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The Blight of Auction-Based Budgeting: **What is it and how can we deal with it?**

What's to blame when an aid-dependent government mysteriously loses 40 percent of its budget and spends the remaining 60 percent on the wrong priorities? Three words: Auction-based budgeting.

Fighting corruption is a key challenge of our time, particularly in developing and aid-dependent countries and in fragile or post-conflict states. The challenge is even greater in these settings where trust in government is very low but the need for stability is high. However, much of the anti-corruption work done to date focuses on individual sectors, institutions, and projects. The problem is that we do this believing that the institutions are a reflection of the political systems to which they have been set up to serve, which leads us to unwittingly provide incentives and opportunities that enable those real sector and institutional breakdowns to occur. Moreover, many times the structural problems expressed in institutions and sectors were established long before the individual project has even started. For this reason, ISE is producing a series of policy notes on how reform-minded governments can work – often with donors but not necessarily – to address these structural enablers of corruption. Topics to be covered in this series will include:

- Over-aiding and perverse incentives for fiscal reform;
- Drivers of successful reform, such as team based performance management;
- Procurement reform and technology;
- Decentralization and social contracting;
- Parliaments and political parties; and
- Social accountability.

The purpose of this note is to raise awareness of one particular corruption issue: auction-based budgeting. We hope that the information that follows will help national reformist leaders understand why their systems are so hard to change. We intend first and foremost to help reformers change the operating rules of the system itself. Otherwise, the leaders and their

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supporters will remain in the "whack a mole" game, trying to prosecute a never-ending series of individual cases and protecting individual projects, but never finding the solution to the problem that they face.

This paper is structured around seven sections that aim to:

1. Describe what auction based budgeting is;
2. Show how it works;
3. Explain why it's so bad;
4. Warn of the problems with existing safeguards;
5. Reveal ways to detect it;
6. Present results of analysis that indicate that fragile states are more susceptible to it; and
7. Outline various courses of action once it is found.

1. WHAT IS IT?

Auction-based budgeting has been around for centuries in a generalized form. Emperors, kings and queens, lords and ladies, dictators and tyrants have all employed it throughout history. Auction-based budgeting is defined here as ***a form of budgeting where resources are provided on the basis of who is willing to pay*** – which is the opposite of providing resources on the basis of altruistic means, such as good government policy, institutional performance and/or public good investment criteria. In other words, auction-based budgeting is a system of ***handing out resources to the highest bidder.*** We see this practice used by people in power throughout history: sovereign resources traditionally end up in the hands of those who are most loyal, those who raise the most taxes, those who provide the most soldiers, etc. In these types of competitions, the highest bidder wins access rights to resources – as provided by the whole national budget.[1] Fiscal secrecy is a necessary precondition for auction-based budgeting to work; otherwise, the many parties that find themselves on the losing end of the bidding would raise objections. If those objections are broad and deep enough, it could lead to a revolution. Since fiscal secrecy flourishes in the absence of rules or when existing rules aren't enforced, a link can be drawn between the extent of auction-based budgeting and how open a government really is.

Modern auction-based budgeting has evolved with the emergence of aid-dependent countries. Here, doing deals directly on budgets rather than indirectly on rights to tax or the provision of resources becomes more important. The returns are different, too. In the past, a king received returns indirectly via contributions such as loyalty, military and taxing strength. In today's aid-dependent countries, a corruption network leader receives a return by taking a direct cut of the budget, including all the aid that flows through it. This happens regardless of whether aid is on or off the budget, since it is the point where approval is provided that matters in auction-based budgeting.

But auction based-budgeting is not necessarily always a bad thing. When practiced by a benevolent and progressive leader, it can be used as a strong force for good. Leaders generally inherit the political system in which they operate; there are only a few modern examples of new leaders coming to power with essentially a "blank canvas of institutions" to work with.[2] In the hands of an experienced benevolent leader, auction-based budgeting can be used for the public good if it is based on altruistic criteria. That said, if it is not used in a way that strengthens social contracts, institutions and the systems of checks and balances – and in particular if it doesn't close most of the loopholes that allow corruption to flourish – the effort for the public good will be wasted and at best will only deliver some short-lived gains. Moreover, using an inherently corrupt system as a force for good carries a high risk because it may become too difficult for the benevolent and progressive leader to both function in and fight against the murky world that auction-based budgeting helps create.

References:

1. This whole national (or public sector) budget here includes annual authorities to spend public resources and all other special appropriations that give rights to spend and use public resources. The typical central government annual budget is thus a subset of the whole government budget, which is technically the ultimate set of authorities for access to a common pool of resources – cash, assets and sovereign powers like taxation, licensing, money creation and debt, guarantee, and concession issuances.
2. Though the opportunities to create a solid governance, legal and institutional foundation in those settings have been wasted.

2. HOW IS IT DONE?

There are different ways to run an auction of a government's budget – the extent of which is determined by the level of control of different institutions, parliament, and the private sector.

- **The first place to run a budget auction is during informal or formal budget hearings** led by a budget committee or its secretariat. This is where an official, for example, makes it clear to other officials that to secure additional budget or retain existing budgets, a fee must be paid up front or in due course, after public funds have been received. Once that agreement is reached, the budget for the entity concerned is pre-approved through the pre-budget hearing process. The same thing can occur during and around out-of-budget cycle hearings on donor projects.
- **The second place is when members of parliament are allowed to actively participate in budget bidding** processes. Here the auctioneer can solicit bids from parliamentarians for allocation of funds for their constituencies or pet projects for their private sector friends and family. Again, payment for a budget allocation, new project approval, or the approval of the continuation of an existing project can either be made up-front or after public funds have been received. Deals can be done on both government and donor executed or off-budget projects if donor projects are within the scope of parliamentary debate.
- **The third place is during the budget approval process in parliament**, where the standard horse trading and deal-making occurs.
- **A fourth place is after the budget is approved by a parliament**. Here there are various opportunities to auction off the budget. The first point is where the budget appropriation[3] turns into real access to cash and authority to enter into contracts. In most public financial management systems, there are things that are often called warrants, allotments and/or apportionments. These are cash and appropriation management tools that basically take the parliamentary authority and split it up. At this point, bids to secure that authority to access cash can be sought by the auctioneer. Again, payment can be up front or after public funds are received. Another point is at even a lower level of disaggregation of the budget when the authority to commit (in other words, to earmark or set aside) funds for a particular purpose is sought. Donor funds are also subject to the same risk in any system where approval of a warrant-type cash management instrument is required.

If an auction of the budget is occurring at all four points, then theoretically at least, there would be some strong incentives to inflate the formal parliamentary approved budget. By inflating the formal approved budget, the auctioneer gets a second chance to run an even more powerful auction than the one run during the pre-budget hearings. It works this way: By having an inflated budget where stakeholders know that only a proportion of the approved budget will actually be made available (the evidence for which is a reputation for low rates of budget execution), it allows a more heated auction of the rights to warrants, allotments, or apportionments. So while there may be a valid appropriation for a particular ministry program, it does not end up getting the authority to spend the full appropriation because another program has secured the access by bidding more for the warrant, allotment and/or apportionment. At this point the auctioneer can employ the standard corruption practice of delaying approval to get anything done, as a way to extract a "process facilitation payment" (i.e. a bribe). In this way, the auctioneer has a better chance of driving the bid up to the maximum amount a bidder is willing to pay.

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3. An appropriation is an authority to spend public funds in accordance with intended purpose.

Another point at which the auctioneer can solicit bids is during the carryover estimation and payment process. Here, the auction works in much the same way: Bids may be solicited for the right to carry over more appropriated funds than is actually required. Bids can be extracted at another point of the carryover process. This is when approval is sought to make a payment of an invoice received in the prior year that is attached to a carryover authority. This can only occur when the carryover system allows payments that were due to paid in the previous year, to be paid in the current year. This happens when an invoice for payment was received too late – for example, too close to the end-of-year cut-off dates for all payment processes to be completed in time.

After a number of years of this auction process being run, the system can become very efficient at doing what it is designed to do: extract massive rents from the budget. Stakeholders know what the fee rates are at the pre-budget hearings and warrant processes, and how payments are to be made up front and after the fact. Given that most people of influence are involved, there is little incentive to blow the whistle on the system, and plenty of incentive to play the game or at least not rock the boat. Systems become well established to ensure payments are forthcoming. Informal garnishing from salary budgets occurs without detection. Ghost worker systems flourish. Deals on projects and contracts are routinely coordinated through the budget collusion systems, with competition in the private sector for public contracts almost impossible to establish. This would be the most crippling form of auction-based budgeting; ***under such a scenario, the culture of corruption would be deep and wide throughout the country.***

3. WHY IS IT SO BAD?

The effects of auction-based budgeting are almost always grave. At a very basic level, the system promotes a culture of corruption during the budget process. This alone can have profound effects on the ability of fiscal management systems to do what they are supposed to do: i) help drive economic growth; ii) improve efficiency and effectiveness of the government; and iii) deliver highly valued public services to citizens.

When fiscal management systems break down, bad things happen to a country. Some examples include: i) the legitimacy of the government would be lost or not restored as revealed in citizen and business surveys, sovereign risk ratings and donor reports; ii) governing performance indicators drop or remain low; iii) budget execution falls or remains low; iv) fiscal misallocation becomes or remains severe - spending goes toward low priorities or the wrong things; v) overwhelming evidence emerges of poor returns from public spending, including poor indicators of social and economic performance; vi) consistent low rates of budget execution; and vii) more volatility and conflict as more people are willing to fight for power and the right to steal (using the established corrupt practices like auction-based budgeting).

The real-world costs of auction-based budgeting can be massive. Deciding "who gets what'" is where the greatest misallocation, mismanagement, and outright corruption usually happens – in other words, during the budgeting process. The amount of rents that can be extracted through this method are staggering: ***Estimates are that in the order of 20-40% of a budget can be lost through the auction process***. Moreover, the effects on the remaining budget are likely to be very damaging, as resources are misallocated because fiscal management systems designed to drive efficient and effective spending are purposefully weakened. The effects of establishing a culture of corruption within government are even greater.

Escalating aid levels have increased incentives to adopt auction-based budgeting. In 2015, the aid industry was worth $192 billion in donor disbursements.[4] While we argued at the beginning of this note that most people in power throughout history have exercised some form of auction-based budgeting, less noble leaders of the past were much more focused on maximizing tax revenue and fiscal secrecy, and less on auction-based budgeting. Consequently, the need to run budget auctions of actual allocations was far

References:

4. OECD tracked donor countries only. Source OECD/DAC CRS.

less. ***In the modern world of unprecedented levels of aid dependency, it can be argued that the budget now matters much more than tax or procurement for the private enrichment of the elite***. Under this paradigm, procurement becomes a secondary fiduciary concern, after auction-based budgeting. Rather, procurement corruption is actually done upstream during the budget process.

4. BUT AREN'T THERE SAFEGUARDS TO PREVENT AUCTION-BASED BUDGETING?

Rules and procedures have evolved relatively quickly over the last hundred years in the field of public finance to help deal with the problems of fiscal secrecy and misappropriation as a result of demand for greater transparency. Fiscal transparency, in particular, has increased and improved over time to help shed light on the truth underlying public finance operations. Irwin[5] identified three key factors that have supported the demand for more robust rules around fiscal transparency. These were:

i. ***The sharing of political power*** *where* rulers need to persuade creditors to lend to them, and get taxpayers' representatives to approve new taxes for their revenue;
ii. ***The spread of technological innovations*** that reduce the costs of storing and transmitting information; and
iii. ***The acceptance of political theories that emphasize accountable government*** and public discussion of public policy.

Today, extensive rules on transparency make auction-based budgeting more difficult, at least in theory. International standards for how governments classify, account for, and report on spending are obvious examples. Publishing reliable audit reports and having auditing standards is another expression of the pursuit of public sector transparency in order to reduce fiduciary risks[6]. Transparency in how procurement activities are organized, tendered, and awarded is one area that gets a great deal of attention. Quality and performance assessment frameworks, like the Public Expenditure and Financial Accountability (PEFA) framework and the Open Budget Index[7], are another. These frameworks work, in theory at least, by appealing to social norms inherent in grading and comparative rankings, as well as through the "name and shame", or a legacy promotion effect. That is, malevolent rulers might be shamed into reforming – or at least giving the appearance of reforming – whereas benevolent leaders, may see value in leaving a legacy by delivering a much stronger system of public finance and accountability – one that is far more resilient in the face of efforts to undermine the rules. These systems reduce the ability for auction-based budgeting activities to take hold.

However, the rules are still too weak, adoption and enforcement is insufficient in developing countries, and their relevance to citizens remains poor. Generally agreed standards for comparability of budgets and accounts are not yet in place. Very basic concepts of ensuring a clear read for the lay-citizen between budgets and accounts have been adopted in some settings, but the idea has not yet become an international standard. Some non-mandatory recommendations are in some public sector accounting standards. For example, the International Public Sector Accounting Standard (IPSAS)[8] provides recommendations on how to report final accounts on spending against annual budget appropriations, in addition to standards for construction of end-of-year financial statements. However, the guidance does not adopt the idea of delivering a clear read between budget papers produced at the beginning of the year, and financial statements produced at the completion of the year. The standard still produces reports that make it very difficult for a lay-citizen to understand what is going on with budgets and actual spending. There are also complications with auditing standards. One issue is the provision that allows auditing to not follow accounting standards if financial statements were not produced on the basis of

References:

5. Irwin, T, 2013, "Shining a Light on the Mysteries of State: The Origins of Fiscal Transparency in Western Europe" IMF Working Paper – WP13/219.
6. Here we mean, the short-term risk of corruption and mismanagement in public finance operations.
7. For more on PEFA and the Open Budget Index see their respective websites: https://pefa.org/ and http://www.internationalbudget.org/opening-budgets/open-budget-initiative/open-budget-survey/publications-2/rankings-key-findings/rankings/
8. Applying to national governments, international organisations and public sector entities around the world. For more see www.ipsasb.org/

a standard. The guidance is that the auditor should audit on the basis of historical accounting practice. What this results in, in practice, is effectively a "get out of jail card" that allows captured/corrupted auditors to legitimately not raise major issues in audits, which in turn allows bad practices to remain. All of these discrepancies mean that the rules aimed at generating transparency and reducing opportunities for auction-based budgeting fall short, while allowing other opportunities for corruption to remain wide open, ready for exploitation.

Development programs typically haven't addressed auction-based budgeting, like they have other areas of anti-corruption. While auction-based budgeting has been around for generations, anti-corruption prevention programs typically focus on areas like taxation, accounting, procurement, and auditing. While these certainly deserve attention, more attention is needed on the role of budgets in driving benevolent or malevolent practices. Hence, raising awareness of auction-based budgeting practices is one of the main purposes of this note, and should be the focus of more development programming. This would require some changes in approaches to reforming fiscal management systems, as well as the way aid is delivered in support.

5. HOW DO WE KNOW IF AUCTION-BASED BUDGET IS GOING ON?

"Policy-based budgeting" is a term that refers to an approach that has been found to improve the efficiency of budget systems. It provides a solid framework within which politicians, officials, and citizens alike can operate. It is argued that if policy-based budgeting rules are in place, respected, and enforced, bad practices like auction-based budgeting have a much harder time taking hold. Policy-based budgeting is well documented in the PEFA frameworks. In the legacy PEFA framework launched in 2005, four key performance indicators were set around a multi-year view, rather than the ubiquitous but myopic view of budgeting. These were: i) managing rolling forward estimates of fiscal aggregates on the basis of international standard classifications; ii) frequent undertaking of debt sustainability analysis; iii) realistic costing of strategies for most sectors; and iv) ensuring investment decisions include provisions for future operation funding requirements.

Policy makers, citizens or development practitioners with an interest in transparency can identify an elevated risk of auction-based budgeting. Assessing the risk is possible by looking at some key PEFA indicators. There are a few tell-tale signs that auction-based budgeting is occurring:

- ***An unreliable or inaccurate and inflated budget***. Under auction-based budgeting, there is an incentive for the auctioneer to inflate the budget higher than it should be in order to get as many bidders into the real auction – the bidding house.
- ***Fragmented budgeting and accounting***. Routine consolidation of budget and financial statements delivers comparability. Consolidation and comparability is crucial for public accountability systems to work as intended. Fragmented operations are the friend of the auctioneer who needs fiscal secrecy to operate.
- ***Lack of a multi-year budget***. Rolling forward estimates makes it much more difficult for an auction of the full budget to occur. This is because annual budgets in this system are only about policy change, not about zero-costed annual budgets (budgets that have all expenditure items for the following year costed), meaning there is much less new budget (fiscal space) to sell off every year.
- ***An absence of realistic multi-year costing and funding of portfolio policies.*** This reveals a weak culture of policy, program and project costing and poor attention to evidence based public resource allocation. This provides circumstantial evidence that auctioning is occurring because policy costings are not important for the auctioneer.
- ***Myopic investment budgeting that does not provide for future operational needs***. This is another warning sign because future financing requirements for operations is not at all a key motivating factor for the bidder or the auctioneer.
- ***Poor commitment control.*** Another red flag for auction-based budgeting. Prior approvals during the year is a standard good cash- and appropriation-management tool to make sure cash is available to pay bills and ensure that legal authorities – appropriations - are not breached. However, as explained above, the

prior-approval of spending against valid parliamentary appropriations via warrant or commitment control systems can also be used by an auctioneer to extract rents from appropriated-budget holders.

6. ARE AID-DEPENDENT OR FRAGILE STATES MORE SUSCEPTIBLE TO AUCTION-BASED BUDGETING? WE THINK SO.

An assessment of the risk of auction-based budgeting has been undertaken for fragile states on the premise that auction-based budgeting is more likely to be found in such settings, given the usual lower standards of governance, higher levels of aid dependency, and/or higher levels of conflict. The g7+ group of countries was selected for this assessment from the complete set of PEFA assessments available on the PEFA website. PEFA scores for the range of key warning indicators of auction-based budgeting cited above were collated and analyzed for each country. Given that PEFA assessments have been undertaken over many years since 2005, the timeline was split between the early period up to 2010, and the late period after 2010. Two-way correlations were also assessed between auction warning indicators, and between each auction warning indicators and the 2015 Fragile State Index (FSI). Main results are in the table below.

Results reveal that fragile states are at high risk for auction-based budgeting. It was found that g7+ countries had lower scores on average in the key indicators as compared to non-g7+contries. The lowest scores (see blue shaded rows in table below) were associated with: i) budget credibility – excessive in-year transfers of annual appropriation for different purposes; ii) lack of rolling forward estimates and functional assignments; iii) myopic investment budgeting; and iv) poor consolidation of budgets and accounts. As far as progress in scores between the early period and the late period, one indicator was found to go backwards: budget credibility – excessive in-year transfers of annual appropriation for different purposes. Very slow progress was found in myopic budgeting and commitment control, with average scores over the time period not improving much at all. The three policy-based budgeting indicators were moderately positively correlated with each other (0.386 or higher). Aggregate budget credibility and excessive in-year transfers, commitment control, donor-funded project information, and government monitoring of public enterprises were negatively correlated, though weakly so. Weak commitment control and excessive in-year transfers were also found to be correlated with the 2015 Fragile State Index. The findings were considered intuitively correct. The assessment demonstrated that fragile states were likely to be more vulnerable to auction-based budgeting.

TABLE: G7+ COUNTRIES AVERAGE SCORES FOR SELECTED PEFA PERFORMANCE INDICATORS FROM 2005 TO 2016

PI No.	PEFA Indicator	Average g7+ Early Period		All Average Early Period		Average g7+ Late Period		All Average Early Period		Cor'n* FSI
	A. PFM-OUT-TURNS: Credibility of the budget									
PI-1	(i) The difference between actual primary expenditure and the originally budgeted primary expenditure	1.71	D+	2.64	C+	2.33	C	2.91	C+	0.00
PI-2	(i) Extent of the variance in expenditure composition during the last three years, excluding contingency items	1.53	D+	2.18	C	1.42	D	2.05	C	**-0.23**
PI-3	(i) Actual domestic revenue collection compared to domestic revenue estimates in the original, approved budget.	2.53	C+	3.35	B	2.25	C	2.68	C+	-0.04

PI No.	PEFA Indicator	Average g7+ Early Period		All Average Early Period		Average g7+ Late Period		All Average Early Period		Cor'n* FSI
	B. KEY CROSS-CUTTING ISSUES: Comprehensiveness and Transparency									
PI-7	(ii) Income /expenditure information on donor-funded {sector} projects which is included in fiscal reports.	1.38	D	2.59	C+	1.83	D+	2.53	C+	-0.07
PI-8	(iii) Extent to which consolidated fiscal data is collected and reported for general government according to sectoral categories.	1.50	D+	2.14	C	1.67	D+	2.12	C	-0.10
PI-9	(i) Extent of central government monitoring of AGAs and Public Enterprises.	1.35	D	2.10	C	1.36	D	1.97	D+	-0.14
	C. BUDGET CYCLE									
	C(i) Policy based Budgeting									
PI-12	(i) Preparation of multi -year fiscal forecasts and functional allocations	1.47	D	1.95	D+	1.83	D+	2.05	C	-0.08
PI-12	(iii) Existence of sector strategies with multi-year costing of recurrent and investment expenditure;	1.47	D	1.84	D+	2.08	C	1.89	D+	0.01
PI-12	(iv) Linkages between investment budgets and forward expenditure estimates.	1.24	D	1.65	D+	1.33	D	1.67	D+	0.02
	C (ii) Predictability and Control in Budget Execution								C	
PI-16	(ii) Reliability and horizon of periodic in-year information to MDAs on ceilings for expenditure commitment	2.24	C	2.63	C+	2.33	C	2.76	C+	**-0.22**
	D. DONOR PRACTICES									
D-2	(ii) Frequency and coverage of reporting by donors on actual donor flows for project support.	1.38	D	1.56	D+	1.58	D+	1.65	D+	-0.06
D-3	(i) Overall proportion of aid funds to central government that are managed through national procedures	1.00	D	1.23	D	1.17	D	1.49	D	-0.09

*Early period is 2005 to 2010. Late is 2011 2o 2016. * Correlation with FSI = Fragile State Index. alpha grade conversion: D=1, A=4. + awarded if numerical average is greater than mid-point of grade. PEFA data set from Aug 2016 was used.*

7. WHAT CAN BE DONE WHEN AUCTION-BASED BUDGETING IS DISCOVERED?

There are certain recommendations that policy makers or development practitioners can take from this assessment when working in fragile states, or other environments where they believe auction-based budgeting is occurring.

Segregation of duties in budgeting is a forgotten good practice. It is a key control against auction-based budgeting as well as a way to safeguard the integrity of the annual budget process. The new 2016 PEFA framework rightly introduced segregation of duties in the area of accounting and spending. It focused on: i) authorization; ii) recording; iii) custody of assets; and iv) reconciliation and audit. These provide institutional and individual firewalls to make it more difficult for corruption to flourish and reduces risks of collusion when spending the budget. Segregation of duties in budgeting, however, is not well documented. Typically, a budget auctioneer does not like segregation of duties because it reduces their scope and power. Experienced ministers of finance, and the administrative heads of high performing ministries of finance and treasuries around the world are acutely aware of the political nature of budget setting. One important mechanism to control information at the very top, but also add resilience to the accountability system, is for key parts of the budget-setting process to be separated. At a very basic level: i) revenue forecasts are completed by one organization; ii) expenditure and resource allocation are undertaken by a different group; and iii) fiscal strategy preparation is done by yet another. This approach helps to ensure that no single group (other than cabinet) or official has the complete picture of the budget parameters, which reduces the power to corrupt the system, including the running of an auction of the budget.

What can stakeholders who are trying to deal with auction-based budgeting do? First, ***be aware*** that it exists. Second ***test*** for it and then ***respond***. Look at the warning PEFA indicators and see if there is risk of it occurring. If a risk is identified, try to understand the problem more fully. If considered a problem, and if the political will and leadership exists at the highest levels to address it, then try to understand how the shadow networks actually run the auction. After that, reform can then be well targeted to plug the right holes in the system. Key shadow network disruption measures that can provide much needed space for reform to work include firings, staffing reshuffles, and instilling transparency measures into the system. Promoting and rewarding real reformers, establishing institutional firewalls, and instituting limits on how long senior executives can stay in a given position can also help. Finally, ***go back to basics and put policy and performance high on the agenda***. In terms of policy, that means pursuing policy-based budgeting system reforms with vigour. (For advice on how, see ISE's Development Practice Note on Medium-Term Focus for Short-Term Problems at http://effectivestates.org/wp-content/uploads/2017/04/ise-0-DPN5-2.pdf) In terms of performance, this means supporting continuous improvement cycles; start with rolling multi-year plans and then use team-based performance management system to focus accountability on teams and use the performance management systems to transform institutional cultures of corruption into cultures of performance. (For more information, see ISE's DPN on Team-based Performance Management at http://stateeffective.wpengine.com/wp-content/uploads/2017/01/Team-Based-Performance.pdf and the ISE DPN on the determinants of public finance system quality at http://stateeffective.wpengine.com/wp-content/uploads/2017/01/Public-Finance.pdf).

Donors can be friends or enemies in the process – a new aid handshake requires reform on both sides. Governments need real reformers to be in charge and donors need to step out of their safety zones and business-as-usual approaches. "Conditionality" has had a bad name for some time for valid reasons. It has often been associated with promoting particular policy ideologies without due regard for the individual country circumstances – regularly seen as parachuted solutions from outsiders. Conditionality built around policy change and reform system building are different things and should not be confused, but often are. System reform is often required to get a policy change, through. Lack of a good understanding about what system reform needs to be achieved for the policy change to be implemented significantly increases the risk of failure of the conditionality. A lack of credibility of the incentive regime – or rather the lack of credibility of threats of adverse consequences from poor performance – is another area that has helped the conditionality approach to under deliver. Underperformance against agreed actions and targets often result in no real consequences. Actual outcomes are often spun to enable disbursements to go ahead, or any withheld funds get reprogrammed to the country through other quick disbursement channels.

In our view, placing conditionality on aid levels that directly incentivize reform in exchange for targeted on-budget support is probably the best way to go, with the caveat that this is on a pre-condition that poor performance must lead to adverse consequences in some credible way. The targeted budget support approach has other advantages because it is much less susceptible to the problems of aid-induced fragmentation, whereby the very act of trying to safeguard donor funds from exposure to fiduciary risk actually results in increases in system-wide fiduciary risk. (For more information see ISE's DPN on Donor-Induced Fragmentation at http://stateeffective.wpengine.com/wp-content/uploads/2017/01/Donor-Induced-Fragmentation.pdf.) Transitioning to such an arrangement can be an incentive in itself, where in exchange for attainment of agreed reform goals and policy change, aid levels can shift to more flexible budget support type arrangements, which puts increasingly more control, but also more accountability, with government institutions.

Shifting from project-based aid to policy-based aid is a crucial step. Policy-based budgeting and transparency of government budget operations is the best way we know of to reduce the risk of auction-based budgeting and limit its damage. But policy-based budgeting still only deters the auction approach by making it much more difficult to do. Actively detecting networks that deliver this sort of corruption must be high on the agenda for both government and donor. This can be difficult due to the conflicting vested interests that can be in play on both sides. For example, the government would obviously be filled with the very people that are running the corruption network if a severe form of auction-based budgeting is in play. Clearly, these people would not be keen on detecting or sanctioning high-level officials involved in auction-based budgeting. On the donor side, there could well be influential staff who have some various types of conflict of interest including local family connections. There are also certain moral hazards to overcome on the donor side where there is a no incentive to properly guard against risk where an institution and its staff are effectively protected from the consequences. Admitting mistakes is difficult for anyone, including donors, especially when it is easier to blame recipients or circumstance.

A new aid handshake would help: policy-based aid for policy-based budgeting. Ideally, a new deal could be made between donor and aid recipient. In return for targeting and delivering real improvements in policy based budgeting, detection and sanctioning capacity, aid allocations would become policy-based, flexible, and integrated into the policy-based budget cycle of government. Soft conditionalities around the PEFA warning indicators could be the basis of fixed and variable performance payments. Under the right framework in an aid-dependent country setting, incentives could be drastically improved to deter, detect, and sanction those involved in auction-based budgeting.

WRAPPING IT ALL UP

The pervasiveness of auction-based budgeting is a high-risk problem in aid dependent countries. Allocating a budget based on a willingness to pay is extremely dangerous. Selling off budgets to the highest bidder undermines the whole "public good" concept of allocating budgets in ways that maximise the "bang for buck from the budget" for the benefit of citizens. Cultures of corruption and fiscal secrecy can be created and become very difficult to disrupt. The amount of rents that can be corrupted away through this method are staggering, with up to 40% of a government's budget being lost directly through the auction, and the rest of the budget being misallocated. The tools are already there to identify if there is a risk of auction-based budgeting happening in a country. Interrogating PEFA with a view to understanding and exploring the risk at the country level is an important first step that development practitioners and reformers can take. Tackling the problem, once it is identified, will be a challenge for both donors and aid recipient governments. That said, fiscal reform in development is always being attempted – and reform is more likely succeed if we understand the true nature of systems in which we operate.