Can governments and donors ensure that resources are effectively targeted to poverty reducing programs?

The question raises difficult issues both regarding the anticipated effect of a specific spending policy on poverty and the quality of budget management. The Heavily Indebted Poor Countries (HIPCs) program attempted to earmark resources released by debt relief to programs that would benefit the poor. Various developing countries with weak public expenditure management systems—such as Tanzania, Ghana, Chad, Honduras, and Zambia—have established special poverty funds, along the lines or similar to Uganda’s Poverty Action Fund.

There are, however, key lessons from Uganda’s experience, both regarding the design of Virtual Poverty Funds (VPFs) and the definition of pro-poor programs, that deserve careful consideration in similar initiatives elsewhere. The issue assumes particular significance in light of the recent decision of the G-8 to expand the scope of debt relief significantly.

Introduction

The provision of debt relief to HIPCs commencing in the late 1990s, and the growing interest among donors in providing direct budget support, increased donor focus on national budget systems. Given that debt relief and aid resources are fungible, donors were concerned that such debt relief be verifiably used to benefit the poor in the recipient country. In effect, the World Bank and the International Monetary Fund (IMF), acting on behalf of donors, asked that HIPC governments put in place systems to track the use of resources freed up by debt relief and show that these were in fact used to finance pro-poor programs. This required governments to have the capacity to identify policies and programs that would benefit the poor and to effectively channel and track resources to such programs.

Budget systems are notoriously weak in most low-income countries. Just how weak was made evident by the 2002 HIPC assessment of budget systems conducted jointly by the IMF and the World Bank, which concluded...
that 15 out of 24 HIPC countries needed substantial upgrading of public expenditure management (PEM) systems. Typically such countries demonstrate:

- An inability to identify Poverty Reduction Strategy Paper (PRSP) priorities within the existing budget classification system
- Budget allocations and out-turns that do not reflect PRSP priority programs
- Unpredictability in budget allocation/implementation processes and the inability to track expenditures during budget implementation.

There was, therefore, an inherent conflict between the capabilities of recipient budget systems and the expectation of HIPC donors. Given such problems, the temptation to address the immediate pressure from donors to account for the use of HIPC resources was to introduce a dedicated poverty fund with special implementation and reporting arrangements.

But such a short-term remedy would create a parallel financial arrangement that would divert scarce capacity and undermine the integrity of the overall budget management system. The alternative was to create a VPF as a bridging mechanism for tracking pro-poor expenditures in the budget, whilst budgetwide mechanisms were being established and strengthened. A well-designed VPF would, in principle, allow for:

- Maintaining the integrity of budget management and systemic reforms
- Adapting the existing budget classification system to “tag” pro-poor programs (hence “virtual” poverty fund)
- Linking specific (e.g., HIPC) resources to these budget allocations
- Protecting budget disbursements to these programs
- Monitoring of performance of these expenditures.

This note considers the Uganda VPF to understand how well it served to allocate resources to pro-poor programs and what weaknesses were observed that may need to be corrected as other countries employ mechanisms similar to the VPF.

**The Poverty Action Fund—Uganda’s VPF**

Uganda was the first country to benefit from debt relief under the original HIPC and enhanced HIPC initiatives. In 1997, prior to receiving HIPC, the Government of Uganda (GOU) developed its own comprehensive strategy to tackle poverty, the Poverty Eradication Action Plan (PEAP). Subsequently, the government introduced the Poverty Action Fund (PAF) in 1998 to reorient government expenditures towards implementing its PEAP as well as to account for HIPC resource use (see box 2).

**Successes of the PAF**

Over time the scope of the PAF budget increased. Explicit criteria for programs to qualify for inclusion were developed. The focus of attention moved to the actual performance of PAF programs.

Although the predictability of disbursements facilitated better performance, the guarantee was qualified, that is, only those programs ac-

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**Box 1: Tracking Pro-Poor Spending**

The performance of a country’s public financial management (PFM) system in terms of its ability to allocate and execute budgets and to track and report on poverty reducing spending is monitored annually as part of oversight of the HIPC Initiative. One of the indicators relates to the existence of effective pro-poor tracking mechanisms for the HIPC funds channeled through the budget. The definition of what qualifies as a poverty reducing expenditure is determined by country authorities and varies from country to country, but generally includes social sector spending, sometimes water, and in a few cases other infrastructure needs.

Of the 27 HIPC countries that were monitored in 2004, only 14 (Cameroon, Democratic Republic of Congo, Ethiopia, The Gambia, Ghana, Guyana, Honduras, Malawi, Mali, Niger, Rwanda, Sierra Leone, Tanzania, and Uganda) had satisfactory tracking mechanisms for pro-poor spending. Of these, Honduras, Sierra Leone, and Uganda have established a virtual fund and protected them against budget cuts. Rwanda and Tanzania have resorted to mechanisms similar to a virtual fund. The remaining countries used existing budget classifications to identify pro-poor expenditures, but have no mechanisms to protect these expenditures from budget cuts.
counting for funds and performing satisfactorily were guaranteed funding. Unless the performance of programs was put under scrutiny, it was felt that there would be little incentive to perform.

**Reorienting budget allocations towards pro-poor service delivery and demonstrating the additionality of debt relief:** The PAF ensured that additional HIPC debt relief and donor direct budget support were channeled into specific PEAP priority programs, helped reorient allocations within sectors towards pro-poor expenditures, and increased the funds channeled to local governments. Expenditures on PAF programs grew from 19 percent to 36 percent of a rapidly expanding government budget between 1997/8 and 2002/3 (see table 1).

| Table 1: Reorienting national and sector allocations towards the PEAP |
|---------------------------------|-----------------|-----------------|-----------------|
| PAF programs as % of national budget (excluding interest) | 1997/98 (pre-PAF) | 1988/89 | 2002/03 |
| Social services<sup>1</sup> | 17 | 21 | 27 |
| Productive sectors<sup>2</sup> | 1 | 2 | 4 |
| Others | 1 | 2 | 5 |
| Total | 19 | 25 | 36 |
| PAF expenditures (Uganda shillings 002/03 prices) | 163 | 267 | 692 |

<sup>1</sup> Primary education, primary healthcare and water.

<sup>2</sup> Agriculture, rural roads, and strategic exports.

**Improved budget predictability, transparency, and accountability:** The government guaranteed that all budgeted resources would be made available in full for disbursement to PAF programs, regardless of resource shortfalls. The PAF provided a platform for establishment of an open and transparent process of budget reporting and review, and improved the focus on the results of government’s programs. A system of activity-based budget reporting was introduced in local government for PAF conditional grants. Five percent of all PAF resources were set aside for oversight institutions and local government to improve monitoring and accountability.

More recently as governance concerns have emerged in Uganda, the PAF has proved important in justifying continued provision of budget support by demonstrating orientation of the budget to pro-poor expenditures.

Figure 1: Earmarking HIPC and budget support to the PAF may actually distort budget allocations
broader reform initiatives such as the medium term expenditure framework (MTEF), SWAPs, and the PRSP combined with a supportive political, institutional, and policy environment have played a major part. But equally, by maintaining the integrity of the budget whilst channeling HIPC resources, the VPF contributed to the success of the PRSP and budget reforms.

**Negative aspects of the PAF**

Some aspects of the PAF are problematic and could potentially be undermining the achievement of Uganda’s poverty reduction goals:

**Unbalanced budget allocations:** The PAF may have skewed budget allocations too far towards the direct provision of basic social services to the poor, illustrated by the movement from point A to point C in figure 1. This reflects the difficulty of predicting the ex-ante impact of a chosen budget allocation. Government’s commitment to the size of the PAF and donor preference for the social sectors has limited the ability to reallocate away from established PAF sectors. Thus more than 70 percent of additional PAF resources were spent on basic social services between 1998/9 and 2002/3, despite the budget already being oriented towards those services.

It can be argued, retrospectively, that there has been underinvestment in areas such as roads, rural electric-

**Box 2: The Key Elements of the Uganda Poverty Action Fund**

The PAF identifies and gives special treatment to specific pro-poor sectors/subsectors/programs in the budget.

- **PAF criteria**—PAF programs are defined as only those that are in the PEAP or PRSP, are directly poverty reducing, delivering a service to the poor, and have a well developed plan. The five major areas are primary education, primary healthcare, water and sanitation, rural roads, and agriculture extension.

- **Matching resources to expenditures**—A PAF table matches specific resources from HIPC, donors, and the government to the budget allocations for PAF programs.

- **Additionality of resources**—PAF resources were shown as additional to the government’s own budget allocations to PAF programs in the 1997/8 budget. Since 2000, the GOU has made a commitment that PAF will consistently grow as a proportion of the overall budget.

- **Protection of disbursements**—Government guarantees that PAF programs are protected from budget cuts during implementation, provided that performance is on track.

- **Reporting and transparency**—There are specific requirements for local governments (LGs) and other government departments to report disbursements on PAF programs, and progress in implementation. Reports are made public and discussed in open quarterly meetings, where civil society, the press, and donors are present.

- **Monitoring**—Five percent of PAF funds are earmarked for enhanced monitoring and accountability.

The Tanzanian model has some useful features that provide greater budget flexibility in future, (see box 3), although early approaches to poverty reducing spending had a similar social sector bias (see figure 2).

**Biased budget implementation:** The bias in budget allocation has been magnified by a similar bias in budget execution. With the growth of the PAF, other sectors have borne the brunt of budget adjustments to resource shortfalls. The protection of disbursements under PAF is required only because the major causes of underdisbursement, such as the serial over-
spending of some government institutions, have not been addressed to date.

**Partial monitoring and evaluation:** The PAF added a layer of monitoring and evaluation (M&E) and external verification processes that have diverted attention away from the overall budget and led to unbalanced scrutiny of government expenditures. Although initially an improvement, currently these systems have not been mainstreamed into government systems, and the coverage of the budget M&E improvements remains partial.

**No exit strategy:** While the Ministry of Finance has expressed a desire to phase out PAF, government agencies within priority sectors and donors supporting those sectors want the preferential PAF treatment continued, making it politically difficult to remove PAF protection, especially given that it was not clearly designed as a temporary mechanism with a sunset clause at the outset.

**Key lessons**

Given weak initial PEM capabilities, VPFs allow priority poverty reduction programs to be implemented without undermining reform of public expenditure management systems (PEMs). To be effective, a VPF should be simple and limited to the identification of PRSP priority expenditures in the budget classification system.

A VPF should be introduced in a way that supports rather than replaces the implementation of such comprehensive improvements in budget preparation and implementation. Donor dialogue and conditions should be based on achievement of such improvements, and not solely the meeting of VPF commitments.

Protection of VPF budgets may be necessary, but it would be important to control overspending in other parts

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**Box 3: Tanzania—different approaches to pro-poor spending**

Tanzania originally adopted a more flexible approach for allocating expenditures to priority PRSP areas by including all spending on the seven broad priority sectors. A system of reporting on pro-poor priority expenditures was also introduced. The broader definition allowed greater flexibility in budget formulation and execution, whilst neither creating an artificial enclave nor undermining the flexibility necessary to complement priority expenditures with other activities.

However, the disadvantage was that it treated all lines of expenditures within a priority sector as equally important. Since the 2004/05 budget, the priority sectors have been replaced by an allocation system that aims to make a more comprehensive link between the second PRSP and budget allocations by requiring all spending agencies to identify how their expenditures are contributing to PRSP objectives.
of the budget to limit the shocks to unprotected sectors.

A VPF does not bypass the need to have a PRSP and an effective budget process that identify priority pro-poor expenditures to be included in the VPF as part of a broader policy framework for growth and poverty reduction.

This represents the greater challenge in the context of countries with weak policy, planning, and budgeting processes. The danger of a VPF is that it can create incentives for development partners to predominantly fund social sectors that can distort the implementation of more balanced and appropriate strategies for improving poverty outcomes.

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