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Is There a Place for Virtual Poverty Funds in Pro-Poor Public Spending Reform? Lessons from Uganda's PAF

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Various developing countries with weak public expenditure management systems are establishing virtual poverty funds (VPFs), drawing on the experience of Uganda's Poverty Action Fund. As a mechanism for tagging and tracking the performance of specific poverty-reducing expenditures in the budget, a VPF can be useful. However, this article argues that such devices should be treated from the outset as transitional, and as part of wider processes of strengthening public expenditure management; otherwise, they can seriously distort public expenditure allocations and management systems, potentially undermining growth. Emphasis needs to be placed on identifying the right balance of expenditures in the entire budget; improving the effectiveness and efficiency of existing allocations; and developing better public-sector policies for promoting pro-poor private sector growth.

The public sector and public expenditure management have a key instrumental role in poverty reduction. Accordingly, developing countries are being supported in the implementation of various initiatives, including Medium-Term Expenditure Frameworks (MTEFs), Sector-Wide Approaches (SWAps), and now Poverty Reduction Strategy Papers (PRSPs), aimed at improving strategic planning, budget formulation and budget execution. At the same time, aid instruments are being realigned towards helping countries to achieve their poverty reduction goals through their own budget systems. The Heavily Indebted Poor Country (HIPC) debt relief initiative, Poverty Reduction Support Credits (PRSCs) from the World Bank, Poverty Reduction and Growth Facilities (PRGFs) from the IMF and the bilateral donors' move towards general and sectoral budget support, are among the manifestations of this shift in policy.

This agenda of change poses several substantial challenges to countries that embark on the process with either weak political commitment to pro-poor policy reform, or ineffective budget and planning systems, or both. In such situations, a case can be made for establishing bridging mechanisms that provide a measure of assurance that public resources, including aid funds provided through the budget, are being utilised effectively to support poverty reduction objectives. This article is an assessment of one such mechanism, the virtual poverty fund (VPF), based on the experience of Uganda. The argument centres on the degree to which VPFs can contribute, and the conditions

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under which they may become an obstacle, to the wider agenda of pro-poor public spending reform.

The agenda of pro-poor public spending reform

Improving financial management

The international financial institutions are supporting large-scale institutional capacity-building and upgrading of financial management systems in most developing countries. Much of this effort is focused on strengthening the budget systems, and increasing the predictability of budget disbursements and expenditures. Many bilateral donors, too, are now interested in supporting reform of financial management and accountability systems as a way to improve fiduciary assurance as they move towards budget support. However, the current agenda of pro-poor public expenditure management goes well beyond the provision of higher levels of efficiency and trust in financial management (see Box 1).

Box 1: Good practice in pro-poor public expenditure management

- Effective resource planning through:
  - better matching of spending with overall resource availability over the medium term, ensuring a sustainable budget deficit;
  - ensuring that sectoral allocations of spending are in line with government (PRSP) priorities, with rational modalities for arriving at inter- and intra-sector allocations;
  - strong sectoral planning and management, through SWAps, with concurrent programming of recurrent and development expenditures, ensuring the sustainable achievement of sector outputs and outcomes;
  - improved effectiveness and efficiency of spending through clear definition of outputs and outcomes, and linking spending to performance.
- Public management systems focus on achievement of results, emphasising the output to outcome and budget to output linkages, with a performance culture, and effective monitoring and evaluation.
- An awareness of costs in sectors and line agencies.
- Ensuring an appropriate balance of inputs for programmes.
- Strong accounting, audit, procurement practice, with transparency in public financial management.
- Encouraging consultation and transparency in the budget process.
- Integrating external aid into the budget.

Source: Based on Fozzard et al. (2001).

Political commitment

Increasingly, the focus of pro-poor reform in developing countries is the PRSP. However, it is becoming clear that a PRSP is an effective tool for translating poverty reduction goals into action only when there is common political and cross-institutional

support for achieving those goals. Without this, any pro-poor budget reforms are likely to be unsuccessful.

If support is there, then a process can start which builds up more concrete political and institutional commitment towards poverty reduction in government. The process of drawing up a PRSP can itself help establish such commitment across the political and administrative arms of government, by fostering greater understanding of the implications of pro-poor reforms. However, there must also be incentives for institutions to buy into such a process. Often the PRSP document is developed hurriedly without adequate political processes, and is then perceived solely as a donor condition for accessing debt relief.

Choosing priorities

The translation of poverty reduction goals into a suitable set of pro-poor strategies, outputs and actions and the prioritisation of areas for public expenditure represent a major challenge, both politically and technically. Box 2 shows the kind of practices currently being promoted for identifying pro-poor public sector interventions. Tools for assessing these types of programme choices include analysis of cost-effectiveness, social cost-benefit analysis, and multi-criteria analysis. Recently, the concept of Poverty and Social Impact Assessments has been promoted by the World Bank and others. Yet, the capacity for rigorous assessment *ex-ante* of the best balance of public sector programmes in developing countries often does not exist. In fact, no country can be said to have the optimal mix of policies to achieve its objectives.

Box 2: Identifying pro-poor spending options in a PRS

- Assess the rationale for public intervention in achieving those goals, through identification of market failures and equity issues.
- Identify the instruments (regulation, taxation, public spending) for addressing market failures and equity concerns, ensuring clear roles for the public and private sectors.
- Choose between programmes that potentially achieve the same PRS goal, on the basis of their efficiency and effectiveness, ensuring that individually and in aggregate the public sector interventions chosen are sustainable and affordable.

Source: Based on Fozzard et al. (2001).

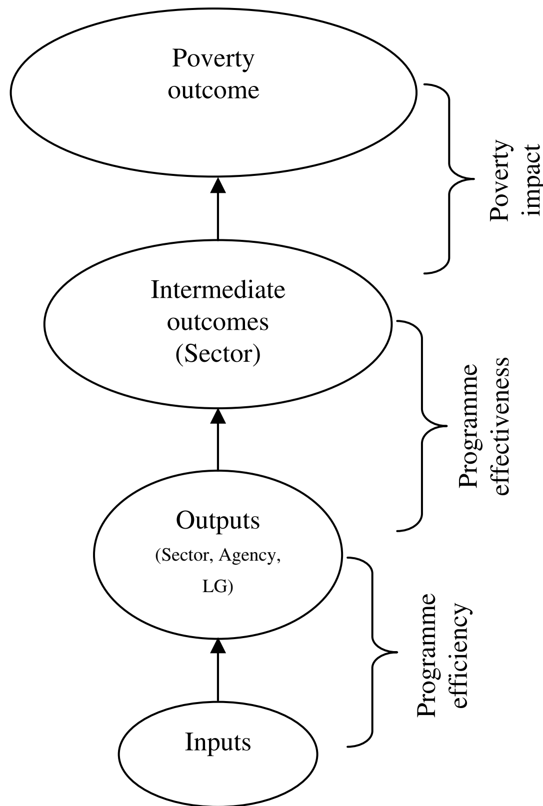
In a recent review by the IMF and World Bank of PRSP implementation, it was observed that in PRSPs there was ‘limited discussion of … the linkages between policy choices and poverty reduction goals, and the trade-offs underpinning these choices … Countries also face difficulties in costing and prioritising measures in their PRSPs’ (IMF and IDA, 2002c: 17-18). The acknowledgement of trade-offs in policies is important. The impact of an intervention which in isolation is ostensibly pro-poor may, in fact, be lessened when combined with other policies, and even in certain circumstances be ultimately poverty-increasing (see Westerhout, 2001). Programmes should therefore be assessed not only in isolation but also in terms of their contribution to the achievement of other poverty reduction goals. This need not, and often cannot,

always be quantitative (it may be impossible to quantify the contributions of all policies collectively towards poverty reduction in an ideal general equilibrium model).

Focusing on results

An essential feature of the current approach is to improve the results orientation of programme design and the associated decision-making processes. Far too often there is an assumption that $1 spent on a sector such as primary education is $1 spent on the poor. Often, however, there are wide variations in the efficiency and effectiveness of public expenditure programmes (see Figure 1). Recognising this problem, results-based practices are being promoted as one way of enhancing the performance of public expenditure in the achievement of poverty reduction goals.

Figure 1: Focusing on results



Cross-country research led by the Overseas Development Institute shows that the implementation of results-based reform is often haphazard, fragmented and characterised by trial and error. However, according to Roberts (2003a: 4):

Used in combination they:

- help to focus attention, personnel and financial resources at all levels on policy priorities and the means of achieving them;
- align personal and group incentives on national goals, and motivate staff in all tiers of government through consultation and involvement in target formulation;
- promote learning – by doing and by performance analysis – about the processes of producing public services and the scope for efficiency and effectiveness improvements;
- identify areas of under-provision and under-performance that require special attention from planners, programme managers and service providers.

If public programmes are to be efficient and effective, governments should be encouraged *ex-ante* to justify public sector programmes and their budget allocations in terms of their contribution to pro-poor results, and the trade-offs between different pro-poor policies should be identified and considered. Monitoring and evaluation systems can help track performance, and strengthen decision-making during and after implementation.

Interestingly, the ODI cross-country evidence suggests that it is those results-based mechanisms which evolve locally, often by trial and error, that add most value to the decision-making process.

Shifting aid modalities

The growing interest among donors in providing aid through the budget reinforces concerns about how far public expenditure is contributing to pro-poor results. At the most basic level, funding agencies need to be concerned not to reinforce 'Samaritan's Dilemma' effects. Put simply, if donor aid is always given to the poorest countries, there is a perverse incentive for the recipient governments to pursue policies that worsen poverty (or at least tacitly hold back on policies which promote poverty reduction), so as to ensure that they continue to benefit from aid (Pedersen, 2001).

The move from project aid towards budget support, and the development of sector-wide approaches, have prompted a move from *ex-ante* to *ex-post* conditionality, and also changes in the types of condition attached to aid, with increased use of performance indicators in the aid contract (Adam and Gunning, 2002). Governments need to be supported in establishing systems which facilitate and track the achievement of results, and in explicitly increasing the efficiency and effectiveness of expenditures. Without this, there is a lack of incentive for governments to achieve pro-poor results. But building incentives into the aid contract for developing countries to perform is a difficult exercise.

In practice, the move towards budget support has increased donor focus on issues of allocation, accountability and fiduciary assurance around the budget and the financial systems used in its implementation. The fungibility of aid, and the apparent imperative of ensuring that budget support has been reflected in allocations to and spending on 'PRSP sectors', remain a key concern of many bilateral donors in moving into budget support. Although the rationale is to move away from *ex-ante* conditionality and towards a focus on results, donors have found it difficult to deliver on this commitment under current conditions (Lawson et al., 2002).

A key concern of funding agencies has therefore been the ability of public expenditure management (PEM) systems in developing countries to track poverty-reducing expenditures. This is also proving a crucial factor in donors' ability to channel their support through government public expenditure systems and to move away from project support. Developing countries are being encouraged to demonstrate clearly that their budget allocations are oriented towards poverty reduction, and that those budgets are actually implemented. Interest in virtual poverty funds arises from the belief that they can help in meeting this requirement.

Virtual Poverty Funds

In 2002 the IMF and IDA concluded an exercise examining the ability of HIPC countries to track poverty-reducing expenditures in their budgets. It was clear that the existing PEM systems needed substantial upgrading to be able to do so comprehensively. However, this exercise failed to examine the tracking of actual performance within established PEM systems; the focus was on tracking financial inputs, and not results.

Box 3: Conclusions of the HIPC tracking exercise

- The responsibility for establishing PEM systems which track poverty-reducing expenditure lies with each individual country.
- HIPCs should track all poverty-reducing expenditures, and not just those funded from the HIPC debt relief initiative. Tracking changes in the overall composition of expenditures should demonstrate how HIPC and donor resources are allocated.
- PRSPs should form the basis of the definition and prioritising of the Poverty Reducing Expenditures in each country.
- Countries should establish bridging mechanisms, where necessary, to facilitate immediate tracking of poverty-reducing public spending. Virtual poverty funds were cited specifically as a means of doing so.

Source: IMF and IDA (2002a).

Following on from their tracking exercise, the World Bank and the IMF proposed that virtual poverty funds were good *bridging mechanisms* for tracking pro-poor expenditures in the budget, whilst budget-wide mechanisms were being established (IMF and IDA, 2002b). A Virtual Poverty Fund is a mechanism which allows for the tracking of poverty-reducing expenditures whilst strong PEM systems are being built by:

- tagging specific poverty-reducing expenditures within the budget, using or adapting existing budget classification systems; and
- monitoring the performance of these expenditures.

A third, additional, element is the linkage of specific resources to the budget allocations for these expenditures. This element is the reason why VPFs are referred to

as 'funds', and is a key element of the first example of a VPF, the Poverty Action Fund in Uganda (PAF).

Uganda was the first country to benefit from debt relief under the original HIPC and enhanced HIPC initiatives, and was an early beneficiary of donor budget support. In response to concerns about the accountability for these funds, and the need to reorient budget expenditures towards poverty reduction, the Government of Uganda introduced the PAF in 1998.

The PAF was a means of demonstrating the additional nature of HIPC and donor budget support, in terms of increases in allocations to pro-poor expenditures within the budget. It identified and protected specific expenditures within the budget that had direct poverty-reducing impacts, identified in the Poverty Eradication Action Plan (PEAP), Uganda's PRSP (Ministry of Finance, 1998, 2001). Since it was formed, the PAF has become a means of ensuring that resources are increasingly allocated towards poverty-reducing expenditures, and that these allocations are disbursed in full. The Government of Uganda also makes specific commitments to ensure the transparency and accountability of PAF expenditures.

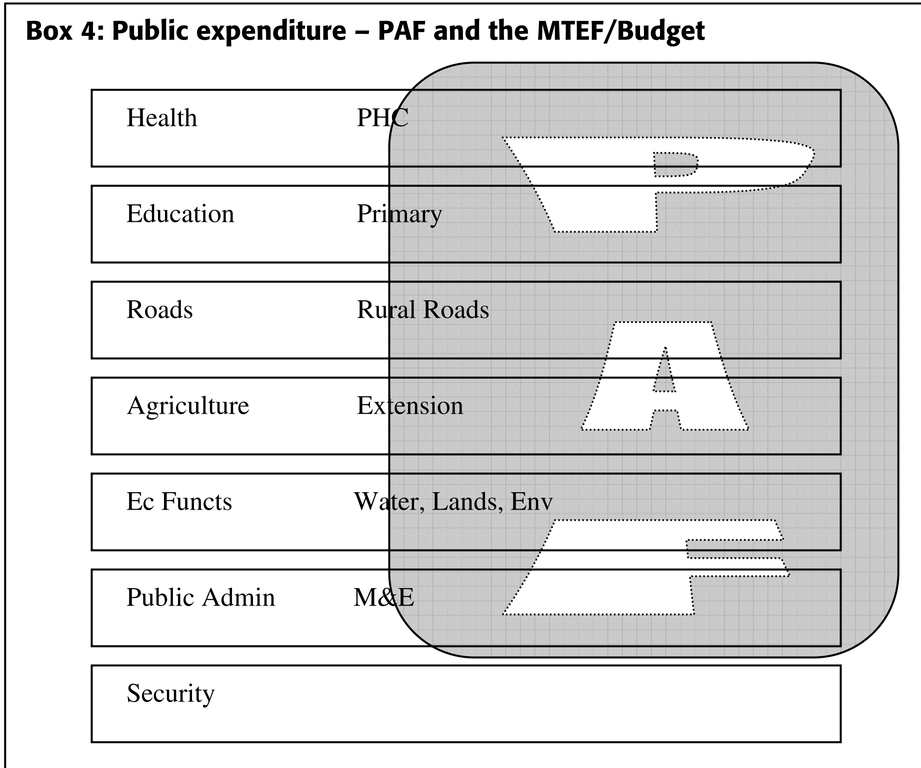
Various developing countries are therefore considering establishing, or have established, virtual poverty funds themselves along the lines of the Poverty Action Fund. However, unlike other mechanisms and instruments that have been developed to promote pro-poor budgeting, there has been little systematic analysis of the costs and benefits of the PAF as a mechanism, and whether the VPFs represent good expenditure management practice and should be replicated in other developing countries.

The purpose of this article is to assess the PAF critically, in the wider context of Uganda's pro-poor public expenditure reforms. This provides important insights into the potential of virtual poverty funds as a bridging mechanism, and also highlights some of the general challenges of managing public expenditure for sustained poverty reduction. The next section describes the origins, scope, mode of operation and evolutionary tendencies of the PAF, followed by an evaluation of the experience, discussing the successes of the mechanism, emerging problems, some questions of attribution and neglected issues in Uganda's approach to poverty reduction. The fourth section then draws out the implications concerning the role of VPFs in pro-poor public spending reform. It is followed by a concluding section.

The Poverty Action Fund – Uganda's Virtual Poverty Fund

Background to pro-poor reform in Uganda

In the early 1990s, the focus of Ugandan policy was on establishing macroeconomic stability through IMF/World Bank-sponsored structural adjustment reforms, following a lapse in fiscal discipline that had resulted in high inflation. A combination of strong leadership, from a merged Ministry of Finance and Planning, and the introduction of instruments such as the Medium-Term Expenditure Framework (MTEF) helped reassert macro-discipline. Although there were efforts targeted at reducing poverty, through interventions such as the Programme to Alleviate Poverty and the Social Costs of Adjustment (PAPSCA), concerns emerged in the government over the need for a more comprehensive approach.



Box 4: Public expenditure – PAF and the MTEF/Budget

A key event was a forum on poverty held in 1995, attended by President Museveni, following which a task force was established and a wide consultative process initiated. This culminated in the preparation of the Poverty Eradication Action Plan (PEAP) in 1997, which set out a comprehensive national framework for reducing poverty, clearly articulating the priorities, which included: universal primary education; primary healthcare; water; sanitation; agricultural extension; and rural roads. Sector-wide approaches (SWAps) in many of the key PEAP sectors have been developed and refined, whilst the MTEF process has been strengthened through the introduction of Output-Oriented Budgeting (OOB). Another key policy development was the introduction of decentralisation, through which the mandate for the delivery of many government services, including the new priorities articulated in the PEAP, was devolved to local governments.

Uganda is now widely regarded as a country at the forefront of reforming budget systems to address the challenge of poverty reduction. Its PEM reforms have helped instil discipline in aggregate public expenditure, and enable improvements in budget efficiency and effectiveness, whilst being increasingly focused on reducing poverty. The Ugandan PRSP, SWAp, MTEF and budget processes are all strongly linked and there is broad public participation and engagement throughout. The reforms have all been achieved within a stable macroeconomic environment, with relatively strong economic growth.

The formation of the PAF

The prevailing political and policy environment, both domestic and international, played an important role in the formation of the PAF in 1998 and the characteristics of the mechanism itself. The PEAP had provided Uganda with a policy framework explicitly geared to poverty reduction and had been backed up by strong political commitment. However, there was no accompanying strategy for reorienting the budget towards the implementation of the PEAP.

In 1998 Uganda qualified for the HIPC initiative, which provided an extra source of budgetary funding. A major concern of the international community was how these savings from debt relief would be spent, and whether it could be verified that spending on 'pro-poor' sectors had increased. At the same time, sector-wide approaches were being developed in the education and roads sectors, and those donors wishing to move towards budget support for the new SWAps had similar concerns that their support would not actually result in increased expenditures in these sectors.

In addition, Uganda did not want to lose the support it was already receiving from Nordic donors for foreign debt repayments under its Multilateral Debt Fund (MDF), once it started benefiting from the HIPC initiative, which made its debt situation officially 'sustainable'. The government therefore needed an alternative mechanism to enable it to continue receiving these funds, once their original justification had been removed.

To address these concerns, it conceived and set up the Poverty Action Fund in 1998/9. The PAF was designed as a means to

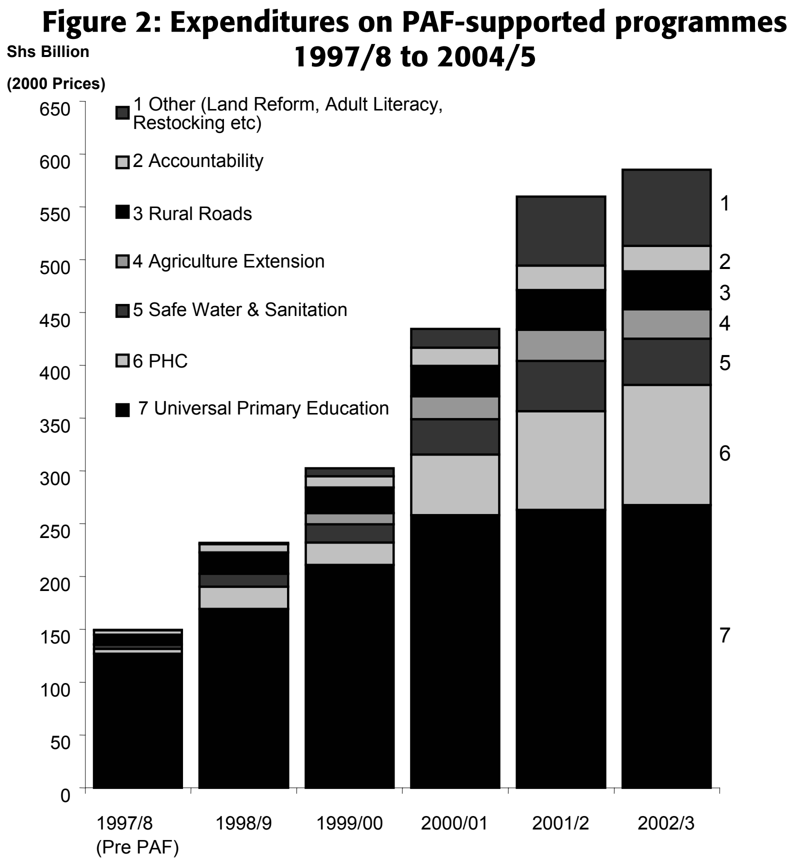
- reorient the budget towards the newly established PEAP priorities, and increase the funding to local governments for service delivery;
- demonstrate that debt relief and donor funds were actually being allocated and spent in full on poverty-reducing areas of the budget, in order to allay the concerns surrounding the HIPC initiative; and
- retain donor support previously channelled to the MDF.

Box 5: The key elements of the PAF in 1997/8

- **Special treatment** – The PAF identifies and gives special treatment to specific pro-poor sectors/sub-sectors/programmes in the budget.
- **Matching resources to expenditures** – A PAF table matches specific resources from HIPC, donors and the government to the budget allocations for PAF programmes.
- **Additionality of resources** – PAF resources were shown as additional to the government's own budget allocations to PAF programmes in the 1997/8 budget.
- **Protection of disbursements** – PAF programmes are protected from cuts during budget implementation.
- **Reporting and transparency** – Specific requirements for the government to report on disbursements on PAF programmes, and progress in implementation. Reports were made public and discussed in open quarterly meetings, where civil society, the press and donors were present.
- **Monitoring** – 5% of PAF funds are set aside for enhanced monitoring and accountability.

The PAF ensured that an amount equivalent to HIPC and donor resources was transferred as additional allocations to pro-poor sectors. The government identified key expenditure lines in the budget, consistent with the new PEAP priorities. In the 'PAF budget', the additional resources from HIPC and donors were matched with equivalent increases in budget allocations to these budget lines, above the base year 1997/8, the year before PAF was created (see Figure 2). The PAF budget allowed the Ministry of Finance to demonstrate the additional nature of the debt relief and donor resources, and donors were able to 'see' the impact their resources were having on budget allocation.[1] The majority (about 75%) of the additional PAF resources were allocated to local governments, as conditional grants. These grants were earmarked for specific activities within each priority programme, providing further assurance that funds were being spent in the areas intended.

Figure 2: Expenditures on PAF-supported programmes 1997/8 to 2004/5



1. However, it still left the government open to the charges that this freed government resources to finance larger increases in other areas of the budget which were not necessarily PEAP priorities.

The government also used the PAF as a mechanism to improve budget management and enhance the accountability of expenditures. The government guaranteed that all budgeted resources would be made available in full for disbursement to PAF programmes, regardless of resource shortfalls, and committed itself to increasing the accountability and transparency of PAF expenditures. In order to demonstrate that funds were being disbursed in full, releases to programmes were published quarterly in the *PAF Financial Statement*. Sectors were required to report quarterly on actual progress in the implementation of PAF programmes, and these reports were compiled by the Ministry of Finance into the *PAF Quarterly Report*. Quarterly PAF review meetings were held in public to discuss PAF performance, to which civil society organisations, donors and the press were all invited, alongside representatives from government agencies. The government also undertook commitments to perform separate audits of the PAF as a whole and of PAF transfers to individual local governments. It allocated 5% of all PAF resources specifically to improving monitoring and accountability, in order to enable central government institutions to carry out their mandate for monitoring effectively.

Because of the perceived simplicity of the PAF mechanism, it was considered that the management of the PAF would require limited additional capacity. The PAF was therefore managed originally by existing staff within the macroeconomic policy department in the Ministry of Finance, who had previously handled the Multilateral Debt Fund.

Table 1: Evolution of PAF and pro-poor expenditure reform

General	PAF
1997/8	
• PEAP developed • Local Government Act	• Multilateral Debt Fund in place
1998/9	
• Uganda qualifies for HIPC • Output-Oriented Budgeting introduced • Education Strategic Investment Plan finalised	• PAF formed • PAF quarterly reports and review meetings start • Scope of PAF expanded to cover entire sub-sectors
1999/00	
• Poverty Eradication Working Group formed	• Increased focus on performance • New planning and reporting guidelines for local governments • PAF Secretariat established
2000/01	
• PEAP revised and accepted as PRSP • Uganda qualifies for enhanced HIPC • HSSP finalised	• Explicit eligibility criteria for PAF programmes developed • PAF 'roll-over' mechanism agreed
2001/02	
• HIPC tracking exercise • Fiscal decentralisation strategy approved • Poverty monitoring strategy	• PAF guidelines streamlined • PAF Q-reports meetings replaced by biannual budget reviews • Intention to phase out PAF over time

Increased size and scope of PAF

Over time the scope of the PAF budget increased beyond the financial mechanism originally conceived of earmarking and protecting expenditure areas. The PAF rapidly grew in size, more than doubling as a proportion of the MTEF from 14.7% of the budget in 1998/9 to 38% in 2001/2.[2] There were two reasons behind this expansion:

- Firstly, the PAF, as a mechanism, actually mobilised extra resources from donors for existing programmes. PAF resources grew a lot faster than other parts of the budget.
- Secondly, the PAF was expanded to cover more of the budget and hence more priority PEAP interventions. From originally funding selected budget lines within a sector or sub-sector, the PAF budget was broadened to cover entire sectors or sub-sectors. This made the PAF approach more consistent with the SWAps being developed.

The prospect of increased resources and protection meant that the Ministry of Finance came under pressure from sectors to include more and more of their programmes within the PAF. Explicit criteria for programmes to qualify for inclusion were therefore developed, as well as a procedure for reviewing prospective programmes against these

Box 6: The PAF definition of 'pro-poor'

The PAF currently promotes budget allocations to pro-poor sectors that improve service delivery. The criteria are that programmes:

- must be in the PEAP;
- must be directly poverty-reducing;
- must deliver a service to the poor;
- must have a well-developed plan.

PAF programmes

Listed below are the original PAF programmes, and the additional programmes, many of which had to meet the PAF criteria *ex-ante*:

Original – 1998	Current – 2002
• Primary education	• Adult literacy
• Primary healthcare	• Strategic exports (cotton, coffee, etc.)
• Water and sanitation	• Land
• Agriculture extension	• Microfinance and restocking
• Rural roads	• Reduction of case backlog
• Monitoring and accountability	• Wetlands
	• LGDP

2. This increase includes both the increase in scope of the PAF and increase in resources to existing expenditure lines. If the 1998/9 allocation included backdated budget allocations of expenditure areas such as primary teachers' salaries, which were brought into the PAF after inception, the percentage would be 18% and not 15%. This backdating exercise is done in the government's PAF table.

criteria. The PAF criteria defined pro-poor expenditures as those which were 'directly poverty-reducing', which meant those programmes delivering services directly to the poor. It was hoped that this would ensure that the inclusion in the PAF would become more objective, and the criteria naturally led the PAF to become oriented towards service delivery.

As the donor contributions to PAF resources increased, donor concerns about fungibility also grew. Some considered that the rapidly expanding PAF resources were allowing greater increases in other parts of the MTEF. To counter this sentiment, the government therefore undertook that PAF expenditures should increase as a proportion of the MTEF over time, and not just be additional to 1997/8.

From protecting inputs to performance management

Initially the concerns surrounding the PAF were about protecting the inputs to PAF programmes in terms of budget allocations and disbursements. However, in the second year of PAF operations concern grew about the lack of accountability as to how the funds were actually spent, and the results being achieved. Disbursements were seen as supply-driven, regardless of whether or not a programme was achieving its intended objectives.

The focus of attention therefore moved to the actual performance of PAF programmes, and the results from the inputs provided. As the majority of PAF funds were channelled to local governments, a system of planning, reporting and releasing PAF conditional grants was introduced which attempted to link budget allocations and expenditures to activities and outputs. Local governments were required to prepare activity-based workplans, and to report regularly on outputs and expenditures.

Efforts were made to improve the output focus of the PAF quarterly reports prepared by the central government. These systems were established for PAF funds only, which diverted attention away from the other central government grants being transferred to local governments.

The guarantee of disbursement was qualified so that only those programmes performing satisfactorily were guaranteed funding; otherwise, it was felt that programmes would have no incentive to perform well. In order to ensure PAF resources were 'spent in full' on PAF programmes, a roll-over mechanism was instituted, so that those PAF funds not released were carried forward into the following years and budgeted as additional PAF resources.

Concern had also arisen over how effectively the money for enhancing monitoring and accountability was being spent, and greater attention was devoted to the results of these monitoring funds and how they were being used. Funds were channelled to local governments themselves to monitor PAF programmes, as well as to central agencies.

Despite remaining an integral part of the budget, the institutional requirements for managing the PAF increased as the Fund expanded. In order to handle the increased workload, a separate PAF Secretariat was established in 2000 within the Budget Directorate of the Ministry of Finance, with dedicated staff assigned to the administration of PAF full-time.

Box 7: Pros and cons of the PAF Secretariat

As the PAF grew in scope, a PAF Secretariat was established to co-ordinate PAF-related activities in the Ministry of Finance, including the collection of reports, administration of releases, compilation of PAF Quarterly Reports, and arrangement of PAF quarterly meetings.

The Secretariat was small, consisting of the PAF Co-ordinator, the PAF Secretary, supported by technical assistance, an accountant and a secretary. The PAF Co-ordinator was part-time and a senior manager within the Ministry of Finance. The Secretary and support staff were originally meant to be full-time.

The Secretariat had its advantages and disadvantages:

Pros

- It facilitated the timely achievement of the government's PAF commitments.
- It supported the introduction of performance-based systems.
- It gave impetus to the drive towards transparency and accountability.
- It facilitated co-ordination between departments within the Ministry of Finance and other Ministries.

Cons

- It entrenched the impression that PAF was being run as a parallel mechanism, and created problems in mainstreaming PAF.
- PAF reporting and review systems were run separately, by different people than other budget-wide initiatives.
- Staff in other parts of Ministry of Finance regarded PAF work as additional rather than part of their day-to-day work.

In late 2001, however, the Ministry of Finance was still experiencing problems managing the PAF concurrently with efforts to improve budget-wide PEM systems, especially in the areas of budget reporting and reviews. Steps were taken by the Ministry of Finance to mainstream the administration of the PAF within those for the wider public sector reforms. New PAF operational modalities were developed in January 2002, which aligned the PAF with the budget-wide systems being strengthened, and reduced the number of parallel PAF requirements.

Box 8: Highlights of new PAF operational modalities 2002

Budget-wide accountability commitments:

- Use of Bi-annual Budget Performance Report instead of PAF Quarterly Reports.
- Use of Biannual Budget-Wide Review forum instead of PAF quarterly meetings.
- Supports government-wide reporting and audit systems, as opposed to separate PAF reporting.

Remaining protection of PAF expenditures:

- Size of PAF budget must not fall as a proportion of MTEF.
- Releases to PAF guaranteed at 95% of budgeted amounts.

Evaluating the PAF

Successes of the PAF mechanism

The PAF has often been cited as having contributed substantially to many of Uganda's achievements in pro-poor public spending reform. Although it is difficult to establish the counterfactual, what would have occurred if PAF had not been formed, we highlight here successes where it can be argued that the PAF mechanism had a major influence.

Reorienting budget allocations Firstly, the PAF has contributed to a substantial reorientation of inter-sectoral budget allocations towards pro-poor service delivery, by ensuring that additional debt relief and donor funds were channelled to specific PEAP priority programmes. This was consolidated through the establishment of specific criteria based on direct service delivery which PAF programmes were required to meet before inclusion. Allocations to PAF programmes grew from 17.5% to 37% of a rapidly expanding government budget between 1997/8 and 2001/2, and in real terms almost quadrupled, from $100m. to $350m. in total.

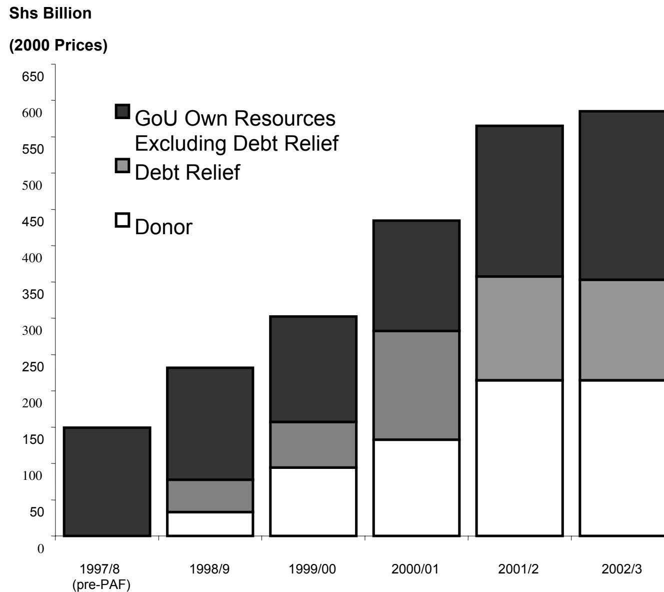
Table 2: PAF as % of budget

	1997/8 (pre-PAF)	1998/9	1999/00	2000/01	2001/2	2002/3
% of budget allocations on PAF						
PAF	17	23	25	30	37	37
% of sector allocations on PAF						
Roads	17	26	23	22	25	29
Education	59	69	62	68	64	63
Health	8	29	25	52	61	67

By promoting growth in budget allocations only in those sub-sectors that were directly poverty-reducing, the PAF has helped reorient intra-sectoral allocations towards pro-poor expenditures. Whilst overall allocations to the health, education, water, roads and agriculture sectors have only increased from 39% of the budget in 1997/8 to 47% in 2001/2, the proportion of those sector budgets going to PAF/pro-poor service delivery increased from 43% to 66%. As local governments are largely responsible for delivering directly poverty-reducing services, this has led to large increases in funds allocated to local governments.

Mobilising donor resources and harmonising conditions The PAF has also contributed to the mobilisation of donor resources, through budget support, for PAF sectors specifically, these resources increasing from $20m. in 1998/9 to over $130m. in 2001/2. The budget as a share of GDP grew over this period from about 17% to 25%. PAF resources therefore contributed to increasing public expenditures as a share of GDP.

Figure 3: Sources of PAF funds 1997/8 to 2002/3



Although this was not an original aim, the PAF became instrumental in the donors' shift from project to budget support. The PAF demonstrated the government's commitment to poverty reduction through the allocation of the budget to poverty-oriented activities. The PAF provided donors with a level of comfort that the overarching MTEF did not provide –in terms both of allocation and protection of the PAF, and also of transparency and accountability. This enabled more donors to provide support for the government budget, earmarked specifically for the PAF or sectors within it. The assurance of the social sectors receiving protection probably also made it easier for those donors providing general budget support grants and loans, such as the European Union, the World Bank and the UK Department for International Development, to raise their levels of funding as well. In aggregate, budget support (earmarked and general) increased from 3.4% of GDP in 1997/8 to 10.1% in 2001/2, or from 20% to 40% of public expenditure over the same period; project support remained constant as a proportion of GDP but fell from 33 to 25% of public expenditure. This indicates a huge increase in donors' confidence in the government's own PEM systems.

Alongside SWAps, the PAF helped to limit transaction costs between government and donors, by presenting, *ex ante*, a set of commitments with respect to allocations and expenditures, which donors could use collectively as conditions for disbursement in funding agreements. It also helped to ensure an element of cross-sector co-ordination in budget support funding agreements. Although the PAF as a mechanism is less intensive in terms of donors' transactions costs with government, it cannot be said to have reduced them, as PAF support has tended to be additional to project support and over time project support has increased rather than decreased.

Improved budget management A major constraint on the ability of government programmes has been the unpredictable disbursement of resources during budget execution. The PAF successfully ensured that disbursements to pro-poor expenditures were protected from cuts during the financial year.

The PAF provided a platform for the establishment of an open and transparent process of budget reporting and review, and improved the focus on the results of its programmes. In doing so, it helped to establish a culture of monitoring in sectoral ministries and local governments that was previously lacking. 5% of all PAF funds were set aside explicitly to improve the monitoring and accountability of programmes, which allowed central government institutions and local governments to carry out regular monitoring activities. Although the quality of the verification of results through monitoring is variable, it is now a regular part of staff work in ministries and local government administrations to verify the implementation of service delivery regularly.

Figure 4: MTEF sector shares 1997/8 to 2004/5 (excluding interest payments)

Emerging problems

The PAF mechanism was designed to achieve the two goals of reorienting the budget towards priorities in the original PEAP, and improving the budget management of those expenditures; it has been successful, if judged solely against these two aims. However, it has produced bad side-affects in the wider budget. The incentives it has provided both to institutions within government and to donor agencies have resulted in budget allocation and implementation problems, which could potentially have a major impact on the ability of Uganda to achieve its poverty reduction goals.

Unbalanced priorities and allocations The PAF has skewed budget/MTEF allocations towards the direct provision of services to the poor over a very short period, and increasingly away from balanced allocations towards PEAP implementation. This is because the selection criteria for PAF programmes have defined pro-poor in terms of direct service delivery to the poor only. PAF allocations were also initially driven by donor resources, with those sectors and sub-sectors under the PAF that attracted earmarked donor budget support receiving even more funding.[3] Sectors have continued with efforts to attract more donor resources to expand service delivery in the short term. The donor and government focus has been on demonstrating the additional nature of donor resources, with no systematic review of the appropriateness of the resulting inter- or intra-sector prioritisation.

There has been little effort to balance this immediate expansion of service delivery with interventions which enhance the economic opportunities of the poor, through stimulating private sector growth, and hence private sector demand for goods and services from the poor, which in turn would improve the ability of the government to sustain services in the future through increased taxation. It can be argued that the sequencing and mix of interventions under the PAF has been wrong. The poor themselves, through participatory research, have voiced concerns:

> Due to their precarious economic condition smallholder farmers adopt risk-averse behaviour and use their available time, energy and resources to secure food and other basic needs. With the exception of water, smallholder farmers do not feel that PAF services provide them with the means to secure their basic needs. As a result men and women place a lower value on projects such as new schools, health centres, and rural feeder roads. They perceive the services these institutions provide to be consumed after their basic needs are assured … (Lentz, 2002: 1)

The bulk of PAF expenditure and the associated services lies in the curative aspects of primary healthcare and education. These sectors are geared to increasing the productivity of the poor. However, expanding these sectors first may not be the best sequencing of interventions. Some areas such as roads, agriculture, water and sanitation may yield higher returns in the short term.

Lentz goes on to argue that only those who have more substantial assets are able to take advantage of PAF services in health and education, and use them to improve their incomes and quality of life. The poorest need economic opportunities that will enable

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3. The sectors which benefited most from donor-driven budget allocations were those that developed their SWAps first, the health and education sectors.

them to secure their basic needs more easily, enabling them to take advantage of the services provided under the PAF and enter into more risky ventures. The trade-off between policies that increase the long-term productivity of the poor and those which facilitate more immediate increases in the demand for goods and services from the poor has not been adequately acknowledged in policy formulation or during the budget process.

The economic growth in rural areas and the associated poverty reduction, thus far, have largely come from an increase in demand stimulated by the increases in government expenditure, in particular due to the flows of funds under decentralisation, a major proportion of PAF transfers being for wages. These increases have, in turn, been funded by donors. The rural economy is therefore very fragile, as it relies not on demand generated from private sector growth, but on government expenditure which is reliant on aid flows (see below). It is also unlikely to receive such a substantial boost in the future. Issues such as the trade-off between the size of the public sector in aggregate and private sector economic growth are only now coming to the fore. The irony of this is that the major source of economic opportunity for the rural poor is being generated from expenditures on those services from which, if Lentz is correct, they may not actually be able to reap rewards.

Without more proactive public sector policies and expenditures that stimulate private sector demand for goods and services from the poor and hence promote private sector-led economic growth, a public sector dependency culture might well become entrenched. Basic services provided in the PAF sectors will only help the poor once they have secured their basic needs, and can take advantage of opportunities for further improving their livelihoods.

Macroeconomic and distribution effects of high donor inflows There are fundamental problems with Uganda's success in mobilising donor resources, namely, the country's heavy dependence on foreign aid inflows, and the effect of these high inflows on the economy. The budget deficit, excluding donor grants, was 12.3% of GDP, or about 50% of public expenditure, in 2001/2, up from 6% of GDP or 33% of the government budget in 1998/9. The Ministry of Finance has itself been increasingly concerned about the macroeconomic effects of the size of the fiscal deficit, its sustainability and the effects this may be having on growth; in 2002 it limited the size of MTEF expenditures to below the level of donor funding on offer.

Why is there concern? First, and most simply, such a high level of dependence on donor funds carries an inherent risk. There is a very real possibility that donor flows may decline in future. Also, an increased proportion of aid is in the form of budget support, and this increases the likelihood of a rapid drop in donor funding, as budget support involves common disbursement conditions, and tends to be agreed on an annual basis. If the government does not meet disbursements conditions, it could lose funding from a number of sources simultaneously. If aid flows do decline, the chance of this decline being rapid is made all the more likely. The increasing scale of donor funding has also actively undermined the incentive for the government to mobilise revenues locally, because it has enabled public services to be expanded without the need to raise unpopular taxes.

Secondly, there are the potentially detrimental macroeconomic effects of substantial increases in donor inflows, often referred to as the Dutch Disease.[4] High inflows are likely to result in a relative appreciation of the real exchange rate, which will have a detrimental effect on the tradable sector of the economy, undermining growth in exports and increasing demand for imports and non-tradable goods and services. There are also short-term effects of high and lumpy donor inflows which have an impact on the day-to-day management of the economy; there is a short-term constraint on the amount of foreign exchange that can be sold by the Bank of Uganda on a daily basis without bidding up the exchange rate. The short-term demand for foreign exchange is inelastic, due to an inefficient and underdeveloped financial sector and a small formal (cash) economy.

Dutch Disease effects are not necessarily bad *per se*, and most economists argue that they will be negated if there are sufficient productivity increases in both tradable and non-tradable sectors. The major question is the magnitude of the supply-side response to aid-funded public expenditure in terms of productivity increase, and, in the context of the poverty reduction agenda, the distribution of any benefits to the poor. Adam and Bevan in their modelling of the Ugandan situation[5] contend that it is these distributional effects that need to be watched:

> Public expenditure is intensive in formal sector (urban) employment and draws disproportionately on the manufactured goods and services sectors for its intermediate inputs. Rural households capture little of the direct benefit from these demand factors. On the other hand, if supply side effects are powerful enough that domestic food prices fall relative to manufacturing and service prices, and if these are reinforced by a low income elasticity of demand for food, rural household incomes suffer, possibly absolutely, as well as relative to urban households. (Adam and Bevan, 2003: 19)

The first half of this statement is not entirely accurate and a sizeable proportion of PAF expenditures are likely to have directly benefited the poor; the salary component of PAF expenditures is high and staff are likely to spend their salaries directly on goods and services from the poor, especially as the majority are posted in rural areas as primary school teachers and health workers.[6] This increase in direct benefits is likely to be one-off, however, and further large increases in recruitment and expenditure on salaries are unlikely to take place. The second effect of the low income elasticity of demand for food from the public sector employees is also likely to hold. The two factors combined mean that it is unlikely that the rapid rate of reduction in poverty seen in the late 1990s can be maintained.

Therefore, even if the government were not concerned about the risks associated with high dependence on donors, the potential adverse distributional effects of aid-fuelled public expenditure need to be taken into account. Examination of the impact of public policy should therefore not be confined simply to measuring the static incidence of expenditure programmes, but also needs to take account of such dynamic effects.

4. Dutch Disease effects technically refer to a short-term increase in inflows. However, they are increasingly referred to in the context of high donor inflows in general.
5. Their simulation model of the Ugandan situation does not show the possibility of each distributional factor actually outweighing the positive effect of productivity gains.
6. One of the reasons mentioned earlier why there has been such a dramatic reduction in rural poverty in Uganda.

This argument also reinforces the need mentioned earlier for policies which stimulate demand for goods and services from the rural poor, which also facilitates diversification away from basic foods with potentially low elasticity of demand.

PAF limiting future sector budget reallocations The bulk of the rapid expansion in PAF funding came before the new macroeconomic concerns, which in turn are now limiting the growth of the resource envelope available for additional pro-poor programmes, policies and interventions coming on stream. The increase in allocations to emerging pro-poor activities is now being restricted. This has led to situations where emerging sectors have been offered grants to fund increased activity by donors, which the government has turned down. Interventions in sectors such as main roads, commercial justice and the power sector, which have been or are being reformed, are not being given adequate expenditure priority relative to the social sectors. These are sectors which potentially ameliorate the adverse distributional effects of Dutch Disease by facilitating the growth in private sector demand for goods and services from the poor, reducing private sector transaction costs, reducing uncertainty and increasing productivity.

Though it is not to blame for this new constraint, the PAF has certainly limited the ability to reallocate between sectors because of commitments to the additionality of donor resources and the size of the PAF budget.

Alignment of sector programmes towards the PEAP Sector programmes whether within or outside the PAF are not always fully aligned towards the achievement of PEAP outcomes. There is still too much of a focus on inputs; it is assumed that $1 spent on a PAF sector by definition means $1 spent on the poor, and that those sectors outside the PAF do not contribute to poverty reduction. Sectors often fail to articulate clearly their own outputs and outcomes. When they do, indicators and targets are often not aligned towards the achievement of specific PEAP goals. Those sectors that benefited from being included in the PEAP at the outset, were never required to justify their budgets in terms of the results they planned to achieve.

Sectors are also not actively encouraged to factor in the contribution from other sectors to the achievement of their development outcomes. This has resulted in the poor ability of the government to exploit inter-sectoral linkages through cross-cutting interventions, to ensure that PAF programmes indeed realise their intended optimal impact.

Budget implementation The protection of disbursements under the PAF is required only because the major causes of under-disbursement, the serial overspending of powerful government institutions, have not been addressed to date. Since the protection of PAF programmes was introduced and the PAF has been increasing in size, the PEAP priorities outside the PAF have been subject to increasingly disproportionate budget cuts, and unpredictable cash flows, especially when there are resource shortfalls. The PAF disbursement guarantee puts an additional strain on budget management as a whole, and does not provide adequate incentives for the government to improve budget discipline across the board. The PAF is therefore not a panacea for addressing budget indiscipline, but more a way of diverting attention from the real problem.

Table 3: Government of Uganda budget outturns (%)

(Total Exp/Budget) %	1997/8 (pre-PAF)	1998/9	1999/00	2000/01
Total budget (excl. contingencies)	99.5	103.3	97.4	99.2
PAF	111.2	99.7	89.6	91.9
Public Admin.	103.5	102.4	101.4	112.5
Security	102.8	116.6	98.5	99.4
Interest	81.9	89.0	105.7	119.1
Rest of budget	94.5	103.4	99.2	93.4

There is concern that services are being administratively de-concentrated as opposed to being fully decentralised, and this is undermining the local ownership and hence the sustainability of investments. This is due to the conflict between the PEAP/sector-driven approach of allocating funds nationally towards the achievement of sectoral targets, and that of decentralisation, which promotes local autonomy in decision-making and local governments' responsibility for the services they deliver. The need for the PAF to demonstrate the explicit results of HIPC/donor funding has exacerbated this trend by ensuring that all funds remain transferred as conditional grants, with tight conditions attached.

Box 9: De-concentration in the education sector

Local governments are allocated three grants to run primary education services – for running costs, salaries and schools facilities. There are rigid guidelines for planning and use of all three UPE grants. Grant allocations are made nationally on the basis of national targets (enrolment; pupil to teacher ratio; pupil to classroom ratio) and local governments cannot transfer funds from one grant to another in line with their own priorities.

Local governments, especially at the lower levels, are hardly involved at all in service delivery. There is weak local ownership of facilities built up through central government funds. There is also a worrying tendency to re-centralisation. As a reaction to poor quality in classroom construction, the Ministry of Education recruited and posted engineering assistants to every district to ensure quality of construction; now it is unclear who is responsible for quality – the district or the Ministry engineer?

Monitoring and evaluation The PAF has also contributed to the unnecessary fragmentation and duplication of the government's monitoring, evaluation and external verification processes, and has diverted attention away from the overall budget. Parallel processes for auditing and reporting and review were set up for the PAF alone, which weakened the government's pre-existing processes for providing fiduciary assurance, and enabled it to avoid having to upgrade the performance of weaker areas of the budget. This has led to uneven progress on budget monitoring and reporting. There is a disjuncture between the monitoring of overall PEAP outcomes and the monitoring and review of sectoral outputs achieved under poverty programmes, which is contributing to inadequate strategic decision-making for improving PEAP implementation.

The PAF only really increased the interest of agencies in results on paper, setting up high-level mechanisms for reviewing the performance of government programmes,[7] but not systems for improving the delivery of results on the ground. There is also a fundamental lack of incentives for institutions to perform – the PAF reporting system for local government is rapidly degenerating into a system of paper for money: local governments know that they will receive funds, whatever the content of the reports. This represents a major gap in the monitoring and evaluation chain. Central ministries do not take enough interest in local government performance. There has been an inadequate focus on systems for delivering results within institutions themselves, and on the incentives for those institutions to actually deliver results.

Attribution of change to PAF – SWAps, PEAP, MTEF and political will

As its scope expanded, various successes and failures have been attributed to the PAF; however, it must be emphasised that they are often not due to the PAF alone, and it is impossible to quantify the PAF contribution. The PAF is just one of many initiatives which Uganda has implemented over the past decade, and it is therefore important to emphasise the other factors that have contributed to many of the changes, achievements and problems. Many of the achievements that can indeed be directly attributed to the PAF may have been achievable only because of the underlying political, institutional and policy environment.

The development and revision of the PEAP, the development of SWAps in the health and education sectors, and the well-managed MTEF/budget mechanism have all been important factors. The inter- and intra-budget reallocations would not have been possible without substantial government and political will; otherwise, they would have been blocked at an early stage. Together, these factors provided an enabling environment for the reallocations within the budget to take place, and the PAF provided an explicit mechanism through which they did actually take place, which gave stakeholders substantial confidence in the government. No doubt, without the PAF there would still have been reallocations within the budget and increases in earmarked budget support; however, it is unlikely that the changes would have been on a similar scale, or would have taken place at the same speed.

The development of SWAps in the health and education sectors, backed up with donor resources, has undoubtedly contributed to the bias towards the delivery of pro-poor services, and this would have driven up the allocations to social services, even if the PAF had not existed. It is inherently easier, and more popular amongst donors and politicians, to develop a SWAp in a social sector, as opposed to a productive sector (for example, agriculture or private sector development). That is why the allocations to agriculture and roads are relatively small. However, it is true to say that the PAF mechanism has helped to institutionalise and entrench this bias towards the short-term maximisation of service delivery, without due regard to sustainability.

The problems in budgetary execution stem largely from the weak management and review systems that existed in government before the PAF was introduced. In many respects, however, the PAF has tended to treat the symptoms of poor budgetary

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7. A common complaint about PAF quarterly reports was that they were very good at identifying problems in implementation, but the same problems kept on recurring, and nothing was done about it.

management by means of the protection of disbursement, without addressing the causes through the enforcement of budget discipline. Where the PAF has addressed problems directly, in areas such as weak monitoring and in-year budget reporting systems, it has addressed them with respect to the PAF element of the budget only, often creating parallel mechanisms and weakening already over-stretched institutional capacity.

Outside the PAF fence – public expenditure and growth

Uganda's emerging problems have been compounded by the difficulty of translating a balanced, coherent set of poverty reduction (PRSP) goals and objectives into an equally balanced set of public sector strategies, and their constituent outputs and actions. The excessive bias towards the delivery of social services to the poor, exacerbated by the PAF, has been at the expense of considering the optimal sequencing of interventions, and the importance of promoting private sector growth. Uganda is not alone in this respect. Programmes for primary service delivery appear to dominate in most PRSPs, thus far, as Table 4 illustrates.

Table 4: A service delivery bias in PRSPs?

Country	**PRSP priority sectors**
Burkina Faso	*Health* *Education* *Water* Agriculture
Mozambique	*Health* *Education* Infrastructure
Niger	*Health and HIV* *Education* *Water* *Urban Habitat* Rural Development
Tanzania	*Health and HIV* *Education* *Water* Rural roads Judicary

The need for strong economic growth is coming to the fore in many country PRSPs. In fact, nearly all PRSPs have the objective of sustained economic growth. The benefits of growth are expressed in terms of raising the poor's income; however, the cross-sector linkages are just as compelling. Increases in tax revenue from increased growth, if translated to increased sector allocations, will increase the ability of the health and education sectors to achieve and sustain pro-poor outputs and outcomes. The government itself recognises growth as the key problem in the second revision of the PEAP:

> In regard to the structure of the economy, it is notable that the progress made … is largely due to the recovery gains as a result of economic reforms as well as advances made in improving institutional service delivery mechanisms … the revision of the PEAP (2002) … should focus on consolidating and bolstering growth and structural transformation which empowers all Ugandans, including the poor, to be active players in Uganda's future prosperity. We need to identify areas that will put us on this path. (MFPED, 2002a)

The argument for supporting public sector policies which promote private sector growth is strong. A major problem, however, is translating the objective of growth into specific public sector actions geared towards its achievement, beyond the establishment of macroeconomic stability. The IMF/World Bank (2002c: 17) observe that 'the analysis of the likely sources of growth … and the contribution of planned policies has often been limited …'. It is not the purpose of this article to discuss what are effective public sector actions in promoting economic growth in developing countries; however, it is important to point out that developing countries have difficulty in doing so – growth-enhancing government policies are difficult to formulate and get right, and far too often are counterproductive. For instance, Box 10 illustrates how Uganda, in the absence of effective policy advice, has developed inappropriate policies for the promotion of exports under the PEAP.

Box 10: Strategic export promotion in Uganda – An inappropriate policy

Uganda has demonstrated a strong political commitment to promoting growth. President Museveni has launched Strategic Export Promotion Programmes in areas such as cotton and coffee; however, the programmes have not been well conceived, and have tended to focus on increasing the supply of primary products through the provision of farmers with inputs, as opposed to expanding demand. Whilst there has been an abundance of technical support for the reform of the social sectors, the donor community has been slow to support Uganda in the development of more effective policies to promote growth, despite the evident political commitment. In the absence of effective advice, poor policy decisions are made.

Donors provide comparatively little assistance to help governments identify the role of the public sector in promoting private sector growth. In fact, donor agencies themselves are biased towards the social sectors, and do not adequately recognise the trade-offs between pro-poor policies. They therefore have devoted a disproportionately large amount of technical assistance and resources to the social sectors. This needs to change.

Conclusions from the PAF

The PAF was successful in achieving its original objectives of reorienting budget allocations towards pro-poor expenditure areas, and protecting those expenditures, primarily because they were in line with domestic political preferences that had previously been expressed in the PEAP. It was relatively simple and did not require building up much additional administrative or political capacity. The subsequent initiatives relating to improving budget management were successful for similar

reasons. The government also had little problem in achieving commitments with donors, as the latter fully accepted the safeguards of the PAF framework as sufficient for their fiduciary concerns. The government's ability to hold to its commitments successfully gave donors substantial confidence in its commitment to poverty reduction, which enabled them to provide more resources via the PAF mechanism.

If one looks at the PAF in the context of the broader framework for evaluating general budget support mentioned earlier, the PAF can be seen to have contributed to most of the potential areas of benefit. The government-donor transactions costs of administering the PAF are lower when compared with project support (although the PAF arrangements were additional to pre-existing projects). The PAF has improved allocations and disbursements to pro-poor expenditures, aligning them more towards the PEAP. The PAF has helped build institutional capacity in ministries and local governments, and it has helped enhance transparency and accountability. The only area where it has not always fulfilled expectations is in the predictability of aid flows; although the amount may be more predictable, aid is increasingly being committed on an annual basis.

It is probable that many of the achievements in these areas would not have been so strong without the PAF. Although it appears counter-intuitive, an explicit system of earmarking and special treatment of expenditures has helped realise the expected benefits of general (i.e. non-earmarked) budget support. This is because the PAF provided a level of safety to donors wishing to move funding and the focus of dialogue towards government systems and expenditures. Those pushing for general budget support should not ignore the contribution of the PAF in generating this confidence in government systems and facilitating the shift towards donor budget support.

However, it is important not to read too much into the successes of the PAF by analysing it in isolation; the benefits mostly relate to PAF expenditures alone, and the costs of the PAF mechanism have largely been felt outside the PAF. From the outset, the PAF framework provided incentives biased towards service delivery. Instead, it should have promoted a more balanced implementation of the PEAP. This shortcoming was due more to the definition problem than to any underlying political design, but it led to a biased selection of sectors which benefited from explicit commitment to additionality and protection. Donor budget support was earmarked specifically for the PAF, and many donors still expect their support to have a direct effect on budget allocations.

This naturally also led to a focus of donor policy dialogue and technical assistance (TA) on the PAF and its constituent sectors, institutions and systems, at the expense of the rest of the budget. In part, this can be put down to a bias in the provision of donor TA to the social sectors, in particular the PAF. It has been compounded by the difficulty government has encountered in developing public sector programmes which promote economic growth. There has been limited donor TA support in such areas. The over-emphasis on the PAF and its budget mechanisms has also downplayed other non-budgetary challenges that are important in delivering pro-poor results, such as the roles and practices of local governments in delivering services.

A major problem reinforcing this bias was that the PAF was not conceived as part of a phased and comprehensive strategy for PEM reform. Initiatives in Uganda for PEM reform were fragmented, and carried out by different agencies. This meant that as the scope of the PAF widened from its original objectives, it became a platform for

introducing parallel elements of PEM reform itself, but only to a subset of the budget. There was therefore no clear relation between PAF budget management initiatives and budget-wide PEM systems that were introduced simultaneously, and no exit strategy for the PAF mechanism once they were established.

Uganda now has a serious problem of exit from the PAF; both government agencies within priority sectors and donors supporting those sectors have become used to the preferential treatment they receive. In PEAP Volume 3 a set of partnership principles is laid out in which the government advocates general budget support as its preferred mechanism of funding, and not earmarked funding via the PAF. This move is backed up by a clearer drive towards broader PEM and sector reforms. However, the PAF sectors have substantial political backing, which will make it very difficult to change the entrenched priorities and practices over time in line with changing needs. If Uganda is to continue making rapid progress, these fundamental challenges must, however, be addressed.

Many of the distorting incentives which the PAF created could have been avoided. In retrospect, the criteria for PAF programmes should have been designed so that the resulting programmes identified could address the PEAP in a more balanced way, and the PAF could have been embedded in a budget-wide sequenced strategy to enhance PEM. The government should not have made commitments to the additionality of earmarked budget support or the size of PAF budget allocations.

If correctly designed and conceived, Virtual Poverty Funds need not, therefore, face the problems that have been faced under the PAF. VPFs are not inherently bad, and could be effective mechanisms for tracking and monitoring poverty-reducing expenditures within the budget.

Despite these emerging constraints, overall the PAF has been a successful instrument for facilitating rapid pro-poor public spending reform. It has promoted significant stakeholder confidence in Uganda’s commitment to the goal of poverty reduction, and substantial increases in aid flows through the government budget. The achievements under the PAF have, however, led some stakeholders to come to the conclusion that poverty is being adequately addressed, which is dangerous, as Uganda will remain one of the poorest countries in the world for decades, even at its present rate of progress. Poverty is not reduced solely by providing services to the poor.

VPFs and pro-poor public spending reform

Should a country consider establishing a VPF?

It is essential that countries considering the establishment of a VPF place it in the context of an overarching strategy for pro-poor public sector reform, and that it is designed in such a way that it supports rather than replaces the implementation of comprehensive improvements in budget preparation and implementation systems. Beforehand, a country should have gone a long way in establishing the following (through the development of its PRSP):

- a comprehensive, balanced set of poverty reduction goals;
- a set of priority public sector strategies and actions that is oriented towards the balanced achievement of poverty reduction goals; and

- strong, widespread institutional and political ownership of and commitment to poverty reduction goals and strategies within government.

From the outset a VPF should be limited to what it is best suited for, namely, to act as a financial instrument for channelling inputs towards poverty-reducing expenditures. A VPF should not be used as a substitute for building budget-wide PEM, which focuses on the achievement of results. From the outset, a VPF should be designed as a temporary mechanism for tracking pro-poor inputs and expenditures only, whilst budget-wide systems are being built.

Therefore, before a HIPC considers the establishment of a VPF, and to avoid institutionalising the VPF, there is a fourth, and necessary, condition:

- a properly sequenced, long-term strategy for public expenditure management reform clearly set out and agreed, possibly as part of the PRSP process.

Given this, it is important to discuss the circumstances where an interim mechanism for tracking and monitoring poverty-reducing expenditures (VPF) is needed, and how it should be designed to avoid the problems faced by the PAF. Not all countries may need to establish a mechanism like the PAF, and wherever possible such parallel mechanisms should always be avoided. It is those countries with weak public expenditure management systems that will therefore benefit from establishing a VPF. In particular, countries may demonstrate:

- an inability to identify PRSP priorities within the existing budget classification system;
- poor orientation of inter- and intra-sector budget allocations and out-turns towards PRSP priority programmes, and weak budget formulation and implementation mechanisms to do so;
- a lack of fiduciary assurance provided by government budget allocation/implementation processes and a poor ability to track disbursements and expenditures during budget implementation.

VPFs supporting not distorting PRSP implementation

If the prerequisite actions recommended above are taken, many of the distorting factors experienced with the PAF would be avoided in other countries. A VPF should be kept simple, and only be a mechanism for tracking poverty-reducing expenditures. This might involve:

- the identification of PRSP priority expenditures in the budget classification system;
- an inclusive[8] definition of programmes to be included in the VPF, to avoid distorting incentives for budget formulation, which is reviewed regularly, and

8. The PAF criteria of 'directly poverty-reducing' instantly excludes a whole range of PRSP interventions from rural electrification and to commercial justice reform, which may all be very important in reducing poverty.

results in a set of programmes in the budget which support balanced PRSP implementation;
- tracking of performance of these expenditures within transparent budget-wide reporting and review systems;
- protection of disbursement against budget allocations, *which should be linked to a system of limiting overspending in other parts of the budget*; and
- establishment and agreement of a clear set of criteria that would signal the end of the need for the VPF, so that stakeholders know from the outset that the VPF is an interim mechanism.

Concurrently, the other aspects should be taken care of with the wider PEM reform process:

- **Budget formulation in support of balanced PRSP implementation** A process for arriving at inter- and intra-sector budget allocations, which is based on maximising the sustained achievement of poverty reduction goals over the long term. Preferential budget allocation should be given to those programmes with clear outputs leading to the achievement of poverty reduction goals, and their contributions to the achievement of cross-sector results. Attention should be given to the sequencing of interventions. Any explicit government commitments to the size of priority expenditures should originate from the PRSP.

  As part of the budget process a regular (annual) review of the programmes to be included in the VPF should be instituted, and the inclusion of programmes should be contingent on budget performance and orientation towards PRSP results. The standards for inclusion of sectors in the VPF could be increased over time, and be based on improving results orientation, financial accountability and, if measurable, value for money. Such a process would avoid bias towards one sector or another, and provide incentives for programmes to improve budget efficiency and effectiveness.

  There should be no static definitions of pro-poor expenditures, which are exclusive, and entrench biased budget allocations over time. Also the explicit linkage of donor/HIPC resources to programme allocations in a VPF should be avoided, as this helps encourage donor-driven budget allocations.

- **Supportive budget-wide PEM mechanisms** Supporting initiatives should be instituted which promote improved budget execution, without creating separate mechanisms for budget management of the VPF programmes. This could involve the production of regular reports on disbursements to all sectors against budget, and the associated results, accompanied by open stakeholder review meetings on budget performance.

  Any parallel mechanisms for budget reporting on VPF programmes in isolation should be avoided.

- **Consistent donor conditions** Donor fiduciary conditions for providing budget support should be linked to undertakings in the comprehensive strategy for PEM reform, and to aspects of PEM reform on VPF programmes alone.

If these principles are adhered to, a VPF should add value as a bridging mechanism whilst PEM systems are developed. However, VPFs by their nature give special treatment to specific programmes in the budget. It needs to be reiterated that, whenever possible, parallel distorting mechanisms should be avoided.

Conclusion

The PAF experience in Uganda has provided valuable lessons for other countries on the possibilities for success and the potential pitfalls in pro-poor public expenditure management reform, and the establishment of VPFs. The PAF mechanism has contributed positively towards the achievement of poverty reduction goals in Uganda, but not without costs.

It is our view that the distorting incentives of the PAF can be avoided when establishing other VPFs, and that, if the conditions require it, VPFs should be formed as interim mechanisms that facilitate pro-poor PEM reform. The following are therefore the key lessons to be learnt for reform:

- the importance of both political and institutional commitment to poverty reduction goals and the associated public sector strategies and goals;
- the importance, and difficulty, of translating poverty reduction goals into balanced public sector interventions geared towards achieving those goals;
- VPFs can make a positive contribution, as temporary mechanisms whilst wider pro-poor PEM reform takes place. VPFs are relatively easy to set up and implement successfully, but they only address the relatively easy issues in pro-poor PEM reform of tracking and reorienting inputs towards pro-poor priorities;
- strong, comprehensive systems for financial management and the achievement of results across all elements of the budget, present the greater challenge in PEM reform.

Our analysis of the PAF has, however, brought into question the wider tenets of the Government of Uganda's approach, and equally its donor partners' support, to pro-poor public sector reform, and whether there can be sustained achievement of poverty reduction goals. The success of the PAF, and of the Government of Uganda more widely, in mobilising donor resources has resulted in public service delivery which is now dependent on external aid inflows. Uganda's recent economic growth, widely lauded, has been fuelled by these increases in aid which have driven domestic demand. There is a real possibility that the distributional effects of public expenditure-fuelled demand will be anti-poor. Such an approach appears to be very dangerous, and the risks noted in this article need to be more rigorously investigated.

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