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Managing Fiscal Policy in Low Income Countries: How to Reconcile a Scaling up of Aid Flows and Debt Relief with Macroeconomic Stability

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I. Introduction

The commitment of the G8 to double aid flows by 2010 offers the prospect for many LICs to see, in the near future, a substantial expansion in the share of their budgets financed from external sources. Some expansion in fiscal space has already emerged from the Multilateral Debt Relief Initiative (MDRI), freeing resources previously used for debt service. Part of the increase in aid flows will undoubtedly come in the form of general budget or sectoral support. Other increases may come from targeted assistance to specific projects or programs, either from bilateral donors or new global initiatives.

Managing these inflows pose important challenges for policy makers. In the last year, the IMF has explored several dimensions of the macroeconomic policy challenges associated with a scaling up of external assistance, including issues of absorptive capacity, exploiting fiscal space, the appropriate debt sustainability framework, possible effects on the real exchange rate and the coordination of monetary and fiscal policy (see Heller (2005a, 2005b); Gupta et al (2006), IMF (2006). However, fiscal policy makers in LICs are beginning to experience a number of other important and interesting challenges associated with the way in which the scaling up of external resources is occurring. The IMF's Medium Term Strategy recognizes the importance of beginning, proactively, to discuss how fiscal policy makers could respond to these challenges, many of which have the potential to complicate macroeconomic policy.

The challenges posed for fiscal policy are interrelated and include the following:

- **Achieving an MDG-oriented spending path:** Countries are being urged to mount ambitious spending programs to achieve the MDGs, and to be more optimistic with

¹ The views expressed in this paper are those of the authors and do not necessarily represent those of the IMF or IMF policy.

respect to their medium-term spending programs than would seem warranted by immediate aid commitments (given that few donors are able to make long-term aid commitments). How should governments respond to this call? Should they scale up their spending programs despite such uncertainties?

- **Reconciling a country's budgetary policy priorities with donor aid priorities:** Some LICs are experiencing a significant increase in aid resources dedicated to social sectors delivering MDG-related services (e.g., for HIV/AIDS prevention and treatment). This may shift the composition of expenditure toward the sectors favored by donors that would be difficult to adjust in the event of aid shortfalls. Wage pressures for specialized workers may spread across other parts of the public sector, increasing budgetary pressures. Should governments simply accommodate these spending pressures, even if wholly financed from grants or concessional loans?
- **Choosing a fiscal anchor:** Three issues make this choice particularly challenging: First, one consequence of the MDRI has been to reduce external debt levels below the commonly used sustainability thresholds. Combined with the potential increase in external funding, this has relaxed the immediate concerns about solvency. In this new environment, where there is a strong imperative for higher growth and spending to achieve the MDGs, **what factors should determine how much spending can be financed by borrowing?** Second, higher aid flows may create pressures for a significant real exchange rate appreciation. **Should governments limit the scale of their absorption (and spending) of aid in the face of these pressures? And lastly, even when funding is available, how can a government ensure that additional funds are spent well in the face of often acute capacity constraints and weak expenditure management systems?**
- **Managing the higher risks associated with greater reliance on external financing of the budget:** LICs are already exposed to many risks that make render the fiscal situation volatile. Increasingly, larger spending programs, particularly in the social sectors, are being financed by donor commitments of only limited term. Many of these programs, once initiated, are difficult to discontinue even if these grants cease. **Should the higher vulnerability associated with increased external financing be considered in determining appropriate spending levels and the size of the overall fiscal balance?**
- **Coordinating monetary and fiscal policy:** The decisions made on the choice of the fiscal anchor and on how to manage the higher risks of increased aid dependency, in terms of both the level and volatility of aid, will have implications for the appropriate fiscal policy stance in different circumstances and would need to be coordinated with monetary policy. How should fiscal and monetary policies be managed to ensure that increased levels of aid can be absorbed and to smooth the impact of positive and negative aid shocks?

- **Managing the transition path to self-reliance and reduced aid dependency:** Finally, no country seeks to have its welfare dependent on the whims or capacity of external donors. LICs must consider how to gradually reduce dependency on external assistance while maintaining many of the scaled-up programs of social service delivery and infrastructure.

Consistent with the Monterrey Consensus, the task of addressing these challenges should be shared between donors and LICs. Actions by donors in terms of increased predictability, harmonization, and alignment could make the task of LICs easier and less costly in terms of planning budgetary decisions and managing fiscal policy. But even an enhanced response by donors will not obviate the need for LICs to consider how to tailor their fiscal policies to respond to the challenges of scaled-up aid or to strengthen fiscal institutions in managing higher spending programs.

Although the issues need to be considered in a country-specific context, this paper offers a perspective on how LICs and the donor community should respond to the above challenges. Chapter **II** considers the appropriate medium-term fiscal framework (MTFF) that should guide LICs as they consider both their objective of achieving the MDGs and higher growth and the potential for higher aid flows. It also examines the implications for fiscal, monetary and exchange rate policy coordination. Chapter **III** then examines alternative approaches to fiscal risk management, in terms of analytic tools (such as the debt sustainability framework and stress testing of alternative scenarios) and specific policies for self-protection, self-insurance, risk pooling, and reduced dependency. Chapter **IV** analyzes how a strengthening of institutions can facilitate fiscal policy formulation in a high aid environment. Chapter **V** offers some concluding thoughts.

II. An Appropriate Fiscal Policy Framework for Scaling Up of Aid

With the prospect of a substantial expansion of foreign aid, LICs are being urged to prepare ambitious spending programs designed to achieve the MDGs that go well beyond the immediate, mostly short-term aid commitments. What does this imply for the design of the fiscal policy framework and the way in which that policy is managed? The starting point is the medium-to-long term fiscal framework. This should reflect a government's policy perspective on how to achieve more rapid growth and reach the MDGs. Both the fiscal framework and the policy perspective will be heavily influenced by how the scaling up of external assistance is likely to evolve for a particular country (which will be influenced by donor priorities) and, for the MDRI countries, the enhanced fiscal solvency that has emerged from recent debt relief initiatives.

This paper advocates for an ambitious medium-term perspective to take advantage of greater donor assistance to maximize the "fiscal space" available to reach the MDGs. LICs will face important policy and management challenges in reconciling such a stance with macroeconomic stability, sustainable and smooth funding for the new spending programs, fiscal solvency, an appropriate policy environment for long-term economic growth, and an ultimate graduation from aid dependency. Addressing these challenges is made more difficult

by the normal macroeconomic uncertainties that compound the uncertainties associated with the timing, magnitude and duration of external assistance flows. In what follows, Section A will discuss the policy issues surrounding the formulation of a MTFF (with the institutional issues associated with implementing such a framework deferred to Chapter IV). Sections B and C will then discuss the various interrelated operational fiscal and macroeconomic policy management issues involved in implementing a more ambitious response to a scaled-up aid environment.

A. Towards a more ambitious MTFF

An important aspect of the HIPC debt reduction initiative was to encourage countries to formulate Poverty Reduction Strategy Papers (PRSPs)—detailed multi-year multi-sectoral strategies to raise growth and reduce poverty. Evolving from these PRSPs, and in association with the IMF and the World Bank, countries were expected to formulate MTFFs, usually with a three-year time horizon, to map out the key fiscal targets guiding budgetary policies in the current fiscal year and provide some perspective on the potential pace of expansion in subsequent years. Given concerns about ensuring consistency with a manageable debt posture and the need for macroeconomic stability, countries need to reconcile the desire for ambitious spending programs with the reality that few donors provide long-term commitments. Hard commitments for the out years of the budget horizon typically diminished. This reality has commonly led to a conservative posture by governments (endorsed in IMF programs) as to the pace at which the overall budget could expand.

This approach has been challenged in recent years as advocacy for the MDGs has intensified. Sachs and others have called on the IMF and the Bank to work with countries to develop and cost comprehensive strategies to achieve the MDGs by 2015.² By estimating the cost and sequencing of these “needs-based” strategies through 2015, Sachs argues that a clearer picture can be derived of the “financing gap” that would need to be filled by the donor community if an MDG-based spending program were to be implemented. Equally, he argues that the IMF should, in the context of the PRSP and its operational fiscal work, support governments in using an MTFF *consistent* with a needs-based MDG scenario.

This approach ignores the basic operational concern that the formulation of a government’s budget and spending programs in individual sectors must be based on reasonably firm expectations that financing will be available in a form consistent with maintaining macroeconomic stability and fiscal solvency. If the financing gap appears large and unrealistic in terms of any prospect for it to be filled, it would be difficult to justify an expansion of government programs or the initiation of new investment projects. Yet the current “realistic” approach can equally be criticized as not reflecting a prospective global environment of enhanced aid flows.

² This appeal was ratified at the UN General Assembly in the Fall of 2005, which called on LICs to put together comprehensive MDG-based strategies.

An alternative approach would be for country authorities to project an “optimistic but plausible” medium-term financing scenario. It would reflect that donor financing commitments rarely extend beyond two or three years, but would take account of this new pro-aid environment. It would thus explore the implications of a level of external assistance—grants and nonconcessional loans—that is at least at the current budgeted level, if not somewhat larger, reflecting the scaling up of various initiatives. Such a framework should also be based on the presumption that domestic revenue shares would *not* diminish. For countries with presently low domestic revenue ratios, they would be targeted to rise (see section below).

Spending priorities within this enhanced fiscal framework would be expected to be consistent with the PRSP. But they would also need to take account of several operational factors (discussed below) that would allow such a program to be absorbed and rendered fiscally sustainable. This “leap of faith” for the out years of the fiscal framework obviously carries risks in the event that donors do not come through with their pledges. It also presumes that a government will not implement domestic policies—abusive governance actions, large-scale corruption in the use of aid, etc.—that “turn off” the tap of external assistance.

As discussed below, debt sustainability considerations, even for debt on concessional terms which is consistent with the potential envelope of enhanced donor assistance, would continue to be a potentially constraining factor on how much borrowing can be seen as consistent with such a fiscal framework. *A fortiori*, this debt sustainability concern applies to nonconcessional borrowing, given that countries with newly found “fiscal space” arising from the MDRI may seek an even more ambitious spending framework than would be possible from available concessional assistance from the donor community.

A key objective in moving toward a fiscal anchor that is based on an “optimistic but plausible” external assistance scenario would be to smooth the budget’s expenditure profile.³ This would help avoid an asymmetric adjustment in spending in the face of temporary shortfalls in donor disbursements. In the past, unexpected aid shortfalls have often complicated fiscal management, mainly concerned with closing quarterly or annual financing gaps, and resulted in cut-backs in productive expenditure. But macroeconomic stability that is achieved at the expense of significant volatility, either in investment projects or in the operation of government social sector programs, is not likely to contribute either to rapid growth or to be efficient or effective in making progress towards the MDGs.

³ This is not to imply that such a profile might not entail significant upfront investments in infrastructure, say in the context of a well-formulated longer term strategy for making progress to realize the MDGs. Rather, it suggests that governments would seek to ensure that the programmed expansion of expenditure would take place according to the prescribed path and limit the extent of abrupt adjustments.

Swings in the availability of aid can be better accommodated if fiscal programming is cast in a medium-term perspective. Financing and expenditure could then be smoothed out over the multi-year horizon, and thus aligned with actual priorities for reaching the MDGs. Such smoothing would also help to follow-through with expenditure commitments in the social sectors that would be particularly damaging if cut back, (e.g., AIDS treatment). In case of a delay in donor disbursement, the spending path would not be affected under such a medium-term framework. Rather, short term domestic borrowing or a draw-down of reserves would help maintain the spending programs. If however the shortfall appears likely to be of significant duration, the MTFE and the spending path would have to be modified downwards accordingly.

B. Developing an Operational Approach to Fiscal Policy in the Context of a Scaling up of Aid

In principle, pursuing the approach suggested above should not be difficult. Operationally however, and as will be discussed below, a number of issues need to be considered in tailoring it to the specifics of a country's situation, its PRSP spending priorities (particularly if they are strategically prioritized), and the composition, terms, and magnitude of the envisaged external assistance. Starting with a recognition of the importance of having a fiscal anchor to guide fiscal policy, these include the approach to determining appropriate aggregate fiscal targets that would maintain macroeconomic stability and debt sustainability, managing cash, including reserves, to smooth the expenditure path, and considering the composition of spending, all consistent with maintaining a conducive interest rate environment and competitive real exchange rate path. The effectiveness of fiscal policy implementation will also depend on the institutional capacity of a government for public financial management (PFM) (see Chapter IV)

1. The Need for a Fiscal Anchor

Underlying any operational approach to the management of fiscal policy, government solvency requires a credible fiscal anchor.⁴ This implies a mechanism (i.e., a set of constraints or an incentives scheme) to ensure that fiscal policy choices satisfy the intertemporal budget constraint (under most, if not all, states of the world) without outright default or strategies akin to default—such as forced restructuring, or a prohibitive inflation tax. In general, an effective fiscal anchor is one that ensures a positive average response of the primary fiscal balance to an increase in the public debt (Bohn, 1998). In practice, a good fiscal anchor is an institutional set-up that leads policymakers to implement fiscal adjustments whenever the public debt threatens to reach levels that would be inconvenient to sustain with permanently high primary surpluses. Indeed, the ability to sustain certain levels

⁴ The term anchor echoes the role of a nominal anchor as a precondition for price stability. Besides, the absence of a fiscal anchor ultimately undermines the credibility of the nominal anchor.

of debt depends directly on policymakers' capacity (or willingness) to generate primary surpluses.⁵

An array of institutional arrangements can provide such a fiscal anchor, leaving each individual country with a menu of options. They range from legally binding fiscal rules to formal commitments supported by strong accountability mechanisms or external incentives—such as those emanating from the conditionality of IMF-supported programs. Of course, the credibility and the effectiveness of these mechanisms ultimately rest on the costs (mainly reputational and political) incurred when ignoring them. In turn, these costs depend on the policymaker's perception of the budget constraint. Specifically, high debt levels make it difficult—and politically costly—to ignore the merits of adhering to a strict fiscal anchor, whereas low debt levels and large needs make it easy to downplay the anchor's importance.

While scaled-up aid and the MDRI have not eliminated the need for a fiscal anchor, they do require new modalities to preserve a credible commitment to macroeconomic stability. By substantially relaxing the financing constraint of LICs and placing high quality fiscal expansions at the core of a strategy to reach the MDGs, these initiatives represent a clear operational challenge for the design of a fiscal framework that also remains consistent with fiscal prudence. Specifically, if the current level of debt is not perceived as potentially problematic and if an expansion of spending programs can be financed by an inflow of grants and concessional loans, the implications of the intertemporal budget constraint for current policies are more elusive, and the importance of debt sustainability as a fiscal anchor is correspondingly weakened. Even rising debt levels may be unproblematic if it automatically triggers an increase in grant financing, or enhanced concessionality in new loans.

Absent the perception of an immediate fiscal anchor related to debt sustainability, scaled-up aid could set in motion a persistent fiscal expansion without adequate safeguards against the risk of an unsustainable accumulation of new debt, prolonged aid dependency, or highly volatile and less productive fiscal policies. These risks arise from various sources. One is the lack of specific incentives to expand the domestic revenue base—and with it the capacity to sustain higher debt levels. The second stems from the pressures for a “durable” increase in current expenditure emanating from aid-supported programs, such as the maintenance costs of new infrastructures, or the impact of expanded social programs on the wage bill. The possible tension between a stagnant revenue base and rising incompressible spending is bound to be reflected in either unsustainable debt increases or growing aid dependency. A third source of risk is related to the greater volatility in government resources that is likely to be associated with scaled-up aid. Lastly, uncertainty about the long-term growth impact of the fiscal expansion, the medium-term dynamic response of the economy (e.g. the

⁵ For example, evidence in IMF (2003) suggests that, on average, emerging market countries stop responding to rising debt with higher primary surpluses once the debt exceeds 50 percent of GDP. Beyond that threshold, an average emerging market country is therefore likely to drift on an unsustainable path of debt accumulation.

possibilities of a real appreciation), and the speed at which absorptive capacities can be built up carries clear risks of hard-to-correct fiscal slippages if expectations prove optimistic.

2. Operational considerations in setting the aggregate expenditure path

We have emphasized above that the objective should be to maximize the extent of absorption of additional external assistance, consistent with maintaining macroeconomic stability, growth objectives, fiscal solvency, and an ultimate weaning from dependency. Once the magnitude of external assistance is projected in terms of what is optimistically plausible, the aggregate fiscal target—stated in terms of the overall fiscal balance (or the primary balance) *exclusive* of grants, can be considered. One starts with objectives for revenue mobilization—as discussed below, an ultimate exit from dependency on external assistance will require rapid growth coupled with an emphasis on raising the overall revenue share to reasonable levels. In principle, one would like then to maximize the size of the expenditure program which could be realistically sustained with both grants and concessional loans. But several important considerations will influence the size of expenditure profile, and whether a lower fiscal balance exclusive of grants may be appropriate as the fiscal anchor:

- **Debt-sustainability considerations** may suggest limits on the amount of spending from concessional loans that should be accommodated (see Chapter III). In principle, the larger the share of grants that can be contemplated as likely for the foreseeable future, the less that solvency issues will be seen as a binding constraint. The greater the reliance on concessional (or a fortiori, nonconcessional) loans, the more quickly debt sustainability concerns will reemerge as a potential constraint as to the size of the expenditure program. Here the quality of the spending programs in terms of their potential growth effects is an important consideration in determining the acceptable level of borrowing. However, there are also limits to the extent that DSF can be used for judging the magnitude of acceptable borrowing in a given year. Particularly if a country is far below the debt threshold, there are in principle numerous potential paths that a country could choose to pursue in scaling up borrowing. Indeed, if a strong case could be made that the additional borrowing could be used for projects which would have a strong growth effect, it could be argued that debt sustainability would be only weakened slowly. IMF staff have recently argued that countries might consider allowing the debt path to rise only gradually—the so-called “glide path” approach—implying a smooth borrowing path with limits on the magnitude of new concessional (or a fortiori, nonconcessional borrowing). But the IMF has also recognized that there may be circumstances where a more rapid accumulation of debt might have merit. The implication of this discussion, particularly for MDRI countries, is that DSA may offer only limited guidance as to whether the “plausible but optimistic” financing scenario raises debt sustainability concerns.⁶

⁶ Moreover, being set in NPV terms (which is required given the concessional nature of these liabilities), the DSF does not lend itself to the design of a simple and transparent fiscal target.

- **The implied dynamics of the scaled-up expenditure program** may also suggest limits. Scaling up public investments as a share of GDP will give rise to expenditure requirements for the operations and maintenance (O&M) of these projects—schools, health clinics or hospitals, roads, port facilities, etc. Yet the growth obtained from such investments may also not yield sufficient revenue to finance these higher recurrent costs. In the event that donor assistance fails to grow commensurately, the principal consequence would most likely be a drop in the investment share—in effect, a fall in the number of investment projects, with potentially adverse effects on the growth momentum. In contrast, if current **donor assistance is principally focused on expanding social sector programs, the need for continuity in these programs will require that such recurrent costs be met in the future.**⁷ Some programs, once initiated, may prove even more costly in the future.⁸ Shortfalls in future donor assistance would then require the government to either implement cutbacks in such programs, which may be hard to do, or engage in domestic borrowing that may jeopardize fiscal solvency or macroeconomic stability.

A key implication is that a concern for a smooth expenditure path requires some consideration of the composition of the scaled-up expenditure program in terms of broad categories of expenditure. Certainly it suggests the need for an awareness of their O&M implications, the extent to which recurrent expenditure programs can be readily adjusted downward, and the cost to growth if the investment program is disrupted. **Operationally, risk management considerations may argue for medium-term expenditure targets, *ex ante*, which are *less than what a “plausible but optimistic”* financing scenario would suggest. Equally, the composition of expenditure program will have operational implications with regard to managing the associated risks.**⁹

⁷ The focus on the MDGs suggests that much of the increased aid may be of this latter type. Whether for construction of primary schools or health clinics, expanded employment in the health sector for vertical disease programs or maternal health and child care, these programs will be hard to discontinue. This would particularly be true if the staffing of such programs arose from an increase in the permanent civil service.

⁸ The increasing donor priority to vertical health sector spending programs (particularly for treatment of AIDS) is a vivid example. Unlike aid for most capital projects, for which the subsequent O&M implications are fairly limited, higher spending on AIDS treatment and care (the provision of antiretrovirals and the treatment of opportunistic infections) requires at minimum the continuity of such spending in future years. Indeed, once started, such programs for the affected individuals must not only continue but the cost of these programs may increase (reflecting that some percentage of individuals may need to have recourse to higher cost 2nd and 3rd-line drugs, offsetting any possible reduction in cost associated with some mortality of the patient base). Governments that commendably increase the size of their spending programs in this sphere, even if fully funded by grants, must nevertheless also consider the possibility that such grants may not continue, and that the government would have to finance the program out of own resources in the future.

⁹ For example, one might anticipate the need for higher reserves where the expansion in expenditures is for social expenditures with O&M implications, as opposed to where the expansion is with regard to capital expenditures with low O&M implications.

- **Growth considerations** may prove a constraining factor as well. Much has been made of the potential difficulties that can arise if the absorption of a sizeable increase in aid flows were to result in a significant appreciation of the real exchange rate that could prove damaging for export competitiveness. This is not an implausible scenario if a substantial share of the higher aid flows were directed to social sector programs with low import content. Preferably, this should not be viewed rigidly. If aid is used to enhance productivity in the economy and to remove key bottlenecks to an expansion in the capacity to produce nontradeable goods, such real exchange rate effects may not be encountered. Moreover, many would argue that a front-loaded investment program may give rise to short-term losses in competitiveness but allow for enhanced rates of growth over the long-term with a strengthening of the human capital base and availability of physical infrastructure. As discussed below, a strategy of maximizing aid absorption is likely, *ceteris paribus*, to require an appreciation of the nominal exchange rate.

However, the issue cannot be dismissed as unimportant from the perspective of LIC policymakers (as was substantiated in a recent IMF (2005b) policy paper). This may be particularly the case for countries operating with a hard currency peg (such as those participating in regional currency unions, such as in West and Central Africa). The key challenge for any LIC is to use aid as vigorously as possible to foster rapid growth and poverty reduction. The real exchange rate is an important parameter affecting the competitiveness of its producers in world markets and the attractiveness of a country for foreign investment. If a LIC perceives the potential scaling up of its expenditure program as creating too much pressure on the real exchange rate, this would equally argue, *ex ante*, for a less ambitious expenditure program. Equally, it might also argue for the accumulation of reserves if there were prospects that future absorption might prove more feasible.

- **The prospects for enhancing the capacity to manage a larger expenditure program:** although *ex ante*, the composition of the expenditure program either advocated within the PRSP or implicit in the priorities arising from donor assistance may suggest some limits on its size, governments may be able to change the composition of expenditures in ways that facilitate higher spending and absorption and limit the consequences of uncertainties. Ideally, sectoral spending agencies should be motivated to explore alternative options for effective and efficient spending programs that do not give rise to the above concerns. Greater flexibility may allow governments to be more ambitious in their spending programs.

An important implication of the above discussion is that the choice of appropriate fiscal policy cannot be made without consideration of the composition of a government's expenditure program. It will influence both the aggregate expenditure target that would appear desirable and it will influence considerations of the level of budgetary reserves that may be desirable (see section IIC for discussion of budgetary reserves). Key issues to be considered are the import intensity of new spending programs, the extent of the shift toward

spending programs with high O&M consequences or which are difficult to compress once started. This does not argue for or against any particular mix of government expenditures as LIC governments, working donors such as the World Bank, are in the best position to judge the appropriate composition for realizing a government's policy objectives. Rather, it argues that fiscal authorities must take account of how the composition of expenditure may affect both monetary and fiscal management in the short term as well as the potential vulnerability and sustainability of the fiscal position over the longer term.

Recognition that the composition of the budget matters implies that ministries of finance must coordinate closely with decision makers in those sectors expecting a substantial increase in ODA.

In part, this relates to understanding the potential macroeconomic and fiscal sustainability consequences of the way in which spending in such sectors take place, as well as to explore whether adaptations in the pattern of expenditure can lessen any potential conflicts with macroeconomic policy imperatives.

In part, it also involves achieving greater clarity as to the risks involved in a sector's expansion and an understanding of how these risks, e.g., such as a future shortfall in funding, would be handled. A difficult remaining question is how much of the burden of adjustment of sectoral risks would need to be borne at the sectoral level as opposed to adjustments in other areas of the budget or in the aggregate fiscal stance (see section III on fiscal risk management).

Finally, the IMF should, as far as possible, base its fiscal programming on a MTFF. A disconnect between yearly fiscal programs carried out under IMF-supported programs and the MTFF should be avoided. Both exercises should be guided by the same "optimistic, but plausible" principle. As the progress of LICs towards the MDGs continues to be hampered by fragmentation of all sorts—competing medium-term scenarios, parallel budgets, extra budgetary spending, a dichotomy between budget planning and execution and a lack of alignment between current and investment spending—the focus of fiscal programming and management should be on integration and alignment, both by the authorities and the IMF.

C. Fiscal, Monetary and Exchange Rate Policy Coordination

Aid inflows, while potentially beneficial for reaching the MDGs, do constitute a major source of liquidity pressure in LICs. The amount of such pressure depends on the fiscal stance adopted by the government, which can be gauged by focusing on the budget deficit excluding grants and import-related spending. When donor funding is used to finance government imports, it has no direct impact on liquidity. However, when the spending is on domestic goods and services (e.g., local wages and salaries), donor-related spending creates domestic liquidity that can potentially be inflationary (depending on the impact on the demand for money as well as its supply). By contrast, domestic spending financed by domestic revenue is not so potentially inflationary, as the liquidity impact of such spending is offset by the contraction in base money resulting from the drawdown of residents' currency holdings or bank deposits to pay taxes.

Although foreign aid increases domestic resources in the economy, the macroeconomic impact of such aid depends on the fiscal, monetary, and exchange rate policy response.

A key policy challenge is to determine how much to absorb in order to maintain macroeconomic stability. From the fiscal perspective, the issue is how much to spend out of the additional aid. From the central bank perspective, the issue is to what extent to absorb the additional aid by allowing the external non-aid current account deficit to widen, through exchange rate and monetary policies (see IMF (2005b)).

Thus, central to managing a scaling-up in aid inflows is coordination of fiscal policy with exchange rate and monetary policies. Fiscal and monetary policy objectives do not always coincide and the policy mix may not be consistent with overall macroeconomic stability without close coordination. Such coordination helps to: (i) ensure consistency between a government's efforts to spend additional aid resources and the central bank's macroeconomic stability objectives, which require absorbing these resources via exchange rate and monetary policies; and (ii) manage liquidity needs in the case of unexpected shortfalls in aid flows.

Several factors will determine the pressures that fiscal policy may create for monetary policy in managing the absorption of aid inflows. First, if risk management considerations suggest the importance of an active policy of reserve management to lessen the potential impact of aid volatility on the smoothness of the expenditure program, this implies that **the fiscal deficit inclusive of grants may need to vary to some extent in reaction to the volatility of aid flows. This would need to be accepted by the IMF in its fiscal policy advice.** With an aid scaling-up scenario, this would probably mean that some reserve buildup or reduction in government debt (as aid substitutes for domestic financing of the government deficit) would need to be accommodated by monetary policy.

Second, how additional aid resources are used will be important. As noted, if the aid scale up leads to a sustained increase in government imports or increased private sector demand for imports, no problems are created in terms of increased liquidity into the economy. If the scaling up of aid and the increased level of activity in the economy leads to a structural increase in the demand for money, a higher level of liquidity in the economy will not create inflationary concerns. Similarly, inflationary pressures will be limited if aid is used in such a way as to remove bottlenecks to increased productivity, particularly in the nontraded goods sector. The implication is that the tension that may emerge between the increase in aid-fueled liquidity in the economy and macroeconomic stability can be lessened by the chosen composition of government expenditure, *independent* of the fiscal policy stance.

For a given fiscal policy stance and expenditure composition, how much aid is absorbed will primarily be determined by the policies pursued by the central bank. Once the fiscal framework defines the pace of expenditure acceleration in line with a sustainable MTFE consistent with the "optimistic but plausible" external financing profile, the central bank has to decide on how to manage the liquidity impact of increases in aid-induced spending in a way consistent with macroeconomic stability and sustainable real growth. More specifically,

it needs to define how much to absorb and through which instruments. **In the case of temporary adverse supply shocks or a delay in aid disbursements, within limits the budget deficit, excluding aid, would ideally not need to be modified, as coordination with the monetary authority would aim to accommodate a smooth predictable expenditure path as laid out in the budget.**¹⁰

If a central bank is faced with a substantial increase in liquidity arising from increased aid being used domestically for nontraded goods, in principle, there are two basic ways it can sterilize the liquidity impact:

- **Selling government securities.** When the central bank sells government securities (treasury bills and bonds) to investors, commercial banks draw down their deposits (reserves) with the central bank to pay for the assets, thereby reducing base money.¹¹ Liquidity management is achieved by varying the size of government bill/bond auctions to mop up the desired excess liquidity at any given time. Since such policy is normally achieved by raising interest rates, it discourages private sector borrowing and spending, and reduces inflationary pressures. However, under this approach, the public sector gains resources at the expense of the private sector. In addition, increasing the outstanding stock of domestic debt and potentially higher domestic interest rates may increase the burden on the budget.
- **Foreign currency sales by the central bank in the interbank market is the other obvious mechanism by which it can sterilize unwarranted liquidity expansion.** When commercial banks buy foreign exchange, they draw on their reserves with the central bank, again reducing base money. However, in order to sell large amounts of foreign currency, the central bank may need to accept a more appreciated exchange rate, either under a flexible exchange rate regime or by allowing an adjustment of the exchange rate peg. Such approach to liquidity management and inflation control effectively works by shifting national spending to imported goods and services, thereby reducing excess demand in the domestic market. Sales of foreign exchange allow donor inflows to expand national spending, as the increased spending in foreign markets is reflected in a larger external current account deficit, the counterpart to the real resource transfer from the donor countries.¹² Also worth noting, an active policy of reserve management would imply that volatility in aid flows should not be itself a source of volatility in the nominal exchange rate.

¹⁰ This would require the government either drawing down its deposits or borrowing (for LICs, most likely domestically).

¹¹ Treasury bill repurchase and swap arrangements with commercial banks also provide a sterilization option that is equivalent in its effect to Treasury bill sales.

¹² The authorities can also resort to “direct instruments” such as increasing reserve requirements or, as a one-off measure, transferring public sector deposits from commercial banks to the central bank but these may be distortionary and cannot be used on a continuous basis.

There remains the question of what would be the “optimal” sterilization mix. The balance between domestic debt and foreign currency sales should vary with market conditions and needs. Increased foreign currency sales would contribute to a more appreciated exchange rate, while reduced Treasury bill and bond sales would be associated with lower interest rates and a greater emphasis by banks on private sector credit. The easing of interest rates and credit should stimulate demand, including business investment, raising long term growth prospects. At the same time, a more appreciated exchange rate would divert some of the additional domestic spending to non-inflationary imports. The increase in spending, associated with a wider current account deficit, would facilitate the absorption of the scaled up aid. In practice, in the recent past country authorities have been reluctant to allow the exchange rate to appreciate, preferring the burden of adjustment to fall on fiscal spending or the private sector through higher interest rates (i.e., limiting the effective absorption of aid flows). With a significant scaling up of aid, exchange rate appreciation would become considerably more difficult to avoid. **In effect, short of approaches to increase aid-financed imports or enhance productivity, LICs must accept that the absorption of significant scaled up aid will imply the possibility of pressure on the real exchange rate which, in a context of maintaining low inflation, would need to happen through a nominal exchange rate appreciation.**

One implication of this discussion is the importance of ensuring consistency between the monetary, fiscal policy, and exchange rate objectives pursued respectively by the central bank and the ministry of finance. As was documented in IMF (2005b), a central bank seeking to limit inflation and the nominal appreciation of the exchange rate may limit the extent of absorption of additional aid which the government may be actively seeking to achieve. **The risks that often stem from a lack of coordination between fiscal and monetary policy need to be actively addressed in order to facilitate an increase in poverty-reducing expenditure as aid is scaled-up.**

In a number of LICs, the burden of adjustment to an increase in domestically spent aid flows or aid volatility has fallen disproportionately on the fiscal agent, as central banks have been reluctant to reduce foreign exchange reserves and/or allow the exchange rate to appreciate (in one case a country deliberately ran significant intra-year arrears to 'protect' the monetary authority even though it had significantly exceeded its foreign reserve targets).¹³ Given the volatility and unpredictable nature of aid, the central bank's natural conservatism is understandable, e.g., Celesun and Walliser (2005) cite a number of countries in which 80-90 percent of annual budget support was disbursed in the last quarter of the year, which means that either domestic financing temporarily fills the gap (and is accommodated by the central

¹³ Celesun and Walliser (2005) cite a number of countries in which 80-90 percent of annual budget support was disbursed in the last quarter of the year, which can severely distort the expenditure profile. In such cases the central bank may need reassurances that the financing will be forthcoming before endorsing the expenditure that may lead to a 'temporary' drawdown of foreign reserves.

bank) or expenditures must adjust. In such cases, the central bank may need reassurance that the financing will be forthcoming before endorsing the expenditure that may lead to a ‘temporary’ drawdown of foreign reserves.

The challenge of coordination and macroeconomic policy management with an aid scale up is highlighted further in the context of a regional currency union for a group of LICs. Given the role of the union’s central bank and the exchange rate peg, the individual member countries cannot pursue an independent monetary policy. The central bank is charged with the responsibility of sterilizing or dampening inflationary pressures that may arise in the individual countries of the union. The currency union thus faces the following dilemma (as illustrated for the case of WAEMU in West Africa—see Box 1). Fiscal rules are devised to limit the extent to which governments can, through fiscal policy, create monetary pressures by running deficits; effectively they restrict the ability of governments to spend additional aid flows. Yet the promise of additional aid flows from recent global aid initiatives would create considerable pressure for the individual countries to relax these rules, allowing spending financed by the additional aid to take place. But such spending, particularly if focused on nontradeables, may create inflationary pressures that would be hard to square with the maintenance of a hard currency peg.

The issue is further complicated by the fact that countries may differ in their attractiveness to donors in terms of higher aid flows. Efforts by the regional central bank to sterilize additional liquidity emanating from one country imposes sterilization costs that would have to be borne by the group of countries as a whole, potentially imposing negative externalities on those countries that are not aid recipients.

Thus, as with any other country dedicated to maintain a hard exchange rate peg, the approach advocated above in Section B in terms of receptiveness to the use of aid resources may conflict with the objectives of macroeconomic stability. The problem in the regional currency union case is that the individual country does not have the option to change the peg and allow a nominal appreciation in the event that aid flows are substantial. At best, its only option is the one noted above in general in relation to the “Dutch Disease issue,” viz., to seek to influence the composition of spending, both as between tradables and nontradeables and in terms of investments that can be shown to substantially increase productivity and remove bottlenecks in the economy.

Box 1. Reconciling a Rules-based Fiscal Framework in a Currency Union with Scaled Up Aid: The West African Economic and Monetary Union (WAEMU) case

Scaled-up aid resources may have important implications for the design of fiscal rules for countries participating in a regional currency union that are the expected recipients of such inflows. In particular, fiscal rules that are geared towards fiscal consolidation through the control of fiscal balances might *counteract* projected expenditure acceleration financed by aid resources and debt relief. Existing fiscal rules, including convergence criteria on fiscal balances in currency union member states, might thus need to be adapted to reflect this new aid environment.

One prominent example of such rules is the WAEMU Regional Pact of Convergence, Stability, Growth, and Solidarity. Adopted in 1999, it strives to promote the convergence of WAEMU member countries' economies, and specifies a set of primary and secondary convergence criteria that countries should comply with. The key criterion among the four primary criteria is that the basic fiscal balance must be in balance or surplus. The secondary criteria comprise, *inter alia*, criteria on capping the ratio of the wage bill to tax revenue to 35 percent, and that the ratio of domestically financed public investment to tax revenue to 20 percent.¹⁴

These criteria, in particular the one on the basic fiscal balance, might not be adequate any longer in a scaled-up aid environment. This fiscal balance is calculated as revenue, excluding grants, minus expenditure excluding foreign-financed investment. As the WAEMU (2006) commission has also noted, this poses the problem that aid and debt-relief-financed expenditure would be reflected on the expenditure side, but the corresponding resources would remain excluded from the revenue side, and thus worsen the basic fiscal balance. Controlling the wage bill in relation to tax revenue might also prove difficult, as much of the aid-financed spending is likely to be channeled into hiring more personnel in the social sectors. Finally, if a large part of public investment is financed externally, bringing the ratio of domestically financed investment to tax revenue to over 20 percent will most likely also prove difficult.

Recognizing these shortcomings, the WAEMU is considering and has proposed several alternative indicators. It examined the existing criteria and proposed to add supplementary fiscal criteria to adjust for expenditure financed by increased aid inflows and debt relief. One suggested approach would be to include all aid and HIPC debt relief on the revenue side when calculating the basic balance. Alternatively, the balance could be calculated by taking only domestic revenue into consideration, and subtracting current expenditure from it in order to have an indicator of government saving.

III. Enhancing the Management of Fiscal Risk

Aid volatility and a lack of short- and long-term predictability add to the inherent uncertainties facing developing countries.¹⁵ **Volatility** leads to instability, uncertainty and risk. At the macroeconomic level, volatility has a direct negative impact on long-term growth (Fatas and Mihov, 2003, Celasun and Walliser, 2005). **Short-term unpredictability** of aid in terms of the magnitude and timing of disbursements within the budget year can complicate macroeconomic management through a variety of channels—large injections of liquidity into

¹⁴ Compliance with these criteria proved difficult. According to the pact, all member countries were supposed to be in full compliance with all criteria by end-2005, but none was. Preliminary data show that seven out of eight member countries violated the basic balance criterion.

¹⁵ See Bulir and Hamann (2006)

a thinly monetized economy may complicate systemic liquidity management and/or negatively impact the terms of trade. At a more micro level, the need to impose ad hoc limitations on expenditure can be extremely disruptive, tending to favor current expenditures over capital as well as politically powerful ministries over those with less ‘voice’ in government. Moreover, the domestic sterilization of the government’s exposure to volatility is often shifted to the private sector, with adverse effects on investment behavior.

An important challenge from a scaling up of aid is that it poses the risk that the absolute magnitude of the volatile element of aid flows will be larger. Specifically, if in the past, the standard deviation of aid flows were, hypothetically, 15 percent, a shift in the share of aid flows from 10 percent of GDP to 20 percent, would imply that the potential standard deviation could rise to 3 percent of GDP.

Long-term unpredictability—reflecting uncertainty as to whether a recipient country can count on a *durable* scaling up of aid—creates a different kind of risk. Building up programs creates expectations not to mention contractual or moral commitments. If the amount of additional aid to finance social expenditure programs is expected to be substantial, governments will need to design an appropriate strategy for scaling up, including the appropriate sequencing of training and hiring. If there is uncertainty as to whether the higher aid flows will eventuate, ministries of finance may rightfully be cautious on both the amount of training that can be invested in, or on the desirability of hiring additional personnel on a permanent basis. In the narrow case of expanding HIV/AIDS treatment programs, the risk of having to discontinue treatment not only would have adverse effects for the population concerned, but would also pose larger risks.

Macroeconomic stability and expenditure smoothing both need to be identified as policy objectives. Due to the precarious nature and weak institutions of many LICs, the maintenance of macroeconomic stability has often taken precedence over expenditure smoothing. However, as many more LICs become mature stabilizers, as fiscal institutions improve, and the focus on sustained poverty reduction increases, the quality of expenditure programs over the medium- to long-term becomes critically important. This has increasingly been recognized in programs with the IMF where adjustments are often made to protect poverty spending in the face of external shocks and aid volatility (see below).

Fiscal risks can be managed through a combination of enhanced risk assessment, self-protection, self-insurance, and risk pooling. Enhanced **risk assessment** relates to the way fiscal risks are considered, managed, and acted upon in the implementation of aggregate fiscal policy and sectoral program design. As discussed above, IMF-style debt sustainability assessments are one such approach, but can be strengthened by aid-specific scenario analysis, stress testing, and a greater focus on liquidity and other balance sheet concerns. **Self-protection mechanisms** seek either to prevent the volatility from occurring or to limit the extent of exposure to significant volatility or unpredictability. In a longer term context, increasing the share in GDP of government revenues constitutes another form of self-protection. **Self-insurance and risk pooling** seek to transfer income built up during good times to deal with potential negative shocks in the future, but do not try to reduce the

likelihood of such a shock. However, it must also be recognized that while temporary changes can be at least partly smoothed, permanent changes in income will eventually need to be offset, to some degree, by an adjustment of expenditure. The technical and political challenge is to distinguish between such shocks.

A. Strengthening the assessment of fiscal risks: enhancing the debt sustainability framework (DSF)

Debt sustainability assessments have become increasingly recognized by the World Bank and IMF as an important vehicle for judging potential solvency risks associated with external borrowing, both by emerging market countries and by LICs. As discussed earlier, with the adoption of the MDRI by the multilateral development banks and the IMF, the formal external debt threshold embodied in the DSF should indicate that a significant easing of the external borrowing constraint is possible. However, this may be misleading and the DSF may need to be modified to provide a more useful first-order tool for countries in characterizing their fiscal policy options and risks, and in determining the appropriate anchor for fiscal policy in the context of a scaled-up aid environment.

The challenge is to use these templates as simulation tools of alternative fiscal rules rather than as projection instruments with constant policy. A four-pronged strategy could be envisaged that would augment the current DSF.¹⁶ It would include:

- **a more extensive use of scenario analyses:** This would help assess the consequences of a range of plausible assumptions on debt sustainability over the typical time frame of 20 years. Scenarios would need to be plausibly related to borrowing scenarios, interest rate levels (embodying concessionality) and potential growth paths; the latter would be related to the broad composition of expenditure (as between infrastructure investments and current expenditure) and the level of private investment. One might also wish to embed scenarios that include a significant increase in grant-financed expenditure programs, taking account of their recurrent expenditure implications;
- **expanded stress-testing:** By attaching some judgmental probability estimates on the likelihood of different assumptions, one can obtain a better perspective on the risks associated with alternative borrowing strategies;
- **Supplementing the analysis derived from the LIC-DSA framework with the simulations derived from the conventional template used for countries with market access:** The latter template has the advantage of including domestic debt, and it is also more straightforward to interpret with a view to linking a certain path of primary balances to debt; and finally,

¹⁶ The IMF is currently considering whether debt thresholds can be calibrated to country circumstances (e.g., perhaps by ranking countries according to their World Bank CPIA rating) to reflect the different levels of debt intolerance (see IMF (2006)).

- **A separate, detailed assessment over a more immediate time frame—say, 5 years—of the plausibility of maintaining a targeted expenditure profile, taking account of potential shocks to the fiscal accounts and liquidity constraints.**

In the context of a fiscal environment characterized by the combination of a drop in debt ratios (due to the MDRI) and the possibilities for expanded fiscal programs if there were to be a scaling up of aid, the challenge is to strike a balance between providing clear incentives to avoid undesirable policy bias (e.g., a suboptimal revenue mobilization effort, free riding on grants, etc.), and accommodating the multiple sources of uncertainty outlined above. The four-pronged strategy outlined above is particularly relevant in such circumstances.

In terms of the scope for LICs to engage in a substantial increase in new borrowing (possibly on nonconcessional terms), **scenario analyses can help pin down a desirable range for such borrowing over a given medium-term horizon.** In cooperation with the authorities, IMF and World Bank staff could design scenarios that explicitly factor in different assumptions (ambitious, realistic and pessimistic) on a number of key dimensions, including revenue mobilization efforts, the impact of expanded aid-financed programs in scaling up the level of expenditure programs which are of a nondiscretionary nature, feasible increases in real expenditure, and even a progressive scaling down of aid (in the perspective of an exit strategy). The risk of debt distress associated with these various scenarios could be assessed by comparing debt outcomes with the existing DSF thresholds.

Expanded stress tests, taking account of the principal sources of uncertainty specific to the aid scaling-up context, could be envisaged. Available data should allow a calibration of reasonable stress tests representing shocks on aid flows. The gains from smoothing strategies built into the fiscal targets, including the build-up of assets during positive shocks, could easily be assessed by comparing outcomes under alternative fiscal rules.

The risk of “free riding” and the possible rise in domestic debt should encourage broader debt sustainability analyses (e.g., including domestic debt), and should include simulations on alternative assumptions. The standard DSA might well give interesting payoffs: (i) it would provide a more standardized picture of the debt situation (even though the LIC framework with its focus on NPV remains clearly the most appropriate and therefore the key tool); and (ii) its greater simplicity allows for a more transparent assessment of risks.

Finally, a more detailed assessment of short- to medium-term vulnerabilities would help to gauge the impact of aid-related fiscal shocks and the design of risk management strategies. The DSF framework focuses on a country’s long-term solvency, but in cases where debt relief has reduced debt stock levels below the commonly used thresholds and/or considerable grant assistance is being provided, the more pressing constraints could be managing cash flows to ensure that expenditure plans are implemented smoothly (i.e., a liquidity constraint) and alleviating absorptive constraints. Where access to financial markets (international and domestic) is typically limited, even a temporary shortfall in aid is likely to

disrupt budget execution, particularly for investment spending where cuts may be permanently lost.¹⁷

The DSF could be augmented to highlight country specific indicators of short- and medium-term aid-related vulnerability. With the relaxation of the external debt constraint, it will become increasingly important to monitor a country's ability to implement its expenditure plans without resorting to disruptive stop-go spending, arrears or default. Given the more immediate nature of liquidity concerns, country-specific risk indicators would best be formulated in the context of medium-term fiscal projections, taking into account the potential intra- and inter-year volatility and unpredictability (see Table 1 for a sample of indicators and section IV-B on medium-term frameworks). A rolling medium-term fiscal program could be based on the anticipated availability of external resources flows (adjusting for the historic variance between commitments and disbursements), and adjusted to incorporate absorptive capacity developments and the authorities appetite for risk, as quantified by the indicators. This framework would provide a country-specific, rules-based framework that suggests, but does not prescribe, a gradual increase in expenditure based on a scaling up.¹⁸

Further developments in the DSA apparatus should be an analytic objective to pursue in the coming year. In particular, model-based, stochastic simulation tools calibrated on country-specific features could provide a more complete and more explicit assessment of risks to debt sustainability. Using existing DSF thresholds, these methods could derive explicit probabilities of debt distress. Conversely, setting acceptable levels of the risk for debt distress would pin down borrowing paths consistent with this acceptable risk level.

B. Self-protection and fiscal credibility

Self protection seeks to reduce the volatility and unpredictable nature of aid flows and can take a number of forms. One obvious choice is to be conservative with respect to how much additional aid to accept, reflecting that volatility may arise from factors exogenous to a recipient country's own behavior (other fiscal or balance of payments pressures on donors; other demands for aid that are seen as politically more acute, etc).¹⁹ Other options are to:

- pursue policies that enhance the likelihood of a smooth flow of donor assistance;

¹⁷ See Celasun and Walliser, 2005. They note that even when aid arrives it is often lumpy, with Burkina Faso receiving 80-90 percent of its annual budget aid during the last quarter of the year, and that temporary shortfalls tend to fall on investments, which are not subsequently recovered.

¹⁸ A gradual scaling up of expenditures would be consistent with the development of a risk-management framework that included measures to mitigate some of the risks identified. It would also be consistent with the assumption of decreasing returns to new aid investments (see Clemens and Radelet, 2003), although infrastructure investments in particular may be lumpy.

¹⁹ A country may also recognize that its own actions, though appropriate in terms of its own political or economic considerations, may give rise to adverse donor reactions.

- incorporate greater flexibility in the design of aid-financed expenditure programs so as to minimize the adjustment cost that would arise if some scaling back is required;
- strengthen the adaptability of financial markets to respond to government policies and manage short-run financing demands;
- use aid inflows in a way to increase the resilience of the economy in the event of future aid shortfalls; and
- increase the domestic revenue share as a means of enhancing a country's capacity to reduce its vulnerability to aid shortfalls, while creating a basis for reduced aid dependency (discussed in section IIIC).

Table 1. Sample liquidity indicators for scaled-up aid

Indicator	Comments
The primary fiscal deficit excluding grants/GDP	A useful indicator for measuring the direction of fiscal policy and the exposure of the fiscal balance to aid shocks. Contrasting the magnitude of the deficit against the historical volatility of anticipated aid-flows could provide a measure of the expected loss from an aid shock that would then need to be financed through a combination of fiscal consolidation, debt accumulation (domestic or foreign) and a possible drawdown of reserves. ²⁰ The focus on the non-grant fiscal balance also supports the objective of eventually reducing the reliance on aid flows.
Domestic revenue/current expenditures	Indicates the extent to which domestic resources cover the least compressible forms of expenditure, although cutting capital spending could reduce long-term growth (and may breach some contractual obligations). This indicator provides a crude measure of a country's ability to maintain its basic operations in the face of a rapid decline in external resources. Some natural resource producers have introduced fiscal rules that require current expenditure to be covered by domestic revenue while resource revenue funds investments (e.g. Botswana).
Reserves/short-term debt	Indicator of reserve adequacy in countries with significant but variable access to capital markets. This indicator could also be sub-divided to consider domestic and foreign debt dynamics.
Short-term debt/GDP or as a ratio of total debt	Indicator of the rollover and interest rate risk. In many LICs with thin financial markets there is limited scope for drawing on bank finance without undermining macroeconomic stability. Uneven or unpredictable recourse to domestic financing may sharply increase debt service costs.

A track record of transparent and prudent fiscal policies may be the best form of self-protection. In response to periods of severe disequilibria, many LICs have resorted to

²⁰ The risk of a prolonged under-performance in scaled-up aid strengthens the case for developing such a MTFP, including an approach to risk management and for building a prudential reserve cushion and contingency measures that could be activated in specific circumstances.

institutional mechanisms such as rule-based cash budgets, which have proven successful in reducing inflation and restoring a measure of fiscal discipline. However, these mechanisms have a cost. Strict adherence to cash-budgeting places the burden of adjustment for revenue shortfalls, including aid, on expenditure programs; where money-demand is growing strongly, it can also be unnecessarily deflationary.²¹ The difficult choice for many LICs and donors is how to manage the transition to more flexible fiscal management whilst retaining the benefits of enhanced fiscal discipline.

Improved budget systems will support better fiscal policies. Enhanced fiscal credibility will be derived from both conducive fiscal policies and better fiscal management. Many LICs need to strengthen PFM systems, i.e., to enhance budget formulation, execution, transparency and fiduciary standards.²² A well articulated MTFE can improve the link between the ‘*need for*’ and the ‘*availability of*’ resources by creating a shared strategy with donors and the integration of programs that are driven by policy priorities and disciplined by budget realities. This framework should be used to set out common objectives, which can be agreed with donors, identify the main fiscal risks, develop possible mitigating strategies, and target external assistance to areas where implementation capacity is sufficient to absorb productively more aid.

Greater flexibility can also be sought through the design and implementation of aid-financed expenditure programmes. Expenditure smoothing can limit disruptions in the programmed expansion of government services. But governments need to weigh this objective relative to the concern for macroeconomic stability (which would be jeopardized if a programmed expansion could not be financed due to cutbacks in aid flows). An obvious approach is to rely more on the use of contractual staff in expanding social sector programs. Contracts of medium-term duration (3-5 years) give flexibility in the event of aid discontinuity. Such contracts can be specified to include most of the benefits normally associated with government civil service employment. Such an approach effectively adopts the type of contractual arrangement already common for some capital expenditures, e.g., where workers are hired on a contractual basis.

The development of a more liquid financial market can enable more ready and less destabilizing, access to domestic financing. Government cash flows generally have a significant impact on banking sector liquidity and, if fiscal management is stable and credible, these flows often serve as a catalyst for the development of deep and liquid money and bond markets. The resulting liquidity premium not only brings down the cost of funds to all borrowers, but also helps to buffer the effects of domestic and international shocks on the economy by providing borrowers with readily accessible domestic financing. This can reduce

²¹ Adam and Bevan, 2000

²² IMF (2005a)

a government's exposure to interest rate, currency and other financial risks. For many LICs this would be a long-term objective, but one that should be more explicit in PRSPs.

How aid is used can also be a form of self-protection. Easing supply bottlenecks can help mitigate the adverse effects of aid volatility while improving domestic absorptive capacity. A substantial boost to aid-financed investment in infrastructure can contribute to increased sustainability of long-term development efforts. Careful investments to bring down production costs and improve productivity may offset the impact of a nominal exchange rate appreciation on competitiveness. As noted, increasing the noncompetitive import content of aid can further reduce pressures for a real exchange rate appreciation.²³

Finally, and more controversially, the approach of ring-fencing priority expenditures—observed in several African countries--**can be seen as a form of self-protection** with respect to priority expenditure areas. The objective has been to ensure that specified programs—e.g., for poverty reduction; for HIV/AIDS treatment, etc. are protected against budgetary cuts in the event of revenue volatility, with the impact effectively borne by non-priority sectors. In Uganda (see Box 2), the Poverty Action Fund constituted a virtual fund used to channel identified resources into priority poverty-reducing programs. The approach was seen to facilitate additionality in spending as well as provide greater transparency and accountability. It also has allowed the government to signal to donors its highest priorities. There are some downside aspects to ringfencing. It may create perverse incentives for donors, deterring them from more general budget support since it may imply spending on nonpriority areas. It can be subject to abuse, as budget reclassification can lead to inclusion of low priority items within the “ring.” Finally, it can create rigidities in budgetary practices; a form of earmarking, multiple ring-fenced budgetary categories can easily develop and concentrate any volatility within the non-protected section of the budget.

C. Self-Insurance

Fiscal reserves can cushion ongoing expenditure programs against the volatility of aid flows. They can also provide a *temporary* cushion if aid disbursements do not meet long-term expectations. In a similar way that central banks hold reserves to manage foreign exchange volatility, the fiscal agent can hold additional reserves, either in foreign or domestic currency, to help smooth expenditures to offset aid shortfalls. Given the lack of financial depth in most LICs, large movements in domestic financing could be destabilizing, so foreign exchange reserves may be preferable.

²³ However, if the increase in imports simply substitutes for goods that are otherwise produced locally, it would still cause a rise in the relative price of nontradables, and thus put pressure on the real exchange rate.

Box 2. Ring fencing of priority expenditures: Uganda's Poverty Action Fund

Uganda's Poverty Action Fund is a virtual fund created in 1998, to channel identified resources into priority poverty-reducing programs. Its objective was to establish a transparent mechanism to ensure that specific resources from debt relief "earmarked" donor funds and government revenues were allocated to key programs within the Poverty Eradication Action Plan (PEAP), originally formulated in 1997. These allocations are thus protected from budget cuts, i.e., if budgetary resources fall short of targets, Poverty Action Fund spending is "ring-fenced" and executed on a priority basis. The fund is virtual because it only amounts to a set of budgetary codes for identified programs, without any corresponding institutional mechanism. The Poverty Action Fund has three essential elements to achieve its objective. It includes only public expenditures considered of the highest priority from a poverty-eradication perspective. The criteria used for accessing the Poverty Action Funds are based on whether the planned activities/programs are mentioned in the PEAP; directly reduce poverty; offer services to the poor; have high economic and/or social returns and are well developed; and have a budget for a specific financial year. **The Poverty Action Fund mechanism allows for a more transparent understanding of the additionality of donor resources**, by comparing current financing with the financing level of the same activities in the 1997/98 budget. When created, donors wished to ensure that the resources they committed to particular sectors led to increases in the total resources devoted to these sectors. Hence the presentation of spending plans in the Poverty Action Fund clearly shows that government and donor funds committed to the Fund are additional to the government's resources.

- **Special measures have been taken to strengthen the transparency and accountability of the high-priority expenditures managed under the Poverty Action Fund.** Funds are released either as conditional grants to the Districts or through the development budget. Five percent of its resources are set aside for enhancing existing monitoring, accounting, and auditing procedures. Data and reports on the use of the Fund's resources are published regularly and discussed at quarterly meetings, chaired by the Government, and at which donor agencies and NGOs attend. The media participate in order to enhance accountability through sharing information with the public.

The Poverty Action Fund has proved to be a transparent and successful mechanism. Donors have increasingly relied on it in their provision of aid, and spending through the Fund increased from about 6 percent of total spending in FY 2000/01 to 24 percent in FY 2005/06. Areas covered by spending through the Poverty Action Fund include: primary education, primary health care (including control of HIV/AIDS), agricultural extension, feeder roads, water and sanitation, and law and order.

Establishing the target level of such reserves, and identifying conditions under which these may be accessed, will be country specific. Calibration may initially be based on the historic level of volatility of aid and other shocks, but with the prospect of a significant scale up of aid, the target for the level of reserves would also need to take account of the potential risks and consequences of a disruption to the smooth financing of government programs at a scaled up level (see section IIIA). In the short-term at least, reserves can be seen as a cushioning device, preventing cutbacks in funding. Over the longer term, and given the large opportunity cost of reserve accumulation, such a policy cannot guarantee the sustainability of an expanded program if, in the worst-case scenario there were sharp drops in aid flows.

Some LICs have pursued such a policy on a *de facto* basis by saving incremental aid, although this could also be more a consequence of additional aid confronting absorptive

capacity constraints than a policy choice.²⁴ However, just as many oil producers have argued that it is difficult to save oil windfalls in the face of pressing social and infrastructure needs, many LICs may find it difficult to abstain from an expansion in expenditure programs unless these reserves are provided externally and are additional to the level of aid that could be justifiably spent to meet the MDGs.²⁵ Donor buy-in to an increase in reserves would also be important, since this would effectively mean the banking of some amount of donor assistance as a cushion against volatility.

What is an appropriate magnitude of reserves? Studies have suggested that the volatility of aid can be very large, with coefficients of variation usually in the range of 40-60 percent of the mean aid flow, exceeding that of fiscal revenue (Bulir and Hamann, 2003 and 2005). This imposes high costs on vulnerable, aid-dependent economies and increases the danger of slipping into a low-level equilibrium where countries budgeting prudently within a sound MTFE, will discount pledges of assistance; and donors will see lower funding gaps, which will, in turn, cause pledges and commitments to fall. Eifert and Gelb (2005) offer a mechanism for managing exogenous volatility of aid flows (i.e., volatility not linked to performance) of aid flows. To determine the size of the equilibrium buffer stock, they propose a scheme based on a reserve tranche of 50-100 percent of annual aid-financed spending (equivalent to 2-4 months of import cover in a typical aid-dependant LIC with an annual import-to-GDP ratio of 40 percent). This would be effective in smoothing expenditure in most periods under a range of levels of aid instability (based on Bulir and Hamann, 2003).

Eifert and Gelb note that most LICs have foreign exchange reserves equivalent to about 5 months of imports, which they deem adequate for the observed aid flows and volatility. Such a mechanism works best when fluctuations are serially independent or tend to offset each other in subsequent years. The buffer stock would be most vulnerable when disbursement shocks are auto-correlated since countries would experience a series of negative shocks. In case of large negative shocks to aid flows, such a reserve buffer would be depleted in several years, during which time countries and donors would have to organize an emergency response.

The question that arises is how such a scheme would need to be modified to deal with a scaling up of aid—say, a doubling of aid from 10 percent of GDP to 20 percent of GDP? If the above relationships hold and the degree of volatility remains as before, the reserve buffer would have to increase to some 6 months of import cover. This would imply a need for a reserve buildup from current levels. Clearly, if the degree of aid volatility rises with the scaling up, a larger reserve buffer would be needed.²⁶ *A fortiori*, with a change in the

²⁴ Ghana and Ethiopia were cited as witnessing periods where incremental aid was saved, although some of this may have had to do with weaknesses in the budgetary process (see IMF (2005b)).

²⁵ For a discussion of oil producers see, Katz, Bartsch, Malothra and Cuc, 2004

²⁶ One must also recognize that political economy incentives may lead a country—perhaps even rationally—from pursuing this type of approach of a smooth expenditure stream, buttressed by a reserve management

(continued)

composition of aid towards programs which are less easily adjusted, an even higher level of reserves would be required.

However, since governments are typically not allowed to borrow from the central bank, a build-up of official foreign exchange reserves would have to be accompanied by a build-up of government deposits (preferably in foreign exchange and of a roughly comparable magnitude) to make such a scheme operational. In the event of a temporary shortfall in foreign aid, some of the accumulated foreign exchange deposits could be sold in the domestic market in order to smooth expenditure. Alternatively, in LICs with relatively developed domestic debt markets, governments could choose to use the proceeds of such a buffer to reduce their domestic debt, which would help lower domestic interest rates. Again, in the event of a temporary shortfall in aid disbursements, the government would be able to borrow in the domestic market.

D. A more durable form of self-protection: enhancing domestic revenue mobilization

The availability—if not the mere prospect—of increased aid may weaken a government’s need and willingness to rely on domestic revenue mobilization to fund spending. A number of studies have found evidence that increased aid can reduce revenue efforts.²⁷ These effects mainly result from a lack of incentives by politicians to enforce tax compliance when “free” funds are available and, more generally, the possible dampening impact of exogenous aid flows on a government’s domestic accountability and governance.

Particularly for LICs with revenue shares significantly below the average for peer countries, an important element of the fiscal policy response to a scaling up of aid should be a targeting of the domestic revenue mobilization effort to achieve revenue ratios in the 15-20 percent of GDP range. The reasons are several:

First, an adequate revenue base is essential for both short-term implementation and long-term planning of spending programs. In the short term, relying on a sufficiently large revenue base can help to insulate the budget against interruptions in donor support. Over the long term, a buoyant domestic revenue stream allows countries to gradually replace external

policy. In a context where ‘absorb and spend’ is the leitmotiv, and where information on true absorptive capacities and policy preferences is asymmetric, countries may be tempted to *signal* to donors their ability to absorb additional aid by spending windfalls, while covering shortfalls with domestic borrowing. Domestic debt would then ratchet up as aid fluctuates, ultimately threatening the credibility of the fiscal anchor. The likelihood of such strategies being used for signaling purposes—and the corresponding need for well-designed fiscal targets—increases with the perceived risk that donors may reduce aid if it is not spent, and that grants would automatically increase if debt grows out of control; and it decreases with the country’s true absorptive capacity. Some indeed have argued that such an approach would be rational with respect to accumulating additional debt; past experience suggests the possibility of debt forgiveness again being provided.

²⁷ For references, see Gupta et al (2003).

financing, thereby maintaining spending levels commensurate with policy priorities when aid is phased out.²⁸

In addition to lowering aid dependency over time, strengthening the domestic revenue effort allows for a further increase in fiscal space for priority spending. The World Bank (2006) observes that the large majority of LICs have made little progress in increasing their revenue ratios in GDP. Over time spending programs of a recurrent nature should be financed from domestic sources.

Increasing domestic revenue enhances a government's accountability. More transparency in the sources and uses of domestic revenue can contribute to strengthening institutions and enhancing governance. In particular, citizens should be informed about the availability of prospective resources for spending, including tax expenditures (i.e., revenue losses due to exemptions and tax incentives). As these are typically granted to powerful groups and vested interests, awareness on their existence and magnitude can generate pressures from excluded groups to undertake reforms to broaden the tax base.

Should targets be set for achieving specified revenue thresholds? The IMF's experience to date with the setting of revenue targets has not been fully positive (see Box 3).

Box 3 Revenue Thresholds: Tanzania's experience

Despite recent and ongoing reforms in tax system and administration, Tanzania's tax revenue has only increased marginally from less than 11 percent in 2000/01 to 12.2 percent of GDP in 2005/06. A recent IMF technical assistance (TA) mission highlighted the size of the agriculture sector in the economy (50 percent of GDP and 80 percent of employment) and the degree of informality in the economy (58 percent of GDP) as bottlenecks to higher tax revenue ratios. These findings partially explain why the tax share remains relatively low, despite modern tax laws and a tax administration that has been improving and which is already judged well by taxpayers and experts. **Yet there is room to improve the tax ratio, mainly by developing policy measures to further enhance tax administration.** The TA mission evaluated Tanzania's tax capacity at 17.2 percent of GDP in 2004/05. By increasing the tax effort from 72 percent to 90 percent, the tax ratio could increase to 15.5 percent of GDP over the medium term (or by 3 percent of GDP). Furthermore, some tax policy measures, consisting mainly of streamlining exemption and tax incentives, could expand the tax base and further increase the tax ratio by another two percent of GDP. The Government recognizes the importance of enhanced domestic revenue mobilization (see the June 2005 PRSP) as a means to gradually reduce reliance on foreign aid for the funding of poverty reduction spending.

Would the setting of explicit revenue targets help in raising additional revenue? The 2000-2003 IMF PRGF-supported program included conditionality on tax revenue in the form of quantitative performance criteria. This was later removed in light of Tanzania's continuous performance. Targets were always met—the track record of the TRA in recent years has been very strong, as it has consistently exceeded its own targets. **However, experience with revenue thresholds is mixed at best.** Setting quantitative targets in the absence of more substantial reforms in tax policy and administration may simply create perverse incentives to “play tricks,” e.g., by delaying VAT refunds or demanding anticipated tax payments. Strengthening domestic revenue

²⁸ On the more general issues of aid volatility, which is the largest for the most aid-dependent countries, see Bulir and Hamann (2005).

collection may be more durably achieved by implementing structural measures, including strengthening tax administration and broadening the tax base by streamlining exemption and tax incentives.

E. Risk pooling

Donor programs could provide more flexible compensating finance. Donors could be more systematic in the provision of funds to insure LICs. Several new initiatives aimed at addressing this issue have been developed, including formalized partnership agreements and the Paris Declaration (see section on donor coordination), the International Financing Facility, and the IMF's Exogenous Shocks Facility. However many of these compensatory mechanisms have been administratively cumbersome, particularly given the large data lags in LICs, or ad hoc. Consequently, they have failed to provide the required support on a timely or consistent enough basis for countries with thin financial markets to avoid the costs of fiscal adjustment.

An alternative approach would be to link debt repayments or aid disbursements to key macroeconomic variables as a means of helping to cushion volatility. There is a growing academic literature on the benefits of linking debt instruments to particular macroeconomic events, such as GDP or a particularly important cash crop.²⁹ Linking debt instruments, including those associated with debt forgiveness, to macroeconomic events can provide a measure of 'automatic stabilization' against shocks by reducing debt payments and also bolstering credibility by reducing the swings in debt-to-GDP ratios. Similarly donors may compensate LICs in the face of natural disasters, droughts etc. While the paucity of reliable information has inhibited the development of state-contingent debt instruments, there are fewer barriers to donors providing some explicit state-contingent financing in the context of the formalized partnership agreements or pooled financing arrangements and MTFs.

IMF programs are also providing greater short-run discretion in circumstances where macroeconomic outcomes deviate from central projections, including where aid flows are higher or lower than expected. To the extent that an IMF program provides state-contingent resources, i.e., to countries with a balance of payments need, such funds provide a form of insurance, while the agreement on a medium-term fiscal program provides a transparent, external endorsement of a countries medium-term strategy (a form of self-protection). IMF programs tend to adjust for both positive and negative aid shocks. While PRGF's do not tend to have explicit targets for expenditure smoothing, adjusters have increasingly been used to compensate for aid volatility.³⁰ These have enabled countries to maintain or even increase spending in the face of significant shocks (e.g., aid inflows increased sharply to Mozambique in response to the floods in early 2000 and to Ethiopia in

²⁹ For a review of state contingent debt instruments see, IMF (2003)

³⁰ IMF (2005b) Box 3.

response to the 2002 drought). Conversely, by allowing some increase in net domestic financing of the government and by lowering international reserve targets, negative aid surprises have only required a limited degree of fiscal adjustment. At one extreme, the IMF-supported program in Tanzania allowed increases in the net domestic financing target by 100 percent of any aid shortfall; at the other extreme, the program in Mozambique did not allow for any adjustment in net domestic financing.

In sum, in order to mitigate the fiscal risks associated with a scaling up of international assistance, LICs could consider a combination of the following measures:

- Most important, a credible MTFE that provides a measure of self-protection against macroeconomic risks;
- A smooth expenditure profile as an explicit objective of the medium-term fiscal strategy, supported by donor programs and contingent on maintaining aggregate fiscal discipline and debt sustainability and reforms in PFM;
- The development of a more liquid financial markets in order to help overcome the destabilizing impact of revenue shortfalls on expenditure;
- Orienting new expenditure programs to address critical supply bottlenecks;
- Strengthening the institutional capacity of a government to assess and manage fiscal risks, particularly liquidity risks; and
- Some build up of prudential reserves by a government on its own account.

On the donor side:

- Implementation of the Paris Declaration (High Level Forum (2005)) in order to lessen the contribution of donors as a source of volatility; and
- Donor provision of state-contingent financing or development of more flexible pooled financing to permit expenditure smoothing.

IV. Institutional approaches to facilitate fiscal management with scaled-up aid flows

The previous sections have highlighted alternative approaches to strengthen fiscal policy management to deal with the potential for greater risks in the context of a scaling up of aid. **But the adoption of strengthened policies is not independent of a country's capacity for implementation.** This can influence whether donor policies facilitate or hamper a country's efforts to absorb additional aid effectively. Strengthened PFM is well-recognized as fundamental. Witness the various efforts to assess PFM quality and to provide TA in this sphere. But four other areas require attention: (i) action by donors and recipients to enhance donor coordination; (ii) embedding a medium-term perspective into fiscal policy; (iii) strengthened institutions and processes for the coordination of fiscal and monetary policy; and (iv) a capacity for independent audits of the fiscal policy framework.

A. Strengthening donor coordination in LICs

The foregoing discussion has underscored the difficulties posed for LIC fiscal policy formulation from the uncertainties as to the timing, duration, magnitude, content, and conditionality of aid, not to mention the sheer number of donors with their individualized procedures and reporting requirements. The greater the certainty, the easier the task of a government in formulating and managing its budget and fiscal policy framework. And the more effective the coordination, the higher the likely overall productivity of the aid and the less taxing it will be on the limited capacity for aid and budgetary management. Aid flows can never be the equivalent of domestically mobilized resources in terms of their fungibility or degree of certainty. But there is significant scope for both donors and recipients to facilitate greater certainty and efficiency in the delivery of aid resources.

1. Scope for donor actions

To some extent, the international donor community already recognizes that external assistance has contributed to the fragmentation of LIC budgets and the volatility of revenues.³¹ The most recent initiatives to improve aid coordination culminated in two high-level OECD/DAC forums—in Rome in 2003 and Paris in 2005. The Paris Declaration articulated five key partnership commitments:

- Donors should support recipient country **ownership**: LIC governments should exercise effective leadership over development policies, strategies and program implementation, as expressed in annual budgets and MTFs;
- Donors should better **align** their support with recipient countries' national development strategies and institutions, including budgetary cycles and procedures (based around strengthened PFM systems);
- Donors should **harmonize** external assistance, ensuring it is delivered in a streamlined and transparent manner, using common arrangements, procedures, and shared analysis;
- Resources should be **assessed and managed for results** rather than focused on controlling inputs; and
- Donors and partner countries should undertake joint assessments of progress in implementing agreed commitments to ensure **mutual accountability**.

³¹ See Bulir and Hamann (2006)

Yet these initiatives, even if they were speedily implemented and broadened to include the multiple other providers of external resources, do not address the lack of certainty as to the duration of the external assistance. Several further initiatives are possible:

- **A lengthening of donor aid commitments:** Actions by donors to commit assistance for a longer time frame are an obvious action (albeit difficult politically to achieve) (e.g., some of DFID's efforts at long-term commitments are described in Box 4).
- **Greater efforts by donors to understand better how to translate the provision of aid into development outcomes.** Grants can be less tied to specific projects, channeled through the budget, and coordinated better with recipient country development frameworks and aid of other donor countries. Donors could seek to disburse aid in a countercyclical manner and find ways to respond more quickly and more efficiently to large adverse shocks. Donors need to expeditiously provide reliable and complete information on flows of development assistance to facilitate their incorporation into budgets and medium-term fiscal plans. This includes presenting the data in a format compatible with internal government systems. A key institutional change would be the harmonization of donor assistance with budgetary procedures, and the alignment of donor assistance to the recipient's medium-term fiscal priorities—this should provide a mechanism for donors to provide predictable multi-year funding, contingent on a relatively stable domestic policy environment.
- **Increased provision of TA to strengthen PFM is critical** if higher aid flows are to be absorbed effectively (see Box 5). The PFM system provides assurances that resources are being used for intended purposes and helps to reduce transaction costs in terms of meeting donor-specified requirements. Measures used to improve the performance of PFM systems, include the development of a MTFF, common performance assessment frameworks (e.g., AAP/PEFA), computerization of financial management systems and more results/performance-based budgeting. Approaches emphasize that PFM reform should be country-led and require donor harmonization and alignment around the country strategy with a focus on monitoring and results, often through PAF and IMF conditionality.³² However, institution-building is a medium- to long-term endeavor. Sustained country and donor commitment, combined with focused reform implementation, sequencing and realistic expectations on the rate of improvement, are essential to overcome capacity limitations.

³² This approach has recently been elaborated by the PEFA group, in consultation with the OECD-DAC Joint Venture on Public Financial management. PEFA (Public Expenditure and Financial Accountability) is a partnership program between the IFIs and a number of donors. See: <http://www.pefa.org>

Box 4. Developing long-term partnerships, The UK experience

The UK has been at the forefront of efforts to provide developing countries with predictable, long-term assistance. In addition to an extensive involvement in multi-donor groups that coordinate aid, particularly budget support, the UK Department for International Development (DFID) has signed long-term bilateral development partnership agreements with a number of countries in Africa. These are underpinned by a published Memorandum of Understanding (MoU). These MoU's provide a transparent framework for cooperation between the two governments, based on a range of economic, political and governance commitments, with a duration of up to 10 years. The MoU's typically indicate a preference and commitment to provide general budget support, based on an evaluation of performance, and stress the need to improve donor alignment and harmonization and country financial management and reporting systems.

In **Rwanda**, under the MoU signed in February 2006 the UK committed to provide at least £460 million in **development assistance over the next 10 years**. The MoU sets out shared commitments, as well as the commitments each partner has made to the other, the monitoring and review process, a clear basis for discussion and dialogue and circumstances under which development assistance would be interrupted or reduced. The intention is to provide at least two-thirds of the support through a rolling program of budget support.

A similar 10-year MoU was signed in 2003 in **Ethiopia**, which stated the UK's intention to provide a substantial proportion of development assistance as direct budget support with an indicative figure provided for the subsequent three years. However, because of concerns over the political situation, in 2006 the UK halted its budget support, but reiterated a commitment to continue support to the people of Ethiopia in their fight against poverty. Alternative methods of aid delivery are currently being investigated with the government and other donors, with an emphasis being placed on tighter "financial reporting and stronger local accountability so that the funds reach the poorest people."

DFID is engaged in a variety of programs in **Malawi**, of which the most innovative is a £100 million six year programme to support the health service through a so-called Sector Wide Approach (SWAp). The concept is an intermediate between traditional project and program support in the sense that resources are an integrated part of the governments budget for recurrent spending, but their use are defined within an agreed programme of work and are guaranteed for a six year span (subject to conditions on government co-financing). A key element of the SWAp arrangement is to provide salary top ups for health sector employees in order to attract and retain qualified staff. The programme is a pooled arrangement with the World Bank and Norway. The MoU was signed in 2005.

It is premature to assess the impact of such long-term bilateral agreements. The MoUs tend to be much broader in scope, including more political commitments, than the more common multi-donor groups that are increasingly being formed around the delivery of budget support. However, these are not exclusive instruments, as the MoUs also provide an explicit link to existing, or emerging, formalized partnership agreements with other donors and seek to utilize their common performance monitoring frameworks. However, this will complicate the evaluation of the MoUs, in terms of improved predictability and reduced volatility, as it may be difficult to separate their impact from that of the multi-donor partnership arrangements.

Box 5. Is There a Relationship between Macroeconomic Performance and Sound PFM Systems?

Sound PFM systems generally support fiscal discipline, and hence can help macroeconomic stabilization efforts. For this reason, IMF-supported program often include PFM measures, most notably in PRGF-supported programs where actions to strengthen PFM systems are the norm. **Is there a relationship between successful macroeconomic stabilization and sound PFM systems?** While different approaches and methodologies can be applied to assess PFM systems, this note uses the results of the Assessment and Action Plans (AAPs) undertaken by the IMF and the Bank in 2005 to analyze this question.

The basic hypothesis is simple: countries that have successfully stabilized their economies (the so called “mature stabilizers” in the recent PRGF review) are also those that have comparatively stronger PFM systems; to the contrary, countries that have failed to stabilize display significant weaknesses in their PFM system. Table 1 confirms this basic intuition for the 22 African countries included in IMF (2005a). The largest number of entries along the main diagonal would seem to suggest that there is indeed a relationship (but not necessarily causality) between sound macroeconomic frameworks and sound PFM systems.

Table 1: Relationship between Macroeconomic performance and PFM Systems

	Mature Stabilizer Countries	Stabilizing Countries
Little of some upgrading of PFM systems required	5	1
Substantial upgrading of PFM systems required	4	12

Source: IMF (2005a and 2005b), covering 26 countries, of which 22 in Sub-Saharan Africa

1/ Based on classification of countries in Box 1 in IMF (2005b). The criteria for defining mature stabilizers include sustainable high growth and low inflation, and government deficits under control. On this basis, the following countries with a PRGF-supported program during 2000-2003 qualify as “mature stabilizers”: Benin, Ethiopia, Madagascar, Mozambique, Rwanda, Senegal, Tanzania, and Uganda; in this note Burkina Faso is also included, although it was excluded in IMF 2005b as its PRGF program only started in 2003.

It may come as a surprise that a number of mature stabilizers (four out of nine in the sample) still need some upgrading in their PFM system; and that one country with a relatively strong PFM system has not stabilized yet. This may be due to specific factors. The arbitrariness of the criteria may also play a role. Overall, however, the exercise would confirm the above basic intuition.

- **Simple, formalized partnership agreements:** These can help to harmonize and streamline aid delivery. Where the relationship between donors and the recipient is advanced, a ‘*joint partnership framework*’ can outline the basic principles of donor collaboration, using a common ‘*performance assessment framework*’ (PAF) for reviews and disbursements (e.g. recent examples exist in Mozambique, Tanzania, Ghana, and Bourkina Faso)(see Boxes 6 and 7).³³

Such agreements can facilitate joint monitoring of program support by donors and recipients, managed according to a set of predefined common principles, even when

³³ For an evaluation of PAFs in these countries, see Lawson, Gerster, and Hoole (2005)

disbursement decisions remain subject to individual donor decisions. The IMF's participation as an observer to these arrangements has helped to provide a link to the macroeconomic framework.^{34 35}

But experience shows that it will take some time before joint partnership frameworks can prove they are successful in improving the predictability and effectiveness of aid.³⁶ For example, in the first two years of operation of the Poverty Reduction Budget Support arrangement in Tanzania, budget support was still the most unpredictable of all government revenue sources, being 22 percent and 32 percent below budgeted levels. This may have reflected the need for a learning period for both government and donors in developing such frameworks. In the Tanzania case, budget support became much more certain in the third year, falling only 2 percent below budgeted levels (FY2003). Incorporating explicit targets for predictability in the PAFs might also accelerate this process.

Box 6: The impact of donor coordination on aid management: Tanzania's experience

By the early 1990s, Tanzania's relationship with donors was strained due to deteriorating policy and fiscal performance and its failure to collect counterpart funds for donor supported programs. Donors also perceived corruption and budget mismanagement, while the government saw donors as inappropriately intrusive and unwilling to deliver on their promises. **In 1994, an independent group of experts was asked to recommend how to improve donor coordination in Tanzania.** *Inter alia*, the Group recommended that the government formulate clear medium- to long-term national development priorities and undertake necessary reforms in public service and financial management. It also urged donors to better coordinate and harmonize their development assistance, including practices and procedures to increase the predictability of aid. These recommendations initiated a process to redefine the relationship between the government and donors and the management of aid on the basis of principles of national ownership, government leadership, harmonisation, and alignment.

One outcome was the launching of the Tanzania Assistance Strategy (TAS) in 2002. An Independent Monitoring Group was set up in 2002 to monitor the performance of the government and the donors, and to develop a TAS action plan. Actions were grouped in four priority areas, viz., increasing the predictability of aid flows, integrating external resources into the government budget, harmonizing and rationalizing processes, and improving national capacities for aid coordination and external resource management.

Donor coordination has improved in light of these actions. The government has strengthened PFM and accountability. Quarterly reports on fiscal performance have greatly improved transparency in policy formulation and implementation. Quarterly consultations on the sector programs provided an opportunity for donors to monitor program implementation and participate in program design. Predictability of external

³⁴ Many of the most advanced arrangements are still being refined, mainly by reducing the number of indicators or PAF conditions, to ease implementation—for example in Ghana the PAF comprised 29 indicators in 2006, down from 39 in 2005, while the performance tranche disbursements are linked to a sub-set of only 10 indicators.

³⁵ Op. cit. The need to simplify donor policies and to encourage collaborative behavior was one of the commitments made by donors at the Rome conference.

³⁶ Bulir and Hamann (2006)

resources has improved and external funds have increasingly been integrated into the budget, thereby strengthening government ownership over resource allocation as well as budget contestability of external resources. As for the donors, they have increasingly aligned their activities with national systems and processes.

Despite progress made under the TAS, weaknesses remain in aid management. Parallel systems and procedures for delivering, managing, monitoring and evaluating development assistance as well as multiple missions, meetings and analytical studies have remained burdensome for the government. Furthermore, the still widespread provision of off-budget financing, most notably for projects, has impeded strategic resource allocation in the national budget process as well as transparency and domestic accountability in the utilization and performance of external resources. **To address these challenges the government and donors have recently launched a Joint Assistance Strategy (JAS)** (March 2006) to further reduce the still high transaction costs that are incurred through the pursuit of different strategies with multiple and often overlapping processes. It also aims at extending enhancing national ownership and government leadership of the development process and to increasingly shift government accountability from donors to domestic stakeholders.

Box 7. The Benefits of Donor Coordination: The Case of Burkina Faso

Through the 1990s, Burkina Faso, which receives substantial aid flows from the international donor community, was plagued by several shortcomings associated with the delivery of these resources.

Above all, lack of predictability and continuity of these funds complicated fiscal programming and management. Excessive conditionality and lack of coordination among donors, delivering their aid in different fashions, further complicated policy making. The government struggled to satisfy the various donors and cope with frequent and demanding donor missions. As a result, ownership of reforms as part of donor conditionality was often weak.

However, in 2001, under the leadership of the European Union (EU), six development partners decided to provide annual budget support to Burkina Faso, and strengthen their coordination through a joint budget support group. The World Bank, which is the biggest provider of budget support, first joined the group as an observer. Declared priorities of the group were to (i) improve predictability and regularity of budget support; (ii) greater ownership by the government of the implementation of the PRS as identified in the 2000 PRSP; (iii) strengthened coordination between partners through joint evaluations of the government's progress with regards to poverty eradication. The group met frequently and regularly, keeping track of committed and disbursed aid to Burkina Faso. As a consequence, predictability of budget aid improved markedly, facilitating fiscal programming for the government. Remaining aid volatility could largely be attributed to the few donors who hadn't joined the partnership.

In 2005, the group harmonized donor interventions in Burkina Faso even further, reflecting an assessment of their collaboration by the Minister of Finance. It expanded to include all other major donors of budget support, particularly the World Bank and AfDB. The new agreement between the donors and the government was coupled with a jointly approved matrix of measures and indicators which forms the basis for budget support disbursements, in tandem with IMF and the group's own periodic program reviews. This matrix presents a break-through in aligning donor conditionality, as the EU has traditionally advocated an indicator framework with a longer-term perspective, whereas the World Bank disbursed its support on the basis of shorter-term policy action triggers. Moreover, the leadership for budget support coordination is now assumed by the government, rather than the donors. The Minister of Finance is the group's President, managing its activities, jointly with a representative of the donors.

Going forward, some challenges remain. In particular, more harmonization of the timing of disbursements is still needed. Some donors favor performance indicators that are lagged by one year, whereas others would like to disburse in the yearly budget period itself, as an incentive for compliance with conditionality for the government. Donors also need to disburse early in the budget cycle, rather than during the last months of the year, and provide multi-annual aid commitments.

2. Recipient country actions

Recipient nations can facilitate enhanced donor coordination, particularly if the scaling up of aid increases the share of programme assistance and sectoral support relative to projects. A number of approaches are possible:

- **Strengthening the capacity to monitor and manage development funds:** Many countries have created dedicated functional units within the ministry of finance to record and monitor the performance of external grants and debt, e.g. Ghana's Aid and Debt Management Unit or Tanzania's External Finance Department. While creating such units may be helpful, e.g., for including commitment information in projections (see below), the move towards budget support also requires coordination *throughout* the budget process, including with the line ministries responsible for delivering the services on which performance conditions are commonly based. Specific financial regulations and procedures are often needed to support such coordination.³⁷
- **Integrating donor information in fiscal data:** In order to assess overall resource availability and allocate resources in line with policy priorities, governments should integrate aid flows (ex ante and ex post) within the budget and program them alongside domestic resources. While program support, loans and debt relief are channeled through the budget, a considerable amount of support is still delivered in the form of discrete projects which disburse funds through separate arrangements (this occurs even when the 'agency' is part of government). Many countries have established dedicated aid management information systems to supplement their accounting systems, with information reported by donors and/or line agencies. However, even where standard reporting formats have been agreed (e.g., Ghana, Uganda, and Tanzania), this problem persists (see Box 8).
- **Improving the realism of the budget:** As an interim measure, countries with a track record of donor assistance can scale donor pledges with 'discount' factors. To be a credible policy tool the annual budget needs to be based on realistic projections of available resources. Governments usually need to adjust donor commitments to provide a better indication of likely disbursements, e.g., Uganda applies a discount factor on donor budget support set at the average level by which disbursements have fallen short of commitments over the last five years (currently around 35 percent).

³⁷ A major challenge is the highly fragmented nature with which aid flows are sourced and managed within line ministries. Line ministries themselves may have difficulty limiting the pressures for absorbing aid for specific projects, and the possibility of organizing a coherent and integrated sectoral strategy is made more difficult by the effective earmarking of a substantial share of a ministry's budget. This makes a rational allocation of budgetary resources even more complex by the central budgeting agency.

This could also be refined for differing donor performance, but should be seen as a second best solution to improving the reliability of donor commitments.³⁸

- **A demonstrated strong commitment to policies.** When government strategies and policies do exist in a form with which donors can engage, donors place strong emphasis on the political commitment to implement these policies. A government's commitment to implementation is an entry-point for donors. When it is lacking, donor support will be weakened.
- **Clear leadership:** Regular in-country meetings under government leadership, dissemination of information on reforms and progress, and clarification of domestic needs to donors at both national and sector level, can greatly improve information flows. This enables donors to better adapt their future programs to their comparative advantage.

B. Strengthening the Medium-Term Fiscal Orientation

Section II highlighted the analytic importance, for policy and budget formulation, of having a medium to long-term perspective on how the fiscal framework would be expected to expand in the context of a scaling up of aid. Section III emphasized the importance of such a framework for developing a shared strategy with donors and identifying the main fiscal risks and mitigating strategies.

Box 8. Managing and accounting for aid not channeled through the budget

The tendency of donors to bypass regular government procedures is ostensibly to speed up project preparation and disbursement where local capacity remains weak; to avoid cumbersome or ineffective financial management and procurement procedures that do not meet the required accountability or transparency standards; and to avoid corrupt practices. However, incorporating this information into budget processes remains problematic for many countries, even when dedicated systems have been established for this purpose. Two examples are elaborated below:

- **Afghanistan** continues to face a complicated post-conflict situation. Domestic revenue covers less than 50 percent of recurrent costs and direct external assistance is extremely large (estimated at around 25 percent of GDP for 2006/07 with an additional 14 percent channeled through the budget). In order to manage this process, the authorities have developed an overarching policy framework with programs overseen by *Consultative Groups* headed by a lead ministry and incorporating the relevant donors. The budget department of the Ministry of Finance, supported by donors, maintains a database that measures donor pledges, commitments and disbursements. This information has been reported *ex ante* in budget documents (and called the '*External Budget*') and *ex post* on an ad hoc basis. However, donor reporting has been sporadic and often not in a format consistent with the government's requirements, making it difficult to report spending by province or to incorporate robust projections and outturns in budget documents. Despite considerable donor assistance, the resources devoted to

³⁸ In Tanzania the MOF's External Finance Department also applies discount factors to some projected project expenditures, based on the past trends in the donors' disbursements.

coordination, recording, and reporting have been considerable and have occasionally diverted resources away from efforts to strengthen other areas of PFM, including budget execution. This is one factor that has contributed to the very low implementation rates for major programs.

- **Tanzania** has made a concerted effort to encourage donors to channel support through the PFM system. The share of annual funding going to either untied budget support or basket funds established for sector-specific activities in 2004/05 was expected to account for 56 percent of total assistance (excluding HIPC relief), compared to 39 percent in 2000/01. Consequently, reporting on donor-funded activities has significantly improved. The authorities have also tried to integrate project spending into budget documents and procedures. There are two forms of budget data: (1) *core* data is based on the domestic accounting systems; and (2) *augmented* data, which includes additional data on foreign financed projects from the *External Finance Database*. Augmented data is used by policy makers for budget projections of foreign project financing and assessing the availability of financing for achieving the fiscal policy objectives, as well as for medium-term budgetary projections. Over the past several years, the augmented data has been used by the IMF for program monitoring purposes. However despite these efforts, the bulk of donor-financed projects remains outside the core PFM system, with only an estimated 25 percent of project expenditures reported to the Accountant-General in 2002/03.³⁹

Three basic stages of institutional development have been identified for multi-year budgeting⁴⁰: (i) a medium-term **fiscal** framework (MTFF) provides a statement of fiscal policy objectives and sector strategies and a set of integrated medium-term macroeconomic and fiscal targets and projections; (ii) a medium-term **budget** framework (MTBF) incorporates projections of spending by individual agencies that allocate resources in line with strategic priorities and consistent with the overall fiscal objectives of the MTFF, and (iii) a medium-term **expenditure** framework (MTEF) extends the analysis further with more detailed sector costing and performance measures (possibly including activity and output-based budgeting) (Lawson and Jones, 2000).

In countries that have the capacity, the expenditure path identified in the MTFF should be the basis for 3-4 year-horizon rolling MTEFs. Ideally, both the MTFF and the MTEF would then be aligned with the yearly budget exercise, and ultimately, budget execution. While for many LICs this approach might still prove very ambitious, such alignment would be instrumental in channeling scaled-up aid and debt relief resources into expenditure geared toward reaching the MDGs. While the yearly budget exercise is by definition subject to tighter constraints, it should strive to converge with the fiscal path identified in the MTFF and resulting MTEF. Equally important, to ensure that the alignment of budget planning with budget execution allows for robust cash-flow planning, countries should be encouraged to move from cash rationing to cash management.

In countries where key aspects of budget management remain weak, a multi-year framework alone will not be able to deliver improvements in coordination or PFM.

³⁹ See Tanzania, 2004

⁴⁰ See Lawson (2000 or 2004?),

Indeed, if annual budgets lack realism or where PFM systems are deficient, a complex MTEF may be counterproductive and divert attention and limited administrative capacity away from more basic reforms (see Box 9).^{41 42} As noted, an intermediate option is to move to a MTBF. Bevan has noted that such a move means adding a mechanism for allocating discretionary resources between competing spending agencies, again over a multi-year horizon. While an informed judgment on allocations for the out years can be a demanding task, he notes that a mechanistic start is possible, with some sectors strategically (and arbitrarily) targeted to grow at a higher rate than the average, some maintaining their share, and others declining. Overtime, as the MTBF process is updated in a rolling framework, the system should be capable of evolving away from this mechanical start.

In the event that even a MTBF would strain a government's PFM capacity, donors should assist governments in developing the capacity to build up appropriate MTEFs. Particular attention should be given to avoiding a dichotomy of current expenditure versus capital expenditure. In countries with limited administrative capacity, an alternative to a fully-fledged MTEF could be a limited set of sectoral scaling-up scenarios, guided by the principles outlined above. The focus would be on those individual sectors (e.g., the social sectors) likely to be recipients of significant aid flows.

Box 9. The Medium-term Expenditure Framework in Ghana

The MTEF was introduced in Ghana with the 1999 budget. As presented to the legislature, the MTEF includes a budget for the upcoming year and indicative estimates for the succeeding two years. It was introduced in order to provide a methodology for costing objectives in detail and prioritizing them to fit within the available resources, both between and within sectors. This responded to the weakness of the national and sectoral objectives of the 'Vision 2020', introduced in 1994 to set out long-term goals, and the 5-year plans (first introduced to cover the period 1997-2001).⁴³

An overambitious reform agenda and difficult economic circumstances hindered the introduction of the MTEF. The MTEF was one component of a broad program of donor-supported assistance designed to improve Ghana's PFM. These included the introduction of: a new computerized integrated financial management system; a computerized integrated personnel and payroll management system; civil service reform; a move towards output measures of budget assessment; and a decentralization program. An Interim PRSP was also produced in 2000. The introduction of the MTEF coincided with the change in government in December 2000. External shocks (as witnessed by a dramatic deterioration in Ghana's terms of trade) and weak macroeconomic management also caused large divergences between budgets and outturns, considerably reducing the credibility

⁴¹ Op cit and see also World Bank 2005, *The Medium-Term Expenditure Framework The Challenges of Budget Integration in SSA countries*, Africa Region Working Paper Series No. 82

⁴² David Bevan (2006) has noted that the difficulties that arise in introducing an extended version of the MTEF include the sheer scale and complexity of what is involved, such as the radical changes to budget classifications and the introduction of new modalities e.g. IFMIS. He emphasizes that even partial success in introducing an MTEF requires a "careful matching of demands to capacity and to the rate at which capacity can be built" and "palpable incentives to induce line ministries to cooperate." The experience to date suggests only partial implementation of an MTEF framework in selected ministries.

⁴³ See Foster and Zormelo (2002)

of the MTEF. Progress was also hindered by the poor PFM system—in 2001 a joint World Bank-IMF assessment concluded that Ghana met only one of fifteen benchmarks, ranking it among the lowest and most in need of substantial upgrading.⁴⁴

Despite the considerable resources devoted to the MTEF and PFM reforms, many of the original objectives have yet to be achieved. A repeat review of the performance of the PFM systems in 2004 (see footnote) concluded that the figures for the MTEF's outer two years continued to be derived by applying uniform growth factors to both domestic and donor-financed spending respectively. The MTEF therefore did not reflect the detailed costing work that had been undertaken in priority sectors for ongoing and planned programs, nor did it reflect changes in sector prioritization based on Ghana's Poverty Reduction Strategy. The apparently mechanical approach to the MTEF for the two out-years is also a concern, as these figures are presented as "discretionary expenditure ceilings" that, if adhered to, would lock spending into the pattern of the 2004 fiscal year, making the budget a purely incremental exercise.

The poor performance of the MTEF does not argue against a medium-term fiscal perspective. Rather, the MTEF concept needs to be further developed to make it a realistic strategic tool for planning and budgeting. In the short-term this may mean simplifying the budget process that is presently designed as both a top down process (to maintain fiscal discipline and allocate resources in line with priorities) and a bottom up process (in which ministries, departments and agencies prepare strategic plans and activity-based budgets). In support of the objectives of the MTEF and to improve coordination around policies and budget support, the main donors have also created a Multi-Donor Budget Support group that has put considerable emphasis on the MTEF and PFM reform program.

C. Strengthening the Institutional Mechanisms for Monetary and Fiscal Policy Coordination

Section II illustrated the importance of close coordination of monetary and fiscal policy in the context of scaled-up aid. Coordination should be a continuous process. It is needed in designing a medium-term financial programming framework, as well as in annual budget preparation, and day-to-day operations. Achieving such coordination does not imply that the central bank would lose its independence. Rather, it argues for much greater interaction between the central bank and the fiscal authorities in terms of sharing of information on budgetary plans and on the timing of expected receipts of aid disbursements and spending plans. The objective would be to ensure that the central bank, in its management of monetary policy, is able to best take account of the impact of fiscal operations, particularly in situations where the magnitude of aid flows and their liquidity effects may be large. This enhanced coordination would be relevant independent of whether the Central Bank is running a flexible or fixed exchange rate policy (and in the latter case, whether or not part of a currency union).

Institutional measures to facilitate improved fiscal-monetary coordination include better cash forecasting and management, often preceded by the consolidation of government bank accounts into a Treasury Single Account structure; enhanced monitoring and forecasting of

⁴⁴ See the HIPC Initiative Assessment and Action Plan exercise conducted by the World Bank and IMF. This exercise was repeated in 2004, when Ghana's PFM systems were assessed as meeting seven out of the sixteen benchmarks: See: www.worldbank.org

the cash flows of large and often lumpy and donor financed projects; initiatives to smooth intra-year revenue and spending profiles; and the development of formal operational agreements and communication arrangements between the central bank and ministry of finance, particularly with regard to the foreign exchange strategy. In addition, better coordination with donors might prevent the concentration of disbursements in the last quarter of the year.

D. Independent audits of the fiscal policy framework

Considering the fiscal challenges posed by a scaling up of aid, LICs might consider fiscal process innovations observed in some industrial countries, specifically either the creation of an independent agency or a strengthening of an existing audit agency by expanding its mandates beyond the ex post auditing of outturns. The objective is to provide an independent perspective on the government's management of fiscal policy. Non-politicized fiscal agencies can enhance transparency and accountability, providing stronger incentives for efficiency and effectiveness, as well as some reassurance to donors. The terms of reference for such a unit would be to (i) assess assumptions in medium term budget plans; (ii) monitor the implementation of fiscal rules (identify slippages, and suggest corrections); (iii) monitor and assess coordination mechanisms between authorities and donors; and (iv) carry out real-time analysis of aid and expenditure flows, tracking specific capacity bottlenecks.

V. Conclusions

Recent initiatives to relieve many LIC governments of much of their debt obligations and scale up aid should allow an expansion of fiscal programs to spur long-term growth and reduce poverty. But they also pose challenges for the design of a fiscal framework that fosters a sustainable delivery of enhanced public services and strengthened infrastructure while still ensuring a credible commitment to fiscal prudence. The challenges arise for many reasons. First, governments face uncertainties about the aid itself. How much additional aid will be forthcoming? How would it be structured in terms of its composition? How conditional will the aid be? What will be the phasing of the aid? And for how long are donors willing to make commitments of enhanced aid? A second set relates to the complexities of development itself—the challenges of using the aid in ways that remove key bottlenecks to growth, foster higher productivity, and achieve the MDGs. Third, with the additional fiscal space afforded by debt relief, governments will have to think carefully about how much and how fast new debt can be accumulated in support of growth initiatives, even if much of the debt is on concessional terms. And finally, there is the issue of whether absorption of scaled-up aid will have substantial effects in terms of a nominal appreciation of the exchange rate. Countries will have to be satisfied that aid can foster higher productivity and sustained competitiveness.

This paper has sought to examine how governments, in the context of a significant scaling up of aid, can formulate a fiscal framework that is ambitious in its goals for absorbing additional aid, while at the same time prudent in terms of ensuring that expanded programs can be

sustained, that fiscal policy is supportive of macro stability, and that the government's financial policies are sustainable. There are six principal points to emphasize.

First, fiscal policy should be formulated in the context of an ambitious MTEF that is based on an “optimistic, but plausible” aid scenario for additional external assistance but one that also embodies higher domestic revenue mobilization, if needed, in order to allow for eventual graduation from aid dependency. As a minimum, scenarios should be prepared for those sectors likely to receive significant additional aid. Such a MTEF should be linked to the annual budget, and possibly, if a country has the capacity, to a MTEF.

Second, an important fiscal policy objective should be the assurance of a stable expenditure path. Volatility in spending programs in the past, whether related to volatility in aid flows or exogenous shocks, has never been neutral across spending programs and input categories and has invariably been damaging to the productivity of projects and programs. The fiscal policy framework should seek to avoid disruptive cutbacks in nonwage spending in sectors and in necessary O&M, as well as the stalling of projects (recognizing that a permanent shock will probably require a downward adjustment in spending).

Third, the composition of expenditure matters in terms of the pursuit of a sound fiscal policy framework. This is particularly the case if much of the increase in aid is intended for the expansion of particular sectors and types of programs and projects. Expanding the share of government spending dedicated to programs that are of a recurrent nature and that are difficult to easily cut back, requires a more prudent posture in terms of facilitating a smooth expenditure path than a spending program that is enhanced through discrete capital projects. Equally, the macroeconomic issues in absorbing aid are very much determined by whether the expansion in aid is used for the purchase of nontradeables or tradables. The aggregate expenditure target consistent with optimistic but plausible financing may thus need to be reduced to take account of the composition of expenditure (and also possibly the sources of financing if heavily reliant on debt).

Fourth, a significant scaling up of aid and debt-financed spending programs calls for enhanced attention to policies of risk management. The uncertainties involved—both in terms of the short-run volatility and long-run uncertainties of aid and the risks of a rising debt ratio—argue for risk management to be a central factor in the construction of the fiscal policy framework. Strengthened practices for assessing risk as well as policies for self-protection and self-insurance are essential in formulating a sound medium-term macroeconomic framework. The paper emphasizes three key elements of such an approach: strengthened debt sustainability assessments that include scenario analyses; medium-term vulnerability assessments under alternative scenarios; and a conscious policy of reserve accumulation that is related to the degree of vulnerability of the budget given its composition and sources of financing.

Fifth, a strengthening of institutions is vital if governments are to manage the absorption of scaled up aid and implement expanded service delivery programs and capital expenditure projects. This paper reaffirms the importance of strengthened PFM. But

it also highlights that additional processes must be elaborated and institutions strengthened if governments are to manage and implement fiscal policy for development more effectively. In particular, countries should bolster their capacity to monitor and manage the terms and duration of prospective aid commitments.

Sixth, donors will play a critical role in determining whether their commitments of aid can be translated effectively by recipient countries into productive and efficient development programs and projects. This entails donor coordination efforts and a greater willingness to make long-term predictable commitments. Donors should be encouraged to facilitate or finance initiatives that contribute to the implementation of smoothing/buffer mechanisms in exchange for well-designed medium-term expenditure programs in support of the MDGs. The latter may derive from either support for reserve accumulation efforts by recipient governments or donor pooling of some reserves.

Two final points. First, this paper largely focuses on the issues posed for countries seeking to absorb to the maximum extent the proffered additional aid resources. A country may believe that it cannot productively absorb more aid without an adverse impact on its real exchange rate and its long-term growth prospects. In such a case, the “optimistic but plausible” fiscal framework—taking account of the potential for some adjustment in the composition of aid in terms of tradables and nontradeables—would need to cap aid absorption, and the consequent amount of spending, to a level consistent with the desired nominal exchange rate (assuming inflation remains contained).

Second, this paper has focused on the challenges that will arise with a substantial scaling up of aid flows by donors in coming years. There is of course the possibility that donor countries may ultimately prove less generous than anticipated. Witness the expansion of ODA flows in 2006, which largely reflected debt relief for Iraq and Nigeria. Much of the expansion of aid flows to LICs was largely focused on a few sectors and was heavily linked to vertical initiatives, particularly in relation to HIVAIDS programs. Coming years might also see a similar levels of aid focused on scaling up for particular program initiatives, but without a substantial scaling up in aggregate aid levels. Most issues we describe for fiscal policy in the foregoing discussion of an aid scaling up would remain germane in this more limited scenario. Others, such as the extent to which governments would confront *macroeconomic* pressures, particularly on the real exchange rate, would be less relevant. However, governments would still need to grapple with the problems that have arisen in the last few years in terms of deciding how and whether to accommodate the implied imbalances that can arise across sectors because of donor preferences. Effectively, the expansion of government expenditure programs may become inconsistent with the overall strategy embodied in the PRSP. Governments would then need to decide whether to accept the additional aid and accommodate such imbalances or seek to exploit fungibility as much as possible in budgetary allocations.

Acronyms

AAP	Assessment and Action Plans
CAR	Cost-at-risk
DFID	United Kingdom Department for Financing International Development
DSA	Development Sustainability Assessment
DSF	Development Sustainability Framework
HIPC	Highly Indebted Poor Countries
JAS	Joint Assistance Strategy
LIC	Low Income Countries
MDRI	Multilateral Debt Relief Initiative
MTBF	Medium Term Budgetary Framework
MTEF	Medium Term Expenditure Framework
MTFF	Medium Term Fiscal Framework
NPV	Net Present Value
ODA	Overseas Development Assistance
OECD/DAC	OECD Development Assistance Committee
PAF	Policy Assessment Framework
PEAP	Poverty Eradication Action Plan
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PRBS	Poverty Reduction Budget Support
PRGF	Poverty Reduction and Growth Facility of IMF
PRS	Poverty Reduction Strategy
PRSP	Poverty Reduction Strategy Paper
TAS	Tanzania Assistance Strategy
TRA	Tanzania Revenue Authority
VAT	Value Added Tax
WAEMU	West African Economic and Monetary Union

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