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Discussant's Comments
on
Absorption Capacity and Disbursement Constraints
by
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1. Introduction

The challenges of effective scaling-up of aid to low-income countries are at the centre of contemporary policy debates amongst donors and recipients (see for example Gupta *et al* (2005)). Much of this is focussed at the macroeconomic level with a focus on resource mobilization on the one hand and macroeconomic concerns about aggregate incentives, principally on competitiveness, on the other. However, to paraphrase the former speaker of the US House of Representatives, Tip O'Neil, this is an area where "all macroeconomics is micro!" The magnitude of macroeconomic effects depends critically on the micro-structure of the supply side of the recipient economy, on labour markets, and on the incentive structures shaping the relationship between donors and recipients. Jakob Svensson's excellent paper provides a *tour d'horizon* of some of the key incentive and agency problems associated with aid transfers and offers some tentative suggestion on their possible mitigation. His bottom line is clear: "while many other factors influence how aid is disbursed and used, these incentive constraints are likely to be among the leading candidates for understanding donor (and recipient) behaviour. To improve the way foreign aid is disbursed and used, one needs to explicitly address, or relax, these incentive constraints."

His paper is constructed around five key themes. To briefly recap, these are:

- Broken information flows undermine relationships of accountability between the contributing taxpayer, implementing donor agencies and the ultimate recipients of aid-funded expenditures resulting in poor oversight of aid-financed activities by those who provide the resources and the risk of capture of aid by implementing agencies (both on the donor and recipient sides);
- Multiple donor objectives tend to generating low-powered performance incentives for donor agencies in general and aid managers in particular;
- Pressures to disburse – combined with a low opportunity cost of disbursing committed funds -- undermine the credibility of donors' conditionality;
- The multiplicity of donors raises the transactions costs and undercuts efficient allocations of aid, generates collective action problems and may exacerbate problems of rent-seeking and patronage;
- Fundamental dynamic inconsistencies in the aid relationship produce a 'Samaritan's dilemma' – the inability not to reward low reform effort.

Many of these themes are not unique to the aid relationship but in this paper Jakob Svensson argues that most are amplified in the particular settings of the contemporary aid relationship. The principal channel for amplification is provided by the interaction of donor altruism on the one hand and the separation of payers, providers and recipients on the other. The important contribution of this paper goes beyond the characterization of these incentive problems to draw out key operational implications. Specifically, the paper identifies a number of important implications for efficient, second-best, mitigation of these adverse effects. Some of the suggestions have been entertained for some time – 'aid tournaments', for example, but others are more novel, with the evidence on the powerful effects of information (and a media-promoted 'voice') in promoting transparency and accountability in local-level education financing in Uganda.

Comments

I shall limit my comments to just three main points and shall devote most of my attention to the third of these which attempts to link donor incentives and the design of aid delivery back to some first-order macroeconomic concerns.

The first point is that to highlight the main themes of the paper, Svensson has, to some extent, developed a caricature of an aid process almost paralysed by incentive problems. It is true that caricatures do not need to be true to be useful – especially when they illuminate core issues as is done here -- but I am concerned that because, in a number of instances, this caricature is rather too backward-looking may actually obscure some of the important innovations and reforms in aid that have occurred in recent years, cases where practice is ahead of theory. One could make a case that the motivating question of Svensson's paper should not be “Why do donors behave the way they do?” but rather “Why have donors changed the way they behave?”.

Consider, for example, the issues of the role of independent evaluation, of coordination amongst multiple donors, and attempts to sharpen the incentives for recipients to maximize reform ‘effort’. Across these three themes we see important developments. On evaluation, for example, the ‘independence’ of the IMF's Independent Evaluation Office has proved much more robust than many critics had feared and the Office has produced a number of influential reports on the Fund's operations and instruments (for example, their report on the IMF's role in the Argentinian crisis). Svensson notes that other countries (Sweden, for example) have moved in similar directions, but I think this shift is more than superficial. The general rise of a culture of transparency and accountability – often outside the traditional channels of oversight – has shifted norms of public sector accountability in a range of areas, from central bank independence to freedom of information to performance charters in public services. This cultural shift spills over into evaluating aid programmes in ways manners that go far beyond a simple focus on aid volumes. For example, the 2002 International Development Act in the UK bind DFID to clear principles of transparency and accountability. But this shift can be seen in other areas as well. Picking up on Svensson's first themes – the weak information

link between donor-country taxpayers and recipients – we could argue that while some commentators felt that Live8 and the Make Poverty History campaign in the UK trivialized the ‘aid and development’ debate, one important legacy of the 2005 Agenda (as well as the earlier Jubilee campaign) has been a significant increase in ‘development literacy’ amongst the population and with it a more subtle discourse on aid effectiveness and evaluation.

Donor coordination and the design of conditionality is also probably more advanced, at least in some environments, than the Svensson caricature admits. The Paris Declaration on Aid Effectiveness of March 2005 attempts to codify some of the best-practice developments observed in a number of countries. These include the untying of aid, the use of ‘lead donors’, the central role of sectoral Memoranda of Understanding in heavily aid-dependent economies and so on. Other developments include attempts to address specific incentive problems head on. For example, Adam and Gunning (2002) and Adam *et al* (2004) review the initial implementation by the European Commission of ‘performance-based conditionality’ which attempts to directly address the moral hazard problem in conventional aid contracts.

My second comments concern the switch towards general budget support and the perception that this involves donors relinquishing ‘too much’ control to recipients. In general, the move towards budget support and lower ‘micro conditionality’ is to be welcomed, but this necessarily forces donors to abandon the somewhat naïve almost apolitical model of government behaviour embedded in many PRSPs in favour of a model that explicitly recognizes that recipient governments operate under the constraints of political reality. This is a very difficult issue for donors to deal with, not least because it brings issues of political sovereignty starkly to the fore. Again, I would point to DFID’s *Partnerships for Poverty Reduction: Rethinking Conditionality* (March 2005) as an attempt to develop a coherent policy that recognizes the political reality of the aid relationship.

For my third point, I want to move from the general to the specific and address a practical issue of the macroeconomic management of aid. This takes me away from the central thrust of Svensson's paper but picks up the question of credibility and predictability of aid flows. Svensson notes recent moves towards greater reliance on budget support as a means of reducing transactions costs of aid and, arguably, "shifting responsibility and hence accountability toward the recipient. This would build recipient capacity and create stronger incentives (and time for) monitoring and evaluating impacts and results."

[Svensson, p26]

This may well be true, but there are reasons to be concerned about deeper tensions in the shift to budget support that need to be confronted by both donors and recipients. To understand these tensions, consider the following three observations:

- First, donors want aid to be spent: neither their constituencies nor their institutions are well adapted to the norms of prudence that economists preach in analyzing the appropriate spending response to volatile sources of revenue or financing, most notably in the context of commodity booms.
- Second, even if donors *intend* to support scaled-up public spending programs on a continuing basis, they cannot credibly pre-commit to doing so.
- Third, even if recipient governments *intend* to adjust spending and revenue to fluctuations in external financing, major fiscal commitments are likely to be partially irreversible, on political grounds if not otherwise.

Taken together, these observations imply that a major increase in aid carries with it the possibility of future financing gaps that will have to be made up domestically.

Under these conditions aid surges that would otherwise be consistent with private capital inflows and stable or falling inflation (see Buffie *et al* 2004) gives rise instead to capital outflows and high inflation. Monetary policy alone cannot handle this problem because,

with thin and undeveloped bond markets, a tight monetary stance causes interest payments and future seigniorage requirements to balloon. The resulting increase in expected future inflation then creates inflation problems in the near term. Barring interventions that directly address concerns about the reliability of future aid flows or the reversibility of fiscal commitments, some degree of near-term fiscal restraint – most likely in the form of a reserve buffer stock – becomes part of the optimal policy response to aid is a necessary component of a successful strategy. Maintaining a foreign reserve buffer stock is something that many donors have been reluctant to countenance. Denied this option, recipient governments may, at best, be forced back onto an inefficiently high level of ‘fiscal flexibility’ or at worst, see the private sector’s fears that aid may be temporary become self-fulfilling as a loss of inflation control induces donors to scale back aid commitments.

Recent work by Buffie *et al* (2005) illustrates this particular problem using a formal simulation model calibrated to the key characteristics of countries undergoing HIPC-style debt relief such as Uganda and Tanzania. When there is no uncertainty about the permanence of aid flows, macroeconomic adjustment is smooth and aid increases can be absorbed without macroeconomic volatility.

Very different dynamics emerge if the private sector views aid as a fiscal time bomb. In particular, when the private sector believes that high aid flows cannot last, and that when aid disappears the government will be unwilling or unable to make an immediate fiscal adjustment, a surge in aid therefore brings with it a net deterioration in the expected time path of the fiscal deficit after grants. This implies an increase in future seigniorage and a rise in future inflation. The prospect of future inflation reduces money demand even during the high-inflow period.

Pessimistic expectations may be grounded in plausible concerns about the durability of aid and the government’s capacity for fiscal retrenchment. The private sector may well be too pessimistic: in reality, the aid may be permanent, or there may be no fiscal inertia. But if this is not assured, low credibility will still alter the macroeconomic impact of the

aid inflow. Low credibility reduces money demand during the high-inflow period and thereby renders any given path of the money supply more inflationary. Inflation rises in response to the aid surge.

Tight money and temporary fiscal restraint represent two natural approaches to the credibility problem. Neither approach works efficiently on its own and we show that winning the battle against weak credibility requires a combination of fiscal restraint and the use of a foreign exchange reserve buffer in which reserves are banked during the aid inflow (the boom phase) to be sold to control money growth while fiscal adjustment takes place. This, in turn, requires donors to recognize that when they cannot resolve deeper issues of predictability, they must, at least, recognize the importance of not denying recipients the fiscal instruments to manage aid efficiently.

References

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