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Retooling Development Aid in the 21st Century

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Abstract

Budget support is an important instrument for development aid, providing key counter-cyclical support during global economic crises and supporting the reform priorities of developing countries. But what is the record on budget support's past performance? Independent evaluation indicates that budget support performs as well as traditional project financing in terms of meeting development objectives (see Figure 1a). At the program level, econometric analysis shows that success depends on both donor and recipient factors, including program design, policy dialogue and the timing of support. But much is still unknown about what makes budget support effective at the level of individual operations, especially on the recipient side.

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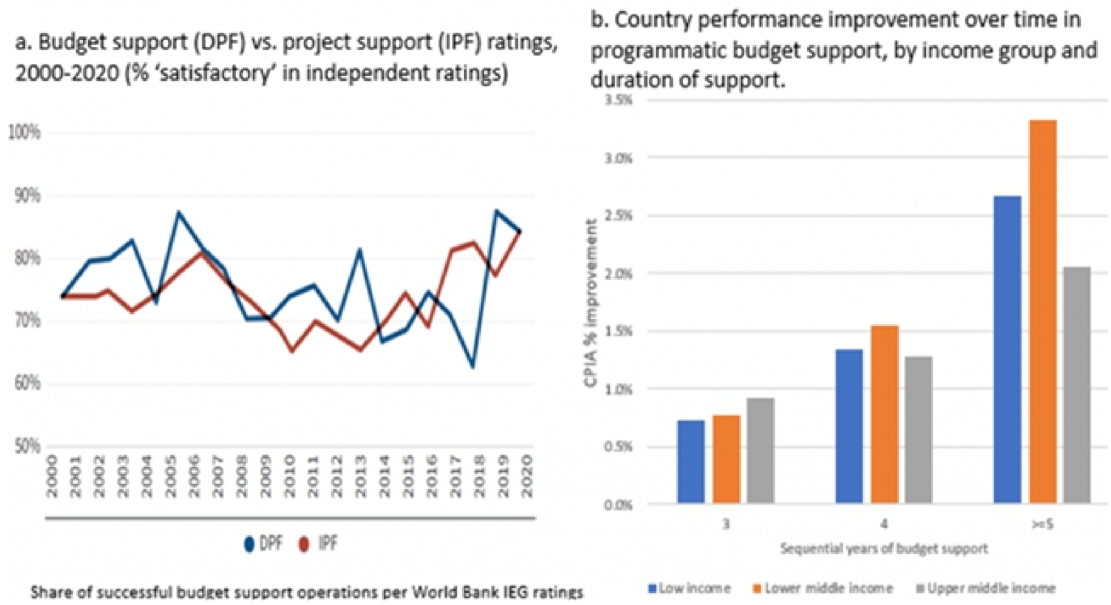
Background to the Study

Figure 1: Budget Support Performs Equally as Project Support



Source: Author. Figures 1a and 1b are based on World Bank data. DPF is development policy financing (budget support); IPF is investment project financing.

A comprehensive review of empirical evidence and quantitative analysis at the country level indicates that budget support works well. It contributes to sustained policy improvements in macroeconomic management, business regulation, social policy and public sector governance. But the policy impact depends on the country context, the process of policy dialogue, and the type and duration of the support (see Figure 1b). The research also shows that economic policy reforms have been more effective than certain areas of public sector governance and social policy. A large evidence base in economic reform, as well as the lack of short-term, tangible benefits in public sector reform, may explain these differences. Support for social policy reform has shown success even in fragile and conflict-affected states, as well as in times of crisis.

Lessons Learned

Despite the optimism and expectations following the 2005 Paris declaration, the use of budget support declined over the 2010s. Several factors drove the shift. Some new donor country governments were disinclined to continue financing 'reform', preferring traditional bricks-and-mortar projects, and debating (without much reference to the evidence base) aid effectiveness indicators and objectives. High-profile cases involving political repression (such as Ethiopia in 2006) or corruption (such as Mozambique in 2015) also undermined confidence in the instrument, despite its focus on institutional strengthening and accountability in public finance. Support was also diluted by the erosion of confidence in Poverty Reduction Strategy Papers. These strategies came to be seen as donor requirements that lacked government ownership, prepared largely by outsiders in the form of World Bank and International Monetary Fund (IMF) staff. Meanwhile, expectations of sharp increases in aid flows (such as at the Gleneagles Summit) fell short of donor pledges and the idea of budget support bore the brunt of the shortfall. Periods of severe economic distress, such as the global financial crisis of 2007-09, saw peaks of fast-disbursing budget support, resulting in short-term balance-of-payments financing with limited conditionality, rather than sustained support for long-term structural reforms. In parallel, new donors outside the Organisation for Economic Co-operation and Development (OECD), including China, also emerged, with a different aid framework, incentives and objectives. This raises new questions about the role of foreign assistance and aid instruments.

Reinventing Budget Support

Regardless of the post-Paris declaration shortcomings, budget support has a vital role to play in addressing the challenges of the 21st century. To live up to its potential, budget support needs to be redesigned, customised to the specific needs of recipient countries and donors, and adapted to the current international financial architecture. In this sense, policy-makers should consider the need for:

1. A deeper understanding of the political economy and specific development conditions of recipient countries
2. New strategies for addressing fiduciary concerns.
3. Realistic conditionality focused on critical reforms relevant to longer-term development outcomes and public goods.
4. Clarification of the division of labour among donors, based on financial and advisory capacity.
5. Realistic projections of development financing, including from the private sector

It should also be noted that rethinking aid modalities and instruments is critical given the emergence of new technologies, the urgency of global climate change, and growing inequality exacerbated by recent crises. The case for increasing budget support to accelerate development, to address resilience to crises and to foster public goods is strong. Its focus on policy dialogue, country ownership, inclusive and sustainable growth, and leveraging private resources makes it well-suited to responding to global crises and tackling future challenges. But budget support is not a panacea, nor is it appropriate everywhere. Risks remain and aligning conditionality jointly with authorities must persist to address development priorities and incentive systems to support reform. And yet, the limitations of official aid underscore the need for both better domestic resource mobilisation and better access to private capital. This includes funding through 'blended financing'- that is, the use of concessional public funds to leverage private development financing.

Coordinated jointly with the private sector arms of multilateral development banks (MDBs), budget support can help to de-risk investments to leverage private investment.

Hopes of leveraging 'billions to trillions' in private financing have not materialised, but the use of budget support to de-risk and help to strengthen the investment environment are promising. Several changes could make budget support more effective. It must reflect specific-country context, reflecting local conditions, rather than relying on generic 'best practices. It should also remain a viable instrument not only in well-performing low-income countries and in middle-income countries (as rapid counter-cyclical support during crises), but also in more fragile settings where it can provide predictable financing for basic administrative functions.

Country ownership of reforms is critical. But this requires a shared understanding by the authorities and donors, based on robust analytic underpinnings, with policy-makers cognisant of local political economy factors and incentive structures. Making the case to donors and MDBs for greater use of budget support also requires convincing them that resources are being allocated to development priorities, that allocations are being implemented accordingly, and that funds are being spent efficiently. This requires strong public financial management (PFM). This takes time to build and needs donor flexibility in terms of aligning their support for policy reform and providing fast-disbursing financing during periods of crisis. Policy-makers should remember that effective budget support is developed through deep country knowledge and a strong development policy dialogue, structured to support collaborative programme design. Further, conditionality should adhere to the principles of criticality, relevance, efficacy, additionality, and measurability. It should address concerns of both donors and recipient countries with regards to purpose, transparency and the evidence base.

Budget support can foster new approaches to leverage private capital flows to augment financing for development. Guarantees by MDBs to mobilise long-term private investment have proven effective to date.

Budget support then can help protect the global commons by:

1. Mobilising support for mitigation of and adaptation to climate change and the cross-border management of pandemics.
2. Supporting institutional reforms for sustainability of project finance in support of public goods.
3. Demonstrating measurable results.
4. Operating in tandem with traditional project finance to build essential infrastructure.

Conclusion/Recommendation

Finally, budget support should promote a division of labour between MDBs and bilateral donors, as well as close coordination with the IMF in supporting sound macroeconomic framework in recipient countries. This could lead to greater efficiency and coherence, where MDBs hold a comparative advantage as the principal sponsors of budget support in support of regional and global public goods. Budget support should also preserve flexibility to adapt as events unfold.

A recent book argues that budget support is vital for addressing 21st century challenges. It should accompany traditional project assistance, spurring shared growth and building resilience to manage future shocks. Given the ever-growing list of complex and interconnected development challenges facing policy-makers around the world, budget support should be prioritized and delivered with careful consideration.

Reference

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