Promoting Economic Reforms in Developing Countries
Rethinking Budgetary Aid?

Ferdinand Bakoup
Promoting Economic Reforms in Developing Countries
Rethinking Budgetary Aid?

Ferdinand Bakoup¹

Working Paper No. 167
January 2013

Office of the Chief Economist

¹ Ferdinand Bakoup is a Lead Economist, African Development Bank. The author would like to thank Mthuli Ncube, Steve-Kayizzi-Mugerwa, Janvier Litse, Ernest Addison, Bernadette Kamgnia-Dia, Ousmane Dore, Tankien Dayo, Kalidou Diallo, Olivier Manlan, Gabriel Victorien Mounjani, Daniel Ndoye, Guy-Blaise Nkamleu and Pascal Yembiline for their comments on the draft of the paper. Comments made by participants at an African Development Bank Staff seminar are gratefully acknowledged.
Abstract

This paper examines donor practices in the use of budgetary aid to promote economic and structural reforms in developing countries, notably those of Africa. It is based on an observation in recent literature to the effect that, despite its increased use since its advent in the 1980s, budgetary aid appears to have had limited impact on the design and implementation of economic reforms in developing countries. To remedy this situation and reposition budgetary aid as a catalyst for structural reforms in recipient countries (one of this instrument’s fundamental objectives), and to strengthen the linkages between fund transfers to national treasury accounts and implementation of profound and far-reaching reforms in support of growth and job creation, the paper proposes a new instrument for donors, namely Enhanced Budget Support (EBS). The latter seeks three major objectives: i) devote budget support to the implementation of reforms requiring the creation of intangible assets, an area in which it has a comparative advantage; ii) clearer identification of the changes in economic behaviors and, therefore, the results, targeted by the reforms and iii) align budget support financing with the estimated budgetary cost of the structural reforms to be pursued, an approach which few donors have adopted today. Apart from enhancing transparency, this approach would afford the stakeholders the means of more fully guaranteeing accountability, thereby strengthening the link between budget support and implementation and, consequently, the outcomes of reforms. The challenges often mentioned in assessing the budgetary cost of reforms, can be overcome.

JEL Classification: E61; O19; O23; O29; O43.

Keywords: Budget support, budgetary aid, economic reforms, balance of payments, development aid, fiscal policy, balance of payments assistance.

Adress correspondance to: f.bakoup@afdb.org
Introduction

This paper examines ways of strengthening the linkages between budget support and economic reforms in recipient developing countries. After over two decades of the intensive use of budget support as a means of providing aid, the issue of its capacity to foster economic reforms and, hence, promote development and progress towards achieving the Millennium Development Goals in recipient countries has re-emerged in the aid effectiveness debate.

Of note is the context of this debate, in which, after several decades of reforms, aid recipient countries, sometimes with the support of donors, have improved the quality of their fiduciary frameworks and public financial management systems, which are often mentioned as a determinant factor of successful budget support. Thus, it is in this apparently favorable fiduciary environment for the use of this instrument in recipient countries that we are witnessing, especially within the donor community, an attempt to deepen discussion about the role of budgetary aid as an instrument of support to reforms, rather than a critique of its relevance. Some donors are reviewing their budget support procedures and raising the threshold for justification of recourse to such an instrument. The impression all these initiatives give is that the budget support debate is far from over. This paper aims to contribute to the debate by exploring approaches likely to strengthen the linkages between budget support and reforms in the recipient countries.

Our strategy for contributing to this key debate is as follows: We begin by examining the origins and development of budget support. Next, we attempt to clarify the nature of economic reforms, notably by presenting an anatomy of economic reforms in which we make a distinction between those requiring tangible asset creation, and those requiring intangible asset creation. We then show that budget support offers a comparative advantage in the financing of reforms requiring intangible asset creation. Following from this, we undertake a review of recent literature, noting that, despite positively contributing to some aspects of aid management, the role of budget support as a reform catalyst in recipient countries has rather fallen short of expectations. We also show that factors accounting for the limited contribution of budget support to reforms may not be related to the conditionality or fungibility of the resources, two areas that have dominated recent literature. This leads us to examine means of

---

2 In 2010, the European Commission, a major budget support donor launched a consultation on “The Future Approach to EU Budget Support to Third Countries” leading to the formulation of a new budget support policy. After a long gestation period, the World Bank adopted a new instrument in 2012, namely the Program for Results Financing. In 2012 the African Development Bank also adopted a new policy on programme aid. Although the Program-for-Results aims at a greater use of budget support as a means of channelling aid, its current design does not seem to suggest an enhanced role for this instrument in the advancement of reforms, which is the central concern of this paper.

3 In this paper, we make the hypothesis that budgetary aid is provided with the intention of supporting the implementation of reforms. This hypothesis is obviously restrictive as we know that some budgetary aid may be provided for reasons other than for reforms implementation. We will, therefore, not deal with issues relating to the political economy of budgetary aid and reforms in this paper. For an interesting discussion of some political economy considerations relating to budgetary aid, see Bergamaschi, L., Diabaté, A., Paul, E (2007). L’agenda de Paris pour l’efficacité de l’aide: Défis de l’appropriation et nouvelles modalités de l’aide au Mali. *Afrique contemporaine*, 2007/3-4 (n° 223-224).
reinforcing the linkages between budget support and reforms and propose a new instrument, namely *Enhanced Budget Support*. This new instrument advocates three things: firstly, devoting budget support to the implementation of reforms requiring intangible assets creation, an area in which it has a comparative advantage; secondly, clearer identification of the changes in economic behaviors and, therefore, the results, targeted by the reforms and, finally, matching the budget support amounts and the estimated budgetary costs of the reforms envisaged. This approach, which few donors use today, aims to effectively apply budget support for the formulation and implementation of reforms in the recipient countries. To illustrate the approach presented, we draw some early lessons from the recent experience with budget support to Euro zone countries in crisis. Finally, based on the points examined throughout the paper, we proffer suggestions for future research on ways and means of improving the effectiveness of budget aid as a support tool for reforms. The paper ends with a final conclusion.

**Origins and Development of Budget Support**

*Definition of budget support:* The concept of budget support has gained currency in today’s development world. However, in view of the multitude of other concepts in use (policy reforms, rapid disbursement support, balance of payments assistance etc.)\(^4\), it would clearly be necessary to clarify the concept of budget support. Hence, an attempt will be made to provide a precise as well as operational definition distinguishing this concept from other aid instruments such as project aid, which we will discuss elsewhere in the paper. The European Commission, a major aid donor to developing countries, defines budget support as “policy dialogue, financial transfers to the national treasury account of the partner country, performance assessment and capacity building based on partnership and mutual accountability”\(^5\). This definition shows that the disbursement of budget support directly to national treasury accounts and the use of such funds to finance Government budgetary operations as well as dialogue on policy and reforms to be pursued form part of fundamental criteria of budget support. Thus, the emphasis on reforms accompanying transfers to national treasury accounts clearly highlights the special role the donor community assigns to budget support in the promotion of economic and structural reforms in relation to project aid. Other key features include dual aspects, in that once the financing has been agreed: i) funds can be rapidly disbursed and made available to recipient countries within a short period of time, sometimes within a day; and ii) the use of the funds is based on national public financial management procedures.

*Affirmation of budget support:* When development aid emerged in the 1960s\(^6\), it was initially in the form of project aid and not budget support. Donors provided resources to beneficiary countries to finance specific projects, notably in the area of infrastructure. In this traditional form of aid, the resources were mainly used to pay for goods, services and works necessary for the execution of major infrastructure projects, especially in the transport, energy, water and agriculture sectors, as well as for the realization of major social infrastructure in sectors such as education and health. One of the main features of this form of aid is the fact that donors often played the role of fund treasurers themselves and only released the funds to the beneficiary countries at their request, depending on the physical

---

\(^4\) These other concepts, whose spirit and implementation mechanisms are close to those of budget support, are discussed elsewhere in the paper.


\(^6\) Although it is difficult to determine exactly when development aid started, it can safely be stated that it was with the establishment, on 24 September 1960, of the World Bank’s affiliate, the International Development Association, responsible for promoting economic development in developing countries, that development aid materialized as a full-fledged component of the international financial architecture.
implementation rate of the projects and in accordance with fiduciary procedures previously agreed to. These procedures which became increasingly sophisticated, from the donor standpoint, were designed to guarantee the observance of a minimum of fiduciary standards in the use of funds intended for projects.

It was not until the 1980s that budget support emerged as a method for conveying aid. Several factors account for this development, but two should be highlighted and explored on: i) the unfavorable international economic climate of the eighties and its impact on aid recipient countries; and ii) project aid difficulties.

With the reduction of commodity prices from the first half of the 1980s, many aid recipient countries were hit by an unprecedented economic crisis that disrupted both their internal and external balances. For many of these countries, balance of payments and public finance deficits widened immensely. Governments found it increasingly difficult to meet their financial obligations. In most cases, the difficulties included external debt servicing7, and countries increasingly found themselves in urgent need of resources to meet this need, and which could only be obtained through quick-disbursing aid. Since project aid was not suitable for such cases, budget support became the only way out. In return for the budget support provided by donors, developing countries were compelled to implement major economic reforms under structural adjustment programmes in order to restore economic balance.

In addition to the economic downturn of the eighties, the difficulties inherent in the implementation of project aid, notably regarding the weakening of public administration capacity, the multiplicity of donor procedures and distortion of accountability at national level, also contributed to the emergence of budget support.

Since then, the use of this instrument has increased considerably. Whereas budget support represented only a negligible part of official development assistance in the 1980s, today it plays a key role. According to the European Union, this form of aid represented about 25% of its EUR 13 billion external aid over the 2003-2009 period. Statistics from other bilateral and multilateral agencies also show significant progression in the share of budget support. Thus, budgetary aid represented about 31.3% of the 11.3 billion Units of Accounts (UC)8 of the operations of the ADB window and 21.8% of the 10.9 billion UC operations of the ADF windows respectively at the African Development Bank over the period 1999-2009.

A few stylized facts on budget support: We will mention five. Firstly, there is the desire by donors to use budget support to promote reforms. It should be noted that this increased application of budget support also and above all arose from the implicit consensus that countries were in dire need of economic reforms and that, given its characteristics, budget support could better meet that need. This reforming ambition appears, however, to have been weakened by the recent tendency of some donors to use budget support to fund public expenditure programmes, even those with limited reform content. Secondly, there is a close link with conditionality (we shall revisit this point).

---

7 These reforms were similar in nature and design, to the reforms Greece and other European countries affected by the economic and financial crisis are compelled to implement in exchange for support from the IMF, European Union and the European Central Bank.

8 1 UC = 1 Special Drawing Rights of the IMF.
Thirdly, budget support is often provided either as general support or sector support. The former case involves the transfer of resources to the national treasury accounts without any indications on the budgetary operations of the government or particular sector targeted by such resources. The fungibility of resources and the will of donors to oversee governments’ general economic management for long periods provided a rationale for general budget support. However, as indicated in this paper, this led to inadequate progress in the area of reforms. In the case of sector budget support, the resources transferred to the national treasury accounts are intended for financing government budgetary operations, again without any a priori indications as to their specific use, with some intentions to reform and improve the performance of the sector concerned. Fourthly, public financial management reform was preponderant among the budget support objectives. Fifthly and lastly, budget support is justified by the existence of an overall financing need, stemming from the budgetary deficit which is deemed to be compatible with macroeconomic stability (often based on IMF assessments). Before reviewing some of the lessons that can be learned from the budget support experience relative to reforms, the nature of these reforms should be specified.

Anatomy of Economic Reforms

In strengthening the relationships between budget support and the implementation of economic reforms, it is necessary to have a good understanding of the nature of economic reforms and of the financing required for the purpose. This section is devoted to such understanding, based on a description of the anatomy of economic reforms but first, we must define the very concept of economic reform.

_A definition of the concept of reform:_ The concept of economic reform is one of those most often used in fields of economic policy and development, but rarely defined in a rigorous, precise, useful and operational manner. What is economic reform and what determines its real impact? We will define economic reform as an action by the government targeting economic policy instruments designed to effect changes in the behaviours of public and/or private economic agents with a view towards either boosting their sustainable and non-inflationary demand addressed to the national economy or increasing their productive investments to achieve national economic growth and employment creation targets.

Despite its apparent clarity, this definition needs to be further elucidated. Although it indicates that the final objective of the reforms is to achieve economic growth and employment creation objectives⁹, it also clearly shows that, to do so, the reforms must first have a positive impact on the demand addressed the national economy and/or productive capacity building. Stimulating supply and demand is therefore an intermediate objective or a necessary transient point for any effective economic reform. This point, particularly the demand-related objective, needs to be stressed, since it has not always been clearly defined in the reform agendas of many developing countries, including those of Africa. Despite their significance, supply and demand objectives are not manifestly influenced by an action on the instruments available to the authorities in charge of the reforms. It is only indirectly, through the variables that are closest to the instruments that the authorities can influence supply and demand,

---

⁹ To be more topical and precise, inclusive and green growth.
particularly their private components of the latter, which are also the most significant in a market economy.\textsuperscript{10}

With this definition, how can reform be characterized? There are several criteria but, in this paper, the following five are proposed: financial effect, role of tangible assets and role of intangible assets in the implementation, credibility, reversibility and sustainability of the reform.

**Financial effect:** To ensure its effective impact on the economy, a reform must have a financial effect on at least one category of economic agents, namely it must translate into a change in the structure of financial assets and liabilities, and therefore, the balance sheets of economic agents. It is this financial effect that changes the system of economic incentives for economic agents and which, in the final analysis, produces the changes in economic behaviors identified above as a crucial objective of any reform. A reform without financial effect cannot have a real impact on the economy. For the government, which is the economic agent of primary interest to us in this paper, as it receives budget support, it is this financial effect of the reform, which if negative, generates a budgetary cost and thereby creates the financing deficit that the budget support is supposed to offset. A reform may also have a positive budgetary effect and, therefore generate incomes for the government. But a reform with a positive budgetary effect should not require budget support for implementation. Graph 1 shows some temporal profiles concerning the financial incidence of a reform.

![Graph 1: Time Profiles of Financial effect of Reforms](image)

*Source:* Author’s estimates

Panel (a) illustrates a reform whose financial incidence is positive and for whose implementation the government does not require budgetary support. Panel (b) shows a standard reform for which budgetary support is particularly appropriate, since it allows for temporary financing of the reform over the period in which the financial incidence is negative, pending the positive effects on the government budget. Panel (c) describes a reform that would have a sustained negative financial impact. The financing of

\textsuperscript{10} For further details on this structure of objectives defining a reform, see also Ferdinand Bakoup (2009). *L’Afrique peut-elle gagner sa place dans la mondialisation? Pour une politique économique systémique*, Éditions l’Harmattan, Paris.
such a reform should not be envisaged, unless there are other considerations to justify it. Panel (d) describes a reform whose financial incidence is negative over a long period and growing. This type of reform should not in principle be envisaged since it could call to question the long-term sustainability of the public finances. This discussion shows that proper identification of the change in economic behavior, which is sought by a reform, and careful evaluation of the associated financial incidence, and thus of its cost, is a key criterion of budgetary support. We argue in this paper that this has been an important missing link in current donors’ practices in the use of budgetary aid to promote economic and structural reforms in developing countries.

**Role of tangible and intangible assets in reform implementation:** The change of the system of incentives in the economy may derive from either the realization of specific tangible assets (e.g. the construction of a road, where transport costs are reduced, may have positive effects in terms of productive investment benefitting from that road, and possibly the purchasing power of economic agents and, therefore, on demand, thereby contributing to economic growth and employment creation), or the introduction of specific intangible measures that also produce financial flows in the economy (e.g. granting or withdrawal of a subsidy, given that, even if the measure does not result in the creation of a tangible asset, it can nonetheless have significant implications for the balance sheets of various economic agents and change their behaviours in the area of demand and/or production). “Reforms requiring the tangible assets creation” thus refers to reforms that require tangible asset creation measures in order to have the desired effects. “Reforms requiring the intangible assets creation” requires implementation of intangible measures, but which have significant effects on the balance sheets of economic agents. 11 How can the costs and nature of the financing required for reforms be characterized?

**Reforms requiring tangible asset creation:** Where the implementation of reforms requires the creation of tangible assets, there are a number of aspects that characterize the financing required. Firstly, their economic composition: generally these are expenditures related to goods, services and works needed to create the assets. This composition does not change much over time. Indeed, the shares of these various expenditure categories are often fairly well-known in advance, thanks to preliminary studies that precede the realization of the tangible assets. This limited variability of the nature of the financing required for reforms requiring tangible asset creation decreases by the same token the importance to be attached to the flexibility given the recipient countries in determining the intra-sector and inter-sector allocation of budget support resources meant for the reforms. An exception to the limited variability arises in the case of large scale civil engineering works. In such cases, the scope of works and, therefore the financing required, may not be certain from the outset. This notwithstanding, the resulting variability would relate, not to the kind of funding required, but the scope, and would therefore not justify more flexibility in the intra-sector and inter-sector allocation of budget support resources intended for the reforms.

In addition to economic composition, it may also be noted that the financing required for reforms needing tangible assets creation has a temporal profile that is somewhat spread over time. This tangible asset creation takes time because of the incompressible timeframe for public financial management procedures, notably with regard to public procurement and natural timeframes inherent in the physical

---

11 Here we attempt to adapt the concepts of tangible and intangible assets frequently used in finance theory to the context of economic policy and reforms. Indeed, in the theory of finance, the tangible asset concept refers to a physical good that can be touched (for example fixed assets, production tools, etc.), while intangible asset refers to an asset or value that cannot be perceived by the sense of touch (for example clientele, reputation, confidence etc.).
creation of such assets. With such spreading out of the financing required, the predictability of the occurrence and the assurance of having the relevant resources in a timely manner become key criteria of the aid intended to support the implementation of reforms requiring tangible asset creation. The experience of many donors in the implementation of investment projects in developing countries shows that it is difficult to foresee the temporal profile of the funding required for this type of project, in view of the many factors relating to the capacity of countries in the area of public procurement and contract management, or the performance of contractors hired to construct such assets.

Reforms requiring intangible asset creation: In the other case where the implementation of reforms requires intangible assets creation (intangible measures but likely to foster significant financial flows in the economy and introduce changes in the current economic incentives), the financing required is characterized by the peculiar nature of its composition. Generally, it entails: i) transfers either between the various socioeconomic categories or between the government and such socioeconomic categories; ii) government staffing expenditures; iii) tax expenditures; iv) net depreciation of non-tax revenues; v) public sector net lending; and vi) debt service variations. There is also the low variability of the economic composition of the financing required. Besides, it would be noted that such costs do not require the use of public procurement procedures.

Credibility: Credibility is an extremely important notion in any reform. To be successful, a reform must be credible, i.e., the economic agents must be convinced that the authorities will effectively implement such a reform. Recent studies show that time consistency is a key determinant of this credibility.\(^{12}\)

Reversibility: This notion relates to the possibility of backtracking on a reform after its implementation. For this criterion, it may be easily noted that a reform requiring intangible asset creation has higher reversibility than a reform requiring tangible asset creation. The importance of the notion of reversibility will be highlighted later on in this paper.

Sustainability: a good reform must also be sustainable, namely its effects must be long-lasting even if the funding that induced the initial behavioral change is withdrawn. The sustainability of any reform relates to the existence of hysteresis effects. Hysteresis effects occur when the effects of a reform outlast the initial reform measure. To ensure the sustainability of reforms, the authorities must seek measures that can generate significant hysteresis effects.

Long term and short term reforms: A distinction is often made, but hardly explained, between long and short term reforms. Long term reform could mean a reform whose financial effect is such that several fiscal years would be needed to mobilize the necessary resources for its implementation or whose technical asset creation for implementation takes time. Thus, for a reform requiring tangible asset creation, the protracted lag could be related to the state of technology, whereas for a reform requiring intangible assets, the political feasibility of the funds transfer involved could be the issue.

To conclude the discussion on the anatomy of reforms, it may be said that the relative role assigned to tangible and intangible assets is highly significant for the characterization of a reform. This

distinguishes the two types of financing required for the reforms requiring the creation of tangible as opposed to intangible assets. For the implementation of reforms requiring tangible asset creation, the recipient countries need slow disbursing resources, which are made available to them gradually. For both types of reforms, flexible allocation of intra-sector and inter-sector allocation of resources does not appear to be a key criterion. The application of a national public procurement system also draws the line between financing required for the reforms needing tangible asset creation and that required for reforms needing intangible asset creation.

The comparative advantage of budget support for reforms requiring intangible asset creation: Once the two types of reforms (tangible asset creation versus intangible asset creation) and the two types of instruments (project aid and budget support) have been identified, the question that naturally comes up is which instrument must be used for which type of reform.

Posing this question also means determining the comparative advantage of each instrument. Although budget support can be used to finance both types of reform, it is clear that project aid has a comparative advantage in the financing of reforms requiring tangible asset creation, while budget support has a comparative advantage in the financing of reforms requiring intangible asset creation. Two considerations underlie these two comparative advantages. Firstly, project aid enables recipient countries to benefit from donors’ expertise in project management and procurement, two key success factors in the implementation of reforms requiring tangible asset creation. This opportunity does not exist in the case of budget support. Secondly, the relative limited reversibility of reforms requiring tangible asset creation mentioned above underscores the need to focus the increased donor participation and the added value it provides on the implementation of this type of reform.

The comparative advantage of budget support in the financing of reforms requiring intangible asset creation is moreover reflected in the current practice that links budget support to economic reforms. We now turn to a review of the experience regarding the role of budget support in the financing of reforms requiring intangible asset creation, an area where budget support has a comparative advantage as indicated.

Review of Recent Literature on Budget Support

A positive contribution to some determinants of aid effectiveness: Budget support is often credited with a positive contribution to some key determinants of aid effectiveness in general, such as harmonization, aid alignment, ownership, transparency, mutual accountability, and reduction of transaction costs. Thus, in an assessment, A. Lawson, D. Booth, M. Msuya, S. Wangwe, and T. Williamson (2006) show that budget support provided to Tanzania contributed to harmonizing and aligning the aid of 14 donors participating in the budget support group for poverty reduction with the national priorities defined in

---

13 The fact that complex and/or high-value contracts are precluded from the Programme-for-Results, the new financing instrument of the World Bank, which aims at a more ambitious use of budget as a means of channelling aid, can also be interpreted as an implicit recognition of the comparative advantage of project aid in the financing of reforms requiring tangible asset creation, and that of budget support in the implementation of reforms requiring intangible asset creation. The complex and/or high-value types of procurement will continue to be done in project aid. See The World Bank (2011). *Programme-for-Results Financing.*

14 The fact that budget support is also called economic reform support is a reflection of this.

the national poverty reduction strategy. In an assessment of the impacts of budget support in Mali, Tunisia and Zambia, Caputo, De Kemp and Lawson (2011) conclude that budget support contributed to the implementation of the Paris Declaration and the Accra Agenda for Action commitments for aid effectiveness, enhancement of dialogue with the countries and greater ownership of resources by the authorities of these countries16.

**Budget support without reforms:** In spite of these positive aspects, the issue of budget support effectiveness has re-surfaced in the debate on development aid. After a decade of the intensive use of this instrument, a kind of fatigue appears to be setting in, both in the recipient countries and the donor community. There is growing uncertainty among donors about the effectiveness of budget support as an instrument of development aid. Although those calling for a return to project aid are few in number, the indications are that the debate is taking the form of a review of practices and in-depth reflection on ways of making budget support more effective in terms of development results.

In this debate, the main issue relates to the role of budget support in the formulation and implementation of economic and structural reforms, an area where recipient countries express the greatest needs in the promotion of their economic and social development. In the final analysis, and as shown throughout this paper, it is indeed in the area of reforms that budget support was supposed to gain credibility. Indeed, so long as the economic and social development of poor countries was deemed to derive solely from the creation of sufficient high-quality tangible assets in these countries, and that aid effectiveness was judged merely on its capacity to contribute to achieving this objective, project aid was considered fully satisfactory. The limitations related to the use of project aid, mentioned above, could be resolved through a concerted effort to harmonize donor procedures and have them converge towards the national ones. This convergence effort is in fact ongoing in the donor community; involving the use of national systems, and is besides showing signs of hope.

Hence, it is in the area of reforms, one of the core objectives of budget support that assessment of the impact of budgetary support seems to indicate that results have been below expectations. For example, in a recent study on public financial management in Africa, an area particularly targeted by donor assistance to support the formulation and implementation of reforms, including through budget support, M. Andrews (2010) shows that the reforms have been slow, showing only *de jure* progress, namely relating to the relevant texts, as opposed to *de facto* progress, or actual progress on the ground and in practices. In other words, while it is important to improve legal texts, the reforms have not gone beyond that stage, and do not have actual impact where expected, that is in practice17. In a previous study, T. Prakash and E. Cabezon had already noted challenges in public financial management improvement18. In a more recent evaluation of the 2001-2010 period, A. Lawson (2012), noted progress in public financial management and the absence of a clear trend towards improvement in Ghana and Malawi respectively19. This evaluation also noted that the factors of successful public finance reform include

---


strong commitment, a concept that takes into account the context of the country and effective coordination by the government to monitor and direct the reform.

This observation clearly denotes the inadequate contribution of budget support to the implementation of reforms in developing countries, notably those of Africa. The debate on ways of increasing budget support effectiveness, particularly with regard to policy-based dialogue, is not limited to donor circles. In many countries, stakeholders are also engaged in national-level reflection on ways of enhancing budget support effectiveness. It therefore appears necessary to refocus budget support on the objective initially set when this instrument was created in the 1980s, namely to support economic reforms. In a sense, budget support must reclaim its future.

In this emerging debate on budget support effectiveness in the implementation of reforms, it would be noted that attention is given to either the means of promoting appropriate use of conditionality to support the adoption and implementation of the desired reforms by both donors and countries, or on the fungibility of resources and its impact on aid effectiveness, especially in view of the substitution effect fungibility is likely to produce.

**Conditionality at fault?** For donors, conditionality means imposing the adoption of economic policy measures on recipient countries in exchange for the aid they receive. Although this practice is age-old, it only witnessed rapid expansion starting from in the 1980s, notably with the advent of budget support. For the International Monetary Fund (IMF), one of the institutions that played a key role in this process, conditionality was justified by a dual need to: i) safeguard the institution’s resources in view of their revolving nature; and ii) enable recipient countries to take the necessary steps to remedy policies accounting for their economic difficulties. The manner in which conditionality was practiced by donors progressively raised considerable controversy. For some observers, the significant increase in the number of conditions and the intrusive nature of some of them weakened ownership by governments and no doubt prevented the implementation of the corresponding reforms thereby contributing to the relative ineffectiveness of budget support in the area of reforms. To remedy this, a number of studies put forward proposals for simplifying and improving donor practices relating to conditionality. The World Bank also formulated principles of good practices concerning conditionality, for the use of its staff. The IMF undertook the streamlining of conditionality. Other major development finance institutions, including the African Development Bank and the European Union, also improved their conditionality practices. Guillaumont (2011) proposes that conditionality based on progress towards achieving the Millennium Development Goals be substituted for conditionality based on the implementation of specific economic policy measures.

The theory of the preponderant role of conditionality in limiting the contribution of budget support to reforms does not stand up to rigorous examination. In one of the most comprehensive studies on conditionality undertaken in the donor community, the IMF Independent Evaluation Office concluded that the implementation rate of the conditions included in its programmes seemed to be acceptable, in

---


23 For a discussion of frequent defaults in conditionality related to instruments, see Guillaumont (2011); Art. Cit.
that about 53 %, 56 %, and 32 % of the conditions of low, average and high structural depth, respectively, were implemented\textsuperscript{24}, which could indicate a satisfactory level of ownership. In the area of tax policy and administration, these rates even attained 59 %, 69 %, and 50 %, respectively (see Table 1). These figures show that the development observed above, concerning aid without reforms cannot be explained by the low level of implementation of conditions by the countries. This conclusion is corroborated by another result from the same IMF study. According to the latter, only about 4 % of the conditions included in its programmes had substantial structural depth and were therefore likely to have a real economic impact if implemented. Therefore, it may be concluded that not only were there few conditions that could have translated into actual reforms (4% of conditions) but also, most of them were generally implemented by the countries. Final conclusion: the conditions cannot account for the inadequate progress in reforms.

Table 1: Implementation of Conditions

<table>
<thead>
<tr>
<th>Structural Depth of Conditions (in %)\textsuperscript{25}</th>
<th>Rate of Implementation of Conditions by Structural Depth Level (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>Limited</td>
</tr>
<tr>
<td>-----------------------------------</td>
<td>---------------------</td>
</tr>
<tr>
<td>Tax Policy/Tax Administration</td>
<td>34</td>
</tr>
<tr>
<td>Public Financial Management</td>
<td>36</td>
</tr>
<tr>
<td>Financial Sector</td>
<td>53</td>
</tr>
<tr>
<td>State Owned Enterprises Reforms</td>
<td>33</td>
</tr>
<tr>
<td>Privatization</td>
<td>64</td>
</tr>
<tr>
<td>Civil Service Reform</td>
<td>57</td>
</tr>
<tr>
<td>Social Policies</td>
<td>59</td>
</tr>
<tr>
<td>Other IMF Core Areas</td>
<td>35</td>
</tr>
<tr>
<td>Other WB Core Areas</td>
<td>47</td>
</tr>
<tr>
<td>All Sectors</td>
<td>43</td>
</tr>
</tbody>
</table>


If the reasons accounting for the slow progress noted in reforms backed by budget support are not to be found in conditionality, could the fungibility of resources be the culprit?

\textsuperscript{24} Structural depth measures the impact of the fulfilment of the condition on institutional and structural changes. See International Monetary Fund (2007). An IEO Evaluation of Structural Conditionality in IMF-Supported Programs; November 2007.

\textsuperscript{25} Low structural depth (conditions that, of themselves, cannot induce a significant change) limited (conditions that could induce an immediate and perhaps significant change, if they are not fulfilled, but which will not be followed by other measures needed to make lasting change); and high (conditions that can induce a lasting institutional change if fulfilled).

\textsuperscript{26} Average structural depth calculated on the basis of 0 for low; 1 for limited and 2 for high.

\textsuperscript{27} This figure is significant for another reason. It tallies with the observation made above concerning aid without reforms, to the extent that only 4% of all the conditions outlined in the programmes did not have the potential of translating into really beneficial reforms for the economy, even if they were met. This also means that in most cases, budget support resources were disbursed in exchange for measures void of any real impact. The number of this type of measure mentioned by the IMF includes adoption of an action plan, submission of a bill to parliament, signing of a decree or appointment of a manager.
Resource Fungibility at fault? Questions were already being raised (in the 1990s,) about the contribution of aid to resolving the economic problems of developing countries. Following the slow progress made by these countries despite the substantial financial resources transferred to them, a sizable volume of literature emerged at the time on the issue of aid fungibility namely, the possibility that by easing the budgetary constraints of recipient countries, aid would enable them to reallocate budgetary resources to activities that were not targeted by the aid funds provided. Indeed, when aid is used to finance activities or expenditure programmes with a high level of ownership, i.e. which the government would finance in any event, it frees resources that can then be used for other activities. Thus, aid may end up being used to finance activities other those initially targeted by the aid resources.

Empirical studies, especially based on data from African countries, point to the existence of fungibility, even if it varies in scale from country to country or sector to sector. These studies suggest that aid was fungible both at macroeconomic level (aid is often linked to less tax effort) and meso-economic level (aid leads to a re-allocation of resources between different sectors to cover public expenditure). They have also showed that the higher the number of active donors in a given country, the higher the risk of aid fungibility. S. Devarajan and V. Swaroop (1998) concluded that, in the presence of major fungibility risks, budget support is preferable. More recently, in their analysis of budget support and project aid, Cordella and Dell’Aricia (2007) arrived at a similar conclusion namely; budget support is comparatively superior when the share of aid in relation to the recipient’s own resources is low, given that fungibility related to project aid would be higher. They also show that budget support is desirable where donor preferences and those of the recipient country coincide, that is, where there is ownership by the beneficiary country of the aid. It is where aid targets reforms whose level of ownership by the country is low that fungibility can account for the lack of progress in the reforms, despite the increased use of budget support to shore up their implementation. One may therefore question reforms that the government has not taken ownership of.

If, as would appear to be the case, the conditionality and fungibility of resources cannot adequately explain the lack of progress in reforms, what should one think of the above observation concerning budget support without reforms that the support was supposed to catalyze? This paper advances the view that the fundamental reasons for the low effectiveness of budget support as a reform catalyst lie in donors’ and recipient countries’ practices in the area of appraisal, costing and budgeting of the reforms to be implemented through budget support. We, therefore, propose a new instrument called Enhanced Budget Support (EBS), based on an assessment of the budgetary cost of reforms.

**Anchoring Reforms to Budget Support: Enhanced Budget Support**

Depending on the nature of the financing required, one of two types of reforms may be pursued: reforms requiring tangible asset creation or those requiring intangible asset creation. We have established that, given its characteristics, budget support has a comparative advantage for the funding of reforms requiring intangible asset creation, whereas project aid, following the ongoing efforts to harmonize donor procedures, can be used to fund reforms requiring tangible asset creation. The financing of reforms requiring intangible asset creation constituted one of the basic objectives of

---


budget support during its period of rapid growth starting from the 1980s, to assist developing countries in pursuing their economic reform agendas.

To remedy the noted decline of the role of budget support as a catalyst for structural reforms in recipient countries and to refocus this instrument on its initial ambition and thereby strengthen the links between fund transfers into national treasury accounts and the implementation of wide-ranging and far-reaching reforms aimed at promoting growth and employment creation, this paper proposes a new instrument for donors, namely, Enhanced Budget Support (EBS). The latter advocates: i) that budget support should be devoted to implementing reforms requiring intangible asset creation as justified above; ii) clearer identification of the changes in economic behaviors and, therefore, the results, targeted by the reforms and; iii) assessing the budgetary cost of the reforms to be implemented as well as calibrating the financing for budget support, in light of the estimated budgetary cost, a practice that few donors currently follow\(^\text{30}\). In addition to fostering greater transparency, this approach would enable stakeholders to better guarantee accountability of the authorities responsible for managing economic policy. The challenges often encountered in estimating the budgetary cost of reforms, can also be overcome.

*Can the cost of economic reforms be estimated?* It should be noted from the outset that the development community has not yet reached consensus on the assessment of budgetary cost of reforms and the grading of budget support financing in relation to the estimated budgetary cost. Indeed, most donors have nearly always held that, unlike project aid, it is not possible to provide an accurate estimate of the cost of economic reforms. In fact, it is on that basis that, in their current practices, most donors do not undertake precise estimates of the cost of reforms to be funded through budget support (as is done in the case of project aid), even though the declared objective of such aid is actually to financially support the implementation of reforms.

Admittedly, the assessment of the budgetary cost of reforms to be financed with public funds can raise greater challenges in the case of economic reforms requiring intangible asset creation than in that of reforms requiring tangible asset creation to be supported with project aid\(^\text{31}\), however such an assessment is desirable and should be carried out. Strengthening the links between budget support and the implementation of reforms could therefore require another change in donor and recipient countries’ practices, notably a greater focus on assessing the budgetary cost of reforms and establish a clearer relationship between financing granted and the real estimated budgetary cost, i.e. between the financing required and the proposed reforms. While, in contrast, the economic impact of such a reform, i.e., its real effect on the economy and society as a whole, may be difficult to assess, the financial cost for the government budget which, in the final analysis, will be taken into account in assessing the amount of the budget support, can be estimated.

\(^{30}\) In the new policy of the European Union for example, the amount of budget support is dependent upon: i) the funding required by the partner country, estimated on the basis of its medium term budgetary framework and/or national/sector development strategies; ii) the partner country’s commitment to allocate national budgetary resources, in accordance with the development strategy and objectives; iii) effectiveness, cost/benefit ratio and impact of the specific value added on achieving the partner country’s strategic objectives; iv) assessment of previous disbursements and their absorptive capacity; and v) the extent to which the objectives agreed were achieved thanks to budget support operations and the results-based approach in the partner country’s development strategy, including a monitoring system. See European Commission (2011); Art. cit.

\(^{31}\) In investment projects, goods, services and works to be financed are clearly identified, which makes it easy to assess the budgetary costs of such projects. Furthermore, in current donor practice, investment costs are fairly accurately estimated, including the economic rate of return of such projects. The amounts of financing provided correspond to the costs thus estimated.
If the assessment of the budgetary cost of reforms is so important to the rehabilitation of budget support as an instrument for promoting economic reforms, how should such an assessment be conducted? Here, three key components of budgetary reform cost may be identified: i) reform preparation cost; ii) reform implementation cost; and iii) budgetary cost of reform implementation.

Reform preparation costs: These involve budgetary costs incurred in the reform design. Reform is a complex domain and its design often requires high-level technical expertise unavailable to the administrations of many developing countries. The costs of reform preparation may therefore include the cost of recruiting consultants needed to work with the authorities in designing the far-reaching economic reforms. This expenditure category may also include the cost of logistics related to the operation of the team tasked with preparing the reforms. Generally speaking, reform preparation costs are not unduly high. Such costs may be funded as part of institutional support, under project aid which donors have now mastered.

Reform implementation costs: This category covers costs related to the reform implementation process. It may generally be expected that once designed and approved by the relevant authorities, the reform implementation would generate costs, notably relating to staffing or material resources, as well as supplementary equipment for the implementation units. Such costs must be estimated and budgeted. Sometimes they may be negligible, especially where productivity gains resulting from better work organization in the reform implementation units lead to significant cost reduction. In the final analysis, it is the failure to consider these cost aspects that have made well-intended reforms in many African countries remain on paper. The costs can also be funded under institutional support as part of project aid whose implementation is now fully mastered by donors.

Budgetary costs of reform implementation: This is by far the most significant component of the estimated budgetary costs of reforms, both in terms of the resources required and the expected positive impact of the financing of the costs on the economy. Although the application of the reform generates a cost, and therefore creates a budget support need for the government budget, the whole idea behind the budget support concept is that the beneficiaries of these resources would be encouraged to change their economic behaviors in a manner that would foster the achievement of the economic objectives of the budget support and, therefore, the countries’ growth and employment creation objectives.

While economic reforms requiring intangible asset creation can be defined as intangible economic policy measures put in place by the authorities to change the economic system of incentives for economic agents, for such reforms to have a real impact on the economy, they must result in a change in the structure of economic agents’ balance sheets. To ensure that such changes occur, the authorities must use either public expenditures or public revenues or both. For a given reform, this would entail on the expenditure side, current expenditure, namely transfers and staff expenditures; on the revenue side, tax revenues, non-tax revenues as well as net lending.

Abstracting from preparation and implementation costs, and representing the budgetary costs of implementation of a reform requiring intangible asset creation by CB, and a change by \( \Delta \),

---

This assumption is used because the preparation and implementation costs are only reform support costs. It is the budgetary cost of reform implementation that has interest, from the viewpoint reforms requiring intangible asset creation, since it is this cost and its financing that will generate changes in the incentives system and, therefore economic behaviours, which is the aim of the reforms. This assumption does not mean that the preparation and implementation costs can be ignored. Such costs are even very important, especially in the context of African countries where
We have the following:
\[ CB = \Delta TR + \Delta PSW + \Delta TR + \Delta NTR + \Delta PSNL + \Delta DS \]  
(5.1)

Where:

- TR = Transfers;
- PSW = Public Sector Wages;
- TR = Tax Revenue;
- NTR = Non Tax Revenue;
- PSNL = Public Sector Net Lending;
- DS = Debt Service.

Hence, the budgetary cost of the implementation of the reforms requiring intangible asset creation materializes through this change in recurrent public expenditures and/or public revenues. The respective shares of these different elements would be uneven, depending on the reform targeted. For some reforms, the increase in transfers will determine the costs to be funded, whereas for others, it is through a variation in tax revenue or even net lending that the costs will appear. The inclusion of the debt service in the calculation needs to be explained. Prior to the debt crisis affecting many countries, the reform programmes were based on the assumption that debt service is a given, that the country must service its debt. But recent experience marked by debt restructuring efforts in both developing and advanced countries show that debt service can also be a variable of reform.

The issue of the estimation of the budgetary costs of economic reforms may raise both methodological and practical challenges. It is perhaps as a result of such challenges that donor practices have hitherto been based on the assumption that the cost of economic reforms cannot be assessed. Two approaches for assessing budgetary cost of implementation of reforms may be envisaged.

**General equilibrium assessment of budgetary cost of reforms:** this approach uses an economic model based on a general equilibrium specification of the economy with a measure of the reforms envisaged as an exogenous variable of economic policy. A change in this variable makes it possible to simulate the impact of the measure on the government budget. Although such an approach may be attractive as it has the advantage of taking into account all the inter-relationships providing a comprehensive description of the working of the economy, it also comes with daunting challenges related to the fact that such directly usable and calculable general equilibrium models do not exist in most African economies. Their construction requires modeling skills which very few countries currently have.

**Partial equilibrium assessment of budgetary cost of reforms:** as the name implies, this approach aims at separately assessing the various components of the reform cost, without regard to the interactions the reforms may produce with other economic variables and which can change the initial effects of the reforms on their cost elements. This approach is easier to implement. The tax departments of most countries can estimate the effect on tax revenues of the granting or withdrawal of a tax incentive, for example, using a simple calculation involving an estimated base and the rate of the affected tax.

---

experience shows that it is at the preparatory and implementation stages that reforms often stumble. But, as already indicated, the preparation and implementation costs are better financed by project aid.
Do clearer identification of the change in economic behaviors targeted by the reforms and the assessment of the associated budgetary cost contribute to the quality of the budget support? Or does it contribute to strengthening the links between budget support and the reforms? A clearer identification of the changes in economic behaviors targeted by the reforms together with an assessment of the associated budgetary costs contributes to: i) greater transparency in the use of public funds, because it gives the public more information on the various elements to be financed; ii) greater accountability on the part of authorities in charge of the design and implementation of economic reforms, because as soon as the costs of the said reforms are clearly estimated, discussed with stakeholders and subsequently included in the budget support, the stakeholders who will bear or benefit from such costs will identify themselves and become interlocutors and ensure accountability, thereby contributing to the effective implementation of the proposed reforms.

The enhanced budget support proposed here would also help better identify the results in donors’ budget support operations, an objective which is difficult to achieve in current form of budget support. Indeed, given that the resources will fund precise economic behavioral changes, it will be easy to measure such changes and associate them with the budget support provided. For example, for employment promotion, notably concerning the youth, some governments provide funding to enterprises that recruit young people. If the budgetary cost of such a reform is funded through external budget support, it will be easy to measure the number of jobs created (an expected outcome of the reform) and link it to the financing provided.

It is, therefore, important that detailed estimated costs of reforms are made for budget support and that the funding provided corresponds to such costs. Current donor practices which do not include such costs in the analysis of budget support weaken the links between this instrument and the effective implementation of the reforms. In this regard, it is not surprising that, despite the sizable volume of budget support and its growing share of development aid, progress in economic reforms, which constitutes one of the fundamental objectives of budget support, an area in which the instrument appears to have a comparative advantage over project aid, has fallen below the expectations of both donors and the aid recipient countries.

**EBS factors of success:** A number of factors can create an enabling environment for the successful use of EBS. They include the following three: i) a risk-minimizing national fiduciary framework; ii) a stability-oriented macroeconomic framework; and iii) existence of sufficient analytical capacity.

Indeed, since EBS is a budget support, it uses the national fiduciary system to channel resources towards the economic agents targeted by the reforms. It is therefore essential that the national fiduciary system guarantees this transfer with the least risks. Furthermore, it is essential that efforts made to improve the economic results targeted by EBS through the well identified reforms it supports, are reflected in the rest of the general economic policy to ensure total success. A stability-oriented macroeconomic framework is therefore necessary.

Lastly, EBS requires more sustained efforts in the conceptualization and appraisal of the reforms to be implemented, compared with the current general budget support. To this end, more in-depth analyses is

---

33 In my professional career I have often been struck by the despair nongovernmental actors, for example, show in carrying out their mandate of controlling the use of public funds when this involves resources provided by donors in the form of budget support. They explain this difficulty by the lack information on the impact of reforms, as in this paper, on the beneficiaries or those who bear the financial impact, and therefore on the cost of reforms.
required by both donors and recipient countries, to identify appropriate reforms and assess the various components of their budgetary costs, as well as assess the expected impact of the implementation of the reforms on the behaviors of economic agents, notably with regard to demand addressed to the national economy and production as well as economic growth and employment creation. These analyses may require time and human and institutional capacity that many developing countries, especially those of Africa, do not yet have. EBS is therefore analytically more ambitious than the current budget support. Although the term “enhanced” translates this ambition, it is also conceivable that countries that accede to EBS will also have greater access to budget support resources. This will serve as an incentive for the formulation of more ambitious reform agendas.

In view of the foregoing, it would be expected that few countries meet the success conditions mentioned above and gain rapid access to EBS. Figure 1 below illustrates the various assumptions relating to EBS eligibility.
As Figure 1 above shows, current budget support will be accessible to countries with highly degraded budgetary situation or those facing an acute economic crisis which they had not anticipated, or to fragile States.
The countries with highly degraded fiscal situations may be considered as countries whose budgetary revenues do not even cover politically incompressible budgetary expenditures, for example wages and interest on the debt. These countries generally have a significant primary deficit and their wages absorb a high proportion of budgetary revenues\(^{34}\). They therefore have very limited latitude in the use of budgetary resources to finance the economic reforms in a discretionary manner. In such conditions, it is likely that the little resources that external support may provide will be used primarily to fund incompressible expenditures. For such countries, the current budget support can continue to be provided. Although its reform content may be limited (as indicated above), current budget support can contribute to maintaining pure macroeconomic stability, since in the absence of such support, the government would probably have resorted to monetary creation, namely a “money printing press” to fund the surplus public expenditures on available budgetary revenues.

Countries affected by a serious economic crisis they had not anticipated and fragile countries also present two other situations where EBS cannot be immediately available and where general budget support may be provided instead. For such countries, the urgent need to have the necessary resources to meet financial commitments may result in priority being given to normal macroeconomic stability and, consequently, budget support being provided in a general form. In the case of fragile countries, the urgency is compounded by obvious lack of human and institutional capacity required to formulate reform programmes appraised in accordance with EBS standards.

**Relationship of EBS to balance of payments assistance:** The literature has often treated with some ambivalence the concepts of budget support, balance of payments assistance and the possible relationships between the two concepts. Indeed, with the government assuming responsibility for the national economic situation as a last resort, the fiscal policy may be considered to be an economic policy instrument or adjustment variable of last resort. In this context, responsibility for balance of payments adjustment also lies with the budgetary instrument. Indeed, any economic imbalance, including balance of payments, may be interpreted as resulting from a misalignment in budgetary policy relative to a position that would restore the balance sought, including that of balance of payments as necessary. Thus, the distinction often made between budget support and balance of payment support is more nominal than real.

Let’s show that any disequilibrium in the balance of payments can be associated to a budgetary imbalance:

If:

\[
    \begin{align*}
    Y &= \text{Gross Domestic Product;} \\
    C &= \text{Consumption;} \\
    I &= \text{Investment;} \\
    X &= \text{Exports;} \\
    M &= \text{Imports;} \\
    Yp &= \text{Private Sector Revenue;} \\
\end{align*}
\]

\(^{34}\) Available data shows that, for example, over the 2001-2009 period, the number of countries of the Economic Community of West African States (ECOWAS) that complied with the convergence criteria on the wage bill to tax revenue ratio (should be less than 35 %), ranged between five and nine out of 15 member countries on the whole. See West Africa Monetary Agency (2009). ECOWAS Monetary Cooperation Programme, Macroeconomic Convergence Report First Half 2009; available on: http://amao-wama.org/fr/Publications.
\[ Yg = \text{Public Sector Revenue}; \]
\[ Cp = \text{Private Consumption}; \]
\[ Cg = \text{Public Consumption}; \]
\[ Ip = \text{Private Investment}; \]
\[ Ig = \text{Public Investment}; \]
\[ Sp = \text{Private Sector Balance}; \]
\[ Sg = \text{Public Sector Balance}. \]

Then:

\[ Y = C + I + X - M \] \hspace{1cm} (1)

After disaggregation of (1), we obtain:

\[ Yp + Yg = Cp + Cg + Ip + Ig + X - M \] \hspace{1cm} (2)

After rearranging the variables, we obtain:

\[ (Yp - Cp - Ip) + (Yg - Cg - Ig) = X - M \] \hspace{1cm} (3)

Assuming that “\( Y \)” also includes net transfers and net factors incomes with the rest of the world:

\[ (Yp - Cp - Ip) + (Yg - Cg - Ig) = CA \] \hspace{1cm} (4)

Or:

\[ Sp + Sg = CA \] \hspace{1cm} (5)

It can be deduced from (5), that a balance of payments deficit may stem from one of the following three sources: a private sector deficit and a public sector deficit, or a private sector deficit and a public sector surplus (but which is not sufficient to absorb the private sector deficit); or, lastly, a public sector deficit and a private sector surplus, (insufficient to absorb the public sector deficit). Below, we shall examine each of these balance of payments deficit assumptions to show that in the final analysis, each can be interpreted as deriving from an unsatisfactory public sector balance requiring a budgetary adjustment and, as necessary, budget support.

**Assumption 1: Private sector deficit and public sector deficit (\( Sp < 0; Sg < 0 \)):** In this scenario, the balance of payments deficit is accounted for by the combined private sector and public sector deficit. To reduce or offset this deficit, the focus should be on both the public and private sectors. Although the distribution of the adjustment effort of the two sectors closely depends on the share of each sector in the balance of payments deficit which is to be offset, it is clear that the public sector will have a role to play in this adjustment, even if its share of the overall deficit is negligible. This is simply because it is the public sector that must stimulate the private sector adjustment. The budgetary instrument must therefore be sought.
Assumption 2: Private sector deficit, public sector surplus (Sp< 0; Sg> 0): In this scenario, it is clear that the sources of the balance of payments deficit can be found in the private sector behavior. It is the scenario where the balance of payments assistance would be the most appropriate - given that the public sector is showing a surplus, there would apparently be no budgetary problem to justify a budget support. But this is only apparent since, even in this case, an improvement in the private sector balance needed to restore the balance of payments requires economic policy measures from the public sector. Since the government is responsible for national economic policy, the cost of such measures must be necessarily borne by the budget. Even in this case, an adjustment of the balance of payments is also a budgetary adjustment. However, unlike the previous scenario, the need for budgetary support depends on the scale of the private sector deficit, in view of the fact that the public sector can use a portion of its surplus to finance the measures required in order to reduce the private sector deficit and, consequently, that of the balance of payments. It is the government that is ultimately responsible for the health of the national economy that lays the basis for the introduction of the budgetary instrument.

Assumption 3: Public sector deficit, private sector surplus (Sg< 0; Sp> 0): In this final scenario, the balance of payments deficit appears to be wholly attributable to the public sector, since the private sector shows a surplus here. The alignment of budget support and balance of payments assistance appears to be all the more perfect as: i) the budgetary origin of the balance of payments disequilibrium can easily be established; ii) the cost of the economic policy measures needed to offset the public deficit and, consequently, the balance of payments deficit is to be borne by the public sector; and iii) the public sector, which is already showing a deficit, needs budget support to finance these measures, while at the same time safeguarding growth. It is, therefore, clear from these three scenarios that the distinction often made in the literature between balance of payments assistance and budget support is only apparent.

Of the three assumptions, the second one seems to be the most favourable. Despite a balance of payments deficit, and therefore a significant problem of economic competitiveness, countries in this scenario have an advantage in that the public sector, with its surplus, has the means of financing the reforms needed to remedy the balance of payments deficit. In principle therefore, such countries can make adjustments without external aid, and therefore without subjecting themselves to supervision by the international community, a situation many countries appear to apprehend. To complete the discussion of the three scenarios above, we can add scenario 1 and Scenario 3 describe situations known in the economic literature as twin deficits, while scenario 2 characterizes a situation in which the Ricardian equivalence hypothesis applies.

Table 2 below summarizes the situation of African countries relative to the balance of payments and budgetary balance. Overall, Africa seems to post a surplus balance of payments, except from 2010 onwards (probably due to the effects of the economic and financial crisis). However, this general situation masks some divergences in the five regions of the continent. While West and North Africa appear to be recording surpluses in their respective balance of payments, East Africa is showing a virtually chronic balance of payments deficit, worsened by the global economic and financial crisis.

35 As an illustration of this reasoning, it would be noted that a major budgetary adjustment was at the heart of most of the programmes some Asian countries had negotiated with the IMF to check the serious financial crisis facing them in the 1990s. At the time, some observers criticized the IMF for imposing harsh austerity measures on the public sectors of these countries, even though many of them were enjoying a budgetary surplus. The view of the IMF was that budgetary adjustment was necessary to restore confidence, contribute to improving the balance of payments and stabilize exchange rates, which is a feasible analysis. In 1996, the year preceding the crisis, Thailand showed a budgetary surplus of 1.9 % of GDP and a balance of payments deficit of -6 % of GDP. In South Korea, the corresponding figures were a balanced central government budget and a -4.4% balance of payments deficit. Indonesia had a -1.2% budget deficit and a -3.4% balance of payments deficit. Source of data: IMF (2000). Recovery from the Asian Crisis and the Role of the IMF—An IMF Issues Brief, available on: http://www.imf.org/external.
Furthermore, this part of the continent appears to be in an unfavourable scenario where the balance of payments is accompanied by a budget deficit.

### Table 2: Current Account and Budgetary Balance in Africa (% of GDP)

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Current Account</td>
<td>8.3</td>
<td>6.6</td>
<td>6.8</td>
<td>0.2</td>
<td>-0.6</td>
<td>-0.6</td>
</tr>
<tr>
<td>• Budgetary Balance</td>
<td>4.8</td>
<td>2.2</td>
<td>2.8</td>
<td>-5</td>
<td>-3.5</td>
<td>-3.6</td>
</tr>
<tr>
<td>Southern Africa</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Current Account</td>
<td>-0.8</td>
<td>-2.6</td>
<td>-2.4</td>
<td>-6</td>
<td>-1.8</td>
<td>-1</td>
</tr>
<tr>
<td>• Budgetary Balance</td>
<td>2.8</td>
<td>2.5</td>
<td>1.1</td>
<td>-5.5</td>
<td>-2.6</td>
<td>-2.5</td>
</tr>
<tr>
<td>Central Africa</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Current Account</td>
<td>4.6</td>
<td>2</td>
<td>2.8</td>
<td>-6.3</td>
<td>-5.6</td>
<td>-2.7</td>
</tr>
<tr>
<td>• Budgetary Balance</td>
<td>17</td>
<td>7</td>
<td>8.7</td>
<td>-1.3</td>
<td>1.7</td>
<td>2.8</td>
</tr>
<tr>
<td>East Africa</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Current Account</td>
<td>-9.2</td>
<td>-8.1</td>
<td>-8.6</td>
<td>-9.2</td>
<td>-6.9</td>
<td>-7.7</td>
</tr>
<tr>
<td>• Budgetary Balance</td>
<td>-4</td>
<td>-3.6</td>
<td>-2.2</td>
<td>-3.6</td>
<td>-4.4</td>
<td>-5</td>
</tr>
<tr>
<td>North Africa</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Current Account</td>
<td>13.8</td>
<td>12.2</td>
<td>10.3</td>
<td>-0.6</td>
<td>1.7</td>
<td>-0.8</td>
</tr>
<tr>
<td>• Budgetary Balance</td>
<td>6</td>
<td>3.8</td>
<td>4.7</td>
<td>-4.3</td>
<td>-3</td>
<td>-6.5</td>
</tr>
<tr>
<td>West Africa</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Current Account</td>
<td>23.6</td>
<td>20.6</td>
<td>21.9</td>
<td>18.7</td>
<td>1.8</td>
<td>4.5</td>
</tr>
<tr>
<td>• Budgetary Balance</td>
<td>6.8</td>
<td>0.2</td>
<td>2.8</td>
<td>-7.4</td>
<td>-6.7</td>
<td>-1.7</td>
</tr>
</tbody>
</table>

Source: African Development Bank, May 2012.

**How can the concept of balance of payments be rendered?** If, as already indicated, the distinction often made in the literature between budget support and balance of payments assistance is more nominal than real, then what can one make of the widespread use of the concept of balance of payments assistance? Upon examination, the concept appears to have survived from the Bretton Woods era. During that period, which lasted from the end of the Second World War to 1971 and was characterized by fixed, but adjustable parities, the balance of payments equilibrium was a key objective of every country’s economic policy. It is for this reason that at its establishment in 1944, one of the aims of the IMF was to provide aid to member countries to help them implement economic reforms designed to correct any fundamental disequilibrium in their balance of payments. Thus, when developing countries faced economic challenges in the 1980s that needed to be overcome through economic policy reform and implementation of reforms requiring intangible asset creation, and it was the IMF that played the role of lead donor, the assistance provided them was naturally called balance of payments assistance, although a significant portion of the assistance aimed at financing budgetary expenditures. It was not until the end of the 1990s, notably thanks to the action of the United Kingdom’s Department for International Development (DFID), responsible for managing the country’s development aid, that donor practices began to change and became more transparent and openly recognize the direct financing of national budgets. Other terms such as “quick disbursing aid” or “economic reform support” were also increasingly used to describe aid intended to facilitate the implementation of reforms requiring intangible asset creation.

---

36 On 15 August 1971, US President, Richard Nixon ended the US dollar gold convertibility, thereby withdrawing from international monetary system one the fundamental pillars formulated at the international monetary and financial conference at Bretton-Woods in 1944. Under the Jamaica Agreements, the IMF Interim Committee made the observation in January 1976, and instituted the period of floating exchange rates that has lasted to this day.
For some time, there were some inconsistencies on the part of donors who were aware that their financing was used to fund the recipient countries’ budgetary expenditures, but still refused to officially admit it. They rather preferred to talk of balance of payments assistance. This attitude appeared to stem from the fact the donors did not have enough confidence in the public financial management system of the recipient countries. They found the fiduciary risks to be exceedingly high, namely risks that the funds would be used for purposes other than the intended ones. To address this challenge, or to avoid using the public management systems which they deemed risky, while continuing to grant support to recipient countries to finance the public expenditures, the donors called their support “balance of payments assistance”. Thus, they claimed to finance balance of payment deficits by supporting the measures required to adjust the latter. Hence, progress was made towards achieving greater transparency in donor practices.

For the donors, balance of payments financing had an advantage over budget support, because balance of payment transactions could be monitored more easily; all that was needed was to consult import statistics. Hence, under balance of payments assistance, donors simply relied on imports statistics to justify the use of resources provided to recipient countries. For more certainty, donors demanded that imports on the negative lists should be deducted from these statistics. The negative lists often included goods and services that donors refused to finance, such as arms, luxury items, environmentally hazardous products and radio-active goods.

The shift from balance of payment assistance to budget support was driven more by the donors’ desire for transparency than an actual change of instrument. Indeed, balance of payments support still remained budget support; to the extent that the funds provided by the aid agencies as part of balance of payments support were always transferred to central government accounts to be used as budget resources. Following this lengthy (but useful) digression on the links between budget aid and balance of payments, we shall return to our main subject, namely EBS.

A comparison between EBS and project aid and current budget support: EBS appears to be a hybrid between project aid and the current budget support. EBS resembles and at the same time differs from project aid. It borrows from project aid the rigour of project cost identification and analysis; except that in the case of EBS, the project entails intangible asset creation whose costs essentially cover the various elements described above (see equation 5.1). It also borrows from the current budget aid, notably in the disbursement of funds directly into the national treasury account. However, given the expected high level of accuracy in identifying the nature of reforms to be supported by EBS, this instrument appears closer to sector or thematic budget aid than general budget support. The difference is in the clear allocation of resources to financing the estimated budgetary cost of intangible assets to be created through the reforms to be implemented.

37 Pure balance of payments assistance would mean that the funds provided by aid agencies were kept by the Central Bank to strengthen the country’s external reserves instead of being transferred to the central government to fund its budgetary operations. Even funds provided by the IMF which were supposed to represent balance of payments par excellence, were not spared this treatment. Only the accounting in the Central Government Table of Financial Operations (TOFE) was different, since the IMF funds were considered to be internal financing of the banking system, while other donor funds were treated as external budgetary financing. But since the international financial and economic crisis that began in 2007, the IMF officially admitted that the resources it provided countries as part of economic programmes it supported could be used to directly finance budgetary expenditures in order to revive economic activity. Even if it was more a case of adjusting the law to practice, it is noteworthy progress. However, the IMF had also requested its member countries to refrain from spending resources granted them under the special drawing rights arrangement that was set up to combat the crisis, but to hold on to them as a means of strengthening their exchange reserves. Here, one might question the effectiveness of the revival sought, if these resources could not be spent.

38 This point also differs EBS from the World Bank’s recent Programme-for-Results, in that the latter also seeks to use budget support to finance tangible assets, an area where, as we have seen, budgetary support and, notably EBS, has no comparative advantage.
Some progress concerning EBS is now being noted, there is need to extend and deepen it

Much as EBS appears to entail major changes on the part of donors and recipient countries regarding the design and implementation of budget support, it will be noted that certain approaches it proposes are already starting to be requested. At least that is the conclusion that can be drawn from careful reading of the current debate on budget support. A recent African Development Bank report\textsuperscript{39} recommends increased use of sectoral budget aid, which, as we have seen earlier, is closer to EBS than general budget support. In addition, certain budgetary aid granted recently seems to fall in line with the EBS approach recommended in this article. For example, in the budget support that the IMF, the European Union and the European Central Bank packaged for Greece, it was clear that the funds would be used in reimbursing the Greek public debt (DS in equation 5.1 Page 17). Moreover, the aid that Spain obtained, in the amount of approximately 100 billion Euros, was clearly intended for recapitalization of its banks (PSNL in equation 5.1 Page 17).

At the beginning of this article, we defined a reform as government action targeting economic policy instruments designed to effect changes in the behaviors of public and/or private economic agents, so as to boost their sustainable and non-inflationary demand on the national economy or increase their productive investments with the aim of achieving national economic growth and employment creation targets. In light of this definition the question arises as to which reforms were supported by the aid to Greece and Spain. In the case of Greece, it can be imagined that it was a question of avoiding an external debt payment default, which would have considerably reduced the country’s access to external financing. Under such a scenario, the country would have found itself in an even more untenable budgetary situation, with increased risk for domestic demand and investment. By financing debt repayment, the budget support provided to Greece would enable it to finance the maintenance of creditors’ loans to the country. In the case of Spain, by financing the recapitalization, the aid would make it possible to finance the maintenance of bank lending to economic agents. The financial incidence required for bank recapitalization had already been independently assessed. These recent examples of budget support granted in the context of the Euro zone crisis thus convey aspect of EBS. The challenge now is that of deepening this approach and extending it to the budgetary aid granted to developing countries.

Directions for Future Research on Budget Support

It is now clear that, in addition to the quality of the recipient country’s fiduciary system (which is only a mechanism for channeling resources intended to support reforms), and macroeconomic stability, the success of budget support closely depends on the identification of precise reform actions, an assessment of their cost, especially the budget impact of their implementation and, lastly, the adequacy of the budget support to cover the estimated budgetary cost of these actions. For budgetary support to effectively achieve its objectives, relevant research should first address the following issues: i) identification of reform actions requiring intangible asset creation; ii) costing of reform preparation and implementation; iii) relationship between the financial effect of reform measures and economic agents’ behaviours in respect of demand and production; iv) restructuring of recipient countries’ budgets to

create financial space for implementing the reforms; v) improving the fiduciary systems of recipient countries; and vi) assessment of the budgetary impact of reforms.

**Conclusion**

When budget support was first introduced in the 1980s, it was primarily aimed at supporting economic reforms designed to improve economic performance (stronger growth, less external vulnerability and greater macroeconomic stability) in developing countries, most of which faced an unprecedented crisis. However, gradually, the expectations concerning this instrument multiplied (reduction of transaction costs, aid ownership, safeguarding and even increased pro-poor public expenditures deemed to be priorities, and public financial management improvement) to the extent that it gradually eclipsed the fundamental objective of the instrument, which is to promote reforms with a positive impact on the productive sectors. This paper aimed at repositioning the support for reforms to the centre of budget support, especially in African countries.

This paper affirms that reforms have a cost, which can be accurately estimated. It stresses that i) budgetary aid should be devoted to support the implementation of reforms requiring the creation of intangible assets, an area in which it has a comparative advantage ii) clearer identification of the changes in economic behaviors targeted by reforms together with an accurate estimate of the associated cost, and alignment of resources made available in the form of budget support with the estimated cost of reforms, is a pre-requisite that must be met if donors are to strengthen the linkages between the definition and implementation of reforms and budget support in recipient countries.

In order to improve, in other words reform, it must be possible to measure. And to measure, there is need to accurately define. This paper systematically upholds this generally acknowledged dual requirement in its bid to contribute to the ongoing efforts in the development community aimed at strengthening the role of budget support in the implementation of reforms by improving donor practices as well as those of recipient countries in the use of this instrument.
Bibliography


The Economist (2012) “The euro area needs structural reforms but they can cause damage when economies are weak”; Free exchange, September 22nd 2012, Page 74.


The World Bank (2011) “Program-for-Results Financing”


Recent Publications in the Series

<table>
<thead>
<tr>
<th>n°</th>
<th>Year</th>
<th>Author(s)</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>166</td>
<td>2012</td>
<td>Sosthene Gnansounou and Audrey Verdier-Chouchane</td>
<td>Misalignment of the real effective exchange rate: When will the CFA need to be devalued again?</td>
</tr>
<tr>
<td>165</td>
<td>2012</td>
<td>Ahmed Moummi</td>
<td>Mobilization of fiscal resources in Niger and its impact on households’ living standards</td>
</tr>
<tr>
<td>163</td>
<td>2012</td>
<td>Christopher Adam, David Kwimbere, Wilfred Mbowe and Stephen O’Connell</td>
<td>Food Prices and Inflation in Tanzania</td>
</tr>
<tr>
<td>162</td>
<td>2012</td>
<td>Evans Osabuohien, Uchenna R. Efobi and Adeleke Salami</td>
<td>Planning to Fail or Failing to Plan: Institutional Response to Nigeria’s Development Question</td>
</tr>
<tr>
<td>161</td>
<td>2012</td>
<td>Mthuli Ncube, Eliphas Ndou and Nombulelo Gumata</td>
<td>The Impact of Euro Area Monetary and Bond Yield Shocks on the South African Economy: Structural Vector Autoregression Model Evidence</td>
</tr>
<tr>
<td>160</td>
<td>2012</td>
<td>Wolassa L. Kumo</td>
<td>Infrastructure Investment and Economic Growth in South Africa: A Granger Causality Analysis</td>
</tr>
<tr>
<td>159</td>
<td>2012</td>
<td>Ousman Gajigo and Mary Hallward-Driemeier</td>
<td>Why do some Firms abandon Formality for Informality? Evidence from African Countries</td>
</tr>
<tr>
<td>158</td>
<td>2012</td>
<td>Stijn Broecke</td>
<td>Tackling Graduate Unemployment through Employment Subsidies: An Assessment of the SIVP Programme in Tunisia</td>
</tr>
<tr>
<td>157</td>
<td>2012</td>
<td>Mthuli Ncube, Eliphas Ndou and Nombulelo Gumata</td>
<td>How are the US financial shocks transmitted into South Africa? Structural VAR evidence</td>
</tr>
</tbody>
</table>