

High-Level Forum on the Health MDGs

**Fiscal Space and Sustainability:
Towards a Solution for the Health Sector**

Paris, 14-15 November 2005

Table of Contents

Acronyms	i
Executive Summary	ii
Table 1: Summary of Problems, and Options for Addressing Them	viii
 Fiscal Space and Sustainability - Towards a Solution for the Health Sector	
Introduction and Questions to be Addressed	1
What can be done? Issues and options	2
1. Encouraging Governments to Reflect Donor Promises of Increased Aid in their Expenditure Plans	2
2. Reconciling Longer-term Commitments with Aid Effectiveness	8
3. Ensuring Donor Support Helps Finance the Government Plan	11
4. Reducing the Cost of Aid Volatility	12
5. Insuring Countries Against Donor Non-Performance	15
Annex 1: Terms of Reference	21
Annex 2: Proposed Aid Guarantee Fund: Comments on the Proposal and Responses from the Author	23
List of Documents Consulted	25

Acronyms

CAS	Country Assistance Strategy (World bank)
CFA	Commission For Africa
CPIA	Country Policy and Institutional Assessment (World Bank)
CSO	Civil Society Organization
DAC	Development Assistance Committee (of OECD)
DFID	Department For International Development (UK)
FTI	Fast Track Initiative (for achieving Education For All)
GAVI	Global Alliance For Vaccines And Immunization
GDP	Gross Domestic Product
HAART	Highly Active Anti-Retroviral Therapy (for treating HIV/AIDS)
HIV/AIDS	Human Immunodeficiency Virus/ Acquired Immune Deficiency Syndrome
HLF	High Level Forum
IFF	International Financing Facility
IMF	International Monetary Fund
MDGs	Millennium Development Goals
MOU	Memorandum Of Understanding
MTEF	Medium Term Expenditure Framework
NGO	Non-Government Organization
ODA	Official Development Assistance
OECD	Organization for Economic Co-operation and Development
PER	Public Expenditure Review
PRGF	Poverty Reduction and Growth Facility (IMF)
PRS	Poverty Reduction Strategy
PRSP	Poverty Reduction Strategy Paper
SDR	Special Drawing Rights
SPA	Strategic Partnership with Africa
SWAP	Sector Wide Approach
TA	Technical Assistance
WB	World Bank

Fiscal Space and Sustainability Towards a Solution for the Health Sector

Executive Summary

Reaching the MDGs in low income countries will require substantial increases in public expenditure that can only be financed with much higher development assistance which will need to be sustained for many years. Donors have responded by promising big aid increases, with global aid expected to increase by over 60% between 2004 and 2010 while aid to Africa is expected to double. The fundamental problem addressed in this paper is that donor commitments to individual countries remain short-term and highly conditional and do not come close to reflecting these global promises of increased aid, while donor disbursement performance remains volatile and unreliable. Governments are therefore understandably reluctant to take the risk of relying on increased aid to finance the necessary scaling up of public expenditure. The paper discusses options for addressing five issues that are critical to tackling the problem. The options, and their advantages and disadvantages, are summarised in a matrix table after this Executive Summary (Table 1). References are to lines in the table.

Issue 1: What Can be Done To Encourage Governments To Reflect Donor Promises Of Increased Aid In Their Expenditure Plans?

Governments need to believe that donors will increase aid and maintain it at the higher level before they will assume it in their expenditure plans. At present, countries tend to include in their budgets and MTEFs only formal donor commitments, and countries such as Uganda discount even formal commitments to reflect the past experience of incomplete and delayed disbursement.

Ideas under discussion internationally mainly focus on making the promised increase in **global** aid more certain, and less dependent on annual budget allocations (1.5). Proposals for financing increased aid include borrowing on international capital markets (the proposed IFF), hypothecating taxes on air travel, selling IMF gold, or making a special issue of IMF Special Drawing Rights (SDRs). These ideas will be difficult to negotiate (delegates may wish to discuss which stand the best chance of being agreed), and will be of only limited help to a Government wishing to know how much aid it will receive. More secure global aid could be used to make longer term country commitments, but at present the global figures have not been allocated to individual countries.

One way to give countries assured long-term access to increased aid is by providing the funding in advance and irrevocably. Debt relief is the only form of irrevocable long-term funding that has been used on a large scale in developing countries (1.1), but it can not provide sufficient support to some of the countries of greatest concern. Other forms of payment in advance have been proposed, but are not attractive to donor countries that have their own budget constraints, and wish to retain some leverage on the future behaviour of aid recipients.

The obvious way to change Government assumptions about future aid levels into line with donor promises is for donor agencies to make long term commitments setting out their intended level of aid to each country (1.2). A rolling forward pipeline of five to ten years, combined with assurances that adjustments beyond that date would be at a moderate pace, would probably give sufficient assurance, if the commitments could be believed. Confidence in commitment and disbursement promises might be improved by transparent donor reporting, in the format requested by Government, with explicit advice on the nature of the risks of under-disbursement.

Unfortunately, long term commitments of future aid are difficult for many donors, who face legislative constraints, and can not commit their successors (1.2). Donors also wish to retain some flexibility to react to events, and are reluctant to tie up a significant share of their budget in long-term commitments. Even multilateral agencies reward staff more for eye catching new initiatives than for sound management of existing commitments. Although some bilateral donors have given long-term indications of support, these are less binding than formal commitments, and have in practice been subject to interruption due to policy differences and governance concerns. The most that is currently on offer from individual donors is non-binding assurances of 'best efforts' to maintain aid beyond the medium term, which is not a secure foundation for financing a long-term commitment to higher public expenditure.

Collective donor assurances, with the donor group as a whole undertaking to ensure that the required level of external finance is forthcoming, have been tried, but with only limited success (1.4). It has proved difficult to mobilise additional funding in the amounts and at the times required to offset the impact of aid falling short of expected levels. Donor assurances are unlikely to be believed, given the past record of aid volatility and of disbursements falling short of commitments.

Donors have historically found it easier to make longer term commitments to specific expenditure programmes or projects (1.3). In cases where long-term obligations are incurred by Government with donor urging, there can be a compelling moral case for guaranteeing that the funding will not be abruptly withdrawn. Anti-Retroviral Treatment for HIV/AIDS sufferers is the most important example, where ethical considerations require treatment to be maintained for the life of the patient. Commitments could also be made to a specific sector, or to a defined sub-set of the budget, such as the EC proposal to provide longer term funding to support Government spending on the Millennium Development Goals.

Long-term commitments to specific programmes in a country could be conditional on the preparation of credible plans to achieve specific outcomes, and would need to be based on an understanding as to how the programme will be financed, and how it will be adjusted and rolled forward over time. This would provide a way to avoid a 'Catch 22' problem where aid is low because plans are un-ambitious, while plans are un-ambitious because of uncertainty over the aid available.

If there is no agreement on overall public expenditure priorities, *the risk to donors* is that the expenditure may not be additional, but will enable Government to redirect domestic revenues to other purposes such as defence. Donors can limit this risk by disbursing their aid for the specific programme on condition that Government

spending exceeds some threshold level. It is far more difficult to address the serious *risk to Government* that aid allocated to a specific programme may not be additional, and may distort spending priorities as donor funds are withdrawn from other areas. For example, a Government spending just \$10 per head on health, half of which is donor funded, is unlikely to choose comprehensive HAART treatment unless it is confident that the resources to finance it are additional and do not reduce the aid available for basic health programmes. To minimise the risks to both sides, it is helpful if expenditures are part of an understanding on public expenditure as a whole, and how it will be financed from domestic and foreign sources. This takes us back to the need for longer term commitments of total aid to the Government budget as the only way to ensure aid additionality.

If little can be done to extend longer term commitments to countries, there may at least be scope to help Governments make realistic assumptions as to the aid they are likely to receive. Improved donor reporting, and the publication of improved long-term forecasts of global aid, would help countries to make realistic assumptions. This needs to happen in country, but the realism of country level assumptions could be improved by better international reporting and forecasting. Publication of commitment and disbursement data by donor would also help pro-aid lobbyists place pressure on individual donors to fulfil their promises. Governments can manage the uncertainty (and lobby for increased aid) by preparing more than one scenario, showing how extra aid would be used. However, none of these measures are an adequate response to the fundamental problem that it is risky to use short-term and volatile aid commitments to finance stable long-term expenditure obligations.

In addition to measures to increase long-term aid, there has also been discussion of measures to address the problem from the other side, reducing the cost of procurement of medicines and other supplies by global subsidies and advance bulk purchase. This can have a significant and very positive impact by reducing the scale of the funding shortfall that needs to be bridged.

Issue 2: How Can Longer-Term Commitments Be Reconciled With Aid Effectiveness?

There is a fundamental inconsistency between the long-term spending programmes that require support, and the short term conditionality used by donors to ensure aid effectiveness (2.1). Governments know what they must do in order to meet the terms of *current* aid agreements, but must gamble on their ability to continue satisfying the donors through a series of future agreements, the terms of which are currently unknowable.

Abandoning conditionality entirely, in favour of a needs based ‘entitlement’ approach to aid allocation, would have the advantage that populations would not be penalised for the failures of their Governments. However, the aid effectiveness literature suggests that such an approach would result in aid being wasted in environments where it can not be effective- though it is arguable that the negative effects of a weak environment might be somewhat reduced if aid is committed longer term and is available to address some of the recurrent cost constraints. (2.2).

As an alternative, aid could be allocated based on a model that takes account of indicators measuring the quality of policy and institutions, and development outcomes, as well as needs. There would be no policy conditionality, but aid levels would respond over time to changes in the indicators, at a speed that Government can adjust to, with opportunity to discuss how a higher aid path could be re-established (2.3). The Country Policy and Institutional Assessments (CPIA) already produced by the World Bank could perhaps be developed as the basis for such a system. The approach could be applied by individual donors in respect of their own aid, or could be the result of agreement between donors, possibly with a lead donor agency such as the World Bank identifying and publicising aid requirements, and itself acting as 'swing donor' to offset biases in global aid allocation. If performance declines, aid cuts would be pre-announced, slow, based on explicit criteria, and accompanied by dialogue on how a higher aid path might be re-established.

The advantage of such an approach would be greater certainty about aid in the medium-long term, and reduced risk of short-term volatility. If the indicators include a stronger focus on outcomes, the approach would also improve country ownership, by allocating aid more on the basis of what it is achieving rather than whether Government agrees with the donors. The swing donor role could also help to improve the quality of aid, since countries would have less incentive to accept aid with strings attached if any shortfall is likely to be made up by other donors. The approach would require investment in a robust and credible indicator framework. Such an approach will not prevent donors reacting quickly to political or governance concerns, though greater transparency might help to ensure that misunderstandings do not cause avoidable aid suspensions (2.6). The proposed 'swing donor' role might provoke objections from bilateral donors reluctant to see the results of their bilateral allocation decisions undermined.

If the main concern is to achieve and sustain the MDGs, funds could be allocated to specific sector or sub-sector programmes, with only sector-level conditions (2.4). Long-term programmes need to adapt to changing circumstances, and longer-term conditions would need to focus on process (how future decisions will be made) rather than seeking to specify the policies and spending programme in detail. There would be a graduated response to poor performance or policy disagreements:- analysis, dialogue, and more restrictive conditions for access to aid would be the first recourse, with reduced commitments or partial suspension only in extreme cases. The approach requires a high measure of mutual trust, though the experience of the longer-running Sector Wide Approaches suggests that it may be workable, if all partners are prepared to work through disagreements. As with the overall aid allocation model, aid funding would maintain a medium-term pipeline of commitments, with spending adjusting slowly to changes in sector performance, and with an implicit donor commitment to continue supporting the sector into the long term future (2.5).

Issue 3: Should External Aid Support the Government Plan?

There needs to be a single overall policy and planning framework for public expenditure on health, although that plan may allow for diversity of funding and of service providers, may be very decentralised, and may include a range of experimental and pilot projects. The importance of an overall framework, however, is to ensure that scarce resources prioritise the interventions that have the largest

positive health impact for the funds allocated, and to minimise inequalities in what services are available, and who has access to them. Aid that is used to fund expenditures that are outside the Government plan may displace spending that Government would have preferred. They will normally have lower ownership and be less sustainable, and will often be worse value for money than the planned activities they displace. If the aid is additional to existing public expenditure plans, and on a large scale, it may have implications for the macro economy, potentially squeezing out private sector spending, especially if expenditure is on local costs. These considerations carry less weight in fragile states, where donors carry more responsibility for co-ordination.

Issue 4: How Can The Costs of Aid Volatility Be Reduced?

Although the lack of long-term commitments is the more fundamental problem, the high volatility of aid flows poses problems for short-term macro-economic and budget management. Volatility in project disbursements does not cause a financing problem, because the finance and the expenditure that it finances usually move together. Volatility may require attention to building absorptive capacity, but does not create a financing problem. It is volatility in budget support that creates the problem.

Best practice approaches to budget support try to address the problems by medium-term indications of support, earlier commitment in time for budget preparation, disbursement early in the budget year, and reduced conditionality applied to the following year's commitment to avoid interrupting the current budget, with only a portion of funding at risk from policy failure in any one area of performance (4.1). None of these measures can prevent occasional interruptions due to political or governance conditionality, although efforts are being made to set out the issues of concern more explicitly, and to ensure through dialogue that both sides are informed of the likely impact of their decisions on aid flows.

Despite these measures, budget support remains very prone to interruption, because it is the easiest form of aid to cut, and (more positively) it is the easiest to increase when additional funds become available. It is therefore important to help Governments to manage volatility, through full and accurate reporting and monitoring of aid flows, and by supporting active use of larger foreign exchange reserves for smoothing the impact on expenditure. The use of foreign exchange reserves for smoothing public expenditure is difficult because high reserves are a temptation to politicians who face spending pressures, while budget managers will find it hard to distinguish between temporary aid shortfalls that can be smoothed by drawing down reserves, and longer-term reductions that require adjustments to expenditure plans. Recognising that volatility cannot be eliminated, improved monitoring and increased use of foreign exchange reserves to manage budget fluctuations can be helpful in mitigating the consequences (4.2).

Volatility may be caused by absorptive capacity problems. Use of harmonised procedures based on those of Government, together with support to reform public expenditure management, can ensure that donors are not the cause of low disbursement (4.3, 4.4).

Issue 5: How Can Countries Insure Against Donor Non-performance?

These measures may not be sufficient to persuade Governments to take the risk of relying on aid to significantly increase their public expenditure obligations. It is not enough for donors to ensure that the promises they have made will be delivered, they must also persuade partner Governments that those promises can be relied on, a difficult task given the long history of volatile aid that falls short of promised levels.

In order to provide the required assurances, a DFID-funded study proposes the establishment of an Aid Guarantee Facility that poor and highly aid dependent countries could draw on if donors do not fulfil promises of increased aid. It would also be drawn on to slow any decline in aid, to give more time for managing the consequences. The guarantee would be limited to budget and programme support, ensuring that aid shortfalls do not create financing gaps in the Government budget. The fund would not guarantee 100% of donor promises, but would limit the extent to which increases in aid fall short of expected levels, while ensuring that higher aid levels, once achieved, are not abruptly withdrawn. The effect of slowing the rate of decline will be equivalent to providing a longer term commitment with a slow taper from the peak, and could be an important additional assurance for finance ministers worried about the vulnerability of donor flows.

The cost would depend on the number of countries to be covered, the definition of the guarantee to be given, and the risk that donors do not fulfil their own promises. Establishing the fund would thus in itself be a declaration of seriousness on behalf of the donors. The risks would be managed by ensuring that there is transparency as to the causes of any shortfalls (to encourage civil society to lobby donors not meeting their commitments), with reviews of prolonged or heavy use. Access would be suspended in the event of catastrophic events such as major human rights abuses, but with an independent panel assessing the case for suspending access to give Governments assurance that arbitrary decisions will be avoided.

The proposed fund would need to be used to smooth budget support as a whole. A specific fund for health would be difficult, given the problems of defining what portion of budget support assists the sector.

The proposal requires further study, but could be an important reinforcement of stated donor intentions to increase global aid. Fuller details are in section 5, and a response to the comments received on the proposal is at Annex 2.

Table 1: Summary of Problems, and Options for Addressing Them

	Possible Approaches to a Solution	Benefits	Constraints and Disadvantages
1	Governments are assuming far less aid than donors have promised, leading to unambitious health & other public expenditure plans that will fall far short of the MDGs.		
1.1	Pay irrevocably in advance, e.g. through deeper debt relief.	Assured long-term flow of additional resources.	Does not reflect relative need, no redress if misused.
1.2	Longer-term donor commitments to support Government spending plans.	If commitments are believed, countries can plan and budget to meet long-term goals with more confidence.	Legislative constraints, inability to commit successors, reduced flexibility to respond to events.
1.3	Long-term commitments to specific spending programmes conditional on credible plans to achieve specific outcomes, joint review and decision taking.	Long-term commitment to specific MDG goals is easier to justify, can co-ordinate ambitious plans & resources to implement them.	No guarantee that the aid, or the expenditure it finances, is additional, unless there is agreement on the overall budget and how it is financed.
1.4	Collective donor commitments to ensure financing gaps in approved programmes are met, 'swing donors' compensate aid orphans, offset shortfalls.	If the collective commitment is credible, reduced risk in implementing challenging spending plans, improved aid allocation.	Has not worked. Problems & delays in identifying need and mobilising resources, donors reluctant to compensate for aid shortfalls deliberately imposed.
1.5	Make global aid less dependent on annual budget allocation: e.g. the IFF, the earmarking of aviation or other taxes to fund aid increases, IMF gold sales or SDR issue, longer-term multilateral agency funding.	If agreed, the probability of realising long-term donor commitment to increased aid is increased.	Time consuming negotiation with uncertain prospects of success. May not help individual country predictability.
1.6	Produce global aid forecasts based on fuller reporting of donor intentions and performance to DAC .	Permits more realistic country planning. Helps civil society hold donors accountable. Identify where aid should increase.	Closer monitoring may increase reluctance to commit. Requires judgement on realism of promises. Need to separately identify aid to Govt.
1.7	Produce more than one aid scenario for PRSPs and sector plans, to show what extra aid could achieve.	Persuade donors to increase aid, by showing it can be well used. Helps prioritize.	Additional effort required may demotivate staff if funding is not forthcoming.
1.8	Reduce the cost of procurement of medicines and other supplies by global subsidies and advance bulk purchase.	Reduces the scale of the funding shortfall that needs to be bridged.	Reduces the scale of the problem, but does not solve it.
2	Governments need long-term funding, but donors need to ensure aid effectiveness		
2.1	Current approaches:- aid is short to medium term in nature, subject to frequent (usually at least annual) review and rolling forward.	Donors can cut aid if it is not used as agreed. Govt knows the minimum short-term conditions it must meet, but aid can still be cut for other reasons (e.g. governance).	Does not provide the assured long-term funding that is needed, because long-term aid levels depend not only on existing agreements, but on negotiating future ones.

	Possible Approaches to a Solution	Benefits	Constraints and Disadvantages
2.2	'Entitlement': unconditional aid, based on need, sustained whatever the Govt does (though possibly via NGOs).	People not penalised for Govt failures, MDGs are pursued equally everywhere.	Ignores evidence that aid achieves less in difficult environments.
2.3	Aid allocation model: adjust aid over time to assessments of policy, institutions, -and outcomes, either by donor consensus or by 'swing donors' adjusting their aid to offset contrary trends by others.	Limits poor use of aid in medium term, while assuring the country that aid availability will change at a speed they can adapt to. Swing donor role helps drive out poor quality aid.	Use of CPIA-style indicators can not avoid some donor subjectivity, political upsets may still provoke aid cuts. Bilaterals may object to 'swing donor' offsetting the impact of their policies.
2.4	'Sector Blueprint' approach: Donors make specific commitments to finance a medium-term expenditure plan for a sector or sub-sector.	Specific inputs agreed in the MOU are guaranteed provided the programme is implemented as set out in programme documents.	Long-term plans need flexibility to adapt. Tends to favour investment rather than recurrent costs. Fragments budget management.
2.5	Longer-term (5+ years) commitments linked to rolling plan & joint institutional arrangements to achieve specific outcomes (e.g. related to a specific sector or MDG) ¹ with assurances of continued funding in long-term (10+ years) if performance is OK.	Support depends only on sector progress, with graduated response to problems: analysis, dialogue, restrictions on use of aid, lower commitments, suspend part of aid in extreme cases. Builds on SWAP best practice.	Long-term aid commitment may reduce pressures for reform. Requires mutual trust & commitment to joint decision-making. May distort spending priorities if not part of an overall agreement on budget & aid levels.
2.6	Greater clarity on donor political & governance concerns, dialogue so decisions are made with knowledge of aid consequences.	Reduces a major cause of uncertainty & reluctance to increase aid dependence.	Donor political pressures override formal agreements and can not be controlled. There may be more scope for a systematic approach to multilateral aid.
3	Aid disbursements may be earmarked for expenditures outside the Government plan		
3.1	Fill gaps in Govt PRS as first call on aid. Collective Govt and donor decision-making on spending priorities, including both financial and TA support.	Resources can be prioritised in support of sustainable plan to achieve the MDGs	Govt and donor priorities may not coincide. In fragile states, donors may need to assume more co-ordination responsibility.
4	Short-term aid volatility disrupts implementation of expenditure programmes		
4.1	Best practice approaches: medium term indications of future aid, co-ordinate with budget preparation, disburse early, no interruption within the budget year, limit the share of aid subject to conditions on any one area of performance, active aid reporting, use Govt procedures.	More reliable planning basis for MTEF, earlier start to budget implementation, less disruption from delayed aid. Applying conditions to future commitments not current budget gives more time to adjust spending obligations. Avoids complete 'stop go'.	Donor commitment still short-term, not enforceable, depends on subjective assessment, and can be suspended for reasons not set out in the agreement. Danger of volatility in year t+1 if all donors reduce funding when e.g. IMF review is delayed.

¹ Such long-term commitments are under consideration by DFID. See Improving the predictability of aid flows: Proposals for action (DFID)-development finance team, Dec 2004

	Possible Approaches to a Solution	Benefits	Constraints and Disadvantages
4.2	Improve aid monitoring, use larger foreign exchange reserves to offset volatility, & prioritize spending to avoid across the board cuts.	Reduced cost of volatility.	Donors may resist use of aid for reserve build-up. Managing reserves is hard given spending pressures & uncertainty over duration of aid shortfall.
4.3	Improve Govt absorptive capacity: capacity building, decentralized management, public expenditure management reforms.	Can improve disbursement, and help motivate staff to deliver services.	Needs committed leadership to address motivation, overcome institutional rivalries. Time needed to train skilled staff willing to work in remote areas.
4.4	Donors use simpler, harmonized procedures based on those of Government.	Improves disbursement and aid effectiveness, releases Government capacity.	Institutional and political constraints for some donors.
5	Stronger assurances less dependent on continuing donor good will may be needed to convince Governments to assume the risk of ambitious aid dependent expenditure programmes		
5.1	Establish a facility to guarantee minimum ODA support to Govt budget in aid-dependent low-income countries.	Automatic access to a facility guaranteeing a floor level of aid greatly reduces the risk of using aid to finance higher public spending.	Relevance depends on first committing higher aid to countries. Needs design, appraisal, negotiation.
5.2	Sector guarantee fund.	A sector guarantee fund on broadly similar lines might prove easier to establish.	Hard to design a simple scheme able to address problems of fungibility & distorted priorities.
5.3	Include in the design a transparent and independent review process with representation from low-income countries to determine the appropriate response to fundamental political, governance or human rights issues.	Reassure donors that the facility will not support countries guilty of human rights abuses or egregious corruption, while reassuring Governments that aid will not be withdrawn without good reason.	Review panel & process needs to command the support of Govt and donors.

Fiscal Space And Sustainability Towards A Solution For The Health Sector

Introduction and Questions to be Addressed

This study was commissioned by the HLF to:

- (i) Identify the aid commitment, aid predictability, and budget management issues that need to be addressed in order to plan and implement a scaling up of health sector expenditure financed by additional aid;
- (ii) Map out the parameters of possible solutions, without making recommendations.

Terms of reference are at **Annex 1**.

In many low income countries, reaching the health MDGs will require an increase in public expenditure on health that is far beyond what can be financed from domestic sources, even on optimistic assumptions as to economic growth, resource mobilisation, the share of public expenditure devoted to the health sector, and the effectiveness with which public health spending is used. The problems related to aid dependence are mainly concentrated in Africa, which contains all 12 of the countries where donor support finances more than 35% of total public health expenditures.² The Commission for Africa estimates an immediate requirement for an additional \$10bn per annum of donor support to health, beyond the growth of African Governments' own contributions, rising to an additional \$20bn per annum by 2015. Additional health spending represents 40% of the total increase in aid called for by the CFA, which advocates an additional \$25bn p.a. to Africa by 2010, with a further \$25bn by 2015, subject to a review of effectiveness³.

According to the OECD, the commitments of the G8 and other donors are broadly consistent with this. They are expected to lead to an increase of ODA to Africa by \$25bn by 2010, more than doubling aid compared to 2004. The OECD estimates that official development assistance to all developing countries will increase from \$80bn in 2004 to approaching \$130 bn in 2010⁴.

The majority of the incremental costs that need to be financed represent long-term recurrent cost obligations from which Government can not easily exit without incurring substantial economic or political costs. Delivering the expanded package of health interventions needed to achieve the MDGs will require extra staff to be recruited, trained, and paid at rates that may need to be significantly increased in order to attract, retain, and motivate them. Additional facilities from which outreach can be organised and services delivered imply incremental costs to staff, operate and maintain them if the investment is not to be wasted. Obligations to treat HIV/AIDS patients require a life-time funding commitment, and in heavily affected countries the

² Wagstaff and Claeson (2004), p151.

³ Commission for Africa, 2005.

⁴ Oecd.org/dataoecd/57/30/35320618.pdf

treatment cost is already absorbing funding equal to or greater than the pre-existing total health budget⁵.

The problem is that Governments in low income countries are understandably reluctant to embark on ambitious plans for expanding their health sectors without reasonable assurances that the funding is in place to sustain the expanded services. This report discusses possible approaches to five questions that need to be addressed if Governments are to rely on aid to fund the substantial increases in expenditure that will be needed:

- i. Governments are assuming far less aid than donors have promised, leading to un-ambitious health and other public expenditure plans that will fall far short of the MDGs. What can donors do to persuade Governments to base their plans and budgets on the higher aid levels that donors say they intend to provide?
- ii. How can the Government need for reliable long-term funding be reconciled with donor requirements to ensure that aid is used effectively and can be withdrawn if Governments misuse it or are guilty of human rights abuses or other behaviour that donors find unacceptable?
- iii. A large share of aid disbursements are used for expenditures that do not form part of Government plans to achieve the MDGs and do not help to fill funding gaps. What are the implications for 'fiscal space', and what can be done to address them?
- iv. What can be done to reduce short-term aid volatility, and avoid it disrupting Government expenditure programmes and undermining their effectiveness?
- v. Stronger assurances, less dependent on continuing donor good will may be needed to convince Governments to assume the level of risk implicit in ambitious aid-dependent programmes. How might such assurances be given? The paper summarises proposals in an earlier DFID-funded report to establish an Aid Guarantee Facility for underpinning global aid⁶.

Throughout the paper, reference is made to row numbers in Table 1 on pages iv-viii, which summarises the advantages and disadvantages of options for dealing with each of these issues.

What Can be Done? Issues and Options

1. Encouraging Governments to Reflect Donor Promises of Increased Aid in Their Expenditure Plans

The problem

Although donors have promised increased aid at the global level, this is not reflected in commitments to the expenditure programmes of individual countries. Aid

⁵ HDNHE, World Bank (2005), Health Financing Revisited, forthcoming.

⁶ Foster, Mick (2005)

commitments to countries are short-term, with indications of future aid levels rarely stretching beyond three years. This is clearly insufficient: - the scaling up of expenditure that is required in low-income aid dependent countries will only be sustainable if the increased aid is maintained for many years, well beyond the planning horizon of most aid programmes⁷.

Even the medium-term indications provided by donors tend to be relatively conservative. Donors are usually reluctant to disclose future aid intentions before formally signing agreements, for fear of being criticised if subsequent budget cuts become necessary. A common pattern is for forecasts of donor aid to over-estimate disbursements in the coming year, due to implementation optimism, but to show a declining future aid pipeline by including only those activities that have been firmly identified⁸. This produces over optimistic assumptions for the coming budget, leading to a chronic problem of under achievement in budget implementation, but excessively pessimistic forecasts of the longer term outlook, leaving little or no scope for more ambitious plans.

Ministries of Finance in aid dependent Africa have recent experience of the problems caused by excessive budget deficits. Some are still struggling to establish macro-economic stability and budget discipline, and habits of prudent economic management remain fragile even in countries with a relatively long track record of improved macro-economic management. An important part of the struggle has been to move away from 'needs based' plans that were never implemented towards prioritised plans and budgets based on a realistic assessment of the resources available. The increased realism has brought significant benefits, and Governments will not risk their improved economic performance on the basis of vague indications of increased aid that may not materialise and may not be sustained. In the absence of clear evidence of donor intent to increase and sustain aid flows, Governments will continue to base their health and other expenditure plans on resource assumptions that are far less than is required to meet the MDGs, and far less than is potentially available. Moreover, in the absence of more ambitious plans, any additional sums that are made available by donors are less likely to be well spent.

Payment in advance

One way to address the problem is by providing the funding in advance and irrevocably. Debt relief is the only form of irrevocable long-term funding that has been used on a large scale in developing countries (1.1), but (though welcome) it can not provide sufficient support to some of the countries of greatest concern. Other forms of payment in advance have been proposed, such as payment into some form of 'endowment' fund that would be invested in international capital markets and drawn on to finance future expenditures⁹. The endowment fund approach fails on a number of practical grounds, the most important of which is that Ministries of Finance in donor countries are unlikely to be attracted to payment in advance of need. Indeed, the proposed International Finance Facility takes the exact opposite approach of borrowing on international capital markets in order to defer the cost of expanding aid flows.

⁷ Wagstaff and Claeson, op cit, p150.

⁸ Foster et al (2002).

⁹ Heller and Gupta, (2002).

Long-term commitments

The obvious way to change Government assumptions about future aid levels into line with donor promises is for donor agencies to make long term commitments setting out their intended level of aid to each country (1.2). If the commitments are believed, countries can plan to meet long-term goals with confidence that funds will be available. It is unrealistic to aim for commitments covering the twenty years or more for which increased aid may need to be sustained¹⁰. A possible alternative would be to combine a five to ten year commitment with assurances that, at the end of that period, the donor will make every effort to limit the speed of reductions in aid to a gradual pace that countries can adapt to. A rolling approach could also be taken, regularly extending the forward commitment in order to maintain a pipeline of sufficient length to inform planning and budgeting.

Unfortunately, donors have not so far been able to provide meaningful long-term commitments. Legislative constraints or sensitivity about committing successor Governments prevent some donors from making such commitments. Although some donors are sympathetic to the principle, they have been able to do no more than provide broad indications of their future long-term intentions, and actual disbursements have proved vulnerable to being interrupted due to policy concerns that lie beyond the formal conditionality of the agreement¹¹. Donors may also be reluctant to provide an increasing share of their aid in the form of long term commitments for fear of reducing their ability to respond to changing priorities or the threat of budget cuts. Donors are of course far better placed to manage such pressures than the poor countries they are assisting, but may nevertheless resist accepting the increased risk.

Long-term commitments to specific expenditure programmes

It may be a little easier for donors to make longer term commitments to specific expenditure programmes within a country (1.3). Donors have traditionally been able to make long- term commitments to projects, commitments that are usually honoured subject to any implementation delays. Projects are not a suitable instrument for funding a major scaling –up of expenditure dominated by recurrent costs, but it would be feasible to make longer term commitments of budget support earmarked to health. They could be designed to overcome the ‘Catch 22’ problem that aid to health may be low because plans are un-ambitious, while plans are un-ambitious because aid offers are low. Government and donor partners to the sector could work together in an iterative process to develop the sector plan and budget and identify the necessary funding.

The aim of earmarked long-term funding is to help finance more ambitious spending on programmes that both Government and development partners regard as of high priority, but which Government is unable to expand without additional and assured finance. However, it is difficult to know whether the aid, or the expenditure that it finances, is actually additional. Donors may fear that additional aid may be offset by a

¹⁰ For illustrations of this point for Ethiopia and Tanzania, see Foster et al, *The Case For Aid*, Volume 2.

¹¹ For example, the 10 year DFID commitment to Rwanda has experienced disbursement delays associated with relations with DRC.

reduced Government contribution, resulting in no overall increase in health expenditure but releasing Government funds for other purposes. Government may fear that the aid allocated to health may not be additional but comes at the cost of lower donor spending on other sectors, distorting national priorities if no offsetting action is taken. Neither Government nor development partners can be confident of achieving their expenditure intentions unless there is an understanding on the expenditure programme as a whole, and how it will be financed.

Crosscutting reforms could also merit assured long-term funding. Salary supplementation would be one obvious example, to enable higher salaries to be paid now in order to recruit, retain, and motivate key staff, with the supplements phasing out over time as GDP and revenue growth enables them to be met from domestic revenue. Reallocation of even a portion of the sums currently spent on expatriate advisers could have a substantial impact if re-applied to finance domestic salaries, but would need to be used for assured funding rather than being subject to hand to mouth conditions. The scheme could be either a general one, or limited to specific categories of staff that are difficult to retain, or used to attract and retain staff to live and work in rural areas where the poor live.

There is a danger that long term donor spending commitments earmarked to specific spending programmes may result in a transfer of perceived ownership and responsibility, as Government gets used to not budgeting own funds for the purpose. This concern can be partly addressed if donor funding is part of the Government budget, using Government systems to plan and disburse funds, perhaps with donor disbursements triggered by reimbursement requests.

Collective donor assurances of future aid

Although longer term commitments are a highly desirable and indeed essential part of the solution, they do not provide more than a very partial answer. Donors are unlikely to be able to make the longer term commitments that are required. If they do provide longer-term indications of support, they will be hedged around with caveats and are unlikely to be believed without heavy discounting of promises. Indeed, prudent finance ministries would be well advised to discount donor promises in the light of experience.

One approach to addressing the problem of individual donors failing to disburse at expected levels could be a collective donor commitment to maintain aid above a specified level, with shortfalls by one donor made up with additional commitments from others (1.4). The level of donor support to be defended in each country could be based on Government assumptions included in the budget and the medium-term expenditure framework. There have also been a number of attempts to provide similar assurances through international agreements, for example the SPA in the 1990s attempted to ensure that no African country with a credible adjustment programme would fail for lack of donor finance, while the Fast Track Initiative is motivated by a similar objective with respect to the funding of programmes to achieve Education For All.. Unfortunately, it is difficult in practice to make collective assurances work, either at the country or the global level. Donors try to avoid having idle funds, and the commitment and disbursement lag is such that it is difficult for replacement funding to be disbursed in the amounts required at the time when it is needed. Attracting

additional commitments will be especially difficult if the cause of under-disbursement is related to policy reservations by a specific donor. Other donors may not share the specific donor view of the situation and the case for reducing aid, but may nevertheless be reluctant to increase their own exposure. Given these various problems, a dedicated facility, as proposed in a DFID financed paper discussed in section 5, would seem to be a necessary underpinning to make any collective assurance credible.

Increase donor credibility by making aid less dependent on annual donor budgets

The credibility of the promised increase in global aid will be increased if measures are taken to make future global aid flows less dependent on annual budget votes (1.5). Measures such as the IFF (and the ‘mini IFF’ recently established to support GAVI), the proposed tax on aviation fuel or airfares, global carbon taxes, or the use of gold sales or SDR issues to fund development finance have the merit that, once agreed, they provide a secure stream of additional global development finance¹².

The funding of the multilateral development banks is agreed over longer-term periods and can be supplemented from their profits and capital market borrowing, making them less subject to fluctuations than the bilateral agencies. One way to secure the promised aid increases would be through larger and longer-term capital replenishments for the multilaterals. If funding for the multi-laterals were to be linked to hypothecation of some global tax, such as airline taxes, there would be a guaranteed source of future vigorous growth in resources for aid.

It is recognised that considerable time and effort will be required to make progress towards implementing any of the proposals at 1.5. Delegates may wish to consider which are most likely to prove feasible to negotiate and bring to fruition.

Improve aid forecasting, based on better donor reporting and accountability

Although Governments should continue to be sceptical of donor promises, it does seem clear that aid is increasing, and that developing countries should factor the increase into their plans.

Donors should help Governments to make realistic assumptions about the level of future aid they should assume. The main focus should be at country level (discussed under aid volatility), but there is also a useful role for improved international aid reporting and forecasting. In the same way that the World Bank produces commodity price forecasts that are helpful to country economic managers in making assumptions about export earnings and tax revenues, it would be possible to produce global and regional aid forecasts to help countries make reasoned assumptions about the aid they might receive, based on an informed assessment of the overall aid environment (1.6). It is suggested that this role might be taken on either by the DAC or by the World Bank. The DAC has published on its website a donor by donor forecast of aid to 2010, but it is explicitly based on the assumption that OECD donors deliver on their

¹² IMF/World Bank (April 2005 and September 2004) discuss a number of alternative mechanisms for financing global aid.

public statements. The World Bank produces a limited forecast for Global Development Finance and might be the more obvious choice, given that the consensual nature of the OECD may make it difficult for it to be associated with forecasts that would need to take a realistic and sometimes sceptical view of donor assertions.

The value of such aid forecasts would be to provide a starting point for framing realistic aid assumptions to be used in PRSPs, IMF programme discussions, medium term expenditure frameworks, sector programmes, and public expenditure reviews. The global aid forecast would provide a reality check on national assumptions. For example, it might prompt questions if the country is assuming aid to be flat when the global and regional forecast is for a significant increase. The reasons for the difference would need to be investigated, comparing aid: GDP ratios to the regional norm for countries of similar per capita income and population, and considering whether there are factors affecting aid effectiveness that might account for the difference. In other words, by informing judgements about the future aid environment, use of the forecast would help to avoid systematic bias in aid assumptions.

The value of aid forecasts depends on their quality. It would be difficult to produce meaningful forecasts without some related improvements in donor reporting. It is suggested that aid forecasting could be improved by each donor agency producing global forecasts of their overall future aid commitment and disbursement intentions, even if they are unable to make explicit future commitments to individual countries. These would need to include a reasonable degree of detail to be helpful. There is a particular need to improve reporting on the share of donor aid that finances Government expenditure plans. A significant share of the ODA flows that are reported to DAC never enter public expenditure or the budget, and do not contribute to financing the PRSP or Government plans.

A useful reality check could be provided if the annual DAC report included data on actual disbursements compared to previously declared intentions. This will require considerable effort to make donor reporting to DAC rather more meaningful than it is at present. Donor self reporting at present is impossible to compare with country level data on what has been received, and it is difficult to know what value or meaning to attach to it. Data that enabled donor promises to be verified would be immensely useful. It would provide an objective basis for adjusting aid forecasts. It would also enable Governments, civil society aid lobbyists, and donor peers to hold agencies to account, questioning the reasons for low disbursement and pressing for promises to be met. For that very reason, donors might be reluctant to provide indications of their future aid, and might also resist publication of the data. However, if there is reluctance to publish future aid expectations, that in itself is an indication that Governments need to err on the side of caution in discounting aid promises.

Multiple aid scenarios for national planning

Even with these measures in place, Governments will face uncertainty as to their future aid flows. There may therefore be a case for low-income countries producing more than one forward scenario for their PRSP and medium and long-term expenditure plans, reflecting inter alia the impact of alternative aid assumptions (1.7). The preparation of multiple scenarios does imply additional effort by hard pressed

Governments, and there are dangers of demotivating staff if the higher scenario proves impossible to implement due to lack of resources. Nevertheless, a clearly articulated 'high' scenario, setting out what could be achieved with higher aid, would be valuable for persuading donors to increase their commitments, and would also help ensure that unexpectedly high commitments can be used in a timely and effective manner.

Procurement Subsidies

In addition to measures to increase long-term aid, there has also been discussion of measures to address the problem from the other side, reducing the cost of procurement of medicines and other supplies by global subsidies and advance bulk purchase. This can have a significant and very positive impact by reducing the scale of the funding shortfall that needs to be bridged.

2. Reconciling Longer-term Commitments with Aid Effectiveness

The problem

Since the early 1980s, donors have used conditionality to ensure that aid is disbursed in a policy environment in which it can be effective (2.1). Budget support is particularly dependent on reaching an understanding with Government on future policy measures, but the approach is also common in sector discussions, and the 'policy matrix' is also a common feature of PRSPs that have a significant influence on the overall level of donor support. The donor approach has been modified to place less emphasis on buying future promises, and more on Government ownership and the track record of implementation. However, the modifications of approach that have been implemented or are under discussion do not address the fundamental problem that Governments are being asked to take on long-term spending obligations based on short-term and conditional offers of support. The Government must be confident not only that it can implement current agreements with donors, but that it will be able to keep the aid flowing by negotiating a series of future agreements, the terms of which are presently unknown. Most forms of programme aid or budget support are based on an annual commitment cycle, linked in best practice cases to the Government budget cycle. Although this can bring greater predictability to the annual budget, it is of little help to a Government deciding whether it dare take the risk of relying on aid to implement a long-term plan to scale up public expenditure, involving recurrent expenditure obligations that will be difficult to withdraw from if funds fall short.

The risks are multiplied by donor insistence on retaining clauses that enable them to withdraw aid if Government behaves in ways that they find unacceptable. It is clearly necessary to be able to withdraw funds in the light of major corruption scandals or human rights abuses. The problem from the Government perspective is that it is difficult to predict or control the issues over which donors may choose to interrupt funding, and the potential intrusion on national sovereignty can be difficult to accept.

‘Entitlement’ approach

The only way to provide completely assured long-term funding would be through an ‘entitlement’ approach to aid allocation (2.2), with commitments based on need and maintained irrespective of Government behaviour (though aid could perhaps be directed through non-Government routes in the worst cases.) This would ignore the evidence that aid achieves less in difficult environments, and would be unlikely to be acceptable to donor Governments, nor would it result in the best contribution to poverty reduction.

An allocation model with performance assessment

A more realistic approach to the need to ensure aid effectiveness in the context of moving towards longer-term commitments would adjust the level of commitment each year based on an annual assessment of need, and of the policy, institutions, and progress being achieved towards development outcomes (2.3). The level of aid would change slowly in the light of changing performance, giving enough time for dialogue on how matters can be improved and, if unsuccessful, giving Government time to adjust spending commitments to a more constrained aid outlook. Ideally, the aid allocation model(s) in use should include not only policy and institutional indicators, but also (and perhaps mainly) indicators tracking the change in outcomes, as Ravi Kanbur has argued¹³. This would shift the policy debate towards what is working rather than what is popular with the donors, and would be consistent with improved country ownership and responsibility.

Ideally, the approach should apply to total aid to a country, from all sources. This could be done through a joint consultation and commitment process. The Commission for Africa proposed something broadly along these lines:

‘To improve the quality of aid an annual discussion should take place between the Development Ministers of the OECD countries and African Finance Ministers, along with representatives of civil society and international organisations. This should consider aid allocation criteria and make suggestions for a better distribution, including between middle and low income countries. In countries where governance and institutions are weaker, donors should seek to provide adequate and effective flows through appropriate channels, bearing in mind the need to avoid undermining national systems and/or long-term sustainability¹⁴.’

Either as an alternative or a complement to such an approach, one or more donors (the World Bank?) could operate as ‘swing donor’, taking explicit account of other donor commitments when allocating funding in order to achieve a desirable global allocation of aid. This might have the added benefit that donors with a poor track record would be forced to reform, since partner Governments would be more inclined to refuse poor quality aid in the knowledge that lower receipts from weak donors would be at least partly compensated by higher receipts of better quality aid from the World Bank. The swing donor role might be controversial, given that it explicitly seeks to alter the impact of allocation decisions by bilateral donors.

¹³ Kanbur, Ravi, 2004

¹⁴ Commission for Africa, op cit.

The main constraint on moving towards such an approach to conditionality is probably the continuing donor need to react quickly to serious problems of a political, governance, or human rights nature. It is unlikely to be feasible to insulate aid flows from such concerns, though it might be possible to ensure that funding that is clearly linked to specific long-term welfare goals is protected even if aggregate aid to Government is reduced.

Conditionality at sector and sub-sector level

There are a number of alternative approaches in use that attempt to provide reasonably predictable, on-budget funding to medium-term expenditure programmes, whether sectoral SWAPs or vertical interventions in areas such as HIV-AIDS. The main donor concern about making longer commitments to sectors is how best to ensure that they are well used, given that ‘blueprint’ style conditions and complete definition of future spending programmes is not feasible beyond a short to medium term time frame (2.4). Longer-term commitments therefore require a combination of both conditions at entry, and agreement on how future decisions will be made in order to ensure that the agreed goals continue to be pursued effectively.

These considerations could lead in the same direction as the ‘aid allocation model’ option, with long term indications of support if progress is maintained, annual performance review, and specific assurances that worse than expected performance will provoke first discussion, and then a moderated response calculated to be gradual enough for the Government to adjust to lower aid flows (2.5). Such a partnership approach is close to existing practice in sector SWAPs, some of which have already been in place since the mid 1990s, and have weathered major disagreements.

Expenditure programmes meriting long-term finance with minimal conditions

It might be feasible for donors to provide assured long-term finance for specific expenditure obligations judged to carry a low risk of significant policy disagreements, irrespective of problems in other aspects of the aid relationship. Although the effectiveness of most public expenditure depends on the overall effectiveness of public sector management, it may be feasible to identify some expenditure areas where long-term commitments are particularly needed and where donors are willing to make them with minimal and clearly specified conditionality. Treatment of HIV/AIDS patients is the most obvious (and most expensive) one. Once people are started on HAART treatment, it would be unethical not to continue it, yet treatment programmes are being committed in five-year tranches, even though Governments will be unable to sustain them thereafter. It should be axiomatic that AIDS treatment programmes take responsibility for maintaining the treatment of those recruited to the programme for the rest of their life; indeed, where the programme creates an expectation that the much larger numbers yet to show symptoms should also receive treatment, it will be necessary to also meet those costs externally. If donors cannot provide such assurances, it could be argued to be irresponsible to encourage countries to embark on treatment programmes that divert funding from interventions that could save more lives at lower cost.

There is no reason in principle why longer term commitments to specific spending programmes should not be made in countries with relatively weak policy and institutional frameworks, particularly if the scale of the donor commitments enables programmes to be significantly protected from some of the problems. However, the stress on Government ownership might be different in such environments, with a focus on helping to build competent and accountable institutions, but with more checks and balances and more earmarking of funds until and unless such efforts pay off.

Conditionality and predictability: Summary

In summary, the approach to conditionality needs to change if longer-term commitments are to be a basis for longer-term and more ambitious plans to reach the MDGs. It seems unlikely that commitments can be entirely unconditional. However, there is scope for moderating the share of aid that is subject to interruption for non – performance, and moderating the speed at which donors react to poor performance, in order to build in time for dialogue and, if agreement is not reached, for adjustment to lower aid levels. Specific longer- term spending obligations could be supported by assured and longer-term commitments from donors, subject to Government implementing the agreed plan and spending allocations. Commitments will never be made for the 20 year period that increased aid will need to be sustained in some country cases, but sufficient assurance might be provided by a combination of 5+ year commitments, assurances of notice before funding is reduced, and a reasonable faith that good performance will continue to attract the required aid to sustain services. Assurances would be more effective in the context of coordination arrangements in which Government and donors jointly review funding needs and identify ways to meet any financing gap. As a DFID financed report has suggested, country level donor efforts to provide more secure donor finance could be underpinned by access to a new Aid Guarantee facility, an external source of funds to compensate for unanticipated funding shortfalls. Section 5 sets out the proposal in more detail.

3. Ensuring Donor Support Helps Finance the Government Plan

With limited resources available, it is important that they be prioritised in support of a single strategy, plan, and budget that has been prioritised and assessed for longer term sustainability. This does not imply some form of Stalinist central planning. The Government strategy may well include support for a mixed system with a combination of public and private finance and a range of service providers. It may include provision for supporting a range of pilot projects designed to learn lessons for future replication. It may involve a good deal of devolution of responsibility to local authorities. However, what it needs to avoid is a situation where uncoordinated donor interventions result in big differences between areas in the resources and services that are available and the ability of the population to access them. It needs to avoid expensive health interventions being prioritised over others that may save more lives for the same budget.

In terms of the macro economy, much depends on the foreign content of donor commitments. The Ministry of Finance and the Central Bank will have established with the IMF a macroeconomic programme that aims for a growth in domestic demand that is thought to be consistent with their inflation target. Unless aid is spent

entirely on foreign exchange with no implications for domestic demand, any aid expenditure can in principle only be accommodated within the macroeconomic programme by displacing some other expenditure with equivalent impact on domestic demand. If donors fund activities that are outside the Government plan, Government has two alternatives. If it leaves total public expenditure unchanged, the donor support will displace other expenditure that Government would have preferred. If a reasonable plan has been produced, expenditure allocation is unlikely to be improved by sacrificing elements of it in favour of donor project commitments that have less Government ownership. If Government decides instead to increase public expenditure to include the off-plan donor commitments, it adds to aggregate demand, and may require a tighter squeeze on the private sector in order to accommodate the extra spending. Although these issues may seem of little practical significance at current levels of aid spending, they will become important if aid is significantly increased. It matters a great deal whether a 10% of GDP increase in aid is used to finance agreed national priorities, or ends up displacing private investment and higher priority Government spending programmes in favour of donor interventions of doubtful sustainability.

It is therefore proposed that donor funding needs to give first priority to filling gaps within the Government strategy, plan, and budget for the sector. Donor agencies can and should participate in the dialogue around the formulation of Government policies and plans, but their support should focus on helping Government to fill the financing gaps in order to realise the strategy that has been articulated.

4. Reducing the Cost of Aid Volatility

The problem¹⁵

Aid is a far more volatile source of finance than domestic revenues. This volatility is most severe in those countries that depend most heavily on aid. The variability of aid does not offset the impact of other shocks on the receiving economy, but actually seems to amplify them, increasing in good times, but falling when difficult conditions increase the need for external finance. The problem of aid variability is highest in countries suffering high levels of domestic revenue variability, compounding their problems.

Aid is not only very variable, it is also hard to predict. Donor commitment promises are so unreliable that predictions based simply on past trends are more accurate than those that make use of donor commitments. Average shortfalls in aid receipts relative to the budget were equivalent to nearly 2% of GDP in a sample of 28 countries, with no less than 24 of them suffering shortfalls. Moreover, the shortfalls were greatest on programme aid, the untied funds of most importance for macro and budget management. Even countries that met policy conditions experienced large shortfalls¹⁶.

The uncertainty and unpredictability of aid has a statistically significant negative impact on growth. It also makes macro and budget management more difficult.

¹⁵ This section draws on the summary of the literature in Foster and Keith, op cit, Annex 2.

¹⁶ Bulir and Hamann.

Best practice approaches

A number of best practice approaches have been identified to tackle the problem of short-run aid volatility, particularly with respect to budget support¹⁷. Where budget support groups exist, donors are trying to move towards providing medium term indications of future aid, committing funds early enough to inform budget preparation, being explicit on donor conditionality (but with not all funding vulnerable to poor performance), providing budget support disbursements in a single tranche scheduled early in the year, with active reporting and monitoring of actual flows, and using Government procedures to disburse and account wherever possible. As far as possible, conditionality is being applied to the following financial year, avoiding disruption of the approved budget. Similar approaches are beginning to be considered in sector wide approaches.

Where they are effective, these approaches facilitate timely and full budget implementation, and give Government more time to react and adjust to donor concerns and funding intentions. The problem is that the formal agreements have not prevented individual donors interrupting disbursements during the year due to political or human rights concerns not reflected in formal conditionality, while next year's budget remains hostage to the ability of the Finance Ministry to convince the donors that past performance and the future programme merit continued support.

In addition to measures to reduce the volatility of donor funding, it is also possible to mitigate the effects.

Use foreign exchange reserves to smooth fluctuations

The impact of fluctuating aid levels can be smoothed through active use of foreign exchange reserves, and through adjusting Government use of domestic credit. IMF programmes usually include provision for automatic adjustments to foreign exchange and net Government borrowing targets to offset over or under estimation of donor funding. Foreign exchange reserve targets are normally set in relation to the need to smooth fluctuations in the foreign exchange market. It is arguable that it is at least equally relevant (in a world of floating exchange rates) to set foreign exchange reserves at the level required in order to smooth fluctuations in the resources available for funding the budget. It would be recognised that countries that are relatively more aid dependent (and those that are increasing their aid dependence) would need to also have higher foreign exchange reserves to cushion fluctuations in aid, and provide more time to adjust to any unexpected decline in aid levels. Rather than setting the foreign exchange reserve target mainly in terms of months of import cover, it could also be set with reference to fluctuations in budget resources and the required level of reserves to achieve a target degree of smoothing of the flows. The level would also depend on the size and sophistication of domestic credit markets, and the extent to which Government can finance any external aid shortfall domestically without incurring debt service problems or generating inflation or a squeeze on private credit.

Although it would be worthwhile to ask the IMF to look at the implications for forex targets of this approach, there are some important constraints. There are risks in

¹⁷ Crown Agents (1); DFID (1); OECD-DAC (1) and (2).

encouraging Governments to think of foreign exchange reserves as part of budget finance rather than one of the resources available to an independent central bank for macro management; and there are clear temptations for Governments to raid larger foreign exchange reserves to help fund pet projects or their own re-election. Donors may also object to increasing aid to countries holding substantial foreign exchange reserves, though that problem should be possible to deal with through explicit discussion of the rationale for the target. The risks of Government raiding the reserves could also be reduced through the design of IMF programme targets.

It is possible that foreign exchange reserve increases may happen anyway as a consequence of a large increase in external aid used to finance an increase in public expenditure with a fairly low foreign exchange content. Central Banks have tended to accumulate foreign exchange reserves to avoid real exchange rate appreciation damaging export growth. In the short term, this problem may disappear due to the impact of higher oil prices, but it is likely to re-emerge, and the scope for ameliorating it through further import liberalisation may not be sufficient to absorb the level of aid increase that is now contemplated. If donors are able to adopt a relaxed attitude to the increase in foreign exchange reserves, this may provide a useful mechanism for building capacity for countries to protect themselves from future reductions in aid. The fiscal space implications, however, are not entirely benign. If increased aid is not absorbed through increased demand for foreign exchange, the implication is that the increased public expenditure has been financed from domestic rather than foreign sources, essentially by squeezing private sector demand.

Helping governments address absorptive capacity constraints – and ensuring donor procedures do not cause them

Volatility or shortfalls in aid disbursements may not originate with the donor. Donors often ascribe low disbursement to absorptive capacity constraints within the recipient Government. Absorptive capacity constraints may reflect absolute supply limitations within the economy:- shortages of skilled personnel or of construction capacity that can only be overcome by bidding resources away from other sectors in the short-term, or by investment in new capacity in the longer term. In most cases, however, the problems in making timely and effective use of additional external aid reflect problems in the effectiveness with which resources are allocated and managed. Common problems include late availability of budgeted funds, and excessively time-consuming and bureaucratic procedures for using them. Donors can help to address these issues by supporting public expenditure management reforms that aim to decentralise budgets and management authority to those responsible for delivering services, while themselves adopting ‘best practice’ approaches to ensure their own procedures are not causing delays.

Governments desire assured donor funding to avoid aid shortfalls leading to interrupted implementation or unplanned budget deficits. However, how should donors react when absorptive capacity constraints prevent Government from meeting their spending targets, resulting in a reduced need for funds? This issue is actually fairly straightforward to handle:-

- i. The main focus of collective donor assurance should be donor support to the annual budget. Dialogue between Government and the donor group providing

budget support should be capable of identifying funding gaps relative to previous assumptions reflected in the budget and the MTEF. A methodology involving advance funding of an account that is replenished based on evidence of expenditure provides a ‘cushion’ of funds that gives time for aid shortfalls to be made up from new commitments, without causing interruptions in budget implementation. On the other hand, aid disbursements would not be triggered if low budget implementation meant there was no need to replenish the account. In principle, budget support could become the main mechanism for external support to Government expenditure, including the development or investment budget.

- ii. Where donor commitments continue to be given for specific Government projects or for earmarked support (e.g. condoms or other commodity imports), the key question is whether the costs of the programme are fully covered by Government and donor funding commitments. Government would as at present seek additional donor commitments for filling funding gaps (for example, to keep the future pipeline of drugs and other commodities full). However, if programmed expenditures are fully covered by existing commitments, a shortfall in expenditure reduces aid disbursements, but the remaining balance of donor commitments remains available for when implementation picks up, and no funding gap is created. The low disbursement might trigger a review of the causes of low implementation and what can be done about them, but would not be an argument for seeking additional commitments.
- iii. Donor commitments to projects or programmes that are outside the Government budget would remain the responsibility of the donor, and would not be the subject of any collective assurance.

5. Insuring Countries Against Donor Non-Performance?¹⁸

The problem

The long term nature of the public expenditure obligations involved in trying to achieve the MDGs will inevitably make Governments wary of embarking on a major scaling up of expenditure based simply on faith in the continuing goodwill of the donor community. It may be helpful to establish a mechanism to insure aid-dependent countries against the risk of aid donors not fulfilling their promises.

Proposed Aid Guarantee Facility

The Aid Guarantee Facility that has been proposed in a DFID-funded study would aim to limit the risk that aid may be less than has been promised, may be excessively volatile, and may decline abruptly leaving Governments with obligations that are difficult for them to meet. Access to the facility would mean that, even if donors provide no long-term commitments, Government can be confident that the speed at which aid declines from peak levels will be moderated to a pace that they should be able to adjust to.

¹⁸ This section draws on Foster, January 2005, op cit.

What types of aid should be stabilised?

Access to the facility would be limited to highly aid dependent low-income countries, to focus support on countries most vulnerable to aid shortfalls, and to limit the cost. For eligible countries, the facility would guarantee minimum levels of programme aid (general and sectoral budget support, plus some types of commodity support and basket funding). Project aid would be excluded because it covers a wide range of disbursement methods, is difficult to monitor, and because spending often reflects physical implementation and therefore aid shortfalls need not imply a funding gap that needs to be filled.

Suggested procedure for accessing funds

The proposal is that:

- Each eligible country, with the endorsement of the participating donor group, would agree with the facility managers which categories of aid will be insured against shortfalls, how disbursements will be monitored, and what level of expected aid will be guaranteed.
- In the third quarter of the budget year, the Government, together with a designated lead donor, would assess the expected disbursements of relevant categories of aid compared to the guaranteed minimum and, if there is a shortfall, apply to the facility for a drawing on the fund. To avoid the need for a cumbersome and time-consuming process for verifying and agreeing the numbers, the other donors providing finance would be copied in but only consulted on a 'no objection' basis.
- If there were no objection from donor partners, funds would be released on a non-discretionary basis by the facility managers, within (say) one month of receiving the application, enabling disbursement to occur within the financial year to which the application refers. The facility managers would only conduct basic checks to ascertain that the guaranteed funding level was as previously agreed, and that the donor partner had endorsed the estimates of likely disbursement.
- There will be discrepancies between actual aid disbursements and those expected at the time of application. Excess drawing from the fund would be repaid in the following year, subject to not causing a dip in aid below the guaranteed level for that year. If the initial drawing proves too low, supplementary requests should be made once it becomes clear that aid has been over-estimated.
- The facility would operate as a revolving fund, but drawings from the fund would only become repayable if and when actual aid receipts exceed the guaranteed level for the relevant year, and will be limited in amount to ensure that aid net of repayments never falls below the guaranteed level.

- Access to the facility would be unconditional, unless two or more donor partners object, in which case the proposal would go for final decision to an international panel with good representation from low-income countries. The aim of this procedure is to protect the facility from the risk of having to disburse in extreme circumstances such as societal breakdown or grave human rights abuses, while also protecting the Government from donors arbitrarily denying access to the facility. For reasons of speed and cost, the panel would use e-discussion, conference calls or video conferencing to make quick decisions, and would have a sufficient number of alternates to avoid delaying decisions for lack of a quorum.

Defining minimum guaranteed aid

The DFID study leaves open the definition of minimum aid levels to be guaranteed. To fully meet the objectives, guarantees would need to be of two types, both of which would be applied in all eligible countries.

The first guarantee protects countries from a sharp decline in the level of disbursements, and is independent of the level of commitments that donors may have made. For example, the facility might guarantee that disbursements of relevant categories of aid in any year, including drawings on the facility, would not fall below (for example) 90% of the average of the two previous years. This would ensure that, having used aid to increase public expenditure, the country is not then faced with a massive financing gap due to an abrupt withdrawal of budget support. Disbursements may still decline over time, but the facility would aim to limit the speed of decline and give the Government more time to adjust spending obligations to the reduced level of external support.

The second guarantee would apply in circumstances where donors have committed themselves to increase aid, and would insure the country against the risk of donors falling short of their promises. The normal profile in a scaling-up situation will be one in which the pipeline of future donor commitments implies increased aid for the next two to three years, tailing off thereafter because of relatively short donor commitment horizons. If longer-term commitments are made, it is possible that the country will request the fund to guarantee a relatively steep and relatively long-term increase in aid. The facility managers will assess the risk and inform the country of the aid levels that it will guarantee. The normal approach will be for the facility to guarantee a minimum rate of increase during the period when aid receipts are expected to grow. For example, if donor promises indicate a 20% per annum increase in the relevant categories of support in the next two budget years, the guarantee might aim to ensure that actual disbursements increase by at least 10% each year above the previous actual disbursements (including drawings on the facility).

The two guarantees, taken together, ensure that a reasonable proportion of promised donor increases in budget support will be received, and that (once a higher level of aid receipts has been achieved) disbursements will be phased out slowly rather than abruptly withdrawn. These two guarantees, taken together, significantly reduce the risks of relying on aid to finance higher public expenditure.

Ensuring the solvency of the facility

The guarantees offered by the proposed facility will only be credible if Governments are convinced that the facility will not itself run out of funds. Some arrangement is needed to underwrite the funding of the facility which, although set up as a revolving fund, will not be self-sufficient and will need a secure source of long-term funding. The problem could be solved by signed long-term agreements from supporting donors, or by linkage to one of the sources of long-term funding discussed in Table 1 (row 1.6).

The facility would also need to limit the risk of continuing to guarantee previous donor promises of medium to long-term increases in relevant categories of aid in a situation where circumstances have changed and disbursements are static or falling. There is a danger that perceived poor performance may lead donors to reduce their disbursements to a country, making the aid guarantee increasingly unrealistic if not revised, and posing a risk to the solvency of the facility.

To control this risk, it has been proposed that, after any drawing on the facility, the Government and contact donor should submit a joint letter setting out the causes of the shortfall, and what action has been taken to mobilise additional funds and improve disbursement outturn. If a country draws particularly heavily (aid less than 70% of guaranteed levels, or more than 15% of fund resources?) or persistently (either two or three years in a row), then Government and donors to the country would review the situation with the facility manager, to assess whether the guaranteed minimum aid levels remain appropriate and how they can continue to be funded.

The action taken following a review will depend to some extent on the nature and causes of the donor shortfall.

It is proposed that, in all but the most extreme circumstances, the facility should always prevent a sharp reduction in aid from levels experienced in previous years. The only circumstances in which this would not apply would be egregious corruption, major deterioration in human rights or security, or planned aid withdrawal following a big increase in wealth due to, for example, bringing on stream of significant oil or mineral production. The facility would thus ensure that the operation of conventional policy conditionality results in a slowing of aid disbursements rather than an abrupt cut.

It is more difficult for the facility to guarantee previous promises of continuously rising aid levels if actual disbursements are flat or declining. One way to provide a useful guarantee without risking exponential growth in drawings would be to base the guarantee on achieving a minimum annual increase above actual disbursements in the previous year or two, including facility drawings, but with the speed of increase limited by the exposure the fund can afford. The proposed review would then examine whether donors still intend to increase their support, and would adjust the guarantee as necessary to reflect a realistic future profile.

This approach, though inevitable, is a little unsatisfactory, in that it protects countries from abrupt declines in aid, but does not ensure that aid will grow as rapidly as has been promised. To mobilise aid for countries facing shortfalls, increase pressure on

donors, and enable civil society organisations to monitor action and lobby for more to be done, the facility web site could publish data on countries making use of the facility, and copies of the explanatory letters and review findings, drawing attention to the scale of the aid shortfalls and actions needed.

Next Steps

The quickest and simplest way to get something up and running would be to develop a proposal and then seek voluntary donations from interested donors. Detailed modelling is required to establish the required size of the facility, and review alternative options for country coverage and the level of guarantee. If the proposed facility is felt to have merit, a working group of interested donors and potentially eligible countries might be convened to develop it further, commissioning a more detailed design study to flesh out the organisational arrangements and operating procedures, and to estimate the financing required on various approaches to defining eligibility for funds. Outline TORs for a design study were included in the DFID study.

To reduce the risks of funds lying idle or of donors facing unexpected and large calls for supplementary resources, it is suggested that the proposed facility should focus to begin with on a small group of very poor and aid dependent countries, and with cautious assumptions as to the minimum aid guarantees, in order to ensure that costs are within the resources available. The ambition of the fund could be expanded as experience improves knowledge of the financial risks, and as (hopefully) success attracts additional donor contributions.

Health Sector Guarantee Fund?

The DFID report suggests that it would also be possible to develop one or more sectoral funds to guarantee aid for specific purposes, such as the expansion of health sector expenditure. The idea is not, however, fully developed.

The main issue that would need to be addressed in applying the idea at sector level would be how to define aid to the health sector, in a context in which an increasing share of ODA to some of the more aid-dependent countries is being provided as general budget support, not earmarked to specific sectors or purposes. There would be a number of issues to be addressed:

- It would not be appropriate to guarantee funding earmarked to health in a situation where total aid is in line with promised levels, but aid earmarked to health had been reduced in favour of general budget support, or spending on a different sector. In such a situation, Government is able to make up for any shortfall in health aid from the increased general budget resources now at its disposal.
- It would also be inappropriate for donor support to compensate for reduced Government health spending from domestic resources, but this may prove difficult to identify in a situation where the amount of donor support helping to finance the overall budget and the health budget may be changing.

- If Government favours receiving an increased proportion of aid as general budget support, it is important to avoid designing a sectoral guarantee fund that provides a positive incentive for donors to continue earmarking their aid to health.
- There is no point compensating Government after the event for donor failure to provide finance for expenditure that did not take place.

Although it should be possible to design a sector guarantee fund that is capable of handling these problems, it would be complicated and not very transparent, and might as a consequence fail to achieve the main objective, which is to convince Government that it can safely increase health expenditure based on increased aid commitments. It is therefore suggested that any guarantee fund should be general, rather than sector specific.

Response to comments on the DFID-financed study

The initial DFID study has so far received only limited discussion. Annex 2 discusses the comments received to date. Although the practical and political difficulties that need to be resolved are formidable, there is nothing in the comments that need prevent the suggestion receiving further study. It remains the only proposal on the table that has the potential to provide aid-dependent Governments with the assurance they need that future aid will be reasonably close to promised levels, and that any subsequent reductions will be phased at a speed to which they can adjust.

Annex 1: Terms of Reference

Background Paper for the High-Level Forum on the Health MDGs on “Fiscal space and sustainability - towards a solution for the health sector”

Background

The Second High-Level Forum on the Health MDGs, meeting in Abuja in December 2004, tasked the World Bank and the IMF to:

1. clarify the concept of fiscal space and sustainability in the presence of long term grant funding and concessional lending at the country level and the implications for sector expenditure ceilings;
2. work with other development partners on possible mechanisms to increase the volume and predictability of funding taking into consideration the DFID proposal¹⁹ (and potentially others); and
3. report back to the Third High Level Forum (HLF3), scheduled for December 2005.

These terms of reference relate to the second point, and this work will explore the political and technical feasibility of mechanisms to increase aid predictability, in particular for the health sector. Work to clarify the concept of fiscal space and predictability will be undertaken separately and in advance of this consultancy, in order to inform its output.

Purpose

In the context of requests made in Abuja, the High Level Forum Secretariat is commissioning a paper which considers the key issues in fiscal space and aid sustainability and makes recommendations for addressing these *from a health sector perspective*. A critical issue concerns how donor agency programming of additional aid should relate to the planning and budget process at country level. Donor agencies have proved reluctant to make medium to long term commitments of aid to specific countries, and commitments that have been made have often not been fulfilled in timing or amount. The Governments of low income countries are accordingly reluctant to undermine hard-won fiscal discipline by preparing ambitious health sector plans and budgets without assurances on future aid levels. The paper will therefore:-

- (i) Identify the aid commitment, aid predictability, and budget management issues that need to be addressed in order to plan and implement a scaling up of health sector expenditure financed by additional aid.
- (ii) Map out the parameters of possible solutions, without making recommendations.

¹⁹ DFID tabled a proposal to move at a faster pace to provide longer term predictable financing. The note suggests that progress is being made within the DAC framework on improving the predictability of bilateral financing, but that multilateral mechanisms are needed to make faster progress. The proposal is to consider IDA financing for 50% of the required incremental recurrent cost for more ambitious health sector plans (designed to reach the MDGs) over a 6 to 7 year time period, with bilaterals providing the other 50%. To overcome the uncertainties of fluctuations in donor funding over the medium term, the establishment of a separate pooled fund to operate along-side the IDA program is envisaged.

At HLF3 in Paris, presentation of the paper will be followed by a series of responses which look at solutions in more detail - (for example, but not yet finalised): EC on long-term commitments; DFID on the Aid Guarantee Fund; IMF on Dutch Disease and increasing reserves; as well as presentations from Ministers of Finance on how they are managing these issues on a day -to-day basis.

Contents

The introductory sections of the paper should briefly summarise the main issues surrounding fiscal space and aid sustainability from the point of view of the health sector. This section will flow directly from paper one of this consultancy.

The paper should outline areas in which new work might be useful, and make suggestions on the future role of the IMF, World Bank, bilateral donors and countries in regard to each. These might include:

- Greater use of reserves
- Innovative financing (such as IFF, European Airline Tax and others)
- Long-term budget support / rolling medium-term commitments
- DFID's Aid Guarantee Fund

In outlining these possible solutions, the consultants might look at the potential *contribution and limitations* of existing processes such as the OECD/DAC work on Harmonization and Alignment for Aid Effectiveness, as well as the move to PRSPs, budget support and multi-sector investments.

The paper should distil the most important findings on all of the above into four or five questions for Health, Finance and Aid Ministers to address during the third High Level Forum. These questions should help frame the discussion in Paris, and encourage participants to reach agreement on actions to improve fiscal space and predictability for health.

Sources of information

This paper should follow on from the HLF-commissioned paper on defining fiscal space and predictability in the health sector.

In addition to publicly-available literature on these topics, the paper should draw on recent work by DFID, the IMF, and the World Bank and IMF. *Country illustrations should be woven into the text rather than presented separately.*

Length

- 15-20 pages single-spaced A4, with a 2-3 page executive summary

Timeline

- A first draft of the paper should be presented for review to the HLF Secretariat by late-September.
- A second draft will be produced in time for a Technical Advisory Group meeting, in London in late September.
- A final draft will be produced by end of the first week of October.

Annex 2: Proposed Aid Guarantee Fund: Comments on the Proposal and Responses from the Author

Comment	Response
<p>An Aid Guarantee Fund could do little or nothing in cases where the reason for the gap between commitment and actual expenditures is due to public expenditure management issues in the recipient country. Rather a program that helps the country overcome these flaws is needed.</p>	<p>It is of course true that implementation problems may result in lower than expected expenditure, reducing the need for aid or for minimum aid guarantees. The proposal aims to guarantee only budget support, recognising that the development budget (mainly funded by project aid at present) is likely to be prone to implementation problems with reduced expenditure matched by reduced finance.</p> <p>Of course, budget support may also be funding areas of expenditure that can be subject to implementation problems, especially if expenditure is increasing rapidly. However, the likelihood of experiencing implementation problems can be reduced if aid is reliably available when needed. Access to guaranteed minimum budget support will be a helpful complement to programmes to improve public expenditure management, enabling the Ministry of Finance to make the full and timely budget releases that are necessary to underpin planned improvements in budget formulation and execution.</p> <p>Aid shortfalls cause major damage to economic growth and public expenditure outcomes, whereas much good, and little harm, is done by donors meeting their budget support commitments in full, even if public expenditure is lower than budgeted. Government borrowing will be a little lower, foreign exchange reserves a little higher, while annual expenditure and PRSP reviews can address the causes and remedies and the implications for the budget in the following year. In any case, the proposal is to guarantee only a portion of expected budget support, keeping any shortfall within manageable bounds, but not eliminating it.</p>
<p>The facility is essentially an insurance mechanism. As such, the incentives created by the facility for both donors and recipients must be carefully taken into consideration to avoid moral hazard. This is especially true for the case of insurance against non-disbursement due to non-compliance with conditionalities. If the condition in question is fully under the control of the recipient country, there should be no need for such an insurance mechanism. The facility should not be used for "fixing" conditionalities which were poorly designed or should not have been set in the first place.</p>	<p>The problem is that the aid will be needed long-term, but the conditions are set annually, so that the Government is taking on the risk of increased aid dependence without even knowing what conditions will be imposed in return for funds that have yet to be committed. Conditions are therefore not in any sense 'under their control.' With the proposed facility in place, Governments that are unable to agree to donor conditions or do not comply with them will face a reduction in their future aid flows, but it will be at a measured pace, designed to give them time to adjust their spending obligations to lower than expected aid receipts. The guarantee limits the impact of short-term conditionality, recognising that Governments need to implement reforms because they believe in them, not because of donor conditions, and that dialogue and slow adjustment to funding levels is likely to produce better development outcomes than stop-go did.</p>

Comment	Response
<p>The Facility must be carefully designed to avoid moral hazard on the part of both donors and recipient countries.</p>	<p>In addition to policy conditionality, discussed above, the design recognises dangers of creating incentives to distort aid figures in order to maximise drawings on the fund, and seeks to reduce them through dual Government and lead donor responsibility, and through the requirement for reviews of fund drawings. Donor exaggeration of commitments will attract publicity and pressure from peers and CSOs.</p>
<p>In the case that the facility is geared towards insuring volatility caused by donor behaviour, it would make sense that the repayments for drawing on the facility be made by the donors and not by the recipient countries.</p>	<p>Who pays makes little practical difference. Repayments will only be triggered if aid receipts exceed the guaranteed level. Although obliging the donors responsible for the shortfall to repay may appear attractive, attribution and collection is likely to prove a messy political and bureaucratic process. The proposed approach has the merit of simplicity. In the event that obtaining repayment proves difficult, the option of budget support donors making repayments to the facility as a first charge on new support is potentially available.</p>
<p>The Aid Guarantee facility cannot and should not insure against all... causes of volatility.</p> <p>The instrument is probably most appropriate for insuring against those risks caused by donor behaviour or that are exogenous in nature.</p> <p>There is an urgent need for a detailed analysis of the relative importance of the factors causing volatility of aid (defined as the difference between donor commitments for a given period and actual expenditures by the recipient country in such period). This volatility may be caused by multiple set of factors, some of which are the donors' responsibility (such as decreased commitments due to political and budgetary reasons or slow disbursement due to bureaucracy in the donor country), some of which are the recipient countries' responsibility (lack of capacity to disburse, public expenditure management difficulties or non-compliance with conditionalities under the control of the recipient country)</p>	<p>The proposal is to guarantee levels of budget support against all causes of shortfall from previously promised levels, with the exception of extreme circumstances (e.g. major corruption scandals, human rights abuses, governance breakdown), when the guarantee would be suspended only if either all donors agree or the suspension is approved by an independent panel. For reasons discussed above, problems of conditionality and difficulties of budget execution are not sufficient reasons for suspending the guarantee, which is in any case proposed to be partial, and would permit gradual reduction in aid levels over time.</p> <p>The proposed facility insures against shocks emanating from fluctuations in donor aid. It would not try to offset exogenous shocks via the terms of trade or natural disasters, though exchange rate impact on the value of aid does need to be insured against. The report proposes guaranteeing aid in terms of constant price units of the currency of the recipient.</p> <p>A study of causes of aid volatility may be valuable for other reasons, but is not required for the design of the proposed facility.</p>
<p>The Facility as initially proposed does not lengthen the maturity of the funding provided by donors, which, in the case of the social sectors, is a major deterrent to increasing recurrent expenditures in a sustainable manner.</p>	<p>The operation of the facility has the effect of increasing the maturity of donor funding, because it not only guarantees that promised increases take place, it also limits the subsequent rate of decline in future aid from the new peak. The extent to which this secures a guaranteed increase in funding into the medium-long term will depend on the funds available for the facility, and the implications for the percentage of promised aid levels that can be guaranteed.</p>
<p>A specific mechanism for diminishing the difference between commitments and actual expenditures, although reasonable and desirable in principle, requires further analysis.</p>	<p>Agreed. The report proposes discussion in a working group, and sets out terms of reference for a design study to take this forward.</p>

List of Documents Consulted

Bulir Ales and A. Javier Hamann, 'How volatile and unpredictable are aid flows, and what are the policy implications?' IMF Working Paper WP/01/167.

Commission for Africa, Our Common Interest. Report of the Commission for Africa.
www.commissionforafrica.org March 2005

Crown Agents, Increasing The Predictability Of Aid Flows, Study Of Good Practice Principles (Study 2, Phase 2), Joint Venture On Public Financial Management, OECD-DAC Working Group Contract Ref N^o: Cntr 04 5677

Crown Agents, Identification of Existing Donor Practices, Department for International Development, Good Practice Principles Underpinning the Notification of Aid Flows, Contract Date 23 December 2003

DFID, improving the predictability of aid flows: Proposals for action (DFID)-development finance team, Dec 2004

DFID Non-Paper, November 2004, Accelerating Progress towards the MDGs: A proposal to provide longer term predictable financing for stepped up recurrent costs for health.

DFID, Partnerships for poverty reduction: changing aid 'conditionality', a draft policy paper for comment. September 17th 2004.

Foster, Mick (2005), Improving the Medium to Long-term predictability of Aid, January (for DFID).

Foster, Mick (2004), MDG-Oriented Sector and Poverty Reduction Strategies: Lessons from Experience in Health: Main Report, and presentation to High-level Forum on the health MDGs

Foster, Mick, with Andrew Keith (2003), The Case for Increased Aid, Final Report to the Department for International Development (August)

Foster, Mick, Adrian Fozzard, Felix Naschold and Tim Conway (2002), "How, when and why does poverty get budget priority? Poverty reduction strategy and public expenditure in five African countries. Synthesis Paper." Overseas Development Institute, Working Paper 168. ISBN 0850035791.

Gottret Pablo and George Shreiber, Fiscal Sustainability and Aid Predictability Brief, January 3, 2005

Heller, Peter S, and Gupta, Sanjeev (2002), Challenges in Expanding Development Assistance. IMF Policy Discussion paper PDP/02/5. Washington, DC: IMF.

HM Government policy paper: Partnerships for Poverty Reduction: changing aid 'conditionality', improving the predictability of aid: issues and prospects

Joint NGO response to HM Government policy paper: Partnerships for Poverty Reduction: changing aid 'conditionality', improving the predictability of aid: issues and prospects

IMF/World Bank (2005), Development Committee, Moving Forward Financing Modalities Towards The MDGs, Background Document, DC2005-0008Add.1, April 14th 2005-09-19

IMF/World Bank (2004), Development Committee, Aid Effectiveness And Financing Modalities, Background paper, September 29th 2004, DC2004-0012/Add 1.

IMF-World Bank Concept Note, 'Aligning Donor Budget Support with the PRSP Process'

Kanbur, Ravi, 2004, Reforming the Formula: A Modest Proposal for Introducing Development Outcomes in IDA Allocation Procedures

OECD-DAC Working Party on Aid Effectiveness and Donor Practices (2004), Joint Venture on Public Financial Management, Draft Good Practice Paper: 8 December, Good Practices in Public Financial Management: Increasing the predictability of aid flows

OECD-DAC Joint Venture on Public Financial Management (2004), Good Practice Note on the Provision of Budgetary Support- A Public Financial Management Prospective -*Draft* – December 2, 2004

SPA Budget Support Alignment Survey 2004, DRAFT of 03/12/04

Wagstaff, Adam and Mariam Claeson (2004), The Millennium Development Goals For Health, Rising To The Challenges, World Bank

World Bank, HDNHE (2005), Health Financing Revisited, forthcoming.

World Bank, Operations Policy and Country Services, Review Of World Bank Conditionality, ISSUES NOTE, December 6, 2004