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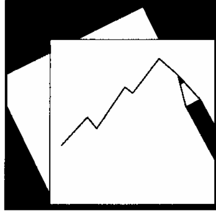

IMF Working Paper

"Pity the Finance Minister": Issues in Managing a Substantial Scaling Up of Aid Flows

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IMF Working Paper

Fiscal Affairs Department

"Pity the Finance Minister": Issues in Managing a Substantial Scaling Up of Aid Flows

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Abstract

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Substantially scaling up of aid flows will require development partners to address many issues, including the impact of higher aid flows on: the competitiveness of aid recipients; the management of fiscal and monetary policy; the delivery of public services; behavioral incentives; and the rate of growth of the economy. Other issues will include the appropriate sequencing of aid-financed investments; balancing alternative expenditure priorities; the implications for fiscal and budget sustainability; and exit strategies from donor funding. Donors will need to ensure greater long-term predictability and reduced short-term volatility of aid. The international financial institutions can play a critical role in helping countries address these scaling-up issues.

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I. Introduction

These are remarkable times. Following the G-8 meeting in Gleneagles, the global community appears energized to confront long-standing issues of persistent poverty in Africa and parts of Latin America and Asia. Major industrial countries have begun to respond to the challenge of mobilizing additional resources for development. Several countries have pledged to reach the 0.7 percent target for overseas development assistance (ODA) within the next decade and others, including the United States, have begun to significantly increase their commitments for development assistance. Combined with the possibility of new global financing initiatives, there is the possibility of a dramatic scaling up of aid resources far beyond the levels of past experience (for some countries at least). This is all to the good and a sign for hope that the enormous gap in living standards between rich and poor countries can be narrowed.

The transfer of real resources on a larger scale to low-income countries (LICs) suggests the promise of a brighter future for millions. The question now is what the different development partners must do to make this promise a reality. This is important because past experience suggests that aid flows have not always achieved the desired results. It is therefore crucial that a large increase in aid take account of the lessons of the past and anticipate the challenges of the future.

This paper emerges from the ongoing effort by the IMF, in working with donors, NGOs, and other members of civil society, to identify what issues associated with a scaling up of aid must be addressed in order to make this transfer more effective. **The immediate goal is to ensure both the absorption and good use of the new aid resources within a stable macroeconomic policy framework. The larger goal is to help low-income countries grow rapidly, reduce poverty, and ultimately graduate from aid dependency.** Five issues in particular require consideration by recipient governments, donors, and the international financial institutions (IFI) in a scaled-up aid environment.[2]

- The macroeconomic impact of a substantial increase in aid levels: Will an aid-recipient's currency appreciate significantly in real terms? Are there consequences for a country's external competitiveness and growth and employment prospects? Any adverse effects would of course need to be weighed against both the benefits afforded by the higher resource transfers and a determination of whether such effects can be moderated. Governments will need to consider what real exchange rate path is appropriate over the long term, associated with both a scaling up and a scaling down of aid.

[2] The definition of what threshold may be a source of macroeconomic or budgetary difficulties is necessarily country-specific, relating in part to the share of aid flows in total budgetary spending and in part to the share of aid in GDP (recognizing, as indicated below, that the composition of aid will also be an important factor determining the potential macroeconomic impact). In general, aid shares in GDP of over 10 percent would likely create macroeconomic policy challenges; aid shares financing more than 40–50 percent of total budgetary outlays would pose equal challenges for budgetary management.

- Managing macroeconomic policy—both fiscal and monetary policy—when a significant share of the economy and budgetary resources derive from multiple, volatile external sources: Uncertainties include the magnitude of aid flows; the timing of their receipt; their likely duration; the differences in the form and conditions associated with the many external resource transfers (project vs. program, and if the latter, whether sectoral or general budget support; whether the aid is tied or untied); and the gap between commitments and disbursements.

- The budgetary challenge of scaling up the delivery of government services and expanding investment, when much of these total outlays are financed from multiple external aid sources subject to the above uncertainties: These budgetary management issues arise at all levels—for the national budget, for local and provincial governments, and for individual ministries and programs.

- The multiple "incentive effects" (often termed "moral hazard") of a substantially higher dependency on external aid flows: Inter alia, these include potential disincentives to mobilize resources or rationalize expenditures; distortions in resource allocation decisions associated with rent-seeking; and an increased potential for corruption.

- How to use this aid to foster higher growth, given the weak evidence that past aid has promoted growth, and with the likelihood of diminishing returns to increasing aid flows to a country: Inter alia, this will require addressing institutional, logistical, and manpower bottlenecks—so-called absorptive capacity constraints—that may have impeded a rapid scaling up of government services in response to higher aid flows.

These are not just issues facing aid-recipient countries. For donors, the gathering of more resources will be only the beginning of their tasks. They must ensure sufficient predictability in the flow of aid resources, not only in relation to short-term commitments, but also in terms of longer-term commitments upon which the development of programs can be based. And they must work with recipient countries to ensure that resources are allocated within the context of a carefully sequenced and well thought out strategy for a country's long-term development path. Part of the overall flow of donor support should be directed toward the provision of global public goods and the reform of policies that would benefit LICs outside normal direct aid channels. For the IFIs, even after debt relief, their role as policy advisors will be even more central, reflecting the challenge of designing programs for scaled-up involvement and service delivery and of managing macroeconomic and budgetary policies.

This paper examines the broad macroeconomic, fiscal, and budgetary policy questions that will be confronted by development partners and the scope for policy actions that can limit the severity of the possible tradeoffs that may arise with substantially more aid. It also examines (in Section III) what recipient countries, donors, and IFIs can do to respond effectively to some of these challenges. Section IV offers some concluding thoughts.

II. Some Key Policy Challenges Associated with a Substantial Scaling Up of Aid

A. The "Dutch Disease" Issue

There remains considerable controversy over whether Dutch disease should be a source of concern to recipient countries if they were to receive aid resources at much larger levels (say over 10–15 percent of GDP). What is the issue? In theory, the impact of receiving inflows of foreign currency should be to increase demand—both for tradables and nontradables (and also possibly for domestic currency itself).[3] Whereas the increase in demand for tradables can be satisfied by an increase in imports, the pressure of increased demand for nontradables may encounter production bottlenecks which would result in a rise in their price relative to tradables, thus pushing up the real exchange rate.[4]

The concern of policymakers is that a real appreciation of the currency would reduce the competitiveness of a country's export industries and make imports cheaper, weakening the potential to reap the benefits associated with international trade. Thus, while foreign assistance may enable a resource transfer to an aid-recipient country—providing vital commodities and financing the provision of critical social services as well as investments—the *downside* effect might be a weakening of a country's capacity to grow itself out of poverty and aid dependency. Thus the first question that policymakers need to consider is whether a substantial increase in aid is likely to cause a significant real appreciation of the currency and a shrinkage of the export sector (see Rajan and Subramanian, 2005a). If Dutch disease effect on the real exchange rate appears likely, a number of obvious questions then arise.

Can and should policy actions address any Dutch Disease problem?

First, is a sustained real appreciation of the currency likely to have an adverse effect on the economy and its potential for growth? The answer to this question is inevitably country-specific and very much related to both the existing structure of production in the economy and the ways in which the aid is likely to be used.

Second, if there is an adverse impact, can the aid still be used so that its *net* impact on growth and welfare is positive (e.g., in terms of achieving the Millenium Development Goals (MDGs))?[5] It may be an appropriate strategy for an LIC to take advantage of resource transfers

[3] If the demand for real cash balances rises sufficiently, it is not impossible for Dutch disease to be kept at bay by simply monetizing the additional inflows; however, this is likely to be an extreme scenario.

[4] One obvious corollary is that the issue of Dutch disease arises *only* to the extent that higher aid flows are *spent* by the government domestically. If aid comes in and is *not* spent, but put away as higher central bank reserves, there is no Dutch disease issue, except for any possible wealth effect on the private sector (a positive wealth effect could lead to increased private consumption and excess demand). As discussed below, if the aid is wholly spent on imports, then a Dutch disease effect is still possible, depending on the composition of imports.

[5] This is not to minimize what could be important distributional effects from such a development, as workers in the tradable goods sector lose their jobs while jobs are created in other sectors, e.g., education and health. In the short-

(continued…)

and accept the costs of a real appreciation in terms of a loss in competitiveness. If the external assistance promotes the achievement of the MDGs and confronts key infrastructural and human resource bottlenecks, it may effectively put in place an economic environment that allows for greater competitiveness over the medium to longer term and attracts foreign investment.[6] A country may thus choose to accept the vulnerability that comes from being dependent on a high flow of aid receipts for a number of years.[7]

In choosing such a strategy, countries must be mindful of the downside risk that the continuity of aid flows is not sustained. In the meantime, the competitiveness of the tradable goods sector would have been weakened, increasing a country's vulnerability to such aid shocks. This suggests that without clear guarantees, a country may wish to be cautious in limiting the scale of its aid dependency. The optimal level of aid would be shaped by how successfully a country can confront and resolve the policy issues described above.

A third obvious question for policymakers is whether an adverse effect on the real exchange rate can be moderated by specific policy actions. Can the way in which aid resources are used *lessen* any adverse effects and *maximize* the gains of a heavier reliance on aid flows? Can macroeconomic policy tools be used to reduce the extent of a real exchange rate appreciation? Much of the operational focus of high-aid-receiving governments has indeed been on the latter issue—using macroeconomic policy tools to limit or moderate the impact of additional aid on the real exchange rate. This is amply illustrated for the cases of Uganda, Ethiopia, and Ghana (see IMF, 2005b). Thus, a central bank can seek, at least in the short run, to limit an appreciation of the real exchange rate by accumulating foreign exchange reserves. This can involve an active policy of sterilization (buying foreign exchange in the local currency market and then using open market operations to soak up excess liquidity) or by restraints on fiscal policy (limiting net domestic credit to the government). Such an approach may operate both in terms of limiting pressures on the nominal exchange rate as well as the domestic inflation rate (see below).[8]

Are there limits to the extent of feasible sterilization? Countries that have opted for this approach have observed the pressures that have arisen in local money markets as sterilization efforts have led to higher domestic interest rates, with the result being higher debt service costs to government and a crowding out of private borrowers. And even if a country is willing to bear

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run, the lack of fungibility of labor could result simultaneously in both unemployment and excess demand for labor.

[6] Certainly, this is an argument many have made for heavily afflicted HIV/AIDS countries, where the alternative to aid might be the decimation of the productive labor force!

[7] Note that in the short to medium term, this may result in a trade-off between realizing the MDGs related to health status, HIV, education, water and sanitation, and gender and the first MDG relating to a reduction in absolute income poverty levels.

[8] This has been the type of policy pursued in a number of countries in the last few years (e.g., Ghana, Uganda, Afghanistan).

such costs, a policy of reserve accumulation implies that the aid resources are not being used for the intended purposes of donors and that donors are willing to accept a phased use of aid over time. While this might be a viable strategy for a one-time surge in aid flows, it would not seem to be practical if donors were committed to sustain such higher levels of aid to a country in the context of an effort to realize the MDGs.

The impact of Dutch disease can also be lessened if the resource transfers are used to remove key bottlenecks to improved productivity and productive capacity in the nontradable goods sector.[9] An increase in the supply of nontradables would dampen pressures for an increase in their relative price. In principle, expanding the supply of so-called nontradables might require investments in roads, ports, telecommunications, energy transmission, training for skilled workers, etc.

Some nontradables can be even treated as tradables. For example, a government can use aid resources to recruit expatriate workers (nurses, doctors, engineers) to carry out many tasks and, importantly, help in the training of local professionals. Aid that contributes to increased productivity and an expanded supply capacity in the *tradables* goods sector may, in contrast, *further* appreciate the real exchange rate by contributing to downward pressure on the price of tradables. But higher productivity in the tradable goods sector might also cushion or offset any adverse effects on the competitiveness of tradable goods arising from a real appreciation of the currency.

Many argue that the Dutch disease concern is lessened when aid is used to finance increased imports, on the grounds that this would reduce pressure for a real appreciation of the currency. However, if the increase in aid-financed imports simply substitutes for goods that would otherwise have been imported or produced locally, the result would still be a rise in the *relative* price of nontradables. Thus, to forestall this, the increase in aid-financed imports would need to be focused on goods that are *noncompetitive* in the local economy, that is, using aid to import goods that are not otherwise imported or produced locally. This is an unlikely situation at least for aid that is buying many useful goods. Imports of antiretroviral drugs might be of this type initially, but over time this would not be the case; imports of foodstuffs would certainly not be of this type.[10]

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[9] An additional approach for coping with the real appreciation of the currency may be for a government to provide targeted subsidies to minimize any adverse distributional impact on the most affected of tradable good sectors. For example, perhaps the key distributional costs are borne by certain primary goods producers. Social safety net schemes can be used to alleviate the impact on the poorest households in this sector.

[10] The possibility of countering adverse real exchange rate (RER) effects by changing the composition of imports financed by ODA may prove difficult. Often the composition is determined by donors, indirectly tied to their exports, or else dispensed on a reimbursement basis, often with procurement having to meet international tendering requirements, all of which often means that the country has limited control on actual purchases and their foreign exchange components.

Thus, an important challenge for LIC governments in a scaled-up aid environment is to actively consider how aid can be used to contribute to an increase in productivity, particularly in the nontradable goods sector, in addition to its role in augmenting the availability of goods and services and facilitating investments in the economy. This point underscores that successful *macro*economic outcomes can be very much facilitated by the character of the *micro*economic policy choices that are made, viz., on the uses to which the aid is put.

Policy considerations with respect to the appropriate policy response to a Dutch Disease situation

Five observations may be useful in guiding countries in their response to the possibility of Dutch disease effects.

- First, the benefits of aid in terms of its impact on social welfare, human capital development, and infrastructural investments may exceed the costs implied in terms of any short-run losses in competitiveness. With careful planning, aid can also facilitate long-run gains in productivity that offset any initial losses in competitiveness.

- Second, for most countries, the potential challenge of Dutch disease remains in the future, since most countries are only now seeing a significant scaling up of aid. This is illustrated in Table 1, where one can see that aid in a number of countries has reached a new plateau which is high but still manageable. The challenge will come only as we see the fruits of efforts to scale up aid flows, particularly given the obvious bias to direct higher aid to better-managed LICs (see Heller and Gupta, 2002). This argues strongly that attention is needed *now*, in anticipation of such higher aid levels, for investments that address potential bottlenecks to expanded productivity in the nontradable goods sector, in effect "keeping ahead" of the factors that can create pressures for a real appreciation of the currency.

- Third, *sectoral* ministries will need to become more adept in using external resources in ways that minimize adverse macroeconomic effects. The dialogue between ministries of finance and sectoral ministries needs to be enhanced, both to finesse potential Dutch disease effects (e.g., using imported inputs that are largely uncompetitive in local markets) and developing sector strategies that can remove bottlenecks to the supply of nontradable goods.

- Fourth, and as discussed in the next section, macroeconomic policies can be used, albeit to a limited extent, to sterilize the impact of higher aid flows on the exchange rate and the domestic money supply.

- Fifth, governments need to develop a desirable "exit strategy" from aid dependency. Even if there were significant certainty that aid flows will eventuate over the next 10–15 years and produce Dutch Disease effects, countries need to anticipate how other sources of foreign exchange earnings can be developed to replace this aid over time. Clarifying

such a strategy implies formulating a perspective on what might be a desirable real exchange rate path for at least a decade (recognizing of course that such a policy would need to be subject to periodic review).

Table 1. A Perspective on Role of External Grants and Loans in Financing Government Expenditure

(in percent of GDP unless otherwise indicated)

Ethiopia, Malawi, Mozambique, Tanzania, and Zambia: 2002-2009

	2002-03	2003-04	2004-05	2005-06
External Grants				
Ethiopia	8	5.7	6.1	6.5
*Ethiopia-MDG scenario**		*7.8*	*9.3*	*13.4*
Malawi	6.7	12.2	15.4	13.9
Mozambique**	11.8	10.6	9.0	8.0
Tanzania		6.2	6.2	7.4
Zambia		6.9	5.4	5.6
Total Gross Foreign Financing				
Ethiopia	14.3	9.3	8.9	8.6
Ethiopia-MDG scenario		*12.0*	*12.6*	*15.8*
Malawi	9.8	16.0	20.2	18.0
Mozambique	18.7	15.8	13.7	14.0
Tanzania		9.2	10.3	11.9
Zambia		10.2	8.2	8.0
Share of Total Expenditures Financed from External Aid Sources				
(in percent)				
Ethiopia	41.1	32.7	29.5	28.9
Ethiopia-MDG scenario		*39.6*	*40.0*	*45.3*
Malawi	25.6	37.4	46.1	43.4
Mozambique	54.8	53.7	50.6	46.5
Tanzania		46.5	46.4	45.6
Zambia		33.0	30.0	29.7

Source: IMF estimates

* A scenario that would entail a doubling of aid flows to Ethiopia
** For Mozambique, related to budget year beginning in year indicated

B. Managing Macroeconomic Policy in the Context of Higher Aid Flows

All countries use macroeconomic policy tools—fiscal, monetary, and exchange rate policies—in order to achieve their desired macroeconomic policy goals—for real growth, inflation, and

the real exchange rate. For an LIC, macroeconomic policy management is already complicated by the need to take account of normal exogenous economic factors (shifts in global demand, changes in the terms of trade, weather shocks, etc.). Does the prospect of significantly higher aid flows complicate the operational tasks of macroeconomic policy management? Higher aid flows pose two additional challenges:

- First, will the fact of higher aid levels for the reasons discussed above prevent the achievement of real exchange rate objectives?
- Second, will the uncertainty associated with the magnitude and time of such aid receipts make it difficult to operationally achieve macroeconomic policy goals?

How specifically does aid enter the field of vision of the macroeconomic policy managers? From the perspective of the central bank, an infusion of aid gives rise to some increase in the domestic money supply. Unless the aid is simply accumulated in reserves (and, if not spent, in higher government deposits), some of this increase in money supply may need to be sterilized, consistent with overall monetary policy targets (in relation to real growth, inflation, and the exchange rate), through the sale of either foreign exchange or bonds. The former approach would give rise to the risk of an appreciation of the local currency. Indeed, more typically, one observes central banks buying excess foreign currency in the market to prevent such an appreciation, followed by efforts to sell central bank or government bonds to absorb the excess liquidity arising from such purchases. The impact of bond sales would be to increase interest rates in the domestic financial market. This would have a number of possible effects, ranging from a crowding out of private sector borrowers, higher domestic debt service costs to the government, and quasi-fiscal losses to the central bank (as it is forced to hold low interest rate foreign exchange assets at the cost of giving up higher-return government bonds).

What is new in a scaled-up aid world is that these normal challenges of macroeconomic policy management are intensified. In the past, countries might have responded to a period of higher aid inflows or volatility in such flows by building up foreign exchange reserves by several months of imports or by allowing some modest real appreciation in the currency. If there were to be a *substantial* and *sustained* scaling up of aid, governments would be confronted with several new and interrelated fiscal and monetary policy decisions. These include:

- Should the monetary targets be revised to allow a larger increase in the money supply and potentially a higher inflation rate (implying more of a real exchange rate appreciation)? Here the concern would be that allowing inflation to reach the double-digit range may not be conducive to either growth or the welfare of the poor.
- Should higher reserves be targeted in order to protect the real exchange rate and provide a cushion in the event of volatility in aid disbursements (given the undesirability of disruptions in aid-financed spending programs)?
- Will the distribution of aid between the public and private sectors affect how much credit growth should be allowed for each sector? For example, if aid is provided directly

to the private sector (e.g., NGO programs for health or education), with a consequent increase in domestic expenditures (as opposed to imports), would the resulting increase in the money supply fit within the overall monetary and exchange rate policy framework? If not, what actions would the central bank need to take in order to limit the growth of the monetary aggregates, again consistent with the macroeconomic policy framework?

- How can the conflicting objectives of fiscal and monetary policymakers be reconciled with increased aid? Governments may be driven by a desire to spend aid while monetary-exchange rate policies are focused on inflation and the exchange rate. The effect may be for aid resources to be used to increase reserves while an aid-related fiscal expansion ends up being financed domestically (see IMF, 2005b). The result is that the beneficial effects of aid are undercut by higher inflation and/or higher domestic interest rates.
- If there is a risk of aid flows proving excessive in terms of their monetary policy consequences, and if there are limits to the feasible amount of reserve accumulation, can the composition of aid flows be altered to facilitate a higher use for imports (as discussed above)?

Some have proposed that higher aid flows should indeed be reflected in higher reserves, principally as a means of buffering against the potential for higher volatility (Lewis, 2005; Eifert and Gelb, 2005). But if countries increase their reserve accumulation, they must then, as noted above, address the issue of how to sterilize its impact on the domestic money supply. If such foreign exchange reserves can be accumulated *without allowing associated spending,* in principle the monetary policy consequences would be contained. For governments, this would involve forgoing the important benefits of the aid, not to mention requiring donor acquiescence to the government putting some of the funds being held in higher deposits at the central bank. For aid, say, to the NGO sector, however, sterilization would be even more complicated, requiring policies to either tighten fiscal policy or limit aggregate credit to other parts of the private sector—either through an increase in government deposits or by open market operations to soak up excess liquidity. Policies with respect to reserve management are not then simply a question of the creation of buffer funds, but also need to be considered in terms of their macroeconomic policy dimensions.

Effective **monetary policy** becomes even more challenging given the uncertainties associated with scaled-up aid flows. These include the complexities of capturing the demand for foreign exchange for imports that take place with higher aid flows as well as those related to the timing and scale of aid disbursements (not to mention uncertainties on the demand for money in a country subject to significant inflows of foreign exchange and, hopefully, rapid modernizing growth). The twin challenges of managing foreign exchange reserves in the context of volatility and scaling up have already been observed in a number of countries in Africa (notably Uganda and Ghana), at levels of ODA far less than may be anticipated in a scaled-up aid environment.

Recipient countries will need to enhance their capacity to conduct monetary and foreign exchange operations.[11]

Fiscal policy will also be more complicated in a high-aid environment. Even in the short term, there are uncertainties associated with aid disbursements, as different donor conditionalities as well as bureaucratic procedures may influence the timing or even the fact of aid disbursements. Over the medium and longer term, once a government scales up its expenditure program in response to more foreign aid, it faces the challenge of how to finance these programs if the new aid isn't sustained by donors. The scaling up of specific programs is likely to be associated with the employment of workers, the delivery of goods and services to the public, and the operation and maintenance (O&M) of infrastructure. Such obligations on government finances are not easily shed or reduced. If governments are not able to reduce expenditures if aid doesn't materialize, the pressure for higher borrowing from the central bank may be unavoidable, raising issues of whether what are essentially *micro*economic budgetary policy pressures may jeopardize the *macro*economic policy framework. Should the government simply scale up or down its budgetary expenditures pari passu with whatever fluctuations in grant receipts it receives? Or should it seek to ensure some degree of smoothing, which would entail some degree of reserve accumulation or reserve decumulation (which would have associated effects on monetary policy). In the context of a given exchange rate policy, such a course of action may also need to be reconciled with concerns that full spending by the government of aid receipts may, in the context of a consistent monetary policy framework, imply limits on available credit to the private sector.

The role of reserve management

In managing their finances, governments may respond to higher aid flows by building up financial reserves (government deposits at the central bank) and reducing outstanding levels of domestic debt. Even if donors are willing to make long-term aid commitments, the greater the degree of dependency, the more that this higher vulnerability to shocks or unexpected disbursement shortfalls will require a prudential margin. Consider the difference between a country where, perhaps, 40 percent of the budget may be financed from external sources (e.g., 15 percent of GDP from domestic and 10 percent of GDP from external sources) relative to a situation where external resources reach 20–30 percent of GDP, raising their share in the budget to 60–70 percent. A 10 percent shortfall in the former situation would imply a reduction in budget resources of 1 percent of GDP or 4 percent of the budget. A similar 10 percent shortfall in the latter situation would imply 2.5–3 percent less revenues as a share of GDP and a 6–7 percent shortfall in available resources to the budget. This higher volatility is equally, if not more, germane to specific sectors, where the share of external financing of a sector's activities may be even larger. For example, as noted above, one could argue that the health sector of some African countries will be particularly vulnerable to such dependence and at risk from a potential

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[11] This would include establishment of liquidity forecasting techniques, improved cash management by the government, introduction of market-based tools for monetary policy (e.g., Lombard-type facilities), a strengthening of dealing operations, and an improvement in the oversight of the financial market.

shortfall in disbursements. The size of the needed reserves would presumably be related to the degree of rigidity in the structure of expenditures.

Higher reserves by the government can have important macroeconomic policy implications with respect to monetary policy management. If and when these reserves are used, the central bank (and fiscal policy managers) would have to be prepared to tolerate possibly significant swings in the level of net domestic credit to the government, possibly financed out of net international reserves but also by the possibility of an increase in the money supply or a squeeze in credit to the private sector.

A mirror image problem may emerge to the extent that a significant amount of new aid flows to the *private* rather than public sectors. This is not a hypothetical. Much of the increased aid effort for HIV/AIDS prevention and treatment derived from the Global Fund and PEPFAR[12] is directed toward the funding of NGO programs *outside* the government and its budget. In many developing countries, the private sector is accepted by the government as a key provider of social services that complement the government's own efforts. Monetary policy management inevitably must address the balance between allowable credit creation for the private and public sectors. Thus, when the private sector is engaged not only in the production of goods and services but also in financing critical social services, the macroeconomic policy framework may put additional pressure on the government *not* to absorb as much aid resources, particularly if higher returns can be gained in private sector uses. Thus, weighing the relative merits of public and private sector uses has macroeconomic as well as microeconomic dimensions.

The scaling up of aid may also reveal tensions between the policy goals of ministries of finance (as reflected in their Poverty Reduction Strategy Papers (PRSP)) and central banks. For example, if the ministry of finance accepts the need for a real appreciation of the currency as a mechanism for absorbing and spending additional aid resources, it must decide whether this will take the form of a nominal exchange rate appreciation or the acceptance of higher inflation with a fixed nominal exchange rate. Central bank monetary policy management would need to be consistent with these objectives. If a central bank's governance structure involves significant autonomy from the government, with an independent goal of limiting inflation, a conflict may arise with the ministry of finance.[13] Such challenges in macro policy may be particularly relevant for countries with pegged nominal exchange rates (e.g., the CFA Franc zone). Absorption in such cases would require the real appreciation of the currency to occur through inflation. Certainly, one implication of a scaling up of aid flows is a need for enhanced coordination of monetary and exchange rate policy with fiscal policy.

[12] The Global Fund to Fight AIDS, Tuberculosis, and Malaria, and the U.S. President's Emergency Plan for AIDS Relief, respectively.

[13] If a central bank has full independence in its management of monetary policy, the issue may arise whether its governance structures allow for consistency between the policy objectives the government wishes to pursue in the context of its PRSP with respect to movements in the real exchange rate in a scaled-up aid environment—thus relating either to movements in the nominal exchange rate and the inflation rate—and those targeted by the central bank.

C. Managing a Budget and the Delivery of Public Services when a Government Is Heavily Dependent on ODA Flows

In a scaled-up aid environment, in addition to facing the macroeconomic policy management issues raised above, ministers of finance and sectoral ministers may find themselves financing a substantial share of their budgets—50 percent or more—from sources associated with multiple uncertainties and conditionalities. This will pose significant management challenges and expose public policymakers to much larger risks and uncertainties. One set of issues arises simply from the fact of a high dependency on external sources of budgetary financing. Such issues would arise even if there complete certainty on the magnitude and timing of projected aid disbursements. A second set of issues arises from the fact that aid exposes a government's *budget* to significant volatility and unpredictability in resource flows (Bulir and Hamann, 2005; Celasun and Walliser, 2005). In the current global aid environment, the sources of aid are already many—multilateral institutions, numerous bilateral donors, several financially significant vertical funding initiatives,[14] and many NGOs. Increasingly, also, aid magnitudes may be endogenous to the policy performance of recipients (in terms of various forms of ex ante and ex post conditionality by donors and multilateral lenders).

Six broad issues arise in managing a budget heavily dependent on external assistance. Some relate to the challenges faced by a minister of finance in dealing with the aggregate financing of the budget and his (her) responsibility for the conduct of fiscal policy. Others relate to the challenges faced by sectoral ministers responsible for the delivery of public services in situations where aid inflows can support a dramatic expansion in sector activities. Some arise strictly from the behavioral incentives associated with being dependent on external sources of financing.

Aggregate budget sustainability

The previous section noted the macro fiscal policy issues associated with substantial reliance on aid flows subject to significant uncertainty. In their role as budgetary managers, ministries of finance also confront the challenge of ensuring the medium- to long-term sustainability of their budgetary framework. If aid receipts rise substantially, should the magnitude of government expenditures rise pari passu? Does this make for a budgetary policy framework that can be sustained without jeopardizing the government's financial viability? Obviously, issues of debt sustainability can arise if such increased aid flows arose even from concessional debt, but are these issues then irrelevant if the higher aid is in the form of grants? In principle, budget sustainability would be guaranteed if there were to be no difficulty in reducing government expenditure programs pari passu with any reduction in external financing.

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[14] These relate to aid targeted to specific subsectors or programs, such as aid from the Global Fund or the Global Alliance on Vaccines and Immunizations (GAVI), which operate independently from the rest of a government's operations in a sector.

The challenge arises because such flexibility cannot be assured and there are significant downside risks in terms of macroeconomic and budget policy management, given the difficulties of retrenching staff or designing programs with built-in flexibility for expansion and contraction. Government programs for the training of teachers or nurses are often associated with commitments to subsequent public employment. More recently, the aid-financed expansion of government social programs may be having the effect of enlarging the share of the government budget that is effectively of a *nondiscretionary* character. While this has always been somewhat the case once employees are hired in the civil service (and thus largely on a permanent contract), these pressures will become even more intense for spending on some sectoral programs (e.g., on HIV/AIDS treatment), where the curtailment of spending would have dire implications for the lives of those that have begun treatment.

Another facet of this phenomenon is that this effective "preemption" by certain sectoral programs may make it very hard for donors themselves to shift priorities to other sectors, even in situations where a consensus emerges that other sectors may warrant a higher priority in spending. Other rigidities may be engendered as the government's scaling up affects relative factor prices, e.g., for specialized workers. For example, pressures to provide salary incentives to attract workers into the medical sector may make it difficult to phase out these incentives in the event of shortfalls in ODA. There may also be pressures to extend such incentives to other parts of the public sector, thus introducing further rigidities in the terms at which the government sector purchases services.

Moreover, when governments cut back their budgets in response to shortfalls in financing, there can be significant losses that reduce the rate of return associated with aid-financed investments. The experience of countries that have undertaken investment projects and failed to consider the O&M implications has long been recognized, with adverse consequences for the operation of government programs and the maintenance of government infrastructure (see Heller, 1974 and 1979).

Thus, the prospect of a significant scaling up of aid resources will force recipient governments to pay greater attention to the financial implications of substantially expanding government programs, given the uncertainty as to how long such external resources will be provided. It will require the budget to be more firmly set in a medium- and even long-term context. Whereas some donors may be willing to commit to the provision of aid resources for as long as five years, most are unable to do so beyond one or two years. Donors are increasingly aware of this issue, as demonstrated by recent discussions in the context of the Development Assistance Committee (DAC) of the OECD on aid harmonization and alignment. [15] Ministries of finance

[15] One nontrivial wrinkle to this point relates to the fact that in a world of flexible exchange rates, even if donors *are* willing to commit to a stable level of foreign assistance, this will translate into more or less resources for the recipient country depending on movements in the donor-recipient exchange rate. Certainly in the last several years, for countries pegged to a basket of currencies linked to the euro, aid flows in U.S. dollars, even if held constant, would have fallen by 30 percent in local currency terms. The budgetary financing consequences of a recipient country's exchange rate policy thus becomes even more sensitive to the expected magnitudes of support from different donors in a world of significant aid scaling up.

charged with formulating a government's budget must pay attention at the aggregate and sectoral levels to the reality of significant uncertainty as to the scale of external financial resources that will be delivered over the medium to long term.[16]

In operational terms, in considering how much to scale up *recurrent* spending programs in the context of such uncertainty, governments thus have to ask how risk-averse should a government be to not having predictable long-term financing available? How would they address a shortfall in *future* donor assistance? How dependent should a government's budget be on external sources? Should aid recipient countries rely on the recent Gleneagles pledges by industrial nations to expand aid flows by $25 billion by 2010? Should they assume that such flows will thereafter be sustained to finance a higher level of spending programs in subsequent years? Would the advent of a financing facility such as the International Financing Facility (IFF) or a global tax financing mechanism increase an LIC government's confidence in its ability to fund a higher level of spending?

These are relevant questions, because most governments cannot easily substitute domestic tax resources or cut other spending easily in the event of such a shortfall (and there are obvious limits on domestic borrowing to finance recurrent programs).[17] The answer to these questions will be influenced by the government's assessment as to the *predictability* of anticipated external resource inflows *and* the expected *duration* of such flows. Thus, recipient governments are likely to rely on external financing to expand programs if they are confident about the long-term continuity of the funding. This in part explains why LICs have a preference for aid in the form of permanent debt relief, since it provides a source of assured long-term funding.[18] Anecdotally, some governments faced with this uncertainty have opted to emphasize investments, given that these can be more readily halted (though this strategy still courts the problem that investments give rise to implications for O&M). This more conservative approach also underlies IMF projections, which tend to be cautious about any assumptions of aid not firmly committed. Other governments have apparently requested fewer resources from donors than the latter were willing to commit.

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[16] This abstracts from the important challenge faced by governments in the short run in formulating their current year budgets, by the uncertainty as to whether current year commitments by donors will materialize in actual disbursements (an issue for which IMF economists are already subject to criticism for excessive conservatism).

[17] This highlights that the challenge for governments in maintaining control over the appropriate *fiscal* policy stance, in terms of macroeconomic policy, cannot be easily separated from the *micro*economic choices that are made in how the budget is scaled up with higher aid flows. In other words, the macroeconomic policy issue of long-run fiscal sustainability—which traditionally has been defined as a government's ability to sustain a given level of expenditure without incurring excessive debt—cannot be separated from the microeconomic issue of "budget sustainability," which can be defined as a government's ability to finance and manage its production of public goods without being subject to significant volatility in service delivery.

[18] Debt relief is unlikely to be a complete solution. For most countries, permanent debt relief is not on the table or has already been delivered. In any case, even full debt relief would not provide the increase in resources envisaged in the more ambitious scenarios. Indeed, it might be associated with a withdrawal of gross aid inflows.

One consequence of the shift to greater reliance on budget (rather than project) support is that it elevates the importance of predictability in aid flows. While such support provides maximum flexibility for a government, given the fungibility of resources, the higher the share of this support relative to total spending and the greater its use for financing recurrent O&M, the more vulnerable a government would be to its discontinuation.[19] As noted above, while aid that comes in the form of dedicated project support is restrictive in its lack of fungibility, it also ensures a certain degree of sterilization in its overall budgetary impact in the event of a failure by the donor to disburse.[20]

It is worth emphasizing that these are *budgetary* issues which are *distinct* from those related to the macroeconomic impact of a scaling up of aid as discussed above (on inflation, the exchange rate, etc.). Yet they are questions obviously germane to the macroeconomic policy management of an economy, pertaining to a government's sustained ability to finance a significant increase in its expenditures as a share of total output.

Sectoral sustainability

Most aid does not come in the form of *general* budget support (that is, available to the government for spending for whatever purpose). While there has been a shift in this direction, donors still tend to earmark significant resources for sectoral (if not subsectoral) spending purposes (in addition to project aid). While the ministry of finance must judge the *aggregate* sustainability of the government's budget, sectoral ministers must worry about the sustainability of resource flows to finance their expanded sectoral programs. Such expansions may be nontrivial—in some sectors, notably health and education, aid resources may facilitate a doubling or even more of a government's sectoral spending program. Table 2 illustrates a rough potential order of the magnitude of external funding for HIV/AIDS programs relative to existing government health spending levels in 2005. In terms of disbursements, 2005 levels represent a way station, in the sense that commitments, say for the PEPFAR program, have only begun to rise (from about $300 million in FY03 to almost $600 million in FY04 to $1 billion in FY05 and with $1.3 billion planned for FY06, and with the bulk of disbursements only scheduled to occur in the year after the commitment phase). Thus, disbursements are likely to double in FY06 and increase a further 30 percent by FY07! Global Fund commitments and disbursements witness the same type of sequencing and growth pattern. Nevertheless, already, it would appear that HIV/AIDS spending could in FY2005 roughly amount to increases of as much as 40–50 percent of public health spending in Ethiopia, Guyana, Kenya, and Zambia, and to even more in Rwanda.

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[19] In effect, aid shares increase in the form of general budget support, and donors become hostages to budget dependency and the consequences of aid discontinuity.

[20] In some respects, there is an important analogy to the impact of significant terms of trade shocks that augment a government's revenue in a given year, given that there remains uncertainty as to how long such favorable terms of trade will prevail. An important difference of course is the extent to which the government's control and use of such resources is subject to conditionality.

Given uncertainties on the sustainability of such aid, sectoral agencies may need to structure their expenditure programs in terms of what is known about the predictability and time frame of external commitments. The greater the uncertainty, the greater the need to ensure flexibility in the way in which employment contracts and service provision are structured. This may also require greater reliance on limited-term contracts for sectoral personnel so as to reduce concerns about the creation of excessive long-term employment commitments. Contracting out to the private sector may be an additional approach that gives the government some degree of flexibility for cutting back in the event that aid resources do not materialize. Heightened attention to clarifying the "priority" level of public service provision in the context of aid volatility becomes particularly important as a risk-averse strategy for managing a government budget. Absorptive capacity concerns, such as the availability of the requisite skilled manpower to staff a scaled-up set of program services, must also be addressed.

The challenges faced by sectoral managers may be further complicated to the extent that there remain continuing inconsistencies between donor and government priorities. In principle, a government's PRSP lays out relative sectoral priorities—such as the balance across sectors, key bottlenecks to be addressed, and the relative roles of the public and private sectors. With pressures for global vertical financing initiatives and some strong donor views on the appropriate character of policy interventions, there may not be full harmonization between donor and recipient country priorities. These issues are not new, but they will acquire added resonance and impact in a scaled-up aid context, where "policy-inconsistent" donor programs may rival in size the government's own program efforts and where macroeconomic constraints may force policy choices as between externally and domestically funded public programs.

Even from the perspective of the minister of finance, the sectoral dimension may create difficulties for fiscal management. Thus, in *aggregate* terms, a country may be able to absorb a sustainable growth in aid resources, but this may not be matched with a comparable level of certainty at the *sectoral* level. In any given year, while aid to some sectors may exceed expectations, aid to other sectors may experience shortfalls. A comparable phenomenon may emerge in the flow of funds to specific regions in the context of decentralization. While there is of course much fungibility associated with budget support, often there are limits on the extent to which domestic budgetary resources can be readily shifted to other non-aided sectors.[21]

[21] It can be argued that money is fungible, particularly when provided by donors in the form of budget support, and that governments have considerable discretion in shifting resources from less essential to more essential purposes in the event of shortfalls in aid flows. While there is some truth to this in principle, a number of constraints apply in practice. In some cases, unless there is a specific budget line accorded to an expenditure item, no matter how important the item may be, it may receive a lower priority in any reallocations of expenditures. Second, with resources flowing to a number of sectors in a high-aid environment, cutbacks tend to be made in a generic way—across-the-board cutbacks, a freeze on nonwage outlays, etc.—that indiscriminately cuts both valuable and less essential expenditure items. Third, while there is much talk of fungibility in the context of sector-wide approaches (SWAPs), these are more the exception than the rule. The United States recently observed that only 13 of the 130 countries it is working with in relation to HIV/AIDS have such SWAPs.

Table 2. Rough Estimate of the Size of HIV/AIDS Disbursement Relative to the Size of the Health Sector and GDP in Selected African and Central American Countries in 2005

	Nominal US PEPFAR Fund FY2005 Disbursement (I)	The Global Fund Undisbursed Funding (II)	MAP FY2005 Disbursement (III)	Total Potential Funding (I+II+III)	Total Potential Funding (I+II+III)	Total Potential Funding (I+II+III)	Total Potential Funding (I+II+III)	Total Potential Funding (I+II+III)
	($ million)				(in percent of public health spending)		(in percent of total government spending)	(in percent of GDP)
Botswana	22.0	9.0	..	31.0	8.9	5.5	0.7	0.3
Côte d'Ivoire	15.0	7.0	..	22.0	9.3	2.1	0.7	0.1
Ethiopia	46.0	55.0	..	101.0	43.8	19.7	3.3	1.1
Guyana	10.0	8.0	..	18.0	53.9	41.1	5.0	2.3
Haiti	23.0	12.0	..	35.0	26.2	10.3	6.8	0.8
Kenya	75.0	99.0	15.0	189.0	51.9	22.8	3.8	1.1
Malawi	..	6.0	5.0	11.0	13.2	5.4	1.5	0.5
Mozambique	29.0	28.0	6.9	63.9	23.2	16.5	2.8	1.0
Namibia	23.0	30.0	..	53.0	22.4	15.7	3.0	1.1
Nigeria	57.0	54.0	22.0	133.0	12.1	3.1	0.4	0.1
Rwanda	29.0	18.0	5.6	52.6	80.6	46.1	..	2.5
South Africa	70.0	22.0	..	92.0	1.2	0.5	0.2	0.0
Tanzania	49.0	27.0	10.9	86.9	26.7	14.6	4.4	0.7
Uganda	82.0	163.0	11.0	256.0	150.2	41.9	12.7	3.1
Zambia	61.0	6.0	10.0	77.0	40.3	21.3	4.0	1.2

Sources: IMF Staff Reports, World Bank Project Appraisal Documents, *World Economic Outlook* Database 2005, and *World Health Report* 2005

The ministry of finance or budget agency then must confront the challenge of how to handle the burdens faced by particular sectoral ministries that have scaled-up service delivery in response to a past increase in aid flows but which now experience shortfalls in aid resources. Of course, donors providing budget support targeted to specific sectors are not enthusiastic if there is a perception that their aid is not effectively additional to a government's own previous level of spending in that sector. From a fiscal management point of view, a scaling up of the role of aid flows in financing a government's budget may thus call for a more conservative posture in terms of domestic debt levels relative to GDP or higher government deposit balances at the central bank. These issues are further complicated to the extent that aid flows are not explicitly incorporated as part of a country's formal budget process, or if included, are so earmarked that there is limited possibility available to the minister of finance for reprioritization.

Similarly, in other critical areas of public sector management, governments will have to find ways to retain highly skilled civil servants with the requisite technical abilities. Experience suggests that governments find it difficult to retain highly trained personnel, say with financial skills. The already rampant phenomenon of using various jerry-rigged mechanisms to indirectly supplement civil servant salaries (through such means as reliance on per diems for travel or for attendance at meetings; formation of semi-autonomous agencies outside civil service salary scales, not to mention more unsubtle means)—for which donors turn a blind eye or facilitate—will become even more of a problem with a scaling up of aid. While contracting out to the private sector may be one way to facilitate more efficient ways of aligning compensation with incentives for production rather than rent-seeking, this can only work if the government's capacity to manage contractors is enhanced. [22]

Responding to the greater challenges posed for public financial management (PFM)

Recent IMF-World Bank studies (IMF, 2005a) highlight the prevailing weakness of PFM systems in terms of budget formulation, budget classification, commitment control, cash management, budget reporting, audit, and capacity for regulation of semi-autonomous agencies and extrabudgetary funds. The scaling up of aid will only exacerbate existing difficulties, intensifying the pressures for budget reform. Ironically, heavier reliance on external sources for budget financing—independent of whether services are to be directly provided by the government or contracted out to the private sector—will place even more difficult challenges on public financial managers. The effectiveness and efficiency of aid in delivering concrete results in terms of increased productivity and higher welfare will be very much contingent on governments being able to manage the funds well.

Higher aid flows subject to uncertainty will force ministries of finance or budget agencies to: strengthen their systems for recording and analyzing the character and duration of prospective

[22] The challenge of civil service reform—which entails both downsizing of low-productivity employees in the government and higher direct compensation to those who are productive—has been a long-standing item on the development agenda, but one which has proven difficult to achieve. The World Bank (2002) did a review of its work on civil service reform and found that experience has been mixed and often disappointing.

aid flows; clarify the potential recurrent cost implications of new spending programs; develop a capacity for formulating budgets robust to alternative aid funding scenarios; extend their analyses of fiscal sustainability to take account of uncertain grant flows; and introduce the use of various risk management techniques in the management of the budget. Technical assistance (TA) efforts in the area of public financial management, already recognized as important, will require even further emphasis in a high-aid environment (see Section IIIC below). Yet even such TA efforts have not often proven successful, as trained workers are often the first to leave for the private sector (creating a treadmill effect in terms of the need for new training).

Addressing the organizational challenges of a scaled-up aid effort

In recent years, NGOs have become highly aware of the unanticipated consequences of success. Those NGOs that have been effective—whether in the sphere of medical care, social services, or micro credit—have received substantial increases in resources from external donors wishing to replicate and extend their success to larger population groups. Organizations that functioned effectively at one scale have found that expansion to a significantly higher level has proven difficult. Functionality at a small size may become dysfunctional at a larger scale. The most recent illustration of this phenomenon relates to many NGOs engaged in the prevention and treatment of HIV/AIDS. They are now wrestling with the challenge of absorbing and delivering services at a much higher level with the new funding associated with the Global Fund and PEPFAR.

There is no reason to assume that government bureaucracies, which may already be constrained by the inflexibilities of civil service rules and cumbersome government budgetary procedures, would be more adept at making the transition to a higher scale of functioning. The sharp increase in resource flows may present comparable challenges for these public bureaucracies. The obvious concern must be that a failure of government bureaucracies to execute an effective transition to delivering services on a far larger scale may result in significant inefficiencies and a wastage of funds that will weaken the resolve as well as the political capacity of donor countries to sustain popular support for higher aid funding levels.

Dealing with the implications of higher fiscal dependency

Lewis (2005), in her recent paper on HIV/AIDS financing issues, highlights some of the dependency factors most often cited. These include concerns that: countries will have a reduced incentive to mobilize domestic resources;[23] the potential for institutional actors—whether in the government or the NGO sector—to tailor their strategies and priorities to conform to what they perceive to be the concerns and interests of donors; and the consequences of a significant segment of the formal economy being dedicated to the interests of the external donor community (whether benignly or with some attendant corruption). Other aspects of dependency include the reduced pressure on government to address existing inefficiencies in how public

[23] Some observers note that some African countries with among the highest ratios of aid to GDP are also those that have stubbornly low tax ratios.

services are delivered. Increased aid may also make governments less receptive to a more significant role for the private sector in the delivery of services. Some of these issues can have important macroeconomic effects—inhibiting the potential for governments to raise their domestic revenue shares or to eliminate unproductive expenditures. The effect of others relates more to microeconomic efficiency concerns, but there are still damaging in terms of realizing the potential of aid for higher growth.

There is one additional point about fiscal dependency which has received less attention. Countries whose budgets rely heavily on aid inflows rather than on their own domestic resources give up significant political autonomy in their capacity to manage and make decisions on budget priorities (Bevan, 2005). At what point does the share of a country's budget financed from external sources become excessive? Is it 25 percent? 50 percent? 70 percent? Consider a country that mobilizes 15 percent of GDP in domestic revenues and receives ODA of 20–25 percent of GDP. In such circumstances, almost *two-thirds* of budgetary outlays would be dependent on external sources. This may not be that unusual. A recent IMF-World Bank scenario for doubling aid in Ethiopia anticipated a fiscal situation by 2015 that would mirror this amount of dependency.

Given obvious conflicts of interest and well-meaning intentions for growth, poverty reduction, and the achievement of the MDGs, recipient countries will have a hard time "looking a gift horse in the mouth" and turning away from ODA flows even in the face of these potential problems. Taking action to minimize the extent of these effects itself requires strong governance. Can farsighted recipient governments work with donors to put in place mechanisms that strengthen their capacity to foster counterweights to these predictable political economy and behavioral incentive pressures?

There have been efforts by donors and aid-recipient governments to develop ways to enhance accountability in the use of aid resources. Some donors have developed approaches to earmark a small portion of aid disbursements specifically for incorporating accountability frameworks—increasing transparency, strengthening the capacity of civil society for monitoring the use of resources, strengthening domestic audit mechanisms (e.g., the comptroller ceneral's office), establishing independent oversight mechanisms for government implementing agencies, and financing external audits (see USAID, 2003).

Various approaches have also been developed by industrial countries to strengthen public sector governance that might be equally considered in a high-aid environment. At the aggregate level, fiscal policy rules may be introduced to ensure fiscal discipline. Tax instruments with high elasticity may be introduced to limit the potential for diminished resource mobilization. Independent project evaluation or sectoral program review boards may be used to raise red flags about questionable policy approaches. Government audit and monitoring and evaluation functions should be strengthened. Multilateral surveillance, both at the macroeconomic level and in terms of periodic public expenditure reviews by the World Bank, may provide an independent counterweight to questionable expenditure policies. The review of the PRSP by multilateral agencies may also serve a valuable role for donors in flagging potential difficulties.

In a similar vein, if a country decides to accumulate financial reserves as a policy management tool in the context of a scaled-up aid flow, the governance of these reserves will need to be structured to limit various moral hazard and institutional risks. The evidence of many commodity stabilization funds that have been established over the years is that they can undermine the budget allocation process without necessarily achieving their stated objectives. Often they have been mismanaged and used for purposes not consistent with a country's growth or poverty reduction purposes. Equally important, the governance of such reserves would need to be established in such a way as to give comfort to donors that aid resources would be used consistent with PRSP objectives and not dissipated by tax cuts or expenditures on unproductive purposes. The risk of a more conservative posture by recipient governments in terms of a buffer fund are, of course, that donors may respond by an equally conservative posture in their provision of ODA (Eifert and Gelb, 2005).

Developing a budgetary exit strategy

In view of the significant imperatives and needs that aid is intended to address, it may appear excessively cautious to raise the longer-term question of the strategy for weaning a sector and the government more generally from external financial support. If donors are willing to scale up aid flows to levels that are a dramatically higher share of the budget and GDP (and a fortiori, even more of an expansion at the sectoral level), it would appear desirable, at least at a conceptual and analytic level, for aid recipients to consider what would be an appropriate long-term scenario as to how ultimately to *phase down* that dependency and substitute financing from domestic sources. With the pressures that aging populations will place on the public finances of donor nations, the time frame for generous aid flows may be limited.[24]

In effect, governments need to have a game plan, both with respect to the scaling up *and* the ultimate *scaling down* of reliance on external aid resources in funding government expenditure programs, that is feasible and does not imply disruptive cutbacks to a recipient country. (This is an issue analogous to that raised concerning the appropriate exchange rate path.) Specifically, at the aggregate budget level, a view is needed as to the extent and time frame over which government budgetary outlays would be externally financed. Similarly, the relative sectoral growth rates envisaged in different parts of the public sector (e.g., health, education, etc.) in the context of a scaling up in aid resources should be clarified.[25] In formulating this view, governments need to put heightened emphasis on raising, over time, the share in GDP of domestic revenues, both for the financing of critical government services and for facilitating the ultimate withdrawal from aid dependency.

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[24] Clemens and Radelet (2003) have estimated the historical pattern of the time frame for graduation. Looking at the 23 permanent graduates from the World Bank's IDA loans, they calculate that the "half-life" of aid (measured as aid as a share of GDP) was about 10 years. With aid measured in real dollars rather than as a share of GDP, the half-life was around 12 years. See also Clemens, Radelet, and Bhavnami (2004).

[25] This also has to take account that the fungibility of budget resources may allow for some shifting of domestic resources to unaided sectors.

These issues are equally, if not more, germane at the micro or sectoral level. How to sequence budgetary outlays to ensure that obvious and critical bottlenecks to scaled-up public service delivery are addressed early in the process? This is most obvious now in the health sector, where governments are increasingly recognizing that investments in the training of both conventional and new types of community health workers must be made expeditiously if a scaled-up level of medical services is to be realized. Similarly, in terms of the ultimate need for governments to scale down their dependency on aid flows, government would do well to consider strategies that anticipate or develop private or social insurance mechanisms whereby the private sector can gradually supplant the role of government and donors in the financing of critical social services. In the health sector for example, Hsiao (2005) has advocated the gradual development of "substitution funds," which may take the form of community or national health insurance schemes that, over time, facilitate a growing private financing role for the health sector.

D. Aid and Growth

Ensuring that increased aid promotes growth and poverty reduction is certainly the most important task. After all, empirical studies offer only mild (and not uncontested) evidence that aid boosts growth. Encouragingly, a recent Center for Global Development (CGD) study (Clemens, Radelet, and Bhavnami, 2004) suggests such a positive relationship. It says that once one excludes those aid flows aimed at political and humanitarian goals, a positive net effect is observed for the remaining aid focused on economic objectives. But recent IMF work by Rajan and Subramanian (IMF, 2005a) finds no robust evidence of an effect—positive or negative—by aid on growth, with their conclusion holding across time horizons, time periods, types of aid, types of donors, and characteristics of recipient countries. They suggest that this may be due to aid flows giving rise to real appreciation of the aid recipient's currency—a Dutch disease effect—thereby undercutting its competitiveness in the tradable goods sector and weakening growth.

The CGD study, as with most studies of aid and growth, also finds *diminishing* returns to aid. The maximum growth rate occurs where the subset of aid aimed directly at growth reaches 8 percent of GDP. Since this subset is about half of aid, this is roughly equivalent to where total aid reaches about 17 percent of GDP (see also World Bank and IMF, 2005). Similarly, recent World Bank analyses of the economic effect of higher aid flows in Ethiopia are highly sensitive to the pace at which aid is assumed to be scaled up. These results may reflect absorptive capacity constraints that may impede a rapid scaling up of government service delivery in response to higher aid flows. Considering that aid to a number of African countries is already above 10 percent of GDP, these results underscore the need for development partners to intensify their efforts at appraising the productivity of alternative uses of aid and should give pause and provoke far more attention by countries and donors alike to ensuring that the factors propitious for growth are designed into the delivery of aid.

In considering these studies, it is important to emphasize that most available data sets relate primarily to levels of aid still significantly below what would be implied for some countries if there is an increase in aid flows eventuating from various new aid financing initiatives. Also, most of the outstanding empirical work relates to cross-country averages and thus is only

germane to a limited degree for a particular country. This suggests the need for caution in excessive inferences from existing studies.

There is also a school of thought that suggests that for some countries, there are critical bottlenecks which, if overcome with the assistance of aid, would enable a breakthrough to a more rapid growth path. To cite an obvious example, there is a growing literature suggesting the adverse impact of HIV/AIDS on growth and human capital formation in countries with high prevalence rates (Haacker, 2004). In principle, there may be a program of treatment and prevention that, by significantly reducing the adverse effects of premature mortality from AIDS and allowing a longer period of productive employment and parenting by HIV/AIDS-afflicted individuals, would enable a country to avoid these adverse output effects and thus to grow faster.

This "exceptionality" argument for the funding of HIV/AIDS programs cannot be dismissed easily, particularly for countries with very high prevalence rates (e.g., in southern Africa). It is certainly plausible that high aid levels might indeed generate a sufficiently high payoff in economic growth as to warrant dealing with many of the fiscal and macroeconomic policy challenges described above, and might create the possibility of higher future fiscal space (Heller, 2005) that would allow for some domestic financing for these future HIV/AIDS prevention and treatment programs. The challenge for all development partners is whether to gamble on the likelihood that these outcomes can be achieved; certainly waiting for sufficient empirical evidence to accumulate may be costly to the countries and individuals concerned.

III. The Task for Development Partners in Responding to the Challenges of a Scaled-Up Aid Effort

A. The Donors

Many of the issues discussed above have not gone unnoticed by the donor community. The Managing Director of the IMF, in his recent statement to the Spring 2005 Development Committee, forcefully emphasized that "higher aid inflows could pose significant macroeconomic challenges for recipient countries [and the IMF] is playing its part by looking closely at ways of helping developing countries manage such inflows" (de Rato, 2005, p. 6). Other members of the Development Committee also made repeated references to such issues as the need for increased predictability, the value of long-term aid commitments, the desirability of a scaling up of aid resources in the context of medium-term expenditure frameworks (MTEFs), the importance of a higher share of budget (rather than project) support, and the need to reduce the discrepancy between commitments and disbursements.[26] All of these reforms would allow

[26] There are efforts by donors to try and limit the extent to which the flow of donor resources is affected by on/off signals from the IFIs—the IMF in particular. The goal is to reduce the extent of all donor aid being subject to identical conditionality terms. Initiatives are being considered to ensure that reductions in aid due to poor performance are structured so as to have less disruptive effects on immediate year budgets (e.g., reductions in aid in a subsequent rather than the immediate budget year). Nevertheless, there is still an inherent contradiction between

(continued…)

aid recipient governments to better plan and sequence the use of aid resources. Recently, the Department for International Development (DFID) of the United Kingdom urged the establishment of a buffer fund mechanism to offset slippages and temporary shortfalls in disbursements, thus facilitating greater predictability in funding. Lewis (2005) has made a similar argument for aid resources devoted to the health sector.

Moreover, a number of donors and academics are giving thought as to how to facilitate greater predictability in funding. At one level, the United Kingdom's IFF proposal represents an effort to provide a longer-term instrument for financing over the next decade as provided in initiatives for global tax instruments. Similarly, the World Bank, the European Union, and the United States are all exploring how to balance the need for predictable funding while ensuring that aid flows are linked in some way to performance (see Eifert and Gelb, 2005; Foster, 2005). Note should also be taken of the recognition of the need for gradualism in the scaling up of aid funds, in order to take account of limits in productive absorptive capacity (a note echoed even by Sachs, one of the more forceful advocates of a scaling up of aid efforts, in the report of the Millennium Development Project, 2005). Efforts by the donor community to adhere rapidly to their commitments under the recent DAC harmonization declaration would go a long way to helping developing countries address some of the concerns implicit in the IMF Managing Director's remarks.

Nevertheless, despite these laudable objectives and efforts, there is much still to be accomplished. For example, developing countries will, at least for a number of years, still confront the fact that the characteristics of external assistance are not even close to the desirable features proposed above. Donor intentions and goals still deviate substantially from the reality of donor assistance practices.[27] Current approaches with respect to the goals for harmonization, alignment, and predictability are still far short of professed objectives and aid recipients have reason to be uncertain about how long it will take for these gaps to be closed. Moreover, it must be daunting for LICs to catalogue both the number of donors with which they must work, as well as the multiplicity of their objectives, modalities of operation, underlying criteria for aid levels, and conditionalities and terms of aid.

Moreover, despite recent innovative and bold thinking on issues of predictability, there is much work still required to formulate more concretely these various ideas into an internationally agreed form that would facilitate the reality of greater predictability in aid flows, while still ensuring adequate performance in the use of the aid. Even if these approaches were to prove successful—and thus address the short-term volatility issue—they would not wholly address a number of the issues which LICs must address in utilizing scaled-up aid flows effectively.

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the fact of conditionality as an element in determining the flow of resources to a country and the need for recipient governments, in making expenditure commitments, to seek unconditional and long-term commitments of resources.

[27] One notes the Development Committee Communiqué of April 2005, which "urges the establishment of targets, as agreed [in the Paris Declaration on Aid Effectiveness] for each of the indicators for 2010." The Communiqué emphasizes that "concerted collective actions will be required to translate these into concrete actions at the country level."

The first and most obvious is the **real resource transfer question**. Even if there were to be complete certainty by developing countries on the aggregate size and composition of resources to be received annually through the next decade (a very large "if"), this does not address the factors that will influence how much can be absorbed. Nor do they address the trade-offs that may be involved in absorption and the challenges that may arise as to who bears the cost of sterilization. A recipient country would still need to determine whether all of the aid can be absorbed and utilized effectively, consistent with the country's long-term development strategy for graduating from aid dependency.

Second, these approaches do not enable the recipient countries to avoid having to address the macroeconomic policy management challenges arising from higher levels of aid and the greater challenges associated with reserve management. Some of the issues can only be addressed by the donor community working in partnership with recipient countries. For example, greater consideration is needed of how to sequence the provision of aid so as to tackle early the key bottlenecks to resource absorption. More attention may be needed to the import composition of aid. Donor-managed trust funds might be developed to allow for a more gradual phasing of disbursements. And as suggested in Heller and Gupta (2002), the donor community should consider alternative ways of utilizing the mobilized aid resources that would not be subject to the real resource transfer problem. These would include spending on global public goods and R&D on products that would benefit LICs (such as inexpensive drugs and vaccines for tropical illnesses, or low-cost seed varieties resistant to climate change).

Third, the issue of predictability in aid receipts, while subject to much discussion, still has a largely short-term focus. Greater predictability can relate to reducing the disparity between commitments and disbursements (one factor contributing to volatility in aid receipts) or to the various factors that result in disbursement shortfalls (bureaucratic delays, conditionality-induced holdups). Various buffer (or reserve) fund, aid smoothing, or innovative private insurance mechanism proposals may be successful in reducing such volatility. Equally relevant and useful in a scaled-up aid environment is for LICs to have greater clarity about the magnitude and duration of aid flows that can be expected over a far longer period.[28] [29]

If donors are serious about scaling up aid flows, this must be matched by a far greater willingness to take the risk of making sufficiently long commitments so that aid recipient

[28] In a forthcoming article, Sperling (2005) suggests that aid to the education sector must be structured with five to ten year commitments in order to maximize incentive for LICs to attempt to succeed in expanding basic education. "Donors should provide countries with clear assurance that they can take the necessary steps for long term reform." He notes that even if funding can initially be pledged only in three-year cycles, donors should be clear that funding could be renewed for six-year horizons upon acceptable performance in order to encourage long term reforms.

[29] Alternatively, some have suggested the idea of an "aid rule" that would allocate certain shares of program aid toward, respectively, up-front spending on current government programs or projects, domestic/external debt reduction (allowing for a permanent and predictable reduction in budget debt service costs), and an "aid annuity" (effectively allowing for the disbursal of a program grant, inclusive of interest over a fixed period).

countries can commit to substantially expanding their public service delivery programs.[30] Some of the new global financing initiatives—specifically the IFF and the global tax proposals of France and Brazil—offer hope for some degree of continuity in financing, but these are still far from realizing international consensus for implementation and the amounts they would provide would still be small relative to those from other aid sources. Moreover, there is much still to be worked out in clarifying the modalities for their allocation to specific countries. The important balancing act of concern for donors is how to ensure that resources are delivered in a way that facilitates their effective use, given the high political economy costs to donors of mobilizing greater aid funds.

There is a final way in which donors may need to strengthen their efforts. One consequence of recent efforts by donors to decentralize their work has been a weakening of the "center" of their institutions. Resources allocated to what might be termed "R&D"—the development of policy strategies that can inform the work of country teams—have progressively shrunk. While there is much to be said for greater operational autonomy and specificity at the country level, if it is not informed by a coherent, evolving, and well thought out perspective associated with systemic or generic issues, there is a risk of inefficient solutions being pressed upon overstretched country authorities by the donor community. It would be unfortunate if the use of higher aid resources is not well informed by the most up-to-date views on appropriate policy in different sectors.

B. The Aid-Recipient Countries

In recent years, the global community has agreed upon a process through which, in principle, a number of the issues associated with a scaling up of aid flows can be frontally addressed by LICs and their development partners. Specifically, countries are expected to work with the latter to develop periodically a coherent strategy for poverty reduction and growth—the so-called Poverty Reduction Strategy Paper. Most of the PRSPs produced since this process began about five years ago have had a medium-term focus, with a cautious focus on tailoring the strategy to the amount of resources likely to be prudently available. More recently, there has been a recognition of the need for a longer-term focus. Secretary-General Annan's recent proposals for U.N. Reform suggest that PRSPs be transformed into MDG plans keyed to consider the strategy and financing that would be required to achieve the MDGs by 2015.

The PRSPs are thus the obvious vehicle and process, in a scaled-up aid environment, for LICs to clarify their acceptable long-run macroeconomic frameworks in terms of key policy targets: the highest rate of tolerable inflation; an acceptable real exchange rate path; and the structure of external financing of the balance of payments. While countries inevitably must adapt macroeconomic policies to many unforeseen developments, PRSPs should include at least a coherent perspective on the potential implications of alternative scaling-up scenarios and a strategy for how to respond to these scenarios in policy terms. This includes clarifying the

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[30] Eifert and Gelb (2005) have indicated a number of challenging issues that must be confronted by donors in balancing their recognition of the importance of greater predictability and durability in aid flows with the need to demonstrate that recipient countries' performance warrants a continued flow of donor support.

extent and time frame for dependency by the budget, and the economy more generally, on financing from aid sources (taking also into account anticipated trends in remittances, the terms of trade, and export receipts).

Since the PRSP also lays out the strategy for the government's own role in fostering growth and delivering public services, it must also provide a coherent strategy for taking advantage of a prospective scaling up of aid resources while dealing with the uncertainties of relying on external sources for the financing of a large share of the government's budget. This should include the scope for expanding the delivery of public services; the appropriate sequencing in the training or recruitment of scarce specialized personnel; the scaling up of specific sectoral programs; the approach to be taken to ensure the resilience of service delivery programs in the event of budgetary shocks (such as lower than anticipated aid flows); and the long-term game plan for either a phasing down of the government's role or expanding domestic resource mobilization to replace external resources.

What is critical for the PRSP process is that the key issues associated with scaling up are directly confronted. In particular, to facilitate maximum absorption of potential aid flows, countries must clarify what efforts will be needed to remove bottlenecks to expanded production in the key nontraded goods sectors. Reliance solely on macroeconomic policy instruments (reserve accumulation and sterilization) will not address the underlying real factors which may hold back an economy's growth. By appropriately sequencing investments in infrastructure and training, countries may have a far greater likelihood of absorbing effectively scaled-up aid flows, while at the same time being consistent with the likelihood that the scaling up of aid flows is itself likely to be gradual. Recipient countries will also need to consider the many institutional policy issues associated with greater fiscal dependency—inter alia*,* the sequencing of training programs for skilled personnel in short supply, the approach to responding to selective market pressures for pay increases for certain classes of civil servants, limiting the potential for corruption and rent-seeking associated with higher aid flows, etc.

Equally critical for the public sector of LICs is to clarify their vision on the end game, the way in which services would ultimately be provided and financed as they are gradually weaned from aid. In a world where scaling up is the principal initiative, achieving clarity as to the duration of likely aid receipts will be an important challenge. But it is in the interest of developing countries to plan for a process of gradual scaling up and scaling down. This also relates to the real exchange path that will influence the competitiveness of the private sector.

C. International Financial Institutions

The recent G-8 debt relief initiative will undoubtedly give rise to renewed debate on the role of IFIs in the channeling of additional financial resources to low-income countries: the balancing of grants versus loans from the World Bank and regional development banks or the nature of the financial support from the IMF. IFIs will be needed more than ever in providing policy advice to help aid recipients cope with the intensified challenges discussed above. In particular, the World Bank and other development agencies will need to provide guidance on the overall development strategy and on desirable sectoral policy frameworks. IMF macroeconomists can

help countries formulate and manage a long-run external policy framework, calibrate monetary policy, and determine an appropriate foreign exchange reserve strategy. IMF fiscal economists can help governments ensure consistency between a sustainable fiscal and budget policy, particularly when aid is heavily relied upon to finance recurrent expenditure programs. Box 1 provides some illustrative ideas on the additional policy challenges on which IMF macroeconomic policy advice may be necessary.

Box 1. Macroeconomic and Budgetary Policy Issues to Be Addressed in the Context of a Scaling Up of Aid

Provision of Macroeconomic Policy Advice

- Assess potential Dutch disease effects
- Advise on policies that could minimize Dutch disease effects
- Advise on alternative approaches to sterilize the monetary impact of measures to contain real exchange rate appreciation pressures
- Assess impact of alternative real exchange rate trajectories over time
- Provide guidance on reserve management policies and reserve targets required to cope with potential for higher volatility in foreign exchange and budgetary receipts

Provision of guidance on strengthening fiscal and budgetary management

- Provide estimates of underlying level of ODA inflows likely over the medium to longer term, including engagement with donors to come up with realistic aid estimates
- Assess implications of ODA flows for future budgetary commitments
- Characterize potential volatility and uncertainties in aid flows
- Assist in the development of a rolling medium-term budgetary framework
- Enrich the analysis of fiscal and budgetary sustainability in a high-aid-dependency environment
- Assist in use of scenario analyses as a means of assessing alternative budget strategies

IV. Some Concluding Thoughts

This paper has sought to highlight some of the important challenges that will be faced by *all* development partners in the context of a more ambitious global aid environment. The donor community has rightly begun to focus on some of the critical weaknesses in the way in which aid flows are presently delivered—the lack of harmonization in donor practices, their

unpredictability, their volatility, their often weak alignment with recipient country policy priorities, and the limited approach to measuring effectiveness.

This paper has underscored some additional policy challenges that will be faced as a consequence of a significant scaling up of aid flows. Even with full harmonization and alignment, these issues will still need to be confronted. The paper emphasizes that in this context, the policy advisory role of the key IFIs—the IMF, the World Bank, and other regional development banks—will become more, rather than less, important. These institutions will need to strengthen their approaches to helping countries respond to some of the critical policy choices and dilemmas that will arise in the areas of macroeconomic, fiscal, and budgetary policy management.

For aid-recipient countries, there will be sectoral policy challenges and trade-offs to confront, as well as operational monetary and fiscal policy and budgetary management issues to be addressed, once a broad aid reliance strategy is determined. Even if donors prove successful in their efforts at harmonization and alignment and clearly and unequivocally commit to an unconditional flow of additional aid resources for the next ten years to support a country's budget, many of the issues discussed above would still have to be addressed by country policymakers. Adverse incentive effects, Dutch disease, volatility arising from movements in global exchange rates among donor countries, policy choices to influence the longer-term provision and financing of public services, and loss of voice in budgetary choices—all would need to be considered even in this more ideal scenario.

In the real world of gradual change in donor policies and practices, multiple other issues relating to uncertainty and volatility will pose constant challenges in the operational management of sectoral budgets and day-to-day decisions on how to increase the supply of critical public services. This will require the concerted efforts of donors, the IFIs, and aid-recipient governments. Particular emphasis should be given to developing strategies for creating financial reserves to buffer uncertainties, manage day-to-day macroeconomic policies in this context, and consider how to facilitate greater flexibility in the way in which public services are produced. Also critical to consider would be the sequencing of investments to facilitate the removal of absorptive capacity bottlenecks in the management and delivery of public services. Reserve management in particular will have macroeconomic policy implications that will require more in-depth consideration, and the IMF has much to contribute in helping country authorities take these into account. Countries may need to consider whether there may be limits that need to be set on the extent of reliance on general or sectoral budget support.

Strategies for boosting domestic resource mobilization and strengthening public sector financial management will be even more critical. Fiscal managers will have to be more adept at considering fiscal risk management in the face of heightened uncertainties in the flow of financial resources. Countries might also need to consider ways of utilizing new mechanisms in capital markets to "bank" promises of future financial support from donors in ways that buffer volatility in aid resources. Financial reliance on the IMF might also increase, to the extent that volatility in external resource flows are not directly linked to poor macroeconomic policy management.

The development community will also be faced with the need to reconcile a tension between what actions and policies may be needed to make progress on the Millennium Development Goals and those required to foster self-sustaining and vibrant growth and fiscal sustainability. With a significant scaling up of aid, there will be strong pressures to absorb as much funds as possible and for a significant scaling up of the role of government agencies and their work force. While this may contribute to enhanced social services, the fundamental driver of sustained growth derives from the private sector. Concerns about the effects of aid in terms of a real appreciation of the currency principally center on potentially adverse effects on incentives in the private sector and the potentially corrosive impact of an expanded state role. Using aid as much as possible to remove bottlenecks to private sector investment and to foster the private sector's role in delivering many quasi-public services must be kept strongly in focus as new development and poverty reduction strategies are formulated. And finally, the impact of big rapid aid increases on governance and institutions may be one of the most important issues to be addressed.

The donor countries, in addition to continuing their current efforts at aid harmonization and greater alignment, must examine alternative ways in which their policy efforts can contribute to the development of LICs. In terms of aid, more effort will be needed to facilitate greater predictability and longer-term commitments of aid flows (complicated issues dealt well with by Eifert and Gelb, 2005; and Foster, 2005). Little also needs to be said about the importance of opening up of industrial country markets and the elimination of subsidies to industrial country producers for the products of the developing world.

There may be other ways in which the financial resources intended for aid can be used by donors to finance global public goods provision that would directly benefit developing countries—financing R&D on critical disease problems specific to the developing world or R&D on alternative agricultural technologies that will offset the impact of climate change on agricultural productivity; the provision of subsidies for the production of inexpensive drugs that can address critical health problems in developing countries; exploration of ways in which information and communication technologies can facilitate an increase in productivity in developing countries; the financing of regional training programs for developing professional and paraprofessional personnel; development of modalities for facilitating emigration of workers from developing countries that would benefit aging industrial countries and facilitate both remittance transfers to developing countries and ultimate reintegration of skilled workers back to developing country labor markets. These alternatives may prove equally valuable ways of promoting growth and the achievement of the MDGs, while lessening the budgetary and macroeconomic difficulties associated with the direct provision of aid.

In closing, the emerging commitment by industrial societies to attack the roots of poverty by mobilizing more resources for aid is an enormously important opportunity. There is no reason to believe that development partners, working together, cannot utilize additional aid resources effectively in order to foster growth and achieve the Millennium Development Goals. The donor community in particular, in concert with the IFIs, has a particularly important role to play in helping recipient countries manage and utilize effectively a scaled-up flow of aid resources.

There will be trade-offs. Perhaps, some short-run growth may need to be sacrificed to address the critical needs posed by epidemics such as HIV/AIDS or to extend primary and secondary education to all children, all with the larger goal of helping to put countries on a long-term growth path which is rapid and sustainable. It is also possible for donors to make the work of the finance and sectoral ministers more manageable by providing aid in ways that lessen these tradeoffs: by significantly increasing predictability of long-term aid commitments; by reducing volatility in aid disbursements; by working with countries in carefully strategizing and sequencing the use of aid; and by strengthening macroeconomic and budgetary policy management. By anticipating the challenges of a scaled-up aid environment, development partners can better ensure that the ultimate outcome is successful.

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