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From budget support to reform financing

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Budget support is viewed as the most consistent development policy instrument for implementing the five principles of the "Paris Declaration" adopted in 2005 to increase the effectiveness of development aid (Ownership, Alignment, Harmonisation, Management for Results, Mutual Accountability). However, budget support has also been criticised because it was unable to meet expectations regarding increasing the speed or comprehensiveness of development progress. Allegations that it (implicitly) promotes corruption and mismanagement in dysfunctional public structures also cannot be put to rest. Against the backdrop of sustained public criticism, many donors have since more or less withdrawn from providing budget support.

Declining budget support, increasing policy-based loans

Parallel to the decline in budget support, several advanced developing and emerging economies have switched to policy loans on concessionality terms for financing larger reform programmes. At many multilateral banks, policy loans have since become an essential part of their financial instruments. The World Bank is the most important player here. On average, it implements more than a third of its commitments with Development Policy Loans. From the partner countries' perspectives, this borrowing is profitable due to returns in the form of yields from economic reform (economic growth, tax revenue) and economic savings (efficiency gains, subsidy reductions).

Now the good experiences with policy loans have in turn ignited the discussion about whether and under which conditions policy-based financing ("reform financing") can be a useful development policy instrument.

How does reform financing differ from budget support?

The new reform financing instrument conceptually ties into the successes experienced with policy loans and develops them further into an approach that can be used for countries with different economic capabilities: grant financing for poorer countries and loans with different concessionality levels for more advanced countries. The intent is to avoid the typical weaknesses of budget support by using conceptual structuring from the beginning:

<u>a) Front loading: first the reforms, then the funds</u>

The most important realisation that came out of budget support is that you cannot buy reforms. Accordingly, reform financings focus on partner countries with undisputed willingness to introduce reforms. Conceptually, this is ensured because the funds are only contractually agreed once the reform steps have already been politically adopted. The conclusion of a contract is the endpoint of a reform dialogue with the partner government which will often have lasted for several months or years and does not take place in the beginning, as it does for budget support.

<u>b) Phases: no "lock-in" with reform prefinancing</u>

Unlike budget support, in reform financing, the funds are not immediately contractually agreed for the entire reform programme, which can usually run for several years. Instead, they are only agreed for each of the current reform phases (usually 1–2 years). This has two key advantages: firstly, donors can also opt out of reform financing at relatively short notice if they are not satisfied with the reform steps or changing reform directions (no "lock-in" over several years). Secondly, together with the aforementioned "front loading", it is possible to ensure that the funds paid out only amount to the equivalent of what the reforms have already accomplished. In other words, reforms are not prefinanced.

<u>c) Improved consideration of reform dynamics (flexibilisation)</u>

Political reform processes usually have high complexity and momentum. It is almost impossible to plan the reform process through to the end ahead of time. In fact, unforeseen difficulties and new opportunities often emerge during implementation, such as favourable political constellations or unexpected alliances. The reform process must be successively further developed based on the achieved progress and against the backdrop of the respective framework conditions. The above-described phases allow flexible reactions and adjustments to be made to the reform programme to suit the current political and economic framework conditions.

Conclusion: not a panacea, but significantly improved chances of success compared to budget support

The framework conditions for the use of reform financing have also developed favourably in the last few years: many countries have improved their public finance management. Advancing digitalisation of budget processes creates more transparency and makes it easier for parliaments to hold their governments accountable. Combined with the conceptual innovations, there are good chances of more strongly anchoring in development cooperation the effectiveness principles from the "Paris Declaration" mentioned at the beginning using reform financing – always provided that they are not used as a panacea as budget support was. Instead, it should only be used in cases where the framework conditions fulfil requirements e.g. regarding willingness to reform and ownership.■