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Working Paper 2

# International Aid and its Management: Some Insights for Zimbabwe in the Context of Re-engagement

MARK SIMPSON AND DALE DORÉ

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# Foreword

This second paper in UNDP's working paper series draws upon the broad outlines of the international aid system, its instruments and processes, contained in the UNDPs *Comprehensive Economic Recovery in Zimbabwe – A Discussion Document* launched in 2008. The paper is an attempt to now provide readers with second and third order levels of detail on what can often seem an overwhelmingly complex system, while at the same time focusing on what were seen by the authors as the key features of that system, the essential debates that have in the past shaped its development, and that continue to do so presently.

In a context in which Zimbabwe is currently re-engaging with the international development community, the authors have sought to provide a primarily Zimbabwean readership with insights drawn from the global experience that might prove useful in helping the country manage what may possibly be significant inflows of aid, the return of a number of development agencies, and a scaling up in the operations of those who have maintained a presence throughout the recent past – with all the demands that this will inevitably place on national systems. The authors have also purposely tried to steer away from detailed country specific prescriptions, since the overall objective of this particular working paper is primarily a pedagogic one, aimed at helping the target readership take on the role of informed and empowered interlocutors as the country re-engages with the donor community.

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# Executive Summary

After years of isolation from the mainstream of international development processes, Zimbabwe's decision-makers need to familiarize themselves with the new aid architecture and mechanisms as the country re-engages with the international community. The purpose of this paper is therefore to discuss the main principles and processes of various aid modalities, international debt relief efforts and the management of aid flows so as to enable decision-makers to ensure that engagement in these initiatives best meet Zimbabwe's development objectives. In doing so it draws on the international debate on the role and effectiveness of aid and the experiences of other countries.

Broadly, the paper is structured around three main themes. The first is the gradual shift of aid delivery away from project-based approaches which are specific 'stand alone' interventions by donors, towards programme-based approaches where donors provide direct support to various sectors and the national budgets of recipients (partner countries). This evolution in approach finds expression in the second theme, the Paris Declaration of 2005, which is a set of principles to improve the efficiency and impact of aid. The third theme is the need for a comprehensive and technically sound national development strategy, known as a Poverty Reduction Strategy Paper (PRSP).

The Paris Declaration groups aid delivery principles into five broad categories. 'Ownership' is the first category whereby the partner country undertakes to exercise effective leadership over the development policies and strategies and coordinate development actions. The second and third categories, 'alignment' and 'harmonization', require donors to base their overall support on the partner countries' national development strategies, institutions and procedures, and ensure that their actions are more harmonized, transparent and collectively effective. 'Managing for results', the fourth category, means managing and implementing aid in a way that improves decision-making to achieve development objectives. The last category, 'mutual accountability', requires both donor and partner countries to be responsible for development outcomes.

The formulation of a national development strategy, or PRSP, through a participatory process involving both government and non-state actors – the private sector, labour and civil society – places ownership of the development process firmly with the partner country. The PRSP then becomes the centrepiece around which donors can align and harmonize their own development assistance and, with improvements in public financial management and national oversight by Parliament, move towards providing direct budgetary support. Under such a scenario, donors and partner countries are likely to benefit significantly from greater transparency and oversight, a reduction in transaction costs and fiduciary risks, as well as greater predictability of aid flows.

The paper concludes with measures that Zimbabwe needs to take when requesting debt relief and managing aid flows as it re-engages with the international donor community.

# Acronyms

| | |
|---|---|
| BWIs | Bretton Woods Institutions |
| CF | Common Fund |
| DAC | Development Assistance Committee |
| DSA | Debt Sustainability Analysis |
| GBS | General Budget Support |
| GDP | Gross Domestic Product |
| HIPC | Highly Indebted Poor Country |
| IDA | International Development Association |
| IFI | International Financial Institutions |
| IMF | International Monetary Fund |
| JAM | Joint Assessment Mission |
| LICUS | Low Income Country Under Stress |
| MDB | Multilateral Development Bank |
| MDTF | Multi-Donor Trust Fund |
| MTEF | Medium-Term Expenditure Framework |
| NGO | Non-Governmental Organisation |
| NPV | Net Present Value |
| ODA | Official Development Assistance |
| OECD | Organization for Economic Co-operation and Development |
| PFM | Public Financial Management |
| PRGF | Poverty Reduction and Growth Facility |
| PRSP | Poverty Reduction Strategy Paper |
| SBS | Sector Budget Support |
| SIP | Sector Investment Plan |
| SWAP | Sector Wide Approach |
| TRM | Transitional Results Matrices |
| UN | United Nations |

# Section 1

# Introduction

## 1.1 DEFINING OFFICIAL DEVELOPMENT ASSISTANCE

Official Development Assistance (ODA), as defined by the Organization for Economic Co-operation and Development – Development Assistance Committee (OECD-DAC),[1] constitutes:

> *'Grants or loans to countries and territories on the DAC List of ODA Recipients and multilateral agencies that are undertaken by the official sector at concessional terms (i.e., with a grant element of at least 25 percent) and that have the promotion of the economic development and welfare of developing countries as their main objective. In addition to financial flows, technical co-operation is included in aid. Grants, loans or credits for military purposes are excluded.'* (OECD, 2007: 232)

This definition of ODA thus excludes other categories of assistance from OECD-DAC countries, such as **Other Official Flows**, i.e., those that do not meet development objectives or because they have a grant element of less than 25 percent.

The volumes of ODA flows from DAC members have grown from US$20 billion in 1980 to a figure of US$104.4 billion in 2006. This represented an estimated 90 percent of total global ODA flows. The Secretariat of DAC has been pushing for some time for a measure that excludes debt relief, humanitarian assistance, administration costs, student scholarships and the in-donor country costs associated with refugees. The objective is to arrive at a figure that reflects **net programmable aid.** Using this measure, the figure for programmable ODA from DAC members for 2006 stood at around US$46 billion.

It is noteworthy that as a proportion of total developing countries inflows, ODA has fallen relative to remittances, commercial loans and foreign direct investment. In regards to foreign direct investment, for example, private flows from DAC countries in 2006 (covering export credits, direct investment and portfolio investments) stood at just under US$195 billion (OECD, 2007: 138). To this must be added the unknown flows from the so-called 'new donors' such as China, Brazil and India. Firm figures for these countries are difficult to ascertain with any degree of certainty given that they are not members of the OECD and are therefore under no obligation to reports such flows to DAC.

International aid architecture is becoming ever more complex, given the multiplication of both the number of actors as well as the financing mechanisms. In recent years there has been a growing recognition that the system is both exceedingly convoluted as well as imposing high transactions costs on all parties.

Broadly speaking, attempts to reform the international aid system have been rooted in two fundamental concerns, namely the efficiency of aid delivery systems and the impact of aid. In other words, on the one hand what recipients (i.e., partner countries) and donors can do to improve the manner in which aid is delivered, received and accounted for, and on the other how to ensure that it achieves its intended objectives.

## 1.2 TRENDS IN ZIMBABWE

Multilateral and bilateral ODA to Zimbabwe decreased sharply as the economic and political crisis deepened after 2000. The World Bank Group

[1] The Organization for Economic Co-operation and Development – Development Assistance Committee (OECD-DAC) brings together 22 OECD member countries plus the European Commission. Its objective is to work towards an expansion of resource flows to developing countries and to improve the effectiveness of the same.

imposed restrictive measures in May 2000 due to the accumulation of payment arrears and loans, and all undisbursed loans and grants were cancelled. Zimbabwe subsequently made substantial payments to the International Monetary Fund (IMF) to offset its arrears in the General Resources Account (GRA), but only made token payments to the World Bank and the African Development Bank in contravention of the World Bank Group's non-discriminatory debt-servicing clause. The World Bank put Zimbabwe on non-accrual status in October 2000, and the IMF closed its Resident Representative Office in Harare in October 2004. Similarly, the European Union's Country Strategy programming process, which had been agreed in July 2001, was suspended in February the following year.

Due to these setbacks, the World Bank and the IMF's engagement with Zimbabwe has been limited mainly to policy advice and dialogue in an effort to improve relations and explore ways in which Zimbabwe could design a mutually agreeable arrears clearance plan to enable re-engagement. The IMF Executive Board meeting in February 2007 felt unable to restore Zimbabwe's voting rights or its eligibility to use the general resources of the Fund. It also noted that Zimbabwe's payments towards settlement of its Poverty Reduction and Growth Facility (PRGF) arrears had been minimal.[2]

OECD bilateral donors withdrew their development aid, but continued their humanitarian assistance. The poorest and most vulnerable elements of society have been provided with vaccines, prophylactics, anti-retroviral drugs to fight HIV and AIDS and, crucially, emergency food assistance. Limited funds have also been channelled towards local community-based recovery initiatives, as well as support in the areas of governance, democracy and human rights. By 2006, this humanitarian and governance ODA as a percentage of GDP is estimated to have stood at six percent.[3] It is noteworthy that in contrast to prevailing international trends, and as a result of the estrangement between the Zimbabwe and Western governments, ODA has been channelled outside government systems directly to beneficiaries through United Nations (UN) agencies and Non-Governmental Organisations (NGOs).

[2] The IMF's PRGF was established in 1999 and replaced the Fund's Economic and Structural Adjustment Facility (ESAF) and was aimed at making the IMF's lending operations more focused on poverty reduction and growth. PRGF-supported programmes are anchored on Poverty Reduction Strategy Papers (PRSPs) and assistance is provided through concessional loans to countries with protracted balance of payments problems. Areas covered by the PRGF include macroeconomic frameworks and financial policies, exchange rate and tax policy, fiscal management, budget execution, etc.

[3] It should be noted that given the rapid deterioration in the country's humanitarian situation between 2006–2008 and significant increases in international humanitarian assistance, coupled with a shrinking GDP, ODA currently stands at probably around 15-20 percent of GDP.

# Section 2

# From Project Aid to Budget Support

The last decade has seen significant shifts in terms of aid delivery mechanisms to improve aid effectiveness. Most significant amongst these has been a gradual policy shift away from *project-based approaches,* which are characterized by discrete, externally financed interventions, to *programme-based approaches*, especially sector wide approaches and direct budget support. In general terms, programme-based approaches may be defined as development cooperation based or coordinated support for a single, nationally owned strategy, be this a national development or poverty reduction strategy, one covering a specific sector (e.g., health or education) or a thematic area such as Governance. More specifically in terms of implementation modalities, these approaches are also characterized by the fact that they possess a single budget and monitoring and evaluation framework, as well as formalized partner country-donor coordination mechanisms.

## 2.1 PROJECT AID AND ITS LIMITATIONS

The shortcomings inherent in project-based aid delivery include the fact that there is often little coordination between donors operating in a given country, as well as coordination between the donors and the partner country government in terms of prioritization. Both disconnects often lead to extensive duplication, poor targeting and waste. Project-based delivery is also often associated with a brain drain from the public to the donor sector, as the donor agencies draw away already scarce national technical capacity in support of their own initiatives by offering salaries which are often many multiples of local average wages.

Given the ad hoc manner in which projects are often implemented – and the disconnect between sector line ministries and their Ministry of Finance, particularly in the areas of planning and budgeting – there is often a growth in the contingent liabilities that governments subsequently found increasingly difficult to sustain. Once projects have been handed over to the partner country, recurrent expenditures, such as maintenance costs for infrastructure projects and personnel costs for social service delivery projects, are often extremely onerous for governments to sustain. There is also a growing recognition amongst donor countries that project-based aid also carries with it the risk of undermining both the ability and incentives for partner countries to perform a number of key government functions. These range from expanding the tax base and revenue collection, planning and prioritizing through the budgetary allocation process, and to implementing, monitoring and evaluating programmes.

Given the pervasiveness of the project-based aid modality, it is clear that political pressures and institutional incentives act on both donors and partner country governments which play out in its favour. Amongst these are the pull factors on the side of partner countries. The parallel funding and management mechanisms generate both material and non-material incentives for ministers and civil servants of partner countries, such as vehicles, salary top-ups, training, and travel opportunities. In addition, the high visibility impact of stand alone projects redounds to the benefit of ministers, civil servants and local interest groups, who are able to claim immediate credit for these, notwithstanding doubts over their longer-term sustainability. This stands in stark contrast to the deeper but more protracted benefits that flow from sector-wide or country-wide reform processes such as Public Financial Management or capacity-building in the areas of planning, monitoring and evaluation.

Other specific advantages for partner country ministries include the fact that aid flows from a stand-alone project are relatively predictable and simple to track. In addition, partner country ministry officials can avoid having to justify funding for these projects within their central government planning and budgetary processes. One not insignificant advantage is that they avoid parliamentary oversight when the flow of donor funds is not reported to their Ministries of Finance, thereby diluting accountability for ODA resources.

Pull factors in favour of project-based aid also operate on donors. As with partner country ministries, the high visibility of stand-alone projects assists bilateral and multilateral development agencies in terms of their own internal budgetary allocation processes. In addition, the attribution and evaluation of the impact of stand-alone projects is easier and faster than in the case of longer-term, multi-donor, programmatic aid flows. There also needs to be a greater acceptance of the 'fiduciary risks'[4] inherent in the programmatic initiatives that entail greater reliance on the financial systems of partner countries, whereas oversight over 'ring-fenced' project-based resources is seen as easier. By using project-based aid, donor agencies and their staff are also able to avoid engagement in complex dialogue processes around the need for reforms in the areas of national policy frameworks and administrative systems in partner countries. Finally, an argument often advanced by both donor and partner countries is that project-based aid – precisely because it bypasses national systems – allows direct assistance to the poor.

The interplay of these forces sometimes leads to what might be characterized as a vicious cycle of aid projectization. Donors are often confronted with a difficult operational environment where partner's policies are either technically weak or absent. Coupled with weak national capacities, institutions and accountability systems – and in many places pervasive corruption and patronage – the donors' default position is to prefer project over programmatic aid because it offers them greater control over resources and targeting. This in turn results in multiple projects that often bypass the planning and financial systems of the central governments of partner countries, and which are often not aligned to national policies and priorities. Project coordination or implementation units outside government structures are then established to provide the necessary support to these projects.

The pull factors operating on both sides of the donor and partner countries aid relationship then lead to situations in which neither donors nor partner countries make an effort to improve national policies or systems. Sector ministries became accountable to multiple donors and not central government or parliament, and their ability and interest in performing core functions such as planning, budgeting and revenue collection is undermined.

## 2.2 COMMON FUNDS

Moves to address the constraints with stand-alone projects and introduce programme-based approaches began in the early 1990's with the rise of *basket* or *pooled* funding, also known as donor *Common Funds* (CFs). These may be used to support activities in a whole sector, e.g., health, a thematic area such as rural development, or a sub-theme such as condom or vaccine procurement and distribution. The key motivation of CFs is to reduce transaction costs on both donors and partner countries, and to strengthen alignment by ensuring that CFs are supporting a national priority for a sector or sub-sector. One key characteristic is that donor CF resources are usually kept separate from other resources intended for the same purpose, and are channelled in any one of three ways:

- Using parallel systems, with donors taking control of design, appraisal and quantity of inputs and using their own disbursement and accounting procedures. Under this modality, CFs stand alone outside sector or national budgets;
- Through NGOs or other non-state service providers; or
- Through government systems and in support of government policies and priorities, *but with specific earmarking of expenditure for a discrete set of activities*. In such situations, the inputs, outputs and objectives of such aid are defined and evaluated separately.

[4] The idea of fiduciary risk means that expenditure may not be properly accounted for, or does not represent value for money, and that it may not be used for the original intended purpose.

## 2.3 THE RISE OF SWAPS

If one could characterize the development of aid instruments in evolutionary terms, the next step up the ladder one finds Sector-Wide Approaches, more commonly known by their acronym SWAPs. These have the following defining characteristics:

- All significant funding for a sector supports a single sector or thematic policy, expenditure, implementation, and monitoring and evaluation framework;
- These frameworks are the result of an iterative process of negotiations between national institutions (usually line ministries) and donors;
- Sectoral/thematic activities are implemented under government leadership;
- All donors gradually move towards common approaches in terms of participation in the process of sector diagnostics, the establishment of priorities, and the means of achieving them; and
- All donors also move gradually towards reliance on Government procedures for disbursement and the accounting of funds.

Two additional planning tools come into play under SWAPs. Firstly, governments need to develop 3-year Medium-Term Expenditure Frameworks (MTEFs) through donor-ministry negotiations. They are meant to show projected partner government contributions to the sector/thematic strategy, and the shortfall to be covered by donor funds. A Sector Investment Plan (SIP) is an integral part of the MTEF, and shows the capital investment requirements.

## 2.4 BUDGET SUPPORT AND ITS ADVANTAGES

Taking the evolutionary analogy one step further, one arrives at various budget support modalities. Budget support can take two main forms:

- General Budget Support (GBS) which is *unearmarked* donor aid disbursed through a partner country's public financial management (PFM) system via the partner country's Treasury. Besides financial resources, a programme of GBS may also include provision for donor-government dialogue processes, technical assistance and the alignment of donor interventions.
- Based on SWAPs, Sector Budget Support (SBS) involves *earmarked* donor funds delivered through a beneficiary government's PFM system, but strictly linked to a sector or multi-sector policy framework. SBS is provided with sector-conditionality, agreement on and execution of an agreed policy and ex*penditure framework through a SWAP process.*

GBS and SBS are jointly referred to as Direct Budget Support (DBS), and are normally provided in support of Poverty Reduction Strategies (see below) and/or sector strategies. One key distinguishing feature of both is that donor funds are mixed with domestic resources.

Advocates of budget support name a number of advantages for partner countries. By directly contributing to the national budget, accountability shifts from the government-donor partnership to the relationship between partner governments, their parliaments and wider citizenry. The direct injection of budget support resources into national financial systems allows partner governments to treat these resources as they would domestic revenues with which to undertake both capital and recurrent expenditures. Direct budget support is thus also intended to make it easier for partner countries to manage their own planning and budgetary processes.

A fundamental consideration that has received increased attention since the G-8 promised large ODA increases at Gleneagles in 2005 is the capacity of donor countries to plan, implement and monitor a multitude of projects. Partner countries are in danger of being swamped by projects which may not respond to national priorities, undermine national institutions, systems and accountability, and have limited impact and sustainability. This point was made forcefully by the European Commissioner for Development and Humanitarian Aid in 2008:

> *'At the moment there are 600 projects involving less than €1 million in the health sector in Mozambique alone. This means that*

*the time and energy of the Minister of Health and his department are taken up in discussions with various donors involved in the sector. If in future, as the volume of aid increases, we all continue to fund our own micro projects, each with our own requirements, staking our own little claims, we can say goodbye to any aid efficiency agenda. Budget support and more of it is the only answer.'*[5]

Changes in the volumes of aid being delivered as budget support (as a percentage of total aid flows) have been significant in a number of countries, and have gone hand in hand with the rise of Poverty Reduction Strategy Papers (PRSPs).[6] In the case of Uganda, for example, between the launching of its 2nd PRSP in 2000, and its 3rd PRSP in 2004, general budget support rose from U$176 million to U$409 million, which represented 45 percent of total aid flows.[7] The evidence to date indicates that the budget support modality does meet its stated objectives of reducing the demands on the scarce national capacity of many partner countries and lowers the transaction costs on both sides of the donor-partner country relationship. While it remains difficult to establish the precise impact of PRSPs on the one hand, and of budget support on the other, in terms of improvements in the systems and procedures of partner countries, it is nevertheless clear that when both have been present there have been significant improvements in terms of national planning, budgeting and accounting systems.

However, while the global shift towards GBS has been significant, it still remains relatively low as a percentage of total OECD-DAC ODA to low-income countries. In 2007, for example, the Strategic Partnership for Africa carried out a survey of a sample of committed GBS donors in Africa. One of its findings was that GBS still represented only between 20-25 percent of total ODA flows to Africa from that particular group of donors.[8] Clearly fiduciary risk considerations, as well as other factors, still loom large in the calculations of donors in terms of transferring funds through the systems of partner countries, while the pull factors on the side of partner countries that operate in favour of projects, as opposed to programme-based aid mentioned above, also still exert strong pressures.

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5 Louis Michel, Foreword, 'Budget Support – A Question of Mutual Trust', Luxembourg: Office for Official Publications of the European Communities, 2008, p.4.

6 These are similar to national development plans, except that they are drawn up with the support of the Bretton Woods Institutions (BWIs) and bilateral donors.

7 International Development Department, School of Public Policy, University of Birmingham, UK, 'Evaluation of General Budget Support, Synthesis Report – Executive Summary', May 2006, p.S2.

8 Strategic Partnership with Africa – Budget Support Working Group, 'Survey of Budget Support 2006', Washington DC, 2007.

## Section 3

# The Role of Poverty Reduction Strategy Papers (PRSPs) in Aid Delivery

Though it is difficult to attribute precise causality in the evolution of aid delivery modalities, it seems clear that the rise of PRSPs in the late 1990's played a key role in driving forward the principles contained in the Paris Declaration, which is the current international normative framework guiding donor-partner country relations (see below).[9]

At the 1999 annual meetings of the Boards of the World Bank and IMF, it was agreed that all future concessionary lending by the Bretton Woods Institutions (BWIs), as well as debt relief, would be conditional on the development of nationally-owned PRSPs. The comprehensiveness of PRSPs (multi-year, multi-sectoral, linked to medium-term expenditure plans and monitoring and evaluation frameworks and annual progress reports), and because they are meant to be country-owned and results-oriented, means that they have become for many donors the national development strategies referred to and called for in the Paris Declaration. Given their centrality in current international aid architecture around which the Paris Principles can be implemented, it is worth exploring the process of developing PRSPs, and their content and impact in more detail.

## 3.1 THE DEVELOPMENT OF A PRSP

At the design stage, some basic groundwork needs to be carried out in order to develop an understanding of the extent and nature of poverty in a given country and its key determinants. The quality of this 'poverty profile' is heavily dependant on the quality of data. According to the guidelines (World Bank, 2002), this profile should go beyond income metric and asset-holding measurements of poverty and consider aspects such as health and education status (the so-called capabilities approach to poverty) and disempowerment (access to institutions and capacity to influence public policy processes).

An effort should be made to disaggregate poverty by gender and region, as well as carry out labour market diagnostics,[10] the impact of macro-economic variables on the national poverty profile, as well as the growth and distributional impact of past policies. Additional areas requiring analysis include the equity, efficiency and effectiveness of past and current patterns of public expenditure, the soundness of a country's public financial management system and service delivery systems. Bringing together these findings should then enable the establishment of linkages between all these variables and their impact on poverty, and thereby the constraints which prevent movement out of poverty.

The next step in the design process is to set targets for the PRSP, and embed these in both existing and future macroeconomic and sectoral policies. Key public actions need to be designed and prioritized. This design stage should be informed by the targets that are set, what is known about inter-sectoral linkages and their impact on poverty, what is known from the poverty diagnostics in order to ensure proper targeting and sequencing, the estimated costs of the interventions, the available domestic resources and a realistic estimate of the external resource envelopes required to cover the funding gap. Institutional capacities should also be

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[9] A UNDP report in 2000 also played an essential role in moving the problem of poverty to the front burner. Amongst other insights, the report noted that less than one-third of developing countries had targets for eradicating poverty, that many anti-poverty measures were vague statements of intent, and that many poverty reduction programmes were too narrow and could more properly be seen as a set of social safety net style interventions. See 'Overcoming Human Poverty', UNDP Poverty Report, 2000, New York, USA.

[10] Given the centrality of employment in poverty reduction strategies, what is required is to arrive at labour force participation rates, unemployment rates, earnings and productivity, formal versus informal sector shares in employment, etc.

assessed. Indicators are then developed to measure progress, which can be for the whole lifespan of the PRSP, as well as for monitoring and evaluating on an annual basis.[11]

In addition to specific sectoral policies, a PRSP must contain a macroeconomic framework. This is meant to be supportive of the growth and poverty reduction targets, and normally includes inflation targets and an external position, projected growth rates and a fiscal stance. Recent PRSPs have also laid out possible trade-offs between short-term and long-term poverty reduction targets, as well as the possible impact of variations in growth rates and their likely impact on the targets. Many also contain structural reform measures to be implemented in the context of the PRSP, such as financial sector reform, privatization, trade and regulatory reforms as well as improvements in governance and public financial management.

An overarching principle of participatory formulation is meant to inform both the design and implementation processes. In addition to parliaments, partner country governments were enjoined to include non-state national actors in discussions about poverty, diagnostic work, the design and implementation phases as well as the monitoring and evaluation of progress. Such participation is seen as a means of building national (not just governmental) commitment to poverty reduction, as well as mutual accountability between national partners, and to move away from the prevailing primary focus on government-donor accountability.

## 3.2 THE ROLE OF THE BRETTON WOODS INSTITUTIONS (BWIs)

Both the World Bank and IMF staff assist countries during the design of PRSPs. Their technical assistance is most prominent during the phase of poverty assessments and diagnostics. They also provide advice on reforms to public financial management systems and on public expenditure surveys and budget management. Guidance on the macroeconomic framework is largely assigned to the IMF. Once a full PRSP has been developed, the staff of the World Bank and IMF conduct a Joint Staff Assessment (JSA). This is intended to play two key roles. On the one hand they provide the Boards with a technical assessment of a given PRSP as a basis for debt relief initiatives and future concessionary assistance from the BWIs, thus allowing the Boards to exercise ‘due diligence’. They also provide an opportunity for the BWIs to provide feedback to the country in question as to how the PRSP might be improved.

## 3.3 THE IMPACT OF PRSPS

As the process of designing a PRSP by the partner country needs to be comprehensive, rigorous and consultative, the average time required between an interim PRSP[12] and a full PRSP is around twenty months.[13] The ubiquity of this mechanism, and the fact that they lie at the heart of current international development discourse and assistance, can be seen by the fact that as of March 2008, over 70 full PRSPs had been submitted to the Boards of the BWIs for Washington ‘sign-off’.

As PRSPs have been rolled out in partner countries, both donors and the BWIs have been able to rewrite their country assistance strategies in support of these single, national, overarching strategic documents and the priorities contained therein. They have enabled donors to make significant progress in harmonizing their joint aid efforts and reducing their transaction costs by gradually moving away from the project-based modalities to budget support, and by being able to accept the structure of

[11] Some of the most common indicators used are the poverty headcount ratio, i.e., the percentage of the population below a given national poverty line, unemployment rates, and capability indicators such as primary school completion rates, illiteracy rates, vaccination coverage, maternal mortality rates and life expectancy at birth.

[12] Given the recognition that country-owned, participatory PRSPs take time to develop, and in order not to delay progress on debt relief, the Boards of the World Bank and IMF allow countries to prepare interim PRSPs. These should contain: 1. a statement of commitment to poverty reduction, 2. an outline of the nature of poverty, 3. existing government strategies to tackle poverty and 4. a timeline and process for preparing a full PRSP, a 3-year policy matrix and a macroeconomic framework.

[13] Experience has shown that the time required depends on the existence and quality of extant poverty data, national planning capacity, the level of integration of Government structures (in particular between line ministries and ministries of finance and planning), as well as the status of consultation mechanisms between Government and national non-state actors.

previously negotiated Annual Progress Reports. The rise of PRSPs as the main form of national development strategies in partner countries has led to a much greater focus on poverty issues within the international development community, by partner governments and civil society actors. Where PRPSs have been rolled out, another significant development has been a greatly improved engagement between partner country governments and national non-state actors in terms of policy debates around poverty reduction.

And on a more technical level and in terms of national systems, the very process of designing, implementing, and monitoring and evaluating PRSPs has led to a noticeable improvement in national poverty analysis, enhanced national databases and statistical skills. National public financial management and planning, and budgeting systems have also been strengthened. Improved inter-ministerial coordination mechanisms arising from the multi-sectoral content of PRSPs, and the basic need for the various bodies of government to cooperate in the process of designing and implementing these strategies, might also be added to these positive developments.

Given the large number of countries involved in the global PRSP exercise, the picture of their specific impact on national poverty levels could not but be mixed. But one example of what can be done given a government's commitment to poverty reduction is that of Mozambique. Mozambique developed its first interim PRSP in 1999, which was one of the first to be approved by the Boards of the World Bank and IMF. This allowed the country to access Highly Indebted Poor Country (HIPC) debt relief and additional BWI concessional finance (see section 4 on debt relief efforts). A full PRSP followed in 2000, covering the period 2001–2005. This contained detailed targets, a timeframe and resource requirements.

Between 1997 and 2003, the poverty headcount fell from 69 percent of the population to 54 percent, an early achievement of the poverty reduction target set for 2005. In line with the government's commitment to rebuild human capital after the civil war, non-income poverty indicators, based on the capabilities approach to poverty, also showed marked improvements. In the area of education, for example, spending increased from US$170 million in 2000 to US$250 million by 2004. It is noteworthy that this increase in spending on education took place against the background of falling external financing for the sector, from 42 percent of total public expenditure on the sector to 38 percent over the 5-year period. This might be interpreted as a strong commitment to poverty reduction, irrespective of external concessionary financing.

An additional and highly instructive aspect of the country's experience lay in the fact that, starting from a very low base – given the residual effects of the protracted civil war from which it emerged – Mozambique was able to sustain very healthy growth rates over the period of its 1st PRSP, averaging above 8 percent per annum. These robust rates of growth were not only a key contributor to reducing poverty through enhanced employment opportunities and improved wages, but also allowed the state to expand its revenue base and increase the volume of its revenue stream. By increasing its fiscal space, the state was able to channel resources to both directly productive public investments as well as increasing expenditures on health and education.

## Section 4

# International Debt Relief Efforts and Debt Management

Given that Zimbabwe will, on the basis of its existing debt profile, be a candidate for international debt relief (see below), a sound understanding of the architecture and mechanisms of international debt relief efforts will be essential for national decision-makers and the wider public. It is therefore worth outlining the historical developments of this aspect of donor-partner country financial flows.

### 4.1 THE PARIS CLUB AND NAPLES TERMS

One long-standing actor in the area of external debt relief to developing countries is the Paris Club. This is an informal grouping of official bilateral creditors from the world's eighteen richest economies, which meet regularly to find coordinated responses to payment difficulties experienced by debtor countries. In terms of their standard practice, Paris Club members agree to either provide debt relief through:

1. Postponement of payments, i.e., rescheduling; or

2. Concessional rescheduling, i.e., a reduction in debt service obligations through downsizing of debt stocks.

As of 2007, Paris Club members had reached around 400 agreements with 85 debtor countries with the total amount covered in these agreements since 1983 totalling around US$500 billion.

In 1994 Paris Club members agreed to adopt a new position on the debt of the world's poorest countries. These became known as the Naples Terms, which were underpinned by the notion of 'debt overhang', i.e., a situation in which a government's external debt exceeded its future capacity to repay its obligations.[14] The eligibility criteria applied were that candidate countries should:

1. Possess a high level of external indebtedness

2. Only be eligible for IDA financing from the World Bank.[15]

3. Have a low GDP per capita (US$755 or less).

In addition, account would be taken of the track record of the debtor country with both the Paris Club and the IMF in terms of their ability to respect the debt agreement.

Under Naples terms, two basic routes were laid out for debt relief.

1. The debt reduction option: 67 percent of bilateral *non-ODA* (Official Development Assistance) *claims*[16] are **cancelled**, with the outstanding part being **rescheduled** at an 'appropriate market rate' with a 23-year repayment period and a 6-year grace period;

2. The debt service reduction option: 67 percent of *non-ODA claims* are **rescheduled** at a reduced interest rate with a 33-year repayment period.

The specific provisions governing ODA claims are that they are to be rescheduled at interest rates at least as favourable as the original interest rate applying to those loans, over a 40-year period with

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14 Many Highly Indebted Poor Countries (HIPCs) had to resort to expensive, short-term commercial borrowing in order to fulfil annual debt-servicing obligations, and thus become sucked into a debt trap. Naples Terms were an attempt to offer an exit strategy through the reduction of Net Present Value (NPV) of debt stock. The NPV applied to debt stock is the sum of all future debt service obligations (both the principal and interest). The NPV measures the degree of concessionality of a country's debt stock. When the interest rate on a loan is lower than the market rate, the resulting NPV of the debt stock is smaller than the face value, the difference between the two therefore representing the grant element.

15 The International Development Association (IDA) is the World Bank's lending window for long-term interest-free loans and grants.

16 i.e., non-concessional debt from Paris Club members.

a 16-year grace period. Such rescheduling is intended to result in a reduction of the net present value (NPV) of the claims, as the original concessional rate is lower than the appropriate market rate of the debt.

## 4.2 THE HIGHLY INDEBTED POOR COUNTRY (HIPC) INITIATIVE

The next stage in the development of international debt relief efforts took place in 1996, when the BWIs recognize that even after the application of Naples Terms by the Paris Club, and despite the provisioning of concessionary financing and their pursuit of sound economic policies, the external debt situation of a number of low-income countries would not allow them to achieve sustainable external debts levels within the reasonable period of time and without additional external support.

These considerations then lead to the establishment of the Highly Indebted Poor Country (HIPC) initiative, the key objective being to provide exceptional assistance to eligible countries following the adoption of sound economic policies (soundness being determined by the IMF and World Bank) to help them reduce their external debt burden to sustainable levels.[17] In terms of eligibility criteria for HIPC, a country's debt levels were considered still unsustainable if either:

1. the ratio of its debt to exports were above a threshold of 250 percent; or

2. the ratio of its debt to government revenue was above 280 percent.

In 1999 both the IMF and the World Bank agreed to strengthen the original HIPC initiative and commit to even deeper debt relief under the *Enhanced HIPC* initiative. This initiative is based on the recognition that the empirical work underpinning the original HIPC was derived from prior debt sustainability analysis (DSA) based on middle-income countries. The reality was that low-income countries had a much lower capacity to sustain external debt. As a result, under enhanced HIPC, the eligibility threshold was reduced further:

1. The ratio of debt to exports was reduced to 150 percent; and

2. The ratio of debt to revenue was reduced to 250 percent.

Most significantly, an explicit condition was established in 1999 that linked the granting of debt relief to the need for HIPC countries to use funds freed up from debt relief for poverty reduction efforts in the context of Poverty Reduction Strategy Papers (PRSP).

The process for accessing this relief on the part of HIPCs requires, firstly, confirmation that a country meets the eligibility criteria; that it adopts an adjustment and reform programme supported by the IMF and World Bank, and pursues these for a minimum of six months; and demonstrates a record of macroeconomic stability. It must also have either already cleared, or reached an agreement to clear, outstanding arrears to the World Bank, IMF and other multilaterals, and have developed an interim PRSP. The staff of the World Bank and IMF then conduct a debt sustainability analysis in order to determine the level of indebtedness of the economy through an examination of the loan portfolio and the level of debt relief required to bring down a country's debt indicators to below HIPC thresholds.[18]

The Boards of the IMF and World Bank then formally decide on a country's eligibility (known as the **decision point**). Other creditors (bilateral members of the Paris Club, other multilaterals such as regional development banks, other official non-Paris Club members as well as commercial creditors) then commit to provide sufficient

[17] Sustainability being defined in terms of levels of debt that would comfortably enable those countries to service their debt through export earnings, aid and capital inflows.

[18] Debt Sustainability Analysis for HIPC have uniform thresholds in order to ensure equity of treatment. They also integrate risk scenarios, and given the vulnerability of low-income countries to external shocks, they use a backward-looking 3-year average of both exports and revenue in order to iron out volatility in both export earnings and revenues.

assistance by the **completion point**. Delivery of debt relief by the IMF and World Bank will depend on assurances of action by these other creditors.

During the interim period the country in question will begin to receive conditional interim debt relief 'based on a country's immediate needs and capacity for channelling the funds to poverty-reducing purposes'. A full PRSP is developed after which it is submitted to the IMF and World Bank boards for approval. At the completion point, the HIPC country must have maintained macro-economic stability under an IMF Poverty Reduction and Growth Facility (PRGF) supported programme for a period of time, and carried out key structural and social reforms agreed upon at decision point in the context of a PRSP which has been satisfactorily implemented for one year. Full, irrevocable debt relief is then granted.[19]

As of 2008, the total cost to creditors of the HIPC debt relief initiative was estimated at U$71 billion in end 2007 Net Present Value (NPV) terms (IDA and IMF, 2008: 18).

## 4.3 THE MULTILATERAL DEBT RELIEF INITIATIVE (MDRI)

At their 2005 summit, the G-8 countries proposed that the IMF, World Bank and the African Development Fund of the African Development Bank cancel 100 percent of their debt claims on countries that either already had, or would eventually reach completion point under the HIPC initiative. This covered debt accumulated prior to end-2004, and became known as the MDRI.

As of the end January 2009, 23 countries that had reached HIPC completion point had benefited from the MDRI, with an additional 10 HIPC currently at decision point (known as Interim Countries) also eligible for MDRI once they reached HIPC completion point. As of the end of July 2008, the total amount of relief granted under the MDRI stood at US$49 billion (IDA and IMF, 2008: 10).

## 4.4 IMPACT, SLIPPAGE AND MORAL HAZARD CONSIDERATIONS

In terms of the number of beneficiaries, as of the end of 2006 there were 22 post-completion point HIPCs (of which 18 were sub-Saharan African countries) that also benefited from the relief offered by the MDRI, 10 post-decision point HIPCs (of which 8 were sub-Saharan African countries) and 9 pre-decision point countries (of which 7 were sub-Saharan African countries).

The total costs as of the end of 2006 under HIPC were US$45.5 billion in NPV terms and US$61.1 billion in nominal terms, while under MDRI the figures were US$21.1 billion and US$41.7 billion respectively. The impact on the debt stocks of HIPCs has been significant, with the total debt stocks of 32 post-decision point HIPCs having been reduced by over 90 percent by the end of 2006. In terms of total volumes, before the application of Naples Terms this stood at US$106 billion in NPV terms, after Naples it had been cut to US$86 billion, after the HIPC initiative it had fallen to US$41 billion, and after the MDRI and additional bilateral debt relief it had fallen to US$9 billion.

Another significant measure of the impact of these international debt relief efforts is the average debt service obligations of post-decision point HIPC as of 2006. The average debt service to exports ratio fell from 16.6 percent in 1999 to 6.4 percent in 2006; the debt service to GDP ratio also dropping from 4.6 percent to 1.9 percent; and the NPV of debt to exports being cut from 440 percent to 132 percent over the same period.

Given the intimate linkage between HIPC and MDRI debt relief and PRSPs whereby the former were intended to release funds for HIPCs to invest in national poverty reduction efforts, it would be instructive to ascertain the extent to which this has taken place. The evidence to date does suggest that there is a robust correlation between a reduction in debt servicing requirements and an increase in poverty-reducing spending through an

[19] The average length of time between decision and completion point varies greatly, from 3 months in the case of Uganda, to 5.7 years in the case of Malawi. The key variable seems to be domestic capacity to both produce a technically sound PRSP and to implement the recommended reforms.

improvement in the fiscal space for priority expenditures of countries benefiting from debt relief. The impact of debt relief on national poverty reduction efforts may be gauged in terms of changes in two variables:

1. World Bank and IMF data shows that such expenditures have increased by about 2 percent of GDP in HIPCs since the late 1990s as debt servicing as a percentage of GDP has decreased by a similar amount (IDA and IMF, 2008: 14).

2. Indicators on the macroeconomic front are also positive, with the average inflation rate for post-completion countries having fallen from 13.8 percent over the period 1994–1998 to 6.6 percent over the period 1996–2005. Real GDP growth rates have averaged about 4.3 percent for those countries that reached completion point, as opposed to their average of 1.7 percent between 1980–1993.

These positive results must be tempered, however, by the fact that these countries have not registered significant improvements in their domestic resource mobilization, which has remained largely constant. Export performance has remained at an average of around 26 percent of GDP. More seriously, and given that the various international debt relief efforts were aimed at ensuring a permanent exit from rescheduling, it cannot but be a source of concern that some slippage has been evident. In 11 of 13 post-completion point countries for which data was available in 2005, external debt sustainability had deteriorated since completion point, and 8 of these were once again above HIPC thresholds. One possible lesson to be drawn is that international debt relief efforts, in and of themselves, are not sufficient to improve export diversification, national debt management capacity or the ability of developing economies to cope with external shocks through either a deterioration of terms of trade or fluctuations in exchange rates.

It is worth recalling that poor debt management and imprudent borrowing played a major role – together with external shocks and the lack of a diversified export base – in the build-up of unsustainable debt in the first place. Debt reduction can only provide temporary relief and an opportunity for countries to undertake the reforms necessary to avoid slippage. One key area that contributes to avoiding this danger is national debt management capacity, the strengthening of which will help to ensure more prudent future borrowing. In many countries, as noted by a World Bank evaluation of the HIPC initiative:

> *'HIPC countries have a fair loan-by-loan record of their sovereign external debt, but not of loans taken on by state enterprises and the private sector... [in addition] Agencies responsible for debt management…are not able to analyse the impact of new borrowing on long-term debt sustainability and on macro-economic scenarios. Countries debt management units need to strengthen institutional frameworks, improve staffs' analytical skills and upgrade technical software'.*[20]

In addition to the dangers of slippage, the issue of 'moral hazard' has also loomed large in the considerations of both bilateral donors and International Financial Institutions (IFIs), i.e., that continual extensions of international debt relief efforts might constitute incentives for debtor countries to increase their borrowing to unsustainable levels and then avail themselves once again of debt relief. One key Multilateral Development Bank (MDB), the African Development Bank, stated as much in a policy document on the dangers of non-concessional debt accumulation by its member states:

> *'ADF [African Development Fund] grants and debt relief may introduce an incentive for countries to over-borrow from other creditors which could cause their debt to be unsustainable and compel ADF and other MDBs to increase the grant share of their assistance.'* (African Development Bank, 2008: 1)

[20] World Bank, Independent Evaluation Group, 'Debt Relief for the Poorest: An Evaluation Update of the HIPC Initiative', Washington DC, 2006, pp.27-28.

Notwithstanding these concerns, the Boards of the World Bank and IMF chose to extend the 'sunset clause' of the HIPC initiative on a number of occasions for 2-year periods at a time in order to allow potentially eligible countries to enter the HIPC process. But in December 2006 these Boards sought to ensure that the HIPC initiative was brought to finality. They decided that only countries that had already been assessed (or are assessed in the future) to have met HIPC income and indebtedness criteria **based on end-2004 criteria**, and that met policy performance criteria and agreed to adopt an IMF-World Bank supervised programme, could enter the HIPC stream.

Zimbabwe entered into arrears with the majority of its multilateral and Paris Club creditors between 2000 and 2002, though it did make some token payments to the IMF, World Bank, the African Development Bank as well as some Paris Club creditors. But as of this writing, its debt ratios are well above the HIPC thresholds. While the HIPC determined NPV of debt to exports threshold at the end of 2004 stood at 150 percent, based on 2006 calculations the IMF estimated that Zimbabwe's ratio already stood at 273 percent. On the assumption that the then prevailing policies remained unchanged, the IMF's baseline scenario expected a strong contraction in exports and negative annual GDP growth of 4 percent to continue until 2011. The ratio of debt to exports was projected to increase to over 440 percent. It is noteworthy that the IMF observed at the time that:

> *'Clearly, if policies improve the debt indicators would improve as well, but the very high debt ratios in the baseline scenario suggest that better policies alone are unlikely to be sufficient to make Zimbabwe's external debt burden sustainable.'* (IMF, 2007: 30)

One technical constraint to Zimbabwe's eligibility for debt relief is that it has been a notionally IBRD/IDA[21] blend country for a number of years. This meant that had Zimbabwe not been in arrears it would have had access to both the World Bank's long-term interest-free loans and grants through its IDA lending window, as well as through the Bank's IBRD lending window, which charges interest on loans. However, a precondition for HIPC debt relief is that the country should be classified as an IDA-only country. For Zimbabwe, this means it will need to be reclassified as a Low-Income Country and therefore also as an IDA-only country before it is eligible for debt relief under the HIPC initiative. With Zimbabwe's re-engagement with the international donor community, and with the necessary political support from the IMF and World Bank boards, a technical case could be made to make it eligible for HIPC debt relief.

[21] IBRD/IDA stands for International Bank for Reconstruction and Development and the International Development Association, respectively.

## Section 5

# Using the Paris Declaration to Maximize Aid Effectiveness

After years of isolation from the mainstream of international development processes, Zimbabwe will have to rapidly familiarize itself with what has happened over the last 10 years. The recent past has seen significant changes to the way aid is delivered and how it is channelled in order to achieve developmental objectives. Yet at the same time, like latecomers to any global process, there will be advantages in terms of being able to quickly play catch-up and update its understanding based on the state of the art, drawing on lessons learned from the experiences of other countries.

Zimbabwe will also be able to benefit from the existence of the Paris Declaration, subject to it becoming a signatory to the agreement. To the extent that there is a single international normative framework guiding relations between OECD donors and partner countries, it is the Paris Declaration. This might be seen as the culmination of numerous evaluations and experiments that took place throughout the 1990's within the donor community as well as partner countries. It was rooted in the widespread disillusionment with the results of development cooperation, particularly in Africa.

In 2005, the Paris Declaration was signed up by 115 donor and partners countries, as well as a large number of international organizations. It seeks to codify a number of principles aimed at improving the effectiveness of aid through focusing on five key commitments. Of these, two may be seen as the primary responsibility of donors, one places the onus in terms of implementation on partner countries, and two are shared, though in fact actions are required from both sides for all five principles. Both donors and partner countries jointly committed themselves to implement these principles in a spirit of mutual accountability. In a welcome development, the Declaration also goes beyond the simple enunciation of general principles, with the signatories agreeing on the need to both monitor and evaluate progress on the basis of an agreed set of progress indicators.

## 5.1 KEY FEATURES OF THE PRINCIPLES

### I - The principle of ownership

The first principle contained in the Paris Declaration is primarily a responsibility of partner countries. Based on decades of experience with the shortcomings of externally generated and imposed development strategies, under the Paris Declaration partner countries undertake to exercise effective leadership over their development strategies. They take the lead in coordinating development activities in consultation with donors, as well as with their respective civil societies and the private sector. Donors on the other hand undertake to respect the leadership of partner countries in terms of their development strategies, while also committing to help them to build their capacity to do so.

The principle makes specific reference to 'national development strategies', which are seen as overarching development strategies that include poverty reduction, and other sector and thematic strategies. This is significant given the general move away from ODA flows in support of discrete projects to supporting longer-term inter-sectoral and nationally devised development strategies. Needless to say, the precise boundaries of what constitutes 'country ownership' have always been difficult to define and to translate into practice. Yet the ubiquity of what are supposed to be internally generated PRSPs is an indication that progress has been made. The specific indicator used for measuring progress in terms of partner country ownership is that by the target date of 2010 at least 75 percent of partner countries have operational development strategies.

### II - The principle of alignment

This principle flows logically from principal 1 on partner country ownership. The ideas underlying the importance of alignment are based on the recognition that parallel donor systems and processes are, in the long term, both unsustainable and counter-productive, and that the efficiency and impact of aid flows will be enhanced if aligned to sound national strategies, systems and processes. Under the principle of alignment, therefore, donors commit themselves to basing their overall support on partner countries national development strategies, and to tailor their support to the priorities identified in those documents. One key indicator for this is the percentage of aid flows to the government sector that is reported on the national budgets of partner countries, with a target of halving the percentage of aid flows not so reported by 2010. In addition, they also undertook to ensure that resource flows would be linked to a single, mutually agreed set of indicators on the basis of which periodic joint reviews of progress could be based.

Under the alignment principle, donors also committed themselves to using the systems and procedures of partner countries. What this entails is the use of Public Financial Management (PFMs) systems, procurement, auditing and monitoring systems of partner countries to avoid creating parallel structures. In the case of PFMs, two targets are set for 2010, namely, that at least 90 percent of donors use these systems, and that aid not going through PFMs is reduced by at least one-third. Similar targets are set for using partner countries procurement systems. Donor countries also commit themselves to work together with partner countries to carry out diagnostic reviews of national capacity in these areas. Where necessary, donors are prepared to assist in strengthening national capacity so that these systems meet generally accepted standards. At the very least, partner countries should have a reform programme underway to reach those standards.[22]

Donors also commit themselves to untying aid in order to increase the effectiveness of these flows,[23] as well as making aid flows more predictable by ensuring that it is released according to agreed schedules. A specific progress indicator is to halve aid scheduled but not disbursed within a particular fiscal year by 2010.

## III - The principle of harmonization

The key objective of this principle is to ensure that donor assistance programmes are more effective collectively. The primary responsibility for the changes necessary to implement harmonization goals rests with donors. Progress on the harmonization agenda requires work in three key areas, namely, the development of common arrangements, the simplification of procedures, and a more effective division of labour to reduce the demands on the capacity of partner countries.

More specifically, the harmonization principle enjoins donors to set up common arrangements within countries in the areas of planning, funding, disbursement, monitoring and reporting to host governments on their aid activities, and to increase their use of ‘programme-based’ aid modalities. A target was set for two-thirds of donors’ aid flows to use programme-based approaches by 2010.

Specific reference is made to the need for donors to address a common source of resentment amongst partner countries, namely multiple, duplicative missions. Forty percent of donor missions should therefore be joint missions by 2010. In coordination with partner countries, donors are called upon to establish a clear division of labour amongst themselves based on the principle of comparative advantage, and to delegate authority to previously agreed ‘lead donors’ to execute programmes.

## IV - The principle of managing for results

Flowing from the growing disillusionment with the results of development cooperation in the 1990’s noted above, the concept of managing for results should be seen as an attempt to ensure that aid flows are managed in such a way that the desired

22 The specific target for monitoring progress in the area of PFMs is that at least half of the partner countries move up at least one measure on the World Bank’s Public Financial Management/Country Policy and Institutional Assessment (PFM/CPIA) scale.

23 The point here is that numerous studies have shown that tying aid to home country, i.e., donor country, supplier pre-conditions, greatly raises the costs of these goods and services in contrast to situations in which partner countries are able to source these on the open market.

results are achieved, and that monitoring and evaluation systems are used to improve impact. Responsibility for achieving this is shared between donors and partner countries.

Donors are called upon to ensure that their own programming systems and their funding flows are linked to specific results. They should also align these results to the performance assessment frameworks of partner countries, both of these being derived from the national development strategies of partner countries. Simultaneously, partner countries are to ensure that their own planning processes are properly linked to budgetary processes. Their monitoring, evaluation and reporting frameworks should also be results-oriented, i.e., based on indicators derived from their national and sectoral development strategies. The target for 2010 is to reduce the number of partner countries without transparent and monitorable performance assessment frameworks by one third.

### V - The principle of mutual accountability

This principle is meant to give substance to the idea that both donors and partner countries are jointly accountable for development results. This mutual accountability should be strengthened and the transparency of development cooperation increased in order to trigger greater public support for both the national development strategies of partner countries and for development assistance in donor countries.

Partner countries are therefore enjoined to strengthen the role of their national legislatures in the process of designing national strategies and their budgetary processes, and to ensure the participation of the general public in the formulation, monitoring and evaluation of the implementation of these strategies. Donors on their part will endeavour to provide comprehensive information on their aid flows in a timely manner that will enable partner country governments to, in turn, present comprehensive budget reports to their parliaments and citizens.

Both donors and partner countries are to move towards mutual assessment reviews in order to monitor progress in terms of progress in implementing these agreed commitments on aid effectiveness, with all partner countries having such review mechanisms by 2010. In practice the mechanisms range from annual consultations around major national strategies, through to joint reviews of sector strategies, and Consultative Group meetings.

## 5.2 HOW HAVE THE PRINCIPLES FARED?

One of the key thrusts of the Paris Declaration was to provide partner countries with greater policy space for formulating and implementing their own strategies. There remains, however, the possibly irresolvable tension between country ownership and leadership of the development agenda on the one hand, and what bilateral donors and the IFIs consider to be technically sound and realistic strategies, that they would be prepared to support, on the other.[24]

Notwithstanding the fundamental asymmetry that characterizes this relationship, annual surveys conducted by the OECD-DAC do indicate that progress has been made on both sides of the relationship, though the picture shows widely differing progress in terms of individual donors and partner countries. In aggregate terms, however, a number of key findings are significant.

On the fundamental first principle of national ownership of the development agenda, one conclusion reached in a highly representative OECD-DAC survey of 2008 – which covered a total of 55 partner countries and more than 50 percent of all aid delivered by OECD members to partner countries in 2007 – was that progress had been made in terms of designing national development strategies since 2005. Weaknesses, however, still remained in linking these to budgeting processes and in the prioritization and sequencing

[24] Some analysts have argued that the concept of national ownership as defined by the Bretton Woods Institutions (BWIs) translates into an acceptance of primary responsibility by countries for the policy reforms put forward by the International Financial Institutions. This is contrasted with more robust definitions that include the designing and implementation of strategies and policies that national governments freely choose based on their own analysis of what reforms are necessary and how and when they should be introduced.

of actions. From a baseline of 33 partner countries used in a previous survey in 2006, the percentage of partner countries possessing operational development strategies had increased from 17 percent in 2005 to 24 percent in 2007. But this was significantly below the progress indicator and target laid down in 2005, namely that by 2010 at least 75 percent of partner countries should have such strategies in place (OECD, 2008: 22).

The highly amorphous and inherently political nature of the concept of ownership helps to throw light on the mixed progress to date, with questions often being raised as to the utility of this progress indicator in capturing the reality of country ownership. This is particularly true in the case of highly aid dependant countries, which have to juggle the need for their development strategies to contain objectives that are both endogenously generated, while at the same time ensuring that they are endorsed by donors. The tension between the two poses real dilemmas for many partner countries:

> *'…highly prescriptive approaches are not consistent with local ownership… On the other hand, national strategies that do not give substantial weight to internationally shared objectives are unlikely to provide an enduring basis for partnership between partner countries and donors.'* (OECD, 2009a: 38)

On the alignment principle, the OECD-DAC survey noted that in general, donors were increasingly gearing their activities in support of national development strategies, as well as using the systems of partner countries. Given the recognition of the key role of PFMs in contributing to both improving the prospects of partner countries achieving public policy objectives as well as progress on alignment, significant efforts have been directed towards improving those systems. Based on the baseline of 2005, which had 40 percent of donors using the PFMs of partner countries, the figure for 2007 had improved to 45 percent (OECD, 2008: 38).

Once again, however, given that the target for this principle is 80 percent by 2010, it is clear that progress has been very slow. Interestingly, the relationship which is assumed to underlie the principle, i.e., that the improved quality of partner country PFMs would logically trigger increased use of these systems by donors, is shown to be less than robust. The survey notes, for example, that while Zambia's PFM system improved from 3.0 to 3.5 on the World Bank's PFM performance scale, which triggered a 25 percent increase in donor use of those systems, in the case of Ghana, notwithstanding an improvement from 3.5 to 4.0 on the same scale, there was a 10 percent decrease in the use of country systems (OECD, 2008: 42).

While improvements in national systems are a necessary condition for donor alignment to partner country systems, they are clearly not a sufficient one. The continued attractions of project delivery modalities, which largely bypass national planning, budgeting, accounting, auditing and procurement systems, may contribute to this. In addition, there is the possibility that donor perceptions of corruption within a partner country, independently of the objective quality of a partner country's PFM, will discourage the use of those national systems.

On the harmonization agenda – as measured by the percentage of aid delivered through programme-based approaches in which donors engage around a single country-owned programme and budget framework – progress has also been made since 2005. The proportion of aid provided in this manner increased from 43 percent in 2005 to 47 percent in 2007 (OECD, 2008: 52). Other harmonization indicators relate to the objective of reducing transaction costs. So, for example, the number of coordinated missions between donors has also risen in the partner countries surveyed. The number of such missions increased from 18 percent in 2005 to 21 percent in 2007 (OECD, 2008: 54). Joint country analytical work by donors, once again aimed at reducing both transaction costs and to avoid duplication, also shows some admittedly limited progress, having increased from 42 percent in 2005 to 44 percent in 2007 (OECD, 2008: 55).

On the 4th Paris Principle covering the areas of accountability on the one hand, and results and assessment orientation on the other, the picture is again mixed. Accountability and improvements in the recording of aid flows in national budgets – to enable partner countries to present accurate and realistic budgets to their national parliaments – show that there has been some progress due to the more comprehensive and timely reporting of aid flows by donors. The percentage of aid recorded on budget improved between 2005 and 2007 from 42 percent to 48 percent amongst the partner countries surveyed, though this still falls far short of the target of 85 percent by 2010 (OECD, 2008: 58). The complementary component that the Paris Declaration sees as contributing to greater budget realism and therefore accountability, under which donors are called upon to provide reliable indicative commitments over multi-year frameworks, shows that the gap between aid scheduled and aid disbursed has also begun to narrow, with an improvement from 41 percent in 2005 to 46 percent in 2007 (OECD, 2008: 61).

The second aspect of the 4th Principle, namely the need to nurture a 'performance culture' in partner countries through the introduction of appropriate monitoring, reporting and assessment frameworks, has shown much more modest progress. Many of the partner countries surveyed continued to not only lack such frameworks, but even the capacity to design them. The 2008 OECD survey concluded that:

> *'As is the case with strategic planning for development, results monitoring succeeds when there is high-level political interest, and not otherwise... Case studies... reveal shortcomings concerning the demand for, as well as the supply of, monitoring information.'* (OECD, 2008: 63)

In terms of the 5th Paris Principle governing mutual accountability for commitments and results, all countries were to have the necessary mechanisms in place to carry out mutual assessments by 2010. On this count, according to the OECD survey, progress has not been encouraging, with the survey noting that the 'expansion of mechanisms for reviewing partnership commitments seems to have come to a halt…' The number of countries with such mechanisms in place has only increased from 12 to 14 between 2005–2007 (OECD, 2008: 64). This lack of progress may be partly attributable to the novelty of the concept of mutual accountability, as well as the power imbalance between donors and partner countries referred to above, which hinders two-way accountability.

It is important to understand the characteristics of the ideal situation that the full implementation of the Paris Declaration would logically lead to. This helps to throw light on the slow progress to date. In this theoretical end game there would be perfect alignment between donors and partner countries around technically sound national development strategies. The national systems of partner countries would be considered completely reliable and would be used by donors to channel ODA resources. Sound monitoring and evaluation systems would be in place, as well as comprehensive and transparent mutual accountability mechanisms. General budget support transfers from donor treasuries to partner countries' treasuries would be the dominant mode of interaction, with partner countries thereby being able to procure technical assistance and project support on the open marketplace. Under this scenario, the intermediation role played by the vast panoply of bilateral, multilateral and non-state development agencies would, logically, also fall away.

Progress to date indicates that certain patterns of behaviour on both sides of the donor-partner country relationship are deeply entrenched and militate against very rapid progress. While the Paris Declaration currently constitutes the most important, if not the only, overarching international normative framework for improving aid effectiveness, and under which both donors and partners can be called to account by their external and domestic constituencies, it is also clear that the initial targets set down in 2005 may have been overly ambitious and failed to take account of the multiple incentives playing out in favour of slow progress.

## Section 6

# Aid and Fragile States

A sub-set of considerations underpinning the Paris Agenda concerns the specificities of aid delivery in 'fragile state' contexts. In terms of the intellectual history of the concept of 'fragile states', in 2000 the World Bank developed the concept of Low-Income Countries Under Stress (LICUS) in order to characterize a specific group of countries that it saw as meriting special treatment.

LICUS were seen as low-income countries (Gross National Income of less than US$825 per capita) characterized by a debilitating combination of weak governance, policies and institutions. Those defined as LICUS are ranked amongst the lowest (<3.0) on the World Bank's Country Policy and Institutional Assessment (CPIA)[25]. One key notion underpinning the concept of a LICUS was that problems of weak policies, institutions and governance had persisted over time. It was not simply a country in a brief spell of crisis.

Running in parallel with the World Bank's work was the OECD-DACs initiative entitled 'DAC Learning and Advisory Process on Difficult Partnerships' which subsequently became known as the 'Fragile States Initiative'. According to the DAC, 'States are fragile when state structures lack political will and/or capacity to provide the basic functions needed for poverty reduction, development and to safeguard the security and human rights of their populations' (OECD-DAC, 2007).

These two processes eventually converged at the 'Senior Level Forum on Development Effectiveness in Fragile States', held in London in 2005 where a set of 'Principles of good international engagement in fragile states' was produced, which were subsequently included as a supplement to the Paris Declaration following their approval in 2007.

Out of a total of 12 key principles, the most significant might be seen to be:

- The need to take context as a starting point – that analysis and proposed actions by donors must be calibrated to specific country circumstances, e.g., whether a specific fragile state is a post-conflict one, or is undergoing prolonged political crisis or characterized by a declining governance environment. It is also necessary, in order to design appropriate interventions, to distinguish between *capacity constraints* and a *lack of political will*.

- Do no harm – There is a need to ensure that development assistance is conflict-sensitive given the very real dangers of external assistance compounding social cleavages or inadvertently contributing to new conflicts.

- Donor countries are called upon to move from reaction to prevention – where possible, help fragile states to build resilient institutions which can withstand political and economic pressures. There is also a need to look beyond short-term palliatives to current problems in order to address the root causes of crises, and to move rapidly where the risk of further deterioration is high.

- An overarching focus on state-building as the central objective – The long-term objective of donors engaged in fragile states must be to assist them to build capacity to deliver basic public goods such as safety, education, health and good governance for their citizens. In addition, there is a need to assist with building an enabling environment for economic growth in order to generate employment as well as revenue streams for the state.

[25] The World Bank's CPIA is used to assess the quality of a country's existing policy and institutional framework, 'quality' being defined as how conducive that framework is for fostering poverty reduction, sustainable growth and effective use of ODA. For partner countries, an evaluation of where they stand in terms of the CPIA framework is key to accessing the IDA (International Development Association – the soft loan wing of the WB) credits, i.e., long-term interest-free loans and grants. This is expressed as the IRAI (IDA Resource Allocation Index).

- Alignment with local priorities and systems in different ways in different contexts– for example, in fragile states in which the political will on the part of beneficiary countries exists but capacity is a constraint, donors should seek to not undermine residual capacity by creating parallel systems.

- Recognize the political-security-development nexus – based on the interconnections between political, economic, security and social spheres, failure in any one of these has a negative impact on the others. Donors are enjoined to support national reformers so that they can develop unified planning frameworks that bring together all these variables, while also ensuring that realistic targets and priorities are set.

- Aid instruments must be mixed and sequenced in order to fix context. Fragile states, particularly those in promising but high-risk transitions, may require a mix of aid instruments, including support for recurrent expenditure. At the same time, attention must be paid to the need to rapidly improve service delivery in health, education and other basic services in order to garner support for reforms, while at the same time avoiding long-term dependence on unsustainable systems.

- There is a need for donors to stay engaged for the long haul in order to give success a chance – given the numerous challenges facing fragile states, in particular their low capacity, donors must be prepared to adopt a longer timeframe than normal before expecting returns.

## 6.1 APPLYING THE FRAGILE STATES PRINCIPLES

Two aid specialists, Leader and Colenso (2005), carrried out pioneering work on aid instruments that are most appropriate in fragile states. As they note, the standard donor choice of aid instruments in fragile state situations has often been based on a 'default, risk-reducing, starting point' (2005: 4). This position is characterized by the restriction of funds, dominance of the project delivery modality as a 'state avoidance' approach, and a shorter time commitment. Given the lack of strong government leadership and capacity in fragile states, the best donors often expect, in terms of the Paris Principles, is some degree of donor coordination rather than harmonization and alignment. Based on their findings, they argue that this framework does not provide a sufficiently strong base for donors operating in fragile state environments.

Contrary to conventional wisdom, their case studies reveal that, as against the standard approach (largely project-based aid, with short time horizons, distributed through NGOs and with a focus on a narrow set of activities), a much wider range of aid instruments can be used successfully in widely differing contexts. One key conclusion is that 'development actors should avoid "one size fits all" prescriptions such as "budget support is inappropriate in fragile states"…' given that they found that 'an imaginative and flexible use of various instruments can have a significant impact on poverty reduction' (2005: 5).

This is hardly surprising given the widely varied contexts of fragile states, and they recommend that work in fragile states requires creative thinking, experimentation and flexibility, as well as a sound knowledge of the local context. While recognizing the attractions of project-based aid delivery in fragile state situations[26], they also argue that it is important to think in programmatic terms right from the outset of engagement. Based on the experience of one of their case studies, namely Afghanistan, they point out that even in the most challenging of operational environments it is possible to work with governments on the development of national plans, with detailed decisions on the most appropriate aid implementation modality, i.e., whether through government systems, NGOs, direct donor implementation, on or off-budget flows, or a mixture of all, being decided subsequently.

[26] The advantages associated with project aid rehearsed above become even more attractive to donors operating in fragile state situations. Project aid can be very flexible in responding to new situations, is often based on relatively easily identifiable needs, has shorter lead times between design and implementation, and can be implemented outside government systems in situations where the state possesses either very weak capacity or even constitutes an obstruction. Finally, it allows for a high degree of accountability to donors and their domestic constituencies.

As they note, in the case of post-Taliban Afghanistan, and notwithstanding the extreme fragility of state institutions, budget support was provided through a World Bank managed Multi-Donor Trust Fund (MDTF). As of 2008, 27 donors were supporting this fund. The World Bank disbursed these funds to the Afghan government on a reimbursement basis. Donor fiduciary risk concerns were further mitigated by the World Bank contracting an 'external monitoring' agent that evaluated the claims submitted by the government on the basis of a set of eligibility criteria and fiduciary standards. Further risk mitigation took place through the contracting of an international auditing firm, which subjected both the Fund and the monitoring agent to audits. This arrangement helped to address donor fiduciary risk concerns, but also strengthened government systems since funding priorities were based on those identified in the country's 12 National Priority Programmes.[27]

Important work has recently been carried forward on the application of Paris Principles to fragile states situations within the OECD-DAC. Most notable amongst these is an OECD-DAC review commissioned in 2008 which draws out the lessons learned from the application of the Paris Declaration Principles in fragile states (OPM/IDL, 2008). One key lesson arising from the case studies is that it is important for donors not to underestimate the task at hand:

> *'A fundamental challenge to aid effectiveness in many transitional contexts is the sheer scale and complexity of the task at hand. The challenges faced in (re)building the infra-structure and institutions of a state, delivering services, securing and sustaining peace are daunting.'* (OPM/IDL, 2008: 25)

This therefore translates into a heightened need to effectively prioritize and sequence activities based on a sound assessment of what can be done in the context of multiple constraints. The authors note that while the Paris Principles assume some degree of shared understanding between partner governments and donors regarding national development goals, as well as some capacity of partner governments to implement policy, these assumptions may not hold in the case of fragile states. Even basic operating assumptions such as an effective control of the national territory and therefore 'state reach' may not apply.

Drawing a distinction between situations of conflict, prolonged crises or impasse with restricted scope for the application of the Paris Principles, and those states characterized as 'hopeful partnerships' (OPM/IDL, 2008: v*)*, the report argues that the 'state-building' imperative applies throughout the continuum, as do the principles of 'taking context as a starting point (principle 1) and adopting a 'do no harm' approach (principle 2). The most adverse circumstances are characterized by a rapid deterioration of socio-economic indicators, conflict, prolonged political impasse and an almost complete absence of dialogue between donors and government. Under these circumstances, even a minimal consensus on an appropriate development agenda is often absent. Paris Principles on ownership, alignment, harmonization, managing for results and mutual accountability become extremely problematic to apply. Nevertheless certain fragile state principles can still be operationalized in such circumstances. The principles of 'aligning with local priorities in different ways in different contexts' and 'doing no harm' have allowed donors to support basic social service delivery through alternative mechanisms in a number of fragile state situations.

In the specific case of Zimbabwe, for example, where the government was often seen by donors as pursuing policies that were contrary to what was required in order to achieve international development goals, there was nevertheless a window for engagement with, and inter-donor harmonization in areas such as HIV and AIDS and Orphans and Vulnerable Children (OVCs). Adopting the principle of 'shadow alignment' to a Government National Plan of Action in which priorities were identified in the area of OVCs, donors were able to both engage at a technical level with line ministry staff and channel funds through UNICEF, which passed these on to NGO care

[27] For an overview of the Afghan MDTF experience see Scanteam, 'Review of Post-Crisis Multi-Donor Trust Funds', World Bank and Norwegian Ministry of Foreign Affairs and NORAD, 2007.

providers and faith-based organizations. While this may be seen as a state-avoidance approach given the emphasis on engaging with sub-state actors and UN agencies, it was a way to 'shadow align' to a technically acceptable National Plan of Action even during a stand-off between donors and a 'partner' government.

In post-conflict and post-crisis situations in which transitions are underway, the principles regarding fragile states become easier to apply. When such transitions have begun, this provides a basis for the development of 'hopeful partnerships' between donors and countries emerging from crises. Notwithstanding the fact that such transitions may be extremely fragile politically, that there may be enormous demands on a new administration when its capacity to deliver is severely debilitated, an incipient development partnership may be established around a shared development agenda on the basis of the Paris Principles and those governing engagement with fragile states.

## 6.2 A TOOLKIT FOR FRAGILE STATES TRANSITIONS

A number of instruments have been designed, tested and refined over the course of recent years, which have assisted in improving the quality of the relationship between donors and the governments of fragile states in transition. These help to lay the foundations for national ownership, harmonization, alignment, accountability and a results-focus in the partnership. In such transitional situations, given the enormity of the task at hand, sound planning, prioritization and sequencing of actions are key to both ensuring maximum impact, as well as managing expectations on both sides of the donor-partner country relationship in terms of what can realistically be achieved.

Joint Assessment Missions (JAMs) and Post-Conflict Needs Assessments (PCNAs) involving both donor and national technicians can, given that they provide a factual basis for dialogue, play a very important role in building shared understanding of what is required and are a first step towards joint planning and coordination. JAMs and PCNAs have been rolled out in many post-conflict and post-crisis situations, and lessons learned over time have helped to refine this instrument.

Another instrument that has proved to be useful in transition situations are Transitional Results Matrices (TRMs), often designed on the basis of the results flowing from JAMs and PCNAs. TRMs are simple planning, coordination and management frameworks. These are usually developed by both donor and partner countries with a view to better prioritizing actions in order to achieve a successful transition in fragile states.[28]

It is worth recalling that transitions in post-conflict/post-crisis situations are fragile because of the interconnections between four challenges facing transition states:

- There are strong links between political and security reforms and the delivery of socio-economic programmes;
- There is a need for prioritization in early recovery environments characterized by high needs and limited capacity;
- The importance of managing expectations of donors, fragile state governments and their populations;
- The above considerations need to be balanced with the imperative of ensuring rapid progress in order to maintain forward momentum at the risk of the transition process either stalling or being reversed.

TRMs can help both donors and national leaderships to meet these challenges by;

- Placing key actions and results in terms of political, security, economic and social priorities in an easily digestible calendar;
- Forcing prioritization and ensuring realistic timelines and therefore managing the expectations of all interested parties;

28 See United Nations Development Group and World Bank, 'An Operational Note on Transitional Results Matrices: Using Results-Based Frameworks in Fragile States', 2005.

- Helping to identify in advance possible bottlenecks and periods of systems 'overload';
- Allowing for the monitoring of progress and the addressing of areas in which progress is sub-optimal; and
- Serving as a basis of dialogue between donors and fragile states on resource allocation between priorities.

Experience with TRMs indicates that the key criteria used in identifying priority actions must be 'crucial areas' where lack of progress would heighten the risk of a reversal in the stabilization and recovery process.

The standard format which has evolved over time is based on four clusters which are key to recovery in transitional situations, namely: 1) political, 2) security, 3) restoration of minimally functioning public financial systems, and 4) socio-economic recovery. For each of these clusters, a TRM should contain:

A – A Strategic Objective or Goal;

B – A baseline – even though it is often extremely challenging in such situations to obtain reliable data, what is available must be incorporated, without which it will be impossible for both donors and partner countries to monitor progress;

C – Properly sequenced and time-bound actions. In situations where the capacity for reform is often limited, the need for effective sequencing is heightened;

D – Targets and monitoring indicators, i.e., observable targets that are subject to verification;

E – Clear responsibilities assigned for each action.

Based on assessments of TRMs in widely varying situations, one key lesson concerns the need to balance comprehensiveness with selectivity. Given the multitude of constraints that characterize fragile states in transition (capacity, dilapidated infrastructure, lack of financial resources) there is a clear need to prioritize. On a related note, the multiple demands on limited resources also entail a need to strike a balance between addressing immediate emergency needs at the same time as planning for the longer-term. Strategic visioning must therefore run alongside the process of developing a TRM to ensure that the inclusion of short-term actions in a TRM does not compromise longer-term, comprehensive and sustainable recovery. Finally, the simplicity of a TRM is central to its utility for all users.

It has also become clear that donor support to a government-owned TRM should be based on progress across the overall programme rather than specific and detailed targets. Given that progress in fragile states is never a linear one, even when they are not undergoing transitions, it is important for donors to base the conditionality of their support on the strategic 'big picture' given that fragile states can simultaneously perform both well and poorly in different areas of the four clusters. The clarification of mutual expectations at the outset is an essential ingredient in the process of building understanding between donors and governments of fragile states.

Reviews of TRMs have also brought to light the fact that the security sector variable has not been given the necessary attention in a number of TRMs. This may be due to the distinct cultures prevailing amongst humanitarian and development actors who often have no previous experience in working with security forces. To this should be added an additional obstacle to deeper analysis and understanding of the security cluster and the designing of appropriate actions in TRMs, namely that work in this area often falls outside the scope of donor's ODA funds. Nevertheless, the maintenance of basic security is a key enabler of the objectives in other clusters, and the longer-term goal of security sector reform can help to ensure the sustainability of the overall transition.

Pooled funding mechanisms such as Multi-Donor Trust Funds (MDTFs) offer an opportunity for donors to begin the process of harmonizing and aligning to national priorities contained in recovery frameworks such as TRMs. World Bank and UN administered MDTFs have been implemented in a range of transitional situations, from Timor Leste to the Sudan, Iraq and Afghanistan. Features common to situations where they have been set up include large un-met needs in the area of basic service provision in the short-term, as well as significant medium-term needs in the area of social and productive infrastructure. The public sector's capacity to deliver is also usually very weak, if not non-existent.

The advantages of MDTFs for donors are that they reduce transactions costs through joint planning, prioritization and the sharing of information. Transferring resources to multilateral bodies to be administered also means that the administrative costs of managing those funds are reduced for individual contributing donors. Single monitoring, evaluating and reporting mechanisms constitute additional attractions. MDTFs also help to address the fiduciary risk concerns of donors in situations that are often characterized by weak public financial management systems. In such situations, donors are unwilling to engage in direct budget support until their concerns have been met, and these can be allayed by channelling funds through the UN and World Bank. Where MDTFs are structured around national priorities (as contained in partner country strategies), which are supported by donors, they help to ensure that donor assistance reflect these budget priorities, even if funds do not initially flow directly through national systems.

There are a number of benefits that accrue to partner countries, especially where their capacity is severely constrained. With MDTFs, they are able to interact with a single, coordinated and harmonized source of external assistance. MDTFs thus provide a forum in which donors and partner countries are able to discuss priorities and implementation modalities. As one survey of a mix of 18 UN and World Bank MDTFs has noted 'many actors look to MDTFs as the key venue for coming together and exchanging information and views. In a number of cases, they are in fact the only structured meeting place…'[29]

Notwithstanding their promise and positive performance overall, and the fact that they represent current donor best practice in post-crisis situations, MDTFs have had their limitations. This may be attributed to the sheer scale of the tasks they face, and the time lags that are inevitably part of the response of all external actors in a situation in which there is an ever expanding picture of needs as any given transition develops. This 'moving target' has to be reconciled with the need to maintain strategic focus and selectivity while at the same time ensuring flexibility. One overview of the experience of MDTFs notes that they:

> *'…can often be overambitious in terms of what they can deliver, and cannot be expected to simultaneously build state capacity and deliver public goods and services in a timely manner. Start up time and costs are often underestimated, and most MDTFs have failed to provide adequate management and technical personnel on the ground'*. (OPM/IDL, 2008: 43)

These shortcomings, which are gradually being overcome with each newly designed MDTF, nevertheless help to explain why in many situations MDTFs, while commanding substantial resources, still only represent a small percentage of total donor aid in each individual fragile state situation. To this must be added the simple fact that there is a need on the part of each bilateral donor to be seen to be 'flying the flag' separately, rather than being one of many within an MDTF, thus contributing to them keeping one foot outside the MDTF structures.

[29] Scanteam, 'Review of Post-Crisis Multi-Donor Trust Funds – Country Study Annexes', World Bank, Norwegian Ministry of Foreign Affairs and NORAD, 2007. p.67.

## Section 7

# The Macroeconomic Management of Aid Flows

A sub-set of concerns on aid effectiveness concerns the impact of large flows of ODA on the macroeconomy of partner countries. These concerns must be seen against the backdrop of the commitment by G-8 leaders at the Gleneagles Summit in 2005 to double aid to Africa by 2010. The prospect of a 'scaling-up' of aid of this magnitude has led a number of development economists to update earlier work on the macroeconomic impact of ODA flows, and to bring to the fore the macroeconomic challenges faced by many African economies that are already heavily reliant on aid.

Since 2000 there has been a significant increase in the number of countries receiving ODA that is over 5 percent of GDP, with some countries such as Mozambique and Sierra Leone receiving ODA flows over 20 percent of GDP for extended periods. In a post-crisis scenario in which there may be significant net inflows of ODA, Zimbabwe should be aware of the possible effects on its balance of payments and the demands placed on monetary, exchange rate and fiscal management.

In examining the possible macroeconomic implications of aid flows, a distinction needs to be made between the *absorption* and *spending* of aid by partner countries (IMF, 2005). According to the IMF's definition, aid absorption is the extent to which a country's balance of payments **non-aid** current account deficit widens in response to increased aid flows. It reflects the increase in net imports resulting from increased aid that should be treated essentially as extra foreign exchange. The extent of an economy's absorption of aid depends on domestic demand for imports and the exchange-rate policy. Assuming there is no spare capacity in the economy, aid only enables an economy to both invest and consume more by financing an increase in imports relative to exports.

Under the assumption of full capacity utilization, and if aid is simply spent on domestically produced goods and services, it does nothing to increase aggregate output. Rather, this increased demand will fuel inflationary pressures. Under these conditions, it could be said that real resource transfers can only take place where there is an increase in net imports, i.e., increased absorption, or else it will only be equivalent to an expansionary domestic fiscal and monetary policy, i.e., deficit financing.

Aid spending is defined as the widening in the government's fiscal deficit excluding aid that accompanies an increase in aid. It indicates the extent to which the government uses aid in fiscal management, i.e., either an increase in expenditure or a reduction in taxation. The Government fiscal deficit excluding aid should therefore be seen as equal to total expenditures less domestic revenue and is financed by a combination of net aid and domestic borrowing.

Spending is determined by the government through fiscal management and absorption by the central bank through its monetary management. Increase aid flows can result in four possible combinations of absorption and spending, each one with different macroeconomic implications.

### 1. *Aid is both absorbed and spent*

Under this scenario, the government spends aid resources – the central bank providing it with domestic currency counterpart funds – while the central bank sells the foreign currency to finance imports. The latter are absorbed by the economy through a widening non-aid current account deficit.[30] Though the non-aid fiscal deficit becomes larger, it is nevertheless financed by increased aid.

[30] The non-aid current account balance is the current account balance excluding official grants and interest on public external debt.

However, sustained high levels of aid inflows can result in real exchange-rate appreciation. The phenomenon is linked to the 'Dutch Disease' common to many economies experiencing an export boom, in which currency appreciation makes tradable goods[31] less competitive and leads to an increase in imports.[32] The Central Bank sells the extra foreign-exchange reserves derived from aid flows, which results in foreign exchange becoming cheaper relative to the domestic currency. This rise in the exchange rate of the domestic currency impacts negatively on both domestic traders of exports (and therefore the gains from international trade) as well as the import-substituting sectors.

However, such an exchange-rate appreciation can be mitigated if aid is used to increase productivity. This can happen when there is spare capacity or significant unemployment in the economy. If a quick supply-side response can be obtained, there will be limited exchange-rate appreciation if the additional aid-induced demand for non-tradable goods results in increased employment and production. In principle using aid to fund infrastructure to boost capacity and productivity, in particular, should also mitigate the macroeconomic effects of aid inflows as it increases production in the long run.

**2. *Aid is neither absorbed nor spent***

This is a situation whereby aid is used for building up international reserves. This might be an appropriate short-run strategy if aid inflows are volatile or if the country's international reserves are low. Under this scenario, government expenditures are not increased, hence there is no expansionary impact on aggregate demand and no pressure on either the exchange rate or price levels. However this scenario might not be compatible with donor requirements in terms of poverty reduction, and should therefore be seen as a largely academic alternative unless it is pursued as a very short-term measure to build sufficient reserves of aid money before absorbing and spending it.

**3. *Aid is absorbed but not spent***

This is a scenario whereby increased aid inflows are used to reduce inflation where the levels are excessively high. The government saves the domestic currency counterpart of aid while the central bank sells the foreign exchange to finance increased imports. This has the effect of releasing more resources to the private sector and results in reduced monetary growth.

The strategy of absorbing and not spending aid is an appropriate strategy as a tool for reducing high inflation, because it allows for a deterioration of the balance of trade to be financed by aid inflows. However, in the longer-term the no-spend strategy is once again incompatible with donor requirements for poverty reduction expenditure. Therefore, once stabilization is achieved, the government is expected to pursue an 'absorb and spend' strategy.

**4. *Aid is spent but not absorbed***

This is a situation whereby the fiscal deficit (net of aid) increases as a result of increased aid inflows. There is no attempt to sell the foreign exchange required to finance additional net imports in order for a real transfer of resources to the partner country to occur. The Government increases expenditures, but keeps aid dollars as reserves in the Central Bank. The resulting fiscal expansion is the same as increasing government expenditures in the absence of aid, since the fiscal stimulus must

31 i.e., items that are readily imported or exported such as consumer durables, as opposed to non-tradables which are items that are not readily imported or exported such as housing.

32 The theoretical underpinnings of Dutch Disease as an economic concept is used to explain the phenomenon whereby an increase in revenues from natural resources will deindustrialize an economy by raising the exchange rate which makes the manufacturing sector less competitive. More broadly, it can refer to any development that results in a large inflow of foreign currency, including a sharp surge in natural resource prices and Foreign Direct Investment (FDI). The term was first coined to describe the decline of the manufacturing sector in the Netherlands after the discovery of natural gas in the 1960s.

be financed by either government borrowing from domestic money markets (thus crowding out the private sector through higher interest rates) or by printing money and thus generating inflation. Increased aid inflows would therefore raise money supply and domestic demand also thereby fuelling inflation. The only positive effect of this scenario is that once again international reserves would rise but then they would only contribute to increased liquidity.

This strategy is the least desirable one and not favoured by donors as it defeats the central purpose of aid in effecting a real transfer of resources to a recipient country, while from a macroeconomic perspective it shows fiscal indiscipline.

The key point about the above scenarios is that highly aid-dependant economies need to adapt and closely coordinate their monetary, exchange rate and fiscal policies in the context of aid surges so as not to penalize their domestic private and export sectors. The point is made forcefully by Killick and Foster (2007), who believe that both donors and partner countries must be aware of the policy implications of aid surges and the possibility of unintended consequences. Partner countries should recognize the need for close coordination of monetary and fiscal policies between central banks and their Ministries of Finance – something that cannot be taken as given in many developing countries. In particular, they need to have sound public policy with a focus on the development of the tradable goods sectors so that aid surges do not disadvantage domestic producers. Without timely countervailing policy measures, aid surges may well contribute to rising unemployment and poverty levels. Amongst the various solutions they rehearse is aid being both absorbed and spent on more directly productive uses such as infrastructural development so as to unblock supply-side constraints operating on the tradable goods sector (2007: 167-192).

It is important to note that the relation between aid inflows and their differentiated impact on various sectors of a recipient economy, depending on how it is managed, has been subject to a large number of empirical studies. Overall, it would be fair to say that the jury is still out on a verdict, with some studies confirming the existence of Dutch Disease effects and others refuting it. For example, an IMF survey of 12 such studies on the relation between aid inflows and exchange-rate appreciation confirms the overall inconclusive picture, with six country-specific studies confirming the relationship, while another three found no evidence for it. Three were inconclusive.[33]

An indication of the difficulties facing analysts in establishing the robustness of the relationship can be seen from another study produced from within the same institution, namely the IMF, that found that aid inflows did in fact have ‘systematic adverse effects on a country’s competitiveness, as reflected in a decline in the share of labour-intensive and tradable industries in the manufacturing sector’ (Raghuran and Subramanian, 2005: 1). Furthermore the researchers found evidence that,

> *‘in countries that receive more aid, labour-intensive and exportable sectors grow slower relative to capital-intensive and non-exportable sectors respectively. As a result of the reduced competitiveness, employment growth in these sectors is slower, and these sectors account for a lower share of the economy than in countries that do not get as much aid.’* (2005: 6)

The significance of these findings on the possible negative effects of aid flows on a country’s competitiveness is obvious. Labour-intensive industries are a source of employment generation, especially for low wage economies. By rendering them uncompetitive, aid inflows could end up constricting a channel through which surplus labour is absorbed and poverty levels reduced. The

[33] Gupta, S., Powell, R., and Yang, Y., ‘Macroeconomic Challenges for Scaling Up Aid to Africa: A Checklist for Practicioners’, IMF, Washington, 2006. Another IMF study based on the experience of five countries that at the time it was conducted had recently experienced aid surges, namely Ghana, Ethiopia, Mozambique, Tanzania and Uganda, found that contrary to the assumptions of the theory of Dutch Disease, there was an absence of any Dutch disease effects on exports via appreciation of the exchange rate. On these findings see IMF, ‘The Macroeconomics of Managing Increased Aid Inflows: Experiences of Low-Income Countries and Policy Implications’, Policy Development and Review Department, Washington DC, 2005.

structural transformation of an economy through the gradual shift of surplus agricultural labour engaged in subsistence agriculture to higher productivity and wages in the manufacturing sector is also jeopardized. Economic history demonstrates that manufacturing exports constitute an essential vehicle for ‘take-off’ for developing countries. Participation in international trade helps economies such as those of many Low Income Countries to overcome their restricted domestic markets in order to achieve economies of scale, as well as acting as an important channel for technology transfers which contribute to productivity gains. The possible short-term negative effects of aid flows on the competitiveness of the tradable goods sector must therefore be factored into the design of a longer-term growth strategy, as well as how fiscal, monetary and exchange-rate policy should react. While any aid surge may be temporary, its longer-term effects may be more lasting and damaging for domestic producers of tradable goods.

As argued earlier, partner country governments should therefore take a longer-term perspective and ensure that a significant portion of aid is used to help raise the productivity and lower the costs of agents in the tradable goods sector. There may be a need to offset the disincentives that flow from an appreciating exchange rate by tackling non-price constraints on both exporters and import-substituters. Investments of aid funds in infra-structure and other services may offer the highest long-term returns to aid spending.

Given the recent dollarization of the Zimbabwean economy, the dangers of Dutch Disease for Zimbabwe through the transmission channel of exchange-rate appreciation in the context of large aid inflows may remain purely of academic interest for the meantime.[34] But in a post-dollarisation scenario, characterized by continued large inflows of aid, the need for careful management of monetary, fiscal and exchange-rate policy will remain strong.

[34] One of Zimbabwe’s major challenges in the short-term will be to reconcile the need to maintain levels of employment, through which poverty reduction is mediated, with the imperative of improving the country’s competitiveness. Under dollarization one standard means of improving competitiveness, namely devaluation, is no longer an option. In the absence of a domestic currency, increased aid cannot give rise to Dutch Disease through the exchange rate, but similar effects may come to be felt through a country’s price level and cost structure. If significant volumes of aid are injected into what is already a skills-scarce and input-constrained economy such as Zimbabwe’s, aggregate demand and domestic price levels may rise and make businesses, especially exporters, even more uncompetitive. To forestall job layoffs, increased aid needs to be accompanied by policy measures that increase competitiveness.

## Section 8

# The Aid-Growth Debate

Given the current volumes of Official Development Assistance (ODA) flowing from donors to partner countries, it might surprise the reader to know that there is an ongoing and heated debate amongst aid economists revolving around what might best be characterized as an ambiguous association between aid and demonstrable development outcomes. The very effectiveness of ODA in helping partner countries to achieve economic growth and broader development targets has been subjected to intense scrutiny. Available evidence has been used to determine the impact of aid in relation to intended outcomes at both sectoral and aggregate levels.

Early views on how aid was supposed to relate to growth in developing countries were based on the assumption that the main constraint to growth in these economies was their poor rates of capital accumulation. Helping these economies to overcome trade gaps and their low domestic savings rates was therefore the role of aid. This would in turn help them to undertake a 'big push'.[35] The larger the volumes of aid, the sooner these 'two-gaps' could be closed and developing economies would reach 'take-off', and thereafter embark on a path of robust and sustained growth.

It is noteworthy that this 'big push' thesis on aid reappears in the 21st century through the advocacy work of Jeffrey Sachs (2005). He argues that a major international effort is required in terms of increasing aid volumes if the Millennium Development Goals (MDGs) are to be achieved, precisely because the accumulated physical, institutional and human capital deficits in low-income countries are so large that these countries find themselves in a poverty trap, and therefore unable to embark on sustainable growth and poverty reduction (Sachs, 2005). The key underlying assumption is, once again, that of the primacy of additional capital in unlocking better growth performance.

As early as the 1970's, however, the above assumption was being queried through a number of so-called 'first generation' studies on aid effectiveness.[36] These focused specifically on the association between aid and national savings, this focus on savings being an indirect way of evaluating the aid-growth relationship. Many reported zero or even negative correlations between aid receipts and growth. A common conclusion was that aid resources were being spent on consumption (largely imports) rather than investment. In addition, aid was also seen to be acting as a disincentive to recipient governments in terms of their revenue collection efforts, the expansion of their tax base, and the sound targeting of government expenditures on growth-enhancing investments.

In these first generation studies, and in line with the two-gap model of their predecessors, aid was treated as an exogenous net increment to the capital stock of beneficiary countries. In other words, each dollar of aid would supposedly result in an increase of one dollar in total savings and therefore investment. Aid was therefore treated as exactly additive to domestic savings, with a causal chain running from aid to savings to investment and then growth. But the possibility of aid being used for ends other than investment was not controlled. In other words, the problem of the **fungibility** of aid whereby all types of aid can be used for purposes other than investment broadly defined was not catered for.[37]

35 The intellectual foundations of this approach were laid down by W.W. Rostow in his 'The Stages of Economic Growth', Cambridge University Press, 1960, as well as Chenery and Strout. For the latter, see Chenery, Hollis. B. and Strout, Alan, 'Foreign Assistance and Economic Development'. American Economic Review, Vol.56, No.4, 1966, pp.679-733.

36 For a representative sample of such work see Griffin, K.B and Enos, T.L, 'Foreign Assistance: Objectives and Consequences', Economic Development and Change, Vol.18, No.3, 1970, pp.313-327.

37 The point is made succinctly by one aid analyst who noted that '…by reallocating domestic resources in the budget, the recipient government can re-direct aid in accordance with its own preferences. For instance, aid intended by donors for investments in human capital (health and education) can be diverted into higher salaries or other perks for ministers and politically favoured groups by reducing domestic budget allocations to the health and education sectors. The money thus freed can be used to finance whatever the government prefers.' Peter Svedberg, 'Comment on Finn Tarp: Aid and economic growth: An alternative interpretation of the evidence'. Swedish Economic Policy Review, 13, 2006, p.17.

At the same time as these negative conclusions from the earlier generation of studies were being reached, there were others that were more sanguine in their conclusions. Some argued that while it may be true that aid did not increase recipient country savings and investments on a strict one for one basis, there was nevertheless evidence that aid did have a net positive effect in terms of increasing total savings, i.e., that aid did lead to an increase in total savings, although not by as much as the aid flow (Newlyn, 1973: 867-869).

One landmark study characterizes the most recent generation of studies, namely the Burnside and Dollar work of 2000 (2000: 947-968). Given advances in computing and econometrics, Burnside and Dollar were able to work with panel data that contained a much larger sample of countries over a longer timeframe than previous efforts. In a novel departure from previous efforts, they factored in economic policy and institutional environment variables in their regressions. These economic policies were grouped into a single policy index consisting of measures on inflation, trade openness and budget deficits. Their hypothesis was that the impact of aid on growth is likely to be greater when there are fewer policy distortions affecting the incentives of economic agents. This assumption is predicated on the existence of transmission channels whereby an improved policy environment would result either in the increased productivity of capital, and therefore of invested aid, and/or because a larger percentage of aid received was actually invested rather than consumed or diverted. The marginal productivity of capital, and therefore of invested aid, increases as distortions in the incentive system decrease.

Burnside and Dollar were able to include 56 countries in their sample over an extended timeframe covering the period 1970–1993. Analysing the aid-policy environment-growth nexus, they concluded that aid does contribute positively to growth, but only in good policy environments defined in terms of sound fiscal, monetary and trade policies. The impact of these findings should not be underestimated in terms of their influence on how international development agencies sought to interact with partner countries. Having originally circulated as a World Bank discussion paper in the late 1990's, the Burnside and Dollar findings came to buttress a landmark World Bank Report on aid that was published in 1998 (World Bank, 1998). Selectivity was the order of the day in terms of ensuring that aid was to be made conditional on sound policies on the part of beneficiary countries. Aid would therefore promote economic growth in those countries that possessed such policy frameworks.

Just when it seemed that the issue had been put to rest, however, critiques of the Burnside and Dollar findings soon appeared. One group of economists tested the robustness of the model used by Burnside and Dollar by expanding the number of sample countries and extending the panel data from 1993 to 1997, and showed that the positive relationship between aid, the policy environment and growth detected by Burnside and Dollar disappeared when the new data was introduced (Easterly, Levin and Roodman, 2004: 774-780).

A similar fate awaited another research initiative, the results of which were published in 2001 and which also seemed to offer advocates of aid strong evidence on the positive links between aid and growth. The Hansen and Tarp study was even more ambitious in terms of the representativeness of its sample, covering over 100 cross-country regressions on the impact of aid on growth from the late 1960's to the late 1990s. What they found was that while the link between aid and growth was a robust one, and that aid did increase aggregate savings and investment, the relationship was not on a one-to-one basis. But their findings also contradicted those of Burnside and Dollar to the extent that they did not find a robust positive interaction between sound policies, aid and growth. Aid was shown to have a positive effect on growth rates wherever and whenever it was driven by capital accumulation, i.e., aid worked, even in countries hampered by an unfavourable policy environment as defined by Burnside and Dollar (Hansen and Tarp, 2001: 103-128).

The layperson would be well entitled to ask why the results are so inconclusive, especially given the fact that at last count over 130 studies had been conducted around the world seeking to bring some clarity to the issue. The title of a relatively recent review of the literature, namely 'Macro Aid Effectiveness: A Guide for the Perplexed' is apposite (Roodman, 2007). For partner countries, this bafflement should be all the greater given the often highly prescriptive content of the aid polices of donors, as well as global commitments to significantly increase aid flows.

To the extent that light can be thrown on the reasons for the inconclusiveness of the findings, one should separate methodological issues from the possibility that the very definition of what constitutes aid may impact on results. In regards to the first set of considerations, it can be said that multivariable regressions of the sort used in the most recent studies are always sensitive to model specifications, the time period covered, the quality of panel data used and the choice of control variables. Given the complex interactions between the multitude of determinants of economic performance, the connection between aid and growth cannot be a simple linear one, thus making it extremely difficult to isolate the effects of aid in any economic system since:

> *'as the consequences of an aid project ripple out and diffuse, they become harder to detect. It is not hard to tell if a road is paved. But it may be impossible to discern whether* all aid *raises* total output per capita *from a national economy in the long run.'* (Roodman, 2007: 3)

To this might be added the problem of establishing a counter-factual, i.e., what might have happened in the absence of aid? These complexities are succinctly expressed by one participant in the debate who noted that 'simply, if one tortures the numbers for a sufficiently long time, they will confess to anything' (Svedberg, 2006: 13).

However, a recent and more profitable line of investigation seems to be that based on the disaggregation of aid. In contrast to earlier work, Clements, Radelet and Bhavani (2004) start out from the premise that much of the earlier work on the relationship between aid and growth has been flawed due to the simple failure to divide aid into their distinct purposes as declared *ex ante* by donors. Economic growth is not, and never has been, the sole objective of aggregate foreign aid. Humanitarian assistance for example is not directly targeted at building productive capacity but rather has a 'saving lives' metric, and aid directed to education and health programmes are unlikely to have a measurable impact on growth rates in the short-term. To this list might be added aid in support of the global 'good governance' agenda, which may have growth only as a secondary and longer-term objective.

Having separated these components of aggregate aid, they arrive at a sub-set of aid which they designate as 'short-impact aid', i.e., aid that could plausibly stimulate growth over the short-term which they define as a 4-year period, such as aid directed to investments in productive sectors such as agriculture and industry, balance of payments support, and investments in infrastructure, communications and energy generation. When this approach is adopted, and the regressions are carried out, the results are encouraging, with a very robust positive relationship between 'short-impact' aid and growth. More specifically they found high returns on such aid, with US$1 in short-impact aid leading to a gross economy-wide cumulative increase in aggregate output of US$1.64 (Clements, Radelet and Bhavani, 2004: 34).[38]

As the authors themselves caution, however, given that their study sets out to only quantify the impact of one sub-set of aid, the results should not be interpreted as meaning that the best use of aid is to direct all ODA resources to short-term impact aid of the 'directly productive investment' kind, let alone that social-sector investments or humanitarian aid may not have longer-term growth effects. But the results do, nevertheless, suggest that partner countries should be aware of possible trade-offs given a finite aid resource envelope. These trade-offs include decisions regarding how to direct resources in order to strike the right balance between short-term growth imperatives and the need to enhance longer-term growth potential, which is partially dependant on the building of human capital over the longer-term.

[38] The figure is arrived at using a Keynesian multiplier. As the authors note, this is higher by a factor of 2-3 times when compared to previous studies that used non-disaggregated aid. It is noteworthy that the robustness of the sample can be gauged by the fact that the researchers classified a total of 275,590 donor-partner country transfers contained in the OECD's database for the period 1973–2001, dividing them into short impact (4 year epochs), long impact and humanitarian transactions.

In the case of Zimbabwe, and given the situation it currently faces with multiple demands on an extremely limited resource envelope, the need to meet short, medium and longer-term objectives is all the greater. Given finite domestic and external resources, key decisions have to be made in terms of the amounts to be channelled to development and humanitarian assistance. While the imperatives of humanitarian aid may, at first sight, seem to easily trump the longer-term objectives of development assistance, there is evidence to suggest that the arguments in favour of solely focusing on immediate humanitarian needs are not clear cut, and that development assistance plays an essential role in mitigating vulnerability to external shocks.[39]

[39] A study conducted in 1998 specifically used Zimbabwean household panel data from 1994–1997 and therefore catered for the 1994/95 drought. The researchers sought to throw light on the opportunity cost in terms of foregone poverty reduction of a shift from development to humanitarian assistance. The authors found that under a scenario in which a certain amount of humanitarian assistance was redirected to development assistance (increasing the agricultural capital stock of households, such as through improved extension services and the provision of inputs and equipment), the incidence of food poverty was significantly reduced even in drought years. See Trudy Owens and John Hoddinott, 'Investing in development or investing in relief: quantifying the poverty trade-offs using Zimbabwe household panel data.' Centre for the Study of African Economies, University of Oxford, Working Paper Series 98, 1999.

# Section 9

# Enhancing Aid Predictability

## 9.1 THE NATURE OF AID UNCERTAINTIES

In addition to having to coordinate fiscal, monetary and exchange-rate policies in order to counter the potential negative macro- and micro-economic consequences of large aid inflows, partner countries also have to deal with the problems of aid predictability and volatility. Widespread recognition of this problem helps to explain the commitment undertaken by donors in the Paris Declaration to '… provide more predictable and multi-year commitments on aid flows to committed partner countries (Principle 26)'. This is translated into a specific progress indicator to measure donor performance on this issue. The measure is the percentage of donor aid disbursed according to agreed schedules in annual or multi-annual frameworks. The target is to halve the proportion of aid not disbursed within the fiscal year for which it was scheduled by 2010 (indicator number 7).

The problem can be defined by looking at both sides of the donor-partner country equation. According to the OECD-DACs guidelines on harmonization, aid is predictable if 'partner countries can be confident about the amount and timing of aid disbursements'. In other words, predictability is defined by how reliable commitments made by donors are. It is 'volatile when fluctuations in aid flows are large relative to the volume involved' (OECD, 2005: 22). Volatility may also be defined in terms of fluctuations relative to domestic revenue. A sub-set of concerns revolving around volatility has to do with the impact of conditions attached to aid and their impact on volatility. Recognition of this relationship between aid volatility and conditionality, though not the only consideration, underpins principle 16 of the Paris Declaration which calls upon donors to 'Link funding to a single framework of conditions and/or a manageable set of indicators derived from the national development strategy'.

An additional problem for partner countries is that aid has been shown to be pro-cyclical, i.e., there is a seemingly strong correlation between aid flows and movements in partner countries' GDPs and their revenue base. The evidence to date indicates that, contrary to the seemingly logical assumption that donors would be most willing to increase and speed up the disbursement of aid to partner countries that need it most urgently, work on time series data indicates that aid is not performing this compensatory, counter-cyclical function. When partner countries have suffered external shocks over which they had no control (e.g., a rapid deterioration in their terms of trade or drought which has negatively impacted on their agricultural exports) and which then leads to sharp contractions in GDP, counter-cyclical aid has not been forthcoming.

The challenges on this front are manifold for partner countries. Given the requirement to develop overarching national and sectoral strategies, these can only sensibly be designed on the basis of realistic resource envelopes in which ODA often figures as a large component both in terms of capital and recurrent expenditure. However, much aid is only committed in the short-term and on the basis of conditionalities by donors, which can make designing long-term spending programmes an extremely precarious exercise. To this must be added the common problem of donor commitments not translating fully into disbursements. When a significant part of public resources is unpredictable it makes the already difficult exercise of deploying resources effectively even more challenging. The consequence is that 'national authorities responsible for executing macroeconomic policy thus have to do so in ignorance of actual and forthcoming movements in a major source of balance of payments and monetary changes' (Killick and Foster, 2007: 172).

## 9.2 THE MAGNITUDE OF THE PROBLEM AND ITS CONSEQUENCES

Surveys of sample countries show large year-by-year swings in ODA flows. The magnitude of the problem can be gauged from a survey conducted by the Strategic Partnership for Africa (SPA) using a sample of donor and partner government behaviour in 15 African countries. The survey found that on average, 81 percent of 2003 commitments were disbursed during 2003, 10 percent were disbursed the following year, and 9 percent of commitments were never translated into disbursements (SPA, 2005).

A more recent IMF survey, covering 76 countries over the period 1975–2003, makes even more sober reading. It demonstrates that notwithstanding certain parallel initiatives anchored in the roll out of PRSPs – Medium-Term Expenditure Frame-works, improved public financial management systems, strengthened accounting and reporting systems, and donor coordination mechanisms – aid remained both unpredictable and volatile. Indeed their findings indicate that contrary to expectations 'aid has become more volatile in the late 1990's and 2000's –the post-PRSP period – than in the mid 1990s –the pre-PRSP period…' (Bulir and Hamman, 2006: 11). Using as a proxy long-term ODA loans from OECD countries for the period 2000-2003, they demonstrate that disbursements fell short of commitments by about one-third. An even more startling finding is that this unpredictability is negatively correlated with GDP per capita, with countries at the lower end of the income scale receiving on average about one half of commitments (Bulir and Hamman, 2006: 16).

The above results help to validate the earlier work of the same IMF researchers. For countries under IMF-supported programmes, IMF staff have to carry out projections for both project and programme aid. The authors found that the discrepancies between projections prepared prior to the start of the programme (derived from past disbursement patterns as well as donor commit-ments) and the actual disbursement as reported by the partner country authorities, ranged from 8 percent in the case of project aid, while programme aid was overestimated by an average of more than 30 percent (Bulir and Hamman, 2001). The conclusion must be that for many partner countries, donor commitments are poor predictors of actual disbursements.

The consequences are particularly pernicious in economies that have come to depend on budget support disbursements. It is incongruous that in a situation in which partner countries are enjoined to move to comprehensive national development strategies such as PRSPs in order to strengthen national ownership and facilitate donor alignment and harmonization, budget support predictability is more vulnerable to fluctuations than stand-alone project delivery. Such volatility cannot but compromise the quality of budget planning processes 'by rendering original allocations obsolete and forcing expenditure adjustments during budget execution' (Celasun and Walliser, 2005: 2). The unpredictability and volatility of aid flows compound the vulnerability of many partner countries, exposed as they already are to external shocks of various kinds such as a sudden deterioration in their terms of trade, unpredictable private capital flows and exchange-rate fluctuations.

The problem of the pro-cyclicality of aid flows compounds these difficulties. In a seminal study based on time series data for 76 countries, the findings showed,

> *'disbursements to be procyclical on average and, worse, we found strong evidence that aid has failed to play any meaningful role in assisting countries to cope with large negative income shocks…of all countries hit by negative GDP shocks of 5 percent, only one benefited from a concomitant increase in aid.'* (Bulir and Hamman, 2006: 20-21)

Explanations for this phenomenon vary. On the one hand the argument has been advanced that since the business cycles of both donors and partner countries are linked, downturns in donor economies result in shrinking aid budgets, thus reducing the potential for aid flows to play a counter-cyclical role in the economic downturn of partner countries. Another attempt to explain the phenomenon is based on the problem of imperfect information about a partner country's policy efforts and its relationship to conditionality. In light of the difficulties in assessing 'effort' on the part of partner countries, donors tend to use easily observable, though in all likelihood imperfect, macroeconomic indicators, to assess **performance (results)** and use this as a proxy for effort. Given the amorphous nature of the concept of 'effort' in terms of the imple-mentation of sound policy, donors may withhold commitments through invoking conditionalities, ignoring the possibility that factors exogenous to a partner country's commitment to agreed policies may explain weak performance. The net result is a reinforcement of the pro-cyclical nature of aid flows, with good performers receiving extra aid and poor performers being penalized for reasons often outside their control.

How do partner countries cope with the unpredictability, volatility and pro-cyclicality of aid flows? In other words how do they deal with 'aid uncertainties'? Amongst the questions they are forced to address is the degree of dependence of their budgets on external assistance. The decision of whether to design and scale up national programmes, such as employing more public sector workers in health and education services, may be based on overly optimistic projections of future aid disbursements. Given the restricted room for manoeuvre (fiscal space) and structural rigidities of many low-income economies, as well as liquidity constraints that hinder their ability to adopt compensatory measures, coping with possible aid shortfalls has to be taken seriously in terms of their planning and budgeting processes.

The aid uncertainties listed above are another contributing factor to the continued attractiveness of project-based aid which is less subject to unpredictability and volatility since it is often committed for the lifespan of the project, with fewer conditionalities attached. Any shortfall on a project is also likely to be less disruptive to national planning and budgeting than unexpected shortfalls in budget support inflows. A rational response on the part of partner countries to these uncertainties is therefore to spread the risks of unpredictability, volatility and pro-cyclicality of aid flows by negotiating with donors an appropriate mix of stand-alone projects, technical assistance, sector-wide programmes which may be either on or off their national budgets, and direct budget support.

A more damaging consequence of these aid uncertainties is that partner countries have also come to 'discount' aid. Given that they have been encouraged to move from uncoordinated project support aid delivery modalities to more coordinated programme support, the benefits of lower transaction costs associated with the latter may be offset by increased risks linked to budget support aid uncertainties. As a result, based on past experience and given the need to budget prudently, some countries have come to discount pledges of assistance.[40] While this may have the benefit of introducing greater realism to the financing plans of government, there are a number of less welcome consequences. One is that discounting can lead to a situation whereby, notwithstanding the objective needs of a partner country, donors find few funding gaps to which their funds could be applied. This in turn may trigger a downward spiral of decreasing commitments and disbursements followed by further aid discounting.

Given the structural rigidities of their economies, discounting acts as a brake on the partner countries' ability to react rapidly and make up the shortfall through an increased export effort. The 'thinness' of their domestic capital markets, and their own poor international credit ratings, means that low-income and highly aid dependant economies cannot off-set the non-disbursement of aid by borrowing either domestically or internationally. Excessively sharp fiscal adjustments, or an inflationary expansion of the money supply, are two possible counter-measures that may end up being adopted, the latter with possibly negative consequences for macroeconomic stability.

## 9.3 MEASURES TO REDUCE AID UNCERTAINTIES

From the vantage point of donors, therefore, their responsibilities require them to enhance aid predictability, to deliver on their commitments and to programme aid over multi-year frameworks. This would in turn require donor agencies to protect ODA as a slice of their own national budgets, and to ensure that such information is transmitted to partner countries so as to allow the latter to incorporate these projections of external resource inflows into their own medium-term plans.

40 The Ugandan experience is instructive. Based on years of experience with donors, the Ugandan government in the course of its planning and budgeting introduced a discount factor for budget support inflows based on the average shortfall between commitments and disbursements over the previous five years.

Corporate constraints militate, however, against any rapid solution on the donor side since:

> *'…aid volatility reflects deeply rooted problems with the way donor budgets are approved and administered… donor development agencies that make aid commitments are different from those that approve funding (parliament) and disburse aid (ministries of finance). While the magnitude of this disconnect differs form country to country, it seems widespread.'* (Bulir and Hamman, 2006: 4)

The specific issue of the impact of conditionality on aid volatility needs to be addressed by both donors and partner countries. On the side of partner countries, there is a need to pursue policies previously agreed with donors in a consistent manner, thereby reducing the dangers of shortfalls, or in extreme cases, cut-offs in aid flows. On the side of donors, conditionality needs to be streamlined and designed in such a way that disbursement is conditional on a restricted number of clear and specific performance criteria, mutually agreed to by both donors and partner country governments. Disbursement should preferably be over periods longer than one year in order to allow for the measurable results of policy reform programmes and poverty reduction efforts to make themselves felt. It would also be logical for targets and indicators on which conditionality is based to be reflective of variables over which partner governments have a substantial degree of control, and for which they can then be called to account for.

It should be noted that there has been significant progress by the BWIs in terms of streamlining their policy conditionalities. In 2002, for example, the IMF issued a set of new Guidelines on Conditionality to reduce the negative effects of their conditionality. The guidelines tried to ensure that conditions were negotiated through a process led by partner governments, and that they were focused on the overall objectives of a PRGF-supported, but nationally designed, programme.[41]

The same process was undertaken by the World Bank following an extensive review of its own practices (2005), which led in 2006 to the adoption of a set of 'Good Practice Principles', whereby conditions were to be agreed upfront with governments, adapted to country circumstances, selective in terms of the number of actions required as preconditions for disbursement of World Bank funds, and based on regular and transparent progress reviews.

Supplementary measures by donors should include ensuring that performance reviews, upon which disbursements depend, are scheduled to fit into the planning and budgetary cycles of partner countries to ensure aid flows are as predictable as possible for national authorities, and to help smooth their budget implementation. In recognition of the numerous challenges facing partner countries which may result in performance slippage, the OECD has proposed that mechanisms be set up that allow for partial disbursements in the case of partial fulfilment of conditions: 'an intermediate option between withholding all funds and releasing them' (2005: 34). Historically, conditionality has been of the 'all or nothing' variety. Given the numerous domestic and external constraints facing partner countries, there are compelling reasons for steering a middle course, with the amount of aid provided reflecting the extent to which targets are met. This diminishes the risk of partner countries having their support suddenly suspended with potentially very serious fiscal and developmental consequences.

A notable example of such a mechanism is found in the European Commission's budget support programme. This is based on 'fixed tranches' and 'variable tranches'. Fixed tranches are linked to the fulfilment of basic macroeconomic conditionalities such as macroeconomic stability as evaluated by an IMF review, and improvements in national PFM. Variable tranches are additional

41 IMF, 'Guidelines on Conditionality', Legal and Policy Development and Review Department, Washington DC, 2002. It is noteworthy that an IMF Staff Statement in 2006 on the guidelines clarified that 'Fund staff will endeavor to reach understandings with the authorities on a mutually acceptable means of achieving program goals, while paying due regard to the domestic social and political objectives, the economic priorities, and the circumstances of the member including… the member's capacity to implement reforms in the necessary time frame'. See IMF, 'Statement of the IMF Staff – Principles Underlying the Guidelines on Conditionalities', Washington DC, 2006, pp.1-2.

resources disbursed in accordance with the fulfilment of specific, mutually agreed targets in the framework of PRSPs, normally centred on improvements in service delivery. The idea is to combine a reasonable degree of predictability for partner countries with performance-based incentives that answer the needs of donors as custodians of public funds to show that they are exercising 'due diligence', as well as monitoring and assessing the results of their development assistance programmes. The mechanism thus allows for a **graduated response** on the part of the EC to shortcomings in a partner country's overall performance.[42]

Additional means of helping to overcome 'aid uncertainties' are to ensure that conditionalities are not excessively detailed, that they are negotiated with partner countries and rooted in a sound understanding of the 'carrying capacity' of a partner country to implement a given set of reforms, and that reviews of progress upon which disbursements are based reflect medium-term considerations. Donors extending their programming horizons by providing their partner countries with multi-year indicative resource envelopes will also assist partner countries with their own medium-term financial planning. Arrangements such as the IMF's Poverty Reduction and Growth Facility (PRGF), which covers a three-year period, and the Country Assistance Strategies (CAS) of the World Bank, which run for four years, are cases in point.

Greater understanding on the part of donors to the 'defensive' posture adopted by partner countries in the face of the aid uncertainties is also essential. In addition to recognizing the reasons behind aid discounting in national planning and budgetary processes in partner countries, there is a case to be made for greater donor flexibility in terms of agreeing to donor funds being used to build up buffers of international reserves, notwithstanding their preference for partner countries to fully absorb and spend aid inflows (see above). In high aid years, there is a compelling logic to saving some aid (i.e., neither absorbing nor spending) so as to cope with future aid shortfalls.

This idea has been fleshed out by Eifert and Gelb, who propose a mechanism based on a reserve tranche of between 50 and 100 percent aid funded spending which translates into between 2-4 months of import cover in a representative aid-dependant low-income country. After subjecting their mechanism to a simulation exercise, they find that it was:

> *'effective in smoothing expenditure in most periods under a range of levels of aid instability...[and that] while our simulated stabilization fund does in some cases go 'bankrupt', this usually requires 3-5 years of large negative shocks to aid flows... [which] would allow countries and donors... plenty of lead time.... to organize an emergency response.'* [43] *(Eifert and Gelb, 2005: 10)*

An alternative to using donor funds as a buffer to aid flow volatility would be to use revenue generated by a Sovereign Wealth Funds (SWFs) – but only under the strictest conditions. As the SWF represents the capital accumulation of a depleting national natural asset (mainly minerals), its funds are 'ring-fenced' and earmarked for reinvestment in specific productive assets and intangible capital. As such, SWF resources could only be applied to certain expenditures mandated by its enabling legislation. The judicious use of SWF funds could, however, reduce fiduciary risks and enable donors to be more flexible in allowing a portion of aid funding to be disbursed as a temporary reserve against volatility.

42 Another suggestion, advanced by a team of World Bank analysts aimed at improving the predictability and volatility of budget support, is to differentiate between **changes in performance** and **levels of performance.** They advance the argument that core budget support flows should remain stable over the medium-term, and that **sharp changes** to such flows should only take place when 'catastrophic' declines in the quality of partner countries PFM, budget discipline or macroeconomic management occur. On this proposal see Been Eifert and Alan Gelb, 'Improving the Dynamics of Aid – Towards More Predictable Budget Support', World Bank Policy Research Working Paper 3732, Washington DC, 2005.

43 The authors note, however, that one of the difficulties in implementing the idea would be that donors, while possibly accepting the need for such a fund as an insurance scheme for partner countries to cater for shortfalls in disbursements that are not performance-related, will also require a mutually-agreed and clear performance framework without which they will come to see such a fund as a means for partner countries to access funds when the funding gaps are the result of performance shortfalls that are not due to exogenous aid volatility.

## Section 10

# Aid Dependency as an Impediment to the Rise of Developmental States

The phenomenon of aid dependency has been extensively treated in the literature, with some arguing that aid, especially large volumes of aid, undermine endogenously generated and sustained development efforts by partner countries. One particular target of criticism is technical assistance. The effectiveness of this particular component of ODA has been questioned largely on the grounds that the current aid system provides incentives for its continuation, rather than building in obsolescence for technical assistance based on the transfer of skills and the building of local capacity.

Another concern arising from high levels of aid dependence is that it can constitute an obstacle to a partner state transforming itself into a developmental state, i.e., a state that shows 'a clear commitment to a national development agenda, that has solid capacity and reach, and that seeks to provide growth as well as poverty reduction and the provision of public services' (Fritz and Menocal, 2006: 4)

Ghani attributes a set of ten functions, which any state must be able to perform in order to be considered effective. It must: (1) possess a monopoly over the means of coercion, (2) enjoy administrative control over the national territory, (3) exercise sound management of public finances, (4) invest in human capital, (5) foster citizenship rights and duties, (6) provide sound infrastructure, (7) engage in market formation, (8) exercise sound management of state assets, (9) engage in effective public borrowing, and (10) uphold the rule of law (Ghani, Lockhart and Callaghan, 2005).

The prominence of sound economic management criteria in the above set of functions raises the question of the effect of aid flows on state effectiveness, and more specifically whether changes from project aid to budget support mechanisms through PRSPs has affected incentive mechanisms in terms of state performance. Some light has been thrown, in particular, on the question of the possible disincentive effects in terms of the expansion of the tax base of developing economies. Moss and Subramanian (2005) have argued that aid lowers the incentives for governments to broaden their tax base and reduce their dependency on aid. They argue that aid dependence locks both donors and partner countries into a permanent situation of high aid and low institutional capacity, and show that aid is negatively associated with tax efforts.[44]

They also note that the composition of aid exerts differentiated pressures on revenue efforts. The need to repay loans leads to increased domestic revenue generation, while grants have the opposite effect since they are free resources that can substitute for domestic revenues, and hence are more likely to reduce domestic efforts to collect more revenue.

Other studies, however, do not detect a negative fiscal effect of aid where governments implement sound macroeconomic policies and make wise decisions in terms of the use of aid in the fiscal domain. McGillivray and Morrisey (2001) show a mixed picture from a survey of various fiscal response models. In some cases they show that

[44] While foreign aid may be necessary at the early stages of growth (or in the case of Zimbabwe, recovery) in order to finance the 'two gaps', i.e., the savings gap and the trade (foreign exchange) gap, over the longer-term and given finite aid, there is also a need for longer-term strategies aimed at the efficient reallocation and creation of factors of production, a process in which a state's taxation and fiscal policy plays a key role. The point is hardly a novel one, and has a long and eminent history. As long ago as 1963 Nicholas Kaldor observed that incentives for collecting taxes, i.e., one of the basic functions of the state, might be undermined by an over-reliance on external resources. See his 'Will Underdeveloped Countries Learn to Tax?' Foreign Affairs, 41, Washington DC, 1963, pp.410-419.

aid may discourage tax efforts and encourage increase public borrowing, but that in other cases aid may increase tax efforts, encourage increased spending on productive investments and support improved fiscal management, thereby reducing over the longer-term, borrowing requirements.

To these concerns might be added another distortion that impacts on partner countries that are highly dependant on aid, namely the negative consequences for domestic accountability mechanisms. The argument is a simple one: large aid inflows trigger a shift in the accountability nexus from the primary contract between state and citizen, to one between governments and external agencies. The hypothesis, borne out by a number of cross national studies, is that:

> *'large sustained aid flows fundamentally alter the relationship between government elites and local citizens… If donors are providing the majority of public finance and governments are primarily accountable to those external agencies, then it may simply not be possible to also expect a credible social contract to develop between the state and its citizens… aid may undercut the very principles the aid industry intends to promote: ownership, accountability and participation.' (Moss, Petterson and van de Walle, 2006: 14)*

# Section 11

# National Aid Policies and Management Systems

## 11.1 EFFORTS TO ADDRESS THE POWER IMBALANCE

National aid policies and management systems go to the heart of the power imbalance between donors and partner countries. Notwithstanding the notion of partnerships embedded in frameworks such as the Paris Declaration and the Millennium Development Goals, it is hardly surprising that there is a clear asymmetry of power in aid relationships, both in terms of who provides the resources and differences in national capacity. It is worth recalling that it is bilateral agencies and donors that determine the quantity of ODA available globally, how it is disbursed and to whom. Conditionalities are applied by these bilateral donors, and the IFIs they largely control. Partner countries have limited influence over donor policies, except ultimately the right to refuse aid.

Yet the asymmetrical relationship is gradually being corrected. Principles such as that of mutual accountability, part and parcel of the more rules-based approach underpinning the Paris Principles, have played a useful role in levelling the field and are a means through which partner countries can hold their donors to account. Mechanisms such as the OECD-DAC peer reviews[45] and country specific Performance Assessments have played a useful 'name and shame' function where specific donors have failed to live up to the Paris Principles.

In situations of high dependence on aid – and where the partner country may not possess a strategic natural resource which could provide it some leverage in negotiations with donors, or does not occupy a strategically important geographical position – the need to develop a sound aid policy management framework and accompanying systems is all the greater. The list of weaknesses and uncertainties detailed in this working paper in terms of current international aid architecture, its systems, processes and instruments, means that the development of effective aid management tools by partner countries increases their chances of overcoming these problems (or at least minimizing their deleterious effects). A sound aid policy would help partner countries ensure that aid flows meet national priorities, that donors are more harmonized, and that they themselves are able to at least partially determine the pace of reforms and exercise effective leadership in the aid relationship.

International experience shows that there are a number of enabling pre-conditions for partner countries intent on exercising leadership of their own national development agendas and in their relations with donors. Firstly, a stable and predictable economic environment greatly facilitates forward planning by any national government, and in the case of highly aid dependant economies this becomes all the more important since it allows them to make sounder projections of their needs in terms of external resource envelopes.

Secondly, open and frank engagement with donors is key to building the necessary mutual trust on the basis of which donors will be prepared to commit resources to support a partner country's development efforts. Thirdly, a partner country's clear commitment to undertake reforms of public institutions, particularly in the area of public financial management systems, is an important trigger for many donors, reducing their fiduciary risk concerns. And finally, the technical quality of a partner country's development strategy, i.e., the degree to which it is properly prioritized, sequenced, based on sound data, consistent in terms of inter-sectoral linkages, and backed up by verifiable

[45] This OECD-DAC mechanism allows for the monitoring of the efforts and performance of individual DAC members in terms of their development cooperation. Individual members are evaluated every four years by a team composed of DAC Secretariat technicians as well as aid officials from two other member countries of DAC. The task requires visits to both the capital city of the member state under review, as well as to partner countries in order to assess the extent of compliance with DAC principles and policies.

progress indicators and sound monitoring, evaluation and reporting systems – makes it easier for donors to align to and support such a strategy document. The above enabling conditions, which should be reflected in the long-term objectives of any national aid policy framework, might usefully be seen as constituting the 'external orientation' aspect of such a framework, geared to the donor-partner country relationship so that both aid flows and donors are aligned to national priorities and strategies.

To this might be added an 'internal disciplining' feature of a national aid management policy which addresses problems that arise from highly projectized aid delivery, and the 'pull factors' operating on the side of partner countries ministries mentioned earlier. In the absence of a clearly delineated approach to national aid management, and assuming that various kinds of project support and technical assistance continue to loom large for some time to come, responsibilities for dealing with donors are usually diffuse and dispersed between government entities. This results in a problem of multiple, disconnected and uncoordinated development interventions based on donor inputs, be these technical or financial. The problem of Ministries of Finance being saddled with fiscal responsibilities in the form of either unbudgeted recurrent and even capital expenditure of which they may not even be aware, because of commitments entered into by line ministries, is a very real one.

The process of developing an aid management policy provides a means to clearly demarcate responsibilities. It may help to counter the continuing attractions of uncoordinated aid flows for line ministries, who understandably are reluctant to give up the freedom to negotiate their own deals with donors, by reassuring them that the development of greater coherence and centralization will not impact negatively on their sectoral and corporate interests.

In sum, the advantages of national aid management policies are seen to be that they can constitute:

- a means for partner countries to assert leadership in the local implementation of the Paris Declaration;
- a framework for improving the channelling of aid inflows to priority areas;
- to serve as a filter that will allow governments to be more strategic and discerning in terms of the volume and types of aid sought;
- over time, assist in raising the proportion of aid passing through budgets and help governments gain a better understanding of the total volumes of aid entering a country;
- help to counter the fragmentation of authority amongst government agencies dealing with aid matters; and
- acting as an important vehicle for confidence-building between partner countries and donors. (Killick, 2008)

A clear strategic vision reflecting how any given partner country would like to see its relations with donors develop over time is essential, and should be reflected in any national aid policy document. An interesting example of this may be found in Yemen's Aid Policy Paper which clearly incorporates both external and domestic aid coherence considerations. The stated objectives of the policy paper are described as:

> *'…a framework for coordination across the Government of Yemen to improve aid effectiveness, since this requires action by many government ministries and agencies…a management framework for development partners to align assistance to Yemeni priorities and… contribute to aid effectiveness [and sets] out Yemen's commitments under the Paris Declaration… how the Government of Yemen intends to honour them, and what it expects from development partners in this regard.'*[46]

[46] Republic of Yemen, Ministry of Planning and International Cooperation, 'Aid Policy Paper', Draft for Discussion, 2006, p.1.

## 11.2 SOME RESULTS IN TERMS OF NATIONAL AID POLICY FRAMEWORKS

The experiences of some highly aid dependant countries in terms of the utility of a national aid policy are both encouraging and instructive. Mozambique, for example, has made significant progress since the end of its civil war in terms of adapting the Paris Principle of mutual accountability to its own situation, and developed means of extending accountability to donors through a rules-based system that contains clear rules and procedures for both itself and donors.

Donor coordination in Mozambique is structured around a single overarching national strategy, namely its PRSP, to which a number of donors provide budget support (i.e., Mozambique's Programme Partners). In 2004 these budget support donors updated and signed a Memorandum of Understanding (MOU) dating from 2000 with the Government. The MOU laid out the commitments undertaken by both sides in order to improve the effectiveness of budget support and to lay the foundations of a partnership-based approach to support of the PRSP. Drawing on many of the Paris Principles, the group of 18 bilateral and multilateral donors involved in providing budget support committed themselves to a series of measures aimed at improving the predictability of their aid disbursements, to eliminate individual bilateral conditionality and reduce transaction costs, enhance the transparency of aid flows through improved reporting, as well as to strengthen the Government's capacity to lead on the national development agenda.

A Performance Assessment Framework (PAF), which draws on the priority targets and indicators contained in the PRSP was designed by both the Government and donors. As a single conditionality framework for those donors providing budget support, and relying on the information generated by Mozambique's own monitoring systems (an application of the Paris Principle of donor alignment to country systems), the PAF constitutes the basis on which joint annual reviews of progress are carried out, thus allowing donors to make aid commitments in a coordinated manner.

It is also noteworthy that the principle of mutual accountability was strengthened when this group of donors also agreed to the establishment of a Programme Aid Partners - Performance Assessment Framework (PAP-PAF). This allows both the Government and donors to monitor donor behaviour and progress in terms of the areas referred to in the MOU. The assessments of the PAPs-PAF are carried out by an independent team of aid effectiveness specialists, and the results are made public.

Progress has been significant. As a result of the PRSP, which has facilitated donor harmonization around, and alignment to, a single overarching national strategy, as well as the various understandings and mechanisms reached between the Government and donors, there have been significant improvements in terms of aid predictability. As of 2006, 14 of the 18 donors had some form of multi-year aid commitment and disbursement mechanism in place, and there were significant improvements in terms of disbursements taking place according to schedule. In addition, the number of donors who were providing more than two-thirds of their aid to Mozambique as budget support had also increased, as had the number of donors aligned to Mozambique's financial planning and budget cycles.[47]

Afghanistan provides another interesting example of what a highly aid dependant country can do to improve its relations with donors. It would be difficult to imagine a country in a weaker position in terms of its bargaining power vis-à-vis donors than post-Taliban Afghanistan. Not only was it highly dependant on external military forces in order to safeguard the state, but in 2006, for example, aid accounted for approximately 36 percent of Afghanistan's gross national income, while for 2006–2007 the volume of aid was almost double that of government expenditure (OECD-DAC, 2008: 1-2).

The new Karzai government moved quickly to take control of the country's development agenda and

[47] For details see Alina Rocha Menocal and Sarah Mulley, 'Learning from experience? A review of recipient-government efforts to manage donor relation and improve the quality of aid', ODI Working Paper 268, Overseas Development Institute, London, 2006.

relations with donors. It designed its own National Development Framework in 2002, which then developed into a more detailed Afghanistan National Development Strategy which clearly set out the government's priorities. The government's principles and expectations in terms of engaging with donors and managing aid inflows were laid out in an annex to the Afghanistan Compact of 2006. This clearly sets out the responsibilities of both donors and the government in terms of joint efforts to improve the effectiveness of aid to Afghanistan, and draws heavily on Paris Declaration principles.[48]

Recognizing the need to take steps to strengthen government systems in order to increase donor confidence in them, as well as to make progress in terms of national ownership, the Government quickly set up an Assistance Coordination Authority in the new Ministry of Finance. It also set about improving its PFM systems in order to address donors' fiduciary risk concerns.

Simultaneously, while this capacity-building effort was underway – and though it early on expressed a preference for budget support from donors – it agreed to the establishment of a small number of multi-donor trust funds in order to encourage early donor harmonization and alignment to national priorities and thereby reduced transaction costs for itself. And in recognition of the importance that aid was likely to play for the foreseeable future, the government set up a computerized system to capture and track aid flows, and strongly encouraged donors to report to this Donors' Assistance Database.

The results, though seemingly modest, must be seen against an extremely poor baseline. By 2007, the percentage of aid disbursed by donors to the Government sector through Afghan PFM systems had increased from 44 percent in 2005 to 48 percent by 2007.[49] By 2006, more than 90 percent of aid flows were being recorded in the Donors' Assistance Database.

The Government was also pro-active in a number of other areas. Recognizing the dangers of donor fragmentation, and its own weak capacity to negotiate and monitor a high number of external development actors, it sought to strengthen its position by limiting the number of sectors that any single donor could operate in, thus avoiding the danger of any single large donor exercising undue influence on government policy. Establishing minimum 'entry fees' for sectors, i.e., a floor in terms of aid resources required from a donor before it became involved in a sector, encouraged a division of labour amongst donors that developed over time. The effect was to gradually reduce pressures on limited central government capacities in terms of managing and responding to donor demands. It also took a strict line on foreign technical assistance, exercising its right to turn down offers for external Technical Assistance (TA) where it felt that competent Afghan nationals were available.

The experience of other countries in terms of their development of national aid management policies and frameworks should be taken on board by Zimbabwe as it gradually reengages with the international development community. Given the significant volumes of ODA that may flow into the country over the next few years, there is an imperative for Zimbabwe to develop and then reach agreement with its development partners on the most appropriate frameworks, systems and processes for managing these resources so that they achieve maximum impact in terms of the country's recovery and longer-term development objectives.

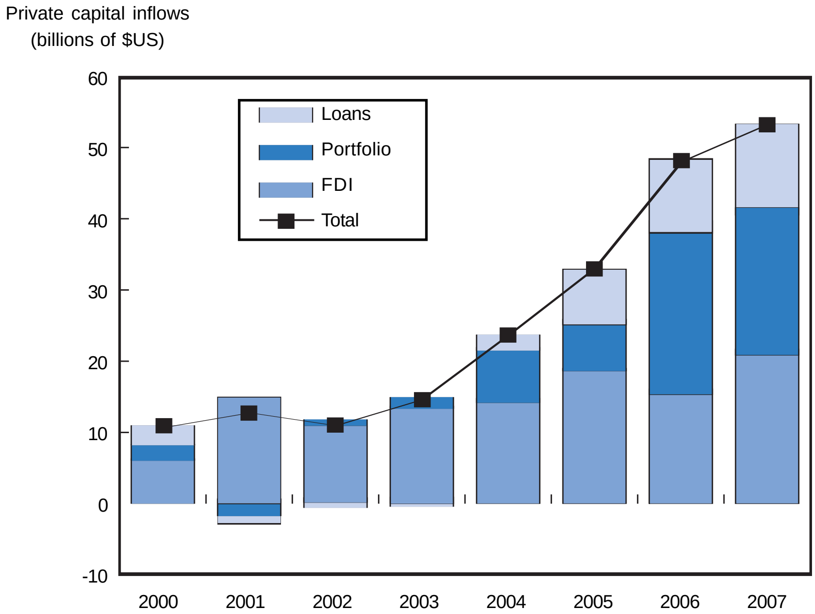
## 11.3 AID AND PRIVATE CAPITAL FLOWS

While there are currently heightened expectations of significant inflows of ODA amongst Zimbabweans as the country reengages with the international donor community, it should be borne in mind that sub-Saharan Africa has experienced

48 The London Conference on Afghanistan – The Afghanistan Compact, Annex II – Improving the Effectiveness of Aid to Afghanistan, London, 2006.

49 Ibid., p.1-8.

*Figure 1: Sub-Saharan Africa capital inflows*




*Source: World Bank (2009)*

large swings in both aid and private capital inflows. After 2002, for example, the global commodity boom saw a five-fold upswing in private capital flows. While small in global terms, Africa relied increasingly on these inflows (Figure 1).

Since the onset of the global economic crisis, however, these private capital inflows have virtually dried up as Western investors rebuild their balance sheets. According to the Institute of International Finance, net private capital flows to poor countries have slumped from almost $1 trillion in 2007 to $467 billion in 2008; and to just $165 billion in 2009.[50] The World Bank estimates that in 2009 most developing countries will not have sufficient reserves to cover private debt falling due (2009). For these countries, total financing needs are expected to amount to over $1.4 trillion during the year, implying a financing gap of about $268 billion. If rollover rates are much lower than expected, or if capital flight increases significantly, this figure could rise to almost $700 billion.

This swing in terms of the relative importance of ODA versus private sector flows during the commodity boom saw the share of aid in total flows to emerging markets fall from 55 percent to just 23 percent (OECD, 2009b). This trend will be reversed during the current global downturn, but given the magnitude of FDI during the commodity boom years, the level of aid funding is unlikely to fill the gap. Even before the onset of the current financial crisis, donor countries – with some exceptions – were already falling short (by around $39 billion a year) of their Gleneagles commitments to significantly increase their aid and double aid to Africa (World Bank, 2009: 9).

Despite pleas from the IMF, and the setting up of a global Vulnerability Fund by the World Bank, official aid flows are likely to decline in the wake of the global recession. While Britain has reaffirmed its Gleneagles' commitment, Italy, Ireland and possibly France have signalled that they intend to cut their aid. Others may follow suit as the recession bites. The Overseas Development Institute estimates that official aid may fall by about a fifth, or $20 billion, in 2009.[51] Others are 'front-loading' their aid commitments (borrowing from future years to keep it steady now), so aid could fall further after 2009.

50 Institute for International Finance, *Capital Flows to Emerging Market Economies*, 27 January 2009.
51 *The Economist*, 12 March 2009.

When the global economy recovers, aid flows are unlikely to rise to the level of the Gleneagles commitments, or even return to the pre-recession levels. Having infused enormous sums into stimulating their economies to avoid a global economic collapse, the ability of Western governments to maintain aid levels, let alone increase them, will be sorely tested. Not only will rich countries need to cut fiscal spending to re-balance their budgets, but demographic factors – notably the dependency ratio – will put pressure on donor governments to reduce aid budgets to shore up funds for their own social welfare programmes, especially pensions and medical insurance.

Given these realities, it may be wise for Zimbabwe to lower its expectations of the volumes of aid it is likely to receive. In addition, in a context in which there are likely to continue to be multiple demands on a restricted global aid purse, the imperative for Zimbabwe to properly utilize such aid as it may receive will be all the greater.

## Section 12

# Policy Implications

Zimbabwe is intent on re-engaging with the international donor community by addressing the overarching concerns that have proved to be stumbling blocks to a normalisation of relations with its development partners. The inclusive government's Short Term Emergency Recovery Programme (STERP) recognizes the need to implement a sound macroeconomic stabilization and recovery programme and to address issues around the rule of law, the rights to freedom of expression and association, and property rights. The international community have indicated they will respond as soon as there is clear evidence of reform.

This working paper has sought to provide a primarily Zimbabwean audience with an overview of the current international aid system, its systems, processes and instruments as well as its historical development, the key debates that have taken place between aid specialists as to how to improve aid effectiveness, as well as insights into the national experiences of some developing countries that were seen to have some relevance to the Zimbabwean situation. As Zimbabwe reengages with the mainstream of international development discourse, and if it is to derive maximum benefit from future aid flows, it is imperative that it deepen its understanding of this aid system and its requirements.

While over the last decade, joint donor-partner country efforts have sought to rationalize international aid architecture in order to make it more 'customer friendly', the paper has sought to convey to readers the continued complexity of the system. Multiple demands continue to be placed on partner countries, many of them with limited national capacity. In the specific case of Zimbabwe, this challenge is likely to be all the greater given the need to play rapid 'catch-up' in light of years of isolation from the mainstream of international development processes. Yet at the same time, like all latecomers to any global process, it will have the advantage of being able to learn from the experiences of other countries in terms of macro-level initiatives such as HIPC, PRSPs, and the Paris process. As a result, there is scope for the country to be able to get to the forefront of these processes, drawing on what is already a significant global track record in terms of lessons learned and best practices.

The need to therefore build national capacity in the management of aid flows will determine, to a large extent, Zimbabwe's ability to take a lead in terms of relations with the donor community. More specifically, such national capacity should include a sound understanding of the technical requirements for meaningful engagement in processes such as international debt relief efforts, the designing of overarching national development strategies such as PRSPs, the development of appropriate frameworks such as TRMs for those states that find themselves in transitional situations, and the designing of appropriate national aid and debt management policies and frameworks.

The level of national effort required in terms of engagement in these initiatives should not be underestimated, particularly given the fact that the demands placed on national systems to engage in multiple processes will take place simultaneously rather than sequentially. Irrespective of the precise volumes and kinds of aid that Zimbabwe may receive in coming years, it would be safe to assume that both aid and donor agencies will loom large in national life for the foreseeable future. Under such conditions, and in order to avoid many of the pitfalls associated with uncoordinated aid flows raised in this paper, the need for strong inter-ministerial coordination in terms of the establishment of technically sound national recovery and development priorities and strategies cannot be overstated. Only under such conditions will it be possible for Zimbabwe to make use of the Paris Principles in order to ensure that harmonization, alignment, a results focus and mutual accountability of donors and their aid takes place, and for the country to exercise leadership in terms of its own development agenda.

In addition, the dangers of aid dependence should also be factored into national dialogues and decision-making on the role of aid in the country's recovery and longer-term development. As this paper has sought to highlight, aid inflows, unless properly managed, can lead to both macro- and micro-economic distortions, as well as impact negatively on national institutions in terms of both a country's need to properly manage and maximize its internally generated resources, as well as at the level of national accountability systems. In the view of the authors, aid should be seen as complementary to, rather than a substitute for, sound economic management, which sustains robust growth rates, and the associated political and institutional reforms seen as necessary by society.

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