StructuredDialogue
for an efficient partnership in development

TECHNICAL SHEET – AID MODALITIES

6 – BUDGET SUPPORT TO LOCAL AUTHORITIES

I. Description

Budget support is defined as the transfer of resources from an external funding agency to the national treasury of a partner country in support of its national development programme or of a specific sector. Therefore, budget support to local authorities (LAs) is understood in the present fiche as the transfer of resources by a donor to a regional or local authority's treasury in support of its regional or local development plan.

Budget support is extensively used in the framework of EU development cooperation and is considered the preferred financing modality, when conditions are met (see legal requirement below). Although it has not been extensively used to directly finance sub-national authorities[1], budget support programmes usually contain provisions and conditions that are directly or indirectly relevant for local authorities. The EC is presently examining options to increase its direct cooperation with regional and local authorities, among others financed through budget support to the extent this would not work against any decentralisation objectives and process.

It must be recalled, however, that budget support funds are not meant to finance specific activities, be it at central or local levels, as it is done through projects. Indeed, budget support is disbursed against performance and progress made, i.e. once the agreed results and reforms have been achieved by the partner government. Therefore, when the payment is decided, these achievements must have already occurred.[2] Dialogue is at the core of any budget support programme between the partner government and the donor, as regards policy options, budget allocations and results, reforms, performance monitoring and reporting. The dialogue is mainly guided by results obtained by the beneficiary through its own budget (to which the donor is contributing) and not focused on activities or equipment funded by the donor.

II. Legal framework

The three main external cooperation financial instruments (Cotonou Agreement/European Development Fund, Development Cooperation Instrument (DCI) and European Neighbourhood Policy Instrument (ENPI)) foresee the granting of budgetary assistance to partner countries. The Cotonou Agreement states that direct budgetary assistance in support of macroeconomic or sectoral reforms shall be granted where: (i) public expenditure management is sufficiently transparent, accountable and effective; (ii) well defined macroeconomic or sectoral policies established by the country itself and agreed to by its main donors are in place; and (iii) public procurement is open and transparent (Art 61/2).

The DCI (Art. 25(1)b) and ENPI (Art. 15(2)e) state that Community financing will take the form of budget support "if the partner country's management of public spending is sufficiently transparent, reliable and effective, and where it has put in place well defined sectoral or macroeconomic policies positively assessed by its principal donors; including, where relevant, the international financial institutions". Art. 25(1)b of the DCI adds that "disbursements of budgetary support shall be conditional on satisfactory progress towards achieving the objectives in terms of impact and results".

The provisions mentioned above refer to budget support to a partner country's national treasury. To enable the granting of budget support to local authorities, the legal provisions and operational requirements may have to be adapted to the realities and constraints of local authorities and various issues remain to be tackled and challenges overcome.

1 Budget support to sub-national authorities is provided in India and South Africa.

2 For example, while a project may finance the construction of X number of classrooms and the provision of Y number of textbooks and measure its performance in terms of outputs, in the case of budget support programmes the conditions are based on results, such as enrolment rates of students, and related activities such as the construction of classrooms, provision of textbooks and payment of teachers have to be planned in advance, included in the national budgetary provisions and funded through the budget.

III . Key issues

There is **no single response to address the needs of all local authorities**. Each decentralisation framework is unique and local authorities are not all equivalent across countries. They benefit from various degrees of autonomy – legally and in practice – in many respects such as functional assignments, policy initiative, budget discretion, revenue collection, setting of financial rules and procedures, contracting powers and human resource management. Any aid instrument would have to be chosen and adjusted against such an analysis of the complexities of the decentralisation setup and no single answer can be adequate to all contexts.

Local Authorities do not have the necessary legal authority to enter into international legal agreements. To receive budget support from the EC, the beneficiary government has to sign a financing agreement which constitutes the legal basis for budget support programmes. The fact that LAs do not have in all partner countries the authority to enter such agreements, providing budget support directly to them would raise basic legal questions with further overall policy implications.

LA must have a large financial autonomy from central government. In order for budget support to represent real additional resources to budgets at subnational level, this level must be largely autonomous from the centre, i.e. any budget support funds transferred to the sub-national level (either directly from the Central Bank or via the National Treasury to an account of the sub-national authority) cannot lead to a reduction of other funds to be transferred by the national authority to the sub-national level.

LAs do not have the necessary decision-making authority to fulfil EC requirements to benefit from budget support. Even in case a sub-national authority is largely autonomous from the centre, most LAs depend to some extent on the central government for the handling of foreign currency (budget support funds are disbursed in euro at Central Bank level), the definition of policy orientations as regards development, the formulation of main principles and rules governing public finance management and the macroeconomic decisions, including the relationship with the IMF. Thus, LAs cannot be held responsible against the eligibility criteria set by the EC if macroeconomic management and public finance reforms are largely in the hands of central government. Nor can LAs engage in comprehensive policy dialogue if development policy options or sector allocations within their budget are decided at another level of government.

Given that budget support has not had the desired impact at local level, the use of other aid modalities such as direct grants to local authorities (without calls for proposal, using the *de facto* monopoly provision), funding through national agencies or through other donors should be explored.

IV . Strengths and weaknesses

Strengths

- Provision of financial means to LA to implement their strategy of poverty reduction, expand delivery of public services, strengthen administrative capacities and public finance management.
- Predictability of resources: the release of tranches by the EC is scheduled and planned in advance. The beneficiary can therefore make mid-term implementation plans for its local development strategy.
- Budget support allows for multi-annual partnership agreements between the EC and LAs.
- Supports governance processes with flexibility and limited time constraints
- Reduction of transaction costs: alignment of donor's aid to local territorial strategy and local procedures (administrative, financial, procurement, monitoring and auditing)
- Strengthens decentralisation and democratic local ownership by promoting a bottom-up approach into the national development plan.
- Budget support offers an opportunity to better cover policy issues and challenges LAs are facing in budget support programmes by taking into account their crucial role in ensuring service delivery to beneficiaries, implementing development policies and promoting domestic accountability on the ground. This could be done by including LAs in policy dialogue with central governments, by monitoring the flow of funds transferred to them and by setting some conditions from which they could benefit directly.

Weaknesses

- Risk of contributing to regional inequalities by creating "donor's pet areas" through the concentration of resources in a specific region, district or municipality
- It is not the most appropriate financing modality for all initiatives: specific activities, stand alone investments, ad hoc technical assistance, pilot initiatives, should be funded via other means (project or pool fund).
- Risks of overfunding or of low absorption capacity of the beneficiary LA
- Given the limited degree of fiscal autonomy generally evidenced in developing countries, budget support does not seem to have had the desired "trickle" down effect to the local communities.

V. Feasibility

The provision of budget support is conditioned to strict requirements in terms of eligibility, namely (i) strong fiscal, institutional, administrative autonomy of sub-national levels to ensure that funds replenish LA treasury with no possibility of replacement by central level; (ii) a medium term expenditure plan should exist to ensure sustainability; (iii) fiscal discipline in public finance management, (iv) local capacity to absorb additional funds. Therefore, budget support is generally restricted to the national level. However, in exceptional situations of emergency or in fragile states where a state budget is not functional, **targeted budget support can exceptionally be provided** to support specific sectors or specific regions or communities.

The feasibility for LA to benefit from budget support relies heavily on the **engagement of subnational authorities in policy dialogue with central government** regarding the definition and agreement on performance indicators based on which the EU disburses the funds. Such policy dialogue is centred on policies and issues of concern and responsibility of LA (percentage of transfers from centre to LA, improvement of service delivery, education, health, etc.).

Further reflection on how budget support could benefit LAs is required and could be based on the assessment of existing experiences (ex. Santa Fe, Argentina and Barcelona, Spain) and funding opportunities offered by EU Member States.