

# The Challenge of Absorptive Capacity

## Will lack of absorptive capacity prevent effective use of additional aid resources in pursuit of the MDGs?

Report on a seminar held at DFID  
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Paolo de Renzio  
*Overseas Development Institute*

*This report summarises the discussions held at the seminar.*

*Recommendations for further action focused on two areas. The first one deals with the need to re-assess current and past practices in **aid delivery systems** in order to learn significant lessons and take into account the challenges posed by absorptive capacity limitations. Improving donor practices and adapting aid modalities to country circumstances is part of this agenda. The second one looks at donors' willingness to experiment with some **alternative mechanisms**, and to test different avenues for addressing absorptive capacity constraints. The potential role of non-governmental and private sector organisations, direct income transfers and inventive economic policy and public expenditure instruments were some of the ideas mentioned.*

*Suggestions for short-term actions included a series of specific and focused **case studies** aimed at addressing the lack of available evidence. These would need to identify existing constraints in a specific sector, look at possible alternatives, suggest reforms that need to be implemented, and propose inventive solutions for intervention both by governments and by donors, including a tentative costing for the reduction of absorptive capacity constraints. The creation of a '**community of practice**' that can share ideas, lessons learned, results of studies and reports, and promote collaborative work and mutual support on absorptive capacity was also suggested.*

## 1. Introduction

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Following the commitments made at the Monterrey Conference in 2002, prospects for increasing aid flows to Africa look much better than they were a decade ago. Current work by the UN Millennium Project, and proposals for the International Finance Facility (IFF) strengthen the probability of substantial additional aid materialising over the next few years. Whilst there is broad agreement that reaching the MDGs in Africa will entail additional finance, there is less consensus on how easily and effectively extra flows will be absorbed. What if additional funds cannot be usefully spent? Worse, what if additional aid causes Dutch disease, and leads to serious imbalances in the receiving economy? In general, will lack of absorptive capacity undermine new aid initiatives?

Some of these important questions were addressed at a seminar convened by DFID and the Commission for Africa, and managed by ODI. The seminar brought together a small number of experts from different organisational, disciplinary and sectoral backgrounds, including participants from the World Bank, the IMF, UNDP, and the Centre for Global Development (see Annex 1 for list of participants).

## 2. An initial framework

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A background paper was prepared by Paolo de Renzio (see Annex 2). The paper identifies five ways in which absorptive capacity might be an issue:

- a) Aid resources have **declining marginal returns**, and therefore there is a limit to the amount of aid resources that can be absorbed by any country in terms of ODA/GNP ratio;
- b) Aid can cause serious **macroeconomic imbalances** given its possible impact on a number of economic variables;
- c) **Institutions** and **policies** of the recipient countries may limit its capacity to use aid resources effectively
- d) Lack of sufficient **administrative capacity** and adequate **infrastructure** can also prevent the achievement of development objectives;
- e) Finally, uncoordinated and burdensome **donor practices** can further prevent the effective use of aid resources.

The background paper goes on to discuss the nature of some of the different constraints identified. It also highlights the importance of distinguishing between constraints that could be relaxed in the short- to medium-term and those that can only be addressed in a longer time horizon.

Finally, the paper discusses some of the roles that donors can play in addressing absorptive capacity problems, and some ideas on possible uses of additional resources. Investing more in research and analysis, improving donor practices and providing additional targeted assistance where constraints are particularly strong are some of the things donors can do in the short term. Scaling up investment in infrastructure and global public goods, and looking into alternative delivery mechanisms such as non governmental and private sector organisations, or direct income transfers are considered as possible initiatives for increasing aid flows while addressing or by-passing absorptive capacity constraints.

### **3. Developing the framework**

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#### ***3.1 Understanding absorptive capacity***

Most participants agreed that absorptive capacity does constitute a problem, which can manifest itself in the different ways indicated in the background paper. It was noted that there was a long tradition of work on some of these areas, for example in food aid on disincentive and dependency effects.

Some new aspects were mentioned by participants. For example, demand-side constraints are not taken into account in the absorptive capacity equation, while they do create enormous difficulties and possible policy distortions. Building schools, for example, will not be sufficient if families are not willing to educate their children. These problems (and capacity problems more generally) are likely to increase as services reach out to the most remote areas or to the most excluded social groups.

It was important not to generalise, however. Each country, and each sector within each country, is likely to be a case of its own in terms of where exactly the roots of the absorptive capacity problem lie, and what can be done about it. In the health sector, the examples of Tanzania and Chad highlighted differences in the relative importance of skilled labour and infrastructure. In the education sector, lack of political commitment to follow through on education policy in Malawi was compared to the significance of demand-side constraints in other countries.

Therefore, the degree to which different constraints become binding, and the time horizon within which they can be relaxed, is likely to change significantly on a case-by-case basis. A comment that was made by numerous participants reflected the lack of specific knowledge of absorptive capacity constraints in different countries which could guide more targeted interventions. The specificity of absorptive capacity constraints is also due to political economy considerations, whereby depending on local political considerations, in certain moments it may be easier to address the issue of absorptive capacity. The example of Uganda was mentioned, where large increases in aid flows coincided with the election of a government which was committed to expanding basic services and improving the capacity of the public administration to deliver them. A counter-example was provided by Kenya under the Moi rule, where neo-patrimonialism and the clientelistic nature of politics prevented aid from contributing to its expected development impact.

The possible macroeconomic effects of increasing aid flows were also discussed, but the general consensus was that they are not necessarily the most stringent ones, as some knowledge exists around sensible policy measures which can address macroeconomic imbalances. A comment was also made, however, on the need to unpack the Dutch Disease issue, by taking into account the different effects that increasing aid flows can have on the various sectors of the economy and on different indicators.

#### ***3.2 Aid and donors can be part of the problem***

An issue that was discussed at length during the seminar was the possible negative effects that donor activities can have on poor country governments' capacity effectively to absorb external finance. The costs associated with different aid delivery modalities were also

discussed, in terms of the burden they place on public officials' time and skills, both in terms of direct costs and of opportunity costs. In this respect, the general agreement seemed to be that project aid is the most burdensome and the one which is likely to take the greatest toll on limited local capacity. On the other hand, sector programmes and budget support are less burdensome when compared to the amount of resources involved. However, recent experience with sectoral programmes seemed to show that while impact was visible at top level, little difference could be seen at delivery point, with lots of resources being spent with little tangible results in service delivery and development outcomes.

A more general point was made about the fact that often not only donor activities, but also policies promoted by donors could have a negative impact on available capacity, such as in the case of the establishment of autonomous agencies. Moreover, given the pervasiveness of the phenomenon of corruption in many recipient countries, the question was raised of the willingness of donors to allow for increasing levels of capture and leakage should additional resources be channelled to poor country governments.

Finally, it was pointed out how certain absorptive capacity problems, such as the availability of teachers and doctors, need to be addressed by raising recurrent expenditure, which often goes against donor preferences, and can clash with macroeconomic conditionalities imposed by institutions such as the World Bank and the IMF. These contradictions point to a clear change in mentality needed on the part of the donor community in order to be able to address the absorptive capacity problem in a much more effective and coherent manner.

### ***3.3 Using aid to build capacity***

Despite some of the criticisms of donor behaviour and of some aid modalities, participants also pointed to a number of interesting factors which could change the course and nature of donor-recipient relations, and open up new opportunities for addressing absorptive capacity constraints. Comments were made about cases where aid, when sensibly utilised, could have increasing marginal returns, as opposed to decreasing and eventually negative ones (as postulated in some of the absorptive capacity literature), by enabling a better utilisation of latent capacity and creating conditions for positive externalities. To reinforce this point, recent theoretical work has pointed to the very strong effect on economic growth that aid can have when targeted specifically at short-term impact on economic activity.

The general agreement that seemed to emerge was based on two propositions:

- a) Donors should adopt a flexible approach which fits to local circumstances, and improve their awareness of the possible perverse effects of aid modalities and donor behaviour. A mixed portfolio of aid products (which can range from NGO support to investment projects, from technical assistance to budget support) that explicitly recognises existing constraints and tries to address them in a medium-term framework should be deployed. In such a way donors can focus on short-term results while at the same time not losing sight of the longer-term implications, thereby 'drawing the process on'. Examples were made of ongoing multi-donor work on public financial management, and of cases in which support for NGO work was complementary to strengthening government structures rather than in competition with it;

- b) Donors should continue and reinforce their efforts towards harmonisation/alignment, mutual accountability and predictability of aid flows. There is great scope in gradually moving towards more harmonised and aligned forms of development assistance, with the aim to reduce transaction costs and lower the overall administrative burden of delivering aid, therefore improving absorptive capacity. The idea of setting up country trust funds for ensuring steady and secure flows of external resources to countries who could provide adequate guarantees was presented, with some discussion on its political feasibility in donor countries.

### ***3.4 Dynamic models: trajectories and time-lines***

There was general agreement that existing conceptions of absorptive capacity addressed the issue in a very static form, taking constraints almost as given, without necessarily trying to identify ways to address them in a dynamic model.

In principle, little progress can be made without strong government leadership. A strong political commitment to developmental policies, a serious perspective of medium-term stability, and a constructive leadership role in engaging with donors and promoting harmonised practices are all factors which contribute to creating opportunities for addressing the absorptive capacity problem in a much more constructive way. The cases of Uganda and Tanzania were quoted in relation to this.

The cases of Rwanda and Mozambique were also identified as providing possible interesting insights into how large increases in aid flows could be achieved in a relatively short timeframe, starting from a situation characterised by extreme poverty, weak institutions and lack of adequate skills. Other successful cases were mentioned in the health sectors, with the highly effective initiatives undertaken to combat smallpox and polio. A more general question was asked about the relevance of lessons from the HIPC experience, in assessing the impact that the additional resources freed through debt cancellation had on development outcomes, and if absorptive capacity constraints had been significant.

However, these conditions for success were not always present. Some more disheartening news came from other Sub-Saharan African countries, where substantial and prolonged efforts to create better capacity in the public sector had not brought the same results. In these cases, someone noted, it is better to take existing capacity and existing government commitment as 'given', and work around the problem by finding alternative ways of ensuring the development impact of aid. This is more generally true for fragile states in post-conflict and emergency situations where weak institutional frameworks call for different rules of engagement by donors.

In these situations, participants noted that the key issue for a dynamic approach is to find solutions to short-term problems which make it easier and not more difficult to find solutions in the long term. For example, a common solution to short-term problems is to bring in outsiders to 'do the job'. These can be NGOs, in programmes ranging from humanitarian relief to long-term service delivery, or private sector firms, for example to supply turn-key projects or, again, long-term services. Examples cited included NGO operations for refugees from Darfur, contracts to build power stations, or the use of companies like Halliburton in Afghanistan and Iraq. All of these, however, can decapitate local government ownership and management.

For donors to adopt a more dynamic approach to the absorptive capacity question, therefore, these and other considerations need to be built into the decision-making process, making sure that present interventions ‘build bridges’ between what is done now and what is seen as desirable for the medium- to long-term. In terms of absorptive capacity this needs to go well beyond the immediate results of any specific intervention, but take into account wider institutional and capacity building dimensions.

A dynamic approach, however, also needs to address two issues which are often overlooked. The first relates to the possible contradiction between investing additional resources in the social sectors in order to promote further effort in reaching the MDGs, and focusing instead on expenditure which could promote economic growth and unchain the potential benefits that come from it. The latter option calls for more attention to measures which could contribute to agricultural growth, such as for example fertiliser subsidies. The second issue deals with political accountability, and with the sort of reforms that are needed to make sure that the use of additional resources is decided upon in a way that reflects the priorities of the local population, and that the implementation of activities has built-in mechanisms for transparency and control. This was mentioned as an important factor in the development trajectory of the Indian state of Bihar.

#### **4. Recommendations for future action**

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There was considerable discussion of practical action points, with suggestions ranging from more use of NGOs and contractors, through ways of economising on scarce government resources (for example by greatly increasing spending on ‘big-ticket’ items like pensions or fertiliser subsidies), to the radical idea of by-passing intermediaries altogether by making direct transfers to populations. The guiding thought in these discussions was that absorptive capacity constraints could not be allowed to impede the achievement of the MDGs, and that careful consideration had to be given to overcoming constraints, country by country, sector by sector, case by case.

The background paper includes a number of practical suggestions. At the seminar, a number of additional recommendations were mentioned, which seemed to reflect two main considerations. The first one has to do with the need to re-assess current and past practices in aid delivery systems in order to learn significant lessons and take into account the challenges posed by absorptive capacity limitations. In this area, some of the ideas mentioned included:

- a) Learn from Social Action/Social Investment Funds, which in some cases were able to deliver large amounts of local/rural infrastructure in an effective and participatory way, while at the same time keeping in mind the necessity to reintegrate parallel structures into government mechanism;
- b) Looking at institutions, it is better to focus on small reforms at the margins that are not politically controversial or in the optimal sequence; adopt opportunistic initiatives where there is wide consensus, such as for example transparency in public accounting;
- c) Promote more research on Dutch disease effects, with a view to unpack its various components, and the different impact on macroeconomic variables and economic activity;
- d) Take local political cycles into account when thinking about resource increases, as their effectiveness will be inexorably linked to political commitment.

The second consideration looked more at donors' willingness to experiment with some alternative mechanisms, and to test different avenues for addressing absorptive capacity constraints. Here, some of the options discussed were:

- a) Rethink and revamp the role of non-government and private sector organisations as service delivery and implementation agents, depending on the situation. In some cases, NGO delivery can be a good and more efficient alternative to government spending; also, NGOs can be very useful in conflict countries or in places where governments have limited legitimacy;
- b) Introduce incentive economic policy and public expenditure instruments, which can positively contribute to reducing absorptive capacity problems;
- c) Consider direct income transfers as possible alternative avenues for increasing aid flows. Pensions can be shown to have more benefits; vouchers for public services are also a possibility

## 5. Next steps

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Part of the reason for the difficulties that exist in proposing radically different approaches to the problem lies in the lack of available hard evidence on the nature and extent of the absorptive capacity problem. This issue was raised a number of times at the seminar, and led to some more practical suggestions of things that need to be done in the short-term, in order to create better conditions for the effectiveness of commitments to increase aid resources.

The main proposal regards engaging in a series of specific and focused **case studies** aimed at addressing the lack of available evidence. Case studies need to identify existing constraints in a specific sector, look at possible alternatives, suggest reforms that need to be implemented, and propose incentive solutions for intervention both by governments and by donors, including a tentative costing for the reduction of absorptive capacity constraints.

Continued improvements in **donor practices** are the other urgent component of the absorptive capacity agenda. This needs to be based on some of the considerations above about donor behaviour, aid modalities and harmonisation/alignment, and on a new 'aid compact' that creates the conditions for significant increases in aid flows in those countries where adequate conditions exist.

Finally, a network of people interested in absorptive capacity problems could be created across agencies and countries, a '**community of practice**' that can share ideas, lessons learned, results of studies and reports, and promote collaborative work and mutual support.

## Annex 1

### List of Participants

1.	Nick Amin	Africa Commission
2.	Nick Highton	DFID
3.	Simon Maxwell	ODI
4.	Paolo de Renzio	CAPE/ODI
5.	Christopher Adam	CSAE, Oxford
6.	Anne Mills	LSHTM
7.	Chris Colclough	UNESCO
8.	John MacKinnon	Consultant
9.	Mattia Romani	Oxford/Shell
10.	Peter Brooke	Bannock
11.	Frances Heeks	DFID
12.	Bruno Versailles	Africa Commission
13.	Mark Sundberg	World Bank
14.	Margaret Kruk	UN Millennium Project
15.	Michael Krause	UN Millennium Project
16.	Brian Levy	World Bank
17.	Benedict Clements	IMF
18.	Michael Clemens	CGD
19.	Steven Radelet	CGD



## SEMINAR on ABSORPTIVE CAPACITY

### Issues Note

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#### **Definitions of “absorptive capacity”**

In the recent literature on the possible impacts of increasing aid flows, and of the difficulties that may arise should increased commitments become reality, the term “absorptive capacity” has been adopted with a number of different, not necessarily similar phenomena in mind. Some of the most common definitions of the term, together with some popular propositions concerning absorptive capacity, are summarised below to capture the lack of a common understanding about its nature and meaning. Possible questions to consider are raised against each.

- Developing countries can only absorb a finite amount of aid resources and put it to good use, given the **declining marginal returns** of additional resources made available. In this sense, absorptive capacity is interpreted as an upper limit for the **ODA/GNP ratio**. Additional aid resources can only have a significant development impact if they are not too significant relative to the scale of the recipient economy. *Is there a well-defined point where diminishing returns set in, and what determines it? If not well defined, how can more and less favourable circumstances for aid be discriminated?*
- Large additional inflows of aid resources are likely to create **macroeconomic imbalances** and distortions, related to inflation rates, exchange rates, interest rates, expenditure patterns, “Dutch Disease” effects, etc if not managed well. In this sense, absorptive capacity may be limited by a recipient country’s macroeconomic variables and management capacities. *How far does consensus exist that Dutch Disease is not an inherent problem in itself, and that the issue concerns capacity of recipients to manage large aid inflows?*
- The quality of the **institutions and policies** of the recipient country (from more formal laws and regulations to informal structures and incentives which shape the behaviour of politicians and bureaucrats) is a crucial determinant of its capacity to transform additional resources into improved development performance. Absorptive capacity here relates to the limitations which come from deficiencies at the level of institutions, incentive systems and policy processes. *How far is this supported by evidence? How far can these constraints be influenced (positively or negatively) through aid and how far are they determined by contextual (e.g. political, cultural) factors?*

- Even when institutional quality is adequate and policies are sound, **administrative capacity** may be lacking, in the form of specific skills or more generally of insufficient human resources and physical conditions (infrastructure and equipment) for policy and programme implementation. Absorptive capacity therefore can be due to such technical and managerial shortages. *How well is this supported by evidence? When if ever can aid be effective when capacity is very weak? When is aid effective in raising capacity?*
- **Donor practices** can also be a limiting factor in a country’s capacity to absorb additional aid resources. Uncoordinated interventions, substantial differences in procedures, unpredictability of aid flows and high transaction costs can impose a great burden on a recipient country’s systems and processes, and therefore generate absorptive capacity problems. *How serious is this problem? Is it possible to discriminate circumstances where a given set of donor practices are more problematic and less problematic for effective absorption?*

### The binding nature of absorptive capacity constraints

Absorptive capacity constraints, as seen above, can be of a very different nature. Some of them are likely to be more binding than others, both in the short- and in the long-term. The table below attempts a preliminary classification of absorptive capacity constraints, evaluating the relative difficulty of relieving them in a reduced timeframe.

Short-term Constraints	Long-term Constraints
<ul style="list-style-type: none"> <li>▪ “Dutch disease” effects</li> <li>▪ Administrative constraints due to lack of adequate infrastructure and equipment</li> <li>▪ Perverse incentives in public officials’ performance</li> <li>▪ Post-conflict and post-emergency constraints</li> <li>▪ Inadequate Public Expenditure Management systems</li> <li>▪ Uncoordinated and un-harmonised donor interventions</li> </ul>	<ul style="list-style-type: none"> <li>▪ Debt sustainability</li> <li>▪ Major deficiencies in institutions and policy processes</li> <li>▪ Technical and managerial skills of public officials (doctors, teachers, accountants)</li> <li>▪ Social/Cultural factors</li> <li>▪ Difficulties in full donor shift to improved practices</li> </ul>

### The role of aid in addressing absorptive capacity constraints

The limited existing literature on absorptive capacity does not say much about the possible role of aid in addressing existing constraints. However, from the discussion above, it is clear that there are certain immediate activities that donors can undertake, which could contribute to the relaxation of some of the most obvious obstacles created by absorptive capacity constraints:

- **Research and analysis:** country-specific assessments of the nature and extent of the absorptive capacity problem could also help shed more light on the best ways to address it
- **Harmonisation/alignment:** constraints due to lack of coordination among donors and high transaction costs mostly depend on donors themselves, and therefore should be addressed as a matter of urgency
- **Institutional development and reform:** donor agencies can also work with recipient governments to address some of the constraints which come from institutional and policy processes
- **Capacity building:** wherever absorptive capacity constraints come from a lack of adequate human, physical, financial and technical resources, donors can step in to provide relevant inputs, through technical assistance, training, provision of equipment, etc.

### Some ideas on the use of additional aid resources

Thinking creatively and innovatively about the problem of absorptive capacity also entails evaluating different options which could provide some answers, or at least ways to circumvent the problem. Some of these, quoted in the literature, include:

- **Infrastructure investment:** many developing countries face a major shortfall in infrastructure financing. Large investments in power, irrigation, road networks, water and sanitation, etc. could compensate for the recent focus on social sectors and promote synergistic poverty reduction efforts
- **Trust Funds:** ensuring that additional resources, even if not immediately utilised given absorptive capacity constraints, are put aside for future use could solve some of the problems related to volatility and lack of predictability, and provide additional incentives to address existing constraints
- **Global public goods:** not all additional resources need to be invested at the country level. Investment in global public goods could bring lots of benefits to all developing countries, by addressing common problems in a coordinated way
- **Debt relief:** an increase in the resources available for debt cancellation could contribute to resolving some of the imbalances due to heavy debt burdens and free up resources for more productive use
- **NGO delivery:** where governments are unable to deliver the services necessary for poverty reduction objectives, funding could be channelled through alternative delivery mechanisms such as NGOs, even though this may undermine ongoing processes based on alignment and support for national systems and processes
- **Direct transfers:** suggestions have been put forward with regard to utilising additional aid resources to directly transfer income to poor people in developing countries, as a more effective means of alleviating poverty

### Basic background documents

Clemens, M. and Radelet, S. (2003): *The Millennium Challenge Account: How much is too much, how long is long enough?*, Working Paper No. 23, Centre for Global Development ([http://www.cgdev.org/docs/cgd\\_wp023.pdf](http://www.cgdev.org/docs/cgd_wp023.pdf))

Clemens, M., Radelet, S. and Bhavnani, R. (2004): *Counting Chickens When They Hatch: The Short-term Effect of Aid on Growth*, Working Paper No. 44, Centre for Global Development (<http://www.cgdev.org/docs/CountingChickensFINAL3.pdf>)

Foster, M. (2003): *The Case for Increased Aid*, Report to DFID (available on request)

Heller, P. and Gupta, S. (2002): *Challenges in Expanding Development Assistance*, IMF Policy Discussion Paper (<http://www.imf.org/external/pubs/ft/pdp/2002/pdp05.pdf>)

Sundberg, M. (2004): *Scaling Up and Strengthening Absorptive Capacity*, Workshop Presentation (available on request)

UN Millennium Project (2004): *Millennium Development Goals Needs Assessment* ([http://www.unmillenniumproject.org/documents/mp\\_ccspaper\\_jan1704.pdf](http://www.unmillenniumproject.org/documents/mp_ccspaper_jan1704.pdf))

World Bank (2003): *Supporting Sound Policies with Adequate and Appropriate Financing* ([http://siteresources.worldbank.org/DEVCOMMINT/Documentation/20127712/DC2003-0016\(E\)-Financing.pdf](http://siteresources.worldbank.org/DEVCOMMINT/Documentation/20127712/DC2003-0016(E)-Financing.pdf))

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Paolo de Renzio  
*Research Fellow*  
CAPE/ODI  
[p.derenzio@odi.org.uk](mailto:p.derenzio@odi.org.uk)