

# **SIERRA LEONE**

## **POVERTY REDUCTION BUDGET SUPPORT PROGRAMME (£15 million)**

**2004/05**

June 2004

## **Sierra Leone: Poverty Reduction Budget Support Programme**

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## List of Acronyms

AfDB	Africa Development Bank
CAFSL	Crown Agents Financial Services
CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment Review
DBO	District Budget Oversight
DDR	Demobilisation Disarmament Reintegration
DEPAC	Development Partners Committee
ERRC	Economic Recovery and Reconstruction Credit
EU	European Union
ESO	Establishment Secretary's Office
GBS	General Budget Support
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Country
IMF	International Monetary Fund
I-PRSP	Interim Poverty Reduction Strategy Paper
IRCB	Institutional Reform and Capacity Building
LS-CFAA	Limited Scope Country Financial Accountability Assessment
NAO	National Audit Office
NRA	National Revenue Authority
MDA	Ministry Department Agency
MDG	Millennium Development Goal
MOU	Memorandum of Understanding
MTEF	Medium Term Expenditure Framework
NPV	Net Present Value
OAG	Office of the Auditor General
PASCO	Poverty Alleviation Strategy Co-ordination Office
PER	Public Expenditure Review
PETS	Public Expenditure Tracking System
PFM	Public Financial Management
PRGF	Poverty Reduction and Growth Facility
PRS	Poverty Reduction Strategy
PRSC	Procurement Reform Steering Committee
PSMS	Public Sector Management Support
SLIHS	Sierra Leone Integrated Household Survey
VAT	Value Added Tax
UNAMSIL	United Nations Mission Sierra Leone
UNDP	United Nations Development Programme

## 1. Summary

### 1. SUMMARY AND RECOMMENDATIONS

1. There is a public commitment by the UK to provide to Sierra Leone an annual baseline of £10m in general budgetary support (GBS) from our current annual bilateral allocation of £40m. This is variable up or down, according to performance against agreed performance benchmarks. The provision of GBS was previously provided for in the Sierra Leone Budgetary Support Programme 2001-2004.
2. It is recommended that DFID provide the Government of Sierra Leone (GoSL) a grant of up to £15 million in 2004-2005 as GBS, in support of the GoSL 2004 Budget, to assist in maintaining macroeconomic stability, promotion of growth and poverty reduction. The level of grant funding disbursed will be linked to progress against the performance benchmarks, agreed between the UK and GoSL, and contained in the UK-GoSL 2004 Memorandum of Understanding (Annex B). Separate proposals will be prepared in due course for 2005-2006 onwards, in the light of progress on the completion of a PRSP and subsequent between GoSL and donors on the timing of arrangements for MDBS.
3. The following arguments support the above recommendation for GBS:
  - a) Sierra Leone is the world's poorest country. Despite an abundance of natural resources Sierra Leone ranks at the bottom of the UNDP's Human development index. GDP per capita is currently US \$160 and income inequality is high. About 60% [of Sierra Leoneans live on less than \$1 a day. Maternal and child mortality rates are high and represent some of the highest figures in sub-Saharan Africa. The deplorable human development conditions prevalent in the country are to a large extent the outcome of a devastating 10-year civil war, which ended in 2002, coupled with a history of poor management of public resources.
  - b) Development assistance, under current circumstances has, at the margin, the potential for large developmental benefits. We believe that the GoSL has made demonstrable progress against both governance and macroeconomic reform programmes to justify continued donor assistance. Our support, at the current time, has also important implications for the maintenance of internal and regional stability, given developments in neighbouring Liberia and anticipated withdrawal of UNAMSIL forces in 2004.
  - c) The GoSL continues to remain on track with the IMF's PRGF programme (agreed in 2001). The fourth review of the 3 year PRGF was concluded in March 2004, and Fund staff approved the disbursement of US\$ 21 million under the current arrangement.

- d) The GoSL, with support from the international community, has made significant progress in consolidating peace in Sierra Leone. These developments together with the improved security situation in the country are having a positive impact on the economy. The United Nations Mission in Sierra Leone (UNAMSIL) deployed throughout the country has provided an effective peace keeping role. However these forces are to be withdrawn during 2005, requiring the government to assume increasingly responsibility for internal security. Our budgetary support will therefore support both the roll out of essential services, such as health and education, but also the resources to expand GoSL's security role.
  - e) Sierra Leone's commitment to poverty reduction is currently articulated in its I-PRSP and most recently in the 2004 Budget Statement. Significant efforts have been channelled towards the preparation and completion of a PRS (September 2004). The 2004 Budget continues to accord high priority to consolidating peace, whilst at the same time promoting social and economic security. The Government's strategy places an emphasis on maintaining macroeconomic stability, poverty reduction and addressing long-term development issues. These objectives are reflected by the government's commitment to improving the delivery of public services and tackling inequality of access (most recently demonstrated by the Government's decision to abolish primary school fees, financed centrally by a subsidy to all schools).
  - f) To foster better service delivery, the GoSL is embarking on a process of decentralisation, with budget allocations for key sectors (health, education, and agriculture) to be deconcentrated at the district level. There is strong re-orientation of the budget towards an increase in capital/development spending (although still principally financed by donors), with a marginal reduction in recurrent spending (although to maintain quality, the goods and services budget is expanding its share), to mark a more growth-orientated stance, and shift from post conflict reconstruction.
  - g) Commendable progress has been made in the area of public financial management reflecting the high priority status accorded to PFM reform by the international donor community. Various donors (including DFID) have made PFM reform measures integral to programme conditionality. The recent establishment of an Auditor Service at arm length from the Government coupled with the competitive and transparent recruitment of personnel demonstrates GoSL commitment to reform. The recent drafting of a new Public Budgeting and Accounting Bill, re-instating the oversight functions of Parliament and the Auditor General's Department, also constitute strategic and note-worthy developments.
4. On the basis of GoSL stated preferences, GBS will be paid in two tranches, scheduled for the second and fourth quarters of 2004. It is

recommended that the first tranche of £5 million be disbursed immediately, in recognition of GoSL efforts in meeting two outstanding performance benchmarks (putting in place an effective PRSP process and the setting up of the Office of the Auditor General at arms length from government), agreed under the 2003 MOU framework. The balance (£5 or £10 million) will be disbursed in Q4 on the basis of satisfactory performance against the benchmarks. The level disbursed will determined by our assessment of progress against GoSL reform agenda and will take into account any unexpected external developments, with repercussion for sound macroeconomic management.

## 2. Logical Framework

Narrative Summary	Objectively Verifiable Indicators	Means of Verification	Assumptions
<p><b>Goal:</b></p> <p>To promote stability, growth and poverty reduction.</p>	<p>Proportion of people living in absolute poverty</p>	<p>Household income and expenditure data</p>	<p>Continuation of peace and security</p>
<p><b>Purpose:</b></p> <p>To enable the GoSL to finance its 2004 Budget, achieve macroeconomic stabilisation and improve service delivery.</p>	<p>Macroeconomic indicators</p> <p>Quarterly and annual reporting of budget expenditure commitments against actual/outcome data</p> <p>Qualitative surveys</p>	<p>IMF IFS data</p> <p>MOF Quarterly economic and budget reports</p> <p>World Bank PER Report</p> <p>PETS report</p> <p>PPAs and RVAs</p>	<p>Coherent PRS produced</p> <p>Sufficient technical capacity exists in Government to carry out reforms, budgeting, and monitoring of expenditure</p>
<p><b>Outputs:</b></p> <ol style="list-style-type: none"> <li>1. Stable macroeconomy supporting sustainable growth and poverty reduction</li> <li>2. Support implementation of 2004 Budget and improve public financial and expenditure management.</li> </ol>	<p>Macroeconomic indicators/data (inflation, official and shadow exchange rate, national income accounts, budget data)</p> <p>Minutes of Financial Management Steering Groups/Committees</p>	<p>BoSL quarterly reports (monetary, external and national accounts data)</p> <p>Government Financial Statistics</p> <p>IMF/WB PRGF review and visit reports</p> <p>Quarterly economic reports and annual budget reports</p> <p>AGD and Public Accounts Committee report</p>	<p>External financing delivered as predicted within the 2004 budget calendar year</p> <p>GoSL satisfactorily implements financial accountability measures</p>
<p><b>Activities:</b></p> <p><b>GoSL:</b> Satisfactorily implements MOU</p>	<p><u><b>Inputs</b></u></p> <p>Budget Support: Up to £15</p>		<p>No significant breaches of</p>

<p>benchmarks, particularly in the following priority areas</p> <ul style="list-style-type: none"> <li>• <b>Governance</b></li> <li>• <b>Public Financial Management</b></li> <li>• <b>Security Sector</b></li> </ul> <p><b>DFID:</b> Support provided to assist the implementation of MOU</p> <p>Disbursement of funds: Transfer in two tranches (by Q2 and Q4, 2004) of an amount to be determined by GoSL performance against MOU benchmarks</p>	<p>million</p> <p><b>Refer to MOU Benchmarks (Annex A)</b></p> <p>“ “</p> <p>“ “</p> <p>“ “</p> <p><i>Refer to MOU Benchmarks (Annex A)</i></p>		<p>MOU</p>
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### 3. Rationale

#### 3.1 Objectives of UK Development Assistance to Sierra Leone

1. The **goal** of UK development assistance is to support Government's reform programme in pursuit of economic stabilisation, growth and poverty reduction. GoSL have articulated these objectives in the UK's 10-year partnership agreement (MOU) and related benchmarks, the I-PRSP, and within the 2004 Budget Statement. A full PRSP is nearing completion
2. The **purpose** of direct budget support programme is to support the GoSL 2004 Budget, with a focus on macroeconomic stabilisation and the delivery of public services.
3. DFID's total programme allocation in Sierra Leone for 2004/05 is £40 million. Direct Budget Support remains one instrument of our support, accounting for a 25-30% share of total development assistance. Projects and technical assistance accounts for the remaining share of the total. DFID's recent policy note on GBS emphasises that '*decisions on types and combinations of aid instruments will reflect country circumstances and the evolution of our relationship with the partner country*'. Such a mix of aid instruments is judged to be appropriate given the operating environment and domestic absorptive capacity constraints in Sierra Leone. GoSL, with the support of the donor community, are continuing their efforts to re-build institutional capacities to improve accountability, transparency and the efficient and equitable delivery of public services. A relatively high proportion of project support is currently necessary.
4. Sierra Leone ranks at the bottom of the UN's development index. It has close to the highest child and maternal mortality rates in the world, and the lowest levels of literacy and life expectancy in the region. Given the wider context, aid channelled at the margin, under such circumstances, whether in the form of project or budget support, has the potential for large developmental benefits, where resources are aligned to meet social and economic objectives. The implications of our development assistance in Sierra Leone for attaining the Millennium Development Goals (MDGs), measured at the international level is unlikely to be significant given the size of Sierra Leone's population (5 million). However if the MDGs were to be measured at the country level the impact is potentially substantial, on the basis of continued government commitment and progress against its reform agenda. For the present however, progress towards the MDGs is very limited, largely due to the continuing impact of a 10 year civil war that ended only in 2002.

### 3.2 Objectives of General Budget Support for Sierra Leone

1. The importance of budget support as a method of development assistance has been assessed within DFID and the wider development community. DFID is committed to channelling more of its financial aid as General Budget Support (GBS) because it:
  - Can help to strengthen local ownership and make governments more accountable to their people by enabling governments to focus on the implementation of their poverty reduction strategy;
  - Enables donors to provide governments with greater certainty about donor flows over the medium term;
  - Provides greater incentives for both donor and recipient governments to strengthen the effectiveness of government systems; and
  - Enables substantial savings in the transaction costs of aid delivery.
2. Research by the Overseas Development Institute (ODI) has found that budget support constitutes an appropriate form of aid in countries that are highly aid dependent and have technical capacity constraints, by providing essential revenues without overwhelming the government with administrative procedures<sup>1</sup>. Sierra Leone remains highly dependent on aid flows to support the budget<sup>2</sup> and human resource capacities are extremely limited across government.
3. The GoSL's most recent statement of economic and financial policies, contained in the 2004 Budget Statement<sup>3</sup>, states that 'the overarching goal of the Government's poverty reduction programme is to work towards the achievement of the Millennium Development Goals (MDGs) for Sierra Leone'. DFID's commitment to provide GBS is based against this backdrop of public commitment to delivery against poverty reduction goals.

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<sup>1</sup> ODI, Economists Handbook, p. 47

<sup>2</sup> In 2003, 50 percent of the government's budgeted revenues were from donor programme and project grants, down from 60 percent in 2000.

<sup>3</sup> Government Budget and Statement of Economic and Financial Policies, for the Financial Year, 2004, GoSL, November 2003.

4. Budget support will contribute to DFID's PSA targets, as the budget remains a central vehicle for and delivery of public services, including health, water and sanitation, roads and electricity (health is principally delivered via NGOs, although GoSL expect to assume increasing responsibility following draw down of NGO activities).
5. A recent policy note on direct budget support (GBS) produced by Policy Division has stated that '*when circumstances are appropriate, GBS is the aid instrument most likely to support a relationship between donor and developing country partners that helps to build the accountability and capability of the state*'. The absence of a comprehensive and well articulated poverty reduction and growth policy has been a key factor explaining the reticence to scale up GBS as a share of our total development assistance. To do so prior to completion would risk undermining the necessary incentives created under our MOU. Following the successful completion of the PRS and its satisfactory implementation, and also subject to continued progress on the PFM reform agenda, we expect to take forward plans for MDBS initially with three other donors currently providing GBS (the World Bank, EU and AfDB). We expect this to lead to a scaling up of GBS as a proportion of our programme, although the timing of such a move will need careful appraisal.

Budget support linked to progress against the MOU has provided DFID with an effective forum for participation in policy dialogue at a strategic level with both GoSL and donors. In so doing, it has supported other components of DFID's Sierra Leone programme activities, delivered as a combination of projects and technical assistance.

6. In the absence of a full Poverty Reduction Strategy, DFID's Memorandum of Understanding (MOU) is currently the interim policy framework (prior to completion of a full PRS) to engage in donor-government dialogue on policy reform and assess GoSL performance. In order to enhance DFID's leverage and donor aid effectiveness, DFID budget support is subject to variation depending upon GoSL performance against a series of agreed benchmarks.

The MOU provides for a baseline of £10 million to be disbursed where performance is judged to be satisfactory, increasing to £15 million where performance exceeds expectations. If progress against the benchmarks stalls, DFID reserves the right to reduce budget support, including (in extreme cases) withholding the full amount of support. The MOU also commits the UK government to a programme of assistance in support of policy reforms. In this way the necessary incentives to reward performance is clearly articulated, and action on both sides regularly reviewed and assessed.

7. The development of a PRS (expected in September 2004) and its subsequent implementation will provide the necessary medium-term policy framework for DFID and other donors to move towards a multi-

donor budget support facility. The PRS will provide the necessary platform to increase donor co-ordination and discuss options to harmonise donor aid procedures.

### **3.3 GoSL Poverty Reduction Policies and the MoU**

1. Despite an abundance of natural resources, Sierra Leone remains one of the world's poorest and least developed countries ranking consistently at the bottom of the UNDP Human Development Index. GDP per capita is approximately \$193 (2004) and income distribution is highly unequal. Latest available data suggests that Sierra Leone's poverty incidence (poverty head count measure) remains high, as one should expect from a country emerging from a devastating civil war. The most recent household survey data (2004), showed that 60% of households depend on an income less than the equivalent of \$1 a day, with a marked variation between Freetown (9%) and the rest of the country (70%).
2. The GoSL has outlined its poverty reduction strategy in an Interim Poverty Reduction Strategy Paper, which was agreed by the donors in 2001. The I-PRSP recommended a two-phased strategy distinguishing between immediate needs related to conflict and peace building, and longer-term structural needs, related to employment generation, and improvements to the efficiency, quality and access to public service. The latter series of policy measures were to be defined during the preparations for a full PRS.
3. In the absence of a full PRSP, and partly to enable DFID to judge GoSL's commitment to poverty reduction during the period prior to completion of a full PRS, DFID in consultation with the GoSL developed an MOU agreement. The ten-year MOU between HMG and the Government of Sierra Leone (GoSL) was signed in November 2002, and commits the GOSL to a wide-range of reforms in return for DFID support. Benchmarks agreed with the GoSL for 2004 are contained in Annex B. The level of aid disbursed varies according to performance against this matrix of (time bound) benchmarks. Progress is assessed jointly on a quarterly basis with the Vice President and Financial Secretary, and discussions are recorded on a formal basis, as part of the decision making process.
4. The donor-partner dialogue surrounding the MOU has proved extremely effective. It has enabled DFID to engage in frank and open discussions on a spectrum of institutional issues ranging from anti-corruption, public financial management and security sector reforms. It has provided an opportunity for the GoSL to demonstrate progress against policy commitments, thereby providing the necessary evidence base to justify disbursement of our GBS. Areas of particular impact in the first year of the agreement include influencing the PRSP and public financial management, namely;

- **On the PRSP:** DFID made clear in 2003 that our budgetary support could not be disbursed above the baseline until clear progress was being made towards developing the full PRS. Our focus of attention on the PRSP, jointly with the World Bank and UN, led to a complete overhaul of the institutional arrangements for its preparation.
- **On PFM:** Concerns conveyed through the MOU discussions were decisive in getting the GOSL to move on its long delayed commitment to establish the Auditor General's Office at arms length from Government. The Auditor General attributes the setting up of her office on this basis to the pressure applied through the MOU review process

## **PRSP Preparations**

5. Following a period of delay the preparation of the PRSP has now gained momentum, following intervention from donors. Donor lobbying efforts resulted in a transfer of responsibility from the Ministry of Development to the Office of the Vice President, with greatly improved involvement from the Ministry of Finance. The transfer of responsibility to the President's office, with more pro-active involvement from Finance, is likely to improve the link between policies articulated in the PRS and resource availability (MoF have since 2002 adopted MTEF budgeting principles). A National Poverty Alleviation Strategy Coordination Office (PASCO) was established in 2002 to oversee the co-ordination of the PRS. The bi-monthly meeting of donors and partners (DEPAC) continues to provide an effective forum to assess progress and maintain momentum on PRS preparations.
6. Significant progress has been made on the, now completed, integrated household income expenditure survey (SLIHS), the first comprehensive survey since 1989, providing much needed analytical data for the construction of Sierra Leone's poverty profile. To inform future policy making, and to allow further analysis of the data, DFID will provide additional funding to permit Sierra Leone's national statistics office (Statistics Sierra Leone), to set up a database to archive survey data. Fourteen sector reviews, to feed into PRS policies, have recently been completed, with support from DFID and the World Bank.
7. To deepen public awareness and ownership of the PRSP, a nationwide sensitisation and awareness-raising programme was conducted for the general public in 2003. To supplement quantitative information derived from the SLIHS, participatory poverty exercises are being conducted at the community level to provide qualitative information on poverty. GoSL plans officially to produce a first draft of the PRS by July 2004; however a more realistic date is September 2004. On completion and approval of the PRS by the Bank and Fund Boards, we intend to move towards a multi-donor, multi-year budget support facility, possibly from 2005/06 onwards, in collaboration with other donors.

### 3.4 Recent Economic Developments

1. Economic activity in Sierra Leone expanded in 2003, reflecting recovery of activity in agricultural and mining sectors. Key macroeconomic developments include:
  - **Real GDP growth of 6.5% in 2003**, representing a marginal increase on 6.3% in 2002. Despite positive real growth rates recorded since the end of the conflict, Sierra Leone's growth performance remains disappointing for a post conflict country.
  - **Inflation saw an acceleration from –3.0 percent in 2002 to 6.6 percent in 2003**, resulting in upward pressures on basic commodity prices (rice and fuel) with implications for the cost of living. Price increases resulted from a combination of two factors:
    - a) A real exchange rate depreciation of the Leone in 2003 (equivalent to 16% on a year-on-year basis), caused by shortfall in foreign exchange due to withdrawal of UNAMSIL post-conflict activities, and continued import demand for reconstruction activities
    - b) Expansion of the domestic money supply owing to higher than **expected** domestic bank borrowing to finance the budget deficit mainly due to failure by the EU and ADB to deliver US\$25 million in promised budget support.
  - **Unemployment, particularly that of youth is becoming a growing and significant problem.** The country's demographics illustrate this situation. Latest survey data suggests that 54% of Sierra Leone's population are below the age of 20 years and the median age is 18.2 years. A large proportion of those unemployed are below 30 years of age. Youth unemployment among men (below 30) is estimated to be 50 percent<sup>4</sup>. This compares to a figure of 9.4% for those above 30 (refer to Table 1 below). GoSL, with donor efforts, should give priority to addressing the youth unemployment problem. Youth unemployment not only represents untapped productive potential (in the form of labour resources) but also represents a significant security risk where youth remain jobless and marginalised.

**Table 1 – Sierra Leone Inactivity Rates by Age Group**

	15-30	>30
<i>Male Inactive</i>	49.7	9.4
<i>Female Inactive</i>	32.9	19.4

(Source: Integrated Household Income Expenditure Survey, SSL 2004)

<sup>4</sup> Latest data, based on a half year cycle, from Sierra Leone's integrated household survey.

- Sierra Leone's **current account deficit, including transfers, was 13.1% of GDP in 2003**. Import growth in 2003 was strong due to oil price increases during the year. Despite the recovery of cocoa and diamond exports, acting to boost foreign exchange revenues, receipts were insufficient to cover the import bill. Exports are expected to expand more rapidly from 2005, as bauxite and rutile exports come on stream, acting to narrow the current account deficit in the coming year.
2. Key fiscal and budgetary developments in 2003, included:
    - **Higher than programmed domestic revenues of Le 284 billion or 15.4 percent of GDP (c. Le 272 billion target)**. However, external grant financing fell substantially short of programme expectations, as delays occurred in the disbursement of project grants<sup>5</sup>. On a positive note, programme grants including debt relief linked to the enhanced HIPC Initiative, were larger than programmed.
    - Due to donor shortfalls, **total expenditures were lower than programmed** at Le 614 bn (below the target of Le 726 bn). Consequently total expenditure and net lending was 23.2 percent of GDP, well below the programmed level of 28.8 percent of GDP. Despite the reduction in expenditure outlays in relation to programme targets, GoSL were able to protect poverty related expenditures<sup>6</sup>.
    - The **overall budget deficit including grants remained within the IMF programme target at 7.3% of GDP**. However recourse to domestic bank financing has resulted in an acceleration of inflation over 2003, while crowding out private sector investment.
  3. Timely disbursement of DFID budget support, on the basis of satisfactory performance, will ease the need for further domestic bank financing, acting to limit inflation and simultaneously increasing availability of credit for the private sector.
  4. A summary of the sectoral distribution of the Government's budget between 2001-2004 is presented in Table 2 below. The GoSL has progressively expanded resources to the education and health sectors as a share of GDP, whilst the share of defence expenditures have declined. A key development over 2004 and beyond, with notable implications for the budget, will be the (almost) complete withdrawal of UNAMSIL forces, and the need for government to assume full responsibility for internal security. GoSL will expand the police force, while the size of the military will be scaled down.

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<sup>5</sup> The shortfall in foreign financing arose in part due to an administrative delay in conducting an audit that constituted part of the EU grant conditionality. Provided the findings of the audit are satisfactory to the EU, disbursement of the grant is expected in the third quarter of 2004. Another cause of the shortfall was the delay in a grant disbursement from the AfDB.

<sup>6</sup> IMF PRGF Review: 'Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility' (February 2004, IMF).

5. In the social sectors, the abolition of primary schools fees in 2003 has resulted in a dramatic increase in primary school enrolment rates. Following a decade of war, primary enrolment rates by end of the 1990s were estimated to be 65%, reaching a low point of 41% during the conflict years. Gross enrolment rates have shot up to an estimated 112% in 2003<sup>7</sup>. The share of education spending in the budget is broadly consistent with the average for other sub-Saharan African countries (approx. 22-25% of discretionary recurrent expenditures). With the inclusion of HIPC debt relief savings, the share of recurrent spending on education was nearer 30% in 2003. From 2001 to 2003<sup>8, 9</sup>, education spending has increased its share of GDP from 3.9 to 5.5 per cent.

**Table 2: Sectoral analysis of the GoSL budget – 2001-2006**  
(Le millions)

	2001	2002	2003	2004	2005	2006
	Actual	Actual	Actual	Est.	Est.	Est.
Nominal GDP	1,507,921	1,678,039	1,863,000	2,076,498	2,291,483	2,526,886
Total Expenditure	610,034	656,210	597,999	839,730	916,098	930,866
Recurrent Expenditure	379,204	392,700	485,368	507,283	552,234	596,687
Interest payments	79,008	70,120	83,771	72,511	67,038	67,992
DDR	43,907	37,019	16,513	0	0	0
Recurrent Expenditure (excl Interest and DDR)	256,289	285,561	385,084	434,772	485,196	528,695
Recurrent Expenditure on:						
Education	58,809	70,478	101,894	110,411	119,122	128,202
Health	22,619	33,561	40,178	46,582	50,758	56,364
Defence	55,793	57,053	66,841	68,406	73,246	77,571
As a % of recurrent expenditure						
Education	22.9%	24.7%	26.5%	25.4%	24.6%	24.2%
Health	8.8%	11.8%	10.4%	10.7%	10.5%	10.7%
Defence	21.8%	20.0%	17.4%	15.7%	15.1%	14.7%
As a % of GDP						
Education	3.9%	4.2%	5.5%	5.3%	5.2%	5.1%
Health	1.5%	2.0%	2.2%	2.2%	2.2%	2.2%
Defence	3.7%	3.4%	3.6%	3.3%	3.2%	3.1%

(Source: Budget Bureau, Ministry of Finance, GoSL, June 2004)

## 6. GoSL expects the following macroeconomic developments over 2004:

<sup>7</sup> An excess above 100% is explained by large numbers of both under and over aged children attending school.

<sup>8</sup> Draft World Bank Public Expenditure Review: Education Sector, World Bank, February, 2004.

<sup>9</sup> A recent survey of ten African countries indicated a share for education of 4 percent ranging from 1.5% to 5.6 %.

- **real GDP** growth of 6.8%<sup>10</sup>
  - overall **budget deficit** of 8.2% up from 7.3% of GDP in 2003
  - **domestic revenues** at 16% of GDP (c. 15.4% in 2003)
  - **an inflation rate** of 3.5%<sup>11</sup>
  - **overall budget deficit** (excluding grants) of 24.4% (c.17.7% in 2003);and
  - **a primary budget balance** of 6.5% of GDP
7. The GoSL 2004 budget, as articulated in the Budget Statement 2004, while continuing to address immediate post-war problems, including further consolidating peace and security, provides resources to achieve the following stated medium term objectives:
- **renewal of basic services**, and tackle **inequality** of coverage;
  - **improve physical infrastructure**; and
  - **reduce inefficiencies** in **public service delivery**
8. The 2004 Budget marks a watershed for the country, with a significant compositional shift towards reconstruction and medium term growth objectives, and a phased reduction of post-conflict activities. The Government is putting in place a more effective framework for managing public resources, through implementation of MTEF principles, setting up of an independent revenue authority and auditor general's department, and a series of reforms aimed at improving governance. Additional to these measures, the 2004 budget statement has given priority to the renewal of public services and tackling inequality, through the process of decentralisation. To foster improved service delivery, budget allocations to key sectors, education, health and agriculture, are being deconcentrated to the district level.
9. The Government's decentralisation policy is contained in the Local Government Act 2004, and provides for an ambitious plan for devolution of functions, expenditures, and revenue generation to local councils. Inter-governmental transfers will be based upon a transparent formula underpinned by the principle of equity. The World Bank's **Institutional Reform and Capacity Building project (IRCB)** has a component targeted at strengthening local government capacities, to allow them to manage their future responsibilities as provided for under the Act.
10. The GoSL proposes substantial increases in 2004 expenditure outlays to 40% of GDP, compared to a 33% over 2003. The IMF PRGF programme has set expenditures at a more realistic level of 36% of GDP. There is a risk for the Government in setting level of spending in

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<sup>10</sup> Growth will be sourced to recovery of agricultural sector and reconstruction and investment activities.

<sup>11</sup> A tight monetary policy is anticipated, with domestic financing of limited to Le 3.5 billion, of which banking financing will be capped to Le 1.5 billion.

excess of 36% of GDP (the IMF programmed level): if revenues or external financing are lower than expected, then expenditures will either have to be reduced or financing will need to be sourced to inflationary domestic bank borrowing.

11. The 2004 Budget aims at promoting continued high growth while maintaining macroeconomic stability, by reducing bank financing of the deficit. The increase in expenditure outlays is attributed to an expansion of foreign-financed development spending, from reasonably confirmed external resources (the AfDB, EU, DFID), while recurrent expenditure is expected to fall slightly (as a share of GDP). The large increase in development spending is accounted for by several delayed donor projects coming on stream (including power, roads and education infrastructure principally from the EU and the World Bank).
12. The shift observable between recurrent and development spending within the Budget reflects a shift of structural priorities; recurrent spending will fall by 1%, while development expenditures are projected to rise by 8% of GDP, funded entirely by foreign loans and grants (refer Annex E).
13. Total grants and revenues in 2004 total 32.2% of GDP: grant funding (programme and project) accounts for half the amount, while the remainder is attributed to domestic revenue generation. Table 3 breaks down confirmed sources of budgetary support from international donors for the 2004 Budget. DFID expect to finance one quarter of total donor budgetary support, as grant financing linked to progress against our MOU. The EU budget support, also grant financing, is made contingent on progress against the matrix of corrective measures (Annex H), and successful audit of 2002 government budgetary expenditures.
14. A decision, is still pending on EU budgetary support. The AfDB has approved the disbursement of US\$ 14.5 million [worth of loan financing under their Economic Rehabilitation and Recovery Loan (ERRL-II) in December 2003. The World's Bank loan (US\$ 15 million) under their ERRC-III credit is contingent upon satisfactory progress against structural benchmarks (including progress towards establishment of a land cadastre). DFID is providing technical and financial support to the Ministry of Mineral resources to establish a land cadastral system. A breakdown of donor budget support for the 2004 is contained in Table 3.

**Table 3: Breakdown of Budget Support by Donor, 2004 (£, m)**

	2004	%
DFID	10	25%
EU	13.56	34%
AfDB	8	20%
WB	8	20%
<b>Total</b>	<b>39.56</b>	<b>100%</b>

Source: *Government Budget Statement, MoF, GoSL, 2004.*

Note: Disbursements from AfDB and WB are soft loans (below the line financing), while DFID and EU budgetary support is grant financing (above the line).

15. Spending on DDR will be ended in 2004 (equivalent to 1.2% of GDP 2003). Such compositional changes signal a transition to a more growth orientated stance and a definite move away from post-conflict activities. To attain fiscal objectives the government intends to implement reform of tax administration (with the support from other donors, including DFID and AfDB), to augment the domestic revenue base; the authorities also expect an increase in external donor financing.
16. In terms of budget management, there are a number of weaknesses in the budget preparation process in Sierra Leone, as articulated most recently in the World Bank's PER exercise. Some of the key constraints relate to the continued separation of development and recurrent budgets, the lack of strategic prioritisation of budgetary allocations, and efficiency of government spending. The former will be addressed through the Bank's Institutional Reform and Capacity Building project (IRCB), with technical support aimed at consolidating the reporting of budget spending under the recurrent and development budgets.
17. The development and subsequent implementation of a PRS should improve the strategic allocation of government spending, although budget planning, formulation and execution will need strengthening through targeted technical support both at the central and also at the local level, as the process of decentralisation takes effect. The World Bank's IRCB is expected to provide technical support to improve financial accountability at the decentralised levels. A programme of EU technical assistance support to the MoF (from July 2004), consisting of 3 long-term advisors, and Euros 1.5 million of short term TA over 3 years, is expected to provide support to strengthen public expenditure management processes.

#### *Debt Relief and Enhanced HIPC Assistance*

18. In March 2002, the Executive Boards of the IMF and the World Bank considered Sierra Leone's decision point document, under the enhanced HIPC Initiative<sup>12</sup>. The Boards concluded that Sierra Leone was eligible for assistance under the enhanced HIPC initiative and, in 2002, the IMF Executive Board approved SDR 23.64 million as interim HIPC assistance to Sierra Leone. Budgetary savings from interim debt service in 2002 and 2003 were re-channelled into poverty related expenditures, with quarterly reporting to donors, against spending

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<sup>12</sup> Sierra Leone has a significant external debt burden with the net present value of outstanding debt over \$1.2 billion and a net present value debt-service to exports ratio of 695 percent in 2001. Approximately 55 percent of Sierra Leone's external debt is owed to the IMF and World Bank with another 40 per cent owed to Paris Club creditors.

targets. The recent IMF PRGF review commended the Sierra Leone authorities on progress against HIPC Completion point triggers. Annex G provides an update on the status of implementation of the triggers<sup>13</sup>. Higher than expected flows of HIPC resources in the 2004 Budget have been instrumental in offsetting delayed disbursement of programmed budgetary support from the EU.

19. Further progress has been made on bilateral **debt rescheduling** following recent negotiations with bilateral creditors. The government has signed debt-rescheduling accords on Naples terms with ten out eleven Paris Club bilateral creditors and on Cologne terms with six bilateral creditors. The outlook for debt sustainability has improved relative to the HIPC Initiative decision point projections. The NPV of debt-to-exports ratio is projected to decline by 35 percentage points to 124 percent at end-2003, (sustainability ceiling under enhanced HIPC is 150 %), compared to the projection at decision point, mainly due to improved export revenues (diamonds and coffee), combined with lower external borrowing.

### 3.5 The PRGF Reform Programme

1. DFID's MOU requires that GoSL remain on track with the Fund's PRGF programme. The GoSL has agreed a 3-year PRGF programme with the Fund beginning in late 2001. The main elements of the GoSL Memorandum of Economic and Financial policies covering 1 July 2003 to 31<sup>st</sup> December 2004 are detailed in Annex F. GoSL has broadly remained on track with the PRGF since its inception in 2001, gaining the Fund's seal of approval for macroeconomic management.
2. A fourth review of the PRGF was completed in February 2004. The review commended GoSL for maintaining macroeconomic stability in a difficult post war situation, although Staff concluded that performance overall had been mixed, mainly due to slow progress against structural benchmarks.
3. Structural conditionality under the current programme (contained in Appendix F) has a strong focus on strengthening public service delivery, accountability and management, with several reform measures targeted at the Ministry of Education. The Fund's emphasis on the education sector is motivated by the large share of education spend in the GoSL budget (c. 25% of recurrent revenues) and hence fiscal implications related to improved expenditure management. Fund structural benchmarks focus on improved accountability and expenditure control in the education sector, including *inter alia*:
  - Issue of identification cards for all teachers

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<sup>13</sup> The Sierra Leone authorities requested additional interim debt relief equivalent to SDR 14.75 million running for a further 12 months starting March 2004 until March 2005, allowing 94% coverage of each principal repayment falling due to the Fund over the next 12 months.

- Financial Audit of the Ministry of Education
  - Photo verification of all existing teachers
  - Financial Secretary to approve recruitment of all new teachers
4. Additional expenditure controls have included the setting up of Bank accounts for schools, and where feasible for teachers, operating outside Freetown, to facilitate direct transfer of teacher salaries.
  5. Despite the mixed reading, on the basis of the implementation of remedial measures against outstanding structural benchmarks, the Fund Staff approved disbursement of US\$21m (£11.5 m) of PRGF funds in February 2004, bringing the total amount drawn under the arrangement to US\$133 million (total approved resources under the PRFG are US\$196 million).

#### *Public Sector Reform*

6. GoSL continues with functional reviews of line Ministries and has begun to implement reforms in Ministries where reviews have been completed. With support from DFID, GoSL will put into effect new civil service rules and regulations relating to pay, grading and job classification, and convert the Establishment Secretary's Office (responsible for civil service recruitment) into a modern personnel management office. GoSL has also published a proposal to introduce a streamlined senior civil service, based partly on performance related pay.

### **3.6 Fiduciary Risk Assessment and Financial Management**

1. Through a series of donor-partner initiatives, public expenditure and financial management systems are being progressively strengthened in Sierra Leone. Key developments have included the re-writing of the Government's Budgeting laws to increase external scrutiny, accountability and sanctioning of budget execution and implementation by the Office of the Auditor General and Parliament. Despite continued efforts and demonstrated progress on the ground, weaknesses in accounting and reporting systems remain. These need to be addressed through on-going reforms. Improvements to financial and public management systems have become an integral part of donor structural conditionality and technical support (IMF, WB, EU, AfDB and DFID) over the last few years, reflecting the higher priority status accorded to strengthening PFM systems and processes, underpinning continued donor support by these organisations.
2. As a result of increasing donor priority assigned to fiduciary risk issues, several donor diagnostic assessments have been completed over the last 24 months, including a joint World Bank-DFID Country Financial

Accountability Assessment (CFAA)<sup>14</sup>, an EU assessment framework, a HIPC accountability assessment and a PER diagnostic assessment. Most of these exercises, however, have been completed on an individual rather than a collective basis, with limited attempts to date to harmonise implementation of respective plans. Despite the many assessments, the various reform initiatives deriving from assessments do exhibit a high degree of complementarity with no two donors delivering overlapping programmes in the same area, reflecting co-ordination on a more informal basis.

3. However in recognition of the desirability for improved sequencing of donor reform activities, a government-donor working group on PFM was established in 2003 to assess progress against the CFAA and other diagnostic studies on a periodic basis. To facilitate this process further DFID and the World Bank have agreed to hire a dedicated public financial advisor on a joint basis, based in the Bank office in Freetown. An early responsibility of the Advisor will be to actively promote more joined up working on the PFM reform agenda, and to strengthen GoSL ability to lead on the co-ordination process.
4. A detailed fiduciary risk assessment, against criteria developed by DFID, is contained in Annex 1 and Table 3. Overall, GoSL continues to make good progress against the public financial reform agenda and was assessed to have an overall fiduciary risk rating of **medium**. A summary of the assessment is contained in Table 3 below. A detailed assessment is contained in the Fiduciary Risk Assessment at Annex A.
5. Due to the country's continuing reconstruction and human development needs (which remain significant) ***the benefits of budget support clearly justify the risks, many of which are being systematically addressed, through a series of donor-GoSL reform initiatives at the country level.*** Significant recent improvements on public financial accountability include the following:
  - Operational independence for the newly established AudiService (formerly the Office of the Auditor General) as provided for in the Audit Service Act 1998
  - A draft Government and Budgeting and Accounting Bill sent to Parliament, to be enacted in a few months. The law enhances the oversight roles of the Auditor General and Parliament, streamlines the budgeting process, and clarifies the relationship between central and local government.
  - The setting up of a joint GoSL/Donor group on public financial management (PFM) to oversee implementation of reform measures identified by the (limited scope) Country Financial Accountability Assessment (CFAA)

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<sup>14</sup> The CFAA conducted in 2003 was considered to be a limited in scope, on the basis that, the review focused on financial controls and accountability at the central level, principally the Ministry of Finance (MOF) and Auditor General's Department (AGD).

- Strengthening internal audit department capacities in the Ministry of Finance including measures to increase compliance with international accountancy standards
6. Areas that require further improvements have been identified by the World Bank (under the IRCB) and the recent PER exercise, details of which are contained in Annex A.
  7. As mentioned, a collective effort on PFM reform is being pursued in country. Improvements to the PFM system have become an integral part of donor IFI conditionality, incorporated within the IMF's Poverty Reduction and Growth Facility (PRGF) and the Bank's Economic Reconstruction and Rehabilitation Credit (ERRC III). Specific conditions have included re-establishing a payroll verification system, implementing systems to prevent the build up of arrears to parastatals and public sector workers, and a financial audit of the Ministry of Education.
  8. The World Bank's Institutional Reform and Capacity Building Project (IRCB) scheduled for implementation from June 2004, has earmarked resources for PFM reforms. The programme, amongst other things, with DFID technical support, intend to implement a new integrated financial management information system (IFMIS), to allow authorities on-line access to financial accounts, to facilitate closer tracking of government expenditures. The programme also intends to provide financial management training at the district council level in support of the GoSL's decentralisation programme.
  9. Sierra Leone's IMF's HIPC Assessment is contained in Annex C. It is interesting to note that Sierra Leone recorded an above average score in comparison to a peer group of HIPC countries – including Ghana. Despite the positive read out, weaknesses remain, and strengthening of both internal and external audit and accounting functions at central and line Ministry level are needed.

Table 3: Assessment Against DFID Fiduciary Risk Criteria

<i>Criterion</i>	<i>Met?</i>	<i>Explanation</i>
A thorough evaluation of public financial management systems, and associated risks, has been carried out	✓	Donors have undertaken a series of PFM assessments including a LS-CFAA, EU assessment, HIPC assessment, with related action plans and reform measures identified.
The government has a credible programme to improve the standards of these systems	✓	The GoSL has set up a joint government-donor working group on PFM, with representation by senior officials across government. An action plan outlining reform measures linked to the CFAA is reviewed on a regular basis, to be

		facilitated by recruitment of a PFM advisor.
The potential development benefits outweigh the risks, taking account of any safeguards that can be put in place to buttress and develop these systems	✓	The GoSL has made significant progress in macro stabilisation and more recently, increased efforts to produce a PRS. Rising share of health and education spend in the budget, coupled with the abolition of school fees, and a stated commitment in the 2004 Budget to increase access and reduce inequality, signal greater poverty orientation of GoSL policies. On-going PFM reforms championed by the major donors (WB, IMF, EU and DFID) will act to mitigate fiduciary risks.
These assessments are explicitly recorded as part of the decision making process to provide assistance	✓	Public expenditure and financial management reform measures constitute key reform measures integrated into donor programme conditionality. Assessments and progress against them are recorded as part of the decision making process to provide assistance.
<b>Overall Fiduciary Risk Assessment</b>	<b>B (medium)</b>	The GoSL continues to demonstrate commitment and progress on a range of areas designed to strengthen budget accountability.

10. In addition to technical improvements,, GoSL has also opened up the budget preparation and implementation process to allow oversight from civil service organisations. These included a nationwide information campaign on the 2003 Budget appropriations in all districts; and, with the support of DFID trained members of the District Budget Oversight (DBOs) Committees on public budgeting, execution and monitoring procedures. The Ministry of Finance now publishes quarterly and half-year resource allocations and expenditures for all MDAs in the Government Gazette, substantially improving the transparency, accountability, and broader public participation in the budget cycle.
11. Another GOSL led initiative has encompassed reform of the highly centralised public procurement system, (based on outdated 1963 legislation), to improve efficiency and utilisation of public funds. A procurement reform steering committee (PRSC), chaired by the Vice President, has approved an Action Plan for procurement reform. Interim procurement arrangements are in place, pending the design of a new system. A Steering Committee on which donors are represented is overseeing the process.

12. To facilitate preparation of the MTEF budgets for financial years 2004-2006, the Ministry of Finance prepared and issued (with donor technical assistance, under the Bank's PSMS), MTEF Guidelines to all Ministries, Departments and Agencies (MDA's). Policy hearings were introduced in 2003, as the first step in the MTEF cycle, with the aim of reviewing sector strategic plans and their cost implications. The production of a PRS will provide a more comprehensive medium term policy framework to guide prioritisation of policies from 2005 onwards.
13. Public Expenditure and Tracking Survey (PETS) was introduced in October 2001, with DFID support, to track the efficiency and effectiveness of public expenditure and to assess the perception of service delivery by communities in rural areas.<sup>15</sup> PETS has become an important tool to review the flow of budgetary resources in key sector Ministries from the point it is transferred from Finance, to sector Ministries and finally to implementing agencies (primary health units and schools).
14. The results of the first PETS fed into the annual budget process for 2002, and included the introduction of new budget and accounting codes showing the distribution of resources by region. The earlier PETS Survey (covering 2001 spending) highlighted weaknesses in the flow of teacher's salaries, from the Ministry of Finance to schools, partly related to transfer of resource via several intermediaries. As a solution, salaries were transferred direct from the Ministry of Finance's account at the Bank of Sierra Leone to school bank accounts and individual teacher accounts where feasible.
15. The most recent PETS exercise tracked the flow of specific line item expenditures in health and education, including the transfer of the school fee subsidy, teaching and learning materials and essential drugs. Although the report indicated a significant improvement in the proportion of school fee subsidy transferred (from 55% to more than 90%), significant accounts discrepancies were uncovered for essential drugs (only 5% of essential drugs transferred from Central Medical Stores to Primary Health Units could be accounted for). Transfer discrepancy of this magnitude imply significant weaknesses in the application of financial rules and regulations requiring immediate priority attention from the GoSL. The PETS report has yet to be officially circulated, but DFID intend to request a formal GoSL response to the report, including a strategy of remedial measures, when made publicly available.
16. The World Bank, with support from DFID, has conducted a comprehensive public expenditure review, during the first and second quarters of 2004, in several spending Ministries. The PER reviewed resource allocation, but also assessed public financial management

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<sup>15</sup> Sierra Leone: Poverty Reduction Strategy Paper Preparation Status Report, June 2003, IMF Country Report No. 03/182, IMF, 2003.

and expenditure systems. Key areas for reform have been outlined in the areas of budget policy formulation, budget execution, macroeconomic management and public financial management. Details are contained in the Fiduciary Risk Assessment at Annex A.

### **3.7 Statement on Risk of Corruption**

1. Sierra Leone has a high level of corruption in public life. The breakdown of governance systems, financial probity and impartiality in the public service during the period following independence, led to widespread corruption, from major diversion of government funds from government contracts at the highest levels, to the imposition of payments for all forms of service delivery in everyday life.
2. A Corruption Perception Survey in 2000 showed that 94% of Sierra Leoneans sampled thought that corruption was widespread; 95% thought it rampant in government departments. In 2002, DFID and the World Bank Institute jointly funded a Governance and Corruption Survey. It showed that over 80% of respondents regarded corruption as a "very serious" problem. The commonest form of reported corruption is bribery.
3. The current administration has presented the fight against corruption as its first priority. President Kabbah made a personal request to the then Secretary of State to help. As a result, the Anti Corruption Commission was established in 2000, largely with DFID support. So far, over 600 reports of alleged corruption have been reported to the ACC. There have been 9 convictions, including a High Court judge. We have helped to strengthen the judiciary, to assist with the processing of cases referred by the ACC.
3. Specific measures on corruption are included in the benchmarks agreed with the Government in the UK/Sierra Leone 10 year MOU. There are 6 such benchmarks for 2004. These include the preparation of a National Anti Corruption Strategy and the setting up in line Ministries of strategies to eliminate corruption. The Ministry of Finance has volunteered to be the first to have such a strategy, and an implementation structure. This will, we hope, further strengthen the measures being taken on PFM, described above and in the attached Fiduciary Risk Assessment. A National Anti Corruption Strategy is in preparation, to be launched in December 2004.
5. A specific requirement of the 2003 benchmarks was that the GoSL move forward with its much-delayed proposal that the Office of the Auditor General be established at arms-length from government, and that recruitment to it take place on a competitive basis. This has now been done. This action was linked by us directly to the provision of budget support, but was not initiated in time for a transfer to be made in our 2003-2004 financial year. GoSL are expecting a response from us,

in terms of an immediate transfer of budgetary support. This will now be included in the transfers envisaged in this project document.

6. Pressure for the maintenance of vigilance on PFM is also shared with other donors, notably the World Bank and EU, who also provide GBS. The matrix of corrective measures developed following a critical EU audit in 2002 is the basis for the joint work of the GoSL/donor group on PFM. It is probably the area in which GoSL action is under closest donor scrutiny, and therefore likely to be most reliable. It is also the case that key positions in the Ministry of Finance are held by expatriate Sierra Leoneans who are generally held in high regard by the donors. Although this is unsustainable, the extent of dependence on this group will probably continue until wider civil service reforms have been carried out, and good quality candidates apply for government posts.

In summary, while corruption remains widespread in Sierra Leone, PFM is subject to particularly close scrutiny. The Anti Corruption Commission, with DFID support, is extending its influence, particularly into prevention. We will support the establishment of anti-corruption measures in line ministries, as a further step in closing down opportunities for corrupt practice.

## 4. Financing Requirement

1. External resources in the form of budget support provide important resources to bridge the significant internal and external resource gaps. Sierra Leone's external current account deficit in 2004, excluding official transfers, is projected at 31 percent of GDP (16 percent, including transfers). Loans and grants from multilateral institutions and bilateral donors, account for the bulk of external financing. Foreign direct investment and private sector loans remain a small share of the total (15%) - refer to Table 4 below, and are unlikely to grow substantially in the medium term. Sierra Leone, due to limited social and physical infrastructure, and external perception problems, is unlikely to attract sufficient private investment flows to bridge the financing gap.
2. A large external deficit is explained by strong import demand related to the recovery of economic activity and imports for reconstruction. Exports, although recovering, are unlikely to grow as rapidly as import demands (rutile exports are not expected to begin before 2005), with principal exports accounted for by diamonds and coffee.

**Table 4: External Financing Requirements and Sources: 2001-2005**

	(Mn US \$)	(%)
<b>Gross External Financing Requirement</b>	<b>306</b>	<b>100%</b>
<b>Sources of Finance:</b>		
Loans for BoP	87	28%

Grants	92	30%
Project Loans	36	12%
Non-Budget transfers	45	15%
FDI	46	15%

**Source:** Sierra Leone Authorities and IMF Staff Estimates

3. GoSL overall budget deficit (excluding grants) for 2004 is projected at 24.4% of GDP. The large financing gap, and domestic resource shortfall, is again explained by slow recovery of the tax base, ahead of growth in demand for services and reconstruction activities. In the medium term as economic recovery becomes more fully establish, external and internal financing gaps as reflected in the IMF programme, are projected to progressively decline, as domestic revenue progressively expands, while non-productive expenditures (including debt-service payments) are written off.
4. To facilitate mobilisation of tax revenues GoSL plan to implement tax policy reforms (including the introduction of VAT, and deferring the planned reduction of corporate income taxes) with measures to strengthen tax administration. DFID is currently in the process of designing a programme of support for the newly established independent National Revenue Authority to increase its capacity to raise domestic tax revenues. The NRA was established in 2003, with (limited) assistance from the World Bank under the Bank's public sector management support programme (PSMS). DFID support will be made contingent upon a commitment by the Ministry of Finance to honour its financial obligations as provided for under the NRA Act 2002. Careful consideration will need to be given to tax concession policies aimed at attracting foreign investment and its subsequent implications for the loss of tax revenues in the medium term.
5. Ongoing public financial management and expenditure reforms, as detailed in the UK-GOSL MOU agreement, will provide the necessary framework to improve the effectiveness of donor financing.

## 5. Implementation

### 5.1 General Commitment

1. The proposed GBS programme consists of a baseline transfer of £10 million, subject to satisfactory performance against MOU benchmarks, up to a maximum of £15 million over the 2004/05 fiscal year. On the basis of £15 million disbursement, budget support would constitute 37% of total DFID bilateral development assistance to Sierra Leone. The proportion remains significantly lower, when compared to budget support programmes in other DFID programmes in Africa. This partly reflects domestic absorptive constraints, Sierra Leone's stage of economic development (an economy recently emerging from conflict), and absence of a medium term growth and poverty reduction

framework in the form of a PRS. With the completion and approval of the PRS by the Staffs of the IMF/Fund and their respective Boards, we expect to move to a multi-donor, multi-year budget support facility in or soon after 2005/06.

## **5.2 Disbursement Schedule**

1. To increase predictability and budget planning, the Sierra Leone authorities have requested that GBS disbursements occur within the GoSL Budget year (equivalent to the UK calendar year). To satisfy our own programme commitments, and GoSL stated preferences, two tranches will be disbursed during the calendar year. The first tranche (£5 million), will be disbursed in Q2, and a second in Q4, (up to £10 million). Transfers of funds will be made direct to the Bank of Sierra Leone in sterling pounds and the counterpart Leone amount transferred to the Treasury account. The funds are not tied to any specific sector, and it will be left for GoSL to decide how best to deploy resources within the budget, to meet policy and spending commitments.

## **5.3 Management and Accounting**

1. DFID procedure for management and accounting follows NAO guidance. DFID will transfer money into a designated Treasury account at the Bank of Sierra Leone. DFID will require a report from CAFSL to follow each tranche release and an annual reconciliation by the Auditor General between CAFSL records and operations of the Treasury account at BoSL. As an additional safeguard measures EU audit reports, to support EU budget support disbursements, will be shared with DFID and other donors.

## **5.4 Monitoring**

1. The MOU is central to our relationship with the GoSL, and continued commitment and progress against policy reforms captured within the MOU will be linked to the proposed level of budget support disbursed. We will review the MOU on a quarterly basis, in-country with the Financial Secretary of the Ministry of Finance and Vice President.
2. We do not intend to tie disbursement to specific benchmarks, as failure to meet conditions risks undermining ownership and predictability. We intend to review the general direction of change (both in terms of GoSL actions and commitment to reform) against MOU benchmarks in our priority areas. Such an approach is more conducive to building a sustainable long-term partnership. Taking a less prescriptive approach confers some degree of policy space for GoSL to pursue domestic policy priorities, while at the same providing the necessary leverage in areas of concern to us. In the event that progress against the MOU framework stalls or breaks down, DFID would consider withholding and/or redirecting some or all of the budget support through other aid instruments.

3. In order to minimise transaction costs and improve effectiveness of development support, DFID's MOU benchmarks refer to conditions prescribed by other donors in areas where we do not take a lead role (macroeconomic stabilisation), but are critical for poverty reduction and growth objectives. Monitoring of the macroeconomic reform programme lies with the Fund. To monitor progress, DFID will participate in IFI review missions whenever possible. In addition, the Economic Policy and Research Unit (EPRU) of the Ministry of Finance will continue to provide DFID with quarterly economic and budget statements. A written update on progress against the MOU is submitted to DFID prior to in-country discussion (or shortly after the review). Reporting against the World Bank's PFM Reform Framework (Annex D), funded under the IRCB, and minutes of the PFM Working Group, will also provide important monitoring information.
4. DFID will consider adapting our monitoring and performance indicators to reflect a common harmonised approach, with that of other donors and GoSL from 2005/05 fiscal year onwards.

## 6. Risks and Undertakings

### 6.1 Undertakings and Timing

1. Disbursement of general budget support is made contingent upon the following performance criteria:
  - Satisfactory fulfilment by GoSL of its obligations under the joint MOU with the UK Government
  - GoSL remaining on-track with the IMF PRGF programme, reviewed on a 6 monthly basis
  - Completion of PRS by September 2004
  - Continued progress on improving financial and expenditure management through implementation of PFM reform programmes (including CFAA Action Plan, World Bank's PFM Reform Framework, EU Matrix of Corrective Measures)

### 6.2 Risk Analysis

1. **Risk A** – Deterioration of peace and security in Sierra Leone, results in the resumption of rebel hostilities [**Probability low/medium, impact high**]. **Mitigation:** GoSL to take increasing responsibility for internal security, with the continuing draw down of UNAMSIL peacekeeping forces during 2004. Small reserve of UN peacekeeping forces (3,000) expected to remain in country.
2. **Risk B** – Weakened capacity within Government leads to inability of GoSL to implement MOU benchmarks in a timely fashion [**Probability medium, impact high**] **Mitigation:** Senior government officials and technical experts, formerly funded through the World Bank's PSMS

project, and currently paid by GoSL salary grants, will be absorbed into the permanent civil service cadre, through the creation of a Senior Executive Service, under new pay and conditions of service. However, full implementation is some way off. We are considering interim support for key posts.

3. **Risk C** – Government fail to implement or make sufficient progress against action plans for public financial management reform, and thereby fail to reduce the level of fiduciary risk. [**Probability medium, impact high**] **Mitigation:** Progress against PFM reform is central to IFI and donor conditionality, integrated into credit and budget support facilities (PRGF and EU Budget Support, UK MOU), and programme grants (World Bank, IRCB). Establishment of the Bank’s PFM project implementation unit, and the recruitment of a joint DFID-World Bank Public Financial Management Advisor, to be based in country, will assist in maintaining the momentum for reform.
  
4. **Risk D** – Disruption of macroeconomic stabilisation, sourced to both internal and external (delayed donor disbursements) developments, leading to GoSL moving off-track with the IMF programme [**Probability medium, impact medium**]. **Mitigation:** Continue donor lobbying efforts through official channels to expedite programme disbursement. Regular donor- partner dialogue will be needed to increase the predictability and realism of the likelihood of donor disbursements.
  
5. **Risk E** – Failure to produce a locally owned PRS within the scheduled timeframe and of a quality that is considered satisfactory by the IFIs and other donors. [**Probability low/medium, impact high**]. **Mitigation:** New institutional structure for the production of PRS, has given renewed efforts to completion of PRS to the agreed timeframe. Donors are providing technical support to PASCO to facilitate development of the PRS.

	Low Impact	Medium Impact	High Impact
Low Probability			A, E,
Medium Probability		D, C	A, B, E
High Probability			

6. Overall the risk matrix illustrates that there is a concentration of risks in the top right hand corner of the matrix, indicating that our 2004 budget support programme is broadly judged to be of a low to medium risk.

