

Project Memorandum

Ethiopia:

Poverty Reduction Support Grant

2003/04

DFID Ethiopia, March 2004

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List of acronyms

ADLI	Agriculture-led Development and Industrialisation
APR	Annual Progress Review
CAP	Country Assistance Plan
CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment Report
DBS	Direct Budget Support
DFID	Department for International Development
DSA	Decentralised Support Activities
EC	European Commission
EMCP	Expenditure Management and Control Programme
GDP	Gross Domestic Product
GoE	Government of Ethiopia
HIPC	Highly Indebted Poor Country initiative
IMF	International Monetary Fund
MDGs	Millennium Development Goals
M&E	Monitoring and Evaluation
MOFED	Ministry of Finance and Economic Development
MOU	Memorandum of Understanding
PFM	Public Financial Management
PRGF	Poverty Reduction and Growth Facility
PRSC	Poverty Reduction Support Credit
PRSG	Poverty Reduction Support Grant
PRSP	Poverty Reduction Support Paper
PSCAP	Public Sector Capacity Building Project
SDPRP	Sustainable Development and Poverty Reduction Programme
WB	World Bank
WTO	World Trade Organisation

1. Summary

1.1 It is recommended that [the Secretary of State approves disbursement of [£20 million] of direct budget support titled the Poverty Reduction Support Grant to the Government of Ethiopia in a single tranche before the end of March 2004, in order to help finance Ethiopia's poverty reduction strategy¹. This is consistent with the International Development Act.

1.2 There is great value in disbursing before the end of the current UK financial year as it enables DFID Direct Budget Support (DBS) to be better aligned with GoE's budget and SDPRP review cycles in subsequent multi-annual DBS operations.

1.3 The international community is agreed that Ethiopia merits more aid to enable progress towards the MDGs. A recent study suggests that a doubling of aid would enable Ethiopia to reach the poverty, hunger, enrolment, water and sanitation and HIV/AIDs targets; and make progress against health, gender and environment targets but without reaching them².

1.4 GoE, DFID and other key donors (World Bank, EC) believe that DBS should be the primary means of providing increased financial aid. Government's budgets reflect most SDPRP priorities. Government has directed additional resources in recent years to sectors it categorises as poverty-related. Furthermore, budget execution rates are good for the government's own resources, to which DBS contributes, but low for externally-financed capital projects. The increase in aggregate health, education, agriculture and roads spending is welcome, but further work is needed to integrate analysis of the costs of MDGs on a national basis with an assessment of Ethiopia's inter-governmental financial framework. This is necessary to ensure that resource flows to lower tiers of government, with prime responsibility for basic service delivery (i.e. key sub-sectors such as primary education), are adequate.

1.5 This will be DFID's second DBS operation in Ethiopia. We expect to follow it with a larger multi-year programme. The operation has a dual Purpose: *"SDPRP implementation is supported and framework for future Direct Budget Support is enhanced."* This purpose will contribute to the goal of adequately financing the SDPRP and achieving the poverty targets for the second year of SDPRP implementation. These targets are set out in the Joint DBS Policy Matrix which DFID will use as the basis for monitoring the effectiveness of the Poverty Reduction Support Grant (PRSG) at the goal level (Annex 3).

1.6 The intended Outputs for DFID (see Logical Framework) are not only to deliver finance in the current Ethiopian financial year, but also (i) to align DFID's DBS programming with GoE's budget and SDPRP review cycles; and

¹ The PRSP in Ethiopia is called the Sustainable Poverty Reduction and Support Programme (SDPRP).

² Baird and Shetty, 'Supporting sound policies with appropriate and adequate financing', September 2003

(ii) to maintain DFID's credibility in SDPRP-related policy dialogue with GoE and role in shaping donor coordination and harmonisation for DBS.

1.7 The first DBS operation, £10m provided in 2002/03, aimed to help DFID learn about Ethiopia's budgeting systems and to incentivise government to develop a Common Monitoring Framework which other donors would be able to use. This has been successful: a Joint DBS Policy Matrix has been drawn up; and DFID has led DBS donors in (a) understanding how DBS resources are factored into the budget and (b) in negotiating with GoE the mechanisms for donor dialogue during budget preparation. There is now an agreed calendar for dialogue linking the government's budget cycle with the Annual Progress Review process. Another six bilateral donors as well as the African Development Bank plan to provide DBS in 2004/05 (Annex 5).

1.8 The arrangements for accounting for use of DBS resources is consistent with NAO guidance. As last year, the DBS will be provided in sterling and the local currency counterpart will be placed in the GOE Counterpart Pooled Grant Account. The central bank will provide documentary evidence of the receipt of the foreign exchange, its conversion to local currency and its transfer to the GOE Account. GOE will provide evidence of the inflows and outflows from the Account, identifying separately the UK DBS inflow but not the use of UK funds.

1.9 On the basis of the draft Country Financial Accountability Assessment, we do not believe that fiduciary risks require additional safeguard arrangements for this one-off disbursement. Reflecting DFID's guidance on managing fiduciary risk, we are waiting for the final step in confirming how the government will take forward the financial management reforms recommended in the CFAA/CPAR. We have been closely involved with the government in this area; and the Minister of Finance has recently confirmed the depth of his commitment in this area to DBS donors.

1.10 GOE is deemed to have met the undertakings relating to this DBS operation through progressing the commitments made at the December 2002 Consultative Group meeting and in the bilateral Memorandum of Understanding with the UK. The World Bank's first Poverty Reduction Credit was approved by the Board in February 2004 on the basis of progress with implementing the SDPRP. The fifth review of the PRGF programme was also completed in February. Ethiopia has met all the actions for HIPC Completion Point and this is expected as soon as the broader HIPC Topping Up issue has been resolved.

1.11 DFID intend to propose a multiyear DBS programme to disburse from 2004/05 in mid-2004. Before this, the final steps need to be taken for: (a) the public financial management action plan; (b) dialogue arrangements on governance issues; and (c) clarity on the government's plans to strengthen the monitoring and evaluation framework.

2. Log frame (Project Header Sheet is separate)

Project Name: **Poverty Reduction Support Grant 2003/04**
 Country: Ethiopia
 Date of Preparation: March 2004
 Design Team: Stuart Tibbs, Rupert Bladon, Claudia Fumo, Helen Winterton
 Latest Date of Revision:

Note : this logframe relates only to the DFID input of DBS

Narrative Summary	OVI	MoV	Assumptions				
<p>Goal: Adequate financing and full implementation of the SDPRP</p>	<p>SDPRP actual expenditure matches projections.</p> <p>SDPRP poverty reduction targets met</p>	<p>SDPRP Annual Progress Reports</p>					
<p>Purpose: SDPRP implementation is supported and framework for future DBS is enhanced.</p>	<p>EoPS: The Common Monitoring Framework is further developed leading to successful APR.</p> <p>Progress against joint DBS indicators (including food security, education and HIV/AIDS).</p>	<p>JSA and Joint Partner Review of 2004 APR</p>	<p>Budgeted resource projections for 2003/04 (domestic and external) are accurate.</p>				
<p>Outputs:</p> <p>1 DFID finance for SDPRP is delivered in timely fashion.</p> <p>2 DFID align DBS with GoE's budget and SDPRP review cycles.</p> <p>3 DFID policy dialogue with GOE is enhanced</p> <p>4 Role of DFID in shaping donor coordination and harmonisation for Direct Budget Support is maintained.</p> <p>5 Provision of DBS by other donors is facilitated.</p>	<p>Receipt of DFID moneys in Counterpart Fund account.</p> <p>DFID DBS resources are available earlier in subsequent Ethiopian financial years.</p> <p>GOE and World Bank accept DFID role in PRSC discussions.</p> <p>Other bilateral donors provide DBS.</p>	<p>Letter from GoE</p> <p>DFID Advisers reports</p> <p>DFID Advisers reports</p> <p>DFID Advisers reports</p>	<p>Border, human rights and political dimensions are acceptable to donors.</p> <p>Sufficient progress is made in GOE-donor policy dialogue, including on budgets and political governance.</p>				
<p>Activities:</p> <p>1 Single transfer of funds</p> <p>2 Discuss use of DBS with MOFED, IMF.</p>	<p>Inputs:</p> <table border="1" data-bbox="628 1912 896 2024"> <tr> <td data-bbox="628 1912 791 1951"></td> <td data-bbox="791 1912 896 1951">£000s</td> </tr> <tr> <td data-bbox="628 1951 791 2024">DBS payment</td> <td data-bbox="791 1951 896 2024"></td> </tr> </table>		£000s	DBS payment			
	£000s						
DBS payment							

Narrative Summary	OVIs		MoV	Assumptions
3 Participate in DBS discussions with GOE and other donors (notably in Joint missions in May and September 2004).				
	Total	20,000		

3. Rationale

3.1 Objectives of UK Aid in Ethiopia

3.1.1 Provision of DBS is a central plank in the DFID Country Assistance Plan (CAP). This DBS operation complies with the “core power” of the International Development Act 2002 because it will help to finance GOE poverty reduction efforts, including its education and health sector programmes³. There is overwhelming evidence that Ethiopia needs substantially more aid than it receives. A doubling could help achieve MDG targets for poverty, hunger, education and HIV/AIDs. There is also a strong case for using DBS rather than project aid in Ethiopia: (1) spending patterns reflect government priorities and fungibility is strong (aid to specific sectors or regions is ‘offset’ by own resources); (2) disbursement rates for GoE’s own resources to which DBS contributes are very high, for both recurrent and capital expenditure including at regional level. In contrast, aid-financed capital projects are not well reflected in budgets and disbursement rates are low.

3.1.2 The CAP also emphasises that DFID will put effort into responding to GOE’s strong demand for donor harmonisation. DFID has taken a lead role in formulating the Common Monitoring Framework (Section 3.x) including by chairing the Donor Budget Support Group. Six other bilateral donors and the African Development Bank intend to provide DBS in 2004/05 (Annex 5).

3.2 Background to the Poverty Reduction Strategy

3.2.1 Following the end of the Derg in 1991, the new government delivered some widely shared progress in infrastructure and social sectors driven by the expenditure priority afforded to roads, agriculture, education and health sectors⁴. During the Ethio-Eritrean war (1998-2000) budget allocations to poverty-related sectors plummeted, domestic bank financing of the fiscal deficit increased dramatically and the IMF programme went off-track.

³ The DBS therefore helps to meet DFID’s PSA Target 1, which concerns progress towards Millennium Development Goals in key countries in Sub-Saharan Africa and SDA Targets II(a) and II(b), which concern support for more effective government-led education and health programmes.

⁴ Ethiopia defines poverty-related expenditure broadly as the sum of the education, health, agriculture and roads/construction sectors.

3.2.2 Following the end of the war, the IMF and World Bank engaged quickly with a PRGF and structural adjustment support programme. In December 2001, Ethiopia reached its Decision Point for HIPC. The Ethiopian PRSP, entitled the “Sustainable Development and Poverty Reduction Programme” (SDPRP), was completed in July 2002 and received endorsement in the IMF and WB Boards in September 2002.

3.3 SDPRP Implementation issues

3.3.1 DFID shared the consensus view among donors that the SDPRP provided a strong basis for partnership and policy dialogue with GOE round poverty reduction objectives. The CAP provides an assessment of the SDPRP in terms of its analysis of poverty and strategic response to tackle poverty. The SDPRP contains four building blocks: Agricultural development-led industrialisation (ADLI) and food security; Justice system and civil service reform; Governance, decentralisation and empowerment; and Capacity Building.

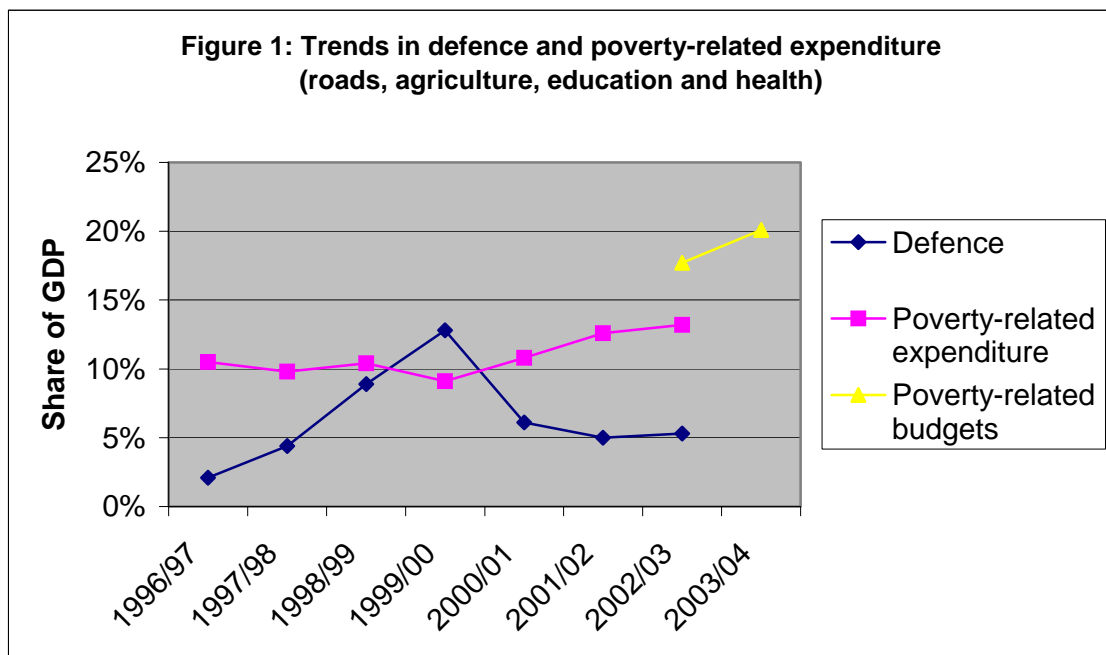
3.3.2 The strategies were appropriate but lacked clarity about priorities and specific timetabled actions to encourage growth, build capacity, tackle chronic food insecurity and achieve other objectives. Another general weakness was the limited treatment of cross-sectoral themes such as gender, urban development, the environment and HIV/AIDs.

3.3.3 To progress implementation, in early 2003 government drafted a Policy Matrix spelling out specific actions to achieve SDPRP objectives. Donor sectoral and thematic groups (DBS and non-DBS donors) reviewed the matrix and provided constructive comments in several iterations during the second half of 2003.

3.3.4 The first Annual Progress Review (APR) of the SDPRP was presented in December 2003. In response to the 2002/03 drought, this APR focused on developing the food security programme further – and with it a change in approach to deal with the numbers of long term food insecure population on a sustainable basis. This priority has been reflected by large increases to the federal food security budget line in 2003/04 and 2004/05.

3.3.5 However, this first APR process was rushed, coming only shortly after the finalisation of the policy matrix. There was insufficient opportunity for consultations with the public or dialogue with donors. 2004 will be an important year for getting the new process of performance review and dialogue working effectively now the framework is in place.

3.3.6 Figure 1 shows trends in poverty-related expenditure and defence spend since 1996/97. When defence spending rose rapidly in 1998-2000, poverty-related spending dropped below 10% of GDP – a significant reduction in money terms. While there are problems as well as advantages with the government’s broad definition of poverty-related expenditures (Section 3.4) all four sectors have seen expenditure increase significantly since 1999/00.



Source: World Bank, Addis Ababa

3.3.7 Poverty-related budgets (the short line in Figure 1) have continued to increase considerably in 2002/03 and 2003/04. Trends *within* poverty-related expenditure are also important (See Section 3.4). The underspend in 2002/03 is typical and is due primarily to two problems with project aid: (1) under-reporting; and (2) slow disbursement. In contrast, at least 90% of the government's own resources to which DBS contribute are spent by all tiers of government on both recurrent and capital expenditures.

3.4 Ethiopia's federal budgeting system: how DBS contributes

3.4.1 Ethiopia is a federal state with a strong central government. There are three tiers of government: federal, regional and local, the latter consisting of districts and municipalities. All tiers of government have budgeting responsibility for important SDPRP objectives and the MDGs: for instance, the federal government's funding for food security is important for economic well being and hunger targets; while the regions have responsibility for most basic service delivery.

3.4.2 Revenue raising is highly centralised with the federal government. Federal government also makes choices affecting resource availability, for instance on acceptable levels of domestic deficit financing. A system of transfers is used to address the vertical resource imbalance between federal and sub-federal governments so that each tier can fulfil its functional responsibilities. The largest transfer component is an unconditional block grant to the regions (there are equivalent arrangements between regions and local government). This block grant is made up of GoE own resources – or Treasury finance – and budgeted external project assistance. The regions raise a smaller amount of revenue themselves – about 10-25% of the block grant. The other type of transfer from the federal government is purpose-

specific grants. Purpose-specific grants are transferred to regions for use within specified guidelines. These have become increasingly significant in recent budgets – especially for food security and capacity building objectives.

3.4.3 Table 1 shows the financing basis for federal and regional tiers of government in 2002/03 and 2003/04 budgets. Italicised lines reflect where DBS contributes to financing and expenditure. Federal revenue is the largest source of resources, followed (in 2002/03) by external project aid, regional revenue, DBS and HIPC interim debt relief. Federal revenue, DBS/programmatic aid, HIPC relief together with domestic financing make up GoE's discretionary resources (or Treasury financing). The federal government in dialogue with the regions decides on the split of Treasury resources between federal functions (all recurrent and part of the capital budget) and the Treasury component of the regional subsidy.

Table 1: Intergovernmental finances: 2002/03 and 2003/04

Millions of Ethiopian birr		2002/03		2003/04
		Revised Budget	Outturn ⁵	Revised Budget
Consolidated government resources	1. Revenue	12,050	11,158	12,642
	a. Federal	9,939	9,053	10,346
	(i) Tax	7,426	6,678	8,202
	(ii) Non-tax	2,513	2,374	2,143
	b. Regional	2,111	2,105	2,296
	2. External project aid	3,565	2,553	3,899
a. Federal	2,077	-	3,366	
b. Regional	1,486	-	623	
	<i>3. DBS/programmatic aid</i>	<i>1,854</i>	<i>1,568</i>	<i>2,569</i>
	4. HIPC interim relief	779	594	695
	5. Total resources	18,248	15,873	19,805
Deficit/financing		1,083	1,365	1,364
	Total expenditures	19,330	17,238	21,169
Federal budget	Total federal outlays	13,347	-	13,097
	1. Recurrent expenditure	7,304	6,262	7,562
	Defence	3,000	2,341	2,400
	2. Capital expenditure	3,872	-	5,776
	<i>a. Treasury-financed</i>	<i>1,795</i>	<i>2,410</i>	<i>2,410</i>
	<i>Food security</i>	<i>150</i>	<i>1,000</i>	<i>1,000</i>
	b. Project aid	2,077	-	3,366
	3. Regional subsidy	6,043	-	5,535
	<i>a. Treasury</i>	<i>4,556</i>	<i>4,523</i>	<i>5,002</i>
b. External project aid	1,488	-	533	
Regional budget	Total regional resources	8,154	-	7,831
	1. Regional subsidy	6,043	-	5,535
	<i>a. Treasury</i>	<i>4,556</i>	<i>4,523</i>	<i>5,002</i>
	b. External project aid	1,488	-	533
	2. Regional revenue	2,111	2,105	2,296

Source: Government's Medium Term Financial Forecast. This reflects IMF revisions but provides a presentation that shows inter-governmental patterns of resource allocations.

⁵ Preliminary data which understates project aid and does not show project capital expenditure attributed by tier of government.

3.4.4 The major increases in Treasury financing for 2003/04 (*italicised*) – and therefore how DBS is reflected in the budget – are to the federal capital budget for food security (plus 850 million birr); and to the regional subsidy (+446 million birr). DBS is becoming an increasingly important source of finance in 2003/04 and this trend will continue in 2004/05 (See Annex 5). The federal government has an unusual degree of discretion over how it funds its own functions (including purpose-specific grants) and how it resources the regional block grant.

Table 3 shows how federal and regional governments respectively use their budgets. Poverty-related expenditure has continued an upward trend as a share of total expenditure. Much of the increase in 2003/04 comes from the federal budget and the allocations to food security. The increase to federal roads and construction reflects a large increase in project aid for this purpose (In Table 2, Federal budget, line 2b). These expenditures, predicated on DBS resources, will contribute to the outcome indicators for June 2004 (Annex 3).

Table 3: Trends in sectoral expenditure and poverty-related expenditure						
Original budgets	2002/03			2003/04		
	Rec.	Capital	Total	Rec.	Capital	Total
Federal						
All sectors	7,534	3,888	11,422	7,670	5,491	13,161
Non-poverty-related expenditure	6,758	498	7,256	6,865	468	7,332
o/w Defence	3,000	-	3,000	3,000	-	3,000
o/w Debt payments (dom and extl)	1,280	-	1,280	1,406	-	1,406
Poverty-related expenditure	776	3,390	4,166	805	5,024	5,829
Agriculture/natural resources	168	1,043	1,211	161	1,798	1,959
Roads and construction	28	1,777	1,806	30	2,434	2,463
Education	501	538	1,038	587	762	1,348
Health	79	32	111	28	31	58
Regional						
All sectors	5,462	2,973	8,435	6,219	3,457	9,676
Non-poverty-related expenditure						
Poverty-related expenditure	3,271	2,417	5,688	3,960	2,823	6,783
Agriculture/natural resources	725	700	1,425	751	864	1,615
Roads and construction	31	472	504	56	851	907
Education	1,936	543	2,480	2,125	547	2,672
Health	578	701	1,280	1,029	562	1,590
Memo:						
Pov-related exp as share of total	31%	85%	50%	34%	88%	55%
Fed share of PRE	19%	58%	42%	17%	64%	46%

Source: World Bank data based on original budget allocations for 2002/03 and 2003/04.

3.4.5 A weakness in the government's definition of poverty-related expenditure is that it conceals important intra-sectoral information. Given the trends in sectoral financing by tier of government – and sub-federal governments' responsibility for basic education and health – it seems likely that capital expenditure for basic social sector services will have seen little improvement. This is the type of issue that the new budget dialogue will enable donors to engage in (Section 3.6). However, it should be noted that the 2003/04 budget figures reflect a more conservative approach to budgeting for external project assistance to regions because of historic low disbursement.

3.4.6 The federal government plans to continue increasing the size of the regional subsidy by ETB 500 million each year to underpin decentralisation and the role of regions and local government in improving service delivery. This is welcome, but careful work to cost the MDGs (Section 3.5) needs to be integrated with analysis of inter-governmental flows to ensure that such an increase is adequate. Furthermore, better disaggregated and timely data is required. This is a focus of DFID's budget dialogue as well as donors' support to financial management capacity building and to the SDPRP M&E system.

3.5 Financing MDGs in Ethiopia

3.5.1 Available resources are being directed increasingly to priority areas. In 2002/03, total poverty-related budgets as a share of the total exceeded pre-war spending shares for the first time – 50.5% compared to 43.5% in 1996/97. In the 2003/04 budget, this share has risen to 55.6%. For education and health, the budget shares in 2003/04 are 17.6% and 7.4%, up from 14.5% and 5.8% in 1996/97 respectively. Education expenditure was 4.8% of GDP in 2002, compared to a Sub-Saharan (SSA) average of 3.4%. Health expenditure was lower than the SSA average of 2.5% of GDP (at 1.8% of GDP) but higher than the low income country average.

3.5.2 However, in per capita terms, the amounts are inadequate to deliver basic services to Ethiopia's poor people – US\$6.50 for education and US\$2.73 for health in the 2003/04 budget.

3.5.3 A recent study suggests that a doubling of aid would allow Ethiopia to reach the poverty, hunger, enrolment, water and sanitation and HIV/AIDs targets; and make progress against health, gender and environment targets but without reaching them⁶. There could be absorption capacity constraints in the public sector if resource availability did double in a short period. However, (a) the government's efforts to develop capacity and (b) high budget execution rates for Treasury (GoE) resources suggest that substantially more aid in the form of budget support could be absorbed.

3.5.4 GoE intends to carry out its own MDG costing exercise during 2004. This is likely to influence the next SDPRP. This is welcome as GoE

⁶ Baird and Shetty, 'Supporting sound policies with appropriate and adequate financing', September 2003

ownership of its own costing exercise will be very strong – we can expect the findings to be implemented vigorously.

3.6 The Common Monitoring Framework for DBS

3.6.1 The DBS Common Monitoring Framework provides a basis for dialogue on policy, implementation and budget issues in relation to SDPRP performance. The Framework is built around five components.

- (1) The Joint DBS Policy Matrix: the Policy Matrix represents a single set of around a hundred indicators derived from the SDPRP primarily by GoE. Policy dialogue and performance review will be based around these indicators;
- (2) A government/donor dialogue around budget performance and priorities, comprising: a Joint Budget and Aid Review in October feeding into the December APR; a budget discussion in January following the APR but ahead of the finalisation of sectoral ceilings for federal ministries and the subsidy for regions; a review of the draft federal budget in April/May;
- (3) Sector review mechanisms between government and donors. These are already in place for the education and health sectors. Similar processes will be formed for monitoring PSCAP and other sectoral/thematic areas, including dialogue around democratic governance.
- (4) A public financial management action plan building on CFAA/CPAR recommendations (Section 3.x);
- (5) A Monitoring and Evaluation system. The M&E system is presently basic, but capable of reporting on most key areas of the matrix through sectoral management information systems, periodic household and poverty surveys and ad hoc surveys. The quality of data collection and its use – including producing a useful APR – needs to be improved. Mechanisms for involving civil society organisations in these processes also need to be strengthened. All of these issues will be part of ongoing dialogue with government.

3.6.2 Together these components feed into the Annual Progress Review in December, which will be the key moment in the year for reviewing performance, discussing future priorities and making firm commitments of DBS for subsequent years. These components are already the subject of dialogue in sectoral and thematic government/donor groups.

3.6.3 Each year, the period from September to November will focus on performance review, culminating in the Annual Progress Review in December. From January the focus will be on implementation – on revising plans to reflect changes in external resource availability and expenditure priorities in the next annual budget.

3.7 PRSG: Performance indicators

3.7.1 DFID will assess progress with PRSG by drawing on a subset of indicators in the Joint DBS Policy Matrix and reviewing progress up to June 2004, the end of 2003/04 that this grant supports. For DFID's planned multi-annual PRSG performance review and dialogue around APRs will inform subsequent disbursement decisions.

3.7.2 There are three categories of indicators that DFID will use reflecting critical areas for successful SDPRP implementation and priority areas in the CAP and MoU. Details of the indicators to be monitored are in Annex 3.

3.7.3 Firstly, the environment for pro-poor economic growth will enable us to dialogue on macroeconomic management and policies for promoting growth. *Sound macroeconomic policies* will be demonstrated by continued progress with the PRGF programme. PRSG will also monitor progress against a subset of indicators of structural *policies for promoting growth*. The private sector in Ethiopia has only been in existence since 1991 before which all property was nationalised. There are a number of key areas where the government needs to act to encourage private sector development from this very low base. The indicators chosen reflect several key bottlenecks: reform of the banking sector that goes beyond that in the PRGF (led by the World Bank); government involvement in infrastructure and utilities (initially telecommunications); and trade integration, explicitly WTO membership.

3.7.4 Secondly, the four CAP core themes will be subject of intensive dialogue as DFID has a comparative advantage in these areas. For *food security*, the indicators concentrate on GoE's recent initiative to plan for predictably food insecure people. The *education sector* indicators provide a strong entry point for dialogue around issues of access, quality and equity. Indicators for *HIV/AIDs* focus on both prevention and care. The indicator for *capacity building* concerns establishing a federally funded programme for cross-sectoral support to capacity building at all tiers of government (PSCAP).

3.7.5 Thirdly, CAP/MOU systems concentrate on critical areas for the Common Monitoring Framework to function effectively. The *public financial management* indicator relates to the government's near-finalised plans to revise its Economic Management and Control Programme to reflect the findings of the CFAA and CPAR.

3.7.6 On *democratic governance*, the proposed indicators and targets are the result of a recently established dialogue between the international community (donors and ambassadors) with the government, chaired by the Prime Minister's Office and involving the Ministries of Foreign Affairs, Capacity Building, Finance and Economic Development and Women's Affairs Office. They will enable the international community to assess the trajectory of change with respect to elections, human rights, judicial reform and gender issues. DFID will also assess jointly with government and donors a process

for monitoring the quality of the *SDPRP monitoring and evaluation* system itself.

3.7.7 A final category that DFID will monitor (though not take a lead in policy dialogue) captures other areas relevant for MDGs. This will include the *health sector* - especially Ethiopia's progress with respect to child mortality and maternal health – and environmental targets. We will do this by collaboration with donors who are directly involved in these sectors, especially Development Cooperation Ireland on health.

3.8 Fiduciary risk assessment

3.8.1 DFID's approach to DBS in Ethiopia reflects National Audit Office (NAO) recommendations⁷. A Country Financial Accountability Assessment (CFAA) and Country Procurement Assessment Review (CPAR) were undertaken in 2002. There has been no further substantial diagnostic exercise since the CFAA/CPAR although progress with budget and accounting reform has continued, especially through the Decentralised Support Activities (DSA) Project in several of the larger regions that account for a major share of regional expenditure.

3.8.2 Since the CFAA and CPAR work was completed, DFID has supported the government to revise its financial management reform programme – the Expenditure Management and Control Programme (EMCP) – in the light of the CFAA and CPAR recommendations. This process has been protracted but government's commitment to addressing financial management weaknesses has never been in doubt. Before DFID's intended multiyear programme of DBS is finalised (planned for mid-2004), government must have finished the Strategic Planning exercise to revise EMCP. The final Plan is expected in April 2004. The importance of this process to the government has recently been emphasised by the Minister of Finance to DBS donors.

3.8.3 The process of finalising the Strategic Planning exercise was complicated by the simultaneous design of a cross-sectoral programme for capacity building at all tiers of government – the Public Sector Capacity Building Programme (PSCAP) which is to receive multi-donor support. The February 2004 Appraisal mission for PSCAP, confirmed that MOFED would be responsible for the federal implementation and technical support for financial management activities under the civil service reform programme (CSR) and PSCAP. The Aide Memoire for that mission stated that the EMCP Strategic Planning exercise is to be fully incorporated within the CSR procurement plans under PSCAP; and that these plans would constitute the government's commitments to roll-out the CFAA and CPAR action plans thereby satisfying the due diligence requirements of several DBS donors. The roll-out of budget and accounts reforms would be an immediate priority for regions and key element of 'minimum mandatory' standards for regions' capacity building plans.

⁷ NAO, 'A review of safeguards against the misappropriation and diversion of aid'.

3.8.4 The developmental case for direct budget support rather than a project approach in Ethiopia is strong. Generic DBS arguments concerning engendering greater ownership of aid; strengthening accountability from government to citizens rather than to donors; the opportunity presented to address systemic budgeting and policy issues; and to dialogue around the overall budget – are all strong. In particular, project disbursement rates are very low and fungibility is very high. Government has strong ownership of its policy programmes, so the extent to which projects finance activities which are truly additional (i.e. which government would not have undertaken otherwise) is limited. DBS is a stronger aid instrument for supporting the SDPRP as it is providing an anchor for dialogue with government on how overall spending priorities are set, both in annual budgets and by strengthening the intergovernmental financial framework to enable federal, regional and local tiers of government to fulfil their SDPRP responsibilities.

3.8.5 DFID's resources have been factored into the Annual Budget, though at a discount - £10 million rather than £20 million for the current financial year (ends July-2004). It is unlikely that there will be a Supplementary Budget to reflect the additionality between budgeted resources from the UK and £20 million that the UK will provide. This is because (a) at present there are no other substantial additional resources from external or domestic financing; and (b) other DBS donors' plans have slipped, so in aggregate DBS financing is below that planned. We are in contact with IMF and government on this issue to ensure that any Supplementary Budget is properly coordinated with the IMF and involves some discussion with donors.

4. Financing Requirement 2003/04

4.1 The macroeconomic framework was severely disrupted in 2001/02 and 2002/03 by the drought. Agricultural growth which accounts for about 50% of GDP contracted by 12%. Cereal production was worst hit declining by 26% and leading to the enormous food assistance needs: 13.2 million people needed the 1.85 million metric tonnes of food aid delivered by donors. GDP contracted by 3.8% (Table 4). Food shortages led to inflation of 15% and together with higher oil prices increased imports significantly although good export performance. Weak economic activity led to lower than expected tax revenues in 2002/03. Defence expenditures bore most of the brunt of curtailed expenditures being cut from 5.0% to 4.1%. High net domestic financing was required mainly due to a shortfall in loan financing.

Table 4: selected economic, fiscal and external indicators

% of GDP unless stated	2001/02	2002/03	2003/04
		Estimate	Programme
GDP growth (% change)	1.2	- 3.8	6.7
Agricultural GDP growth (% change)	-	- 12.0	-
GDP deflator (% change)	- 6.3	14.5	5.2
Revenue	20.1	19.6	19.5

Grants	4.7	8.0	7.1
Total expenditure and net lending	32.2	34.8	32.8
Fiscal deficit with grants	- 7.4	- 7.3	- 6.2
Fiscal deficit without grants	- 12.1	- 15.3	- 13.3
Net domestic financing	0.6	2.9	1.8
Current acct def. excluding transfers	- 12.9	-12.8	-14.0
Current acct def. incl. official transfers	- 5.7	- 4.7	- 7.9

Source: IMF, PRGF Fifth Review. The Ethiopian fiscal year runs from July 7th to July 6th.

4.2 Despite a reasonably strong effort to mobilise domestic resources over the last five years – the tax to GDP ratio grew from 11.3% in 1998/99 to 16.5% in the 2003/04 budget – the per capita tax-take is very low due to the tiny GDP in relation to the population. Per capita revenue (tax and non-tax) is about US\$19.3⁸. Available resources are being directed increasingly to priority areas (Sections 3.4 and 3.5).

4.3 The effects of the drought are seen in the 2003/04 programme, with even lower revenue forecast than in the original programme. External finance – increasingly in the form of DBS – continues to play a critical macroeconomic role with respect to both the budget and balance of payments. £10 million of DFID's DBS for 2003/04 are reflected in the budget reflecting GoE's conservative approach to budgeting, though a rational approach given the unpredictability of DBS as well as project aid to date. It is expected that DFID's additional £10 million to that budgeted will not be part of a Supplementary Budget but contribute to financing the original budget although this will be watched with the IMF.

5. Evaluation and Lesson Learning

5.1 DBS design in Ethiopia has taken into account the findings of the Evaluability Study on General Budget Support, such as including the need for DBS to be complemented by (i) close donor coordination on objectives of DBS; (ii) action on cross-cutting issues (such as civil service reform, decentralising responsibility for service delivery, procurement reform); (iii) closer donor-government working at sector level.

5.2 The Strategic Partnership for Africa (SPA) Budget Support Working Group has made two visits to Ethiopia to monitor progress with establishing the Common Monitoring Framework for DBS. The December 2003 mission noted that the agreement of a common matrix for all DBS donors, joint DBS missions, the commitment of DBS donors to use the APR as the occasion for DBS decisions and the involvement of non-DBS donors in key policy discussions as positive developments. Since December, donors and

⁸ Based on tax and non-tax revenue in 2002/03 of ETB 11,149 million; US\$/ETB exchange rate of 8.58 (both IMF PRGF 5th Review) and population of 67.2 million in 2002 (World Bank).

government have followed up on SPA recommendations to clarify the Aligned Calendar with government (e.g. links between the recently approved financial calendar and SDPRP review cycle). Another priority is to establish expectations for the content and consultation for the APR process in 2004.

5.3 Ethiopia is also a candidate for a 'quick study' under the recently started Joint Evaluation of General Budget Support by OECD DAC.

6. Implementation

6.1 Design and Management

6.1.1 UK DBS will be transferred to the National Bank of Ethiopia in sterling in a single tranche and the counterpart equivalent in Birr will be transferred to the GOE where it will be mixed with DBS funds from other donors. There will be no restrictions on how GOE uses the Birr counterpart resources.

6.2 Management and Accounting

6.2.1 The £20m will be transferred in March 2004. The detailed procedural steps are set out in Annex A. These were used and followed by GoE and DFID for the first £10 million DBS operation in 2003.

6.2.2 To meet UK accountability requirements, the National Bank of Ethiopia and GoE should provide documentary evidence as described in Annex A of the correct and timely transfer of funds into the GoE Counterpart Pooled Grant Account.

6.2.3 In addition, MOFED (Treasury Department) should provide a report in English to the British Embassy (DFID Section) on operations (inflows and outflows) of the Counterpart Pooled Grant Account for 2003/04 (Ethiopian Fiscal Year 1996), which should identify separately the receipt of DFID funds.

6.3 Audit

6.3.1 In view of the fungibility of resources in the Counterpart Pooled Grant Account there is little value in trying to conduct an audit of GoE expenditure associated solely with the UK's £20m of DBS; the funds cannot be separately identified once they have entered the Account. Neither IDA nor EU require audit of the use of their DBS funds, focusing instead on the wider PFM systems as assessed by the CFAA.

6.3.2 DFID therefore propose to take the opportunity of GOE-donor discussions of the CFAA findings to initiate a dialogue with GOE on how financial reporting and audit processes for this Account and for GOE more widely will help improve accountability for DBS funds.

6.4 Monitoring

6.4.1 Beyond the arrangements described in the Management section above, there will be no separate monitoring arrangements for the financial aspects of the UK DBS.

6.4.2 DBS donors are presently moving to harmonise their programmes round a Common Monitoring Framework, drawn from the SDPRP, and to align their DBS process round the GoE SDPRP Annual Progress Review. GoE want DBS donors to minimise any additional requirements outside this framework, limiting them to issues of governance and fiduciary risk drawn, where possible, from Government policy statements.

6.4.3 The SDPRP monitoring and evaluation system will continue to be an area of focus. Important elements are to strengthen how information systems in different parts and levels of government are linked and used; how to make greater use of different sources of information; how to link the M&E system to the annual cycle for reporting against the SDPRP and for budgeting and planning; and how to improve public access to information.

6.4.4 Monitoring of public financial management improvements will be undertaken within the PSCAP monitoring framework for EMCP, once the finalised EMCP Strategic Planning exercise is finalised.

7. Risks and undertakings

7.1 Risks are relatively low for this second one year operation. The main risks to achieving the Purpose of enhancing the framework for DBS are:

- (a) A deterioration in the Border situation and resultant additional defence spending this year;
- (b) Multi-donor DBS could be upset if political instability and human rights issues in Ethiopia dampened the growing interest of bilateral donors in DBS. The inclusion of political governance issues in the Common Monitoring Framework should provide a mechanism for discussion of democratic governance risks but cannot completely remove the risk;
- (c) Economic shocks or continued slow rebound from the effects of the drought, for instance on revenue, would affect the macroeconomic picture. Economic management is generally prudent and poverty-related expenditures protected when resources are constrained;
- (d) The risks of GOE not finalising its action plan for PFM improvements based on the CFAA/CPAR recommendations are low. GoE are committed to PFM improvements for domestic reasons, and both the Expenditure Management Control Programme and the national capacity building initiative PSCAP – are high priorities.

7.2 There are no further special GOE undertakings required before disbursement.

7.3 The multiyear 2004/05 DBS programme is under design and is expected to be ready by mid-2004. Based on the Common Monitoring Framework, especially the Joint DBS Policy Matrix, GOE and UK will discuss how to link disbursements with performance against targets.

- (i) Progress under the UK/GOE development partnership Memorandum of Understanding;
- (ii) Implementation of measures to strengthen public financial management reflecting CFAA/CPAR recommendations;
- (iii) Implementation of the systems for monitoring, reporting and review of the SDPRP agreed by GoE and donors (aligned calendar).

7.4 GOE undertakings will as far as possible be linked to the Common Monitoring Framework from which specific triggers may be drawn.