

DEPARTMENT FOR INTERNATIONAL DEVELOPMENT

UGANDA

POVERTY REDUCTION BUDGET SUPPORT

2004/05 ONWARDS
(rolling three year programme)

PROGRAMME MEMORANDUM

10 December 2004

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List of Key Background / Reference Documents (available on request)

Project Completion Report of previous budget support arrangement
Uganda: PRBS Management Options Submissions (DFIDU, 19 November 2004 and 7 December 2004)

GoU 3rd Poverty Eradication Action Plan (Nov 2004)

World Bank PRSC4 Programme Document (August 2004)

Budget Statement, MoFPED, June 2004

Country Integrated Fiduciary Assessment

- Vol.1 Main Report (August 2004)
- Vol.2 PER (June 2004)
- Vol.3 CFAA (May 2004)
- Vol.4 CPAR (June 2004)
- Vol.5 LGIFA (August 2004)

Partnership Principles (September 2003)

List of Acronyms

BHC	British High Commission
CFAA	Country Financial Accountability Assessment
CIFA	Country Integrated Fiduciary Assessment
CPAR	Country Procurement Assessment Report
CPIA	Country Policy and Institutional Assessment
CSO	Civil Society Organisation
DFID	Department for International Development
DFIDU	DFID Uganda
FCO	Foreign and Commonwealth Office
FRA	Fiduciary Risk Assessment
GoU	Government of Uganda
HIPC	Heavily Indebted Poor Country
IFMS	Integrated Financial management System
IPPS	Integrated Payroll and Personnel System
JSAN	Joint Staff Advisory Note
LGIFA	Local Government Integrated Fiduciary Assessment
MDG	Millennium Development Goal
MoFPED	Ministry of Finance, Planning and Economic Development
MTEF	Medium Term Expenditure Framework
NPV	Net Present Value
PAF	Poverty Action Fund
PCR	Project Completion Report
PEAP	Poverty Eradication Action Plan
PEMCOM	Public Expenditure Management Committee
PER	Public Expenditure Review
PFM	Public Financial Management
PFMA	Public Financial Management and Accountability
PRBS	Poverty Reduction Budget Support
PRSC	Poverty Reduction Support Credit
PRSP	Poverty Reduction Strategy Paper
PSA	Public Service Agreement
TA	Technical Assistance
UJAS	Uganda Joint Assistance Strategy
WB	World Bank

1. SUMMARY

1.1 This Memorandum proposes a Poverty Reduction Budget Support (PRBS) grant of up to £145 million over the period 2004/05 – 2006/07, the first period of a rolling three-year arrangement. This grant will support the implementation of the Government of Uganda's Poverty Eradication Action Plan (PEAP), which has just been revised to cover the period up to 2007/08.

1.2 Uganda has been one of Africa's best performers for over a decade, with a strong budget process and a focus on poverty reduction in the management of its resources, including aid. But Uganda remains a poor country, heavily dependent on external assistance. It is on track to meet a number of the Millennium Development Goals (MDGs), but others, especially in health, will be missed, without further policy and institutional reforms and additional support.

1.3 The purpose of the PRBS grant is to enhance the Government's institutional and financial capacity to implement the PEAP and reduce poverty. Its goal is to reduce poverty in all its dimensions. It contributes directly to DFID's PSA targets, is fully consistent with DFID's May 2004 policy paper on PRBS, and conforms to the International Development Act 2002.

1.4 PRBS will be managed in line with a set of "Operational Guidelines" being finalised with other budget support partners and the Ministry of Finance, Planning and Economic Development (MoFPED). Each year's grant will comprise a core and a variable component. It will be linked to the World Bank's Poverty Reduction Support Credit (PRSC), and to an agreed set of political governance indicators. In 2004/05, we recommend that £30m be disbursed immediately with up to a further £10m in March 2005, following an assessment of progress on political governance. In future years, disbursement decisions regarding both core and variable components will be made following an assessment in September/October of progress against agreed PRSC prior actions and political governance indicators. These decisions may again allow for tranching of part or all of the variable component.

1.5 The overall level of risk for the programme is judged to be medium, although the political transition process which is now underway in the run up to elections scheduled in March 2006, poses a particular challenge to PEAP implementation. Uganda performs well in comparative assessments of public financial management. Fiduciary risks are judged to be medium. There is a sufficiently credible programme of reform to address areas of weakness. The developmental benefits of providing PRBS to support the implementation of the PEAP outweigh the risks.

2. LOGFRAME

Narrative Summary	Objectively Verifiable Indicators	Means of Verification	Assumptions
<p>Goal: Reduction of poverty in all its dimensions</p>	<p>1. Key PEAP “strategic results”</p> <ul style="list-style-type: none"> - % below poverty line reduced from 38% in 2003 to 28% by 2013/14 - Inequality (Gini coefficient) reduced from 0.43 - infant mortality rate down from 88 to 68 (2003-2008) - maternal mortality rate down from 500 to 300 (2003-2008) - literacy up from 70% to 85% (2003-2010) - real GDP up from 5.2% in 2003 to average 7% subsequently <p>(see PEAP matrix for full set of indicators and targets)</p>	<p>GoU Poverty Status Reports and PEAP Progress reports</p>	
<p>Purpose: GoU institutional and financial capacity to implement the PEAP and reduce poverty is enhanced</p>	<p>1. Stable macro environment for private investment and growth</p> <ul style="list-style-type: none"> - underlying inflation maintained below 5% - gross reserves maintained at min. 5 months of imports cover - fiscal deficit down from 11.3% in 2003 to <8% in 2008 - private sector credit/GDP up from 7.1% in 2003 to >10% in 2008 <p>2. Government services effectively delivered and pro-poor</p> <ul style="list-style-type: none"> - net primary enrolment rate up from 86.7% to 90% (2003-2008) - primary completion rate up from 56% to 69% (2003-2008) - (2003-2008) - OPD utilization rates (visit/person/year up from 0.79 to 1.0 (2003-2008) - % approved posts filled by trained health workers up from 68% to 90% (2003-2008) - rural population accessing safe water up from 55% in 2003 to [...] in 2008 (90% in 2014) - % of rural households accessing electricity increased from 3% in 2003 to [...] in 2008 (10% in 2014) <p>3. Regulation of private initiative works to ensure business confidence, equity, efficiency and sustainability</p> <ul style="list-style-type: none"> - % perceived incidence of corruption measured by National Integrity Survey down from 23% to 12% (2003-2008) 	<p>PEAP progress reports and JSANs</p> <p>PRSC Aide Memoires and Board documentation</p> <p>PRGF reviews</p> <p>GoU budget + Public Expenditure Review presentations and minutes</p> <p>Health, Education, Water, Agriculture, JLOS, PMA and MTCS sector reviews</p> <p>Governance matrix assessments</p> <p>National Integrity Survey</p> <p>Public Financial Management Monitoring reports</p>	<p>Internal and regional security context does not deteriorate</p> <p>Exogenous shocks (weather, terms of trade) can be effectively managed</p> <p>Political transition does not lead to increased instability, or affect commitment to PEAP and maintenance of macroeconomic stability and budget process</p> <p>Government continues to prioritise its public financial management, anti-corruption and public service reform agendas</p>

Narrative Summary	Objectively Verifiable Indicators	Means of Verification	Assumptions
	<p>- private investment up from 17% of GDP in 2003 to >19% in 2008</p> <p>- time spent by MSMEs in obtaining licences reduced from [...] to [...]</p> <p>4. More effective and accountable government</p> <p>- % of public confidence in legal and justice system up from 30% in 2003 to 70% in 2008</p> <p>- agreed political governance indicators met</p> <p>- number of IMF/WB Public Expenditure Tracking Assessment benchmarks passed up from 9 (2004) to 12 (2007) out of 15</p> <p>5. Appropriate public actions to address market failures</p> <p>- satisfactory implementation of agreed undertakings in key sectors (health, education, water, agriculture)</p>		
<p>Outputs:</p> <p>1. More favourable budget financing structure</p> <p>2. GoU empowered</p> <p>3. Efficiency of public expenditure enhanced</p>	<p>1.1. aid delivered as BS increased from 50% in 2004 to >60% in 2008</p> <p>1.2. % of aid pledges actually received up from c.80% in 2004 to [...] in 2008</p> <p>2.1. % of discretionary GoU budget directed to PAF increased from 34.3% in 2003 to 39.7% in 2008</p> <p>2.2. improved alignment of donor missions and support with GoU processes</p> <p>3.1. full operationalisation of integrated budget ceilings, with all aid to Central government captured on-budget by 2008</p> <p>3.2. % satisfaction with public service delivery increased from [...] in 2003 to [...] in 2008</p> <p>3.3. Budget endorsed at May PER and subsequently executed in line with budget</p>	<p>GoU budget documents</p> <p>GoU budget documents</p> <p>SPA questionnaire reports</p> <p>GoU budget documents</p> <p>National Integrity Survey</p> <p>PRSC documentation</p>	<p>As above, plus:</p> <p>Coordinated donor provision of Budget Support does not lead to damaging volatility in aid disbursements</p>

Narrative Summary	Objectively Verifiable Indicators		Means of Verification	Assumptions									
<p>4. Intra-govt incentives & capacities are strengthened</p> <p>5. Democratic accountability enhanced</p>	<p>4.1. <i>% perceived incidence of corruption as measured by National Integrity Survey reduced from 23% in 2003 to 12% in 2008</i></p> <p>4.2. reduction in number of project implementation units and semi-autonomous agencies</p> <p>5.1. greater role of Parliament in monitoring budget results</p> <p>5.2. <i>% of public satisfaction with extent of democracy up from 54% in 2003 to 90% in 2008</i></p>		<p>GoU budget documents</p> <p>National Integrity Survey</p> <p>Budget Committee reports</p>										
<p>Activities:</p> <p>1 PRBS resource transfer +</p> <p>2 Policy dialogue</p> <p>3 Conditionality</p> <p>4 TA/capacity building</p> <p>5 Alignment of DFID aid with national goals and systems</p> <p>6 Harmonisation of DFID aid with other donors</p>	<p>Inputs: 2004/05-2006/07</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;"></td> <td style="width: 30%; text-align: right;">£s</td> <td></td> </tr> <tr> <td>PRBS +</td> <td></td> <td>£145m over initial 3 years of rolling programme</td> </tr> <tr> <td>DFIDU staff inputs and associated "Strategic Fund" support</td> <td></td> <td></td> </tr> </table>			£s		PRBS +		£145m over initial 3 years of rolling programme	DFIDU staff inputs and associated "Strategic Fund" support				
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DFIDU staff inputs and associated "Strategic Fund" support													

- Notes: (1) this Logframe is derived from the "Evaluation of General Budget Support" framework (February 2004).
(2) all indicators *in italics* are drawn directly from the PEAP Results and Policy Matrix (though specific targets (2002/03 baseline or for 2007/08) have not yet always been defined). Other indicators are drawn from other key documents
(3) 2003 refers to fiscal year 2002/03 (and similarly for other years).

3. RATIONALE

Country Context

3.1 Uganda has been a strong performer with a long record of sound macroeconomic management, rapid economic growth averaging over 6% p.a. for the past decade, effective poverty reduction (down from 56% to 38% between 1992 and 2003), increasingly pro-poor budgets and sound public expenditure management. But it remains an extremely poor country with per capita income of about \$270 and a Human Development Index ranking of 147 out of 175 countries.

3.2 More recently, growth has started to slow (averaging nearer 5% in the past 4 years), while income poverty has deteriorated slightly and inequality has worsened. The proportion of the population below Uganda's poverty line rose from 34% in 1999 to 38% in 2003 (the last two survey points) – due largely to poor agricultural prices and deteriorating security in the North and East of the country. But in spite of rising income poverty, other living standards measures such as access to primary education, health care, roads and telephones, have improved for every income quintile – particularly the poorest two - in both urban and rural areas:

- primary school enrolment has increased from 3.1 million in 1996 to 7.6 million in 2003. Currently 86% of school age children are enrolled in primary schools;
- gender equality amongst primary school children has increased from 93% in 2000 to currently 98%;
- since 2000 health utilisation rates have increased from 0.42 to 0.79 outpatient visits per day, and child immunisation coverage has risen from 41% to 83%;
- the proportion of poorest households with access to a primary school and a public hospital (within 3km) increased from 86% to 88%, and from 24% to 36% respectively between 2000 and 2003;
- The proportion of households in the lowest income quintile with access to a telephone (within 2km) increased from 4% to 11% between 2000 and 2003;
- HIV/AIDS prevalence rate amongst expectant mothers has fallen from about 20% in the early 1990s to 6.2% currently;

Progress Against the Millennium Development Goals

3.3 On current trends, Uganda is expected to meet most of the MDGs, as summarised in the table below, although continued progress will be vulnerable to deterioration in policy performance and/or significant cutbacks in aid. Most of the remainder can be met with a combination of improved policies, institutions and funding, although the health targets for maternal and child mortality remain a challenge.

Table 1: Uganda MDG Status

MDG Area	Target possible at current trend?	Target possible with better policies, institutions and additional funding?
Income Poverty	Yes	Yes/ better than MDG
Hunger	Yes	Yes
Primary enrolment	Yes	Yes
Primary Completion	No	Yes
Gender Equality	Met for Primary Educ.	Yes
Under 5 – mortality	No	Uncertain
Maternal mortality	No	Uncertain
HIV/AIDS	Yes, Target Met	Yes/ better than MDG
Water	Yes	Yes
Environment/ other	No	Yes

Source: World Bank

Uganda's Poverty Eradication Action Plan (PEAP)

3.4 Uganda's own goals and targets are set out in its Poverty Eradication Action Plan (PEAP). First produced in 1997 as a framework for enhancing the poverty focus of the budget and pro-poor sector reforms, Uganda's PEAP provided the model for the PRSP (Poverty Reduction Strategy Paper) approach. It was revised initially in 2000/01, and again in 2003/04. Cabinet approved PEAP 3 in early November 2004.

3.5 PEAP 3 (see Annex 1 for further details) sets out targets, policies and programmes under five "pillars":

- *Economic management*: maintenance of macroeconomic stability, fiscal consolidation, export promotion, and private investment enhancement;
- *Production, competitiveness, and incomes*: agriculture modernization and commercialisation, infrastructure development (including roads, electricity, and railways), and promotion of private sector participation;
- *Security, conflict-resolution, and disaster management*: key priorities in this area are to end rebel insurgency in the North, deal with internal displacement, and end cattle-rustling;
- *Governance*: human rights and democratisation, enhancing the legal system, transparency, accountability, and the fight against corruption;
- *Human development*: key priorities are primary and secondary education (with a particular focus on quality), health outcomes, population growth, and adult literacy.

3.6 The PEAP clearly sets out the way in which resources, including aid resources, are to be managed and prioritised to achieve PEAP objectives. A final chapter describes arrangements for monitoring progress, and a matrix of key performance indicators and policy actions for achieving these targets. A Joint Staff Advisory Note (JSAN) has yet to be completed, but the PEAP is widely regarded as providing a clear and credible strategy for poverty reduction. But while it has been produced following a lengthy consultative process, there remain some concerns about the strength of political support, ahead of elections in 2006. This will need close monitoring.

Donor harmonisation and the Uganda Joint Assistance Strategy (UJAS)

3.7 Development partners have been working towards more harmonised methods of supporting the GoU as set out in “Partnership Principles” agreed at the end of 2003. This has included coordinating the design and monitoring of budget support around the World Bank’s Poverty Reduction Support Credit (PRSC, now in its fifth annual cycle), to which most bilateral budget support is tied.

3.8 In addition, the World Bank and DFID have been developing a Uganda Joint Assistance Strategy (UJAS) with inputs also from the Netherlands, Norway, Sweden, Germany and the African Development Bank. While still in preparation, the UJAS will set out a joint approach to support the Government’s implementation of its PEAP, with budget support a central element of this strategy.

The Case for Budget Support

DFID Policy

3.9 The general case for budget support is set out in DFID’s May 2004 PRBS Policy Paper. This paper states that we will use PRBS when:

- *a partner government’s budget priorities support poverty reduction:*
We believe this to be substantially true in Uganda. The share of discretionary expenditure spent on the Poverty Action Fund (PAF) has increased from below 20% in 1997/98 to 31.4% in 2000/01 and to 36.3% in 2003/04. It is projected to rise further to 38.8% in 2006/07. PAF budget lines are at least 95% protected from in-year cuts: in the last two years, actual PAF spending amounted to 100% and 98% of original budget. The defence budget remains contentious and expenditure on public administration is universally acknowledged to be too high. But the longer-term budget priorities to 2013/14 set out in the PEAP look well justified, and Uganda’s budget process is one of the strongest and most transparent in Africa (see paras 4.2 - 4.8 and Annex 2).
- *a partner government is committed to improving its administrative, technical and financial systems:*
Uganda is one of the top rated low-income countries in Sub-Saharan Africa using the World Bank’s “Country Policy and Institutional Assessment” (CPIA), and has one of the best ratings of all HIPC countries in the IMF-WB poverty expenditure tracking assessment (with a satisfactory rating in nine of the fifteen assessed aspects of public expenditure management in the 2004 update). The recent Country Integrated Fiduciary Assessment (CIFA, August 2004), undertaken jointly by a number of donors and drawing on DFID’s template for assessing fiduciary risk, provides a comprehensive assessment with improvements since 2001 in 7 of the 18 criteria assessed (see paras 4.16 – 4.18 and Annex 3).

- *the provision of budget support will produce significant benefits relative to other forms of aid delivery:*

Initial assessments of this in Uganda are positive. DFID's Budget Support "Evaluability Study" Phase 1 report (December 2002), which drew heavily on emerging lessons from Uganda's experience with budget support, concluded *inter alia* that budget support had led to clear gains in both the management of the budget process and the allocative efficiency of the budget; improvements in the effectiveness of state institutions; and improvements in the degree of public accountability. The Uganda PRSC stocktaking report (June 2004) confirmed these findings and also concluded that budget support had contributed to improvements in service delivery, strengthened GoU processes and systems, improved the predictability of resource flows at an aggregate level, reduced transactions costs, and improved both coordination amongst Government institutions and between donor agencies¹. Box 1 illustrates how a switch from project to budget support financing has contributed to significant improvements in service delivery in the health sector.

Box 1: The benefits of budget support: an example from the health sector

Progress against key health outcome indicators in the 1990s was disappointing. But since 1997/98, there has been a marked shift away from donor funded projects towards GoU funding, financed largely by increases in budget support (donor project funding fell from c.60% of health sector financing in 1997/98 to 33% in 2004/05). This has been associated with significant improvements in key health output indicators: between 1999/00 and 2003/04, utilization rates have increased from 0.42 to 0.79 outpatient visits per person per year, while DPT3 immunisation rates for children under one year have increased from 41% to 83%.

Other factors (such as some increases in overall health sector financing; improved management of resources; the effective involvement of NGO health service providers; and the abolition of user fees) have also been important, but the shift to budget support has been critical. An analysis of 2003 project financing suggested that only 32% was directly related to the core Health Sector Strategic Plan. But the GoU's own budget has been allocated ever more efficiently and equitably: between 1999/00 and 2003/04, the share of the GoU budget allocated to district primary health services increased from 33% to 54%, per capita spending on drugs doubled from 80c to \$1.60, while the proportion of approved posts filled by trained health workers increased from 33% to 68%.

GoU Policy

3.10 Moreover, the Government of Uganda has clearly declared general budget support as its preferred form of aid delivery in the *Partnership Principles*, and in the PEAP. These statements have emphasised that budget support enhances Government ownership of the budget and enables a more

¹ It concluded, however, that providing aid to Uganda *only* through budget support is *not* the best approach, with there being a continued role for projects to support, for example, capacity building and major infrastructure investments.

internally coherent budget to be formulated, whereas project aid leads to fragmentation of the budget and typically involve much higher unit costs.

Lessons from past DFID budget support

3.11 DFID's previous 3-year budget support programme (2000/01-2002/03) was approved in November 2000, and extended by 1 year until March 2004. Budget support averaged 68% of DFID's assistance to Uganda over this period, but disbursements in each of the last two years were affected by disagreements over defence spending (see expenditure summary below).

3.12 The Project Completion Report (PCR) is provided in Annex 8. It concludes that the provision of substantial sums of flexible budget support, coupled with effective policy dialogue and supporting TA at both macro and sectoral level with a generally willing partner government and increasingly coordinated group of budget support donors, contributed significantly to the achievement of project purpose (continued macroeconomic growth and stability and improved outcomes from public spending). Although there had been areas of disagreement, the provision of budget support enabled DFID to engage effectively in debate on budget and broader policy issues in a way that would not otherwise have been possible.

Table 2: DFID Budget Support Disbursements, 2000/01 – 2003/04 (UK FYs)

£m	2000/01 plan	2000/01 actual	2001/02 plan	2001/02 actual	2002/03 plan	2002/03 actual	2003/04 plan	2003/04 actual
Total DFID Africa Div. Programme	536		639		654		683	
Total Uganda programme	57	77.1	68	63.7	75	49.6	65	54.9
Uganda as % of Africa	10.6%		10.6%		11.5%		9.5%	
Budget support (*)	47	60	47	47	47	29.5	40	30
BS as % of total	82%	78%	69%	74%	63%	59%	62%	55%
Non PRBS:								
- Govt project		12.5		11.9		12.6		13.1
- non-Govt/SF		4.5		4.7		5.0		5.0
- humanitarian		0.1		0.1		2.5		6.8

Notes: Total Africa and Uganda plan figures come from DFID Departmental Reports; actual Uganda spend comes from expenditure cubes.

* Budget support includes £12m education sector budget support in 2000/01, 2001/02 and 2002/03 (in both planned and actual columns, except for £15m actual in 2000/01, when £3m held over from 1999/00); 2000/01 actual also included one-off £10m GBS supplement to help Uganda cope with substantial deterioration in its terms of trade.

3.13 Other key lessons from the PCR include:

- there are significant gains to be had by operating collaboratively with other donor partners;
- an "all or nothing" approach to budget support disbursements is too blunt: some mechanism for a "graduated response" is desirable.
- a judicious use of conditionality has been helpful in strengthening the hand of pro-reform elements within GoU and accelerating the pace of

change - but conditions need to be agreed and communicated clearly, and acted upon to be credible;

- it is important to be specific with GoU about sensitive areas that are likely to cause political difficulties to budget support donors, and to agree an agenda and forum for dialogue.

3.14 These lessons have helped inform best practice principles for the design of budget support in Africa, and have been taken into account in the design of this new PRBS arrangement.

Objectives of PRBS in Uganda

3.15 The **goal** of this new PRBS programme is the reduction of poverty in all its dimensions, as summarised in the PEAP's key strategic results covering reduced poverty, improved human development and increased growth. Its **purpose** is to enhance GoU's institutional and financial capacity to implement the PEAP and reduce poverty. The purpose and output level indicators are drawn directly from the Budget Support evaluation framework, and collectively represent the developmental benefits we expect to deliver through the provision of budget support.

3.16 This programme will contribute directly to DFID's PSA targets for the reduction of poverty and achievement of the MDGs in Sub Saharan Africa, to targets for greater harmonisation, and to the target to deliver at least 61% of our support to Africa as PRBS by 2007/08. It is fully consistent with DFID's May 2004 policy paper on PRBS, and conforms to the International Development Act 2002.

4. KEY APPRAISAL ISSUES

4.1 Key appraisal issues are covered in the World Bank's programme document for PRSC4 (approved by the World Bank Board in September 2004), as well as in the Public Expenditure Review Report (June 2004) and the Country Integrated Fiduciary Assessment (August 2004). The first includes commentary on issues and progress in key sectors such as health, education, water, agriculture, and justice. DFID and other bilateral budget support donors have contributed to the preparation of each of these documents. The following sections highlight some key issues, including discussion of political governance that is not covered in the PRSC appraisal.

Macroeconomic and budget issues

4.2 Uganda has a long track record of sound macroeconomic management and adherence to its IMF programme. Growth has averaged 6.5% since 1990/91 and underlying inflation kept below 5% for the past decade. Uganda runs a large current account deficit (c.12% of GDP in 2003/04), but this has been more than fully funded by official and private transfers and other capital inflows, allowing reserves to recover to a healthy \$1bn (6.5 months of import cover). The NPV debt:exports indicator of debt sustainability had deteriorated

to over 250% by June 2004 (cf. 150% achieved at HIPC completion point in 1999), although debt service costs as a percentage of exports (10%) and of domestic revenues (11%) remain well below accepted critical threshold levels of 15-20%.

4.3 The budget deficit (before grants) doubled from c.6% of GDP in 1997/98 to a peak of 12.4% in 2001/02 (5.5% after grants), largely financed by HIPC debt relief and a rapid expansion in aid inflows. But concerns about the absorptive capacity of the economy, value for money, the effects on interest rates and the exchange rate of 'sterilizing' excess liquidity, and political economy concerns regarding aid dependency, have resulted in a strict GoU policy of deficit reduction: the deficit (before grants) had fallen to 11.5% by 2003/04, and is projected to fall further to 9.1% in 2006/07 (3.4% after grants) and to 6.5% by 2009/10. The appropriate measure and level of the deficit continues to be a subject of debate and analysis.

4.4 Domestic tax revenues have improved moderately over the past three years to 12.5% of GDP in 2003/04, but the tax take remains comparatively low by regional standards (hampered by the high subsistence agriculture share of GDP). Targets for future tax growth remain disappointingly modest, with implementation of the East Africa Customs Union estimated to reduce tax take by about 0.5% of GDP, administrative reforms taking time to make an impact, and the forthcoming elections in 2006 affecting GoU's willingness to make bold new tax policy reforms.

4.5 GoU has operated an MTEF for 10 years and has one of the strongest and most transparent budget processes in Africa. This is underpinned by the Budget Act (2001), which sets out a legally binding timetable for budget preparation and consultation. Donors and other stakeholders have significant opportunities to contribute (eg. during the October budget workshop and May Public Expenditure Review, and during regular sector working group discussions). Budget execution is monitored closely by the Public Expenditure Working Group, for which the Ministry of Finance produces quarterly budget execution reports. More detailed half and full year budget execution reports are posted on the Internet. The Government has produced audited accounts within the statutory period of 9 months for the last six years.

4.6 As noted above, the budget has become increasingly pro-poor with PAF items effectively protected from in-year cuts in the budget. Medium term priorities set out in the MTEF indicate a modest switch, in line with the PEAP analysis, from the social sectors to the more productive sectors such as roads and agriculture. More detailed budget analysis is provided in Annex 2.

4.7 Defence and public administration have been contentious areas of the budget for several years and are likely to remain so in the medium term. However, GoU is showing increasing willingness to review levels and quality of defence expenditure in discussion with development partners. The government's recently concluded Defence Review, which DFID helped finance, provides the basis for this dialogue. The government has agreed to establish confidential arrangements to share detailed information on the use

of classified defence expenditure, which is used for major equipment purchases (about 25% of the defence budget). It is also establishing a defence sector-working group to provide for joint donor/government review of expenditure plans and management based on a corporate plan for implementation of the Defence Review, although progress in each of these areas has been slower than initially promised.

4.8 Our experience suggests however, that the highly open and transparent nature of the budget setting process, and the opportunities afforded to engage constructively in the debate over budget priorities, have resulted in better budget outcomes. The MoFPED have found some degree of donor pressure welcome where it has reinforced their own efforts to ensure that the budget reflects PEAP priorities.

Public Service Reform

4.9 Progress towards restoring the capacity of the public service was quite rapid in the early and mid-1990s, when the Government consistently and boldly pursued public sector reforms, but recent years have seen some stagnation. The PRSC process, supported by analytical work, has partly succeeded in reinvigorating the reforms: for example, bottlenecks to recruiting teachers and health workers have been largely removed, concerns about the integrity of the payroll are being addressed, and the Government has committed to a policy to enhance pay for technical, professional, and managerial personnel.

4.10 However, progress has been slow and limited resources have been allocated to public sector reform (including pay reform). During the PRSC5 and PRSC6 periods, Government plans to vigorously pursue pay reform through an updated policy and strategy that reflects affordable medium-term salary enhancement targets and the resource commitments embodied in the medium-term expenditure framework. Complementary measures will be geared to reining in the growth in public sector employment. Indicative budget ceilings for the 2005/06-2007/08 period suggest that a higher priority is now being given to public sector reform.

Political Governance

4.11 The Movement political system has delivered a great deal in terms of development outcomes since President Museveni came to power in 1986, and, arguably, better representation of poor people's interests than most of Uganda's more formally democratic neighbours. The Government has pledged that elections in 2006 will be contested on a multi party basis for the first since time 1980. This will require a constitutional process that provides for the timely opening up of political space, transparency and inclusion, and the elections themselves will need to be free and fair. Failure to achieve this risks provoking violence and insecurity, and poses risks to Uganda's international reputation, investor confidence, and aid flows, and the successful implementation of the PEAP.

4.12 There are a number of concerns about the process of political transition.

- Government has been slow in providing a level playing field for political groups in advance of 2006. The Registrar General, citing lack of funds, has failed to register the main opposition party within the legally specified timeframe, while opposition MPs have at times faced intimidation from state agencies and government supporters, affecting their ability to hold meetings.
- The volume of proposals in the White Paper on constitutional change, a number of which are contentious, may lead to lengthy Parliamentary debate and make it difficult to enact those amendments to the legal framework necessary for a smooth transition to a multi-party system sufficiently in advance of the 2006 elections.
- Government intentions to handle the associated constitutional amendment bill – with the final vote in Parliament (requiring a two thirds majority) covering all amendments together – may be challenged in court amidst concerns that the process has been compromised.
- Allegations that the transition process may be subject to financial manipulation have surfaced. Some MPs have been paid U.Sh 5 million (approximately £1,500) each through the political party arm of the National Resistance Movement. The payments appear to have been limited to pro-third term MPs. The government claims that the source of the approximately £400,000 is private donations rather than public funds, but there is no firm evidence for this either way.

4.13 It is too early to judge whether the run up to elections will allow for a free and fair process. Balanced against these concerns, Uganda enjoys a relatively free press compared to other African countries and issues around the political transition continue to be vociferously debated in Parliament and the media. Government has also responded positively to concerns over human rights abuses. The Uganda Human Rights Commission, the Director of Public Prosecutions, the Army Commander, the Inspector General of Police and Commissioner of Prisoners acknowledge the problem and are committed to joint monthly meetings to review any cases of torture and establishing a mechanism to inform the public about action taken.

4.14 Donors (including all budget support donors) have agreed a common set of political governance indicators under the “Governance Matrix”. The Matrix is based on Uganda’s PEAP, and has been established to help monitor and assess progress as a basis for dialogue with Government on political governance.

4.15 The Matrix was revised recently to take into account the revised PEAP. The specific indicators developed by DFID Uganda and the British High Commission/Foreign Office (already agreed by the Secretary of State as key benchmarks for assessing the political transition process) have been

incorporated into the Matrix. These same indicators have been adopted by EU Heads of Missions as the basis of 6-monthly progress reports on the political transition. It proposed that they also be included in the UJAS as the key indicators against which an assessment of political governance would be made. The indicators (see also Annex 4) are:

- establishment of rules for multi-party competition and the capacity to monitor these sufficiently far ahead of the 2006 elections;
- separation of the organs of state from the Movement in law and practice;
- unhindered and inclusive debate on political and constitutional reform, including freedom of press and association, and respect for human rights;
- respect for the rule of law, an independent judiciary, constitutional process and the strengthening of independent political institutions; and
- absence of significant physical intimidation or financial manipulation of process of change.

Fiduciary Risk Assessment

4.16 A comprehensive Fiduciary Risk Assessment report conforming to new DFID guidelines is attached at Annex 3. It draws on a number of diagnostic exercises undertaken jointly by budget support development partners in the first half of 2004, notably the innovative Country Integrated Fiduciary Risk Assessment (CIFA). It concludes that there have been improvements in 6 of the 15 DFID benchmarks since 2001, with 10 of them rated as low or medium risk. But there remain significant weaknesses in the areas of expenditure reporting (including payroll), procurement, anti-corruption (see below), and audit. The overall fiduciary risk rating is judged to be medium.

4.17 Many aspects of the CIFA Action Plan to address these risks are already being implemented through ongoing public financial management reform programmes that have already contributed to the significant improvements over the past three years. We judge the reform programme to be a credible response to the risks identified. GoU's Public Expenditure Management Committee (PEMCOM) is considering the remaining recommendations and has been charged with developing a more comprehensive reform programme. Progress will be monitored quarterly through the regular meetings of PEMCOM, with a fuller assessment undertaken annually (see also para.6.4).

4.18 DFID guidelines on how to assess the development benefits of providing budget support, against which the fiduciary risks need to be compared, are still being developed. But given the positive conclusions from initial assessments highlighted above, we believe the benefits outweigh the risks².

² It is instructive to note that even if 20% of all budget support is *completely* wasted (20% is the Auditor General's estimate of the value of public procurement lost through corrupt practices), the efficiency of public spending would only need to rise by about 1% for the overall benefits of budget support to outweigh these losses.

Corruption

4.19 Uganda's institutional framework to fight corruption is strong in international comparative terms. Progress is being made at the technical level. A credible anti-corruption strategy was recently launched by the Department for Ethics and Integrity, and GoU has agreed to a number of specific undertakings on its implementation as part of the PRSC. Uganda's rating on Transparency International's "Corruption Perception Index" has improved for three successive years, particularly in the last year: between 2003 and 2004 Uganda's ranking improved from 17th from bottom to 42nd from bottom, while the absolute score has risen from 2.2 to 2.6 (out of 10).

4.20 But while progress continues to be made on developing the legal framework to tackle corruption, there is limited evidence of effective implementation. Uganda's record on successfully prosecuting corrupt officials is poor, while the necessary political will at higher levels of Government to tackle corruption has not been demonstrated. Overall, corruption is high. Further details are in Annex 3 on Fiduciary Risk.

5. FINANCING

5.1 Total aid requirements 2004/05-2006/07 are reflected in Uganda's macroeconomic programme and MTEF summarised in Annex 2. These reflect MoFPED's estimates of what can be effectively spent without creating adverse macroeconomic consequences. Total budget support receipts over this period (including c.\$60m HIPC relief) are currently projected at c. \$360m p.a., although GoU is looking for total commitments much in excess of this to allow for some slippage in disbursements, and to replace less favoured project funding.

5.2 It is proposed that DFID should provide a total of up to £145m over the 3 year period 2004/05 – 2006/07 (with an indicative £55m in 2007/08). This figure reflects a rising share of an expected flat Aid Framework, in line with DFID's resource allocation model and policy towards budget support. The rationale for this level of funding is set out more fully in the "PRBS Management Options" discussion paper (November 2004, available on request). Projected disbursements in relation to the overall programme are summarised in Table 3.

Table 3: Proposed DFID Budget Support Disbursements, 2004/05 – 2007/08

£m	2004/05	2005/06	2006/07	2007/08
Total DFID Africa Div. Programme	864	1100	1170	1300
Total Uganda programme	65	70	70	70
Uganda as % of Africa	7.5%	6.4%	6.0%	5.4%
Budget support	40 ^	50	55	55
BS as % of total	62%	71%	79%	79%

Notes: Africa Division totals (DRAFT) taken from Management Board Paper, 23 Sep'04;

^ initially expected to be £45m, but cut to allow space for additional humanitarian assistance.

5.3 The approximate annual contributions from other budget support partners are set out below:

Table 4: Projected annual budget support contributions (\$m)

Budget Support Partner	Approximate annual commitment (\$m)	Approximate annual commitment (%)
World Bank	150	43%
DFID	90	26%
EC	40	12%
Netherlands	30	9%
Ireland	12	3%
Norway	12	3%
Sweden	10	3%
Denmark	6	2%
Germany	5	1%
Total	346	100%

Note: the AfDB is also expected to start a new budget support operation from 2005/06

6. IMPLEMENTATION

Key design and management features

6.1 Options for the design and management of DFID's PRBS were discussed extensively with other budget support partners and the GoU, and set out in a discussion paper for the Secretary of State on 19 November 2004. These drew heavily on emerging "best practice" regarding PRBS design, while taking account of the specific Uganda context. Based on discussions around that paper, and a further submission (7 December) regarding the tranching of PRBS, it is proposed that:

- The PRBS programme be provided on a rolling 3 year basis, with early signalling of plans to best suit the GoU's budget calendar.

- The agreed set of PRSC “prior actions” serve as the main set of disbursement triggers, supplemented by an agreed set of political governance indicators (Annex 4).
- Each year’s grant will comprise two components: a core component linked to the core PRSC prior action on budget formulation and execution; and a variable component linked to performance against the remaining PRSC actions (which include progress in the health, education and water sectors), and against the agreed set of political governance indicators.
- disbursement decisions regarding both core and variable components will be made following an assessment in September/October of progress against agreed PRSC prior actions and political governance indicators. This may involve tranching some or all of the variable component.
- PRBS should not be earmarked to specific sectors.

Monitoring

6.2 Monitoring progress against the PRSC prior actions will be undertaken, as at present, collectively by all budget support donors in the context of the regular cycle of PRSC missions. These missions are currently built around existing GoU review processes, but the coordination, frequency and timing of these missions is currently under review to further improve the linkages with the GoU’s monitoring of the PEAP.

6.3 Monitoring of the political governance indicators will be undertaken by DFID/BHC in conjunction with the Donor Democracy and Governance Group (comprising bilateral Heads of Mission) with the support of a Donor Technical Group (largely comprising agency governance advisers).

6.4 Monitoring of fiduciary risks will be undertaken in the context of monitoring mechanisms being established by GoU’s PEMCOM. Monitoring of the anti-corruption programme will take place in the context of PRSC missions and assessment of the governance matrix. DFIDU will provide an annual progress report on its FRA, with a full update at least every three years, in line with new guidance for rolling PRBS arrangements being prepared by DFID’s Public Financial Management and Accountability policy team.

Evaluation

6.5 Uganda was the main case study country in the initial Phase 1 Budget Support “Evaluability Study” Report (December 2002), and this PRBS programme has been significantly influenced by its findings. Uganda is also one of the 7 case study countries of the formal evaluation itself that is currently ongoing. Lessons arising from this exercise may be incorporated into the design of this programme within the annual submissions to the Secretary

of State. Consideration of a further evaluation will be made not less than 3 years after the current exercise concludes.

Management, Accounting and Auditing

6.6 On approval by the Secretary of State of each disbursement, Crown Agents will make the transfer into a budget support account at the Bank of Uganda (BoU) for subsequent disbursement into the Consolidated Fund. MoFPED will provide to DFIDU documentary evidence of the amount and date of each foreign exchange payment received under this Grant by the Bank of Uganda, and of the amount and date of receipt of each transfer under this Grant from the Bank of Uganda into the Consolidated Fund.

6.7 Annual Audited Statements, as prepared by the Office of the Auditor General in accordance with Ugandan law, will be provided to DFIDU no later than 9 months after the end of the Government of Uganda's financial year.

6.8 Further details regarding the transfer, reporting and auditing of these flows are set out in the (draft) "Operational Guidelines for Budget Support" (see Annex 6), currently being finalised by MoFPED and nine budget support partners.

Timetable for submission and decisions

a) for 2004/05

6.9 It is proposed that a disbursement of £30m for the 2004/05 fiscal year should be made immediately on approval of this submission. The justification for this disbursement is that all PRSC 4 prior actions are judged to have been satisfactorily met, with the World Bank Board approving the grant on 2nd September 2004 (see summary in Annex 5).

6.10 Up to a further £10m will be disbursed in March 2005, subject to an assessment of progress against the political governance indicators (Annex 4) undertaken at that time. These indicators will be clearly communicated to GoU at the time of signing the PRBS agreement.

b) for subsequent years

6.11 *March submission:* a submission to the Secretary of State would be made in March each year (starting March 2005) with recommendations regarding the size of budget support disbursements for the following three Ugandan fiscal years (July-June). This would be based on an assessment of the underlying conditions for budget support and an assessment against agreed political governance indicators. For the year ahead, it would also provide specific recommendations covering the percentage split between the core and variable components of the grant, the proposed triggers (PRSC plus political governance) for disbursement, and an initial view on tranching. The expectation would be that:

- the core component (expected to be 50%) would be conditional on the key PRSC prior action on budget formulation and execution being met³;
- the variable component (also 50%) would be based on performance against the remaining PRSC prior actions (including performance in key social sectors) and political governance indicators.

The Secretary of State's decision, including confirmation of the agreed disbursement triggers, would be communicated to MoFPED to include in the draft budget discussed in Cabinet in late March and submitted to Parliament by 1st April.

6.12 *September submission*: a further submission would be submitted after the World Bank PRSC Board discussion (expected in September each year), summarising the assessment of performance against agreed PRSC prior actions, updating the assessment against agreed political governance indicators, and recommending the size of the disbursement of both core and variable components, plus any possible tranching. Provisional indications (to be confirmed in the following March submission) of the total amount of budget support to be provided for the following three fiscal years, and disbursement triggers for the first of these, would also be included in the submission for approval. These would then be communicated to MoFPED for inclusion in the indicative MTEF ceilings presented at the October Budget Workshop.

7. RISKS AND UNDERTAKINGS

Risks

7.1 A description of the major risks and set of mitigation measures is contained in Table 5a.

Table 5a: Key Risks

Risks	Risk Mitigation
A. External shocks (adverse weather patterns, terms of trade and other global developments) cannot be effectively managed, affecting macroeconomic stability and PEAP targets	<ul style="list-style-type: none"> • National Disaster Preparedness and Management Act and Policy implemented with partner support. • Donors press for mainstreaming of disaster planning in PEAP implementation. • Donors support removal of key constraints to the rural sector and private sector growth, with attention to equity and vulnerability issues.

³ In time, this could be modified to reflect a broader based assessment of progress against the PEAP and the underlying conditions for the provision for budget support.

<p>B1. Internal security situation fails to improve</p> <p>B2. Regional security situation deteriorates</p>	<ul style="list-style-type: none"> • Donors engage in co-ordinated dialogue directly with GoU on both internal and external security. • Donor support for GoU peace efforts. • Donor provision of humanitarian assistance. • Donor support, when appropriate, for regeneration of conflict-affected areas and IDP rehabilitation. • Donor support for improved dialogue on defence.
<p>C. Political transition leads to increased internal instability and reduced commitment to the PEAP, macroeconomic stability, and the budget process</p>	<ul style="list-style-type: none"> • Donor dialogue with GoU about potential costs of waning commitment to PEAP priorities. • Donors to engage in co-ordinated dialogue with GoU to urge transparent and inclusive processes around governance matrix. • Donors engage in range of project activities, e.g. support to democratic processes, human rights, media and civil society. • Encouragement of NEPAD peer review mechanism.
<p>D. Inadequate implementation of GoU's public financial management, anti-corruption and public service reforms (with negative effects on investment, growth, value for money, and service delivery)</p>	<ul style="list-style-type: none"> • Policy dialogue (through PRSC, PEMCOM, Anti-Corruption working group etc) and judicious use of conditionality. • Provision of TA to institutions of oversight. • Support to CSOs focused on accountability. • Donor support for design and implementation of new public service reform programme at all levels of government. • Decentralization programme strengthening capacity for service delivery at local levels.
<p>E. Increasingly coordinated provision of Budget Support increases risks, and potentially damaging volatility in disbursements</p>	<ul style="list-style-type: none"> • Donors are explicit in disbursement triggers attached to budget support. • Adoption of "graduated response" by all donors provides appropriate balance between leverage and predictability. • GoU able to mitigate risks through use of reserves and discounting projected aid inflows.

7.2 A summary Risk Matrix is set out in Table 5b below. Overall we judge the level of risk to be medium.

Table 5b: Risk Analysis Matrix

Probability of occurrence →	Low	Medium	High
Possible negative impact ↓			
Low	E		
Medium		B2, A,	
High		B1, C, D	

Undertakings

7.3 GoU and DFID both commit to adhering to the agreed Partnership Principles as a general undertaking with respect to this PRBS grant. Uganda's commitment to peace and to promoting free, credible and democratic political processes, independence of the judiciary, rule of law, human rights, good governance and probity of public life, including the fight against corruption are also considered as underlying principles for the provision of budget support.

7.4 Specific undertakings will be defined annually in the context of the PRSC cycle, and of the donor-GoU dialogue around the governance matrix focused on the political transition. Both of these are increasingly driven by the GoU's PEAP. These undertakings will be confirmed annually in March as set out in section 6.