CHAPTER

1 Introduction

The international community has committed to scaling up aid and improving aid delivery to low-income countries to help them meet the Millennium Development Goals (MDGs). The March 2002 Monterrey Consensus called on donors and international financial institutions to provide additional financing, improve aid predictability, and ensure that aid is aligned with national priorities. Recipient countries, on the other hand, have committed to implementing appropriate policies, strengthening institutions, and enhancing governance to ensure that aid is used effectively. At the 2005 Gleneagles Summit, the Group of Eight (G-8) countries committed to significantly increasing the amount of development assistance they provide to the low-income countries over the next decade. Specifically, donors committed to double aid to sub-Saharan Africa by 2010 (G-8, 2005).

Although official development assistance (ODA) to sub-Saharan Africa, net of debt relief, remained broadly unchanged in 2005, some countries are receiving rising private and public flows. Preliminary data suggest that total ODA declined slightly in 2006.[1] On the other hand, a wide range of other "emerging" donors are increasing their assistance to low-income countries. In many countries, the health sector is progressively receiving more assistance from the private sector, as well as from health funds.[2] Debt relief provided under the Multilateral Debt Relief Initiative and the Enhanced Heavily Indebted Poor Countries (HIPC) Initiative has created space for new borrowing by low-income countries, and some countries (for example, Ghana and Kenya) are using this opportunity to tap international capital markets. Remittances to low-income countries increased by more than 80 percent between 2000 and 2005, totaling twice the amount of ODA in 2005.[3] Moreover, many countries are benefiting from high commodity prices. Thus, resource flows to many low-income countries are increasing, enabling them to scale up spending.

[1]World Bank (2007c). Throughout this paper, the term "aid" includes project aid and program aid, as well as extrabudgetary aid.

[2]The overall aid from private sources doubled during 2001–05 to US$14.7 billion (World Bank, 2007c). The Bill and Melinda Gates Foundation has provided more than US$6 billion for health programs. Global funds to combat HIV/AIDS were estimated to reach US$9 billion in 2007 (Serieux and McKinley, 2007).

[3]For a discussion of the contribution of remittances to poverty reduction in Africa, see Gupta, Pattillo, and Wagh (2007).

Effective and sustainable use of these flows—both public and private—requires sound fiscal management. In an environment of scaled-up resource flows, countries need to frame their spending programs with a medium-term perspective in mind. In addition, they need to ensure that resources are used efficiently, both by ensuring alignment of budget priorities and those of donors and by strengthening critical fiscal institutions. The IMF's Medium-Term Strategy calls on the IMF to assist low-income countries in establishing policies and economic institutions that help them "absorb the projected scaling up of aid in a sustainable way" (IMF, 2005b). This paper addresses four questions that shape fiscal policy response to scaled-up aid:[4]

- How should the *medium-term resource envelope* for the budget be assessed? Formulating spending plans in a medium-term perspective requires information about the availability, phasing, and magnitude of resource flows over the medium term. In many countries, comprehensive information on current resource flows is not available, making this particularly difficult. The task is further complicated by an increase in the number of donors—both official and private.

- What considerations should influence the choice of a *medium-term spending path* for the budget? Once the resource envelope is established, countries need to decide how much and how fast available resources should be spent over the medium term. Factors influencing this decision include macroeconomic conditions, capacity constraints (both absorptive and institutional), and debt sustainability considerations.

- How should the budget deal with *aid uncertainty and volatility*? Aid volatility and uncertainty have often complicated policy implementation, especially in countries where a large part of government spending is financed by aid (see Bulíř and Hamann, 2006). These issues are likely to become even more relevant when external flows are scaled up.

- Which *fiscal institutions* are key to using resources effectively and how can they be strengthened? Scaled-up but uncertain and volatile aid flows will place increased pressure on fiscal institutions in general and on public financial management (PFM) systems in particular. Strengthening fiscal institutions is therefore crucial to ensuring that spending is efficient.

The rest of the paper is organized as follows: Chapter 2 deals with establishing a medium-term resource envelope for the budget. Chapter 3 explains the considerations that influence the choice of a medium-term expenditure path and provides guidance for setting short-term fiscal targets. Chapter 4 discusses the problems associated with volatility and uncertainty of

[4]By focusing on fiscal issues, this paper complements other recent work in this area. See IMF (2005a); Gupta, Powell, and Yang (2006); and Isard and others (2006).

aid flows and possible steps to mitigate them. Chapter 5 discusses basic reforms for strengthening fiscal institutions so that aid can be used more effectively, drawing on recent IMF Fiscal Affairs Department technical assistance to member countries. It proposes specific measures that will assist countries in this regard, as well as factors that should be taken into account in preparing an action plan for PFM reforms in low-income countries. Summary and policy conclusions are presented in Chapter 6.