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**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN
PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL
COMMITTEE AND THE COMMITTEE OF THE REGIONS**

THE FUTURE APPROACH TO EU BUDGET SUPPORT TO THIRD COUNTRIES

1. WHAT IS BUDGET SUPPORT; WHY DOES THE EU USE THIS INSTRUMENT?

Budget support involves policy dialogue, financial transfers to the national treasury account of the partner country, performance assessment and capacity-building, based on partnership and mutual accountability. It should not be seen as an end in itself, but as a means of delivering better aid and achieving sustainable development objectives by fostering partner countries ownership of development policies and reforms, as well as by implementing the aid effectiveness agenda and commitments set out in the Monterrey Consensus (2002), the European Consensus on Development (2005), the Paris Declaration on Aid Effectiveness (2005), and the Accra Agenda for Action (2008).

Budget support is an important instrument in EU's comprehensive development policy towards partner countries. The Commission will ensure that EU budget support¹ is consistent with the overarching principles and objectives of EU external action (Article 21 TEU) and development policy (Article 208 TFEU).

Following a Communication on budget support in 2000², the Commission pioneered a results-oriented approach based on outcome indicators. Predictability, ownership and accountability were further enhanced by the introduction of Millennium Development Goals (MDG)-Contracts in 2008.

EU budget support is not a blank cheque, nor is it provided to every country. "Underlying principles" matter and policy dialogue is a key part of the package. Moreover, eligibility criteria have to be met before and during the programme and conditions need to be fulfilled before payments are made. This ensures that resources are used for their intended purposes, mitigates risks, and creates incentives for improved performance and results. It also creates incentives for our partner countries to improve their governments systems.

Based on ten years of experience on budget support and calls of stakeholders to continue improving and refining the budget support mechanism, the Commission decided to launch a consultation in late 2010 on "The future of EU budget support to third countries"³.

In this Communication, the Commission sets out a new policy on budget support and puts forward policy proposals for an EU coordinated approach.. It aims to adapt budget support policy to the changing political and policy environment, including the Treaty of Lisbon, and to make EU budget support a more effective instrument. Member States may also consider these as recommendations as regards to their bilateral budget support, in order to achieve a coordinated approach by the EU as a whole.

¹ Defined as budget support for which the Commission is responsible.

² COM(2000) 58, 2.2.2000.

³ COM(2010) 586, 19.10.2010.

2. A MODERN APPROACH TO BUDGET SUPPORT

2.1. Building on success

EU budget support should continue to ensure a high degree of predictability, to put strong emphasis on development strategies that are nationally owned and to use performance related tranches. The Commission remains committed to results-based budget support operations and intends to further strengthen the assessment of progress and monitoring of outcomes, including by using process and output indicators, so as to better demonstrate and communicate the way EU budget support contributes to the development of partner countries. Improving the visibility of EU action and better communication of results will help maintain public support for development.

The EU should continue to apply a dynamic approach to eligibility criteria, focusing on progress in the implementation of credible and relevant reform strategies. The Commission intends to improve its eligibility criteria and their assessment and the allocation of funds ensuring greater efficiency of the budgetary process towards achieving policy objectives.

The Commission will refrain from establishing global targets for EU budget support to third countries. It considers that the appropriate mix between the different aid modalities is best decided as part of a portfolio approach that comprises several aid modalities in response to a partner country's specificities and agreed development objectives.

The Commission will strengthen its risk management framework for EU budget support in line with the Court of Auditors' recommendations. This will include closely monitoring progress in the fight against corruption and fraud with a view to ensuring sustainable development benefits.

2.2. Responding to new development challenges and objectives

The new approach should strengthen the contractual partnership on EU budget support between the EU and partner countries in order to build and consolidate democracies, pursue sustainable economic growth and eradicate poverty. 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 operations, allowing the EU to respond better to the political, economic and social context of the partner country. It will require close coordination between Commission services, the EEAS and Member States.

The Commission is committed to strengthening transparency and accountability in EU budget support by introducing a specific eligibility criterion on budget transparency and oversight.. The Commission is also committed to publishing relevant information on EU budget support operations.

The EU should provide budget support as a vector of change to address the following development challenges and objectives.

2.2.1. *Promoting human rights and democratic values*

Commitment to the fundamental values of human rights, democracy and rule of law is essential for the establishment of any partnership and cooperation between the EU and third countries.

General budget support is seen, by its very nature, as an implicit recognition that the partner country's overall policy stance and political governance is on track. Therefore, general budget support should be provided where there is trust and confidence that aid will be spent pursuing the values and objectives to which the EU subscribes, and on which partner countries commit to move towards meeting international standards.

When providing EU general budget support, the Commission aims at fostering domestic accountability and strengthening national control mechanisms as a basis for improving governance and adherence to fundamental values.

In cases where the partner country's commitment to fundamental values shows a significant deteriorating trend an adequate and coordinated response strategy at EU and Member States level needs to be defined and implemented. Unless there is a clear cut-situation where EU financial interests and reputation need to be protected, in which case general budget support can be suspended immediately, the response to deterioration should be progressive and proportionate. Where appropriate, measures to limit the impact on poor people should be designed jointly by the EU and Member States, in cooperation with other non-EU donors. This could include making adjustments to the size of any fixed tranche and/or reallocating funds to sector programmes, channelling funds to target groups via non-governmental organisations or reinforcing other aid modalities such as projects.

In order to better reflect these fundamental changes, EU general budget support should be referred to in future as "Good Governance and Development Contracts".

As regards EU sector budget support, the Commission tends to focus on sectors where policies and reforms are more promising to promote development and poverty alleviation; the drivers of change are stronger and aiming at addressing the basic needs of populations (e.g. basic services such as health, education, and water and sanitation). Most of the time, it is more efficient to use government delivery mechanisms to reach the population via sector budget support programmes. This also offers a means to improve the sustainability of programmes by improving the efficiency and effectiveness of the government's sectoral delivery structure. Sector budget support therefore remains a useful tool even where the conditions do not exist to permit the use of a Good Governance and Development Contract, 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 serve and protect the population. However, where political governance has severely deteriorated, the EU should reassess its overall cooperation with the partner country, including sector budget support.

2.2.2. *Improving financial management, macroeconomic stability, inclusive growth and the fight against corruption and fraud*

Budget support, in particular "Good Governance and Development Contracts", should be used to strengthen core government systems, such as public finance management and public administration. It should promote macroeconomic stability and fiscal sustainability, making

the systems more effective and accountable and lead to a comprehensive and transparent budgetary allocation process. It should be used to address constraints on sustained growth and to promote the "green economy", including the protection and sustainable use of public goods and natural resources, while ensuring that the benefits of growth are widely shared.

As part of its objective to improve core government systems, particularly procurement, budget support will contribute to the fight against corruption and crimes involving fraud. Partner countries should be committed to inform the Commission, and in general all partners, when allegations of possible fraud or corruption are brought to the attention of the national authorities. Whenever possible and without prejudice to investigations, the findings of the relevant national investigative institution and any proposed action should be shared with the Commission, and in general with all partners.

2.2.3. Promoting sector reforms and improving sector service delivery

When promoting service delivery or reforms in a specific sector (or a set of interlinked sectors) on the basis of a partner government's sector strategy, the provision of sector budget support can be decisive in enhancing the government's capacity to perform its functions and deliver sector objectives.

Clear objectives should be defined, mainly in terms of improvements in public access and use of quality services and, in particular in the neighbourhood countries, support for the partnership agenda. Sector specific conditions should lead to a regular policy dialogue, including on budgetary allocations to the sector, implementation of reforms, strengthening of institutions and systems, progress towards sector objectives, and efficient service delivery. Emphasis will be on issues relating to frontline service delivery, particularly pro-poor, gender and children's issues, and the capacity to absorb and use sector research results, as well as creating conditions for inclusive and sustainable growth for human development..

"Cash on Delivery" approaches will also be explored, building on experience with the variable tranche and taking into account each country's level of development and financing needs.

The Commission intends to make more use of sector budget support to address sector constraints, promote reforms and improve service delivery to populations. In order to better reflect these fundamental changes, EU sector budget support should be referred to in future as "Sector Reform Contracts".

2.2.4. State-building in fragile states and addressing development challenges of SIDS and OCTs

Situations of fragility call for action to help partner countries ensure vital state functions, to support the transition towards development, to promote governance, human rights and democracy and to deliver basic services to the populations. These situations require a global, coherent and coordinated response for which budget support can be instrumental. Together with other aid modalities (humanitarian aid, pooled funds, project aid, technical assistance etc), it has to be accompanied by reinforced political and policy dialogue.

The decision to provide EU budget support 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. The dynamics of change should be assessed on the basis of a joint analysis by the EU and Member States wherever possible. This should serve as the basis for coordination with the main development partners. A gradual and sequenced approach to EU budget support should be privileged, to best adapt to specific circumstances and to manage the risk.

This should be referred to in future as "State Building Contracts" to better reflect these elements.

The EU will also pay attention to SIDS (Small Island Developing States) and overseas countries and territories (OCTs). There, budget support can have an important impact, given the strong level of accountability and 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.

2.2.5. Improving domestic revenue mobilisation and reducing dependency on aid

In programming EU budget support, in particular the Good Governance and Development Contracts, the Commission intends to give stronger emphasis to domestic revenue mobilisation, including from natural resources. Fair and transparent tax systems are central to fostering citizenship and state-building, and lead to enhanced domestic accountability and political participation. While the EU is committed to providing predictable assistance through budget support, this assistance should complement (not substitute) the partner country's own efforts to mobilise domestic revenues.

In resource-rich countries, the EU should reinforce support for comprehensive reform programmes promoting enhanced natural resource governance, transparency and accountability, in line with EU policy on tackling the challenges in commodity markets and on raw materials⁴.

By assisting partner countries to address challenges in mobilising domestic revenues, the EU would contribute to improving self-reliance and reducing long-term dependence on aid.

3. EU COORDINATED APPROACH

The primary objective of an EU coordinated approach to budget support would be to increase the effectiveness of this modality in contributing to development and reform policies, and to provide coherent and consistent responses to challenges encountered. The EU should work with Member States in particular towards a "single EU Good Governance and Development Contract". Acting together would increase leverage on political and policy dialogue, as well as the impact of EU and Member States' bilateral budget support on partner countries' development. Coordination should be guided by the following key principles:

- *Sovereign decision making*, recognising that individual EU Member States need to retain ministerial authority over budget support operations and that the EU needs to comply with its legally binding agreements and financial regulations.

⁴ COM(2011) 25, 2.2.2011, and Council doc 7029/11, 10.3.2011.

- *Systematic information exchange* as a minimum, with coordination of responses and common approaches to budget support mechanisms being the ultimate goal.
- EU coordination should be supportive of wider donor coordination and country-led coordination.
- Coordination entails the involvement of both HQ and field level and builds on existing bodies, mechanisms of cooperation as well as existing legal frameworks.

In line with those principles, the EU should:

- share the initial assessment of the commitment of the partner country to the EU fundamental values with a view to finding a common approach;
- share, where relevant, diagnostics and assessments of eligibility conditions;
- harmonise, as far as possible, risk assessment tools and promote a coordinated dialogue on mitigating actions;
- perform joint assessments at country level and regular joint evaluations of budget support operations;
- ensure a high level of expertise for effective policy dialogue with the partner countries, including the use of delegated cooperation and transfer arrangements;
- engage jointly in high level political dialogue, including the monitoring of fundamental values and the appropriateness of pursuing the good governance contract;
- jointly communicate to local stakeholders the disbursements made and the compliance with disbursement conditions.

4. DESIGN AND IMPLEMENTATION

The EU should assess whether pre-conditions exist to entrust Good Governance and Development Contracts to a partner country, i.e; whether fundamental values of human rights, democracy and rule of law or a clear path towards international standards exist and whether such a Contract could clearly act as a driver to accelerate this movement.

In order to engage in a genuine high-level political and policy dialogue with countries eligible for budget support in general, and for Good Governance and Development Contracts in particular, staff resources at EU Delegations will have to be reviewed nationally and regionally, both in terms of level and expertise. To this end, the Commission will set up senior regional teams, at Headquarters and in Delegations, with the participation of relevant Commission services and the EEAS. These teams will also consult with Member States as appropriate.

4.1. Budget support eligibility criteria

i) The Commission will continue to apply the existing three eligibility criteria while reinforcing the following dimensions of each:

4.1.1. *Stable macro-economic framework:* *The Commission will pay particular attention to whether fiscal policy and targets are consistent with macroeconomic stability and managed according to sound rules of fiscal transparency and debt sustainability. Domestic revenue mobilisation is also an important dimension that will be reinforced as a crosscutting issue within the macroeconomic eligibility criteria (fiscal policy)*

and public finance management eligibility criteria (tax administration). The assessment will be in line with the EU policy on tax and development⁵.

*4.1.2. **National/sector policies and reforms.** This should focus on sustainable growth and poverty reduction in line with the policy proposed in the Communication "EU Development policy – An agenda for change: increasing the impact of EU Development Policy"⁶. Moreover, a sound social fabric requires a high degree of justice and fairness in tax collection and expenditure allocation (pro-poor, gender, and children issues), effective social protection and progress in improving employment and quality of jobs.*

*4.1.3. **Public financial management:** Before launching a budget support programme, the Commission will assess the institutional, legislative and regulatory framework and the performance of the public financial management (PFM) system in the partner country in order to identify a baseline upon which the dynamic approach will be based and the key reforms will be addressed during implementation by policy dialogue, capacity building and disbursement conditions.*

The Commission may decide, on a case by case basis whether in a weak PFM environment it should be appropriate to require some short term measures selected from the partner country's own PFM reform strategy before starting budget support operations.

The fight against corruption and fraud is a key dimension that should have greater prominence under this criterion. The Commission will pay particular attention to the fight against corruption and will promote a stronger use of anti-corruption provisions. Partner countries need to be actively engaged in the fight against corruption and fraud and be equipped with appropriate and effective mechanisms to prevent and detect fraud and corruption (including adequate inspections authorities and judicial capacity) as well as to provide adequate responses and effective sanction mechanisms. Failure to do so may lead to the suspension of EU budget support.

ii) The Commission will also introduce a new eligibility criterion

⁵ COM(2010) 163, 21.4.2010 and Council doc 11082/10, 14.6.2010.

⁶ COM(2011) 637.

4.1.4. Transparency and oversight of the budget: *The public availability of budgetary information is essential for promoting greater scrutiny of the budget. Based on the most relevant budget information, the Commission will define an "entry point" to assess this eligibility criterion. Countries will have to show that they either provide the relevant information to the public or are making progress in a short period to do so. This may also imply an assessment of the statistical system and in particular of the quality of budget data. Moreover, the Commission will apply a dynamic approach by focusing on the implementation of a credible reform aimed at gradually achieving full disclosure of budgetary information. The Commission will also take into account the specific features of Fragile States and SIDS/OCTs in applying this criterion.*

4.2. Managing risk

Commission services and where appropriate the EEAS will develop an improved risk management framework adapted to the specific risk profile of budget support, covering political governance, macroeconomic stability, development risk, public financial management, corruption and fraud. This framework will be an important complementary tool in programming, designing and implementing programmes and to inform policy dialogue. It will identify, assess and manage risks in line with levels judged acceptable by the Commission. Risk response and mitigating measures will be proposed according to the balance between risks and benefits.

4.3. How much EU budget support to provide to a partner country

The Commission will make a broad qualitative assessment of the following need 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 strategies.
- Commitment of the partner country to allocate national budget resources in line with development strategy and objectives.
- Effectiveness, value for money and impact of the specific added value that budget support will bring in achieving the partner country's policy objectives.
- Track record and absorption capacity of past disbursements and how effectively agreed objectives were achieved with budget support operations.
- Result orientation in the partner country's development strategy including a monitoring system.

4.4. Policy dialogue

Policy dialogue should be consistent with the EU's overall political dialogue conducted with partner countries. The Commission will strengthen policy dialogue to ensure that major reforms are discussed and fully resourced, objectives are identified and results assessed. Policy measures and verifiable results should be at the core of a more strategic and focused dialogue.

The scope of policy dialogue at country level will depend on the specific objectives of budget support operations and will include eligibility criteria. The Commission will continue to broaden its access to the expertise necessary for effective policy dialogue by signing

delegated cooperation agreements and/or accepting financial transfer arrangements with Member States.

4.5. Performance incentives and conditions

Budget support should continue to involve a combination of base tranches linked to eligibility, and performance tranches linked to progress against indicators in addition to eligibility criteria. The indicators should be drawn from each country's national and/or sector development policy or reform programme and should generally contain a mix of process, output and outcome indicators. Indicators and targets should be reviewed as part of each annual review, and may be adapted in the light of lessons learned. For Good Governance and Development Contracts, conditions may be attached to supporting democracy and human rights.

4.6. Predictability

The Commission will make EU budget support programmes predictable by ensuring that eligibility conditions, and the processes for their assessment, are specified as clearly as possible. Furthermore it will make longer term commitments in countries that have demonstrated a strong track record in implementing budget support, taking account of lessons learned from the MDG Contracts.

4.7. Strengthening domestic and mutual accountability

Domestic and mutual accountability on budget support should be further enhanced by:

- Strengthening the openness, transparency and accountability of the budget process;
- Supporting a participatory budget support approach;
- Systematically integrating programmes to support national legislative and oversight bodies, as well as sub-national authorities and civil society organisations;
- Increasing transparency by publishing relevant information on budget support financing agreements and performance reviews.

4.8. Capacity development

Capacity development needs will be assessed systematically to enhance government's capacity to implement policies and deliver services to final beneficiaries; to promote the active engagement of all domestic stakeholders and to strengthen the national statistical system. The Commission will provide support to capacity development based on demand, linked to clear outputs, and through harmonised and aligned initiatives.

4.9. Monitoring, evaluation and communication

The partner country should have a credible and functioning system in place for monitoring and evaluation (M&E) of results. If weaknesses are identified actions should be agreed to strengthen the M&E system. The Commission will pay particular attention to the following elements:

- Institutional setup of an M&E system.

- Existing M&E plan linked to policy development objectives and key processes.
- Quality, regularity and reliability of data, including official statistics, information systems, indicators (input, process, output and outcome) and reporting documents.
- Capacity development to support M&E functions.

The M&E system should contribute to strengthening the voice and legitimacy of national stakeholders in the partner country's budgetary process and ensuring that factual and verifiable information on budget support operations is placed in the public domain.

The EU should communicate better on both EU and bilateral budget support, based on analytical work, performance assessment frameworks, the results of actual evaluations and lessons learned.

5. CONCLUSIONS

The Commission calls on the Council to endorse the proposed Communication, which seeks to:

- make EU budget support more efficient and effective in delivering development results, and to endorse these proposals, in relation to bilateral budget support, as a means to
- equip the EU and Member States with an EU Coordinated Approach on Budget Support.

The guiding principles set out in this Communication will be incorporated in programming and implementing EU budget support.