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The Case for Increased Aid

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Volume 2: Country Case Studies

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Burkina Faso Case Study

Summary

Burkina Faso is an extremely poor country that has been undertaking stabilisation and liberalisation reforms since the early 1990s. Although economic recovery ensued and substantial amounts of foreign assistance were received, progress in poverty reduction and social development indicators has been minimal or negative. Based on recent trends, the MDGs are unlikely to be met. The main constraints to poverty reduction are vulnerability to external shocks and poor public service delivery. Lack of economic diversity means Burkina is highly vulnerable to terms of trade shocks and adverse climatic conditions. Participatory development is strong in Burkina Faso, and Government initiated democratic reform and, under the PRSP process, improvements in public expenditure management. However, institutions are weak, hindering the planning, co-ordination and monitoring of spending programmes. Burkina piloted a Conditionality Reform Initiative, which highlighted lack of co-ordination between donors and government as a major constraint to aid effectiveness.

Aid, mainly in project form, accounts for over 40 per cent of public spending, and Government plans to reduce aid dependency gradually by increasing the share of domestic revenue. A significant increase is merited, but the doubling of aid by 2007 implied by aid allocation models would increase it to 70% of public expenditure, implying donor finance of over half of recurrent spending. This level of exposure to risks from fluctuating aid commitments may be undesirable. It would need to be provided mainly in programme form as budget support, and would have to be predictable and sustained into the longer term given the slow pace of revenue growth.

1. Aid trends

1.1 Burkina Faso's historically high and increasing dependency on foreign assistance led to it qualifying for HIPC debt relief in 1997 and being one of the first to reach Completion Point of original HIPC Initiative in 2000 and the Enhanced HIPC Initiative in 2002 as well as 'topping-up' assistance due to adverse external factors. According to DAC figures net ODA peaked in 1995, and has remained fluctuating US$ 385 million per annum since then. Gross multilateral ODA averaged US$ 208 million per year in 2000-01, two-thirds of this being from the IDA, by far the largest single donor. Bilateral donors provided about 50 per cent of total gross flows in 1999-2001, France contributing the most (US$ 70 million) of any one country (OECD *Aid at a glance* tables). Technical co-operation accounts for between 20 and 25 per cent of total aid flows. A large proportion of total aid is delivered through project assistance, about 80 per cent of grants being provided in this way. Debt forgiveness grants amounted to US$ 17 million on average in 1995-99 and were US$ 187 million in 2000 due to HIPC Completion Point.

1.2 Instability is apparent in ODA figures and is also reflected in IMF balance of payments figures for public external financing. The latter represent the amounts of aid reported to Government and are significantly smaller than DAC figures. Projected external financing requirements of Government only extend to 2003. Using the same balance of payments method, Government estimates total external financing requirements of CFAF 239 billion (US$ 377 million) in 1999, rising by 1 per cent in 2000 and by another 4 per cent in 2001 before levelling off and falling by about 1.5 per cent by 2003 (GoBF, 2000, Annex 12). The IMF figures in Table 1 indicate that external financing fell well short of the 2000 target, even accounting for depreciation of the CFAF against the dollar, partly due to delays in disbursing HIPC relief. Annual public external financing requirements (including foreign financed projects) are estimated to be about CFAF 217 billion (US$ 305 m) in 2000 and 2001, falling by about 4 per cent to CFAF 209 billion in 2002 and 2003 (GoBF, 2000, Table 16). Projections do not exist on relative shares of grants and loans in total aid, but for projects, the share of grants is expected to decrease from 61 to 56 per cent over 2000-03.

Table 1 ODA to Burkina Faso (current US$ millions)

	1995	1996	1997	1998	1999	2000	2001
Grants	365	352	305	304.6	305	452	291
Loans and other LTC	126	68	64	95.4	93	-116	98
Total	491	420	368	400	398	336	389
ODA/head (US$)	49.2	41.0	35.2	37.3	36.2	29.8	33.6
% of GDP	22.5	16.9	16.1	16.1	16.2	15.3	16.7
IMF external public financing*	332	349	270	313	374	271	340
GDP growth (%)	4.5	7.5	4.8	6.4	6.3	2.2	5.7
Exchange rate CFAF/$	499	512	584	590	616	712	733

* Calculated from IMF Statistical Appendix and Article IV balance of payments tables as the sum of grants (OTs + project grant capital transfers), official capital, debt relief and change in arrears.
Source: World Bank World Development Indicators, DAC Official Development Indicators, IMF (2002).

2. Aid Effectiveness

Progress in poverty reduction and the MDGs

2.1 Given average GDP growth rate of 5 per cent per annum during the 1990s, even accounting for the substantial annual 2.4-2.8 per cent estimated population growth, it is surprising that poverty incidence has remained stable at 45 per cent. According to the most recent household survey, almost half the population of Burkina Faso live below the absolute poverty line. The majority (94 per cent) of the poor live in rural areas where poverty reduction stagnated over the period 1994-98, and urban poverty incidence rose by 5 percentage points to 16 per cent. Improvements in human development indicators have also been limited and Burkina Faso ranked 169 out of 174 countries in UNDP's (2000) Human Development Index. Burkina Faso is unlikely to meet most MDGs even when accounting for substantial foreign assistance.

Table 2 Progress towards the MDGs

	1994	1998
% living below $1 a day line	61.2	
% living below nutrition poverty line	44.5	45.3
Gross primary enrolment (%)	35.2	40.9
Female:male gross enrolment (%)	72	74
Under-5 mortality (per 1000)	204.5 (1993)	219 (1999)
Infant mortality (per 1000)	107.6 (1993)	104 (1999)
Stunting under-5s (%)	29.5 (1993)	
Maternal mortality per 100,000 births		484 (1999)
Fertility rate (number of children per woman aged 15-49)	6.9 (1993)	6.8 (1999)
HIV prevalence (% total population)		7
Access to safe water (%)	78	78
Contraceptive prevalence (%)		5

Source: GoBF (2000); World Bank WDI; UNDP HDI; IMF (2002b).

2.2 The Government's Poverty Reduction Strategy, set out in the PRSP, is to reduce poverty incidence to 30 per cent by 2015 and increase life expectancy by 10 years. The necessary growth rate required to halve poverty over 2000-2015 is 5.8 per cent, given population growth of 2.8 per cent and assuming a poverty elasticity of growth of 1.5 at mean income (World Bank, 2000). The PRSP's target growth rate of 7 per cent per annum would translate into about 4.2 per cent per capita growth, and an annual decline in poverty headcount of 6.3 per cent, which would achieve 125 per cent of the MDG if sustained to 2015.

2.3 Primary education has been identified as the top priority area for social spending. Government committed itself to increase education's share of budget to 26 per cent by 2010 in order to achieve 70 per cent primary enrolment by 2010, which assuming constant rate of growth would give 87 per cent in 2014. Govt also committed to work with NGOs and community associations to improve literacy rates from 18 to 40 per cent over the same period, focussing on women and people in disadvantaged areas.
Primary enrolment rates are low but improving, although the gender gap remained high in the 1990s. Improvements relate to expanding primary education share in total education budget (from 45 per cent in 1990 to 60 per cent in 1999), reduction of unit costs and demand-side policies including provision of text books free of charge, water and sanitary facilities at schools and by providing mothers' associations with income-generating resources. However, the cost of producing a primary graduate in Burkina Faso is twice the levels of comparable countries in Africa due to high unit costs and high repetition rates. HIV seroprevalence of 6.5 per cent among the general population, but much higher in urban areas, is likely to exacerbate the problem, imposing significant and increasing costs of teacher and student absenteeism and teacher replacement.

2.4 Burkina Faso is one of the worst performing in the world in terms of health indicators. Deterioration in under-5 mortality means that it is extremely unlikely to achieve the two-thirds reduction required by the MDG. Immunisation coverage is low (less than 50 per cent) and fell over the 1990s, and health services are under-utilised by poor and vulnerable groups. IMF (2002, Table 10) estimates maternal mortality figures to be over 900 per 100,000 in 1998, double the rates indicated in the PRSP, indicating problems of inaccurate measurement. Public spending on health as a proportion of govt budget rose from 7 to 12 per cent over 1993-98, but the effect of devaluation on costs of imported medicine and equipment reduced the potential impact. Donors provide a significant proportion of the health budget, but although Government and external donors expend significantly highly on health (US$ 7 per capita), it is poorly co-ordinated and distribution is skewed away from rural areas. Government recognised that it was unlikely to meet MDGs but committed itself to ambitious targets in the PRSP: 60 per cent reduction in both infant and maternal mortality by 2015, and 75 per cent immunisation coverage by 2004. Significant reductions in mortality rates are feasible from such a high starting point if key programmes are implemented focussing on immunisation and the main causes of infant death.

2.5 Environmental concerns regarding water and soil management have been recognised by Government and soil-conservation and irrigation projects implemented.

The Policy Environment

2.6 Burkina Faso commenced a programme of World Bank- and IMF-supported stabilisation and structural adjustment in 1991, in which it redefined its role relative to the private sector, particularly in agriculture, moving away from direct production and marketing and towards supporting private enterprise, infrastructure and human resources. The usual reforms have been pursued, i.e. domestic and foreign trade liberalisation, public enterprise and banking sectors deregulation, and reforms to the tax system and process of budget preparation and execution. Government also pledged to improve democratic accountability and rule of law. Rural development is being decentralised to enable grassroots communities to use resources more efficiently. Overall, the IMF concludes that Burkina Faso has a good record of meeting conditional reform programmes (2002). Burkina has also been undertaking a pilot conditionality reform test aiming to improve aid effectiveness.

Economic Management

2.7 Annual GDP growth was slow (2-3 per cent) during the 1980s and early 1990s but, following devaluation of the CFAF and implementation of donor-supported stabilisation and structural adjustment reforms, increased to 5 per cent on average from 1994-99 and remained above that level despite terms of trade deterioration in 1997-9. The new economic programme for 2000-02 aims for an ambitious 7 per cent GDP growth, as well as 3 per cent inflation and current account deficit (excluding grants) of 13 per cent of GDP. Growth projections are ambitious and based on the assumption of rising public investment enabled initially by an increase in ODA and rising private investment, as well as 'good' exogenous conditions. Growth failed to reach projected levels in 2000-01 due to external factors (world cotton prices fell in 2000, crop disease and low rainfall), falling to 2.3 per cent in 2000, but recovering in 2001 to 5.7 per cent, mainly due to good crops.

2.8 Burkina Faso is a member of the WAEMU currency union, whose currency (CFAF) is pegged to the euro. Annual inflation has been relatively low, averaging 5 per cent in the 1990s. Inflation was briefly negative in 1999-2000 and rebounded to 2 per cent in 2001, mainly due to poor harvests in the previous year. This caused a real exchange rate appreciation in 2001 and eroding some, though not all, of the competitiveness gained from the 1994 CFAF devaluation. After a significant rise in 2000 due to low primary exports, the current account deficit fell in 2001 to about 2 percentage points less than envisaged in the PRSP because of improved cotton exports and low petroleum prices. Total reserves have slightly increased and are the equivalent of just over 5 months of imports.

2.9 PRSP projected current spending: GDP (excluding foreign financed projects) to increase to 16.8 per cent in 2001 and fall thereafter to 14.3 per cent in 2003, with tax revenue financing an increasing proportion from 13.2 to 13.9 per cent of GDP in 2000-03. Tax revenues fell 1.5 per cent of GDP short in 2001, reflecting slow GDP growth and general weakness in tax structure and revenue collection. Furthermore, less than 30 per cent of HIPC resources committed in 2000 and 2001 were spent by end of 2001 owing to delays in disbursement reflecting donor concerns about inadequacies in decentralised spending and accounting and the Government's potential role in diminishing regional stability (IMF, 2002). The overall fiscal deficit was kept within target of 5.1 per cent of GDP by cutting non-essential public spending. However, social sector spending increases were retained.

2.10 HIPC has brought the large external public debt down to sustainable levels (debt service burden is below 1 per cent of GDP, see Table 5) and debt appears manageable, assuming GDP continues to grow by 5 per cent annually. Significantly increased aid needs not cause renewed debt problems provided it is provided as grants or highly concessional loans.

Table 3 Selected economic indicators Burkina Faso (% of GDP unless specified)

	1998	1999	2000	2001*	2002**
GDP growth (%)	6.2	6.2	2.2	5.7	5.7
Inflation (%)	5.0	-1.1	-0.3	4.9	2.0
Gross Dom Investment	29.6	27.2	26.9	26.7	28.1
Gross Dom Savings	12.7	9.4	7.7	10.2	13.4
Gross Nat Savings	19.6	14.3	12.6	14.2	17.8
Current account (excl OTs)	-14.5	-16.0	-17.6	-15.9	-14.1
Current account (incl OTs)	-10.0	-12.8	-14.6	-12.4	-10.3
External public debt	54.7	59.9	62.1	59.7	58.7
Tax revenue	13.1	14.4	12.8	12.5	13.8
Domestic current exp	12.6	11.9	12.2	12.8	13.4
Fiscal balance (excl grants)	-9.8	-13.3	-12.7	-13.0	-13.5

Fiscal balance (incl grants)	-2.9	-4.0	-4.3	-4.8	-5.9

* estimate; ** projection.
Source: IMF Article IV (2002)

Structural Policies

2.11 As well as increasing GDP growth, Government pledges to direct limited available public resources to priority agricultural and social sectors (education, health, clean water and sanitation). Agriculture, which accounts for a third of GDP, 80 per cent of employment and 60 per cent of export earnings, is the main driving force of the economy, causing the growth decline in 2000 and subsequent surge in 2001, when primary sector growth was 13 per cent as compared to 0.1 and 3 per cent in secondary and tertiary sectors respectively. Government expenditures in all priority sectors are projected in the MTEF to rise from 56.3 per cent of current spending in 1999 to 66.2 in 2003. The PRSP estimated additional costs of priority spending to be CFAF 14.5 billion (US$ 20 million) in 2000, rising by 228 per cent to CFAF 32 billion per annum in 2001-03. HIPC debt relief was expected to provide about 80 per cent of this. However, the source of residual funding was uncertain, with Government relying on the generosity of its development partners.

2.12 Trade is being liberalised. Internal cotton, rice and sugar marketing was deregulated in the 1990s, and Burkina Faso is the only WAEMU member to have fully implemented Common External Tariff regulations. The share of tax revenue from international trade has fallen from 28 per cent in late 90s to 18 per cent in 2001, although tariffs on petroleum imports increased in 2001 to maintain revenue in the face of lower-than-expected receipts. The Government operates a liberalised exchange system policy, i.e. there are no restrictions on international payments and transfers.

2.13 Government is also moving forward on its privatisation programme. As of 2002 it had privatised 20 per cent of enterprise capital since 1991, was in the process of privatising another 58 per cent and completed privatisation of 3 SOEs in 2001 (IMF, 2002). Reforms to improve efficiency of cotton sector include rural road building in cotton-producing areas, and increasing private sector role in production, and marketing and financing of inputs. The monopoly on cottonseed collection and marketing by cotton-buying monopsony, SOFITEX, was abolished. Energy and telecommunications sectors are in the process of deregulation.

2.14 The banking system has improved and is relatively healthy. Only 2.5 per cent of all loans non-performing in 2001 and all but one bank complying with 8 per cent capital:risk target of the regional banking commission. However, the main local bank was weakened by withdrawal of its foreign shareholder, and private savings and investment are limited by the large spread between deposit and lending interest rates. More generally, the banking system suffers from weak financial intermediation and performs poorly in transferring savings into productive investments (IMF, 2000). Microcredit initiatives, organised by co-operatives, NGOs and the public sector, have expanded to alleviate the intermediation gap. Government supplies credit to promote small enterprise in particular groups or sectors such as women and informal sector. Access to credit is improving and microcredit financed an increasing share of agricultural inputs in 2001, but there are concerns of the impact on the poorest who remain largely in the non-monetised economy.

Social Inclusion/Equity

2.15 The overall stagnation in poverty reduction and other welfare indicators hides large differences in regional and rural-urban levels and changes over time. Those most disadvantaged groups are rural inhabitants, in particular food-crop farmers who comprise 75 per cent of all poor, those living in central regions and women. Variations in achievement between agro-climatic regions indicate the extent to which poverty reduction is thwarted by poor natural resource endowment, poor climatic conditions and population pressure. During the 1990s poverty remained constant or grew in central regions where these problems are acute, but fell in other areas where conditions are better. However, ineffective public policy is also to blame; huge rural-urban differences in standards of living (urban gross primary enrolment was around 100 per cent for both boys and girls in 1998, whilst rural was at 30 per cent with a significant gender gap) demonstrate the need to focus on rural areas and the PRSP commits policy to this.

Public sector management and institutions

2.16 There is a strong tradition of participatory governance in Burkina Faso. The decision to undertake economic reform was taken following a national discussion, with a review consultation of strategies taking place in 1994; national health and education plans were prepared using input from meeting of high-level government with stakeholders; a forum on justice in 1998 provided the basis for judicial reform. Government has also promoted the recent debate on poverty reduction, widely publicising the PRSP and debating its implications with civil society and development partners. Since 1995 there has been a process of government decentralisation, empowering local government and grass-roots communities to take a leading role in development.

2.17 The current government, in power since 1987, has initiated democratic reform, including the adoption of a liberal constitution and execution of several multi-party elections, the most recent in May 2002 significantly reduced govt parliamentary majority and was deemed satisfactory by international observers. IMF (2002) deemed that Government had met its targets in 2001 regarding establishment of an anti-corruption unit, but would have to roll forward targets for establishing a fully operational Supreme Audit Court and amending VAT legislation. Govt has also been in the process of implementing and harmonising various fiscal management plans, including Budget Management Improvement Plan and MTEF. Govt proposes to hold individual ministries accountable for wage bills in order to improve control over salary management and keep wages bill: tax revenue ratio in line with PRSP projections (i.e. falling from 38 to 32 per cent in 2000-03).

2.18 There has been a serious lack of detailed data on govt accounts since 1993. Data exist on govt budget and capital expenses financed by grants but not on extra-budgetary and social service operations and operations financed by foreign loans. Lack of co-ordination among fiscal agencies is at the heart of this problem causing data to be unreliable and untimely, and Government has requested technical assistance from the IMF to improve quality of national accounts and other economic statistical information.

Impact of Shocks and Aid Variability

2.19 Burkina Faso is extremely vulnerable to climate and terms of trade shocks. The primary sector accounts for about 38 per cent of GDP and Burkina cotton provides almost 60 per cent of total exports. Cereal exports and workers remittances also account for a large proportion of foreign exchange earnings. Furthermore, Burkina Faso's fixed exchange rate system means that govt is unable to influence nominal exchange rates to diminish impact of terms of trade shocks.

2.20 In 2000 cotton production fell by 10 per cent and cereals by 15 per cent as a result of low rainfall and crop disease and cotton revenues were also adversely affected by plummeting world prices, the result of US export subsidies. In addition, owing to political unrest in neighbouring Côte d'Ivoire where 3 million Burkinabè reside, remittances also dropped by about 40 per cent in 2000-01 to 1.7 per cent of GDP. The overall impact was to reduce GDP growth to 2.2 per cent in 2000 (thus contracting GDP per capita from US$ 240 in 1999 to US$ 210), reduce fiscal revenue by 1.6 per cent of GDP (due to fall in revenues from international trade) and increase overall balance of payments deficit by 2.1 percentage points to 3 per cent of GDP. Net aid disbursements did not increase to offset this – they fell in substantially in 2000 (although debt forgiveness grants were large) and were again below commitments in 2001. The pick-up in growth levels in 2001 was attributed to end-of-year cotton yields increase of 45 per cent due to good rainfall and IMF estimated that this impact of this and higher farmgate prices would raise farmers' incomes by 70 per cent and significantly impact on poverty. However, in light of this experience, IMF (2002) revised downward medium term growth projections to between 4.5 and 5.5 per cent depending on primary sector growth and remittance levels.

2.21 Government demonstrated that it was able to manage the fiscal balance in this period whilst preserving poverty reduction goals. In the face of a substantial shortfall in tax revenues relative to budget plans caused by low production throughout most of 2001, fiscal deficit was maintained at manageable levels by cutting spending, although not in priority poverty reduction programmes. Govt more than met its targets for spending reallocation to education and health in 2000-01, although overall spending for health and education fell short of target because foreign-financed investment remained lower than commitments (HIPC assistance was 25 per cent short in 2000).

2.22 Simple analysis does not suggest that aid has been responsive to GDP shocks: aid and GDP growth are positively correlated in this highly aid-dependent economy.

Aid and public expenditure management

2.23 PRSP indicates that major constraints to growth and poverty reduction are weak governance and ineffective public sector institutions, particularly regarding service delivery in rural areas. Private investment is deterred by resource misallocation, unnecessary state intervention in some sectors, poor transparency and corruption (World Bank, 2002). Thus the PRSP sets out a framework for state intervention, including guidance on when and how to intervene, based on planned surveys including a PPA, priority survey and PER of education, health and water sectors in 2001-02. PRGF programme is monitored using quarterly performance criteria, benchmarks and indicators. A special bank account was opened at the BCEAO (regional bank of WAEMU) to register resources from HIPC debt relief programme and expenditures for poverty reduction.

2.24 Whilst presenting a clear poverty profile, the PRSP’s budget plans remain limited in terms of costing and to a 3-year timeframe, with the exception of education for which there is a fully-costed 10-year plan. Government is undertaking independent monitoring of poverty spending and social outcomes but IMF staff noted deficiencies in the latter. The JSA of the first PSPR Performance Review indicated that in the education sector greater efforts were needed to improve general effectiveness and efficiency of public spending, to ameliorate low and inequitable access, high costs, resource wastage and quality of schooling (IMF/IDA, 2001). In health, efforts were required to increase demand among the poor, reduce staff turnover and involve women in village health services to ensure their priorities are recognised. There are also deficiencies in terms of measurable targets and indicators in the areas of governance and, most worryingly given the huge poverty in rural areas, the rural development programme.

2.25 The PRSC established a rolling MTEF framework in support of the PRS programme, defining progress benchmarks and outcome indicators. IMF deemed that Government had made progress in implementing reform measures and exceeded expectations by presenting full a MTEF for 2001-03 to parliament in 2000. However, serious overall deficiencies in budget formulation, execution, monitoring and performance evaluation and internal auditing and external oversight remain to be tackled. The Government focus on anti-corruption has also been limited. World Bank/IMF studies have concluded that whilst Burkina Faso has been one of the best performing HIPCs in terms of budget formulation, execution and monitoring, improvements are particularly needed in decentralised expenditure accounting, external aid assessment and dissemination of economic information (World Bank, 2002).

Impact of Aid

2.26 Data is unavailable in sufficiently disaggregated form to make a decent assessment of the contribution of external financing to particular sectors and social outcomes. However, as the above analysis has indicated, whilst there were some improvements in social indicators such as primary education, overall performance has been extremely limited, particularly considering good GDP growth. Much aid provided bypasses budget, government accountability is inadequate, and there has been distinct lack of co-ordination among donors and between donors and government. However, since the onset of the PRSP process, co-ordination between government and donor objectives and priorities has increased. Shares of total social spending on education and health have risen and already there have been some improvements in social indicators like immunisation coverage (IMF/IDA, 2001).

2.27 The conditionality reform initiative has attempted to improve co-ordination among the large numbers of donors operating projects in Burkina Faso, thus enhancing aid effectiveness (see Box 1). The government has since proposed a set of indicators, agreed on by most donors, facilitating PRSP monitoring and evaluation. There has been some progress as a result of this. In 2001 the EU and 5 European bilateral donors pooled resources in form of budget support, with limited joint conditionality except for annual reviews of PRSP progress and adequacy of macroeconomic policies. Some donors have also expressed desire to co-finance World Bank PRSCs, e.g. Belgium is financing 12 per cent of the US$ 35 million PRSC II. This is indicative of a desired shift of donors away from project lending and towards budget support.

Box 1 Conditionality reform initiative in Burkina Faso

In 1997-2000 Burkina Faso piloted a test of performance-based conditionality initiated by the SPA donors, at EC urging. The programme highlighted the major constraints to aid effectiveness as being poor co-ordination, weak domestic ownership due to policy-based conditionality, and the large share of aid given via projects that strained implementation capacity and resulted in uneven and unsustainable progress. The aim was to increase ownership and aid effectiveness by focusing attention on outputs and outcomes using previously identified, measurable indicators, while leaving Government more discretion on the choice and sequencing of specific policy measures. Other objectives were to reduce fluctuations in aid caused by delays in meeting specific policy conditions, and to improve coordination between donors through a process of joint review and progress assessment.

The objective was to reach a donor-wide consensus on performance indicators for government activities, and on the links between resources, and the outputs and outcomes they are intended to achieve. Final outcomes (e.g. literacy rates) are often infrequently measured with long delays, and are influenced by factors beyond Government control. Output indicators such as number of schools do not measure the underlying objective. The aim was to find indicators that measure Government performance (e.g. school enrolment), with the ultimate aim of linking donor disbursements to Government performance.

The evaluation of the test argued that outcome indicators can be identified and tracked, but also revealed the complexity of the task. It is difficult to identify indicators that are available with reasonable timeliness and accuracy, that measure the objectives Government is trying to achieve, that can be adjusted to separate out the effect of factors beyond Government power to influence. A high degree of subjectivity was found to be inevitable in sorting out what Government should be held accountable for, with the risk that disbursements could be less rather than more predictable. The EU in a number of countries is nevertheless implementing the approach of linking some portion of budget support to assessments of Government performance. Source: SPA (2000).

3. Absorptive Capacity and Potential Impact of Increased Aid

3.1 Burkina Faso's future growth projections are highly uncertain given its susceptibility to external shocks. World cotton prices remain low and the return of significant numbers of Burkinabè from politically unstable Côte d'Ivoire could generate high unemployment. Thus external assistance will remain an important requisite of the poverty reduction strategy over the medium to long term. Most assistance is in the form of projects due to weak government administrative capacity, although this is improving and some donors have committed to Budget Support rather than project aid. IDA has projects ongoing, amongst others, in the agriculture sector (including Agricultural Services, Private Irrigation, Community Based Rural Development) amounting to US$ 113 million, in education and health (Post-Primary Education and HIV/AIDS Disaster Response) amounting to US$ 48 million, and US$ 70 million in Water Supply.

3.2 Government expenditure plus net lending was budgeted to remain around 25 per cent in 2000-03 in the PRSP, with tax revenue projected to grow by 11.5 per cent per annum, providing an increasing its share of total spending by 10 percentage points 61 per cent in 2002, or 15 per cent of GDP, based on optimistic growth forecasts. However, the World Bank (2002) estimated external fiscal financing requirements to be one-third higher in 2001 than envisaged, and projected requirements to be triple the 2001-level in 2002 and double it in 2003, hugely above PRSP predictions. Despite the various measures to improve domestic financing performance such as petroleum excise taxation increase and introduction of informal sector tax, domestic financing projections remain ambitious given GDP growth volatility. Increases in taxes on income and goods and services made up for losses from external tariff revenues in boom years 1997-99 (IMF, 2000). However, the tax system is regarded to be inefficient and inequitable. High tax rates on the small formal sector result in significant exemptions and widespread evasion.

Table 5 Government financial operations

% of GDP	Ave. 1996-99	2000*	2001*	2002*	2003*
Total revenue	13.4	14.3	14.6	14.9	15.0
Tax revenue	12.4	13.2	13.5	13.8	13.9
Total spending and net lending	24.0	25.8	25.6	24.3	23.3
excl. net lending	13.5	15.4	15.7	15.3	14.9
Interest and amortisation	2.5	2.2	0.9	0.8	0.7

* forecast
Source: GoBF (2000).

3.3 There is a case for both increasing aid and ensuring that quickly-disbursable funds are available to cushion public spending programmes against external shocks. Government has demonstrated its commitment to poverty eradication in the face of unanticipated external problems, as well as aid disbursement shortfalls below commitment, by maintaining spending increases in education and health sectors, enabling it to exceed targets for vaccination rates and girls' primary enrolment.
However, Burkina Faso remains unlikely to achieve the MDGs at current levels of domestic spending. Aid could provide the funding to increase social spending, without resorting to incentive-distorting tax increases on a small formal sector.

Table 6 Performance in 2000-01 in selected PRSP indicators

Measure	2000		2001	
	Target	Actual	Target	Actual
Share of infants (0-11 mths.) vaccinated (%)				
Tuberculosis	70	80	80	84
DCT/polio	50	57	60	64
Measles	55	59	60	65
Yellow fever	55	56	60	65
Girls' primary gross enrolment (%)	34	36.2	37.2	N/A
Girls' first-year enrolment ratio (%)	32	32.9	34	N/A

Source: World Bank (2002).

3.4 The main arguments against increasing aid relate to debt sustainability and potential macroeconomic problems such as 'Dutch disease' and aid dependency. Burkina Faso has received significant debt relief, but will need to exercise caution over the terms of future external financing. Sustainability is a major issue, particularly as the country remains vulnerable to external shocks and terms of trade changes. Although there is considerable scope for making more effective use of existing public expenditure, the scale of the needs will require a substantial increase in public spending if significant progress towards the MDGs is to be made. Government has committed itself to raising the revenue: GDP ratio, but the narrow tax base is a constraint, and to increase spending at levels required in order to approach the MDGs would need to be mainly financed from additional external assistance. The PRSP process has made possible improvements in aid effectiveness, by improving planning, prioritisation and co-ordination among donors and government. However, the majority of external assistance remains in project form.

3.5 Although previous studies (see Heller and Gupta) have found evidence for Dutch disease, it seems unlikely that the costs are significant relative to the potential benefits of well-directed aid. The Dutch disease describes a situation where the pressure on demand for domestic goods and services created by an aid inflow raises the real exchange rate and makes tradeables uncompetitive. It is true that export: GDP levels, although increasing, remain the lowest in West Africa and inflation has been high in years where aid inflows increased. However, World Bank analysis shows that output and investment are both held back by inadequate infrastructure and weak human capital (Box 2). If well used, the positive effects of aid on productivity by helping to overcome infrastructure and other supply bottlenecks should dominate any negative impact on competitiveness.

Box 2: Major Constraints to Growth

The World Bank CAS identifies the major constraints to growth as the following:

- Fast population growth significantly reduces per capita growth levels, augmenting the dependency ratio (50 per cent of population are aged under-15), increasing population density and exerting pressure on limited water resources.
- Unemployment is high and labour productivity estimated to be one of the lowest in West Africa, a likely reflection of low education and health status.
- Export growth is hampered by inadequate infrastructure, but poor quality and high costs of transport, communications, power and water infrastructures are a disincentive for private investment.
- Small formal sector, which accounts for only 40 per cent of GDP and 2 per cent of the total work force, constrains the public sector's revenue collection.
- Weak institutional capacity is reflected in deficiencies in rule of law and revenue collection and resource allocation.
- Burkina Faso is a relatively closed economy, and its share of exports in GDP is the lowest in West Africa. Emigration of workers in significant numbers constrains export growth and contributes to low labour productivity.

3.6 An important constraint not listed in Box 2 is poor climate and vulnerability to external shocks, which is caused by dependency on a narrow resource base and lack of economic diversity. Vulnerability to external shocks is more important than theoretical Dutch disease risks. Aid can help combat these problems by supporting social sector programmes, investing in rural roads and infrastructure, helping develop micro-credit coverage and supporting the rural development programme. Aid could in principle also help the economy to weather the macro-economic consequences by boosting disbursements following shocks, but has not in practice done so.

4. Conclusion

Table 7: Implications of doubling aid by 2007

2007 capital spending as % GDP	18.6
2007 current spending as % GDP	16.2
2007 Public Expenditure as % GDP	34.8
2007 domestic financing as % GDP	13.9
Of which, capital % GDP	6.7
Recurrent funding from aid, % GDP	9.0
Memo: aid as % Public Spending	71.6%

4.1 Progress in poverty reduction in Burkina Faso is likely to be dependent on external resources for the foreseeable future due to its narrow resource base, small formal economy and vulnerability to external shocks. Tax revenue is likely to rise only slowly with improvements in tax collection and formal sector expansion, and significant fiscal financing gaps will need to be financed from programme aid and HIPC debt relief. Table 7 looks at the implications of a doubling of aid by 2007, as would be implied by aid allocation models discussed in Volume 1. This would give Burkina Faso an additional 10% of GDP in external resources relative to IMF projections. It would raise the aid: GDP ratio to nearly 25% of GDP, slightly higher than the level in 1995. If used entirely to finance additional spending, it would permit public expenditure to increase from 24.1% to nearly 35% of GDP. Poverty spending as defined for the HIPC agreement is planned at 27.5% of total spending, around 6.6% of GDP. If entirely spent on additional poverty expenditures, the extra aid would enable these to be increased by 2.4 times, which can be compared with the required 2.5 fold increase in primary enrolment. In practice, not all of the additional resources can or should be used for poverty spending, since poverty reduction will also require spending to increase on infrastructure and secondary education, while there may be a case for using some resources to retire debt and build reserves against external shocks.

4.2 The implications for sustainability are problematic. Table 7 assumes that capital and recurrent financing continue in the same ratio, and that the Government continues to finance the same level of capital investment from domestic resources as assumed in the IMF programme. This is a realistic assumption, since not all capital spending is attractive to donors, and some projects require a domestic counterpart. The implication of these assumptions is that over half of current spending would need to be financed from external sources. Given that wages and salaries alone account for 40% of current spending, this level of vulnerability is dangerously high.

4.3 Burkina Faso has received debt relief under the HIPC and Enhanced HIPC Initiatives and 'topping up' assistance due to the adverse impact of external shocks on its debt: export ratio. Initiatives are underway to improve effectiveness of general social spending and aid. The PRSP process and the Conditionality Reform Initiative have supported improvements in public expenditure management and in co-ordinating the priorities and activities of the large number of donors with government's. Reforms have been made to improve public sector management and accountability and decentralise spending, but institutions remain ineffective, significantly reducing Government's ability to plan and administer programmes. For these reasons, aid is predominantly given as project assistance, even though donors have recognised the benefits of shifting to Budget Support. An increase in aid of the scale proposed would take it beyond the relative levels that provoked earlier concerns about high transactions costs, and will require a shift towards programmatic, on-budget support, which will also generate increased incentives to address the weaknesses rather than simply by-passing them. The increased aid would in large part need to be used for funding recurrent costs, which implies that the commitment would need to be sustained into the longer term, and would need to be predictable and reliable.

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The case for Increased Aid: Democratic republic of Congo, Case Study

Summary

After 40 years of decline under a rapacious Government, and a terrible succession of civil conflicts since 1998, DRC has a fragile opportunity for peace and to begin to tackle the legacy of deep poverty and social deprivation. If the peace process holds and can be built on, the opportunity exists for increased aid to have a major role and impact, with the likelihood of rapid gains in poverty reduction and social indicators- as has been achieved in similar circumstances by Mozambique. Conversely, the risks of a continuation of conflict will be greater if donors wait too long before committing and disbursing significantly higher sums for reconstruction. The IMF programme envisages a sharp increase in external support from less than 5% of GDP to around 20% of GDP in 2003-05. There would be scope for going further, if the peace holds, to perhaps 30% of GDP to fund reconstruction, implying disbursements increasing from $250mn in 2001 to around $2300mn in 2007.
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1.Aid Trends

Table 1, Aid to DRC,US$Mn

	1997	1998	1999	2000	2001
ODA, US$mn	158	125	132	183	251
ODA/Head, US $	3.37	2.60	2.67	3.60	4.79
% of GDP	4.8	3.0	3.0	3.8	4.8
FDI, net,US$mn	-44	61	11	23	32
GDP Growth	-5.62	-1.62	-4.4	-5.97	-4.52

Sources: World Bank,WDI on-line database;

1.1 DRC had been a major aid recipient during much of the Mobutu period, partly due to strategic interests of major donors, and partly due to IMF and World Bank anxiety to avoid the consequences of default on their debt. Increasing recognition of the lack of ownership of the policies aid was supposed to be supporting and the all too personal ownership of the proceeds by a rapacious regime eventually resulted in the decline in aid to a rump of mainly humanitarian assistance. The prospects for an end to the civil wars that caused further suffering from the late 1990s has seen increased aid flows, initially from the Bank and Fund, and large scale debt relief (Table 3). The IMF programme envisages aid growing to 20% of GDP, in order to finance reconstruction and re-unification. Most of the additional finance has been identified, and no financing gap is expected.

2. Aid Effectiveness

Progress in Poverty reduction and the MDGs

2.1 Living standards have collapsed in DRC, as a consequence of long term decline under the corrupt kleptocracy of Mobutu, followed by complex civil conflicts that have resulted in an estimated 3 million deaths, with a further 2-3 million people internally displaced. GDP has declined on average by 0.3% per annum since 1960, while population has continued to grow at rates approaching 3% per annum. Over 80% of the population are below the poverty line. Government only controls six of the eleven provinces, covering 60% of the population, and statistics are in short supply, but it is clear that levels of poverty and deprivation are among the highest in Africa (Table 2). Only 14% of children enter school at the official age of 6, in rural areas only 15% complete year 5. The IPRSP describes 'complete abandonment' of health services in most districts, and child and maternal mortality rates are at appalling levels even by African standards. Less than 30% of children are vaccinated.

2.2 The most immediate requirement for poverty reduction is an end to the fighting and protection of the population from violence and conflict. A formal peace agreement is in place, though the situation remains fragile, and even if peace between the formal combatants is achieved, the populations in the conflict areas remain at risk from armed lawlessness, localised conflicts over the control of resources, and risks of ethnic violence. The December 2002 peace agreement and the withdrawal of foreign troops initially created a power vacuum in the North and East, with intensified conflict motivated in part by competition to control valuable natural resources of gold, diamonds, oil and coltan. In Ituri, home to an estimated 4.6 million people, there have been mass ethnic killings of civilians. Fighting in the Kivus intensified in late June, though on July 12th the leader of the main group opposing the Government, the RCD/Goma, declared the war to be over, and left to join the transition Government as one of four Vice Presidents. Although there are some international peace- keepers on the ground, their numbers are too small to protect populations outside the main towns.

Table 2: Progress towards the Millenium Development Goals

Target	Sub-Saharan Africa (1994-2000)	Current Levels & recent trends	Latest Year	Required Progress late 1990s-2015
Halve from 1990-2015 the % of population living on less than $1/day		Poverty increasing for several decades.	84% (2001)	Halving of incidence by 2015 not achievable; rapid improvements would be.
Enrol all children in primary education by 2015			NPE 52% (IPRSP estimate, may be too high)	Existing Govt estimates look exaggerated, UPE not achievable by 2015.
Reduce infant and child	162/000		<5 mortality: 207/000 (1998)	Not achievable, though rapid

mortality rates by 2/3 1990-2015				improvements possible with e.g. immunisation.
Reduce maternal mortality by ¾ 1990-2015		1995: 870/100,000	2001: 1289/100,000	Not achievable by 2015.
Halt by 2015 & begin to reverse spread of HIV/AIDS, malaria, other major diseases			5% HIV positive, 8% women in conflict areas.	
Integrate principles of sustainable development into country policies, reverse loss of env. Resources, halve % without sustainable access to safe drinking water.			Peace is essential to control unregulated exploitation of natural resources for personal gain.	

Sources: IPRSP, IMF (2003), WDI

The Policy Environment

Economic management

2.3 With crucial support from the IMF and the World Bank, Government has begun the process of stabilising the economy in the areas it controls, and is preparing for re-unification under the transitional Government. The first review of the June 2002 IMF Poverty Reduction Support Credit has been successfully completed. Inflation has been brought under control, the exchange rate unified and floated, other price distortions removed, budget disciplines and procedures re-imposed. Action has been taken to confront corruption, with several cabinet ministers and senior officials dismissed following a UN report on the illegal exploitation of natural resources. The economy has achieved positive growth in 2002 and 2003, for the first time in 13 years. Government has not yet been able to shift public spending towards poverty reduction, due to continuing high security and reunification spending, but is committed to do so.

2.4 The main risks to restoration of economic growth and the beginnings of poverty reduction are related to the peace process, either that it will break down, or that the transition Government will not maintain the improved economic policies. The Government is to be significantly expanded in order to accommodate all of the factions. Collective decision-making on how to allocate limited budget funds will inevitably be difficult, with the temptation to accommodate spending pressures rather than risk renewed conflict. Re-unification will bring an estimated 140,000 civil servants back onto the

Government payroll. There will be a massive bill for physical reconstruction and for beginning to rebuild meaningful services. The Fund argue that delayed restoration of significant external assistance is a major risk to the likely success of the transition to peace.

Structural Policies
2.5 Given the lack of capacity and pre-occupation with the conflict, the Government has made remarkable process on a structural reform agenda that has unified the exchange rate at a realistic rate, liberalised prices, strengthened the legal and judicial framework, given the central bank independence over monetary policy, approved investment, labour and mining codes, abolished the diamond export monopoly and introduced certification of origin. Actually enforcing the new legislation will be challenging given weak public sector institutions, but the right signals are being sent. There have even been some signs of private investment reviving, in cellphones, offshore oil, and power generation. Government has produced an Interim Poverty Reductions Strategy Paper that received approval of all parties at the intra-Congolese dialogue held in Sun City.

2.6 Spending on defence, security and the presidency takes 50% of public spending, compared to just 7% going to the social sectors. Government is committed to increase the share, and should be able to do so once the ‘peace dividend’ enables security spending to be reduced.

Social Inclusion/Equity

2.7 Living standards and access to services are much higher in urban areas (e.g. 60% urban primary school children reach grade 5 compared to 15% in rural areas). Comparing rural areas, severe poverty and absence of public services is pervasive throughout the country, though conditions are worst in the conflict- affected areas in East and North.

Public Sector management & Institutions
2.8 The decades of mismanagement and conflict since 1998 have left DRC with Government institutions that are deeply corrupt, with a Government that funds little beyond inadequate salaries, and those often late and in conflict areas not at all. There is supposed to be a decentralised structure, with an inequitable system whereby 20% of central Government revenues are returned to the provinces where they were collected. Actual payments have been less than this, while the collapse of tax revenues has eroded their value. Government is committed to undertaking surveys of revenues, actual expenditures and needs following reunification.

Policy Dialogue
2.9 The IMF and World Bank became involved in DRC before the formal end of fighting. The IMF were providing advice but not financing under a Staff Monitored programme from June 2001 to March 202, followed by a Poverty reduction and Growth facility from June 2002, although the peace agreement was not achieved until December. The Bank and Fund engagement has drawn upon lessons from other post-conflict situations. They argue that the

window for restoring peace and stability is short, and early positive results have to be achieved in order to consolidate the momentum. Increased external aid to abet hardship can be critical. Ownership at the top of Government is essential, and has been strong from the President, backed up by an Inter-Ministerial Committee. Government recognises that the lack of technical capacity made it essential to draw upon external support and analysis, drawing up a prioritised and sequenced ‘road map’ setting out urgent tasks to rebuild the economy, with Bank and Fund providing technical support in implementing it. Both Civil Society representatives and Government authorities consulted as part of the PRGF review praised the role that Bank and Fund policy advice and technical support had played. They also emphasised that, given the fragility of the situation, technical support needs to be followed fairly quickly by financial resources, and the IMF programme envisages rapid increase in external financial support.

Aid and Public Expenditure Management

2.10 Only the IMF and World Bank are presently (June 2003) providing financial support to the Government and the Central Bank. The IMF argue the need to expand the share of aid provided as non-project budget support to the comprehensive reform programme. This involves significant accountability risks, given the long history of corruption. Although Government has embarked on efforts to improve the transparency and accountability of public expenditures, achieving acceptable standards will be a long process. Moreover, the transition Government will bring into power representatives of all of the factions who have been fighting, in many cases motivated as much by personal gain as by any political objective. It will be difficult for a coalition Government to discipline those who prove corrupt without risking breakdown of the peace. It is clear that a significant share of increased resources will need to go via Government, since much of the extra spending will be needed to pay recurrent costs for restoring services, at least until tax revenues can be re-built. Budget support will need to be accompanied by enhanced monitoring of how resources are used in practice.

Impact of Aid

2.11 Aid has already had a positive impact in restoring macro-economic stability and a return to economic growth. The experience of previous post-conflict countries such as Uganda and Mozambique suggests that aid can be of major importance in the reconstruction phase. World Bank and UN will lead on programmes for demobilising combatants and re-integrating them in civil society, probably as part of broader community programmes in order to avoid the moral hazard of rewarding combatants over civilians. Experience of previous post-conflict countries confirms that re-unification can result in rapid revival of the economy, and reconstruction of infrastructure with donor support yields high returns. IMF are projecting 6% per annum economic growth, based on infrastructure rehabilitation to remove supply bottlenecks, re-starting of mining and other economic activity following re-unification, and the impact of improvements in economic management and the regulatory environment. Mozambique experience suggests that the 6% growth assumption may prove conservative if the peace process holds.

3. Absorbtive Capacity & financing needs

3.1 In common with other post-conflict countries, the IMF envisage that DRC will need substantial external assistance, of the order of 20% of GDP in the period to 2005 (Table 3). The experience of other post conflict situations, and the depth of poverty and the extent of the collapse of Government services, suggests that high aid flows will need to be maintained for at least a decade. If absorptive capacity can be built, there would be s strong case for aid expenditure significantly above these levels, which have been determined more by the finance available than an assessment of needs. Expenditure of 30% of GDP would imply disbursing around $2300mn in 2007, a level of expenditure still below peak spending in Mozambique following the war, and only $38 per head of population.

Table 3, External Aid Requirements: IMF Programme 2003-05

	2002 Est.	2003 Proj.	2004 proj.	2005 Proj.
Humanitarian assistance	180	146	127	114
Debt service relief	367	412	396	409
Project grants & loans	192	515	692	713
Budget & balance of payments support	91	157	168	118
Total external support	830	1229	1381	1354
% GDP	14.6	21.6	22.1	19.7

Source, IMF 2003

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Interim Poverty reduction Strategy Paper

Ethiopia Case Study

Summary

Ethiopia is arguably the poorest country of its size in the world. With almost half its population of 66 million estimated to be in absolute poverty, Ethiopia's progress in poverty reduction is also important for regional and global MDGs. Due to drought, on average 4 million people per year are food insecure and require food aid to support their consumption and the country is currently experiencing its worst recorded drought, potentially affecting a quarter of the population. This problem has been exacerbated by conflict and frequent commodity price shocks. Ethiopia is therefore heavily reliant on aid, which supports 40 per cent of public sector spending, and will remain so over the long term. Ethiopia could make good use of significantly increased aid flows, provided donors reform their procedures, and provide some of the aid in support of recurrent costs. Capacity at the centre is remarkably high for such a poor country. Although capacity at sub-national level is limited, there is evidence that some of the problems that have been experienced in absorbing aid are caused by inflexible donor procedures: it is notable that the implementation rate on Government financed projects is much higher than on donor ones. Central Government adjusts domestic financial allocations to ensure that donor funding does not distort the allocation between regions, one reason for problems in utilising aid because regional governments have been reluctant to accept donor funding in substitution for easier to utilise federal funds. The $2bn increase in donor funding from current levels as envisaged by the aid allocation models may be beyond a prudent level: - it would imply aid financing 60% of public spending. Maintaining the higher level of per capita expenditure would require aid to be maintained at the higher level for 20 years, and would leave Government dangerously exposed to aid cuts. A more realistic target may be to double aid to $1.7bn p.a. over 5 years, which would permit a 50% increase in per capita spending, and could be maintained with aid levels falling back to the pre-increase level by 2027.

The long-term growth rate of the economy exceeds the share of interest payments in GDP, implying a falling debt: GDP ratio over time. However, aid will have to be in grant form or highly concessional in order to sway concerns about debt sustainability in the context of low and slow growing exports and the recent growth collapse due to drought.

1. Aid trends

1.1 External assistance has been important for Ethiopia's economic development programmes since the 1960s. During the 1980s the biggest donor was Russia, which mainly provided military assistance. Since the end of the Soviet era, Ethiopia has attracted more aid from the multilateral community and bilaterals led by US, Japan, Germany, Italy, the Netherlands and the Scandinavian countries. ODA finances the majority of investment and private foreign investment represents only a small proportion of total financial flows (2.5 per cent in 1999-2000) (OECD *Aid at a Glance*).

1.2 Total aid disbursement increased over the 1980s and early 90s, but significantly declined from 1995 and remained low until 2001 following the resolution of the Ethio-Eritrean war. Per capita ODA flows to Ethiopia are low in comparison with other African countries. The share of grants increased steadily and accounted for 75-80 per cent by the late 90s. However, loans dramatically increased in 2001 and are forecast to exceed grant flows over the medium term. Project aid represents over 70 per cent of total aid flows. Technical assistance and food and emergency aid each account for about 15-20 per cent of total ODA per annum, and food and emergency aid increased to 30 per cent of total ODA in 2000 due to a combination of war and drought. IDA is the largest single donor, and the US has recently emerged as the largest bilateral donor.

1.3 Instability in ODA is also reflected in IMF external public financing estimates. These represent the aid reported to government and are significantly less than DAC figures. Donor support is integral to the PRS. The Government's PRSP, the Sustainable Development and Poverty Reduction Programme (SDPRP), estimated aid flows to have increased by 60 per cent between 2000/01 and 2001/02 and projected aid flows to increase marginally from this level in 2002/03 and subsequently fall by 15 per cent by 2004/05. If realised aid will finance between 30 and 40 per cent of total public spending.

Table 1 Net ODA to Ethiopia (current US$ millions)

	1995	1996	1997	1998	1999	2000	2001
Grants	640	593	509	549	465	552	555
Loans and other LTC	243	225	70	111	178	141	525
Total	883	818	579	660	643	693	1080
ODA/head (US$)	15.6	14.0	9.7	10.8	10.2	10.8	16.8
% of GDP	15.3	13.6	9.1	10.1	8.6	11.0	17.6
IMF external public financing*			343	299	456	318	563

* calculated from IMF (2002b, Table 9 & Table 20) as the sum of grants and net external financing, converted at period average exchange rate. Estimates are for fiscal years 1996/97 to 2000/01.
Source: World Bank World Development Indicators, DAC Official Development Indicators, IMF (2002b).

2. Aid Effectiveness

Progress in poverty reduction and the MDGs

2.1 Ethiopia is arguably the poorest country of its size in the world. With a population of 67 million in 2002, almost 50 per cent of whom were poor in 2000, Ethiopia's own progress in poverty reduction is also an important factor in regional and global progress towards the MDGs. GDP growth has well exceeded population growth in recent non-drought years, but the 1996/97-2002/03 average has been reduced to 3.3 per cent by adverse climatic conditions. Growth is estimated to be 0 per cent or possibly negative in 2002/03 due to the worst ever recorded drought. In 2001, per capita GDP was US$ 100, or US$ 710 in purchasing power parity. The latter was equivalent to 45 per cent of the sub-Saharan PPP average and ranks Ethiopia 200 of 207 countries. Social indicators have improved dramatically over the 90s but remain below regional averages.

Table 2: GDP Growth, % p.a.

1997	1998	1999	2000	2001	2002	2003 (est.)	Period Ave.
5.2	-1.2	5.2	5.4	7.7	1.2	<0	3.3

Source; World Bank, quoted by Agence France press, July 2003

2.2 Poverty reduction was limited over the 1990s due to drought, commodity price shocks, and war (which was ongoing during the 1999/2000 data collection period). Rural poverty accounts for 88 per cent of the total and exceeds urban poverty by 8 percentage points, although the difference between them has narrowed because of a substantial increase in urban poverty. Food poverty incidence, a better indicator of food insecurity, particularly increased in urban areas, although decreased overall. Growth required to halve poverty by 2015 is calculated at 5.7 per cent per annum, given existing estimates of the poverty elasticity of growth. The SDPRP's 7 per cent GDP growth target would therefore more than meet the MDG, but it is highly ambitious (more than double the recent average), based on strong agricultural growth and, therefore, good rainfall and external environment.

Table 3 Progress towards the MDGs

	1995/96	1999/2000
% Households living below $1 a day line	44	
% Below of households below poverty line	45.5	44.2
% below food poverty line	45	41.9
Gross primary enrolment (%)	35.5	58.9
Net primary enrolment	19.4	33.8
Female:male net enrolment (%)	74	88
Under-5 mortality (per 1000)	204	
Infant mortality (per 1000)	120	
Stunted under-5s (%)	66.6	56.8
Maternal mortality per 100,000 births		500-700 (2000/01)
HIV prevalence (% adults)		7.3 (2000/01)
Access to safe water (%)		30
Contraceptive coverage (%)		18.7

Source: SDPRP (2002), World Bank (1998), World Bank *WDI*.

2.3 Social services remain of inadequate availability and quality, although there have been some improvements in education and health. Average distance to schools has decreased, particularly in rural areas, and primary enrolment rates increased by about 70 per cent during the four years following 1996/97, indicating that dramatic improvements are achievable from a low starting point. However, large inter-sectoral disparities prevail: net enrolment rates were 75 per cent in urban and 25 per cent in rural. Female enrolment rates have grown faster than males' and gender differences have fallen in both rural and urban sectors. High repetition rates cause net enrolment rates to be well below GERs. The adult literacy rate improved by 2 percentage points to 29 per cent in 2000, but remains very low particularly among women and in the rural sector. Primary education is the top priority sector for social spending and the SDPRP target for primary GER is 65 per cent by 2004/05. Government pledges to increase the number of schools and teachers and develop assessment mechanisms to ensure quality does not suffer.

Secondary education coverage is also proposed to expand in line with primary, and similar measures are proposed to maintain quality.

2.4 Health indicators have also improved, as indicated by the reduction in long-run malnutrition measured by child stunting and improvement in access to health facilities in rural areas and immunisation coverage. However, per capita spending on health is about one-sixth the sub-Saharan average, access to health services remains limited and 60 per cent of all those who reported illness in 2000 did not receive medical treatment. Again, this is worse in rural areas and amongst women. The concentration on curative medicine rather than preventative measures and general public hygiene has also reduced the potential impact of public spending on health outcomes. Relatively modest increases in spending on preventative medicine can have significant effects on health indicators from such a high base, thus recent trends such as the doubling of immunisation coverage in 1997-2001 have great potential for bringing down mortality rates.

2.5 HIV/AIDS is a growing threat and 7.5 per cent of adults (17 per cent in urban areas) are infected. Data are on maternal mortality rates are imprecise, but estimated to be high. In the SDPRP, Government proposes to improve health service coverage from 52 to 65 per cent over 2000-05 by supporting community health extension services, focussing on preventative measures, and recruiting more health workers, 75 per cent of whom will be female. The target for HIV/AIDS is to reduce prevalence by 25 per cent by 2007, and support vulnerable and affected individuals and communities.

2.6 Only around 25 per cent of the population, mostly the better off, have access to drinking water. Large sectoral disparities are evident, with 15 per cent access in rural and 75 per cent in urban areas. Government aims to expand water supply coverage to 40 per cent of total population by 2004/05 (83 per cent in urban, 31 per cent in rural), as well as improving urban sewerage coverage by 3.5 per cent per annum from 7 per cent in 2002 and irrigation coverage.

Box 1 Sector Programmes have supported dramatic improvements in indicators from a low base:

- Enrolment in primary education increased by 14 per cent per annum during 1997/98-2000/01, the first four years of the Education Sector Development Plan I, and exceeded the target of 7 million students. Gender and rural-urban disparities also decreased, although the gap between lowest and highest performing regions for GERs increased to 107 per cent. It is difficult to say whether overall quality improved. Although the pupil: textbook ratio halved, student: teacher ratios increased by almost 50 per cent owing to limited capacity of teacher training institutions, and repetition rates for grade I increased though declined for all primary (MoE, 2002).
- The first Health Service Development Programme (1997/98-2001/02) increased immunisation coverage from 20 to 42 per cent, raised potential health coverage from 33 to 52 per cent and reduced threat and loss of life from major infectious diseases.

- The first Road Sector Development Programme (RSDP) expanded the total road network by 30 per cent, mainly through regional road expansion of 80 per cent, which reduced by 10 percentage points the proportion of farm more than half a day walk form the nearest all-weather road to 70 per cent. However, reflecting initially severe road dilapidation, overall quality of regional roads has remained static. RSDP II aims to increase the number of 'acceptable' roads from 57 per cent on average to 82 per cent by 2004/05 and raise road density by over 62 per cent. Sustainability will require improvements in organisational capacity of road agencies and increased involvement of the private sector in maintenance.

The Policy Environment

2.7 Ethiopia has been in transition from centrally planned to market orientated economy since 1990. Initial reforms were driven by internal factors. Advancement of rebel movements in the 1988-1990 civil war and poor performance of agricultural co-operatives and parastatals put pressure on the totalitarian Derg Government to enact reforms, which, though relatively modest, laid the foundations for future reform (Abegaz, 2001). Transition from war to peace was relatively smooth. The Ethiopian People's Revolutionary Democratic Front (EPRDF) Government, in power since 1991, has since implemented donor-supported stabilisation and structural adjustment reforms, including improvements in fiscal and monetary management, internal and external trade and exchange rate devaluation and liberalisation, privatisation and financial market reform, as well as democratisation and decentralisation.

2.8 In 2002 the Government completed the SDPRP, which aims to accelerate progress towards the MDGs through further structural and institutional reform, which it acknowledges are central to poverty reduction and economic growth. The priority sectors are education, health, agriculture, water and roads. Reforms are being undertaken in budget, accounting and expenditure planning under the Civil Service Reform Programme, including further decentralisation. Govt also recognises the importance of addressing gender inequalities for poverty reduction and the need to improve women's access to agricultural extension services, education and health, in particular in the context of HIV/AIDS.

Economic Management

2.9 GDP growth over the past few decades has failed to outstrip population growth leaving Ethiopians with the same per capita income level as the 1970s. Whilst there have been good growth periods such as in the mid-1990s, overall growth has been adversely affected by factors such as commodity price shocks, drought and conflict, as well as the implementation of two ideologically opposed structural reform programmes. Achievement of the Government's ambitious 7 per cent growth targets is heavily dependent on good climate and favourable external environment, but also on institutional reform and good macroeconomic policy (IMF/IDA, 2002). Due to the continued decline in coffee and cereals prices and drought, growth was estimated to be well below target at about 1.2 per cent in 2001/02 and possibly negative in 2002/03.

2.10 During the 1990s macroeconomic stability was well managed. Government's monetary policy aims are to maintain low inflation and rebuild international reserves. Inflation was on average 5 per cent during the 1990s but has been recently negative because of food surplus created by the net imports of food aid in kind. Gross international reserves accounted for 3.9 months of imports in 2001/02 and were forecast to increase to 4.7 months in 2004/05. The current account deficit (including OTs) widened to almost 7 per cent of GDP in 2001/02.

2.11 Tax rates have been lowered and the fiscal deficit reduced, although it increased to 10 per cent in 2001/02 due to the implementation of special programmes and capital and poverty expenditure. Government has committed to reduce the fiscal deficit to 7 per cent whilst stepping-up poverty-reducing expenditure on agriculture, roads and social sectors, by reorienting spending away from defence. The war with Eritrea exacerbated the fiscal deficit, and defence expenditures vastly outstripped current poverty reducing expenditure. Government commitments to finance social spending did continue to be met during the war: - the overall decline in education and health spending was directly related to the withholding of donor funds[1]. Nevertheless, although defence spending has plummeted since 2000, defence spending exceeded budget by 15 per cent in 2001/02 and planned increases in current health and education spending were curtailed.

2.12 The economy is increasingly dependent on external assistance to finance the substantial and increasing savings gap. This, together with vast debts incurred by the Derg government for military financing, has left Ethiopia with a huge and unsustainable debt stock. Debt relief of over US$ 4 billion reduced the debt stock from 178 per cent of GDP in 1995/96 to 80 per cent in 1996/97, but debt: GDP has steadily increased since then. Total debt represented 560 per cent of exports in 2000 and Ethiopia has received HIPC relief to reduce debt-servicing costs and is due to reach Completion Point in 2003. Government has agreed not to contract new non-concessional loans and was in the process of finalising bilateral debt relief agreements in 2002.

2.13 Government wants to reduce dependency on aid by promoting export growth and increasing tax revenues, which at current levels of 15 per cent of GDP are insufficient. Problems exist due to a conflict of interest over privatisation of commercially profitable SOEs, which will have negative implications for revenue, as well as significant tax arrears and corruption. Direct tax receipts have increased in recent years, but revenue is increasingly reliant on receipts from import tariffs, which provide over 40 per cent of tax revenue, the largest share of any one type (IMF, 2002b). In contrast, taxes on domestic sales provide less than 20 per cent of total tax revenue. Government intends to broaden the revenue base by introducing VAT in 2003 and tax receipts are forecast to rise from 14 per cent of GDP in 2000/01 to 18 per cent in 2004/05.

[1] Public Expenditure review, 2001.

Table 3 Selected economic indicators (% of GDP unless specified)

	Ave. 1995/96-1997/98	Ave. 1998/99-1999/00	2000/01	2001/02*	2002/03**	2003/04**	2004/05**
GDP growth (%)	4.8	5.7	7.7	5	6	6.9	7.1
Inflation (%)	-0.6	4.05	-7.2	-7.2	4.5	4.3	4
Gross Dom Investment	17	16	18	20	21	22	23
Gross Dom Savings	8	0.7	2	2	4	6	8
Current account (excl OTs)	-6	-11	-11	-14	-12	-10	-7
Current account (incl OTs)	-1	-7	-4	-7	-7	-5	-3
External debt	103	84	88				
Fiscal balance (excl grants)	-7	-12	-6	-8	-8	-7	-7
Fiscal balance (incl grants and special programme)	-4	-10	-6	-10	-10	-9	-7

* Estimate; ** forecast.
Source: SDPRP (2002).

2.14 However, the objectives of the SDRP already look unachievable due to the drought, which has brought Ethiopia negative per capita GDP growth in 2001/02 and prospect of possible overall decline in GDP in 2002/03. This implies lower overall spending and a difficult financing position with ambitious growth in revenue unattainable. There is a strong case for additional aid to help maintain momentum, though it needs to be on grant or highly concessional terms given that the shrinking economy will have increased the relative size of the debt.

Table 4 Current expenditure on poverty reduction and defence (% of GDP)

	99/00	00/01	01/02 budget	01/02 actual*	02/03**	03/04**	04/05**
Total poverty exp	4.5	5.2	5.6	5.4	6.7	6.7	6.7
Education expenditure	2.5	2.9	3.2	2.9	3.8	3.8	3.8
Health expenditure	0.8	0.9	0.9	0.9	1.1	1.1	1.1
Agriculture expenditure	1.0	1.2	1.3	1.2	1.6	1.6	1.6
Road expenditure	0.2	0.2	0.2	0.2	0.3	0.3	0.3
Defence expenditure	13.2	6.4	5.1	5.9	5.3	4.7	4.2

* estimate; ** forecast.
Source: SDPRP (2002).

Structural Policies

2.15 The Government has rightly emphasised agriculture, rural development and food security in the SDPRP. Agriculture accounts for 45 per cent of GDP and 85 per cent of employment and is thus the main source of GDP growth. Changes in growth performance over time are reflected in erratic agricultural performance (e.g. real annual GDP growth of 7 per cent over 92/93 to 96/97 reflected agricultural growth of 4.8 per cent, whilst negative agricultural growth in 97/98-99/00 reduced GDP growth to 3.5 per cent). Government has also allocated spending to promote industry and export diversification. Although low shares in total employment limit their impact on total GDP, industry and service sector growth has been faster and more robust, and greater shares in GDP and exports would reduce Ethiopia's vulnerability to drought and terms of trade shocks. Roads are another major area of proposed public spending. With only 30 per cent of area served by modern road transport system, Ethiopia has the lowest road density in sub-Saharan Africa and large areas of potentially productive land are distant from all weather roads.

2.16 Internal and external trade liberalisation policies have been pursued. Government has been gradually shifting away from agricultural sector dominance. Agricultural and retail prices, except petroleum, have been deregulated and monopoly powers of some government marketing and trade corporations eliminated. Export taxes have been removed, except on coffee, maximum import duties reduced from 230 to 40 per cent, and Government has pledged to reduce average import tariffs from 19.5 in 2002 to 17.5 by 2003. The birr (ETB), previously overvalued, was floated in 1992 and has depreciated over the past decade. Along with disinflation this resulted in significant depreciation of the real exchange rate and improved export competitiveness. Automatic surrender of forex was abolished and restrictions on foreign exchange holdings and purchases reduced. An interbank forex market was opened in 2001 and official, auction and parallel exchange rates have converged.

2.17 Privatisation has proceeded slowly because of the substantial impact on fiscal revenues. SOEs, being commercially profitable in Ethiopia, previously provided a large share of federal revenues (e.g. 90 per cent in 1996). However, the large number of companies owned in whole or part by the state has created a two-tier private sector in which politically connected state enterprises are able to practice rent seeking and are favoured for government contracts and credit from the state controlled banking sector (Abegaz, 2001). Thus the SDPRP stresses private sector development to promote growth and Government has begun to consult with private sector on important issues such as investment climate, the financial sector and land policy.

2.18 According to the IMF, the main weakness of Ethiopia's liberalisation programme has been the financial sector. Banking sector reforms are being enacted slowly. Foreign banks are banned, the state-run Commercial Bank of Ethiopia has a near monopoly and non-performing loans of the banking sector remain above international best practice. The SDPRP envisages a medium term strategy to foster competition and efficiency in the banking sector, support micro-finance initiatives in rural areas and bring to the point of sale the Construction and Business Bank by end-2002. Government recently refused to liberalise the banking sector, fearing the negative impact on its weak financial sector, as for example had occurred in Kenya, where liberalisation led to rapid growth of local commercial banks, but inadequate legislation and supervision led to collapse of 14 banks in 1993 and 1994 (see Stiglitz, 2002).

2.19 The Government is also concerned by the correlation between environmental degradation and poverty and has formed the Environmental Protection Agency as well as national programmes to combat desertification and the effects of droughts.

Social Inclusion/Equity
2.20 For historical reasons Government takes a more interventionist approach to development than other nations and places high priority on equitable distribution of growth to rural areas. Income inequality is lower in Ethiopia than in other African countries, partly because of the egalitarian land holding

system in which 98 per cent of rural households own land. The income Gini coefficient was estimated to fall marginally in 1995-2000 from 29 to 28.

2.21 Despite relative equality, huge inter-sectoral and inter-regional differences exist in poverty incidence and other social indicators. Whilst overall poverty (accounting for non-food items) is higher in rural areas, urban food poverty rose dramatically by 43 per cent in 1995/96-1999/00 to exceed rural levels, which declined over the 90s. Hopefully this heightened urban food insecurity is a temporary phenomenon brought on by the adverse impact of war on infrastructure and prices. The relative stagnation in overall poverty reduction during the 1990s masks regional disparities. Poverty incidence decreased substantially to 30 per cent in Amhara region, which accounted for 50 per cent of the poor in 1995, but increased in other areas and exceeds 60 per cent in Tigray.

Public sector management and institutions
2.22 The EPRDF Government has enacted democratic reform and was re-elected in two national elections held in 1995, described by the World Bank as fair but uncontested, and in 2000. Ethiopia adopted a federal constitution in 1994, but Government remained relatively unresponsive to local needs throughout the 1990s. Central Government, which collects 80 per cent of total revenue, has neglected special requirements of regions and offered weak incentives for good regional administrative performance (Abegaz, 2001). This problem is now being tackled. The last couple of years have seen a radical deepening of decentralisation, involving unearmarked block grants from regions to woredas 9average population 100,000), with more awareness that service delivery approaches require local adaptation.

2.23 There was a noticeable lack of public information and public participation in the early economic reform process. Ethiopia has honest, dedicated and competent policy makers and civil servants, but owing to its political legacy it has lacked an institutionalised mechanism for debating economic policy proposals with important stakeholders, thus weakening public ownership of reforms and undermining their long-term sustainability.

2.24 Government has since recognised the importance of co-ordinating with stakeholders. The SDPRP, praised for strong ownership and broad-based participatory process (IMF/IDA, 2002), was written following consultation with the private sector, civil society, NGOs and donors. Consultative fora were held at district, regional and federal levels, as well as with pastoralist communities, and press, NGO and the Donor Assistance Group participated and monitored at various levels. The consultation process, the first to be held without government moderators, was described as free and open, although it mainly consisted of providing reaction to existing policies than providing new ones. Government has committed to further participatory involvement for PRSP implementation and monitoring.

2.25 Decentralisation and devolution have been implemented to promote community empowerment and public accountability, and regions now account for 34-40 per cent of total and almost 70 per cent of social spending. Thus public expenditure management is a high priority. Government proposes to strengthen budget formulation, execution and reporting by introducing budget classification and financial information systems and improving internal and external audit. However, more specific measures are needed to strengthen the judicial system, deepen civil service reform at regional level, improve transparency and reduce corruption. Donors have also pressed for more detailed information to be regularly provided from district level to central government. This might be argued to say more about the centralised bureaucratic processes of donors than the needs of Ethiopia, where focus arguably needs to be on implementation and monitoring within the district and accountability to district citizens[2]. More generally, limits to local level capacity reduce the potential benefits of decentralisation in improving responsiveness of services to the poor (IMF/IDA, 2002).

Impact of Shocks and Aid Variability

2.26 Arguably Ethiopia's two biggest problems are high susceptibility to famine due to low rainfall and the Government's recent inability to support peace and stability in the region. Programme aid was suspended in 1998-2000 because of fears that Government would use fungible resources to finance the war with Eritrea, which claimed a large proportion of budget resources, displaced about half a million people and during which the northern province suffered a major famine affecting 5-6 million people.

2.27 On average, 4 million people suffer food shortages every year and rely on food aid to survive. Ethiopia is currently experiencing the worst drought in recorded history, potentially affecting 15 million, and is likely to rely on emergency aid throughout 2003 and into 2004. In response the World Bank has pledged a US$ 60 million quick disbursing grant under the Emergency Drought Recovery Project. Food security is therefore a top priority for Government. Timely intervention is necessary to support food-insecure rural households in the short term and improvement of early warning and strategic reserves capabilities is an essential requisite of this. Over the medium term the objective is to reduce households' reliance on food aid by using food aid resources to build agriculture and rural infrastructure capacity. However, a key problem is that donors depress prices by importing vast quantities of food aid. Food security is often a regional issue and famine has co-existed with overall domestic surplus. Thus Government has requested that rather than import food aid, donors purchase food from surplus regions and transfer to deficit regions. Sweden and the EU are two donors who have heeded this.

2.28 GDP and the trade balance are also highly vulnerable to commodity price shocks due to heavy reliance on agriculture, particularly coffee which accounts for 60 per cent of export revenue. International coffee prices have rapidly declined since 1998 and although recent bumper coffee crops have kept export revenues on track, imports of food have increased causing the current account deficit to progressively worsen. To limit adverse impact on terms of trade, Government has suspended export taxes and relaxed restrictions on domestic sales. In the medium term the authorities' strategy is

[2] Stephen Lister, personal communication.

to encourage crop and export diversification, to halve the current account deficit (excluding OTs) to 7 per cent of GDP by 2004/05.

2.29 Foreign aid accounts for almost 20 per cent of GDP and the majority of federal budget capital expenditure, thus its predictability is a key factor in its effect on growth and poverty reduction. Aid is not given systematically to offset losses in export earnings. Abegaz (2001) notes that variation in growth rate of net financial aid is much greater than export or GDP growth and the correlation between growth of exports and ODA, although negative, is low. Increasing the share of programme aid would provide more flexibility to stabilise foreign exchange inflows in the face of external shocks, lessen investor uncertainty and stimulate growth.

Aid and public expenditure management

2.30 Whilst economic liberalisation has in the main progressed fairly rapidly, donors have had problems effecting second-generation political conditionality reforms. With the exception of the IFIs, donors on the whole have not used the threat of aid withdrawal to quicken these reforms, perhaps because it would punish the poor (Abegaz, 2001). However, the PRSP process appears to have facilitated donor and Government co-ordination, and reforms to improve public sector efficiency, transparency and stakeholder participation are underway. A JSA commended the SDPRP for its good poverty profile, rightful emphasis of agriculture and private sector development, reorientation of public expenditure away from defence, and clear set of indicators and targets for monitoring and evaluation (IMF/IDA, 2002).

2.31 However, the SDPRP is lacking in several important areas. Policies for stimulating private sector and agricultural development are not specified in detail, programme costing is inadequate and implementation capacity is uneven, particularly at district level. Links between central government and local monitoring must be strengthened, and involvement of non-governmental stakeholders will be necessary to improve local monitoring capacity. Furthermore, the MTEF is based on highly ambitious growth rates and revenue collection. It assumes donor financing, though gradually falling, to be broadly maintained at the current high levels. Thus IMF has advised Government to develop contingency plans to prioritise essential programmes and develop ways to improve efficiency in service delivery.

2.32 Formal aid co-ordination procedures have until quite recently been weak in Ethiopia. GOE tended to see dialogue as infringing on sovereignty, relations between donors and the World Bank and IMF were strained at times, and the promising development of sector programmes were interrupted by the war. However, the last two years have seen promising improvements. Ethiopia is one of the pilot countries of the donor harmonisation initiative, which aims to align Government and donor priorities, build domestic capacity for aid delivery and management and improve aid effectiveness by reducing transaction costs. A joint donor group on budget support has been formed, and aid co-ordination is facilitated externally through the SPA and CG meetings and internally through frequent consultations between local representatives of donors and Government. PERs and PFPs have also played an important role in linking project, sector and programme aid coherently and progressively. The establishment of a unified planning and finance ministry has been accompanied by much greater Government willingness to engage systematically with the donors, who have also been co-ordinating themselves better through the Development Assistance group and its working groups. Following the 2002 SPA mission, there appears to be a greater willingness to use budget support.

Impact of Aid

2.33 Following externally supported market-oriented reform, aid supported strong growth and improved social indicators in the 1990s. However, progress was interrupted by the Ethio-Eritrean war. The majority of aid flows remain in projects, but multilateral assistance has shifted recently to Sector Investment Programmes (SIPs), which exist in education, health and roads. SIPs improve aid's impact by incorporating aid into the budget and establishing a long-term sector policy framework, which is driven by local stakeholders and allows co-operation with all donors (Abegaz, 2001). Marked improvements in education and health indicators have been associated with sector programme implementation.

2.34 However, a major constraint to aid and more generally public spending effectiveness is weak institutional capacity, especially at local level. Low institutional quality and inadequate human resources reduce ability to undertake effective planning, implementation and monitoring of programmes and therefore negatively impact on programme effectiveness and efficiency. Low capacity, as reflected in the merely 'satisfactory' loan portfolio performance rating, inadequate judicial system and corruption (though not on the grand scale of other African countries), limits full utilisation of committed aid (ibid.). However, much of the problem may lie with donor procedures. Public expenditure reviews and sector programme reviews have found that the implementation rate is far higher on Government financed than Aid financed projects. Because Government adjusts own funding to offset donor commitments, to avoid distorting regional allocations, there is no incentive for regional Governments to seek or accept aid, since Government funds are available more quickly and reliably and with fewer strings attached[3].

2.35 The EU have found a mixture of success and failure in their aid programmes, but note that aid effectiveness is undermined by unfavourable policy, over-centralisation and shocks to the economy. However, part of the problem lies with donors. Donors are unreliable and effectiveness of EU aid has been weakened by the EU's poor policy dialogue and neglect of the importance of local administration in implementation (Maxwell, 1998).

3. Absorptive Capacity and Potential Impact of Increased Aid

3.1 External assistance will be essential to progress in poverty reduction over the medium to long term. External financing requirements are projected to remain high but decrease over FY 2002/03 to 2004/05 in absolute terms and as shares of GDP and total spending. Government aims to reduce

[3] I am grateful to Stephen Lister for this point.

dependency on aid by increasing domestic revenue as a share of GDP and reducing total spending: GDP. This relies on increased domestic financing associated with high growth and improved tax base.

Table 5 Projected external financing (ETB millions)

In ETB millions	2000/01	2001/02*	2002/03**	2003/04**	2004/05**
Grants	2628	2724	2748	2700	2597
o/w Project grant	*1651*	*2060*	*2267*	*2023*	*2108*
Programme grant	*977*	*664*	*481*	*677*	*489*
Net external loans	2070	4669	4677	4408	3756
o/w Project loan	*1744*	*1906*	*2200*	*2481*	*2827*
Programme loan	*941*	*3377*	*3134*	*2864*	*1791*
Amortisation	*-616*	*-614*	*-657*	*-937*	*-862*
Total grants and loans	4698	7393	7425	7108	6353
% of GDP	9.0	14.5	13.0	11.1	8.8
% of total spending	30.3	41.4	37.6	33.3	26.9
Memo item:					
Exchange rate ETB/$	8.34	8.55	8.7		

* estimate; ** forecast.
Source: SDPRP (2002).

3.2 Government expenditure plus net lending is budgeted to increase by 5 per cent of GDP in 2001/02, but subsequently fall by 2004/05, with total revenue providing a marginally increasing share from 62 to 68 per cent over 2001/02-2004/05 due to increased tax receipts. However, despite the various measures proposed to improve performance such as VAT introduction, domestic financing projections remain ambitious given recent GDP growth volatility.

Table 6 Government financial operations (% of GDP)

	Ave. 1995/96-1997/98	Ave. 1998/99-1999/00	2000/01	2001/02*	2002/03**	2003/04**	2004/05**
Total revenue	18.2	18.1	19.6	21.7	21.8	22.0	22.4
o/w tax revenue	12.3	12	14.3	16.2	16.6	17.1	17.7
Domestic current exp	14.7	23.7	20.1	21.9	21.6	19.5	18.2
Total spending	25.4	31.55	29.8	34.9	34.6	33.4	32.7
Interest payments (after debt relief)		2.2	2.1	1.9	2.2	2.0	2.0

* estimate; ** forecast.
Source: SDPRP (2002).

3.3 Domestic revenues will not be enough to raise sufficiently domestic savings and investment rates to increase growth, and Ethiopia requires further institutional reforms in land use, banking and transparency to convince private investors of its commitment to an 'open, rule-based market economy' (Abegaz, 2001). The restrictive environment in which the private sector operates is a major challenge to growth. The domestic private sector lacks competitiveness. Conflict and lack of transparency and efficiency of financial management suppress private investment. Efficiency is reduced by poor quality infrastructure (power, telecommunications and logistics), which also deters FDI. Private savings are constrained by the level of income per capita, high unemployment and lack of instruments for domestic savings. Liberalisation of input/output markets has not been accompanied by improved competitiveness, which has stalled rural private sector development, and development of institutions providing support and extension services is still in early stages. Agricultural growth is suppressed by lack of private land ownership: farmers are unable to use land as collateral, discouraging investment, labour mobility is limited and optimal farm size is not achieved among efficient farmers who are unable to buy more land.

3.4 Aid flows are below regional averages in per capita terms, and there is clearly a strong case for increasing aid to Ethiopia based on its low level of development and vulnerability to frequent external shocks. Additionally, recent donor-supported sector programmes have been relatively successful (see Box 1).

3.5 However, there are concerns about increasing aid relating to dependency, debt and the macroeconomic environment. Government has committed to raising domestic revenue to gradually reduce its reliance on foreign assistance, but over the long term Ethiopia will remain highly dependent on aid, which provides almost all its public investment spending. The debt stock is unsustainable and Ethiopia is due to reach Enhanced HIPC Initiative Completion Point in 2003. Long-term GDP growth exceeds the 2 per cent share of interest in GDP, which implies debt stock to be falling relative to GDP. However, external factors such as recurring drought are a major constraint to sustained GDP growth, and low exports growth implies that aid increases will need to be on highly concessional terms. Defence sector spending, although plummeting in recent years, remains high relative to social spending, and fungibility will therefore remain another major concern.

3.6 Food aid appears to have caused damaging Dutch disease effects by depressing domestic prices and displacing potential domestic producers from food grain markets. More significant, food aid has presumably caused increased food insecurity because domestic producers face the likelihood of their domestic market being taken by aid imports, and therefore have been discouraged from entering the market. However, there does not appear to be evidence of adverse macroeconomic effects of aid in other areas. The real exchange rate has depreciated consistently since the nominal exchange rate was floated in 1992. There is a problem of low exports volume and growth but this is likely due to adverse external factors such as drought and commodity price decline and reliance on a narrow basket of commodities.

3.7 The speed at which aid can be increased will depend on creating capacity to use it well, as well as donor commitments to simplify procedures and ease the capacity burden of aid. Particularly at local level, poor institution quality, working systems and human resources diminish the ability to manage and implement programmes. Government has recently proposed a National Capacity Building Programme focusing on capacity building at various levels of government hierarchy as well as in the private sector and civil society with the aim of improving service delivery efficiency and accountability.

4. Conclusion

4.1 Aid allocation models imply giving Ethiopia an additional $2-$3bn from the proposed $50bn increase in global aid, taking total aid to Government from $865mn in 2001-2 to $2.8bn-$3.7bn. Assuming that this increase occurs by 2006-7, and allowing for 7% p.a. increase in nominal US$ GDP, aid would represent at least 33.5% of GDP, and the additional finance would enable public expenditure to increase from 35% of GDP to 56%, with aid financing 60% of public spending, which would imply significant aid financing of the current budget- something that Government has previously been reluctant to contemplate. In order to sustain per capita expenditure at the higher level, the real level of aid would need to be sustained above $2.8bn until 2022, and would still be above $2.5bn in 2027, assuming 5% p.a. GDP growth, constant revenue: GDP, and 2.5% population growth (Table 7). These dynamics follow from the problem that revenue would be a small proportion of public spending after the aid increase, and the absolute finance gap initially widens even though the domestically financed percentage increases. It would be risky for Government to commit itself to a level of public expenditure that would require aid to be maintained at such high levels for so many years.

Table 7: How soon could increased aid spending be financed from domestic revenues?

	Actual	Projections, constant 2007 prices				
	2002	2007	2012	2017	2022	2027
GDP, $mn	5963	8364	10672	13618	17377	22173
Population, Mns	67.7	76.6	86.6	97.9	110.8	125.3
Revenue (22.4% GDP)	1293	1873	2390	3050	3892	4967
Public Expenditure p.c. $	30.73	61.06	61.06	61.06	61.06	61.06
Revenue p.c.$	19.1	24.5	27.6	31.1	35.1	39.7
Required aid p.c.$	12.78	36.6	33.5	29.9	25.9	20.4
Aid needed $Mn	865	2800	2898	2930	2871	2557

Sources; Actuals from table 5, table 6.

4.2 Although the increase set out in Table 7 may be beyond a prudent level, Ethiopian progress towards the MDGs will be dependent on external resources for the foreseeable future due to its narrow resource base and vulnerability to external shocks, and a significant increase is merited. A doubling of aid flows to around $1.7bn by 2007 would permit a 50% increase in public spending per capita. Revenue growth would enable the higher per capita spending level to be maintained with aid flows of $1.3bn in 2022, falling back to the initial level of around $875bn by 2027. Extra flows would need to be in grant form or at least highly concessional to avoid problems of debt sustainability.

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The Case for Increased Aid: Ghana Case Study

Summary

Between 1983-91 Ghana was perceived as being one of the most promising reforming countries in Africa. From a position of economic collapse, the economy rebounded strongly during the first decade of reform. This strong performance was accompanied by a sharp increase in aid inflows from both bilateral and multilateral sources. The reform programme was characterised by a high degree of ownership by top Ghanaian policymakers and by the President himself. It was implemented by a group of competent technocrats brought into the civil service by Rawlings. The impetus for reform appears to have been both the depth of the economic crisis faced and also an evolution in the thinking of policymakers as they increasingly had to compete for political survival in a more pluralistic environment.

During the 1990's the Ghanaian economy grew at an average 4.3% per annum resulting in moderately rising levels of real GDP growth per capita. Household survey data confirmed that aggregate levels of poverty incidence (based upon consumption data) declined rapidly during this period, largely as a consequence of growth. Social welfare indicators, while improving, have lagged behind the growth and poverty performance. In the late 1990's negative price shocks to key export sectors such as gold and cocoa production have further exacerbated an existing structural balance of payments deficit. The government's response to twin fiscal and external deficits, as well as rising levels of domestic debt, has led to macroeconomic instability, with higher inflation, rising domestic interest rates which have choked off investment and further devaluation of the cedi.

Derailment of the economic reform programme in the nineties coincided with increased democratisation and greater demands on the government's institutional capacity. The end of the Rawlings era has created further uncertainty about the path of future reforms (both amongst donors and the private sector) but also offers the opportunity for a new government/ donor partnership to move forward with challenging structural reforms. Private sector investment levels continue to very low even by African standards, partly due to political uncertainty and regional instability amongst Ghana's neighbours, particularly Côte d'Ivoire.

Economic reforms are continuing under the new Kufuor government, but the implementation of further structural reforms are being increasingly challenged by powerful domestic interest groups. Donors have recently shown a greater willingness to accept lower performance in order to guarantee a successful political transition and regional security and stability. Ghana can perhaps be characterised as experiencing "adjustment fatigue" and needs to concentrate upon achieving macro-economic stabilisation and consolidating institutional reforms already undertaken.

Ghana is a moderately aid-dependent African country that could undoubtedly absorb higher levels of financial inflows into key poverty-related sectors without significant problems of absorptive capacity. However, both in terms of the government's ability to effectively implement "good" policy and the strength of key domestic institutions, there are some doubts as to whether increased aid to Ghana would have a significant positive impact upon either growth or poverty reduction in the short run. Ghana's challenge is to demonstrate its ability to use existing resources more effectively and equitably.

Acronyms

DFID	Department for International Development (UK)
ECA	Economic Commission for Africa (UN)
GDP	Gross Domestic Product
GLSS	Ghana Living Standards Survey
GNI	Gross National Income
GoG	Government of Ghana
GPRS	Ghana Poverty Reduction Strategy 2003-05
IDA	International Development Association (World Bank)
IMF	International Monetary Fund
MDG's	UN's Millennium Development Goals
MDBS	Multi-Donor Budget Support
MTDP	Medium Term Development Plan (1997-2000)
MTEF	Medium Term Expenditure Framework
NIRP	National Institutional Renewal Programme (commenced 1994)
ODA	Overseas Development Assistance
NGO's	Non-governmental organisations
NPP	New Patriotic Party
PRGF	Poverty Reduction and Growth Facility (of IMF)
PRSC	Poverty Reduction Strategy Credit (of World Bank)
PRSP	Poverty Reduction Strategy Paper
VAT	Value Added Tax

1. Aid Trends

Aid Volumes

1.1 Total ODA to Ghana has been relatively constant in recent years at between US$ 600-650 million per annum. This represents a moderate decline from the higher levels seen in the mid-1990's largely in response to concerns about the recent economic performance. In 1999, total ODA represented nearly 8% of Gross National Income (GNI) and financed approximately 29% of budgeted public expenditure. As can be seen from the comparative data presented in Table 1, this places Ghana as a moderately aid dependent country in the Sub-Saharan Africa context.

Table 1

Total ODA to Ghana in Comparison with Selected Other African Countries

	Net ODA Receipts ($ million)					GNI/CAP (e)	Population	Current GNI	ODA/GNI
	1996	1997	1998	1999	2000	1999	1999	1999	1999
						US$	*million*	*$ million*	*per cent*
Ghana	**651**	**494**	**702**	**609**	**609**	**400**	**18.78**	**7 638**	**7.98**
Botswana	75	122	106	61	31	3 040	1.59	4 671	1.30
Kenya	597	448	477	310	512	360	29.41	10 486	2.96
Mozambique	888	948	1 040	804	876	220	17.30	3 657	21.99
Tanzania	877	945	1 000	990	1 045	260	32.92	8 726	11.35
Uganda	676	813	647	591	819	320	21.48	6 409	9.21

Source: OECD/ DAC Tables 2002 (Table 25. ODA Receipts[a] and Selected Indicators for Developing Countries and Territories)

1.2 The major donors to Ghana are shown in Table 2 with DFID in third place after the World Bank (IDA) and Japan, whose support programme to Ghana has grown rapidly in recent years.

Table 2

Ghana - Top 10 Donors

ODA 1999-2000 average, USD million

IDA	211
Japan	121
UK	86
USA	52
IMF	48
Denmark	38
Germany	37
EC	30
Netherlands	22
Canada	15

Source: OECD/ DAC Tables 2002

1.3 The size of the DFID programme in Ghana doubled in real terms between 1997/98 to 2001/02 from £25.3 million to £54.6 million. The most recent DFID Country Assistance Plan for 2003-2006 envisages a moderate further expansion of the programme - with the provision of annual funding of not less than £63 million (US$ 104 million) in each of the financial years 2003/04 to 2005/06. This commitment is based upon the twin assumptions of continued progress in the implementation of the Ghana Poverty Reduction Strategy (GPRS) and full disbursement of variable tranches under the budget support programme – see below.

Sectoral Composition of Aid

1.4 The broad sectoral composition of aid is shown in Table 3. The share of bilateral aid being delivered as programme-based support to key social sectors is certainly increasing in Ghana, however project-based and mainly off-budget interventions in the health and education sectors are still common. Donor support to economic infrastructure has focused upon a comprehensive roads sector programme, coordinated by the World Bank. There has been a gradual move of aid resources away from adjustment lending (which predominated in the 1980's) towards support for the government's social expenditure programme in the 1990's.

Table 3

Bilateral ODA by Sector

ODA 1999-2000 average, % of total	
Education	13
Health	7
Other Social Sectors	19
Economic Infrastructure	22
Production	5
Multisector	4
Programme aid	25
Debt relief	1
Emergency aid	0
Unallocated	3

Source: OECD/ DAC Tables 2002

Future Aid Flow Expectations

1.5 It is not expected that aggregate aid flows to Ghana will increase substantially in the short term, although financial projections included in the poverty reduction strategy are based upon an assumption of increased donor assistance to priority medium-term programmes. In the light of past policy slippage, donors are adopting a more cautious approach with the new Kufuor government, elected in December 2000[4], and certainly wish to see clear

[4] The New Patriotic Party (NPP) government of President John Kufuor took office in January 2001. This represented the first change in ruling party since 1981.

evidence of the Government's commitment to the implementation of the new GPRS before committing further resources.

1.6 The World Bank's Country Assistance Strategy for 2001-2003 (June 2000) sets out various scenarios for its lending programme, including a base case which anticipated a slight increase in total lending from US$ 454 million in 1997-2000 to US$ 490 million in 2001-2003. In the low case, which would pertain if fiscal performance deteriorated, lending would be cut to 66% of its previous level. The main medium-term risks identified by the Bank were the continued "under-performance" of the economy relative to the rates of growth and poverty reduction that could be achieved with an appropriate enabling environment, stronger fiscal performance and more attention to ensuring equitable development.

New Aid Instruments

1.7 Bilateral donors to Ghana are looking to establish a multi-donor budget support programme (MDBS). This will involve a considerable effort to harmonise existing disbursement mechanisms and to agree a common set of objectives of the programme with government. It is also recognised that two major risks to the success of the programme are weak public financial management systems and a lack of commitment/ capacity to reorient existing expenditure patterns to more effectively meet GPRS priorities.

1.8 Ten donor agencies are working with the Government of Ghana to develop a MDBS programme worth US$ 500 million in budget support over the period 2003-2005. It is envisaged that the support will be disbursed annually in two tranches: a non-conditional 50% in the first quarter in order to provide a predictable level of funding and up to 50% in the third quarter based upon evidence of progress made in meeting a set of disbursement triggers. The main pre-conditions for the MDBS programme is that government remains on-track in its IMF programme and is also judged to be making progress on the implementation of the GPRS.

1.9 A Policy Matrix for MDBS has been developed with a set of performance triggers linked to disbursement. However, experience elsewhere suggests that there will be considerable pressure on donors to provide continuity of support even with slippage in meeting these trigger points. A multi-donor technical assistance fund is being developed, using up to 5% of the funds available for budget support, to support capacity building in key areas, including public financial management and public sector reform.

1.10 The IMF's support to Ghana is now in the form of a Poverty Reduction and Growth Facility (PRGF)[5]. One of the main criteria for access to the PRGF facility is that the Government of Ghana adopts a comprehensive Poverty Reduction Strategy Paper (PRSP) prepared by the borrowing country and to be endorsed by the Boards of the IMF and World Bank. The PRSP is

[5] The IMF introduced this instrument in 1999 as a successor to its Enhanced Structural Adjustment Facility.

designed to act as the foundation of both the PRGF and the World Bank's Poverty Reduction Strategy Credit (PRSC), a form of non-earmarked budget support credit to support key poverty reduction programmes. An interim PRSP was approved in June 2000 with the full version published only in February 2003.

2. Aid Effectiveness

Progress in Poverty Reduction and Against MDG's

2.1 In the early 1990s it had appeared that economic policy reforms instigated in the mid-1980s were beginning to have a positive impact on reversing Ghana's earlier economic decline. During the 1990's the Ghanaian economy grew at an average rate of 4.3% per annum. This was marginally higher than the population growth rate and thus allowed the index of GDP per capita to rise gradually from 100 in 1988 to 120 in 2000, a 20% increase over the period. This reversed the decline in per capita income levels observed throughout the 1980's.

Key Recent Policy Instruments & Events

- Ghana implemented its first Medium Term Development Plan (MTDP) from 1997-2000
- Ghana achieved its HIPC decision point in December 2000 and completion point in xxx *[??]*. Ghana is now eligible for enhanced HIPC terms – decision point reached in 2002.
- The Interim PRSP was approved in June 2000 but the full PRSP was delayed until February 2003 – largely due to the change in government at end of 2000. Consequently, the full PRSP only covers the period up to 2005.
- Ghana's overall development strategy is contained in the Ghana Vision 2020 document that was adopted in 1997.

2.2 Ghana's recovery came to an abrupt halt towards the end of the 1990's. Despite successes in some areas, a combination of lax monetary and fiscal policy failed to create conditions for macroeconomic stability. This eventually resulted in the collapse of the domestic currency in 1998-2000. The exchange rate of the cedi to the US$ fell from 2340 in 1998 to 6000 by the end of 2000, a rise of 150% when the price level rose by only 34%. This devaluation has severely affected sectors of the economy that depend upon imports of goods and services, including manufacturing and agriculture. Since 2001, the new government's stabilisation programme has gradually recovered the situation. Ghana achieved GDP growth of 4.5% in 2002 up from 4.2% in 2001 and 3.7% in 2000. Inflation fell from 40% in 2000 to 21% in 2001 and 13% in 2002 (Source: ECA Report 2003).

2.3 Evidence from the third and fourth rounds of the Ghana Living Standards Survey (GLSS) give the best estimates of what happened to poverty incidence during the 1990's. Official estimates indicate that poverty levels declined quite substantially during the decade (Ghana Statistical Office 2000). The incidence of poverty is estimated to have declined from 51.7% of the population in 1991/92 to 39.5% in 1998/99, a fall of over 12% - probably one of the fastest rates in Africa during this period. The proportion living in absolute poverty fell from one third to one quarter of the population.

2.4 Despite this laudable achievement at the aggregate level, closer analysis of the patterns of poverty and how these have changed points to several areas of continuing concern. In several regions, poverty incidence actually increased over the same period (Central, Northern and Upper East). Poverty incidence rates continue at 70% and above in the northern savannah regions. Subsistence farmers and female-headed households are two groups that are particularly vulnerable.

Table 4
Ghana Poverty by Location 1991/92 and 1998/99 (% of population)

	Poverty line = 900,000 cedis		Poverty line = 700,000 cedis	
	Poverty Incidence	Contribution to total poverty	Poverty Incidence	Contribution to total poverty
GLSS3 - 1991/92				
Accra	23.1	3.7	11.3	2.5
Urban Coastal	28.3	4.7	14.2	3.4
Urban Forest	25.8	5.5	12.9	3.9
Urban Savannah	37.8	3.9	27.0	3.9
Rural Coastal	52.5	14.4	32.8	12.7
Rural Forest	61.6	35.3	45.9	37.3
Rural Savannah	73.0	32.6	57.5	36.3
Urban	27.7	17.8	15.1	13.7
Rural	63.6	82.2	47.2	86.3
All Ghana	51.7	100.0	36.5	100.0
GLSS4 - 1998/99				
Accra	3.8	0.8	1.7	0.6
Urban Coastal	24.2	4.8	14.3	4.2
Urban Forest	18.2	5.4	10.9	4.8
Urban Savannah	43.0	5.2	27.1	4.9
Rural Coastal	45.2	16.7	28.2	15.3
Rural Forest	38.0	30.4	21.1	24.8
Rural Savannah	70.0	36.6	59.3	45.5
Urban	19.4	16.3	11.6	14.4
Rural	49.5	83.7	34.4	85.6
All Ghana	39.5	100.0	26.8	100.0

Source: Ghana Statistical Office 2000

Notes: Poverty Line = 900,000 cedis represents expenditure necessary for essential food and non-food consumption (per adult per year); Poverty Line = 700,000 cedis represents expenditure necessary to meet minimum nutritional requirements only (measure of extreme poverty)

2.5 Poverty-related indicators linked to the MDG's have mostly improved over this period, but perhaps not as rapidly as had been expected, either by government or by donors. These limited improvements reflect an increase in the access of rural populations to key social sector services, for example education and health facilities, but there are continuing concerns about the distribution of the benefits from these services, both in terms of geographical distribution and their targeting to families at the lower end of the income distribution.

Table 5

Ghana's Progress Towards the Millennium Development Goals

	1990	1995	1999/ 2000	2005 (GPRS target)	2015 (MDG target) #	Will MDG's be Met? *	State of Supporting Envir? *
Population below national poverty line (%)	51.7	--	39.5	32.0	26.0	Probably	Strong
Population in extreme poverty (%)	36.5	--	26.8	21.0	18.0	Potentially	Fair
Gross primary enrolment ratio (% of relevant age group)			77.6	82.0	100	Potentially	Strong
Ratio girls/ boys in primary & secondary education (%)			71.0	80.0	100	Potentially	Fair
Under 5 mortality rate (per 1000)	119	108	112.1	95	39.6	Probably	Strong
Maternal Mortality (per 100,000)	200		200	160	50	Unlikely	Fair
Prevalence of HIV, female (% ages 15-24)			3.4	?		Potentially	Weak but improving
Access to an improved water source (% popn)	56.0		64.0	?	28.0	Potentially	Weak but improving
Other statistics:							
Population (millions)	15.1	17.3	18.9				
GNI per capita	390	360	340				
Life expectancy at birth (years)	57.2	59.2	56.9				

Source: DFID CAS 2003, data from World Development Indicators 2002

 # Author's own calculations based upon available 1990 values of indicators

** Assessment made in Ghana MDG Report, UNDP, September 2002*

2.6 An assessment by the United Nations (Ghana: Millennium Development Goals Report 2002) concludes that Ghana will probably reach two out of twelve of the MDG's (these being halving the proportion of the population below the national poverty line by 2015 and reducing under-five mortality by two-thirds by 2015) and has the potential to reach most of the others. But there is still a question as to whether this undoubted potential to improve current levels of social welfare can be effectively realised. Initial donor reactions to the new GPRS have reinforced these doubts.

Poverty & Public Expenditure

2.7 A review of Ghana's public expenditure programmes in the health and education sectors between 1992-98 (Canagarajah and Ye 2001) reaches some worrying conclusions in terms of the previous government's ability to implement social sector reforms which will contribute significantly to poverty reduction. Public expenditures in the education sector are shown to have declined in the second half of the 1990's. Basic education enrolment was stagnant or declining in public schools, probably due to poor quality and resources, but increasing in private schools.

2.8 Regional disparities in expenditure were shown to be large, with lower public resource allocations and lower enrolment ratios in the three poorest regions (namely Northern, Upper West and Upper East). In Accra, an active private education sector is fulfilling a large proportion of educational needs but this does not extend to other regions. Benefit incidence analysis, based upon household survey data, showed that the incidence of public primary school subsidies for the poor (bottom two quintiles) had either declined or stabilized, but for the richest quintile it had increased. In conclusion, the primary education system was found to be "not pro-poor" but to provide reasonably equal access to a majority of the population.

2.9 Ghana ranks high amongst West African countries in health indicators, although again its health expenditures tend to favour the non-poor. While more of the rural population have gained access to health services in recent years, many still have limited access or none. In addition, the level of public expenditure on health was found to be low compared to other West African countries and has declined as a ratio of total health expenditures to GDP from 2.3% in 1997 to 1.9% in 1999. Canarajah and Ye also found that there is no link between the pattern of public expenditures and health outcomes, particularly in the pattern of immunization. They argue that in order to ensure that social services are efficiently and equitably delivered, public expenditures need to be more closely linked to outcomes.

Recent Policy Environment

2.10 Ghana is characterised in the World Bank's 2001 Aid and Reform study as a "successful reformer", along with Uganda the only two countries out of ten analysed which achieved this designation. This accolade was however bestowed upon Ghana based upon an assessment of policy reforms during the period 1980-1996 (Tsikata 1999) and is looking increasingly misplaced in the light of subsequent developments. Adam and Bevan (2001) characterise Ghana as a country that has "still to graduate to the post-stabilisation phase" enjoyed by other countries such as Uganda, Tanzania and Mozambique. This is because price stability has still not been fully achieved and low inflation is only being sustained by a fiscal stance that is tighter than desirable over the medium-term. Exerting fiscal and particularly expenditure control and concerns over privatisation still dominate the policy debate in Ghana, at the expense of greater concentration on social sector performance and generating a pro-poor growth environment.

2.11 The IMF's August 2001 Article IV review commented that the newly elected government was beginning to make strong efforts to break the cycle of increasing deficits and rising interest costs. Interest repayments on domestic debt absorbed 20% of total government expenditure in 2000, thus crowding out poverty-related spending. Economic performance based upon macro indicators has improved since 2001. The new government is gradually re-establishing the confidence of both donors and the private sector. Major challenges for 2003-05 include parastatal reform particularly in the energy[6] and utilities sectors, reform of the tax system and establishment of a more effective system of budgeting and expenditure control and reducing levels of domestic public debt.

2.12 The Government's own poverty reduction strategy for 2002-2004 indicates that "the emphasis over the period will be on stabilising the economy and laying the foundation for sustainable, accelerated and job creating agro-based industrial growth". The report recognises that one of the fundamental problems faced by the Ghanaian economy is the persistent reliance upon the export of a few primary products with little or no domestic value added – namely cocoa, gold and timber. This situation and reliance upon oil product imports makes Ghana's balance of payments extremely vulnerable to price fluctuations that are externally determined.

Economic Management

2.13 It has been argued that recent experiences in Ghana reflect deep problems with "adjustment fatigue" (Adam and Bevan 2001). Weak external conditions in 1999/2000 were compounded by a lack of fiscal control in the run up to the December 2000 elections and specifically by an unwillingness of the part of the Ghanaian authorities to implement critical revenue measures. As a result none of the quantitative performance criteria attached to the PRGF were satisfied in December 2000. Following extensive negotiations in early 2001, IMF staff requested waivers for the slippages in meeting 2000 performance criteria and benchmarks in order to keep the PRGF on track. This has been supported by extensive structural conditionality through to March 2002.

2.14 Issues contained in the conditionality of the revised PRGF include clearance of arrears, divestiture and public enterprise reform, gasoline pricing, VAT reform and expenditure control. This focus in the budgetary debate upon short-term expenditure and contingent liability management has been at the expense of a more comprehensive analysis of expenditure composition or the

[6] As one example, subsidized fuel prices to domestic producers and consumers have meant that TOR, Ghana's state-owned monopoly fuel importer, has accumulated debts to local commercial banks estimated by the IMF at 5% of GDP in 2000 (IMF 2001). These and other parastatal debts pose a continuing threat to the health of the financial system and also a range of contingent liabilities on the government's public expenditure programme.

development of an effective MTEF. Adam and Bevan comment that “These chronic stabilization difficulties have meant that any meaningful debate on alternative fiscal policy stances is currently otiose.”

Impact of Shocks

2.15 Ghana has been subjected to significant terms of trade shocks during the last decade. The undiversified nature of the Ghanaian economy and particularly the narrowness of the export base – with dependence of the export sector upon gold, cocoa and timber – means that it is highly vulnerable to external price shocks and exchange rate movements.

2.16 Cocoa prices reached a 27-year low in 2000 while oil prices rose to over $30 per barrel, a 200% increase over 1998. The IMF (2001) calculated the net loss in foreign exchange earnings that this terms of trade shock represented to the Ghanaian economy, compared to their initial programme assumptions as of May 1999. This represented a loss of foreign exchange of about US$ 308 million (4% of GDP) in 1999, US$ 597 million (12% of GDP) in 2000 and US$ 680 million (14% of GDP) in 2001. As can be seen, the foreign exchange losses for 2000/ 2001 are of roughly similar dimension to the size of Ghana’s aid programme. Hence, it could be argued that, at the margin, donor financing is basically plugging the hole in Ghana’s balance of payments position.

Donor Policy dialogue

2.17 While donors continue to enjoy a relatively strong and favoured position in negotiations with the Ghanaian government over the future direction of policy reform, there is a feeling that the nature of this relationship is changing from the early reform period (1983-1990) where essentially donors “called the shots” to a more nuanced position where the Ghanaian government has begun both to assert its sovereignty more forcefully and has also been required to respond more closely to domestic political considerations in setting out its economic and social programme. Important sectors of the Ghanaian population continue to be sceptical about the benefits of liberalisation, which has resulted in the collapse of the domestic manufacturing sector, loss of public sector jobs and greater levels of economic insecurity.

2.18 It can be argued that the donor-supported adjustment process has faced an important challenge emerging from the nature of the domestic political situation in Ghana in recent years. Since early 2000, legitimate political considerations have limited the scope for rapid fiscal reform, both by the incumbent government in the run up to the elections in December 2000 and also by the incoming new administration of President Kufuor. This has required the IMF to back down from their preferred fiscal reform programme (specifically reform of VAT) in favour of a more gradualist and arguably less effective adjustment strategy.

2.19 Tsikata (1999) concludes that Ghana's periods of most rapid reform occurred under a non-elected government. "Democracy has complicated the process of reform, but Ghana's experience is also a function of the nature and maturity of democracy in the country". Ghana's experience of the tensions between rapid economic reform and the need to accommodate democratic pressures upon the actions of policy-makers is of relevance to many other reforming African economies.

2.20 DFID's 2003 Country Assistance Plan (April 2003) recognises that they will never have more than "a modest overall impact" in achieving the MDG's in Ghana. This is a somewhat surprising conclusion given the large absolute size of the DFID programme in Ghana. Donor scepticism on their scope for "voice" and impact seems to be based upon a recognition of (a) the relative autonomy of the Ghanaian government's budgetary programme - the proportion of all development aid in public expenditure is 29% which is considerably lower than in many other African countries, and (b) the current lack of a clear poverty focus in the government's expenditure programme.

2.21 Potential domestic opposition to fuel and utility price increases, which aim to bring these more closely in line with actual delivery costs, is also a concern to the stability of the new government – the potentially destabilising impact of this issue can be seen in the nationwide strikes which took place in Nigeria in June 2003 to protest against fuel price increases, largely due to their impact on transport costs for urban workers. Ghana also has a history of well-organised civil society opposition to unpopular economic policy measures[7], which needs to be taken into account in discussions over the sequencing and speed of future stabilisation and adjustment measures.

Public Sector Reform

2.22 Ghana has been unsuccessfully attempting to initiate a comprehensive programme of public sector reform since the mid-1990s. The National Institutional Renewal Programme (NIRP) begun in 1994 envisaged components covering public sector management reform (PSMRP), public finance reform (PUFMARP) and measures to improve civil service performance (CSPIP). These early reform initiatives were not successful due principally to a lack of sustained political commitment to the reforms and the failure to effectively enforce agreed policies and programmes.

2.23 The lack of institutional capacity to implement reforms and resistance of some parts of the civil service to contemplate change are ongoing and serious problems in Ghana. The reform agenda has proved to be too complex and broad-ranging for any one agency to effectively implement. Foster and Zormelo (2002) argue that the failure to maintain a disciplined budget process, due partly to exogenous shocks and weak macro management, has

[7] The most well known recent example being public protests in Accra and Kumasi against the introduction of the Value Added Tax in March 1995, which led to its withdrawal by the government. After an extensive public education campaign, it was reintroduced in 1998 but at a lower rate of 10% compared to the 15% recommended by the IMF.

resulted in a “chaotic policy environment that has made effective reforms ineffective.”

3. Absorptive Capacity & Potential Impact of Increased Aid

3.1 The case for increased aid to Ghana is principally based upon the likely impact that this will have upon the levels of economic growth necessary to meet the government’s poverty reduction targets set out in the GPRS, see Table 5 above. Future economic growth trends are of particular importance in the Ghanaian case given the body of evidence showing that income redistribution, via fiscal policy instruments, is unlikely by itself to significantly impact current poverty levels. The current targets are based upon attaining annual GDP growth rates of 5% by 2005 and also achieving an acceleration in GDP per capita growth from 1.4% per annum in 2000 to 2.4% per annum in 2005. The question is to what extent further external financial resources would contribute to achieving these targets?

3.2 There is no explicit mention of government policy on future aid levels in the GPRS, which is focused primarily upon setting out macroeconomic policy options for achieving stabilisation of the economy. However, implementation of the priority components of the GPRS is based upon the assumption that additional external funding will be identified (see below). The targets for budgetary performance set out in the GPRS for 2002-2005 essentially envisage a constant level of domestic revenue at around 22% of GDP supplemented by donor grants at a level of around 4% of GDP over this period. It is envisaged that the existing budget deficit will be reduced by a gradual reduction in government expenditure as a proportion of GDP from 29.7% in 2003 to 26.8% in 2005. In these circumstances, higher levels of donor funding would permit a more expansionary fiscal position but possibly at the risk of undermining the government’s attempts in the short term to establish greater control over inflationary pressures and the value of the domestic currency.

Table 6
Government Budgetary Targets 2002-2005, as % of GDP

	2002	2003	2004	2005
Total revenue (excluding grants)	18.0	22.3	22.5	22.3
Grants	1.3	3.8	4.1	3.9
Total expenditure (inc. capital outlays)	26.1	29.7	28.2	26.8
Overall balance (inc. grants)*	-6.8	-3.6	-1.6	-0.6
Domestic primary balance	2.0	3.0	2.6	2.5
Domestic debt stock	28.9	23.6	17.8	14.8
Divestiture receipts	0.0	0.7	0.6	0.0
Net domestic financing	4.8	0.0	-2.4	-2.0
External debt service (as % of govt. revenue)	37.1	24.3	20.5	19.6

Source: GPRS, February 2003

** After clearance of domestic arrears*

3.3 Beyond 2005, in order for Ghana to achieve the enhanced levels of economic growth of 7% per annum identified as necessary to impact significantly on existing poverty levels, it is undoubtedly the case that a more expansive fiscal programme will need to be followed. An increase in donor funding targeted towards supporting priority social sector expenditures will be necessary to achieve this outcome, particularly in the absence of a significant increase in the level of domestic revenue generation, either from taxation of from divestiture receipts or other non-tax domestic revenue sources, such as user fees.

3.4 The GPRS contains some indicative costs of programmes for the period 2003-06. Total costs of all identified projects and programmes is US$ 5,283 million over four years[8], although it is recognised that financial and other technical constraints imply that some of these programmes and projects will take longer than this to actually implement e.g. energy sector reforms and investments. Within this overall package, the Government has identified a subset of priority medium-term programmes costed at US$ 2,515 million (see Table 7 below). These are a combination of new and ongoing programmes. It should be noted that the cost estimates presented here do not include recurrent personnel and administration costs, which are assumed to be already covered by the existing government budget. It is anticipated that these priority programmes will be financed from a combination of government own revenues, external grants, savings from HIPC and the private sector, including US$ 900 million from the Ghana Investment Fund. Total public sector capital expenditure is projected to be US$ 674 million or 9.4% of GDP in 2003, of which 69% represents expenditure on the priority investment programmes identified in the GPRS.

[8] Broken down as follows: 8% of total for projects/ programmes designed to contribute towards macro-economic stability, 27% for increasing production and employment, 58% for promoting human resource development and provision of social services, 3% for special programmes for vulnerable groups and 4% towards institutional reform and good governance.

Table 7

Ghana Poverty Reduction Strategy: Cost Summary of Medium-Term Priority Programmes

	2003	2004	2005	2006 and beyond	Total	% of total
Macro-economic Stability	33.5	43.4	47.5	24.5	148.9	5.9%
Production and Gainful Employment	315.2	355.5	372.9	369.3	1,413.0	56.2%
Human Resource Development & Basic Services	157.1	186.6	187.3	218.8	749.7	29.8%
Special Programmes for Vulnerable & Excluded	16.1	17.8	20.4	79.5	133.9	5.3%
Governance	22.0	20.0	20.0	0.0	62.0	2.5%
Monitoring & Evaluation	0.2	2.5	2.5	2.5	7.7	0.3%
Total	**544.1**	**625.8**	**650.6**	**694.6**	**2,515.2**	**100.0%**

source: GPRS, Volume 2, Appendix B, February 2003

Note: Financing plan for 2003: GoG - $44 m (8%); HIPC savings - $100 m (18%), ongoing external - $70.1 m (13%); new external - $329.6 m (61%). It is not clear whether this plan has been accepted by donors or whether additional resources have been committed?Also, whether projected HIPC savings have been realised.

3.5 The total additional donor funding requested to finance new programmes in 2003 is US$ 330 million, on top of anticipated donor funding of US$ 70 million for existing programmes. Total costs are US$ 544 million, with Government of Ghana's contribution being US$ 44 million and the financing gap being met with an anticipated US$ 100 million in HIPC-related savings. Over the 2003-06 period, assuming a similar ratio of new/ existing programmes, implementing the identified priority programmes would entail additional requirements from the donor community of approximately US$ 1320 million, out of the total US$ 2515 million budget. Any additional funds over this amount could thus either be used to finance additional programmes which are not part of the medium-term priorities or to reduce the size of the government's own contribution from domestic resources.

3.6 These additional GPRS-related requirements are well within the estimated increases in levels of annual resource flows to Ghana under the Collier-Dollar model for allocation of aid resources based upon target aid/ GDP ratios and levels of poverty. This model projects an increase in aid to Ghana from current levels of US$ 609 million per annum (ODA per capita of US$ 32.43 and ODA/ GNI of 7.98%) to US$ 1,751 million by 2006 (ODA per capita of US$ 93.24 and ODA/ GNI of 22.92%). While such resource levels would in theory allow the Government to implement not just its priority investment programmes, but also a significant proportion of the non-priority programmes as well, there must be some considerable doubt about the existing capacity of the Ghanaian civil service to effectively undertake such an ambitious investment programme over a relatively short time period.

Macro Issues & Evidence of Dutch Disease

3.7 In order to examine the potential macroeconomic impact of increased aid in the future in Ghana, it is perhaps best to start by reviewing available evidence of the effects of the rapid increases in aid levels which took place from 1983 onwards, at the beginning to the economic liberalisation period.

3.8 Aid represented an average of 21.7% of total foreign exchange inflows during 1983-86, and subsequently increased further to 26.5% in 1987-90 and 26.7% in 1991-95. Increased aid flows coincided with increased inflows of foreign exchange from other sources during most of this period. As Tsikata (1999) argues “balance of payments support provided the government with the breathing space it required to contain domestic opposition to market-based reforms.” A similar argument in favour of aid could certainly be made regarding support to the Kufuor government’s attempts to make progress with difficult structural reforms against the background of continuing vulnerability of the Ghanaian economy to exogenous commodity price shocks.

3.9 Sowa (1996) presents some results of general equilibrium modelling of the effects of aid upon the performance of the Ghanaian economy during the period 1983-1995. He finds strong evidence that aid has financed higher imports, investment and government spending and has thus made a positive contribution to growth.

- the main macroeconomic impact of aid in the 1980’s was to relax Ghana’s binding import constraint. In the early 1980’s Ghana was unable to raise other sources of foreign exchange, so that the level of imports was constrained to that allowed by exports. The higher import levels allowed by aid were a vital component of economic recovery.
- In fact, import levels increased at faster levels than aid, since the aid inflows were accompanied by recovery in export earnings and also an increase in remittances by expatriate Ghanaians (reverse capital flight) during the 1980’s as the government began to implement increasingly “capital friendly” economic policies.
- total investment levels increased from around 5% of GDP in the early 1980’s to over 20% in the 1990’s. Aid played an important role in financing this investment recovery, as did a rise in the levels of domestic savings during the 1980’s. However, the domestic savings rate has now declined and is at worryingly low levels.
- higher government expenditure was financed out of both a rise in aid and increased tax collection. Increased revenue effort was both part of the reforms and also an indirect consequence of it, as revenues rose with rising income levels and depreciation increased the domestic currency value of taxes on traded goods.

3.10 On the negative side, the poor performance of private investment is an ongoing problem for the Ghanaian economy. It is possible that high aid-financed public investment programmes could be crowding out private investment, although excess liquidity levels in the banking system cast doubt upon whether private investment is constrained by lack of domestic credit. A more plausible explanation is that uncertainty continues to be the main cause of a weak private investment response to reform (Aryeetey 1994). This uncertainty is mainly related to domestic price instability and the weakness of the domestic currency. To the extent that uncertainty over future aid flows contributes to macroeconomic instability, this will continue to undermine the private sector's investment and supply response to market liberalisation.

3.11 The IMF (Selected Issues, 2000) has undertaken an analysis of alternative fiscal scenarios for managing the impact of the 1999 terms of trade shock. Their suggested fiscal strategy relies upon both domestic tax measures and also additional external assistance. They provide a simulation of the effect of a shortfall in external assistance (against a baseline model) over the period 2000-2007. The shortfall in external assistance causes fiscal performance to deteriorate, mainly due to the need for higher net domestic financing of the budget – to make up for direct losses of external programme support and also lower import tariff revenues due to lower levels of imports. The IMF also recommended an increase in the VAT rate to 12.5% in 2000 and 13% in 2003 as the most efficient way to address revenue losses from trade taxes and to achieve budgetary balance in the medium term[9]. The main risk is that enhanced external financial flows will allow the government to further postpone necessary tax reforms. This is an area in which conditionality of aid disbursements will play an important role.

Micro Issues: Institutional Capacity

3.12 Donor and NGO support for poverty reduction needs to be more effectively coordinated and also incorporated into the Medium Term Expenditure Framework (MTEF). Ghana has already begun to put in place some of the mechanisms necessary for achieving this, including the National Poverty Reduction Program (NPRP) and the Social Investment Fund (SIF). Approaches to poverty reduction are gradually becoming more bottom-up and involve more effective consultation with and involvement of community-based organisations. Under these funding sources and programmes, resources are being channelled directly to poor groups and communities through district assemblies, NGO's and community-based organisations. This approach is proving to be the most effective way of establishing some kind of safety net for vulnerable groups, in the absence of more comprehensive national programmes. A key issue for donors in the coming years will be the extent to which they choose to work within government budgetary systems for the allocation of aid resources or to what extent they choose to channel resources directly to potential beneficiaries through project-based interventions. In reality, a mixed strategy will probably continue to be the preferred approach of most bilateral donors.

[9] These reforms were not implemented and the VAT rate remains at 10%

3.13 Technical assistance by donors has had a mixed record in Ghana and the overall impact appears to have been weak (National Capacity Assessment 1996, Tsikata 1999). Ghanaian civil servants tend to have a sceptical view about the need for and benefits of technical assistance. One of the most serious difficulties results from continuing lack of coordination amongst donor agencies in the provision of technical assistance. Attempts by UNDP to establish a formal TA coordination mechanism in the mid-1990s were not successful due to a lack of donor commitment. This is an issue that will need to addressed if capacity is to be successfully and sustainably built within key government departments in order to effectively manage increased budget allocations. Successful experiences in the health and education sectors with the implementation of multi-donor sectoral programmes are beginning to reduce scepticism about the potential for effective technical assistance.

4. Conclusions

4.1 Probably the main achievements that can be directly attributed to aid and donor intervention in Ghana during the 1980’s and 1990’s were to (a) effectively support early reform efforts and government reformers against potential challenges and (b) contribute to poverty reduction mainly through supporting economic growth and increasing incomes for broad sections of the society. By contrast, some of the main failures have included an inability to significantly push forward the restructuring of the Ghanaian civil service, continuing problems in achieving a poverty focus in the government’s resource allocation procedures via the budget, significant problems with some key infrastructure projects and several failed attempts to proceed with privatisation of Ghana’s parastatal utility sector.

4.2 As far as enhanced donor support to Ghana’s public expenditure programme, there must be some concerns about the capacity of Government to effectively manage increased aid levels in the short term and to utilise these resources to contribute to effective poverty reduction. The lack of a clear poverty focus in existing public expenditure programmes imply the need for significant reallocation of both financial and technical resources. Weak public financial management systems mean that such reallocations will be difficult to achieve in an acceptable timeframe. Significantly increased resource flows should be made contingent upon demonstrable progress in these key areas.

4.3 The conclusions of Foster and Zormelo (2002) still seem to be pertinent. Aid donors have helped to raise poverty issues at the level of government rhetoric, but dialogue, conditionality and earmarking has not succeeded in significantly raising the poverty focus of public expenditure. There has been an increase in programmatic support for the budget, particularly in the health sector where pooled funding has been properly accounted for. However, the unwillingness of donors to give up parallel support systems in other sectors reflects serious concerns about corruption and weak financial management.

4.4 Although it is undoubtedly the case that additional aid could potentially be used to stimulate growth and poverty reduction, there are significant downside risks to achieving these potential gains in the short term. The Government of Ghana still has some work to do to re-establish its credibility as an effective development partner (and to shake off the image of “reform fatigue”) and to demonstrate that it has the ability to implement the wide range of policy reforms and programmes set out in the GPRS. In these circumstances, enhanced support to Ghana’s balance of payments position to compensate for shocks to its external balance may be more effective in reducing poverty (via its growth consequences) than a significant expansion of support to the government’s domestic spending programme.

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The Case for Increased Aid: Kenya Case Study

Summary

Current levels of aid to Kenya are considerably below the regional average and declined dramatically in 1990's. The end of the cold war era in 1989, which reduced some of the more "political" motivations for continued aid flows to Kenya, coincided with a weakening of economic reform efforts and a sharp deterioration in economic performance in Kenya in 1989-92. There was a hardening of political opposition to continued reform at the same time that donors were beginning to emphasise "good governance" and democratisation as important criteria for judging the worthiness of aid recipients. The result of these various internal and external factors has been an intensification of a mutually disadvantageous "stop-go" relationship between aid donors and the Kenyan Government, at least until recent elections in December 2002. Donors have expressed sustained concerns about government commitment to reform, endemic corruption and the poor governance record of the Moi regime.

The Kenyan economy, which is considerably more developed and diversified than its regional neighbours, has suffered over a prolonged period from mismanagement and unconstrained rent extraction by public officials. The private sector complain about bureaucratic interference and the high costs of doing business due to disintegrating public infrastructure, high energy costs, inefficient public utilities and high crime levels particularly in Nairobi. These factors plus more global security concerns have resulted in sharp falls in domestic private investment and savings rates, a drying up of inward investment, as well as substantial capital flight.

The new Kibaki government elected in 2002 has sought rapid re-rapprochement with the donor community and has recently completed important Article IV negotiations with the IMF over the pre-conditions required for renewed PRGF lending. The first change in governing party since independence in 1963 and the high expectations that this has generated has created a potential "window of opportunity" for Kenya to resume a more positive pro-poor developmental path. The inherent strengths of the Kenyan economy, including the relative diversity of the productive sector, high levels of human capital in a regional perspective and prospects for a strong agricultural performance, all imply that rapid poverty-reducing growth should be attainable given an appropriate policy environment and commitment to improving the institutional environment.

Current levels of aid to Kenya are quite obviously well below both (a) the Kenyan economy's capacity to absorb additional levels of external financing and (b) the levels that are necessary if Kenya is to have any prospect of achieving the MDG's by 2015. In these circumstances the proposed share of a $50bn increase in total ODA implied by aid allocation models, which would raise Kenyan aid from US$ 512 million per annum (2000 actual) to US$ 1.1-1.3bn, is both feasible and probably an underestimate of both actual requirements and the level of aid that the Kenyan economy could feasibly absorb before diminishing returns become a binding constraint.

Bearing in mind that total ODA to Kenya peaked at roughly US$ 1,600 million in 1990, this is probably a good benchmark for assessing the levels of aid that the Kenyan economy could eventually accommodate given evidence of sustained government commitment to reform. This level of aid would represent an aid/GDP ratio of only 7.8%, which is well within the regional average for other moderately aid dependent countries in Africa.

Acronyms Used

CG	Consultative Group
DAC	Development Assistance Committee (of OECD)
DFID	Department for International Development (UK)
GDP	Gross Domestic Product
GoK	Government of Kenya
IMF	International Monetary Fund
I-PRSP	Interim Poverty Reduction Strategy Paper
KANU	Kenya African National Union
MDG's	Millennium Development Goals (of United Nations)
MTEF	Medium-Term Expenditure Framework
NARC	National Rainbow Coalition
NPEP	National Poverty Eradication Plan
ODA	Official Development Assistance
OECD	Organisation of Economic Co-operation and Development
OED	Operations Evaluation Department (World Bank)
PRGF	Poverty Reduction and Growth Facility (of IMF)
PRSP	Poverty Reduction Strategy Paper
REER	Real Effective Exchange Rate
SDR	Special Drawing Rights (quotas at IMF)

1. Aid Trends

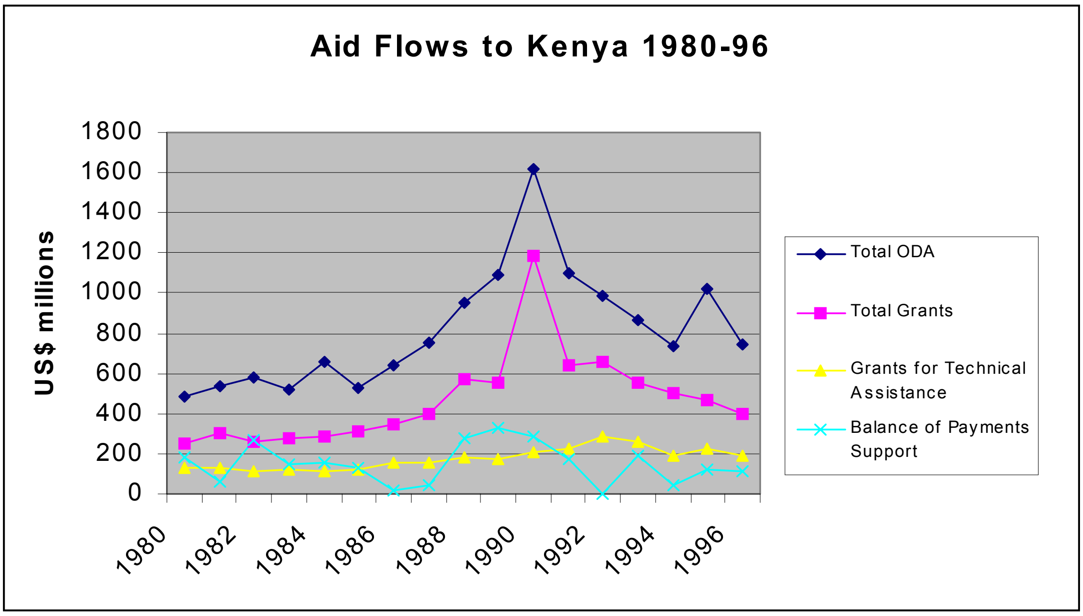
Aid Volumes

1.1 Table 1 shows the recent pattern of ODA flows (as defined by the OECD/ DAC[10]) to Kenya in comparison with five other African countries. It can be seen that the volume of aid flows to Kenya have declined sharply in real terms throughout the 1990's from a peak of $1.3 billion on average in 1989-90 to approximately one third of this level ten years later. By 1999, total ODA represented only 3% of Kenya's gross national income, making it one of the least aid dependent countries in Africa. The reasons for these declines will be discussed below. Given its large population and low and declining levels of per capita income, there is a strong case for arguing that Kenya now represents one of the most "under-aided" countries in the region.

Table 1
Total ODA to Kenya in Comparison with Selected Other African Countries

	Net ODA Receipts ($ million)						GNI/CAP (e)	Population	Current GNI	ODA/GNI
	1985-85 average	1989-90 average	1997	1998	1999	2000	1999 *US$*	1999 *million*	1999 *$ million*	1999 *per cent*
Kenya	**835**	**1,333**	**448**	**477**	**310**	**512**	**360**	**29.41**	**10,486**	**2.96**
Botswana			122	106	61	31	3,040	1.59	4,671	1.30
Ghana	395	759	494	702	609	609	400	18.78	7,638	7.98
Mozambique	658	1,150	948	1,040	804	876	220	17.30	3,657	21.99
Tanzania	1,034	1,253	945	1,000	990	1,045	260	32.92	8,726	11.35
Uganda	340	661	813	647	591	819	320	21.48	6,409	9.21

Source: OECD/ DAC Tables 2002 (Table 25. ODA Receipts[a] and Selected Indicators for Developing Countries and Territories)



[10] Total ODA includes both concessional loans (those with a grant element of at least 25% according to the DAC definition) and grants. Grants include both technical cooperation and debt relief on previous ODA loans.

1.2 Total multilateral aid to Kenya from 1990-96 was US$ 1,758 million (25% of total) compared to bilateral aid of US$ 5,310 million (75% of total) over the same seven-year period. The balance between multilateral and bilateral aid has been relatively constant over the period 1970-96. The proportion of grants in total ODA to Kenya increased in the 1990's compared to earlier periods but was still only 61.5% of the total between 1990-96 (O'Brien and Ryan 1999). The variability of aid flows to Kenya over the period 1980-96 is illustrated in Figure 1. The stop-go nature of donor relations with Kenya is particularly stark with regard to balance of payments support, which includes both IMF loans, and other multilateral support to Kenya's external balance.

1.3 Major donors to Kenya are shown in Table 2 below. As Western donors withdrew from Kenya in the 1990's in response to growing concerns about governance-related issues and endemic corruption, at least part of the gap seems to have been filled by Japan and other non-OECD/ DAC donor countries and organisations (see expanding share of total ODA from "other sources"). The relative decline of UK government support as a percentage of total ODA since the beginning of the 1980's is particularly marked. Other medium-sized bilateral donors including the Scandinavian countries, Canada and the Netherlands have also reduced their aid programmes to Kenya in recent years. Norway broke diplomatic relations with Kenya during 1990-95 and aid disbursements fell from US$ 25 million per annum in the 1980's to US$ 2.5 million per annum from 1992-96.

Table 2
Major Donors to Kenya 1970-1996 (% share of total ODA)

	1970-79	1980-89	1990-96	1970-96	*ODA 1999-2000 average, USD million*
World Bank/IDA	19.9	20.4	16.2	18.5	*211*
Japan	4.0	8.6	17.0	11.8	*121*
Germany	11.3	6.6	12.6	9.8	*37*
UK	17.9	9.3	5.5	8.7	*86*
USAID	6.5	9.7	8.1	8.1	*52*
Netherlands	5.8	6.6	5.0	5.8	*22*
Canada	4.9	4.7	3.8	4.3	*15*
Sweden	8.6	3.7	2.3	3.7	
EC	1.3	4.1	4.1	3.7	*30*
Denmark	4.1	3.6	2.6	3.2	*38*
AfDB/ ADF	0.9	3.0	2.7	2.6	
Norway	4.2	3.7	0.6	2.4	
Others	10.6	16.0	19.5	17.4	
Total	100.0	100.0	100.0	100.0	

Source: O'Brien and Ryan (1999), Aid and Reform in Kenya; OECD/DAC Tables 2002

Sectoral Composition of Aid

1.4 The broad sectoral distribution of ODA between 1999-2000 is shown in Table 3 below. Distinguishing features are the relatively low proportions of ODA to the education and health sectors, compared to other social sectors, and the relatively small proportion disbursed as programme aid (18% of total). Policy-based lending linked to structural adjustment reforms was a major component of total resource inflows through the 1980's. At its peak in 1990-91, net ODA inflows were equivalent to 14% of GDP and approximately 45% of the government budget. Bilateral donor grants for key social sectors and public infrastructure projects also peaked in the early 1990's and have declined since.

1.5 The major areas which have been the focus of bilateral donor attention in the last decade include education, health and population control, natural resource management, the transport sector and small enterprise development programmes. Several of the bilateral donors, including DFID, have increasingly sought to bypass government systems and perceived bureaucratic barriers in their attempts to deliver development assistance directly to the poor. This has involved a concentration on project-based approaches involving a range of "non-official" partnerships with NGO's, community associations and the private sector. For example, 24% of all DFID programmes by value in 1997/98 were implemented through such partnerships.

Table 3

Bilateral ODA by Sector

ODA 1999-2000 average, % of total	
Education	9
Health	13
Other Social Sectors	22
Economic Infrastructure	8
Production	7
Multisector	5
Programme aid	18
Debt relief	3
Emergency aid	9
Unallocated	6

Source: OECD/ DAC Tables 2002

Future Aid Flow Expectations

1.6 Initial indications of a strong commitment by the new Kibaki government to a comprehensive economic reform programme and immediate action on strengthening judicial and other governance-related institutions imply that a range of both multilateral and bilateral donors are now gearing up to increase their aid commitments to Kenya significantly in the short term. The realisation of an upward future trend in aid flows is predicated upon the successful negotiation of a new PRGF programme with the IMF, which is currently in progress (see details below).

1.7 Following the elections in December 2002 and the inauguration of the new Kibaki government on 29th December 2002, one of the first priorities of the new government was the re-opening of previously stalled negotiations with the Bretton Woods institutions. An IMF Africa Department delegation visited Nairobi in January 2003 to hold initial meetings with the President and new Ministers of Finance (David Mwiraria), Planning and National Development (Anyang Nyong'o) and Justice and Constitutional Affairs (Kiraitu Murungi) as well as with the political opposition. This has been followed by Article IV consultations in March and April and a visit by the IMF Managing Director, Horst Kohler in July 2003.

1.8 The new government's development strategy is currently being elaborated in the form of an "Economic Recovery Strategy for Wealth Creation and Employment". It is anticipated that this will form the basis of a full PRSP to be produced in the next 12 months. An interim PRSP was produced in late 1999 covering the period 2000-2003 which was judged to have been an "exemplary" participative process, although the resulting document lacks a clear prioritisation of interventions in the light of both financial and technical constraints to implementation. It is not clear at this stage to what extent the new government's policy programme will entail significant changes to the existing poverty reduction strategy, but the likelihood is a change of emphasis rather than fundamental design.

1.9 The IMF concluded its 2003 Article IV consultations with the new Kenyan government on May 3rd 2003. The executive board assessment of the new government's initial programme was extremely positive. The economic reform programme is expected to be far-reaching and to encompass the following main areas:

- improvement in governance and fiscal transparency;
- consolidation of the budgetary position to address the domestic debt problem and ensure fiscal sustainability;
- a credible strategy to reform the tax system and enhance revenue;
- strengthened public expenditure policy and management, involving a decisive reorientation of expenditures towards the priorities of the Poverty Reduction Strategy Paper;
- improved tracking of spending on poverty programmes;
- a renewed privatisation program, including the divestiture of government ownership of commercial banks and strengthened banking supervision.

2. Aid Effectiveness

Recent Economic Performance & Policy Directions (1997-2002)

2.1 Kenya's economic performance deteriorated sharply in the 1990's. Table 4 shows a number of key macroeconomic indicators for the period 1997-2002. Economic growth levels have been moribund since the mid-1990s and consequently per capita income levels have fallen consistently. Total investment rates have fallen by 5% points of GDP since 1997 and domestic savings rates have also declined by an equivalent percentage. The Kenyan authorities managed to achieve a degree of macroeconomic stability in the period 2000-02 with low inflation and a relatively stable exchange rate. But IMF (2001) judged this stability to be very fragile principally due to an increasingly unsustainable fiscal position, sluggish economic growth and a weak banking sector with a heavy non-performing loan portfolio.

2.2 Government's budgetary performance has also been an ongoing cause for concern. Domestic revenue levels declined from 27.2% of GDP in 1997 to an estimated 22.2% of GDP in 2002, but are still considerably higher as a % of GDP than most other African countries. These declines principally reflect weaknesses in the tax administration system and evidence of widespread tax evasion – which is itself partly a response to a fundamental lack of confidence amongst the private sector in the government's legitimacy and evidence of widespread abuse of public finances by corrupt officials. Expenditure levels have been maintained at over 25% of GDP, although these expenditures are heavily biased towards salaries and other forms of remuneration for Kenya's bloated civil service.

2.3 The government's fiscal programme subsequently went off track over the course of 2000/01 in the lead up to the elections. A sizeable loss of foreign program financing, as donors withdrew their support, and the failure to privatise Kenya Telkom severely limited cash expenditure. Government's subsequent recourse to arrears accumulation and a lack of finance to implement stalled expenditure programmes brought about an escalation of pending claims upon future government revenues which completely undermined any attempts to enforce budget ceilings and allocations made through the MTEF process. Accumulated net government domestic debt rose to the level of 26.2% of GDP in 2002, an increase by almost 7% of GDP in just two years. One of the major policy objectives of the new government is to reduce domestic government debt to more sustainable levels, thus reducing upward pressures on domestic interest rates and hopefully stimulating higher levels of private investment, while at the same time freeing up additional resources for priority expenditure programmes, through reduced debt service payments.

Table 4

Kenya - Recent Economic & Budgetary Performance 1997-2002

	1997	1998	1999	2000	2001	2002 estimate
Main Economic Indicators (annual % change, unless otherwise indicated)						
GDP	2.4	1.8	1.4	-0.2	1.2	1.2
GDP per capita	0.1	-0.4	-0.7	-2.4	-0.8	-0.6
Consumer prices (annual ave)	11.9	6.7	5.8	10.0	5.8	2.0
Terms of trade for goods (neg=deterioration)	2.0	-5.0	-1.3	-0.7	-2.6	-5.0
Exchange rate (KSh per $, period average)	58.0	61.8	70.4	76.3	78.6	78.6
Real Effective Exchange Rate (neg=depreciation, end of period)	-1.9	-6.6	0.1	12.0	2.9	4.3
Total investment (% of GDP)	18.5	17.4	16.2	15.4	14.5	13.5
Gross National Savings (% of GDP)	14.3	12.5	14.0	12.7	11.0	9.3
Budgetary Performance (% of GDP, unless otherwise indicated, based upon July-June fiscal year)						
Total central govt. revenue	27.2	26.8	23.1	22.6	21.6	22.2
Total central govt. expenditure and net lending	29.5	27.6	23	27.4	25	27.7
Overall central govt. balance, exc. Grants	-2.3	-0.7	0.2	-4.8	-3.4	-5.5
Overall central govt. balance, inc. Grants	-1.5	0	0.7	-2	-2.2	-4.6
Government domestic debt, net (end of period)	20.7	20.5	21.2	19.4	22.3	26.2

Source: adapted from IMF Article IV Staff Report, May 2003

2.4 Other major setbacks in the Government's worsening relations with the IFIs and other bilateral donors in 2000/01 were the passage of the Central Bank of Kenya (Amendment) Act (the so-called 'Donde Act'), which in principle empowers the central bank to set limits on the commercial banking sector's deposit and loan interest rate structure[11]. This reflects a widespread feeling amongst both ordinary citizens and the more populist politicians that Kenya's economic woes are at least partly the result of foreign-owned financial institutions exploiting Kenyan entrepreneurs by setting high lending rates and low deposit rates. By contrast, key (at least for the donors) legislation for the re-establishment of the Kenya Anti-Corruption Authority failed to be passed by the Parliament and two other bills, the Anti-Corruption and Economic Crimes Bill[12] and the Public Service (Code of Ethics) Bill, were withdrawn before they could be discussed. This further reinforced fears

[11] This act is currently not being implemented due to ongoing legal challenges to its constitutionality. The new authorities have also apparently indicated that they would not be in favour of bringing this law into effect, despite public support for its objectives (if not necessarily for the means of achieving them).
[12] The original version of this bill, approved by Moi and his cabinet, included the rather controversial intention to grant a blanket amnesty for all economic crimes committed before December 1st 1997.

about the lack of political will amongst the KANU party and government to effectively challenge corrupt officials and politicians within its own ranks.

Change in Government & Policy Environment 2002-03

2.5 President Mwai Kibaki was elected as Kenya's third post-independence President in December 2002. He is the first not to represent Kenya's independence political movement, the Kenya African National Union (KANU), despite having previously been a leading figure in both party and government. Kibaki has a long history in Kenya politics having been Finance Minister under Kenyatta from 1969-82 and Vice-President from 1978-88. In 1991 he left the ruling KANU party to form the Democratic Party, when opposition parties were finally authorised after external pressure for democratic reform. He is a respected economist and has a reputation for honesty and probity in public life. He ran unsuccessfully for the Presidency against Moi in 1992 and 1997. He now leads a coalition of opposition parties known as the National Rainbow Coalition (NARC), which holds a reasonably sized Parliamentary majority. The leader of the opposition and new leader of KANU is Uhuru Kenyatta, the son of Kenya's first post-independence President and the hand-picked successor to Moi.

2.6 The results of the December 2002 elections have generated considerable expectations, both among ordinary Kenyans and the international community, for a fundamental break with the previous economic and governance policy regime. The key challenge for the new government will be in meeting these high expectations while also managing demands from the various coalition partners, who include several powerful politicians who were until recently closely associated with the KANU party and Moi's regime, for economic rewards and patronage for them and their political constituencies. One of the first decisions of the new Government has been to push forward with legislative and constitutional reform to promote good government and to clamp down on corruption in public life. There are signs that senior members of the previous regime, up to and including the former President, his family and advisors, may be investigated and prosecuted for theft of state assets and other types of fraudulent activity.

Progress in Poverty Reduction and Against MDG's

2.7 Poverty levels rose in Kenya during the 1990's. Results from the 1997 Welfare Monitoring Survey set overall national incidence of poverty at 52% of the population. It is highly probable that poverty incidence has increased further in the last five years. Over the past 25 years, food poverty has increased more than absolute poverty. The number of poor people is estimated to have increased from 3.7 million in 1972-73 to 11.5 million in 1994 and further to 12.5 million in 1997. The 1999 IPRSP estimates that 15 million Kenyans live in poverty out of a total population of 29.4 million. Women constitute the majority of the poor and three-quarters of poor people live in rural areas. Poverty incidence is high among small farmers, pastoralists in semi-arid areas of the country, agricultural labourers, casual labourers, unskilled and semi-skilled workers, female-headed households, the physically handicapped and HIV/AIDS orphans and street children.

2.8 Progress towards addressing poverty and formulating an effective poverty reduction strategy was commenced in the late 1990's with the elaboration of the National Poverty Eradication Plan (NPEP) which covers the period 1999-2015 and is based upon achievement of the MDG's. The Interim PRSP was produced in 1999 and sets out a range of sectoral priorities, programmes and resource allocations for the 2000-2003 period. This document and the macroeconomic and sectoral targets that it sets out were largely superseded and rendered void by events, including a renewed breakdown in Government of Kenya's relationship with the IMF and domestic political pressures in the build-up to the 2002 Presidential and Parliamentary elections.

2.9 Table 5 provides a summary of data available on main social indicators and Kenya's progress towards meeting the MDG's from a number of sources. The overall picture is one of increasing poverty incidence throughout the 1990's and a deterioration in some of the main welfare indicators. Infant mortality levels have risen due to the impact of HIV/AIDS on babies of infected mothers and a general decline in both the quality of public health services and the access of the poor to these services. Gross primary enrolment levels have fallen in Kenya (one of the few developing countries to have achieved this feat) due to the increasing costs of primary education and low family disposable incomes. Poor families also have very restricted access to post-primary education, which serves to further reinforce existing economic and social inequalities.

Table 5
Kenya's Progress Towards the Millennium Development Goals

	1990	1992	1997	1999	2001	*2002 target (Interim PRSP)*
Population below national poverty line (%)	42	45	52		??	*??*
Gross primary enrolment ratio (% of relevant age group)	105			90.5	87	*92*
Ratio girls/ boys in primary education (%)		95	--	98		
Under 5 mortality rate (per 1000)	97			112	122	*98*
Maternal Mortality (per 100,000)				590		*500*
Prevalence of HIV, adults (% ages 15-49)				13.9		
Access to an improved water source (% popn)	40			49		
Other statistics:						
Population (millions)	23.6			29.4		
GNI per capita (US$)				360		
Life expectancy at birth (years)	57			51		*55*

Sources: various, Kenya Interim PRSP 2000-2003, UNDP Human Development Report 2003, World Bank WDI 2000

2.10 The DFID Annual Plan and Performance Review 2001 also reiterates the lack of progress in Kenya towards meeting the MDG's in the 1990's and the need to adopt and effectively implement reforms across all areas of government. However, on the positive side most donors believe that the inherent strengths of the Kenyan economy, including the relative diversity of the productive sector, high levels of human capital in a regional perspective and prospects for a strong agricultural performance, all imply that rapid poverty-reducing growth should be attainable given an appropriate policy environment and commitment to improving the institutional environment. DFID (2001) states that "With reform, Kenya could move ahead fast. The rapid growth in horticultural exports and international acclaim of Kenya Airways and Kenya Wildlife Services illustrates Kenya's successes and potential. Recent reform efforts showed that even in a difficult environment operational improvements in delivering benefits to the poor are possible."

Poverty & Public Expenditure

2.11 There is an apparent lack of recent good quality research and analysis on the poverty impact of public expenditure programmes in Kenya. However, the evidence that does exist tends to confirm that current budget allocations are not pro-poor and are in fact strongly biased by political factors in favour of certain regions and ethnic groups, particularly those which have continued to support the KANU party. A World Bank Public Expenditure Review (1997) emphasised the very large number of projects (1,169 in total) and the poor quality of investments contained in Kenya's public investment programme, which was being completed at the rate of only 3% per annum. Reorienting Kenya's largely discredited public financial management systems towards developmental ends will be an enormous challenge.

2.12 The new government has recognised in its economic recovery programme the urgent need to restructure public expenditure in order to free resources for poverty reduction. They are currently reviewing policy options to reduce Kenya's public sector wage bill and intend to redesign the mechanisms for setting public sector wages to align them more closely with productivity levels, performance and resource availability. All existing wage agreements and contracts are being reviewed. The Department for Personnel Management (DPM) is undertaking a strategic review of the role of government and the missions of individual government agencies, with a view to downsizing and focusing limited resources on core government functions.

2.13 Work has also commenced on the design of an expenditure-tracking system for pro-poor expenditures. With the assistance of the World Bank, a number of core poverty-related programmes are now being monitored on a quarterly basis. These programmes were initially chosen on the basis of ten criteria determining priorities for social expenditures as part of the PRSP consultative process. As part of the medium-term expenditure framework (MTEF) budget process, spending ministries have been requested by Ministry of Planning to provide an updated list of priority programmes which meet the criteria. The criteria for selection include (a) measures to increase incomes of the poor e.g. access roads, agricultural services, access to credit; (b) measures to improve quality of life e.g. health care, access to clean water, primary education; (c) measures to improve security and governance e.g. protection of human rights, law and justice administration, protection of property; (d) measures to improve equity and equality e.g. equal opportunities and local empowerment programmes.

Corruption & Governance Issues

2.14 Corruption continues to be one of the major constraints to prospects for economic growth and poverty reduction in Kenya. Kenya consistently ranks poorly on international comparative scales of corruption and institutional quality. Transparency International's 2002 Corruption Perceptions Index ranked Kenya in equal 96th position out of 102 places alongside Indonesia and just ahead of Angola and Madagascar. Attempts by the previous regime to implement an effective anti-corruption strategy, through for example the establishment of the Kenya Anti-Corruption Authority, were largely as a result of external pressure and the desire to regain access to withheld external financing. They were also marked by bureaucratic delays, parliamentary obstruction by the majority KANU party and ultimately politically-motivated judicial intervention to rule the proposed institutional changes unconstitutional[13].

2.15 Table 6 below is taken from the results of a nationally representative sample survey of manufacturing enterprises in Kenya undertaken in late 2000. Firm managers or owner/managers were asked to rate a number of government agencies and public sector bodies according to their overall quality, integrity and efficiency. The table shows the average ranking given to each agency (the average rating for firms which responded) in descending order of performance ranking. The worst average scores are given to the roads department, followed by the police, healthcare services and water/sewerage agencies. Non-response rates were particularly high for the armed forces, customs, parliament, government leadership and the judiciary. In these cases, it is likely that the resulting mean scores are biased downwards, since non-respondents often made clear their low opinions of these agencies, but did not wish these opinions to be officially recorded. These results indicate the challenge facing the new government in seeking to restore confidence amongst the private sector in the institutional and regulatory environment in Kenya.

Table 6
Kenya Enterprise Survey 2000
Firm's Rating of Overall Quality, Integrity and Efficiency of Government Services

	Average Ranking (where 1=very good and 6=very bad)	Proportion non-responses
Roads department/ public works	4.8	0.04
Police	4.5	0.04
Public healthcare services/ hospitals	4.4	0.06
Water/sewerage service/ agency	4.4	0.04
Central government leadership	4.2	0.17
The parliament	4.1	0.19
The judiciary/ courts	4.1	0.15
Customs service/ agency	3.7	0.31
Education services/ schools	3.6	0.08
Electric power company/ agency	3.5	0.04
Telephone service/ agency	3.5	0.04
Postal service/ agency	3.1	0.02
Armed forces/ military	2.3	0.62

Note: the following ordinal scale was used to rank entrepreneur responses: 1=very good, 2=good, 3=slightly good, 4=slightly bad, 5=bad, 6=very bad. The full sample was 188 manufacturing firms in six main industrial locations in Kenya. Survey conducted by CSAE and UNIDO in late 2000.

2.16 Importantly, the 1999 interim PRSP at least recognised, possibly for the first time under the Moi regime, that one of the main problems leading to the increase in poverty was poor governance. Several of the measures to improve governance which are set in the interim PRSP are still on the agenda today including:

[13] The Human Rights Watch 2002 report on Kenya provides a good summary of developments in the 2001/02 period on human rights, corruption and other governance related issues and the donor community's response to them. www.hrw.org/wr2k2/africa6.html

- Combating corruption, especially through the strengthening of the Kenya Anti-Corruption Authority;
- Greater transparency in government procurement policies and practices;
- Enforcement of financial accountability through improvements in the public accounting and audit functions;
- The adoption and implementation of a code of ethics for all public servants;
- Downsizing of a bloated and inefficient civil service and rationalisation of government agencies;
- Divestment of state interests in the productive sector, financial sector and selected utilities;
- Achievement of a predictable and impartial justice system.

2.17 This is a challenging reform agenda for any government, especially one that is based upon a relatively new and untested political coalition. However, the government was elected on the basis of a strong “anti-corruption” campaign and can thus claim to have a clear mandate from the Kenyan people for fundamental change. The government has established a Department of Governance and Ethics in the Office of the President to oversee the implementation of the proposed Public Officer’s Ethics Bill. The department is headed by the former head of Transparency International (Kenya) who is widely respected. The government is also making provisions for the establishment of an anti-corruption agency in the new constitution that is under consideration, which will have powers to investigate alleged corruption cases and undertake prosecutions independently of the Attorney General. A number of other anti-corruption measures have also been implemented including the suspension of all senior public officials under investigation and a moratorium on sales of public assets, including housing, and payments of pending bills until their legality can be established.

Donor Policy Dialogue

2.18 Kenya’s recent relationships with the donor community can at best be described as erratic and at worst as catastrophic. In fact, experience with donor attempts to “buy” reform in Kenya over the last 15 years provides an excellent case study of the thesis that aid does not work in a sub-optimal policy environment and where there is a clear lack of ownership by the Government of its economic reform programme. Despite widespread and ongoing concerns about government commitment to reform and the misuse of aid funds, the donor community still managed to disburse over US$ 15 billion in aid to Kenya since 1980. The only conclusion is that there is not much to show in concrete terms for this massive financial investment.

Box 1: The Highs and (Mainly) Lows of Recent Government/Donor Relations in Kenya

1989	Kenya becomes first country in sub-Saharan Africa to negotiate an ESAF with the IMF worth SDR 261.4 million over four years; Kenya becomes eligible for Special Programme of Assistance (SPA) organised by the World Bank to assist with debt rescheduling
November 1991	CG meeting: Bilateral donors dissatisfied with progress on

	political governance. Postpone making new pledges
January 1992	IMF suspends 1989 ESAF – SDR 216 million drawn down before suspension of programme; programme expired March 1993 and was renegotiated December 1993
November 1993	CG meeting: Government agrees to multi-party system, relationship with donors improves and suspended aid programmes reinstated
December 1994	CG meeting: Mixed feelings regarding governance but new commitments of $800 million made by bilateral donors for 1995
March 1996	CG meeting: Considerable concern on both governance and public financial management issues. GOK assures donors that budgetary transparency and accountability are being addressed, Parliamentary and Presidential elections in 1997 will be free and fair.
July 1997	IMF suspends 1996 ESAF due to governance concerns and lack of progress in investigation of the Goldenburg scandal – only SDR 25 million out of total SDR 149 million drawn before suspension; scheduled CG meeting postponed
July 1999	New reform initiative launched with the appointment of a “reform team” of high profile Kenyans recruited from the private sector and overseas to head up key Ministries. This triggered a resumption of IFI, EC and AfDB adjustment lending. Interim PRSP produced.
August 2000	Three year arrangement under the PRGF totalling SDR 150 million approved by IMF, modified in October 2000 to allow for a higher than programmed fiscal deficit (attributed to the effects of drought); no reviews of the PRGF were completed and expires in August 2003.
January-April 2001	Key governance reforms not implemented. Anti-Corruption Authority declared unconstitutional and ceased operations. Key privatisation of Kenya Telkom delayed. Dr. Richard Leakey replaced as Head of the Public Service and Secretary to the Cabinet; other members of the so-called “dream team” also left government. IFI and donor budget support suspended.
December 2002	Presidential elections result in defeat of KANU candidate and election of opposition leader Mwai Kibaki as President; National Rainbow Coalition (NARC), formed as a coalition of opposition parties against KANU, becomes the majority party in Parliament
April 2003	New Government completes Article IV negotiations with IMF and request new program under the PRGF, signalling start of process of donor re-engagement with Kenyan Government

2.19 Sectoral and project lending does not have a history of success in Kenya, mainly due to the deteriorating economic and governance environment. For example, the World Bank’s evaluation department, OED, gave an overall satisfactory outcome ratio of 57% to Bank lending to Kenya from 1980-96, below the average for the Africa region of 63%. Sustainability was judged to be likely in only 21% of commitments and institutional development substantial in only 6% of commitments. The World Bank's most recent country assistance paper (World Bank 2000) points to a history of weak compliance, current situation of poor governance and inadequate commitment of the Government to take decisive action in key areas as major impediments to the success of their programme and hence recommends a limited lending strategy for "small targeted interventions" and resistance of pressures to lend either from the Government or other development partners. The World Bank in 2000 also raised concerns about cosmetic efforts at reform designed to woo donors back

3. Potential Effects of Increased Aid & Absorptive Capacity

Proposed Increases versus Needs

3.1 Current levels of aid to Kenya are quite obviously well below both (a) Kenya's capacity to absorb aid and (b) the levels that are necessary in Kenya is to have any prospect of achieving the MDG's by 2015. The inherent strengths of the Kenyan economy, including the relative diversity of the productive sector, high levels of human capital in a regional perspective and prospects for a strong agricultural performance, all imply that rapid poverty-reducing growth should be attainable given an appropriate policy environment and commitment to improving the institutional environment. The sustained support of the donor community will be essential in ensuring that the newly elected government is able to achieve its ambitious economic recovery programme and also tackle entrenched corruption and dysfunctional state institutions. Recent IMF projections of required programme funding are given in Table 7 below.

3.2 In these circumstances the proposed increase in total ODA envisaged under the Collier-Dollar aid allocation model from US$ 512 million per annum (2000 actual) to US$ 1,169 million is both feasible and probably an underestimate of both actual requirements and the level of aid that the Kenyan economy could feasibly absorb before diminishing returns become a binding constraint. Bearing in mind that total ODA to Kenya peaked at roughly US$ 1,600 million in 1990, this is probably a good benchmark for assessing the levels of aid that the Kenyan economy could eventually accommodate given evidence of government commitment to reform. This level of aid would represent an aid/GDP ratio of only 7.8%[14] which is well within the regional average for other moderately aid dependent countries in Africa, see Table 1 above.

Macro Effects of Aid Flows

3.3 Probably the major macroeconomic issue concerning the likely rapid increase in donor funding is the impact that this will have on the real exchange rate. Kenya's real effective exchange rate (REER) has been particularly volatile in the last two decades. Following a sharp depreciation of approximately 29% between 1981 and 1991, the REER has appreciated back towards its 1980 level. According to IMF (2003), this broadly reflects changes in Kenya's terms of trade, which deteriorated in the 1980's

[14] Author's own calculation based upon IMF's 2002 GDP estimate of US$ 20.4 billion.

due to falling international prices for major agricultural exports such as tea and coffee, but have subsequently improved. However, between the end of 1999 and April 2001, the REER appreciated by 16% while the terms of trade were unchanged. This divergence was at least partly the result of a sudden inflow of donor funding, including the November 2000 Paris club debt rescheduling. The appreciation of the REER in 2000 was one of the factors contributing to lower than forecast growth levels.

Table 7

Kenya: Medium Term Fiscal Scenarios - Selected Fiscal Years

(in percentage of GDP, unless otherwise indicated)

	2000/01	2002/03	2003/04	2005/06	2007/08
A. High Case Scenario					
GDP Growth (annual % change)	1.2	1.6	2.8	5.8	6.1
Assumed program support (UD$ millions)	**0**	**145**	**327**	**1,050**	**1,539**
Total government revenue	21.6	22.2	22.6	24.0	24.9
Total expenditure and net lending	25.0	27.7	28.0	27.8	28.9
Of which: wages and benefits	*8.5*	*9.2*	*9.2*	*7.9*	*7.2*
development expenditures	*2.5*	*3.2*	*3.3*	*4.9*	*6.9*
operations and maintenance	*5.2*	*5.2*	*5.2*	*5.7*	*6.6*
Overall Balance excluding grants	-3.4	-5.5	-5.4	-3.7	-4.0
Stock of domestic debt, net (end of period)	22.3	26.2	28.7	19.5	7.3
B. Base Case Scenario					
GDP Growth (annual % change)	1.2	1.5	2.5	4.7	4.6
Assumed program support (UD$ millions)	**0**	**145**	**235**	**704**	**663**
Total government revenue	21.6	22.2	22.5	22.4	22.3
Total expenditure and net lending	25	27.7	27.9	27.5	29.1
Of which: wages and benefits	8.5	9.2	9.4	8.5	8.3
development expenditures	2.5	3.2	2.8	3.4	4.4
operations and maintenance	5.3	5.3	5.3	5.3	5.5
Overall Balance excluding grants	-3.4	-5.5	-5.4	-5.1	-6.7
Stock of domestic debt, net (end of period)	22.3	26.3	29.7	25.6	23.7

Source: adapted from IMF (2003) Staff Report for Article IV Consultation, Table 2

3.4 Table 7 shows two medium-term scenarios (source: IMF 2003) based upon alternative assumptions about progress with economic reforms, subsequent growth rates and levels of donor programme funding. The high-case scenario assumes implementation of a strong package of economic reforms, which succeed in raising the GDP growth rate to about 6% per annum by 2006/07. It is also based upon the assumption of a rapid restoration of budget support by donors, which can be used to facilitate the rapid retirement of domestic debt. This will require donor support to the level of US$ 1 – 1.5 billion over several years in order to reduce the domestic debt to GDP ratio from 28.7% in 2003/04 to 7.3% in 2007/08. Resource inflows at higher levels than programmed here would obviously allow debt levels to be brought down at a more accelerated rate, if properly and transparently applied to this objective.

3.5 Hence, increased and rapid donor aid flows should be targeted in the short term to reduce the government's stock of domestic debt and hence the proportion of government revenue that will be absorbed by high levels of debt service, to the detriment of poverty-related expenditure programmes. Due to the fungibility of aid, donor support to sectoral programmes or non-earmarked budget support will in effect at the margin be financing debt repayments. Donors will effectively be clearing the debts accumulated by the previous administration, in order to facilitate the rapid reorientation of the new government's programme to poverty reduction.

Micro Issues: Institutional Capacity

3.6 There are obviously serious ongoing fiduciary risks to the effective and transparent management of donor funds. Civil service reform in Kenya will be a long and complex process. Expenditure control has historically been weak and existing financial regulations have not been enforced. Poor financial compliance and accountability (particularly by line ministries to the Ministry of Finance) have led to the persistent accumulation of domestic arrears (pending bills). The unrealistic costing of policies has aggravated these problems, leading to many within-year budget revisions, usually upwards. Too many capital projects have been included in the development budget, few have been completed and there is now a backlog of stalled and semi-completed projects, which the new government has inherited. High levels of debt service and the overall wage bill have crowded out operations and maintenance spending, especially utility payments.

3.7 Several initial measures have been taken by the new administration to resolve outstanding payment issues and also to begin the process of establishing greater control over future public expenditure and ensure fiscal discipline and good practice. All pending bills are being investigated, particularly in the light of allegations that a number of contractors were paid illegally just before the December 2002 election. An inventory of stalled capital investment projects is being updated in order to inform decisions about whether these projects should be continued, divested or mothballed.

4. Conclusions: The Case for Increased Aid

4.1 Current levels of aid to Kenya are considerably below the regional average and declined dramatically in 1990's. The end of the cold war era in 1989, which reduced some of the more political motivations for continued aid flows to Kenya, coincided with a weakening of the economic reform efforts and a sharp deterioration in economic performance in Kenya in 1989-92. There was a hardening of political opposition to continued reform at the same time that donors were beginning to emphasise "good governance" and democratisation as important criteria for judging the worthiness of aid recipients. The result of these various internal and external factors has been an intensification of the "stop-go" relationship between aid donors and the Kenyan Government, at least until recent elections in December 2002.

4.2 The main achievements of aid in Kenya during the 1980's and 1990's can be summarised as follows:

- Donors were instrumental in pushing the Moi regime towards democratisation and the key decision to permit opposition parties to participate in the 1992 elections – this has eventually led to the regime change which seemed a necessary, if not sufficient, condition for achieving further progress on improved governance and poverty reduction;
- Donors have also played an important role in other areas of governance and as acting as an external "agency of restraint" upon the actions of an autocratic and kleptocratic regime, thus probably preventing an even more pronounced decline in Kenya's economic performance;

- In a poor policy and governance environment, some targeted poverty-related interventions supported by donors, often implemented outside of official government channels with non-official national counterparts, have probably served to mitigate the effects of the economic collapse on vulnerable sections of the Kenyan population and prevented an even sharper increase in poverty levels;
- However, aid inflows, and particularly the unpredictability of these flows, have undoubtedly contributed to macro-economic instability and particularly to sharp fluctuations in the real exchange rate in the late 1990's. In general, macro-economic programming has been poor, assumptions unrealistic and World Bank interventions were judged (by their own Operations Evaluation Department) to have lacked cohesion and not taken sufficient recognition of the poor overall policy environment.
- The Moi regime perceived the western donor community as a source of finance but not of policy advice and became highly skilled in playing off donors against each other, particularly during the Cold War years when aid flows were more responsive to political issues than concerns about poverty reduction and good government. The results are an example of the "curate's egg" or "good in parts" effects of aid flows in a poor policy environment where there is a clear lack of government ownership of the reform programme.

4.3 Kenya now has a "window of opportunity" to resume a more positive pro-poor developmental path and to restore confidence amongst both international donors and the private sector in the government's commitment the creation of a more propitious enabling environment for investment, employment creation and growth. The rapid economic gains made by Kenya in the decade after independence demonstrate that, given an appropriate policy environment and commitment to improving the institutional environment, rapid poverty-reducing growth should be attainable. In these circumstances, Kenya could still meet the MDG's by 2015 despite the significant reverses of the 1990's.

4.4 The major risks to a rapid increase in aid levels to Kenya are the legacy of the effects of poor governance, which may serve to derail or at least delay the new government's attempts to implement reforms. The risk of revenue shortfalls, either from domestic sources or from external donors, and their implications for the successful implementation of the PRSP. The danger of fostering high public expectations which cannot be met due to financial and human resource constraints and which lead to further political instability, thus reducing private sector confidence and the supply response of the productive sectors. Other exogenous risks include continued vulnerability to drought and food shortages in some semi-arid regions of the country, where a large proportion of Kenya's rural poor exist, and also the risk of increased insecurity (from either internal criminal elements or externally supported terrorist groups) undermining Kenya's attempts to relaunch its tourism industry and other important sectors of the economy.

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The case for Increased Aid: Mozambique Case Study[15]

Summary

Mozambique is a good illustration of the potential for rapid growth and effective utilisation of massive aid flows in the post-conflict phase. Aid financed physical rehabilitation of the country, the demobilisation of armed forces, and underwrote the peaceful transition to democracy, helping build the confidence of both sides. Policy dialogue and technical support from the IFIs and other donors made a major contribution to securing macro-economic stability and re-orienting the economy towards a private sector, market based approach. Mozambique has prepared a generally sound poverty strategy, but it has not been costed, and weaknesses in the budget process give little assurance that the priorities will be reflected in the actual pattern of spending. Planning is further weakened by the proliferation of donor projects, which have strained the weak capacity of Govt, and caused fragmented and uneven development. Sector programmes are being introduced in an effort to improve planning and coordination, though support to them remains largely projectised. Unexpected shortfalls in budget support in 2001 led to arbitrary cuts in budget releases for salary and other recurrent costs- though the priority sectors identified in the poverty strategy have been protected, and Government could probably have used ample foreign exchange reserves to manage the shortfall with less disruption. Severe problems of Governance and public expenditure management are being addressed, though capacity is a constraint, and there are question marks over the extent of political commitment to tackle corruption. Nevertheless, overall, the high aid levels that Mozambique has received have made a major contribution to peace, poverty reduction, and the rebuilding of infrastructure and public services in one of the world's poorest countries.

Mozambique is mainly useful as an illustration that high aid receipts can be effective. Government is looking to reduce rather than increase overall aid dependence as economic growth proceeds, and rapid taxation increases and modest growth of public expenditure have been planned in order to achieve this. Although the relative share of aid in public expenditure should fall as rapid economic growth continues, a case can be made that even a country as relatively aid dependent as Mozambique could make good use of increased aid flows. The needs are massive and the MDGs will not be met on existing trends. Lack of finance is not the main constraint, but additional funding could be helpful provided public expenditure is better planned and coordinated, including bringing the bulk of donor funding within the budget process. This would need to be accompanied by Govt and donor willingness to coordinate in support of a single, prioritised public expenditure programme, with more predictable donor support, and Government commitment to a more disciplined budget process. A 50% increase by 2010 would enable Government to maintain a constant share of public expenditure in GDP, or avoid the need for distortionary tax increases, or some combination of the two. Overall aid

[15] The whole case study quotes heavily from Mick Foster (2002), Direct Budget Support to Mozambique, Report to the Department for International Development, November.

dependence, assuming growth targets are met, would not increase in relative terms. Donor support, if committed medium term and made more predictable, could accelerate the physical integration of the country and help to more rapidly address the low levels of human capital development.

1.Aid Trends

1.1 Mozambique is one of the most heavily aided countries in the world. Aid of around $50 per head is equivalent to around a quarter of GDP, according to World Bank figures (Table 1). These figures are higher than those in the Government poverty strategy, the PARPA, because they are captured from donor sources and include substantial amounts of TA, NGO, and project disbursements that bypass the budget and even the knowledge of the finance ministry[16]. Although sector programmes are being introduced in an effort to improve planning and co-ordination, a large part of external aid remains off budget, and planning, prioritisation and implementation of coherent public expenditure programmes is severely impeded. Even based on the PARPA figures, aid financing is equivalent to half of total imports, more than half of Government expenditure, and 17% of GDP. This high aid dependency reflects the needs of a low-income country with high levels of poverty, low tax capacity due to low levels of engagement in the market economy, yet enormous needs.

Table 1, Aid to Mozambique, US$Mn

	1995	1996	1997	1998	1999	2000	2001
Net ODA, US$	1064		948	1040	805	877	935
ODA/Head, US $	67		57	61	47	50	52
% of GDP			28	27	20	23	26
IMF, external public financing,$mn[17]			605	601	628	869	692
PARPA,net external finance assumed					442.0	522.6	645.5
GDP Growth		7.1	11.1	12.6	7.5	1.6	13.9

Sources: World Bank,WDI on-line database; GOM, PARPA.;IMF July 2002 Statistical Appendix.

1.2 The apparent instability in net ODA figures is not reflected in IMF balance of payments figures for public net external financing, including debt relief and changes in external arrears, arguably a better indicator of the variation in the external financial resources available to the public sector. These figures are far less erratic, with the exception of a boost in 2000 associated with increased donor disbursements in response to the flooding.

[16] For a full discussion of the problem, see Batley, Richard (2002), Mozambique, A Country Case Study, International Development Department, School of Public Policy, University of Birmingham, September

[17] Calculated from IMF Table 27, by adding grants, net borrowing, debt relief, and the change in external arrears.

2. Aid Effectiveness

Progress in Poverty reduction and the MDGs
2.1 Mozambique has achieved remarkable progress following the cessation of civil war in 1992 and subsequent restoration of democracy, with GDP growth averaging 8% per annum since 1992, one of the fastest rates in the world. Macro economic stability has been maintained, the private sector role in the economy expanded, prices liberalised, and major reconstruction undertaken. Aid largely financed the physical reconstruction, and underwrote the costs of the transition to peace, including the costs of the successful demobilisation of the armed forces.

2.2 Poverty in this vast and sparsely populated country nevertheless remains severe, and access to Government services poor. In 2002, Mozambique's Human Development Index ranked it 170 from 174 countries covered in the UN Human Development Report. Table 2 summarises limited information on prospects for achieving the MDG targets.

Table 2: Progress towards the Millennium Development Goals

	1996 (1st household survey)	1997	1999	2000	2003	2005 (PARPA target)	2010 GOM Target	UN Judgement on meeting MDG goal & supporting environment
% Households below $1/day	69.4%						50%	Potentially Strong
NetE1 enrolment (5yr cycle)		44		55	63			
Net Primary Enrolment		38.5	43.6					Unlikely Weak but improving
Girls NPE		34.1	39.8					Potentially Weak but improving
Under 5 mortality	277 (1994)	246				190		Unlikely Fair
Access to safe water[18]		15.3		37.1		40		Unlikely Weak
Halt & reverse spread of HIV					12.3%			Potentially Weak but improving
Maternal mortality per 100000	200		150			100		Potentially Fair

Source: UN 2002 (1)

2.3 The Government poverty strategy, the PARPA, aims to reduce the headcount measure of absolute poverty from 70% of the population in 1997 (date of the first household survey) to 60% in the year 2004. Although we

[18] Defined as 'piped water', so arguably underestimates access to safe water sources.

currently lack household survey based estimates of poverty since 1997, it has been calculated that real GDP growth of 7% per annum on average would be sufficient to deliver the target, assuming broadly unchanged income distribution. The growth target has so far been exceeded despite the 2000 floods.

2.4 Though Maputo and the South have grown most rapidly and have been the location of enclave 'mega projects' such as the MOZAL aluminium project, the growth has to date been broad based as resettlement and investments in infrastructure have supported growth in rural incomes. With poverty a mainly rural phenomenon, it seems probable that the new household survey will confirm rapid reduction in poverty. If the rapid growth can be maintained now that the initial reconstruction gains have been largely achieved, Mozambique would most likely achieve the MDG target of 50% reduction in absolute poverty by 2015, though the low starting point means that a large share of the population would continue to be below the threshold.

Table 3: Average Annual Percentage Growth Rates in GDP by Sector

Sector	1987-99	1996-99	2000	2001
GDP	6.5	9.3	1.6	13.9
Agriculture	6.4	9.0	-10.3	10.0
Industry	6.5	22.0		
Construction	-	18.7	1.5	53.6
Gas, elect, water	-	98.2	-7.7	8.0
Mining	-	-4.6	-29.4	11.8
Manufacturing	-	18.2	11.0	10.3
Services	7.2	11.2		

Sources: World Bank CEM, and IMF Statistical Appendix

2.5 Primary education enrolment rates are low, with a significant though narrowing gender gap. Quality is poor, and drop out and repetition is high, with 13 years schooling required to produce one completer of the 5 year EP1 cycle. Gross enrolments in the 5-year EP1 cycle increased from 74% in 1999 to 99.3% in 2001, but are only 28% in senior primary (EP2). Drop out and repetition mean that schools are choked with over age and repeating children, and net enrolments (proportion of relevant age group enrolled) are very much lower. Prospects for expansion are constrained by low secondary enrolments, which both limits the demand for education since opportunities to progress beyond the primary cycle are so constrained, and constrains the pool of future teachers. HIV/AIDS is also a severe constraint, with 12% prevalence among 15-49 year olds leading to severe losses of teachers. The Education sector is developing costed and prioritised plans for achieving targets set out in PARPA. Full UPE is unlikely to be achieved by 2015, though Mozambique is making rapid progress in providing basic education (the 5 year EP1 cycle).

2.6 Under 5 mortality has fallen significantly from very high levels since 1994, though the two-thirds reduction by 2015 envisaged by the MDGs is judged unlikely to be achieved. Poverty, under-nutrition, low access to clean water, a major malaria problem, an HIV/AIDS crisis that is not yet under control, and poor quality health services with major regional inequalities in access are among the constraints. . Health sector expenditure is dominated by donors (70%), and has yet to develop a credible approach to planning. An increased volume of health services is being delivered with a 7% increase in service delivery units per capita between 1998 and 2000, but with no consistent trend to narrow existing regional inequalities.[19]

The Policy Environment
2.7 Government has redefined its role in relation to the private sector, largely withdrawing from areas where the market can operate effectively, though there is scope for further deregulation in a number of areas. What Government has not yet been able to do is to prioritise public expenditure programmes within an affordable resource envelope, a problem exacerbated by the proliferation of donor projects that have not been brought within the budget nor integrated into sustainable overall plans for the development of key sectors of public expenditure

Economic management
2.8 During the 1990s Mozambique had an excellent record of macroeconomic management and commitment to poverty reduction and is still performing reasonably well. Since 1999, however, fiscal policy has been rather expansonary and monetary policy has had to be tightend several times.

2.9 Many key elements of a strategy for maintaining future economic growth at high rates are present. Maintaining macro stability, an open trading environment and exchange rate convertibility are rightly prioritised. Attention is being given, with World Bank support, to improving the judicial and legal framework and reducing corruption in the criminal and civil justice systems, though there is a long way to go to reach adequate standards. The major impediments posed by weak infrastructure are being tackled, with for example the World Bank supporting liberalisation of the telecommunications sector, while banking supervision is being strengthened following the major banking problems in 2000 and 2001 requiring expensive Government action to re-capitalise commercial banks. Investments in improving human capital through education and health are rightly being prioritised though there are major challenges in delivering effective services given the poor pay and performance in the public sector. Severe weaknesses in public sector financial management are in the early stages of being addressed through a comprehensive reform programme (SISTAFE) receiving co-ordinated donor support.

2.10Though significant reforms have been undertaken and macro-economic management has been good, there remain a range of policy and governance concerns. The ongoing reform agenda is ambitious, and is stretching the very limited capacity of the Government. Some key reforms are not yet being addressed, including a continuing legacy of red tape and restrictive policies in

[19] Service delivery units are a weighted average of deliveries, bed occupancy days, immunisations, and consultations.

areas including labour and land markets, and petty taxes and regulations at local level that impose significant burdens on traders and farmers.

Structural Policies
2.11The PARPA approved in 2001 prioritises macro stability, education, health, agriculture and rural development, basic infrastructure and good governance. Expenditure on these priority areas is envisaged to increase beyond the current two-thirds share of spending. Expenditure on PARPA priority sectors has increased in relative terms and as a share of GDP, which implies rapid real growth in funding given the fast pace of GDP growth:-

Table 4: Priority Public Expenditures as share of GDP

Year	1999	2000	2001 Prelim.
Percentage of GDP			
Education	3.5	5.4	6.5
Health	2.9	3.5	3.0
All PARPA priority sectors	13.3	18.3	18.8
Current Expenditure	12.2	13.3	14.0
o.w. Goods and Services	3.7	3.4	3.9

Source: IMF Staff Report for Article 4 Consultation, June 3 2002.

2.12The IMF confirms that the macro-economic and expenditure assumptions set out in the PARPA remain realistic and consistent with good macro-economic management.

2.13 Although the PARPA included a resource envelope, costing of programmes was only applied to a very limited extent. The PARPA therefore remains as a document which has a broadly sound diagnosis of the poverty problem, some sensible general indications of priorities for tackling it, followed by a long operational matrix listing many targets and activities but neither costed nor prioritised in terms of capacity to implement. Subsequent work that Government undertook to do in order to operationalise the strategy had not been undertaken as at end 2002. The first annual monitoring report on PARPA had not been released to donors as at November 2002.

Social Inclusion/Equity

2.14 Although all regions shared in the economic growth following restoration of peace, there are severe urban-rural and regional disparities. Under 5 mortality is 38% higher in rural areas, and 3 of the 10 provinces have rates more than double the Maputo level. Zambesia with the worst IMR receives the lowest pc health expenditure, reflecting low staffing levels and poor communication making it harder to deliver services. Gender and regional inequity in education coverage is recognised and being addressed in plans for accelerating UPE.

Public Sector management & Institutions
2.15 Donors have been pressing Government for more committed action on a range of governance concerns. Failure to prosecute high profile cases linked

to corruption are a worrying indicator of the extent of commitment to the rule of law, while labour market restrictions and a continuing burden of discretionary red tape create a climate in which corrupt behaviour is widespread while the sanction of dismissal is difficult to apply.

2.16 If successful, the SISTAFE will permit Mozambique to introduce modern public expenditure management and accounting systems by 2004. It should achieve full coverage of domestically funded spending and full reporting of external funds, will improve the control of commitments and hence facilitate fiscal management, and should improve accountability and financial reporting while reducing the risks of misappropriation.

2.17 In addition to the weakness of financial accountability that SISTAFE will tackle, the effectiveness of public expenditure is limited by low wages and an over-centralised public expenditure system in which provinces have lost most of their discretion over spending. A public sector reform including functional reviews of departments and a pay reform policy is under preparation, but not yet approved.

Impact of Shocks & Aid variability

2.18 Although we have not attempted a full analysis of the relationship between external shocks and aid flows, Table 1 suggests that donors did react positively to the floods in 2000. These reduced GDP growth from 7.5% to less than 2%, with agricultural GDP falling by 10%, while private consumption fell. Donors responded with increased disbursements, helping to mitigate the shortfall. Based on IMF balance of payments data, gross disbursements increased by $180mn, with total foreign financing boosted by debt relief increasing by $240mn over the previous year. Despite the external shock of the floods, Mozambique increased foreign exchange reserves in 2000.

2.19 According to IMF analysis, Mozambique suffered a sharp reduction in external assistance in 2001, something that is difficult to reconcile with the WDI figures, which show an increase. Relative to the IMF programme, Mozambique experienced a 2% of GDP shortfall in project assistance, reflected in an equivalent reduction in capital expenditure. There was also a reduction in expected budget support, associated with donor Governance concerns. This obliged Government to introduce cash controls on Government expenditure, resulting in a 0.5% of GDP reduction in wage payments and a 0.6% of GDP reduction in expenditure on goods and services. IMF targets were nevertheless met and priority social expenditures were in line with the PARPA and the programme targets. The shortfall nevertheless must have had a disruptive effect on the execution of spending programmes, and it would have been worse had the donor action not coincided with a year in which GDP recovered sharply from the previous year's floods while domestic revenues exceeded targets.

2.20 The massive discrepancy between the recorded balance of payments figures and the ODA that donors claim to have provided illustrates the difficulties of economic management in a situation where donors are a law unto themselves, with most donor project aid bypassing Government monitoring.

Policy Dialogue

2.21 The World Bank have not taken a lead role in policy dialogue in relation to the poverty strategy, though they have been very active in relation to aspects such as parastatal and banking reform. They are in the process of beginning to prepare a PRSC that would begin to address this. In the absence of a lead from the Bank, the G10 group of budget support donors have engaged with Government, but policy dialogue may have been conducted at too low a level to have much impact on major issues that are central to poverty reduction, including growth issues (e.g. land and labour market reform), governance (corruption and related judicial problems), public service reform issues (need for major pay reform), or the actual decision making on budget planning and resource allocation. This would not matter if there was strong ownership of credible pro-poor policies in each of these areas, but there are policy concerns in each of them. There is policy dialogue around some parts of this agenda (for example, judicial and public sector reform), but the extent of Government commitment to effective reform remains to be demonstrated. The need to pursue high profile murder cases linked to corruption around banking reform is seen by some donors as a key acid test of commitment to the Governance agenda.

2.22 The commitment to introduce the SISTAFE is arguably the major and very significant achievement of the G10 donor group. Though other pressures also contributed to this decision, the focus on financial management issues as a key concern that had to be addressed to keep the funds flowing probably contributed to the decision by the Minister of Finance to commit to the approach, and to establish UTRAFE as a unit led at Vice Minister level with the authority to ensure that it is implemented. The G10, led by the IMF which has observer status on the group but nevertheless plays a leading role in areas of Fund expertise, helped to develop the initial proposals into a more fully developed action plan with clearer management, co-ordination and monitoring arrangements. The G10 donors are also in the painful process of agreeing with Government a pooled approach to all technical assistance to MPF, with UTRAFE acting as co-ordinator and ensuring that the dangers of duplication, redundancy, or inconsistency in technical support are avoided in future.

2.23 SISTAFE provides a clear forward path for addressing most of the legitimate donor concerns regarding the fiduciary environment for budget support. If successful (and everyone acknowledges there are high risks), it will provide the basis for sound stewardship of both Government and donor moneys into the future, a very significant achievement which goes to the heart of the kinds of institutional development that DFID and the other DBS donors hoped to encourage through themselves using rather than bypassing Government systems.

Aid and Public Expenditure Management

2.24 In the absence of a stronger MPF role, it is less clear than would be desirable exactly what set of public expenditure policies and programmes aid is helping to finance. This is true at every level of analysis: - the geographical distribution, the sectoral distribution (given the ambiguity of the commitment to sector shares), the functional distribution (e.g. future pay policy), and the allocations to priority expenditure programmes within sectors. In so far as there is a definition of the expenditure priorities that are being supported, that definition comes from those sectors where sector expenditure plans have been developed, and the assurance that those programmes will be respected comes not from their integration in a unified budget, but from the power and influence of Government-donor dialogue at sector level.

2.25Though Government has developed SISTAFE to deal with accountability and in year budget management issues in the public sector, the way forward on planning, budgeting, and the monitoring of outputs and outcomes is less clear.

2.26 The PARPA includes a resource envelope and some medium term forecasts for the allocation of budgetary resources between sectors, but does not attempt to relate the targets to the resources required to achieve them. It was envisaged that the medium term financial framework would be further developed together with the sectors in order to fill this gap. In practice, this has not happened, and the budget continues to be an annual exercise for allocating the available funds without being linked to any analysis of how they will be used or what they can achieve. Budget ceilings are not an effective constraint even within-year, because they are repeatedly changed during the course of the budget year, and because a large part of the resources are effectively managed outside the budget, both donor resources and some domestic revenue sources. The planning of public expenditure has actually worsened since the PARPA, with the MTFF being seen as a purely technical exercise not part of the mainstream planning and budgeting system, and having minimal influence. In these circumstances, it is difficult to define what is meant by using the financing to support the PARPA, and still more difficult to monitor this and hold Government accountable

3.Absorbtive Capacity & potential impact of Increased Aid

3.1There are a number of potential macro-economic and budget management problems in depending on high levels of aid flows, problems that have led the PARPA to target a reduction in future aid dependence. PARPA projections aim for rapid reduction in aid dependence through a combination of increased domestic revenue as a share of GDP, reduced public expenditure as a share of GDP, and external aid assumed to fall from recent levels and then remain broadly constant in current US dollars (Table 5).

3.2 These trends are partly a reflection of assumed rapid GDP growth of 8% per annum, but they do imply quite modest growth of public expenditure. The level of public expenditure in 2000 and 2001 was boosted by drought and bank re-capitalisation expenditures, but the 2001 spending level is not expected to be exceeded until 2005. From 2005-2010, real expenditure levels are envisaged to increase by 5.4% per annum. Given the low starting point in terms of basic infrastructure and services, this looks too low to make the desired impact on achieving the development targets (Box 1). There may be real constraints over the capacity of the administration to cope with a faster rate of expansion, but in financial terms the resource envelope appears highly constrained relative to the ambitions set out in the PARPA.

Table 5Projected External Financing 1999-2010 (US$ Mns)

	1999	2000	2001	2002	2003	2004	2005	2010
Grants	289.9	419.7	489.0	444.3	413.4	413.5	417.2	400.0
Projects	197.3	215.5	259.6	255.0	240.0	240.0	240.0	240.0
Counter Values	92.6	172.4	197.0	170.0	160.0	160.0	160.0	160.0
IMF via BM	-	31.8	32.4	19.3	13.4	13.5	17.2	-
Credits	152.1	102.9	156.5	150.0	150.0	150.0	100.0	100.0
Projects	97.4	92.7	126.4	100.0	100.0	100.0	100.0	100.0
Counter Values	97.2	28.7	66.1	100.0	100.0	100.0	50.0	50.0
Amortization	-42.5	-18.5	-36.0	-50.0	-50.0	-50.0	-50.0	-50.0
Net External Financing	**442.0**	**522.6**	**645.5**	**594.3**	**563.4**	**563.5**	**517.2**	**500.0**

Source: PARPA

3.3 While the expenditure assumptions may be unambitious, the assumption that domestic revenues will increase from 12% to 17% of a rapidly growing GDP seems ambitious against a background of continuing cuts in external trade taxes as part of the welcome liberalisation process within the SADC region.

Table 6 Projection of Budgetary Resources 1999-2010

	1999	2000	2001	2002	2003	2004	2005	2010
Ratio of domestic resources to the total	53.1	49.4	45.9	41.5	48.1	52.7	58.3	69.3
Total resources in relation to GDP	23.6	27.8	31.5	26.0	25.9	25.7	25.3	24.9
Revenues as a proportion of GDP	12.3	12.7	12.0	11.9	12.9	13.6	14.8	17.2
External finance as a ratio of GDP	11.1	14.1	17.0	15.2	13.5	12.1	10.6	7.6

Source: PARPA

3.4 The tax authorities and the IMF argue that the revenue figures are realistic, based on the tax yield from new income and corporation tax laws, increasing registration for VAT (introduced in 1999), and a significant contribution from the SAZOL pipeline project from 2007. The tax base has been broadened with fewer exemptions, computerisation (with DFID support) will improve monitoring and control, while the introduction of the independent tax authority when implemented should also help raise the tax take. Revenue is currently running a little ahead of projections due to exchange rate depreciation.

3.5 Even if the revenue targets are realistic, their desirability should be questioned. The subsistence dominated agricultural economy largely escapes the tax net, except in so far as the items households purchase attract import taxes and VAT, though a variety of locally imposed charges add significantly to the burdens of the poor without making much net contribution to total revenue. The large international enterprises have been able to negotiate special tax exemptions, though Government is committed to negotiating more demanding tax contracts for future investments. The bulk of the tax burden is thus born by the middling enterprises, and tax rates on these enterprises have been shown to be relatively high by regional standards and a real constraint on the competitiveness of the economy. The Country Economic Memorandum estimates tax rates approaching 15% of turnover on middling enterprises, and quotes a study of 30 African countries that suggested each 1% increase in tax as a proportion of GDP costs 0.25% p.a. in slower GDP growth. Even after recent improvements, the Mozambique tax regime will have significant distortions and inequities not dissimilar from other African countries. If costs of this order of magnitude were to be experienced in Mozambique, the targeted increase in tax ratio by 2010 would reduce GDP growth by 1% of GDP per annum.

3.6 There is therefore some a priori reason to argue that additional aid would be useful for both boosting public expenditure beyond the fairly modest ambitions of the PARPA, and/or moderating the increase in the tax burden. The main counter arguments relate to the dangers of ‘Dutch disease’, and the macro-economic management problems of depending on aid for financing such a large share of the budget.

3.7 There is no empirical evidence that Dutch disease has been a problem[20]. The economy has been one of the fastest growing in the world, there is no evidence of real exchange rate appreciation (Table 7), and the output growth has been broad based by sector and has included a rapid increase in the output of most traded goods and services. In so far as there has been a problem in the traded goods sector, it has mainly been the result of weak international prices for export crops and of environmental problems in the fisheries sector rather than any domestically generated loss of competitiveness. There has been a decline in manufacturing exports that would merit investigation.

Table 7: Real Exchange Rate Trends in Mozambique since 1990

1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
84.7	65.3	64.6	62.8	59.9	68.3	74.0	76.6	73.9	72.8	61.7

Source: IMF Statistical Appendix

[20] Falck (2000); Foster (2002)

3.8 It is evident that the potential impacts of aid flows in reducing the costs of producing traded goods and services should dominate any negative effects on the real exchange rate. The distance and isolation of Mozambique mean that much of the economy is unable to trade due to huge transport costs, while low productivity of a poorly educated population in poor health also keeps costs high. The risk can be monitored through looking at the real exchange rate and at the level and pattern of growth in the economy. If negative effects are detected, it will be possible to take offsetting action by reducing some of the other costs faced by the traded goods sector as a result of taxation and regulatory burdens.

3.9 Although there may be little or no overall impact on the growth of the economy, there may be localised impacts that might be addressed if more of the aid were provided as budget support. Aid does increase the demand for skilled staff for aid projects, inflates the demand for goods and services demanded by the aid community in and around Maputo. These effects do not show up as significant in terms of the overall growth of the economy, but may have a significant negative effect on the productivity of Government and private sector competing for a limited pool of skills. An important advantage of budget support is that it pays to build capacity within Government rather than within the donor community, and should impose lower overall costs on the economy in order to administer it effectively

3.10 At sector level, though education and roads may be developing credible sector wide plans, the problem of sectors in receipt of multiple uncoordinated funding sources continues, with the inevitable consequence that there is little incentive or possibility to plan and prioritise. This problem continues to be acute in health, where two thirds or more of spending is donor funded.

Table 8: Shares of Non-Project support in total donor funding of Government Expenditure in Mozambique

(Bns of meticais)	1999	2000	2001 Prelim
Non-project :Grants	3287	3045	3652
:Loan	0	472	1171
Total Non-Project	3287	3517	4823
Projects: Grants	2787	3810	5985
Loan	1394	1484	1032
Total Project	4181	5294	7017
Total external assistance	7468	8811	11840
Non-project as % of total	44%	40%	41%
Non-project grants as % of grants	54%	44%	38%

Source: IMF Statistical Appendix

3.11Budget support is fulfilling the role that balance of payments support used to fill in supporting and encouraging economic reforms, but has not begun to replace projects and has not yet influenced the overall management of external funding to the sectors. Non-project aid seems to be at best stable, at worst declining, as a share of aid flows (Table 8). It has therefore yet to make much impact on the overall problems of managing the total aid flow in an environment of low capacity.

Box 1: The case for increased road expenditure.

The World Bank CEM gives road rehabilitation overriding importance in raising agricultural growth and rural incomes, and says that expenditure on maintenance is still significantly below the required levels. In the light of that, the targets in the PARPA seem modest, raising the share of roads from 9% of public expenditure to about 11% by 2005, with targets implying that over one quarter of roads would be left in poor quality by that time. Though there may be capacity constraints on how rapidly the progress in the road sector can be accelerated, the sector does not receive the degree of attention in the PARPA document, nor the priority in spending, that would be indicated by the importance that the World Bank's country economic memorandum gives to isolation and lack of road access as a cause of poverty. Significantly increased spending on improving physical communications within this vast country would be one valuable way to utilise increased aid in a way that will minimise the risk of Dutch disease, since the costs imposed by poor internal communications dwarf the impact of real exchange rate appreciation. Of course, increased spending would need to be accompanied by assurances that maintenance expenditures would be enhanced and protected.

4. Conclusions

4.1 Looking at the implications for the financing projections in the PARPA, a 50% increase in aid by 2010 would yield an extra $270mn per annum, equivalent to around 17% additional expenditure in 2010, enabling the public expenditure share in GDP to be maintained at around 30% rather than declining to 25%. Alternatively, the increase would permit PARPA targets to be achieved without further increasing the share of GDP taken in tax. In terms of aid dependence, the assumed increase would still be consistent with a decline in the reliance on external funding of the budget, from around 50% at present to between 42% if all of the increased aid were used to raise expenditure.

4.2 These figures are based on the PARPA figures for aid flows. Some of the increase could be achieved by channelling an increased share of donor funding through the budget or at least using it to finance projects included within the PARPA. There is a mystery concerning where a large proportion of existing aid is spent, but the suspicion is that much of it is used unproductively in technical assistance related to the unmanageable number of donor projects.

4.3 It may nevertheless be regarded as prudent and responsible to plan on conservative assumptions as to future aid flows, particularly given the recent history of renewed inflation associated with fiscal deficits financed by inflationary means. The problem with this approach is that no 'high case' scenario has been developed. Donors will react to the bids that the Government develops for their support. The PARPA sends the message that donors are neither expected nor invited to even maintain existing levels of support in real terms, yet alone increase them. In these circumstances, donors can be expected to commit their resources elsewhere. The opportunity to develop an ambitious programme that would capture the imagination and a constant or growing share of the resources of the donor community is lost.

4.4 It is instructive to look at the structure of Government expenditure in relation to the size of the aid flow. Domestic revenue in 2002 was expected to cover 44% of Government expenditure. Project aid, which is subject to cuts only in extreme circumstances, and where the expenditures and the financing are usually simultaneous, accounts for a further 30% of expenditure. The non-project support that is most at risk of being interrupted or reduced in ways that could prove difficult to manage represented in 2002 only 18% of total spending. Although some donors are planning to increase this source of finance, great priority is being given to managing it in such a way as to maximise the predictability of the flows to ease the problem of managing them and planning them within the budget. In the absence of major governance incidents of a seriousness to lead to an abrupt cessation, the vast majority of donor support will be secure within the coming budget year, and much of it committed for some time beyond that.

4.5 If the worst should happen, and non-project support be abruptly interrupted, domestic revenues will be sufficient to meet over 90% of current expenditure, and will be comfortably sufficient to cover the key non-discretionary requirements to meet salaries, debt service, pensions and other transfers for example to local authorities. Moreover, with foreign exchange reserves equivalent to 5 months of imports, Government has access to what is in effect a ‘store of aid’ to enable it to negotiate a path through a crisis of interrupted aid. The risks of maintaining aid at current levels or even seeking to increase it further appear to be manageable, especially if part of the additional flow is directed towards building and maintaining a higher level of foreign exchange reserves relative to imports and public expenditure.

4.6 Even with SISTAFE beginning to be implemented, the fiduciary risks must be judged to be high: - poor planning costing and prioritisation, risks of funds not reaching their intended use, unknown but probably low levels of efficiency and effectiveness, significant risks of misappropriation. At present, we have no way of knowing what effect budget support has since the budget is no guide to actual spending patterns by purpose, sector, geographical location, or functional use, and we also lack convincing monitoring information on the outputs being achieved. It will be important to ensure that the PARPA and the implementation of necessary reforms are carefully prioritised and closely monitored by Government with donor support, providing a clear set of agreed objectives with implicit or explicit resource commitments against which progress can be monitored.

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The case for Increased Aid: Nigeria Case Study

Summary

Nigeria has a uniquely awful reputation for squandering substantial oil revenues to little benefit in the past, and there is as yet little evidence that the underlying political and institutional factors that have caused the pressures for wasteful spending and corruption have been addressed. Per capita income is low, poverty is high and social indicators are weak, but there is consensus in the literature that the main problem is gross mismanagement, not lack of resources. Technical assistance to help willing institutions to reform is merited, but large-scale increase in financial aid transfers should await evidence of better use of existing resources.

1.Aid Trends

Table 1, Aid to Nigeria, US$Mn

	1997	1998	1999	2000	2001
ODA, US$Mn	200.1	204.2	152.4	185.3	184.4
ODA/Head, US $	1.70	1.69	1.23	1.46	1.42
% of GDP	0.55	0.64	0.44	0.45	0.45
GDP Growth	2.7	1.9	1.1	3.8	3.9
GNI/Head. Atlas method, US $	270	260	250	260	290

Sources: World Bank, WDI on-line database;

1.1 Aid to Nigeria is insignificant in relation to GDP, despite some modest revival since the return to civilian rule (Table 1).

2. Aid Effectiveness

Progress in Poverty reduction and the MDGs

2.1 Living standards in Nigeria have been in long-term decline since the mid 1970s, with the exception of a brief period of recovery under Babangida in 1987-1993, when attempts were made to implement a reform programme that did begin to reduce poverty. Fiscal indiscipline resulted in an erosion of urban incomes that eventually resulted in reversals of some of the key policy reforms[21].

Table 2, GDP Growth

Years	1984-87	1987-93	1993-00
GDP Growth p.a.	3.7%	5.9%	2.9%

2.2 Health and education indicators have deteriorated during the years of neglect under the Abacha regime, with big variations between states. Primary education net enrolments have fallen, with an unskilled teaching force irregularly paid, lacking in teaching materials.

[21] WB, CAS, 2002.

Table 3: Progress towards the Millennium Development Goals

Target	1990	1998	Target 2015
Halve from 1990-2015 the % of population living on less than $1/day	43 (1992)	66(1996)	21
Enrol all children in primary education by 2015	n.a.	NPE 78% in 1998- thought to have declined to 60% (WB CAS)	NPE 100%
Eliminate gender disparities in primary & secondary enrolments by 2005, & at all levels by 2015		Boys:Girls 1.23	1.00
Reduce infant and child mortality rates by 2/3 1990-2015	Child mortality 193/000	151/000	64/000
Reduce maternal mortality by ¾ 1990-2015			
Halt by 2015 & begin to reverse spread of HIV/AIDS, malaria, other major diseases			
Integrate principles of sustainable development into country policies, reverse loss of env. Resources, halve % without sustainable access to safe drinking water.			

The Policy Environment
Economic management

2.3 Nigeria's cumulative oil revenues over the last 35 years, net of payments to the oil companies, have been $350bn at 1995 prices, roughly $100 per head per year[22]. Successive oil revenue booms in Nigeria have been squandered on massively increased public spending in ways that were usually wasteful and often corrupt, with variations depending on which coalition of forces was in power at the time. The experience of the 1970s is typical (Box 1). The end of each boom has left Nigeria with an unsustainable fiscal deficit.

[22] Sala-I-Martin and Subramanian, 2003.

The huge external debt that Nigeria has accumulated and that has been repeatedly rescheduled has not been regularly and fully serviced, even in high oil price years as at present when Nigeria could afford to do so. The expansion of an inefficient public sector has been at the expense of sharp contraction in agriculture, virtually killing off commercial agriculture[23]. Successive military and civilian Governments have existed primarily to distribute the spoils of Government through patronage networks. Hopes of a significant change following the return to civilian Government have not been fulfilled. The federal capital budget increased to unsustainable levels in 2001, and still lacks either poverty focus or economic justification[24]. Government is again spending at imprudent levels, and the intention to base the budget on a $20 per barrel oil price and save revenues against future lower prices has not been implemented. The November 2002 IMF Article 4 report records a troubling increase in the fiscal deficit, despite historically high oil prices. Macro stability remains elusive, with high inflation, a growing black market premium on the exchange rate, and negative growth expected in 2002[25].

Box 1: Wasting the Oil revenues: 1st Oil Boom 1973-79
'…almost the entire windfall was invested, and yet…there was nothing to show for it…oil revenue not wasted on unproductive public investment was wasted on subsidising unsustainable industrial output.[26].' The political imperative was to channel resources to Government supporters in the North, but the civil service lacked the skills to appraise and implement such a massive investment programme, while corruption was unchecked.

Structural Policies

2.4 The legacy of past failures is pervasive poverty, growing unemployment in the formal sector, collapsing Government institutions, pervasive and large-scale corruption, high levels of violent crime and civil disturbance, unresolved tensions with the potential for conflict between the regions, and the implicit threat of renewed military rule if interests of those who benefit from oil based patronage are threatened. Surveys of private investors rate Nigeria bottom from 24 countries with respect to the quality of economic infrastructure, and bottom or close to bottom on most aspects of the regulatory environment[27].

2.5 The specific challenges for the Government are to restore macroeconomic stability, develop a credible poverty reduction strategy including improving the poverty focus of the budget and the management of public expenditure, tackle corruption, and begin to privatise the public enterprises that drain budget resources. Nigeria also needs to tackle the problems of infrastructure and of the appalling environment for competitive private sector investment.

Social Inclusion/Equity

[23] Sala-I-Martin and Subramanian. The demand pull from expanded Government seems to have been more significant than 'Dutch disease' effects.
[24] WB CAS, February 2002
[25] IMF, Staff Report for the 2002 Article 4 Consultation, November 2002.
[26] David Bevan, Paul Collier and Jan Willem Gunning, Nigeria and Indonesia, The political economy of poverty, equity and growth, April 1999.
[27] WB, CAS, 2002

2.6 Nigeria has a dual economy. Oil and gas accounts for between one third and one half of GDP, and is the source of income for a middle-income enclave in which some 5 million people enjoy average per capita incomes of around $2200. The remaining 115 million live in a non-oil economy in which per capita incomes are around $200. Two thirds of the population live below the $1 per day international poverty line[28]. There are pronounced inequalities between and within regions. Women face severe inequality, especially in the North where Sharia law has been introduced, and where gender gaps in education are especially large.

Public Sector management & Institutions

2.7 The World Bank CAS comments that 'by and large Nigeria has sufficient resources of its own to achieve sustainable development.' At current production levels, net oil revenues are $140 per capita ($425 in PPP terms), and represent 43% of current PPP GDP[29].They are expected to increase by three quarters as Nigerian gas is fully exploited. The problems of Nigeria are the failure to manage resources effectively, and more especially the lack of institutions of Governance that enable Governments to retain power while adopting policies that favour economic development as opposed to using the control of oil revenues to buy the support of the coalitions that sustain them in power.

2.8 The 1999 constitution envisages an increased role for the States. The States are entitled under the constitution to a one third share in all revenues. There is nevertheless an imbalance between the services States are mandated to deliver and the resources actually available to them. During the years of 'misrule and decay' under Abacha, all States suffered, although some succeeded in maintaining civil service capacity better than others.

2.9 Sala-I-Martin and Subramanian propose a radical solution to the curse of oil. They argue that the best way to escape from the problems of corruption and rent seeking is to distribute all of the oil revenues directly to the adult population (or possibly just the adult female population) on an equal per capita basis. Government would then need to gain consent for raising revenue through taxation and would be more likely to behave responsibly. Private individuals are likely to prove no worse than Governments in making effective use of the resources. Though it is difficult to envisage how a confluence of political forces with an interest in implementing such an approach might come to power, it is an intriguing idea that would offer a solution to a set of problems that has seemed intractable.

Impact of Shocks & Aid variability

2.10 Aid is insignificant in financial terms. The key shock that Nigeria has to manage is variations in the oil price. The February 2002 WB CAS argued that, at $25 per barrel, the problem is managing very high oil revenues without

[28] World Bank, Country Assistance Strategy, February 2002.
[29] Sala-I-Martin and Subramanian, 2003.

inflation. At $15 per barrel, Nigeria needs to draw down reserves and, if sustained for 2 years, will need to undertake fiscal adjustment[30]. In fact, despite historically high oil prices, Nigeria has continued the past practice of overspending in the boom years, and faces the prospect of severe macro-economic problems when prices fall.

Policy Dialogue
2.11The structural adjustment programme of the late 1980s received technical and financial support from both World Bank and the UK aid programme. The main advantage to Nigeria was that a programme endorsed by the IFIs unlocked the prospect of badly needed debt rescheduling, covering far larger sums than the ODA flows. The provision of bilateral programme aid in support of a reform programme in a context where the sums offered were entirely trivial relative to the scale of oil revenues, debt service and other financial flows was questioned within the UK at the time, and the experience has not been repeated.

Aid and Public Expenditure Management
2.12 During the 1987-93 period, some efforts were made to integrate aid within some kind of credible planning process. DFID for example tried to support overall reforms of the state power utility, NEPA, and also embarked on developing a health sector programme. During the 1990s Abacha years, DFID and other donors did not work with the federal Government, focusing instead on State and local Government and on NGO service providers. Fiduciary risks in Nigeria are arguably among the highest in any aid recipient, and the past history of grotesque waste of federal revenues does not encourage a move towards greater reliance on Government procedures to disburse funds.

2.13In order to address the corruption and Governance issues by helping those outside Government to press for reforms, DFID has developed a Strategic programme of Engagement with Civil Society programme, working with civil society organisations and with potential drivers of change. DFID is also working with federal Government and with four of the States to promote reforms, though with the emphasis primarily on technical support rather than financial transfers.

Impact of Aid
2.14 Aid has been able to achieve little in the political and economic context of Nigeria. In the 1985-92 period, 52% of World Bank projects were judged to have produced unsatisfactory results, while 85% were judged to be unsustainable. The reform programme of the late 1980s did succeed in increasing growth and reducing poverty in rural areas, with headcount poverty falling from 43% in 1985 to 34% by 1992[31]. The higher economic growth would have reduced poverty faster (by 14 percentage points, rather than 9), but even in this period the benefits to the poor were reduced by further growth

[30] WB CAS, Feb. 2002
[31] S Thoms and Sudhasha Canagarajah, Poverty in a wealthy economy: The case of Nigeria. The headcount percentages quoted differ from those used in the WB CAS, presumably being based on a different poverty line.

in inequality. The benefits proved short lived, and all World Bank lending to Nigeria ceased during the 1994-2000 period of chaotic military leadership and economic and institutional decline.

3. Absorptive Capacity & potential impact of Increased Aid

3.1 The pervasive corruption and inequality make it difficult to believe that increased aid can have much impact without deep-rooted reforms to political and governance institutions at all levels.

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Tanzania Case Study

Summary

Tanzania is a good case for increased aid disbursements. Since independence in 1961, poverty reduction has been a primary objective of Government and Tanzania traditionally received significant donor assistance. However, relations between Government and the international community deteriorated during the 1980s and early 90s and aid fell as a share of GDP. As a result, expenditure programmes were under-funded, and progress in human development stalled. In recent years relations and co-ordination between donors and Government have improved. A coherent, strongly domestically owned Poverty Reduction Strategy has been developed and there have been dramatic improvements in public sector management and accountability. There is a strong case for increasing aid, which derives from this and the fact that Tanzania is unlikely to meet most MDGs. Government has demonstrated commitment to improve revenue collection, aid dependency and debt have been reduced significantly and there is no evidence of adverse macroeconomic effects of Dutch disease. Moreover, research has indicated that increases in aid are likely to improve GDP growth and therefore poverty reduction. Increased aid would need to be sustained because of limited revenue potential. If aid doubles to $1.7bn by 2007-8, it would be 2022 before Tanzania could maintain the higher per capita public spending with the pre-increase aid level.

5. Aid trends

1.1 Tanzania has been one of the largest aid recipients in sub-Saharan Africa since the 1960s both in absolute terms and as a share of GDP. As is typical for sub-Saharan Africa, aid fell substantially as a share of GDP in the 1990s, from a peak of 30 per cent in 1990, although it has recently rebounded due to improved donor relations. There has been a shift from project to more flexible programme aid since the late 80s and most of the increase in total ODA since 1995 has been programme related. The bilateral share in total ODA exceeds 70 per cent, and over 50 bilateral donors have supplied aid to Tanzania. The two biggest donors are currently Japan and the UK, although Scandinavian countries have been historically the major donors. IDA is the third biggest of all donors, and the largest of the multilaterals (OECD *Aid at a Glance*). The large and increasing majority of total aid is in grant form. Technical co-operation has decreased as a percentage of total ODA from over 30 per cent in the early 90s to 12.5 per cent in 2001.

1.2 The consistent fall in aid: GDP throughout the 1990s as measured by DAC figures is reflected in IMF estimates of external public financing reported to Government, although the latter are more fluctuating and generally lower than DAC figures. In line with efforts to improve co-ordination, the share of aid accounted for in the budget increased over 1998-2000, although it subsequently fell in 2001, the year in which donors claimed to have increased disbursements significantly.

1.3 The PRSP budget assumes total aid disbursements including HIPC relief to increase by 25 per cent in 2001/02, equivalent to just over 1 per cent of GDP, in line with projected Government spending increases of 2.5 per cent of GDP. Aid needs are about 5 per cent lower in 2002/03 due to reductions in the share of total government spending in GDP (although the ratio of priority poverty reducing expenditure to GDP is projected to rise).

Table 1 Net ODA (current US$ millions unless otherwise stated)

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Grants	716	684	649	840	722	882	1120
Loans	161	193	296	160	268	140	113
Total	877	877	945	1000	990	1022	1233
% of GDP	16.7	13.5	12.3	11.6	11.7	11.3	13
Aid per capita (current US$)	29.6	28.8	30.2	31.1	30.1	31.0	36
IMF external public financing estimate (% of GDP)			12.7	7.5	9.2	10.3	8.4
GDP growth	3.6	4.6	3.5	3.7	3.6	5.1	5.6

Source: DAC *International Development Statistics*, World Bank *World Development Indicators*, IMF (2003c).

6. Aid Effectiveness

Progress in poverty reduction and the MDGs

2.1 Tanzania is one of the world's poorest countries. It has a population of 33 million growing at about 2.7 per cent per year and per capita GDP of US$ 210. Structural reform programmes were introduced in the 1980s, but reforms were slower and less comprehensive than in neighbouring Uganda, which on average grew by 6.5 per cent annually during the 1990s. A faster pace of reform has seen Tanzanian growth pick up to 5 per cent since 2000. Health and education services that were set up with donor support in the 1960s proved unsustainable, given slow growth, so that domestic capacity to pay for them was never sustainable. As a result, socio-economic indicators of development deteriorated, particularly during the early 90s, a period of relatively low foreign assistance in which budgetary resources allocated to social sectors declined.

2.2 Results of the latest Household Budget Survey in 2000/01 indicate that poverty has declined modestly over the past decade. Progress has been highly varied, with significant progress in Dar es Salaam but limited reductions in rural areas. Rural poverty accounts for over 85 per cent of the total and incidence is about 150 per cent of urban poverty at both poverty lines. The Government's target is to halve poverty by 2010 by achieving 6 per cent GDP growth by 2003 through strong agricultural performance. However, this assumes that the economy is not adversely affected by severe external shocks and that significant efforts are made to direct resources to rural areas.

2.3 Health indicators are weak and despite major improvements in infant and child mortality since the 1970s, progress has recently stalled. Malaria, anaemia and pneumonia remain major child killers. Child nutrition as measured by stunting and wasting barely improved during the 1990s and malnutrition is highest among the poorest. Localised food insecurity and famine are common. Maternal mortality is high, although trained personnel attend half of all births. Life expectancy deteriorated from 52 to 48 years over the 90s due to HIV/AIDS. AIDS accounted for the majority of disease-related deaths in the 15-59 age group in sampled urban and rural areas. Government's target is to restore life expectancy to previous levels by cutting child mortality by 20 per cent, infant and maternal mortality by 15 per cent each and reducing malaria deaths among children. This is to be achieved by increasing immunisation coverage from 71 to 85 per cent by 2003, and promoting general availability of drugs and medical supplies, HIV/AIDS awareness campaigns and births attended by skilled personnel. The budget for 2001/02 proposed to abolish VAT on hospital equipment and all taxes for drugs and preventative materials for TB, HIV/AIDS and malaria. Public health spending has increased in recent years but remains only about two-thirds the level deemed necessary to finance acceptable levels of health care (US$ 9 per capita). Severe resource constraints limit further increases in public health spending in the short term (GoT, 2000).

Table 2 Progress towards the MDGs

Goal	Indicators	Progress		Prospect for achieving goal
		1991/2	2000/01	
Halve absolute poverty by 2015	% living below national poverty line	38	37	Unlikely
	% below food poverty line	22	19	
Universal primary education by 2015	Net primary enrolment (%)	58.8 (1990)	85	Potentially
	Gross primary enrolment (%)	77.6 (1990)	100.4	
Gender equality in education by 2005	Female: male gross enrolment (%)		97	Probably
Reduce child mortality by 66 per cent by 2015	Under-5 mortality (per 1000)	163 (1990)	165 (2000)	Unlikely
	Infant mortality (per 1000)	102 (1990)	104 (2000)	
Halve proportion of underweight children by 2015	Stunted children (%)	Urban 28, rural 48	Urban 26, rural 48 (1999)	Unlikely
Reduce maternal mortality by 75 per	Maternal mortality per 100,000 births	529 (1994)		Unlikely

cent by 2015				
Halt and reverse spread of HIV/AIDS by 2015	HIV seroprevalence rate in women		5.5-23%	Potentially
Halve proportion without access to safe drinking water	Access to clean water* (%)	Urban: 89 Rural: 34	Urban: 89 Rural: 47 (2000)	Unlikely
Reverse loss of environmental sources by 2015				Potentially

* Defined as piped water for urban areas. The share of urban residents with 24-hour access is less than half the figure presented for 2000 and in rural areas 30 per cent of safe water facilities are not working properly.
Sources: GoT (2000), IMF (2003b), UN (2000).

2.4 Access to protected water sources appears to have improved marginally from less than 50 per cent of the population in 1991/2. However, outbreaks of cholera and waterborne diseases affect low-income areas and poor households spend substantial time collecting water or are heavily charged by water vendors. PRSP target is to increase proportion of rural people with access to safe water to 55 per cent by 2003.

2.5 Tanzania fares much better in terms of education indicators. The literacy rate was estimated to be 84 per cent in 1997 and over 60 per cent in rural areas. About half of the rural poor are literate. Primary GERs are high for the region and have increased to over 100 per cent with low gender disparity, although net enrolment is lower. Government has pledged to expand adult education programmes and promote education quality (e.g. more textbooks, lower pupil: teacher ratios, better inspection). Primary school fees were abolished in FY 2001/02 to improve the poor's access to education.

The Policy Environment

2.6 Tanzania is a reforming post-socialist economy. The state began to reconsider its role in direct economic activity in the early 1980s during a crisis period in which aid was suspended. Following agreements with the IFIs in 1986, Tanzania embarked on a standard structural adjustment and stabilisation programme, involving improved macroeconomic management; internal and external trade liberalisation, privatisation, financial sector reform, and reforms to governance and public sector management. The progress of reform has been mixed, with Government fairly rapidly implementing initial reforms, but resisting 'second generation' structural reforms. However, since the election of the Mkapa Government in 1995, domestic ownership and support for reform has improved.

Economic Management

2.7 Following implementation of structural adjustment and stabilisation reforms the economy recovered from negative per capita growth in the early 1980s. However, growth has been relatively low. Per capita growth was negative in 1992-94 (the period of programme aid suspension) and overall growth averaged less than 4 per cent per annum between 1986 and 1999, although it has picked up to over 5 per cent since 2000. Since Mkapa came to power in 1995, Government has restored macroeconomic discipline and refrained from excessive domestic bank financing (which occurred during 1992-94). Inflation has been below 10 per cent since 1999 and gross official reserves were equivalent to 6 months of imports in 2001. In 2002 the monetary authorities were on target to lower inflation to 4 per cent in line with Tanzania's main trading partners.

2.8 The fiscal deficit has significantly declined, although is projected to increase with priority poverty reducing spending, but this will be fully externally financed. The deficit reduction during the 1990s was not achieved through increased tax revenue, which has remained around 11 per cent of GDP, despite measures to broaden the tax base such as introduction of VAT and reforms to fiscal management. Rather, there were reductions in total government spending, from about 20 per cent of GDP to 15 per cent, although spending increased again late in the decade (IMF, 1999, 2003c). Spending cuts had negative implications for most sectors, although some priority social sector spending was protected by funds made available through debt relief. The marked decline in public investment spending has not stimulated private investment, suggesting that cuts in infrastructure investment have lowered private investment productivity (Bigsten *et al.*, 2001). Over 60 per cent of all roads require rehabilitation, and most district roads are earth roads of which 92 per cent are in poor condition. Increased public spending on infrastructure such as roads (particularly important given high transport and marketing costs) is likely to increase private investment.

2.9 Fiscal revenue as a share of GDP is the lowest in the region. Problems of increasing revenues arise not only from instability in overall GDP growth and the massive share of subsistence agriculture in the economy, but also due to the emerging private (informal) sector lying outside the tax net, slow reform to tax collection and administration, and tax exemptions for some sectors. However, revenue collection has outperformed recent targets (see Table 5), thus IMF (2003) state that the proposed increases in fiscal revenue are too modest, arguing for increases of 2-3 per cent of GDP over 2003-06 to reduce dependency on aid, limit vulnerability to aid declines and alleviate pressures to sterilise aid inflows to keep monetary growth on target.

2.10 Tanzania is highly indebted and external debt stock: GDP was over 100 per cent in 1999. HIPC Completion Point was reached in November 2001, although only 70 per cent of funds projected in the Completion Point document were disbursed due to delays in meeting World Bank and AfDB programme loan conditionalities. Additional forgiveness has come from the Paris Club and the Multilateral Debt Relief Fund, set up by Government as a precursor to HIPC. Debt relief has reduced the NPV of debt to 18 per cent of GDP or 131 per cent of exports, and HIPC relief is projected to reduce debt service: government spending ratio by almost half to 6-7 per cent from 2002/03 onwards (Ronsholt, 2002).

Table 3 Selected economic indicators Tanzania (% of GDP unless specified)

	Ave. 1991-93	Ave. 1994-96	1997-99	2000	2001*
Per capita GDP growth (%)	-1.1	0.2	1	1.8	3
Inflation (%)	24.8	27.3	12.3	6	5
Gross Dom. Savings	-2.0	4	3.4	5.6	7.3
Investment	26.3	20.5	18.5	18.9	19
Exports		24	17.1	21.4	23.8
Imports		39	32.2	34.7	35.4
Current account (excl OTs)		-16	-13.2	-9.4	-9.3
Current account (incl OTs)		-6.3	-8.3	-5.1	-5.4
Budget balance (excl grants)	-5.6	-3.9	-4	-4.8	-6
Budget balance (incl grants)	-2.2	-1.3	-0.3	-0.2	-0.7

* Estimate. Budget balance refers to fiscal years 1991/92-2001/02.
Source: GoT (2001), IMF (1999, 2003c).

Structural Policies

2.11 There has been a shift in state intervention from direct economic activity towards facilitation of the market, and the past decade has experienced higher average growth, driven by increases in agricultural productivity and output as well as increases in non-agricultural growth. Growth is projected at 6 per cent over the medium term assuming continued improvement in agriculture, and therefore favourable external conditions, and strong performance in other sectors such as tourism, construction and mining (IMF, 2003).

2.12 Agriculture accounts for the majority of GDP, total employment and income of the poor, thus rural sector development is one of Government's spending priorities (along with education, health, water, HIV/AIDS and the judiciary). Agricultural growth has been held back by inadequate access to water resources as well as lack of all-weather roads and a poorly maintained rural road network. Investment is hindered by the limited availability of credit, and farmers experience severe difficulties gaining access to credit for inputs, new technology and agricultural extension services. Government's programme aims to promote rural development and exports by providing training and research, rationalising controls on crop movements, facilitating use of land as collateral, and encouraging and supporting organisation of farmers' co-operatives, voucher schemes and community road maintenance and irrigation schemes.

2.13 External trade liberalisation is being pursued. The 2001/02 budget implemented reductions in tariffs, particularly on imports from Uganda and Kenya, Tanzania's partners in the East African Community, which were reduced by 80 per cent. The share of import duties in GDP has decreased from 1.8 to 1 per cent over 1996/97-2001/02. The current account deficit (including OTs) narrowed by almost half to 5.4 per cent of GDP over 1999-2001, despite a decline in coffee and cotton exports, due to growth of non-traditional exports and stable aid flows. From a pegged system in 1990, the exchange rate has been liberalised gradually and is determined in the inter-bank foreign exchange market. Official and parallel rates have converged and there are no restrictions on current international transactions. The real exchange rate has appreciated since 1995. The monetary authorities enacted a nominal depreciation against the dollar of 15 per cent in 2001, although this was insufficient to offset the impact of declining international coffee and cotton prices.

2.14 As in other African post-socialist reformers, structural reforms, particularly regarding privatisation and the financial sector, were initially more difficult to implement than macroeconomic ones, reflecting political opposition and low technical capacity. The privatisation programme began slowly but accelerated over the 1990s. Since 1992, two-thirds of SOEs have been privatised including large enterprises such as the National Bank of Commerce (NBC). Government is establishing regulatory agencies to enforce operational and safety standards in the market. There has been a slow but steady improvement in the soundness of the banking sector. Capital adequacy ratios have risen and removal of non-performing loans and recapitalisation of the NBC has increased profitability from a low in 1999.

2.15 However, private investment remains below expectations. Interest rates have been high and financial sector lacks capacity to determine credit ratings, preferring to lend to Government rather than investing in more risky long-term private sector projects. Government is attempting to promote private investment by creating the Investors' Roundtable, which provides a forum for discussion of investment constraints, and improving access of the poor to credit by promoting micro-finance strategy and savings and credit schemes. However, there remain significant impediments to investment, including a wide interest rate spread and inadequacies in legal processes.

2.16 The PRSP recognises the high dependency of the poor on environmental resources and noted environmental concerns relating to land degradation, lack of access to good quality water, pollution, loss of biodiversity and deforestation. However, a detailed policy on environmental sustainability has not been presented, nor have environmental indicators been incorporated into the poverty-monitoring programme.

Social Inclusion/Equity

2.17 There is growing inequality as measured by the increase in Gini coefficient from 0.34 to 0.35 over 1991/2-2000/01. Surveys have identified significant sectoral and regional disparities in socio-economic indicators. For example, in 1999 there was a four-fold difference in per capita income between the richest and poorest region, a three-fold difference in infant and child mortality rates between least and most deprived regions and seven-fold difference in low birth weight percentages. Whilst gender disparities in primary education are relatively low throughout Tanzania, GER of the worst performing region is two-thirds that of the best. The poor have identified weak health service provision, particularly in rural areas, as a major concern. The PRSP aims to reduce such disparities by paying particular attention to deprived regions and sectors.

Public sector management and institutions

2.18 Tanzania ranks above average African levels in the World Bank's policy and institutional assessment. Government has been pursuing the Public Sector Reform Programme, recognising that reforms to public sector management and governance are essential to improve public sector competence and therefore Tanzania's socio-economic development. It has significantly reduced its workforce, and aims to improve efficiency of fiscal management and discipline and accountability of public service delivery. Modern management techniques are being implemented including budget incentives for individual ministries and agencies. Attempts have also been made to boost civil service morale and performance by improving remuneration and the wage structure. Government replaced the tax departments of the Ministry of Finance with the semi-autonomous Tanzanian Revenue Authority in 1996, and has recently endeavoured to broaden the tax base, reduce tax evasion and improve tax administration. However, tax revenue:GDP has declined due to fall in local sales tax and remained around 12 per cent of GDP, indicating that tax reforms have been relatively unsuccessful.

2.19 The National Poverty Eradication Strategy in 1997 set out the country's long-term strategy in line with the International Development targets. MTEF and PER frameworks have identified priority sectors and relevant poverty indicators. The PRSP indicates that poverty has been sustained by low growth, lack of access to services and infrastructure and weak governance, and commits to remove these constraints. It was completed rapidly, building on earlier work, and provides a strong foundation for poverty eradication, presenting a poverty profile, priority sectors for public spending, and a list of medium term targets for social indicators, the methods for monitoring them and a cost estimate in the MTEF. Whilst the PRSP represents a work in progress, lacking particularly in areas of costing, substantial progress has been made since, and Government is following a rational strategy to close future funding gaps (IMF/IDA, 2001).

2.20 Government commissioned the Warioba report on public sector corruption and mismanagement, which particularly criticised the police and judiciary, but little action was taken in the 90s. However, in recent years there has been a firmer commitment to promoting rule of law and raising efficiency, equity and accountability of the justice system. The Commercial Court, established in 1999, has significantly improved commercial dispute resolution. Independent Judicial Ethical Committees have been established to monitor judicial officers and a Human Rights and Good Governance Commission was set up in 2001. Progress has also been made in public sector accounting and national auditing. In 2001 a centrally managed computerised Integrated Financial Management System (IFMS) covering all government ministries, departments and regional offices was introduced. This serves the additional function of providing a single coherent framework through which donor assistance can be channelled. In order to improve poverty programme monitoring, which was highly inadequate during the 1990s, a large-scale household income and expenditure survey was completed in 2000/01 and a Demographic and Health Survey and Population and Housing Census were proposed for 2001 and 2002 respectively.

2.21 Historically, participatory governance was weak in Tanzania and local groups were marginalised from policy debates and policy making. In recent years, however, the public sector has made major improvements in opening up to debates with stakeholders, and the Joint Staff Assessment characterised the PRSP process by strong country ownership and broad-based participation of civil society (IMF/IDA, 2000). The PRSP consultation process involved central and regional government officials, international donors and 'Zonal Workshops' in which grassroots views were collected from village representatives and NGOs. A major focus of the Government's poverty reducing intervention is to work in co-operation with local communities through self-help schemes to build classrooms, health centres, water facilities and rural roads.

Impact of Shocks and Aid Variability

2.22 Tanzania is highly vulnerable to climatic shocks because agriculture accounts for a large proportion of GDP (50 per cent), exports (85 per cent) and employment (80 per cent). Food security is undermined by adverse weather conditions, which often result in famine. In 1997 drought and floods reduced agricultural production, in particular the main export crops coffee and cotton, deteriorating the trade balance and reducing growth by a percentage point to 3.5 per cent. Adverse weather conditions and the collapse in export prices of cashew nuts, cotton and coffee reduced agricultural growth again in 2000. However, the economy appears to be becoming more robust to shocks. GDP growth exceeded 5 per cent in 2001-02, despite continued deterioration in the terms of trade, in part due to growth of non-agricultural sectors, and the trade deficit has narrowed due to growth of non-traditional exports. Furthermore, levels of existing and projected foreign reserves, at about half a year of imports, are able to provide some cushion against short-term shocks.

2.23 Government has attempted to find new export markets, revive agro-processing, improve crop quality and distribute disease-resistant seedlings, and has established safety nets to protect the incomes of the poor, such as the Tanzania Social Action Fund, which supports the vulnerable through community managed projects. An early warning weather monitoring system exists to predict yields variations, and the state proposes to reduce rainfall dependency by promoting irrigation in dry regions and improving access to food in surplus regions through the rural roads programme. However, aid will be necessary to support these programmes given low public spending and limited capacity of Government to deliver.

2.24 In previous decades, significant reductions in aid may have led to or certainly exacerbated economic crises. During both periods of programme aid suspension in the early 1980s and in 1992-94, GDP growth was negative and there is evidence that socio-economic development slowed and the poor suffered over 1990-96. However, it is also true that Government contributed to slow growth by proceeding slowly on critical reforms (e.g. exchange rate liberalisation, Government maintaining dominance of main growth sectors and banking sector). Co-ordination and relations between Government and donors have dramatically improved since 1995, particularly in recent years under the PRSP process. Aid reported to the state budget was 4 per cent below the projection for 2000/01, but 4 per cent above that for 2001/02 (see Table 4).

Policy Dialogue

2.25 During the 1970s, Tanzania received high praise from the international community for its policies of self-reliance and growth with equity under Nyerere's leadership and consequently received substantial aid flows. However, between 1979 and 1985 there was a severe economic crisis in which the economy contracted. Aid flows declined as donors criticised the Government for not achieving its aims and supporting inappropriate domestic policies that limited aid effectiveness. The first steps towards reform were taken in the early 1980s prior to donor involvement, and positive growth and high aid disbursements resumed following agreements with the IFIs in 1986. Under ERP I (1986-89), Government committed to a programme of macroeconomic stabilisation and structural adjustment, which comprised of trade liberalisation and unification of exchange rate. 'Second generation' reforms were instigated under ERP II (1989-91) in the banking sector, agricultural marketing, SOEs and the civil service.

2.26 Government initiated early reform but was reluctant to undertake major changes, particularly regarding more intrusive second-generation reforms, due to ideological opposition among high-ranking officials in the late 80s and early 90s. Resistance has since diminished. Programme aid was suspended between 1992-94 owing to poor fiscal discipline and fears of corruption relating to failure to raise domestic revenue collection. However, relations have since improved following election of a new Government in contested elections in 1995 and conclusion of an ESAF with the IMF in 1996.

Aid and public expenditure management

2.27 It is unclear whether ineffective implementation of conditional reforms during the 1990s reflected lack of willingness on the part of Government or structural characteristics and low competence (Bigsten, 2001). Reforms to governance as well as the relationship between donors and Government have been initiated to ameliorate this. Donors have supported initiatives to improve budgetary planning, management and accountability. The PRGF and PSAC-1 facilities have assisted in the introduction of the IFMS and Local Government Reform Programme to strengthen capacity of local government management. Implementation of the PRS is monitored in Annual Progress Reports, though lack of Government capacity resulted in the most recent of these being written by IMF staff, a bad precedent for country ownership. An important aspect of the PRSP is to recognise that improved donor co-ordination, integration of external assistance into the budget and simplification of aid disbursement procedures are necessary to promote aid effectiveness (IMF/IDA, 2000).

Impact of Aid[32]

2.28 It can be argued that whilst aid has played a major part in instigating and accelerating the reform process, it has had a poor record in generating economic growth given the large disbursements received. The major constraints to aid effectiveness are poor donor co-ordination and lack of Government ownership of reforms. There are too many donors, projects and sets of procedures. For example, just for multilateral development banks, Government is required to submit 8,000 audit reports annually, seriously undermining the development of capacity to audit public expenditure as a whole rather than donor projects (Main Report). However, aid effectiveness has also been constrained by slow implementation of reform and poor capacity, and the budget has been dysfunctional until very recently.

2.29 Poor co-ordination between donors and Government and between donors themselves originates in the fact that there are so many donors operating in Tanzania. As well as the multinationals, Tanzania receives aid from 40-50 bilaterals and over 8,000 NGOs are registered there. There have been major problems as a result of aid bypassing the budget, conflicting priorities and duplication of efforts. A recent survey of Government and NGO officials in Tanzania (Ronsholt, 2002) highlighted lack of co-ordination with national priorities, excessive donor demands and inconsistent requirements between donors. Other grievances included problems of excessive and ineffective technical assistance, excessive demands on time for reporting and meeting, delays in aid disbursement and lack of NGO co-ordination. Individual donors' project management systems can bypass official channels for aid management and the 1999 PER estimated that 70 per cent of aid bypassed the budget in the previous year.

2.30 However, the fault is not all with the donors. It is difficult to co-ordinate with a government where nine separate ministries are involved in one programme, as was the case of education in the 1990s. Additionally, Government salaries relative to private sector are low, hindering its ability to hire competent staff and therefore run an efficient bureaucracy. Civil servants are able to supplement salaries in urban areas such as Dar es Salaam, but access to such resources in rural areas is inequitable leading to lack of transparency and resistance to rural postings.

2.31 Government-donor relations have recovered from two severe crises in the early 80s and 90s, and a variety of measures are being attempted to improve co-ordination and government ownership. Monthly joint Government-donor meetings are held and the World Bank co-ordinates with other donors through the SPA. Aid is mobilised through CG meetings and the 1997 meeting held in Dar es Salaam allowed dialogue to occur between the donor community and major domestic stakeholders including Government, trade unions, NGOs and the private sector, improving ownership. However, donors took a step back in this respect in 1999 by holding the meeting in Paris, arguing that they would be more able to attract high-level representation.

[32] This section draws from Bigsten (2001).

Government has been trying to create a body to assist co-ordination between itself and the large number of NGOs registered in Tanzania.

2.32 Sector working groups are active and play a defined role in the MTEF and budget process to co-ordinate spending, even if some remains outside the budget. The introduction of sector wide approaches in education and health have helped tie donor assistance to Government priorities and developed pooled funding arrangements to which all donors can contribute. Aid harmonisation initiatives are also being pursued in the adoption of annual PERs and MTEFs since 1996, as well as various debt relief funds. Progress is being made to incorporate all aid into the Government budget and the share of aid in the 2003 budget was dramatically increased, although it is not yet clear to what extent full and timely information on actual disbursements by donors will be provided to the government's new IFMS accounting system. The PRSP, PER and MTEF frameworks have provided a common policy framework from which policy conditionality is drawn, improving consistency and reducing transaction costs for Government.

2.33 Domestic ownership concerns, arising from the fact that the structural adjustment reforms originated from the IFIs with limited Tanzanian input, are being alleviated gradually. Government commissioned *Vision 2025*, which set out the long-term development strategy aiming to reduce aid dependency and promote capacity building, a competitive economy and participatory development. The Tanzania Assistance Strategy was published in 2002, specifically aiming to restore domestic ownership and leadership in design and implementation of aid funded programmes. Donors responded positively to Government's commitment therein to tackle major concerns such as governance, transparency, accountability and capacity building to improve aid effectiveness (Ronsholt, 2002).

3. Absorptive Capacity and Potential Impact of Increased Aid

3.1 In the PRSP, Government assumed that total aid would remain high and increase by about 1 per cent of GDP, subsequently decreasing gradually over the medium term. The share of grants in total aid is projected to increased from 70 per cent in fiscal year 1999/00 to over 80 per cent by 2002/03, while the share of programme aid (including HIPC) increases over the same period from 40 to 52, peaking at 58 per cent in 2001/02. In 2001/02, total disbursements notified to government exceeded commitments, possibly due to the depreciation of the shilling against the dollar, and 65 per cent of aid was given in more flexible non-project forms.

Table 4 Actual and projected aid flows (in Tsh. billions)

	Ave. 1996/97-1999/00	1999/00	2000/01 Proj.	2000/01 Actual	2001/02 Proj.	2001/02 Actual	2002/03 Proj.
Grants	183	278	367	286	379	385	395
o/w programme	63	116	124	114	114	183	116
HIPC	0	11	46	49	53	62	58
project	120	150	196	124	212	140	221
Loans	79	212	152	173	201	187	167

o/w programme	41	54	72	45	116	87	76
project	39	158	80	128	85	101	91
amortisation	-61	-91	-124	-83	-94	-69	-84
Total net ODA*	202	399	394	377	486	504	478
Memo items:							
Exchange rate** (Tsh/$)	638	745		800		876	
Nominal GDP (Tsh billions)		6850		7727	8402	8613	9495

* excludes change in arrears. ** calendar years 1997-2002.
Source: GoT (2000), IMF (2003c)

3.2 Government has committed to increasing spending in poverty-reducing areas and raising domestic revenue collection. Spending projections are based on strong real GDP growth of 5-6 per cent per annum and fiscal and monetary prudence, as well as increases in external support. Revenue collection exceeded target in 2000/01 and marginally in 2001/02. The share of total budget spending on priority programmes was projected to increase from 51 to 78 per cent over 2000-2002. Despite total spending above target, priority:total spending was 7 percentage points below target in fiscal year 2001/02 owing to slow increases in spending on rural roads and lack of implementation of the HIV/AIDS programme. Spending did, however, reach projected levels in education, health, water, judiciary and agriculture (GoT, 2001).

Table 5 Public spending and domestic revenue as a share of GDP

	Ave. 1996/97-1999/00	2000/01 Proj.	2000/01 Actual	2001/02 Proj.	2001/02 Actual	2002/03 Rev Proj.
Domestic revenue	12.1	11.3	12.0	12.2	12.1	12.3
o/w tax revenue	10.8	10.2	10.7	11.1	10.9	11.2
Total expenditure	15.5	16.5	17.3	19.5	18.1	22.2
o/w development exp.	3.9	4.1	3.7	3.5	3.4	6.2

Source: IMF (2003), GoT (2000).

3.3 Since the PRS has been implemented, there have been encouraging developments in priority sectors. The joint staffs praised the successful reorientation of public spending towards poverty reduction and creation of a more open environment for policy discussion (IMF/IDA, 2001). PRSP Progress Reports (GoT, 2001, IMF, 2003) identify improvements in the following areas:

- Education, as measured by increases in GERs and NERs, which have well exceeded PRSP targets.
- Health service has expanded management of child illness and strengthened maternity service. Public spending on health has risen to US$ 6 per capita. Immunisation rates have increased but there are large regional disparities.

- Judiciary has improved as measured by strong performance of commercial court
- Fiscal management and accountability have improved due to implementation of the IFMS.
- Empowerment of the poor through local government reform and community level operations.
- Gender relations have also progressed due to the Land and Villages Act, which provides land ownership for women, as well as the Sexual Offences Act and increased female representation in parliament to 20 per cent.

3.4 However, there remain significant problems, notably in the health sector. The trend in HIV/AIDS is particularly worrying, and this has not been helped by lack of public spending in 2001/02.

3.5 The case for increasing aid to Tanzania is strong. Initiatives to promote aid co-ordination and domestic ownership of reform have been successful and there have been significant improvements in public sector management and accountability since the mid-90s. Growth rates are higher and Government has demonstrated its commitment to reorienting public spending to poverty reduction programmes, as well as increasing domestic revenue to pay for them and reducing reliance on aid. However, various studies have indicated that the cost of financing public programmes to meet minimum needs, particularly in health, exceeds available funding even assuming optimistic revenue increases, and the likelihood of Tanzania meeting most MDGs is low. Although the economy is becoming less vulnerable through income and export diversification, Tanzania remains highly susceptible to weather and export price shocks, which have intensified food insecurity and significantly reduced growth performance and therefore revenue collection in the past.

3.6 Recent research has demonstrated the potential beneficial impact of increased aid disbursements. Bigsten *et al.* (2001) analyse the impact of HIPC debt relief on the Tanzanian economy using a CGE model. They estimate real GDP growth to be 0.3 percentage points higher with HIPC relief, which although a relatively modest increase reflects the small size of HIPC flows relative to debt service. This result is likely to underestimate the impact of debt relief since they do not account for the potential impact of increased public spending on growth and productivity, e.g. through education and health programmes, nor do they account for improved credit ratings associated with the country meeting its debt service obligations. Jung and Thorbecke (2001) use a general equilibrium framework and estimate increased public education spending of 15 per cent to raise economic growth by 0.1-0.3 per cent. The impact is maximised if education spending is accompanied by physical investment to improve labour productivity and measures to link more closely graduate supply with the structure of labour demand.

3.7 Dependency and debt are not the major issues they once were. Aid dependency reduced considerably over the 1990s and Tanzania has experienced high growth in the last two years at aid:GDP levels considerably lower than their peak in the early 1990s. Tanzania has also received substantial debt relief in recent years, which has brought its debt stock down to sustainable levels (as measured by the debt: exports ratio), and the share of grants in total aid is projected to increase over the medium term.

3.8 The main risk of increasing aid relates to potential adverse macroeconomic effects of 'Dutch disease', which refers to a reduction in domestic competitiveness brought about by absorptive capacity of the economy failing to grow at the same rate as aid inflows. Relatively high inflation led to a 50 per cent real exchange rate appreciation in 1995-2000. Given the reduction in world commodity prices also occurring, the monetary authorities intervened in the foreign exchange market and as a result the nominal exchange rate has depreciated considerably since 2000. However, whilst this has improved tradable sector competitiveness, it has also brought about excess liquidity in the economy, potentially putting upward pressure on prices and therefore the real exchange rate. Thus on the face of it, it would appear that increasing aid inflows at this time would undermine external competitiveness by generating inflation. However, IMF (2003c) does not find any evidence to suggest that increased aid would cause Dutch disease and, since 2000, export performance has improved and become more diversified. Accelerating export growth will require major investment in the transport network to improve market access in rural areas.

7. Conclusion

4.1 Aid disbursements have been reduced considerably as a share of GDP since the early 1990s, limiting aid dependency but also impeding progress in socio-economic development because of tight budget constraints. Since the mid-90s, growth rates have improved, there have been considerable achievements in public sector management, Government has articulated a domestically owned Poverty Reduction Strategy, and donor co-ordination has improved. In the PRSP, aid flows are assumed to increase by about 25 per cent, from levels in 1999/00 that are already double 1996-99 averages, to support public sector development programmes. However, it remains unlikely that Tanzania will achieve the MDGs given inadequate domestic revenue generation and the potential growth-retarding effects of external shocks.

4.2 Aid allocation models indicate that aid:GDP ratios of 30 per cent are consistent with high returns to aid, assuming good policy environment (see Collier and Dollar). The DFID allocation model, applied to the proposed $50bn increase in global aid, implies aid to Tanzania increasing to $4.3bn, equivalent to over 30% of 2007-8 GDP, broadly equivalent to the previous 1990 peak in the aid:GDP ratio. If aid is entirely used to increase spending, and assuming 5% pa growth in US$ GDP and revenue increasing to 15% of GDP, an increase to $4.3bn could raise public expenditure to 46% of GDP in 2007-8, compared to around 22% in 2002-3. Such an increase would increase per capita spending from $63 to $145, more than sufficient to cover the marginal costs of achieving the MDGs, though it is questionable whether such an increase could be absorbed. Two thirds of the higher level of public spending would be aid financed, including a large share of recurrent spending. Table 6 looks at the dynamics of maintaining this higher level of spending in per capita terms. Although some of the increased spending will be on capital investment that need not be maintained at the same level, it is also the case that other spending pressures will arise as per capita income increases, so the assumption of at least maintaining per capita spending is not unreasonable.

4.3 Table 6 shows that, if aid were increased to $4.3bn over 5 years, public expenditure could not be sustained at this per capita level without further increases beyond 2007-8. Assuming GDP and revenue continues to grow at 5% per annum, sustaining the same level of per capita spending would require aid to increase to over $5bn in 2022. Revenue finances an increasing share of spending, but the absolute financing gap increases continually. Even with revenue increasing to 20% of GDP, aid of $3.9bn would be required to sustain per capita spending at the higher level. Although a significant increase in aid flows is feasible and would be merited, it seems clear that such an increase should be more modest than implied by the DFID model. A still substantial increase to $1.65bn would be consistent with revenue growth allowing aid to return to the 2002 level by 2022. It would permit a 70% increase in per capita spending, maintainable with gently declining aid levels from 2010.

Table 7: How soon could increased aid spending be financed from domestic revenues?

	Actual	**Projection**			
	2002	**2007**	**2012**	**2017**	**2022**
GDP,$mn	9495	12059	15387	19634	25053
Population, Mns	37.2	42.1	47.6	53.8	60.9
Scenario1: Aid increased to $4.4bn by 2007, maintain higher p.c. spending, with revenue:GDP 15%					
Revenue 15% GDP, $Mn	1168	1808	2308	2945	3758
Public Expenditure p.c. $	56.7	145.0	145.0	145.0	145.0
Revenue p.c.$	19.1	42.9	48.5	54.7	61.7
Required aid p.c.$	12.78	102.1	96.5	90.3	83.3
Aid needed $Mn	865	4300	4593	4858	5072
Scenario 2: Maintain $145 p.c. spending level with revenue:GDP 20%					
Revenue 20% GDP, $Mn		2411	3077	3927	5011
Revenue p.c. $		57.3	64.6	73.0	82.3
Aid needed p.c. $		87.7	80.3	72.0	62.7
Aid needed $Mn		3692	3824	3873	3818
Scenario 3:Maximise sustainable spend p.c. with 20% revenue:GDP, subject to aid returning to 2002 level by 2022					
Public expenditure p.c.	56.7	96.5	96.5	96.5	96.5
Aid Required:-.	865	1650	1518	1264	865

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Bangladesh Country Case Study

Summary

Bangladesh is a very poor and vulnerable country that has achieved significant reduction in income poverty and major advances in health, family planning, education, disaster management and nutrition. It has achieved higher economic growth of 5% p.a. in the 1990s and has maintained macro stability. Despite this creditable record, donor aid has halved since 1990 and now equals just 2% of GDP. This partly reflects reduced need for food aid, and partly reflects problems in disbursing a growing pipeline of project commitments making slow progress due to a bureaucratic and corruption prone public sector where personal inducements are too often required before civil servants will 'move the file on.' There is also a perception that Bangladesh is not living up to its potential. Problems include:-

i. Corruption,
ii.Inefficient SOEs that dominate infrastructure, utilities, banking, holding back economic growth and wasting public money.
iii. Low tax revenues, just 10% of GDP.
iv. Poor law and order and Governance hold back economic growth.

These negative perceptions need to be balanced by recognition of good pro-poor allocation of the budget, and real achievements in the social sectors, partly reflecting Government partnership with alternative NGO delivery agents. The Government elected in October 2001 has instituted a credible reform programme, though the institutional problems have deep roots and will not be quickly solved. Nevertheless, Bangladesh needs and deserves much higher aid. Direct quantification of spending needs and comparison with spending levels in other countries confirms that increases towards the $9.7bn p.a. envisaged by Table 5 of the main report could be justified. On reasonable assumptions regarding GDP and revenue growth, Bangladesh could sustain these higher levels of per capita spending even if aid returned to the pre-increase level after 10 years.

Actually spending increased aid will require a decisive movement away from the project aid PIU model that has so far been used even for the health and population sector programme. Increased aid needs to be given in programme form, and mostly through the budget. This entails fiduciary and Governance risks, and will need to be accompanied by public expenditure reform and performance monitoring. Nevertheless, the risks are arguably no greater than in many countries that have received far higher aid with much of it via the budget. The evidence suggests that Bangladesh has not deserved the poor reputation it has acquired with donors. Past cuts in the aid:GDP ratio should be restored, with further increases if policy and Governance reform achieves reasonable progress.

Aid Trends

1.1 While total aid flows rose steadily from independence in 1971 to the late 1980's, the 1990s witnessed a general decline, with the sharp fall in 1995 coinciding with civil unrest following a contested general election[33].

Table 1.1
Total Net ODA to Bangladesh by top 10 Donors
Current US$ (millions)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
IDA	449	239	307	277	379	155	229	245	290	339	275	217
ADB	303	268	319	217	358	248	263	149	183	214	197	126
Japan	373	114	163	185	227	254	174	129	189	123	201	125
UK	97	97	102	71	65	76	71	70	98	114	103	124
USA	169	129	130	94	152	56	41	30	4	113	62	87
EC	58	58	51	70	56	111	112	81	87	64	68	71
Netherlands	71	57	72	53	54	57	67	63	57	36	32	43
Denmark	54	57	37	28	33	32	36	39	46	42	33	41
Germany	77	97	79	75	104	61	84	47	65	46	36	30
Canada	102	94	108	41	53	52	37	73	53	29	38	30
Total	**2095**	**1881**	**1820**	**1372**	**1752**	**1292**	**1236**	**1010**	**1158**	**1215**	**1171**	**1023**
ODA/GNI %	8.8	7.7	5.3	3.8	4.7	3.2	2.9	2.3	2.5	2.6	2.4	2.1

Source: OECD DAC Statistics Online

1.2 In the early 1970's, food and commodity aid accounted for the vast majority of total aid, reflecting the humanitarian crisis that followed the establishment of Bangladesh. However, project aid rose to 43% of total aid by 1983 and stands at 75% of total aid today. The halving of the value of aid since 1990 is a steeper decline than can be accounted for by the global reduction in aid levels, or by reduced food and commodity aid as Bangladesh developed resilience to natural disasters. It partly reflects disbursement problems, with the pipeline of undisbursed commitments having increased to over $5bn (May 2003 PER). It also reflects the ending of policy based lending in 1994, as the reform process of the early 1990s stalled. A case study of Bangladesh commissioned as part of the OECD DAC funded series on donor practice highlights tensions between the GoB and donors over economic strategy, public sector reform, and donors' increasing focus on civil society organisations as probable causes of the decline in actual disbursements of aid commitments. Although there are weaknesses in Government policy and in governance, it is difficult to find a rational explanation for the extent to which donors have turned away from a very poor country that has continued to achieve real progress in reducing poverty and improving human development, in the face of extremely difficult environmental challenges. Other countries with worse policy and institutional environments have continued to receive far higher aid levels.

1.3 Looking ahead, the Government elected in October 2001 has shown renewed commitment to reform, and the recent JSA of the interim PRSP asserts that Bangladesh enjoys considerable goodwill among the donor community, and that support to the country will increase if the reform effort is sustained and broadened. The need for significant additional external

[33] Programme Aid and Development: Beyond Conditionality, 2003

resources to implement the interim PRSP, combined with the recent revival of the structural reform programme and prudent macroeconomic management have led to large disbursements from the World Bank's approved Development Support Credit, the IMF's Poverty Reduction Growth Facility, and the Japanese Debt Relief fund, totalling US$2.5 billion in 2003, more than double recent aid levels.

2. Aid Effectiveness

Progress in Poverty Reduction and the MDGs

2.1 At independence in 1971, Bangladesh was one of the poorest countries in the world, and faced continuing declines in living standards and human development in the first few difficult years after independence. However, since 1980, good progress has been made towards achieving the MDGs - particularly in comparison with other countries with similar per capita income levels. It is an indication of the low starting point that the incidence of both income and non-income poverty in Bangladesh remains the highest in the South Asia region with around 50% of the population living below the $1/day poverty line.

2.2 Economic growth has increased from an average 3% p.a. in the 1970s to 4% p.a. in the 1980s and 5% p.a. in the 1990s. This improving trend in economic growth is reflected in poverty statistics. Analysis of household data sets indicates that the incidence of poverty was relatively stable from 1983-84 to 1991-92, and then experienced a statistically significant decline from 59% to 50% by 1999. Similar trends can also be found in the depth and severity of poverty – stagnation in poverty during the 1980s and a decline in the 1990s. Trends in Gini coefficients suggest that inequality was relatively stable in the 1980s, increased between 1991-92 and 1995-96, and did not change much in the second half of the 1990s.

2.3 Agriculture has been the most important sector for poverty reduction, since 85% of the poor live in rural areas. The green revolution technologies of improved seeds, fertilizer and irrigation have seen rice production increase 2.5 fold since 1974, with no change in the land area under rice[34]. The landless also benefited as increased cropping intensity increased demand for their labour, and as food prices declined. Agriculture still employs 63% of the labour force, but only absorbed one third of the increase in the labour force over the 1990s, while employment in family enterprises (mainly smallholder farming) actually fell. The slow productivity growth in rural non-agricultural sector relative to the agricultural sector has reflected crowding in of under-employed rural landless, and has prevented an accelerated rate of poverty reduction.

2.4 Bangladesh has achieved remarkable progress in improving non-income aspects of human welfare. Estimates of the various dimensions of non-income poverty show that it declined faster than income poverty over the last two decades (UNDP, 2000). First, the Total Fertility Rate declined at a rate of 2.1 percent per year between 1975 and 1997 – the highest rate of decline among

[34] WB/ADB Public Expenditure Review (PER), 2003

South Asian countries. Second, there has been an impressive decline in child mortality rates with the rate of reduction in under-five child mortality being 2 per cent per year between 1970 and 1997. The figure is higher than the South Asian average of 1.8 per cent per year over the same period. Third, significant progress has been made in reducing child malnutrition, evidenced by better preventive (vaccination coverage) and promotive (greater access to information on nutrition and safe drinking water[35]) health care indicators as well as anthropometric measures on stunting and wasting. Finally, progress has been achieved in adult literacy and primary education, both in overall numbers as well as in closing the gender gap.

Box 2.1 Bangladesh: Trends in Millennium Development Goal indicators

MDG	Trends over 1980-2000
1.Extreme poverty and hunger	Incidence of poverty decreased at 0.9% per year between 1980-1999 with poverty rates declining from 59% to 50% over the last decade. Progress in reducing child malnutrition, with prevalence of stunting, wasting and underweight reduced by 20-25% over decade. The rate of stunting dropped from 54.6 to 44.8 % between 1996/97 and 1999/00 (BDHS).
2.Universal primary education	The gross enrolment in primary schools has increased from 59% in 1982 to 96% in 1999 (UNDP). 12.5 percentage points improvement in literacy over the last decade, but the literacy rate continues to be extremely low (45% among 7+ years). Decline in boys' (aged 6 – 15 years) enrollment indicated by recent surveys is cause for concern.
3.Gender equality and women's' empowerment	The gender gap in adult literacy was 35% in 1974; it declined to 26% in 1999 (UNDP). The trends of the 1980s were reversed in the second half of the 1990s with more girls than boys attending primary school. Despite stipends, there are 41% girls to 48% boys in classes 6-10 and only 15% girls to 30% boys in classes 11-12. Progress in other areas of gender equality has not been so rapid.
4.Child mortality	Drop in IMR from 87 in 1989-93 to 66 in 1995-99. Decline in CMR from 133 to 94 over the period. However, large disparities persist across income groups.
5.Maternal health	There has been some modest improvement in maternal mortality: the BBS estimates for the 1990s vary between 4.8 and 4.4 (per 1000) compared to around 6 in the 1980s, but the figures are still the highest outside sub-Saharan Africa.
6.HIV/AIDS, malaria and other major diseases	Diarrhoeal diseases were the main killers in the 1980s but their prevalence declined by 44% by late 1990s. In contrast, tuberculosis is gaining importance especially in rural areas while respiratory illnesses still remain

[35] There is evidence of arsenic contamination in what was considered safe drinking water in many areas, thereby requiring some qualifications in achievements in access to safe drinking water.

	widespread (UNDP).
7.Environment sustainability	River erosion, desertification and salinisation of land; arsenic contamination of ground water; and deforestation are on-going environmental challenges.

Source: Fighting Human Poverty: Bangladesh Human Development Report 2000. UNDP, Dhaka. Poverty in Bangladesh: Building on Progress, World Bank and Asian Development Bank 2002.

Prospects for Future Poverty Reduction

2.5 The DFID funded paper, *Supporting drivers of pro-poor change in Bangladesh*, looks specifically at the issue of progress towards achieving the MDGs in Bangladesh, and the prospects for meeting them by 2015. It calculates that if progress were to continue at the levels achieved in the 1990s then the Millennium Development Goals would be partially met by 2015. The extreme poverty goal would be reached – but 16 million would still live on less than $1/day, and 40 million would be below the upper poverty line. Universal primary education should be achieved by 2010 – but with grave doubts about its quality. The gender equality goal in primary education has already been reached – but on most other measures of gender equality such as higher secondary education, literacy, labour force participation women will fare worse than men. The child mortality reduction targets would be met. Maternal health and environmental sustainability targets would not be reached.

Box 2.2 Bangladesh's prospects for achieving the MDGs

Extreme Poverty & Hunger	Should halve the proportion of extreme poor by 2015 if a per capita growth rate of 3% per year is maintained. Significant challenges remain: close to half the children stunted or underweight. Integrated approach across sectors needed to maintain rate of progress. This should include creating knowledge of health practices.
Universal Primary Education	Should achieve universal primary education (on completion rate basis) by 2010. However, survey-based estimates show stagnation in enrollment during second half of 90s. Need to improve quality of education; problems of governance continue to plague the system. Universal coverage of primary education important tool to boost literacy rates; adult literacy programs need better delivery system.
Gender equality & women's empowerment	Gender equality in primary education enrolment and completion rates has already been achieved. Progress in increasing women's participation in public life and in the formal labor market, but female labor force participation continues to be quite low.
Child Mortality	Should reduce infant and 'under 5' mortality rate by 65% by 2010.
Maternal Health	Should reduce maternal mortality by 75% by 2010. Cross-sectoral approach needed (including behavioral change and massive training of midwives, given that

	95% deliveries occur at home) to lower mortality rates. Births attended by skilled staff extremely low, around 12% in 1999-00. Remarkable progress achieved in access to improved water sources by spreading tubewells virtually universally. Rapid urbanization poses new challenges. Arsenic contamination threatens gains achieved.
Combat HIV/AIDS, malaria and other diseases	Projecting whether or not these major diseases will be 'halted' is presently not feasible.
Environmental Sustainability	Doubts over providing safe drinking water to 90% of the population by 2010. Growing pressure on natural resources, and global warming, make 'reversing the loss of environmental resources' unlikely. Energy use the lowest among South Asian countries. Only 30% of the population has access to electricity. Structural reforms in the energy sector needed.

Source: Supporting drivers of pro-poor change in Bangladesh, 2002

The Policy Environment

2.6 The most authoritative recent policy document, providing the key framework for donor assistance strategy and the basis for the IMF poverty reduction and growth facility, is the recently published Interim PRSP (Box 2.3).

Economic management

2.7 Bangladesh has sustained steady growth of 5.1% pa in the 1990s with manageable inflation and improving social indicators. The fiscal deficit rose to unsustainable levels in the run up to the 2001 election, but the new Government has taken effective measures to place public finance back on track. Bangladesh has successfully managed its economy through a succession of external shocks and climate related crises such as the floods in 1998, while successfully mitigating humanitarian disasters and avoiding economic instability. External debt remains moderate and manageable.

Box 2.3: The Interim PRSP

Preparatory consultations with poor communities revealed widespread concern about the fragility of past achievements including: the lack of physical infrastructure, deteriorating law and order amidst growing incidence of organised crime, extortion and economic violence, lack of effective local government, poor quality of education, health and other social services and lack of democratisation of political processes.

The Interim PRSP sets a more ambitious target than the MDGs by using 2000 as a baseline from which to track progress rather than 1990. In order to halve the number of people living in extreme poverty between 2000 and 2015, a real GDP growth target of 7%p.a. is set. Growth also needs to become more pro-poor. There is a significant role for both direct public action, which will necessitate careful priority setting within the budget process, and the creation of an enabling environment for others to take action, including businesses and NGOs. To achieve high pro-poor economic growth, the strategy emphasises:

- a stable macroeconomic balance and economic reform (including State Owned Enterprise reforms),
- a gender sensitive macro and policy framework,
- strong institutions and improved governance,
- private sector-led and outward oriented growth which will take advantage of globalisation whilst ensuring that appropriate social safety nets are in place,
- accelerating rural and agricultural growth, targeting of small and medium enterprises,
- improvements in infrastructure and increasing use of information and communications technologies and improved partnerships between GoB, the private sector and NGOs.

The Interim PRSP covers all relevant issues, but it lacks an overall vision for the future of the country in a changing global context. The Parliament still has not discussed the interim strategy and the degree of Cabinet support is as yet uncertain. How policy prescriptions will be turned into programmes is still being worked out as part of the consultation process. This will be a key issue to monitor for all development partners.

The strategy devotes little attention to analysis of the political economy. However, the document refers to various forms of corrupt behaviour and highlights the need for capacity building. It also refers to promotion of voice and participation of civil society and the private sector, particularly the poor and disadvantaged groups, as a step towards a transparent and open government. The Interim PRSP discusses women's advancement, social protection, enhancing participation from below and reducing inequality but the strategy does not set out a programme that will guarantee full equal citizenship for women, including issues such as dowry, inheritance and rights to access land, employment both inside and outside Bangladesh, access to health services and physical security.

Poverty monitoring is key to accountability. The PRSP is only valuable if the country's leaders sign up to its commitments and it leads to positive changes for poor people. There is a need to monitor both the process and the impact of the delivery of policies and measures outlined in the strategy. Specifically this should include measuring changes in resource allocations, food security, and access and uptake of basic services in key sectors (such as primary education, water, safety nets and health services), and the effectiveness and impact of the delivery of these services at the individual and household level. It will be important to develop and publish a set of sex-disaggregated data on service quality, utilisation and customer satisfaction.

Consultations within Government on the Interim PRSP have been extensive but to date consultations with the private sector have been limited. Discussions among the donors and the Government on the Interim PRSP have also been fragmented and uneven. Some independent groups of professionals and NGOs have held consultations and made robust comments on the drafts. Yet, there are still significant questions around the depth of ownership of the strategy among the politically influential government line departments and among the broader population that need to be addressed.
Source: Adapted from DFID (2003)

2.8 The avoidance of macroeconomic crisis is all the more impressive in a country which has suffered dwindling aid receipts, and where the tax take is an extremely low 10% of GDP. Public expenditure of just 15% of GDP is one of the lowest in the world. The high cost domestic borrowing required to fill the budget financing gap has pushed interest rates to high real levels, squeezing out private sector investment.

Structural Policies

2.9 The growth and poverty reduction potential of the Bangladesh economy is handicapped by state owned enterprises in banking, energy, telecommunications, transport, and manufacturing. Private investment is discouraged by the high interest costs associated with state owned banks burdened with non-performing loans, many of them to other state enterprises; by costly and inefficient operations in state owned ports, telecommunications, and energy sectors, resulting in wholly inadequate infrastructure; and by a Government culture in which bribes have to be paid to secure any government services.

2.10 Although budget funds are in general appropriately allocated, their amount is wholly inadequate. This partly reflects low tax take and associated corruption. It also reflects the burden of unbudgeted subsidies to state owned enterprises who receive preferential access to capital, but earn low or negative returns as a consequence of low, controlled prices, poor collection of revenues due, and generally poor management, governance and accountability. World Bank has provided technical assistance on the reform of state owned enterprises. They have pressed for Government to get out of activities that could be undertaken in the private sector, and for the imposition of hard budget constraints and introduction of private sector enterprises in partnership roles even within sectors staying public. The new Government has committed itself to privatisation, and has started by closing the largest jute mill complex in the country and has started action on a range of other enterprises. It promises to impose hard budget constraints.

2.11 The remarkable achievements in human development and poverty reduction reflect well-targeted and relatively effective public expenditure programmes in the social sectors. Since 1990, the share of the Annual Development Program (ADP) devoted to the social sector more than doubled, and is considered to be partly responsible for the progress in human poverty indicators The social sectors receive 30% of budgetary expenditure, though with budget expenditure only 15% of GDP, the per capita spending levels are still low compared to other South Asian countries. For example, $12 per head of Government spending on health and education is below even Pakistan ($13) and compares with $21 in India and $37 in Sri Lanka. Households meet some 50-70% of expenditures on health and education.

2.12 The limited Government spending on health and education, as well as social safety nets, are relatively well targeted, however, and the share of the poor in the benefits of social sector spending is higher than their share in national income:

- Some 60% of health spending is on an essential services package, ¾ of spending is via facilities at or below district, the poorest 20% of the

population benefit from 16% of health outlays, and 23% of outlays on child health.
- Basic education receives the overwhelming share of education spending, the poorest 40% of the population benefit from 27% of education spending and 45% of spending on primary education.
- 0.6% of GDP is allocated to disaster management. The two main programmes (gratuitous relief and vulnerable group feeding) played an important role in protecting the poor during the massive 1998 floods. Over three quarters of food grains went to recognised flood victims, ¾ from the poorest 60% of the population.
- The targeting of social expenditures on the poor has improved significantly since the 1980s, when the largest share of food assistance leaked away in benefits to the better off.
- Several targeted transfer programs were introduced over the 1990s for destitute female-headed households, and the elderly, while existing programmes, Food for Work, Food for Education and Vulnerable Group Development were further fine-tuned to attempt to reach the extreme poor population.
- Bangladesh also allocates an appropriate 1.5% of GDP to rural development. Rural infrastructure, especially roads, has been particularly important in raising the incomes of the poor.
- Defence and interest costs are low.

2.13 Although Government spending allocations are relatively equitably allocated, problems of corruption and poor motivation of civil servants mean that the benefits actually gained by the poor are less than intended. Government has made widespread use of partnerships with NGOs to deliver services in the fields of family planning, HIV/AIDS, immunisation, education, disaster management, water and sanitation, and micro credit. This partly reflects the donor preference to increasingly channel dwindling aid through NGOs, and has at times been a source of conflict between donors and the GoB, which has been reluctant to see the low levels of resources available for funding Government still further reduced. Nevertheless, the involvement of these alternative service providers has improved accountability, and has promoted innovation in schemes such as the payment of stipends to encourage girls' school attendance. Several NGOs in Bangladesh have reached a size that puts their poverty reduction programs on a par with government programmes, and have shown superior performance in providing better micro-credit, health and education services than either the government or the private sector (World Bank, 1999). NGOs have also progressively sought, with mixed results, to target the poorest of the poor. The public expenditure review argues that the existence of these partnerships help to explain why the weakness of Government institutions has not prevented success being achieved within the social sectors.

Public expenditure management

2.14 Although strategic allocation of public spending is appropriate, and there is good evidence of real achievements, there are severe structural problems in the budget, and major institutional problems limiting the effectiveness of services. The budget is split between development and recurrent budgets.

The development budget has far more projects than can be implemented with available funds, many of them of poor design. Expenditure on ‘initiatives of national importance’ escape budget disciplines entirely, a major loophole. The recurrent budget is prepared on an incremental basis. Recurrent costs of development projects are not taken into account. The recurrent budget is an amazingly low 8% of GDP, non- wage operating and maintenance spending is only 1% of GDP. Recurrent spending is so low that Bangladesh appears to run a recurrent budget surplus, though this may be misleading since ‘projects’ on the development budget include operating costs, one reason why project completion and closure proves difficult since operating costs have to be negotiated onto an overstretched recurrent budget.

2.15 Financial management still has serious weaknesses, despite improvements introduced with DFID support. Significant revenues and expenditures are not reflected in Government accounts. There is no checking of aggregate payments against approved budgets. Weak cash management leads to wide monthly fluctuations in borrowing from the central bank. There is no consolidation of accounts between central and local government. The Financial management Reform Programme, supported by DFID and the Netherlands, was signed in March 2003 and aims to address many of these problems.

2.16 If Bangladesh could eliminate wasteful subsidies to SOEs and prune poor projects from the development plan, World Bank estimate that an additional 2% of GDP could be released for higher priority spending.

Social Inclusion/Equity

2.17 Bangladesh has a large and relatively well-targeted social safety net. It offers income protection to the most deprived and achieves important development objectives, especially boosting girls school attendance via food for education and the girls secondary education stipend. These together receive a remarkable 0.3% of GDP, targeted on the poor (with the poorest 20% five times more likely to receive the benefits than the richest), and have had a remarkable impact on girls’ enrolments.

2.18 Despite Government efforts, the growth process has increased inequality in recent years. The poor are primarily landless and dependent on daily wage income and informal sector casual self-employment. Growth has not been fast enough to drive up the demand for their labour at a sufficient rate to avoid a decline in their relative position, although all groups have increased their incomes. Government and NGO interventions in micro credit have sought to benefit the poor by enabling them to acquire assets, including some innovative schemes such as Grameen Bank’s programme to extend credit to enable cell phones to be purchased by the poor for renting to others.

2.19 Although Government and NGO policy and spending programmes have improved the lot of the poor, Bangladesh continues to suffer from lawlessness and gender discrimination. Bangladesh has the highest rates of armed robbery and of reported rapes in the region, and violence against women has been an important and growing problem. The organisations of the criminal justice system that should offer protection are reported in opinion surveys to be among the most corrupt. Inequality at village level continues to enable the wealthy to oppress the poor and landless, who have few opportunities for redress. The growth of effective NGOs working with the poor and helping them to acquire assets and assert rights has been an encouraging development since the 1980s, arguably helping to improve not only the incomes but also the status of the poor and their ability to defend their rights. Nevertheless, the process of economic growth has brought increasing inequality.

Public Sector management and Institutions

2.20 Bangladesh scores near the bottom in league tables of governance. The World Bank argues that Bangladesh loses 2-3% p.a. in growth through weak institutions and a weak governance framework. In the Bank's world business environment survey, Bangladesh stood out as a country in which all firms reported paying bribes to get things done, and half of Bangladeshi firms said that they always have to pay to secure Government services- which is more than twice the level reported in India or Indonesia.

2.21 Improving law and order, tackling corruption, and improving human rights are at the top of the priorities of the new Government. However, 'there is no easy solution' to problems with deep roots in society and politics. The Bank propose the usual agenda of reforms: - improved legal frameworks, more transparent public expenditure management and accountability, improved procurement systems, stronger and more independent scrutiny by auditors and parliamentarians, reform of civil service and local government, more partnership with change agents in civil society, better monitoring, possibly decentralisation though with some concerns about even weaker accountability at local level. The Government appears to be committed to reforms, and has identified sensible initial priorities. It is important to recognise that progress may be difficult and subject to reversals, but to keep in view the fact that despite the problems, Bangladesh has achieved a rate of progress in poverty reduction that would be the envy of all but a handful of low-income countries.

Impact of Shocks and Aid Variability

2.22 Bangladesh has managed reasonably well over the years, weathering repeated natural disasters and several international financial shocks, while avoiding debt crisis or hyperinflation. It has become highly effective at using safety nets to alleviate the impact of natural disasters on the poor, and has largely weaned itself off the need for large food aid transfers.

2.23 The continuous decline in aid over the 1990s has reflected reduced need for commodity aid, and problems in spending the project aid pipeline. It does not appear to have caused major problems in the macro economy, though the long-term decline has clearly constrained poverty spending.

Policy Dialogue

2.24 The burst of poverty reform in the early 1990s included substantial trade liberalisation and was supported with Bank and Fund lending. Policy lending ceased from 1994 when the reform process stalled. Although there has been limited macro policy dialogue in the 1990s, Government did negotiate a health and population sector programme that received coordinated donor support. The programme has experienced some severe difficulties in implementation, though Government intends to persist with the sector approach and hopes to extend it to education.

2.25 The new Government that came to power in October 2001 appointed a senior team to identify reform priorities and accelerate progress on the PRSP. The World Bank prepared 18 policy briefs for the new Government, as well as preparing with the ADB a major public expenditure review and a poverty assessment. The bank assisted in preparation of privatisation policy, subsequently endorsed by Cabinet, and is providing technical assistance on procurement. New procurement guidelines have been approved, and were due to be implemented from July 1st.

2.26 The Bank and Fund both regard the reform programme approved by the new Government as appropriate, and there appears to be willingness to seek support and assistance from development partners on both policy and design and implementation. There has been wide consultation, partly in the context of preparation of the interim PRSP, and there seems to be wide consensus. The Bank argues that the acid tests of commitment will be progress in fiscal sustainability (where the FY 2003 budget was regarded as encouraging), pruning of the annual development plan (review in progress), privatisation, reform of SOEs, and actions to combat corruption, especially within the criminal justice system.

2.27 Though overall dialogue may be improved, the health and population sector programme has run into problems, and donors' suspended disbursements in May 2003. The programme merged the family planning service, which previously was run as a project and financed from the ADP, with the Ministry of Health. The intention to unify the two services was not implemented, partly because of the problems of transferring staff onto the recurrent budget. An elaborate framework of plans was prepared for each aspect of the combined health and population programme. A recent review found that no serious attempt had been made to implement the HPSP programme after the third year. The Government has now decided to de-merge family planning and health, prompting the donor action.

Aid and Public Expenditure Management

2.28 Donor funding represents roughly one quarter of the development budget. The weaknesses in the Governance framework have caused donors to seek to reduce their fiduciary risk by establishing parallel structures for development assistance. Even the health and population sector programme was run through a massive parallel structure based on the project implementation unit approach. Implementation progress has been hampered by an over-stretched Government budget with too many projects, and by the problems of a civil service culture in which action by staff at all levels often requires personal inducements to 'move the file on'. Procurement has been the most important single issue in public expenditure management according to the PER, with diverse rules and practices being used but with no assurance of transparency or accountability. The Government is taking comprehensive action on this through a World Bank supported project. IMF comment that coordination, monitoring and reporting of foreign financed projects remains poor.

2.29 It is recognised that these aid management problems will need to be addressed if Bangladesh is to restore cuts in development assistance, and indeed go further towards the aid levels that would be expected for a country that is poor and has evidence of both commitment and progress in poverty reduction. A joint Government-Donor Working Group has been set up under the 'Aid Governance' initiative with the mandate to identify modifications of Government and donor policies, procedures and practices that could improve the efficiency, accountability and transparency of development assistance. This group submitted findings and recommendations to Government in May 2003.

Impact of Aid

2.30 Despite the overall problems of aid management, development assistance can point to some striking successes: -

- The rapid decline in fertility is strongly associated with an effective family planning programme, largely financed by the donors. The health and population sector programme was partly motivated by a desire to put this effective programme and the staff it employed onto the regular recurrent budget.
- A major role in the research, extension and irrigation investments that enabled Bangladesh to increase rice and wheat production fast enough to eliminate the food grain deficit and achieve lower prices without any increase in cultivated area.
- Aid supported International Centre for Diarrhoeal Disease Research developed oral rehydration therapy that not only made a major contribution to the dramatic decline in child mortality in Bangladesh, but also saved millions of lives throughout the developing world.
- Donor pressure was instrumental in channelling donor and Government resources through non-Government channels, enabling far more effective impact on social welfare.

2.31 Earlier donor interventions proved less sustainable. Major investments in state owned enterprises in electricity, gas, railways, ports, and fertilizer were made in the 1980s, to little lasting benefit. Donors have mainly learned their lesson, and largely withdrawn from funding of the state owned enterprise sectors, pending effective reform to privatise where possible in involve private partners where not.

3. Absorptive Capacity and Potential Impact of Increased Aid Flows

3.1 The public expenditure review says that additional resources are needed in order to meet the poverty reduction targets the Government has set itself: -

- Meeting the UPE target requires a doubling of public expenditure on education, an additional 2.3% of GDP, or $1.2bn p.a.
- Current per capita health spending of $11 compares with $44 required to deliver the essential services package. If met from public expenditure (a not unreasonable assumption given the high cost recovery burden already met by the poor), this implies an additional $4.6bn p.a.
- Bangladesh currently finances 1.5% of GDP budget deficit from expensive domestic sources that squeeze private sector access to credit and keep interest rates painfully high. Increased aid of $800 million would enable Bangladesh to meet present spending commitments without recourse to damaging domestic funding.
- There are also large financing needs to overcome the problems of poor infrastructure, and to finance the reform and privatisation of commercial banks and SOEs, and of central and local Government.
- Overall public expenditure of 15% of GDP is far too low for meeting economic and social needs. Even Pakistan spends 21% of GDP, our other case study countries spend 25% or more of GDP, yet still face difficulties in financing vital public expenditures for meeting the MDGs. A 10% of GDP increase in spending would imply a financing gap of the order of $7bn p.a. in 2007-8.

3.2 Part of the gap could be met by improving revenue collection from the current deplorably low level. The PER estimates reducing poorly targeted SOE subsidies and eliminating poor projects from the ADP could release some 2% of GDP. On the other hand, even 25% of GDP remains a modest level of public spending for such a poor country with so many unmet needs: in most countries, it is the baseline from which our study is considering the need for large aid increases. Purely on a needs basis, an increase of at least $7bn p.a. to $8.2bn appears reasonable, and indeed it would only increase the aid: GDP ratio to 12%, not much higher than present median levels in Africa and way below the levels implied by the proposed $50bn increase in global aid. The higher level of $9.7bn implied by the Collier-Dollar model would still only increase aid: GDP to 13.9%.

3.3 Bangladesh should be well placed to gradually reduce the need for high levels of aid. If peak aid of $9.7 bn is reached in 2007-8, Bangladesh would be able to sustain spending at the higher level in per capita terms from 2017-8 on the assumption that: -

- Aid returns to the pre-increase level of $1.1bn;
- GDP grows at 5% p.a., and revenue increases to 15% of GDP by 2017 from the current 10% level;
- An additional 2% of GDP becomes available for the budget by 2017 as a result of reduced subsidies to SOEs and other efficiency improvements;
- Population grows at 2% p.a., in line with current trends.

3.4 These are not unreasonable assumptions, and suggest that the IFF proposal to increase aid now at the expense of lower aid later would not cause sustainability problems when applied to Bangladesh.

3.5 A bigger concern is the ability of Bangladesh to absorb and make productive use of a big increase in aid flows. Bangladesh has been unable to utilise the current project aid pipeline using current aid management procedures. Donors have so far been reluctant to liberalise and make use of the Government budget to disburse funds, fearing problems of corruption. The financial management reform programme is the potential solution to this dilemma. Government seems to be committed to achieving improvements in public expenditure management. For their part, donors should take the risk of using the Government budget to disburse assistance, while maintaining dialogue and support for improving standards of financial management, working with Government and with bodies outside Government to maintain the pressure for better compliance with financial regulations, and better performance by public servants.

Conclusions
3.6 Even if progress is disappointing, there is a strong case for at least restoring the aid: GDP ratio to the 1990 level, implying aid of $6.2bn by 2007-8. If the reform programme continues to achieve good progress, aid of up to $10bn is justified. Government and donors need to continue to work together to solve the disbursement problems.

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The case for Increased Aid: India Case Study

Summary

India has sustained relatively rapid economic growth with increasing equity since the 1970s, achieving substantial poverty reduction and improvements in social indicators. India nevertheless still has more poor people than Sub Saharan Africa. Successive Indian Governments have recognised that progress could be accelerated with further reforms, to open the economy to trade, reduce the over-regulation of enterprises, reduce the burden of subsidies, increase the private sector role (especially to improve power, transport and water infrastructure), and enable Government to focus on providing basic social services and better targeted safety nets. The huge fiscal deficits have already slowed economic growth, and need to be reduced urgently to avoid a domestic debt crisis with serious consequences for economic stability.

The bias against large countries means that aid plays a minor role. The finance provided is negligible as a share of imports, Government revenues, or GDP, and India understandably resists external influence on policy. India has a large and highly skilled domestic policy community, and does not need external advice. The weaknesses in Indian policy reflect political constraints on action rather than lack of good local analysis of what to do.

The fundamental question is: why increase aid to India when Government could perhaps achieve Chinese rates of progress in poverty reduction if it would address the fundamental policy problems? Why provide increased external assistance when a large part of domestic revenue is wasted on unproductive spending?

The main response is that the constraints on reform are no less real for being political in nature- as the Europe of the CAP should recognise. Reforms have not been reversed, but they have slowed with weaker coalition Governments since the mid 1990s. The world should value Indian democracy, but recognise the constraints it places on the speed at which reforms can be undertaken. Notwithstanding the serious weaknesses in the policy environment, the record of India in sustaining economic growth and poverty reduction over a long period is a creditable one.

There are some areas where committed policy reform will be essential before aid can achieve sustained benefits, as review of past results confirms. But the needs are enormous, and a very substantial and fast increase in disbursements would be both feasible and merited in sectors where real benefits are already being achieved and can be expanded. Primary education is one example. GOI wishes to raise Government spending by 2% of GDP to finance an ambitious national education for all programme, based on earlier Government and donor experience through the district education project. It will be difficult to achieve this while also struggling to reduce the budget deficit. A quadrupling of aid flows entirely focused on primary education would only provide half of the required additional finance, and would only raise the

donor share in primary education spending from 4% at present to a little more than a quarter of the total. The impact, however, would be to put far more children in school than equivalent spending in high-cost sub Saharan Africa- provided the donor support ensured that increased donor resources were matched to increased GOI spending in line with GOI stated policy.

1.Aid Trends

1.1 In quantitative terms, aid to India is of negligible and declining significance, representing just 0.35% of GDP in 2001. This reflects the small country bias in aid distribution. Aid is so dwarfed by other flows that a major IMF study of fiscal and balance of payments funding problems did not find it necessary to make any reference to aid as a source of finance[36].

Table 1, Aid to India, US$Mn

	1996	1997	1998	1999	2000	2001
ODA, US$		1.65bn	1.61bn	1.49bn	1.48bn	1.70bn
ODA/Head, US $		1.71	1.64	1.49	1.46	1.65
% of GDP		0.40	0.38	0.33	0.32	0.35
IMF, net external assistance, FY, $mn[37]	0.9	1.1	0.9	0.8	0.9	0.4
FDI, net, US$BN		3.58	2.63	2.17	2.32	3.40
Capital account balance $bn, FY[38]	4.2	12.0	9.8	8.4	10.4	9.0
GDP Growth		4.45	6.50	6.10	3.95	5.40

Sources: World Bank, WDI on-line database;

1.2 The World Bank remains the lead donor to India. Bank commitments were reduced as a consequence of sanctions introduced in the wake of nuclear testing by India. These have now been lifted. The Bank has defined a base case lending level of $3bn, dependent on the speed of reform in India. Actual commitment levels of $1.75bn in 2001-2 have fallen short of this, reflecting slower than hoped progress of economic reforms at State level, delaying state level structural adjustment and power sector credits.

2. Aid Effectiveness

Progress in Poverty reduction and the MDGs

[36]

[37] IMF Where is India on globalisation?FY 95-96 shown under CY96.

[38] ibid

2.1 Poverty in India was fairly static at around 55% of the population until the mid 1970s, since when it has achieved a major reduction as a consequence of higher growth more focused on the rural areas where the poor live. The seed-fertilizer-irrigation technology of the Green Revolution made a significant contribution, dramatically increasing grain output and increasing the demand for the labour of the landless. Poverty fell to 38% of the population by 1985, and has since fallen further to reach just 26% by 1999/2000[39]. Life expectancy has doubled, and infant mortality has fallen by two thirds, since independence.

2.2 Levels of poverty and social disadvantage nevertheless remain high, and India is ranked 132 from 174 on the HDI. India is crucial to achieving the millennium development goals, having over one third of the world's poor, 20% of out of school children, and accounting for 23% of deaths under 5 years of age (Table 2).

2.3 Good progress has been made in reducing **income poverty**, which is on track to reach the target. Given the relatively even income distribution, India requires 1.5% p.a. growth in per capita income to reach the target[40], whereas even the slower growth of recent years is equivalent to more than 3% per annum[41]. Achieving universal primary **education** and closing the enrolment gender gap requires acceleration in the rate of progress, which will be difficult to achieve because enrolment will need to be extended to marginalised and hard to reach groups. Achieving the **health** targets also requires a marked acceleration of progress, which has actually slowed in the 1990s relative to the 1980s. Improved access to safe **water** will depend on reforms to improve financial sustainability.

Table 2: Progress towards the Millennium Development Goals

Target	% of World Total to reach MDGs	Current Levels & recent trends	Progress 1990s	Required Progress late 1990s-2015
Halve from 1990-2015 the % of population living on less than $1/day	36% of worlds poor	On MDG definition, 1993-4, 46% 1999/00. 39%	Fell 1.2 % points p.a.	Fall 1.0% points p.a.
Enrol all children in primary education by 2015	20% of out of school children	1993-94:71% 1999-00:77%	Increased 1.0 % points p.a.	Increase 1.5 % points p.a.
Eliminate gender disparities in primary &	20% of world shortfall in girls enrolment	Gap in enrolment ratios, % points: 93/4 99/0	Annual % point increase in enrolment rate: Boys 0.7	Annual % point increase in enrolment rate: Boys 1.3

39 DFID Country Strategy Paper, July 1999, based on Indian National Sample Survey estimates. The Indian poverty line is lower than the international $1 per day figure, hence these proportions are lower than Table 2.
40 DFID country strategy paper, July 1999.
41 Though there is controversy on measurement issues, all estimates now agree that poverty fell significantly in the 1990s. See WB CAS review, Jan 2003.

secondary enrolments by 2005, & at all levels by 2015		6-10 11 8 11-14 17 10	Girls 1.3	Girls 1.8
Reduce infant and child mortality rates by 2/3 1990-2015	23% of under 5 deaths	92/3 98/9 CMR 109 95 IMR 78 68	CMR fell 2.3 points p.a. IMR fell 1.7 points p.a.	CMR 3.3 points p.a. IMR 2.4 points p.a.
Reduce maternal mortality by ¾ 1990-2015	25% of world total	Stable at aprox 540 per 100,000	No change	Reduce by 24/100000 p.a.
Halt by 2015 & begin to reverse spread of HIV/AIDS, malaria, other major diseases				4 mn HIV infected, still increasing; TB deaths remain high at 500,000 p.a.
Integrate principles of sustainable development into country policies, reverse loss of env. Resources, halve % without sustainable access to safe drinking water.	30% of global deaths from poor water & sanitation.			Degradation of soil, forestry, fish, coastal zones high, safe drinking water access improved but not continuous, 10% of deaths due to water born diseases.

Source: World Bank CAS, and Jan 2003 Review of the CAS.

The Policy Environment

2.4 From independence, India has stressed the importance of poverty reduction, but for many years pursued a centrally planned, closed economy model of development. Poverty reduction was pursued in part through widespread subsidies and transfers. These were poorly targeted with most benefits going to the non-poor, yet caused growing fiscal problems and ironically limited the resources available for spending on basic infrastructure and social services. Growing fiscal deficits associated with the subsidy and entitlement culture as well as weak performance of public enterprises triggered a fiscal and balance of payments crisis in 1990-1991. This crisis was followed by a period of economic reform, which saw trade liberalised, the deficit reduced, and the environment for private investment improved. This resulted in a period of accelerated economic growth (Table 3). However, fiscal adjustment and the pace of structural reforms were not sustained, and growth slowed. Despite significant reforms following the 1991 balance of payments crisis, India still has a highly protected, highly regulated economy. Indian reforms have been less comprehensive and more slowly implemented than competitor countries, and the relative position has not improved.

2.5 Weak coalition Governments in recent years, distractions from ethnic tension and corruption at home and tension with Pakistan, have led to drift in the implementation of continued economic reform, though there continues to be a broad consensus on the need for further reform. This is reflected in the five-year plan, which emphasises growth with social justice and equity, fiscal balance, and Government playing an enabling role in a private sector led growth strategy. The State role is to be re-oriented to focus on basic health and education services, employment, regional balance, and rural development. There is explicit recognition that competition between states for private investment can play a positive role in driving reform.

2.6 In January 2001, the Government released a second-generation reform programme, and many measures were endorsed in the 2001-02 budget. There has subsequently been some sign of renewed attention to structural change, with privatisation finally making progress, though the overall fiscal deficit problem has not been tackled and is the critical constraint that needs resolution before other reforms can achieve sustainable impact.

Economic management

2.7 Although the general Government fiscal deficit was reduced from 9.6% at the time of the 1991 crisis to 6.7% by 1995-6, the expenditure cuts did not prove sustainable and the deficit subsequently increased to exceed 10% of GDP in 2001-2, with no improvement in 2002-3. The composition of the deficit as share of GDP is 5.3% central Govt, 4.5% States and union territories, 1.4% central level public entities[42]. The key drivers of the deficits are low and falling domestic revenue, poorly performing public enterprises at centre and state level, poorly targeted subsidies that have proved politically difficult to reduce, and civil service wage increases without the complementary reduction in staff numbers that was intended to accompany them. On the revenue side, the central plus state level tax: GDP ratio of 14.5% is below regional averages, and is over dependent on trade and excise taxes with arbitrary exemptions, causing distortions and the potential for corruption. Income and profit taxes make little contribution, with only a quarter of India's 100 million strong middle class registered for taxation[43].

2.8 The legacy of cumulative deficits and higher interest rates following financial reforms are also driving up the domestic debt-servicing burden. IMF analysis shows that the domestic debt burden is growing unsustainably, a problem that has been recognised by the Finance Minister. The high level of domestic savings (up from 20% of GDP in 1991-92 to 25% by 2000-01) has enabled Government to maintain these high deficits without balance of payments problems, but the current levels of the deficit, if not corrected, would eventually spill over into balance of payments problems if savers lose confidence in the ability of central and state Government to service the debt. Moodys and S&P have already downgraded their assessments of Indian domestic debt. The IMF have estimated that India needs to achieve a 1.3% of GDP improvement in the primary balance per annum, sustained for 5 years, in order to stabilise the debt stock at 60% of GDP target level. The real extent of the problem is still greater, since contingent liabilities including the debts of

[42] IMF selected issues
[43] IMF Selected issues, op cit.

SEBs and unfunded pensions may add a further 50% to the real debt liability on GOI. The position will also have worsened since the deficit has run on unchecked since the Fund analysis in 2001. The combination of lower drought affected growth (below 5% in FY03) and a 10% deficit will have caused the domestic debt to further increase towards 100% of GDP.

2.9 Even if a fiscal crisis is avoided, the large call that the state makes on domestic savings is thought to be squeezing private sector investment. After growing at 15% pa in the mid 1990s, private fixed investment has grown at less than 4% p.a. since 1996/7, falling as a share of GDP. The lower fiscal deficits of the mid 1990s were associated with faster economic growth; the return to lax fiscal policy has seen a reduction in the GDP growth rate.

Table 3: Indian GDP Growth Since Independence, % p.a.

1950s-1960s	1970s	1980s	1991/2-1996/7	1996/7-2001/2
3.8	3.1	5.6	6.7	5.3

Source: IMF Country Report 02/193:Selected issues and Statistical Appendix, Sept 2002

2.10 Although general Government spending of 28% of GDP is a little higher than unweighted Asian average of 24%, spending on infrastructure investments and on basic health and education is below regional averages (even after cuts necessitated by the Asian crisis) because of the constraints caused by the huge subsidy burden, estimated as equivalent to 14.5% of GDP[44]. Private investment is depressed not only by the high interest rates required to fund the Government deficit, but also suffers from the poor quality of infrastructure and Government services. Infrastructure spending is the only aspect of Government expenditure found to be positively associated with private investment according to the IMF, but it has been squeezed and has not kept pace with growing demands, especially in urban areas[45].

2.11 Spending on social sectors is below the levels required to meet the targets: different estimates of the additional cost of meeting the education targets range from $1.2bn per annum (UNESCO) to $3.8bn per annum (World Bank). Spending on education is currently 4% of GDP, with only half of this on the primary level. Government plans to raise spending to 6% of GDP to fund eight years education for all children, though the feasibility of achieving that depends crucially on reducing the burdens of less productive spending.

2.12 The draft Financial Responsibility and Budget management Bill targets eliminating the revenue deficit by 2006, prohibits borrowing from the reserve bank beyond ways and means advances, and requires three year rolling targets and quarterly reports on progress to be submitted to parliament. It has not yet been passed (Jan 2003). The Expenditure Reform Commission has already provided a blueprint setting out what reforms are needed to address the fiscal problem: the difficulty is one of implementation. Some measures

[44] IMF selected issues and statistical appendix: fiscal situation in international perspective.
[45] IMF, selected issues and statistical appendix.

have been taken (e.g. fertlizer subsidies reduced from 0.45% of GDP in FY 2000 to 0.28% in FY03), they are not sufficient.

2.13 At State level, in 1999-00, GOI signed MOUs with 13 States willing to promise fiscal reform in return for GOI relaxing borrowing constraints. Non-compliance has been a serious problem. In order to improve State level incentives for improved fiscal management, GOI has introduced an incentive fund offering additional resources to States who prepare an acceptable fiscal strategy and achieve a minimum 5% (per annum?) improvement in their revenue balance. However, the financial incentives are small relative to the scale of transfers to States. There is as yet no credible action being taken to address the scale of the fiscal problem, either nationally or at state level.

Structural Policies

2.14 The Reserve bank Governor and the Prime Ministers' Council of Economic Advisers have both argued that India remains one of the least globalised economies in the world. Trade and capital market liberalisation from the mid 1980s accelerated after the 1991 crisis, and saw the share of trade (merchandise exports plus imports) increase from 11.6% of GDP in the 1977-86 period to reach 21.7% in 1992-96, a level which has been broadly maintained but not increased since[46]. According to IMF modelling, India in 1995-98 traded 70-80% less than would be predicted given its income level and geographical situation. Measures of trade policy explain why: India continues to have one of the most highly protected economies in the world (Table 4). Effective rates of protection are arbitrary and random, with numerous exceptions[47]. Between 1980-2000, India marginally increased its share in world trade from 0.5% to 0.7%, while China tripled its share to 4%. The main bright spot is that exports of services, which face fewer barriers, have grown by 25% p.a. and now account for 25% of exports of goods and services, as a consequence of explosive growth in software exports and call centre services. Although liberalisation has increased (remaining QRs abolished, average tariff reduced to 29%), India continues to be a heavy user of anti-dumping measures (second only to the USA), and there is a long way to go to match regional competitors.

Trade 4: Policy Comparisons (1== most open)

Country	Overall Rating	Non-tariff barriers rating	Tariff Rates	Average Tariff (%)
India	**8**	**2**	**5**	**36**
Bangladesh	**8**	**2**	**5**	**36**
China	**5**	**2**	**2**	**14**
Sub Saharan Africa	**4.3**	**1.5**	**2.7**	**17.2**
Asia	**4.4**	**1.8**	**2.1**	**12.5**

[46] 'Where is India on globalisation? IMF (2002), India: Selected issues and statistical appendix, country report 02/193, September.
[47] IMF ibid.

World Average	**4.1**	**1.7**	**2.1**	**12.9**
Hong Kong	**1**	**1**	**1**	**0**

Source: IMF, 'Where is India on globalisation?'

2.15 India also receives a low share of private capital flows, with direct investment of $2.3bn in 2000 (1/2% of GDP) comparing with $38bn (4% GDP) to China and $33bn (51/2% GDP) to Brazil. The Global Competitiveness Report says that India requires more permits and it takes longer to establish a firm than in almost any other country, while huge swathes of the economy are reserved for small enterprises, preventing the economies of scale needed for successful export. Although there have been further liberalisation moves in 2002,only 55 from 813 items have been removed from the list reserved for small scale enterprises.

Privatisation

2.16 Government has preferred to reduce its share in enterprises rather than sell them outright, while the lack of bankruptcy legislation has given many failing private enterprises a call on Government funding as so called 'sick firms.' There does seem to have been a pick up in privatisation after 10 years of sluggish activity, with sales of $1.9bn in 16 months to end 2002, and projections of a further $2.5bn to be realised in 2002-3.

Social Inclusion/Equity

2.17 Poverty reduction and reduced social exclusion have been central objectives for successive Indian Governments since independence. Measured by the Gini coefficient, there has been a steady 0.3% per annum decline in inequality since the 1950s[48]. The draft 10th 5 year plan emphasises poverty reduction and human development, recognises the millennium development goals and develops explicit goals and targets which in some cases go beyond the MDGs.

2.18 All 15 of the largest states, accounting for 90% of the population, showed progress in poverty reduction in the 1990s and improvement in social indicators. Rates of progress nevertheless differed, and poverty became more concentrated, with the three poorest states (Uttar Pradesh, Madhya Pradesh and Bihar) increasing their share in poverty from 41% in the early 1990s to nearly half by 1999-2000. The range is from 12% in Punjab to 55% in Bihar, home of 16% of the population and a state where the civil service has collapsed and lawlessness prevails[49].

Table 5: Poverty continues to be more prevalent in rural areas, but the gap has narrowed:

Headcount Poverty, %	1993-4	1999-00
Rural	37.3	27.1
Urban	32.4	23.6
Total	36.0	26.0

Source: World Bank CAS, based on GOI National Sample Survey estimates, and GOI poverty line (below the MDG definition)

[48] WB OED, India, The challenges of development, A country assistance evaluation, 2001.
[49]

2.19 India continues to have major problems of social exclusion, with women over-represented among the poor. In 1993-4, more than half of the 25% of population accounted for by scheduled castes and scheduled tribes were still below the poverty line. Gender gaps remain serious (Table 2). Federal and State Governments have made marked efforts to address these problems, with long standing policies of reserving education opportunities and jobs and a positive focus on marginalised groups.

Public Sector management & Institutions

2.20 India is a robust democracy with a free press and an apolitical army. Mechanisms for accountability and transparency of Government exist, though they are not always enforced. The bureaucracy is effective at one level, but is slow and inflexible, subject to corruption and patronage. The judicial system is slow and capable of being influenced by political pressures. On WB assessments, India scores worse than developing country averages on Government effectiveness, the same on rule of law and the business environment, but better than average on general public administration and public finance. India scores 9th (from 54) on the Transparency International corruption index[50].

Impact of Shocks & Aid variability

2.21 As a large, relatively closed economy, India is less exposed to external shocks. Although agriculture has shrunk to just 24% of GDP, compared to over half in 1950, some 70% of the population remains rural and is dependent on agriculture for income, either directly or by supplying non-agricultural goods and services to the sector. Agriculture remains central to poverty reduction in the medium term, with a 75% correlation between agricultural growth and the growth of private consumption. Fluctuations in rainfall continue to be highly correlated with GDP growth, though rainfall has been within 10% of the long run average for the last 13 years and has not caused major shocks to the economy. Growth has slowed to less than 6% p.a. since 1997-98, partly due to the impact of the Asian crisis, oil price changes, patchy monsoons and the Gujarat earthquake. But deeper, domestically caused structural factors are also important: - infrastructure weaknesses, regulatory constraints, high real interest rates associated with fiscal deficits, and the uncertainty on further reform measures and their impact[51]. Sanctions imposed by donors as a consequence of the nuclear tests had no detectable macro-economic impact.

Policy Dialogue

2.22 The Government of India does not invite or welcome unsolicited policy advice from donors, while the low level of aid dependence provides negligible leverage. The full range of technical expertise required is available within Government and within the wider Indian policy community, and there is little that outsiders can add beyond perhaps a greater familiarity with models that

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[50] Srinivassan, TN (2002), India: Development in the Near Term: Constraints and prospects
[51] IMF (2001), India, Recent economic developments and selected issues, IMF Country report 01/181

have worked elsewhere in the world. The OED Country Evaluation could find no examples where World Bank policy dialogue had resulted in policy change, and indeed there have been many periods when the Bank was reluctant to raise contentious policy issues for fear of damaging the relationship[52]. There have been some examples where Government has invited donors to contribute to the development and implementation of policies to which it was already committed, and Government does value access to the experience of other countries. Nevertheless, it is striking that GOI have themselves undertaken or commissioned good technical analysis of the policy issues that need to be confronted, while OED concluded that 'most World Bank reports appear to have little direct impact.' It is the political and governance constraints that prevent improved economic and structural policies.

2.23 With dialogue and policy analysis achieving little influence, donors are faced with the choice of continuing to provide support despite weak policy and institutional environments, seeking to focus their support on states and sectors that are reforming, or reducing support until reforms are implemented.

2.24 For much of the post independence period, the Bank continued to make loans that were inconsistent with their own policy advice. The Bank saw resource transfer as the key goal in the 1980s, and supported public sector heavy industry, unsound credit institutions, and loss-making state electricity boards. Dialogue focused on project level issues, but covenants on issues such as electricity pricing were often not carried out. The 1995 CAS said that World Bank lending would be reduced if the fiscal deficit was not reduced, but no such downward adjustment in commitments was made until forced by the sanctions introduced as a consequence of nuclear tests.

2.25 More recent policy in the Bank and some other donors has been to be more selective, focusing resources on reforming states and sectors with reasonable policy environments. The World Bank has given particular stress to state level structural adjustment and policy support to reduce fiscal deficits, and to reducing the fiscal burden and improving the efficiency of state electricity boards. At State level, there is more positive evidence of a role for policy dialogue, and the federal Government appears to welcome World Bank involvement at that level in helping it to achieve more responsible policies within the states, which account for nearly half of the overall fiscal deficit (Box 1). There have been some modest gains, but there is no evidence of significant progress in reducing the fiscal deficits:

Table 6: Consolidated Fiscal Deficit as % GSDP: World Bank Focus States

State	1998-9	1999-00	2000-01	2001-02
Andhra Pradesh	6.7	5.7	6.0	5.7
Karnataka	4.7	6.6	6.7	5.9
Uttar Pradesh	8.0	6.6	6.1	7.1
Unweighted Average	6.5	6.3	6.3	6.2

[52] World Bank OED, Winter 2002, India: Improving the development Effectiveness of assistance

2.26 The hoped for improved impact of a new approach to supporting power sector reform at State level has also yet to achieve significant results. The approach, introduced in 1993, makes lending conditional on SEBs agreeing to adopt restructuring, including unbundling generation, transmission and distribution, privatising all distribution and new generation, introducing an independent regulatory authority. The new generation of state level power projects were introduced in Orissa (with DFID), Haryana, AP, and UP. The OED country evaluation described them as 'best practice'- possibly a good example of the perils of leaping too early to judgement. Andhra Pradesh made a promising start, introducing stiff penalties for non-payment, introducing commercial entities for transmission and distribution, and establishing a 3 year record of state Government not interfering in tariff decisions. Operating losses halved in the first half of FY02, but then ballooned again as a consequence of the growing burden of power subsidies to farmers and some other groups, resulting in little net improvement in the bottom line. Orissa also faces problems, with private sector power generator AES having shut a power generator for non-payment. Financial rates of return in the power sector in India have worsened from -13% in 1991 to -41% in 1999-2000[53]. If political commitment to power subsidies cannot be challenged, a way needs to be found to transfer the costs to Government rather than the utilities[54].

Box 1: Examples of Policy Dialogue and Analytical Support

1. UP Fiscal Crisis: State Government requested World bank support in analysis of the fiscal problems. Bank and State Govt officials worked on the report jointly. State politicians were involved to test the political feasibility of recommendations.
2. The Jomtiem 1990 conference highlighted that Indian achievements were lagging, and led to GOI preparation of a report on primary education that drew heavily on research and contacts with Bank and other staff, including Indian staff shadowing Bank experts. This report, 'India Primary education: Achievement and Challenges' has guided policy and implementation plans since then. The subsequent 1st Bank education project was prepared by Government but working closely with the Bank to obtain advice on what should be covered and how Bank concerns could be addressed[55].

Aid and Public Expenditure Management

2.27 The hands off approach of the Government places limitations on the effectiveness of **monitoring and evaluation**, which is particularly criticised in the OED Country Evaluation of World Bank support. The district basic education project is in many ways a model of effective monitoring. It involves collaborative joint twice yearly monitoring between the 6 donors and Government, with a well specified set of indicators and a complex but effective approach to field supervision. However, there are questions. Although the programme has built in some independent verification of administratively collected data, there have been questions on whether staff have yielded to the temptation to exaggerate their enrolments in order to

[53] IMF, selected issues
[54] WB CAS, Jan 2003
[55] World Bank OED, Overview of Sectoral Assistance Evaluations, Education chapter.

benefit from various incentives. Supervision visits have to be announced in advance, giving time for schools to prepare, while donor members usually lack local languages and cannot follow lessons. The joint nature of monitoring means that supervision reports are to some extent negotiated, and may be less frank. On the positive side, the approach limits transactions costs to Govt and donors, but ensures that there is a channel for regular feedback on what the programme is achieving.

Impact of Aid

2.28 Aid can claim to have had a significant role in some remarkable achievements in India: -

- Though not uncontroversial, aid had a major role in driving the green revolution that raised grain production from 12 million tons in 1965 to 20 million tons by 1970. By 1990, 70% of food grain production was from HYVs, irrigation coverage had doubled since 1956.The Rockefeller and Ford foundations supported the initial research by the Indian Council for Agricultural Research, while USAID and World Bank supported the commercialisation of new seeds and the investments in irrigation and extension. There are questions over the longer-term environmental costs and the distribution of benefits, but much of the poverty reduction in the 1960s came from the application of the seeds-irrigation-fertilizer technology. The approach lost steam in the 1990s because public investment in maintaining the quality of irrigation infrastructure fell, and development of new varieties slowed down.[56]
- The Green Revolution had limited impact on rainfed agriculture but, since 1990, the ‘watershed approach’ to rainfed agriculture has been introduced in 25 states with WB and donor support, and has achieved significant improvements in the yields of pulses, cereals and jute.
- Operation Flood, though also controversial, produced solid and sustainable benefits for ?how many? small and poor milk producers through dairy cooperatives that helped them market their milk in urban areas. OED argued the increases achieved in milk production were comparable to green revolution increases in food grains, while the distribution of benefits was more pro-poor. Though dependent on subsidies and on a degree of protection from imports, OED argue that the programme may have been a more effective way to deliver benefits to the poor than alternative transfers, while the impact on incomes rivalled that from green revolution technology in irrigated areas.
- WB UP sodic lands reclamation projects achieved 50% increase in family incomes for 22,000 mainly poor households, though sustainability may be an issue with limited recovery of operation and maintenance costs[57].
- The district primary education project achieved significant benefits for 50 million schoolchildren. Although foreign funding has been only 4% of total spending on basic education, it has been catalytic. The District primary education project has developed a joint approach to monitoring

[56] Pellekhaan, Jack van Holst, in OED op cit
[57] OED, op cit.

and supervision between the GOI and the 6 donors supporting the programme. Lessons learned have been incorporated in the national education for all programme.
- DFID supported slum improvement projects had a substantial positive impact on living conditions of 1.4m slum dwellers in 3 eastern states over 9 years, with major improvements in environmental conditions, access to water and electricity, and increased economic activity- though there are questions regarding sustainability given inadequate municipal resources for maintenance[58].

Table 7: Improvements in Primary Education

	UP Basic Education project, change 1991-2000	District Primary education Project, change 1996-2000
Girls enrolment	+97%	+39%
Boys enrolment	+51.5%	+10%
Total enrolment	+67.5%	+21%
Gross enrolment rate	66% 1991, 107% 2000	
Scheduled caste girls enrolment		+44%
Quality and efficiency	Efficiency improved: Dropouts reduced, textbooks available and used, teachers in post including para-teachers locally recruited to overcome long-standing gaps. Impact on attainment is less clear, but has at least been maintained while enrolments increased: some evidence of improved test results in Grade 1, less so in Grade 3-4, maths and language skills at G5 no different from baseline[59].	

2.29 But the overall impact of aid has been modest, with sustainability compromised by weaknesses in the policy environment: -

- Transport investments have been ineffective due to failure to maintain highways adequately, while railways subsidise passengers but impose high costs on freight, and ports have long turnaround times and high costs;
- Power sector investments have not prevented unreliable supply and high financial losses (now 1.5% of GDP)[60], with privatisation hindered and made ineffectual by continued subsidisation of rural power use and Government interference in pricing decisions;
- Irrigation schemes have under performed due to low cost recovery leading to wasteful use, poor maintenance, and consequential low benefits. Failure to maintain irrigation infrastructure (in which the donor community invested massively in the 1970s and 1980s) is one factor risking the sustainability of the gains of the green revolution.

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58 DFID CSP, and DFID Evaluation Summary 475, Hyderabad Slum Improvement project,
59 Abadzi, Helen (2002), India: Education Sector development in the 1990s,India Country Assistance Evaluation, WB OED.
60 WB CAS Jan 03

- Despite 25 years of WB assistance to urban water, no Indian city can provide safe water for more than a few hours per day, most agencies are in financial difficulty and offer inadequate services[61].
- Agricultural development is impeded by the overhang of grain stocks, by the over-valued exchange rate implicit in high levels of trade protection, by widespread movement and marketing controls, by canalisation of input supplies through inefficient state trading agencies, and through the distortions caused by subsidised water and fertilizer, while rainfed agriculture has received too little research and support.
- Health and education spending receive too little money due to other pressures, and too little is focused on primary services. Some 80% of health services are delivered by private providers, used by poor as well as rich due to quality problems in the public sector. Programmes such as the DFID Orissa Health and Family Welfare project have been criticised for focusing exclusively on state sector providers, with excessive focus on infrastructure and equipment due to difficulties in addressing institutional constraints. Recent re-orientation is welcomed, but with questions as to why it took 15 years before 'basic design faults were addressed.'[62]
- DFID's Country Strategy Paper concludes that projects achieved good local impacts, but were not linked to policy and institutional reform and were not scaled up.

2.30 The World Bank country evaluation study found that less than half of World Bank lending operations were rated satisfactory at entry in the 1985-89 period. Satisfaction ratings on completion have been around 70-73% since the 1980s, somewhat lower than regional averages. Projects at risk increased from 15-20% in the mid 1990s to reach 25% by 2000, though they have since been reduced to 6% as a result of attention to portfolio management. Implementation has also improved with a steady rise in the disbursement ratio from 14% in 1996 to 20-21% in 2001-2002.
Only two thirds of World Bank projects were judged by OED to be sustainable in 1996-2000, reflecting weaknesses in the policy environment and the reliance on parallel Project Implementation Units with little attention to building sustainable institutions within Government[63]. Of projects for which an ex post rate of return could be calculated, 25% achieved rates of return less than the 10% required rate, with projects in water, agriculture, financial sector, power, and the environment achieving the worst results.

2.31 The Bank have sought to address the problems by: -

- Within non-reform states, dialogue, analytical work, demonstration projects, only scale up to sectors when there is evidence of ownership and reforms have started;

[61] OED India country assistance evaluation, working paper 16, overview of sectoral assistance evaluations.
[62] Van Diesen, Arthur, Quality of British Aid to India.
[63] OED country evaluation op cit says only 16 of 100 evaluated WB projects had an institutional focus, and even those defined it narrowly.

- Risks limited by using Adaptable Programme Loans where the future pace of reforms is uncertain, enabling the Bank to adjust disbursement to progress achieved;
- Support structural adjustment at State level through a series of single tranche operations recognising prior reform actions, to avoid the complications and sensitivities of 'buying promises;'
- In the infrastructure sectors, support increased private sector participation; Single tranches focusing support on reforming sectors and on focus states, chosen because of apparent willingness to reform. This may be at the expense of poverty focus: high poverty states had 66% of the poor but received only 53% of World bank commitments in 1998.

2.32 DFID argues that aid to India contributes mainly through influence on the way that policies are implemented. Adrian Wood suggests that the influence is more at the nuts and bolts level (how to, e.g. consultancy support to Andhra Pradesh on privatisation) rather than any influence on the choice or even the sequencing of policy reforms. Innovative projects financed with aid have also scored some successes in piloting approaches that were subsequently scaled up by federal or state Government (Box 2).

Box 2: Scaling Up of Aid-Supported Innovation: Examples from India

The added value of aid in India lies in supporting innovation and introducing new approaches to development issues as much as in additional resources. These benefits are frequently cited by officials in central and state governments. They arise in some cases from exposure to international practice and experience; in others from making available discretionary resources which can be used to finance experimental programmes which would not necessarily receive funding from the government budget; donor attention to and support for monitoring, evaluation and dissemination are also significant. There are numerous examples of such interventions being scaled up or generating valuable lessons which have informed policy development. Some of these are as follows:

Universalising Elementary Education: in 2002 India amended the Constitution to make eight years of elementary education a fundamental right, and initiated through the current (tenth) five year plan an ambitious programme (the *Sarva Shiksha Abhiyan*) to achieve this by 2010. This present policy and programme environment has evolved in large part out of the long term relationship between the Government of India (GoI) and external agencies (World Bank, DFID, EC, Netherlands and UNICEF) through the District Primary Education Programme (DPEP). This support has contributed to both the steadily increasing demand for policy change, through raising public expectation for education, as well as the capacity for service expansion and improved delivery.

The gradual extension or up-scaling of a successful "project" model into a fully national "programme" points to aid effectively influencing both policy and practice. Salient features of DPEP that have influenced policy and service delivery have been a specific focus on girls, the targeting of socially and geographically disadvantaged groups and areas, information based planning, programme flexibility and responsiveness through rigorous evaluation and review, and the adoption of a broader, sectoral approach.

Power Sector Reforms: DFID and the World Bank began supporting power sector reforms in Orissa in 1996. The pioneering reforms adopted in that state – corporatisation and unbundling of the integrated state-owned electricity board, followed by privatisation and establishment of an independent regulator – are now being pursued by many states, with the encouragement of and incentives from GoI. Lessons from Orissa's experience – such as the need to avoid overburdening new entities with past liabilities, and the need for transitional support until the sector reaches full commercial viability – have been internalised and incorporated in official GoI reports on power sector reform.

Also in Orissa, a DFID-funded project on community electricity supply has successfully demonstrated that innovative social and financial engineering can substantially help to improve the coverage, quality and commercial viability of rural electricity supply through decentralisation, community participation and franchising of commercial functions. This model is now being promoted by GoI and replicated by electricity distribution entities in several states as well as other regions of Orissa.

Rural Water Supply and Sanitation: over the past decade, the World Bank has assisted three different state governments in implementing rural water supply and sanitation (RWSS) pilot projects. These made impressive progress in successively developing and implementing innovative strategies to improve the sector's performance. In 1998, with the Bank's support, GoI developed a national sector strategy for RWSS that was widely discussed with the states and the donor community. This strategy was significantly influenced by the success of the Bank-financed projects. GoI is now committed to institutionalising a demand-driven, community-based approach to RWSS across the country, and central resource transfers for the sector are linked to uptake of these reforms.

Urban Infrastructure: since 1994, USAID has been supporting the development of an infrastructure finance system and improved delivery of urban environmental infrastructure services (water and sanitation) through the Financial Institutions Reform and Expansion (FIRE) project. The project has achieved significant results in creating an enabling environment for improved urban service delivery. There is now wide acceptance of the concept of commercial viability in respect of such services, an improved policy framework, a structure for municipalities to access domestic capital markets through municipal bonds, accounting reforms, and sharing of lessons learned from pilot innovations. The project has made progress in reaching benchmarks and addressing critical issues at the national, state and local levels.

Sources: DFID staff; World Bank Country Assistance Strategy; USAID

3. Absorptive Capacity & potential impact of Increased Aid

3.1 Absorptive capacity is not a constraint on expanding aid to India, given the small relative size of aid flows. The fundamental question is: why increase aid to India when Government could perhaps achieve Chinese rates of progress in poverty reduction if it would address the fundamental policy problems? Why provide increased external assistance when a large part of domestic revenue is wasted on unproductive spending? Why use scarce concessional aid in a country that could get increased access to private capital- though this last argument is weakened to the extent that the domestic debt issue should imply a cautious attitude to increasing Government borrowing.

3.2 The main response to these arguments is that the constraints on reform are no less real for being political in nature- as the Europe of the CAP should recognise. Reforms have not been reversed, but they have slowed with weaker coalition Governments since the mid 1990s. The world should value Indian democracy, but recognise the constraints it places on the speed at which reforms can be undertaken. Notwithstanding the serious weaknesses in the policy environment, the record of India in sustaining economic growth and poverty reduction over a long period is a creditable one.

3.3 There are some areas where committed policy reform will be essential before aid can achieve sustained benefits, as review of past results confirms. But the needs are enormous, and a very substantial and fast increase in disbursements would be both feasible and merited in sectors or states where real benefits are already being achieved and can be expanded. Of course, fungibility is likely given the trivial share of Government spending accounted for by aid, and there is some (controversial) analysis to suggest that donor support to focal State Governments may not have been additional[64].

3.4 One way to avoid the fungibility problem is to focus a large increase on one major spending programme that Government is committed to devote more resources to, but which it is constrained from fully realising from own resources because of the problem of the fiscal deficit. Primary education is one example, and is also a sector where there is a good degree of policy consensus. GOI wishes to raise Government spending by 2% of GDP to finance an ambitious national education for all programme, based on earlier Government and donor experience through the district education project. It will be difficult to fully achieve this while also struggling to reduce the budget deficit, but commitment is strong, and Government may well be willing to enter a partnership agreement in which both GOI and donors were explicit as to the resources they would devote. A quadrupling of aid flows entirely focused on primary education would only provide half of the required additional finance, and would only raise the donor share in primary education spending from 4% at present to a little more than a quarter of the total. The impact, however, would be to put far more children in school than equivalent spending in higher-cost sub Saharan Africa- provided the GOI carried out its commitments to increase state spending alongside the donor contribution. This is merely an illustration, and Government has in the past been sensitive about reliance on donor contributions in such a politically sensitive sector, but the principle is sound.

3.4 The argument that aid to India is justified primarily by influence on the way that policy is implemented may therefore be at one level too flattering to the donors regarding the feasibility or even the desirability of them having increased 'influence', and at another level too pessimistic about the scope for well directed financing to have a real impact on the proximate target for which it was provided.

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The case for Increased Aid: Pakistan Case Study

Summary and Conclusion

Pakistan has sustained positive per capita growth since independence, but poverty remains relatively high, and human development deplorably low, given the per capita income. Low spending on social services, a pronounced bias against agriculture, and chronic problems of excessive Government deficits and weak macro-economic management have been recurring features through frequent changes in Government and in policy direction. The other constant has been fundamental Governance issues associated with a highly unequal society in which national and local male elites dominate and distort political, economic, administrative and legal systems to their own advantage. The entrenched position of the elites has made it difficult to implement public expenditure programmes benefiting the poor and vulnerable. Decentralisation of management to elected local Government is planned and might help, though it will be difficult for representatives of disadvantaged groups to resist elite domination.

Politically motivated, abrupt changes in aid flows to Pakistan have had significant economic consequences, both negative (suspension of aid after nuclear test) and positive (current aid bonanza, which is helping to pull Pakistan out of an unsustainable debt problem). Aid remains significant for Pakistan, both as a source of finance, and (via the IMF and World Bank) as a means to signal to investors and creditors that credible policies are being pursued. Government recognises that it needs the donor endorsement, and has participated willingly in policy dialogue. The extent of the debt crisis has enabled Government to pursue a more rigorous reform process than might otherwise have proved politically feasible. One irony of the increased aid flows is that, to the extent that the macroeconomic problems have eased with increased aid, it may prove more difficult to persuade Parliament to support radical reform.

Though the military Government adopted a disciplined approach to stabilisation and reform, it is unclear whether this will survive a return to parliamentary Government. The small majority provides a weak foundation for challenging vested interests.

The current national Government is trying to do broadly the right things for poverty reduction (though social spending has yet to increase), and deserves support so long as the reform programme remains on track. There is a case for enabling Government to increase spending on social services faster, by reducing the debt problem- provided the additional resources are indeed focused on social spending, and provided the Government continues to seek ways to ensure the additional spending translates into improved services.

The Government poverty strategy, and the analytical work by the donors, is somewhat unconvincing in developing ideas on how the effectiveness of public spending can be increased and the benefits focused more towards the poor. In achieving poverty reduction and improved human development,

institutional mechanisms to empower the disadvantaged will be more important than technical solutions. What will work remains unclear, though there are some pointers from successful programmes. Close attention to monitoring and evaluation, to piloting and then expanding successful innovations, are needed. This needs to be done in the context of overall improvements in budgeting and public expenditure management that are currently in train with donor support. The approach to devolution needs particular attention to ensure that the impact on service delivery and on misuse of resources is monitored. An increased role for the private and NGO sector in service delivery would be appropriate.

In conclusion, there would be real benefits from successful action to improve access to primary education, improved health services, safe water and improved nutrition, and bringing those benefits to a generation currently denied adequate education and a healthy start in life will be worthwhile even if they can not, ultimately, be sustained for the next cohort. The fiduciary risks, and the risks of poor outcomes, are high, but the prospects for success at present are higher than for some time.

1.Aid Trends

Aid Since 1960

1.1 Aid to Pakistan has been declining in relative importance since the 1960s (Table 1), but with periods of great volatility, mainly for reasons connected to global politics.

Table 1: Aid as % of GDP, 1961-2000

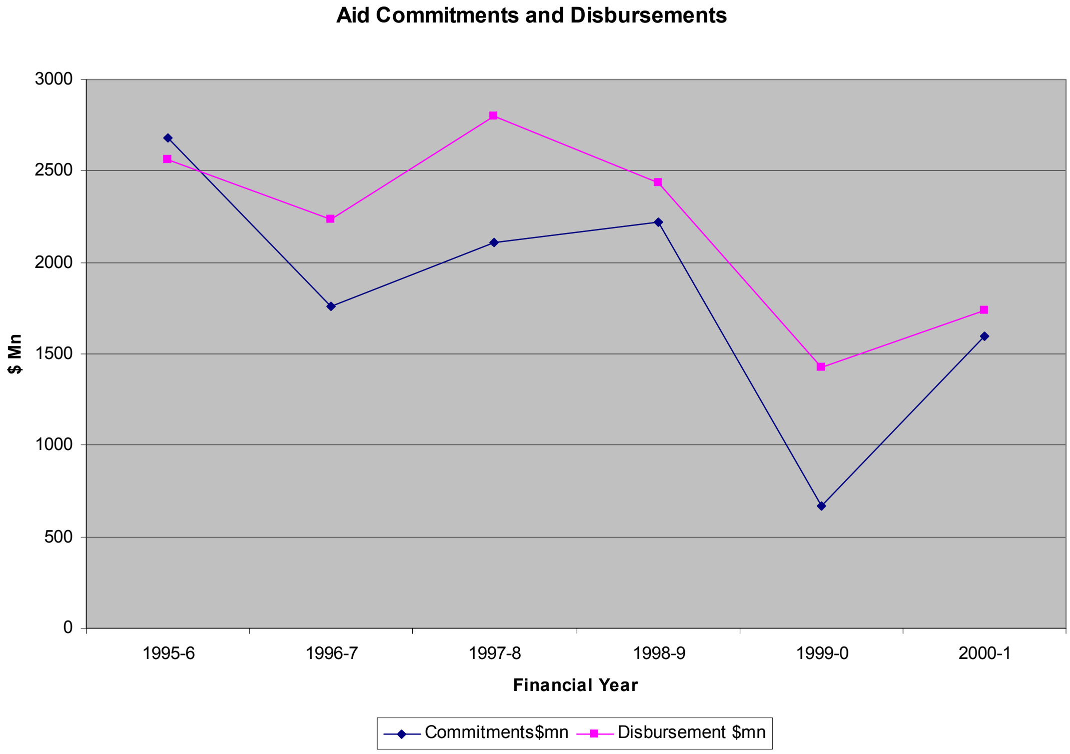
Years	1961-65	1966-70	1971-75	1976-80	1981-5	1986-90	1991-5	1996-00
% GDP	6.5	5.0	3.8	4.6	2.3	2.8	2.2	1.8
Comment			Populist socialism			Support connected to Afghan conflict	End of Soviet Afghanistan conflict	Sanctions after 1998 nuclear tests

Source: Mahmood Hasan Khan

1.2 The roller coaster nature of aid to Pakistan is exemplified by three episodes: -

- Aid was reduced in the early 1980s in the light of rapid economic growth and large remittance flows, but was sharply increased in the mid 1980s in recognition of Pakistan’s role in supporting the war to end Soviet occupation of Afghanistan. This additional support ended abruptly with Soviet withdrawal in 1990, yet Pakistan continued to have a large burden of Afghan refugees.
- Nuclear testing in 1998 resulted in a sharp decline in commitments. Lifting of sanctions resulted in a bounce back in aid commitments (Chart, and Table 2).

- Support against the Tailbone and Al Quid has resulted in a further increase in commitments of aid and in debt relief, enabling Pakistan to put together a fully financed PRGF programme with the IMF despite a very difficult debt situation.



Source; Asian Development Bank

1.3 The major donors are AsDB, WB, USA and Japan, who together account for two thirds of commitments (1996-2001)[65]

Aid prospects

1.4 In the short term, the level of aid to Pakistan probably depends more on political than development considerations. President Bush has announced that he is seeking an additional $3bn for Pakistan, split between civil and military aid. This increased largesse could again evaporate quickly if political constraints prevent Pakistan continuing to cooperate with US objectives, or if the US decides that it no longer needs Pakistani support. However, Pakistan has taken the opportunity of increased aid and debt relief to reduce reliance on expensive forms of external capital (e.g. early repayment of USDA loans), so the aid boost will have achieved real benefits even if it is not sustained.

1.5 In the medium term, access to ODA will depend on commitment to develop and implement a sound PRSP that stabilises the economy, restores growth, and reduces both poverty and especially the 'social gap' in relation to very low human development for the level of income. Pakistan has so far only produced an interim PRSP: costing the financial requirements for achieving

[65] ADB,2002

the MDGs and full development of financing scenarios will await the full version under preparation.

Table 2, Aid to Pakistan, US$Mn

	1995	1996	1997	1998	1999	2000	2001
Net ODA, US$ mn			596	1053	733	703	1938
ODA/Head, US $			4.64	8.00	5.44	5.09	13.70
% of GDP			0.95	1.69	1.25	1.16	3.30
GDP Growth			1.01	2.55	3.66	4.24	2.74

Sources: World Bank, WDI on-line database;

2. Aid Effectiveness

Stylised Economic History

2.1 The early years to 1958 were characterised by fairly ad hoc responses to internal and external crisis. Domestic industry was protected through import controls and licensing, at the cost of poor incentives for the agricultural sector, public expenditure favoured defence and infrastructure while little was spent on education and health, a neglect that has been a persistent factor in economic policy. Growth was a sluggish 3.5% per annum.

2.2 The military rule period 1959-71 saw higher growth (6.6% 1961-71) based on green revolution technology in agriculture (despite low prices to keep urban food cheap) and private sector investment in highly protected import-substituting industry. Aid increased to 7% of GDP by 1965. Investment in social sectors remained low.

2.3 The period of populist economic Government from 1972-77 saw growth slow to 5% per annum, mainly led by expenditures on defence and public administration, and growing macro-economic instability. Basic industries were nationalised. Public expenditure grew, financed by heavy Government borrowing, though the quality of spending fell as a result of poorly performing public enterprises and labour union wage pressures. Private capital fled though offset by growing remittances from workers in the Middle East. The economy was also hit by extreme weather conditions.

2.4 Military Government from 1977-88 began to reduce control and regulation of the economy and improved incentives for the private sector, with structural adjustment support from the IMF and World Bank. Remittances grew to $3bn per annum, equal to 10% of GDP, and aid grew in response to Pakistan's support to the effort to eject the USSR from Afghanistan, enabling needed but difficult reforms to be postponed. It was a period of crony capitalism, with favoured private sector firms earning huge rents from import licences, while financial institutions were weakened as loans were provided for non-commercial reasons. Corruption and uncompetitive industries were the consequence. Further problems were imported as a consequence of the Afghan situation, which brought 2-3 million refugees as well as the security problems associated with illicit guns and drugs. Poverty and inequality fell with strong growth, but Government did not address the inadequate physical and social infrastructure, while the budget deficit grew to 8.5% of GDP.

2.5 The period from 1988-October 1999 saw political instability with frequent Government changes, while poverty increased from the mid 1990s as growth slowed. Three attempts were made to stabilise the economy with IMF support, but programmes were not implemented due to frequent changes of Government and lack of political consensus. The position of the poor worsened because of the instability of economic growth with few safety nets available. Remittances from the Middle East declined, the US withdrew aid after 1990, unrest in Sindh continued to the 1990s, floods and droughts hit the economy in three years. The nuclear test in 1998 prompted a sharp reduction in aid commitments and disbursements, and prompted a financial crisis. Government froze foreign currency accounts and imposed capital controls, with the predictable result of capital flight and plummeting foreign investment. The budget deficit continued to average 7% of GDP, and debt reached unsustainable levels, with debt service in 1998 accounting for 67% of Government revenue.

2.6 Since the coup in October 1999, the military Government has steadfastly implemented an IMF programme to begin to stabilise the macro-economy, and has begun to implement wide ranging reforms. The fiscal deficit was reduced to 5.2% of GDP in 2000-01, the lowest level in 23 years.[66] Debt was rescheduled by the Paris Club in December 2001. The programme remains on track, the most recent review reported domestic revenues on track, remittances exports and external support over-performed, and foreign exchange reserves have been rebuilt to 7 months of imports. Not surprisingly, investment has yet to revive: it fell from over 20% in 1992-3 to 14% of GDP in 2000-01. From October 2002?1, the Government has had to Govern via an elected Parliament in which it has a small majority, which may constrain freedom to implement reforms that confront many vested interests.

Progress in Poverty reduction and the MDGs

2.7 Pakistan has sustained positive growth in per capita income since independence, but growth has been below potential, and Pakistan has performed poorly in translating such growth as did occur into poverty reduction and improvements in human welfare. Growth has been held back by political and policy instability, unstable macroeconomic management, low levels of savings and investment, low expenditure on health and education and on physical infrastructure, and an over-regulated and distorted economy. High levels of protection have resulted in a severe anti-export and anti-agriculture bias. Traditionally, agriculture ‘was used to transfer surplus to the industrial sector by under-pricing agricultural production’[67]. The bias against agriculture and low spending on health and education has not only reduced economic growth but has limited the impact of growth on poverty. Elite groups

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[66] ADB,2002
[67] GOP, Interim PRSP, Nov 2001.

have dominated successive Governments, ensuring that policies and budgets support their own interests, and frustrating efforts at poverty reduction.

Table 3: Annual real GDP Growth Rates in Pakistan

1961-70	1971-80	1981-90	1991-95	1996-00	1991-00
7.2	4.7	6.3	4.8	2.9	4.0

Source: Khan, 2002

2.8 Headcount poverty fell in the 1980s, GDP growth of 6% per annum reducing it from nearly half of the population (46% in 1984-5 earliest household survey) to 34% by 1990. Poverty fell further to 29% by 1993-4, but the 1990s as a whole proved to be a lost decade, with poverty increasing as growth slowed to just 2.9% p.a. in 1996-00, and poverty registered little change in headcount or severity over the decade as a whole. The Government poverty targets are predicated on growth recovering to 5.2% p.a. by 2003-4.

2.9 Government spending on primary education disproportionately benefits the poor in Pakistan, but has been held back by low spending, low demand (especially for girls education), and problems of delivery. Spending is below regional levels, and dominated by teacher salaries (97% of spending in 1997-98). Children enter school late, and 41% drop out by age 13. Quality is poor, and increasing numbers of parents are relying on the private sector, which accounts now for 17% of primary enrolments. Financial returns to primary education are high in urban areas (42% higher earnings), but much lower in rural areas, with no impact on agricultural earnings, though a significant increase in the probability and level of non-farm earnings[68].

2.10 Progress has been made recently in reducing infant mortality albeit from very high levels, and Pakistan still has higher rates than would be expected given its income level. Overall, achieving any of the targets would require a step change in performance compared with the 1990s.

Table 4: Progress towards the Millennium Development Goals

Target	Units	1990	1999 Actual	2004 Target	2011 Target	Comment
Halve from 1990-2015 the % of population living on less than $1/day	% below national (international $1/day) pov. line	34.0% (47.8)	32.6% (31%)[69] (1996)	25.0% (-)	15.0% (-)	
Enrol all children in primary education by 2015	Gross primary Enrolment (No NPE target)	GPE 73%	GPE 71%	GPE100%	GPE 104%	Demand and supply side problems.

[68] IMF Selected issues.
[69] This figure comes from ADB (2002), though seems implausible. The Pakistan poverty line is probably a better indicator of trends.

Target	Units	1990	1999 Actual	2004 Target	2011 Target	Comment
Eliminate gender disparities in primary & secondary enrolments by 2005, & at all levels by 2015	Ratio of girls to boys in primary and secondary school (%)	69	75	75	94	Improvement partly declining boys enrolment
Reduce infant and child mortality rates by 2/3 1990-2015	IMR (under 1)\1000 CMR (1-5)\1000	127 -	90 20	65 17	55 -	
Reduce maternal mortality by ¾ 1990-2015	MMR\100,000	-	400	300	180	
Halt by 2015 & begin to reverse spread of HIV/AIDS, malaria, other major diseases	Contraceptive prevalence rate	14	17	39	53	HIV low but high risk, CPR mainly permanent methods.
Integrate principles of sustainable development into country policies, reverse loss of env. Resources halve % without sustainable access to safe drinking water.	% Of population with access to improved water source.	-	63	68	84	

Source: ADB. Poverty figures from World Bank, Poverty Assessment, Oct 2002.

The Policy Environment

2.11 Government policy is set out in the 2001-2011 perspective plan, as well as in the interim PRSP. The focus is on reducing poverty and increasing employment opportunities through private sector growth, requiring attention to improving the competitive environment. Space for increased private savings and investment will be created by reducing Government borrowing, while focusing public spending on physical and social assets, and on safety nets. Some emphasis is given to empowerment, mainly through devolution to local Government.

Economic management

2.12 Under successive Governments, Pakistan has suffered from weak macro-economic and fiscal management leading to periodic crises. A range of serious shocks has compounded the difficulties of macro-economic management. Regional political instability prompted high defence spending, brought major problems in dealing with 3 million refugees, exacerbated domestic security concerns as a consequence of a massive influx of guns and illicit drugs, and caused large politically motivated shocks to aid flows. Pakistan is also vulnerable to droughts and floods, and has suffered from the decline in migrant remittances and the fluctuations in oil prices. Managing this has been made difficult by frequent changes of Government while the relatively high debt burden has reduced room for manoeuvre. The military Government that took power in October 1999 has established a track record of beginning to deal with the macro problems, staying on track with the IMF, while the rewards of alliance with the USA have eased the debt service burden and ensured that the programme is fully financed. Nevertheless, sustainability is a risk with the return to a Parliamentary form of Government, and past history suggests that continuation of politically motivated aid flows cannot be guaranteed. Over the longer term, the successive changes in economic policy and in Government have discouraged private investment (less than 10% of GDP in the 1990s) and direct investment from abroad (less than 1% of GDP), both of which are below international comparators.

2.13 Pakistan has struggled with large budget deficits and mounting debt problems since the 1980s. Domestic revenues averaged 18% of GDP in the early 1990s, but fell to 16.1% in 1996, and have remained below 17% since. Subsidies were1.7% of GDP in 2002-03 instead of the programmed 0.5% largely confined to the power and water utilities and reflecting failure to pass through fuel price increases. Privatisation is planned, and meanwhile the financial burden should ease as new hydro capacity and new generation contracts reduce costs.

2.14 The fiscal problems of the 1990s have obliged Pakistan to reduce public expenditure as a share of GDP from 24% in 1995-6 to 20.8% planned in the 2003-4 IMF programme. Development spending, already low at 4.4% of GDP, has been cut further to 3.5% of GDP. The interest burden peaked at 7.8% of GDP in 1999-00, but has since been reduced as a result of debt relief to around 5%, and is projected to decline further. Defence spending was steadily reduced from 6.9% of GDP in 1995-6 to just over 3% in 2000-2001. Cooperation against Al Quid and tension with India subsequently saw it increase again to around 4% of GDP. The net effect of these changes has been to squeeze social sector spending, which has declined from the mid 1990s peak of 2.6% of GDP to 2.2% by 2000-01, with a modest recovery to 2.4% of GDP the following year.

Table 5: Public Expenditure as a Percentage of GDP

								Rev.Prog	Program
% GDP	1984-5	1989-90	1995-6	1996-7	1999-0	2000-1	2001-2	2002-3	2003-4
Total Expenditure	24.7	26	24	21.5	22.8	21.2	21.9	21.3	20.8

Table 5: Public Expenditure as a Percentage of GDP									
								Rev.Prog	Program
% GDP	1984-5	1989-90	1995-6	1996-7	1999-0	2000-1	2001-2	2002-3	2003-4
Development Exp.	7	6.6	4.4	3.2	3.1	2.7	3.3	3.3	3.5
Current Expenditure	17.7	19.4	19.6	18.3	19.7	18.5	18.6	18	17.3
Defence	6.7	6.9	5.5	5.1	4.8	3.1	4	3.8	3.6
Interest	3.5	5.5	6.1	6	7.8	6.9	6.6	5.3	4.8
Subsidies	1.1			0.5	0.5	0.6	0.6	0.8	1.5
Social Services	2.2	2.4	2.5	2.6	2.5	2.2	2.4		
Non interest recurrent	14.2	13.9	13.5	12.3	11.9	11.6	12	12.7	12.5
		Sources: WB Public Expenditure Review; IMF Statistical Appendix							

2.15 The IPRSP sees little scope for increasing spending on social sectors in the medium term (Table 6), which implies Pakistan will continue for the next few years to spend less on health and education than other countries (Table 7). To the extent that US security policy provides Pakistan with an aid bonanza, this cautious picture might be significantly changed. Nevertheless, the negative impact on investment and growth if conflicts against terrorist groups continue may outweigh any positive impact from aid and debt relief.

2.16 With donor support, an earlier attempt was made to close the gap in the 1990s through the Social Action Programme (Box 1). The growing debt service burden squeezed Government resources available for expenditure on the social sectors, and ultimately frustrated and reversed the increase in expenditure shares that the programme was intended to bring about.

Table6: Health and Education Spending as % of GDP, IPRSP Plans

	Actual 2000-01	Projected 2001-02	Projected 2002-3	Projected 2003-4
Education	1.6	1.7	1.7	1.8
Health	0.5	0.5	0.5	0.5

Source: Government of Pakistan, IPRSP, 2001

Box 1: The Social Action Programme

The social action programme involved coordinated donor finance for the social sectors, conditional on an increase in Government budget spending. The first phase (1993-97) focused on resource transfer and monitoring and evaluation, the second phase (1997-02) placed more emphasis on policy, governance and capacity building.

The resource objectives were not met; the increase of Government spending to 2.7% of GDP in the mid 1990s was not sustained (Table 5). The focus of spending was mainly on construction, but operating budgets are more of a constraint on improving service delivery, e.g. 97% of elementary education budget is teacher salaries, Q4 1999 survey found half of primary health facilities lacked 3 essential drugs[70]. The improved monitoring and evaluation supported by the programme revealed widespread failures in the system, with problems of elite capture, an emphasis on patronage over service delivery, and some facilities offering no services at all, e.g. 34 of 200 surveyed schools conducted no lessons.

Although some improvements were achieved in the health sector, little was achieved in education, the main sector of focus. The GER at primary level languished at 69% in 1998-9 compared to the SAP target of 88%, and Pakistan continued to have the lowest enrolments and largest gender gap in the South Asia region. ADB conclude that a radical change is needed in how services are managed with stronger roles for communities and for private providers.

Sources: ADB, WB Poverty Assessment, IMF Selected Issues.

Structural Policies

2.17 Structural conditions in the IMF programme focus on the budget: tax policy and administration, public expenditure management, as well as reform to reduce the financial burden of the power utilities, and to begin to privatise the banking sector. The financial sector is a concern, given the legacy of non-performing loans from the past, and banking reform including bank privatisation is a major focus of IMF and WB support. The World Bank has additionally focused on civil service reform and on improving social service delivery. They have also supported structural adjustment in two provinces, again with a focus on public expenditure management and delivery. ADB has focused on trade and export promotion and on the judicial reform. There has been significant trade liberalisation though there remain some areas of high protection, especially the domestic vehicle industry. Government is 'moving towards' market based pricing of agricultural produce[71].

2.18 The competitive environment for the private sector has improved since the early 1990s, with investment licensing abolished and most sectors opened to foreign investment, tariffs and non-tariff barriers reduced, most manufacturing SOEs and two Banks privatised. Private investment and growth initially increased in response, though the political instability and deterioration in law and order in the second half of the decade brought about a slowing of investment and growth and increase in poverty. The current Government has continued to liberalise the economy and has accompanied these policies with a commitment to macroeconomic stability. Privatisation has stalled recently as a consequence of lack of demand for buying assets in Pakistan given political and regional uncertainty. If reluctance to buy continues, this may prove a significant problem, since Government has been planning on privatisation receipts of more than $3bn over the period to 2003-04, 1.5-2.0% of GDP.

[70] IMF, Selected issues.
[71] IPRSP, op cit.

2.19Pakistan has major environmental problems (water logging and soil exhaustion, pollution, deforestation). Enforcement of environmental regulations is weak.

Social Inclusion/Equity

2.20 Poverty in Pakistan is 75% rural, and poverty is both deeper and more widespread in rural areas. Land ownership is very concentrated, with 50% of population landless, yet 40% of land area held in farms larger than 40 acres. Agricultural productivity is low, especially on larger farms. Share crop tenancy is widespread, lack of secure tenancy gives low incentives to conserve the soil. Serious water logging in Sindh and Punjab is a legacy of long-term irrigation with poor water management. There is scope to raise productivity, but unequal asset ownership and low skills means rapid growth is required before labour demand increases sufficiently to raise incomes of the growing numbers of landless.

2.21 Poverty incidence varies from 16% in urban Sindh to 42% in rural Punjab. Inequality increased in all four provinces in the latter 1990s, with urban income distribution more unequal than rural. The poor are disproportionately characterised by lower education, landlessness (70% of rural poor) and lack of other assets, less education, more children, an older household head, increased reliance on the informal sector. Poverty is higher among women, and Pakistan is 100 from 102 countries on an index of gender empowerment. Much poverty is transient, and the poor are likely to be those most exposed to environmental risks. Some 56% of the population are vulnerable to weather shocks, and 87% of the chronic poor are included in this group. Some 43% of the population are within 25% of the poverty line income, and risk moving in and out of poverty with the severe shocks to which Pakistan has been vulnerable[72]. The severity as well as the incidence of poverty has increased in the latter 1990s.

2.22 Pakistan has some of the worst social indicators in the world, with women faring especially badly in access to education and health services. Large landowners dominate in Sindh and the Punjab, tribal chiefs in the other two provinces. Though the situation is not monolithic, the rural elites have generally manipulated government spending, the legal and judicial system, and political patronage to their own advantage. Public expenditure has been more concerned with who gets the benefits from contracts and employment opportunities than with delivering services. Irrigation and other benefits have been monopolised by the influential, with the poor often having to pay more to receive less. There has been little interest in education or literacy, with particular hostility to education for women. Caste and ethnic exclusion remains a problem. Sectarian violence was a major problem in Sindh in the early 1990s.

2.23 The consequences are evident from a comparison of social indicators with averages for South Asia and for low-income countries.

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[72] World Bank, Pakistan Poverty Assessment, October 2002.

Table 7: Social Indicators Compared

Indicator	Pakistan	South Asia	Low Income
Income p.c. PPP	$1757	$2030	$1790
Population growth 96-99	2.5	1.9	2.0
MMR	400	368	
Under 5 mortality	120	89	107
Adult Literacy %			
Male 98	58	65	70
Female 98	29	41	51
Net Primary School Enrolment (99)	42	64	66
Public Spending	IPRSP Target 2003-4	Latest year	Latest year
Health (% GDP)	0.5	0.9	1.2
Education (% GNP)	1.8	3.1	3.3

Sources: - Expenditure data from IMF, 2003. Other data from ADB, 2003.

Public Sector management & Institutions

2.24 There is a need for major reforms to put in place incentives for national and local politicians, the civil service, local Government, police and judiciary to deliver effective services.

2.25 The devolution plan of March 2000 is regarded by Government and ADB as a fundamental reform. It will replace a centralised and control oriented central Government with a 3 tier local Government system. Elected Governments took power in August 2001 in 100 districts. Each district has 3 tehsils (population aprox 300,000), each of which has 20-30 union Governments (population 10000 or so). The local Governments were elected on a non-party basis through full adult suffrage. One third of seats are reserved for women, with other reservations for marginalised groups. Heads tend to be locally influential families, but 50% of councillors are 'peasants women or workers.' The big question is whether this nominal representation of the less advantaged will in practice be able to stand up to the elite, rather than being easily dominated and suborned to support elite interests. The precedents are not that encouraging.

2.26 Poverty focused services (health agriculture education water and natural resource management) have been devolved to district level and below. The Province role is now to 'support and supervise' rather than manage. Other checks and balances have been designed in the form of 'citizen community boards' and 'public safety commissions', with the aim of strengthening participation and local accountability.

2.27 Experience elsewhere suggests that it will take considerable time to work out how the new roles will operate in practice, and they are likely to meet resistance and experience confusion to begin with. Decentralisation is not an alternative to fundamental reforms in the incentives and management of public sector workers, though it may make a contribution if well managed.

2.28 Improving poor public sector financial management is one of Governments top priorities. A draft fiscal responsibility Law has been published, aiming to overcome previous problems of lack of political will by declaring targets to reduce public debt (to 60% of GDP by 2011). With World Bank and IMF support, the national accounting and audit systems are being modernised. The aim is to improve the accuracy, completeness and timeliness of intra year and year-end financial reporting at national, provincial and district level. Policy measures related to improving financial management are prior conditions for World Bank structural adjustment at national and provincial level. Accounting improvements are complemented by DFID support to improve the budget process, including introduction of a medium term budget framework to give more of a medium term perspective to budget decisions, while attempts are being made to require budget submissions from sectors to jointly consider capital and recurrent costs.

Impact of Shocks & Aid variability

2.29 Pakistan is highly exposed to shocks of many types, and they have often been compounded by shocks to aid flows. In 2000-2001, Pakistan was affected by the worst ever drought. This resulted in negative growth in agriculture for the second time in a decade, with value added shrinking by 2.5%, and the balance of payments suffering by $1bn. Including the impact of reduced water supplies on electricity generation and the consequent need for gas imports, Government estimates that the drought reduced GDP by 2.6%[73].

2.30 Politically motivated changes in aid flows have also had a significant impact on Pakistan. The sanctions imposed after the nuclear test in 1998 reduced disbursements by some $1bn the following year, equal to 1.6% of GDP, and was a major factor in reducing foreign exchange reserves by nearly $800mn, to less than one months imports, and prompting a financial crisis. Pakistan was still experiencing low foreign exchange reserves and sharply lower aid receipts when the drought hit in the following year, exacerbating the problems of managing the consequences.

Policy Dialogue

2.31 Aid forms a more significant share of the Pakistan economy than it does in India,
and has at times been extremely important as a source of finance, and as the gateway to debt rescheduling. The present Government needs the donors, and has been a willing partner in policy dialogue. There appears to be ownership of the reform programme, though it is as yet too early to be confident that the commitment shown since October 1999 can be maintained with a parliamentary style Government. ADB and World Bank both argue that their policy lending has been more successful than project lending. The most critical problems are not over policy at national level, but are concerned with how to get it executed through elite-dominated lower tiers of Government.

[73] GOP, IPRSP

3. Impact of Aid

3.1 In 1997-98, Pakistan ranked in the 25 worse performers for World Bank lending, with more than half of the portfolio of projects classified as ‘at risk.’ The proportion has since been reduced to 20%, partly the consequence of reviews of the portfolio, but mainly as a result of improved policies and management under the new Government. The Bank have also reduced their apparent risk through increased focus on policy based fast disbursing loans in which the policy actions are taken before the loan is released. Though this avoids the problems of delayed tranches, there are issues about sustainability and the likely future momentum of reform that are not captured by the ‘at risk’ criterion.

3.2 ADB review of their operations found that programme loans in support of Government reform efforts had performed satisfactorily, project and sector loans less well. Major constraints have been Governance problems related to the relations between the tiers of Government, together with capacity problems at sector level, and problems of patronage and lack of ownership at local level. Khan argues that the rural elite and Government officials were ‘the major participants, activists and beneficiaries’ of rural development programmes[74]. Evaluations show these programmes made some contribution to the improvement of physical infrastructure and provided some temporary employment on project works, but did so at high cost, with little lasting impact on the rural poor.

[74] Mahmood Hasan Khan, 2002

Box 2: Social Services: What are the problems, and what influences improvements? Ideas from the literature.

Patronage

Electorate does not believe politicians can improve services, so vote for prospect of personal gain, not easily changed. Empower the excluded (how?), encourage contested elections, devolution to community level, more transparency and financial accountability.

Education

Quality: Use private providers (already 17% of enrolment?) Pilot community management of schools, local recruitment?

Proximity: 42% girls enrolment where school in the community, 32% when have to travel, a bigger disincentive than being educated with boys.

Women teachers increase girls' enrolment (52% where all women, 22% where none).

Demand: needs national incentives to increase girls' enrolment, piloting paying families.

Health

Presence of a facility: - 31% of villages lack access, but IMR, CMR and women's health are better in those that have them.

Staff absenteeism and shortages a major problem, e.g. Q4 1999 survey found half of PHC facilities had no supplies of 3 essential drugs.[75].

Focus will be on preventive and disease control programmes, especially immunisation & child health, reproductive health, nutrition, TB, malaria, Hep B, HIV.

Expansion of successful 'lady health workers' scheme, which achieved significant improvements in utilisation and health outcomes.

Absorptive Capacity & potential impact of Increased Aid

3.3 There has been a sharp increase in aid flows and debt relief for Pakistan in 2001-2. The IMF programme does not envisage this being sustained, but the recent announcement by president Bush of an additional $3bn package for Pakistan would imply financing considerably greater than assumed in the IMF programme, and would permit higher spending and a more rapid reduction in the debt burden. The external debt service ratio has halved from 77% in 1998-9 to 36% in 2002-3, while interest payments are down to below 5% of GDP. If progress is sustained, the debt burden should reduce even faster than programmed, raising the prospects for a quicker acceleration of growth and for higher spending on social expenditures.

[75] IMF, selected issues.

Table 8 :Official Finance 2001/2-2003/4

	2001-2	Rev. Programme 2002-3	Projection 2003-4
% GDP			
Grants	2.46	1.50	1.09
Project lending	0.87	1.09	0.96
BOP support	1.45	1.17	1.24
Paris Club debt relief	1.99	1.34	0.00
Gross	6.77	5.11	3.30
Net	4.44	3.19	1.57

Source, IMF (2003), calculated from Table 2 & Table 7

3.4 The question of whether increased aid can be justified by development benefits is more difficult. The current national Government is trying to do broadly the right things for poverty reduction, and deserves support so long as the reform programme remains on track. Increased economic growth should translate into reduced income poverty, though it would do so more effectively if politically feasible means could be found to increase the access of the poor to physical and social capital. Micro credit, as proposed under the Khushali Bank initiative could be a good route- but Government involvement in micro credit institutions often compromises their financial sustainability. There is a case for enabling Government to increase spending on social services faster, by reducing the debt problem- provided the additional resources are indeed focused on social spending, and provided the Government continues to seek ways to ensure the additional spending translates into improved services. These are both big ifs. Neither central Government nor donors know how best to transform the way that rural society works to exclude the poor from many benefits. The problems experienced imply a need for improved monitoring. The Government has developed for the PRSP a comprehensive approach that will track expenditures, map them to outputs, and enable the movement of outcome indicators to be monitored[76].

3.5 In conclusion, there would be real benefits from successful action to improve access to primary education, improved health services, safe water and improved nutrition, and bringing those benefits to a generation currently denied adequate education and a healthy start in life will be worthwhile even if they can not, ultimately, be sustained for the next cohort. The fiduciary risks, and the risks of poor outcomes, are high, but the prospects for success at present are higher than for some time.

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Vietnam Country Case Study[77]

Summary
Vietnam remains a poor country despite unprecedented progress in poverty reduction and improvements in social welfare. Transition from a centrally planned and state owned economy has been cautious but continuous since 1986. There are concerns about the role of state owned enterprises, about problems of corruption and lack of transparency, and about sustainability linked to inadequate operations and maintenance spending and issues over pricing policy for public services. Nevertheless, the track record of converting public spending into real improvements in welfare is impressive. Aid is mainly in project form and accounts for nearly 20% of public spending, with little of it focused on poverty reduction. There is a strong case for increased aid flows, targeted to the problems of persistent poverty in the poorer regions, especially the central and northern uplands. Absorptive capacity has been a problem due to conflicts between GOV and donor procedures, and more flexible approaches would be needed to ensure rapidly increased commitments can be disbursed. The PRSC is a good vehicle for increased disbursement.

1. Aid trends

1.1 In the first decade after reunification in 1975, the Soviet Union was the main donor. Policies of central planning and collectivised agriculture achieved growth of less than 4%, while inflation surged to 500% by 1986. Vietnam then embarked on the transition to a market economy that saw growth surge to average 7.5% per annum in the 1990s. Vietnam also began to attract increasing aid from DAC donors and multilateral, especially after the US embargo was lifted in the early 1990s. ODA averaged 4.3% of GDP in the 1996-2000 period, growing to peak at 4.8% of a significantly higher GDP by 2000, equivalent to US $16 per head. Japan is by far the most important donor, accounting for more than half of total donor flows, followed by the World Bank and ADB who jointly account for around 27%. Other bilateral donors in total account for less than 20%. Some two thirds of ODA is on loan terms.

1.2 Official development assistance financed a rising share of public spending in the 1996-2000 period, increasing from 5% in 1996 to 18% in 2000, before falling sharply to 12% in 2001. It financed roughly half of public investment in 1996-2000, peaking at 62% of capital investment in 2000. Project aid dominates, accounting for 61% of aid flows. Technical assistance accounts for a further 21% of the flows. Programme aid accounted for 16% of aid flows in 2000.

Table 1: ODA to Vietnam

	1995	1996	1997	1998	1999	2000	2001
Grants,US$mn	153	150	175	172	130	136	150
Loans	358	148	384	539	787	1123	780
Total	511	298	559	711	917	1259	930
US$/Head	6.91	3.95	7.45	9.34	11.89	16.21	11.75

[77] I am grateful to Carrie Turk for comments on an earlier draft, and for Table 3. Errors of fact and interpretation are mine.

	1995	1996	1997	1998	1999	2000	2001
% of GDP	2.5	1.2	2.2	2.7	3.2	4.1	2.9
% of Public Expenditure	10	5	10	13	15	18	12

1.3 The Comprehensive Poverty Reduction and Growth Strategy (CPRGS) published in May 2002 is GOVs poverty reduction strategy paper, and provides the overall framework for cooperation between GOV and donor partners. The CPRGS assumes that aid will average $1.8bn over the 2001-2005 period, compared to an average $1.4bn in the 1996-2000 period as a whole. Recent aid disbursements have averaged only $1bn per annum in 1999-2001, and would need to double to $2bn per annum to make up the shortfall in the 2002-2005 period. If realised, these figures imply ODA financing 20% of public expenditure and 68% of public investment capital over the period.

2. Aid effectiveness

2.1 A DAC survey found that most donors view Vietnam as a promising environment in which aid can be effective, and believe that the quality of aid management is improving[78]. Nevertheless, there are areas of frustration and most respondents had specific suggestions for improving the efficiency and effectiveness of aid.

Progress in Poverty Reduction and MDGs

2.2 Vietnam has made spectacular progress in reducing poverty. The gains have been widespread, all regions and all groups have benefited albeit at different rates.

Table 2: Rapid Poverty reduction and welfare improvements

	1993	1998
% Households below $1 per day line	58%	37%
% below food poverty line	25%	15%
Net Primary Enrolment	86% (1990)	95% (2000)
Under 5 mortality	81/000 (1990)	42/000 (2000)
Access to safe water	26% (1990)	52% (2000)
Use of modern contraception by married couples	36% (1990)	60% (2000)
Maternal mortality per 100000	200 (1990, GOV est.)	100 (2000)
% underweight under 5 children	52% (1985)	34% (2000)

Source: UN Country Team, IDT/MDG Progress-Vietnam

2.3 The proportion of households below the poverty line fell from 58% in 1993 to 37% in 1998, while the proportion below the lower food poverty line fell from 25% to 15%. Other indicators of deprivation have also improved sharply

[78] Lister and Bartholemew, 2001.

and are remarkably good for a country that still has a per capita income of just $410 on WB Atlas methodology. Net primary enrolments are over 90% for boys and girls; lower secondary enrolments have doubled to reach over 60%, with a rapidly reducing gender gap. Under five mortality has halved to a level characteristic of countries with far higher incomes per head. The proportion of the population lacking access to safe water has been reduced from three quarters in 1990 to less than half in 2000. These improvements are reflected in reduced malnutrition. Stunting remains high by international standards but fell from over half to one third of under 5 year olds between 1985-2000.The proportion of married couples using safe and reliable contraceptive methods has increased from 37% in 1993 to over 60% by 1998. Official figures suggest that maternal mortality has halved from 200 to 100 per 100,000 births. Although donors may question the 1990 baseline, there is no dispute that significant gains have been achieved.

The Policy Environment

2.4 These remarkable achievements have been the consequence of a home-grown reform effort, with aid playing a supportive but secondary role.

Economic Management

2.5 Macro-economic and fiscal management have been sound. Inflation has come down from 17% in 1995 to below 5% since the late 1990s. The balance of payments current account has been in surplus since 1999, foreign exchange reserves have increased though still account for only two months of imports. Rescheduling of non-convertible Russian debt in 2000 eliminated debt arrears, and the debt service ratio is a manageable 11%.

2.6 Budgets have been realistic, revenue: GDP targets were met in the 1996-2000 period, and public investment reached 98% of the Plan level. ODA disbursements reached only 78% of the Planned level, but were compensated for by higher than expected domestic revenue mobilisation.

2.7 Though overall macro management has been sound since the mid 1990s, there has been a lack of transparency in the allocation of the budget, with the first budget only published in 1999 and giving very limited information.

2.8 Provinces, Districts and Commune Governments have a high degree of financial autonomy, and are responsible for a large share of total expenditure, for example three quarters of education spend and two thirds of health spending is managed at local level[79]. Considerable Government attention is now focusing on how to support poverty reduction planning, budgeting, monitoring and accountability at sub-national level. Central Government has few levers available to ensure that Province plans reflect the national targets. The new Budget law does require provinces to set out one year and five year spending plans, updated annually and showing both recurrent and investment spending, though it is unclear what sanctions can be used if province proposals diverge from national priorities. Although the allocation of central subsidies aims to offset the differences between provinces in their revenue

[79] VDR 2003, page 96.

raising capacity, it does not fully succeed in preventing wealthier provinces being able to finance higher expenditure levels and better services. The problem is compounded by higher unit costs in the more remote and mountainous provinces where the bulk of the poor live. (Box 1).

Structural Policies

2.9 Eighty percent of the poor are farmers. The improvements in rural living standards during 1993-98 have been driven by agricultural sector reform. Collectives were dismantled in 1988 and land was distributed among farming households. Controlled prices for most goods and services were abolished in 1989. The macro economy was brought under control, and the economy opened to international trade, with the unification of the exchange rate at a realistic rate. Vietnam has transformed from a vulnerable and food insecure economy to one of the largest exporters of both rice and coffee in the world. Though the pace has been gradual, there have been no policy reversals, and commercial rating agencies have recently upgraded their assessments of Vietnam.

Table 3The share of State enterprises in the economy

Indicator	1998	1999	2000	2001	2002
No. of SOEs	5861	5713	5571	5326	5195
Share in industrial output (%)	45	40	32	30	29
Share in non-oil exports(%)	62	54	48	44	35
Share of Bank credit(%)	52	48	45	42	39

Source: NSCERD; GSO; SBV; Vietnam Exports: Challenges and opportunities, World Bank (2003); and WB staff estimates

2.10 State enterprise reform has seen the role of SOEs shrinking rapidly (Table 3), and one third of the state enterprise labour force left the sector as hard budget constraints were imposed[80]. This has been balanced by a series of reforms since 2000 that have significantly improved the environment for the private sector. Private sector enterprises are being established at the rate of 1600 per month, and private sector manufacturing growth (both domestic and foreign) is outpacing the growth of state owned enterprises. Employment in the formal private sector has reached 1 million, equal to two thirds of the level in SOEs. Though this growth is encouraging, the formal domestic private sector remains small and fragile, accounting for less than 4% of GDP, 6% of manufacturing output, and 3% of total employment in 2002. Moreover, though significant reforms have been introduced, there is not yet a level playing field: different legislation and regulations apply to SOEs, foreign enterprises, formal private sector enterprises and household enterprises. There are differences in access to land and capital, and there is also a plethora of provincial level requirements for licences, approvals, regulation and inspections, making the

[80] Attacking Poverty,2000.

operating environment still difficult and opaque, and carrying risks of rent seeking and corruption.

2.11 The financial sector is dominated by four state-owned banks. There are problems of non-performing loans to State Owned Enterprises, a legacy of past policies of meeting the financing needs of public enterprises. The banking sector reform envisages restructuring the commercial banks and letting them operate on competitive principles. IMF ceilings on bank credit to state owned enterprises have been observed, suggesting that these principles are being observed. While credit to SOEs is being controlled, there has been significant overall financial deepening, with the bank credit to GDP ratio increasing from 13% in 1990 to 44% in 2000.

2.12 The GOV has drafted strategies and action plans for making development more sustainable, but the environment is described by UN as being under enormous pressure. Population pressure in mountain areas has contributed to land degradation. Forest cover has improved with the Government-led sector programme, though the quality of some reforestation work is unclear. Pollution is becoming an issue in towns.

Social Inclusion/Equity

2.13 Growth in the 1990s was very pro-poor, mainly due to the land redistribution, though heavy investment in education and health over several preceding decades meant that human capital was also reasonably equitably distributed. Although most groups benefited, the remaining problems of poverty and poor access to services are increasingly concentrated on ethnic populations living in the remote mountain areas. The CPRGS aims for increased investment in the lagging regions, but it also envisages an increasing share of expenditures being financed from community contributions. The Vietnam Development Report, 'Attacking Poverty', published in 2000, already showed that these contributions were a major problem for the poor. Although the poor are supposed to receive free education and health care, the Bank and Fund have expressed concern that Decree 10 on cost recovery sends mixed messages. Within the field of rural transport infrastructure, particularly costly in the mountain regions, the problem appears especially serious (Box 1).

Box 1: Financing Improved Rural Roads

Rural roads have large benefits to the poor (Box 3), but three quarters of the rural road network is in poor condition.

Half of rural transport investment has been financed from household contributions of compulsory labour and materials. The MOT rural transport plans envisage annual investment spending more than doubling in real terms in 2002-2010, while the share of peoples' contributions is also expected to increase to 57% of total investment. Although state spending will meet a higher share of the costs in poor mountain districts, the very much higher construction costs still imply that the poorest communities will pay the most per head. The implied charges are nearly 10% of the poverty line level of spending, and may be unaffordable for poor individuals and communities.

The reliance on increased household contributions for upgrading the road network may exacerbate the serious maintenance problem by drawing these resources away from road maintenance.

Public sector management and institutions

2.14 Vietnam still lacks many of the institutions required to sustain a market economy. Property rights require further definition, the judiciary is not independent, and some aspects of the regulatory and legal environment are confused, contradictory, and lacking in transparency. There have been efforts to strengthen informal channels of accountability through the grassroots democracy decree, which requires budgets to be posted up at facility level to enable people to seek information and make complaints if funds are being squandered. It is not yet clear that people feel safe to apply these new freedoms, though there are examples of local pressures forcing the removal of corrupt or ineffective officials. Overall, the confusing environment leaves ample scope for corruption, and Vietnam scores joint 75th out of 91 countries surveyed by Transparency International in its 2001 *Corruption Perceptions Index.* This is above Indonesia (joint 88th with Uganda) and Russia (79=), but below India (71), China (57) and Thailand (61).[81] The introduction of a financial management information system under the World Bank supported public financial management reform programme should begin to significantly strengthen formal accountability, while the introduction of a medium term expenditure framework at macro and sectoral level should bring about more transparent planning and make possible greater accountability for the outputs delivered with public funds. With assistance from Sweden, a diagnostic survey of corruption is being undertaken to inform subsequent action.

Impact of Shocks and Aid Variability

2.15 The main shock experienced by Vietnam since the start of significant aid flows was the East Asian crisis, which was weathered with only a slow down in GDP growth, which dipped briefly from 9% in the mid 1990s to just below 5% in 1999, but then recovered to 7% from 2000. Foreign direct investment has fallen from $2bn per annum achieved in the mid 1990s, but has recovered from $700mn in 1997 to $900mn in 2001. Exports grew throughout the period, and are expected to increase further following a bilateral trade agreement with the US and if Vietnam's application to join the WTO is successful.

2.16 Aid was stabilising during this period, offsetting a relative decline in revenue: GDP, and enabling Vietnam to continue to increase public expenditure and foreign exchange reserves throughout the slowdown period:

	1995	1996	1997	1998	1999	2000	2001
GDP Growth	9.5	9.3	8.2	5.7	4.7	6.8	6.9
Financial Aid: GDP	2.5	1.2	2.2	2.7	3.2	4.1	2.9
Domestic Revenue: GDP	22.61	22.37	20.01	19.62	19.03	20.09	20.84
Aid plus revenue: GDP	25.07	23.59	22.20	22.35	22.25	24.23	23.74
Growth of real domestic revenue		8.16	-3.25	3.71	1.69	12.65	10.91

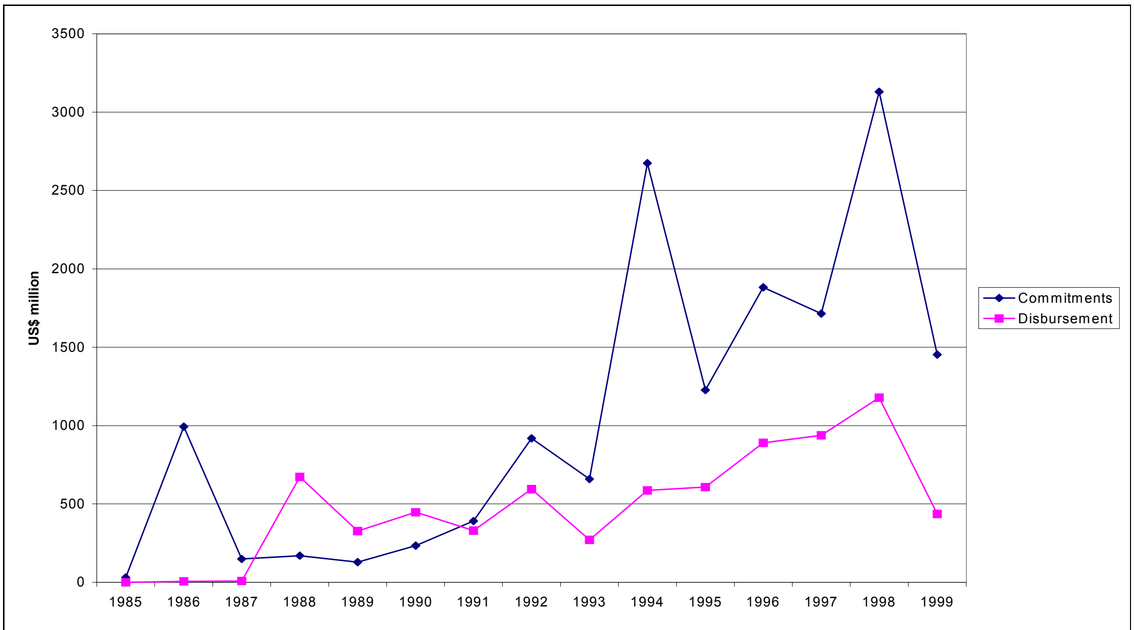
81 See http://www.transparency.org/cpi/2001/cpi2001.html.

$ Aid index	1	0.583	1.094	1.391	1.795	2.464	1.820
VND Aid index	1	0.590	1.221	1.755	2.285	3.246	2.492

2.17 Although Aid has grown rapidly since 1996, there have been sharp downturns in disbursement in 1996 and again in 2001. The decline compared to the previous year was equal to 0.5%-1% of GDP in both cases, and to around 4% of public expenditure. However, as the bulk of the aid was in project form, expenditures and financing may have fallen together, avoiding causing financing problems. Increased aid flows have been associated with falling revenue: GDP share, reflecting the difficulties of sustaining revenue during a growth slowdown rather than any lack of political will. Though revenue fell as a percentage of GDP, it continued to grow in real terms, and the tax share has recovered strongly since the 1999 low-point of the growth slowdown.

2.18 Although disbursements grew rapidly, the 1990s have seen a growing gap between aid commitments and disbursements, and Government and the three largest donors have conducted joint portfolio reviews in order to determine the reasons (Graph 1). The World Bank's average 29-month elapsed time from project concept document to Board approval is 40% longer than the regional average. This has been the major reason why the World Bank maintained Vietnam lending close to the base case in 2001/02, even though their CAS assessed the policy environment as closer to justifying high case lending. In order to address the problems, Government clarified the management arrangements for external aid, and moved procurement regulations (a major cause of problems) closer to international best practice. There has been a modest recovery in the World Bank disbursement ratio from 12% in 2001 to 15% for projects and 19% overall, but this remains far short of the 22% achieved in 1998 and further action is needed over the medium term by both Government and donors to raise disbursement performance.

Figure 1: Commitments and Disbursements of ODA in Vietnam 1985–89



Source; CAPE Transactions Cost Study

Policy Dialogue

2.19 A DAC study has commented that: ‘the economic reform process originated in Vietnam. It was not imposed from outside, nor was it 'bought' with aid. The upsurge in aid was subsequent: it may have rewarded the reforms, but it did not bring them about[82].’ After initial adjustment loans in 1994, neither the IMF nor World Bank were able to conclude further policy lending until 2001, reflecting the difficulty of forming a consensus around the policy reforms urged by the IFIs, with particular caution about the pace of reform following the East Asian financial crisis. Policy based lending from Bank and Fund restarted in 2001 in support of the CPRGS. The PRSC approach, where each annual credit is based on an assessment of prior actions rather than future promises, is seen as particularly appropriate. In recognition of the quality of the track record, Vietnam was the first country to agree a PRSC on the basis of an interim poverty reduction strategy paper.

2.20 The main channels for donor influence have been through pilot projects, and to some extent through technical assistance and policy advice. Although GOV is sceptical of the value of much technical assistance, it has been keen to learn from the experience of other countries, and has valued the role of the donors, especially the World Bank, in providing access to that experience.[83] Reforms and innovations are regularly pioneered on a small scale and then scaled up if successful. The DAC study argues that aid has been more important as a conduit for ideas and innovations than as a source of financial capital.

Aid and Public Expenditure management

2.21 World Bank are supporting the introduction of reforms in budget planning and financial management, including introduction of an MTEF and of an integrated financial management information system. Donor projects require central approval, and GOV has sought to keep control of where donor funds are allocated. However, with the exception of the PRSC, donor funds bypass core GOV public expenditure management systems. Donor concern at the lack of GOV transparency and inadequate accountability in fiduciary issues has made donors reluctant to use government financial mechanisms and procedures. GOV has responded by making Project management Units the mechanism for implementing aid projects. Although they are composed of established staff and are part of the central Government administration, they do nevertheless cause avoidable duplication of functions, with responsibility for administration of investment within a sector split between several PMUs at national level, and sometimes even at provincial level. The World Bank Rural Transport 2 Project Appraisal Document commented that the rural transport sub-sector was fragmented, and that ‘international donors finance several rural transport programmes with varying technical standards and road selection criteria, different project management arrangements, and no exchange of experiences.’

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[82] Lister and Bartholemew.

[83] OED, Nov 2001

2.22 GOV still faces the usual problems of lack of donor information on their forward programme, and failure by donors to provide full budget and disbursement information on projects where they control the procurement. World Bank and the like-minded donors are committed to introducing sector approaches in order to reduce fragmentation, but Japan and ADB remain committed to the project approach.

Impact of Aid

2.23 Energy, transport, and economic management have been the three largest sectors for aid disbursement, accounting for over half of aid disbursed in 2000. This reflects the infrastructure focus of Japan in particular, with transport and energy accounting for three quarters of commitments in the 1990s, compared to less than 10% in the social sectors, and only 6% for agriculture[84]. Donor spending on the social sectors in 2000 was less than 15% of total ODA, less than the 17% share of social sectors in GOV investment, and far less than the 50% share of social spending in the GOV non-interest recurrent budget.

2.24 Within the infrastructure sectors, most aid was devoted to national transport corridors and major power generation and transmission projects, and this continues to be the focus of support from Japan. The World Bank has encouraged private involvement in national infrastructure, while shifting direct lending towards improving rural infrastructure, including rural roads and electrification. GOV has also given higher priority to improving rural infrastructure, partly in response to World Bank analytical work showing the crucial role of transport in poverty reduction.

Box 3: Benefits of Rural Transport Investment

Deolalikar[85] analysed the impact of the establishment of a village road on household per capita expenditure, using data from the 1993 and 1998 household living standards surveys. He found that roads have very strong beneficial impacts, and that those impacts are especially strong in the poorest provinces. In the poorest provinces, the establishment of a village road was associated with a 27% real increase in per capita expenditure. A 10% increase in spending on roads raises rice yields by 0.36%, with the effects also being strongest in the poorest provinces, where the impact of road spending is more significant than investment in irrigation. In a separate exercise, using panel data on households surveyed in both 1993 and 1998, he finds that the presence of a village road increases the probability of a household escaping poverty by ‘a staggering 68 percent’. The presence of a road also has a strong positive effect on school enrolment and on utilisation of public sector health facilities.

[84] JBIC, ODA Operation in Vietnam, Hanoi, April 2002.
[85] Deolalikar, Sept 2001

2.25 At one level, these donor investments have been highly successful in overcoming bottlenecks to growth. During the 1990s, the percentage of paved roads doubled, freight carried more than doubled, electricity generation tripled, and access to electricity increased from 48% of households in 1990 to 75% by 2000. Given the rapid growth in the economy, it would be surprising if the infrastructure investments did not yield high rates of return. The key questions are perhaps whether GOV could and should have financed much of this commercially, and whether the donor intervention helped or hindered the development of a more commercial approach to these sectors. Sustainability remains a struggle, with inadequate attention to maintenance of roads and irrigation, while commercialisation of the energy sector has been impeded by low tariffs. Donor coordination in the energy sector has clarified that donors are not prepared to continue providing concessional loans for the sector at the level required to sustain growth, and has been instrumental in persuading GOV to involve private capital, though institutional arrangements need further development.

2.26 It is Government and community contributions that have largely financed the investments in education, health and clean water that have delivered the improvements in the MDGs. There have of course been significant donor interventions in these directly poverty focused areas, and some of the analytical contributions have enabled donors to have an impact wider than their financing. World Bank health interventions helped re-establish commune level health service delivery and made a significant contribution to the increased immunisation coverage that was a significant cause of the progress in reducing under 5 mortality[86].

3. Absorptive capacity and potential Impact of Increased Aid flows

3.1 There needs to be a gradual movement away from infrastructure and towards interventions directly targeted on the poor- though the Government also intend to look again at the relationships between national infrastructure and poverty reduction, something welcomed by Japan. With major improvements in access to infrastructure and to GOV services already achieved, the critical next phase needs to focus on the hard to reach populations who have so far benefited least. They are predominantly from the poor mountainous regions in the North and Central Highlands, plus the Mekong Delta, and a disproportionate 30% of them are from ethnic minorities. Current plans, especially in infrastructure, will only achieve the targeted improvements by loading possibly unaffordable extra financial burdens on those least able to pay them (Box 1). There is a strong case for focusing additional central Government and donor support quite narrowly on those provinces and communities facing both low revenues and incomes but high costs for extending services and infrastructure. In the rural transport sector, this might mean 60% of central help going to the Northern uplands where just 17% of the population live.

[86] OED, November 2001

3.2 The introduction of the MTEF process provides an opportunity for central GOV, donors, and Provinces to coordinate in support of national strategies linked to the medium term expenditure plans. Education is developing an approach to coordinating around a sector wide approach, preliminary discussions have also begun in rural transport. Some such approach will be required if the excluded populations are to be reached. The core element is likely to be additional support targeted to low-income high-cost provinces, conditional on commitment to effective policies, plans, expenditure proposals, and accountability for results achieved.

3.3 There is no absolute barrier to a substantial increase in aid disbursements targeted on the poor. Given the rapid pace of economic growth, simply maintaining the existing share of GDP and of public expenditure would require a doubling of aid flows over the next decade. The existing costings in the CPRGS need to be further developed, and this will be undertaken in the course of elaborating sector MTEFs. The CPRGS numbers imply an 80% increase over recent aid levels. If this is to be used wisely in support of poverty reduction, improved planning and coordination arrangements will need to be put in place, even if the project approach remains. This is especially important in order to help build capacity in province and district Governments, given the decentralised responsibility for direct service provision.

4. Conclusions

4.1 Vietnam is a poor country, which is growing rapidly and making exemplary progress in reducing poverty and achieving improvements in the indicators relevant to the MDGs. The structural reforms have proceeded at a cautious pace, but the Government has implemented those reforms to which it has committed itself. Reforms in governance have lagged behind those in the economic arena, and there are concerns that the lack of transparency of the legal and regulatory framework may continue to be a drag on growth. Corruption is an issue, and there are also concerns about rent seeking and conflict of interest in a situation in which relations between public and state owned sector are yet to be fully and transparently defined. Although there are concerns, significant progress continues to be made, there have been no policy reversals, and important reforms are underway in a number of areas of long-term concern, including financial management and the introduction of a medium term budget framework.

4.2 The costings in the CPRGS only go to 2005 and are not entirely transparent. They envisage aid flows averaging $1,8bn per annum, compared with average disbursements of $1bn per annum in 1999-2001. World Bank figures in the 2003 Vietnam Development Report envisage ODA flows of $1.5bn in 2004-2005. Both sources therefore imply scope for substantially higher disbursements.

4.3 There is scope to go further. The CPRGS envisages a substantially increased reliance on community contributions. The participatory poverty assessment includes compelling evidence that these contributions are already at levels that are unaffordable to the poor, and that cause exclusion from access. Government has recognised the need to finance a larger share of costs for poor households, including free access to primary health and education.

4.4 Government is introducing budget management improvements over a sensible time frame, linked to improvements in financial management and to the development of ways to link central direction on priorities to sustaining a large measure of local discretion over budgets.

4.5 If donors are flexible over their management arrangements, aid could be doubled over a five to ten year period with good prospects of it being sensibly spent and contributing to poverty reduction, a goal to which GOV has to date shown more evidence of commitment than have some leading donors. The increased commitments should be focused on providing additional resources to the poorer provinces, within the context of credible commitments to address maintenance and public expenditure management issues. Fiduciary concerns exist and need to be a continuing focus of policy dialogue and a concern in the design of disbursement arrangements, but the track record of achievement argues that GOV has been relatively successful in turning additional public expenditure into real improvements for the poor.

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