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NOTE TO MEMBER STATES ON BUDGET SUPPORT AND POLITICAL DIALOGUE

Summary

This paper follows up on the request made by the Netherlands at the General Affairs Council in May 2009. It aims to clarify how to address political issues in the relations with partner countries in which we use the instrument of budget support, in respect of the different legal frameworks governing our relations with developing countries.

The paper recognizes that budget support is an aid modality likely to raise political sensitivities, given the more direct involvement with partner countries governments that it by definition entails. Therefore, it is important to clarify how political issues that may potentially have an impact on budget support operations can be most effectively addressed in the context of existing partnership frameworks between the EU and developing countries.

The wide range of areas for EU cooperation with developing countries on policy development and programming is governed by different legal bases. However, commitments by all partners to respect human rights, democratic principles, the rule of law and good governance are part of all these agreements and enforced through specific procedures and rules. In ACP countries, the Cotonou Agreement distinguishes between compliance with fundamental elements of cooperation, which cover all actions and are the foundation of the partnership, and the eligibility criteria for budget support, which is a specific form of implementing EU aid. In other regions, the agreements between the EU and partner countries cover the fundamental elements of cooperation, while the Development and Cooperation Instrument (DCI), European Neighbourhood and Partnership Instrument (ENPI) and Instrument for Pre-Accession (IPA) define eligibility criteria for budget support. Obviously, it is of utmost importance that any action be taken in conformity with existing rules and legal bases. The Commission is committed to fully respect the relevant agreements in its use of budget support.

The Cotonou Agreement establishes a clear hierarchy between political dialogue at the level of the overall partnership and discussions around individual aid instruments such as budget support or projects. This has as a consequence that if instruments such as budget support are affected by political issues exceeding the remit of policy dialogue at the level of instruments, such issues need to be addressed in the framework of political dialogue.

Political dialogue under Cotonou and budget support discussions, while operating at different levels, should be coherent and mutually re-enforcing. There are 4 ways in which they can relate:

- When political issues emerge in the course of policy discussions, such as in budget support forums, these are elevated to and actively pursued through political dialogue at the level of overall cooperation¹;

¹ Under Cotonou specifically Article 8, 96 and 97 processes.

- When political issues are resolved during political dialogue, agreed actions can, where appropriate, be delegated to policy based processes, such a budget support operations, for implementation.
- When decisions on appropriate measures agreed under Cotonou include action on budget support operations, these are carried out at the level of budget support operations.
- When the EU identifies during political dialogue issues that relate to any direct and imminent risks to the budget support eligibility criteria, i.e. macro economic stability, public financial management or poverty/sector strategy policies, this information is provided to the budget support donors group and may impact on budget support operations.

Ways forward:

1. The effectiveness of this approach and the abovementioned interaction requires strengthened support for EU coordination under its contractual frameworks, in particular under the Cotonou Agreement, and notably Article 8. This may require earlier coordination on joint EU positions, for example as we move from routine to intensified political dialogue under Article 8.²

2. Budget Support "Memoranda of Understanding" should respect the legal provisions on the appropriate setting and level for political dialogue as foreseen in the Cotonou Agreement. Where this is not the case, the EC cannot adhere to those elements of the MoU. In addition, the EC and member states should give consideration to adjusting such MoUs to make them consistent with Cotonou.

3. To help ensure consistency in approach across EC development assistance, guidance could be produced on the relationship between EC budget support operations and political dialogue in ACP as well as in non-ACP developing countries. In ACP countries, political dialogue and budget support eligibility are subject to provisions of the Cotonou Agreement.³ Non-ACP developing countries do not fall under a single form of agreement but under a variety of cooperation and association agreements. In general, respect for human rights, rule of law and democracy (often summarised as the human rights clause) are essential elements contained in these agreements. These agreements usually include some reference to modalities of political dialogue and a mechanism for suspension of the agreement. In addition, in non-ACP developing countries development assistance is provided under a set of financing regulations, which provide distinct budget support eligibility criteria consistent with those described in Cotonou.

² Intensified dialogue process under Article 8 is outlined in Article 8 (6a) and Annex VII of Cotonou.

³ Articles 61, 8, 9, 96, 97 and Annex VII

1. Introduction

A. Why budget support is more likely to be affected by political issues than other modalities of delivering aid

The paper submitted by the Netherlands for the 19 May 2009 GAERC⁴ highlighted recent experience of budget support operations both raising political issues and being affected by them. While all forms of aid bring their own challenges, budget support is generally seen as a modality more likely to raise issues of political concern. There are a number of reasons for this:

- i. Budget support finances the entire budget and therefore de facto all areas of a partner government's operations ;
- ii. It promotes policy dialogue at the highest levels within partner governments
- iii. It often represents a large part of a country's overall development assistance;
- iv. Donor coordination mechanisms are in general well developed in countries receiving budget support; and
- v. Administratively, it is often seen to be simpler to suspend budget support disbursement rather than other forms of aid such as projects.

The challenge presented by the issues paper was that the Commission and Member States should develop a common understanding on how to clarify the interaction between the issues of political concern and the budget support operations, and their place in the in-country dialogue with the recipient government.

2. Relationship between Policy Dialogue And Political Dialogue

B. Policy Dialogue and Political Dialogue: distinct roles

Many policy dialogues, for example on macro-economic policy, on how to retain trained health staff, or on better targeted social protection, are normally run in parallel to political dialogue. While the processes overlap to a certain degree, a practical distinction between political and policy dialogues is that the former is primarily concerned with agreeing high level "constitutional" or "fundamental" commitments (see Cotonou Article 8) and the latter with developing and implementing a plan to deliver on a wider range of sectoral commitments.

Thus, when high level political dialogue delivers an agreement on a set of actions in response to alleged corruption, a budget support group may be tasked to assist in the revision of procurement legislation.

In turn, discussions at the policy level can raise issues whose resolution will have wider ramifications than the specific policy being discussed, in which case these issues often need to be dealt with at the level of the political dialogue. This is particularly relevant since partner

⁴ Strengthening Policy Dialogue in EU/Commission Aid Relations with Developing Countries Issues Paper prepared by the Netherlands for GAERC/Development 18-19 May 2009.

government counterparts involved in a sector-specific policy dialogue may, consequently, provide only a partial picture of a government's position on the wider political issue.

Given this interaction between policy and political dialogue, we can see them as mutually reinforcing processes.

However, engaging in political dialogue at the more limited level of a specific aid instrument, such as budget support, is unhelpful for several reasons:

i. It has a negative impact on the political dialogue:

1. It excludes some EU Member States from key political discussions, because only budget support donors are fully part of the budget support policy dialogue with government;
2. It makes the partner government's ministry of finance the key interlocutor on political issues – which is not appropriate nor effective;
3. It limits the choice and effectiveness of response (e.g. suspension of social sector budget support rather than a security sector project in response to human rights abuse, also see Box 1);
4. It runs the risk of decisions being made in a context of specific but more limited expertise, without taking into account the larger political context or the wider political impact of a decision;
5. It weakens the instrument of political dialogue as a centre of gravity for our partnership at the very moment we are engaged to promote its further.

ii. It has a negative impact on budget support.

1. It undermines the focus of budget support dialogue, which is progress on delivering stable economic policy, public finance management and social reforms;
2. It affects negatively the qualities of EC budget support as an aid modality with positive implications for predictability and aid effectiveness, ownership and managing for results.

Box 1. Ethiopia: selective suspension of budget support as a political instrument.

Ethiopia is an example in which, in the aftermath of the 2005 national elections, an EC General Budget Support operation was discontinued due ‘to serious and flagrant violations’, based on a unilateral political decision by the group of donors (Commission and others). The Commission informed Ethiopian government of the decision within the Article 8 political dialogue though there was no formal suspension evoking Article 96 of Cotonou.

The impact of this discontinuation has been more political (message of mistrust) vis a vis the Ethiopian government than economic. On the one side, concern about losing substantial resources (up to €260M in budget support in EC case) and on the other side the political reluctance to escalate tension with the EU, lead to finding other ways to use the money. Funds instead have been channelled into a number of multi-donor programmes, including the Protection of Basic Services programme. The discontinuation of one single financing modality and, at the same time, the increased use of multi-donor programmes, sent a mixed signal to the government. Consequently, this approach did not discourage the government from proceeding with questionable policies in the area of human and political rights, without much regard to the views of the donor community, and without affecting the disbursement plans of many donors

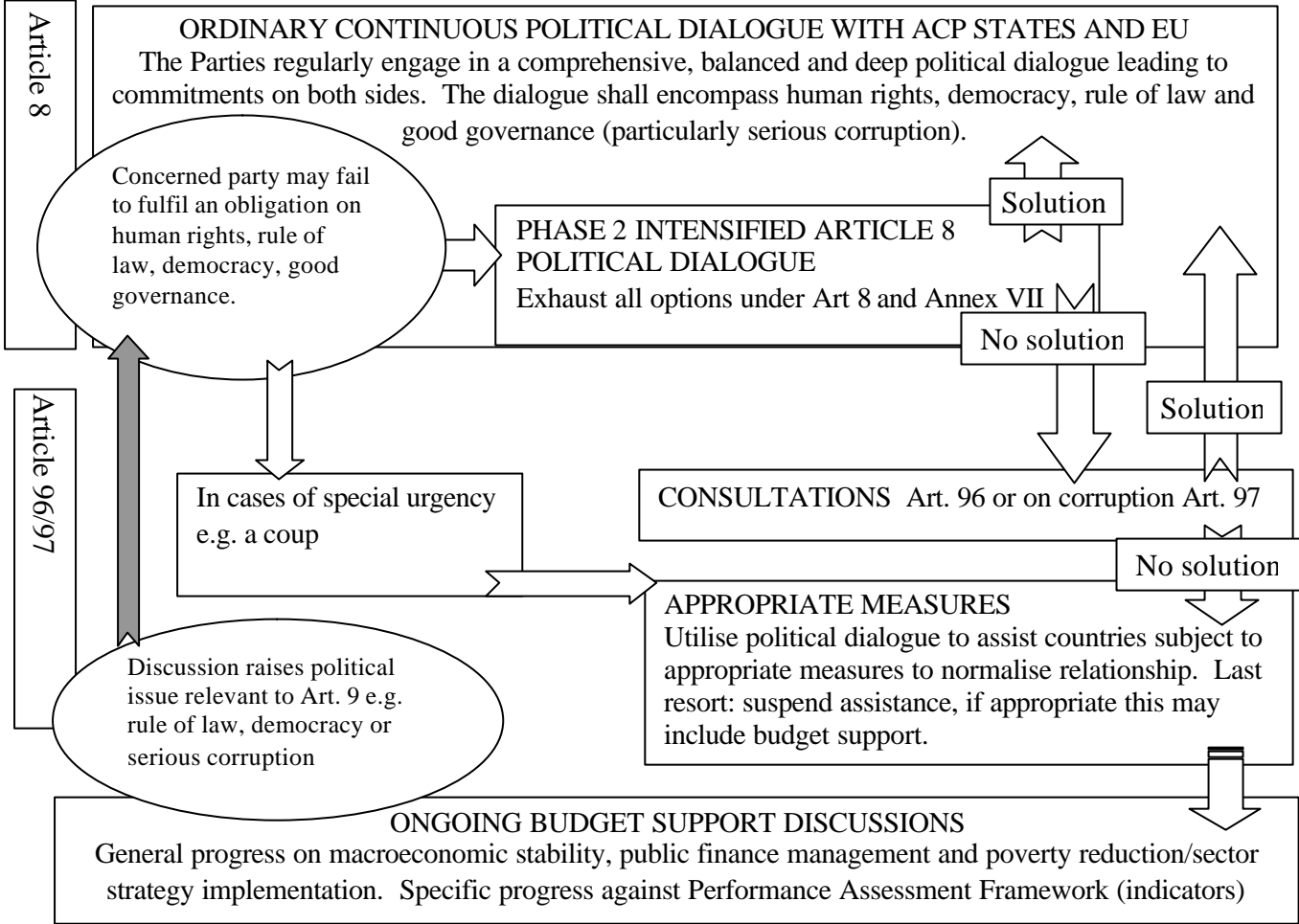
The Ethiopian experience demonstrates the need for a transparent approach to issues such as human rights and democratic principles, through using the dialogue and procedures foreseen in the Cotonou Agreement, even if such as formal approach is politically more challenging than the informal suspension of a specific financing modality.

C. Budget support dialogue brings political issues to level of overall cooperation and political dialogue

Therefore, whenever in budget support discussions issues arise that go beyond the eligibility criteria for budget support and that pertain more to the underlying values, principles, essential and fundamental elements, specifically human rights, rule of law, democracy, good governance (especially serious cases of corruption), these should be elevated to the level of political dialogue⁵. Hence, when in the context of the EDF Committee concerns are raised concerning a budget support operation that are political in nature and go beyond compliance with eligibility criteria (Article 61 of Cotonou), these are referred to the Council for discussion.

⁵ Under Cotonou Articles 8, 96, 97 and Annex VII

Figure 1.



This elevation of political issues is indicated by the grey arrow in Figure 1. Figure 1 provides a representation of the political dialogue process under Cotonou and aims to clarify the operation of Article 8 and its relationship with Articles 96 and 97 as well as highlighting two possible links with budget support operations.

To illustrate this relationship, we can consider corruption and public finance management. One of the objectives of improved public finance and expenditure management is better development output and reduced risks for misappropriation of public resources. It is therefore appropriate that performance in this area is discussed in reviews of budget support programming. However, where serious structural cases of corruption are identified that potentially undermine commitments to good governance, dialogue should be raised to the level of consultations which cover overall partnership (intensified Article 8 or Article 97 in ACP countries).

D. Political dialogue informs budget support groups of possible risks linked to budget support implementation

The political dialogue process also feeds into assessments carried out within budget support frameworks. Indeed, before budget support is disbursed, an eligibility assessment is undertaken which considers public financial management, poverty reduction/sector strategies

and macro economic management⁶. Failure to meet budget support eligibility criteria results in a postponement of budget support disbursements and commencement of policy discussions with government aimed at agreeing actions to restore budget support eligibility. The EU should, therefore, use its political dialogue process by providing information to the budget support group of any direct and imminent risks to macro economic, public financial management or poverty strategy policies identified during political dialogue.

3. Legal Framework

E. Political dialogue at the level of overall cooperation

Cotonou Agreement

The Cotonou Agreement is the legal basis for all action with respect to ACP countries and it provides a comprehensive and multi-levelled framework to assist coordination of our discussions with partners on the political dimension of our partnership, (Articles 8, 9, 96 and 97). This includes the essential and fundamental elements (Article 9) of human rights, democratic principles, the rule of law and good governance that underpin the ACP-EU partnership and shall be actively supported by it. These articles apply to all cooperation action, regardless of the nature of financing and are not limited to a single financing instrument or modality.

Consultation procedures and appropriate measures in case of failure to fulfil obligations stemming from the essential and fundamental elements are defined in art 96 and in art 97 respectively. These provisions are intended for cases in which failure to meet obligations occur "despite the political dialogue conducted regularly between the Parties". The suspension of the Partnership is contemplated as a measure of last resort (art 96, c).

Annexe VII, added in 2005 during the revision of the Agreement, introduces the concept of intensified political dialogue (under article 8) that may include joint agendas and priorities and also specific targets and benchmarks. Consultations under article 96 should be entered into only after exhaustion of all options under intensified political dialogue.

For "cases of special urgency" defined as exceptional cases of particularly serious and flagrant violation of one of the essential elements that require an immediate reaction (article 96, 2, b), the Cotonou Agreement foresees the possibility for any of the "Parties" taking appropriate actions independently from dialogue and consultation. Measures that are taken in cases of special urgency shall be immediately notified to the other Party and the Council of Ministers. The Council is required to adopt the proposed appropriate actions.⁷

At the level of secondary legislation and consistent with the Cotonou Agreement are the General Conditions of EDF Financing Agreements. These General Conditions of individual Financing Agreements, including those of budget support programmes, refer to the respect of fundamental and essential elements of Article 9. Suspension of programmes on the basis of a

⁶ Under Cotonou drawing on Article 61 (2)

⁷ International Agreement between Representatives of the Governments of the Member States, meeting with the Council, amending the Internal Agreement of 18 September 2000 on measures to be taken and procedures to be followed for the implementation of the ACP-EC Partnership Agreement, Article 1.3. Official Journal of EU L247/48 9.9.2006

non-respect of these elements is done on the basis of the implementation of Article 96/97. The appropriate measures taken under Article 96/97 cover the whole of the EC's action, including, but not limited to, budget support.

In exceptional situations where a very rapid response is required and in anticipation of a decision by Council on the basis of Article 96/97, including 96.2b, precautionary measures can be taken by the Commission at the concrete project or programme level based on the General Conditions of the individual Financing Agreement. In practice, such measures are taken by the Commission where it has indicated that, following the Article 8 processes, it will propose opening Article 96/97 and while awaiting a Council decision on the basis of Article 96/97 of Cotonou.

DCI Financial Regulations

Unlike ACP countries, the partner countries and regions covered by the DCI, ENPI and IPA regulations operate under a range of agreements with the EU. In general, respect for human rights, rule of law and democracy (often summarised as the human rights clause) are an essential element contained in these agreements. These agreements also usually include some reference to modalities of political dialogue and a mechanism for suspension of the agreement.

The DCI financial regulation that covers the majority of countries receiving budget support outside the ACP also refers to the values of democracy, rule of law, respect for human rights and fundamental freedoms (Article 37). The Article provides for measures to be taken in response to a breach of these principles and that could eventually lead to a suspension of the assistance. Such decisions would be taken by the Council acting by a qualified majority on a proposal from the Commission. The DCI Regulations refer to consultations that should take place in the partner country prior to any consultation at Council level.

DCI - Article 37 - Suspension of assistance

"Without prejudice to the provisions on suspension of aid in partnership and cooperation agreements with partner countries and regions, where a partner country fails to observe the principles referred to in Article 3(1), and where consultations with the partner country do not lead to a solution acceptable to both parties, or if consultations are refused or in cases of special urgency, the Council, acting by a qualified majority on a proposal from the Commission, may take appropriate measures in respect of any assistance granted to the partner country under this Regulation. Such measures may include full or partial suspension of assistance."

The process described in Article 37 is very similar to that in the Cotonou Agreement.

F. Rules for Budget Support Eligibility

Cotonou Agreement

The Cotonou Agreement distinguishes between compliance with essential and fundamental elements of cooperation,⁸ which cover all action and are the foundation of our partnership,

⁸ Cotonou Articles 8 and 9

and the eligibility criteria for budget support which is a specific form of implementing EU aid. The Cotonou Agreement defines eligibility criteria for budget support in article 61 (2), where it states that "direct budgetary assistance in support of macroeconomic or sectoral reforms shall be granted where (a) public expenditure management is sufficiently transparent, accountable and effective (b) well defined macroeconomic or sectoral policies established by the country itself and agreed to by its main donors are in place and (c) public procurement is open and transparent".

Financial Regulations

While very similar in content, the exact language on budget support eligibility varies between Cotonou and non ACP regulations such as DCI (Art 25 (1) b.), ENPI (Art 15 (2)e) and IPA (Article 15 (1)). EC budget support guidance amalgamates these variants into a single set of conditions referring to progress in implementing (i) general or sectoral development policies, (ii) stability-oriented macro-economic policy and (iii) reform strategy of public finance management. Revision of Cotonou is likely to seek to make the language more consistent with the guidance.

G. Budget support memoranda and political dialogue

The Netherlands 17 May 2009 GAERC paper also raised the issue of underlying political principles in budget support memoranda. As set out above, progress in development policies implementation as well as in macro-economic and public financial management should be at the heart of budget support memoranda and reviews, and monitored in the related *aide memoirs*. The underlying political principles in budget support memoranda covering democracy, human rights and the rule of law should not be the object of specific monitoring mechanisms at the level of the joint reviews. As discussed, both the means of monitoring continued commitment to these political principles and the mechanism for resolving issues arising should be situated at a level above discussions focused on a single aid instrument. Budget support Memoranda which place the dialogue on the respect of underlying principles at the level policy dialogue are not coherent with the legal frameworks in place and should be reviewed.

4. Policy Framework

The need to bring discussions on democracy and governance to the level of political dialogue and overall cooperation is also reflected in the EU policy frameworks.

Democracy and good governance are mentioned in article 20 of the Cotonou Agreement as one of the aims of cooperation strategies. This is reinforced in article 33 that mentions "promote and sustain democracy, human dignity, social justice and pluralism" (article 33, 1, a) as one objective of institutional development and capacity building.

The Communication on "Governance in the European Consensus on Development: towards a harmonised approach within the European Union" concludes that "while governance and capacity building should indeed be high on the development cooperation agenda, poverty reduction and the other MDGs remain the overriding objectives of EU development policy". The Communication also concludes that "the processes of democratic governance will be supported more effectively by dialogue than by sanctions and conditions". And it adds that "dialogue with individual partner countries on governance reforms should be conducted jointly by the Commission and those Member States represented on the ground. This dialogue should then be translated into coherent approaches to aid programming and coordinated support for governments' reform programmes".

The Council⁹ conclusions stress the importance of regular political dialogue between the EU and the partner countries...that should cover all aspects of democratic governance in order to facilitate mutual understanding of reforms needed, and also to guide support measures.

5. International Guidance

Finally, this approach is also reflected in the DAC Guidelines on Harmonising Donors' Practices for Effective Aid, Budget support (vol. 2, 2005) which states: "While prohibited in the case of the international financial institutions, political conditionality can be legitimate for other donors. Political sensitivities are also likely to be more intense in the case of budget aid since some constituencies may see the provision of budget support as an endorsement of the partner country's overall policy stance. However, the very nature of political conditionality makes it difficult to formulate clearly defined conditions that leave very little margin for interpretation. Accordingly, political conditionality should not be specifically linked to budget support or any individual aid instrument, but rather should be handled in the context of the overarching political dialogue between a partner country and its donors".

⁹ GAERC 16 October 2006