

## **TRANSPARENCY INTERNATIONAL'S CONTRIBUTION TO THE EUROPEAN COMMISSION CONSULTATION ON THE FUTURE OF EU BUDGET SUPPORT FOR THIRD COUNTRIES**

### **EU Budget Support can strengthen partner country commitments to anti-corruption, good governance and sustainable development**

Transparency International (TI) is the global civil society organisation leading the fight against corruption. Through more than 95 chapters worldwide and an international secretariat in Berlin, Germany, TI raises awareness of the damaging effects of corruption and works with partners in government, business and civil society to develop and implement effective measures to tackle it. There is strong evidence of the devastating impact of corruption on poverty reduction and sustainable and participatory development, particularly as it leads to considerable waste and misallocation of scarce resources. Most importantly, corruption creates unequal opportunities for citizens to participate in society. Advancing development by fighting corruption is one of TI's main areas of expertise and experience.

#### **Pros and Cons of Budget Support**

##### *Pros*

Budget support is a structured and systemic aid modality that is directly channelled into the financial management, accountability and procurement systems of a country so that a beneficiary country ('partner country') can manage development programmes and poverty reduction policies according to domestic priorities. These features are intended to strengthen domestic accountability and responsibility, which supports the principles laid down in the Paris Declaration on Aid Effectiveness (2005) and the Accra Agenda for Action (2008), particularly concerning the renewed emphasis on domestic ownership in the use of official development assistance (ODA) and recognition of the state as the central actor in the development process. The clear implementation of these principles is central to the fight against corruption.

Budget support provides key advantages over project-based and other types of aid:

1. By dispersing aid through a centralised structure, it can harmonise aid programmes and avoid the type of aid proliferation and fragmentation that increase transaction costs, special staffing arrangements and parallel development structures.
2. It allows optimal finance for long-term, sustainable development strategies by increasing funds for recurrent costs.
3. It can stipulate resources for long-term national planning, budgeting and oversight functions, including Public Financial Management systems (PFMs)<sup>1</sup>, but also the judiciary, the parliament and civil society, among others – the type of oversight functions that are vital to sustainable and accountable development.

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<sup>1</sup> *Public Financial Management systems* comprise the key financial controls placed on the proper functioning of the state. They include the capacity to collect revenues, to allocate and use budgetary funds and other public revenues, for instance in public procurement, but also the internal and external auditing of public spending and performance of state institutions.

4. It can strengthen predictability and timeliness of foreign aid, which is a prerequisite for the proper and successful implementation of development strategies at the national level.
5. It can strengthen partner countries' domestic accountability to their own constituencies (rather than to the donor community) in the management of public resources through greater use of the government's own accountability and review mechanisms (public account committees, external audit offices, the parliament etc).

### Cons

As stated on page 13 of the Budget Support Consultation paper (COM/2010/586), "Corruption is one of the key factors that affect the balance of arguments for and against budget support. Failure to tackle corruption undermines confidence in both the budget and the wider political economy, and has **implications for both financial and development risks**" (emphasis in text).<sup>2</sup>

Where budget support is provided towards PFMs that do not function with transparency and integrity, there are corruptions risks that the budget: a) is not used for the intended purpose; b) does not achieve value for money and c) is not properly accounted for. The added budgetary discretion, without effective oversight, afforded to partner countries creates increased opportunities for rent-seeking and corruption, while there is a concern that budget targets are realigned in response to the increase of funds, for example when government funds supplanted by general or sectoral support are diverted towards arms acquisitions. Finally, there is a clear attribution problem – if a country provides project-based support, for instance in the construction of a road, it is simple to see the cause and effect of the project. Budget support (at least in terms of general budget support) does not provide clearly observable results.

### Assessment

**While there are risks, budget support is** a key aid modality for ensuring country ownership. It helps to ensure a high level of accountability between the government, its elected representatives and citizens regarding which programmes are funded and why. Finally, budget support allows for complementary institutions and processes to be strengthened that make development efforts more sustainable and long-term.

**For these positive outcomes of budget support to occur, there must be full budget transparency of aid activities in the country – on and off-budget.**

**There also must be some features that characterise the country context for budget support to be effective.:** a) the budget in question should be an expression of the common interest of the partner country; b) the partner country should maintain, or commit to, a participatory political process; c) budget support should be monitored by donor, recipient and local civil society (organizations and citizens); d) preparation for budget support, including fiduciary risk assessments and/or public financial management, should be sufficiently transparent, accountable and effective; and e) the partner country should be committed to good governance reforms designed to foster domestic ownership, accountability and transparency in development programmes and public contracting.

**There also must be some features that characterise donors' aid flows for budget support to realise its benefits.** Despite a donor commitment to improve aid predictability (as per the Accra Agenda for Action), donors on the whole do not provide partner countries with enough forward information to plan 3-5 year activities. This creates asymmetries in information and reduced levels of accountability (a corruption risk) and budget transparency (on both sides). The lack of information creates a breakdown in accountability on the part of donors to their taxpayers as well as the intended beneficiaries of the funded programmes.

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<sup>2</sup> COM/2010/586, 13.

## **Commitments - Not Conditionalities**

There are two ways in which budget support may be provided: either you are demanding in your criteria, or you receive serious commitments towards structural change in the future. The former method implies a precise sense of conditionality, which can produce negative effects for the partner country in terms of its development. **Transparency International takes the view that the risk of corruption should never be used as a condition to prevent the allocation of budget support.** While the conditions laid out in Article 61 (2) of the Cotonou Agreement<sup>3</sup> provide a good overview of commitments, they cannot be objectively observed, and are prone to more political consideration as to the degree of transparency and accountability of the PFM system, or whether a programme is ‘well-defined’.

Budget support should move away from ‘conditionalities’ and towards ‘commitments’. Commitments can be tailored to the partner country’s immediate demands – in effect matching budget support to realistic, observable outcomes that are determined by the country context.

While a dynamic approach implies more risk, it can be twinned with serious commitments towards reforms. This argument reflects Box 3, page 5 of the Budget Support Consultation paper (COM/2010/586), where it is stated that “the Commission (along with most other providers) applies a dynamic approach rather than compliance with minimum standards” (own emphasis).

In this sense, the “dynamic” approach must be an expression of partner country needs to ensure domestic ownership, domestic accountability and an appreciation of the most important in-country issues. Positive advances can be supported by looking at existing commitments that a partner country has made, such as through regional and international conventions, and providing assistance in a manner that allows the partner country to achieve its commitments.

Thus, as part of the dynamic approach, ***the beginning of evidence of progress on the commitments mentioned above can serve as the starting point for the provision of budget support.***

## **Political Governance and the role of Political Dialogue**

In many respects the effectiveness of budget support depends on the political will to use the instrument while knowing its risks. This must take account of the political governance of the partner country and, in particular, its commitment to good governance. In the context of the political dialogue over human rights, democratic principles and the rule of law, the Cotonou Agreement Article 9 (3) defines good governance as “the transparent and accountable management of human, natural, economic and financial resources for the purposes of equitable and sustainable development”. A commitment towards good governance and the administering of development programmes therefore necessarily walk hand-in-hand.

However, issues relating to a country’s political governance should be addressed within the political dimension – in foreign relations and bilateral discussions, for example – and not within development cooperation, which is and remains an effort to alleviate the suffering of the most vulnerable and to reduce overall poverty. Budget support is merely an aid *modality* – it has no specific role to play in setting a partner country’s human rights or political agenda, so long as the national budget gives expression to the interests of the majority. Therefore, ***budget support should not be addressed in political dialogue.***

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<sup>3</sup> The Cotonou Agreement, Article 61 (2), reads:

“Direct budgetary assistance in support of macroeconomic or sectoral reforms shall be granted where:

- (a) public expenditure management is sufficiently transparent, accountable and effective;
- (b) well defined macroeconomic or sectoral policies established by the country itself and agreed to by its main donors are in place; and
- (c) public procurement is open and transparent.” (ACP/CE/en 81).

## **General versus Sectoral Budget Support**

General budget support assists countries in developing a national plan for development, implies a greater level of domestic ownership and assists in the creation of society-wide PFMs. The level of oversight (in terms of measurable development outcomes), however, may be challenging if there are not concurrent and appropriate levels of transparency, accountability and integrity.

In terms of a partner country's responsibility towards donors, in many cases the provision of general support is too marginal a percentage contribution to the budget to allow donors to demand oversight over the administering of the entire budget. While donors should have the ability to 'track' the use of their funds, a small contribution, percentage-wise, should not force a partner country towards duplicative levels of disclosure – this would appear in many respects as interference.

Sectoral budget support has its own advantages and in some cases it may be preferable to general budget support. For example, it allows for setting measurable, attributable outcomes and can allow for a systematic and serious dialogue with respect to the given sector e.g. the health sector. With sectoral support, a donor may even have a greater capacity (and political legitimacy) to engage with a partner country on policies related to the given sector, and more entry points for oversight - by monitoring a given sector one can trace irregularities in the money trail that would alert donors and civil society to the misuse / mismanagement / diversion of funds earmarked, such as for certain procurement programmes. Finally, non-state actors are, in general, accustomed to providing services in sectoral support - in many cases, actors on the ground are engaged in projects that complement the work of donors in a given sector. In this sense, just as general budget support encourages domestic ownership and accountability, the sectoral approach can address sector-specific risks, repair weaknesses in the system and complement the overall effectiveness of general support.

## **Accountability**

For budget support to foster democratic ownership and accountability, there must be transparency and accountability of the budget.

Simply put, **budget transparency is defined as the full disclosure of all relevant fiscal information in a timely and systematic manner**. As TI has previously asserted, budget transparency should be supported as an essential aspect of all forms of aid and used to assist recipient countries in fulfilling their global anti-corruption commitments. Below is a list of measures and tools that should frame all efforts towards effective budget support by donors and partner countries:

- 1. Avoiding off-budget activities** - in budget presentation, the full picture of the government's financial status must be given. Many developing countries have lost control over their financial affairs due to the segregation of budgetary execution data, or ad hoc budgetary execution records. Donors should be particularly aware that off-budget programmes should be avoided or be fully transparent. Aid practices could otherwise distort the budgetary process and undermine government accountability.
- 2. Sound budget and expenditure management systems** - the budget system should be built in a way that is transparent and open to public scrutiny. Improved public expenditure management systems are currently put in place in many developing countries in the context of Poverty Reduction Strategies (PRS). They are part of an overall reform package consisting of macro-economic and budget reform, civil service reform, and changes in the legal and regulatory structures.
- 3. Making information available** - the budget system should be designed in a way that produces comprehensive, timely information. Communication technology can play a crucial role in this. Electronic records of all transactions can contribute to avoiding

expenditures without previous authorisation and proper justification. Pro-active government or civil society organisation information campaigns can generate public interest in the monitoring of spending and thus prevent leakage of funds.

4. **Build budget literacy** - if citizens are to hold their leaders to account, they have to be able to understand the budget. The legislature is more likely to effectively monitor the budget process if there is widespread public interest in budget issues. The media and civil society organisations play a particularly important role in sparking public debates about the budget.
5. **Develop capacity of parliamentarians** - budget literacy is particularly important for members of parliaments who should be able to analyse the budget proposal, monitor expenditures and evaluate outcomes. Parliamentarians can initiate public hearings and debates, establish special committees and request further information from the executive.
6. **Public Expenditure Tracking** - in the budget execution phase, transparency can be enhanced through expenditure tracking, a method of finding out how, and at which level of the system, money disappears. Public Expenditure Tracking Surveys (PETS) measure the transformation of public expenditure into public goods and are today carried out by a number of institutions, including the World Bank. Public Expenditure Tracking can help identify entry points for anti-corruption reform.
7. **Strong and independent audit institutions** - unfortunately, fiscal review bodies, such as audit institutions, are not always able to do their job. Means to enhance budget transparency should therefore also aim to strengthen the effectiveness of these institutions. To effectively monitor and assess public spending, they need political independence as well as adequate financial and human resources that allow them to produce accurate reports in a timely manner.

### **Managing Corruption Risks through policy dialogue**

Policy dialogue is an important area in which to discuss a step-by-step approach to development, and to ensure overall budget transparency, that is applicable to the partner country. The EU can play a significant role in advising partner countries to adopt reform strategies that place a primacy on national development and the proper management of the budget. However, the proportionality of support is often a significant element for determining the possible seriousness of the policy dialogue on reform.

***Policy dialogue can manage expectations and improve the effectiveness of both general and sectoral budget support*** and the accuracy of measurable outcomes if it includes discussions on country-specific risk assessment and performance indicators.

Generally, a streamlined, coherent reform process would include a) short term safeguards and arrangements facilitating the tracking and accounting of expenditures; b) mechanisms for monitoring key corruption risks and related reforms in the medium term; and c) a comprehensive programme of reforms to address corruption risks in PFM systems in the long run.

While donors tend to look towards the short- and medium-term objectives, particularly in policy dialogue, long-term programmes are vital to ensure sustainable development and the transition from aid-dependent to budgetary independence – policy dialogue would benefit from the involvement of the wider group of stakeholders, including civil society at both the global and the local level. ***In this regard, it is vital to stress in policy dialogue that the process be linked up with domestic policy-making and open and accountable to all citizens.***

### **A credible reform programme**

For a partner country to put in place a serious, long-term programme against corruption, this would entail a commitment, preferably with timelines, for critical systems to be put in place. Such a programme of reforms should include, but should not be limited to:

1. **An initial country-specific risk assessment** – an effective risk assessment tool should be used prior to the provision of budget support. This should be conducted in conjunction with relevant partners such as the European Anti-Fraud Office (OLAF), and should assess the condition of Public Financial Management systems (preferably within the framework of the Public Expenditure and Financial Accountability tool).
2. **A commitment towards full budget transparency** – this commitment envisages reforms towards higher budget disclosure requirements, public expenditure tracking systems and the creation of sound budget management systems with a view towards enhancing overall accountability.
3. **A commitment to reforms of public procurement** – TI estimates that 70% of all government budgets are spent on contracts, while 20% of the value of all public procurement is lost due to corruption. To mitigate these losses, an effective, transparent and competitive system of public procurement should be put in place, preferably involving clear commitments on behalf of both the awarding authorities and the competing entities to refrain from acts of bribery as outlined in the OECD Anti-Bribery Convention, from colluding with competitors to obtain the contract, or engaging in such abuses while carrying out the contract. Bidders should disclose all commissions and similar expenses paid by them to anybody in connection with the contract; and sanctions will apply in cases of violations.<sup>4</sup>
4. **An effective monitoring process for the implementation of reforms** – guidelines and training on the expected responsibilities of parliamentarians, and on the expected responsibilities and the independence of courts of auditors, should be clearly and simply outlined, and a timeline put in place to ensure measurable, observable reform.
5. **Complementary efforts towards monitoring** – oversight is essential. Where such instances exist that neither parliaments nor courts of auditors are sufficiently ready to monitor the reform process, complementary monitoring must be provided by other means, such as the efforts of national civil society. Local-level or sectoral monitoring is necessary to ensure that implementation reaches the intended recipients of development – the poor and the vulnerable. Civil society is best placed to assist in this regard.
6. **Periodic evaluation of the ‘state of play’** – constant monitoring involves constant engagement with the reform process. It is often the case that, by providing budget support, donors step back from monitoring and implementation of funding and instead focus on increased policy dialogue. While efforts of policy dialogue are integral to overall development, this creates a monitoring ‘gap’ that could otherwise ensure effective implementation. Periodic evaluation of all steps taken is vital as well as investment in monitoring.

## **The role of civil society**

The role of civil society and citizens in demanding accountability in the use of funds has been increasingly recognised as critical to ensure that budget support is not lost to corruption. Civil society organisations are no longer seen as mere watchdogs but important elements in the policy dialogue<sup>5</sup>. Provisions for participatory planning, budgeting and management of implementation at local government levels, anchored in the Poverty Reduction Strategy Papers (PRSPs) of many countries, are now seen to depend on active civil society engagement. Further, the call for civil society participation is echoed by the European Parliament Resolution of 21 September 2010 *on poverty reduction and job creation in developing countries: the way*

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<sup>4</sup> For more information on Transparency International's position on public procurement, please see:

- *The Integrity Pact: A powerful tool for clean bidding* ([http://www.transparency.org/global\\_priorities/public\\_contracting/integrity\\_pacts](http://www.transparency.org/global_priorities/public_contracting/integrity_pacts)); and
- *Procurement Handbook: Curbing Corruption in Public Procurement – Experiences from Indonesia, Malaysia and Pakistan* ([http://www.transparency.org/publications/publications/other/procurement\\_handbook](http://www.transparency.org/publications/publications/other/procurement_handbook))

<sup>5</sup> COM/2010/586, Section 4.2, p.9

*forward* (2009/2171(INI)), which “encourages governments in developing countries to maximise involvement by civil society organisations in formulating and monitoring public policy”.

Transparency International would offer its assistance in promoting civil society involvement in implementation and oversight. As a global civil society movement of more than 90 national chapters, Transparency International possesses an expertise in engaging with the risks of corruption at the local level and can contribute to the reform process by way of local and national level projects and research. TI suggests specifying the set of indicative questions and the according performance indicator to ensure that desired results are measurable. As an orientation how to develop a more effective and holistic approach to an evaluation of risk, we attach TI's National Integrity System (NIS) assessment questionnaire (please find via the reference below).<sup>6</sup>

To support civil society involvement, the EU's sector and national policy programs should capitalise on the opportunities for combining support to participatory policy and budget formulation with support to public involvement in advising anti-corruption measures. Such an incentive fund for local authorities could be made part of a national level budget support operation. Support to civil society that demonstrates improved accountability should be linked to a commitment at the national level to replicate such features and provide an enabling framework for local service provision to be accountable to local communities.

An independent media and active civil society are an integral aspect of ensuring public accountability, preventing corruption and achieving development effectiveness. The Commission's thematic programme 'Non-state actors and Local Authorities' is already supporting local authorities through what is essentially otherwise a civil society funding mechanism – the Commission should explore funding lines that could potentially support the long-term partnership with, or the foundation of, civil society organisations directly connected to budget support operations. The EU's support to civil society must be proportionate to its support to government institutions.

Finally, it must be noted that not all countries possess the political space for civil society to act independently and without risk. In such instances, it is imperative that the donor of budget support seeks out ways to promote the expansion and education of civil society to the extent that it can function effectively and efficiently as both a monitor and as a local-level expert of reforms. ***A free and properly-functioning civil society is a vital component of the reform process and should be seen as a strategic partner, rather than as an implementation tool, involved in the long-term, sustainable application of development programmes.***

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<sup>6</sup> National Integrity Systems, Annex 3 – NIS indicators and foundations  
([www.transparency.org/content/download/49652/794096/ANNEX+3+-+NIS+Indicators+and+Foundations.doc](http://www.transparency.org/content/download/49652/794096/ANNEX+3+-+NIS+Indicators+and+Foundations.doc))