

Criteria for general budget support and general sector support

**Report commissioned by the
Norwegian Ministry of Foreign Affairs**

Hildegunn Kyvik Nordås

R 1998: 6

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Summary

This report assesses a set of criteria for providing development aid in the form of general budget support and sector support. The criteria are suggested by the Norwegian Ministry of Foreign Affairs and relate to good governance, structural reforms, the budget process, accounting, auditing and reporting. The criteria are assessed on the background of a discussion of how general budget and sector support work from a macroeconomic view. In addition an analysis of the workings of such support in combination with the most common conditions on which it is given is provided. It is recommended that budget or sector support should be given when the recipient government has adequate administrative capacity. Macroeconomic policy measures should be left to the recipient government in cooperation with the IMF in order to ensure internal consistency. Budget and sector support should be given under the condition of accountability and transparency. If these conditions are not fulfilled, debt relief may be considered as an alternative to sector or budget support.

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Overview and recommendations

This report assesses a set of criteria for providing development aid in the form of general budget support and sector support. The criteria are suggested by the Norwegian Ministry of Foreign Affairs (MFA) and relate to good governance, structural reforms, the budget process, accounting, auditing and reporting. The report is commissioned by MFA, but the responsibility for the views and recommendations herein rests with the author.

We start by raising some general issues related to transfers to least developed countries. We first argue that under any circumstances, new projects should not be approved unless existing structures are in good working condition. Second, we argue that borrowing should not take place unless the return on the loan-funded project is at least as high as the cost of the loan. Third, we argue that donors must ascertain that total transfers to the recipient country and corresponding programs are compatible with an effective and sustainable public sector. Finally, we argue that sector and budget support should be given when the recipient government has adequate institutional capacity.

Next, we provide an analysis of the macroeconomic impact of budget support. The interdependency of macroeconomic policy measures is emphasized. Therefore, we argue that macroeconomic policy making should be left to at the most one decision-making body for each policy measure. We go on to show how the different policy measures work under different policy regimes, and how transfers affect the stabilization efforts made by the recipient government. Two important conclusions are made: First, transfers have an expansionary effect on the economy, and often lead to a widening of the trade deficit. Second, transfers under the most common conditionalities imposed by ESAF programs are in principle equivalent to debt relief. Therefore, debt relief could be considered as an alternative to sector programs and budget support when the institutional capacity of the recipient government is weak.

The following recommendations regarding the suggested criteria for sector and budget support are made:

The good governance criteria: The criteria should apply to all recipients of Norwegian development aid, independently of the form the aid is given in.

The structural reforms criteria: It is sufficient to require that the recipient government has entered an agreement with the IMF on structural reforms.

The budget process: The criteria imposed should be related to accountability and transparency, not to any particular budgetary system.

Accounting and auditing: The conditions related to accounting and auditing should be emphasized and receive the highest priority. Reliable accounting and auditing should be made unconditional requirements for the public sector as a whole.

1 The mandate

The mandate for this report is to look at a set of suggested criteria for providing development aid in the form of general budget support or general sector support and assess the suitability of the criteria. The criteria are as follows:

Good governance:

- The country should observe international agreements on human rights;
- The country should be a democracy, or at least in a process of democratization;
- The country should be fighting corruption.

Structural reforms:

- The country must have entered an agreement with the IMF on structural reforms;
- There must exist a policy framework paper (PFP) which summarizes the country's policies on social and economic reforms and lays out the structural reforms which the donors have agreed to fund.
- The government must be committed to the above mentioned agreements.

The budget process:

- The recipient country must have a coordinated budget process established within responsible departments. The budget process should entail the entire public sector. The budget process must facilitate the operationalization of priorities.
- A process aiming at incorporating all donor funding in the budget must have been initiated.
- The budget process must be linked to a multiyear budget. This should contain a framework for long-term planning and the extrapolation of future current expenditure resulting from investment projects. At least such a framework must be under preparation.
- There must be a system in place which ensures that budgeted funds are disbursed to spending agencies.
- There must be a system in place which ensures that each spending agency adheres to the budget ceilings and that embezzlements are prevented.

Accounting and auditing:

- The recipient country must have an accounting system which corresponds to the budget system. Accounts must be prepared shortly after the fiscal year has ended.
- The sectors which receive Norwegian sector support must establish systems for reporting results and transactions in such a way that it is possible to undertake sound and complete accounting and auditing. Such systems must at least be under planning for the entire public sector
- The public sector accounts must incorporate all public sector activities and give an accurate picture of the public sector's expenditures and revenues. They must be sufficiently detailed to show the resources available to the sector program in question and the disbursements on each item.
- Discrepancies between the budget and the accounts should not reflect a systematic lack of budget discipline.
- The government accounts must show at a reasonable level of detail the funds going to sectors not involved in sector programs.

- Auditing must be performed by an institution independent of the spending agencies, including the ministry of finance. The audited accounts must be prepared according to international standards and must be completed within a reasonable period of time.
- Where the public sector undertakes off-budget activities, a consolidated budget and accounting must be prepared.

Sector reports:

- The responsible departments must prepare or plan to prepare performance indicators for the sector engaged in sector investment programs.
- The responsible departments must prepare or plan to prepare a system for reporting obtained results and achievements to donors. This system must as far as possible correspond with the needs of the recipient country.

During the assessment, we are asked to look at:

- The level of detail;
- the realism given the information available;
- whether the criteria introduce additional procedures on the part of the recipient;
- whether the recipient is capable of adjusting to the criteria within a period of 2-3 years; and
- whether the conditions can prevent mismanagement of donor funds.

1.1 Interpretation of the mandate

The criteria for giving general budget support are very much dependent on the objectives of such support. Since one of the suggested criteria is that the recipient has entered an agreement with the IMF on a reform program, we assume that the countries under consideration for budget support are among the 35 countries currently under an Enhanced Structural Adjustment Facility (ESAF) with the IMF. The majority of these countries are least developed countries in sub-Saharan Africa (Fisher 1997, Abed et. al. 1998), and a common feature is a relatively weak administrative and analytical capability. This assumption has important bearings on our recommendations.

Structural adjustment programs usually involve adjusting government expenditure to sustainable levels given the revenue potential. In addition, improving resource allocation and efficiency within the public sector are important objectives of the ESAF programs. Combined with a sound monetary policy these measures are expected to stabilize the economy. In particular, they are expected to bring down inflation. Finally, liberalization of internal and external trade are usually part of the program in order to induce a more efficient resource allocation in the economy as a whole. The structural adjustment programs in all these respects build on generally accepted principles for macroeconomic management.

The pre-ESAF situation was characterized by highly distorted economies with substantial imbalances. In fact, the average government deficit amounted to 13.8 percent of GDP for the ESAF countries before the program was initiated (Abed et. al.

1998). In addition the current account deficit was on (unweighted) average about 5.5 percent of GDP in the countries which entered structural adjustment agreements with the IMF during the period 1986-1988.¹ The average masks a large variation from a current account surplus of 3.3 percent of GDP in the Gambia to deficits of close to 17 percent of GDP in Mali and Malawi. In comparison, the current account deficit in Thailand in 1996 was about 8.5 percent of GDP. A deficit of this magnitude had been sustained for several years in Thailand. It was to a large extent financed through short-term capital flows. This put the Thai economy in a vulnerable position. Combined with a loss of confidence in the economy this is widely believed to have triggered the financial and currency crisis in 1997.

Both at the time the structural adjustment packages were introduced and now with the additional experience from the Asian financial crisis, it was clear that "business as usual" is not an option in the face of huge and accumulating macroeconomic imbalances. In this situation the necessary adjustment process produces winners and losers and may be painful for the latter. Structural adjustment programs are therefore usually combined with extended credit from the IMF and grants and loans from bilateral aid agencies. In this report we assume that one important objective with general budget support and sector support is to bolster structural adjustment while shielding crucial social expenditure. In addition the donors emphasize the objective of promoting recipient ownership of the programs related to sector support. The recipient is hence expected to initiate and run the projects and programs according to their own development priorities and strategies.

2 General considerations

2.1 Forms of development aid

The most common form of development aid is loans and grants to particular investment projects. In the early days of development assistance, project grants and loans totally dominated. However, a growing dissatisfaction with such aid emerged as the projects did not lead to the expected economic growth (World Bank 1995). The problem was that even where individual projects were considered reasonably successful, the macroeconomic impact appeared to be insignificant. This micro-macro paradox has been widely discussed in the literature.² As a consequence of the meager results on the macroeconomic level, a gradual shift in focus and emphasis towards the macro level arose. Development aid in the form of import support and general budget support were introduced as a response to the shift in focus and rapidly increased their share of total transfers.

General budget support and import support are equivalent if foreign exchange is not rationed and trade is free. In that case importers buy the foreign exchange provided by donors at the going exchange rate. The proceeds from sales of foreign exchange accrue to the government in the same way as budget support. In principle the same

¹ Author's calculations based on IMF (1998).

² See for example White (1992) for a survey focusing on the macroeconomic impact of aid.

reasoning applies if foreign exchange is rationed due to an overvalued exchange rate. In this case, however, donors and recipient governments can influence the allocation of scarce foreign exchange. If rationing is effective, it constitutes an additional policy measure for allocating resources to priority areas also in the private sector. However, rationing also creates distortions and rent-seeking behavior. In order to minimize these negative effects, both budget support and import support come with a host of conditionalities which aim at ensuring a more efficient resource allocation, at least within the public sector.

General budget support or import support did not entirely measure up to expectations. For example, it turned out to be difficult to collect the full amount of counterpart funds in several countries. That being the case, importers did not pay the full price of imports. As a consequence, local producers were put at a great disadvantage compared to imports. Sector investment programs (SIPs) were then designed in order to improve performance. The SIPs aim at ensuring that the sectors thought to be most critical for economic development receive adequate resources. At the same time recipient ownership and initiative are encouraged. Finally, an important argument in favor of SIPs is that they are supposed to reduce bureaucracy and administrative burden.

SIPs do not resolve all the incentive problems, however. Therefore they too come with an array of conditionalities. A number of performance indicators have been developed in order to monitor performance related to the conditions. Initially, conditions came mainly from the multilateral donors, as part and parcel of the ESAF programs. But bilateral donors have followed suit during the 1990s, imposing their own conditions. Recipient governments hence face an increasing number of policy conditions related to budget and sector support (Killick 1993). The reduced administrative burden of not having to confront a host of donors with different procedures at a project level may then be partly offset by new procedures. This is particularly the case when donors impose conditions in an uncoordinated way and the conditions as a result are internally inconsistent. Donor coordination, preferably by the recipient country, is therefore of utmost importance if SIPs are to improve the efficiency of development aid.

This very brief description of the changing forms of development aid illustrates, in our view, that there are certain problems and paradoxes related to development aid which occur irrespective of the form in which aid is provided. We suspect that they will not go away as a result of a more detailed and scientific approach to development lending as reflected in the conditions and performance indicators mentioned above. Expectations as to what budget support can achieve where other forms of aid have failed should therefore be realistic. The most central of these problems are further elaborated below.

2.2 Loans or grants; investment or current expenditure?

It is a general principle of economic prudence both in households, the private business sector and the public sector that borrowing should only be for investment purposes. This has also been a guiding principle for development aid. Thus, a condition for structural adjustment lending has been that local resources finance current

expenditure. By the same token, ESAF agreements usually involve shifting resources from the recurrent to the development budget in order to ensure that donor funds are used for investment.

Distinguishing between current and investment expenditure was easy when investment was defined as the accumulation of physical capital. As human capital has gained prominence in development and growth theory, the definition of investment expenditure has become less clear-cut. Recent developments in growth theory find that human capital accumulation is the engine of growth and that investment in physical capital plays a secondary role, or follows as a response to human capital accumulation (Lucas 1993). Expenditure assumed to contribute to the accumulation of human capital can be considered as investment according to this theory. Expenditure on education and health probably at least partly qualify as investment in human capital, and could be financed by borrowing.

Whichever way investment is defined, borrowing should not take place unless the expected economic rate of return on the investment is at least as high as the cost of obtaining the resources. The return depends on the absorption capacity of the recipient country and is not likely to be influenced by how development is funded.

In practice, development lending has led to a tendency to favor new projects at the expense of the operation and maintenance of existing infrastructure, particularly in the least developed countries (Tanzi 1990). It appears therefore that the volume of investment has been higher than what could be sustained by local resources. Jenkins (1997) has studied World Bank lending in this perspective. He found that the Bank did not assess the implications of investment projects for future current expenditure properly. He also argues that both donors and the recipient government have neglected financial viability in project appraisals until very recently.

The ESAF programs aim at addressing the problem of financial viability by incorporating both the revenue and the expenditure side of the budget. In addition, conditions on all other relevant policy measures are included in order to ensure stabilization of the economy and sustainability of the reforms. However, the assumptions on the resources which can be raised from local sources may be on the optimistic side in these programs. In an assessment of experience with ESAF programs, the IMF finds that revenue mobilization has fallen behind targets, particularly in the countries with the lowest local revenue/GDP ratio (Abed et. al. 1998). These findings underline the importance of incorporating careful financial viability analysis in the SIPs.

Even in the absence of rigorous analysis of financial viability, a simple general rule applies: *new investment projects should be approved only if existing investments are in good working condition.*³ When this criterion is fulfilled, support may be given in the form of loans. If not, aid should preferably be given as grants aiming at operating and maintaining existing structures. In the latter case it is of particular importance to

³ Provided that the investments were not "white elephants" in the first place. See Tanzi (1990) for further discussion.

have a realistic time schedule for the transfer of financial responsibility to the recipient country.

2.3 Fungibility

The fungibility problem of development assistance has been discussed at length in the literature. Usually it is seen as a problem that development assistance is used for projects which would or could have been implemented even in the absence of development assistance. Local revenue, which would otherwise have been spent on the donor-funded project is then spent on other projects or programs, or not collected at all. A recent study of the fungibility of aid (Feyzioglu et. al. 1998) finds that only a third of foreign grants and about two thirds of concessionary loans are used for government spending in a sample of 38 countries. The rest is used for tax relief. This is an efficiency problem only if local resources are better spent by government than by those who benefit from the tax relief. In a smaller sample of 14 countries no evidence of fungibility was found.

Turning to the distribution of aid on recurrent and investment expenditure, it appears that between two thirds and three quarters are actually spent on current expenditure. Again loans are less fungible in this respect than grants (Feyzioglu et. al. 1998). Recall, however from our previous discussion that expenditure on human capital accumulation may qualify as investment expenditure. The diversion of funds from investment to recurrent expenditure may therefore not necessarily be a problem.

Finally, fungibility is a problem if local resources are diverted to projects thought to be wasteful, for example sophisticated weapons systems. However, fungibility at the sector or project level is not a problem from an efficiency point of view when donors prefer to fund projects of top priority to the recipient, and as a result, the recipient can afford additional projects further down on the priority list. Particularly when the latter projects are economically and financially viable and contribute to development. In this case fungibility is an indication of efficient economic management.

When resources are fungible, transfers are not likely to affect total resource allocation much.⁴ This is an argument for providing general budget support to developing countries which have fairly well managed public sectors, and development strategies acceptable to the donor(s).⁵

In the same way as a high degree of fungibility has positive aspects, a low degree of fungibility has negative aspects. Thus, when donors fund high priority projects that the recipient government can not afford, the recipient government almost per definition operates at an activity level which it, at least at the outset, could not sustain in the absence of donor funds. A key question then is when, or even if one can realistically expect the recipient government to take over the funding of the program in question. An indicative answer to this can be obtained by noting that investment projects and programs always have implications for future current expenditure. If

⁴ It may, however, affect the exchange rate. If so, it will also affect resource allocation, but that will happen through price signals in the market.

⁵ If development aid is needed at all in such countries.

current expenditure increases faster than GDP, then government expenditure increases as a share of GDP. Donor-funded, non-fungible projects/programs may then contribute to the expansion of the public sector beyond what is desirable or intended, irrespective of whether aid is given as project lending/grants, import support or sector support.

There is an unambiguous negative correlation between economic growth and government consumption relative to GDP (see for example Barro and Sala-i-Martin 1995). The poorest and most aid-dependent region in the world, sub-Saharan Africa, has generally a much higher ratio of public expenditure to GDP than developing countries elsewhere, and much higher than today's developed countries when they had a similar level of GDP per capita.⁶ The region has also experienced slower growth. Assuming that the negative correlation between public expenditure as a share of GDP and growth involves some degree of causality, donors need to consider how much additional activity they should fund. This has to be evaluated against a presumption on what is the optimal size of the public sector.⁷ SIDA (1995) realizes this and does not require that its funding is additional, while the Netherlands (1996) considers it to be important that aid is additional or non-fungible.

On the background of this discussion we would argue that the fungibility problem does not warrant too much concern from the donors' point of view. The crucial point is the absorption capacity of the recipient country – in particular its capacity for efficient resource allocation.

2.4 Is general budget/sector support appropriate when the recipient has a weak or a strong institutional capacity?

The Netherlands considers budget or sector support as a suitable form of development assistance when the recipient country has a strong institutional capacity (The Netherlands' Ministry of Foreign Affairs 1996). ECON (1996) argues that sector support, as opposed to project lending, is most suitable when the institutional capacity is weak. The reasoning behind ECON's conclusion is that a large number of uncoordinated projects is a larger administrative burden than a coordinated sector program. The World Bank (1995) reasons along the same lines, but nevertheless emphasizes the importance of institutional capacity as a key to ownership and success of sector programs. The Bank's suggested solution is to build capacity as part and parcel of the sector investment program.

When sector investment programs are introduced in countries with weak institutional capacity, there is a danger that donor coordination means that the donors more or less

⁶ In 1994, government consumption relative to GDP was 13 percent in all developing countries, 10 percent in least developed countries, 17 percent in sub-Saharan Africa and 17 percent in industrial countries (UNDP 1997). The corresponding development assistance as share of GDP was 1.4 percent in all developing countries, 17.5 in least developed countries and 12.6 percent in sub-Saharan Africa (UNDP 1997). Total public expenditure was about 10 percent of GDP in Europe in 1880 (and government consumption was less than that), when it had a comparable income level with today's developing countries.

⁷ The optimal size of public expenditure is reached when the marginal cost of raising the extra revenue equals the social benefits of the extra expenditure.

take over the policy formulation and even the running of the sector in question. Donors thus gain much more influence than their contribution to the sector warrants.

If both institutional capacity and donor coordination are weak, sector programs easily end up as an exercise in lumping together existing projects under new headings on the planning ministry's (or planning division in the ministry of finance) computerized project database, and little else.

From this discussion we conclude that if local ownership is a priority consideration, general budget or sector support should be given when the recipient has adequate institutional capacity. Although we accept the argument that a coordinated sector program is a lesser administrative burden than a large number of uncoordinated projects, we would argue that it is better to limit the number of projects than to introduce sector programs in countries with very weak institutional capacity. Donors should in this case scale the total number of projects and the total amount of transfers to the absorption capacity of the recipient. When financial and institutional capacity is weak, donor coordination should probably be concentrated in the area of financial viability analysis as discussed above. In addition, debt relief could be considered an alternative to sector support in the case of weak capacity (see sections 3.1.2 and 3.2).

2.5 Summary and conclusions

A paradox related to development aid demonstrated in this section, is that aid appears to be most effective and efficient when it seems to be the least needed. The stronger the institutional capacity, the greater the absorption capacity for external capital inflows. This applies whether inflows are official or private, and irrespective of the form the development aid is given in. Weak institutional capacity goes hand in hand with low absorption capacity and low returns to investment, and again whether aid is given in the form of project lending/grants or program lending/grants. Capacity building, including accumulation of human capital and institutional infrastructure, therefore seems to be a key to success. This is usually a lengthy process, and it is not clear exactly how external assistance may accelerate it. Nevertheless, some general principles have been highlighted in this discussion:

- New investment projects should be approved only if existing investments are in good working condition.
- Borrowing should not take place unless the expected rate of return on the investment is at least as high as the cost of obtaining the resources.
- The total share of government consumption in GDP should be an important consideration when project and program aid are planned.
- The better the recipient government's institutional capacity, the more it makes sense to give loans and grants in the form of general budget or sector support.

3 How does budget support work?

A transfer has the same effect on the overall macroeconomic balance regardless of the form it is given in. The channels through which the economy adjusts to the transfer

are, however, different depending on the exchange rate regime and the form the transfer is given in. Consequently, the conditionalities attached to a transfer should be different depending on the macroeconomic context. We therefore focus on some basic macroeconomic relations before we discuss the particular conditions suggested in the terms of reference for this report. Consider the macro-economic identity:

$$T-G + S-I \equiv X-M + NTR + NINT$$

Where T is government revenue, G is government expenditure, S is private savings, I is private investment, X is exports of goods and services, M is imports of goods and services, NTR is net transfers from abroad and NINT is net interest payments and remittances from abroad. The right-hand side of the identity represents the current account on the balance of payment, or the external balance, while the left-hand side represents the internal balance. The identity implies that a government budget deficit combined with a savings/investment deficit in the private sector necessarily come with a deficit on the current account of the balance of payment.

The identity can be interpreted as follows:

1. If we keep the domestic private investment - savings balance constant, there is a one to one relationship between the government budget deficit and the current account deficit. Thus, a million-dollar increase in the government budget deficit widens the current account deficit by one million. Or equivalently, a million-dollar increase in transfers in the form of budget support narrows both the internal and the external balance by one million if government expenditure is kept constant.
2. If we keep the current account deficit and private savings constant, there is a one to one relationship between private investment and the government deficit. Thus, if the government deficit increases by one million, it is financed by private savings and private investment declines with one million.

This is of course a mechanistic way of analyzing the macroeconomic impact of general budget support. It does not take the dynamics of the adjustment process into account. Nevertheless, the identity always holds and is a good starting point for the analysis. It is immediately clear that a government deficit crowds out either local investment or net exports, or a combination of both. If the budget deficit is large compared to GDP and sustained, private investment may be insufficient to generate or sustain an income level compatible with a minimum level of welfare. Furthermore, it may lead to a permanent balance of payment crisis. These are important insights. The relations represented by the identity imply that balance of payment problems may arise from fiscal problems and are not necessarily rooted in international trade conditions.

The ESAF countries typically face credit constraints in the international financial market. The prevailing current account deficit can no longer be financed through the international financial market. The ESAF programs are designed to reduce macroeconomic imbalances. They aim at narrowing the left-hand side gap of the identity above through an increase in T, an increase in S and a reduced level of G. Such measures narrow the external imbalance by the same amount through mechanisms explained below. However, since there are few measures that directly

influence private savings,⁸ and since increased tax revenue is limited by both a narrow tax base and administrative capacity (Fjeldstad 1995), it may take time to narrow the gaps demonstrated by the identity through T and S. The burden of adjustment then often falls on G and I to a larger extent than desirable. The credit facilities from the IMF and bilateral grants and concessionary loans are usually given in order to avoid this outcome.

The following sections analyze the macroeconomic impact of budget support given to a country under an ESAF program under different assumptions on the exchange rate regime and the degree of international capital mobility. When donor funds are fungible, the analysis also applies to sector investment programs. We start with the common case of fixed exchange rates and relatively low capital mobility. Next, we demonstrate the case with flexible exchange rates and a relatively low degree of capital mobility. We provide a stepwise analysis of the adjustment process - first the automatic adjustments to a transfer and next the additional policy adjustments incorporated in the ESAF program - starting with a situation where the macroeconomic imbalances are unsustainable.

3.1 Fixed exchange rate, low capital mobility⁹

A transfer in the fixed exchange rate, low capital mobility regime has the following impact:¹⁰

- Disposable income increases and aggregate demand with it.
- The interest rate declines and private investment increases as a consequence.
- Import demand increases as a result of the increase in total demand. Exports are unaffected. Therefore the trade deficit increases.
- Money supply increases.

The magnitude of the changes depends on the degree of capital mobility. In the extreme case when capital is perfectly mobile, the transfer will have no effect on interest rates, investment, or income. This is because the transfer adds to money supply which in turn puts a downward pressure on interest rates. A lower interest rate than the rest of the world is not possible with perfect capital mobility and the transfer will simply flow out again seeking higher returns elsewhere. In countries with a high degree of "capital flight," therefore, a transfer is equivalent with debt relief.

When capital mobility is low, on the other hand, a larger portion of the transfer remains in the country. The effects listed above are stronger the less mobile is capital.

The transfer adds to foreign reserves which is part of the money supply. An increase in money supply is compatible with a fixed exchange rate and no additional

⁸ A higher real interest rate usually helps when financial markets are reasonably developed, but higher interest rates also reduce investment. The interest rate should in any case be positive in real terms in order to mobilize local savings and discourage unproductive investments.

⁹ We define low capital mobility as the case where the balance of payments curve is steeper than the balance in the money market curve in a typical Keynesian macro model for an open economy.

¹⁰ The analysis is based on a standard Keynesian macro model.

inflationary pressure if the supply side responds to the stimulus from the demand side. If it does not – if for example a lower interest rate fails to generate additional investments, the increased demand and money supply is more likely to lead to an increase in the rate of inflation.

From the list above, we can see that a transfer has one and possibly two effects which are contrary to the ESAF objectives, namely the widening of the trade deficit and a possible increase in the rate of inflation. The policy measures necessary to improve the external and internal balance then become even more important in the presence of transfers. We therefore turn to a discussion of a typical ESAF program in a regime with fixed exchange rates and low capital mobility.

3.1.1 ESAF and budget support

Consider a situation where there is initially a large government deficit and an unsustainable current account deficit. So far the current account deficit has been financed through short-term debt rescheduling, arrears and other ad hoc arrangements with creditors. Further, assume that the local financial markets are thin such that the government deficit has been largely monetized, leading to a relatively high rate of inflation. This country enters an ESAF agreement with the IMF and bilateral donors support the adjustment process by providing budget support or sector investment programs. Let us finally assume that the budget support and/or SIPs are initiated immediately after the ESAF has been agreed, and hence before any policy measures have taken effect. This is in fact the usual order of events (Abed et. a. 1998).

As explained above the budget support or SIP leads to an increase in aggregate demand, an increase in local investment and a larger trade deficit. It is also a danger that inflation may increase if the investment response to a lower interest rate is weak. The effect on the trade balance and the possible inflationary impact are undesirable and contrary to the objectives of the ESAF. Therefore, additional policy measures are necessary in order to obtain the objectives of the ESAF. These measures can be divided into two major categories:

1. Measures that improve the workings of the market;
2. Measures that regulate aggregate demand and the composition of demand.

The first category relates to removing distortions and introducing or improving institutions such that for example investors respond to the investment opportunities that arise from a lower interest rate. Or such that producers respond to the export opportunities that arise from a devaluation of the exchange rate (discussed below) and improved access to foreign markets. Such measures reduce the probability that higher demand or improved terms of trade generate inflation rather than a supply side response.

The second category relates to fiscal and monetary policy, trade policy and also exchange rate policy. Monetary policy has no impact on aggregate demand in the case of fixed exchange rates (see the appendix). Money supply does, however have an impact on inflation. This is the reason why ESAF programs emphasize the need for a

switch in financing of the government budget deficit from “printing money” to foreign financing.

Bringing monetization of the budget deficit to an end is only a first step towards stabilization, however. In fact, foreign reserves contribute to the money supply as well. Reserves are more easily absorbed through increased imports, however, and thus less inflationary than monetization of the budget deficit.

In the long run the deficit net of transfers has to be reduced in order to obtain a stable macroeconomic environment. As pointed out above, the budget deficit as a share of GDP was on average close to 14 percent prior to the ESAF programs. In most of the countries it is not possible to narrow the deficit to sustainable levels from the revenue side alone, and budget cuts are therefore necessary. A reduction in government expenditure is a fiscal policy measure and has the following effects:

- Lower aggregate demand;
- Lower interest rate and therefore a higher rate of private investment;
- Improved trade balance;
- Lower money supply (given low capital mobility);

Taking the transfer and the tighter fiscal policy together, both stimulate investment, which is a good thing for future income levels. A tighter fiscal policy helps reduce the trade deficit which was a problem before the ESAF program and which was further aggravated by the transfer. Fiscal policy is usually not tight enough to counterbalance the effect the transfer had on the trade balance. After all the transfer was given to be spent in the first place. In the case of import support, it is even given to be spent on imports. Further measures are therefore necessary in order to improve the trade balance. A devaluation of the local currency is then the most commonly recommended policy measure.¹¹ A devaluation will improve local producers’ terms of trade both on the domestic and foreign markets. Imports become more expensive and local producers can better compete with imports on the local market, and they are able to export more.

Table 3.1 Structural adjustment in a fixed exchange rate regime

	Transfer	Cut in public expenditure	Devaluation
Aggregate demand	+	-	+
Interest rate	-	-	+
Trade balance	-	+	+
Inflation	0 or +	0 or -	0 or +

The policy analysis is summarized in table 3.1 where the columns represent policy measures and the rows represent the policy objectives. Each cell shows the impact on the policy measure on the policy objective. Zero indicates that the policy measure is neutral in respect to the policy objective in question.

¹¹ The exchange rate is fixed after the devaluation, but at a higher level (it takes more local currency to buy a dollar).

The policy objectives of the ESAFs are to bring down inflation, improve the external balance and increase aggregate output. Table 3.1 clearly illustrates the difficulties of obtaining all three objectives at the same time. In all four rows there are both + and -, and the net impact is ambiguous. The policy measure that comes closest to having a positive impact on all policy objectives is devaluation of the exchange rate. However, if the distortions and bottlenecks in the economy are such that producers are not able to respond to the stimulus represented by improved terms of trade, the effect of a devaluation would be undermined by inflation.

This discussion underlines the points we made in section 2 about the need to scale the transfers to the absorption capacity of the recipient government. Otherwise there is a danger that transfers jeopardize the attainment of policy objectives other than increasing aggregate demand. When the institutional capacity within the government as well as the economy as a whole is weak, this is not an unlikely outcome. Debt reduction could in that case be considered as an alternative to budget/import/sector support. This would be equivalent to a transfer combined with policy conditions to the effect that public expenditure should not increase and the trade balance should not deteriorate.

3.2 Flexible exchange rates, low capital mobility

The impact of a transfer from abroad is more complex in the flexible exchange rate regime:

- Disposable income and aggregate demand increases.
- The impact on the interest rate depends on how much of the transfer is saved. The more is saved, the more likely it is that the transfer will lead to a decline in interest rate.
- The impact on the exchange rate is ambiguous.

An increase in supply of foreign exchange leads to an immediate appreciation of the exchange rate. However, as the adjustment process unfolds, the negative impact on the trade balance (similar to what we saw with fixed exchange rates) is corrected by a depreciation of the local currency. In other words, the adjustment made through a devaluation in the case of fixed exchange rates takes place automatically in the case with flexible exchange rates. The net effect depends on how businesses and households respond to changes in relative prices and has to be estimated in each case.

3.2.1 ESAF and budget support

Assume that the initial situation and the objectives of the ESAF are the same as in section 3.1.1. A reduction in government expenditure in order to improve the internal (and external) balance has a different impact compared to the case with fixed exchange rates:

- Aggregate demand declines, but the more mobile is capital the less the impact on aggregate demand.
- The interest rate declines, but the more mobile is capital the less the impact,
- The exchange rate appreciates if the capital mobility is low and depreciates if capital mobility is high.

In the case of flexible exchange rates, monetary policy is the most efficient in controlling aggregate demand. A tighter monetary policy has the following impact:

- Aggregate demand declines;
- The interest rate goes up;
- The exchange rate appreciates.

Table 3.2 Structural adjustment in a flexible exchange rate regime

	Transfer	Cut in public expenditure	Tighter monetary policy
Aggregate demand	+	- (small)	-
Interest rate	-	- (small)	+
Exchange rate	?	+	+
Trade balance	-	-	?
Inflation	0 or +	0 or -	0 or -

As seen from table 3.2 macroeconomic policy is more complex in the case of flexible exchange rates. Note that the adjustment process through monetary policy is harsher in the sense that it takes a greater toll on aggregate demand than a combination of fiscal policy and a devaluation did in the case of fixed exchange rates. If the trade balance improves in this case, it does so more from a reduction in imports than an increase in exports.

Finally, it should be noted that although a fixed exchange rate regime may seem more favorable than a flexible exchange rate regime, the fixed exchange rate can only be sustained as long as the market has confidence in the regime. Otherwise the country will be forced to devalue or a parallel market develops. Finally the positive effects of a devaluation in a fixed exchange rate regime are often undermined by inflation.

3.3 Summary and conclusions

The effects of the macroeconomic policy conditions related to ESAF programs depend on the exchange rate regime. They should therefore be designed as a package where the effects of the policy measures are balanced against each other. Only then is it possible to first stabilize the economy and then create an environment for subsequent increases in income and welfare. It should be noted that the policy objectives of stabilization and expansion might be internally inconsistent in the short run. This is particularly the case when the exchange rate is flexible and monetary policy tight. It should further be noted that the donor transfers affect the macroeconomic variables, often in the opposite direction as the objectives of the ESAF program. For example, transfers lead to a widening of the trade deficit, which needs to be counterbalanced by

a depreciation of the exchange rate or demand management. In addition transfers may lead to a downward pressure on the interest rates and entail inflationary pressure, while the ESAF programs aim at reducing inflation and increase the interest rate at least to a level where the real interest rate is positive. Therefore, the total amount of transfers needs to be taken into account when the macroeconomic policy measures are designed.

On this background we recommend that macroeconomic conditions are left to two central decision making bodies, which should be the government and the central bank of the recipient country in cooperation with the IMF. *Bilateral donors should not impose additional conditions as far as macroeconomic policy conditions are concerned.*

4 An example: Tanzania

This section illustrates the discussion in section 3.2 with flexible exchange rates. As discussed above, the impact of transfers and a typical ESAF program is more complex and less predictable in such a trade regime than in a fixed exchange rate regime. A numerical example is therefore provided in order to illustrate the relative importance of the effects of the transfer and the policy measures. The example chosen is Tanzania. It has a flexible exchange rate and capital mobility appears to be fairly high.¹² We apply a Keynesian macroeconomic model for the Tanzanian economy (Macmod) for the exercise.¹³

As a benchmark we use a base line scenario with "business as usual." In the Tanzania case this means a rather tight monetary and fiscal policy. The baseline scenario also incorporates the impact of unfavorable weather conditions in 1997 and a recovery in 1998.

We start by running a scenario in which foreign transfers to the government is increased by 10 percent compared to the base line scenario each year between 1998 and 2001. We assume that the transfer is used for financing the government budget deficit, and that the share of the deficit financed by the transfer would otherwise had been financed by money-creating bank borrowing. The net impact on money supply is therefore zero. Finally, we assume that public expenditure is unchanged compared to the base line scenario. As should be expected from the discussion in section 3, the transfer in this case has no impact on aggregate demand, the interest rate or the exchange rate. The only thing that happens is a narrowing of the internal and external balance by the amount transferred. On the balance of payment this is seen as an improvement on the current account which stems directly from the transfer and a reduction on exceptional financing "below the line" on the overall balance of payment. The latter also stems directly from the transfer. In other words, the transfer is equivalent to debt relief.

¹² The capital mobility parameter was estimated by calibrating the model to the three most recent years for which a full set of data is available. The average for these three years is used for projections.

¹³ Macmod has been developed by CMI for, and in cooperation with, the Planning Commission in Tanzania. See Nordås (1998) for a full description of the model.

This was probably not a very interesting case, but demonstrates that the macro model behaves according to theory predictions. Our first alternative scenario introduces an attempt to reduce the imbalances in the economy net of transfers. The adjustment process is undertaken mainly on the fiscal side. Government consumption is reduced compared to the base line scenario. In addition there is a gradual increase in indirect taxes. Money supply is unchanged compared to the base line scenario. This may call for the Bank of Tanzania to sterilize parts of the transfer if it exceeds what the government would otherwise have financed through money creation.

In our second alternative scenario, the adjustment is mainly taken on the monetary side. Government expenditure is unchanged compared to the base line scenario. However, we maintain the assumption of an increase in local indirect taxes, since this is already in the pipeline in the country.

Stabilization of the economy, which first and foremost involves getting inflation under control has been and still is of utmost importance in Tanzania and other ESAF countries. All three scenarios are therefore run with a policy mix that brings inflation down from about 15 percent by the end of 1997 to about 7 percent in 2001.¹⁴

The exogenous assumptions are presented in table 4.1 and the main results in figures 4.1 – 4.4

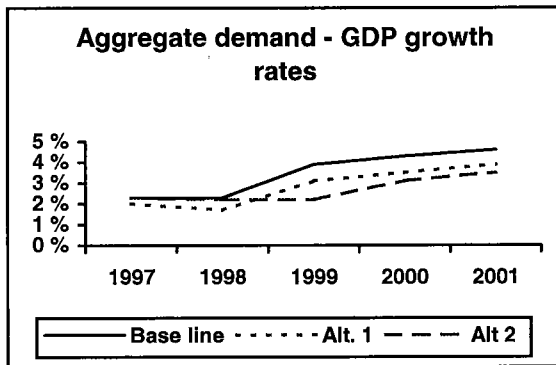
Table 4.1 Policy assumptions

	1997/98	1998/99	1999/00	2000/01
<u>Transfers to govt.</u>				
Base line	200	200	200	180
Alternative 1 and 2	220	220	220	198
<u>Government consumption</u>				
Base line	2	2	2.5	30
Alternative 1	0	0	0	0
Alternative 2	2	2	2.5	3
<u>Indirect taxes (local)</u>				
Base line	3.5	3.5	3.5	3.5
Alternative 1 and 2	4.0	4.5	5.0	5.5
<u>Money supply</u>				
Base line	1998	1999	2000	2001
Base line	12.1	11.3	9.3	8.7
Alternative 1	12.7	12.1	10.1	9.4
Alternative 2	13.2	10.1	7.9	6.9

Note: Transfers to government are given at mill. USD, government consumption as percentage increase from one year to the next, indirect taxes are presented as a share of GDP and money supply is presented as percentage change in M2 compared to the previous year. Money supply is given for calendar years while the other variables are given for fiscal years.

¹⁴ This is in fact above the stated target of about 5 percent inflation by the year 2000.

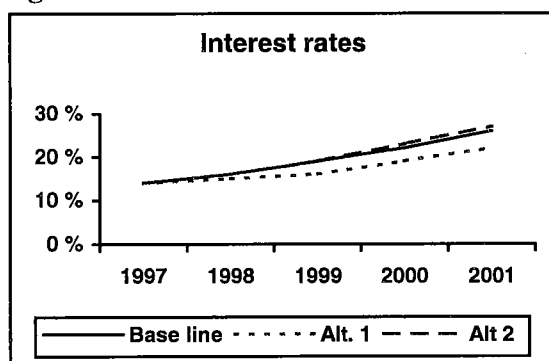
Figure 4.1



As expected, a tighter fiscal policy has a negative impact on aggregate demand and economic growth is lower in the alternative scenario than in the base line scenario. Also as indicated earlier, monetary policy is the most powerful instrument in regulating aggregate demand in a flexible exchange rate regime. Therefore, alternative 2 where the Bank of Tanzania pursues a tight monetary policy mainly in order to curb inflation, has a negative side-effect on aggregate demand. This is the case even when public expenditure is unchanged compared to the base line scenario. Alternative 2 thus yields the lowest growth rate of the three scenarios. This result underlines the importance of fiscal discipline in a country with flexible exchange rates. In the absence of such discipline, the burden of adjustment has to be taken from the monetary side, which proves to be much more negative for the national income than adjustment from the fiscal side.

The real interest rate is presented in figure 4.2. As expected, it declines as a consequence of tighter fiscal policy and increases as a result of tighter monetary policy. However, note that the interest rate is high and increasing over time in all three scenarios. This is due to the fact that bringing down inflation is a high priority in Tanzania. In addition our modeling work suggests that private savings and investment are not very sensitive to changes in the interest rate and strong measures are therefore needed until the rate of inflation has stabilized at a sufficiently low level.

Figure 4.2



The exchange rate is presented in figure 4.3. The difference between the three scenarios are not very big, but the exchange rate depreciates compared to the base line scenario in the tighter fiscal policy scenario and appreciates compared to the base line scenario in the tighter monetary policy scenario.

Figure 4.3

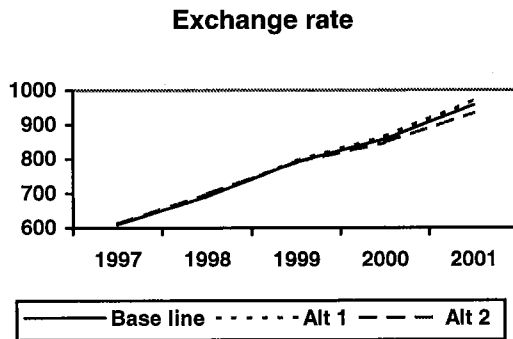
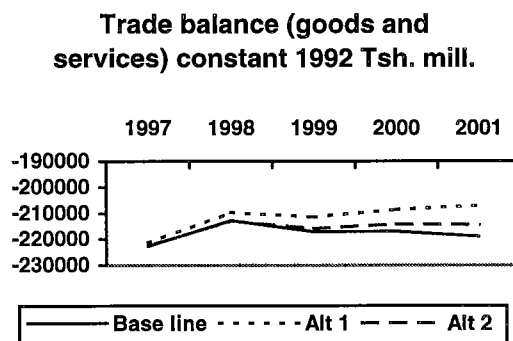


Figure 4.4 illustrates the severity of the external imbalance problem. In spite of the fact that the policy measures introduced are strong enough to have a significantly negative impact on aggregate demand and national income, they are not strong enough to reduce the external imbalance significantly over the four year projection period. It could also be argued that even the base line scenario produce growth rates that falls short of government as well as donor objectives. The tight fiscal policy scenario has the largest positive impact on the external balance at the least cost in terms of lower income growth. Recalling the discussion of the identity in section 3, this should not be surprising. In a country where private savings and investments are not very sensitive to changes in the interest rate due to thin financial markets, government expenditure is more likely to crowd out net exports than private investment.

Figure 4.4



This section has illustrated the macroeconomic policy options and tradeoffs facing a government during the adjustment process. The following conclusions can be drawn from the analysis:

- In a policy regime of flexible exchange rates and weak fiscal discipline, aid in the form of debt relief could be considered.
- Adjustment is least painful in terms of loss of national income when public expenditure takes the burden of adjustment.
- Reallocation of public expenditure towards growth-enhancing and welfare-improving areas will further reduce the burden of adjustment.

5 The criteria for budget and sector support

This section discusses each group of suggested criteria separately. However, some general guidelines should apply when setting criteria:

- They should relate to variables and measures over which the recipient has control.
- They should be measurable/verifiable, such that it can be determined with certainty whether the criteria have been fulfilled or not.
- They should be internally consistent and consistent with the objectives of the reform program.

In addition we argue that Norway should not insist on conditionalities in excess of what is included in the Policy Framework Paper (PFP) for countries subject to ESAF programs. As argued above, additional conditions would increase the administrative burden of the recipient country, and could even unintentionally undermine the ESAF program. It is therefore better to raise eventual concerns within the IMF than impose additional conditions.

5.1 Good governance

The following criteria are suggested:

- The country should observe international agreements on human rights;
- The country should be a democracy, or at least in a process of democratization;
- The country should be fighting corruption.

These are criteria suitable for selecting recipient countries of Norwegian aid in general, irrespective of the form in which aid is given (except perhaps emergency aid).

5.2 Structural reforms

The criteria suggested under this heading are:

- The country must have entered an agreement with the IMF on structural reforms;
- There must exist a PFP which summarizes the country's policies on social and economic reforms and lays out the structural reforms which the donors have agreed to fund.
- The government must be committed to the above mentioned agreements.

The two first points are internally dependent. Thus, an ESAF program with the IMF is manifested in a PFP negotiated between IMF staff and the recipient country. The IMF executive board, where all IMF member countries are represented, approves the PFP (Fisher 1997). The third point on the list implies that the Norwegian government reserves the right to evaluate independently whether the recipient government is committed to the reform program. A footnote related to this point gives some examples of evaluation criteria. Here economic growth is included as a criterion. However, growth is a variable which is not under the control of the government. It is therefore not included as a condition in the ESAF programs, but appears as a policy objective (Fisher 1997). *We therefore recommend that growth is not introduced as a condition for Norwegian budget or sector support.*

On the basis of the general discussion above and in section 2, we think that Norway should not impose additional economic policy conditions when there is an ESAF program in place. These criteria in turn can be reduced to the first point on the list, namely that the country must have entered an agreement with the IMF.

There is a possibility that Norway wants to support countries currently not under an agreement with the IMF. The only time this is defensible is when the potential recipient needs temporal support, has a considerable administrative and institutional capacity and has a reasonably balanced economy. An example of such a country is South Africa. It should, however, be noted that such countries have access to the international financial market at reasonably good terms of borrowing.

5.3 The budget process

The following criteria are suggested:

- The recipient country must have a coordinated budget process established within responsible departments. The budget process should entail the entire public sector. The budget process must facilitate the operationalization of priorities.
- A process aiming at incorporating all donor funding in the budget must have been initiated.
- The budget process must be linked to a multiyear budget. This should contain a framework for long-term planning and the extrapolation of future current expenditure resulting from investment projects. At least such a framework must be under preparation.
- There must be a system, which ensures that budgeted funds are disbursed to spending agencies.
- There must be a system in place, which ensures that each spending agency adheres to the budget ceilings and that embezzlements are prevented.

We agree that a condition for getting budget support is that the budget process is sound and transparent. Further, the budget should be an instrument for management of the public sector as well as a fiscal policy instrument. We would also argue that all too often donors have accepted lax budgetary control because of the recipient's institutional weakness. There are, however, examples of countries and institutions, which with small resources have managed to establish accountability and sound

administrative systems. The Botswana planning system is a case in point (see Nordås, Sekgoma and Somolekae 1998). Another case is the Bank of Tanzania, which has been “right-sized” and its performance has improved tremendously over the past four years. In both cases there has been committed and competent (local) leadership. And not least, the right incentives seem to have been in place.

The budgetary system and the budgetary process vary a lot among countries, both in developed and developing countries. Thus, there exist many different systems which are working well both as management tools for the public sector and as an instrument for the implementation of fiscal policy. Which system is in place in a given country depends on history and tradition,¹⁵ the size of the country, the ethnic, economic and cultural diversity of the country, and how the division of labor between state and market is seen in the country. Hence, countries differ regarding the relation between central and local government, whether they have one-year or multiyear budgets and what is incorporated into the budget. There is no conclusive evidence that one particular system is superior under all circumstances. Therefore, the criteria regarding the budget process should relate to general principles of transparency and accountability rather than insisting on particular systems and procedures. In the following we will discuss each point on the list above:

5.3.1 Coordinated budget process

This criterion deals with the scope of the central government budget. A general principle is that it should be comprehensive and incorporate all the inflows and outflows to the central government. This principle has, however, turned out to be impractical and no country even in the OECD adheres to it (OECD 1995). Areas of particular difficulties and differences among countries are the following:

- State enterprises;
- local government;
- loans and grants provided by the government to the private sector; and
- social security.

The boundaries between private and public enterprises are sometimes not clear-cut. There are publicly owned enterprises which are run as autonomous entities subject to the same conditions as private enterprises. And there are public enterprises which have a role in public administrative management. Usually *net flows* to the latter type of enterprises are included in the central government budget. In countries where state enterprises are a drain on government resources, there is most likely a privatization program in place as part of the ESAF agreement, and this should suffice as a condition for budget support in this area.

Transfers to local government are usually included in the central government budget. In many cases such resources are earmarked for particular sectors such as primary education and health care. However, local government expenditure and own revenue from local sources are usually not incorporated into the central government budget.

¹⁵ The colonial past is often decisive for which budgetary system and processes are established.

Primary education and health care are among the major sectors receiving donor support. The administration of these sectors is usually decentralized to the local government. Weak local government administrative capacity is therefore a particularly serious problem for donors focusing on these sectors. The British ODA has taken the approach not to finance programs managed at local government level in cases where the administrative capacity is very weak. In cases where the administrative capacity is better, financing has been provided in parallel with capacity building assistance (ODA 1996). We believe that the British approach is commendable. It involves a judgement on the efficient use of donor money without imposing conditions on how the recipient country should organize its budget as far as the relation between local and central government is concerned.

Loans and loan guarantees from the central government to the private sector or public enterprises impose particular problems in the budget process. On the one hand the payment of loans is an outlay on the part of the government and contributes to the overall deficit. On the other hand, loans are paid back in due course and may not constitute a drain on public resources in a longer time perspective. A solution in some OECD countries is to include only the subsidy element of the loan or loan guarantee in the budget (OECD 1995). Again there is no consensus on how loans should be treated in the budget, and it is therefore difficult to recommend a particular condition on this issue.

Finally, special or trust funds usually finance social security such as pensions and other transfers to individuals. Eventual transfers from central government to these funds are usually included in the budget, but not payments from the funds.

We have sketched some areas of particular difficulties related to the scope of government budgeting. In developing countries in transition from a state-led planned development strategy to a market-based development strategy, these difficulties are of particular relevance. We have also emphasized that there are no universal solutions to these problems. Four criteria on whether a budget is sufficiently comprehensive are however suggested by the OECD (1995):

1. It should facilitate the measurement of the economic consequences of government actions.
2. It should facilitate the control of the financial resources of the government.
3. It should facilitate accountability of decision-makers and managers in the public sector.
4. It should facilitate the efficient use of public resources.

These are general criteria which we believe are universal. They are, however, not easily operationalized into a set of conditionalities. We therefore suggest that these criteria should provide guidance during the process of selecting countries and sectors for sector support.

5.3.2 Incorporating all donor funds

A precondition for the budget working as a management tool is that the public sector is manageable, and that the ministry of finance has full information on the operations of the public sector. In order to fulfil this precondition, both donors and the government in the recipient countries have some way to go. First, as argued above, donors have in many cases contributed to the establishment of a public sector which is too big to be sustained from local resources. When this is the case, the scaling back, or even leveling off of donor transfers will leave the recipient government in a position of crisis management. This is not a situation where good planning systems are likely to emerge. Second, as emphasized by the World Bank (1995), the central government in the recipient country is often unaware of the existence of a large number of donor-funded projects. This is to a large extent because donors feel that their funds are better utilized if they are disbursed directly to the local government in the area where the project is implemented. Quite often neither the local government nor the donor inform the ministry of finance on the ongoing project. Third, when donors deal with the central government, each donor has its own systems and procedures of project preparation, documentation, disbursement and accounting. When many donors are involved, this is a heavy burden on the administrative capacity of the recipient government.

Our experience from working as consultants and advisors to African ministries of finance indicates that it is often difficult to access the necessary information from donors during the budget process. This is particularly the case when multiyear budgets are being prepared. Few donors have been willing to release information about grants and loans planned over the next few years. This is often because the donors themselves do not have multiyear budgets and therefore do not know how much their parliaments will grant. Furthermore, some of the donors who do provide information on how much funding they will make available to the recipient government, do not actually disburse the declared amount. Therefore, some recipient countries have developed rules of thumb on the basis of past experience on how much of the funding declared by each donor will actually come forth.¹⁶ Thus, they incorporate in the budget what they expect to receive, not what the donor declares it will disburse.

Making the budget a management tool comprising all the resources available to the government in question requires some improvement of the exchange and flow of information both on the part of recipients and donors. We therefore recommend that donors and recipients of budget and sector support work on systems and routines for incorporating all donor funds in the budget as part of the capacity building process.

5.3.3 Multiyear budgets

Donors differ regarding whether to introduce multiyear budgets (MYB) as a condition for sector support. The Netherlands insists on multiyear "rolling" budgets and argue that this is the only way that the recipient government can make commitments to an expanding contribution to the sector program. Denmark and the UK do not mention

¹⁶ Norway usually provides the necessary information.

MYBs in their sector investment program documents, while Sweden states that the policy for the SIDA-supported sector should be included in the recipient country's "forward budgeting process," without elaborating.

MYBs were first introduced in OECD countries in the 1960s (OECD 1995). They were introduced as a planning device in order to identify programs and set aside funding for them. Early MYBs took a bottom-up approach and soon developed into engines of expansion as the spending agencies saw them as entitlements to future increases in resources (Keating and Rosalky 1990, OECD 1995). As further expansion of the public sector in the OECD area became unsustainable, MYBs were considered an inappropriate approach to public sector management. In recent years, however, MYBs have seen a renaissance. This time they are used as instruments for constraining future spending, and usually take a top-down approach. This means that the ministry of finance estimates the total resources available for government expenditure over the next few years. This is done on the basis of macroeconomic forecasts, estimated tax and non-tax revenue, grants and loans, and norms and targets for the development of the overall budget deficit.

In some countries the MYB process stops here. Hence, the MYB only incorporate targets for overall government expenditure and the budget deficit. The targets for overall expenditure are either expressed in terms of percentage real growth or as a percentage of GDP. The target for the budget deficit is usually expressed as a share of GDP.

In other countries the MYB process is taken one step further. Overall resources available for expenditure are allocated among sectors and votes on a fairly aggregate level according to priorities and policies. This facilitates the operationalization of the central government's policy objectives of restructuring the public sector and a redefinition of the role of government. It sends clear signals to the spending agencies as to the trend and direction of their activity levels, and gives them time to adjust.

A further step in the MYB process is to include elements of a bottom-up approach. Usually this is limited to extrapolating the cost of continuing existing programs and the current expenditure stemming from existing investments. The bottom-up part thus shows the cost of maintaining the current responsibilities and functions of the government. The gap between this estimate and the top-down estimate shows how much room there is for new programs, or how much of existing programs must be phased out. In a structural adjustment situation the phasing out of projects and programs and the reallocation of scarce resources are usually what is required. For this purpose, the top-down approach, including a broad sector allocation of resources is probably useful.

The extent to which the multiyear expenditure ceilings have actually translated into the budget ceilings for the annual budget differs among both developed and developing countries.

The merits of the MYB approach depend crucially on the quality of the macroeconomic forecasts made. This in turn depends on the nature of the economy in question. If it is a relatively stable economy with productive sectors not too

vulnerable to weather conditions and other factors over which the economic agents have little or no control, the quality depends on analytical capacity and the flow of information. If the economy is very vulnerable to exogenous shocks on the other hand, forecasts are not likely to provide much guidance.

In most countries at least three quarters of total expenditure in any year is already committed by law, agreements or otherwise. The degree of freedom for future expenditure is therefore limited. This is a factor that has to be taken into account before deciding whether to commit scarce administrative capacities to multi-year budgeting. When the country in question is operating mainly at a level of crisis management, there is no degree of freedom whatsoever. Thus, some countries with severe internal and external imbalances have had to limit expenditure at any point in time to what is actually collected from domestic revenue and grants on a monthly or quarterly basis (often this is a condition imposed by the IMF). Under these circumstances, the spending agencies are not even sure what they can spend next month. It therefore makes little sense to introduce comprehensive multiyear budgets in such a situation.

Multiyear budgets have been most successful when used as a top-down instrument for government expenditure restraint. The bottom-up approach in contrast, tended to enhance public sector expansion. We conclude that experience with MYBs has been mixed. We can therefore not recommend that MYB should be a condition for receiving budget or sector support. A minimum requirement should, however, be that there is a financial viability assessment, as discussed in section 2.1.

5.3.4 Budget implementation

The two last points on the list of conditions under the budget process relate to expenditure control. The conditions imply that the budget is actually an instrument for public sector management and that the spending agencies are accountable. Further, the conditions imply that there is a close relation between the budget and the audited government accounts.

In our view these are the most crucial and important conditions together with the ESAF macroeconomic policy conditions. Thus, there is little gain from creating sophisticated plans and multiyear budgets (with substantial donor technical support) if there is not a system in place for the effective implementation of the plans. We therefore recommend that developing systems for implementation and performance monitoring should be made the top priority in the sector support and budget support programs. Monthly flash reports on expenditure and revenue collections developed in cooperation with the ministry of finance and the central bank are useful instruments in this respect, provided that they are reasonably reliable. This is a first step that controls expenditure and cash flows only. A further step is to introduce performance indicators in order to control performance as well. We discuss these issues further under the next heading related to accountability and auditing.¹⁷

¹⁷ See also Abedian, Ajam and Walker (1997) for a discussion of the South African approach.

5.4 Accounting and auditing

The suggested conditions related to accounting and auditing are as follows:

- The recipient country must have an accounting system which corresponds to the budget system. Accounts must be prepared shortly after the fiscal year has ended.
- The sectors which receive Norwegian sector support must establish systems for reporting results and transactions in such a way that it is possible to undertake sound and complete accounting and auditing. Such systems must at least be under planning for the entire public sector
- The public sector accounts must incorporate all public sector activities and give an accurate picture of the public sector's expenditures and revenues. They must be sufficiently detailed to show the resources available to the sector program in question and the disbursements on each item.
- Discrepancies between the budget and the accounts should not reflect a systematic lack of budget discipline.
- The government accounts must show at a reasonable level of detail the funds going to sectors not involved in sector programs.
- Auditing must be performed by an institution independent of the spending agencies, including the ministry of finance. The audited accounts must be prepared according to international standards and must be completed within a reasonable period of time.
- Where the public sector undertakes off-budget activities, a consolidated budget and accounting must be prepared.

As emphasized in section 4.3.4 above, delivery, accountability and transparency are essential for public sector performance, and in the next instance the entire economy's performance. In our view, therefore, accountability should be an absolute requirement, not only for the sector subject to sector programs, but the public sector as a whole. Hence, we suggest that points 2, 3 and 5 on the dot-list above are combined into one condition to the effect that the government accounts are timely and show how the public sector has spent its resources. These conditions should be strictly enforced.

The level of detail in the budget and in the accounts depends on the capacity of the government and the budget system in place. In some countries there has been a shift from itemized appropriations to block appropriations. This has been done in order to introduce some flexibility into the system. With greater flexibility it is possible to introduce incentives for improved efficiency. When such systems are being introduced and show promising results, the level of detail in the accounting process has to take this into account.

5.5 Sector reports

The suggested criteria are the following:

- The responsible departments must prepare or plan to prepare performance indicators for the sector engaged in sector investment programs.

- The responsible departments must prepare or plan to prepare a system for reporting obtained results and achievements to donors. This system must as far as possible correspond with the needs of the recipient country.

We have already emphasized the importance of accountability and transparency and we repeat it here. The requirement that recipients prepare reports and performance indicators should be made unconditional after a short period of time. However, the reporting systems should be kept simple and the performance indicators should be few and easy to monitor. Finally, it is important that the performance indicators relate to variables over which the government or the spending agent have control and that the targets for the indicators are internally consistent. Recall the discussion in section 3 above about how the macroeconomic indicators are interrelated.

6 Summary and recommendations

In this report we have discussed the conditions under which sector support and general budget support should be given. We have assumed that the recipient country is under an ESAF program with the IMF. We have argued that the conditions laid out in the PFP, which outlines the ESAF program, are so comprehensive and interdependent, that additional conditions on macroeconomic policy and budgetary procedures are most likely to be counterproductive. We therefore suggest that the British and Swedish approach of selecting recipient country and sector on the basis of a careful evaluation of the accountability and capacity of the recipient is applied. In addition, the recipient government's policy objectives should be compatible with Norwegian objectives related to sector and budget support.

We have argued that the suggested conditions regarding macroeconomic policy and budget processes are too detailed and that they are likely to impose additional procedures on the part of the recipient. However, there are certain universal criteria as to what constitute good public sector management that should apply. These criteria relate to transparency and accountability.

Further, we have argued that it is not possible to identify a particular budget process or system, which is superior under all circumstances. We therefore suggest that the criteria related to budgetary procedures should address accountability, transparency and performance. In our view these are the most important of all the suggested criteria, and should be emphasized and strengthened. This is because we believe that incentives are very important for performance. Incentives for improved performance in turn can only work in a system of accountability and transparency. Further, we argue that lack of transparency and accountability has fostered a climate which has protected vested interests at the expense of the development objectives of the country in question. Experience shows that transparency and accountability can be achieved within a reasonable period of time (the 2-3 year period suggested), when the recipients as well as the donors are committed to the task. Finally, we argue that the capacity to account for funds is probably strongly and positively correlated to the capacity to use funds effectively.

Appendix

The model on which the reasoning in section 3 is based is a simple Keynesian macroeconomic model (IS-LM) for an open economy:

Fixed exchange rates:

The goods market (IS equation):

$$(S_y + M_y)y - I_r r = G + X \quad \text{where } S_y, M_y > 0, I_r < 0 \quad (1)$$

The money market (LM equation)

$$L_y y + L_r r = D + R \quad \text{where } I_r < 0 \quad (2)$$

The foreign exchange market:

$$-M_y y + K_r r = -X \quad \text{where } K_r > 0 \quad (3)$$

Where S represents savings, M imports, y aggregate demand or GDP, I is investment, r is the interest rate G is government expenditure, X is exports, L is money demand, D is money supply in terms of nominal domestic assets, R is foreign reserves, $R+D$ is money supply and K is net inflow of capital. The endogenous variables in the model is the national income, y , and the interest rate, r . In addition the money supply is determined by the other variables in the system, such that money supply is subordinate to the fixed exchange rate. This rules out monetary policy as an instrument for regulating aggregate demand.

Solving the system and differentiating with respect to the relevant policy measures give the following results:

$$\frac{dy}{dG} = \frac{K_r}{K_r(S_y + M_y) - I_r M_y} \geq 0 \quad (4)$$

$$\frac{dr}{dG} = \frac{M_y}{K_r(S_y + M_y) - I_r M_y} > 0 \quad (5)$$

Note that an increase in government expenditure has no impact on aggregate demand when capital mobility is zero.

Flexible exchange rates

The goods market (IS equation):

$$(S_y + M_y)y - I_r r + (M_e - X_e)e = G \quad \text{where } X_e > 0 \quad (6)$$

The money market (LM equation)

$$L_y y + L_r r = D + R \quad \text{where } I_r < 0 \quad (2)$$

The foreign exchange market:

$$-M_y y + K_r r + (M_e - X_e)e = 0 \quad \text{where } M_e < 0 \quad (7)$$

A new endogenous variable, the exchange rate e given as local currency per USD is introduced.

Differentiating the system with respect to the relevant policy variables yields the following results:

Fiscal policy

$$\frac{dy}{dG} = \frac{L_r}{L_r S_y - L_y K_r + I_r L_y} > 0 \quad (8)$$

$$\frac{dr}{dG} = \frac{-L_y}{L_r S_y - L_y K_r + I_r L_y} \geq 0 \quad (9)$$

$$\frac{dr}{dG} = 0 \text{ when } K_r \rightarrow \infty$$

$$\frac{de}{dG} = \frac{-(L_y K_r + I_r M_y)}{(M_e - X_e)(L_r S_y - L_y K_r + I_r L_y)} \quad (10)$$

$$\frac{de}{dG} > 0 \text{ if } \frac{M_y}{K_r} < \frac{L_y}{L_r}$$

e.g. an increase in public expenditure leads to a depreciation of the local currency if the LM curve is steeper than the balance of payments curve, and capital is relatively mobile.

Monetary policy

$$\frac{dy}{d(D+R)} = \frac{-(K_r + I_r)}{(L_r S_y - L_y K_r + I_r L_y)} > 0 \quad (11)$$

$$\frac{dr}{d(D+R)} = \frac{S_y}{L_r S_y - L_y K_r + I_r L_y} \leq 0 \quad (12)$$

$$\frac{de}{d(D+R)} = \frac{-(I_r M_y + (S_y + M_y)K_r)}{(M_e - X_e)(L_r S_y - L_y K_r + I_r L_y)} > 0 \quad (13)$$

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