DFID Department for International Development

Foreign & Commonwealth Office

HM TREASURY

Partnerships for poverty reduction: changing aid 'conditionality'

A draft policy paper for comment

September 2004

Summary

Our understanding of what makes aid effective is changing. Evidence and experience have challenged traditional approaches to 'conditionality' (where each donor frequently attached conditions to its aid in order to promote particular policies in the partner country). This paper sets out a new approach to building a successful partnership for poverty reduction. We believe that developing countries must have room to determine their own policies for meeting the Millennium Development Goals (MDGs), and can use aid most effectively if they can predictably rely on it as part of their long-term budget plans.

As in any relationship, a good aid partnership is based on an open dialogue, with rights and responsibilities on both sides. Each partner will take account of the views and concerns of poor people. Each will be committed to transparency, and will make public their decisions and the evidence on which they are based. Both donor and developing countries will be accountable, to their citizens and the wider global community, for showing how aid is supporting sound policies, which improve the quality of life for poor people.

Within a framework of partnership, both parties need a clear statement of the terms and conditions of aid. Donors need to show that aid is being used to support an effective programme of poverty reduction. Developing countries need to know what aid they can expect when, and to be clear under what circumstances it can be withdrawn.

This paper sets out the UK's position on the use of conditions in effective partnerships for poverty reduction:

- Aid terms and conditions must support, not 'buy' reform. The terms and conditions of aid will be strongly linked to benchmarks, which both partners agree are critical for tracking progress on poverty reduction.

- A major purpose of setting terms and conditions will be to demonstrate to UK citizens and Parliament that overseas aid is well spent; and to strengthen the public accountability of DFID and partner governments in delivering on their commitments.

- In sensitive policy areas such as privatisation, the UK will only use conditions to back reforms where partner governments have had space to debate - including where appropriate in Parliament - the full range of policy options, and have made their own decision informed by clear evidence of the benefits to poor people. The UK strongly supports the use of poverty and social impact analysis (PSIA) for such purposes.

- The UK will continue to attach ‘process conditions’ to improve the quality and effectiveness of aid. For example, we will use conditions that strengthen participation by poor people in decision-making. However, such conditions must be carefully designed so as not to interfere with national political processes.

- The UK will seek to make aid more predictable by being clear up front about the basis on which funds will be reduced or stopped. Relevant criteria will include compliance with international obligations on human rights and peace and security.

- The UK will work with other donors to improve aid harmonisation and limit the overall burden of ‘conditionality’. In particular, we will continue to press both the World Bank and the IMF to monitor and streamline their combined terms and conditions.

This paper also identifies areas where more work is needed. Specifically, we will look at the appropriate use of ‘conditionality’ in fragile states. And, building on recent European Union experience, we will explore the potential to link aid to performance results or outcomes rather than a partner government’s policies.

Over the coming months, we shall seek comments on this draft policy paper from developing countries, other development agencies and members of the public. By early 2005, we will develop new guidelines for DFID staff to help put this new approach into practice.

Introduction

This paper sets out the UK Government's position on effective aid relationships, and how the terms and conditions attached to aid (often referred to as 'conditionality') can best be used to promote poverty reduction. It signals a significant change in our thinking and practice.

In recent years the UK has been moving away from traditional approaches to 'conditionality'. We believe that it is inappropriate and ineffective for donors to impose policies on developing countries. Instead, we argue that successful aid relationships are based on mutual commitment and dialogue, transparency and accountability. We will promote the use of terms and conditions of aid, which are agreed with our partners and are open to public scrutiny.

Whilst macroeconomic stability is fundamental to sustainable development, the policies needed for poverty reduction are much broader. They encompass the social, cultural, economic, civil and political rights of all men and women, and environmental concerns which are essential to achieving the MDGs. The terms and conditions of our aid will reflect this.

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

Recognising that there are widely divergent views on these issues, we hope that the paper will stimulate debate with our international partners, particularly developing countries, on the appropriate use of 'conditionality'.

The paper is in five sections:

- I. What do we mean by 'conditionality'?
- II. What impact has 'conditionality' had?
- III. The UK government's position on effective aid partnerships
- IV. Unresolved challenges
- V. The way forward

I. What do we mean by 'conditionality'?

Aid agreements typically set out terms and conditions to be met by the parties. Donors agree to give a certain level of aid in support of particular policies or activities, or on condition that the country meets certain undertakings. These undertakings cover a range of policy approaches expected, from past experience, to raise the living standards of the poor. They have included economic, environmental or social policies, such as the pursuit of macroeconomic stabilisation or increased access to social programmes such as health or education. If the country fails to implement agreed conditions, then donors may reduce or even stop their support.

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

From the mid-1990s there has been a significant evolution in aid relationships, which has implications for the appropriate role of ‘conditionality’. First, poverty reduction has become the primary objective of development assistance. The Millennium Development Goals agreed by the international community have provided a new framework for development, based on a different kind of partnership. The new partnership approach emphasises inclusive development – putting poor people first, country ownership of policies, and donor alignment behind these policies.

Second, while there is continuing consensus that macroeconomic policies are important, understanding has also grown about the importance of good governance in reducing poverty and conflict and the role of democratic, participatory processes in developing national plans to reduce poverty (often called ‘poverty reduction strategies’ or PRS). There is increasing evidence that the quality of both political and economic governance can influence policy outcomes. For example, excessive military spending and corruption have an impact on the delivery of public services and the investment environment.

In response, donors have attached aid conditions linked to political and institutional change. Such conditions might include commitments by the partner country to tackle corruption or establish more transparent and inclusive systems of government. Donors also use so called ‘process conditionality’, for example to support a country’s commitment to prepare a national poverty reduction strategy taking account the views of a wide range of domestic and external stakeholders, or make other improvements to the process of policy making without specifying the content of the policy that should result. This has been driven by recognition that unless a reform agenda is tailored to local circumstances and ‘owned’ by local policy-makers, it will not be successfully implemented.

II. What impact has ‘conditionality’ had?

Evidence on the impact of ‘conditionality’ is at best mixed.

Have conditions been met?

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

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

Have conditions reduced poverty?

Concerns have been raised that traditional ‘conditionality’ has promoted reforms that have made poor people worse off. In the past, poverty reduction was not always given the priority in development assistance programmes that it has today. For example, structural adjustment reforms during the debt crisis of the 1980s often resulted in bad results for poor people because they failed to take account of the social impacts. Criticism has centred on IMF-supported macroeconomic reforms such as lowering the budget deficit or changes to exchange rates.

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

Evidence on the impact of privatisation policies is not clear-cut. Some privatisations have increased investment in service delivery while others have worsened the standard of service received by the poor – particularly where governments have limited capacity to define contracts and regulate the behaviour of private sector providers.

On trade reform, the evidence is also mixed. Overall, trade reforms have been an important element explaining growth of poor countries and hence poverty reduction. But there are concerns, for example, that aid conditions have constrained poor countries from following the development path of successful East Asian economies that relied on protection during early stages of development; and that conditions requiring unilateral trade liberalisation affect the ability of poor countries to negotiate effectively in multilateral discussions. In some cases poor people have suffered during trade liberalisation, where 'conditionality' has been excessively restrictive, or where insufficient attention was paid to factors that help poor people to benefit from trade – such as being able to access health and education systems, financial services, and infrastructure.

There has been insufficient analysis of the impact of different reforms on poor people. In the last few years, donors have recognised this gap and started supporting 'poverty and social impact analysis' (PSIA) of major policy changes. This analysis assesses the impact of policy changes on poor men and women and vulnerable groups (such as ethnic minorities, disabled people, older people and children), both before and after changes take place. So far over a hundred assessments are completed or underway. But PSIA needs to be implemented much more consistently, and be more widely owned within developing countries. The UK is working with partners to encourage a country led approach, involving all stakeholders at each stage of selection, design and implementation, and including social and political analysis as well as economic analysis.

III. The UK Government's position on effective aid partnerships

Views differ widely across the international community about the right approach to aid relationships. Some advocate abandoning 'conditionality' altogether, or removing conditions on particular areas of reform, such as privatisation. Others favour much tougher conditions, for instance in relation to corruption, environment, and human rights.

The UK Government believes that:

- Mutually agreed terms and conditions linked to poverty reduction benchmarks can protect the effective use of aid. They provide the basis for citizens in both donor and partner countries to hold their governments accountable for the effective use of aid finance. Where conditions are not met, they allow donors to reconsider whether their aid could be more effectively used elsewhere. Reformers in developing countries often favour 'conditionality', as it can signal that they are serious about reform.

- Aid conditions should not be unilaterally imposed by donors, but should be agreed by both partners within the framework of the recipient country's own poverty strategy. Reforms will not be implemented - or will not be sustainable - if a partner country is acting purely in order to qualify for external financial support and does not consider that the reforms are in its own interest. It is ineffective and inappropriate to use 'conditionality' to push specific reforms that are not agreed by the country's government.

- Conditions need to be used in a limited and selective way, so that they do not weaken government ownership or impose an unmanageable administrative burden.

- Terms and conditions of aid should provide for funding to a partner government to be interrupted if the basis for the partnership breaks down[1]. This might happen because countries veer significantly away from their poverty reduction objectives (e.g through instigation of hostilities or an unjustifiable rise in military spending which reduces the amount of funds available to be spent on reducing poverty) or are in significant violation of international obligations (e.g on human rights, or international peace and security). Funding may also need to be interrupted if accountability systems break down (e.g through corruption). Where a partnership breaks down, the UK will need to judge carefully where to reduce or suspend aid. This judgement will depend on whether there are special mitigating circumstances, such as the existence of firm evidence that the breach will be reversed, or that the government is making efforts to address the problem in question. In all cases the UK will seek to talk the issues through with partner governments before taking a decision on aid. Funding should not normally be cut for minor deviations from an otherwise satisfactory programme. DFID, in consultation with other government departments, is undertaking work on poverty reduction in fragile states, and on security and development that will carry forward more detailed thinking about our aid relationships.

There are **six key elements of the UK position on the terms of aid partnerships.** In some countries this already represents UK practice; in others progress needs to be made. We shall continue to work to make sure that the approach is applied universally:

1. Terms and conditions must support, not 'buy', reform.

The UK government accepts the evidence that 'conditionality' cannot 'buy' policy change which countries do not want. We want instead to move to a position where terms and

[1] This would not normally include humanitarian assistance.

conditions of aid both reinforce countries' reform programmes and priorities and support achievement of the MDGs. Donors can support developing countries in thinking through their policy choices about reform, but should not seek to use their financial support to impose their own views.

Linking terms and conditions to the national poverty reduction strategy (or equivalent development plan) gives the best chance of this (see **Box 1**: Vietnam case study). The UK and other donor agencies are providing substantial support to improve countries' ability to produce and deliver these plans.

> **Box 1: Vietnam case study**
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> The government drew up a comprehensive strategy in May 2002 that sought to reduce poverty and encourage growth. This reform package was agreed by the government following a year-long consultation process that canvassed a broad range of views, including those of local officials.
>
> Donor organisations offered their technical support to this process and were consulted on its progress. The end result was a strategy that was widely supported by the international community, but which was developed entirely by the Vietnamese government.
>
> The basis of the commitments made by the government in order to qualify for Poverty Reduction Budget Support (PRBS)[2] are now linked to this strategy.

Terms and conditions will, wherever possible, be based on the benchmarks which countries set to measure progress towards the goals in their national poverty reduction strategies. Also, in the light of the significant transaction and other costs associated with 'conditionality', the UK will apply conditions sparingly. Where possible, a single set of conditions will be agreed for the entirety of the UK's engagement with a country, in place of numerous, separate terms and conditions for individual elements.

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

2. Transparent terms and conditions are important for UK accountability.

As well as supporting country reform, a key purpose of setting terms and conditions is to demonstrate that overseas aid provides value for money and is used for the purpose for which it was intended. Like all donors the UK has a duty to citizens and Parliament to ensure that aid is used for poverty elimination. We will therefore set terms and conditions that cover fiduciary issues such as ensuring adequate finance and accounts systems. Safeguards must be in place to ensure that aid funds are not misused through corruption, or diverted for illegal purposes such as terrorism or weapons proliferation. In

[2] For further information about PRBS see **Annexe**: glossary of development terms.

the UK, overseas aid comes under the additional scrutiny of the National Audit Office, which regularly examines different aspects of the aid budget.

Setting terms and conditions that track progress against countries' performance benchmarks can help donors manage the risk of funds being mismanaged or lost through corruption. This is crucial for maintaining public confidence in – and support for – development assistance. Donors also have a legitimate expectation that recipient governments fulfil their obligations under international human rights law.

The UK will seek to make our own aid conditions more transparent, by publishing aid agreements on DFID's website.

3. Mutual accountability in sensitive policy areas.

Accountability requires that stakeholders openly debate reforms introduced by a government, and this usually includes debate in Parliament. Therefore, aid conditions should be open to debate. The final decision must rest with the partner government.

The use of 'conditionality' to support policy reforms in sensitive areas such as privatisation or trade liberalisation may be controversial, especially where the evidence about the impact on poor people is disputed. The UK believes that conditions in these areas must only be used when two criteria are met. The first is that the reform in question has been identified – in dialogue with domestic stakeholders – as critical to the overall poverty reduction strategy. The second is that it will benefit the poor, and that this assertion is based on clear, country specific evidence.

Where reforms – and associated conditions – are disputed, it will be absolutely critical that there is a full and frank national debate in the country – including in Parliaments and National Assemblies - before final decisions are taken on the way ahead. This debate should be informed by poverty and social impact analysis (PSIA). The World Bank and IMF have agreed that PSIA will be completed on the key reforms they support. The UK strongly supports this process. Progress is being made, but considerably more needs to be done to increase the number and to improve the quality of PSIA, and to ensure that the results of the PSIA are used effectively in the policy process. PSIA can also inform policy choices around trade or privatisation by considering alternative institutional arrangements, their timing and phasing, and the needs of the poor.

4. Terms and conditions can help promote participatory processes but they need to be applied carefully.

The UK Government is fully committed to improving the quality of poverty reduction strategies. We will continue to support mutually agreed process conditions which help partners to develop plans that take account of a wide range of stakeholders' views and reflect the concerns of poor people. Civil society can play a critical role, especially when supported by local media, in helping to make this happen. These conditions must be sensitively tailored to local circumstances, to avoid excessive donor intrusion in domestic political processes.

5. Aid partnerships should enable predictable funding.

The UK Government is very concerned that aid to developing countries is unstable. A recent study found that aid is seven times more volatile than domestic revenues. Countries cannot properly plan their public policies if they do not know for certain how much external finance they will receive. The UK's proposed International Finance Facility (IFF) would provide the opportunity to improve predictability of aid at the international level without adding a new layer of conditionality.

Box 2: How an International Finance Facility could improve predictable funding

The UK has proposed an International Finance Facility (IFF) that could generate an additional $50 billion a year in predictable, stable and coordinated aid flows. Donor governments participating in the IFF will sign up to high-level aid principles to ensure the additional aid is, for instance, targeted at the poorest countries, untied, and delivered in predictable multi-year streams. The resources generated by the IFF will be disbursed through existing bilateral and multilateral disbursement mechanisms, with no additional burden of 'conditionality' on recipient countries beyond the requirement that they avoid prolonged IMF arrears.

A major reason why aid has been so unpredictable is that donors do not always make clear the basis on which they will cut or stop aid flows. And where they do have rules, they do not always consistently apply them.

Where it is necessary to withdraw aid, we will make the decision based on criteria and processes, which have been agreed with our partner country up front. If countries breach these commitments, the process for a modification of aid provision should allow for a period of discussion between the developing country government and donor agencies. Substantive or sustained departure from the agreed framework and failure to resolve this through discussion will lead to a variation or cessation in aid flows. We recognise that changing planned aid disbursements within a financial year can severely disrupt the recipient's budgetary process, and will therefore consider carefully the timing of any reduction in aid.

The UK government will seek to establish clear criteria concerning the monitoring of this framework and the process by which aid may be altered. Good monitoring systems are needed, so that it is possible to distinguish minor from more serious breaches. The stress on dialogue is particularly critical when several donors have conditions in the same areas and there is a risk of countries losing a substantial amount of aid at short notice by failure to adhere to certain conditions.

Box 3: Ethiopia case study

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

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

Where the UK is unable to provide aid to a government, we may seek other options for supporting poor people, including channelling support through non-governmental organisations or the private sector.

6. Donors must work together more effectively.

The UK strongly supports efforts to improve donor coordination and harmonisation. These efforts are leading to some rethinking of how donors, collectively, use 'conditionality' and reduce the overall number and intrusiveness of conditions. The International Monetary Fund (IMF) has already moved significantly in this direction, through their 'streamlining conditionality' initiative. This has clearly distinguished between the conditions the IMF sets and those set by the World Bank. The IMF has made good progress in limiting its conditions to areas that have a major impact on a country's macroeconomic situation. As set out in its Articles of Agreement, the IMF is not allowed to use 'political conditionality', but can only directly link lending conditions to their eventual economic impact.

The World Bank has also moved to reduce its 'conditionality', but this now needs to be applied more systematically. We will continue to press both the World Bank and IMF to monitor the combined burden of their 'conditionality'. More action is also needed from bilateral donors, including the UK, to limit their 'conditionalities'.

Donors should where possible draw the terms and conditions for their aid from a collectively agreed framework of poverty reduction benchmarks. Mozambique has recently agreed a common policy matrix with 14 donors (see **Box 4**: Mozambique case study). We would like to see this coordinated approach become the norm, not the exception. We recognise however that countries may not wish to agree exactly the same terms and conditions with all donors, since this leaves them vulnerable to a collapse in aid flows if they go off track.

Box 4: Mozambique case study

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

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

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

The Government and 14 donor partners, including DFID and the World Bank, signed a memorandum of understanding governing the provision of budget support in April 2004. All agencies are now working to a common policy matrix.

Macroeconomic stability is extremely important if measures to tackle poverty are to be successful. Donors, including the UK, have traditionally relied on an IMF programme to indicate that a country's macroeconomic performance is satisfactory before granting aid. However, if donors suspend all programmatic aid in response to an IMF decision to do so, this leads to high volatility.

The UK would like to move to a more graduated assessment of macroeconomic and social policy performance. Donors' decisions on providing aid to low income countries should be driven more by the countries' needs and circumstances – such as the capacity to implement reform and its importance to poverty reduction – rather than by a determination by the IMF of whether the country's economy is 'on-track'. We would welcome a discussion with partner governments and donor countries as to whether this is an approach that other donors might take.

IV. Unresolved challenges

While many aspects of the UK's approach to 'conditionality' are clear, there remain some unresolved issues. More work is needed in two main areas:

1. **Fragile states**: the international community lacks a clear framework for supporting poverty reduction in states where the government is either weak or unresponsive to development issues. The approach set out in section III cannot be fully applied in such environments. A better understanding is required of the role of aid terms and conditions in such countries (see **Box 5**: dealing with fragile states). A number of donors are taking a hard look at this question, and a senior level international meeting is planned for January 2005 to agree a common framework.

Box 5: Dealing with fragile states

The situation in fragile states is of particular concern. These countries are disproportionately at risk of failing to meet the MDGs. In addition to the severe implications for poor people within the country, there are risks for regional instability, international insecurity and the fight against terrorism. This is why finding ways of engaging with fragile states is a key priority for development agencies.

The UK supports the idea of tailor-made aid programmes that reflect the particular needs of each individual state. But problems can arise when a state is unable - or unwilling - to introduce reforms that reduce poverty. For example, a government may be able to tackle poverty but choose not to, or may be keen to act but be too weak to introduce meaningful reforms.

Donors need to be aware that weak governments forced to adopt unpopular or destabilising reforms may be tipped into political instability or civil conflict. At the same time, poor political governance such as wide scale human rights violations can also hasten a country's decline towards such instability. Aid used to support better political governance, and to strengthen human rights, can be a useful tool in avoiding this.

In addition, there is concern that, in some fragile states, aid can help bolster an unresponsive government and can even exacerbate corruption. Where a fragile state is unable or unwilling to tackle poverty, the UK Government may choose to channel its aid efforts through, for example, local leaders, community groups, non-governmental organisations or international relief organisations.

Aid is sometimes interrupted because sanctions are imposed against a country by an international organisation such as the UN or EC. In such cases the UK will ensure that sanctions are properly targeted and enforced, and where possible, take measures to avoid unnecessary suffering by the civilian population.

2. **Linking conditions to performance outcomes**: the European Commission (EC) is piloting an approach that bases the terms and conditions of its poverty reduction budget support on the *impact* of reform on social services delivery (such as the increases in girls attending schools) rather than the specific policy reforms themselves. The UK is very interested in this new framework. It could mean that countries have freer rein to choose their own policies with less intrusion from donors. But there are potential downsides. Developing countries are concerned that they will be penalised for failing to achieve results for reasons outside their control (such as a collapse in commodity prices forcing a cut in education budgets because of a shortfall of revenues). There are other difficulties, such as the problem of attributing changes in performance when there are time lags in policy implementation, or where a new government takes power. The UK will review the lessons of the new framework and consider how this can be reflected in our own approach.

V. The way forward

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

Much of the solution rests with donors. We need to take a back seat, giving more space to countries to draw up their own plans for poverty reduction, as long as these remain compatible with their international obligations (for example on human rights and peace and security). To make this happen, we need to find more effective ways to strengthen countries' policy expertise. We need to make good our commitment to align our aid with country priorities and cut back on old style 'conditionality'. We need to improve the predictability of our aid and increase the transparency of any conditions applied. And at a more technical level, we need to step up support for poverty and social impact analysis (PSIA).

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

- advocate a strong emphasis on aid partnership where accountability is linked to a country's own strategy for reducing poverty;
- promote a more equal approach in which conditions are agreed by all parties, rather than being imposed on partner governments;
- encourage greater cooperation between all organisations providing aid, including national governments and international financial institutions;
- continue to support efforts by the World Bank and the International Monetary Fund to streamline their use of terms and conditions when granting aid, seeking further progress from the World Bank and considering the overall impact of 'conditionality';
- continue to seek commitment from other donor agencies to harmonising terms and conditions of aid;
- seek to promote a much greater use of Poverty and Social Impact Analysis both bilaterally and in the International Financial Institutions to improve the quality of policy reforms;
- develop further analysis on the issue of maintaining predictable and stable aid flows, and limit the use of 'conditionality' that can result in aid being cut or reduced with very little warning. This will consider further the issue of whether donors should link aid to IFI programmes in an automatic way, and

how to tackle political concerns at the level of the overall aid relationship to avoid interruptions to short term aid flows;

- work further to develop our understanding of the appropriate terms of partnerships in fragile states;

- explore the scope for a shift in focus that will link terms and conditions to a partner country's service delivery performance rather than its policies and objectives; and

- aim to increase transparency (including on DFID’s website) on conditions retained in bilateral programmes.

Over the coming months we will be engaging in public consultations to refine our policy, and developing new guidelines for DFID staff. We would welcome comment and feedback by 30 November 2004 (send to conditionality@dfid.gov.uk)

Annexe: Glossary of development terms

Millennium Development Goals (MDGs)

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

- Eradicate extreme poverty and hunger
- Achieve universal primary education
- Promote gender equality and empower women
- Reduce child mortality
- Improve maternal health
- Combat HIV/AIDS, malaria and other diseases
- Ensure environmental sustainability
- Develop a global partnership for development

Poverty and Social Impact Analysis (PSIA)

Poverty and Social Impact Analysis (PSIA) refers to the systematic analysis of the impact of policy reforms on the welfare of different stakeholder groups, with particular focus on poor women and men and vulnerable people (such as people with disabilities, ethnic minorities, older people and children). During 2002-03 the World Bank funded 11 pilot PSIAs, with DFID supporting an additional 8 studies. These provided the basis for a rapid expansion in World Bank-funded PSIAs and by early 2004 there were some 100 PSIA activities being carried out, with two-thirds of these based in PRSP countries.

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

Poverty Reduction Budget Support (PRBS)

Poverty Reduction Budget Support (PRBS) is a form of financial aid in which funds are provided

- in support of a government programme typically focussing on growth, poverty reduction, fiscal adjustment and strengthening institutions, especially budgetary processes; and
- directly to a partner government's central exchequer to spend using its own financial management, procurement and accountability systems.

PRBS is also commonly known as Direct Budget Support.

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

Poverty Reduction Strategy (PRS)

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

The International Development Act

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

IFI programmes

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

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