



Ministry of Foreign Affairs

# IOB Evaluation

## Evaluation of General Budget Support to Nicaragua 2005-2008

Evaluation of General Budget Support to Nicaragua 2005-2008 | IOB Evaluation | no. 329 | Evaluation of General Budget Support to Nicaragua 2005



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# *IOB Evaluation*

## **Evaluation of General Budget Support to Nicaragua 2005-2008**



## Preface

During the past decade donors and recipient countries have shifted increasingly from a project approach to general and sector budget support. The expectation was that budget support, by contributing to the overall national development strategy and sector strategies, would enhance the effectiveness and efficiency of development cooperation.

General Budget Support (GBS) is financial aid that is not earmarked to specific projects or sectors and directly channelled to partner government's national budget. The Netherlands has been providing GBS since 1998. In 2009 GBS was directly provided in ten countries. GBS is not without controversy and its impact on poverty reduction has frequently been questioned in Dutch parliament and in the press.

The growth of budget support created the need to evaluate its effectiveness. Proponents and opponents seem to hold strong views about the effectiveness of budget support, but these views are not necessarily supported by (rigorous) evidence.

A joint evaluation, by 24 donors and 7 governments was carried out in 2005 to evaluate the effectiveness of GBS in the 1994-2004 period. IOB actively participated in this evaluation. IOB is currently involved in a multidonor initiative to realize a new series evaluations on the impact of budget support. Ongoing evaluations are carried out in Zambia and Mali. The evaluation of GBS to Nicaragua is the first publication of this new series of evaluations on general budget support. The GBS evaluation to Nicaragua forms part of a broader country-evaluation of the Netherlands development cooperation to Nicaragua (published in Spanish as "Evaluación de la cooperación holandesa a Nicaragua 2005-2008").

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Nico van Niekerk of IOB was responsible for the evaluation. Geske Dijkstra (Erasmus University Rotterdam) and Arturo Grigsby (Nitlapan, Universidad Centroamericana) were the consultants for this evaluation and are the authors of this report. Kirsten Mastwijk has been responsible for the editing of this report. A reference group consisting of staff members of the relevant policy departments of the ministry of Foreign Affairs and external members provided comments and advice on the report. The study greatly benefited from support provided by the Netherlands Embassy in Managua and informants as mentioned in annexe 3.

IOB bears responsibility for the contents of this report.

Henri Jorritsma  
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## Abbreviations

ALBA	Alianza Bolivariana para los Pueblos de Nuestra América / Latin American Bolivarian Alternative
BCN	Banco Central de Nicaragua / Central Bank of Nicaragua
BSG	Budget Support Group
CAFTA	Central American Free Trade Agreement
CENIs	Certificados Negociables de Inversión / Negotiable Investment Certificates
CONPEs	Consejo Nacional de Planificación Económica y Social / National Committee on Economic and Social Policies
COSEP	Consejo Superior de la Empresa Privada / Supreme Councils for Private Enterprise
CPC	Consejo de Poder Ciudadano / Citizen Power Council
DfID	Directory for International Development (UK)
EC	European Commission
EQ	Evaluation Question
ERCERP	Estrategia Reforzada para Reducir la Pobreza / Strengthened Poverty Reduction Strategy (2001)
ESAF	Enhanced Structural Adjustment Facility (IMF)
FISE	Fondo de Inversión Social de Emergencia / Emergency Social Investment Fund
FSLN	Frente Sandinista para la Liberalización Nacional / Sandinista Front for National Liberalization
FSS	Fondo Social Suplementario / Supplementary Social Fund
FTAA	Free Trade Area of the Americas
GBS	General Budget Support
GDF	Global Development Finance (World Bank database)
GDP	Gross Domestic Product
GNI	Gross National Income
HIPC	Heavily Indebted Poor Country Initiative
IDB	Inter-American Development Bank
IFIs	International Financial Institutions
IMF	International Monetary Fund
JFA	Joint Financing Arrangement
KfW	Kreditanstalt für Wiederaufbau / Reconstruction Credit Bank (Germany)
LSMS	Living Standards Measurement Survey
MASP	Multi-Annual Strategic Plan (Netherlands)
MCA	Millennium Challenge Account (US)
MHCP	Ministerio de Hacienda y Crédito Público / Ministry of Finance
MIPYME	Micro, Pequeña y Mediana Empresa / Small and medium sized enterprises
MTEF	Medium Term Expenditure Framework
NGO	Non-Governmental Organization
NIO	Nicaraguan Córdoba (currency)
OECD-DAC	Organization for Economic Co-operation and Development – Development Assistance Committee

## Abbreviations

PAI-NIC	Programa de Apoyo Institucional Nicaragua / Institutional Support Program Nicaragua
PAM	Performance Assessment Matrix / Framework
PFM	Public Finance Management
PLC	Partido Liberal Constituyente / Liberal Constitutionalist Party
PND	Plan Nacional de Desarrollo / National Development Plan
PNDH	Plan Nacional de Desarrollo Humano / National Human Development Plan
PND-O	Operational National Development Plan
PRGF	Poverty Reduction and Growth Facility (IMF)
PRS	Poverty Reduction Strategy
PRSC	Poverty Reduction Strategy Credit (World Bank)
PRSP	Poverty Reduction Strategy Paper
PSTAC	Public Sector Technical Assistance Credit
RNE	Royal Netherlands Embassy
SAI	Supreme Audit Institution
SCJ	Supreme Court of Justice
SEPRES	Secretaría de la Presidencia / Secretary of the Presidency (after 2007)
SETEC	Secretaría de la Presidencia / Secretary of the Presidency (before 2007)
SIDA	Swedish International Development Agency
SIGFA	Sistema Integrado de Gestión Financiera y Auditoría / Integrated System for Financial Management and Auditing
SINASID	Sistema Nacional de Seguimiento a Indicadores de Desarrollo / National Development Indicators Monitoring System
SNIP	Sistema Nacional de Inversión Pública / National Public Investment System
UNDP	United Nations Development Program
USAID	United States Agency for International Development
USD	US Dollar
WB	World Bank
WDI	World Development Indicators (World Bank database)

## Summary and conclusions

General Budget Support (GBS) has been an important part of Dutch development cooperation to Nicaragua over the years 2005-2008, representing about one-third of total bilateral aid to Nicaragua. The amount involved has been EUR 9 million in 2005, EUR 10 million in 2006, EUR 11 million in 2007 and EUR 6 million in 2008.<sup>1</sup> These funds were disbursed in the context of the Joint Financing Arrangement (JFA), a multi-donor arrangement with the government of Nicaragua on the provision of budget support. In May 2005, nine donors signed the Joint Financing Arrangement (JFA). The Netherlands was the third donor and the largest bilateral donor of budget support, with a 16.4% share in the total. This multi-donor cooperation implies that the evaluation cannot just look at the impact of Dutch budget support, but must include the budget support from the other involved donors as well. Between 2005-2008 total budget support amounted to USD 300 millions and it represented 12.3% of total aid. On average, budget support represented 5.9% of total expenditure.

In line with the expectations for GBS, four evaluation questions (EQs) have been formulated:

1. Has General Budget Support (GBS) been implemented in such a way that it fostered aid effectiveness in line with the Paris and Accra declarations; in particular has it contributed to harmonization, ownership, alignment, and predictability?
2. Have the donors in general, and the Netherlands Embassy in particular, through GBS been able to influence policies and institutions? If the answer is yes, then how and what are the concrete results?
3. Has GBS been able to strengthen national systems, to reduce estimated transaction costs, to increase allocative efficiency of government expenditure and to strengthen domestic accountability?
4. Have government policies and institutions, supported by GBS money and possibly changed by donor influence through the GBS policy dialogue, become more effective in fostering economic growth and in reducing poverty?

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Table 0.1 (page 14) gives a summary of the answers to these questions, indicating the section of this report where these findings are discussed.

Most of the Paris Declaration principles have been implemented (EQ 1), at least to an important degree. Virtually all budget support resources were fully aligned with the national budget and other national systems, but there were some problems with the predictability of resources. The exception is ownership, but this could be expected, as ownership is to a large degree incompatible with donors attempts to exert influence (EQ 2). Donors have had some influence on the elements of the Performance Assessment Matrix (policies and quantitative indicators) and in some cases compliance with these policies and indicators was also achieved. But compliance was often more formal than real. Poverty expenditure was maintained but poverty was not reduced. With long delays, donors

<sup>1</sup> Due to the exclusion of two opposition parties from the November 2008 municipal elections, the amount committed for 2008 was halved.

managed to have external budget audits carried out and a Judicial Career Law approved, but this did not lead to more effective control of government expenditure or to improved functioning of the judiciary.

GBS has led to some positive intermediate effects in Nicaragua (EQ 3). Compared to project aid, it involved lower transaction costs and led to higher allocative efficiency of government expenditure. It also helped strengthening some government systems and there were some positive effects on domestic accountability under the Bolaños government. The most likely macro-economic use of GBS has been the repayment of domestic debts, thus contributing to macro-economic stability.

The final evaluation question (EQ 4) regards the ultimate effect of GBS on economic growth and poverty reduction. In this area, we can only examine the effects of government policies supported by GBS money and possibly changed in the GBS dialogue. In this area the results are limited. The limited growth of the first years under president Bolaños (2001-2006) did not trickle down to the poor, and poor targeting and poor efficiency of government expenditure hampered progress on social indicators. The policy dialogue around budget support has done little to change the intended policies of this government. Although donors have raised attention for improved poverty spending, the priorities were clearly elsewhere: most pressure has been exerted in order to guarantee macro-economic stability (in 2005), and a good “second” priority were governance issues.

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In this context it is important to analyze the motivations for donors to start GBS. The most important motivation for starting budget support was the expectation of higher aid effectiveness, in line with the Paris Declaration. A second motivation was the intention to support the Bolaños government in its efforts to modernize the state in issues such as improving public finance management and transparency, building career perspectives in civil service and improving the rule of law. In general, the donors had confidence in the Bolaños’ government, in particular in its policy priorities (economic growth and macro-economic stability), in its willingness to fight corruption - evidenced from the jailing of former President Alemán - , and its attempts to improve the country’s governance.

This evaluation concludes that heavy risks could be identified at the start of the process. First, the Bolaños government had no support in Parliament, so it was unlikely to carry out its governance modernization agenda that pleased the donors so much. Donors were over-optimistic in thinking that by talking to and supporting this executive they could change deep institutional and political structures in the country. Second, the donors had a far too rosy picture of the intentions of the Bolaños government itself. It was clear that this government did not give priority to investing in poverty reduction, and the results in this area confirm this.

After the change in government in 2007, new risks appeared. The Ortega government was far more interested in implementing policies that benefit the poor, but its main priority proved to be to consolidate its power - breaching liberal democratic principles, if considered necessary. While bilateral donors continued budget support in the first period,

with the main purpose to *improve the country's governance*, they stopped disbursing budget support in the second because of a *deterioration in governance*. This means that in both periods improving governance seems to have been the most important objective for budget support. This was based on the policy assumption, dominant at the time, that improving governance (in the direction of bringing about developed-country like institutions) is a necessary condition for growth and poverty reduction. However, recent empirical evidence leads to questioning this assumption. Not all elements of the good governance agenda are equally necessary for growth and poverty reduction - although they may be objectives in itself, especially insofar as democracy and human rights are concerned. This reveals a difficult trade-off between *political* and *socio-economic* human rights as international cooperation objectives. Whatever the judgement is, fact is that the Ortega government's efforts - admittedly, politicized and perhaps not always effective - to increase productive capacities of the poor and to improve access of the poor to social services are no longer supported by GBS from bilateral donors.

<b>Table 0.1 Summary of findings on the four Evaluation Questions (EQs)</b>	
<b>EQ 1: Implementation in line with Paris Declaration principles?</b>	
Harmonization	Within GBS to a large extent achieved with respect to disbursement conditions and procedures (2.3.2), but less harmonized responses to breaches of fundamental principles from 2008 onwards (3.4.2, 3.6)
Alignment	Within GBS achieved, but share of GBS in total aid lower than that of program aid in 1990s (2.3.4, 2.3.6)
Ownership	In 2005-6: executive government ownership of fundamental principles, much less of the PAM; 2007-8: more ownership of PAM, less of fundamental principles (2.3.3, 3.3)
Predictability	Good in 2006 and 2007, less in 2005 and 2008 (2.3.5)
<b>EQ 2: Donor influence?</b>	
On the PAM	2005-6: high, 2007-8: somewhat lower (3.3)
Compliance with PAM	2005-6: low, 2007-8: much more (3.4)
Influence on important topics	Poverty expenditure: volume maintained, but doubts on targeting and efficiency (3.5.1) Government transparency: improved public finance management achieved, mostly due to combination of donor technical assistance and high government commitment (3.5.2) External budget audits and Judicial Career Law: formally achieved but few actual changes (3.5.2, 3.5.3) Democracy, human rights, women's rights: not much achieved and deterioration in recent years (3.5.4)
<b>EQ 3: Intermediate effects?</b>	
Macro-economic effects	Positive for macro-economic stability, until 2008 (4.2)
Allocative efficiency	Positive (4.2)
Transaction costs	Positive (4.3)
Strengthening government systems	Some positive effects (4.4)
Improved domestic accountability	Limited positive effects during 2005-6; deterioration since 2007 and little results from donor attempts to turn tide (4.4, 3.5.4)
<b>EQ 4: Government more effective in growth and poverty reduction?</b>	
Bolaños government	Growth policy hampered by neglect of structural inequalities in access to assets; income poverty was not reduced for the same reasons; limited progress in social indicators due to regressive government income and expenditure policies (5.1, 5.2, 5.3)
Ortega government	More attention for structural bottlenecks in advancing productive capacity of the poor majority, but results not clear yet; improved access to health and education (5.1, 5.2, 5.3)





1

# Introduction

## 1.1 Aim of this report and methodology

This report evaluates the provision of Dutch budget support to Nicaragua. General Budget Support (GBS) has been an important part of Dutch development cooperation to Nicaragua over the years 2005-2008, representing about one-third of total bilateral aid to Nicaragua. The amount involved has been, EUR 9 million in 2005, EUR 10 million in 2006, EUR 11 million in 2007 and EUR 6 million in 2008.<sup>2</sup> These funds were disbursed in the context of the Joint Financing Arrangement (JFA), a multi-donor arrangement with the government of Nicaragua on the provision of budget support. This multi-donor cooperation implies that the evaluation cannot just look at the impact of Dutch budget support, but must include the budget support from the other involved donors as well.

GBS is a form of program aid, along with balance of payments support and debt relief. Program aid is aid that is not earmarked to specific uses (projects), and is usually accompanied by policy conditions. This definition implies that technical assistance is not considered to be part of GBS. The policy conditions may be in the form of pre-conditions, i.e., selection criteria, and/or in the form of inputs for a policy dialogue with the government on policies or institutions to be changed, or outcomes to be achieved.

GBS is expected to have four positive effects:

- It will be more effective than other aid modalities (project aid, sector support) because it is expected that there will be more recipient country ownership, more alignment with national systems of procurement, planning, budgeting, reporting, accounting and implementation, and, to the extent general budget support is coordinated among donors, it is also expected to lead to greater donor harmonization. The predictability of GBS money is a precondition for this increase aid effectiveness.<sup>3</sup>
- Donors will be able to influence policies and institutions of the recipient country in the direction of their own priorities through the policy dialogue
- By using government systems, GBS will contribute to strengthening these systems instead of undermining them, GBS will reduce transaction costs for both donor and recipient, will enhance allocative efficiency of government expenditure,<sup>4</sup> and will contribute to greater transparency of government expenditure and to improved domestic accountability
- Finally, through monetary support and through possibly improved policies and governance, government policies are expected to become more effective in fostering economic growth and in reducing poverty.

<sup>2</sup> Due to the exclusion of two opposition parties from the November 2008 municipal elections, the amount committed for 2008 was halved.

<sup>3</sup> Ownership, alignment, harmonization and predictability are principles from the Paris Declaration, agreed by more than 100 countries in March 2005 in Paris, and confirmed in the Accra Agenda for Action (2008).

<sup>4</sup> Allocative efficiency is the efficiency gain in output as a result of a better combination of inputs; when governments can freely use resources they can choose the optimal combination of spending destinations.

The evaluation aims to assess the efficiency, effectiveness and relevance of general budget support to Nicaragua. The evaluation matrix (table 1.1) shows the intervention theory for GBS, tracing the expected outputs, outcomes and impact that follow from the two GBS inputs, the money and the policy dialogue (the attempt to influence). In line with the four expectations regarding GBS, four Evaluation Questions (EQ) will be answered:

1. Has General Budget Support (GBS) been implemented in such a way that it fostered aid effectiveness as stipulated in the Paris and Accra declarations; in particular has it contributed to harmonization, ownership, alignment, and predictability?
2. Have the donors in general, and the Netherlands Embassy in particular, through GBS been able to influence policies and institutions? If the answer is yes, then how and what are the concrete results?
3. Has GBS been able to strengthen national systems, to reduce estimated transaction costs, to increase allocative efficiency of government expenditure and to strengthen domestic accountability?
4. Have government policies and institutions, supported by GBS money and possibly changed by donor influence through the GBS policy dialogue, become more effective in fostering economic growth and in reducing poverty?

| 18 | EQ 1 assesses whether the implementation of GBS is in line with the principles of the Paris and Accra declarations, in particular harmonization, ownership and alignment, and predictability. To some extent, ownership (part of EQ 1) is the opposite of influence (EQ 2). EQ 2 attempts to assess the results of donor attempts to influence policies and governance. In order to measure influence, a first step is to investigate the preconditions for GBS of the different donors involved and to analyze the extent to which they are fulfilled. Next, an assessment will be made of the extent to which the policies, measures and targets of the Performance Assessment Matrix (PAM) coincide with priorities of the government or of the donors. In the first case, there is ownership (at least among the executive government), and in the second, there may be influence. Donors have influence if the priorities are different at the outset and if these donor-preferred policies and measures are implemented. Within implementation, there may be a difference between formal compliance (for example, approving a law) and actual compliance, which would mean that the law is also implemented.

Inputs	Donor preferences in the policy dialogue	Money
Relevant counterfactual	Project aid or sector support	Project aid
Immediate effects	Harmonization	Ownership, or donor influence
Output	Institutional change and policy change	Harmonization
Outcome	Improved governance	Alignment
Impact	Improved government effectiveness: higher quantity and quality and better targeting of services	Domestic systems strengthened by using them Allocative efficiency improved Lower transaction costs Domestic accountability improved Lower deficit or additional money for poverty reduction*
	Economic growth	
	Poverty reduction: income and non-income poverty	

\*Counterfactual: no aid.

EQ 3 deals in fact with four separate issues. Together they can be considered the outputs of GBS, mostly related to the availability of freely usable money, but sometimes also related to the other input of GBS, the policy dialogue. First, it will be examined whether government systems for planning, procurement, budgeting, reporting, auditing, implementation and monitoring have improved since the start of GBS and to what extent this is due to GBS and its accompanying conditions and policy dialogue. Second, and mainly on the basis of perceptions of participants, it will be assessed whether transactions costs of aid have diminished as a result of GBS.

Third, the effects on allocative efficiency of government expenditure are examined. While operational efficiency (or X-efficiency) measures the relation between inputs and outputs, allocative efficiency, or Pareto efficiency, concerns the efficiency gain in output that can be obtained by a better combination of different inputs - in this case, different types of spending. According to IDD and associates (2006: 51),<sup>5</sup> allocative efficiency is “the degree to which resources are allocated according to the strategic priorities of the government”. However, it is difficult to know what the strategic priorities of the government are. It cannot be taken for granted that pro-poor spending is the strategic priority, as IDD and associates (2006) do.<sup>6</sup> For this reason, we assume that the availability of more discretionary (non-earmarked) resources will enhance the chance that the government can spend according to its strategic priorities - unless there is a serious lack of predictability of these discretionary resources and unless donors require too much ring fencing of specific expenditure, e.g. pro-poor expenditure.

<sup>5</sup> Apparently based on World Bank 1998, *Public Expenditure Management Handbook*.

<sup>6</sup> Woll (2008), for example, concluded for Ghana that Millennium Challenge Account investment was more in line with the government’s priorities than the pro-poor expenditure made for the GBS donors.

Fourth, it is examined whether GBS through the assumed improved transparency of budgets and budget execution, has increased the government's domestic accountability. This means investigating to what extent civil society and the public at large use the increased transparency to critically monitor government action and to formulate demands, and to what extent the government is responsive to these demands. Fifth, it will also be attempted to analyze the marginal macro-economic effect of GBS money, which is not different from the effect of all aid provided to the government. The additional money may lead to higher government expenditure, to a lower deficit, or to lower taxes. The first two are positive effects, the latter would be negative, meaning that GBS leads to a reduction in the country's own efforts in raising resources.

The ultimate objective for GBS is assumed to be economic growth and sustainable poverty reduction. A direct link between GBS money and the possible achievement of these objectives cannot be established. EQ 4 therefore examines the results of government policies, since they have been supported by GBS money and have possibly been changed by the GBS policy dialogue. Although GBS money officially only began to flow in 2005, donors have supported the Bolaños government whose policy priorities were known at the beginning of the process. For this reason, we investigate the results of government policies of the full period of the Bolaños administration (2002-2006), as well as first results of the Ortega administration (since January 2007). First, we discuss the content of these policies and examine to what extent the objectives growth and poverty reduction were or are likely to be achieved. Second, we present the relevant macro-economic indicators, including income poverty indicators, and attempt to assess the contribution of government policies. Third, we examine government expenditure and revenue policies in order to assess whether and to what extent they have contributed to reducing income poverty and to improve social indicators. In order to do so, we analyze the incidence of expenditure and taxes, and the efficiency of government spending.

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For this evaluation, many documents and papers have been studied. In March 2009 interviews have been held in Nicaragua with representatives of donors, the current and previous government, as well as with independent experts. In May 2009, interviews have also been held in The Netherlands with Dutch staff involved in the start-up of budget support in both Nicaragua (Royal Netherlands Embassy) and The Netherlands. A first and incomplete draft of this report has been discussed with stakeholders in Nicaragua in October 2009, and in the same week some additional interviews were conducted. Finally, this report also benefitted from fieldwork in Nicaragua carried out by the first author in the context of an "Evaluation of International Debt Relief", for the Dutch Policy and Operations Evaluation Department (IOB, in 2002), and in the context of the study "Monitoring and Evaluation of Latin American Poverty Reduction Strategies", for the Swedish International Development Agency (SIDA, in 2004 and 2006).

It must be stated at the outset that the expectations and aspirations for GBS as aid modality are far too high. First, it cannot be expected that donors, even the more progressive ones, will set aside their own criteria and priorities for poverty reduction policies, let alone their own economic and foreign policy interests. This reduces the possibilities for donor

harmonization, but also for national ownership. To the extent that donors use GBS in order to impose their own priorities, this undermines ownership and may reduce government commitment with agreed policies. Second, in practice it may be impossible to achieve both socio-economic objectives and objectives with respect to governance. If donors withdraw their money because conditions with respect to good governance are not fulfilled, this may reduce chances for achieving growth and poverty reduction. As a result of these constraints and inherent contradictions, it is *a priori* impossible that this evaluation generates positive answers to all four Evaluation Questions.

In chapter 2, we start by analyzing whether GBS was relevant at the start: what were the motivations and objectives for GBS, were the preconditions fulfilled and could it be expected that GBS objectives would be achieved? We continue by examining how much and in what way GBS was provided in Nicaragua and whether the implementation meets the criteria of the Paris Declaration: harmonization, alignment, and ownership. This provides an answer to EQ 1. The next chapter examines the extent of donor influence through GBS, EQ 2. EQ 3 is answered in chapter 4, and chapter 5 deals with the results of government policies. Chapter 6 concludes.

In the remainder of this introductory chapter, we provide a short political-economic and historic background in Nicaragua, including the history of foreign aid in the country and the quality and results of the accompanying policy dialogue. Analyzing the background is important because it defines the context in which the relevance (*ex ante*) of providing budget support in this particular case can be assessed. In the following, we highlight first the economic and social developments in the country over the last 30 years, and then discuss the role of aid and in particular the results of the policy dialogue between government and donors in the period before the beginning of the Bolaños administration.

## 1.2 Background and context

### 1.2.1 Political economic history

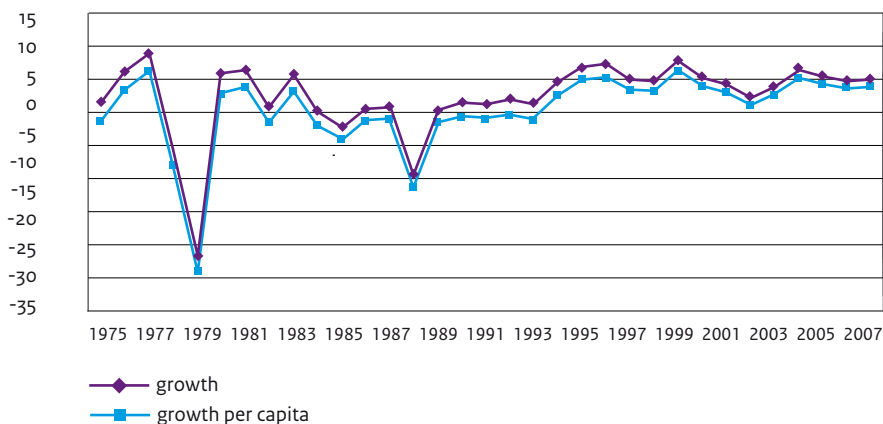
Nicaragua is one of the poorest countries in Latin America with a per capita income of USD 1163 (2008).<sup>7</sup> It has a turbulent political economic history. Between 1939 and 1979, the country was ruled almost continuously by the Somoza family under a dictatorship. Although economic growth was high during the 1950s and 60s, with real GDP rising at an average rate of 7 per cent a year,<sup>8</sup> much of the Nicaraguan population lived in poverty and did not have access to education, health care or water and sanitation. In July 1979, after intensive fighting and destruction, especially during the last two years, the Sandinista National Liberation Front succeeded in expelling the Somoza regime.

<sup>7</sup> World Bank, World Development Indicators.

<sup>8</sup> Bulmer-Thomas, 1987, Appendix A.1, pp. 308-9.

Between 1979 and 1990, Nicaragua was ruled by the left-wing Sandinistas. This government nationalized the banks and all property from the Somoza family. The rest of the economy remained in private hands, but state influence was strong: the state allocated credits and foreign exchange and established many prices. A literacy campaign was launched and health and education services expanded. During the first years, the economy experienced positive growth rates, and the income distribution improved. However, these positive growth rates could not be maintained (Figure 1.1). This was partly due to policy inconsistencies and partly to external circumstances, in particular the hostility from the United States government. The US government imposed a trade embargo, impeded loans from multilateral organizations and, most seriously, financed the armed opposition to the Sandinista government which led to a devastating civil war. From 1984 onwards, output declined in every year and inflation accelerated, leading to hyperinflation in 1988. As the international organizations and also most Western donors withdrew, the economy became more and more dependent on support from the Soviet Union and other Soviet bloc countries.

**Figure 1.1** Economic growth, 1975-2007 (in percent)



Source: WDI Online

The elections in 1990 led to a victory of the opposition under the leadership of President Violeta Chamorro. Hostilities came to an end and Western donors including the US started supporting Nicaragua again. In 1991, hyperinflation was successfully defeated and the country concluded an agreement with the IMF. The new government also immediately started with the liberalization of the foreign exchange market, liberalization of prices and privatization of the firms that had earlier been nationalized. Later during the 1990s, and in line with conditions of the IMF and donors such as World Bank, IDB and USAID, many other reforms were carried out, such as lowering import tariffs, liberalization of the financial sector, privatization of all state banks as well as some of the public utility companies. This was not a smooth process however, as the country remained highly polarized politically and the government had to fight many battles with FSLN dominated trade unions and peasant organizations, with former soldiers from both factions, with the National Assembly and with former owners of properties nationalized during the 1980s.



**Table 1.2 External indicators Nicaragua, 1990-2008 (in millions of USD)**

	Exports	Trade balance	Remittances	Current account balance	Aid	External public debt*
1990	331	-241	15	-509	481	10.7
1991	272	-397	15	-852	1144	10.3
1992	223	-575	10	-1130	648	10.8
1993	270	-409	25	-883	387	11.0
1994	335	-446	50	-912	580	11.7
1995	466	-415	75	-786	516	10.2
1996	466	-577	95	-882	537	6.1
1997	577	-794	150	-927	398	6.0
1998	573	-824	200	-820	485	6.3
1999	545	-1154	300	-1092	609	6.5
2000	645	-1003	320	-917	544	6.7
2001	895	-910	336	-805	536	6.4
2002	914	-939	377	-744	527	6.3
2003	1056	-971	439	-663	586	6.6
2004	1369	-1088	519	-649	652	5.4
2005	1654	-1302	616	-734	565	5.3
2006	2034	-1451	698	-710	640	4.5
2007	2336	-1759	740	-1001	689	3.4
2008	2675	-2173	818	-1475	413	3.5

\*Billions of USD.

Source: Central Bank of Nicaragua.

Although inflation remained low, budget deficits and balance of payments deficits continued to be high. Economic growth only resumed in 1994 and was still modest (Figure 1.2). Although between 1991 and 1996, large amounts of debts, especially from former Soviet countries (including former Eastern Germany) and also from Mexico were cancelled, the external debt remained very high by the end of 1996, at around USD 6 billion (Table 1.2). The country was therefore highly dependent on foreign aid. During Ms. Chamorro's Presidency this aid was coming in large amounts, but this changed after the 1996 elections in which Arnoldo Alemán of the liberal party PLC came to power. This leader of the PLC did not show any interest in cooperating with the donors. The country's reserve position deteriorated rapidly, which ultimately brought the government to conclude a new agreement with the IMF in the form of an ESAF (Enhanced Structural Adjustment Facility), in 1998.

After hurricane Mitch struck the country in November 1998 Nicaragua received large amounts foreign aid again, as well as debt relief. But there were increasing signs of large-scale corruption by the President and his closest allies. In October 1999, the ruling liberal party made an agreement with the second largest party in the Assembly, the FSLN, in which they divided all seats of the Supreme Court, the Electoral Council, and several other

public bodies. This “Pacto” virtually meant the end of all parliamentary opposition and also of an independent judiciary. This added to the governance concerns of bilateral donors.

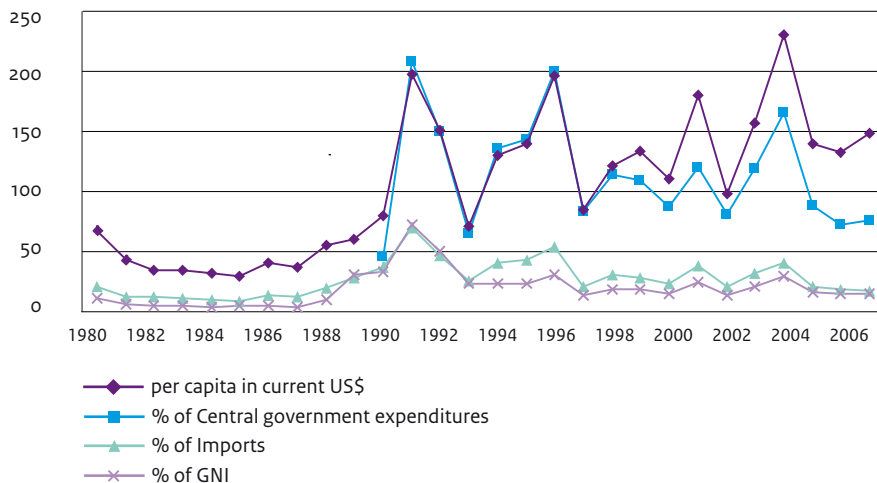
The 2001 elections were won by Enrique Bolaños of the same PLC, who had been Vice-President under Alemán. However, one of his first actions was to have the corruption of his predecessor investigated. In August 2002 Alemán was indicted for misappropriating USD 97 million during his Presidency. Later that year he was convicted and sent to jail. This gained Bolaños ample support from the donors. But almost all PLC members in the National Assembly continued to side with Alemán so that Bolaños did not have much support in Parliament. This made it very difficult for the Executive to carry out any policies for which new laws were necessary.

### 1.2.2 Foreign aid

During the 1990s, aid was very important to finance the budget deficit and the current account deficit. Between 1992 and 1997, the average budget deficit of the central government before grants was 10.7%, and after grants 4.0% (Dijkstra, 1999: 51). Between 1990 and 1996, the volume of aid was always larger than that of exports (Table 1.2). After the government change in 1997, aid declined except for a peak after Hurricane Mitch. The relative importance of aid for the economy began to diminish from around 2000. Exports increased, and so did remittances. Yet, by 2002 aid still constituted [81 % of central government expenditure], 21% of imports and 14% of Gross National Income (Figure 1.2).

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**Figure 1.2** Aid indicators, 1980-2007



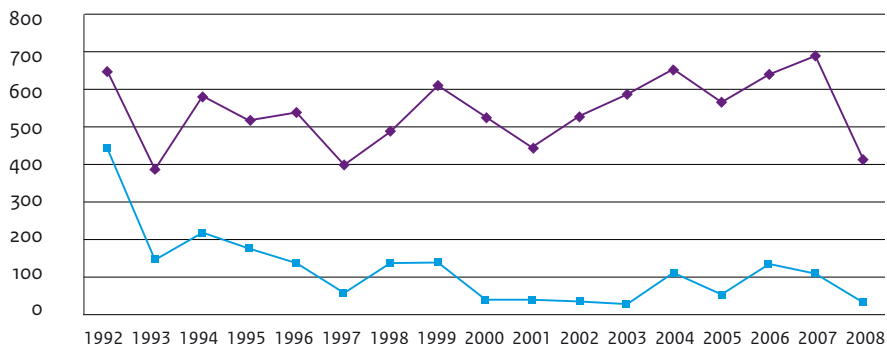
Source: WDI Online

The IDB is the largest donor to Nicaragua, with annual disbursements of about USD 100 million. The World Bank used to be second with about USD 80 million, but is being surpassed in recent years by the European Commission (EC). Among the bilateral donors,

Spain has been most important between 2000 and 2007 (20% of all bilateral plus EC), followed by the US (14%), and then Germany (13%), Japan (7%), Sweden (6%), Denmark (6%), and the Netherlands (5%) (OECD-DAC). This composition of the bilateral donor group implies that the largest amounts of aid are provided by donors who are not very much in favor of program aid: Spain, US, and Japan.

During the 1990s, most program aid was provided by multilateral donors in the form of structural adjustment loans or sector adjustment loans. But bilateral donors also provided program aid (grants) in the form of balance of payment support or debt relief. Debt relief could imply forgiveness on debt service obligations to the donor itself, or taking over the government’s debt service obligations to the international financial institutions. An IMF agreement was always a pre-condition for these forms of program aid. Nicaragua started IMF programs in 1991, 1994 and 1998. Figure 1.3 shows that program aid peaked in those years, and was lower in other years. This was because the governments usually stopped complying with IMF conditions in the year after the agreement. In 1999 this was different, mainly as a result of more flexible conditions after hurricane Mitch.

**Figure 1.3** Program aid and total aid to Nicaragua, 1990-2008 (in millions of USD)



Source: BCN.

During the Chamorro administration, several bilateral donors were concerned about the fragile democracy, and they maintained a dialogue with the government on those issues. There was no difference between donors willing to provide program aid or not.<sup>9</sup> The dialogue on economic reforms was left to IMF and World Bank, although some bilateral donors began to be concerned about the social consequences of budget cuts. In 1997, a group of “like-minded donors” was formed, consisting of Denmark, Finland, Germany, The Netherlands, Norway and Sweden, with the objective of trying to influence the draft of the ESAF. In particular, they wanted more attention for governance issues, in particular control of corruption, for poverty reduction expenditure and they wanted to eliminate the priority

<sup>9</sup> For example, the Support Group for Nicaragua, installed by the General Assembly of the UN and which played a role in a conflict between Executive and National Assembly on a reform to the Constitution in 1995, consisted of Canada, Spain, Sweden, The Netherlands and Mexico (Dijkstra 1999).

for US citizens in granting indemnity for confiscated properties under the Sandinista government (Dijkstra, 1999). They were successful with respect to the indemnity issue, and managed to include a clause in the ESAF that social spending was allowed to increase *if* fully financed by foreign aid. To this end, the government established the Fondo Social Suplementario (Supplementary Social Fund, FSS). Donors could contribute to this fund for specific projects or for social spending in general, which would then be additional. But the like-minded donors were not able to include demands on governance. As described above, “Mitch” led to large amounts of aid and debt relief, but donors were increasingly concerned about governance, in particular, the Pacto and rampant corruption.

### 1.2.3 The policy dialogue until 2003

On the basis of its huge foreign debt, Nicaragua qualified, in principle, for the enhanced Heavily Indebted Poor Country (HIPC) Initiative that was launched in 1999. In order to meet conditions for the Decision Point, the government wrote an Interim Poverty Reduction Strategy Paper. The other condition was to show a six year compliance with IMF agreements. This was far more difficult and by 2000 the country was not even on track with the current 1998 ESAF. But the IMF gave a waiver “because of Mitch” so that the Decision Point was achieved in December 2000. Nicaragua benefited from the “Millennium rush”: the international desire to admit as many eligible countries as possible to the Decision Point of the HIPC Initiative. A full PRSP with participation was one of the conditions for the Completion Point. With Presidential elections approaching in November 2001, both donors and government had an interest in rushing through the approval of the full PRSP, which happened in August 2001 (Dijkstra & Evans, 2003).

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However, program aid from bilateral donors was hardly provided due to the serious concerns about corruption of the Alemán government. Some few contributions were made to the FSS, and following the donor conference for Central America in Stockholm in response to the hurricane, several donors set up the Central American Emergency Trust Fund which implied temporary suspensions of debt service payments. In July 2001 the IMF decided to have a staff-monitored program with Nicaragua.

Apart from writing a full PRSP, the country had to meet a long list of conditions for meeting the Completion Point.<sup>10</sup> The (new) government should conclude a new IMF program and show a satisfactory performance for at least a year, should use the HIPC interim debt relief for poverty reduction expenditure, and had to implement several other structural reforms such as civil service reform, public procurement and pension reforms and the privatization of the Nicaraguan telephone company ENITEL. In this period there was again a group of like-minded bilateral donors, composed of Sweden, Norway, Denmark, Switzerland, the UK and the Netherlands, while Germany and Canada sometimes also joined. This group attempted to include conditions related to governance in this list of reforms. But they did not succeed in influencing the IMF or the World Bank (Dijkstra and Evans, 2003). All in all, the often expressed governance concerns of bilateral donors in the period 1997-2002 did not have much influence on the government or on the multilateral institutions.

<sup>10</sup> After this Point, debt relief according to the HIPC Initiative would become irreversible.



2

## The implementation of budget support

## 2.1 Introduction

The aim of this chapter is to assess the expected advantages of budget support in the Nicaraguan context. To this end, the first part of this chapter assesses the origin and motivations for budget support in Nicaragua. It examines the objectives and rationales of the donors and assesses whether the preconditions as mentioned by the donors, were fulfilled at the start of the process. Special attention will be given to Dutch motivation and risk analysis in the decision to provide budget support. The second part of the chapter describes the particular form that the joint system of budget support has taken in Nicaragua, and examines whether the budget support practice has furthered some of the principles of the Paris Declaration, in particular harmonization, ownership, alignment, and predictability. In this context, the actually provided budget support resources 2005-2008 will also be presented, both in historical context and in relation to total aid to Nicaragua.

## 2.2 Objectives and conditions

### 2.2.1 Introduction

This section describes the preconditions for general budget support for the different donors and analyzes to what extent these preconditions were fulfilled at the start of the process, during 2003-2005. It also discusses the specific motivations and objectives for budget support, with particular attention to the Dutch motivations and objectives.

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As described above, President Bolaños immediately started to act against the corruption of his predecessor. This gained him a lot of credit among bilateral donors and removed an important obstacle for program aid. In November 2002, the new government concluded an agreement with the IMF. This formally freed the way for program aid, as an IMF agreement is an important pre-condition for the policy based loans of World Bank and IDB and for program aid from bilateral donors. Since debt relief or balance of payments support were not considered necessary anymore, and in line with the dominant consensus on aid effectiveness at that time, donors wanted to move to (General) Budget Support.

In the absence of (as yet) a joint system for providing GBS, bilateral donors had three options: giving the money right away, co-financing of the Poverty Reduction Strategy Credit (PRSC) of the World Bank, or supply the money to the Fondo Social Suplementario (Supplementary Social Fund – FSS). Germany preferred the co-financing mode, some other donors provided money to the FSS: Denmark, Finland, the Netherlands, and Sweden in 2003, and Finland, the Netherlands, Norway and Switzerland in 2004. In 2004, Sweden provided general budget support without any further conditions. The EC began to prepare its own sector budget support program, leading to an Education sector support program in 2004.

The FSS, established in 1999, was a list of projects that were already financed by three donors: USAID, the IDB and the World Bank. The earlier bilateral contributions (Sweden in 1999 and the Netherlands in 2000) had mainly been used to finance the counterpart funds for these projects (Dijkstra & Evans, 2003). In 2003, the FSS changed into something that was more like a virtual fund in which poverty reduction expenditure would be registered. It would be “fed” by HIPC debt relief, by donor contributions for poverty reduction and by the government’s own contributions. But the bilateral donors involved still considered the FSS as too much project-like. Projects were still individually discussed and approved. Another reason for considering the FSS as sub-optimal, especially for the Dutch government, was that this modality lacked the possibility for influence on both governance and on poverty policies in the country.

For these reasons, Sweden and The Netherlands took the initiative for setting up a Budget Support Group (BSG), with the aim of establishing, together with the government, a harmonized system for GBS. In May 2003, this group consisted of two multilateral donors (The European Commission<sup>11</sup> and the World Bank) and eight bilateral donors (Denmark, Finland, Germany, Norway, Sweden, Switzerland, UK, and The Netherlands).<sup>12</sup> Several other donors, such as the IDB, Japan, USAID and UNDP participated as “observers”.

| 30 | The general motivation for the involved donors was that they subscribed the international consensus for improving aid effectiveness (the 2003 Rome Declaration and later the 2005 Paris Declaration). In principle, GBS is the aid modality that best guarantees national ownership and alignment with national systems. If it leads to the elimination of a large amount of projects, and if donors coordinate their disbursement conditions and procedures, it is also the best way to achieve donor harmonization. However, usually, the donors want certain preconditions to be fulfilled before they begin to consider providing GBS.

In Nicaragua, by 2004, the donors considered the following three broad preconditions important (Guimarães et al., 2004):

- Macroeconomic stability, which for the majority implied that there was an ongoing IMF program
- An approved Poverty Reduction Strategy or a similar consensus-based national development plan in which poverty reduction plays an important role
- A basis of transparency and efficiency in public finance management, or at least a positive trend in this.

With respect to this third precondition, some donors were more exigent than others. For example, a minimum degree of budget transparency was very important for KfW (Germany) while the Swiss wished to see a serious Medium Term Expenditure Framework (MTEF) in place.<sup>13</sup> Some donors expressed additional concerns or conditions. For Sweden the

<sup>11</sup> The European Commission in Nicaragua currently considers itself to be a “bilateral” donor.

<sup>12</sup> Denmark moved out during the preparatory phase. This donor is worldwide much more hesitant to start with budget support due to concerns about fiduciary risks in particular.

<sup>13</sup> An MTEF implies that governments make estimates of expenditure for 3 years ahead. It allows much better planning of, in particular, investment.



commitment to poverty reduction was important, as shown in actual policies. The Swedes monitored the indicators and targets mentioned in the World Bank's PRSC that had started in January 2004. For the Netherlands, an important criterion for providing GBS was that there were observable improvements in governance. This not only implied public finance management and control of corruption, but also issues like an independent judiciary and civil service reforms. We now describe the development in these three groups of conditions in the years 2003-2005. Governance is taken as part of the third group.

### 2.2.2 Macroeconomic stability and HIPC Completion Point

The new government quickly succeeded in reducing the budget deficit and in meeting the other quantitative targets of the IMF, so that a PRGF (Poverty Reduction and Growth Facility) could be agreed in November 2002. This program was still on track in 2004. The country also met the other conditions for the HIPC Completion Point. Although President Bolaños did not have much support in the National Assembly, all deputies were convinced of the urgency of receiving HIPC debt relief. For this reason, the government managed to get all the laws approved that were required for achieving the Completion Point. These included laws that were important for several bilateral donors, such as the Financial management law that envisages, among other things, annual audits of public expenditure by the Supreme Audit Institution (SAI), and a civil service reform law that establishes merit-based careers for civil servants.

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The country achieved the Completion Point of the HIPC Initiative in January 2004 and as a result HIPC debt relief became irreversible. Formally, all conditions were met and donors could provide budget support. However, after reaching this Completion Point, the temporary cooperation between the Executive and the Legislative power came to an end. In addition, it was by no means clear that the government would be willing or able to implement the approved laws.

### 2.2.3 PRSP

The situation with respect to the Poverty Reduction Strategy was ambiguous. The Bolaños government had rejected the PRSP prepared by the previous administration, the ERCERP. However, since having a PRSP was important for achieving the HIPC Completion Point, it did write Progress Reports on this strategy. In the meantime it presented its own National Development Plan (PND), which was very different from the earlier ERCERP. This PND was not accepted by the donors as new PRSP. The main criticisms on contents were that there was too little attention for the social sectors and for social protection and that it was not sufficiently operational. Although the donors recognized that this strategy was much more owned by the (executive) government than the previous one, they criticized the lack of consultations with society at large.

Donors responded to this situation in different ways. The World Bank based its Poverty Reduction Support Credit on the old PRSP. This PRSC was approved in January 2004 and received co-financing from KfW (Germany). The European Commission (EC) also began to

provide sector budget support (for education) in 2004 on the basis of the old PRSP. Most bilateral donors, however, continued to press the government for making a revised PND, and World Bank and EC argued that this was also needed for a next disbursement (WB) and for another sector budget support program (EC).

Some donors, including the Netherlands, began to financially support consultations on the strategy through the Technical Planning Secretariat of the Presidency (SETEC). In practice, consultations were held in all territories and departments in the country. During these meetings the implications of the national strategy for a specific department or territory were discussed and they often led to lists of projects that the regions wanted to see executed (Guimaraes et al., 2005). Dutch decision makers of the time remember the consultations as a serious attempt to get people involved in development policies, “much better than in most other countries”, although they do recognize that the meetings often just resulted in wish lists.

At the national level, the plan was only once discussed in the CONPES, an advisory organ with participation of civil society, and not at all in the National Assembly. This meant that the general assumptions and strategic options of the plan have never been discussed seriously (Guimaraes et al., 2005). With hindsight, a high government officer of the time admits that the Plan had not sufficiently been shared and discussed with the political parties in the National Assembly and it therefore could not be expected to survive the Presidential elections.<sup>14</sup>

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In October 2004, the government came up with its Operational PND (PND-O). But this version was still not fully acceptable to the donors. Finally, the government presented another version of the PND in November 2005, and this version was approved by the donors, including the Boards of the IFIs, as “second PRSP”. Apparently, the lack of an approved Plan did not prevent the joint budget support scheme from coming about, as the Joint Financing Arrangement (JFA) was signed in May 2005. It can be argued that what really mattered, more than having an approved plan, was the government’s *commitment* to poverty reduction. The original PND and all other public statements of the Bolaños government made it clear that achieving economic growth was its first priority. It wished to focus attention on growth clusters (agricultural exports, free zones) and had a strong belief in automatic “trickle down” effects. Policies would foster foreign investment and the resulting growth was expected to benefit the poor. In 2003 and 2004, most donors, including the Netherlands, thought that this focus on economic growth was welcome after the perhaps too one-sided attention for poverty reduction and the social sectors in the first PRSP. Although most donors were asking for more attention for social expenditure in the text of the PND, there was only a single donor expressing doubts on the “sensitivity” for poverty reduction among the current government.<sup>15</sup>

<sup>14</sup> Interview March 2009.

<sup>15</sup> Interviews held in 2004 with donors in Managua.

## 2.2.4 Governance and PFM

With respect to public finance management, the general opinion among the donor community was that transparency of public expenditure was improving. Most donors of the BSG were, in one way or another, involved in technical assistance programs for the improvement of public finance management, which also helped in raising confidence that the situation would improve. From 2004 onwards, the World Bank provided a Public Sector Technical Assistance Credit (PSTAC) which was co-financed by Denmark, DfID, Finland, the Netherlands and Sweden (Guimarães & Avendaño, 2007). One of its components was the expansion of the System for Financial Administration (SIGFA) which led to more control of actual expenditure. SIGFA, already introduced in the 1990s, was improved and extended to other state entities. Other components of PSTAC included strengthening of financial management by introducing a Medium Term Expenditure Framework (MTEF, first applied in the 2006 budget but in practice due to Swiss support), setting up a structure for negotiating and monitoring general budget support in the Ministry of Finance, fostering a law to introduce administrative careers, and supporting a public ethics office and improving the national public investment system. The EC had its own program for technical assistance which, among other activities, supported the government in its negotiations on GBS, and the Swiss provided assistance specifically for the setting up of an MTEF.

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The general governance situation was difficult. Once the HIPC Completion point was achieved, the Executive lost all support from Parliament. Many laws that were approved could not be implemented for lack of approval of further regulations by the National Assembly. For much the executive government wanted to cooperate with the donors in working towards a more independent judiciary or a national audit by the SAI, it did not have any influence on these agencies or on Parliament. The *Pacto* was still in existence and implied that the two political parties dominated all these institutions. Democracy was also lacking *within* those political parties, as the *caudillo* (strong man) culture dominated. This prevented change from coming about.

## 2.2.5 Dutch motivations, conditions and objectives

For the Netherlands, the general motivation for GBS as method to improve aid effectiveness was important. The Royal Netherlands Embassy (RNE) had many different projects in Nicaragua and wanted to get rid of this project proliferation. Two other factors were important;<sup>16</sup> first, the fact that President Bolaños was acting against corruption and had put his predecessor Alemán in jail, and second, that there was a development strategy that was perceived as much more owned than the previous one, while the government also made a serious attempt to broaden this ownership by organizing the departmental consultations.<sup>17</sup>

The Multi-Annual Strategic Plan 2005-2008 (MASP) of the RNE sees political and institutional changes as necessary for poverty reduction (RNE, 2004). In this context, it defines “just and

<sup>16</sup> Interviews held in May 2009 in The Netherlands

<sup>17</sup> Comment from authors: with Dutch money.

democratic governance” as its main objective, and “budget support that promotes governance” as its first strategic result. The same MASP states that the Embassy expects that, by means of a joint budget support scheme, it will be able to exercise leverage on two levels: on the Executive level for the promotion of transparency, accountability and for improvements in public finance management, and on the National Assembly in areas such as reform of the judiciary and equity.

These expectations, and in particular these motivations and objectives for budget support were confirmed in recent interviews with Embassy staff and other key decision makers at the time in the Ministry of Foreign Affairs in The Hague.<sup>18</sup> According to one interviewed former Embassy staff member, the confidence in poverty reduction policies of the Bolaños administration was weak, yet there were no signs of worsening poverty at the time. Also in The Hague, poverty reduction was “no issue” at that time. The main rationale for providing GBS was to improve governance. Specifically, the Dutch government wished to support the Executive in its fight with the National Assembly so that the latter would approve the proposed laws that would reform the civil service, the pension system, and the judiciary, among other institutions.

This confirms that at the start of the process, the most important aim for GBS was to improve governance, apparently from a strong presumption that this was a necessary condition for achieving poverty reduction. It was expected that the mechanism for providing GBS, - with agreed policies and targets in a Performance Assessment Matrix that would be monitored twice a year - , would guarantee that poverty reduction policies would be carried out. GBS would be a much better means to these ends than the alternatives, such as providing money to the FSS or co-financing to the World Bank’s PRSC: in both of these cases it would not be possible to exert influence on governance.

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Yet there were also other opinions, both within the Ministry in the Hague and within the Embassy. Some were more hesitant on using the budget support instrument in Nicaragua, and others even took the position that the governance situation in the country did not meet the conditions for GBS at all. There was no independent judiciary, no democracy within political parties and there was too much corruption. In this view, corruption during the Bolaños administration was perhaps more sophisticated than under the previous government, but nevertheless it did still occur. The opinions also varied on the Bolaños government’s commitment to poverty reduction. Some believed strongly that economic growth and foreign investment would automatically reduce poverty, while others were of the view that the Bolaños administration did not have enough attention for the living conditions of the poor.

The MASP 2005-2008 extensively lists the risks mentioned above: the *caudillismo* within political parties, the weak rule of law, upcoming elections and therefore more politicization, weak interest among the government in social themes, the lack of parliamentary support for the government, and the non-poor interests that dominate the political parties. Yet, it unambiguously opts for providing GBS, and proposes to increase the amount from € 9 million in 2005 to € 12 million in 2008, and in the “high-case” scenario to € 15 million (RNE, 2004: 16).

<sup>18</sup> There was agreement on this between former Embassy staff and former staff of DEK, the department that was responsible for GBS.

## 2.2.6 Conclusion

The expectation of higher aid effectiveness, in line with the Paris Declaration, was the most important motivation for starting budget support. In addition, at a general level donors had confidence in the Bolaños' government: its policy priorities (economic growth and macro-economic stability), and its willingness to fight corruption - evidenced from the jailing of former President Alemán - , and to modernize the state, in issues such as improving PFM, building career perspectives in civil service and improving the rule of law.

However, it can be doubted whether the conditions for budget support were fulfilled. First, the political risks were underestimated, as also concluded by Gosparini et al. (2006). In fact, the Bolaños government had no support in Parliament so it was very unlikely to carry out its governance modernization agenda that pleased the donors so much. Donors were over-optimistic in thinking that by talking to and supporting this executive they could change deep institutional and political structures in the country.

Second, the donors had a far too rosy picture of the intentions of the Bolaños government itself. Donors knew or could know that the government did not give priority to investing in poverty reduction. Some donors agreed with the government that with private sector growth, poverty reduction would follow automatically (overlooking the fact that a large part of the donors' poverty reduction agenda depended on quality and targeting of government social expenditure). Others donors expected to address this government shortcoming in the policy dialogue accompanying budget support. It can be doubted whether budget support is relevant at all if a crucial condition, namely commitment to poverty reduction, is missing.

Third, among the objectives for general budget support there was a heavy emphasis on governance issues on the assumption that improving governance (in the direction of bringing about developed-country like institutions) is a *necessary* condition for growth and poverty reduction. However, more recent empirical research questions the empirical basis for this assertion (Holmberg et al., 2009; Kurtz & Schrank, 2007). In addition, "first best" institutional solutions often do not work in a "second best" environment, and may even be harmful (Rodrik, 2008).

## 2.3 Budget Support and Paris Declaration Principles

### 2.3.1 The process leading to the JFA and the first PAM

The Budget Support Group aimed at defining common conditions and procedures for GBS. But the process was not easy and took a long time. There were several reasons for this.<sup>19</sup> First, both the government and most donor representatives had little experience with and little knowledge of general budget support and how it is commonly provided. The World Bank invited experts to explain what a performance assessment matrix (PAM) was, and what kind of indicators were feasible in terms of data availability, and how the monitoring process could be organized.

<sup>19</sup> Interviews March 2009 Nicaragua and May 2009, The Netherlands.

Second, some of the donors forming part of the BSG had already started their own budget support programs and wanted to include these programs in the joint system. The World Bank had started its PRSC in 2004 with a long list of policies and measures to be implemented and also some outcome indicators. It wanted to take this PRSC as basis and invited the other donors to co-finance it. However, the bilateral donors were generally of the view that the PAM should focus on results oriented targets (outcomes) and should not include policies and measures (processes). This would leave more autonomy (ownership) to the government. This controversy provoked lengthy discussions among the donors. The EC had started an education sector program, in which the money would be transferred to the general budget (Treasury) but with many agreed policies and targets for the education sector. It also wanted to include them in the PAM. In the end, the PAM implied a compromise and included some of the WB policies and EC targets.

Third, the confusion with respect to the PRSP played a role. Rather than using the PRSC as basis for a PAM, the bilateral donors preferred using the revised PND (PND-O) because that was much more owned by the government. However, it took a long time before the PND-O appeared. Fourth, although the government was interested in setting up a joint GBS system, it did not always give a high priority to it. Given the adverse political climate, it needed all its time and energy to get some support for its policies within the National Assembly.

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A fifth reason was that it was a complex process in which many actors were involved. The donors wanted to involve not only the Ministry of Finance in the discussions on indicators to be met, but also other government agencies. At the start of the negotiations, there was little coordination between Finance and the line ministries. Representatives of the donors began to consult with sector ministries directly. Another strategy was to involve the sector roundtables (consisting of government, donors and sometimes also civil society representatives) on the definition of suitable targets. All this was very labor intensive and took a long time.

In May 2005, nine donors finally signed the Joint Financing Arrangement (JFA) and agreed on the PAM. The JFA defined the procedures for providing GBS, with an annual Meeting in May of year  $n$  in which the achievement of the past year ( $n-1$ ) would be assessed. Within four weeks after the meeting, donors would indicate their preliminary commitments for the next year ( $n+1$ ). In the Mid-Year Meeting in August, the country's performance in year  $n$  would be assessed and within four weeks after that the commitments for year  $n+1$  would be confirmed, so that they could be included in the government budget for  $n+1$ . The JFA also defined some fundamental principles that both donors and government had to abide with. In case of non compliance with the fundamental principles, disbursements could be withheld. These fundamental principles are "commitments to international law and conflict prevention, respect for human rights, democratic principles including free and fair elections, the rule of law, independence of the judiciary, free, transparent and democratic processes, accountability and the fight against corruption, sound macro-economic policies and commitment to poverty reduction".<sup>20</sup>

<sup>20</sup> Joint Financing Agreement on General Budget Support, May 2005.

However, it was not very clear how these principles would be used. Some of them, like the independence of the judiciary, were not fulfilled at the start, and several others principles were also very weakly present, if at all. In addition, for none of them a minimum level was defined so that it was impossible for the government to know in what case disbursements would be at risk. The discussions among donors and between donors and government for a long time only focused on the PAM. The fundamental principles were added later with hardly any discussion.<sup>21</sup> According to Dutch Embassy staff involved at the time, they were included to make it clear to the government and to the country that some thresholds should not be surpassed. As examples, they mentioned a military coup or the release of Alemán from jail.<sup>22</sup>

The PAM on which the donors finally agreed contained a total of 161 policies, measures and indicators for a period of two years (2005-2006). According to all parties involved, this was far too much. The high number was the result of the fact that all donors wished to include their priorities, while the same held true for all government agencies. Although the JFA was clear on a time schedule for the monitoring of the PAM and of the consequences, also in this case it was not clear how it was going to be used. What percentage of the total would have to be met in order for disbursements to follow? Were all indicators of the same weight? Obviously, different donors attached different priorities to the indicators and policies.

During the long and intensive period of negotiations, some risks involved in budget support were reduced, and others increased. Between 2003 and 2005 there were clear improvements in the government's financial administration and financial management. By end-2004 a new PND appeared that presumably had benefited from extensive regional consultations. On the other hand, May 2005 was only one year and a half before the next presidential elections which meant that the climate would become even more politicized than it already was, and that President Bolaños would have even less authority to get things done. This became immediately clear when two weeks after signing the agreement, the IMF declared its program with the country off track. The problem was not that the financial targets were not met, but that the National Assembly failed to approve certain laws that were considered indispensable for macro-economic stability in the medium term. Since one of the conditions of the PAM was macro-economic stability "to be defined by the IMF", the budget support donors had to define their position (see chapter 3).

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### 2.3.2 Budget support and harmonization

The JFA was signed by the ministers of Finance and of Public Affairs of Nicaragua, and by nine donors: the European Commission, Finland, Germany, the Netherlands, Norway, Sweden, Switzerland, the United Kingdom, and the World Bank. The IDB was mentioned as signatory in the JFA but in the end did not sign, because a "legal problem" prevented its participation. This means that several important aid donors in Nicaragua were not part of the GBS agreement: Japan, the United States, UNDP, Spain, and the IDB, reducing donor harmonization. However, representatives of these donor agencies could attend the

<sup>21</sup> Interviews with several donors in Nicaragua, March 2009.

<sup>22</sup> Interviews The Hague May 2009.

meetings of the Budget Support Working Group and the Budget Support Technical Working Groups (established by sector) as observers, at least until early 2008. This facilitated the flow of information and thus donor coordination to some extent. However, along with these coordination mechanisms for the operation of GBS, other donor coordinating bodies continued to exist: the Mesa Global (Broad Roundtable) for the representatives and ambassadors, and sector roundtables for the donor agencies' sector specialists and representatives of the government sector agencies. The Mesa Global's task was to carry on the overall dialogue between donors and government, and the sector roundtables dealt with the dialogue around all aid activities. This implied continued high transactions costs for both the government and for donor representatives. In the first year of the JFA (2005), the co-existence of the Mesa Global with high-level meetings on budget support caused some irritation among government officers, because it led to a duplication of discussions (Guimarães and Avendaño, 2007). In later years, however, the importance of the Mesa Global was greatly reduced.

In the course of time, the composition of the JFA donor group changed. With a new representative in Nicaragua, the IDB finally joined at the end of in 2007. On the other hand, the headquarters of two bilateral donors decided to phase out their assistance to Nicaragua and therefore to also finish their budget support: Sweden made this decision in 2007 and the UK in 2008. Sweden continued to be a member of the group until early 2008 and DfID until early 2009. At the end of 2007, the German Parliament suspended general budget support worldwide awaiting a study of this modality by its National Audit Office. Although the conclusions in March 2008 were not negative, governance became even more important as an entry condition for Germany. No new disbursements were announced but the country continued to be a member of the BSG.

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Although observers (donors not contributing to budget support) could still participate in the BSG meetings, in 2008 they were no longer admitted to the meetings with the government.<sup>23</sup> This was probably related to the fact that the political dialogue between donors and government was deteriorating. Donors qualified the non-invitation of observers to the 2008 mid-year meeting as indicating a reduced openness of the government.<sup>24</sup> At the end of 2008, the active members of the BSG were the European Commission, Finland, the Netherlands, Norway, Switzerland, the IDB and the World Bank, while Germany was a non-contributing member.

Most donors that did participate in the JFA continued with other aid modalities as well. GBS implied between 25 (WB) and 90 (EC) per cent of total aid from these donors. This means all these donors were also still involved in project aid and/or in sector support; modalities in which harmonization in Nicaragua was less advanced than in general budget support. However, given the risks involved in GBS, this use of different aid modalities was probably a good choice.

<sup>23</sup> In 2009, observers were again invited to a high-level meeting.

<sup>24</sup> According to the Report of the meeting.



With respect to donor harmonization *within* the JFA, the text of the JFA holds that bilateral agreements between individual donors and government take precedence over the JFA. Some specific bilateral conditions are already included in the JFA, for example, that the Nicaraguan Parliament has to approve a budget consistent with PRS priorities (Switzerland) or that Nicaragua must be on schedule with payments to KfW (for Germany). The World Bank continues to identify specific disbursement “triggers” related to its PRSC. Both the EC and Switzerland apply a so-called split response mechanism: part of disbursements (the “fixed tranche” in the EC system and the “general portion” in the Swiss system) are linked to a general assessment of the PAM and the fundamental principles. Another part is linked to the degree of performance in specific indicators. For Switzerland these are indicators linked to Public financial management and private sector development (each 25% of total flow). The EC defines “variable tranches” for each of its sector budget support programs. In the EC education sector program, for example, results in the education sector in year n-1 and during the course of year n are assessed, and disbursement of the variable tranche in year n+1 can be 0%, 50% or 100% depending on the degree of fulfillment. More implicitly, all agencies have their own priorities within the PAM and the fundamental principles, and these priorities will heavily influence actual disbursement. Chapter 3 deals with the different donor responses to breaches in compliance with the conditions.

### 2.3.3 Extent of national ownership

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As described above, providing GBS was an initiative of the donors. The donors began discussing the idea and also began discussing among each other the indicators and policies for the PAM. The President and the highest government officers had an interest in receiving as much donor support as possible, especially since domestic support was so limited. The Ministry of Finance obviously had an interest in receiving the funds because GBS funds are transferred directly to it.

However, although there was government ownership of the *idea* of GBS, ownership of JFA and PAM was partial. With respect to the fundamental principles, donors and the executive agreed to a large extent: for example on the adherence to democratic principles, an independent judiciary, the rule of law, and the need for macroeconomic stability. But this ownership was limited to top political officers of the Bolaños government and did not extend to the dominant political parties or the National Assembly.

On the other hand, representatives of the government expressed that there was very little government ownership of the PAM (with the exception of macro-economic stability and PFM). This already held for the PRSC: negotiators at the time felt that they had very little influence on the policies and indicators included in the PRSC. There was “heavy conditionality”.<sup>25</sup> This did not change with the PAM. The indicators reflected donor interests, much more than government interest (Gosparini et al., 2006). Donors, including the IDB that ended up not-signing, tried to use the PAM for influencing government sector policies - in sectors in which they also carried out projects. In fact, many of the targets and indicators reflected current donor projects. The Ministry of Finance, which was the

<sup>25</sup> Interviews government officers, 2004.

coordinating agency for budget support, felt uneasy with several policy conditions as they often concerned the work of other ministries and there was little coordination *within* the government. This was even worse if donor wishes had to be met by agencies on which the executive had no control whatsoever, such as the SAI, the Judiciary and the National Assembly. During the second year of the JFA, 2006, the coordination with line agencies went somewhat better. This was partly due to PAI-NIC, the technical assistance program of the European Commission.<sup>26</sup> According to the donors, the dialogue with the government improved during the second year because they (the donors) also began to meet directly with the National Assembly and with the SAI.<sup>27</sup> All in all, the government representatives felt that GBS was accompanied by heavy conditionality. For the amount of influence the donors tried to exert, they provided far too little money, in their view.<sup>28</sup>

With the new government from early 2007 onward, the national ownership changed. The Ortega government had an interest in continuing GBS, basically because of the freely spendable funds. But this government did not subscribe many of the fundamental principles, and attempted to eliminate them from the JFA. This was not accepted by the donors and the JFA was not changed. Nevertheless, the donors were willing, in principle, to continue GBS and decided to give the government the “benefit of the doubt”. As will be analyzed in the next chapter, this led to increasingly difficult discussions on elements of, or related to, the fundamental principles.

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On the other hand, ownership of the PAM increased. During its first annual meeting, the government made it clear that it wanted to change the PAM in order to bring it more in line with its own priorities. After intensive discussions, a new PAM came about, with fewer indicators and policies. According to all respondents, these indicators and policies were more realistic and easier to achieve than the previous ones. Some donors even qualified some of the new indicators as having little validity.<sup>29</sup> It was clear that this time it was much more the government’s PAM.

### 2.3.4 Amounts of GBS 2005-2008

The Central Bank of Nicaragua registers all aid disbursements (loans and grants) to Nicaragua and keeps track of “liquid” aid resources versus aid directed to projects. Liquid resources is in fact program aid. After 2000, budget support (general or sector) was its largest component, although there was still some balance of payments support. Table 2.1 shows that program aid in general, and budget support in particular, has been small relative to total aid disbursements 2000-2008, although in 2004 (pre-JFA), 2006 and 2007 the amounts were substantial and exceeded USD 100 million. In the years 2004 and 2006, budget support constituted more than 10 per cent of the government budget (and about 2.5% of GDP), but in other years this share was more modest. Yet, total aid in most years

<sup>26</sup> Interview former government officer, March 2009.

<sup>27</sup> Interview with donor representatives 2006.

<sup>28</sup> Interviews government officers, 2006.

<sup>29</sup> For example, the share of women benefiting from the new Hambre Cero program (handing out cattle to poor rural inhabitants) was not considered a good indicator for gender equality or women’s rights.

amounted to more than half of the budget and more than 10 per cent of GDP. It is clear that project aid was still the dominant aid modality.

On average, program aid represented 13.3 % of total aid between 2005 and 2008, and 5.9 % of total expenditure. This is higher than between 2001 and 2004, when the relative figures were 7.2 and 4.2 %, respectively. However, if we look at a longer time frame, program aid has become less important. Between 1995 and 2000, the share of program aid in total aid was 22% (Dijkstra & Komives, 2008), see also Figure 1.3.

Table 2.1 also shows that year-to-year fluctuations in budget support disbursements were large. This is to a large extent due to ups and downs in the policy dialogue with the government (see next chapter).

The European Commission was the largest budget support donor between 2005 and 2008, with 24.7 percent of total resources provided (Table 2.2). The World Bank and IDB also provided large amounts - but these banks disbursed loans, not grants.<sup>30</sup> The Netherlands was the third donor and the largest bilateral donor of budget support, with a 16.4% share in the total.

<sup>30</sup> IDB did provide budget support, even before being a member of the JFA.

<b>Table 2.1 Budget support, program aid, and total aid (in millions of USD, and in per cent if so indicated)</b>											
	2000	2001	2002	2003	2004	2005	2006	2007	2008	Average 2001-04	Average 2005-08
Total budget support	7.9	0.0	31.2	25.2	109.3	40.2	131.9	98.5	30.0	41.4	75.2
Loans	0.0	0.0	14.9	0.0	50.9	5.2	62.6	45.7	0.0	16.5	28.4
Grants	7.9	0.0	16.3	25.2	58.4	35.0	69.3	52.8	30.0	25.0	46.8
BOP support	4.0	3.7	2.7	2.4	1.1	11.2	0.7	10.6	0.8	2.5	5.8
Total Program aid	11.9	3.7	33.9	27.5	110.4	51.3	132.7	109.1	30.7	43.9	81.0
Total aid	544.0	536.0	527.0	586.0	652.0	565.0	640.0	689.0	413.0	575.0	577.0
Budget support as % of total aid	1.5	0.0	5.9	4.3	16.8	7.1	20.6	14.3	7.3	6.7	12.3
Program aid as % of total aid	2.2	0.7	6.4	4.7	16.9	9.1	20.7	15.8	7.4	7.2	13.3
Total public expenditure, USD, budgeted	847.0	1093.0	924.0	933.0	1008.0	967.0	1247.0	1385.0	1571.0	990.0	1293.0
GDP in USD	3938.0	4102.0	4026.0	4106.0	4465.0	4872.0	5294.0	5691.0	5365.0	4175.0	5306.0
Budget support as % of total expenditure	0.9	0.0	3.4	2.7	10.8	4.2	10.6	7.1	1.9	4.2	5.9
Budget support as % of GDP	0.2	0.0	0.8	0.6	2.4	0.8	2.5	1.7	0.6	1.0	1.4
Aid as % of total expenditure	64.3	49.0	57.0	62.8	64.7	58.4	51.3	49.7	26.3	58.4	46.4
Aid as % of GDP	13.8	13.1	13.1	14.3	14.6	11.6	12.1	12.1	7.7	13.8	10.9

Sources: Central Bank of Nicaragua for aid figures and GDP in USD, Ministry of Finance and Public Credit for total budgets, CBN for exchange rates; and own calculations.

Table 2.2 Budget support by donor, 2005-2008 (in millions of USD and in percent)						
	2005	2006	2007	2008	Total 05-08	In %
<b>Loans:</b>						
World Bank	0.0	30.3	25.2	0.0	55.5	18.5
IDB	0.0	29.7	14.9	0.0	44.6	14.8
Germany	5.2	2.6	5.7	0.0	13.5	4.5
<b>Grants:</b>						
European Commission	11.5	27.6	26.2	9.1	74.4	24.7
Finland	1.8	4.4	0.0	0.0	6.2	2.1
Netherlands	10.8	12.8	18.0	7.7	49.3	16.4
Norway	3.0	3.1	3.4	3.2	12.7	4.2
United Kingdom	0.6	1.9	0.0	4.8	7.3	2.4
Sweden	7.4	9.5	0.0	0.0	16.9	5.6
Switzerland	0.0	10.0	5.2	5.2	20.4	6.8
<b>Total</b>	<b>40.3</b>	<b>131.9</b>	<b>98.6</b>	<b>30.0</b>	<b>300.8</b>	<b>100.0</b>

Source: Central Bank of Nicaragua.

### 2.3.5 Predictability of the funds

The predictability of budget support resources is an element of mutual accountability in the Paris Declaration. It is important that the government knows in advance how much budget support is forthcoming, because in this way resources can be included in the budget and can be spent. If already committed budget support is not disbursed, this may affect macro-economic stability. On the other hand, if budget support is not announced beforehand and is provided at the end of the budget year, it is unlikely to be used for the goals of the donors i.e. poverty reduction. It may just be added to the reserves - which may or not be a good thing, depending on the macro-economic situation. Apart from the predictability of funds for a certain budget year, the predictability of disbursements *within* a budget year also matters. For the government, the availability of budget support by trimester is important, since the IMF assesses the reserves at the end of every quarter.

According to the JFA, donors would give indicative commitments for the next year at or just after the Annual meeting, which would be confirmed after the mid-year meeting in August. Donors would then also provide a disbursement calendar to facilitate government planning and also in order to spread disbursements throughout the year. On both these issues, there have been some problems.

Table 2.3 shows that in all years, JFA members' disbursements have been lower than commitments, and the gap was particularly large in 2005 and 2008. In 2005 disbursements were lower due to the IMF program being temporarily off track. When government and IMF had signed a "Comfort letter" (in October) and the donors finally decided to disburse, one donor had administrative problems to disburse the full amount quickly (EC) and another decided that the money would be more useful if provided within next year's budget (Switzerland). In the case of the World Bank, some prior actions for the second tranche of PRSC 1 were not met in time. The disbursement figure for 2006 therefore includes some amounts promised for 2005 (in the case of Switzerland, the 2005 pledge seems to have been repeated in 2006).

In 2007, and despite the government change, the gap between pledges and disbursements was small. In 2008, however, the gap was large. Most bilateral donors applied sanctions in view of perceived breaches of the fundamental principles, in particular the exclusion of two parties from the municipal elections, and the fraud committed in the same elections. The two banks (IDB and WB) did not disburse for legal reasons: due to all election turmoil the National Assembly did not meet at the end of 2008 so that the budget for 2009 could not be approved. The banks disbursed early 2009 (Tables 2.3 and 2.4). The EC sometimes disbursed less money than committed due a lower performance in the indicators for the variable tranche.

| 44 | With respect to actual disbursements, most budget support was disbursed in the last quarter of the year (Table 2.4 and Figure 2.1). The multilateral banks (2006, 2009) and the EC (2006) sometimes disburse in the first trimester, but usually this concerned commitments of the year before. Some bilateral donors in some years managed to disburse earlier in the year, for example Finland, Norway, Sweden and Switzerland.

In order to assess the predictability *within* the budget year, we need information on the schedule of both commitments and disbursements. For 2005 and 2006, this information is not available. However, according to interviews with both donors and government officers held in 2006, the donors disbursed in 2006 according to the agreed schedule. There was only one donor with a small delay. Among the pledges for 2007, six out of nine donors indicated when they planned to disburse, which was always in the first or second trimester.<sup>31</sup> These promises were largely not kept, with the exception of, partially, the EC (Table 2.4). For 2008, only four donors announced a calendar: World Bank (first trimester), Netherlands (second), the EC and Finland (third or fourth). In this year, the pledged money was delayed until 2009 (WB), reduced, or not disbursed at all.

In sum, GBS funds have not always been predictable over time, mainly due to perceived breaches of the fundamental principles - if the IMF program being off-track is assumed to be a breach with maintaining "sound macro-economic policies". This also reduced predictability within the budget year. The fact that most funds were disbursed in the last quarter of the year (except when commitments due in year  $n$  were disbursed in year  $n+1$ ) also complicated the government's financial management.

<sup>31</sup> Letter from the BSG's Presidency to the Ministry of Finance, 30 October 2006. The six donors were Germany, the EC, Finland, Norway, Netherlands and the UK.

	2005		2006		2007		2008		2009	
	Pledge	Actual	Pledge	Actual	Pledge	Actual	Pledge	Actual	Pledge	Actual
Loans:										
World Bank	35.0	0.0	35.0	30.3	25.0	25.2	20.0	0.0	20.0	20.0
IDB		0.0		29.7	25.0	14.9	20.0	0.0	20.0	60.0
Germany	5.6	5.2	2.4	2.6	5.1	5.7	0.0	0.0	0.0	0.0
Grants:										
European Commission	19.9	11.5	30.9	27.6	22.9	26.2	39.8	9.1	65.9	14.0
Finland	1.8	1.8	4.2	4.4	2.5	0.0	2.7	0.0	3.2	0.0
Netherlands	10.8	10.8	12.0	12.8	14.0	18.0	16.2	7.7	19.1	0.0
Norway	3.3	3.0	2.9	3.1	3.3	3.4	4.2	3.2	4.9	0.0
United Kingdom <sup>3</sup>	0.0	0.6	1.8	1.9	2.8	0.0	5.0	4.8		
Sweden	7.7	7.4	8.7	9.5	0.0	0.0	0.0	0.0		
Switzerland	5.1	0.0	10.0	10.0	5.2	5.2	5.4	5.2	4.9	0.0
<b>Total</b>	<b>89.2</b>	<b>40.3</b>	<b>107.9</b>	<b>102.2</b>	<b>105.8</b>	<b>98.6</b>	<b>113.3</b>	<b>30.0</b>	<b>138.0</b>	<b>94.0</b>

Sources for actual: Central Bank of Nicaragua. For pledges: 2005 and 2006: data obtained from BSG. For 2007, 2008 and 2009: letters from the Presidency of BSG to Ministry of Finance, respectively 30 October 2006, 14 December 2007, and 28 July 2008.

<sup>1</sup> Since donors commit resources in their own currencies, differences between commitments and disbursements may be due to exchange rate variations.

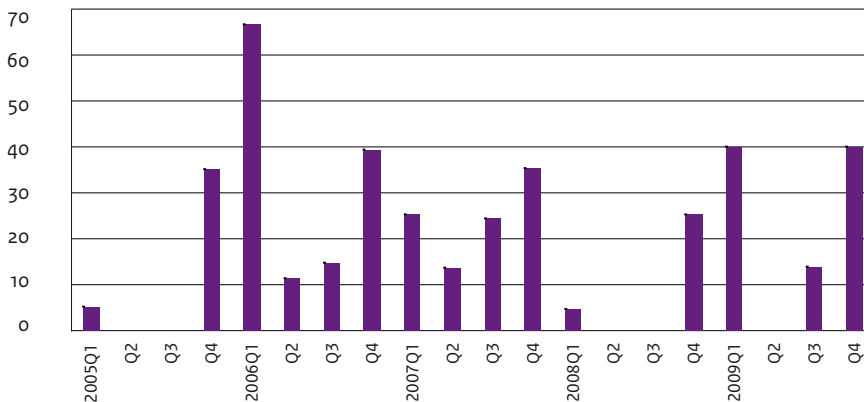
<sup>2</sup> The IDB only became a member in (end) 2007, so pledges are not known for 2005 and 2006. Source for pledge 2007: Report Mid-Year meeting 19 November 2007.

<sup>3</sup> According to BSG, the UK did disburse the pledged amount in 2007, but this has probably been sector budget support, as DfID already notified the government of this possibility in the October 2006 letter of the BSG's President.

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	2005				2006				2007				2008				2009
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
World Bank					30.3				25.2								20.0
IDB					14.9			14.9				14.9					20.0
Germany	5.2							2.6			5.7						
European Commission				11.5	11.4			16.3		8.5		17.7				9.1	
Finland				1.8		1.9		2.5									
Netherlands				10.8			12.8				15.3	2.8				7.7	
Norway				3.0				3.1			3.4					3.2	
United Kingdom				0.6			1.9						4.8				
Sweden				7.4		9.5											
Switzerland				0.0	10.0					5.2						5.2	
<b>Total</b>	<b>5.2</b>	<b>0.0</b>	<b>0.0</b>	<b>35.1</b>	<b>66.6</b>	<b>11.4</b>	<b>14.7</b>	<b>39.4</b>	<b>25.2</b>	<b>13.7</b>	<b>24.4</b>	<b>35.4</b>	<b>4.8</b>	<b>0.0</b>	<b>0.0</b>	<b>25.2</b>	<b>60.0</b>

Source: Central Bank of Nicaragua.

**Figure 2.1** Disbursements of budget support by quarter, 2005-2009 (in millions of USD)

Source: Central Bank of Nicaragua.

### 2.3.6 Alignment to national systems

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Most GBS resources were provided to the central government without restrictions on their use. In 2005, however, DfID (UK) earmarked its (small) disbursement and required that it would be transferred to municipalities (additional to the 6% of the budget that municipalities received regularly), and that it would be spent on investment. The reason was that the disbursement was late and that DfID wanted to have a big impact with its small amount of money.<sup>32</sup> This objective of course contradicts the essential feature of GBS.

The resources of the EU sector budget support programs are not earmarked in principle, but in practice the conditions for the variable tranche are so extensive that at least part of the resources must be transferred to the sector involved. This happened, for example, with the Education program. The Ministry of Education and Culture did receive a higher budget due to this program.<sup>33</sup>

### 2.3.7 Conclusions

The expected advantages of budget support for achieving aid effectiveness depend on the degree to which actual budget support arrangements further the principles of the Paris Declaration, in particular, harmonization, ownership, alignment and predictability. They also depend on volume of budget support relative to total aid. On the latter, a first thing to be noted in this respect is that important donors in Nicaragua did not engage in budget support and that budget support only represented, on average, 12% of total aid between 2005 and 2008 – the share of program aid in total aid was 13%. Although this is higher than in the period 2001-2004, it is much lower than the share of program aid in total aid during 1995-2000, which was 22%.

<sup>32</sup> Interview with a DfID representative Managua, August 2006.

<sup>33</sup> Acevedo Vogl (2007) and interviews, March 2009.



Harmonization was achieved to a large extent within the common scheme of nine (later eight) donors. Some donors maintain specific disbursement conditions, however. The Bolaños government (i.e., the executive) had a large degree of ownership of the fundamental principles (but limited political power to enforce them), but much less of many of the indicators and policies of the PAM. The negotiations were experienced as heavy conditionality. With the Ortega government it was broadly the other way around; there was limited ownership of fundamental principles, but a lot more of the (revised) PAM.

Virtually all budget support resources were fully aligned with the national budget and other national systems, but there were some problems with the predictability of resources. In 2005 and 2008 actual disbursements were much lower (45 and 26%, respectively) than pledges. In 2008, this was clearly the result of donor responses to breaches with the fundamental principles (the problems with the municipal elections). In 2005 the reason for non-disbursement was that the IMF program was off track.

On the whole, GBS helped to achieve the implementation of the Paris Declaration. However, compared to the previous decade, progress on the principles of the Paris Declaration is limited. The share of fully aligned aid in total aid is smaller, while the conditionality has increased: more donors are involved (not just the multilateral institutions) and it covers more areas of government policies and institutions.

3

Influence

### 3.1 Introduction

This chapter aims to answer the question whether the donors in general and the RNE in particular, have been able to exert influence on government policies. To a large extent, influence is the opposite of ownership. If priorities of donors and government coincide, the government “owns” the policies preferred by the donors and there is no (need to exert) influence. We can only conclude that donors had *influence* if these priorities were different at the start. We concluded in chapter 2 that under the Bolaños government there was ownership of the donors’ governance agenda but much less so of its poverty reduction agenda, while it was a little bit the other way around under the Ortega government

This chapter provides an overview of the policy dialogue and its results as conducted between government and the BSG donors between 2005 and 2008/9. It begins with a short description of the framework of this dialogue, the formal and informal channels for influence used. A next section analyzes a first result of this dialogue, namely the contents of the Performance Assessment Matrices (PAM) and the changes in it over time. This also shows the scale and scope of the attempts at influence. Section 3 describes in chronological order the monitoring and assessment of JFA and PAM. It examines the extent of compliance and the donor responses to it. Special attention is given to the Dutch responses. The next section examines the outcomes of the policy dialogue. What are the results according to the donors and what can be said about actual policy changes? In the final section, conclusions are drawn.

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### 3.2 The framework: channels of influence

The framework for the policy dialogue around budget support is set in the JFA and consists of the Annual meetings (in May) and the Mid-year meetings (in August). The aim of the meetings is to assess performance of the government in general and on the PAM in particular. The meetings consist of both plenary sessions and technical working group sessions. During the plenary meetings, high-level representatives of all signatories are present. On the government side the ministers of Finance, the Vice-Chancellor and the Technical Secretary of the Presidency participate. On the donor side participants include Ambassadors (for bilateral donors and EU) and Representatives (World Bank, IDB). The technical working groups discuss performance in each of the five (later four) matrices of the PAM. For each of these meetings, the government prepares reports of the status of execution of the PAM, and usually other documents are sent as well, such as reports on budget execution, (draft) national development plans, progress reports on national development plans and other statistical information.

Apart from these formally stipulated high-level meetings, there were many other contacts and thus channels of influence between government and budget support donors. During the years 2005-2008, there was an intensive schedule of meetings during the entire year, both of the BSG (donors only) and of all the technical working groups (with government), which intensified in the weeks before these high-level meetings. In addition, government and these same donor representatives met each other in other fora such as the Mesa Global

and the sector roundtables, and there were of course numerous informal occasions for donors and government representatives to meet, such as receptions or other celebrations. Donors also had bilateral contacts with government representatives, which they could use for exerting influence. In our analysis of the policy dialogue we focus on the formal channels as established within the JFA because this is best reported on. We add information on the other channels to the extent we know them.

### 3.3 The content of the PAM

The content of the PAM as agreed in the May 2005 JFA has changed many times. In practice, donors and government were almost continuously working on revisions: developing new indicators, discussing baseline data or sources of information, removing or changing actions and indicators. From the contents of the various matrices it is clear that the policy dialogue covered all possible sectors and areas of government policy.

The first PAM was very extensive. It contained 95 separate “actions” (policies, measures and laws) the government had to carry out over three years: 2005-2007, as well as 66 indicators, leading to a total of 161 separate items (Table 3.1). This was in line with the earlier PRSC (2004) which had contained 143 items (for three years). “Actions” often included laws to be approved by the National Assembly, or measures to be taken by entities over which the executive had little influence, such as the Supreme Audit Institution (SAI) or the Supreme Court of Justice (SCJ). The targets for the indicators were defined for two or three years: with 2004 as baseline, targets were defined for 2005 and sometimes for 2006, too.

Both donors and the government were convinced that this first PAM was too large, and in 2006 they worked on a revision. This led to a substantial reduction in the total items and especially in the number of specified actions. In itself, a shift from “actions” to indicators and targets implies an increase in results orientation - one of the principles of the Paris Declaration - and may lead to an increase in ownership and a reduction of micromanagement, as the donors monitor the *results* of policies, not the specific policies themselves. However, Table 3.1 shows that the number of “actions” was still considerable in 2006. The total number of actions and indicators also remained large. According to a government representative interviewed by one of the authors in 2006, a larger reduction in the number of actions and indicators was not only resisted by the donors, but also by the different government ministries: they all wanted to maintain their presence in the PAM. Reductions were particularly large in the area of public finance, - where many of the required changes had been accomplished during 2005 and early 2006 - , but also in the productive sector matrix.

In 2005 the content of the PAM was clearly dominated by donor wishes. Donors wanted to use budget support to influence all areas and sectors of government policy (macro-economic, public financial management, social policies, governance and the productive sector). By including all this in the PAM and given the agreed mechanism for monitoring, donors were secured of at least two moments in the year in which they could hold the government to account on this very broad range of government policies. They managed by

	2005			2006			2007			2008*		
	Actions	Indicators	Total	Actions	Indicators	Total	Actions	Indicators	Total	Actions	Indicators	Total
Macro-economic	3	3	6	3	6	9	3	1	4	3	1	4
Public finance	22	9	31	2	9	11	2	5	7	2	5	7
Pensions	4	1	5									
Decentralization	2	1	3	2	1	3						
Tax revenues	4	1	5	0	3	3	0	1	1	0	1	1
Civil service	2	1	3	0	2	2	0	1	1	0	1	1
Public finance management	7	3	10	0	2	2	1	3	4	2	2	4
Public procurement	2	1	3	0	1	1						
Auditing	1	1	2	2	1	3	0	1	1	0	1	1
Productive sector	33	14	47	14	13	27	7	7	14	12	6	18
Competition and competitiveness	8	4	12	4	3	7						
Land	8	4	12	4	4	8	1	1	2	2	1	3
Environment and natural resources	4	1	5	1	1	2						
Rural development	3	1	4	1	1	2	2	1	3	3	1	4
Energy	6	2	8	1	1	2	1	2	3	1	2	3
Finance	2	1	3	1	1	2	2	1	3	4	1	5
MIPYME				1	1	2	1	1	2	2	1	3
Infrastructure (roads)	2	1	3	1	1	2	1	2	3	2	1	3
Social and public services	15	24	39	19	15	34	5	7	12	7	7	14
Poverty	1	2	3	2	2	4	1	1	2	2	1	3
Education	1	2	3	3	3	6	2	2	4	3	2	5
Health	9	14	23	9	7	16	1	2	3	1	2	3
Water, environment	4	5	9	5	3	8	1	2	3	1	2	3
Governance	22	17	39	8	17	25	6	7	13	11	8	19
Judiciary, including access	8	10	18	1	5	6	1	2	3	1	2	3
Security	5	1	6	0	2	2						
Citizen participation, access to information	2	1	3	0	1	1	1	1	2	3	2	5
Human rights and women's rights	5	3	8	2	5	7	2	2	4	3	2	5
Transparency and corruption	2	2	4	3	3	6	1	1	2	2	1	3
<b>Total</b>	<b>95</b>	<b>66</b>	<b>161</b>	<b>48</b>	<b>61</b>	<b>109</b>	<b>23</b>	<b>29</b>	<b>52</b>	<b>37</b>	<b>28</b>	<b>65</b>

\* The 2008 PAM looks bigger than the previous one but the 2008 PAM includes actions for 2008 and 2009, while the 2007 PAM only covers actions for 2007

and large to include their priorities, but with a few exceptions. For example, due to lack of data, no information was included on the flow of budget resources to poor areas nor were data gender disaggregated (Gosparini et al., 2006).

In 2007, the (new) government started to propose the new indicators, which were then negotiated with the donors (Guimarães & Avendaño, 2008). It was a complicated process which took a long time, but it led to a further reduction. The macro-economic and public finance matrices were combined into one “macro-economic and financial” matrix, and the other matrices were streamlined. In fact, many topics that had been important for the donors were no longer included, leading to a total of only 52 items to be monitored. Another change was that the matrix no longer contained actions for which the executive was dependent on the National Assembly. Only in one case, the government was to “promote” (*impulsar*) a law approval. In 2008, the PAM did not change much although on the action side, new measures were added. Most indicators were maintained. All in all, as also concluded above (2.3.3), the degree of government ownership of the PAM was much larger than under the previous administration.

### 3.4 The monitoring and donor responses

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As analyzed above (Chapter 2), it was not at all clear how the donors were going to use the JFA and the PAM. What would be defined as a “breach” with the fundamental principles (many of which were not met at the start)? And when would performance with the PAM be assessed as “insufficient”? It could be expected that the government would not be able to comply with all 161 items to the full extent, but it was not clear what would be the minimum compliance level for disbursements. In the following, we describe the degree of compliance and the donor responses to it.

Year		Complied	Not complied or remarks	Degree of compliance
2005	45 actions	25	23	45%
	62 indicators	20	32	32%
2006	32 actions	13	19	41%
	55 indicators	16	39	29%
2007	24 actions	18	6 in 2008	67%
	28 indicators	25	3	89%
2008	24 actions	10	14 with 50% progress	
	28 indicators	9	19 with 50% progress	

Source: Interview with government coordinator for budget support, March 2009.

Table 3.2 suggests that there was an increase in compliance with the PAM over time, and in particular between 2006 and 2007. This is not surprising, as the policies, targets and indicators for 2007 and 2008 were not only much more owned by the government, but also easier to achieve. Another reason why this overall compliance is not such a valid indicator for influence is that not all actions and indicators are equally important. For this reason we

analyzed the reports of the Annual and Mid-Year meetings in order to find out in which areas compliance and non-compliance was important to the donors and to what extent donors succeeded in improving compliance.

### 3.4.1 The period 2005-2006<sup>34</sup>

Two weeks after the signing of the JFA the first annual meeting was held. Donors were satisfied with the overall performance, but had a number of concerns. These involved the governance matrix, in particular the lack of cooperation of the Supreme Audit Institution (SAI) and the lack of progress in the fight against corruption, but also the social matrix where concerns were expressed on the low efficiency and equity of expenditure in health and education, leading to a worrying *decrease* in primary school enrolment. But the donors were most concerned with the lack of progress in some structural reforms that were considered important for maintaining macro-economic stability, and that upheld the IMF program (the PRGF).<sup>35</sup> These were laws that the National Assembly had to pass but did not, because of tensions between the executive and the two main political parties.<sup>36</sup>

In the weeks after this first Annual Meeting, the donors had an intensive debate on whether the fact that the IMF program was “off track” was a reason for withholding budget support. They finally achieved a consensus. They notified the government that they wanted to see a Comfort Letter from the IMF (to be requested by the government), which would confirm that there were no problems with macro-economic stability in the short term, but that the only reason for the program being off track was that some structural measures had not been taken. In the meantime, donors suspended budget support disbursements.

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Most donors expected that publication of this Comfort letter would be a matter of a few weeks. In practice, it took until early October before the IMF wrote this letter. Moreover, according to most observers, it was not a Comfort Letter but rather a “Discomfort letter”, because it contained a long list of *additional* government measures and laws that had to be approved (Guimarães & Avendaño, 2007).

The Mid-Term Meeting was held on 30 September, when it was clear that the IMF was going to write the Comfort Letter and that the suspension could be lifted soon. Donors were satisfied with improvement in public finance management but they pressed for an independent audit of the budget. Progress in the productive and governance matrices was mixed, while in the social area many targets were missed and often with a large margin. Donors raised concerns on the volume of “poverty expenditure” and on its quality.

<sup>34</sup> Unless otherwise indicated, sources in this and the following section are the agreed minutes (Ayuda Memoria) of the Annual and Mid-Year meetings.

<sup>35</sup> The PAM did not have its own indicators for macro-economic stability, but instead stipulated “to be defined by the IMF”.

<sup>36</sup> These included a law to improve the budgeting process (Financial Administration Law), a reform of the tax equity law, and laws to address and mitigate the increased government expenditure as a result of an earlier approved pension reform and as a result of increased transfers to municipalities (a donor priority) without expanding their responsibilities.

After this meeting the (Dis)Comfort Letter appeared and the government agreed to it. This Letter had several consequences (Guimarães and Avendaño, 2007). First, the sheer existence of the Letter made donors release most of their promised disbursements for 2005.<sup>37</sup> They also confirmed their earlier promises for 2006. Second, this agreement, backed by pressure not only from the IMF but also by all budget support donors, pushed the National Assembly to discuss and approve many of the required laws. Thirdly, the IMF agreed to an extension of the PRGF until end of 2006.<sup>38</sup> In January 2006, an agreement on the PRGF extension was achieved. It included that the government had to send many more law proposals to Parliament before 31 August of that year, and one particular law had to be approved as well.

When donors reflected on these events, they were satisfied with their harmonized response. However, some donors regretted that budget support disbursements had become dependent on IMF judgment, and in practice also on delays in IMF missions. DfID organized a survey among donor representatives in Managua to investigate how and at what level budget support decisions were made, and how important an IMF agreement was. It turned out that for most donors it was not formally necessary that an IMF program be on track. However, the IMF's opinion on the macro-economic situation was always an important input in the decision, and it would be difficult for most representatives to defend disbursements to their headquarters in case of a negative IMF assessment.

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In order to reduce dependence on the IMF, donors began to develop their own indicators for macro-economic stability for the revised PAM in 2006. However, the selected new indicators all formed part of the IMF program as well. Another lesson from the events in 2005 was that donors planned to intensify the policy dialogue with those powers over which the executive had little influence: the National Assembly, the SAI, and there were also plans to talk to the Supreme Court of Justice and the Electoral Council.<sup>39</sup>

The 2006 Annual Meeting was held according to schedule, on 16 and 17 May. The donors applauded the government for meeting the IMF targets so far and for the fact that some important laws had been adopted by the National Assembly. Progress was again observed in financial management. In the productive sector, ten out of fourteen indicators showed satisfactory performance. Governance performance was in general satisfactory, but not in all aspects. Donors complained on the fact that no regulations were approved for the Judicial Career Law so that this law - itself the result of donor pressure - could not be implemented yet. The representative of the Supreme Court of Justice (SCJ) informed the donors that the approval of the regulations would soon follow. In the social area, four out of six policies were implemented, but only nine out of 24 indicators were met. Several indicators were not available due to the fact that the results of the Census and of the Living Standard Measurement Survey (LSMS), carried out in 2005, were not yet available.

<sup>37</sup> A government officer told us that despite the government not complying yet with the IMF or with the poverty indicators of the PAM, donors disbursed quickly, because there was a threat of a possible coup d'état by the two political parties of the Pacto.

<sup>38</sup> This was remarkable, since 2006 was the year of presidential elections and usually the IMF is cautious in those years.

<sup>39</sup> Interviews held in August 2006.



The mid-year meeting was held on 5 and 6 October 2006. With respect to public finance management, the donors requested to make a new procurement law, because the complexity of the recently approved law (in accordance with IDB standards) induced many state entities to request *and* obtain exemptions, so that in practice the law was not implemented. In the productive and social areas, there was progress on the majority of the agreed actions. However, there was still no information from the LSMS so that progress in actual poverty reduction was not known. By this time, the majority of donors began to have doubts on the intentions of the government in the area of poverty reduction.<sup>40</sup> Furthermore, rumors held that results were not very positive and that the government was hiding them until after the national elections.

Under the strategic themes discussed in the plenary, there was again a discussion on the *quality* of social spending, as the higher volume did not seem to translate in improved social indicators. Donors also continued to complain about the failure to adopt the regulations for the Judicial Career Law. Another “strategic theme” brought up by the donors was the external auditing of the 2005 budget. The Supreme Audit Institution (SAI) had still not started this auditing, despite the additional budget allocated to it. Apparently, the SAI had used this money for raising salaries. It requested additional funds. The donors made it clear that the now committed budget support funds for 2007 could only be disbursed if the results of the auditing would be presented.

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During 2006 disbursements were only slightly lower than commitments.<sup>41</sup> The World Bank reduced disbursements because the country missed one trigger in 2006. The EC reduced its variable tranche on the education budget support program with € 1 million due to the decrease in the primary school enrolment rate.

### 3.4.2 The period 2007-2008

Early 2007, the new FSLN government of President Ortega began its rule. This changed the context for the monitoring of the JFA and the PAM. In fact, this change already began at the end of 2006, when the National Assembly approved the penalization of therapeutic abortion, with support of the FSLN. This gained the FSLN important support from the conservative Catholic Church in the upcoming presidential elections.<sup>42</sup> Another change was that the group of donors participating in the JFA gradually became smaller.

Most donors gave the new government the benefit of the doubt, and began to monitor its actions. These actions sent mixed and confusing signals. On the positive side, the government showed a willingness to maintain macro-economic stability and negotiated an agreement with the IMF (achieved in October 2007). Furthermore, it showed a much higher priority for poverty reduction. It announced free education and health care services, and

<sup>40</sup> Interviews August 2006.

<sup>41</sup> According to Table 2.3, actual disbursements were *higher* than commitments, but this is caused by delayed transfers of the 2005 commitments.

<sup>42</sup> In fact, the Bolaños faction was in favor of an even more conservative version of the law than the FSLN (interview RNE staff March 2009).

introduced special programs for the poor, such as *Hambre Cero* and *Usura Cero*.<sup>43</sup> The aim of these programs is to make the poor more productive. The government also appeared willing to maintain the improvements in public finance management and managed to make an end to the proliferation of well-paid consultants in the public sector. On the other hand, there were signs of decreasing government transparency and more concentration of power in the hands of the President and his wife. The government began to receive large amounts of aid from Venezuela but these funds were managed in a non-transparent way, thus providing rumors that they were primarily used for party interests - in particular, securing re-election of President Ortega - rather than state interests. The government wanted to foster direct democracy by installing CPCs, Citizen Power Councils, but this raised concerns of possible exclusion on party-political basis. The donors were divided on how to respond to these developments.

In this context, the first Annual Meeting with the new government took place on 10 July, so with a slight delay. The government reported the progress in 2006 on the previous PAM, on the expectation that a new matrix would be agreed upon soon. The results of the 2005 Living Standards Measurement Survey were now presented but they were indeed not very positive on the poverty incidence, and more than half the indicators of the Social matrix of the PAM were not met. In the plenary session several “old” strategic themes were discussed, such as the independence of the judiciary (only 25 of the 120 required regulations now approved), the audit of the budget (2005 now done but implementation of the recommendations necessary, as well as secured funding for the audit of the 2006 budget), and the quality of social spending. There were two new themes. First the donors made it known that sexual and reproductive rights of women are part of the fundamental principles and that they would closely monitor maternal mortality as a way to assess the practice with respect to therapeutic abortion.<sup>44</sup> Second, and as the government had rejected the NDP, the donors requested a new national development plan. It was not enough for the government to present its policy priorities.

During the Mid-Year meeting on 19 November 2007 drafts for a new PAM were discussed. Many of the same strategic issues were brought up as well. The government presented a plan for the audit of the 2006 budget, and promised to elaborate a National Human Development Plan. Donors emphasized the importance of citizen participation and access to information for *all* citizens, not just members of CPCs.

The 2008 Annual meeting was held on 23 May. By this time, the external economic situation began to deteriorate with rising food and especially oil prices, leading to higher inflation and an increasing current account deficit. The first revision of the PRGF in March 2008 had not led to a release of the second tranche, although quantitative targets were still met. The IMF demanded control of illegal energy consumption and transparency on the volume,

<sup>43</sup> The first implies handing over a cow, a pig and a hen to a poor household, the second is a transfer of credit to female micro and small enterprises at an annual interest rate of 4%.

<sup>44</sup> However, this was problematic. First, maternal mortality has many more causes than the legal prohibition of therapeutic abortion, and second, reliable figures on maternal mortality (from the Demographic and Health Survey) are only available once in about five years.

terms and uses of the loans from Venezuela.<sup>45</sup> It also worried about the consequences of the negotiations that the government had started on the payments on government bonds (Negotiable Investment Certificates or CENIs) that were mostly held by domestic banks. Some members of the Board of the Central Bank had stepped down and the IMF requested replacements. The donors expressed these same concerns during the Annual meeting.

The final version of the new PAM had only been completed in March of that year. Many of the indicators were achieved but there were important exceptions such as the number of cases passed on by the Prosecutor General to the courts. The approval of the Regulations for the implementation of the Career Law moved slowly: 107 of the 142 articles were now approved. The donors were also concerned with the delays in the audit of the 2006 budget and with the lack of institutionalization of this external auditing. As the SAI required more money for doing the audit, the IDB offered to finance this as part of its promised technical assistance grant. This was accepted by the government - reluctantly so by the other donors. The law on access to information had been approved, but was only applied in five institutions. Donors complained about the lower transparency of government institutions. They applauded the first draft of the PNDH but did not approve its contents yet: it contained a "lot of ideology" and was not sufficiently operational. This held up disbursement of the fixed tranche of one of the EC programs.

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The Mid-Year meeting took place on 25 September 2008. The IMF had finally approved the first revision of the PRGF. Information on the amount and uses of Venezuelan aid was now made available, and re-establishment of the Central Bank Board was at hand.<sup>46</sup> On the other hand there were rising tensions between donors and government on issues related to the fundamental principles. In June, the Supreme Electoral Council had taken away the legal personality of two political parties that aimed to participate in the municipal elections of November 2008. During the meeting, donors raised concerns about the possibility for free and fair elections, and about government harassment of civil society representatives.

With respect to the PAM, a lot of progress was observed. According to Ministry of Health figures, maternal mortality rates were declining, for example. The regulations for the SCJ were finally approved and the 2006 auditing had just been received. The government was urged to include more ambitious indicators and targets on several objectives.<sup>47</sup> And donors complained about decreasing transparency and possible corruption in public procurement due to the systematic exemptions granted.

The government, on the other hand, worried about the lack of predictability of the 2008 disbursements: hardly any had been received. The donors responded that disbursements were upheld by the discussions on the fundamental principles and for some (EC) also for "technical reasons" (the non compliance with specific conditions). The donors considered the exclusion of two political parties from the elections and the lack of a decision on

<sup>45</sup> IMF Press releases 08/45 and 08/147, <http://www.imf.org/external/country/NIC/index.htm> accessed 14 September 2009.

<sup>46</sup> <http://www.imf.org/external/np/sec/pr/2008/pro8204.htm> accessed 14 September 2009.

<sup>47</sup> For example, the number of institutions applying the Law on access to information was set too low.

allowing external observers as signal of a weakening democracy in Nicaragua and the former also as a breach of the fundamental principles.

Both sides considered the quality of the policy dialogue to have deteriorated.<sup>48</sup> The donors perceived the government as non-responsive to their demands and called it a dialogue with deaf people, (*sordos*). The government complained that discussions were no longer on the PAM or on poverty reduction but only on issues related to the fundamental principles – while the principles themselves were formulated vaguely and it was not clear how the government would be able to satisfy the donors. In view of the dominance of political issues in the dialogue around budget support, the government decided to transfer the coordination of budget support from the Ministry of Finance to the Ministry of Foreign Affairs.

In the meantime, donors did no longer succeed in unifying their responses. For two BSG members, namely the World Bank and the IDB, governance issues were no reason to stop disbursements. They disbursed in 2007 and intended to do so in 2008 as well. From mid-2008 onwards, the other members of the BSG began to make different assessments of the political and governance situation in the country. In practice, a first division was already evident early 2007 when Sweden and Germany took the penalization of therapeutic abortion much more seriously than the other budget support donors.<sup>49</sup> Although Sweden and DfID no longer disbursed in 2008, they were still present in the meetings with government and usually they were the first to take the floor and criticize the government. This caused some resentment among the other donors. Germany also had its own reasons for not contributing anymore since the end of 2007: discontent on governance issues but also a dispute with the government on the appreciation of private water supply. A government change in Finland led to a harsher stand towards the Nicaraguan government, and Finland suddenly stopped disbursements in 2008. At the end of September 2008 the Netherlands decided to halve the committed amount for 2008 due to the exclusion of the two political parties. Decisions in both Finland and the Netherlands were taken at headquarters without much consultation with the other members of the BSG.<sup>50</sup> Norway, Switzerland and the EC did disburse at the end of 2008, but the EC disbursed only a small amount relative to commitments due to lack of compliance with several conditions for the fixed and variable tranches of its programs, so-called “technical reasons”.

On 9 November 2008, the municipal elections were held and there was clear evidence of fraud. According to the final report of the authoritative Nicaraguan civil group *Ética y Transparencia*,<sup>51</sup> at least 33 and probably around 40 mayors (out of 146) were elected in a fraudulent way. Within a few days after the elections, protesting against this fraud led to demonstrations in the streets but the government suppressed them by force, leading to casualties. The opposition parties in the National Assembly also protested and the National Assembly refused to meet. This implied, among other things, that loans from WB and IDB could not be disbursed as by law they have to be approved by the National Assembly.

<sup>48</sup> Interviews with government and donor representatives, March 2009.

<sup>49</sup> The protesting against this measure was left to the Mesa Global in which the UN took a leading role.

<sup>50</sup> The Netherlands at least *informed* the other members of the decision.

<sup>51</sup> Published in *Revista Envío* No. 332, March 2009. <http://www.envio.org.ni/articulo/3952>

After the election fraud, the European Commission, Finland and the Netherlands froze budget support for 2009. Switzerland and Norway were the only bilateral donors still considering disbursements, but they came in a difficult position. Norway, in particular, preferred to disburse in view of the predictability objective, but did not want to be the only bilateral donor to do so. The BSG continued to discuss their response. Donors did not agree on the demands to be forwarded to the government and on what exactly the government would have to do in order to unfreeze disbursements. This ranged from the *undoing* of the results of past elections to providing guarantees for free and fair *next* elections. The EC also required an improved version of the PNDH. In the meantime, the financial situation of the government deteriorated rapidly. Due to the global economic crisis, lower growth and lower tax revenues were expected, and the lower oil price reduced the aid volume from Venezuela. All this came on top of the about USD 60 million budget support forgone in 2009. This made the government willing to at least talk to the budget support group.

When discussions with the government were resumed, the BSG attempted to coordinate also with the US Embassy especially on its Millennium Challenge Account (MCA), money that is also conditional on governance. In response to the election fraud, the US government had decided to freeze the MCA. A definitive decision would be taken before 1 April. In coordination with the BSG, this was later postponed to 1 July to give the government more time for an appropriate response. Norway did not want to maintain uncertainty any longer, and decided to discontinue budget support and leave the BSG in May 2009. By 1 July, the MCA was definitely cancelled.

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In May and June, the BSG discussed with representatives of the government on three themes: macro-economic issues, the PNDH and governance. The latter included an attempt to install a national dialogue with the opposition on the past elections. On the government side, high party leaders participated. No results were achieved, however. A next series of discussions focused on guaranteeing free and fair *next* elections. The BSG formulated four concrete demands, with the intention to link partial disbursements to their compliance - although it was clear that not all remaining donors of the group would (or will) do so. These demands included:

- Allowing national and international observers
- Making improvements in the registration of voters
- Rehabilitation of the two parties that had been excluded
- Improving the credibility of the Supreme Electoral Council by appointing new officers.

In July, the government announced that it would admit observers to next elections, i.c. the March 2010 elections in the Atlantic (Eastern) regions. In response, the EC unfroze €10 million of its budget support resources, earmarking this money to the education sector. This was again a decision made at headquarters, with no consultation with the other BSG members. Switzerland was *ex post* willing to join the EC, but did not want to be the only bilateral donor doing so. For the Netherlands, unfreezing was not considered appropriate yet. However, in practice national observers were not admitted to these elections and the two earlier excluded political parties were not allowed to participate. Other breaches of

democratic principles were also observed. For these reasons, the EC did not see any reason to unfreeze budget support in 2010 and in May of that year the Dutch government decided to not extend the JFA. Finland came to the same conclusion and Switzerland also followed, implying that no bilateral donors remained in the BSG.

### 3.4.3 Dutch monitoring and responses

In 2006, the Dutch were in general satisfied with the possibilities to jointly influence government policy in the budget support group. When confronted with the possibility that data might show that the poverty incidence did not decrease between 2001 and 2005, the response of Dutch staff of the Royal Netherlands Embassy (RNE) was that in that case “we”, donors, had done something wrong in the policy dialogue. At the same time it was admitted that a government failure to reduce poverty might be a reason to reconsider budget support. In view of these concerns, the RNE was preparing a study on the possibilities for “trickle down” in Nicaragua.<sup>52</sup>

The National Assembly’s decision to penalize therapeutic abortion gave rise to a debate within the Ministry of Foreign Affairs in the Netherlands. Some considered this a violation of human rights and thus a reason to suspend budget support. Others argued that predictability of budget support was important; disbursements should not be reconsidered after these kinds of political events. In June, 2007, Dutch Development Assistance minister Koenders visited Nicaragua and he transmitted a strong discontent to the Nicaraguan government about the abortion policy, but there was no threat of sanction.

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According to the MASP 2008-2011, the Embassy expected that by emphasizing good governance, and also by supporting sustainable economic development and social services, it could “contribute to creating an inclusive and more equitable society.” (RNE, 2008: 2). The policy dialogue around budget support would again be the instrument to foster governance and transparency. In 2007 and 2008, the dialogue was used to continue the struggle for the external audits of the budget execution and for a more independent judiciary. It was also used for monitoring the government policy for women’s rights and its attention for mother and child care. In addition to this, the Netherlands along with the other donors expressed criticism on the decreasing transparency of the government, the party-political use of the CPCs, and the limitations set to the work of NGOs.

The Supreme Electoral Council’s decision to withhold legal personality of two political parties came in June 2008, just after the Annual meeting and just before the donors would make known their disbursements for 2008 and their commitments for 2009. The RNE proposed the Netherlands’ government to make a signal by halving the amount committed for 2008 that was due in the third quarter. It was hoped that this would put pressure on the government to eliminate this decision so that the two parties would still be able to participate in the elections. There was no immediate response from The Hague. Early September Minister Koenders met in The Hague with Minister Santos of External Relations of Nicaragua, but also after this talk no decision was made. At the end of September, the

<sup>52</sup> Interview of one of the authors with Embassy staff, August 2006.

government decided to halve the disbursements for 2008. In the view of the RNE, the fact that the decision was made so late implied that the Embassy could not use the *threat* of suspension in the political dialogue in Managua.

After the observed election fraud, the Embassy proposed to follow the EC and freeze disbursements for 2009. In The Hague, there were again different opinions. The regional department agreed with RNE but the budget support department preferred to postpone such a decision until January 2009, when the Track Record would have been made up and a full assessment of the government could be made. This would have led to a more balanced decision, taking into account the successes achieved so far in the policy dialogue, and the fact that this government did a lot more for reducing poverty. The Minister, however, decided to freeze the full 2009 amount.

During the next months, the RNE again wanted to continue the dialogue with the government of Nicaragua. By luring with the carrot, it hoped to induce political concessions. Negotiations *within* the BSG were difficult, but it was also difficult to convince the Dutch government. In March, the Embassy proposed to define minimum actions of the Nicaraguan government necessary for unfreezing the support. The Dutch government preferred to wait for Nicaraguan actions and did not want to define precise criteria. In 2010, the JFA was not extended (see above).

### 3.5 Results of the policy dialogue

According to the above analysis, important topics in the policy dialogue have been the volume and quality of poverty expenditure, the transparency of budgets and the auditing of budget execution, the Judicial Career Law and its Regulations, and the Law of access to information. In later years, political issues also became important, including for most donors (and certainly for the Netherlands), the area of women's rights. Table 3.3 gives an overview of the achievements of the policy dialogue in these areas. Column 2 lists the formal successes as the donors tend to see them, column 3 puts them in perspective, and column 4 shows the real results in these areas, based on interviews with other stakeholders such as government representatives and independent observers. The actual donor influence in these four specific areas (poverty expenditure, government transparency, rule of law, and democracy & human and women's rights) will be analyzed in more detail below.

We start with discussing some other perceived achievements of the policy dialogue. One such achievement is the coming into being of the National Development Plan as "Second PRSP" in 2005, on which budget support could be based. For this plan regional and municipal consultations had been held, with donor financing, but that proved insufficient for the plan's sustainability after the elections. The new government rejected this plan as it had other priorities, and in particular, other political priorities. Under donor pressure, it began to write its National Human Development Plan (PNDH) but in 2008, the plan was considered to be more a political manifest than a development plan, with a lot of attention for the Citizen Power Councils (CPCs). In 2009, the government elaborated a "Technical Summary" of the PNDH. This new version of the plan was approved by the donors in 2010.

1) Topic	2) Formal successes	3) Limitations	4) Real results
Poverty expenditure	Poverty expenditure increased 2002-04, was maintained 2005-08; social spending increased 2002-08	Almost half of poverty expenditure benefits the non-poor, this holds even more for social expenditure	No reduction in poverty incidence 2001-05; mixed progress social indicators; Actual social indicators are worse than official figures
Transparency	Improved budget transparency through Law 550; aid in budgets; improved expenditure control; improved planning of investment	Lack of transparency of Venezuelan aid; in 2008 amounts and uses were published	Real progress in government financial management has continued in GBS period; Programs funded with Venezuelan aid are under party control
	External audit of 2005 and 2006 budget execution, coverage increased from 21 to 28 agencies	With delays and largely paid by donors; No follow-up of audits' findings	Political pressure within Supreme Audit Institution limits findings
	Law on government procurement adopted	Law is complex, so many exemptions are granted	Law is hardly implemented
	Approval of Law of access to information 2008	Applied in limited number of state agencies, low targets for implementation in PAM	Actual access to government information decreased since 2007
Rule of law	Approval of Judicial Career Law 2005; approval of Regulations for this Law 2008	Law only applies to lower echelons of judges; regulations approved after long delay; appointments in 2008 made according to old Law, "retroactively"	No improvement in judicial system since 2005
Democracy		1999 Pact between PLC and FSLN dominates politics; no democracy within these parties	Since 2008 deterioration in formal democratic processes
Women's rights	Approval of Law of Equal Opportunity 2006; More attention for violence against women since 2007; Reduction maternal mortality in 2008	Penalization of therapeutic abortion in November 2006, not changed; Figures on maternal mortality not reliable, but decreasing tendency is true – although due to other factors rather than donor influence	Law on therapeutic abortion is implemented; since 2007 more attention for socio-economic women's rights and for fighting violence



Many donors used the policy dialogue around budget support also to influence sector policies in areas in which they executed project aid. Some results were achieved. For example, for the Germans it was important that a national water and sanitation strategy came about which separates policymaking and monitoring from execution. However, the extent to which this will be implemented under the current government is not clear. The World Bank and the EC have promoted school autonomy with their education programs, and the number of schools under this regime gradually increased. However, the current government did not want to pursue this road and the donors have accepted this change. Some also see donor pressure behind the improvement in the energy situation in the country under the current government, but more likely this is due to Venezuelan aid.

### 3.5.1 Poverty expenditure and social expenditure

Poverty expenditure in percent of GDP has always been an indicator in the PAM. However, the definition of this spending has changed twice, in 2005 and in 2007. Since 2005, programs to strengthen institutions not directly related to poverty reduction (such as the Secretariat of the Presidency) were excluded, as well as the costs of the Managua offices of the ministries of Health and Education. Infrastructure investment (roads, airport) was still included (Report Mid-Year meeting 2006). In 2007, the new government changed the classification again in order to include its own poverty programs.<sup>53</sup> In view of the changed and sometimes arbitrary definitions, the figures for poverty spending are not a fully valid indicator for the actual anti-poverty spending. For this reason, we also examine social spending. Although social spending may include non-poverty spending (tertiary education, for example), the trend in this figure may give some additional information of policy priorities.

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Poverty expenditure increased in all years between 2002 and 2008, but relative to total expenditure and to GDP it increased only between 2002 and 2005. Between 2005 and 2008 it remained more or less stable (Table 3.4). Social expenditure registered a more continuous positive trend relative to total expenditure and to GDP, and both health and education benefited from it. It seems that the policy dialogue around budget support managed to increase social spending and to at least maintain poverty reduction spending.

<sup>53</sup> According to an interview with a government officer at SEPRES, the new classification is explained in Annex 5 to the PNDH but the version of April 2008 available on internet [www.pndh.gob.ni](http://www.pndh.gob.ni) does not contain annexes (accessed 16 September 2009). The same officer also said that this classification plus retroactive data with this new classification has been presented to the BSG in one of the 2008 meetings. However, this does not appear in the reports or in the government presentations.

	2002	2003	2004	2005	2006	2007	2008
In current billions of NIO:							
Poverty expenditure	5.2	6.9	8.5	10.7	11.4	14.0	16.5
Social expenditure	4.9	6.3	7.4	9.1	10.3	12.3	15.2
Education	2.3	2.9	3.1	3.9	4.4	5.3	6.6
Health	1.8	2.2	2.3	2.8	3.2	3.9	4.6
In % of total expenditure:							
Poverty expenditure	44	46	53	58	54	59	58
Social expenditure	42	42	46	50	49	52	54
Education	20	19	19	21	21	22	23
Health	15	14	14	15	15	16	16
In % of GDP:							
Poverty expenditure	9.1	11.1	12.0	13.1	12.3	13.3	13.4
Social expenditure	8.5	10.2	10.3	11.2	11.1	11.7	12.3
Education	4.0	4.7	4.4	4.7	4.7	5.0	5.3
Health	3.1	3.5	3.2	3.5	3.4	3.7	3.7

<sup>1</sup> As explained in text, poverty expenditure and social expenditure are partly overlapping categories but they are not the same.

Source: MHCP for budget data, BCN for GDP and exchange rates (mid-year).

According to the government, poverty expenditure was financed partly from its own resources, and partly from external loans, grants and debt relief (forgone debt service) (Table 3.5). The external grants and loans are project aid. Budget support is here included in “recursos del tesoro” (government resources). It can be observed that the share of government financing of poverty expenditure increased in 2005 and 2006. However, this share was in 2006-08 lower than in 2002. As will be shown below (chapter 4), only a small part of the substantial debt relief received was used for poverty reduction expenditure.

	2002	2003	2004	2005	2006	2007	2008
Government resources	55	33	28	39	52	52	50
Debt relief	9	21	23	19	15	16	17
External grants	16	19	17	19	17	18	19
External loans	21	27	32	24	16	14	14

Source: MHCP. [www.hacienda.gob.ni](http://www.hacienda.gob.ni)

### 3.5.2 Government transparency

Many improvements have been achieved in budget planning and budget transparency during the Bolaños government. Government control over budget execution improved through the expansion of SIGFA (Integrated System for Financial Management and Auditing), and from 2006 onwards a Medium Term Expenditure Framework was gradually introduced, which

improved government planning. The classification of investment (capital expenditure) also improved. The Financial Administration Law (Law 550) introduced stricter rules for the budgeting process. For example, all external resources had to be included in the budget.<sup>54</sup>

	2002	2003	2004	2005	2006	2007	2008
Total revenues	2	2	9	1	0	0	-2
Total expenditure	-13	-7	-9	-7	-8	-7	-5
Social expenditure	-13	-6	-11	-4	-6	-5	-3
Education	-12	-2	-9	-3	-4	-6	-3
Health	-11	-4	-6	-3	-4	-2	-3
Other social expenditure	-20	-18	-20	-8	-8	-6	-5
Capital expenditure	-23	-14	-19	-13	-20	-14	-9
Current expenditure	-8	-3	-2	-1	-2	-3	-4

Source: Elaboration of MHCP budget reports. [www.hacienda.gob.ni](http://www.hacienda.gob.ni)

Table 3.6. shows that there are only small differences between budgeted and actual data on budget execution. Actual expenditure never exceeds budgeted expenditure, and the degree of under-execution has decreased over time, indicating a better planning. Under-execution occurs especially in investment. In this respect, Nicaragua performs much better than many other low income countries, e.g. Ghana or Bolivia (De Jong 2009, Lawson 2007).

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The discussion on, and later implementation of GBS fostered technical assistance programs for improving public financial management from World Bank, IDB, IMF, EC and some bilateral donors. These programs were effective because there was also a high level of commitment among government officers. Actual donor *influence* on improvements in PFM is therefore limited.

After 2007, the technical improvements in budget processes continue, but transparency of budgets and budget execution deteriorated. This is mainly due to the aid resources coming from Venezuela, which are not included in the budget. So far, pressure from the IMF and also from the BSG donors has at least managed to reveal the amount of these resources and their uses in 2008. Most resources stem from Venezuelan oil imports: the government only pays part of the bill, and the remainder is a long-term loan at a 2% (later 1%) interest rate. The government argues that this aid is in fact a loan to a *private* company (in which both the Nicaraguan and the Venezuelan state oil companies participate), so there is no reason for approval by the National Assembly. But Petronic, the state oil distribution company is led by the FSLN party treasurer, which harbors suspicion of mixing up state and party interests (Linneker, 2008). This limited transparency about a huge amount of money, probably around USD 1 billion in three years, is a serious concern for the budget support donors.

<sup>54</sup> This sometimes caused delays in the use of foreign aid, as the National Assembly first had to approve the budget expansions.

In 2005, a new procurement law was introduced based on standards of the IDB. However, this law has not improved actual procurement procedures. Too many exemptions are granted, and if anything, corruption in government purchases seems to be on the rise. Donors have made the external auditing by the Supreme Audit Institution a condition from the start of the JFA. In 2006 they threatened with sanctions in 2007 if the 2005 audit would not be forthcoming. With delays, and after additional IDB financing, the 2005, 2006 (and in 2009 also 2007) budgets have been audited. This is an achievement, but according to independent observers, the SAI is politicized and the auditing cannot possibly have revealed all abuses. There is evidence of political pressures on the officers carrying out the audit.<sup>55</sup> Furthermore, so far no follow-up has been given to the findings of the 2005 and 2006 audits.<sup>56</sup>

Although the Law on Access to Information was approved, in the implementation the government emphasizes its technical aspects such as the coming into being of offices for the general public and access through the internet. Lack of resources constrains this implementation. In practice, civil society representatives observe that access to government information has been reduced under the Ortega administration. This was also experienced by the authors of this report. With the exception of the Central Bank and the Ministry of Finance, websites of government agencies are no longer maintained.

### 3.5.3 Improved rule of law

An independent judicial system is important for the protection of human rights but also for the business climate. Donors wanted to support the Bolaños government in its attempt to improve the malfunctioning judicial system. This malfunctioning affects the rule of law: in case of a violation of private rights or other abuses, firms and citizens do not have access to justice and even if they have, they cannot expect fair and impartial procedures. The Supreme Court of Justice is a political organ in which the judges are appointed according to the Pacto. This influences all other judges and other officers in the system. For this reason, the donors have tried to foster the independence of the Judiciary by having a Judicial Career Law approved. The aim was that judges - at least, those below the highest level who continue to be appointed by the National Assembly - would be appointed on the basis of merit rather than their political alliances. However, the two main political parties of the Pacto were sabotaging the execution of this Law by holding up the Regulations that allegedly were necessary to implement the Law. Under heavy donor pressure (among other things, approval was a prior condition for the EC Justice sector budget support program), these Regulations were finally approved in June 2008. However, even after this approval, new judges were appointed on the basis of the old Law, "retroactively". According to independent observers the new Law and its regulations have not made any difference in the functioning of the judicial system. It is possible, however, that the law and the regulations have some effect in the medium term.

<sup>55</sup> Interviews, March 2009.

<sup>56</sup> This is the conclusion of an assessment, commissioned by RNE and carried out by DES S. de R.L., consultants and auditors (2009), of the 2006 audit carried out by the SAI.

### 3.5.4 Improved democracy and human and women's rights

As noted above, the donors have so far not been able to improve or restore the democratic character of the 2008 elections. The two parties remained excluded, no external observers were allowed and the 2008 election results have not changed. In June 2009, however, the government announced that EU observers would be admitted to *next* elections, the March 2010 regional elections. In practice, these elections proved to be not fully transparent either.

The Nicaraguan human rights situation is considered to be good, especially in comparison with other countries of the region. However, there are recent incidences of harassment of civil society members and there is also evidence of increasing self-censorship in the press. Also in these areas, the policy dialogue has not been successful.

On women's rights, an important blow was the penalization of therapeutic abortion in November 2006. So far, pressure from donors and from other sectors of society has not been able to change the law. According to the government, in practice doctors will care about the life of the mother and will carry out abortions in emergency situations. This seems to be confirmed by the lower maternal mortality rate in 2008. Although these government figures are not reliable and most likely underestimate actual maternal mortality, a lower figure in 2008 may reflect a real decrease. But this is probably not the result of doctors being flexible with the abortion law. There are many other plausible explanations for a possible reduction in maternal mortality. Since 2005, aid projects of several donors helped to establish more health posts in the countryside including specific mother and child care centers. Via sector budget support to the health sector, donors fostered training of health personnel and more access to family planning. After the 2007 change in government Cuban doctors came to work in Nicaragua and they were assigned to the Atlantic region where maternal mortality was highest.<sup>57</sup> According to a recent report of Amnesty International on Nicaragua, many doctors in Nicaragua *do* implement the law, resulting in widespread suffering, pain, and deaths.<sup>58</sup>

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In 2006, and with some pressure from donors, the Law on Equal Opportunity was approved by the Assembly. But ownership among state institutions, other than the Nicaraguan Women Institute, was limited (Agurto, 2006). The current government has not yet met with the donor demand of making a national gender equity plan, but it does give a higher priority to gender equity. It targets women in its priority programs Hambre Cero and Usura Cero. It also gives much more attention to reducing violence against women, establishing women's police offices where women can denounce this violence.

<sup>57</sup> Interview with health specialist at RNE, March 2009.

<sup>58</sup> [www.es.amnesty.org/noticias](http://www.es.amnesty.org/noticias)

### 3.6 Conclusions

This section summarizes the conclusions from the analysis in this chapter. First, some remarks will be made on aspects related to the *process* of the policy dialogue, and then some conclusions will be drawn on the *results*, the actual influence.

The JFA and the PAM have provided the budget support donors a mechanism for a policy dialogue with the government on all areas and sectors of government policy. The reports of the Annual and Mid-Year meetings reflect detailed discussions, in which the government is held to account for what is has and has not done - comparable with what usually happens in Parliaments. This policy dialogue around budget support managed to foster the *coordination within* the government on policies to be implemented – principally between Ministry of Finance and line agencies and other state bodies, and also among line agencies. During the Bolaños administration, this coordination was also fostered by donor-financed consultants in the different ministries who took care of this coordination. During the Ortega government more ministers and vice-ministers participated in the discussions with donors themselves, instead of delegating this to consultants or other staff. The policy dialogue created spaces for technical coordination among them, while before there was only coordination on political issues.

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The donors did not always succeed in *harmonizing* their responses in the policy dialogue with government. During the years of the Bolaños government it went well, but donors acted more and more on their own in 2007, 2008 and 2009. The deterioration in donor harmonization was partly due to the fact that governance issues do not hinder disbursements from the multilateral banks. The IDB even stepped up lending, including budget support, in 2009 in order to compensate Nicaragua for the negative effects of the global economic crisis. But also among bilateral donors and the EC the response was not uniform, mainly due to headquarter interventions. As soon as political factors began to play a role, decisions were no longer taken in Managua and were therefore more difficult to harmonize.

What have been the results of the policy dialogue? The principle objectives of the policy dialogue in 2005 and 2006 were two-fold: first, to expand and improve (or establish) poverty reduction policies and second, to support the modernization agenda of the Bolaños government in the sense of achieving more budget transparency, and improving the rule of law. After the change in government, it was less necessary for donors to raise attention for poverty reduction. Instead, donors continued to press for improvements in transparency and in the judiciary, and began to bring in demands related to the functioning of the democracy and in the area of human rights, in particular women's rights.

Over the full period, the donors were successful in maintaining poverty reduction expenditure (after the increase between 2002 and 2004) and in improving some aspects of public financial management. The former result is some evidence of influence on the Bolaños government. Whether this higher expenditure translated in poverty reduction or improvement of social indicators will be examined in chapter 5. The improvements in

public finance management can be partly ascribed to the stimulus that budget support has provided to technical assistance programs in this area. Priorities of donors and of the executive mostly coincided in this issue so donor *influence* was not needed.

Donors proved to have some influence on sector policies if they managed to convince the involved officers and ministers. But given the limited implementation power of the previous government, actual execution was slow. In addition, with the government change, some of these policies have been reversed. The current government is less likely to concede to donor wishes. But if it does get convinced, the chances of implementation are much higher than under the previous government. In this respect, it can be expected that a policy dialogue on poverty reduction policies can be more fruitful than it was in 2005 and 2006.

Donors had much less influence on the more political components of the policy dialogue, areas that potentially affect the power base of the Ortega government, or that were related to the division of power according to the Pacto, agreed in 1999 between Ortega's FSLN and Alemán's PLC. The Bolaños administration did not have any support from these two parties that dominated the National Assembly, and was dependent on donor pressure to get things done. In 2005, donors suspended budget support to add leverage to the demands of the IMF for having several laws approved by the National Assembly. The Bolaños government agreed with the contents of these laws, but the two political parties dominating the National Assembly did not. In the end, this donor pressure was successful and the laws were approved. Earlier, this use of budget support was typified as supporting the IMF ("Grupo de Apoyo al Fondo", Guimarães & Avendaño, 2007: 38). But interviews held in 2009 with both government officers and donor representatives involved at the time, made it clear that donors and executive in fact worked together together against the interests of the majority in the National Assembly. In this case donors had influence, because the laws were approved. But if laws are approved just because of donor pressure while their content runs counter to majority opinions in Parliament, one can doubt whether they will be fully implemented.<sup>59</sup> A possible effect is a reduced confidence in laws themselves. This raises the question of the *legitimacy* of these donor interventions.

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In some other instances, donors used the *threat* of suspension in order to increase pressure on the government and on the two main political parties. In 2006, the donors collectively threatened to not disburse in 2007 if the government would not present the audit of the 2005 budget execution. And the EC did not start its Judicial Sector Program of about €20 million per year if and as long as the Regulations for the Judicial Career Law were not approved. In both cases, compliance was achieved after heavy pressure and with long delays. These achievements are so far more formal than real, but they may have some effects in the medium to long term.

After the perceived breaches of the fundamental principles of the JFA by the Ortega government, in particular human (women's) rights and the conditions for free and fair elections, bilateral donors and the EC froze disbursements. The government responded by

<sup>59</sup> As happened, for example, with the laws approved in order to comply with the HIPC Completion Point in Nicaragua.

interrupting the policy dialogue, and did not change any of its policies in these areas. However, early 2009 the country's economic situation proved so adverse (lower tax revenues and lower aid from Venezuela) that the government re-opened negotiations with the BSG. So far, these have produced one government concession, in the form of a promise to allow EU observers in the 2010 elections for regional governments in the Atlantic region.

These results confirm the findings of earlier studies, namely that policy conditionality is not very effective (Collier et al., 1997; Dijkstra, 2002; Dollar & Svensson, 2000). Governments will only implement what they intended to do anyway, and the country's political economy is determinant in what will be implemented. Political conditionality is least effective (Crawford, 1997). From these earlier studies it can also be learnt that donor influence in political areas is more likely to be effective if donor demands are specific - confirmed by success of the specific demand for allowing external observers in next elections.





# 4

## Intermediate outputs of budget support

## 4.1 Introduction

This chapter examines some intermediate effects of budget support. Budget support implies resources which the government can spend according to its own priorities and using its own systems for planning, budgeting, reporting, procurement, and auditing. At the macro-economic level, there are three possible “uses” of the money involved in budget support. First, budget support may enhance macro-economic stability if these resources help to finance a budget deficit. Second, budget support may increase government expenditure. A third possible effect is that the availability of these resources gives an incentive to reduce tax efforts: the so-called “fiscal response”. A combination of the three effects is possible. To the extent that project money is fungible, at this macro-economic level there is not much difference between project aid and budget support.<sup>60</sup>

Some other assumed intermediate effects are specific for budget support as opposed to project aid. Within the government, the flow of discretionary resources is supposed to enhance the allocative efficiency of public expenditure and to strengthen local systems. Furthermore, it is expected that this aid modality reduces transaction costs for both government and donors. And finally, for society at large, budget support may foster the government’s domestic accountability, since it is the government that is responsible for priority setting and actual implementation of these resources. This positive effect on domestic accountability may also be the result of the policy dialogue around budget support, as donors usually demand more transparency of budgets and budget executions. The domestic accountability effect is in part contingent upon the strengthening of local systems and will therefore be dealt with in the same section (4.4) of this chapter. Section 4.3 deals with transaction costs, and we begin with the macro-economic effects and allocative efficiency.

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## 4.2 Macro-economic effects and allocative efficiency

This first section attempts to analyze the macro-economic effects of budget support resources: so whether they increased expenditure, reduced tax revenues or helped financing a deficit. By examining changes in (other) components of government income, expenditure and financing of the deficit, we try to establish a “counterfactual”: what would have happened in the absence of these resources? This question should in particular be answered for the years 2004-2007, when “liquid aid resources” (most of it budget support)<sup>61</sup> were at a relatively high level (Chapter 2). Important years for which changes must be examined are therefore 2004 (when liquid resources, or program aid, increased) and 2008 and 2009 (when they fell). We start the analysis in 2002, the first year of the Bolaños administration, and examine first income, then expenditure, and then the deficit.

<sup>60</sup> In addition, there are many modalities in between general budget support and project aid, such as sector budget support and sector baskets.

<sup>61</sup> The Central Bank of Nicaragua registers aid as either “liquid resources” (*recursos líquidos*), which are not linked to projects, or “tied resources” (*recursos atados*), which are. Liquid resources is in fact program aid, and general budget support is, especially in the period under study, its dominant modality. Before 2000, balance of payments support was the most important modality of program aid.

With respect to the actual macro-economic uses of budget support, its predictability is an important factor. We concluded in Chapter 2 that budget support disbursements have been (much) lower than commitments in 2005 and 2008. This means that predictability across years was modest. Predictability within the budget year was good in 2006, but much less in the other years, and in all years most resources were transferred at the end of the year. These two characteristics (moderate predictability and late receipt) reduce the possibility for using (the bulk of) budget support for additional expenditure. The moderate predictability makes it also unlikely that the government has reduced tax efforts.

**Table 4.1 Sources and uses of government resources (in % of GDP)**

	2002	2003	2004	2005	2006	2007	2008
Government revenues	14.8	16.4	17.2	18.0	18.8	19.6	19.0
Tax revenues	13.4	15.1	15.7	16.7	17.4	18.0	17.6
Other income	1.4	1.2	1.4	1.3	1.4	1.6	1.5
Total expenditure	20.4	24.1	22.4	22.5	22.7	22.7	22.9
Deficit	-5.6	-7.8	-5.3	-4.5	-3.9	-3.1	-3.8
Financing of deficit:							
Grants	3.7	5.3	2.8	3.8	3.8	3.7	3.3
Net external financing	2.0	4.0	5.7	3.5	2.7	2.6	1.7
Net internal financing	-0.1	-1.5	-3.2	-2.8	-2.6	-3.2	-1.2
Total expenditure	20.4	24.1	22.4	22.5	22.7	22.7	22.9
Poverty expenditure	9.1	11.1	12.0	13.1	12.3	13.3	13.4
Social expenditure	8.5	10.2	10.3	11.2	11.1	11.7	12.3
Interest internal debt	1.6	2.5	1.6	0.6**	1.2	1.0	0.7
Interest external debt	1.1	1.9	0.3	0.4	0.5	0.4	0.3
Other expenditure*	9.2	9.6	10.2	10.3	9.9	9.5	9.5
Memo items:							
Program aid	0.8	0.7	2.5	1.1	2.5	1.9	0.5
Amortization external debt	2.0	3.2	0.5	0.6	0.8	0.7	0.6
New external loans	4.0	7.2	6.2	4.1	3.5	3.3	2.3
Deficit after grants	-1.8	-2.5	-2.5	-0.7	-0.1	0.6	-0.5

\* Total minus social minus debt payments.

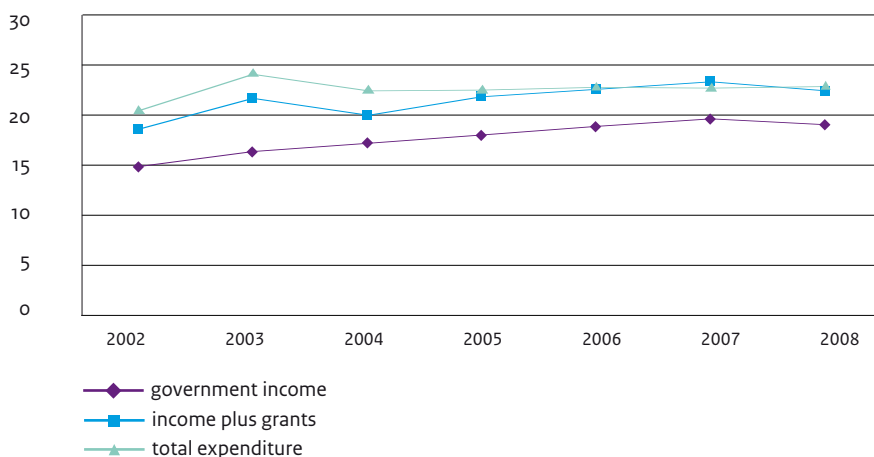
\*\* The 2005 figure for interest on internal debt is much higher in Table VI-9 of Fiscal accounts from the Central Bank (1.4% of GDP), but here we use the MHCP figures.

Sources: Own calculations based on: MHCP (Liquidación presupuestaria) for budget data, BCN for GDP data and exchange rates (year average).

Government revenues and also tax revenues increased during the whole period. Tax revenues increased from 13.4% in 2002 to a peak of 18% of GDP in 2007 (Table 4.1 and Figure 4.1). These increases are due to the effect of a new tax Law adopted in 2002, and further improvements in the efficiency of tax collection during the Bolaños administration. On first sight there does not seem to have been a “fiscal response”. However, one of the motives for the 2002 tax Law was the long-term declining trend in foreign aid, in real terms. In addition, a World Bank study (Artana,

2005) shows that tax exemptions still reduce tax income by the equivalent of 4% of GDP. In 2009, when foreign aid and budget support fell further, and under the influence of the economic crisis which reduced tax income, the Ortega government proposed a new tax law in order to increase revenues and make them more progressive. In conclusion, budget support in itself is perhaps unlikely to have induced a “fiscal response” due to its unpredictability, but *total aid* may have had this effect: tax revenues might have been raised earlier in the absence of the generous aid flow.

**Figure 4.1** Government income and expenditure, 2002-2008 (in % of GDP)



Source: Table 4.1

With respect to other income components, the government obtained substantial “virtual income” from 2004 onward by the reduction in external debt payments. Interest payments on external debt decreased from 1.9% of GDP in 2003 to around 0.4% of GDP in later years (Table 4.1). Amortizations also decreased substantially (memo item), which is reflected in a higher net external financing,<sup>62</sup> but this effect only seems to have occurred in 2004. As of 2005, the volume of new loans decreased, so net external financing decreased again. The virtual flow of forgone interest payments on external debt from 2004 onwards was of about the same size as the increase in program aid between 2003 and 2004. However, the debt relief was permanent, while the program aid increase was only temporary, lasting up until 2007.

Total expenditure peaked in 2003, and this seems related to the one-time rise in interest payments in that year. From 2004 onwards, expenditures have been stable in relation to GDP, but at a higher level than in 2002 (Figure 4.1). However, government revenues in relation to GDP increased more than expenditure between 2002 and 2004, so it is difficult to conclude that the higher expenditure is due to budget support, or to foreign income in general. The combination of stable expenditure from 2004 onwards, increasing domestic revenues in all years, and a one time surge in foreign income (including forgone external

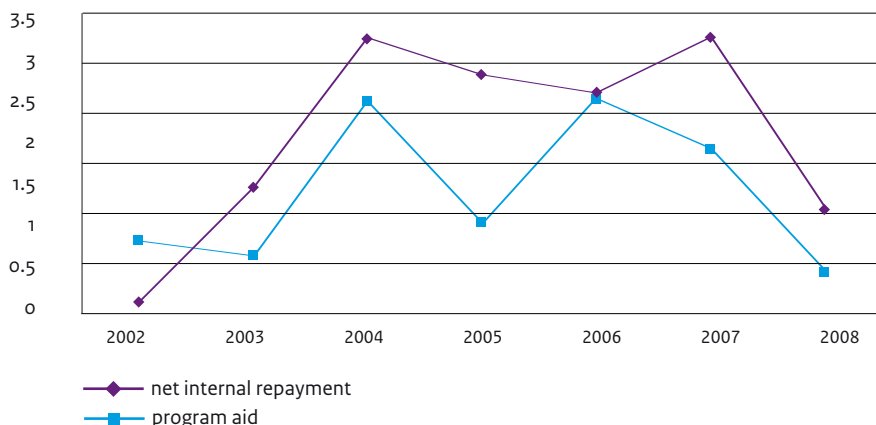
<sup>62</sup> Net external financing is new external loans (memo item) minus amortization external debt (memo item).

interest payments) in 2004, led to a lower deficit. The budget deficit continued to decrease until 2007, and rose slightly in 2008 (Table 4.1). The deficit after grants (memo item) became negligible since 2005 and was even positive in one year (Figure 4.1). This shows that macro-economic stability has been achieved in these years. But budget support does not seem to have played a large role. In 2005 and 2008 actual budget support proved to lower than promised, but this did not lead to a higher deficit - with a possible exception in 2008, but in that year revenues also decreased. Apparently, consecutive governments were determined to keep the deficit at a low level.

In all years, the deficit has been financed by external loans and grants, while net internal financing was negative. The higher flow of freely spendable external resources (budget support plus the virtual flow of forgone external interest payments) since 2004 was accompanied by an *increase* (in absolute terms) in the negative net internal financing of the deficit. This means the government was repaying on its internal debt more than it was borrowing. This negative internal financing moved from around 1% of GDP in 2002 and 2003 to around 3% over the years 2004-2007. In 2008, when budget support was reduced substantially (and tax revenues decreased), this net negative internal financing decreased to around 1%. Figure 4.2 shows the parallel movements in negative net internal financing (repayment) and in budget support in the years 2004-2008. In 2009, with the economic crisis and the further reduction in budget support, it became clear that net internal financing had become positive. This means that macro-economic stability is affected, the more so since the government is borrowing at an increasing domestic interest rate.<sup>63</sup>

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**Figure 4.2** Program aid and net internal repayment (in % of GDP)



Net internal repayment = minus net internal financing.

Source: Table 4.1.

It can be concluded that it is unlikely that budget support has led to an increase in government expenditure (there was no such increase, see Figure 4.1) or to reduced tax

<sup>63</sup> In March 2009, this interest rate was 10.5%.

revenues. Although Figures 4.1 and 4.2 cannot prove anything, they do make plausible that the most likely use of budget support over the years 2004-2007 has been an increase in the negative internal financing of the budget deficit (in Figure 4.2: an increase in internal repayment). In this sense, budget support has contributed to macro-economic stability. This is confirmed by the developments in 2008 and 2009 - years in which budget support was reduced. The immediate effect was an increase in the government's domestic borrowing, in 2009 followed by an increase in the deficit itself.

With respect to the composition of expenditure, Chapter 3 already concluded that poverty reduction expenditure in relation to GDP increased between 2002 and 2005 and was then maintained, and that social expenditure increased more continuously between 2002 and 2008. This is also evident in relation to total expenditure (Table 4.2). This rising trend was achieved despite stable total expenditure between 2004 and 2008. In 2004, the increase in poverty and social spending could be financed by lower debt payments. In later years, the (smaller) increases in poverty and social expenditure were at the cost of other (non-social and non-debt) expenditure (Table 4.2). It must be remarked, however, that Nicaragua received large amounts of HIPC debt relief after 2001 and that over the years 2002-2006, only 44% of debt relief has been allocated to poverty reduction expenditure (Guimarães and Avendaño 2008: 61-62).

	2002	2003	2004	2005	2006	2007	2008
Total expenditure	100	100	100	100	100	100	100
Capital expenditure	32	36	43	42	32	32	27
Current expenditure	68	64	57	58	68	68	73
Poverty expenditure	44	46	53	58	54	59	58
Capital	21	26	32	32	27	28	23
Current	24	20	21	26	27	31	35
Social expenditure	42	42	46	50	49	52	54
Interest payments	13	18	8	5	8	6	5
Internal debt	8	10	7	3	5	5	3
External debt	5	8	1	2	2	2	1
Other expenditure*	45	40	45	46	44	42	41

\* Total expenditure minus social expenditure minus debt payments.

Sources: See Table 4.1.

Budget support may enhance the *allocative efficiency* of government expenditure because governments can spend a larger part of the total resource envelop according to their own priorities. Budget support can only increase allocative efficiency if i) resources are really freely spendable and not earmarked to specific uses, ii) there is not too much donor-demanded ring fencing of expenditures, and iii) resources are predictable, both during the budget year and across years. Chapter 2 concluded that most budget support resources were freely spendable, but that there have been some problems with predictability in 2005 and 2008. With respect to donor requirements for ring fencing, the requirement for

poverty reduction expenditure and also other demands such as raising transfers to municipalities from 6 to 10% of tax revenues in 2010<sup>64</sup> may have reduced allocative efficiency. On the whole, general budget support may have had some positive effect on allocative efficiency in comparison with project aid.

### 4.3 Transaction costs

One of the assumed advantages of budget support as compared with project aid is that transaction costs will be reduced. Transaction costs are the costs of making a transaction, in this case aid; i.e. the costs of preparing a transaction (information and search costs), negotiating it, and the costs of monitoring (donors) or bonding (recipient) in relation to the transaction (Hazeu, 2000). Table 4.3 lists these costs if we apply them to project aid and to budget support. Most of these costs involve *time*, and are thus salary costs. But there is also a small component of material costs (travel costs, meeting costs, paper, etc.) The problem is that there is no hard information on these costs.

**Table 4.3 Overview of transaction costs of aid, for donor and recipient, project aid and budget support (by type of costs)**

	Project aid		GBS	
	Donor	Recipient	Donor	Recipient
Information and search	Priority setting at HQ and in country; preparatory visits or missions to the field	Defining “supportable” projects and programs, selecting appropriate donors for them	Determining criteria for GBS at HQ; Assessment of quality of PRSP, governance, PFM, macro-economic stability (e.g. via “track records”)	Finding out donor criteria for GBS and trying to comply with them; e.g. writing PRSP; negotiating and maintaining IMF agreement
Negotiation	Negotiation with particular agency involved	Negotiation with particular donor involved	Discussion on JFA, preamble and annual matrices; among donors and with government	Discussion on JFA, preamble and annual matrices
Monitoring and bonding	Financing executing agency and/or monitoring unit; monitoring in embassy and at HQ; mid-term and final evaluations	Reporting, auditing and monitoring as required by the donor	BSG meetings; Mid-term and annual meetings	Writing progress reports for mid-term and annual meetings; participation in those meetings; Writing Annual Progress Reports on PRSP

<sup>64</sup> Interview with government officer in March 2009.



In the following, we attempt to compare the transaction costs of an “average” bilateral or multilateral project with the costs of joint general budget support as it has been implemented in Nicaragua. But of course we must bear in mind that an average bilateral or multilateral project is probably around USD 5 million,<sup>65</sup> while budget support was meant to be around USD 120 million annually, or more. In practice, the average total disbursements over the years 2005 to 2008 were USD 75 million (Chapter 2). This was at least 15 times the estimated size of an individual project. So budget support has reduced transaction costs if we can prove that the transaction costs for budget support are less than 15 times those for an individual project.

Information and search costs for the government have been much higher than for an average project. The Bolaños government had to write and later revise its National Development Plan (NDP). Largely because of donor demands, it also held regional consultations on this plan. Donors again required the elaboration of a comprehensive national development plan from the Ortega government (a third PRSP). The costs of preparing these plans, and the costs of the consultations held for the NDP are huge.<sup>66</sup> In part, however, they were incurred by the donors who provided technical assistance (consultants) and resources for organizing the consultations of the NDP.

Donors had to define their selection criteria for budget support and had to investigate whether the country meets these criteria. The defining of the criteria is usually done at headquarters, but applying them to a particular country still takes a lot of time and effort from in-country donor staff. The RNE, for example, elaborates track records every year for each country.<sup>67</sup> Other donors commission specific studies on public finance management, for example. To a large extent, donors still have separate, non-harmonized, criteria and procedures for their assessment. This increases transaction costs for the donors. There are a few exceptions, such as the jointly organized Public Expenditure and Financial Accountability (PEFA) assessment in 2006. In 2007, three bilateral donors worked together in writing an assessment of the political situation in Nicaragua (Norway, Switzerland, and Finland). However, many other separate bilateral assessments were also written or commissioned to consultants, for example by Finland, Switzerland, and The Netherlands.<sup>68</sup>

Chapter 2 showed that the preparation of the JFA and in particular of the PAM took about two years and involved an intensive coordination and negotiation process. There were many meetings among the donors, meetings between donors and government and meetings between government institutions. The donors were of the view that transaction costs were

<sup>65</sup> In 2008, Nicaragua received around USD 400 million in aid, in the form of about 270 projects. But this includes aid going to NGOs and budget support, registered by donor as individual “project” (Information Vice-Chancellor, November 2009). If budget support is excluded, USD 370 million and around 265 projects remain, or an average project size of USD 1.4 million. It can be expected that bilateral and multilateral projects are larger than the average project, so USD 5 million is a conservative estimate.

<sup>66</sup> These national comprehensive plans, and the participation processes that (should) accompany it, may have benefits in itself. But there are reasons to question these benefits, as argued, for example, in Dijkstra (2005).

<sup>67</sup> Recently only once in four years a “full” track record is required, and in the other years the Embassy elaborates a track record “light”.

<sup>68</sup> For example, a SCAGA (Social Corruption And Governance Analysis) was carried out in 2008.

very high in the preparation phase.<sup>69</sup> The government experienced these intensive meetings as an “increase in transaction costs”,<sup>70</sup> probably as compared to the liquid aid provided *before* the JFA, for example in the context of the FSS, or compared to the individual budget support loans by the multilateral banks or the balance of payments support from bilateral donors in the 1990s. The negotiation process had become more complex than under previous program aid modalities because many more donors and many more government institutions were involved.

Also after the signing of the JFA, negotiation costs continued to be high for both donors and government. This includes the annual and mid-year meetings (taking one or two days each), but also the meetings of technical working groups of donors and government to work on permanent revisions of the PAM. Usually there are some additional high level meetings of the BSG and with the government as well.

In terms of monitoring and bonding, the transaction costs for the government are somewhat higher than in the case of projects, but not much higher. Part of the required reports such as the report on budget execution, are prepared anyway because they are presented to the National Assembly. In addition to these reports, the government must elaborate Annual Progress Reports on the national strategies - which probably would not happen otherwise. For the donors, the monitoring costs of budget support are not much higher than for project aid. They hardly have to read additional material - over and above what informed agency staff would read anyway.

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Table 4.4. lists the possible factors with which transaction costs of an individual project must be multiplied in order to get the transaction costs of budget support. The negotiation of the first JFA was heavy but can be seen as a one-time investment. On the other hand, the information and search costs are in part recurrent. During all years, donors do not just monitor the progress on the PAM, but they continuously assess whether Nicaragua meets the entrance criteria. A new government in the recipient country that does not agree with the existing national plan, is required to elaborate a new long-term, comprehensive and preferably participation-based strategy.

	<b>Donor</b>	<b>Recipient</b>
Information and search	3x	14x (partly financed by donors)
Negotiation, first JFA	8x	8x
Annual negotiations	3x	3x
Monitoring and bonding	1x	2x

Source: own estimates.

<sup>69</sup> Interviews with donors 2004 and 2009.

<sup>70</sup> Interview March 2009 with former officer Hacienda, and in 2004 with vice Chancellor.

If these estimates are approximately correct, and given the assumption that the volume of budget support was at least 15 times the volume of an individual bilateral or multilateral project, the balance is positive for budget support. The multiple in transaction costs for budget support is slightly higher for the recipient government than for the donors. Yet, also for the recipient government the balance is positive. This positive balance is confirmed in interviews with officers of the current government.<sup>71</sup>

So far, we have related the transaction costs of budget support to the volume of the transaction. However, as shown above, most transaction costs in budget support are the result of donors setting entrance conditions and establishing policy conditions via negotiations with the government. This means that transaction costs must also be assessed in relation to the benefits of these attempts to influence government policies. Chapter 3 shows that some results have been achieved, but that these results were in many cases limited to the formal level.

## 4.4 Strengthening local systems and domestic accountability

### 4.4.1 Strengthening local systems

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Budget support is transferred directly to the government and thus uses national systems for planning, budgeting, procurement, reporting and auditing. By using these national systems, it is expected to help strengthening these systems. This section investigates to what extent GBS helped strengthening these systems, both in the Ministry of Finance and in the most important line ministries, those of Health and Education.

There is no doubt that some government systems have been strengthened, especially during the government of Bolaños.<sup>72</sup> SIGFA has been introduced and has allowed a much better control and transparency of government spending. Planning and budgeting of resources have improved due to the adoption of Law 550 and the introduction of the MTEF. During the last years of the Bolaños administration, investment planning improved and also became more participatory: the national investment planning system SNIP was integrated with the municipal and departmental investment plans, which in turn were established with broad participation. A new procurement law was adopted that matched international standards and the 2005 and 2006 budgets were externally audited. Due to the inclusion of all aid resources in the national budget, planning also improved at sector level. Line agencies also managed to improve their monitoring systems.

In addition, under the influence of donors and with donor-financing, the government set up a statistical information system, SINASID, to monitor progress on the Millennium Development Goals and other social indicators mentioned in the National Development

<sup>71</sup> March 2009.

<sup>72</sup> See for more extensive overviews Guimarães and Avendaño (2007, 2008) and Acevedo Volg (2007).

Plan. This system brings together information from many different sources (line ministries, statistical institute). SINASID was however far from perfect, since there was no provision for systematic updating of the indicators (Guimarães & Avendaño, 2007).

Some of the improvements achieved during the Bolaños administration were more formal than real (procurement, external auditing, see chapter 3). In addition, the government change in 2007 led to a change in the monitoring systems for social indicators (starting from scratch with a new system) and weakened the geographic coordination of investment planning.

General budget support has contributed to the strengthening of government systems by using these systems and not undermining them, and also by giving a stimulus to technical assistance programs from World Bank, IMF, IDB, EU, and Switzerland (MTEF), some of them co-financed from other bilateral donors such as the Netherlands. The financial volume of these programs (including equipment, training and salaries of well-paid consultants) was huge. Programs in the area of public financial management were relatively successful since there was a high extent of commitment, both at the political level and among senior management in, for example, the Ministry of Finance and the Central Bank. This commitment also made the benefits more sustainable.

#### 4.4.2 Domestic accountability

Budget support may also increase domestic accountability. If a larger share of the foreign aid resources is channeled through the regular revenue and expenditure channels, and if the dialogue around GBS brings about more transparency in public finance management and more public knowledge of government policies and results, citizens have more possibilities to hold their government to account. This may then also lead to more government responsiveness to its own citizens. On the other hand, GBS and aid more generally are sometimes said to decrease domestic accountability. In highly aid dependent countries, governments tend to listen more to the donors than to their own citizens; accountability is outward and upward instead of inward and downward (Moyo, 2009; Sogge, 2002).

In Nicaragua, a combination of donor technical assistance and government commitment led to improved transparency in public finance management. Government budgets are available online, and information on budget execution is also fully transparent - data being published immediately after each trimester. This means that transparency not only improved for the donors, but also domestically.<sup>73</sup> Transparency on government policies, on investment projects (the SNIP) and on laws being discussed in the National Assembly has also improved, with most of this information available online. Despite the adoption of the Public Access to Information Law in 2007, which would guarantee citizens access to information on government policies, in practice this access diminished across the board since 2007. Except for the BCN and the MHCP, government agencies' websites became

<sup>73</sup> There were exceptions. For example, in 2004, the government sent the IMF more realistic tax revenue projections than it did to the National Assembly in the context of the budget. This was meant to lower the transfers to universities and municipalities, which by law are a percentage of tax revenues (Guimarães and Avendaño, 2007: 48).

incomplete and outdated. Transparency of budgets and budget execution was, but a problem is that these budgets themselves are no longer complete, since they do not include Venezuelan aid.<sup>74</sup> However, pressure from the IMF and from GBS donors led to the publication of all sources and used of this aid in 2008. The new government moved SINASID to the Institute for Statistics (where it was not maintained due to lack of resources) and set up a new monitoring system for policy outcomes in the domain of social welfare, including 458 indicators. However, so far this system can only be accessed by government officers. It is not available for society at large or for members of the National Assembly.<sup>75</sup>

The greater transparency of government budgets and policies that was achieved under the Bolaños government has certainly been used by civil society and Parliament. The National Assembly had always discussed national budgets and revenues intensively, but became more active in monitoring the actual use of government resources. For example, in 2006, the National Assembly formally recognized SIGFA as the only source for monitoring budget execution (Guimarães & Avendaño, 2007). Civil society also makes active use of the publicly available budget information. The Coordinadora Civil<sup>76</sup> has an Economic Committee that scrutinizes the allocation of government expenditure, government policies and outcomes, as well as the IMF agreements and the conditionality involved (Acevedo Vogl, 2007). The Coordinadora Civil has, among other things, denounced IMF conditionality and the high and allegedly illegal payments on internal debt.

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Although the Bolaños government was very dependent on donor support and therefore paid attention to donor wishes, it was also dependent on Parliament for approving its budgets and other laws. As it did not have a majority in Parliament, it had to work hard for obtaining this support. High government officers did not always participate in the technical working groups of GBS and were more involved in negotiating with members of Parliament. In this sense donors did not weaken domestic accountability systems. On the other hand, donors have added leverage on Parliament for approving certain laws, in particular in 2005 when the IMF program was off track. This was successful, which means that laws have been approved against the original opinion of Parliament's majority. The long-term effects of this are not clear: if these laws are beneficial to the country and are implemented, the effect may be positive. If these laws are not implemented, donor pressure contributed to a weakening of formal institutions such as laws, but also of Parliament itself.

With respect to possibilities for civil society to respond to government actions, donors urged the government to discuss drafts of the National Development Plan (NDP) in regions and municipalities, which may have improved domestic accountability. In the same period, the Citizen Participation Law was adopted in the National Assembly which increased participation at municipal and departmental levels (Guimarães & Avendaño, 2007). On the other hand, the Bolaños government initially weakened the CONPES (National Committee

<sup>74</sup> In 2007, a study on budget transparency in Latin America showed that Nicaragua was the penultimate of the region, just before Venezuela (interview with representative of Coordinadora Civil).

<sup>75</sup> Interview with representatives of Secretariat of the Presidency (SEPRES), March 2009.

<sup>76</sup> This is the most important umbrella organization of civil society in Nicaragua, representing more than 400 organizations and persons.

on Economic and Social Policies), an advisory organ to the government in which civil society participated, by directly appointing a large number of its members. The NDP was only once discussed in CONPES and never in Parliament. Towards the end of the Bolaños period the CONPES was expanded and regained some independence.

Under the current government, the possibilities for independent citizens and civil society organizations to express opinions and to influence government policies have been reduced. Civil society representatives complain it that has become more difficult to openly criticize the government. Some people have been arrested, against other persons legal charges have been raised, and yet others have been threatened by government officers. Under President Ortega not a single meeting of CONPES has been held. Despite FSLN support in the National Assembly for the Citizen Participation Law, this Law is no longer implemented. Instead, the Ortega government has set up its CPCs, which are supposed to be instruments of direct democracy. CPCs *do* discuss government plans in some cases, for example the draft gender equity plan.<sup>77</sup> But in practice they are more likely to be instruments for top-down control of the population. The election fraud in the 2008 municipal elections is another signal of the limited responsiveness of this government to the opinions of the population: the government did not even respect the ballot results.

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Donors have attempted to prevent these deteriorations in formal democratic procedures and in citizen's rights. In comparison with the relatively small amount of GBS money, donors have been able to get a lot of attention for their demands especially after the 2008 election fraud. Despite the reduced membership of the BSG in 2008-2009, press attention for GBS meetings and statements remained high. In the aftermath of the elections, the domestic opposition sometimes seemed to use the external actors as their spokespersons. This means that during the Ortega government, donors have attempted to improve domestic accountability in line with attempts of domestic actors. However, donor demands have so far mainly focused on formal systems of accountability and could pay more attention to the protection of civil rights, such as freedom of speech and of press.

## 4.5 Conclusions

The most likely use of budget support resources has been the financing of the deficit. In particular, budget support resources were used to increase the net negative internal financing of the budget deficit. Budget support did not lead to lower tax revenues or higher public expenditure. Total aid, however, may have reduced tax efforts in Nicaragua, especially if a longer time period is considered. Budget support may have had some positive effect on allocative efficiency.

Although transaction costs have been huge, especially during the preparation phase of the JFA, the relatively high volume of budget support during the years 2005-2008 still brings about a positive balance for budget support in comparison with project aid. Transaction costs in budget support are slightly higher for the recipient government than for the donors.

<sup>77</sup> Interview with government officer at Ministry of Gobernación, March 2009.

Government systems have been strengthened, especially during the Bolaños government (2002-2007). The policy dialogue around budget support played some role. But the most important factor in strengthening local systems was donor technical assistance linked to budget support, which was effective due to a high degree of commitment among government officers.

Domestic accountability improved somewhat during the final years of the Bolaños administration, and the policy dialogue around budget support may have played a role. Also in this area, the situation is deteriorating under the current government, and the policy dialogue around budget support has not been able to counteract this trend.

5

## Government policies and poverty reduction



General budget support implies that donors transfer their money directly to governments, so that these governments are able to carry out their policies for growth and poverty reduction with a larger resource envelop. It is therefore important to examine what these policies are and what their results have been. Donor money has contributed to these results. This chapter analyzes these policies and their results.

In Nicaragua, general budget support has been provided to two different governments: in 2005 and 2006, donors supported the Bolaños administration that was already in power from 2002 onwards. For this period, we examine the policies carried out in the full period 2002-2006, and the results of these policies over the same period. The data obtained in the Living Standard Measurement Surveys (LSMS) conducted in 2001 and 2005 are a good proxy for assessing the results of President Bolaños' policies. In 2007 and 2008, donors supported the Ortega administration. We examine the policies of this government and in particular the policy changes, but it is hardly possible to examine their outcomes, as the results of new LSMS will only be available in 2010. There is some recent information on several social indicators, and with respect to poverty reduction we limit ourselves to assessing *expected* outcomes.

This chapter first analyzes the growth and poverty reduction policies of the two consecutive governments. A next section analyzes the results in terms of private investment, growth, and poverty reduction, in particular income poverty. Section 3 analyzes government policies and expenditure policies for the social sectors as well as their outcomes.

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## 5.1 Development policies under Bolaños and Ortega

This section analyzes and compares the growth and poverty reduction strategies of both the Bolaños and the Ortega governments during the period under study (2004-2009). Although both governments have maintained the same post-conflict macroeconomic framework developed under the tutelage of the IMF since the 1990s, they have significant difference in their socioeconomic philosophies and development policies. The Bolaños administration believed that foreign investors and the relatively large domestic private sector were the driving forces of economic growth and employment generation, while the Ortega government emphasizes the key role of the state in fostering economic growth with equity.

Both governments incorporate in their growth policies the large social segment of small agricultural producers and informal businesses, but with different strategies. The Bolaños policy was to promote the modernization of peasant agriculture and the informal business sector, while the FSLN promotes food security and employment generation. There are significant discrepancies between these two administrations in their diagnoses of the causes of Nicaragua's weak post-conflict economic performance. Hausmann, Rodrik and Velasco developed a model for identifying the causes of low levels of private investment and entrepreneurship in developing countries (Rodrik, 2007). Based on this model, the causes of low economic activity identified by the Bolaños administration were mainly the government failure to protect property rights, reduce corruption and provide adequate infrastructure for private investors. In contrast, the Ortega administration's diagnosis of the

causes of low private investment is that the high cost of finance, poor infrastructure, and market failures cause the exclusion of the key small and medium business sector in economic development. This exclusion is the key constraint on economic growth.

The centerpiece of the Bolaños government growth policy was its cluster development strategy for the business export sector. The underlying logic was that private and public investment in a selected group of clusters was going to improve Nicaragua's competitiveness in the global market. These selected clusters of firms were going to generate growth through economies of scale and externalities of information, skilled labor and productive chains. The key sectors identified with growth potential were textile and garment, tourism, agro-industries (coffee, beef and dairy) and natural resources industries (forestry, fishing and mining).

The main government role in this context was to improve the business climate for foreign and domestic investors. This included both the reform of the judicial system to guarantee investors rights, and public investment in the transport and communications infrastructure needed to develop the clusters. In particular, the infrastructure development was geared towards facilitating access to the US market given the business opportunities that had been generated by the Central American Free Trade Agreement with the US (CAFTA). This development strategy also included the privatization of sectors that were still partially or totally state-owned such as telecommunications, energy and water. The implicit diagnosis of this growth policy was that the rate of return on private investment was too low because investors' risks were too high and export infrastructure was inadequate and inefficient. The high level of investors' risk was mainly caused by uncertainty over property rights and the corruption of the judicial system.

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In contrast, the FSLN government has abandoned the cluster development strategy arguing that it was biased in favor of foreign and large domestic investors. The new Human Development Plan emphasizes the role of the state in making markets work and fighting social inequality through market regulation and intervention. One goal is to support small-scale agriculture and the micro and small business sector oriented towards both the domestic and the external markets. The role of the government in this strategy is to intervene in the markets to facilitate access to credit and business services, and to promote the organization of rural and urban cooperatives.

Another goal is to regulate the capitalist sector to protect consumers from monopoly pricing. The strategy includes the partial or total re-statization of the energy and water sectors and the establishment of a new state development bank. Public investment serves both goals. It is oriented to finding cheaper energy sources such as renewable energy and to improve transport infrastructure, particularly in the rural sector. In this case, the implicit diagnosis of the government strategy is that market failures and the lack of infrastructure are the main causes of the low rate of return of private investment, particularly for the rural sector.

Another key dimension of the FSLN government strategy is the creation of a parallel public sector financed by the Latin American Bolivarian Alternative (ALBA), aimed in part to promote trade diversification to reduce Nicaragua's dependence on the US market. This

parallel public sector operates through public-private corporations that intervene in a wide variety of sectors including imports and distribution of oil, food, machinery and equipment, finance, agro-industries, tourism, housing and transport. ALBA is a regional integration plan initiated by Venezuela's President Chávez as an alternative proposal to the Free Trade Area of the Americas (FTAA) promoted by President Clinton in 1994. It is based on two fundamental concepts: cooperative advantages and Great Nationals.

Cooperative advantages consist of incorporating a dimension of solidarity in international relations and maintaining the principle of national sovereignty. To construct these advantages ALBA envisages the creation of regional compensation funds—a sort of special and differential treatment that must be used to achieve social and economic objectives. That is, Nicaragua receives petroleum under a preferential agreement, such that the savings from oil purchases can then be invested both in social spending and in new public-private businesses. It is in this context that Petroalba came about, to facilitate access to oil and payment for it over longer periods. Albacom, Telesur and ALBA TV are businesses that emerged to develop communications, services and infrastructure, along with ALBA-Medicines for the importation of generic drugs and ALBA-Food for accessing agricultural and industrial supplies.

The Great Nationals, a “state” version of transnationals, would be in charge of implementing all these large projects. In practice, they have been implemented through public-private links. The cooperative Nicaraocoop is an example of a private entity with links to the FSLN government that is used for selective distribution to farmers of urea fertilizer provided by Venezuela and channeled through ALBA officials and agreements.

The poverty reduction policies of both governments also have significant differences. The Bolaños government approach was characterized by its strong belief that economic growth generated by the export clusters would have trickle down effects and reduce poverty. This approach was supported by three sets of specific poverty reduction policies. The first set was human capital investment policies that emphasized increased coverage of primary and technical education, primary health care and infant nutrition. This included investing in the construction of new schools and health centers or the repair and expansion of existing ones. It also included administrative decentralization to increase efficiency in these services. Administrative decentralization of schools and hospitals involved providing limited government funds and a degree of administrative autonomy. In the schools, this meant that participating schools received some central funding, including for infrastructure repairs, but had to raise their own funds as well, mainly by charging parents. School managers had greater autonomy in decision making, and parents had more incentives to be involved. School directors and teachers received salary incentives when schools participated in the program. This policy, however, contradicted the government's stated goals, because the rise in fees led to the exclusion of the poorest families. In the health sector, decentralization involved the development of a two-tiered system, whereby privatized services were available within the public hospitals. Patients could choose to be treated without charge, or they could pay and receive a private room and better service. The theory was that people who could afford to pay would then contribute to the funding of the public system. In practice, however, this policy led to a decline in the quality of services to those who could not pay.

A second set of policies sought to improve the standard of living of the poor with increased coverage of the provision of drinking water and sewage, and improved housing. The third set was the cash transfer program to reduce extreme poverty. This was called the Social Protection Network (Red de Protección Social) based on the Mexican model of Progresa/Oportunidades. It consisted of monthly cash payments to the caregivers of children living in extremely poor households, conditional on all children going to primary school and under-fives attending regular clinics to monitor their health and growth.

The Ortega government has substantially modified this poverty reduction approach. It eliminated the two-tiered system in the health sector and the school autonomy program. Human capital investment policies now emphasize increased and free access to all levels of education, and the reduction of illiteracy of the population above fifteen years old. These policies also include the development of a decentralized and participatory health model that stresses preventive care (modelo de salud familiar y comunitario).

Nonetheless, there is continuity in the social infrastructure investment policy such as the expansion of schools, health centers, drinking water and sewage facilities. The only significant exception is the policy shift from improving existing houses to a massive program of construction of low cost houses (casas para el pueblo).

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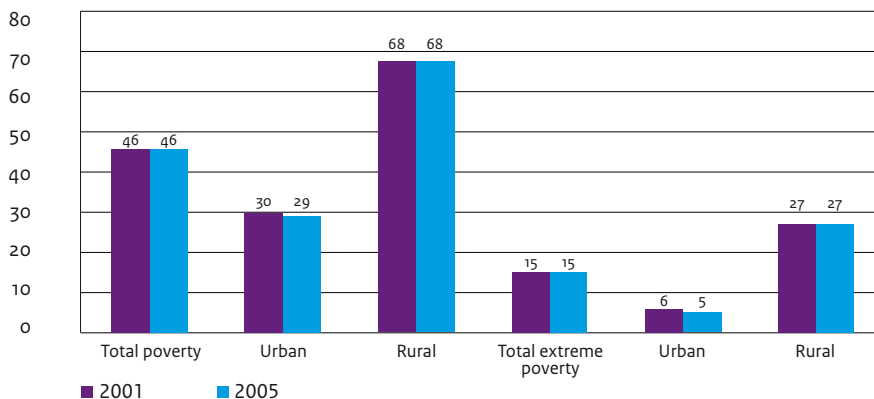
The other significant change is the creation of programs to recover the productive capacities of both the rural and urban poor, instead of the cash transfer policy. The Ortega government launched the Zero Hunger program (Hambre Cero) to provide animals, inputs and equipment to 75,000 rural women, representing about 7% of the total rural female population. Similarly, the other new program, Zero Usury (Usura Cero), aims to provide small loans at low interest rate to urban women engaged in informal business. Neither program is sustainable because each has a very low rate of loan or cost recovery. In addition, there are concerns about political influences on the selection of beneficiaries (Kester, 2009).

## 5.2 The impact of growth policies

Under both Bolaños and Ortega governments, growth policies have had limited impact on Nicaragua's overall economic performance. The Nicaraguan economy grew at an annual average of 3.2 percent during the period 2001-2008, well below the annual growth rate of 5.5 percent that the World Bank estimates would be necessary to achieve the Millennium Development Goal of reducing extreme poverty by half (World Bank, 2008a).

In fact, the absolute poverty rate was virtually unchanged from 2001 to 2005. Nicaragua had a positive poverty elasticity in these years, which is very unusual (World Bank, 2008a). Poverty, and also extreme poverty, is much more severe in rural areas (Figure 5.1). Rural poverty did not change at all, while there was a slight decrease in urban poverty. The continuation of high poverty levels suggests that more efforts have to be made to pursue broad-based and inclusive growth policies.

**Figure 5.1** Poverty and extreme poverty in Nicaragua, 2001 and 2005 (in % of population)



Source: World Bank 2008a.

Moreover, growth will be significantly lower during 2009-11 because of the impact of the global financial crisis. The Nicaraguan economy contracted in 2009 for the first time since the early post-conflict years (1990-1993) with an estimated 2.3%.<sup>78</sup> Growth rates in 2010 and 2011 are expected to be around plus 1.8%, which means that per-capita growth will be negative over the years 2009-2011. As a result, the modest gains in poverty reduction achieved since the end of the armed conflict (1990) could be partially reversed by the impact of the current global crisis on the Nicaraguan economy.

**Figure 5.2** Growth by sectors



Source: Elaboration of data from BCN.

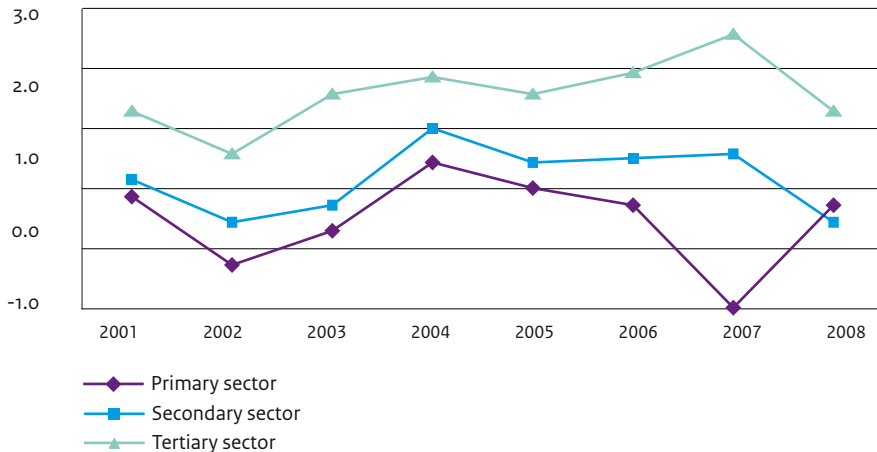
<sup>78</sup> Economist Intelligence Unit, Country report Nicaragua, February 2010. [www.eiu.com](http://www.eiu.com)

The modest growth performance during this period (2001-2008) has been marked by strong fluctuations (Figure 5.2). During the first two years of the Bolaños administration (2002-2003), growth performance was affected by several factors, including the contraction of exports and public spending, and the slow recovery of banking credit after the financial crisis of 2000-2001 that led to the closure of four banks. Traditional exports were hampered by low international prices, while fiscal adjustment took place after the widening of the government deficit during the electoral year (2001). In addition, the government bail out of the banking sector led to a significant increase in domestic public debt. This increased debt burden has restricted the government's ability to increase social spending and hence reduce poverty. After this initial phase of economic stagnation, there was an economic recovery during the last three years under Bolaños. The reactivation was stimulated by a significant expansion of public investment and by the upturn of exports due to better international prices. The investment climate improved with the successful negotiation of the Central American Free Trade Agreement (2003-2005), the fiscal reform (the 2003 Fiscal Equity Law) and the entry of Nicaragua into HIPC (2004), which both strengthened public finance.

These policies continued under the Ortega administration, which respected CAFTA and the macroeconomic agreement with the IMF. However, growth was weaker because of the negative impact of high international food and oil prices combined with the global financial crisis that started in 2008.

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**Figure 5.3** Sources of growth



Source: Elaboration of data from BCN.

The main source of growth (Figure 5.3.) over the period 2001-2008 was the moderate and steady expansion of the commerce and services sector (tertiary sector), although the most dynamic sector of the economy was manufacturing (secondary sector). In contrast, the primary sector had a weak performance, after being the growth engine of the post-conflict recovery during the second half of the 1990s. Agriculture, which accounts for almost one

half the primary sector value added, was affected by low international prices, increasing vulnerability to climate change and the reduction of the availability of tropical forestland that could be converted into agricultural production.

The main agricultural export, coffee, which also accounts for over one fifth of agricultural value added, was particularly affected by a substantial reduction of its international price. Average coffee prices during 2000-2008 were 5 percent lower than over the period 1995-1999. The decline of coffee profitability led to a sharp deterioration of coffee plantations because of a lack of investment and even basic maintenance. Average coffee output during 2001-2008 was significantly lower (-26 percent) than during 1995-2000 and has not yet recovered its pre-crisis levels. This had adverse social consequences in rural employment and income, and might be one of the factors that explain the persistence of high levels of rural poverty.

Nonetheless, the increase of the value added of the other main agricultural activities –sugar cane, peanuts, grains and other crops- helped to offset the contraction of coffee output. Sugar cane and peanuts were stimulated by the increase of their export quota to the US under the CAFTA agreement, while grains production for the domestic market has been growing since the early post-conflict years, mainly through the conversion of tropical forestland into agriculture, though this growth has decreased in recent years. Red beans exports, which are also included in grains production, has been particularly encouraged by the growing demand of El Salvador and other Central American markets. The future growth of grains production, however, is likely to be restricted by the exhaustion of the agriculture frontier and by the increasing variability of rainfall caused by global climate change.

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The expansion of the other main pillar of the primary sector, cattle production, has also been based on the availability of forestland. Cattle and milk production have grown steadily, stimulated by private investment in the establishment of new processing plants and the renovation and expansion of existing ones. Cattle growth, however, has been negatively affected in recent years by government restrictions on the export of live animals to the growing markets of Mexico and other Central American countries. The government acted under the pressure of the beef processing industry that felt threatened by foreign competition. The other significant animal production activity, poultry, also experienced a steady growth over the period, stimulated by increasing demand from the domestic market.

The depletion of natural resources has severely affected the growth of other primary sector activities such as forestry, fishing and mining. The extensive and indiscriminate exploitation of timber forced the government to establish a moratorium on extraction of the most profitable timber species, which in turn has slowed export growth. Likewise, overfishing prompted new government regulations that aim to replenish the stocks of fish, lobster and shrimp. The decline of ocean fishing, however, has been offset by the rapid growth of shrimp farming. Mining has also been affected by the exhaustion of the existing gold mines, and the gross production value of metal mining has declined by one third over the period 2001-2008.

The weak performance of the primary sector contrasts sharply with the dynamic growth of the manufacturing sector over the period 2001-2008. The textile, garment and leather and the food, beverages and tobacco manufacturing branches were the main drivers of this expansion. Thus, the share of the primary sector of total value added declined from 21.5 percent to 20.2 while the corresponding share for the secondary sector increased from 17.1 to 19.7 percent.

The value added of textile, garment and leather products more than doubled over the period in response to the successful negotiation of the CAFTA with the US. Under this trade agreement, the Nicaraguan textile and garment industry was favored with more concessionary rules of origin than those negotiated for its Central American counterparts.

The strong development of agro-industrial activities –beef, dairy products and sugar- played a key role in the significant increase of the value added of the food, beverages and tobacco manufacturing branch. The sugar industry has benefited from increased access to the US market as mentioned above and the growing international demand for ethanol. Beef and dairy products have benefited from the growing demand from Central American countries and the Caribbean, and from the migrant communities that live in the USA. Thus, the cluster development strategy was successful at promoting export growth.

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The commerce and services sector grew faster than the economy as a whole over the period. Financial services, communications and hotels and restaurants were the most dynamic activities of this sector. Banking coverage and services expanded considerably after the government rescue of the banking system during 2000-2001, while the entry of new firms stimulated the telecommunications' market and has improved the access to telephone lines and the Internet. Nicaragua still has the lowest access rate to telephone lines (including cell phones) and to Internet in Central America. Finally, the growth of the hotels and restaurant services was associated with the dynamism of tourism.

In synthesis, the weak economic growth performance over this past decade and the adverse consequences of the global financial crisis suggest that aid supported government policies need to be modified and adapted to foster economic recovery and poverty reduction. While the cluster development strategy succeeded in fostering the growth of industry and services, such as textiles and tourism, the overall stagnation of the key primary sector held back economic and social development and explains the stagnation in rural poverty reduction. In fact, the few dynamic branches in primary production, notably sugar cane, peanuts and cattle, are relatively capital intensive and provide little employment.

The cluster development strategy also failed to address key structural bottlenecks, such as the needs of the large informal sector and the limited skills of the labor force. The micro, small and medium enterprises and agricultural holdings of the informal sector employ 63% of the economically active population. These enterprises are characterized by low capital invested per worker, resulting in low labor productivity and in most cases also low product quality and market potential.

The majority of the labor force still has no or only primary education. The educational pyramid is not conducive to economic growth considering Nicaragua's level of development.



There are many more youth enrolled in universities than in technical education. Furthermore, the public system for provision of technical and vocational education and training is ineffective and does not respond to the demands of the private sector.

The rural sector, which harbors the majority of Nicaragua's poor population, faces three additional structural problems: inequality of access to land and land markets, lack of access to financial services and inadequate transport infrastructure, particularly roads. Despite the considerable land redistribution that took place during the 1980s and early 1990s, land distribution is highly skewed. The estimations of the Gini Coefficient varies from 0.72 (Carter et al., 2005) to 0.86 (World Bank, 2003), which means that Nicaragua has one of the highest level of land concentration in Latin America (Hollinger and Davies, 2008). The landless represent 38% of the rural population (Reardon and Corral, 2005).

Land concentration has been stimulated by two parallel processes. The first is the expansion of the agricultural frontier through the destruction of the remaining humid tropical forests followed by the conversion of small agricultural plots into large cattle farms. The other key process is the sale of land by the former beneficiaries of the agrarian reform of the 1980s and early 1990s because of land rights insecurity, lack of credit and of technical assistance. The poor access to financial services has improved with the growth of microfinance over the last decade but is still limited. Only a quarter of the total households have access to credit according to the LSMN 2005, and the proportion is slightly lower for the rural sector. Other financial services, such as savings and insurance, are even less developed.

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The condition and coverage of Nicaragua's road network are the poorest in Central America, limiting access to markets and social services for many rural communities, particularly in the Caribbean regions. Only about 19% of rural households in Nicaragua has access to a paved road, and in the Caribbean region it is only 10% (World Bank 2008a). Road access is an important factor in economic development.

These structural problems have been only partially addressed by the Ortega government. Although the Human Development Plan identifies the market exclusion of the small and medium agricultural holdings and enterprises as the key constraint on pro-poor economic growth, the Ortega government has not significantly changed the existing policies and programs towards this sector.

Rural development policies do not deal with the inequality of access to land and land markets, and have instead given continuity to the Bolaños policy of legalizing existing agricultural holdings. Yet, the Ortega government gives serious attention to the demarcation and titling of indigenous territories. Though the government recognized that one of the main constraints on rural producers is the lack of access to financial services, and proposed the establishment of the state development bank, this bank still only exists on paper. In addition, the starting capital of the bank that has been approved by Parliament falls far short of the estimated needs of the agricultural sector. The government has not been able to improve rural road infrastructure due to fiscal constraints.

There is limited government support for improving market access and competitiveness of micro, small and medium manufacturing and services enterprises. Their access to financial markets has not improved significantly because the government program Zero Usury only provides a limited amount of working capital and has low recovery rates. Furthermore, this program's lenience with respect to the repayment obligation has negative spill-over effects on the sustainability of other micro-credit programs in the country and may therefore have a net negative effect on poverty reduction.

With regard to education, school attendance seems to have increased slightly with the elimination of school fees but the policy towards higher education has not changed. Technical education continues to be relegated in favor of university education. Per-capita education expenditures have not increased.

Finally, two sets of tensions affect the climate for economic growth and poverty reduction. The first set is related to the tension between building the parallel public-private ALBA business group and the national business sector. The justification for the formation of ALBA was an ideological anti-capitalist and anti-American discourse, while arguing at the same time for the need to improve the climate for private investment. Through ALBA, the government is creating firms that compete with domestic and foreign private investors. To address this problem, the government engages in bilateral negotiations with the domestic private sector (COSEP) and with individual foreign investors. It remains to be seen whether this is sufficient to temper the private investment decline that has already set in.

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The second tension is between the use of Venezuelan aid to build up the ALBA business group and for political clientelism, and the urgent need to expand social expenditure, productive credit and public investment more generally in the context of economic recession. Unless there is a reorientation of the use of these funds, Nicaragua will continue to have slow growth and limited poverty reduction.

### 5.3 Social policies and results

Over the long term, from 1993 onwards, most social indicators improved. However, in the period 2001-2005 (or 2006), the period of the Bolaños government, the picture is much less favorable. Progress on social indicators was limited, with small improvements in infant and child mortality and virtual stagnation in primary school enrolment rates (Table 5.1). Family planning coverage declined from 24.5% in 2001 to 12.9% in 2005 (World Bank, 2008b). In access to water and sanitation, some progress has been made between 2001 and 2005 and also, it seems, between 2007 and 2008 (Table 5.1).

After 2006 some more improvements can be observed. According to government figures (not in Table 5.1), maternal mortality decreased in 2008. Government figures show some increase in school enrolment and a large decrease in the illiteracy rate in 2008. However, the reliability of many of these figures, especially those provided by the government, can be questioned. The most reliable data are those obtained in the 1993, 2001 and 2005 LSMS, and in the 1998, 2001 and 2006/7 (registered under 2006) Demographic and Health Surveys (DHS).

	1993	1998	2001	2002	2003	2004	2005	2006	2007	2008
Net primary enrolment	76		83	86	86	87	84	86	87	87
Illiteracy	19		19				18		20	8
Infant mortality	58	42	30					29		
Child mortality	72	51	37					35		
Chronic malnutrition	20		18				17	17		
Immunization rate		80	72					85		
Institutional births		64	66					74		
Access to water*	68		70				72	85	65	70
Access to sanitation*	45		52				56		36	42

\* Given the large fall in 2007 and 2008, the definition of this access has probably changed over time.

Sources: 1993, 2001, 2005: World Bank (2008a); child and infant mortality, immunization rate and institutional births 1998, 2001, and 2006: DHS 2008; For 2002, 2003, and 2004: MED and MINSA as published in Guimarães & Avendaño (2008); for 2006: Government of Nicaragua (2007), and for 2007 and 2008: Government of Nicaragua, "Programa Económico-Financiero 2007-2010, Evaluación de Indicadores Sociales 2008" (available from [www.bcn.gob.ni](http://www.bcn.gob.ni)).

Nevertheless, it can be asked why progress has been so slow between 2001 and 2006. Social indicators improved only slightly despite increases in social spending and poverty reduction spending as of 2002. This section attempts to answer some of these questions by analyzing in more detail government income and expenditure: the structure of revenues and expenditure and their incidence, and the targeting, efficiency and quality of government services. To the extent possible, changes in 2007 and 2008 are analyzed as well.

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### 5.3.1 Government revenues: structure and incidence

Some of the structural inequalities in the Nicaraguan economy as analyzed in 5.2. are also visible when we examine the structure of government income and expenditure. As shown in Chapter 4, tax revenues as percent of GDP have increased since 2002, from 13.4% of GDP in 2002 to 18.0% of GDP in 2007. This was due to introduction of the Tax Equity Law in 2003 and to improvements in the tax administration. Economic growth also helped. Before this Law, taxes on goods and services, including taxes on trade, represented almost 80% of total tax revenues. Apart from a value added tax, there were excise taxes on about 1000 products. On the other hand, income taxes for both companies and individuals had many exemptions. The new Law introduced a tax on assets, increased the tax base by taxing financial profits and by eliminating the accelerated depreciation mechanism for investment, and simplified excise taxes. A Poverty and Social Impact Analysis concluded that the new Law would increase the progressiveness of the tax system. This study used the shifting assumptions method and measured the tax burden per quintile of household consumption (Gasparini et al., 2006). The same study found that the existing individual income tax was already progressive before the tax reform, and that this would not change after the reform.

	2002	2003	2004	2005	2006	2007	2008
Income tax	20.9	26.1	28.3	28.6	29.5	30.4	32.3
VAT	19.2	17.0	16.6	15.7	16.3	16.4	14.5
Special consumption taxes	6.9	6.4	5.5	5.4	5.1	4.9	5.2
Oil products tax	18.2	16.7	14.4	12.9	11.4	11.1	10.0
External trade	34.5	32.0	34.8	37.3	31.3	31.4	32.3
Other tax income	0.3	1.8	0.3	0.1	6.3	5.7	5.8
Tax revenues	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memo items:							
Tax revenues in % of GDP	13.4	15.1	15.7	16.7	17.4	18.0	17.6
All revenues in % of GDP	14.8	16.4	17.2	18.0	18.8	19.6	19.0

Source: Elaboration of MHCP liquidación presupuesto, several years.

In fact, Table 5.2 shows that the share of income tax in total revenues indeed increased after 2002, from 20.9% to 32.3%. The share of VAT and special consumption taxes decreased. As income taxes are probably more progressive than other taxes, the progressiveness of the tax system did indeed increase. However, it must be born in mind that the system was regressive at the start. In addition, the system still had many weaknesses, also after this reform (Artana, 2005). The tax base is still low due to widespread evasion and also due to still existing special treatments, the so-called tax expenditures. Artana estimates that the total loss in forgone tax income is about 11% of GDP, of which 60% is due to evasions and 40% due to tax expenditures. It can be expected that the benefits of both accrue mainly to the higher income groups. The very large extent of evasions puts the information on the progressiveness of the tax system in perspective: one can only measure the relative tax burden for taxes that are actually paid. The largest inequality in tax payments is probably due to the fact that the rich manage to not pay taxes at all.

### 5.3.2 Government expenditure

Table 5.3 shows the functional distribution of expenditure, in percent of total expenditure including debt amortization. Total debt payments have taken 20% of total expenditure over these seven years – more than the average amount spent on education. That is very high, and this money could not be used for improving the social indicators. More importantly, the share of expenditure spent on *internal* debt payments directly contributes to the skewed income distribution in the country, since it accrues either to rich individuals or it helps to increase the profits of domestic banks - which are owned by rich Nicaraguans. This share has been 12.8% on average, which means that one-eighth of the total budget is directly benefiting the rich in Nicaragua. This structural feature of the Nicaraguan budget both maintains poverty and inequality in the country, and reduces the chances of improving the other Millennium Development Goals as well. In this context, it is positive that the Ortega government managed to renegotiate the terms of the domestic debt. The agreed reduction in the interest rate is already visible in a slight decline in 2008 internal debt payments, but 12% is still high.

	2002	2003	2004	2005	2006	2007	2008	average
Social	37.1	35.6	41.2	43.0	43.0	45.3	47.6	41.8
Education	17.5	16.4	17.4	18.2	18.4	19.4	20.7	18.3
Health	13.3	12.2	12.8	13.3	13.2	14.4	14.4	13.4
Other social	6.3	7.0	11.0	11.5	11.5	11.5	12.6	10.2
Economic services	15.6	13.5	18.0	15.5	11.8	14.9	14.4	14.8
Administration	12.0	9.0	11.6	13.4	15.0	9.9	10.5	11.6
Defense and security	11.6	10.2	10.6	10.3	11.3	11.6	11.4	11.0
Total debt	22.8	30.7	18.0	17.3	18.5	17.9	15.7	20.1
Internal debt	9.3	12.9	15.0	13.4	13.5	13.8	12.0	12.8
External debt	13.5	17.8	3.0	3.9	5.0	4.1	3.6	7.3
Total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memo item:								
Total expenditure in % of GDP	23.0	28.6	25.1	26.0	25.8	25.9	25.8	25.7

\* Total expenditure includes debt amortization.

Source: Elaboration of MHCP liquidación presupuesto, several years.

### Targeting, efficiency and quality of expenditure

According to the Public Expenditure Review (PER), Nicaragua spends a similar percentage of GDP on health and education as the average Latin American country (World Bank, 2008b). Health spending is slightly above the average for Central America. However, the country spends relatively much less on secondary education, and more on tertiary education. In fact, the country spent USD1000 per university student in 2005. At the same time, the Poverty Assessment found that virtually all of this spending benefits the non-poor (World Bank, 2008a). There are also other categories within social spending that mainly benefit the non-poor. A large part of “other social spending”, for example, comprises pensions that are received by those having enjoyed formal employment, usually the middle and higher income groups. Social spending as a whole has been shown to benefit the non-poor more than the poor: more than 55% of this spending is enjoyed by the non-poor.

The same study also analyzed poverty reduction expenditure. Poverty reduction expenditure excludes spending on higher education, and includes rural development programs, municipal transfers for social infrastructure, and rural roads, among other issues. It was found that within poverty reduction spending, primary education, pre-school education, adult education, school feeding programs, the conditional cash transfer program (social protection), and curative health care are pro-poor meaning that these services are more used by the poor than by the non-poor. However, several other social programs included in poverty reduction spending are more used by the non-poor, for example secondary and technical education. Preventive health care was only marginally pro-poor. In the non-social areas, rural development programs were pro-poor as well as food aid from the World Food Program. Most projects of the Emergency Social Investment Fund (FISE) were pro-poor, with the exception of community works. On the whole, the targeting of the poverty reduction spending proved to be slightly better than of social spending, but still 47% of this spending benefits the non-poor (World Bank, 2008a).

This benefit incidence analysis of government spending shows a too rosy picture of the actual distribution effects, as it only examines the use of actual government services of different income groups. Those who do not have access to these services at all are not included in the measurement of the concentration indices. Some 15% of pupils in school age do not attend primary school, and 38% of children of four to six years old do not have access to pre-school education. The most important reason given for not attending school is “lack of money”, which may include lack of money for transport (World Bank, 2008a).

In 2004, a study has been carried out on the targeting of public investment (Belli, 2004). It focused on investment in education, health and infrastructure, and found that this state investment was highly regressive with respect to geographical areas. Most investment was carried out in the central and Pacific regions, which are the most prosperous ones. The reverse targeting was largest in health. But this may have improved. FISE explicitly uses a poverty map in the allocation of its thousands of small-scale investments all over the country.

It is difficult to conclude on the targeting of poverty reduction expenditure after 2005. Poverty reduction expenditure itself decreased in 2006, which was mainly due to a slower execution of investment projects. Although it recovered in 2007, the level is only slightly higher than in 2005. Some changes came about within this spending (Table 5.4). The new government abolished the conditional cash transfer program (FISE social protection) which was highly pro-poor. At the same time, it expanded adult education (with literacy campaigns, among other things) and abolished fees for primary education and health care services. Some effects of these measures can be observed, for example in the enrolment rate and the illiteracy rate (Table 5.1). The new government also aims to give more attention to preventive care, including mother and child care. The reduced maternal mortality rate in 2007 and 2008 may be due to these efforts, but is also due to other factors, such as aid-financed or donor-induced expansions of health post and of family planning programs, already started during the previous government, and the cooperation of Cuban doctors in the Atlantic region. In the new poverty reduction spending definition, the programs Zero Hunger and Zero Usury are now also included, but effects of these programs on poverty are as yet unknown.

The efficiency of health and education spending, measured by comparing input with output indicators, proves to be low in Nicaragua. The health sector performs slightly better than the education sector, but both rank below the medium Latin American country (World Bank, 2008b). A sector analysis of health spending found that health spending is not only badly targeted, but that there is also too much emphasis on curative care instead of on preventive care. Another structural inefficiency of the health sector is evident in the procurement and distribution of medicines (World Bank, 2007). This is confirmed in the outcomes of the LSMS: among the poorest two quintiles, the most important reasons for not seeking care when ill (apart from self-medication) are “lack of medicines”, and “distance”, before “too expensive” and “low quality” (World Bank, 2008a). The health sector PER also found that the increases in health expenditure in 2005 and 2006 have mainly been absorbed by salaries (World Bank, 2007).

**Table 5.4 Some categories of poverty reduction spending, 2005-2008 (in % of total expenditure)**

	2005	2006	2007	2008
Total expenditure	100.0	100.0	100.0	100.0
Poverty expenditure	50.4	47.7	51.6	51.7
Education minus universities	13.3	13.1	13.9	15.3
Primary	6.7	7.7	8.2	7.5
Secondary	1.5	1.3	1.4	1.3
Pre-school	0.2	0.2	0.3	0.2
PINE (school feeding)	0.0	0.4	0.3	1.2
Adult education	0.5	0.5	0.3	0.4
Health	13.3	13.2	14.4	14.4
FISE water and sanitation	0.9	0.2	0.1	0.1
FISE social protection	0.1	0.0		
Bonos productivos			0.6	0.8
Usura cero			0.2	0.3
FISE social investment	0.8	0.2	0.6	0.9

Source: Elaboration of data from MHCP, *Informes de Ejecución Presupuestario, 2005-2008*.

The education sector expenditure review analyzed internal efficiency of the sector and found that some indicators for this deteriorated between 2002 and 2006. Dropout rates from preschool education increased from 13% to 16%, and from primary education from 7 to 13% (Moore & Soto, 2007). The pupil teacher ratio in the public primary school increased in the same period. On the other hand, the primary completion rate increased from 26% in 2001 to 41% in 2005 and was maintained at 40% in 2006 (p. 44). This review also found that the increased budget had mainly been used for salaries. In 2005 and 2006 there was a marked decrease in physical investment for the sector, which was expected to have serious consequences for the future.

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## 5.4 Conclusions

The economic policy of the Bolaños government focused on improving the investment climate for large and foreign investors, especially in some targeted clusters: textiles and clothing, tourism, and agro-industry (coffee, meat, dairy). This would lead to growth and the benefits of this growth would automatically trickle down to the poor. For the poorest of the poor the government maintained the social protection network (set up and still mostly financed from foreign aid), the Nicaraguan conditional cash transfer program.

There has been growth between 2001 and 2006, but it was lower than 2% per capita. The most dynamic production sector was textiles and clothing, which was mainly assembly production from the free trade zones. Some of the other clusters favoured by the Bolaños government also registered high growth rates, especially agro-industry (food, beverages and tobacco). Other dynamic branches were transport and communication, financial services, and trade, hotels and restaurants. However, growth rates in many other sectors lagged

behind. In any case, the Bolaños strategy of improving the business climate for domestic and foreign investors has not trickled down. Despite this positive growth, there was no reduction in poverty between 2001 and 2005 and only a slight decrease in extreme poverty. While social indicators improved, several others deteriorated despite steady increases in social spending.

Explanations for the slow progress in poverty reduction include:

- The extreme inequality in assets (land, credit) and income in Nicaragua, which causes a low poverty elasticity, implying that a much higher growth rate is necessary for reducing poverty;
- The growth policy of the Bolaños government focusing on clusters that - with the exception of assembly industries, are *extensive* in employment;
- The liberalization policies of both previous and the Bolaños government that allowed for high profits in trade, transport and communications, energy, and the financial sector - sectors with little employment;
- A (although improved since 2002) regressive tax structure, exacerbated by many exonerations and by pervasive evasion;
- The highly regressive structure of government expenditure with some 13% of expenditure directly going to the richest households in the form of internal debt payments;
- The poor targeting and low efficiency of social spending;
- The high leakage to the non-poor (47%) of “poverty reduction expenditure”

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From 2007 the Ortega government pursued different growth and poverty reduction policies. The policy of free education appears to have increased primary enrolment rates and adult education programs have managed to reduce illiteracy rates. The government managed to negotiate a lower internal debt service. In the productive realm, it abolished the cluster strategy and has more attention for the structural constraints of small producers. This may enhance prospects for employment growth. However, in practice, access to land and to credit hardly improved so far. The use of Venezuelan aid to create a new public-private business group appears to be hampering private investment. In addition, growth prospects are reduced due to the impact of the global financial crisis. All in all, it can be doubted whether a substantial reduction in poverty will be achieved under the Ortega government.





# Annexes

## Annexe 1 About IOB

### Objectives

The objective of the Policy and Operations Evaluation Department (IOB) is to increase insight into the implementation and effects of Dutch foreign policy. IOB meets the need for independent evaluation of policy and operations in all policy fields falling under the Homogenous Budget for International Cooperation (HGIS). IOB also advises on the planning and implementation of the evaluations for which policy departments and embassies are responsible. Its evaluations enable the Minister of Foreign Affairs and the Minister for Development Cooperation to account to parliament for policy and the allocation of resources. In addition, the evaluations aim to derive lessons for the future.

Efforts are accordingly made to incorporate the findings of evaluations into the Ministry of Foreign Affairs' policy cycle. Evaluation reports are used to provide targeted feedback, with a view to improving both policy intentions and implementation. Insight into the outcome of implemented policy allows policymakers to devise measures that are more effective and focused.

### Approach and methodology

IOB has a staff of experienced evaluators and its own budget. When carrying out evaluations, it calls on the assistance of external experts with specialised knowledge of the topic under investigation. To monitor its own quality, it sets up a reference group for each evaluation, which includes not only external experts but also interested parties from within the Ministry.

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### Programme

The evaluation programme of IOB is part of the programmed evaluations annexe of the explanatory memorandum to the budget of the Ministry of Foreign Affairs.

### An organisation in development

Since IOB's establishment in 1977, major shifts have taken place in its approach, areas of focus and responsibilities. In its early years, its activities took the form of separate project evaluations for the Minister for Development Cooperation. Around 1985, evaluations became more comprehensive, taking in sectors, themes and countries. Moreover, IOB's reports were submitted to parliament, thus entering the public domain.

1996 saw a review of foreign policy and a reorganisation of the Ministry of Foreign Affairs. As a result, IOB's mandate was extended to the Dutch government's entire foreign policy. In recent years, it has extended its partnerships with similar departments in other countries, for instance through joint evaluations.

Finally, IOB also aims to expand its methodological repertoire. This includes greater emphasis on statistical methods of impact evaluation. As of 2007 IOB undertakes policy reviews as a type of evaluation.



## Annexe 2 Terms of Reference Budget support Nicaragua

An elaboration of the applied methodology by evaluation question

### Evaluation Question 1: Ownership

On the one hand, ownership is the opposite of donor influence (EQ 2): the more influence of donors, in the sense of getting things done that the government would not have done otherwise, the less ownership. But under this EQ we can also measure the perception of national ownership and national accountability among different actors within government, political parties (National Assembly members), and civil society. The question is, first, whether GBS has increased the perception of national ownership among these actors (as compared to project aid), and second, whether GBS through the assumed improved transparency of budgets and budget execution, has increased national government's accountability.

### Evaluation Question 2: Influence

This involves four steps:

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#### 1. *Preconditions for budget support*

Why did, and do, the Netherlands and other donors provide budget support, what were the conditions and to what extent were these conditions considered to be fulfilled and actually fulfilled at the start? For the earlier years, use can be made of previous studies (Guimarães *et al.* 2004; Guimarães *et al.* 2005; Booth *et al.* 2006; Gosparini *et al.* 2006). For the years 2007 and 2008, donor documents will be studied and interviews with donors will be held.

#### 2. *An investigation of government and donor priorities for the PAM*

In interviews with government representatives (separate 2005-06 and 2007-08, if possible) of different agencies (MHCP, MINREX, SETEC, line agencies), it will be asked what the priorities were for the PAM. In the case of donors, the investigation involves inquiring after donor concerns, in terms of *discrepancies* between donor wishes and actual policies and institutions, and the actual attempts at influence via the setting of priorities for the PAM. In all this it is good to distinguish between *development* concerns and priorities, and *governance* concerns and priorities as in Hyden (2008). Measuring influence on the basis of discrepancies or explicit priorities or donor wishes implies that so called "latent influence" is excluded. This latent influence (if government considers certain policies as obvious or natural, while in fact they are based on donor influence or donor power) is very difficult to assess.

Sources: Interviews with government officers, donor documents and interviews with donors.

### 3. Assessing the influence of government and donors on the PAM

What was the influence of donors and of government on the PAMs, i.e. to what extent are the respective priorities reflected in the contents of the matrices, 2005-08? How did this come about? Extent of pre-meetings among donors and degree of harmonization of priorities/concerns, discussions with government officers: which officers, how many meetings and how long? What instruments were used?

Sources: JFA plus matrices, interviews with donors and government officers involved. In interviews with government officers: why were donor concerns accepted (if so): expert knowledge brought in by donors, or power of the money? Is the PAM perceived as owned?

### 4. Influence on actual policies and institutions

Actual influence may occur through three channels: direct contacts with government officers (what level on both sides?), attempts at influencing policies via the process indicators in the PAM, and attempts at influencing outcomes via the output and outcome indicators in the PAM. The question is whether these three types have been effective in influencing actual policies and outcomes and to what extent. I will look for concrete examples of influence.

Sources: Mid-year and annual evaluations of GBS and donor responses to these government reports. But also broader evidence of actual policies and institutions via own data collection, an analysis of fiscal accounts to examine poverty reduction expenditure,<sup>79</sup> using PEFA indicators for analysing PFM, using documents such as IGR, PER, Doing Business, Poverty Assessment and Progress Reports on PRSP; and interviews with key informants in and outside government.

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## Evaluation Question 3: Intermediate effects

### 1. Strengthening government systems

a) Have government systems for planning, procurement, implementation and monitoring changed since 2005? Focus on health and education ministries. To what extent was this due to GBS or SBS? To the extent there was a move from project aid to GBS, SBS or basket funding, did this help for bringing about the observed changes?

b) Have public financial management systems (budgeting, reporting, auditing) changed since 2005? In particular at the Ministry of Finance but also in health and education ministries and in decentralization: budgeting, reporting and auditing at municipal level. To what extent are changes due to GBS or SBS?

Sources: PERs 2001 and 2008, IGR, other documents; plus interviews with (former) government officers in different ministries and municipalities, donors.

<sup>79</sup> It is important to also look at the definition of poverty reduction expenditure as it has changed over time (Guimarães and Avendaño 2008).

2. Transaction costs<sup>80</sup>

Transaction costs are the costs of making a transaction, in this case aid; i.e. the costs of preparing an aid contract (information and search costs), negotiating it, and of monitoring of and bonding for the aid contract (Hazeu 2000). The evaluation question is whether transaction costs have been reduced. Should actual transaction costs be compared with the situation of before GBS, so 2004? Or should GBS transaction costs be compared with project aid transaction costs? I propose to focus on the latter, but to use its outcome, together with an assessment of the extent of changes in aid modalities since 2004, in order to estimate whether transaction costs have been reduced between 2004 and 2008. For the assessment of changes in aid modalities some work has already been done (Dijkstra and Komives 2008).

**Table 1 Overview of transaction costs of aid, for donor and recipient, project aid and budget support by type of costs**

	Project aid		GBS	
	Donor	Recipient	Donor	Recipient
Information and search	Priority setting at HQ and in country; preparatory visits or missions to the field	Defining “supportable” projects and programs, selecting appropriate donors for them	Determining criteria for GBS at HQ; Assessment of quality of PRSP, governance, PFM, macro-economic stability (e.g. via “track records”)	Finding out donor criteria for GBS and trying to comply with them; e.g. writing PRSP; negotiating and maintaining IMF agreement; cooperating with TA in PFM
Negotiation	Negotiation with particular agency involved	Negotiation with particular donor involved	Discussion on JFA, preamble and annual matrices; among donors and with government	Discussion on JFA, preamble and annual matrices
Monitoring and bonding	Financing executing agency and/or monitoring unit; monitoring in embassy and at HQ; mid-term and final evaluations	Reporting, auditing and monitoring as required by the donor	BSG meetings; Mid-term and annual meetings	Writing progress reports for mid-term and annual meetings; participation in those meetings; Writing Annual Progress Reports on PRSP

<sup>80</sup> The measuring of transaction costs is not the highest priority within this evaluation. Rigorous data collection would probably take too much time from the evaluator but also from government officers. Estimates will be made.

Transaction costs should be related to the value of the aid contract; ideally its ultimate benefit, so its impact. Impact is a result of both the effect of the aid money and of the attempt to influence government policies and institutions. It can be assumed that the latter is larger with GBS, so both in comparison with before GBS and in comparison with project aid. For the moment, I assume that impact of different types of aid is proportional to the amount of aid money involved. If the results of the evaluation give reason to think otherwise (more effective budget support than project aid - or the reverse) then this assumption can be revised. This means that transaction costs will be related to the amount of money involved in the respective aid contracts. Applying the three types of transaction costs to GBS and to project aid, and looking at costs at both sides, results in Table 1.

Transaction costs will be calculated via an estimate of the amount of time spent. Time can be converted in money by taking the opportunity costs of, say, an hour spent; usually this will be the value of an hour's salary of the person involved. I propose to focus on transaction costs for the recipient and to attempt to estimate time involved in the three types of transaction costs during a specific period. The number of hours involved will be broken down by level of the government officer involved, in three broad groups: minister or higher, senior officers, and junior or lower officers.

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For project aid, transaction costs can be estimated for the (one) Dutch project in health (Direct support to a project aiming at the prevention of cervical carcinoma, implemented by both government and an NGO) and projects in private sector support. For projects, transaction costs must be estimated over the life cycle of the project (not annually) and compared with the full project amount. Alternatively annual transaction costs can be compared with annual disbursements, but the disadvantage is that preparation costs are not covered in that case.

### 3. Operational and allocative efficiency

#### Allocative efficiency

According to IDD and associates (2006: 51),<sup>81</sup> allocative efficiency is “the degree to which resources are allocated according to the strategic priorities of the government. .... greater allocative efficiency might involve reorienting expenditures towards PRSP priorities.” However, it cannot be taken for granted that PRSP priorities or pro-poor expenditures are strategic priorities of the government. Woll, for example, concluded for Ghana that Millennium Challenge Account investments were more in line with the government's priorities than the pro-poor expenditure made for the GBS donors (Woll 2008).

It is difficult to know what the strategic priorities of the government are. It can be assumed that the availability of more discretionary (non-earmarked) resources will enhance the chance that the government can achieve its objectives - unless offset by possible negative effects of lack of predictability of donor disbursements (both during budget years and across years) and of donors requiring ring fencing of specific expenditure (e.g. pro-poor

<sup>81</sup> Apparently based on World Bank 1998, *Public Expenditure Management Handbook*.



expenditure), as donors generally do. The latter is precisely what the Uganda country report of the Joint Budget Support Evaluation found: the protection of the Poverty Action Fund led to greater unpredictability of resources for other spending and decreased allocative efficiency of the overall spending (IDD and Associates 2006).

In sum, I propose to not equalize allocative expenditure with increased pro-poor expenditure. This issue is investigated under EQ 2. Instead, allocative efficiency is improved if the government is more able to achieve its expenditure objectives. This is by definition the case if there is a larger amount of discretionary resources available, provided these resources are predictable. The higher chance to achieve government objectives includes the possibility to help improve the balance between capital and recurrent expenditure,<sup>82</sup> providing counterpart funds for donor investment projects or providing recurrent costs other than wages (school meals, maintenance) for the social sectors.<sup>83</sup> It also has to be examined, however, to what extent donor demands for increased poverty reduction expenditure decrease allocative efficiency of expenditure.

Sources: analysis of actual expenditure 2004-2008 by capital and recurrent (wage and non-wage), preferably by sector; interviews with officers in Ministry of Finance and financial officers in line ministries.

### Operational efficiency

In line with (Leibenstein 1966), I define operational efficiency as the technical or X-efficiency of government expenditure, or the relation between inputs and outputs. A higher operational efficiency means that the same amount of money spent leads to a higher number of people served and/or to a higher quality of services or, conversely, the same number of beneficiaries and/or the same quality are achieved with a lower amount of money. In this respect, a positive effect of GBS cannot be taken for granted and a negative effect due to abundant resources in some sectors is possible - and was in fact found for Uganda (IDD 2006) and Tanzania (Lawson *et al.* 2005).

In fact, examining the quantity and quality of relevant services delivered is part of the investigation of the effects of government policies, and thus part of EQ 4. Operational efficiency can thus be determined after those results are available. However, under this third EQ data can be collected on the input side of the efficiency equation: data on expenditure by sector 2001-2008,<sup>84</sup> in per cent of total expenditure, in percent of GDP, in real spending, and in real spending per capita. Sectors examined will be health, education, perhaps also water and sanitation, ...?

<sup>82</sup> Also in this case it is important to look at definitions, as investment proved to include a large amount of recurrent expenditure (World Bank 2008b).

<sup>83</sup> In IDD (2006) these aspects are included under operational efficiency but in my view this is not appropriate.

<sup>84</sup> The year 2001 is selected because the previous Poverty Assessment is of that year. In addition, it is one year before start of Bolaños government so a good benchmark.

## Evaluation Question 4: The effect of government policies on economic growth and poverty reduction

Only a preliminary assessment can be made of the effects of policies of the Ortega government (2007- ) but those of the Bolaños administration (2002-2006) can be examined fully.

For this EQ, many data on outcome and impact indicators will be collected. There are two methodological approaches to establishing the link between policies and outcomes. One is to start with policies (including expenditure, laws, decrees, etc.) and assess their outcomes, and the other is to start with outcomes and assess the influence of policies along with other possible influencing factors. I propose to do both.

### Assessing the impact of policies

#### Targeting of expenditure and incidence of taxes

How much did the poor benefit from government expenditure and how much is the relative contribution of the poor to government revenues? This implies carrying out a benefit incidence analysis and a tax incidence analysis. The former can be found in the latest Poverty Assessment (World Bank 2008a). Estimates will have to be made of distributional effects of expenditure changes made after 2005 (the year of the household survey reported in the Poverty Assessment).

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Sources: unfortunately, there does not seem to be a tax incidence analysis available. An assessment will have to be made of the distributional consequences of tax measures implemented since 2005 (or 2002?).

#### Establishing a relationship between expenditure by sector and sector outcomes

Expenditure data have been collected (see under EQ 3). For education, relevant output and outcome indicators include enrolment rates, completion rates, pupils by teacher, dropout and repetition rates, measures (tests) for quality of education (if available); separate for primary, secondary and tertiary education if possible; For health: number of doctors, nurses, drugs, health posts, number of clients served (use of health facilities), number of births attended by skilled employee, reduction of main diseases, weight for height, height for age, maternal mortality rate, infant and child mortality rates, vaccination rates, ... For water and sanitation: new connections to water and to sanitation, households with improved water source, access to sanitation. All indicators for the years 2001-2008.

Sources: if possible, data will be collected for assessing the geographical targeting of government expenditure in the these three sectors, and compare it with outcomes per region.

#### Poverty Expenditure Tracking Survey (PETS)

Unfortunately this has not been done yet in Nicaragua, so results cannot be used. It could be considered to carry out a PETS in the context of this evaluation. The objective is to trace the flow of resources from the central budget via regions (departments) and municipalities to the actual service providers. Apart from examining what share of the money actually arrives at

service delivery level, it also includes an assessment of transparency, timeliness, and possible regional and municipal disparities. It would indeed have to be a survey and possibly limited to one sector. Perhaps a local research institute can be commissioned for this research.

#### **The effect of changes in policies and institutions on output and impact indicators**

Following up on the analysis of changes in policies and institutions (see EQ 2) and including other, not donor-induced changes in institutions and policies, the possible effect on outcome and impact indicators can be assessed for each and every change.

Indicators to be considered for the period 2001-2008:

- Time involved in setting up a new business, and other outcome indicators for the business climate (From Doing business in Nicaragua)
- Private investment
- Exports
- Economic growth
- Social indicators at outcome level (see above)
- Income poverty: (extreme) poverty headcount, poverty gap
- Gini index

#### **Assessing outcomes and their causes**

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What other factors - apart from government policies and institutions - can explain the changes in outcome and impact indicators as listed above?

Use will be made of documents and studies commissioned by government and donors, of academic literature and of interviews with Nicaraguan researchers.



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Ministry of Health (MINSAs)

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Omar Cabezas Lacayo, Ombudsman

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Ministry of Energy and Mining (INE)

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World Bank

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Jaime Remmerswaal, Secretary for governance

Jan Bauer, Secretary for sustainable economic development

Silvia Porres, Advisor human and women's rights

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*October 2009*

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General Budget Support (GBS) has been an important part of Dutch development cooperation to Nicaragua over the years 2005-2008, representing about one-third of total bilateral aid to Nicaragua. This report aims to assess whether the outcomes of General Budget Support to Nicaragua have been in line with the expectations for this aid modality. It is the first publication of a new series of IOB evaluations on General Budget Support.

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