivers of change in often rapidly-evolving contexts.

The existing national policy coordination and country-led dialogue structures establish the basis for evaluating the relationships between the different stakeholders, the inclusiveness and representativeness of the existing frameworks, as well as the technical and political capacity of the stakeholders to engage in and to coordinate the dialogue. A correctly aligned budget support contract benefits from domestic policy coordination and monitoring and evaluation processes, as well as existing dialogue structures between the partner country and the EU, its member states and other relevant international partners<sup>218</sup>, and should also be able to strengthen them while avoiding duplication.

Context analysis can make use of different tools. These can include political economy analysis (PEA), drivers of change analysis, the risk management framework, relevant country and sector documentation (in countries with joint programming this should include the relevant joint analysis), government progress reports, peer review reports, field visits, budget analysis tools, communication audits<sup>219</sup> or fundamental values assessment.

**Stakeholder mapping and political economy analysis** should guide the identification of dialogue actors. The key **formal interlocutors** relevant to policy reform are the government ministries in charge of implementing the reform, and should include the Ministry of Finance, which provides the link between the budget and the strategic budget allocations, and the key

<sup>218</sup> E.g. the structures under the EU Accession Negotiations and SAAs processes

<sup>219</sup> A communications audit is a process of identifying the organisation's internal and external communication strengths and weaknesses. It assesses the organisation's communication practices, how well the target stakeholders are informed of the organisation and its policies, how well the current communication processes are working, and it makes recommendations for improvements.

institutions responsible for the overall public administration reform in the country (i.e. centre of government institutions and Ministry of Public Administration or similar). These institutions are usually responsible for setting the framework for the overall reform/reinforcement of strategic planning, human resource systems, accountability systems and the monitoring and evaluation frameworks. **Other stakeholders** include oversight and accountability institutions (parliament, Supreme Audit Institution, judiciary, independent regulatory bodies, national human rights institution, Ombudsperson), civil society organisations, political parties, other donors/cooperation partners, international organisations present in the country, private sector organisations, academia or subnational government entities. **Where the national coordination structures have weaknesses in terms of inclusiveness, the EU should aim to play a facilitator role**, supporting the participation of domestic stakeholders in policy and budgetary processes<sup>220</sup>.

## **Step 2. Defining dialogue objectives**

- **Identification:** define objectives and gaps to be closed before the financing agreement is completed, drawing on the results from the EU policy and political dialogue
- **Formulation:** define expected results, conditions
- **Implementation:** review progress and update objectives
- **Evaluation:** results and lessons learned

### **Tools:**

- Programme design documents
- Programme intervention logic
- Rolling dialogue plan
- Performance Assessment Frameworks
- Risk Management Framework
- Relevant BSSC/FAST conclusions
- Government progress reports
- EUD annual eligibility assessments
- Fundamental values assessment

**The EU policy dialogue objectives should support the general and specific objectives of budget support contract, taking into account the country and sector analysis and the risks identified** under the Risk Management Framework, and where applicable, the Fundamental Values assessment, as well as EU policy and political dialogue with the partner country and different stakeholders concerned. The emphasis will differ depending on the programme cycle stage.

The contract **identification phase** produces the understanding of the policy and political context, and an assessment of the readiness for a budget support contract, together with the proposal for the scope of the contract. During this phase, negotiations will take place in terms of the issues that will need to be agreed during the formulation phase to allow the conclusion of the financing agreement. Important opportunities for policy dialogue exist, especially where the policy framework is already undergoing change. Areas for policy dialogue at this stage can include:

<sup>220</sup> See *Promoting civil society participation in policy and budget process*, DEVCO Tools and Methods Series, May 2014 (see <https://europa.eu/capacity4dev/public-governance-civilsociety/document/promoting-civil-society-participation-policy-and-budget-processes>).

- The general eligibility criteria for EU budget support, with a view of taking actions necessary to ensure they are met at the moment of the approval of the contract;
- Assessing the level of political commitment to the reform(s) in question, in order to assess the credibility of the policy changes proposed and the potential sustainability of the reform process. Policy dialogue efforts at this stage may aim to strengthen the commitment of the public and non-state actors for the policy objectives;
- Inclusiveness of the consultation process and degree of participation in decision making
- Trying to influence policy in a constructive direction where important content gaps in policy formulation still exist;
- Assessing the national / sector monitoring and evaluation systems, as they play a crucial role in enabling the target setting and in producing progress and results information. Improving the M/E framework during the formulation phase may be negotiated; and
- The progress of the partner country in delivering on relevant human rights commitments.

In addition to the objectives of the budget support contract, the **risk management framework** is a management tool to identify, in a structured way, priorities for policy dialogue, in particular to mitigate key risks. **Cross-cutting issues** such as gender, the implementation of a rights-based approach, climate change and environmental mainstreaming are also obvious candidates for policy dialogue. Furthermore, enhancing the involvement of civil society in policy processes, ensuring effective coordination, monitoring/evaluation systems and overall government reporting systems, and addressing the strategic communication and visibility of the government policy and of EU support, are areas that should typically be covered under the policy dialogue.

**During the formulation phase** the aim is to develop a common more detailed understanding with the partner country regarding the expected results, specific conditions and the design of the budget support contract. Experience has shown that imposed conditionality has a limited impact. It is therefore necessary to build a consensus with the partners on the key issues to be addressed and if conditionality can support their achievement. However, **a focus on indicators and conditions should not come at the expense of the wider dialogue on policy solutions**, and of staying abreast of the developments at the wider sector level and underlying policies. During the formulation phase, the key policy dialogue objectives are woven into the action document intervention logic. Some **key policy dialogue targets should be set in the intervention logic at the level of direct outputs**. By the end of the formulation phase, a rolling plan for dialogue can be established (see below). This rolling plan is then updated during the implementation phase.

During the **implementation phase** policy dialogue has a twofold objective: first, to review progress in relation to the general and, if any, the specific conditions by looking back at what has been achieved, and thus drawing lessons from policy implementation. As a rule, the government's own policy monitoring and reporting framework should provide the reports and information required for an effective review of progress, and for the policy dialogue. Second, the review of progress usually revisits the policy objectives, priorities and targets in light of the results achieved. The policy dialogue priorities should therefore be updated regularly in the context of preparing the budget support payment files, and taking into account relevant recommendations from the BSSC/FAST.

**The evaluation** of budget support contracts focuses on the contribution of budget support to results, and aims to draw lessons learned. In order to be able to demonstrate the impact of

policy dialogue, it is essential the process is well documented during each phase (i.e. the identification phase, the formulation phase and the implementation phase).

**Policy dialogue is more effective when it is prioritised.** The need for information exchanges can be reduced by ensuring budget support contracts are aligned as much as possible to existing domestic policy processes, whereas influencing objectives will have more impact when prioritised to a limited number of key issues, both to focus partner interest and bearing in mind capacity constraints. Dialogue **objectives can be set out and monitored as part of the risk mitigating measures in the RMF, or detailed in a rolling policy dialogue plan** (see table below). Such a plan can be established during the formulation phase of a budget support contract, providing the basis for defining and monitoring policy dialogue activities, and can be updated regularly.

### Example of a yearly policy dialogue plan for a PFM SRPC

<u>Objective for 201x</u>	<u>Principal Interlocutor(s)</u>	<u>Principal Forum</u>	<u>Whom</u>	<u>Progress achieved</u>
<b>Operational level</b>				
1. CSO participation in the relevant working groups	Ministry of Finance	X. working group	EU Delegation Task manager	X meeting held with CSO participation
2. Improve the transparency of the (sector) policy implementation	Ministry of Finance,	X working group	EU Delegation Task manager	The Ministry of Finance publishes the annual PFM progress report on their website
3. Improving the environmental mainstreaming in the public sector	Ministry of Finance, Ministry of Environment	X working group	EU Delegation Task manager	Terms of reference for a TA on environmental budgeting prepared / procurement law recognises the environmental aspects in tendering
4. Action plan for arrears clearance	Treasury Director Ministry of Finance,	X working group	EU Delegation Task manager	Action plan finalised and arrears reduced by 20% compared to baseline
<b>Strategic Level</b>				
1. Ensure that the CSOs are included into the coordination mechanisms	Ministry of Finance X, Y, Z CSOs	Bi-annual review meetings Meeting with the x CSOs in the Delegation	Head of Economic Section Head of Cooperation	X meeting held with CSO participation Outcome of the EUD meeting with the CSOs: X CSO declares interest to join the working group on xxx.
2. Draft public procurement law prepared in an inclusive and evidence- based process	Prime Minister's Office / Ministry of Finance Civil society Private sector	Bi-annual review meetings Informal	Head of Economic Section Head of Cooperation	Inter-ministerial and public consultation meetings organised on the concept document Budgetary impact assessment prepared on the costs of implementing the law Draft law finalised
<b>Political Level</b>				
1. Adoption of the amendments to the State Audit Institution law (to ensure financial independence)	Ministry of Finance / State Audit Institution	PFM Dialogue meeting /PAR special group Visit of the Director, Visit of DG BUDG Informal	EC services <sup>221</sup> , Head of Cooperation & Political section Head of Unit Director Head of Delegation	New law passed

<sup>221</sup> In this case these may include PAR Desks (EUD & HQ), Thematic expertise, line DGs (BUDG, HR).

### **Step 3. Setting up and resourcing the dialogue**

- **Agreement on the dialogue structures and levels**
- **Agreement on the dialogue process**
- **Resourcing the dialogue**

#### **Tools:**

- Policy dialogue annex to financing agreement (suggested)
- Rolling dialogue plan
- Technical assistance
- Dialogue or technical cooperation facility
- Sector organisation diagram

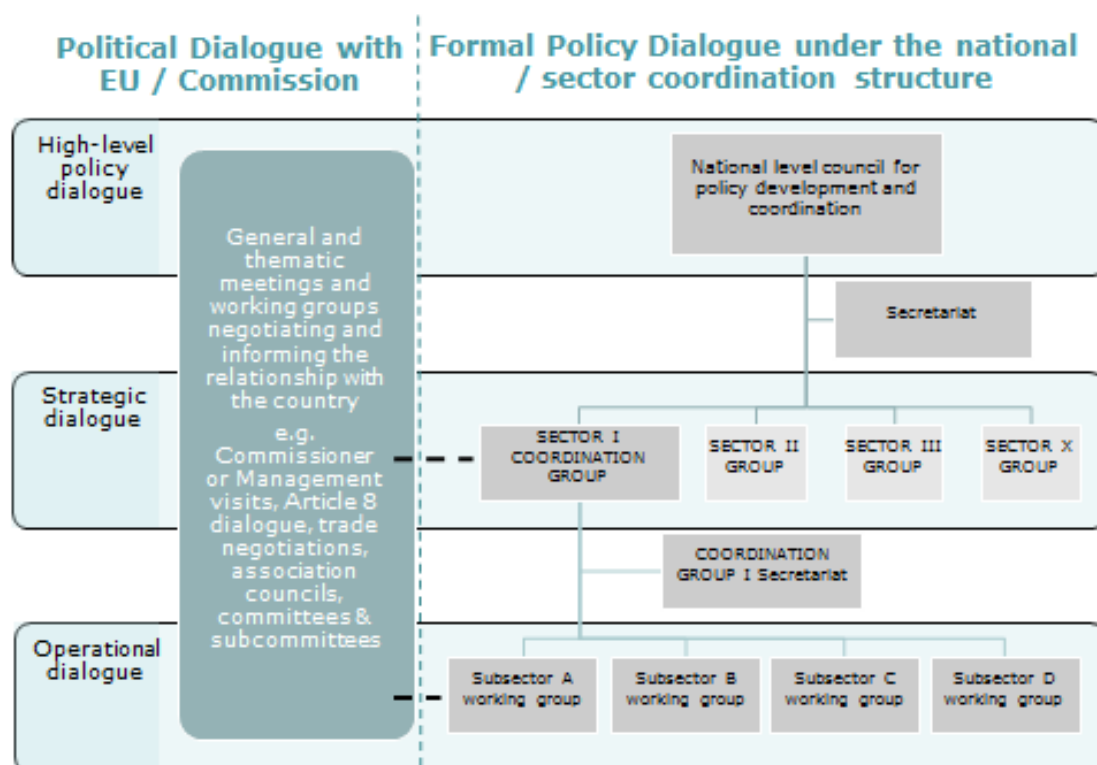
Policy dialogue takes place at all levels, i.e. by all staff members within the scope of their responsibilities. The **operational** level dialogue comprises the routine interaction between the EU Delegation and the reform coordinators in the implementing ministries and agencies, and the technical working groups.

The **strategic** dialogue should be led by the government and consists of regular, formal meetings with relevant institutions and external stakeholders, including the Commission, but also (where relevant) with cooperation partners, IFIs and other International Organisations. The key moments for the strategic dialogue include the second half of the implementing year, when the upcoming year's plans are discussed, and the beginning of the financial year, when the draft of the government's progress report for the previous year is discussed.

**High-level dialogue** takes place under the lead of the politically elected leaders in the country and with the appropriate representatives available from the EU side.

Policy dialogue is a continuous process, taking place both in formal and informal contexts. **Setting up the process of policy dialogue entails the determination of the actors and the dialogue framework.** The formal dialogue needs to be described during the design of the contract, and, in some countries, it can be formally agreed and incorporated in the financing agreement as an annex. The description of the formal dialogue should stipulate the actors, structures, processes and content of the policy dialogue, and explain how the structures link with other EU dialogue platforms in the country. **The guiding principle for such an agreement should be harmonisation and alignment with domestic policy and budgetary processes.** Furthermore, the framework should seek to ensure the inclusiveness of the policy dialogue by comprising and empowering the different stakeholders relevant to budget support contracts, including oversight and accountability bodies/actors (parliaments, SAIs, Civil Society). The graphic below gives an example of the coordination and dialogue structures for policy and political dialogue:

## Example of a sector coordination & dialogue structure



Note that evaluations of budget support have shown that the process of policy dialogue is often better developed than the content. **An emphasis on dialogue processes should not come at the expense of content.** Evaluations have furthermore highlighted the importance of informal channels such as social events, retreats, joint missions or informal meetings.

**Effective policy dialogue requires the investment of sufficient human resources** by all participating parties. EU Delegations, supported by headquarters (including EEAS, line-DGs, Chapter desks, and thematic expertise where appropriate), are expected to be equipped with the required skills, expertise, and incentives to engage in credible policy dialogue. Equally, the partner governments and other stakeholders must deploy sufficient capacity in terms of technical expertise and monitoring and coordination skills. Complementary support, if needed, can be provided for setting up the structures in case of weak capacity in the partner country. In some cases, dedicated structures for the beneficiary-donor coordination can be warranted, as is the case of EU-South Africa Dialogue Facility.

### EU-South Africa Dialogue Facility

The Dialogue Facility supports dialogue and cooperation in bilateral, regional, African and global matters between the Government of South Africa and the European Union and the EU Member States. The Facility is designed to support both existing and emerging dialogue by providing technical assistance and resources for the related costs. Through its Programme Management Unit, the Dialogue Facility supports the establishment and development of functional dialogue fora. The Facility is providing a wide spectrum of support to dialogue covering technical assistance, resources for missions, workshops, meetings, surveys or drafting of substantive papers.



## **Step 4. Recording and reporting**

- **Recording key policy dialogue events**
- **Reporting regularly on progress against policy dialogue objectives**

### **Tools:**

- Joint aide memoires
- Risk Management Framework
- Disbursement file transmission note by Head of Delegation
- Rolling dialogue plan
- Consultancy reports
- Minutes of the meetings
- Correspondence, briefing notes, back-to –office reports or others

In order to learn from policy dialogue and to provide evidence for the contract achievements during the evaluations, it is essential to document the key dialogue activities and to monitor the impact of the policy messages in the sectors of EU involvement, hence the need to explain how policy dialogue will be documented as part of the budget support design.

A rolling policy dialogue matrix (see above) can form the basis for reporting on progress towards dialogue objectives, complemented with minutes of key meetings to record the most important dialogue events. Of particular importance in relation to budget support are formal joint review meetings where agreement is reached on the degree of progress in relation to the general conditions and variable tranche indicators, and where forward looking objectives, and expected results are agreed upon. In addition, it is important to record briefing papers, back to office reports or exchange of substantive correspondence.

**EU delegations should (as a minimum) maintain a record of the key dialogue meetings or correspondence, directly related to budget support conditions, and provide a brief progress report on policy dialogue objectives in the disbursement transmission note.** Where policy dialogue is foreseen as a mitigating measure in the risk management framework, the specific dialogue objectives and progress achieved should be briefly set out.

## **Conclusion**

A successful budget support contract depends critically on sound policy analysis and continuous policy dialogue with the partner country at every step of the contract: the earlier and deeper the policy discussions, the higher the likelihood for a robust contract design and successful implementation. The entry points for policy dialogue vary depending on the country and the sector context, capacities and interests involved. However, common factors can be identified for establishing the foundations for fruitful dialogue.

### **Seven enabling factors for an effective policy dialogue**

1. Solid country and sector knowledge forms a basis for setting up and conducting efficient and credible dialogue, and for adding value for partner countries.
2. Dialogue targets are limited to the key achievable objectives, and set out in a rolling dialogue plan.
3. Dialogue is appropriately resourced and involves all relevant actors.
4. Dialogue respects the principles of ownership and involve "soft" skills to build trust.
5. Dialogue is aligned with existing country/sector coordination structure and policy/budgetary cycle.
6. Harmonisation reduces transaction costs and adds weight to the dialogue. Robust country-led (sector) policy coordination, monitoring and reporting framework supports evidence-based dialogue.
7. Although the scope for dialogue varies, the enabling factors pave the way for the willingness of actors to engage in dialogue.