

Partnerships for poverty reduction: rethinking conditionality

A UK policy paper

March 2005

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Foreword

Five years ago, the world agreed an ambitious plan for development in the 21st century – the Millennium Development Goals. It called for a new sort of relationship between donors and developing country partners based on a shared commitment to common goals, and to joint action to achieve them.

There is, rightly, much debate about how this shared commitment should work in practice. President Mkapa of Tanzania has said: ‘Development cannot be imposed. It can only be facilitated. It requires ownership, participation and empowerment, not harangues and dictates.’

I agree, but our thinking and practice on conditionality has not kept pace with this new approach. That’s why the UK Government has reviewed its policy; and is calling on the World Bank, the International Monetary Fund and other donors to do the same.

This paper shows how donors can support policy leadership by developing countries without imposing our own views. It also sets out our clear responsibility to parliament and people to ensure that aid is not used corruptly and is well spent for the purpose for which it was intended. The right kind of partnership must have reducing poverty at its heart, alongside upholding human rights and strong financial management. The paper also highlights the importance of good economic and social policies, and of strong commitment to transparency, accountability and good governance.

In this new approach, agreed benchmarks for measuring progress on the reduction of poverty, rather than policy conditions set by donors, will be the basis for both partners to be accountable to their citizens. The paper makes firm commitments to prevent the misuse of funds through corruption or weak financial management. It is also clear about the circumstances in which accountability to taxpayers will require the UK to consider interrupting or reducing agreed aid. It expresses our commitment to make aid more predictable and more transparent, and explores how donors can work together more effectively.

The ‘Make Poverty History’ campaign is calling on donors to provide ‘more and better aid’ to help developing countries achieve the Millennium Development Goals. I see the principles in this paper as central to both objectives. By supporting policy leadership in developing countries, donors will make their aid more effective. And by ensuring that aid is effectively used for reducing poverty, donors will give their own countries confidence that more aid will be worthwhile.



Rt Hon Hilary Benn MP
Secretary of State for International Development

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1. Summary

1.1 Our understanding of what makes aid effective is changing. Evidence and experience have challenged traditional approaches to 'conditionality' (where donors make their aid conditional on the pursuit of particular policies in the partner country). This paper sets out a significantly new approach to building a successful partnership for poverty reduction, focussing on poverty outcomes rather than specific policy conditions.

1.2 Good policy matters for development. Macroeconomic stability, growth, good governance and social inclusion are all important for long term poverty reduction. We believe that developing countries must be able to determine their own policies for meeting the Millennium Development Goals (MDGs). We are committed to supporting greater country ownership, especially of the policy process, and better mutual accountability.

1.3 The UK Government believes that an effective aid partnership should be based on a shared commitment to three objectives:

- a) reducing poverty and achieving the Millennium Development Goals;
- b) respecting human rights and other international obligations; and
- c) strengthening financial management and accountability, and reducing the risk of funds being misused through weak administration or corruption.

Developing country governments and donors should agree on benchmarks to assess progress in these areas. These benchmarks should where possible be drawn from national poverty reduction plans. As in any relationship, an aid partnership should be based on open dialogue, with rights and responsibilities on both sides. Each partner should take account of the views and concerns of poor people.

1.4 In deciding how to allocate aid between countries, the UK will take account of the extent of poverty in a country, and of its ability to use aid effectively (as evidenced by the expected impact of its poverty reduction programme and its commitment to sound financial management and accountability standards). Even where the shared commitment needed for a good partnership is not in place, or is under threat (for example in some fragile states), donors can still contribute effectively to reducing poverty. In countries where the government is weak or uninterested in development, the UK will seek to provide aid in ways which build the government's commitment and strengthen its capacity. Where appropriate the UK will also work with civil society and the private sector.

1.5 Within a partnership, both donors and developing country governments need to agree the purpose for which aid is given. This ensures that both parties have a shared understanding of how aid will contribute to reducing poverty, and can be held publicly accountable for delivering on their commitments.

1.6 In its aid relationships, the UK will be guided by five principles:

- **Developing country ownership.** DFID will support nationally owned poverty reduction plans that take account of the views and concerns of poor people. We will not make our aid conditional on specific policy decisions by partner governments, or attempt to impose policy choices on them (including in sensitive economic areas such as privatisation or trade liberalisation). Instead we will agree with partners on the purpose for which aid is being given, and will agree benchmarks to assess progress. We will draw these from countries' own plans, where available, and these benchmarks will relate to the impact and outcome of countries' overall programmes in reducing poverty, rather than to specific policies.
- **Participatory and evidence-based policy-making.** Both donor and developing countries should be accountable, to their citizens and to the wider global community, for showing how aid is improving the quality of life for poor people. The UK supports participation and the use of evidence in policy-making, and will press for the use of Poverty and Social Impact Analysis (PSIA). We will also encourage national debate – including in parliaments – on the relative impact of different policy choices.
- **Predictability.** Developing countries can use aid most effectively if they can rely on it as part of their long-term budget plans. The UK will seek to make aid more predictable by being clear in advance about how much aid will be given and the basis on which funds will be reduced or stopped. We will talk to partner countries before any interruption of aid, and will assess the impact that reducing or interrupting aid would have on the poor.
- **Harmonisation.** The UK will work with other donors to improve aid harmonisation and limit the overall burden of conditionality. In particular, we will encourage the World Bank and the International Monetary Fund (IMF) to use conditionality in accordance with the principles in this paper; and will continue to press them to monitor and streamline their combined terms and conditions. DFID will use analysis from the IMF and World Bank in making its assessment of progress towards poverty reduction. However, an IMF or World Bank programme going 'off track' will not automatically lead DFID to suspend its assistance.
- **Transparency and accountability.** Both partners – donors and developing country governments – should be committed to transparency, and should make public their decisions and the evidence on which they are based. The UK aims to increase transparency around the process of decision-making on conditions, the conditions themselves, and the process for deciding to reduce or interrupt aid. The UK will use conditionality to ensure that aid is not used corruptly or for purposes other than those intended. In giving aid we will also take account of countries' commitment to universal human rights standards and other international obligations.

1.7 The circumstances in which the UK will consider reducing or interrupting aid are, therefore, if:

- a) countries move significantly away from agreed poverty reduction objectives or outcomes or the agreed objectives of a particular aid commitment (e.g. through an unjustifiable rise in military spending, or a substantial deviation from the agreed poverty reduction programme); or
- b) countries are in significant violation of human rights or other international obligations; or
- c) there is a significant breakdown in partner government financial management and accountability, leading to the risk of funds being misused through weak administration or corruption.

2. Introduction

2.1 This paper sets out the UK Government's position on effective aid partnerships. It outlines the principles we will apply in building partnerships. It explores the relationship donors should have with the policy-making process in developing countries. It sets out the circumstances in which we will consider modifying or withdrawing existing aid commitments. It signals a significant change in our thinking and practice.

2.2 In recent years the UK has been moving away from traditional approaches to conditionality. We believe that it is inappropriate and has proven to be ineffective for donors to impose policies on developing countries. Instead, we believe that successful aid relationships must be based on mutual commitment and dialogue, transparency and accountability.

2.3 Good policy matters for development. Macroeconomic stability and growth are essential for lasting poverty reduction. But the policies needed for poverty reduction and long term development are much broader, and encompass the social, cultural, economic, civil and political rights of all men, women and children. They also include governance issues, environmental concerns and social exclusion. We will support developing countries to decide for themselves what policies to include in their poverty reduction plans. We will use our aid to back these plans, wherever possible.

2.4 The paper has been produced jointly by the Department for International Development, HM Treasury and the Foreign and Commonwealth Office. It is based on a broad range of international experience and evidence.

2.5 The paper is in four sections:

- What do we mean by conditionality?
- What impact has conditionality had?
- The UK Government's approach to aid partnerships
- The way forward

3. What do we mean by conditionality?

3.1 The UK applies terms and conditions through the programmes it has directly with a country (so-called bilateral programmes) and those it supports as one of many donors such as through membership of the World Bank or European Union (multilateral programmes).

3.2 Aid agreements typically set out terms and conditions to be met by the parties. Agreements often allow donors to stop funding if there is a significant breakdown in the performance of public financial management and accountability. This is sometimes known as 'fiduciary conditionality'. They can also allow donors to stop funding if a country veers significantly from its poverty reduction objectives or international obligations. There is general agreement that conditionality in these areas is important, though there is debate about the particular circumstances in which it is appropriate, given the potentially adverse consequences on poor people of any reduction or interruption of aid.

3.3 There is more disagreement around the use of 'policy conditionality', where donors agree to provide aid on condition that the country pursues particular policies. Aid has often been conditional on economic, environmental or social policies, such as macroeconomic stabilisation or increased investment in health or education. Sometimes it has been conditional on specific policies such as privatisation, which have been controversial in the partner country. If the country failed to implement agreed commitments then donors have reduced or even stopped their support.

3.4 From the mid-1990s there has been a significant evolution in aid relationships, which has implications for the appropriate role of conditionality. First, poverty reduction has become the primary objective of development assistance, and the Millennium Development Goals have provided a new framework for development.

3.5 Second, while sound macroeconomic policies are essential for growth and poverty reduction, there is also greater understanding of the importance of good governance in reducing poverty and conflict, and of the role of democratic participation in developing national plans to reduce poverty. For example, excessive military spending and corruption have an impact on the delivery of public services and the investment environment.

3.6 In response, donors have broadened the focus of aid conditions from macroeconomic policies to include also conditions linked to political and institutional change, as well as social and environmental policy. Such conditions have included commitments by the partner country to tackle corruption or establish more transparent and inclusive systems of government. Donors have also been readier to include conditions about the process of policy-making, for example making aid conditional on a country's commitment to consult poor people in preparing a national poverty reduction strategy. These so called 'process conditions' cover the process of policy making without specifying the content of the policy that should result.

4. What impact has conditionality had?

4.1 Evidence on the impact of policy conditionality in bringing about policy change is at best mixed.

Have conditions been met?

4.2 In many cases, either donors or developing countries have not kept to the conditions that they signed up to. Developing countries sometimes agreed conditions in areas of reform even though they were unconvinced of the case for change. Unsurprisingly, countries have largely ignored conditions set in such circumstances, or the reforms pursued have not been sustained. Put simply, conditionality which attempts to 'buy' reform from an unwilling partner has rarely worked.

4.3 Donors, too, have sometimes failed to fulfil their part of the bargain. Aid has been withdrawn in response to domestic financial pressures in donor countries or external political events, with limited notice or consultation. There are also frequent examples of donors continuing to provide assistance even when countries have not kept to their agreement.

Have conditions reduced poverty?

4.4 Concerns have been raised that some conditionality has promoted reforms that have made poor people worse off. In the past, poverty reduction was not always given priority in development assistance programmes. For example, structural adjustment reforms during the debt crisis of the 1980s sometimes failed to take account of the social impact, especially on poor people.

4.5 The spotlight has also fallen on privatisation and trade reforms. There is particular concern that in the 1980s and 1990s donors pushed for the introduction of reforms, regardless of whether these were in countries' best interests. This led to growing discomfort that developing country governments were becoming more accountable to donors than to their own people, and that this distorted national priorities in the process.

4.6 Evidence on the social impact of privatisation policies in the area of public services, particularly in the absence of effective competition and regulation, has been a subject of much debate. In some cases, developing country governments have limited capacity to regulate the private sector effectively. There are examples where privatisation has not benefited poor people, and therefore the use of conditionality in such cases has been criticised.

4.7 On trade reform, the evidence is also mixed. Overall, trade reforms have been important in encouraging economic growth in poor countries and hence poverty reduction. But there are concerns, for example, that aid conditions have constrained poor countries from incorporating some of the lessons of successful East Asian economies that relied on appropriately sequenced trade measures during early stages of development, and that conditions requiring unilateral trade liberalisation affect the ability of poor countries to negotiate effectively in multilateral discussions. In some cases poor people have suffered during trade liberalisation, where conditionality has been excessively restrictive, or where insufficient attention was paid to the capacity of the economy to take advantage of the opportunities of more open trade, or to factors that help poor people to benefit from trade, such as their ability to access health and education, financial services, and infrastructure.

4.8 There has been insufficient analysis of the impact of different reforms on poor people. In the last few years, donors have recognised this gap and started supporting Poverty and Social Impact Analysis (PSIA) of major policy changes. This analysis anticipates and assesses the intended and unintended consequences of policy changes for the welfare of poor men and women and vulnerable groups, such as ethnic minorities, disabled people, older people and children. It covers both income and non-income measures of welfare. So far over 100 assessments have been completed or are underway. But PSIA needs to be implemented much more consistently, and be more widely owned within developing countries. The UK is working with partners to encourage a country-led approach, involving all stakeholders at each stage of selection, design and implementation, and including social and political analysis as well as economic analysis.

5. The UK Government's approach to aid partnerships

5.1 We believe that an effective aid partnership is based on a shared commitment to three objectives:

- a) poverty reduction and the Millennium Development Goals;
- b) respecting human rights and other international obligations; and
- c) strengthening financial management and accountability, which reduces the risk of funds being misused through weak administration or corruption.

Partners need to agree the basis for assessing progress in these three areas to ensure that the partnership is achieving these shared objectives.

Commitment to poverty reduction

5.2 The International Development Act, which came into force in 2002, makes the elimination of poverty the primary purpose of UK development assistance. DFID provides aid to further sustainable development and improve the welfare of people outside the UK.

5.3 Within a framework of partnership, both donors and country governments need to agree the purpose for which aid is given. This ensures that both parties have a shared understanding of how aid will contribute to poverty reduction, and can be held publicly accountable for delivering on their commitments.

5.4 Poverty reduction programmes produced by developing country governments should specify benchmarks of progress – to clarify for all stakeholders the results intended from the programme, and to prompt changes in the programme if it is not leading to the expected results. We are increasingly interested in assessing whether the programme is producing the desired poverty outcomes, rather than whether the government is implementing a particular policy measure.

Commitment to human rights and other international obligations

5.5 The UK Government believes that the realisation of all human rights underpins sustainable development. States have a shared responsibility to ensure that human rights are upheld, that violations do not take place, and that governments respect their international obligations. Donors have a particular responsibility, as part of their accountability to parliament and the public, to ensure that their development assistance is not used in ways that abuse human rights. The human rights situation should be assessed on the basis of the partner country's own international human rights obligations. We will explore ways of working with partner governments and civil society to incorporate human rights-based benchmarks into poverty reduction plans

and into frameworks for determining progress on poverty reduction. We will also work to ensure that our own policies, alongside those of other donors, do not impede the ability of recipient governments to fulfil their human rights obligations.

5.6 We will also consider a country's position in relation to other international obligations, for instance on peace and security.¹

Commitment to strengthening financial management and accountability

5.7 We believe that improving performance in public financial management and accountability is critical for building the capability of states to deliver basic services and to progress towards the Millennium Development Goals. Partner governments, like donors, are also accountable to their electorates for the propriety of public finances.

5.8 DFID is accountable to Parliament for how UK taxpayers' funds are used. We have a duty to ensure that development assistance is used to promote poverty elimination. Where aid is provided directly to partner governments through direct budget support, we evaluate the strength of public financial management and accountability and support governments to implement a programme of improvement. This should address weaknesses in the system to minimise the risk of funds being misused through weak administration or corruption. Where necessary, additional short-term safeguards should be considered in dialogue with partner governments and other donors.

5.9 The implication of this approach to aid partnerships is that the UK will consider reducing or interrupting committed aid if:

- a) countries veer significantly away from their agreed poverty reduction objectives or from the agreed objectives of a particular aid commitment (such as through an unjustifiable rise in military spending, or a substantial deviation from the agreed poverty reduction programme); or
- b) countries are in significant violation of human rights or other international obligations; or
- c) there is a significant breakdown in the performance of partner government financial management and accountability systems leading to the risk of funds being misused through weak administration or corruption.

¹ DFID is publishing a paper on security and development. This will consider how international obligations on peace and security should affect development partnerships. It will make clear that development assistance resources must remain focused on the MDGs, but a country's commitment to its own international obligations will be relevant in assessing whether the basis for a development partnership has broken down. Judgement will be required. For example, if a country were to adopt an explicit policy of actively supporting terrorism, this would be a clear reason to rethink our aid relationship. If, on the other hand, a country were unable to meet stringent requirements at ports of entry to check all containers for illegal arms export, we would be unlikely to use this as a justification for ending our aid programme.

Any decision to reduce or interrupt aid because countries have veered from their poverty reduction objectives will be based on an assessment of the long term impact on poverty of the overall programme of the government, not on failure to implement any specific policy.

5.10 Where a partnership breaks down, the UK will need to judge carefully whether to reduce or suspend aid. This judgement will need to consider the impact for poor people, and for longer-term poverty reduction efforts, of stopping or continuing aid. The judgement should also take into account any special circumstances, such as evidence that the breach will be reversed, or that the government is making efforts to address the problem in question. In all cases the UK will seek to talk the issues through with partner governments before taking a decision.

Commitment to key principles

5.11 In its aid relationships, the UK will be guided by five principles:

- developing country ownership;
- participatory and evidence-based policy making;
- predictability;
- harmonisation; and
- transparency and accountability.

5.12 In some countries this already represents UK practice; in others progress needs to be made. We will continue to work to make sure that the approach is applied universally.

Developing country ownership

5.13 The UK Government accepts the evidence that conditionality cannot 'buy' policy change which countries do not want. Reforms will not be implemented – or will not be sustainable – if a partner country is acting purely in order to qualify for financial support and does not consider that the reforms are in its own interest. The UK will not make our aid conditional on specific policy decisions by partner governments or attempt to impose policy choices on them (including in sensitive economic areas such as privatisation or trade liberalisation). Instead we will agree with partners how aid will contribute to poverty reduction in a manner that can be sustained over the long term, and agree benchmarks to show what progress is being made. These benchmarks should focus on the impact of the government's overall programme, rather than on specific policies.

5.14 Wherever possible we will base our assessment of partner country programmes on evidence of actual impact, since we recognise that policies have different effects in different institutional and social environments. We also recognise that in some cases

where the lag between policy action and impact on poverty is long, or the likely impact is well established through the evidence in other similar country situations, our assessment may need to precede the availability of data on impact. In these cases, we will base our assessment on transparent dialogue with the partner country government and relevant stakeholders.

Box 1: Vietnam case study

The Vietnamese Government drew up a comprehensive strategy in May 2002 that sought to reduce poverty and encourage growth. This reform package was agreed by the government following a year-long consultation process that canvassed a broad range of views, including those of local officials.

Donor organisations offered their technical support to this process and were consulted on its progress. The end result was a strategy that was widely supported by the international community, but which was developed entirely by the Vietnamese Government.

The basis of the commitments made by the government in order to qualify for Poverty Reduction Budget Support (PRBS)² are now linked to this strategy.

5.15 We will support broad-based country ownership of poverty reduction plans, including through processes that take account of the views and concerns of poor people. For us, 'country ownership' requires that the country has leadership over its development policies. It requires partner governments in consultation with citizens to define a poverty reduction programme, which donors can support (see Box 1). We do not only equate country ownership with government ownership. We believe that civil society, including poor people, should also have a voice and stake in their development, and that governments should be accountable to them.

5.16 The UK aims to support country-led development and maximum country ownership of development, whilst also maintaining accountability to the UK Parliament and public, and ensuring that aid is used effectively. We believe donors have a useful and legitimate role as catalysts for change, and should continue to participate in policy dialogue based on well-researched policy options. Policy matters in poverty reduction – both policy content and the policy process. If we are concerned that policy choices included in a poverty reduction strategy (PRS), or other national strategy, will not lead to poverty reduction, or might even exacerbate poverty, we will discuss these differences of opinion with our partner.

² For further information about PRBS see Glossary of development terms.

5.17 Questions remain about the amount of genuine autonomy enjoyed by countries, given the greater financial power and technical capacity of donors in some aid dependent countries. Openness and transparency in agreeing the terms on which aid is provided and systems of mutual accountability can help to offset this power imbalance.

5.18 Where a partner government requests technical co-operation (TC) (in the form of specialist personnel, training or research advice), this must not undermine country ownership. Partner governments will always be responsible for deciding the terms of reference for such assistance. Both donors and partner governments have responsibility for ensuring open and transparent procurement processes for the selection of consultants.³

Participatory and evidence-based policy-making

5.19 Both donor and developing countries should be accountable, to their citizens and the wider global community, for showing how aid is supporting sound policies, which improve the quality of life for poor people.

5.20 To improve the quality and effectiveness of policy-making the UK will encourage participation by poor people and by parliaments in decision-making and policy-making. Civil society can also play an important role, as can the media.

5.21 It is critical that there is a full and open national debate in a country – including in parliaments and national assemblies – on the relative impact of different policy options, before the government takes final decisions on the way ahead. This debate can be well informed by poverty and social impact analysis (PSIA), and is especially important if partner country governments are considering the adoption of policies which may have a negative impact, or do not have broad consensual support in the country. As part of the partnership commitment to poverty reduction, all policy choices in the PRS or other national strategy should be well researched and debated.

5.22 The World Bank and IMF have agreed to increase the use of Poverty and Social Impact Analysis (PSIA) for reforms which are likely to have significant impacts on different groups and on the distribution of resources between different groups. Progress is being made, but considerably more needs to be done to increase the number and to improve the quality of PSIAs, to promote their ownership by country governments, and to ensure that the results of the PSIA are used effectively in the policy process.

Predictability – aid partnerships should enable predictable funding

5.23 The UK is very concerned that aid to developing countries is unstable. Countries cannot properly plan their public policies if they do not know with any certainty how much external finance they will receive. A major reason why aid has been so unpredictable is that donors do not always make clear the basis on which they will cut or stop aid flows. And where they do have rules, they do not always consistently apply them.

³ The UK believes that the procurement of goods and services financed by aid should be through open competition internationally. We do not tie our aid to purchases from UK suppliers.

5.24 The UK proposal for an International Finance Facility (IFF) will also help to improve the predictability of aid flows. Donors would make legally binding commitments over the medium to long term to allow increased levels of aid to be disbursed in the years to 2015. This would allow multi-year funding to be agreed for recipient countries, and could therefore enable them to invest more efficiently.

5.25 Where it is necessary to reduce or interrupt aid, we will make the decision based on criteria and processes agreed with our partner country in advance. The process will allow for a substantial period of assessment and discussion between the developing country government and donor agencies. Any planned disbursements will continue during the period of dialogue. Dialogue is particularly important when several donors have conditions in the same areas and there is a risk of countries losing a substantial amount of aid at short notice by failure to adhere to certain conditions.

5.26 We recognise that changing planned aid disbursements within a financial year can severely disrupt the recipient's budgetary process. We will only reduce aid within a country's financial year in exceptional circumstances.

Box 2: Ethiopia case study

The UK and Ethiopian Governments have drawn up a 10-year agreement that aims to link action on reducing poverty with progress on key issues such as justice, human rights and enhancing democracy. The initiative seeks to build a stronger partnership between the two governments by setting out their mutual commitments and expectations.

As part of the arrangement, there will be regular dialogue between the two sides, making the future actions of each government easier to predict. As a result, the Ethiopian Government should be able more accurately to predict future aid, and the UK should have more confidence in the outcome of aid, to the ultimate benefit of the poor.

Harmonisation – donors must work together more effectively

5.27 The UK strongly supports efforts to improve donor coordination and harmonisation. These efforts are leading to some rethinking of how donors, collectively, use conditionality and reduce the overall number and intrusiveness of conditions. The International Monetary Fund (IMF) has already moved in this direction, through its 'streamlining conditionality' initiative. This has clearly distinguished between the conditions the IMF sets and those set by the World Bank. The IMF has made good progress in limiting its conditions to areas that have a major impact on a country's macroeconomic situation.⁴

⁴ As set out in its Articles of Agreement, the IMF and World Bank are not allowed to use 'political conditionality', but can only directly link lending conditions to their eventual economic impact.

5.28 The World Bank has also moved to reduce its conditionality, and this now needs to be applied more systematically. The World Bank is currently reviewing its approach to conditionality and we are contributing to the debate (see Box 3). We will continue to press both the World Bank and IMF to monitor the combined burden and impact of their conditionality and to use conditionality in accordance with the principles set out in this paper.

Box 3: World Bank review of conditionality

At the 2004 World Bank/IMF Annual Meetings, the World Bank agreed with the UK's suggestion that the Bank should carry out a review of its approach to conditionality, and report back at the 2005 Annual Meetings.

We have specifically asked the Bank to take a critical look at the following five issues: the scope and content of policy conditionality; the appropriate level for application of conditionality (i.e. overall programme or individual project); improving harmonisation and alignment behind country-owned plans for poverty reduction; improving predictability; and conditionality in fragile states.

In addition to a comprehensive policy statement on conditionality, the Bank is expected to publish operational guidelines for staff, and also to propose monitoring mechanisms to support policy implementation and strengthen accountability to stakeholders.

5.29 Unlike the IMF and World Bank, whose Articles of Agreement require them to link lending conditions to their eventual economic impact, and prevent them using 'political conditionality', the European Union sets its development cooperation within the framework of its overall political relationship. Under the Cotonou Agreement with African, Caribbean and Pacific countries, the EU has a clear process for dialogue when concerns arise over human rights and other political issues. Where there is a need for dialogue over issues of this kind, the UK will wherever possible work jointly with other donors, through the EU or other multilateral channels.

5.30 The European Commission (EC) is piloting an approach that bases the benchmarks of its budget support on the impact of reform on social services delivery (such as the increase in girls attending schools) rather than the specific policy reforms themselves.

5.31 Using outcomes rather than policies as the basis for assessing progress offers a way of maintaining accountability for the effective use of aid whilst giving countries a freer rein to choose their own policies. But there are potential downsides. Developing countries are concerned that they will be penalised for failing to achieve results for reasons outside their control, such as a collapse in commodity prices forcing a cut in education budgets because of a shortfall of revenues. There are other difficulties, such

as the problem of attributing changes in performance when there are time lags in policy implementation, or when a new government takes power. In addition, accurate and timely data may not be available to determine whether outcomes have been achieved.

5.32 The UK will be looking to learn from the EC experience with this approach, and to explore the scope for incorporating outcome benchmarks as part of an approach harmonised with other donors.

5.33 More action is also needed from bilateral donors to limit their use of conditions. To promote respect for national ownership, and provide a common framework around which donors can harmonise, we will encourage all donors to draw the terms and conditions for their aid from a collectively agreed framework of poverty reduction benchmarks, a country's existing international human rights commitments, and a credible programme of improvement in public financial management.

5.34 Mozambique has recently agreed a common policy matrix with 14 donors (see Box 4: Mozambique case study). We would like to see coordinated approaches become the norm, not the exception. We recognise however that not all donors and not all recipients yet wish to develop a framework of support with identical terms and conditions. This may impose excessive restrictions on donor-recipient relationships and potentially increase downside risks for the recipient. It may also increase rather than reduce the potential imbalance of power between donors and recipients.

Box 4: Mozambique case study

Total external aid to Mozambique has averaged 12% of GDP over the past decade, and is now just below 10%, compared with an Africa average of 6%-8%. The government has a medium term objective to reduce aid dependency by funding a larger proportion of expenditure through domestic revenues.

External aid will still be needed for the foreseeable future, however, and DFID has made a five-year commitment to support Mozambique's poverty reduction efforts. Our programme, which has more than doubled in size since the late 1990's, will reach £47 million in 2004/05 and £50 million in 2005/06. This will put DFID amongst the top three donors to Mozambique.

Around a third of grant assistance is provided in the form of Poverty Reduction Budget Support (PRBS), channelled directly through the government's own systems. DFID believes that increasing the proportion of aid channelled in this way is essential for sustainability and for the development of domestic accountability. By 2005/06, some 70% of our programme in Mozambique will be in the form of PRBS.

The government and 14 donor partners, including DFID and the World Bank, signed a memorandum of understanding governing the provision of budget support in April 2004.

5.35 Donors, including the UK, have traditionally relied on an IMF programme to indicate that a country's macroeconomic policy stance and strategy are satisfactory before granting aid. A stable macroeconomic environment is critical for establishing a basis for growth, avoiding adverse effects on the poor and protecting government expenditure that benefits the poor. Our primary concern of poverty reduction places the emphasis on long-run macroeconomic stability, sustained economic growth and institution building. The UK will form its assessment of progress in these areas by using IMF assessments and other sources of information. It will not necessarily require a financed IMF programme to indicate that a stable macroeconomic environment is in place. If an IMF programme is suspended (or 'off-track'), we will decide whether to continue or suspend assistance according to the principles laid out in this policy paper.

5.36 In view of the IMF's competence in macroeconomic analysis, the UK will look to the IMF to provide an assessment of a country's macroeconomic position, independently of IMF financing. The assessment will require regular monitoring and policy evaluation by IMF staff. We will seek to identify, along with other donors and partner governments, an appropriate macroeconomic standard for assessing country performance. We will also continue to assess whether IMF programmes allow sufficient fiscal flexibility to accommodate priority poverty reduction expenditure while maintaining macroeconomic stability.

Transparency and accountability

5.37 Both partners – donors and developing country governments – should be committed to transparency. Accountability is enhanced when both make public their decisions and the evidence on which they are based.

5.38 We are committed to increasing transparency around the process of decision-making on conditions, the conditions themselves, and the process for deciding to reduce or interrupt aid. We will encourage greater involvement of parliaments in the oversight of conditions prior to their agreement, and greater involvement of line ministries, parliamentarians and civil society in the identification of agreed benchmarks. We will also encourage other donors, including the international financial institutions (IFIs), to be more transparent, particularly in relation to the process of agreeing the terms and conditions for their aid.

5.39 The UK will make our own aid conditions more transparent, by publishing them on DFID's website.

Fragile states

5.40 In deciding how to allocate aid between countries, DFID will take account both of the extent of poverty in a country, and of its ability to use aid effectively (as evidenced by the expected impact of its poverty reduction programme and its commitment to sound financial management and accountability standards).

5.41 In fragile states the shared commitments for a good partnership are often not in place. The UK's focus on promoting good partnerships does not mean that we cannot work effectively in these countries. DFID has recently published a paper on working in fragile states,⁵ which sets out a number of ways of contributing to poverty reduction in these countries.

5.42 Poor political governance, such as widespread human rights violations, can hasten a country's decline towards instability. Instead of withdrawing from these countries, the UK is committed to finding ways of delivering targeted, selective aid focusing on improving governance and delivering services.

5.43 In the fragile states where we can work with the government, we should as far as possible apply the principles set out in this paper. Partnerships can be built around simple planning instruments for prioritisation and sequencing of reforms. Transitional Results Matrices are currently being piloted in some fragile states, to help apply the poverty reduction strategy principles of a unified, country-owned plan. They have an element of mutual accountability by identifying actions for partner governments as well as donors, and can provide the basis for a partnership in the absence of a poverty reduction strategy.

5.44 In countries where the government is weak or uninterested in development, we will closely monitor the situation to identify opportunities for political dialogue. Wherever possible, we will remain involved through partners other than the government, for example supporting NGOs in the provision of services. Apart from decisions on aid, well-targeted sanctions may also have some impact on the pace of reform. Measures such as asset freezing and travel bans which target those individuals most likely to be able to influence a positive change on the ground can often help limit any wider negative impact on the population. The UK always seeks to ensure that sanctions are properly targeted and enforced, while aiming to avoid unnecessary suffering to the civilian population.

⁵ *Why we need to work more effectively in fragile states*, DFID, January 2005.

6. The way forward

6.1 The UK would like to build a new consensus across the international community on effective aid partnerships and accountability, drawing on the approach outlined in this paper. There is already significant international agreement on many of the elements. Critical to making this new approach work will be the evolution of poverty reduction plans into processes that are truly owned and pushed forward by developing countries. As the recent evaluation by the IMF and World Bank demonstrates, despite considerable progress there remain question marks about the level of genuine autonomy that countries, especially those that depend heavily on aid, have over their own policies.

6.2 Much of the solution rests with donors. We need to take a back seat, giving more space to countries to draw up their own plans for poverty reduction. To make this happen, we need to find more effective ways to strengthen countries' policy expertise. We need to make good our commitment to support country priorities with our aid and to cut back on old style conditionality. We need to improve the predictability of our aid and increase the transparency of any conditions applied. And at a more technical level, we need to step up support for Poverty and Social Impact Analysis (PSIA), so that developing countries can make choices based on the full range of evidence.

6.3 The UK is keen to work with our partners to make this happen. We also have more to do ourselves to put our new approach into practice. In summary, the UK Government will:

- build aid partnerships where accountability is linked to a country's own plan for reducing poverty;
- promote a more equal approach in which donors do not impose conditions but agree benchmarks with partners;
- highlight the importance of good economic and social policies and of strong commitment to transparency, accountability and good governance;
- promote a shared commitment to respecting human rights by donors and recipient governments, and explore ways of incorporating human rights benchmarks into frameworks for determining progress on poverty reduction;
- encourage greater cooperation between all organisations providing aid, including national governments and international financial institutions;
- act to prevent the misuse of funds through corruption or weak financial management;

- continue to support partner countries' efforts to improve public financial management and accountability through using donor and IFI assistance;
- continue to support efforts by the World Bank and the International Monetary Fund to streamline their use of terms and conditions when granting aid, seeking further progress from the World Bank and considering the overall impact of conditionality;
- continue to seek commitment from other donor agencies to harmonising terms and conditions of aid;
- promote a much greater use of Poverty and Social Impact Analysis, both bilaterally and in the international financial institutions, to improve the quality of policy reforms;
- consider further how to maintain predictable and stable aid flows. This will look at the issue of how to tackle political concerns about the aid relationship while avoiding interruptions to aid with very little warning;
- develop further our understanding of effective partnerships in fragile states;
- publish more information (including on DFID's website) about the conditions used in DFID's bilateral programmes; and
- produce operational guidelines for DFID staff, review agreements to ensure consistency with this policy and monitor the impact of the policy over time.

Glossary of development terms

Millennium Development Goals (MDGs)

The Millennium Development Goals were derived from commitments made in a series of United Nations conferences in the 1990s and agreed by nearly 150 heads of states and governments at the 2000 Millennium Summit. By 2015, we aim to:

- eradicate extreme poverty and hunger;
- achieve universal primary education;
- promote gender equality and empower women;
- reduce child mortality;
- improve maternal health;
- combat HIV/AIDS, malaria and other diseases;
- ensure environmental sustainability; and
- develop a global partnership for development.

Poverty and Social Impact Analysis (PSIA)

Poverty and social impact analysis (PSIA) refers to the systematic analysis of the impact of policy reforms on the welfare of different stakeholder groups, with particular focus on poor women and men and vulnerable people (such as people with disabilities, ethnic minorities, older people and children). During 2002-03 the World Bank funded 11 pilot PSIAs, with DFID supporting an additional eight studies. These provided the basis for a rapid expansion in World Bank-funded PSIAs and by early 2004 there were some 100 PSIA activities being carried out, with two-thirds of these based in PRSP countries.

These studies have provided evidence to inform decision-makers and have strengthened the process of domestic policy-making. Although the total impact of these studies has not yet been measured systematically, early evidence suggests they have influenced actual policy design in Malawi, Zambia and Armenia, amongst others.

Poverty Reduction Budget Support (PRBS)

Poverty reduction budget support (PRBS) is a form of financial aid in which funds are provided:

- in support of a government programme typically focusing on growth, poverty reduction, fiscal adjustment and strengthening institutions, especially budgetary processes; and

- directly to a partner government's central exchequer to spend using its own financial management, procurement and accountability systems.

PRBS is also commonly known as direct budget support. DFID uses PRBS explicitly to link the provision of aid to the partner government's commitment to poverty reduction. Where circumstances are appropriate, PRBS is the aid instrument most likely to support a relationship between the donor and partner that strengthens the accountability and capability of the state. For further information see DFID's policy paper 'Poverty Reduction Budget Support', May 2004.

Poverty Reduction Strategy (PRS)

In September 1999, the World Bank Group and the IMF agreed that nationally owned 'poverty reduction strategies' should provide the basis of all their concessional lending. In many countries, this strategy takes the form of a PRS paper, which links debt relief to poverty reduction goals. The UK works actively with poor countries' governments to support the development of these national frameworks. We are also supporting the consultative process to ensure that PRSs are built on a broad-based consensus in which the poor have a voice. Interim or full poverty reduction strategies have been developed in 53 countries.

The International Development Act

The Act came into force in June 2002. It makes clear that the sole purpose of UK development assistance is the elimination of poverty. It is illegal for the UK Government to spend development assistance for any other purposes. Our aid is 'untied' in that the provision of development assistance is no longer conditional on the use of British goods and services.

IFI programmes

This refers to programmes carried out by any of the international financial institutions (IFIs) concerned with development, namely the World Bank, the Regional Development Banks, and the International Monetary Fund (IMF).

Department for International Development

DFID, the Department for International Development: leading the British government's fight against world poverty.

One in five people in the world today, over 1 billion people, live in poverty on less than one dollar a day. In an increasingly interdependent world, many problems – like conflict, crime, pollution, and diseases such as HIV and AIDS – are caused or made worse by poverty.

DFID supports long-term programmes to help tackle the underlying causes of poverty. DFID also responds to emergencies, both natural and man-made.

DFID's work forms part of a global promise to:

- halve the number of people living in extreme poverty and hunger
- ensure that all children receive primary education
- promote sexual equality and give women a stronger voice
- reduce child death rates
- improve the health of mothers
- combat HIV & AIDS, malaria and other diseases
- make sure the environment is protected
- build a global partnership for those working in development.

Together, these form the United Nations' eight 'Millennium Development Goals', with a 2015 deadline. Each of these Goals has its own, measurable, targets.

DFID works in partnership with governments, civil society, the private sector and others. It also works with multilateral institutions, including the World Bank, United Nations agencies, and the European Commission.

DFID works directly in over 150 countries worldwide, with a budget of nearly £4 billion in 2004. Its headquarters are in London and East Kilbride, near Glasgow.

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