

# Peacebuilding Commission - Working Group on Lessons Learned

## *Buttressing the State's Fiscal Capacities: Comparative Lessons from Budget Support*

8 November 2007, ECOSOC Chamber

### Chair's Summary

The fifth meeting of the PBC's Working Group on Lessons Learned was held on 8 November with the participation of a large number of member states in New York and Bujumbura-based representatives of the IMF, the World Bank, BINUB and UNDP through video conferencing. The event was chaired by H.E. Ambassador Carmen María Gallardo Hernández, Permanent Representative of El Salvador and included presentations by four speakers from the World Bank, the IMF and the UN Department of Economic and Social Affairs (DESA). The Chair *noted that the session addressed an issue of growing interest to many post-conflict countries*. While the topic was selected at the request of the Government of Burundi, discussions on budget support form part of PBC's sustained attention to marshalling financial resources for post-conflict peacebuilding and fiscal capacity building. Ambassador Gallardo added that the Briefing Note prepared by PBSO provided a useful introduction to key features of budget support and offered a comparative summary of its application in conventional development and post conflict contexts.

Introductory remarks were provided by Mr. Eloho Otobo, Deputy Head and Director of Strategic Planning at PBSO. He indicated that one of the fundamental attributes of a well functioning state is its ability to undertake sound macroeconomic management which encompasses sound fiscal policy. He emphasized that as a modality for aid delivery, budget support seeks to reconcile national ownership with partnership by using national allocation and accounting systems. Even so, the effectiveness of budget support in post conflict countries critically depends on a number of factors such as national technical expertise, the robustness of national fiscal institutions and the level of political risks. Mr. Otobo noted that, from a peacebuilding perspective, *a key challenge is not just delivering financial resources to post conflict countries but also to build national fiscal capacities*.

#### Presentations

Mr. Shamsuddin Tareq, Deputy Division Chief in the Fiscal Affairs Department at the International Monetary Fund (IMF), addressed the challenges of rebuilding fiscal institutions in post-conflict countries. He stated that building *sound fiscal institutions is key to effective utilization of budget support*. Damage to institutions makes the task of stabilization and growth more challenging in post-conflict settings. Added to weak macroeconomic conditions, this explains the need for a gradual increase in spending by donors in order to increase transparency, policy-based budgeting, accounting, recording and reporting, and external scrutiny and audit. Such a challenge is addressed in post-conflict countries by a relatively high level of good donor practices observed in comparative studies. Mr. Tareq indicated that several steps are needed to rebuild fiscal institutions and enable budget support. These include rebuilding a legal framework, strengthening capacity in the Ministry of Finance, and designing simple policies and administrative procedures to get fiscal institutions working again. He then highlighted two crucial elements for success. First, the choice of an appropriate spending path depends on country specific circumstances; and second, short-term measures need to be consistent with long-term objective of moving to an efficient and modern fiscal system.

Mr. Jan Walliser, Lead Economist in the Operations Policy and Country Services at the World Bank, presented a comparative study of project aid and budget support in different contexts. He showed that *partners in developing countries are faced with "the challenge of predictability"*. Compared to more stable countries, this includes greater difficulties in macroeconomic management, less steady program

implementation, risk aversion and possible “herd” behavior by donors which can exacerbate negative impacts on budgetary resources. In this regard, he emphasized that while clarity by donors about the consequences of weak performance in the recipient country was welcome, the announcement of financing decisions should be made early enough to avoid dramatic spending cuts.

Mr. Tito Cordella, Lead Economist for Latin America and the Caribbean Region at the World Bank, presented a conceptual model on the issue of budget aid vs. project aid based on the size of the aid program (relative to the recipient government’s own resources) and on the degree of misalignment between the objectives of donors and recipients. The model indicated that ***budget support is preferable to project aid when donors’ and recipients’ preferences are aligned, and when assistance is small relative to recipients’ resources.*** Thus, aid should be tailored to recipients’ characteristics. If donors know recipient preferences, budget support can be allocated to the more committed (and “richer”) recipients while project aid should be preferred for less committed (and “poorer”) countries. If donors do not know recipient preferences, they can use conditionality as a “screening device” to determine their commitment to implementing the necessary policies and reforms.

Ms. Benu Schneider, Chief of International Finance, Debt and Systemic Issues Unit at the Financing for Development Office (UN-DESA) described the ***risks linked to liquidity arising from budget support*** and the importance of taking into account the capacity of the Ministry of Finance and the Central Bank to manage this liquidity. Basing her analysis on the cases of Uganda, Mozambique, Ghana and Tanzania, she showed that management of donor flows required enhanced coordination between the Ministry of Finance and the Central Bank. Risks of crowding out private credit and of building up domestic debt also ought to be addressed. She proposed setting up a working group on budget support to examine the idea of creating an external investment account that would serve to smooth aid flows and reduce their volatility, including for budget support.

## **Discussion**

In the follow-up discussion, speakers welcomed the clarity of presentations and participation of the IFIs as well as the inclusion of several key documents that served as a basis for the presentations. The discussion can be grouped around three sets of issues: the effectiveness of budget support as an aid instrument; predictability of budget support and its role in the context of fiscal capacity building; and the implications of this topic for the work of the PBC.

***It was agreed that budget support can be an effective aid instrument in post-conflict countries depending on the presence of certain pre-conditions.*** It was noted that there is no contradiction in having both project aid and budget support in a post-conflict situation and that EU countries are actually seeking to increase their capacity to deliver budget support in difficult environments through reinforced cooperation with other relevant international institutions.<sup>1</sup> For the EU, budget support is considered as the instrument better suited to foster national ownership, and a flexible design for budget support disbursement is not only possible but also necessary in post-conflict contexts. Other speakers emphasized that international partners need to work in close cooperation and design innovative approaches to aid in post-conflict countries, recognizing that budget support is an important instrument to rebuild fiscal institutions. They noted that budget support could be an efficient aid instrument with clear rules to ensure a timely disbursement of funds. It was also emphasized that budget support is more a medium term aid instrument than a short term one. In written comments provided after the meeting, one member state stressed the need to find the best balance in aid modalities but cautioned against the use of budget support in post-conflict countries on the grounds that these countries lack the necessary capacity, policy and institutions.

***Participants viewed the issue of aid predictability as an important element to buttress fiscal capacity in line with the recipient country’s ability to fulfill certain conditions under budget support.*** Yet, it was also noted that political will on the part of the recipient government (rather than conditionality) is more important to make budget support a productive instrument. In this regard, it was stated that the recent

experience of Burundi showed that donors need to think through their procedures to ensure quick and flexible disbursement of funds in response to the needs of recipient countries while taking measures to ensure that funds are not used improperly. A representative from the IFIs highlighted the importance of good governance in the context of budget support and explained that it had been a determining cause of the recent difficulties in Burundi. Another speaker also pointed to governance as a key element for adequate disbursement, adding that the absorptive capacity of a country needed to be considered based on the presentations by Ms. Schneider and Mr. Walliser. It was noted that the need for budget support is most acute but also most difficult in post conflict contexts. As a result, there is often a significant deviation between commitments and disbursements which creates serious problems. This calls for a reconsideration of current aid strategies and for measures to adapt conditionality to the needs of fragile states.

***Finally, member states considered the implications of this thematic discussion for the PBC.*** Affirming the importance of budget support for the work of the PBC, some participants argued that without this instrument some of the ambitious goals of post-conflict transition would remain elusive. Another speaker highlighted the importance of dialogue and support among partners in order to avert impasses such as the one experienced by Burundi until recently. In this context, PBC was urged to examine important issues related to fiscal capacity and probity, including the legality of previous public contracts. Noting that the issue of budget support is key to peacebuilding, speakers acknowledged that the WGLL proved itself to be a good forum to draw upon the expertise of key stakeholders such as the World Bank and the IMF in order to make good progress on these issues. At the same time, participants inquired how the PBC might address some of the difficulties linked to budget support, such as aid volatility or absorptive capacity. Similarly, questions were raised about possible follow-up to the meeting, including through the sharing of best practices on broader issues related to customs reform or setting up a tax base in post-conflict contexts. It was suggested that there should be a follow-up discussion on the proposal made by Ms. Schneider. An IFI representative also called for further cooperation among partners on the issue of budget support in order to keep it on the agenda from a longer term perspective.

## **Next Steps**

The Chair welcomed the value added of the discussions and took note of the various suggestions by participants. She agreed to:

- Encourage early involvement of interested partners in the preparation and follow-up to the WGLL.
- Integrate the outcome of the discussions of the WGLL into the future work of the PBC.
- Consider a follow-up to this round of discussions on budget support.

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<sup>i</sup> See, for instance, EC Communication “Towards an EU response to situations of fragility - engaging in difficult environments for sustainable development, stability and peace”, COM (2007) 643 final, Brussels, 25.10.2007. The recommendations of the EC Communications are being discussed by the Council of the EU Member States with final conclusions expected for November 15. EC will be able to report on such conclusions in future meetings.