

# **ADDRESSING ENVIRONMENTAL OBJECTIVES IN THE CONTEXT OF BUDGET SUPPORT**

Overseas Development Institute  
111 Westminster Bridge Road  
London SE1 7JD

November 2006

# Table of contents

<b>Acronyms</b>	<b>3</b>
<b>Executive summary</b>	<b>4</b>
<b>1. Introduction</b>	<b>6</b>
<b>2. Environmental governance and the context of development aid</b>	<b>8</b>
2.1 Environmental governance challenges	8
2.2 Development aid context: aid effectiveness and budget support	10
<b>3. Aid to the environment and financing instruments</b>	<b>14</b>
3.1 Aid to the environment	14
3.2 Overview of aid instruments in use	15
<b>4. Working with budget support and beyond</b>	<b>22</b>
4.1 Areas requiring attention in the environment sector	22
4.2 Selecting aid instruments: core principles, opportunities and risks	22
4.3 Opportunities and limitations of budget support for environmental actions	27
4.4 Other mechanisms for supporting the environment	29
<b>5. Further enquiry</b>	<b>31</b>
<b>References</b>	<b>32</b>
<b>Annex 1. Aid instruments: definitions and typologies</b>	<b>35</b>
<b>Annex 2. List of people interviewed</b>	<b>37</b>
<b>Annex 3. DFID bilateral spending in 2004/05</b>	<b>38</b>

## Acronyms

CBF	Common Basket Funding
CEA	Country Environmental Analysis
CPF	Common Pool Funding
DFID	UK Department for International Development
DPL	Development Policy Lending (of the World Bank)
GBS	General Budget Support
MDG	Millennium Development Goal
MTEF	Medium Term Expenditure Framework
ODA	Official Development Assistance
PAF	Performance Assessment Framework
PEER	Public Environmental Expenditure Review
PFM	Public Financial Management
PRS	Poverty Reduction Strategy
PRBS	Poverty Reduction Budget Support
PRSC	Poverty Reduction Support Credit (of the World Bank)
PRSP	Poverty Reduction Strategy Paper
SBS	Sector Budget Support
SEA	Strategic Environmental Assessment
TC	Technical Cooperation

## Executive summary

This report looks at how environmental objectives are pursued by donors in a context of changing aid architecture. It examines how General Budget Support (GBS), and other aid instruments, can be used to promote action on environmental programmes that contribute to poverty reduction. Aid in support of improved environmental management has to address the fact that whilst the State has a role in tackling market failures (through regulation and taxation) and the provision of public goods (e.g. education on environment friendly practices), its position is contested in certain areas associated with the environment, such as natural resource management. Even where the role of the State is clear, action is often compromised by the fact that this role is spread across various parts of government, with the lead environmental agency often being under-resourced in terms of poor institutional capacity and political leverage.

Budget support is a new aid modality. Its main features include a partnership-based provision of untied budgetary resources; a focus on nationwide policy processes (e.g. Poverty Reduction Strategies); a prominence given to institutional development objectives (such as improving planning and financial management capacity); and the use of predictable, transparent methods for external finance, working through government systems. Experience to-date has shown that GBS does not transform national political realities and should not be used as a lever to enforce policy change. It is largely a mechanism for funding, through the State Budget, an approved policy strategy. It is not a mechanism for enforcing policy change where domestic support for change is lacking – as has been attempted through some Performance Assessment Frameworks (PAFs). However, PAFs have been useful as a signalling device to identify important reforms within the government programme and to support their efficient implementation.

What is clear is that different aid instruments can complement each other. The selection of aid instruments involves judgements concerning: (i) the level of earmarking (placing limitations on how aid can be used); (ii) the use of financial management procedures (whether or not to use domestic public financial management systems); and (iii) the entry point and level of interaction (e.g. the State, line ministry, local government, or NGO). Selection needs to be based on a judgement of the underlying risk of using government systems against the benefits. Some guidance is becoming available, based on early experience:

- Use, wherever possible, domestic systems and procedures for delivering and managing financial resources to the public sector.
- Avoid policy conditionality which has proved to be ineffective in enforcing policy reform – concentrate instead on the process of policy change (understand the context and promote the conditions for the most adequate solutions to be adopted).
- Engage in policy dialogue with all levels of government and non-governmental players to strengthen the mechanisms of democratic decision-making.
- Recognise different entry points; within government, domestic and international actors.

The use of budget support provides a number of opportunities for assisting national environmental programmes. First, it offers the prospect for increased funding through the budget (at bare minimum it reduces financial pressure on environmental agencies). Second, it can strengthen budgetary processes within the Environmental Ministry and increase ownership over environmental spending plans. Third, it offers the prospect for broad system changes by providing access to the Ministry of Finance and the centre of government (e.g. accelerating reform of the regulatory framework; introducing

comprehensive environmental screening). Fourth, it strengthens the role of Sector Working Groups (SWGs) in promoting multi-sector policy dialogue and coherence. And finally, it offers opportunity for more transparent decision making on environmental matters (e.g. subject to Parliamentary scrutiny).

Against these opportunities a number of challenges need to be faced. With the use of budget support impact is limited by the existing policy framework and political interests. Donor-set policy conditionality will not change the fundamental policy direction of government. So, keeping environment (and particularly contentious environmental issues) on the policy agenda may be difficult given other policy priorities. There is also the difficulty associated with addressing the details of policy formulation and implementation without a continuing donor presence at sector level.

Recognizing these limitations, other mechanisms of aid delivery beyond GBS need to continue. Where GBS is not an option, sector budget support may be possible but common pooled funding or project funding is more likely. Even where GBS is in use other forms of aid delivery can be justified. First, the provision of technical assistance can be efficient when procurement is complex or when important technical issues need to be addressed and there are capacity gaps within government. Second, support to working outside government can be justified to help build demand for better environment policies. External support can also assist those lobbying for the strengthening of international initiatives and agreements.

Based on this initial review, a number of areas warrant further research. The first is more detailed in-country diagnostic studies to better understand the nature of environmental problems that have had an impact on the poor. As part of such studies, there is the need to understand where the demand for better policies originates. A review of successful experiences of major environmental policy changes would allow the main drivers of such changes to be identified and whether donor funding facilitated such change or not. Second, the role of Sector Working Groups appears to be a key new forum for promoting multi-stakeholder policy dialogue. Early experience of such groups needs to be documented and lessons learnt of emerging best practice. Finally, there is the question of what sort of donor in-house capacity is required to address the policy dialogue and influencing agenda that is now part of the new aid architecture.

## 1. Introduction

This report looks at how environmental objectives are pursued by donors in a context of changing aid architecture. It examines how General Budget Support (GBS), and other aid instruments<sup>1</sup>, can be used to promote action on environmental programmes that contribute to poverty reduction. The analysis is based on a review of the literature currently available on these themes as well as interviews with a selection of key informants<sup>2</sup>. It seeks to highlight the most relevant issues and provide evidence of the effectiveness of different aid instruments in supporting environmental goals. The depth of the analysis is constrained by the limited time that was available to conduct the study. Therefore, some of the issues are only briefly raised and will require additional investigation.

The following three hypotheses were used to help guide the research:

- a. GBS will deliver environmental benefits efficiently only when:
  - there is broad agreement on environmental policy (perhaps through a widely-supported sustainable development strategy) **and**
  - when environmental aspects are considered across a range of government sectors and policies, e.g. agriculture, water, industrial development **and**
  - where there is both a robust public financial management system, and a reasonably effective framework for public sector regulatory and service delivery activities.
- b. The ability of donor agencies to influence government policies and systems is limited in the absence of political commitment to the same objectives.
- c. Effective integration of environmental issues is likely to require a two-pronged strategy, complementing budgetary instruments with other forms of engagement (including support for cross-ministry institutional forums and civil society engagement).

There has been considerable change in the way that donor organisations deliver aid in recent years. Questions over aid effectiveness and the continuing high levels of poverty in many countries have been major drivers in the search for new aid instruments that will lead to the attainment of the Millennium Development Goals. A crucial ongoing change in the way aid is delivered has been the progressive shift from project support to more upstream mechanisms, the so-called 'programmatic' approaches. In particular, there has been a growing interest in a specific modality - budget support - for providing aid to governments in development countries. Budget support, although not yet the dominant aid modality, is increasingly seen as the preferred mechanism for supporting national governments in the pursuit of their Poverty Reduction Strategies (PRSs), while contributing to strengthening domestic ownership, policy-making and implementation systems. DFID is seen as a strong proponent of this type of aid delivery and has committed considerable funding through its Poverty Reduction Budget Support (PRBS) modality. However, it is important to recognise that, even for DFID, there has been no complete turn around in the use of aid instruments. What change is happening is

---

<sup>1</sup> A description of the aid instruments examined in this report is presented in Annex 1.

<sup>2</sup> The list of people interviewed is attached at Annex 2.

gradual, with considerable lesson learning taking place (of which this study is one small contribution).

There is significant regional variation in the use of GBS<sup>3</sup>. For example, out of 13 countries in the western hemisphere receiving DFID bilateral aid in 2004/05, in only one (Bolivia) was aid disbursed under a GBS arrangement. The situation is quite different in Africa, where nine countries (Tanzania, Ethiopia, Mozambique, Ghana, Uganda, Rwanda, Malawi, Zambia and Sierra Leone) have GBS as an established aid delivery mechanism, with between 27 and 75 per cent of the country's bilateral aid delivered in this way. However, other types of financial aid and technical cooperation continue to feature strongly in these countries. There is not one country where other aid instruments have ceased as a result of the introduction of GBS. Elsewhere in Africa, 19 countries continue to receive over £1 million in aid annually from DFID under more traditional aid instruments (Annex 3).

However, as this report will show there are strong arguments for a move to GBS, including the need to improve the effectiveness of aid. This involves the strengthening of domestic planning and financial management systems, and providing national governments with discretionary resources to support them in the implementation of their PRSs. There is an assumption in this argument that the allocation of public resources defined by Medium Term Expenditure Frameworks (where these exist), and State Budgets, reflects the priorities established in national policy strategies and that the evaluation of policy outcomes feeds into the revision of policies and resource allocation decisions. In practice, however, these links are not straightforward. This raises concerns about the ability of domestic planning and financial management systems to make effective use of GBS funds in the pursuit of poverty reduction and sustainable development objectives.

The international environmental agenda was set in the early 1990s, with the subsequent decade being a time of much policy discussion. As a result of this dialogue a consensus arose on the importance of the environment to sustainable development, as articulated in MDG 7. More recently, the Millennium Ecosystem Assessment highlighted that poverty eradication and sustainable development depend upon ensuring environmental sustainability; otherwise, any gains will be transitory and inequitable (MEA, 2005). Although such international action has a role to play, the key to improved environmental stewardship lies with implementation at the national level. Governments have the responsibility to ensure strong environmental governance, particularly in the natural resources sectors, whilst the call for better environment policies depends on an active civil society. This report therefore focuses its attention on country-level experience and donor support for national environmental actions.

---

<sup>3</sup> DFID's PRBS includes both GBS and another form of budget support where sectoral earmarking is specified – Sector Budget Support. The differences between these two types of budget support are discussed in section 3 of this report.

## **2. Environmental governance and the context of development aid**

### **2.1 Environmental governance challenges**

The state has a role to play in environmental management on account of the externalities, market failures, and complex trans-boundary and trans-generational issues associated with the environment. Yet, this role is often less clear than in other areas of state intervention. Unlike health and education, the position of the state can be ill-defined – and contested – when it comes to issues such as accessing, and benefiting from, environmental goods and services. The lack of consensus on public sector intervention is particularly significant with regard to the environmental aspects of natural resource management (Swanson and Lunde, 2003).

As a result of this lack of clarity, there continues to be poor definition of national environment policies and priorities. For example, the treatment of environmental issues within PRSs has been limited to date, reflecting a lack of understanding between poverty reduction and environmental management (Bojö *et al.*, 2004). Despite this, there is increasing evidence to show that sustainable development and poverty reduction depend heavily on the environment. This is particularly true in low income countries, where a high percentage of the national wealth comes from natural capital (World Bank, 2006a). Stronger environmental governance in the natural resource sectors is critical to ensure that (a) these sectors contribute optimally to future growth, and (b) economic growth does not come at the cost of environmental degradation. In sectors such as forestry and mining more transparent and accountable fiscal management of relevant government agencies is of particular importance to avoid short-lived consumption of natural resources that will leave a country poorer than before. Getting the most from environmental assets implies better state regulation, more effective capture of the economic value of the resource, better collection of tax revenues, higher levels of reinvestment and savings, and less wasteful utilization of natural resources.

However, the role of national governments in addressing environmental concerns is more limited than might at first appear. Theory tells us that there is an economic rationale for government intervention in the market either to ensure the provision or protection of public goods or to ensure externalities are reflected in market operations. This creates an important role for the national government in environmental regulation and in the application of environmental taxes, but does not generally require large-scale provision of subsidised services. Even where the role of the national government should in principle be significant, it may be constrained by capacity issues. These capacity constraints may arise from political economy issues (the constellation of interest groups represented in government) or from genuine capacity problems due to poor institutional frameworks or inadequate human resources. As a result, the number of occasions where there is both a legitimate rationale for national government intervention and a proven (or easily developed) capability to carry out such functions may be relatively limited.

Appropriate incentives to generate and enforce the required policy framework are lacking in many countries. Environmental fiscal reform (e.g. ecological taxes, user fees) and economic instruments (e.g. emission trading) are taking on greater significance in furthering environmental stewardship, at least in policy circles. However, these instruments remain poorly developed, with limited practical application.

Lack of policy, planning and management capacity within national environmental agencies remains a recognised bottleneck. This weak institutional capacity has much to do with the short history of many ministries and departments of the environment. These tend to be non-revenue generating and so act as a drain on the national budget. In addition, the institutional structures that have been put in place often need to be modernized if they are to acknowledge and respond to the needs of the poor. Another less well reported constraint is the risk aversion culture that predominates within the government service in many countries, which dampens enthusiasm for innovation in environmental management.

The valuation of environmental assets is constrained by limited analytical capacity at all levels (by government, donors, and civil society). New approaches that include accounting for natural resources in national wealth estimates are only just beginning to be used (World Bank, 2006a). The analyses from such studies show that natural capital (that accruing from agricultural land, minerals and forests) provide a greater share than produced capital in low-income countries. This result highlights the importance of managing natural resources wisely, and optimising the use of environmental assets as part of national development strategies. Public environmental expenditure reviews (PEERs) can be used to provide feedback to policy circles on government spending levels on the environment. These are also potentially useful tools to map out the institutional layout of the sector. However, the use of such reviews is at an early stage and at present it is difficult to track down expenditures beyond the core environmental agencies (Box 1).

#### **Box 1. Defining public environmental expenditure and the use of PEERs**

An important aspect of policy implementation is the management of financial resources, that is, making sure resource allocation is consistent with policy priorities and resources are used to fund activities which contribute to the pursuit of those objectives in an efficient manner. A good understanding of public environmental expenditure is critical to the assessment of the effectiveness and efficiency of environmental financial management.

Yet, defining environmental expenditure is not straightforward. Swanson and Lunde (2003) reported the variety of definitions and typologies (systems of classifying expenditure) in use. They noted, for example, that most organisations conducting public environmental expenditure reviews or PEERs do not use a comprehensive definition since there are a number of areas (particularly environmental aspects of natural resource management) on which there is no consensus on what the public sector's role is. Hence, there is a tendency to focus on subcategories of environmental expenditure that are reasonably well defined.

Swanson and Lunde proposed a wide general definition of public environmental expenditure: *“expenditures by public institutions for purposeful activities aimed directly at the prevention, reduction, and elimination of pollution or any other degradation of the environment resulting from human activity, as well as natural resource management activities not aimed at resource exploration or production”*.

They also proposed the use of a classification system that accounts for the various dimensions of environmental expenditure, and which helps to illustrate the complex nature of public environmental expenditure and environmental governance in general:

- Agency dimension: distinguishes between expenditure made by ‘core’ environmental agencies and other line ministries and agencies. This helps in examining the degree of mainstreaming within the government.
- Economic dimension: allowing for the classical distinction between recurrent and capital expenditures, which is important to analyse technical efficiency and sustainability of expenditure.
- Functional dimension: accounts for the type of environmental functions or services provided by the public sector – may include policy design, regulation, enforcement activities, provision of services (e.g. waste management), environmental education, studies,

dissemination of information, etc.

- Environmental domain dimension: is based on the international CEPA classification and it provides information of the specific environmental medium that the expenditure is aimed at protecting. This could be useful for international comparison.
- Regional dimension: distinguishes central and regional expenditure. Useful to assess inter-regional distribution of resources.
- Financing dimension: accounts for the sources of funding, including foreign and off-budget sources as well as earmarked funding.
- Programme/policy issue dimension: allows expenditure to be measured against policy priorities (which are usually closely associated with programmes).

**Source:** Swanson and Lunde (2003).

These are some of the challenges that donors face in their attempts to support environmental programmes in aid-receiving countries. The next section describes the major changes in aid delivery that have been underway in recent years, which necessarily call for a re-think on how environmental goals can best be supported by the donor community.

## **2.2 Development aid context: aid effectiveness and budget support**

During the early years of development cooperation, aid to governments was normally provided through specific project implementation units, either operated directly by the donor agency or by sub-contracted organizations. Donors had a major role in the design, implementation, monitoring and evaluation of the project. The main concern at the time was to delivery services and carry out investments efficiently, while minimising fiduciary risk by maintaining separate financial management mechanisms. The proliferation of projects and funding agencies led to a considerable fragmentation in development operations, which generated inconsistencies between interventions and allocative inefficiencies, resulting in high transactions costs in aid delivery. Other weaknesses included the unpredictability of overall funding levels and, related to this, the difficulty in macroeconomic management of monetary flows; and the fact that, by relying on parallel and often non-governmental structures, projects undermined domestic governance systems and the structures of democratic accountability.

In response to these perceived failures, new aid delivery mechanisms started to emerge. Since the mid-nineties there has been a gradual shift away from stand-alone project assistance towards more coordinated and progressively more upstream mechanisms of aid delivery such as programme-based and budgetary support<sup>4</sup>. This shift is consistent with the broad trends in the architecture of international development assistance, including the commitment to reducing poverty and reaching the MDGs through the framework of Poverty Reduction Strategies (PRSs) and the growing emphasis on domestic ownership and accountability.

In 2005, Ministers of developed and developing countries and Heads of bilateral and multilateral aid agencies signed the Paris Declaration on Aid Effectiveness. Agreement was

---

<sup>4</sup> The term programme-based approach or support refers to a generic approach based on comprehensive and coordinated planning in a sector or thematic area.

reached on the principles of national ownership, alignment with domestic policies and systems, donor harmonisation of procedures, managing resources for the attainment of policy results, and mutual accountability in aid relations. Box 2 lists the progress indicators established. The Paris Declaration committed the signatories to undertake measures to increase the impact that aid has in reducing poverty and inequality, increasing growth, building capacity and achieving the MDGs (OECD/DAC, 2005). These measures include reducing project-based support managed by parallel structures and increasing the use of programme-based aid modalities in a joint effort to strengthen domestic ownership and accountability and hence improve the effectiveness of international development assistance. The aid effectiveness agenda rests strongly on the assumption that the reduction in fragmentation in aid delivery through joint forms of assistance not only reduces transaction costs but also contributes to better policy coordination and coherence and hence improvements in allocative and technical efficiency in the use of public resources.

**Box 2. Paris Declaration on Aid Effectiveness – progress indicators**

The Paris Declaration stresses, in line with the previous 2003 Rome Declaration on Harmonisation and the 2004 Marrakech Roundtable on Managing Development for Results, the importance of the principles of ownership, alignment, harmonisation, results-based management and mutual accountability for aid effectiveness and, in particular, the impact of aid on poverty reduction, growth and the achievement of the MDGs. The Declaration sets the following progress indicators for each of its guiding objectives:

1. Ownership
  - a. Partners have operational development strategies – number of countries with national development strategies (including PRSs) that have clear strategic priorities linked to a medium-term expenditure framework and reflected in annual budgets.
2. Alignment
  - a. Reliable country systems – number of partner countries that have procurement and public financial management systems that either (a) adhere to broadly accepted good practice or (b) have a reform programme in place to achieve these.
  - b. Aid flows are aligned on national priorities – percent of aid flows to the government sector that is reported on partners’ national budgets.
  - c. Strengthen capacity by co-ordinated support – percent of donor capacity-development support provided through co-ordinated programmes consistent with partners’ national development strategies.
  - d. Use of country procurement systems – percent of donors and of aid flows that use partner country procurement systems which either (a) adhere to broadly accepted good practices or (b) have a reform programme in place to achieve these.
  - e. Use of country public financial management systems – percent of donors and of aid flows that use public financial management systems in partner countries, which either (a) adhere to broadly accepted good practices or (b) have a reform programme in place to achieve these.
  - f. Strengthen capacity by avoiding parallel implementation structures – number of parallel project implementation units (PIUs) per country.
  - g. Aid is more predictable – percent of aid disbursements released according to agreed schedules in annual or multi-year frameworks.
  - h. Aid is untied – percent of bilateral aid that is untied.
3. Harmonisation
  - a. Use of common arrangements or procedures – percent of aid provided as programme-based approaches.
  - b. Encourage shared analysis – percent of (a) field missions and/or (b) country analytic work, including diagnostic reviews that are joint.
4. Management for results
  - a. Results-oriented frameworks – number of countries with transparent and monitorable performance assessment frameworks to assess progress against (a) the national

development strategies and (b) sector programmes.

5. Mutual accountability

- a. Mutual accountability – number of partners that undertake mutual assessments implementing agreed commitments on including those in this Declaration.

**Source:** Paris Declaration –

[http://www.oecd.org/document/18/0,2340,en\\_2649\\_3236398\\_35401554\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/18/0,2340,en_2649_3236398_35401554_1_1_1_1,00.html)

In addition to this shift away from projects and towards 'programmatic' forms of aid, there has also been a move away from policy conditionality towards a more partnership-based approach to the provision of aid, at least in development thinking. The latter trend is a response to the mounting evidence that policy conditionality is ineffective and undermines national ownership and accountability (Lawson and Booth, 2004). Several studies on conditionality have demonstrated that domestic considerations over policy reform are largely immune to donor imposed pressures and hence conditionality is ineffective as a lever to foster policy reform in recipient countries where a local constituency in support of reform is absent<sup>5</sup>. This is partly because donors themselves are under pressure to spend and are likely to disburse even if the agreed conditions are not met by the recipient government (the 'reverse dependency' argument). This is not to imply that donors do not have influence over policy change. The experience with structural adjustment provides a number of examples of policy reforms having been forced upon national governments. Yet, evidence also shows that where there was not willingness (or capacity) to undertake certain reforms, they were carried out only partially in a way that did not risk the continuity of external assistance (the 'partial reform' argument).

On the basis of this experience with project aid and policy-based conditionality, a new form of providing financial aid has developed, emphasising the importance of domestic ownership and using government planning and financial management systems. The main characteristics of the 'new' budget support modality, or GBS, are (Lawson and Booth, 2004):<sup>6</sup>

- partnership-based provision of untied budgetary resources;
- a focus on nation-wide policy processes (such as PRSs);
- prominence given to institutional development objectives (such as improved planning and financial management capacity); and
- use of predictable, transparent methods for external finance, working through government systems and processes.

There have been two recent assessments of early experience with the new budget support modality (Daima Associates Ltd and ODI, 2005 and IDD and Associates, 2006). The evidence from the eight countries<sup>7</sup> reviewed indicates that the instrument has contributed to:

- increased discretionary funding (both by increasing on-budget aid and reducing aid earmarking) and hence national ownership of the resource allocation process;
- improved budgetary process, particularly the comprehensiveness and transparency of public financial management and the institutional relations between line ministries and the ministry of finance;

---

<sup>5</sup> See Killick (1998), Killick (2004) and Lawson and Booth (2004) for a discussion on the effectiveness of conditionality.

<sup>6</sup> 'New' because it changed considerably the form of budget support used by the International Financial Institutions to provide adjustment lending in the 1980s and 1990s.

<sup>7</sup> Burkina Faso, Malawi, Mozambique, Nicaragua, Rwanda, Tanzania, Uganda and Vietnam.

- greater policy alignment of aid with government budget cycles and donor harmonisation;
- focused government-donor dialogue on strategic policy issues and widening partner's involvement in the policy debate, particularly on macroeconomic and public financial management issues; and
- reinforced macroeconomic management and stability.

The instrument is said to have contributed also to the wider improvement of government-donor relations beyond the GBS framework, through greater harmonisation between donor agencies and greater awareness of links between sector specific and wider policy issues and debates, such as macroeconomic stability or public financial management. Yet, a crucial message coming out of the studies is that GBS does not transform political realities and should not be used as a lever to enforce policy change (Daima Associates and ODI, 2005: 146):

*'GBS and the related policy conditions are unlikely ever to be more than a modest influence over the processes of public sector reform and institutional development'*

The evaluation studies also note also that there is little or no evidence that GBS has resulted in any savings in transaction costs, improvements in public expenditure efficiency or domestic accountability. This is argued to be partly related to the persistent use of other aid instruments and mechanisms operated outside the PFM system, which limits the scale effects of GBS – particularly in terms of improving the coverage and efficiency of the budgetary process. However, and of importance when it comes to considering how best aid can support environmental goals, it is also recognized that different instruments complement each other and that there are synergies between GBS and other aid modalities, particularly technical cooperation.

### 3. Aid to the environment and financing instruments

#### 3.1 Aid to the environment

The evidence from the four countries (Ghana, Honduras, Uganda and Vietnam) of the Waldman study (Waldman *et al.*, 2005) suggests that environmental mainstreaming has relied on considerable donor support. However, concern has been raised recently over the apparent failure of donor assistance to maintain environmental sustainability as a high-level policy issue (DEG, 2006). Understanding the importance of environmental resources to national development therefore needs to be broadened and deepened within donor organisations at the present time. This is particularly pressing because attribution of environmental impacts arising from general budget support is likely to be far more difficult than with project interventions, as the linkages are both complex and case specific (Gueorguieva and Bolt, 2003).

In parallel with this, donor harmonization on environmental matters needs to be strengthened, as recognised in the 2005 Paris Declaration (Box 3). Opportunities for donor coordination are currently centred on two main initiatives that attempt to raise awareness of the linkages between poverty reduction and environmental sustainability: the UNDP/UNEP Poverty and Environment Initiative and the Poverty-Environment Partnership. Attention also needs to focus on cooperation at the national level, with in-country working groups of developmental partners being one positive investment to secure a harmonized approach. However, involvement in such groups requires donors to have appropriate staff present in-country, which is often not the case.

#### **Box 3. Donor harmonisation on environmental issues**

The 2005 *Paris Declaration on Aid Effectiveness*<sup>1</sup> devoted two paragraphs to the environment:

##### **Promoting a harmonised approach to environmental assessments**

40. Donors have achieved considerable progress in harmonisation around environmental impact assessment (EIA) including relevant health and social issues at the project level. This progress needs to be deepened, including on addressing implications of global environmental issues such as climate change, desertification and loss of biodiversity.

41. **Donors** and **partner countries** jointly commit to:

- Strengthen the application of EIAs and deepen common procedures for projects, including consultations with stakeholders; and develop and apply common approaches for “strategic environmental assessment” at the sector and national levels.
- Continue to develop the specialised technical and policy capacity necessary for environmental analysis and for enforcement of legislation.

<sup>1</sup> <http://www1.worldbank.org/harmonization/Paris/FINALPARISDECLARATION.pdf>

One challenge facing donors is that the link between policy articulation and budgetary implementation is not straightforward. Ideally, environmental objectives should be reflected in performance criteria agreed within government spending plans, such as Medium Term Expenditure Frameworks (MTEFs). However, the total number of performance criteria in MTEFs (where these exist) usually has an upper ceiling and in most cases to date environmental criteria have not been included. Ensuring that environmental policy objectives are reflected in spending plans therefore tends to be problematic.

Another concern that arises with increasing aid levels delivered through budget support is that such arrangements may prove detrimental to environmental NGOs and civil society groups that have participated in the PRSP process. These groups may be less likely to receive financial support from their own national governments than when they benefited directly through donor-assisted projects. As these groups are often instrumental in making sure that the environment is on the national policy agenda, there is the danger of some weakening of the reform effort as PRS implementation programmes begin. However, with the new aid modalities also come new opportunities for promoting improved environmental management. One of the most important of these is the possibility of engaging with the Planning and Finance Ministries, which provides new entry points for discussion on upstream policy issues such as environmental fiscal reform.

The next section describes a number of short case studies where different aid instruments have been employed to strengthen environmental management within development cooperation programmes. Ranging from general budget support to the provision of technical cooperation these studies bring out a number of general issues that warrant further attention as the use of GBS becomes more widespread.

## **3.2 Overview of aid instruments in use**

### **3.2.1 GBS and environment conditionality in Ghana**

#### *Donor harmonisation around general budget support*

Multi-donor budget support is now the predominant aid instrument in Ghana, supporting the implementation of Ghana's Poverty Reduction Strategy (GPRS) through the Government's budget. The GPRS is in its second iteration, with the 2006 publication of GPRS II. Although strategic environmental analysis was used to identify weaknesses in the strategy's initial coverage of environmental issues, these appear to remain on the margins of the strategy.

Donor coordination efforts have been extensive, with support channelled through a joint Country Assistance Strategy, to which development partners contribute. A Memorandum of Understanding was signed in 2003 between the Government and nine of these partners to establish the joint approach. Central to this agreement is the Performance Assessment Framework (PAF), which is the set of policy reform measures and poverty reduction goals that are used to assess progress of GPRS implementation and determines donor disbursements under the GBS modality – see Box 4. The process of developing the PAF is an important, complex and centralised process. As it involves a large number of development partners the likelihood of differences in view emerging is high, reflecting the different institutional cultures of the organisations involved and their experience with this aid modality. Such differences of view have tended to surface in the assessment of the small number of PAF triggers, which directly control the annual donor performance-based GBS disbursements.

On the government's side, 15 sectors feed into this mechanism. Each sector ministry has an incentive to promote issues it feels need broad political support, whereas the Finance Ministry, which leads for the Government, is naturally reluctant to include triggers that contain any element of risk. Agreement over triggers is ultimately a political process. Initially the PAF consisted of two matrices (a multi-donor budget support policy matrix for the bilateral donors and EU, and the World Bank's PRSC). These two matrices were the subject of separate arrangements. In 2004 the two matrices were brought together. This required the resolution of a number of operational issues concerning different budgeting cycles, which are only now beginning to be resolved with the move to a three-year framework.

#### **Box 4. Performance Assessment Frameworks for GBS – lessons from experience**

A Performance Assessment Framework (PAF) is a monitoring tool developed in the context of General Budget Support (GBS). Its main objective is to assess the fulfilment of a set of commitments by Government to GBS donors and, in theory, vice-versa. A PAF determines the conditions for GBS disbursements and the rules by which GBS donors should operate.

There are at least four approaches to assessing performance, and PAF experiences to date have embodied a mixture of these approaches:

- IMF's analysis of macroeconomic and structural conditions through the Poverty Reduction and Growth Facility (PRGF);
- World Bank-style assessment against 'prior policy actions', as used by Poverty Reduction Support Credits (PRSCs);
- Use of a differentiated response mechanism, involving a virtually guaranteed fixed tranche and a variable tranche, whose value is determined by performance in relation to predetermined performance indicators;
- General assessment against overall progress with the PRS, as commonly favoured by bilateral agencies.

A recent study (Lawson *et al.*, 2005) on the experience with PAFs identifies good practices to be mainstreamed and ineffective practices to be avoided.

**Good practices include:** (i) managing all budget support through a single harmonised framework with major reductions in transaction costs; (ii) having a common schedule for performance review, disbursement decision and tranche release which improves predictability in GBS flows; (iii) significant level of alignment to government systems and procedures, particularly by using government reporting mechanisms on service delivery, budgets and expenditure; (iv) using the PAF concept to monitor also donor obligations thereby strengthening mutual accountability (Mozambique has a pioneering experience, having developed a PAF on donor specific commitments); and (v) efficiency of the parallel PRGF assessment process on macroeconomic and fiscal performance, suggesting that in principle 'sub-contracting' discrete aspects of assessment could be an effective way of dealing with the excessive size and complexity of PAFs.

**Ineffective practices to be avoided include:** (i) unnecessary expansion in scope and complexity of the PAF (often involving a mix of prior actions, policy actions and performance indicators) which is likely to undermine the focus on priority reforms, generate inconsistencies in performance reviews and make the review process burdensome; (ii) trying to achieve too many objectives through the PAF, and (iii) ineffectiveness of variable tranche schemes when there is not a minimum 'critical mass' of financing behind them.

The study stresses that the problem of the excessive size of PAF matrices needs to be addressed. Yet, it also notes that a careful balance is required in using the PAF as a performance assessment and as a policy dialogue tool. The fact that the PAF is used as a method for assessing disbursement conditions might inhibit dialogue over sensitive issues. It recommends that the PAF should be conceived as one element within a wider process of performance assessment and dialogue, and one which is aligned to domestic processes and accountability systems. The study also stresses that the mechanisms for ensuring the GBS donors adhere to their commitments are much weaker than the mechanisms for monitoring government commitments and that PAFs are generally still a long way from ensuring mutual accountability.

**Source:** Lawson, A., R. Gerster and D. Hoole (2005) "Learning from experience with Performance Assessment Frameworks for General Budget Support", synthesis report.

#### *Consideration of environmental triggers within the PAF*

There have been persistent efforts to include NR-related indicators and triggers within the PAF in Ghana. This represents a significant challenge as there is an agreed principle to keep triggers to a small number and there is a clear advantage to focus on key areas of progress where the government is confident that targets can be met.

In 2004, the Ministry of Lands, Forestry and Mines (MLFM) expressed an interest to have a forest-related indicator included in the PAF. This was likely prompted by a desire to retain some donor interest in the sector after the closure of most project-based support. However, the significant revenue-raising function of this ministry complicated the internal government discussions. Resource allocation under budget support has to go through the Ministry of Finance and Economic Planning, which placed the MLFM under their fiduciary control for the first time. The proposed indicator did not appear.

In 2005, a completely different approach was taken by the donor lead economists, who recognised the value of including a NR-sector governance trigger to help address major governance challenges. This view was no doubt influenced by recent research that highlighted Ghana's economic growth was being achieved only at a high cost to the environment. Those costs have been estimated at approximately six percent of GDP, or around US\$520 million, annually (World Bank, 2006a). The rapid depletion of natural resources, on which so much economic activity depends, represents a serious threat to sustained economic growth in Ghana and national poverty reduction. Discussions over the NR-governance related trigger continued to a late stage, but were not concluded either because the government did not buy into the proposed reforms or the risk was considered too great.

*Issues emerging from this case-study include:*

- Environmental assets such as forests and minerals are the subject of considerable political interest as they can represent major sources of revenue. This greatly increases the risk to the reform process.
- Donor harmonisation requires improved understanding across diverse institutional cultures, particularly between the Bretton Woods Institutions and bilateral agencies. A new consensus has been slow to emerge with respect to operational ways of working. One challenge is to keep the strategic focus of the PAF and hence limit its size.

### **3.2.2. Environmental governance and the policy debate in the context of GBS in Mozambique**

Mozambique obtained a very high score in the Bojö *et al.* (2004) assessment of environmental mainstreaming in PRSPs. The study used four rating criteria: (i) diagnosis of environmental issues; (ii) analysis of poverty-environment links; (iii) environmentally relevant actions; and (iv) the extent to which participation and consultation allowed environmental concerns to be heard. Two hypotheses were offered in explaining the high scores: (a) the quality of the PRSP process and the extent to which the environmental constituency was mobilized and allowed to contribute; and (b) the recent occurrence of natural disasters that might have sharpened the political awareness of environmental vulnerability.

Mozambique is considered to have quite robust environmental legislation and has been rated strong on environmental analysis (CIDA, 2004). Also, the Mozambican PRSP includes the environment in its selection of poverty reduction priority actions and the PRSP policy matrix contains various indicators and targets to monitor progress in the implementation of these actions. Likewise, the GBS monitoring framework (PAF) includes three indicators on natural resource management: on access to land, small-scale irrigation techniques and sustainable management of natural resources<sup>8</sup>. Furthermore, there is an environment specific Sector Working Group (SWG), including government representatives and donor

---

<sup>8</sup> Government of Mozambique and Programme Aid Partners (2004) 'Performance Assessment Framework (PAF)', agreed at the Joint Review held on the 7<sup>th</sup> April 2004.

agencies, which played an important role in supporting the Ministry of Environment (*Ministério de Coordenação da Acção Ambiental – MICOA*) during the preparation of the PRSP environment component.

Yet, despite these achievements, implementation of environmental policies is thought to be quite poor. MICOA is very weak and the prospects for strengthening capacity seem limited, given the recent withdrawal of sector support from donor agencies.<sup>9</sup> In addition to this, the environment has been getting relatively little treatment under the GBS policy dialogue framework. Of the various cross-cutting policy areas analysed by a recent evaluation of GBS, the environment was the one to have received the least attention under GBS (Batley *et al.*, 2006). Furthermore, the cross-cutting nature of this sector makes its management very challenging. MICOA does not have the political clout to coordinate other ministries that hold a mandate on the environment (such as agriculture, industry, energy or health). Part of this difficulty is thought to be related to the fact that in Mozambique ‘coordination’ tends to be equated with ‘control’, and MICOA does not have enough influence to deal with other more powerful ministries.

Environmental governance is also quite narrowly defined, still being strongly associated exclusively with what MICOA does. This is reflected in the way policies are formulated and debates conducted both by the government and by donors. The environment SWG, for example, has not been successful in attracting government or donor interest beyond those working directly with the core environment agency.

*Emerging issues from this case-study include:*

- Designing good policies is not difficult, what is difficult is putting them into action.
- The cross-cutting nature of the environment makes the governance of the sector very challenging, particularly when the coordination agency has limited political leverage and convening power.
- Despite the global rhetoric, donors’ support to environment mainstreaming is falling down the agenda, particularly in the context of GBS.

### **3.2.3 Programmatic Environmental Structural Adjustment Loan in Mexico**

The Programmatic Environment Structural Adjustment Loan (EnvSAL) is a World Bank programme of support to the Government of Mexico, which aims to balance socioeconomic development with environmental protection and improvement. In particular, it focuses on (a) mainstreaming of environmental concerns in key sectoral development programmes and (b) improving the effectiveness and efficiency of local environmental management processes. A programmatic approach was adopted due to the complexity and multi-sectoral nature of the reforms and the need for flexibility in implementation. Priority sectors supported under the programme include water, energy, forestry and tourism.

The programme consists of three loan operations. The first, EnvSAL I, was approved in 2002 and closed in January 2004. Interventions during this first period included:

- the establishment of high-level institutional coordination mechanisms between energy, forestry, water, tourism and environment sectors;
- support for the approval and implementation of fiscal instruments;
- the creation of an enabling environment to decentralise federal environment management functions via changes in key laws;

---

<sup>9</sup> Dutch and Finnish cooperation are both closing their programmes and DANIDA is now the only agency providing institutional support to environmental governance. The World Bank also has a small number of project interventions on the environment but it is said that the Ministry of Environment is seen as an implementation agency, with little emphasis given to ownership or institutional capacity building (Hessel-Anderson, *pers. comm.*).

- the assignment of a federal grant programme to finance capacity building in federal states with plans to assume new environmental management functions; and
- the development and implementation of a strategy to improve public access to information on Environmental Impact Assessment (EIA).

The programme's implementation report (World Bank, 2004b) noted several achievements. First, environmental fiscal instruments were developed for the first time in the history of environmental management in Mexico. Second, the statutory provision of public access to information on EIA was made through the passing of three pieces of legislation. And third, some advances in inter-institutional coordination aiming at facilitating environmental mainstreaming in key sectors were also made, with the establishment of Inter-sectoral Technical Working Groups (ITWGs). Yet, despite this progress, inter-institutional coordination was also one of the main sources of delay to the implementation of the programme. Difficulties in coordination resulted from the time needed to learn how best to coordinate work under EnvSAL I, scarcity of human and financial resources assigned to support the functioning to the ITWGs, and difficulty in getting high-level staff to participate in meetings (a requirement of the loan conditionality).

The implementation report concluded that the experience with EnvSAL showed that inter-institutional coordination is a complex process requiring substantial efforts and sustainable commitments from the participating entities. It also stressed the need for adequate human resources to support inter-institutional coordination and recommended exploring complementarities between budgetary support and technical assistance modalities. The use of technical assistance from the Bank and grants from other sources to promote inter-institutional coordination was also recommended. Another important finding was that the high number of conditionalities in EnvSAL I made implementation and supervision very demanding both in terms of financial and human resources. The report recommended the selection of a limited number of strategically important conditionalities to help focus interventions on the priorities which have significant development impact.

*Issues emerging from this case-study include:*

- Inter-sectoral coordination is crucial to address environmental issues but it is difficult to put in practice, requiring substantial efforts and commitment.
- Technical assistance is an important form of aid that can complement budgetary support and could be used to assist inter-sectoral coordination.
- Having a complex conditionality framework attached to development assistance increases transaction costs and is unhelpful in keeping the focus on priority interventions.

#### **3.2.4 TC support to environment mainstreaming in Tanzania**

In 2002, DFID provided Technical Cooperation (TC) support to the Government of Tanzania to assist environment mainstreaming and, in particular, the integration of poverty-environment linkages in the PRSP. TC support consisted of the secondment of a DFID Poverty-Environment Adviser to UNDP, who worked within the Poverty Eradication Division of the Vice President's Office (VPO). The mission of the Vice-President's Office is to formulate policies and strategies on poverty eradication, the protection of the environment, and non-governmental organisations. Three Divisions reflect this mission and provide the institutional structure to allow close collaboration between environmental and poverty reduction specialists within a central component of government (namely the Vice President's Office).

This TC arrangement developed from a request by the VPO for technical support from UNDP to help strengthen the integration of poverty-environment objectives in Tanzania's second PRSP. As there was already close cooperation between the UNDP and DFID on

poverty and environment issues, consultation between the three parties identified that DFID could provide the necessary expertise. From the outset, there was a high level of national ownership in the process, with the VPO Permanent Secretary being part of the Adviser's selection board.

TC was funded under a separate off-budget arrangement. Management of the TC adviser was initially the responsibility of the UNDP, with reporting lines to both the UNDP and the Director of Poverty Eradication within the VPO. In addition, the adviser retained a professional link with DFID with regard to technical support. This led to some confusion in the lines of accountability and so was changed after the first year to the adviser being solely responsible to the Director within the VPO.

This TC posting is regarded by DFID as having had high impact. The adviser is perceived as having played a key part in contributing to the improved integration of environment in the PRSP. Fourteen per cent of the 99 targets in the second PRSP are related to the environment and natural resources, and interventions on environment are expected to contribute to other targets. Suggested explanations for this success include the high level of technical expertise of the individual, his ability to create strong working links across a range governmental and non-governmental players, and a supportive and reformist institutional environment. Although there has been no formal evaluation of this experience, DFID's internal assessment (DFID, 2006c) noted that the TC arrangement played an important catalytic role in integrating cross-cutting issues into the PRS process and that it was a useful complement to other instruments of financial assistance by DFID and other partners:

'by strengthening the PRSP processes and dialogue on poverty-environment issues, it increased the effectiveness of mechanisms such as PRBS to address environmental issues'.

*Issues emerging from this case-study include:*

- As with all developmental initiatives, national leadership is critical to success, allowing additional donor resources to come in behind a momentum for reform.
- There is some uncertainty over the optimal mode of TC funding. In Tanzania, discussions appear to have focused initially on pooled TC funding arrangements with one part of government. However, there is no barrier to the government allocating the necessary funds under general budget support arrangements.
- Recipient government management of TC is considered necessary for the successful implementation of this type of aid, although the costs of management do not appear to have been critically examined.
- Donor harmonization needs to take into account the different reporting systems of donors.

### **3.2.5 The Global Environment Facility**

Although this report focuses on donor support to environmental actions at the national level, multilateral instruments also have an effect on the national stewardship of global public goods. Since 1991, the Global Environment Facility (GEF), which is implemented by the United Nations Development Programme, the United Nations Environment Programme, and the World Bank, has been one of the principal mechanisms for global environment funding. A number of advantages are suggested for the use of such global instruments: (a) additional donor funding is made available for development outside of national programmes; (b) there is more donor harmonisation; (c) increased untying of aid; (d) more pooled funding; and (e) the focus on public/private financing partnerships. In addition, global funds offer flexibility in aid delivery and may channel funds directly to civil society (Montes, 2005).

GEF projects must be country-driven, based on national priorities designed to support sustainable development, as identified in the context of national programmes (GEF, 2002). These objectives reflect the current consensus on good developmental practice. The 2002 GEF review found that capacity building had been one of the most successful aspects of GEF biodiversity projects, which remains a major challenge in many countries with respect to national environmental agencies. In addition, GEF has had political impact by bringing global environmental issues to the attention of national policy makers and informing public opinion, and has assisted countries meet their obligations under the Multilateral Environmental Agreements.

Experience to date on delivering global public goods locally suggests that ideas for interventions that come from multiple sources - global, national, local, community - acting in concert have a better chance of succeeding (World Bank, 2003). This brings out the importance of complementarity in aid delivery. Global instruments can be a powerful vehicle for local and community groups to help them gain access to national institutions and processes. For example, the 2002 GEF review found evidence to show that the GEF biodiversity programme had made significant advances in demonstrating community-based conservation within protected areas and, to a lesser extent, in production landscapes.

One weakness identified in the implementation of GEF projects has been a poor alignment with national systems. Montes (2005) reports that in South Africa significant government administrative resources had to be devoted to ensure alignment. Before 1999 GEF projects were largely driven by GEF implementers, with little integration into national strategies. However, this has changed with all GEF projects in South Africa now having to be included in the 3-year strategic plan of the country's MTEF. Another constraint on widespread country government ownership concerns the power of sectoral ministries to influence across government. In the case of the GEF, ministries of environment continue to lack the authority to influence cross government policy or to persuade ministries of finance.

*Issues emerging from this case-study include:*

- Complementarity of aid delivery can deliver additional benefits, although this can increase the complexity of management for national governments;
- The national budgetary process provides the integrating framework for donor support;
- The GEF offers a mechanism for continuing donor support for long-term capacity building of national environmental agencies.

## **4. Working with budget support and beyond**

### **4.1 Areas requiring attention in the environment sector**

As the previous chapter has shown, the environment is a complex policy domain, at both national and international levels. There is difficulty in defining the boundaries of the concept, in clarifying areas of responsibility (e.g. the roles of various parts of government, the private sector and civil society) and in understanding the institutional set-up of the governance structures. This report suggests several areas that require particular attention:

- With regard to the institutional set-up of the environment sector, the post-Rio period saw the creation of new ministries and/or departments of the environment to act as the focal point for government action on the environment. However, many of these agencies have remained chronically under-resourced and have found it very difficult to play the crucial inter-sectoral role required to address environmental issues.
- Technical and analytical capacity and tools remain weakly developed, and appear to be given lower priority than traditional economic planning tools (e.g. cost-benefit analysis) when it comes to making developmental decisions.
- There is a lack of incentives to address environmental concerns. This is a sensitive policy area as it involves potentially large financial flows that would deliver benefits mostly over the long term. This runs counter to the short-term perspective associated with most political cycles.

Having these challenges in mind the sections that follow discuss how donor agencies, and DFID in particular, can work in a GBS context and what complementary mechanisms and entry points should be used to improve environmental results within its developmental programmes. But before entering into these, we offer some guiding principles regarding the selection of aid instruments.

### **4.2 Selecting aid instruments: core principles, opportunities and risks**

#### *Core principles*

This report suggests as a starting point the consideration of three core principles which should guide the selection process:

- Use, wherever possible, domestic systems and procedures for delivering and managing financial resources. This implies using public financial management systems when providing financial aid to the public sector.
- Avoid policy conditionality which has proved to be ineffective in enforcing policy reform and concentrate instead on the process of policy change.
- Engage in dialogue with all levels of government and non-governmental organisations to strengthen the mechanisms of democratic policy dialogue.

The selection of instruments (or portfolio of instruments) is then determined by the particular country circumstances (at the political, institutional and operational levels) and by an assessment of the opportunities and the risks associated with each modality. These are summarised in general terms in Table 1.

**Table 1. Selecting between aid instrument: opportunities and risks**

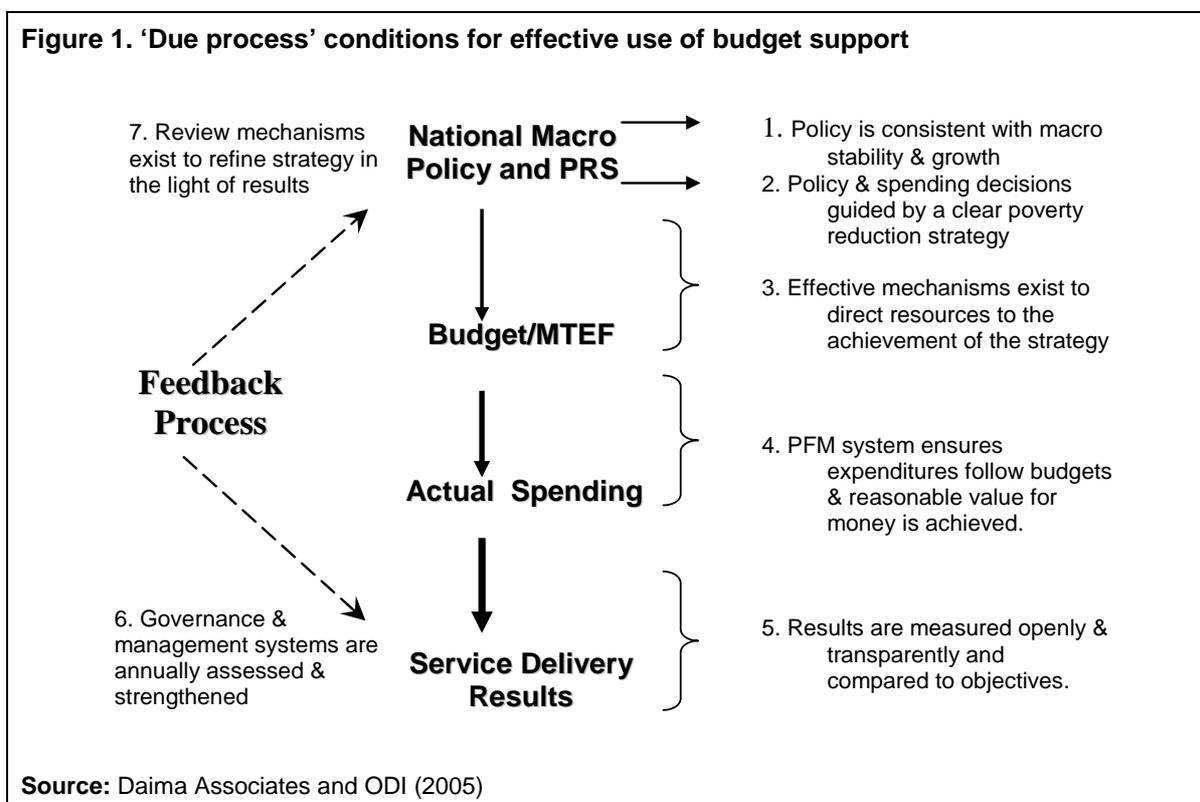
Instrument	When to use it?	What opportunities?	What risks?
General budget support	<ul style="list-style-type: none"> <li>• The objective is to provide discrete financial aid to the government to assist the implementation of the government's policy programme.</li> <li>• Policy and spending decisions are guided by a clear policy strategy (normally a PRS).</li> <li>• Government planning and financial management systems ensure that resources are allocated and used in consistency with policy objectives and with reasonable efficiency.</li> <li>• Monitoring and evaluation mechanisms exist to measure progress and results.</li> <li>• Sufficient checks and balances are in place to meet accountability requirements (to both donors and domestic constituencies).</li> </ul>	<ul style="list-style-type: none"> <li>• Improve ownership of development process by increasing the volume of aid resources subject to the national budget process and parliamentary scrutiny (although it may undermine country ownership by concentrating the policy dialogue at a very central level – around the MoF).</li> <li>• Focus policy dialogue between government and donors on the strategic issues of public policy and economic management.</li> <li>• Increase the level of discretionary funding to the budget – improving the allocative efficiency of public expenditure</li> <li>• Dynamic effect of budget support on public financial management systems</li> <li>• Donor alignment and harmonisation – expected reduction of transaction costs (even in the short term these might increase)</li> </ul>	<ul style="list-style-type: none"> <li>• Threat of withdrawing support with important consequences over public expenditure (for governments).</li> <li>• Unbalanced policy dialogue – donors ganging up against government.</li> <li>• Over-centralised policy dialogue (Ministries of Finance as main policy stakeholder).</li> <li>• Fiduciary risk (for donors).</li> <li>• Donors funding of recurrent government expenditure raises concerns about sustainability.</li> <li>• Undermine incentives to raise domestic revenue.</li> <li>• Technical quality of donor dialogue – donors are likely to loose touch of sectoral and local realities.</li> <li>• <i>Dutch disease</i> (resulting from a substantial increase in foreign exchange which may lead to the appreciation of the exchange rate and competitiveness losses).</li> </ul>
Sector budget support	<ul style="list-style-type: none"> <li>• Same conditions as above hold but sector specific earmarking and sometimes specific reporting procedures are required.</li> </ul>	<ul style="list-style-type: none"> <li>• Provide additional funding to a sector considered under-funded while not undermining the functioning of domestic planning and financial management systems.</li> <li>• Donor influence in sector policy fora.</li> </ul>	<ul style="list-style-type: none"> <li>• Earmarking could be seen as undermining ownership of the resource allocation process.</li> <li>• Earmarking might be offset by government resource allocation process (fungibility).</li> <li>• Transaction costs with additional sector specific conditions and reporting procedures, where these are required.</li> </ul>

Instrument	When to use it?	What opportunities?	What risks?
Common basket fund	<ul style="list-style-type: none"> <li>• Same reasons for using projects (see below) with the added advantage of pooling donor resources and hence potentially reducing transaction costs and improving allocative efficiency of donor resources.</li> </ul>	<ul style="list-style-type: none"> <li>• Offer advantages in relation to project support both in terms of donor coordination and alignment with government policies and expenditure programming systems.</li> <li>• Reduces transaction costs (in relation to project modalities) by introducing common reporting, disbursement, accounting and procurement procedures for activities which would otherwise be funded through a number of discrete projects.</li> <li>• May provide a useful 'learning ground' for building confidence between government and donors and hence facilitate the move towards budget support and the use of government procedures.</li> </ul>	<ul style="list-style-type: none"> <li>• A transitional arrangement that might become a permanent one.</li> <li>• Undermines GBS potential effects on budget coverage, transparency and allocative and technical efficiency.</li> <li>• Experience shows that the establishment of pooled funds is highly demanding of government time and very costly in terms of technical assistance and preparatory costs.</li> </ul>
Project support	<ul style="list-style-type: none"> <li>• Technical assistance support, where very specific earmarking is required and where specific procurement rules to recruit advisers might be needed,</li> <li>• Large scale infrastructure investments, where the transaction costs for managing procurement through the PFM system might be too high.</li> <li>• Piloting projects, where particular service delivery innovations need to be tested before their mainstreaming by government.</li> <li>• <i>Ad hoc</i> response to a narrowly specified, perhaps transitory need – such as change management processes.</li> <li>• Support to entities outside the government (i.e. civil society , private sector).</li> </ul>	<ul style="list-style-type: none"> <li>• Better targeting of specific groups and regions.</li> <li>• Keep issues on the agenda.</li> <li>• Retain connections with local realities.</li> <li>• Explore comparative advantages of donor or other intermediary agencies in the management of resources (particularly in large scale one-off investments).</li> </ul>	<ul style="list-style-type: none"> <li>• Poor ownership by domestic agencies.</li> <li>• Undermines comprehensiveness and allocative efficiency of the State Budget.</li> <li>• Undermines the domestic structures of democratic accountability.</li> <li>• High transaction costs resulting from fragmentation of development interventions.</li> <li>• Inefficiency in spending – when for example procurement is tied to donor countries' own contractors.</li> </ul>

## General Budget Support and Sector Budget Support

GBS should, in principle and as long as certain base conditions apply, be the default mechanism for delivering financial aid to the government since it is considered to be the most adequate instrument to strengthen domestic ownership of the policy process and the structures of domestic accountability. But, what are these base conditions? Daima Associates and ODI (2005) suggest seven 'base level' or 'due process' conditions for the effective use of GBS. They relate to the performance of policy formulation and implementation systems, particularly the PFM and accountability mechanisms (Figure 1). The usefulness of using these process or systems-related conditions relates to the fact that, unlike specific policy interventions, these do not change significantly from year to year. They are about systems and processes for policy design and implementation rather than the actual policies *per se*. Hence, the rationale is to draw a conceptual separation between policy content and policy process conditions when assessing eligibility for budget support. By doing this not only the principle of domestic ownership is reinforced but also the volatility of budget support flows is mitigated.

Yet, in practice, many of the 'due process' conditions do not hold, or at least not entirely. Also, it is difficult to provide an objective assessment about the extent to which they are verified because the means of verification are frequently insufficient. For example, assessing whether condition 2 in Figure 1 holds is constrained by the fact that often the linkage between priority interventions set in PRSPs and resource allocation decisions established in State Budgets, as well as in expenditure execution, is not clear (Holmes and Evans, 2003; GTZ, 2005). This is because the budget usually does not provide detailed information on resource consumption by activities or policy objectives (which would allow a direct comparison with poverty reduction policy interventions).



Therefore, either because these 'due process' conditions do not hold or because donors can not be sure about the extent to which they hold, the use of GBS is contained, at least as a short-term solution. However, even in cases where these 'due process' conditions do not

hold completely, GBS should still be considered as one of the mechanisms for providing development assistance to governments. The rationale for this is that there are threshold effects generated by GBS – i.e. a significant increase in the level of discretionary funds flowing through the public financial management system contributes in itself to the improvement of the resource allocation, management and accountability mechanisms (Daima Associates and ODI, 2005; IDD and Associates, 2006).

The use of SBS is determined by the same due process conditions. The choice of SBS results from a decision to target specific sectors because additional funding is thought to be required (in relation to government resource allocation decisions) or because donors want to retain some degree of influence in sectoral fora. Both of these are arguments could be applied to supporting environmental actions. Since SBS funds flow through the domestic PFM system, the same advantages of GBS apply. There is however, the risk that the sector specific earmarking and conditionality may constitute a threat to domestic ownership and accountability procedures and may raise the costs with managing and reporting on the use of funds.

### *Project support*

Looking at the other end of the spectrum, when is the decision for a project modality justified? There are cases where the nature of the assistance requires specific arrangements to be put in place for delivering aid outside the domestic planning and financial management systems. Daima Associates and ODI (2005) provided the following examples:

- Within the public sector, projects may be appropriate for mutually agreed activities where a development partner is better placed - technically or administratively - to manage the project on behalf of government, for example:
  - technical assistance support, where very specific earmarking is required and where specific procurement rules to recruit advisers might be needed,
  - large scale infrastructure investments, where the transaction costs for managing procurement through the PFM system might be too high, and
  - piloting projects, where particular service delivery innovations need to be tested before their mainstreaming by government – such as new approaches to agricultural extension, road safety or teaching science.
- Within the public sector, projects may also be appropriate as an *ad hoc* response to a narrowly specified, perhaps transitory need – such as change management processes associated with government reform, emergency relief interventions, etc.
- Projects are also likely to be the best form of support to entities outside of the public sector, such as NGOs and private sector associations, to undertake actions which would not normally be financed by government.

Where projects modalities are used there are certain operating conditions which should be verified. The EC (2003) suggests five important areas for consideration. First, and foremost, is the need to ensure that the project is consistent with sector policy objectives. Second, project implementation should rely as far as possible on the use of government structures. Third, project planning should take into account other expenditures within the sector by government and other donors, so as to maximise complementarities wherever possible and minimise future recurrent cost implications. Fourthly, it is necessary for government to be provided with full information on project budgets and expenditures, ideally in the same format and timetable utilised for reporting on government expenditures. Finally, transaction costs should be minimised through co-ordination with government and other donors and, if appropriate, through co-financing of projects.

### *Common Basket Funding*

And when is the intermediary category of CBF an appropriate modality? CBF may be best used where it is seen as a transitional arrangement from discrete projects to the use of budget support. The underlying rationale is that so long as there are doubts over the quality of the PFM system a CBF can permit tighter financial supervision by donors, whilst offering advantages over discrete projects. This argument would seem to be valid in a weak PFM environment where GBS is not being provided, or being provided only on a small scale.

### *Opportunities, risks and sequencing*

In the real world, the selection of instruments is not straightforward. There are important trade-offs to take into account, related to the various opportunities and risks associated with each aid instrument. Finding solutions to these dilemmas will depend on conducting analysis of the advantages and disadvantages of using each instrument in the specific context, whilst being aware of the core principles which should guide selection. The aid effectiveness agenda should be interpreted as setting the direction for improvements in the effectiveness of aid rather than implying a sudden switch to the aid modalities that are thought to better incorporate the principles set out in the Paris Declaration. Donors have therefore to take strategic decisions on how to deliver aid in a way that developmental objectives are addressed but also ensuring that domestic policy processes are not undermined on the way.

### **4.3 Opportunities and limitations of budget support for environmental actions**

Although GBS is not the dominant aid modality – it represents between 4 and 31 percent of total ODA in the seven countries reviewed by IDD and Associates (2006) – there has been a significant shift in development policy towards aid modalities that are thought to strengthen domestic ownership and accountability. This shift has involved moving away from policy-related conditionality and improving donor harmonisation and alignment with domestic planning and financial management systems and procedures. So how should environment policy advisers and practitioners work in a context where GBS is increasingly seen as the preferred modality for delivering assistance?

### *Understanding what GBS can and cannot do*

First of all, it is important that the potential contribution and limitations of GBS are well understood. As the recent evaluation studies on GBS indicate, the instrument is effective as a way of increasing discretionary funding to the public sector to support implementation of a government's national policy strategy (normally the poverty reduction strategy). It has also contributed to improving the comprehensiveness and transparency of public financial management and the institutional relationship between line ministries and the ministry of finance in the budgetary process. GBS cannot, however, be expected to be a means for driving policy change. GBS is a mechanism for funding, through the State Budget, an approved policy strategy (where certain policy priorities, actions and targets are established). It is not a mechanism for enforcing policy change where domestic support for change is lacking – as has been attempted through some Performance Assessment Frameworks (PAFs). However, PAFs have been useful as a signalling device to identify important reforms within the government programme and to support their efficient implementation.

### *Avoiding policy conditionality*

There is compelling evidence that policy conditionality has been largely ineffective in enforcing policy reforms. Domestic political considerations are the main determinant of the direction and pace of reform. Hence, linking policy-related conditions to GBS (including those related to environment policy) is likely to be ineffective and threaten not only domestic ownership but also the predictability of GBS flows. Process conditions, related to the quality and performance of the policy formulation, implementation and accountability systems, are now being proposed as a more credible way of assessing eligibility for GBS. Such process conditions are clearly important when it comes to the development of national environmental policies. Evidence also shows that having a complex conditionality framework (or PAF) attached to development assistance increases transaction costs and is unhelpful in keeping the focus on government priority reforms.

### *Exploring opportunities under GBS*

Although it does not provide the space for a specialist environmental focus, GBS offers a high level platform for policy dialogue at the core of the government policy process. This can be explored to assist the much needed cross-sectoral visibility of environmental issues and the coordination of approaches across donor and government stakeholders. Given the prominent role played by Ministries of Finance and macroeconomists, the GBS framework constitutes an important entry point for a debate on environmental fiscal reform. It also creates an opening to mainstream the notion of environment as a development and growth opportunity (particularly in countries rich in natural capital) rather than a risk to be mitigated.

Another opportunity to be explored is the potential of Sector Working Groups (SWG). This policy dialogue forum has gained new impetus in the context of GBS and the harmonisation and alignment agenda. There are already examples of environment-specific SWG in operation. Despite the reported difficulties with their functioning, they constitute a potentially important forum for inter-sectoral and multi-stakeholder coordination.

### *Risks and challenges posed by GBS*

Despite the opportunities, GBS presents very concrete risks for those policy areas which are not high on the policy and political agendas of both recipient governments and donors, as it is often the case with the environment. Furthermore, if environment-related departments are in a weak bargaining position within the government resource allocation process they are unlikely to benefit from the GBS flows.

Donors working under GBS risk losing touch with other levels of government and with sector specific realities. Donor harmonization, a critical element of GBS, requires improved understanding across diverse institutional cultures, particularly between the Bretton Woods Institutions and bilateral agencies.

GBS also presents new challenges for donor due diligence. Risks are likely to increase, or at least become more uncertain, as the linkages between policy reform and environmental outcomes under GBS are known to be highly variable and difficult to attribute. Environmental screening – and due diligence procedures more generally – carried out by donors with respect to project interventions need to be reviewed with the move to GBS. Despite the increasing emphasis on national ownership, donors will continue to have responsibilities (particularly to their own country constituencies) to ensure that environmental due diligence is carried out.

#### **4.4 Other mechanisms for supporting the environment**

Despite the advantages and opportunities offered by GBS, this instrument is likely to be insufficient to address the specific challenges posed by the environment, which tends to be in a unfavourable position both in terms of political interest and in financial and technical capabilities. Since the environment is universally considered a critical component of sustainable development (e.g. MDG 7), what other channels and instruments could be used to ensure that the main challenges are addressed? This report suggests interventions at five levels: (i) assisting the clarification of the mandates and institutional structures governing the environment; (ii) promoting multi-stakeholder policy debate; (iii) building strategic thinking and analytical capacity of environmental agencies; (iv) generating the required political incentives for achieving better environmental outcomes; and (v) strengthening international environment processes. Some of these may require sector specific earmarking and working outside government.

##### *Assisting the clarification of mandates and institutional structures of the environment*

The cross-cutting nature of the environment makes the governance of the sector very challenging, particularly when the coordination agency has limited political leverage and convening power. There is often a need to clarify institutional mandates and structures. One key requirement is to ensure that the legal authority for environmental regulation is clearly established. The overlapping remits for environmental management between different government agencies, with no clear separation of responsibility, need to be resolved. Following on from this, the institutional landscape in each country needs to be well understood by donor agencies. The key entry points into environmental policy-making and implementation need to be known so that donors can select the best modalities for working through them. Supporting the implementation of Public Environmental Expenditure Reviews (PEERs) can help, as they provide the necessary tools for analysing in detail the sources and destinations of environmental financial resources. The use of technical cooperation and specific earmarked funding are possible ways of supporting these exercises.

##### *Supporting the creation/operation of multi-stakeholder policy dialogue fora*

Sector working groups, as already mentioned, can bring together relevant stakeholders into the policy debate. They can provide opportunities for improving inter-sectoral coordination but require incentives for their effective operation. One challenge facing the successful functioning of such groups lies with securing the required political engagement to ensure policy influence. Again, the use of technical cooperation and specific earmarked funding are possible ways of assisting the functioning of these fora.

##### *Supporting strategic thinking and analytical capacity of environmental entities*

Government entities dealing with environmental issues need to be empowered. These include not only the core environmental agencies but also environment-related departments in sectors where environment opportunities and threats are significant (such as ministries of natural resources, agriculture, mining, civil works, industry and health). This should involve strengthening their capacity for designing the necessary policy interventions (including their contributions into the formulation of PRSPs and national policy plans/strategies in the relevant sectors) and their bargaining capacity in negotiating the allocation of public resources (in MTEFs and State Budgets).

Part of this capacity strengthening process is about improving the analytical competence of environmental policy-makers, advisors and practitioners. Technical cooperation is an important form of assistance that complements budgetary support, as this can be used to support the development of analytical capacity and inter-sectoral policy coordination. At

present, there is some uncertainty over the optimal mode for funding such support. In Tanzania, discussions appear to have focused initially on pooled funding arrangements with one part of government. Yet, in principle there is no barrier to the government allocating the necessary funds under budget support arrangements. Capacity building may also be supported through global funds, such as the GEF.

There is also the need to support tools that assess the environmental opportunities of proposed development. Such tools need to be able to convey a positive narrative, highlighting the opportunities to be gained from investment in the environment. Strategic environmental analysis (SEA) is considered the most appropriate instrument to get environment into strategic decision making successfully. Donors can support its development not only by advancing understanding of the technical elements of this type of analysis but also by encouraging transparency, access to information, public participation and accountability (as happened in the SEA of Ghana's PRS).

#### *Building the demand for better environment policies*

In addition to measures on the supply side of environment policy, there is also significant scope for strengthening the demand for better environment policies. There is already capacity in many countries within civil society to address environmental issues, but this remains dependent – to a lesser or greater extent – on external funding. Continuing project support may be warranted to support such groups, although increasingly this needs to be managed through some form of pooled arrangement within country in order to build national ownership. Other stakeholders that can influence environmental policy should not be forgotten, in particular parliamentarians and cross-party parliamentary committees that have a remit for the oversight of government actions.

The voice of all environment stakeholders needs to be heard. This includes the urban and rural poor. Poverty and Social Impact Assessments (PSIAs) and Participatory Poverty Assessments (PPAs) are methods of articulating their voice. These methods need to be strengthened to ensure that the environmental concerns of the poor are taken up by national policy processes. As part of this, they need to adopt approaches that acknowledge the complexities that arise from the often weak tenurial claims held by the poor over environmental assets. Donor research funding may be the most appropriate instrument to support such methodological advances.

#### *Lobbying at the international level*

Many countries continue to be placed in a disadvantaged position in international processes due to a lack of capacity and knowledge on how to operate within such fora to advance their national positions. This applies with regard the main multilateral environment agreements (e.g. the Convention on Biological Diversity, the Convention to Combat Desertification, and the Framework Convention on Climate Change) as well as more specific initiatives, e.g. the UK's Extractive Industries Transparency Initiative. Continuing project type of support may be an appropriate measure for donors to support the strengthening of national representations from developing countries in these processes.

## 5. Further enquiry

The scope of this study has been limited by the amount of time available for research. Several important issues were not analysed but remain important areas of enquiry. Three topics, in particular, warrant further research.

*Defining the nature of the 'environmental problem' at the national level.*

The national context is the predominant factor in determining the most effective way of donor support to environmental reform. Further studies are required to help determine the nature of national environmental problems, to describe instances of positive reform and to identify possible entry points for donors to raise environmental concerns. Constraints may lie within a poorly defined regulatory framework; a lack of capacity to implement environmental programmes; or a lack of funding. Most often, all these factors will contribute in some way, so there is a need to identify the 'tipping factor', where a combination of reform efforts leads to sustainable improvements. A review of successful experiences of major environmental policy changes would allow the main drivers of such changes to be identified and whether donor funding facilitated such change or not.

*Sector Working Groups: what are the opportunities and limitations in promoting multi-stakeholder policy dialogue?*

Sector Working Groups (SWG) are often suggested as a mechanism for fostering multi-stakeholder policy dialogue and coordination. Several countries (with Uganda, Tanzania, Mozambique and Ghana in the vanguard within Sub-Saharan Africa, but Nicaragua and Vietnam also at a more international level) now have active SWG structures involving a wide range of civil society organisation, private sector entities and development partners. But is there evidence that SWG have actually secured the required political engagement to ensure policy influence? Further research to investigate the experience with SWGs and the opportunities and limitations presented by this policy dialogue forum is called for. In doing this, it would be interesting to explore the extent to which SWGs could be used a means for donor agencies to engage with the national policy debate (and influence policy change) regardless of the type and level of funding provided.

*Donor in-house capacity: what are the implications in relation to the new challenges regarding policy dialogue and influence?*

As donors de-link from the implementation level of project interventions, a different set of skills are required to advance environmental reform. There is evidence that environmental issues are becoming part of the portfolio of generalist staff within embassies or donor offices in country. The question is then whether these staff are sufficiently empowered through existing environmental guidelines and expert advice from specialists in headquarters to play a successful role in influencing national reform efforts. Further research to investigate the different ways of working between donors, to identify examples of best practice, would help to identify capacity needs under the new aid modalities. This should include further country studies to examine examples of successful 'influencing strategies' and to analyse why these have been successful.

## References

Batley, R., Bjørnstad, L. and Cumbi, A. 2006. Joint Evaluation of General Budget Support, 1994-2004 – Mozambique Country Report, International Development Department. The World Bank, DC.

Bojö, J., Green, K., Kishore, S., Pilapitiya, S., Chandra Reddy, R. 2004. Environment in Poverty Reduction Strategies and Poverty Reduction Support Credits. The World Bank Environment Department. Paper no. 102. The World Bank, Washington DC.

CIDA. 2004. A Direct Budget Support Pilot for Poverty Reduction in Mozambique. Project Approval Documentation.

Daima Associates Ltd. and ODI. 2005. Joint evaluation of general budget support. Tanzania 1995 -2004. Revised final report. Report to the Government of Tanzania and to the poverty reduction budget support development partners. Dar es Salaam and London.

DEG 2006. Eliminating world poverty: for people and planet. Submission Two. An Evidence Based Analysis (in further support of submission one). For the DFID White Paper Consultation Process. Development and Environment Group (DEG) of British Overseas NGOs for Development (BOND). Accessed at: [http://www.bond.org.uk/pubs/groups/deg\\_dfidwp\\_evidencebasedreport\\_apr06.doc](http://www.bond.org.uk/pubs/groups/deg_dfidwp_evidencebasedreport_apr06.doc)

DFID. 2005b. Statistics on International Development 2005. DFID, London.

DFID. 2006c. DFID Technical Cooperation for Poverty Environment Mainstreaming in Tanzania – a Case-Study. DFID, London.

EC. 2003. Guidelines for European Commission Support to Sector Programmes. February 2003 – Version 1.0. Brussels: European Commission.

Global Environment Facility. 2002. The first decade of the GEF. Second overall performance Study. GEF, Washington, DC.

GTZ. 2005. Making Poverty Reduction Strategies Work – Good Practices, Issues, and Stakeholder Views. Study commissioned by the GTZ Poverty Reduction Mainstreaming Project on behalf of the German Federal Ministry for Economic Cooperation and Development.

Gueorguieva, A. and Bolt, K. 2003. A Critical Review of the Literature on Structural Adjustment and the Environment. Paper No. 90, Environmental Economics Series. Environment Department, The World Bank, Washington DC.

Holmes, M. and Evans, A. 2003. A Review of Experience in Implementing Medium Term Expenditure Frameworks in a PRSP Context: A Synthesis of Eight Country Studies. London: Centre for Aid and Public Expenditure, Overseas Development Institute.

IID and Associates. 2006. Evaluation of general budget support: synthesis report. Joint evaluation of general budget support 1994 – 2004. Burkina Faso, Malawi, Mozambique, Nicaragua, Rwanda, Uganda, Vietnam. University of Birmingham, UK.

Killick, T. 1998. *Aid and the Political Economy of Policy Change*. London and New York: Routledge.

Killick, T. 2004. Politics, Evidence and the New Aid Agenda. *Development Policy Review*, 22 (1). London: ODI.

Lawson, A. and D. Booth. 2004. Evaluation of General Budget Support: Evaluation Framework. Report to the Management Group for the Joint Evaluation of General Budget Support. Overseas Development Institute and Oxford Policy Management.

Millennium Ecosystem Assessment. 2005. Ecosystems and Human Well-being: Synthesis. Island Press, Washington, DC

Montes, C. 2005. Review of global programmes. DevStrategies, Cambridge, UK.

OECD/DAC. 2005. Harmonising Donor Practices for Effective Aid Delivery. Volume 2. OECD, Paris.

Swanson, P. and Lunde, L. 2003. Public environmental expenditure reviews (PEERs); experience and emerging practice. Environmental Strategy papers no. 7. The World Bank, Washington DC.

Waldman, L., with Barrance, A., Benitz Ramos, R.F., Gadzekpo, A., Mugenyi, O., Nguyen, Q., Tumushabe, G., Stewart, H. 2005. Environment, politics, and poverty: lessons from a review of PRSP stakeholder perspectives. IDS, UK.

World Bank. 2003. Delivering Global Public Goods locally: lessons learned and successful approaches. The World Bank, Washington, DC.

World Bank. 2004b. First Programmatic Environment Structural Adjustment Loan - Simplified Implementation Completion Report, Report No. 29259, Mexico and Colombia Country Management Unit, Latin America and the Caribbean Region, World Bank.

World Bank. 2006a. Where is the wealth of nations? Measuring capital from the 21st century. The World Bank, Washington, DC.

## **Other papers reviewed in preparing this report**

Bojö, J., and Reddy, R.C. 2003. Status and Evolution of Environmental Priorities in the Poverty Reduction Strategies. The World Bank, Washington DC.

DAC. 2006. Budget Support, Sector Wide Approaches and Capacity Development in Public Financial Management. DAC Guidelines and Reference Series on Harmonising Donor Practices for Effective Aid Delivery, Volume 2. OECD.

DFID. 2004. Poverty Reduction Budget Support – a DFID policy paper. London: DFID.

DFID. 2005a. *Partnerships for poverty reduction: rethinking conditionality - a UK policy paper*. Department for International Development, Foreign and Commonwealth Office and HM Treasury.

DFID. 2006a. DFID's approach to the environment. DFID, London.

DFID. 2006b. Guidance on aid instruments. DFID, London.

DGIS. 2006. Mainstreaming Environment and Mainstreaming Water in Dutch Development Policy and Practice: Discussion Paper. DGIS, The Netherlands.

Economic Commission for Africa. 2005. Review of the application of environmental impact assessment in selected African countries. ECA, Addis Ababa.

Foster, M. and Fozzard, A. 2000. Aid and Public Expenditure: A Guide. ODI Working Paper 141. ODI, London.

Foster, M. and Leavy, J. 2001. The choice of financial aid instruments. ODI Working paper 158. ODI, London.

Flint, M., Balogun, P., Gordon, A., Hoare, R., Smith, D., Voysey, B., Ziegler, A.. 2000. Environmental Evaluation Synthesis Study. Environment: Mainstreamed or Sidelined? Main Report. Volume I. Evaluation report EV626, DFID, London.

ODI. 2003. Choice of Aid Modalities. Key Sheets For Sustainable Livelihoods, No. 19. London: ODI.

OECD/DAC. 2006. Good practice guidance on applying strategic environmental assessment (SEA) in development co-operation. Final Draft. OECD/DAC Environet Task Team, OECD, Paris.

World Bank. 2004a. Good practice note on environment and natural resource aspects of development policy learning. The World Bank, Washington, DC.

World Bank. 2005a Environmental fiscal reform. What should be done and how to achieve it. The World Bank, Washington, DC.

World Bank. 2005b Development Policy Lending and Forest Outcomes. Influences, interactions, and due diligence. World Bank Report No. 33537-GLB. The World Bank, Washington, DC.

World Bank. 2006b. Implementation of environment and natural aspects in development policy lending: first year review. The World Bank, Washington, DC.

## Annex 1. Aid instruments: definitions and typologies

Aid instruments, or modalities, are the mechanisms used to deliver international aid.<sup>10</sup> There is a wide spectrum of instruments in use, ranging from financial transfers to the government with no conditions attached through to very restrictive forms of donor managed assistance. Different aid instruments can be distinguished according to a set of specifications, which include the following:<sup>11</sup>

- **Recipient:** whether it is the government (ministry of finance, line ministry, local government agencies), NGOs, the private sector or specific individual beneficiaries;
- **Conditionality:** measures the recipient agrees to implement in exchange for assistance. These can be macroeconomic or structural conditions, sector policy conditions or project specific conditions. There is also an increasing move towards 'process conditionality', where conditions are linked to the policy-making process rather than the content of policy reforms *per se*;
- **Earmarking:** limitations placed on how aid can be used. There are different degrees of earmarking ranging from general forms such as earmarking to poverty reduction priority sectors to very restricted forms such as the acquisition of technical assistance to conduct environmental screening. The effectiveness of earmarking of aid depends on what happens to government spending;
- **Financial management procedures:** the rules and procedures governing the disbursement, management and recording of aid. This is usually assessed in relation to the government's public financial management (PFM) systems. Hence, aid can be managed according to the PFM rules and procedures (or at least some of these) or it can be managed through parallel systems.<sup>12</sup>

The combination of these parameters gives rise to a complex taxonomy of aid instruments. Pure forms are rare and in practice what is normally found are hybrid arrangements that result from the mix of variations to the above specifications. In this report we focus almost exclusively on forms of government to government assistance and discuss the selection of aid instruments by considering the different available options in terms of conditionality, earmarking and financial management procedures used.

There are four broad types of financial aid instruments currently in use:

- **General budget support (GBS)** – financial assistance is provided to the government's budget with no specific earmarking, and can be used to increase spending, reduce borrowing or reduce taxes. Funding is disbursed into the government accounts and used and managed according to the national PFM rules and procedures. Conditionality is centred on country-wide policy strategies and increasingly focuses on policy processes rather than on specific policy outcomes.

---

<sup>10</sup> The terms instrument and modality are used interchangeably throughout this report.

<sup>11</sup> Although not discussed by this study, other important specifications include: the pecuniary nature of aid (whether it involved the delivery of financial resources or assistance in kind, such as food aid, knowledge and dialogue), and repayment obligations (whether assistance is provided in the form of loan, with repayment obligations, or a grant with no repayment obligations).

<sup>12</sup> The PFM system consists of the structures and procedures by which governments raise revenues and plan, allocate, use and account for public funds. PFM is a key component of public sector governance, and its performance an important determinant of the effectiveness of public policies and efficiency in the use of public funds. A PFM system usually consists of five subsystems – although this may vary from country to country: (i) revenue collection, (ii) expenditure planning and budgeting, (iii) treasury, (iv) accounting and (v) auditing. Different aid instruments relate differently to the various PFM subsystems and their operational rules and procedures.

- **Sector budget support (SBS)** – this is a variation on the above modality, with the difference being that assistance is provided with sector specific conditions and sector earmarking. Hence, funds are channelled to finance an agreed expenditure plan for a sector and disbursed and accounted for through government systems, sometimes with additional sector specific reporting. There is usually a requirement to demonstrate additionality in the level of sector spending (EC, 2003).
- **Common basket funding or common pool funding (CBF)** – this is a form of funding used when specific earmarking within a sector’s programme and expenditure plan is required because the donor(s) limits aid to specific expenditure categories within the sector. CBF can be used to fund a multi-sectoral, sectoral or sub-sectoral programme/project. The difference with the above forms of budget support is that there is earmarking to a specific policy domain and there are specific financial management procedures.<sup>13</sup>
- **Project support** – this modality provides specific earmarking of expenditures to a set of agreed activities. Project aid can use government or parallel (sometimes donor managed) project-specific financial management systems. Although funds may be registered in the budget, project support is usually managed through project specific management units, with separate rules and procedures (sitting inside or outside government structures). Technical assistance can be seen as a form of project support, where advisory or training support is provided either directly in kind or the funds are provided to be used in the acquisition of technical assistance.

There are slight differences in taxonomy across donor agencies with regards to these broad types. DFID, for example, uses the term Poverty Reduction Budget Support (PRBS) to refer to both GBS and SBS. The World Bank, on the other hand, has a very specific modality for providing GBS to the government – the Poverty Reduction Support Credit (PRSC).<sup>14</sup> The European Commission distinguishes between targeted (earmarked) and non-targeted SBS. It also distinguishes CBFs according to three criteria: (a) whether they are managed by government or by donors; (b) whether they finance the whole sector programme of specific activities or expenditure items; and (c) whether they use the government accounting and reporting systems, donor specific or custom-design procedures (EC, 2003). The concept of aid instrument has also been expanding. DFID, for example, now considers “policy engagement” or “policy dialogue” to be a non-financial form of assistance.

---

<sup>13</sup> Sector budget support can be seen as a form of basket funding to the sector, where funds are managed through the government’s PFM system.

<sup>14</sup> PRSCs are a form of programmatic lending to the government to support the implementation of the country’s poverty reduction strategy and the associated program of social, structural, institutional, and policy reforms. It has specific conditions attached in the form of ‘prior actions’ and ‘benchmarks’ which are written into the programme’s specific performance assessment mechanism and are expected to be undertaken prior to the PRSC loan release.

## Annex 2. List of people interviewed

Name	Designation
Helen O'Connor	Environment Adviser, DFID
Peter Colenso	Aid effectiveness team, DFID
Zoe Stephenson	Social Development Adviser, DFID
Anna Balance	DFID
Jon Hobbs	Environment Adviser, DFID
Sean Doolan	Environment Adviser, DFID
Tessa MacArthur	DFID
David Smith	UNEP
Ian Myles	CIDA
Tara Shine	Irish Aid
Alexandra Wachtmeister	SIDA
Anna Holmryd	SIDA
Hans Hessel-Anderson	DANIDA - Mozambique
Steve Bass	IIED

### Annex 3. DFID bilateral spending in 2004/05<sup>15</sup>

Total DFID Bilateral Aid by Recipient Country (2004/05) where country spend exceeds £1 million											
								£ thousand			
Financial Aid											
	Poverty Reduction Budget Support		Other Financial Aid	Technical Cooperation	Grants and Other Aid in Kind	Humanitarian Assistance	DFID Debt Relief	Total DFID Bilateral Programme <sup>2</sup>	n	%	
		%									
<b>Africa</b>											
Tanzania	65 537	68	17 783	2 846	7 531	2 817	-	96 514			
Ethiopia	45 000	72	1 151	2 603	6 890	6 719	-	62 364			
Mozambique	35 839	75	5 068	2 167	4 837	28	-	47 940			
Ghana	35 000	49	23 741	6 439	6 136	-	556	71 872			
Uganda	35 000	57	612	7 512	6 479	11 851	-	61 454			
Rwanda	34 250	81	514	4 126	3 579	13	-	42 482			
Malawi	15 000	27	10 384	8 689	17 636	4 573	-	56 282			
Zambia	13 198	43	7 523	4 675	3 921	398	872	30 585			
Sierra Leone	12 000	44	1 408	6 761	6 309	800	-	27 279			
								496 772	9	61	
Sudan	-		74	132	6 049	77 709	-	83 964			
Nigeria	-		763	33 598	12 478	393	-	47 232			
Kenya	-		3 344	10 787	15 541	5 516	-	35 188			
South Africa	-		-	12 644	18 065	13	-	30 723			
Congo (Dem Rep)	-		576	149	6 329	22 230	-	29 284			
Zimbabwe	-		2 620	506	8 975	13 753	-	25 854			
St Helena & Dependencies	-		10 903	3 538	-	40	-	14 481			
Liberia	-		-	51	2 155	6 249	-	8 455			
Madagascar	-		7 113	-	398	200	-	7 712			
Angola	-		-	78	3 660	2 137	-	5 874			
Burundi	-		-	5	211	5 395	-	5 612			
Somalia	-		14	-	2 263	3 043	-	5 320			
Lesotho	-		201	2 114	1 207	-	-	3 522			
Egypt	-		-	2 756	44	-	406	3 206			
Niger	-		2 973	-	95	-	-	3 068			
Chad	-		-	-	-	2 000	-	2 000			
Cameroon	-		198	284	1 506	-	-	1 988			
Eritrea	-		-	-	245	1 065	-	1 310			
Namibia	-		-	580	622	-	-	1 201	19	39	
<b>Total</b>	<b>290 824</b>		<b>96 963</b>	<b>113 040</b>	<b>143 161</b>	<b>166 942</b>	<b>1 834</b>	<b>812 766</b>	<b>28</b>	<b>100</b>	
Per cent	36		12	14	17	21	0	100			
<b>Asia</b>											
India	71 260	27	109 478	16 430	61 843	442	-	259 452			
Bangladesh	29 800	23	9 512	25 856	37 690	25 038	-	127 896			
Vietnam	20 000	49	5 544	3 236	11 574	71	-	40 425			
Pakistan	7 500	24	216	6 904	16 619	140	-	31 378			
Nepal	2 107	6	1 111	8 970	18 057	4 840	-	35 085			
								494 236	5	66	
Afghanistan	-		55 109	2 384	15 029	7 067	-	79 589			
Iraq	-		892	16 622	10 209	21 383	-	49 107			
China	-		12 287	6 729	16 859	-	-	35 876			
Indonesia	-		7 778	2 859	12 219	2 110	-	24 966			
West Bank & Gaza	-		575	5 437	9 753	1 800	-	17 565			
Cambodia	-		60	993	8 900	-	-	9 954			
Sri Lanka	-		6	955	5 346	250	-	6 558			
Burma	-		3	120	4 879	1 005	-	6 007			
Yemen	-		104	778	4 422	7	-	5 312			
Jordan	-		123	3 160	287	-	1 734	5 305			
East Timor	-		-	89	4 424	-	-	4 512			
Kyrgyzstan	-		-	3 852	635	-	-	4 487			
Philippines	-		945	22	345	309	-	1 621			
Tajikistan	-		-	462	873	24	-	1 359			
Iran	-		-	-	-	1 202	-	1 202	15	34	
<b>Total</b>	<b>130 667</b>		<b>203 743</b>	<b>105 858</b>	<b>239 963</b>	<b>65 688</b>	<b>1 734</b>	<b>747 656</b>	<b>20</b>	<b>100</b>	
Per cent	18		27	14	32	9	0	100			

<sup>15</sup> DFID. 2005b. Statistics on International Development 2005. DFID, London. Available at:

<http://www2.dfid.gov.uk/pubs/files/sid2005/contents.asp>

Total DFID Bilateral Aid by Recipient Country (2004/05) where country spend exceeds £1 million											
								£ thousand			
Financial Aid											
	Poverty Reduction Budget Support		Other Financial Aid	Technical Cooperation	Grants and Other Aid in Kind	Humanitarian Assistance	DFID Debt Relief	Total DFID Bilateral Programme <sup>2</sup>	n	%	
		%									
<b>Americas</b>											
Bolivia	1 250	23	1 053	1 709	1 390	-	-	5 402			
								5 402	1	9	
Montserrat	-		12 539	1 402	66	144	-	14 151			
Guyana	-		2 552	1 190	497	497	4 036	8 771			
Jamaica	-		1 342	1 115	292	-	3 672	6 421			
Grenada	-		5 502	434	7	-	56	5 998			
Brazil	-		-	3 554	1 474	-	-	5 028			
Peru	-		-	1 022	2 452	- 1	518	3 990			
Haiti	-		-	-	114	1 913	-	2 027			
Nicaragua	-		232	243	1 300	-	-	1 775			
Belize	-		23	15	146	-	1 458	1 642			
Anguilla	-		-	1 078	112	-	-	1 216			
Turks and Caicos	-		196	878	-	-	113	1 187			
Dominica	-		-	401	145	-	541	1 087	12	91	
<b>Total</b>	<b>1 250</b>		<b>23 439</b>	<b>13 041</b>	<b>7 995</b>	<b>2 553</b>	<b>10 394</b>	<b>58 672</b>	<b>13</b>	<b>100</b>	
<b>Per cent</b>	<b>2</b>		<b>40</b>	<b>22</b>	<b>14</b>	<b>4</b>	<b>18</b>	<b>100</b>			
<b>Europe</b>											
Moldova	200	8	177	1 284	830	81	-	2 571			
								2 571	1	5	
Russian Federation	-		-	10 758	3 002	1 374	-	15 133			
Ukraine	-		-	5 270	443	400	-	6 113			
Serbia & Montenegro	-		-	4 032	1 451	-	-	5 483			
Bosnia-Herzegovina	-		-	4 545	679	-	-	5 224			
Romania	-		-	3 861	379	-	-	4 240			
Armenia	-		-	2 351	262	840	-	3 453			
Albania	-		-	1 662	316	204	-	2 183			
Georgia	-		-	1 450	227	64	-	1 741			
States of ex Yugoslavia	-		-	1 170	125	320	-	1 615			
Macedonia (FYR of)	-		-	1 331	197	2	-	1 529			
Turkey	-		1 458	-	-	-	-	1 458			
Bulgaria	-		-	1 041	133	-	-	1 175	14	95	
<b>Total</b>	<b>200</b>		<b>1 635</b>	<b>38 755</b>	<b>8 044</b>	<b>3 285</b>	<b>-</b>	<b>51 919</b>	<b>15</b>	<b>100</b>	
<b>Per cent</b>	<b>0</b>		<b>3</b>	<b>75</b>	<b>16</b>	<b>6</b>	<b>-</b>	<b>100</b>			