Fiscal Management of Scaled-Up Aid

Sanjeev Gupta
Senior Advisor, Fiscal Affairs Department
International Monetary Fund

Overseas Development Institute
London, November 7, 2007
1. Overview

The presentation focuses on four questions:

- How to assess the medium–term (MT) resource envelope for the budget?
- How to choose a budget’s MT spending path consistent with a country’s absorptive capacity?
- How should the budget deal with aid uncertainty and volatility?
- What fiscal institutions should be strengthened to improve effectiveness in aid utilization?
2. Establishing the resource envelope

- Obtaining timely and reliable information on public and private donors
- Ascertaining **nature of aid** (degrees of concessionality, earmarking, requirements of counterpart funds)
- Sustaining and strengthening **own revenue effort**
  - Broadening the tax base and strengthening revenue administration are key policies for revenue mobilization, including for recouping revenue loss due to trade liberalization
3. Choosing a spending path

- Countries need to take a longer-term view of spending needs and resource availability
- Can be achieved through Medium Term Frameworks (MTFs). These can take three forms
  - Medium Term Fiscal Framework
  - Medium Term Budget Framework
  - Medium Term Expenditure Framework
3. Choosing a spending path (cont.)

- Reliance on MTFs will reduce the need for ceiling on specific spending categories, such as wage bills

- Many LICs do not have a MTF. In some cases where they exist, they are not integrated into the budget process
Figure 1. Medium-Term Framework in Low-Income Countries

Source: Fiscal ROSC reports for 31 countries in Africa, Asia, Europe, and Latin America.
3. Choosing a spending path (cont.)

But the MT spending path should be:

- **Consistent with:**
  - Macroeconomic absorptive capacity
  - Sectoral absorptive capacity
  - Administrative absorptive capacity

- **Should also take into account the effects of spending on growth and on debt sustainability**
4. Dealing with aid volatility

- Aid has been more volatile than tax revenues and significantly more volatile than remittances.
- Aid volatility complicates fiscal management. Mismatch between available resources and planned spending can result in expenditure volatility.
- Options for dealing with aid volatility:
  - **Government options**: Smooth expenditures over time; build up reserve buffers.
  - **Donor actions**: Provide reliable medium-term disbursement commitments; Increase collaboration among donors.
5. Strengthening fiscal institutions

- Most PFM systems in LICs need substantial upgrading

- Budget execution and capacity to track poverty-reducing spending are especially weak
HIPC AAP: Progress in PEMs by Key Indicator Categories
(the number of countries meeting benchmarks in percent of total) 1/

1/ Figures in brackets refer to total numbers of assessed countries in each year.
Aggregate PEFA Ratings by Indicator Categories

(in aggregate score; the perfect score = 4)

A. Credibility of the Budget
B. Comprehensiveness and Transparency
C(i) Policy-Based Budgeting
C(ii) Predictability and Control in Budget Execution
C(iii) Accounting, Recording and Reporting
C(iv) External Scrutiny and Audit
C. BUDGET CYCLE
D. Donor Practices
5. Strengthening fiscal institutions (cont.)

- Countries should formulate action plans to reform PFM systems.
- Plans should be based on diagnostic study, such as the PEFA framework.
- Reforms should be sequenced in line with country capacity—core building blocks should precede more advanced reforms.
5. Strengthening fiscal institutions (cont.)

- More than 60 percent of PRGF-eligible countries either have a PFM reform plan or are in the process of preparing such plans.

- The Fund, through TA from FAD, including the RTACs, has provided support for preparing these plans in more than half of these countries.
6. Conclusions

- Sound fiscal policy is critical for effective utilization of scaled-up flows.

- Fiscal policy decisions should be anchored in a MT framework.

- The chosen spending path should be consistent with absorptive capacity.

- Expenditure smoothing can help deal with aid volatility and uncertainty.
6. Conclusions (cont.)

- Strengthening domestic revenue effort and debt management capacity should be an integral part of the policy response to scaled-up flows.

- Efficient utilization of scaled-up flows will require further strengthening of fiscal institutions.

- LICs will require substantial TA for strengthening PFM systems and improving budgetary processes.