Pro-Poor Public Spending Reform • Lessons from Uganda’s Virtual Poverty Fund

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 of the appropriate form of budget management. Various developing countries with weak public expenditure management systems - such as Tanzania, Ghana, Chad, Honduras, and Zambia - have been establishing virtual poverty funds (VPFs), along the lines of Uganda’s Poverty Action Fund. There are, however, key lessons from Uganda’s experience, both regarding the design of VPFs and the definition of pro-poor programs, which deserve careful consideration in similar initiatives elsewhere.

Introduction

The provision of debt relief to Highly Indebted Poor Countries (HIPCs) commencing in the late 1990s, and the growing interest among donors in providing direct budget support, has 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, donors asked that HIPC governments, through the development of Poverty Reduction Strategies Papers (PRSPs), identify programs that would benefit the poor and to report that HIPC resources were in fact used to finance such programs, as they felt this would ensure greatest impact on the poor.

Budget systems are notoriously weak in most low income countries. The 2002 tracking of poverty reducing expenditures carried out jointly by the IMF and World Bank concluded that 15 out of 24 HIPC countries needed substantial upgrading of the PEM systems. Typically such countries may demonstrate:

- weak systems for, and poor orientation of inter- and intra-sector budget allocations and out-turns towards PRSP priority programs;
- an inability to identify PRSP priorities within the existing budget classification system;
- significant unpredictability in government budget allocation/implementation processes and a poor ability to track disbursements and expenditures during budget implementation.

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. In addition to Uganda, countries such as Ghana, Zambia and Chad among others have been required to prepare separate reporting on poverty funds (see box 1). 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 Virtual Poverty Fund (VPF) as a bridging mechanism for tracking pro-poor expenditures in the budget, whilst budget-wide mechanisms were being established and strengthened. A well designed VPF allows 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
- Protection of budget disbursements to these programs; and
- Monitoring of performance of these expenditures

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 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).

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**Box 1: Tracking Pro Poor Spending in HIPC**

The performance of a country's 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 poverty reducing expenditure varies from country to country, but generally includes social sector spending, sometimes water and in a few cases 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) have satisfactory tracking mechanisms for pro-poor spending. Of these, Honduras, Sierra Leone, and Uganda have established a virtual fund by tagging program items in the budget to identify expenditures in pro-poor sectors and protect them against budget cuts. Rwanda and Tanzania have resorted to mechanisms similar to a virtual fund. Guyana earmarks budget lines to prevent funds from being diverted to sectors other than pro-poor ones, but allows expenditure under-runs and uses a very broad definition of poverty reducing spending encompassing entire ministries (Health, education, water). The remaining 8 countries (Cameroon, Democratic Republic of Congo, Ethiopia, The Gambia, Ghana, Guinea, Mali, and Niger) - use existing budget classifications to identify pro-poor expenditures but have no mechanisms to protect these expenditures from budget cuts. Burkina Faso, Chad, Zambia and Nicaragua have established special funds and special accounts to channel resources towards poverty-reducing spending, but do not report comprehensively on all pro-poor budget expenditures.

**Source:** Individual country assessments of HIPC action plans for update on the assessment and Implementation of action plans to Strengthen Capacity of HIPCs to track poverty reducing public spending, IMF, World Bank 2005.

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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, i.e., only those programs accounting 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.

**Box 2: The key elements of the Poverty Action Fund**
The PAF identifies and gives special treatment to specific pro-poor sectors/sub-sectors/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 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** – 5% of PAF funds are earmarked for enhanced monitoring and accountability.

**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. Allocations to PAF programs grew from 17.5% to 37% of a rapidly expanding government budget between 1997/8 and 2002/3 (see Table 1).

**Mobilising donor resources and harmonising conditions:** Over time, the PAF has also contributed to the mobilization of PAF sector-specific donor resources through budget support, which increased from $20m in 1998/9 to over $130m in 2001/2. By providing donors with a level of comfort in terms of allocation, implementation and transparency, the PAF enabled the donors’ shift from project to budget and SWAP support.

**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.

While a number of the achievements can be directly attributed to the PAF, it must be emphasized that broader reform initiatives such as the 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 equally contributed to the success of the PRSP and budget reforms.
Table 1: PAF Reorienting National and Sector Allocations towards the PEAP

<table>
<thead>
<tr>
<th>PAF Programs as a % of national budget</th>
<th>1997/8 (pre-PAF)</th>
<th>1998/9</th>
<th>2002/3</th>
</tr>
</thead>
<tbody>
<tr>
<td>PAF Programs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Roads</td>
<td>17</td>
<td>23</td>
<td>37</td>
</tr>
<tr>
<td>Health</td>
<td>8</td>
<td>29</td>
<td>67</td>
</tr>
<tr>
<td>Education</td>
<td>59</td>
<td>69</td>
<td>63</td>
</tr>
</tbody>
</table>

Negative Aspects of 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 has skewed budget allocations too far towards the direct provision of 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 mix of 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. It can be argued, retrospectively, that there has been underinvestment in areas such as roads, rural electricity, water and sanitation that may have a larger impact on poverty over the medium to long term, and in fact the budget allocations with maximum impact on the poor would be point B on the diagram, rather than C. This has been compounded by the difficulty government encountered in developing appropriate public sector programs which promote the private sector, exports, and more generally economic growth. The Government needs a more dynamic process for determining what priority poverty reducing expenditures are.

**Unbalanced Budget implementation:** With the growth of the PAF, other sectors have borne the brunt of budget adjustments to resource shortfalls (see box 3). The protection of disbursements under PAF is required only because the major causes of under-disbursement, the serial overspending of some government institutions, have not been addressed to date.
**Partial monitoring and evaluation:** The PAF added a layer of monitoring, evaluation and external verification processes, which has 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.

**Undermining Local Accountability:** The PAF financing of local governments via conditional grants, with funds directly earmarked to deliver national targets and reporting to the central government rather than local councils has undermined local autonomy and ownership of investments, and arguably the responsiveness of services to local needs and priorities. This national control similarly afflicts SWAPs.

**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 at the outset.

It is also important to acknowledge two broader concerns regarding the PAF, which raise concerns about sustainability of this approach to poverty reduction.

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**Box 3: Tanzania: a more flexible approach to pro poor spending**

Tanzania adopted a flexible approach for allocating expenditures to priority areas by including all spending on the seven priority sectors identified in the PRSP. In contrast to the Uganda PAF approach where expenditures were clearly defined and protected, the Tanzanian approach adopted broad parameters within which expenditures were allocated and reported on.

Defining priority sectors broadly during allocation allowed greater flexibility in budget execution. In Tanzania, SWAPs and Tanzania Road Fund were fully protected from spending shifts, while all other priority sector expenditures had considerable degree of flexibility to adjust within-sector expenditure during budget execution. The advantage of this approach is that it did not create an artificial enclave nor did it undermine 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. Hence budget reporting did not provide specific information on how priority expenditures were protected or were receiving increased attention.

In order to incorporate some elements of a more structured approach, Tanzania introduced from 2003/04 a detailed monitoring system which reports on all pro poor priority expenditures. This provides a more balanced approach to protecting priority expenditures, without ring fencing. More thinking needs to go into developing an approach to pro-poor spending reforms that strikes a balance between achieving greater flexibility and protecting priority expenditures.

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**Public finance drives rural poverty reduction:** Economic growth in rural areas and the associated poverty reduction, have been greatly fuelled by the increase in demand for private sector goods and services resulting from the increases in government expenditure, in particular due to the flows of funds under decentralization, a major proportion of which is for wages. The rural economy is therefore very fragile in as much of it relies on government expenditure, which is itself reliant on aid flows, which are unlikely to increase rapidly in the future.

**Macroeconomic and distribution effects of high donor inflows:** Uganda has since the introduction of the PAF become heavily dependent on foreign aid inflows. Some fear this has reduced the incentive for increasing domestic revenues. High inflows are also likely to have a detrimental effect on the tradables sector of the economy, which are likely to be negated if there are
sufficient gains in productivity. However, the distributional effects of increases in aid fuelled public expenditure may not be particularly pro-poor, as the major benefits tend to be accrued in the formal sector.

**Key lessons**

VPFs can make a positive contribution to public expenditure management systems by protecting budget disbursements and tracking pro-poor expenditures, especially where public expenditure management systems are weak. Such elements of VPFs are relatively straightforward to establish and implement. From the outset a VPF should be simple, and limited to the identification of PRSP priority expenditures in the budget classification system; tracking of performance of these expenditures within transparent budget-wide reporting and review systems; and the protection of disbursement against budget allocations, which should be linked to a system of limiting overspending in other parts of the budget. 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.

However the scope of a VPF is limited. A VPF does not bypass the need to have a PRSP and budget process, which identify and deliver a dynamic, balanced set of priority pro-poor expenditures to be included in the VPF. This represents the greater challenge in the context of countries with weak policy, planning and budgeting process, and is a matter of Public Expenditure Policy. The danger of a VPF is that it can create incentives for development partner for predominantly funding social sectors, which can distort the implementation of ostensibly balanced PRSPs, which may set out more appropriate strategies for improving poverty outcomes.

**Key Reading**


Adam, Christopher and David Bevan (2003): *Aid, Public Expenditure and Dutch Disease*, CSAE WPS/2003-02


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