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DG ENLARGEMENT

SECTOR BUDGET SUPPORT GUIDELINES

EXECUTIVE SUMMARY

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Introduction

The purpose of the guidelines is to provide guidance to those who programme, design and implement budget support programmes in pre-accession countries. This Executive Summary is designed to provide an overview for decision makers on how budget support will be applied in Enlargement countries.

While under the current IPA Regulation budget support was limited to "exceptional cases", the rules for IPA II allow for broader use of budget support, provided the conditions are in place. This instrument has the potential to fill a significant gap in the range of modalities currently available for the delivery of pre-accession financial cooperation. More specifically, budget support shall be implemented in the first instance in the context of moving under IPA II to the "sector approach", i.e. focusing on support to sector reform strategies rather than on financing individual projects. Budget support will thus be provided as "Sector Reform Contracts" to co-finance national sector reform agendas, as defined in the latest Commission Communication on budget support of 13/10/2011.

1 RATIONALE FOR BUDGET SUPPORT

1.1 What is Budget Support?

Budget support is a financial assistance modality. It should not be seen as an end in itself, but as a means of delivering better pre-accession assistance and achieving sustainable results. It involves dialogue, financial transfers to the national treasury account of the beneficiary country, performance assessment and capacity development, based on partnership and mutual accountability. Therefore, it is important to distinguish between the budget support *aid modality*, which incorporates all four elements of this package, and budget support *funds*, which relates only to the financial resources transferred to the beneficiary country. **Budget Support is not a blank cheque**, nor is it provided to every country. Eligibility criteria have to be met before and during the programme and conditions need to be fulfilled before payments are made. **There are no targets for the amount of EU budget support** to be programmed at either national or global level in pre-accession countries. Rather, the appropriate mix between different aid modalities should be decided as part of a portfolio approach that comprises several financing modalities in response to a beneficiary country's specificities and agreed pre-accession objectives[1].

1.2 Objectives of Sector Reform Contracts

The **general objective** of sector reforms contracts in the context of pre-accession assistance is to support the beneficiary countries in implementing the political, institutional, legal, administrative, social and economic reforms required to bring the countries closer to Union values and to progressively align to Union rules, standards, policies and practices with a view to Union membership.

[1] Distinctions can also be drawn between untargeted and targeted budget support (depending on whether funds are linked to a defined set of eligible expenditures or budget lines). However, as a rule, Commission support in pre-accession countries will be provided as untargeted budget support.

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

- Consistency with EU enlargement policy. The specific objectives should address the key enlargement challenges, i.e.: economic governance and competitiveness; the rule of law; the functioning of institutions guaranteeing democracy; fundamental rights; and overcoming the legacy of the past in the Western Balkans.
- Alignment with beneficiary countries own policies, priorities and objectives (and thus harmonised and coordinated with other aligned donors), provided such policies are consistent with EU enlargement policy.

SRCs should be used when the specific objectives are focused on supporting sector policies and reforms, improving governance and service delivery in a specific sector or set of interlinked sectors. Complementary aspects of a SRC might also be fostering domestic accountability, strengthening government systems and support macroeconomic and public financial management reform. Financial additionality may be a key feature of many SRC programmes but SRC programmes may also have objectives that do not necessarily imply significant increases in sector expenditure. The value added of a SRC is often in supporting an acceleration of reforms, in improving efficiency and effectiveness of sector expenditures, in knowledge sharing or capacity development.

1.3 Arguments for Providing Budget Support

The key reasons for developing a budget support programme in pre-accession countries are the following:

- Increased impact of EU assistance by providing an incentive to implement reforms at sector level, rather than implementing isolated projects.
- Increased ownership and accountability of the beneficiary country through greater government control over the allocation of funds and the selection of projects.
- Improved capacity building as the beneficiary country needs to meet certain conditions to qualify for budget support, in particular a stable macro-economic framework and sound public financial management.
- Clearer link between the political agenda (which requires sector reforms) and the financial assistance (to support such reforms), including progress towards accession benchmarks within an integrated policy dialogue framework.
- Efficiency gains in terms of reduced transaction costs for the European Commission and the beneficiary country.

However, budget support might not be the appropriate form of assistance in certain circumstances, and risk mitigation mechanisms might have to be established.

2 GOVERNANCE FOR EU BUDGET SUPPORT IN DG ELARG

The Geographical Directors in DG ELARG are responsible, in their role of Authorising Officers by Sub-Delegation, for the management of all budget support programmes in their area. There will be no change in the current financial circuits. Relevant DG ELARG services, including chapter desks, will continue to provide technical advice and support to the Geographical Directorates through the internal quality review mechanisms at the level of the individual Geographical Directorate or upon request.

In order to involve the senior management in the decision making-process early enough to provide necessary strategic guidance, **budget support programmes and disbursement decisions will be presented to the IPA Steering Committee** and, where appropriate, a representative from other DGs will be invited to participate to the meeting. The IPA Steering Committee will ensure quality and policy coherence of budget support programmes across pre-accession countries.

The Geographical Directors are responsible for the implementation and monitoring of the risk management in their area and shall propose alternative options for decision-making, including in response to deteriorating situations.

3 DESIGN AND IMPLEMENTATION OF BUDGET SUPPORT

3.1 Political and Economic Accession Criteria and Budget Support

When preparing Sector Reform Contracts, adherence of beneficiary countries to the political criteria should be taken into account. In general, Sectoral budget support is geared at promoting sectoral policy reforms. However, Sector Budget support can also be used as a vector to improve governance and the functioning of the economy.

Where political criteria are not sufficiently met, the EU should reassess its financial assistance to the beneficiary country, including sector budget support, and focus the assistance towards meeting the criteria. For all countries, particular care should be taken when supporting sectors which have a direct link with the political criteria and chapter 23 and 24, notably sectors which rely on Rule of law, Justice, Home Affairs and Fundamental Rights. When economic criteria are not yet met, the sector support and its preparatory steps will help reaching the status of a functioning market economy and improving its competitiveness.

3.2 Eligibility Criteria for Budget Support

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

1. **Stable macro-economic framework.** There is a credible and relevant programme to restore and/or maintain macroeconomic stability.

2. **Sound public financial management.** There is a credible and relevant programme to improve public financial management.
3. **Transparency and oversight of the budget.** The government has published either the Executive's Proposal or the Enacted Budget within the previous or current budget cycle.
4. **National/sector policies and reforms.** There is a credible and relevant national/sector strategy that is consistent with the EU accession strategy and supports the objectives of smart, sustainable and inclusive growth, and democratic governance.

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

A) Assessment, **during programme preparation**, of the **relevance** and **credibility** of the beneficiary country policy and strategy related to each eligibility criterion:

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

B) 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.

Assessments should be reasonably short and analytical, providing a clearly argued and justified recommendation regarding eligibility. Three general points are relevant to the assessment of each criterion:

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

Budget support can be provided only in a sector which has been identified in the Country Strategy Paper as a priority and which is endowed by an appropriate sector reform plan. Such plan must be linked to the enlargement agenda; it should be ambitious but with SMART targets (Specific, Measurable, Agreed, Realistic and Time-Related).

3.3 Budget Support Dialogue

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

The budget support policy dialogue should be complemented by the outcomes of the relevant **IPA Monitoring Committee and Sectorial Monitoring Committees meetings**, as well as Stabilisation and Association Agreements Sectorial Sub-Committees. In pre-accession countries where negotiations have already been opened on a particular chapter, the budget support policy dialogue should be closely interlinked and reinforce the discussions in the context of chapter negotiation.

3.4 Risk Management Framework

The development of an improved risk management framework adapted to the specific risk profile of budget support operations is a key element of the Communication on the "Future Approach to EU Budget Support to Third Countries". The Risk Management Framework for budget support operations is focusing on the country system and framework in order to identify the risks that may impede achieving the general objectives of budget support and make sure that they are managed in line with the Commission's guidelines on risk management.

The risk management framework is an internal assessment which allows, for each beneficiary country, to define the level of risk, by replying to a simple questionnaire, which is based on **five risk categories**: political risks, macroeconomic risks, developmental risks, public financial management, and corruption/fraud. Each question in the risk questionnaire has to be judged in terms of **four risk ratings** (low, moderate, substantial, high), capturing both the likelihood and impact of a risk with regard to the general objectives of budget support. The decision on the risk level for each question has to be justified through a very short narrative comment.

Depending on the assessment of risks, an appropriate **risk response** has to be defined through the identification of **mitigating measures**. The assessment of residual risks (after mitigating measures), will lead to the decision on the final response: risk acceptance or risk avoidance.

The **monitoring of risks** and their mitigating measures is crucial in order to check that identified risks are adequately managed. If the inherent risk level of one of the risk categories is substantial or high, the budget support programme, its mitigating measures and residual risks, as well as the potential benefits, need to be discussed in the IPA Steering Committee leading to a decision on the budget support programme (commitment or disbursement).

3.5 Performance and Variable Tranche Design

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

Variable tranches have several advantages: i) creating incentives for improved performance through partial payment for partial performance; ii) reducing damaging "stop-go" volatility in aid disbursements; iii) enhancing the credibility of disbursement conditions by focusing on concrete and measurable performance indicators.

A balance needs to be struck between creating incentives and avoiding excessive unpredictability or volatility in disbursements, particularly in more aid dependent contexts. SRCs would typically cover commitments for 3 years, or more, and a variable tranche of about 40%. There are no clear rules regarding the appropriate share of base and variable tranches. The European Commission should follow a pragmatic approach taking into account the budget support programme's share of the beneficiary country's budget; its track record of budget support implementation; the weakness of the country’s commitment to reform, and; the risk assessment.

The variable tranche indicators should be selected, in agreement with the authorities and in co-ordination with other technical and financial partners, among a number of performance indicators derived from the public policy. The following **principles** should be applied:

- There should be **coherence** between the programme objectives, the diagnosis of the problem, and the selected indicators and targets.
- A **combination of indicator types** can be selected. The greater the willingness of the beneficiary country to be held accountable for such outcomes, and the greater the confidence in the government’s ability to deliver and in the quality of such performance data, the more emphasis should be placed on outcome indicators.
- The **number of indicators should generally be limited to a maximum of 8** per tranche (and could be much less) in order to avoid a loss of policy focus.
- **Indicators, targets and assessment methodology should be precisely and unambiguously defined** during the programme preparation phase. The data source should be clearly identified and the quality of the data assessed.

Performance assessments should be an inclusive process led by the government, whereby performance results are also subject to stakeholder consultations and are made publicly available, and feed into domestic accountability mechanisms.

In order to **enhance predictability** and respect the country's budgetary and planning cycles, conditions, criteria, procedures and timing for disbursement should be clearly defined with and understood by the beneficiary country. This is a core element of the budget support contract between the EU and the beneficiary country. Assessments and decisions regarding disbursements should take place on a timely basis 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.** Also, **undisbursed funds should not be 'recycled' in later tranches** as this can reduce the initial incentive effect of variable tranches.

3.6 Domestic Revenue Mobilisation

Domestic revenue mobilisation plays a determining role in fostering sustainable and inclusive growth and good governance. Within budget support contracts, Domestic

Revenue Mobilisation will be considered within the macroeconomic (fiscal policy) and public financial management (tax administration) eligibility criteria, and it should be given greater attention in policy dialogue and capacity development. Tax/GDP ratio, tax effort and tax policy should be part of the macroeconomic assessment, including tax exemptions and incentives. This will provide an overview of the amount of tax revenues in relation to GDP, of the extent to which the country exploits its tax potential, and of the composition, level and relevance of the various taxes in the country and other sources of domestic revenues.

3.7 Accountability

Mutual accountability is important for the donor governments to demonstrate to their stakeholders that public funds for pre-accession are used effectively and efficiently. For beneficiary countries, it is important to receive credible donor commitments and timely, predictable, transparent and comprehensive information on aid flows, 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 frequently not. Accountability will be enhanced by:

- Strengthening the openness, transparency, and accountability of the budget process, for example by the new eligibility criterion on budget transparency.
- Supporting a participatory budget support approach.
- Integrating programmes to support national legislative and oversight bodies and civil society organizations.
- Increasing transparency by publishing relevant information on budget support Financing Agreements and performance reviews.

3.8 Fraud and Corruption

The fight against fraud and corruption is a key element that should have great prominence in budget support, particularly when assessing the PFM eligibility criterion. The Commission will pay particular attention to these issues and will promote a strong use of anti-fraud and corruption provisions, as well as the cooperation between the European Anti-Fraud Office (OLAF) and the inspection and judicial authorities of the beneficiary countries. Beneficiary countries need to be actively engaged in the fight against fraud and corruption, and be equipped with appropriate and effective mechanisms.

3.9 Capacity Development

Capacity development is a key part of the budget support modality, as it supports effective and efficient organisations, enhances government's capacity to implement policies and deliver services to final beneficiaries, and promotes the active engagement of all domestic stakeholders. Capacity development needs are assessed systematically and should be provided based on demand, ownership and commitment, be linked to results, and be provided through harmonized and aligned approaches.

Capacity development measures can be embedded in budget support operations by means of twinning or service contracts. These will have to be implemented in accordance with the implementation modalities applied in the beneficiary country.

4. BUDGET SUPPORT INTERVENTION LOGIC AND PROGRAMME CYCLE

4.1 Whether to Provide Budget Support

The process for reaching this decision involves the following steps:

First, an **assessment of a country's commitment to the reform agenda** in line with the country specific path to accession. In particular, the commitment to the Copenhagen political criteria is a pre-condition. Proposed SRC during the programming phase with substantial or high political risks will be submitted to the IPA Steering Committee who will decide whether a SRC is the appropriate aid modality.

Second, an **assessment of the eligibility against the four criteria**. This assessment will be done for all budget support contracts during the preparation phase for approval, and during the implementation, in addition to variable tranche performance, for disbursement.

Third, an **assessment of the risks** and whether these are likely to be outweighed by the mitigation measures and expected benefits during the preparation and implementation phases.

4.2 How Much Budget Support?

Decisions on how much budget support will be based on a broad qualitative assessment of the following key elements:

- **Financing needs** of the beneficiary country assessed on the basis of the Country Strategy Paper and/or the national/sector strategies.
- **Commitment** of the beneficiary country to allocate national budget resources in line with enlargement strategy and objectives.
- **Effectiveness and added value** that budget support will bring in achieving the beneficiary country's policy objectives.
- **Track record** and absorption capacity of past disbursements and how effectively agreed objectives were achieved with budget support operations.

Each criterion may be judged as high, medium or low, allowing an overall structured approach, which includes the flexibility to define an appropriate mix of modalities that best fits the country context.