

Burundi: Country Financing Parameters

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Introduction

1. This note provides the supporting rationale for the country financing parameters (CFP) eligibility for Burundi. The new policy allows IDA to finance expenditures needed to meet the development objectives of the operations it supports, within an overall framework that addresses risks related to fiscal sustainability and the appropriate use of IDA resources, in a way that is consistent with the Articles of Agreement. The proposed approach is expected to increase flexibility to permit the use of IDA financing for a number of expenditures. It rests on three guiding principles, namely: (a) the expenditures financed from IDA credit proceeds are productive; (b) the impact of operations financed under such credits on the borrowing country's fiscal sustainability is acceptable; and (c) oversight arrangements on the use of IDA funds are acceptable. The CFPs would be applied within the overall framework of the Burundi Interim Strategy Note (ISN) for FY06-07, which provides the background context relevant to the CFPs.

2. The Government of Burundi (GoB) was consulted on the proposed policy, and has indicated that it welcomes the increased flexibility in the World Bank's new policy of financing investment projects. Discussions with stakeholders and the Government have taken place during the mission held from February 21 to March 16, 2005 in Bujumbura under the coordination of the World Bank Country Manager. The analysis of Bank staff and Government feedback has established that Burundi could make use of greater flexibility in financing: (i) up to 100% of the costs of individual operations; (ii) recurrent costs; (iii) local cost; as well as (iv) taxes and duties, with careful consideration of risks to sustainability.

I-PRSP and IDA's Interim Support Strategy

3. As highlighted in its I-PRSP, Burundi continues to address difficult development challenges. In terms of social welfare indicators, Burundi is the fourth least developed country in the world (2004 United Nations Development Program (UNDP- Human Development Index)¹. These challenges include: (i) strengthening peace, security, and good governance, and promoting national reconciliation, (ii) resettling and reintegrating displaced persons and other victims of conflict, (iii) rehabilitating destroyed economic and social infrastructure, (iv) revitalizing and diversifying the economy for a sustained growth, (v) promoting the private sector while improving the investment climate, (vi) strengthening human resource capacities, and (vii) accessing the debt relief initiative. The Government's I-PRSP was discussed by the Bank and Fund Boards in January 2004.

¹ The index measures a country's achievements in three aspects of human development: longevity, knowledge, and a decent standard of living.

4. The new Bank Interim Support Strategy for FY06 - FY07 discussed and endorsed by the Board on May 3, 2005, reflects the outcome of the consultations with stakeholders in Burundi; and is fully aligned with priorities set forth in the I-PRSP. The two strategic elements of the Interim Strategy include: (a) improved security, social stability and service delivery; and (b) debt relief, economic growth and diversification. Governance and institutional strengthening are cross-cutting issues that will need to be addressed throughout the whole program in order to sustain progress. Preliminary estimates put the funding needs of the TSS at US\$170 million over two years in grant form. The planned operations are expected to be implemented throughout the country, with a focus on ensuring a distribution of benefits across all provinces. These include: (i) a Community Rehabilitation; (ii) an Education/Health Sector; (iii) an additional financing to the ongoing Public Works and Employment Creation; (iv) a Post Conflict Transitional Economic Rehabilitation Grant; and (v) Multi-Sector Infrastructure Rehabilitation project. It is expected that progress will be made during this period towards the preparation of a full PRSP, which will provide the basis for preparation of a Country Assistance Strategy.

Portfolio

5. Burundi has a relatively large but very young active portfolio, ranging from infrastructure through public sector management to social sectors. The current IDA portfolio consists of ten projects for a total commitment of US\$352 million and an undisbursed amount of about US\$168 million, reflecting the recent Bank's re-engagement in Burundi after almost a decade of civil strife and economic turbulence. Nine of the eleven ongoing projects are currently rated satisfactory. The development objectives and implementation progress rating of one project (Demobilization and Reintegration Project) is currently rated moderately unsatisfactory, and one project (Multisector HIV/AIDS Project) is rated as a potential problem project. Average age of these projects is about 3.2 years, with five projects about one year old, but also five projects due to close by end-2006.

6. **Eight new projects were approved** under the 2002 transitional support strategy. These include six operations identified in the TSS: (i) an Economic Recovery Credit intended to support economic recovery through balance of payments support, US\$54 million; (ii) a supplemental for the Second Health and Population Project, US\$9.5 million; (iii) a supplemental for the Social Action Project, US\$14.2 million; (iv) an HIV/AIDS operation, US\$36 million; (v) a Road Sector Development Project, US\$51.4 million; (vi) a Demobilization and Reintegration Program, US\$33 million; and two operations: (vii) an Economic Management Support Project, US\$26 million and (viii) the Agriculture Rehabilitation and Support Project, US\$35 million - that, while not foreseen in the 2002 TSS, were judged necessary to respond to the positive evolution of the peace process.

7. **Substantial policy advice was also provided to Burundian authorities** The Bank's cooperation with the IMF has been very close, with Bank staff focusing on Public Expenditure tracking and review. Bank support to Burundi's access to the Enhanced

HIPC Initiative included hands-on policy advice, debt sustainability analysis, preparation of the HIPC Preliminary Document, as well as preparation of a Joint Staff Assessment (JSA) of the Interim Poverty Reduction Strategy Paper (IPRSP). On governance and fiduciary issues, a Country Financial and Accountability Assessment (CFAA) and a Country Procurement Issues Paper have been completed. The Bank, together with the European Union, has provided close support to the government's liberalization of the coffee sector. Finally, in order to enhance the knowledge base on social sector issues, a Post-Conflict Social Sector Assessment has been conducted.

Macroeconomic Context

8. Following a decade of economic turbulence due to the civil strife and economic embargo, and despite continued sporadic hostilities in three provinces and commodity price shocks, the Government of Burundi is managing the economy relatively successfully. A macroeconomic program agreed with the IMF under a 3years PRGF arrangement is being implemented since January 2004, the first review was endorsed by the IMF Board on January 19, 2005, and the second on July 27, 2005. Economic growth in 2004 was estimated at 5.5 percent, and projections for 2005 suggest a growth rate of 5 percent.

9. The government also made progress in fiscal consolidation, restoring taxation yields in excess of 20 percent of GDP, and reining in military expenditures. Nonetheless, the decline in world coffee prices in 2003 and 2004 led to the establishment of minimum government-determined producer prices, at considerable budgetary cost. The establishment of a transitional government incorporating the political factions that negotiated the Arusha Accord, plus those joining the accord later, and the pressing need to restore coverage of social programs also added to expenditure² pressures. Revenues excluding official development assistance (ODA) stood at 19.4 percent of GDP, and expenditure about 42 percent of GDP in 2004, of which project spending (ODA) represented 15 percent of GDP.

10. The Government continues to implement prudent monetary and exchange rate³ policies to contain inflation. However, the monetary policy was under pressure in 2004, resulting from delayed budget support and higher than expected government spending reflected by an increase on net credit to the government. The broad money growth was about 19 percent by end-2004. The recent tightening of the Central Bank (BRB) credit ceilings to banks is likely to lower broad money growth in order to achieve the envisaged decline in inflation. The expectation is the 2006 is for a return to tighter policy and an increase in the use of indirect monetary instruments in this regard. Finally, there has

² The primary fiscal deficit for 2004 is believed to have been about 3.2 percent of GDP.

³ Beginning in 2000, the government floated the exchange rate; this process was complemented by the central bank's tightening of monetary conditions and more active role in the foreign exchange market. After a steep depreciation of the Burundi franc in 2000-2001, the exchange rate stabilized and the differential between the official and parallel market came down from over 30 percent to less than 5 percent in 2004.

been liberalization of foreign exchange market, with the differential between the official and the parallel falling to under 5 percent in 2005.

11. The current account deficit amounted to 14.6 percent of GDP in 2000 and reached 18.6 percent in 2002. Owing to a significant drop in coffee exports, the deficit widened to 22.6 percent in 2003. The surge in world petroleum prices, along with continued depressed coffee prices, has kept the external current account under pressure in 2004. The deficit is therefore expected to be around 26.1 percent of GDP.

12. Burundi has historically been ODA dependent and has a heavy debt burden. Its external debt is not sustainable - with an NPV of debt-to-exports ratio of more than 1,800 percent, debt service to export ratio at 132.3 percent, and the debt service-to-revenue at 52.2 percent. The results of the DSA show that Burundi's external debt situation would remain above the HIPC debt-to-exports threshold even after application of traditional debt-relief mechanisms. According to the DSA's baseline scenario even after the HIPC completion point Burundi's debt service will remain above the threshold level throughout the period 2006-2021. However, sustainability may be reached in 2011, provided 100 percent grant financing⁴. Burundi has reached the decision point on July 27, 2005 upon satisfactory completion of the ongoing PRGF second review. It is expected to reach its floating completion point around December 2006.

Public Financial Management

13. With IDA support through the ongoing Economic Management Support Project (EMSP)⁵ the government is putting in place an integrated public expenditure computerized system (IPECS)⁶ which will enable the tracking of resources allocated by activity and region, and the monitoring of the use of resources for poverty reduction purposes. Improvements are also underway in programming instruments to support the Budget preparation.

14. The main accountability issue in the Burundian system has been the lack of external controls. With EMSP's support, the government has put in place a General Accounting Office – Audit court - (*Cours des Comptes*) to review the State accounts. Furthermore, a harmonized budget and accounting nomenclature was adopted in 2004,

⁴ For all ODA excluding IMF financing.

⁵ Following a PER, the CFAA and ongoing EMSP, the Government adopted a new budget nomenclature and accounting system to facilitate budget execution and reporting.

⁶ An interim integrated public expenditure computerized system (2IPECS) is expected to be operational by end-2005, and the reporting based on different nomenclatures (Economic, Administrative, Geographic, PRSP and by function) including the TOFE for IMF, will be able to be generated at any given time. This makes possible a fully transparent and accountable budget execution by so doing, improves the budget allocation and makes possible the tracking of poverty related resources including HIPC resources – (HIPC resources have been integrated as source of financing therefore could be retrieved to trace related spending).

and was used for the 2005 budget preparation, which makes possible an accurate budget reporting and closing of book accounts for the audit court.

The New Country Financing Parameters

15. The new Country Financing Parameters cover: (a) investment cost sharing; (b) recurrent cost financing; (c) local cost financing; and (d) payment of taxes and duties. In this section these components of financing are analyzed in light of the government's strong ownership and commitment to its development program, and its inability to provide counterpart funding.

(a) - Cost Sharing

16. Burundi is in a crucial period in its transition from conflict to peaceful recovery and growth. A comprehensive peace accord among different political fractions of the country emerged from negotiations in Arusha, Tanzania, in August 2000. A power-sharing Government inaugurated on November 1, 2001 for a 36-month transition period has seen a peaceful transition from a Tutsi to a Hutu presidency. Legislative elections were smoothly held in early July 2005, and presidential elections will be completed on August 19, 2005, thus completing the transition and opening a new era.

17. Although debt relief under the Enhanced HIPC Initiative would help free resources for critical social and infrastructure programs, Burundi's current budget situation cannot allow a substantial shift in budget allocation. As a result of a 6 percent wage increase for civil servants, and the hiring of sorely needed 2,300 new teachers and 500 medical personnel The revised 2004 budget targeted a primary deficit close to 3.2 percent of GDP. There is a limited flexibility on fiscal policy given structural constraints of Burundi's economy. Nonetheless, the Government continues to apply prudent fiscal policies in a difficult macroeconomic environment, within the context of a PRGF framework and post-conflict situation. While there was some election-related fiscal expenditure in 2004, the government continues to try to contain unnecessary expenditure and finance the deficits through a combination of domestic debt instruments and drawing down on foreign reserves. The need to accommodate representatives from former rebel factions into the national transition institutions, and to restore coverage of social programs, constitutes additional expenditure pressures towards peace consolidation and poverty reduction. Thus the PRSP can hardly be financed through domestic resources which will remain very weak compared to Burundi's challenges. Only 6 percent of the USD 120 million⁷ in capital expenditures in 2005⁸ are expected to be funded from

⁷ République du Burundi – Cabinet du Président : Loi No 1/ 021/ du 31 Décembre 2004 portant fixation du budget général de la République du Burundi pour l'exercice 2005.

⁸ The Bank and other donor investment financed-projects are integrated into Burundi's normal budget system as memorandum items, because of donor's disbursement procedures and Bank's rules and principles to hold a separate account - (in Central Bank or a Private Bank) - for projects, when it is not a budget support. Efforts are underway with EMSP's support to better integrate Bank and other donor

domestic resources. The remaining 94 percent are expected to come from IDA and other development partners.

18. The government is firmly committed to combat poverty and mobilize development partners to support its poverty alleviation agenda. It has demonstrated ownership of its development program as illustrated by the formulation and adoption, following a broad-based process, of its I-PRSP in January 2004. All IDA as well as other donors'-funded projects are aligned with the Burundi's poverty reduction program. A *Forum of Development Partners*, held in January 2004 in Brussels, resulted in donor's pledges of more than US\$1 billion. The government is committed to: (i) create a sound macroeconomic environment, and promote the private sector for a sustained growth and to generate fiscal revenues for poverty reduction, and (ii) promote non-traditional exports to expand the export base and build up foreign exchange reserves for a sound balance of payments and consequently, to mitigate the risk of ODA unpredictability.

19. Government ownership is key, and will continue to be emphasized and encouraged. Actual decisions regarding the financing percentage are made on a case-by-case basis during project preparation. Given the current fragile post-conflict context and very tight financial situation, the provision of counterpart funding to IDA-funded projects is a poor proxy of government's commitment and ownership of its development program. Delays in mobilizing the counterpart funds have been a recurrent problem in recent years and has severely impacted implementation of critical community driven activities (for example the Public Works and Employment Creation and HIV/AIDS projects⁹). The 100% financing would therefore be particularly relevant to allow a rapid implementation of critical activities for Burundi's social and economic recovery and development. Based on the demanding needs of ensuring peace during the transition and the government's poor financial situation, it is proposed that IDA be permitted to finance 100 percent of project costs¹⁰ for FY06-07 - period covered under the current IDA Interim Strategy.

20. In principle, counterpart funding will be encouraged thereafter and the Bank would encourage project teams to seek co-financing from other development partners in all projects (as is the case in many ongoing and proposed projects such as the Demobilization, Reinsertion and Reintegration Program, Support for Child soldiers, and Agricultural Rehabilitation and Support Project). In projects implemented at the local level, contributions by beneficiary communities (cash and/or in-kind) are expected to be built into the project design as a signal of commitment and involvement (e.g., under the upcoming Community Rehabilitation Project). Project design and sustainability considerations call for contribution from other sources in some projects. It can however be expected that there would be some projects in which the Bank may finance 100% of project costs. In this case, the Bank would continue to look for alternative measures (i.e.,

financed-projects in the context of Burundi budget execution modernization so as to consolidate reporting as regards government spending.

⁹ For which the government was unable to provide its counterpart and has requested an amendment to the DCA.

¹⁰ There is no need to increase IDA financing envelope, the project will be designed as such and reflected in the costab.

other than counterpart contribution) of country ownership and commitment such as completion of some critical actions before the project is approved; involvement of beneficiary communities and local governments in the planning, implementation and monitoring of projects as a central element in projects implemented at the local level (in line with the Government's strategy); and satisfactory implementation of ongoing projects. Allocations of IDA funds to individual projects will continue to be determined by the availability of the overall IDA financing envelope and the prioritization laid down in the I-PRSP and the upcoming PRSP, and in the recently approved Interim Strategy Note.

(b) - Recurrent Cost Financing

21. The government's fiscal position remains fragile. The overall budget imbalance (before grants) widened from -4.9 percent of GDP in 2000, to -14.2 percent in 2003. This trend continued in 2004 with the overall budget imbalance excluding grants reaching -2.8 percent of GDP¹¹. Fiscal pressures increased in 2004, and the primary balance moved into deficit of about 3.1 percent of GDP. The overrun in primary spending was generated by the need to sustain the political transition and the peace process, payment of guaranteed coffee sector credit losses, and the domestically financed counterpart to much higher-than-expected project spending.

22. Alleviation of debt burden is essential for consolidating the efforts to sustain peace, to stabilize the society and revive the economy, as well as to deepen structural reforms for durable poverty reduction. Burundi reached the HIPC decision point in August 2005. Following continued satisfactory performance under the PRGF, and one year of implementation of the full PRSP including satisfactory review of the first annual PRSP progress report, the completion point could be reached in December 2006. Therefore, the current external GoB's debt policy is to seek grant financing given its weak foreign exchange reserves and poor export performance. Burundi's traditional development partners (EU and Belgium) are currently providing budget support in form of grants. The new IDA Interim Strategy Note also proposes 100 percent grant financing. The government plans to expand exports base and performance, and embarked on public debt management reform with IDA support for efficient resource management.

23. IDA has already financed some recurrent costs in several projects. Examples are the direct support for strategic human resource development, fees for long term consultants in many institutions, and project-related operating costs. During FY01-FY04, IDA-financed recurrent costs represented an average of 8.4 percent of IDA investment lending commitment.

24. Financing of recurrent cost¹², including salaries, would facilitate the implementation of certain projects, especially those in agriculture, the social sectors and public financial management modernization (EMSP). Pay scale is inadequate to attract

¹¹ IMF –first review under the three-year arrangement under the PRGF, December 2004 - EBS/04/179.

¹² Will be specified before the project is approved and no negative impact is expected on fiscal and debt sustainability particularly in the context of 100% grant financing for (FY06-07).

and retain quality civil servants. While the necessary skills are scarce in the private sector, under current Bank policy, civil servants must resign from their positions in order to be hired as consultants under IDA-financed projects. This is not seen as a viable option. Civil servants are thus only marginally involved in the management of projects, and opportunities for capacity building within the government are lost. Therefore, it is important for IDA to retain flexibility to fund recurrent costs as needed¹³ in individual projects especially with long-term impact on human capital and productivity. After careful assessment of risks to sustainability, IDA financing of civil servants salaries will be considered within the framework of regular civil servant compensation, and on a case by case basis.

25. Enhanced flexibility in recurrent cost financing would also be beneficial in the case of financing service delivery of public entities. Funding of recurrent expenditures under investment operations would improve the likelihood of attaining development objectives, while improving sustainability of the country's developmental programs in the medium to long-term. Examples of recurrent costs that IDA would continue to finance include rural programs, goods and services in social sectors, as well as funding of project-related operating costs. In addition, and after a careful assessment of risks to sustainability, IDA will consider financing of civil servants salaries. The level of recurrent cost financing is expected to stay broadly within the ranges of recent years. The Government is making efforts to sustain recurrent costs after IDA funding stops. In all cases, recurrent cost financing would be undertaken after careful assessment of risks to sustainability. The policy will be applied selectively, based on short-term needs and requirement to meet outcomes targets, and with a view to ensure long-term sustainability at the sector and project levels, including a consideration of implied future budgetary outlays.

(c) - Local Cost Financing

26. Total external financing requirements for Burundi's development program is estimated¹⁴ at US\$293 million over the 2005-2006 period. After accounting for anticipated loans and grants (US\$181 million¹⁵) and possible HIPC debt relief (US\$60 million), there would still be a financing gap of US\$52 million needed to be met with additional external financing. While necessary, a significant increase in domestic resource mobilization is not likely to occur in the short- to medium-term without adding unnecessary fiscal pressure over the embryonic and already overstretched private sector.

27. The financing requirements for the country's development program therefore exceed the government's current resources and expected domestic borrowing. Indeed, monetary policy was under pressure in 2004 due to delays in donor budget support and higher than expected government spending reflected by an increase on net credit to the

¹³ In line with the Development Credit Agreement (DCA) and the PDO and defined in the process of project design.

¹⁴ IMF – Burundi first review under the three-year arrangement under the PRGF, December 2004. – EBS/04/179.

¹⁵ IDA financing is considered to be a critical part of Burundi foreign financing.

government. The broad money growth was about 19 percent by end - 2004. To contain inflationary pressures the Central Bank (BRB) was compelled to tighten its credit ceilings to banks, which consequently impacted the private sector, and thus the overall country's development program. Financing of social priority spending and infrastructure rehabilitation¹⁶, which is predominantly in local currency to local contractors, have substantially increased. IDA financing of foreign expenditures alone would therefore not be sufficient to enable IDA-funded projects meet their development objectives.

28. The Standard Disbursement Percentage (SDP) for works is 100 percent; for goods is 100 percent on foreign and 90 percent on local costs; and for consultant services is 100 percent. The consolidated SDP is 90 percent. For FY99-FY04, local costs accounted for 59 percent of IDA disbursements in investment projects. During FY02-04, that proportion went up to 72 percent. For the FY02-04, IDA has been financing approximately 65 percent of local costs of civil works, 25 percent of local costs of goods, and 77 percent of local consultants' services. Burundi meets the two criteria for IDA financing of local expenditures: (i) financing requirements for the country's development program exceed its own resources and expected domestic borrowing; and (ii) the financing of foreign expenditures alone would not enable IDA to adequately assist in the financing of Burundi's development program. Therefore, it is recommended that IDA would finance local cost and foreign costs in any proportions as needed for individual projects.

(d) - Taxes and Duties

29. Burundi tax system relies principally on indirect taxes, which account for approximately 75 percent of total tax revenues. The major indirect taxes are: (i) transaction tax (TT) which generates a substantial amount of government revenue - set at 17 percent (similar to value added tax) but collected at the border crossings – (ii) the service tax set at 6 percent, also internal tax collected at the border on all import regardless of origin. Top income tax rate in Burundi is 60 percent. The top corporate tax rate is 35 percent, down from the 40 percent in 2004. Authorities are reluctant to exempt local expenditures from taxes, as this approach would cause distortions. Burundi is part of the COMESA trade region and is committed to tariff harmonization and elimination of other forms of restrictions beginning in 2005. However, rapid and effective reduction of tariffs in the post-conflict context characterized by shrinking public resources and a smaller tax base appears as a serious challenge in the short-run. Nonetheless, starting with the 2005 budget, the government reduced the top import tariff to 30 percent and tariff bands to only three (10, 15, and 30 percent). There are no discriminatory taxes for IDA-financed projects/activities.

30. In conclusion, there are no taxes and duties that have been identified to be unreasonable, or discriminatory. Therefore, IDA may finance taxes and duties associated with project expenditures. The application of this policy will be subject to an ongoing reform of Burundi's tax system, and how taxes are applied to IDA-funded projects. At

¹⁶ Works are generally funded at 100% both foreign and local costs and goods and other local costs tend to be at 95% excluding when it is on grant basis in which case, local costs are covered up to 100%.

the project level, IDA would consider whether taxes and duties constitute an excessively high share of projects costs.

Concluding Remarks

31. IDA and Burundi government find that the framework set out reflects the best arrangements for the country, keeping in mind the three guiding principles mentioned in the opening remarks. As a part of the Interim Strategy process, the parameters will be reviewed approximately on a bi-annual basis, and when the next IDA assistance strategy is prepared, with any necessary adjustments as appropriate, in accordance with IDA procedures.