Dollars, Dialogue and Development

An Evaluation of Swedish Programme Aid

Howard White
Institute of Social Studies

A Sida EVALUATION REPORT

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Evaluation of Swedish Programme Aid

Thirteen working papers, constituting the evaluation of Swedish programme aid, have been synthesised into this one final report "Dollars, Dialogue and Development. An evaluation of Swedish programme aid", Sida Evaluation 99/17.

In 1998 Sida, the Department for Evaluation and Internal Audit, commissioned an evaluation of Swedish programme aid.[1] The evaluation has been carried out by the Institute of Social Studies (ISS). The evaluation comprises field studies in three countries; Uganda, Nicaragua and Vietnam and desk studies of five countries; Bangladesh, Cape Verde, Mozambique, Tanzania and Zambia. There are three thematic studies on conditionality, impact of adjustment policies and modalities of programme aid respectively. Finally, there is a study of the management of Swedish programme aid and a paper commenting on the World Bank report "Assessing Aid".

The synthesis report and the 13 working papers constituting the evaluation of Swedish programme aid are listed below.

99/17	**Dollars, Dialogue and Development. An evaluation of Swedish programme aid.**
99/17:1	Development by Default. Programme aid to Bangladesh.
99/17:2	Supporting Success. Programme aid to Cape Verde.
99/17:3	Reform, Rehabilitation and Recovery. Programme aid to Mozambique.
99/17:4	Debt, Dependence and Fragile Development. Programme aid to Nicaragua.
99/17:5	Counting the Donors' Blessings. Programme aid to Tanzania.
99/17:6	What Does the Showcase Show? Programme aid to Uganda.
99/17:7	Fostering High Growth in a Low Income Country. Programme aid to Vietnam.
99/17:8	A Black Sheep Among the Reformers. Programme aid to Zambia.
99/17:9	Trends and Turns in the 1990s. Programme aid and the Swedish experience.
99/17:10	Programme Aid, Policies and Politics. Programme aid and conditionality.
99/17:11	The Impact of Adjustment Policies. Programme aid and reforms.
99/17:12	From Commodity Aid to Budget Support. Programme aid and its modalities.
99/17:13	Assessing Aid: a Manifesto for the 21st Century?

[1] See appendix 1 Terms of reference.

ACRONYMS

CAR	Country Assistance Review
CAS	Country Assistance Strategy
CIE	Centre for International Economics
CIS	Commodity Import Support
CISP	Commodity Import Support Programme
CF	Country frame
CG	Consultative Group
CPF	Counterpart Funds
DAC	Development Assistance Committee
DFI	Direct Foreign Investments
EC	European Commission
ED	Executive Director
EKN	Swedish Export Promotion Agency
ERDR	Support for Economic Reform and Debt Relief
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
FAIM	Fund for Imports for Manufacturing Industry
FEMAC (Zam)	Foreign Exchange Management Committee
Frelimo	*Frente de Libertação de Moçambique*
FY	Fiscal Year
GCPI (Moz)	*Gabinete de Coordenacao dos Programas de Importacao*
HIPC	Highly Indebted Poor Country
IDA	International Development Association
IFI	International Finance Institution
IMF	International Monetary Fund
JEM	Joint Evaluation Mission
MFA	Ministry for Foreign Affairs
NGO	Non Governmental Organisation
NRM	National Resistance Movement
OECD	Organisation of Economic Co-operation and Development
OED	Operations Evaluation Department
OGL	Open General Licence
PA	Programme Aid
PAICV	*Partido Africano da Independencia de Cabo Verde*
PFP	Policy Framework Paper
PNDC	Provisional National Defence Committee
PSI	Pre-Shipment Inspection
QDA	Quick Disbursing Assistance

RAP (Zam)	Zambian Rights Accumulation Programme
Renamo	*Resistencia Nacionais Moçambicana* (National Mozambican Resistance)
RRV	Swedish Audit Office
SAF	Structural Adjustment Facility
SECAL	Sector Adjustment Loan
SEP	Sector Expenditure Programme
SF	Social Funds
SIDA	Swedish International Development Authority
Sida	Swedish International Development Agency
SIP	Sector Investment Programme
SNAAD	*Sistema Não-Administrativo de Alocaçao de Divisas*
SOE	State Owned Enterprise
SP	Sector Programme
SPA	Special Programme for Assistance to Africa
SWAP	Sector Wide Approaches Programme
TA	Technical Assistance
TBE	Theory based evaluation
TOR	Terms of Reference
UK	United Kingdom
USAID	United States Agency for International Development

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Executive summary

1. Background to the evaluation

1.1 During the 1990s Sweden has disbursed over SEK 7 billion of Swedish programme aid, comprising nearly 12 per cent of total aid.

1.2 Over the past ten years there have been evaluations of Swedish programme aid to a number of countries. But these have been on a country-by-country basis, lacked a common framework and have typically not addressed the central question of how programme aid supports policy change.

1.3 In order to obtain a comprehensive picture, Government decision dated 1996-11-18 charged Sida with the task of evaluating Swedish balance of payments support, which has been more broadly construed by the Evaluation Department to mean programme aid (PA).

1.4 According to the TOR **"the purpose of the study is to evaluate the impact of the resources transfer on economic growth"** (Sida's other objectives are mentioned in passing, but, as demonstrated below, PA is linked mainly to the growth objective). The key questions identified in the TOR are: (1) what is the rationale for Swedish PA and how has it changed over time? (2) how has PA evolved over time? and (3) the three questions of PA impact: (i) how aid affects policy; (ii) how policy affects performance; and (iii) the impact of the funds.

1.5 **The evaluation has produced 13 Working Papers**. Eight of these are country studies: three field studies (Nicaragua, Uganda and Vietnam) and five desk studies (Bangladesh, Cape Verde, Mozambique, Tanzania, and Zambia). In addition there is a study of the management of Swedish PA ("the Swedish report"), and thematic reports on conditionality, impact of adjustment and modalities of PA. A final paper is a critique of the World Bank's report *Assessing Aid*.

1.6 This note summarises the findings from the evaluation around four main areas: (1) management and modalities; (2) aid and reform; (3) impact of adjustment; and (4) the impact of the funds.

2. Management and modalities

Definition of Programme Aid (PA)

2.1 **Programme aid (PA) is aid that is not intended to finance a specific project**. This defining characteristic is spelt out in the definition given by DAC's *Principles for Programme Assistance*:

> Programme assistance consists of all contributions made available to a recipient country for general development purposes i.e. balance-of-payments support, general budget support and commodity assistance, not linked to specific project activities.
>
> (OECD, 1991: 5

2.2 A **common characteristic** is that it is linked to economic reform, i.e. that it is policy-based aid. World Bank and IMF policy-based lending is PA and most bilaterals link their PA to IFI conditionality. This link is present for most Swedish PA, although two countries – Cape Verde and Vietnam – received PA in the absence of IFI programmes (although they were implementing home-grown reform at the time). The link with IFI conditionality may be either very close, disbursing when conditional IFI funds are disbursed, or more general, such as observance of a PFP.

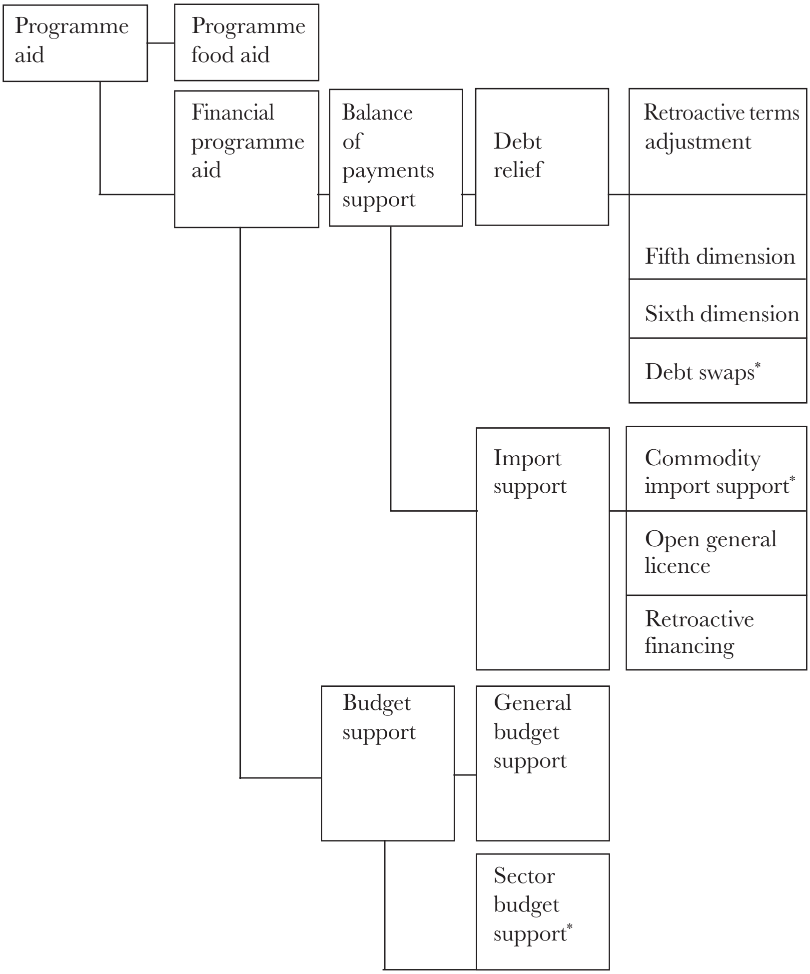
2.3 The different **modalities** of PA are shown in Figure 2.1. The main points to note are: (1) this evaluation is concerned only with financial PA; (2) the main distinction is between balance of payments support and budget support; and (3) budget support need not necessarily be PA, but much of it is – this last point is particularly pertinent with respect to sector programmes (discussed below).

Trends in Swedish PA

2.4 **Swedish PA has seen three big changes in the 1990s**: (1) a fall in both absolute and relative terms; (2) a shift in the relative importance of modalities as import support has virtually disappeared, debt relief increased in absolute terms and the relative importance of budget support increased (Figure 2.2); and (3) scaling down of PA disbursed through the country frame in favour of the fund Support for Economic Reform and Debt Relief (ERDR) created in the mid-eighties (Figure 2.3).

2.5 From 1990/91–1997 SEK 6.7 billion of programme aid was disbursed (and a further SEK 0.6 billion in 1998), amounting to just under 12 per cent of total Swedish aid over the period as a whole. However, **there has been a secular decline in PA in the 1990s, in both absolute and relative terms.** Annual disbursements peaked at SEK 1.7 billion in 1990, falling to just SEK 0.4 billion in 1997, corresponding to **a reduction from 20 per cent to just 5 per cent of total aid**.

Figure 2.1 Schematic representation of programme aid



Note: * some items under this heading may not be classified as programme aid.

Figure 2.2 PA modalities

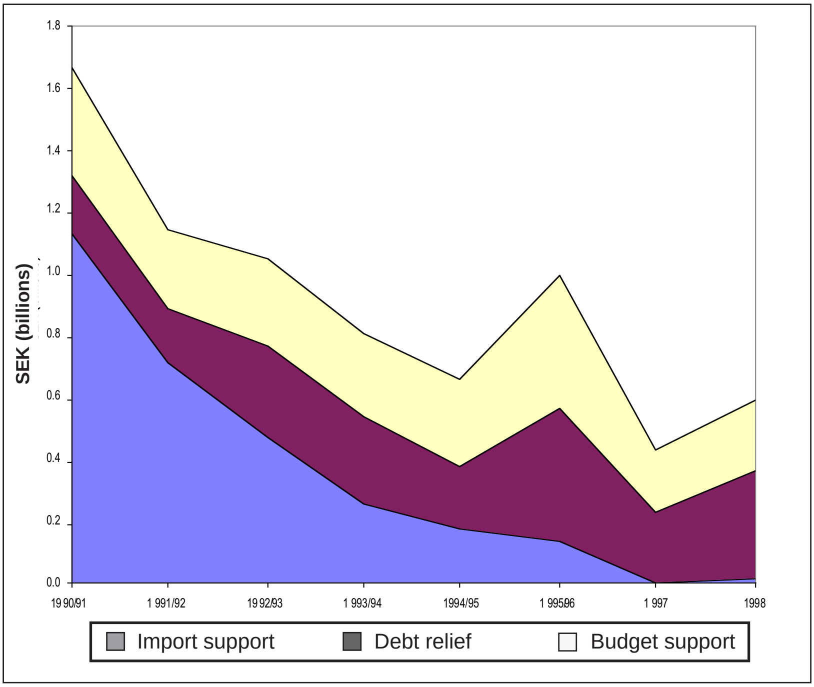
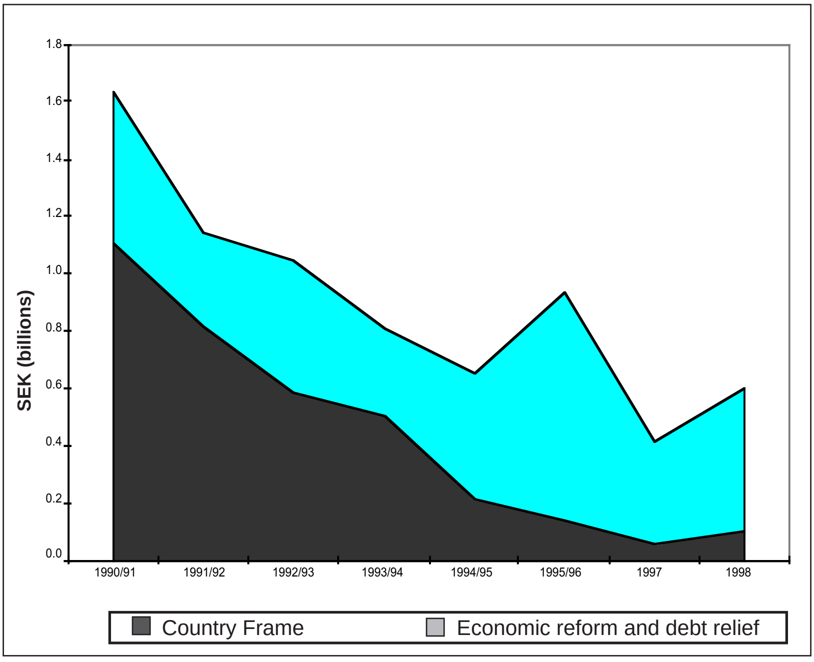


Figure 2.3 PA windows



2.6 Total Swedish aid also fell in the first part of the 1990s, and the falling share of PA over this period shows that **PA is vulnerable, meaning that it suffers a larger than proportionate fall when aid is cut.** The nature of PA, and the fact that it is largely outside the country frame, makes it easier to impose cuts and large year-to-year fluctuations in the budget on the part of the donor, and it is this fact which explains the fall rather than a deliberate move out of PA as a matter of policy. But such actions undermine the credibility of PA as an important part of the aid programme, and can be damaging to recipients (and are more likely to be so as the sector approach is developed).

2.7 Modalities have changed as **import support all but disappeared by 1997.** By contrast, **debt relief has been on a fluctuating upward trend,** accounting for over half of all Swedish PA in 1997 and 1998. Budget support has fluctuated (quite widely) in nominal terms, but its share has risen as import support has vanished.

2.8 **The cut in PA has been entirely at the expense of that disbursed through the country frame, with an increasing amount disbursed through the ERDR window.** The ERDR window was created to allow MFA more say over the use of these funds and to increase the flexibility of PA to act as an incentive for reform. In 1994/95 it was decided to remove PA from the CF altogether, although its declining share had already been evident for some time. This decision was subsequently reversed so that reservations could be utilised as PA, though the decline continued.

2.9 There is some debate as to **whether PA should be put back into the country frame.** Such a move may be expected to be resisted by some parts of MFA and the Ministry of Finance, partly as they will lose control over the funds as a result, though they will use the incentive argument (that a separate fund is needed to reward "good performers") to defend their position. Whilst it is true that putting PA into the CF gives the impression that the country has the funds (so that behaviour does not matter), various options might be examined for including PA in the CF. The most obvious of these is an application of the partnership concept, so that a larger CF, part of which is PA, goes to "good performers" and so is *ex post* conditionality (rather than the current *ex ante* conditionality of conditioning aid on future performance). A related move could be multi-year programming of the CF, although the arguments for that are rather different.

Management of Swedish PA

2.10 In line with the Swedish tradition, Sida is an autonomous agency operating within guidelines set by its parent ministry, Foreign Affairs. However, **MFA has more direct control over PA than other parts of the aid programme** for three reasons: (1) there is a close day-to-day relationship between Sida and MFA on many aspects relating to PA, including detailed consultations on Sida's recommendations to MFA for the allocation of PA; (2) MFA has direct control over a part of the ERDR, i.e. it authorises the disbursements; and (3) any reallocation within the CF in excess of SEK 35 million must be approved by MFA – such amounts are most likely to be involved in the case of PA. The control of MFA appears to have increased over time, both as ERDR has replaced the country frame as the main window for PA disbursements, and since MFA rejects an increasing percentage of Sida's recommendations on allocation of PA.

2.11 However, the part of PA over which MFA has direct control is only around 10 per cent of total Swedish PA. MFA is responsible only for some debt relief, whereas Sida disburses all three modalities.

2.12 A further distinctive feature of the management of PA is the involvement of the Ministry of Finance. Finance is responsible for Sweden's board representation at the IFIs and heads Sweden's delegation to the Paris Club, and so is an actor in one of the main channels for influence on policy dialogue. It is also involved in discussing the proposed PA allocations. Many officials in Sida and MFA mentioned that Sida and MFA are of a like mind, but that disagreements can arise with Finance, which is seen as more strongly "towing the IMF line".

2.13 **The allocation profile of PA is more progressive than that for Swedish aid as a whole**, although it is difficult to find an allocation rule which would explain this pattern. The eligibility criteria appear to be (1) low income, (2) heavily indebted, and (3) undergoing reform, but exceptions can be found in all cases, as can apparently eligible countries who do not receive PA.

Modalities

2.14 Import support underwent a transformation from allocative systems in accordance with the control regime to market-based systems making forex available through a variety of flexible mechanisms. Two sets of criticisms may be levelled at import support: (1) systems were prone to corruption and supported inefficiency; and (2) excessive bureaucratic procedures acted as a constraint on both utilisation of funds and market liberalisation. There is truth in both these complaints: but they are made with the benefit of hindsight, and both sets of problems were reduced as import support schemes became more liberalised. And, as explained below, import support had positive systemic effects at various stages. Nonetheless, **the problems caused by the excessive bureaucratic burden associated with import support holds important lessons for sector programmes today.** The key lessons are the importance of donor harmonisation and the dangers of donors trying to micro-manage government processes by requiring detailed reporting that may detract from the real objective of systems development.

2.15 Debt relief does not have these disbursement problems, and has much to be said for it as a form of PA.

2.16 Not all budget support is PA, but its importance may increase with a move by the donor community to sector programmes. There are, however, important unresolved issues with respect to sector programmes: (1) the extent to which it is intended to finance additional expenditures (and the implications for government expenditure planning), (2) identification of individual donors with programme components, (3) whether or not it is quick disbursing assistance (QDA). Underlying these issues is a division between those who see the sector approach as the latest manifestation of PA (so the policy dialogue focuses on the sector and the funds are PA), and those who see it as an evolution of project aid (so the sector is a project list plus policy dialogue). Current proposals for an overall expenditure plan met by government revenue and donors adopting either of these two approaches do not resolve all these problems and leave sector planning donor-driven (and create problems if some donors finance the recurrent component of another donor's project).

Objectives and rationale

2.17 **PA is linked to Sida's growth objective, although this is most commonly stated as being support to economic reform.** Analysis of documentation for seven of Sweden's programme countries shows that support for reform was given as the objective 25 times, improving economic performance 19 times and other objectives six times. However, Sida documentation rarely explains either how PA supports reform or how this will promote growth.

2.18 Despite suspension of PA for violations of good governance, political reform is not mentioned as an objective in any of the agreements (nor amongst the conditions). Social sector reform was mentioned three times in the objectives, which is the closest the agreements get to a poverty-related objective. However the 1998 Budget Bill stated that "economic reform is a precondition for long term economic and social development and efficient poverty reduction" and so may herald a change in this respect. But to date the objective for PA is dominated by growth/reform and there has been no change over time.

2.19 The rationale most often given for Swedish PA is an external gap, couched in various ways such as a shortage of forex, or possibly with reference to the debt burden. In recent years the external gap has been referred to less frequently, which reflects the demise of import support. Budget support is more likely to be given the rationale of an internal gap. But **there is no economic logic in rationalising import support with reference to an external gap and budget support with reference to an internal gap** (see below).

2.20 There is, however, a rationale for evolving PA modalities. This rationale is the systemic effects of different modalities. For example, changing systems of managing import support played an important part in several countries in liberalising forex markets. Budget support can potentially play the same role with respect to government budgetary systems. But Sida documentation rarely mentions these benefits. This fact is a manifestation of a more general shortcoming in the documentation, whereby the links between programme aid funds and their intended outcomes is not made. This gap reflects **an apparent weak understanding of the workings of PA on the part of many Sida officials**.

3. The role of donor agencies in policy change

3.1 **Domestic political considerations are the prime factor in determining economic and political reform.** All but two of the countries studied (Uganda and Zambia) initiated reform without donors. Several have carried out some measures not required by donors (e.g. the cash budget in Uganda) and all have not implemented other policies that have been required. In each case domestic factors can be identified which are important in understanding the timing and pace of reform, although some roles can be ascribed to donors. However, **donors over-state their own importance at the expense of understanding the political dynamic**. IFI documents often date reform from their own involvement rather than when the first changes were initiated and in general pay scant attention to possible implementation constraints; a corollary is that transparency is often measured by government sharing information with donors rather than civil society.

3.2 Analysis of policy dialogue has been excessively focused on the formal trappings of conditionality and the associated negotiations (from which bilateral donors are excluded). In fact, **policy dialogue is a set of processes**: conditionality is only the formal, directive end of policy dialogue, other parts of the policy dialogue have often been more effective, and the formal and informal channels complement one another. Indeed, Formal conditionality has a mixed record. **There is ample evidence from the evaluation for the view that conditionality has failed**, and of the reasons for this failure; **but there are also cases where conditionality has influenced policies** and reasons to believe why this may have been so.

3.3 **Bilateral donors have played an increasingly important role in policy dialogue***:* in the 1980s bilaterals signed up to the conditionalities of the IFIs, although they still do this formally, their role has increased partly with the development of political conditionality and partly as the policy dialogue processes have deepened. Whilst bilateral agencies have moved forward the agenda of political conditionality and supported the implementation of economic reforms, they have had little influence on the content of IFI programmes. Formal channels for influencing the IFIs appear not to work, and the informal ones are also weak. Rather, bilateral influence is most likely to operate through semiformal and informal channels, including co-ordination bodies such as like-minded groups.

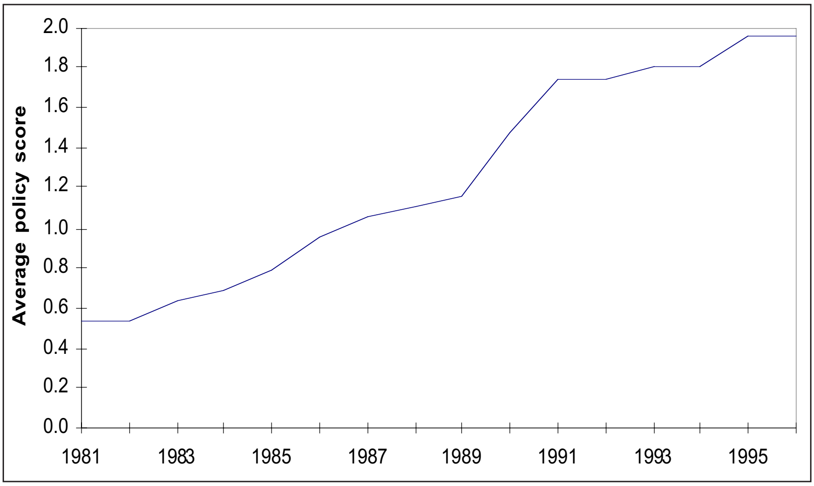
3.4 Sweden subscribes to the notion of promoting policy change, and is broadly supportive of IFI policies, although reserving the right to make independent judgements. However, there does not appear to be a "Swedish position": **Sweden's role in policy dialogue at the country level does not reflect what may have been expected from a "progressive donor".** Unique aspects of Sweden's involvement in policy dialogue have usually revolved around political conditionality (on the economic front the use of Matching Funds in Tanzania is the only exception), and there is no evidence of trying to put poverty more strongly on to the conditionality agenda at the country-level. **PA has both direct and indirect links to poverty reduction of which Sweden has by and large only paid attention to the indirect channels.**

3.5 The relative lack of Swedish influence in general is not the result of inability to have an influence, as such influence can be seen in a few cases, most notably those countries in which Sweden has a "presence" established through years of good relations (which appear not to sour if governments change). Indeed, the rationale for Swedish PA in countries where there is no presence is far less strong. In some countries Sweden has played a non-directive role in policy dialogue. This is most obvious in the case of Vietnam, but also applies to Nicaragua. There are good reasons to oppose the current hegemony of the IFIs in setting the policy agenda, and the most useful way that this can be done is through facilitating policy debate. Sweden's reputation for independence means that it is well placed to play this role. However, it is not clear that Sida has the capacity (in terms of either or both staff time and training) to properly carry out this part.

4. The impact of adjustment

4.1 **There has been a dramatic change in the policy stance of virtually all developing countries over the last twenty years.** Swedish aid was to some extent focused on those which had gone furthest toward a planned economy – such as Guinea-Bissau, Mozambique, Nicaragua, Tanzania and Vietnam. But today all these countries have introduced very substantial amounts of market 1980s (Figure 4.1). There is no doubt that a change has taken place: the question is, what has been its impact?

Figure 4.1 Policy index for Swedish programme countries



4.2 Table 4.1 reports the median score of some economic aggregates for Sida programme countries grouped according to policy stance (the data are from 1981–96 so a country will appear in a different group at different points in time). This analysis is thus a control group approach, which has well-known shortcomings. Nonetheless, the results are at least suggestive of a pattern that needs to be explained. First, **unreformed economies perform worse in all but one area (agricultural growth) than those that have initiated reform.** Second, other than for export growth (and to a far lesser extent for overall growth), **more intensive reform does not yield additional benefits over those with a lesser extent of liberalisation.** A before versus after analysis confirms these findings and delivers the additional insight that reform has restored growth in some countries (e.g. Uganda) but not in others (e.g. Zambia), which gives the third result that **reform appears to be necessary but not sufficient for restoring growth.**

Table 4.1 Economic performance for Swedish programme countries classified by policy index (group medians)

	0	*1*	*2*
Growth	1.7	3.8	4.9
Inflation	30.2	13.0	11.8
Investment rate	15.3	21.8	21.4
Export growth	–1.1	4.9	7.8
Agricultural growth	3.4	3.1	2.9
Manufacturing growth	0.0	4.5	4.7

4.3 Confirmation of these findings from a firmer analytical base requires examination of the determinants of the different variables and how these have been affected by reform. In the case of growth these determinants include inflation, investment and human capital. There is no doubt that taming the hyperinflation that threatened or actually occurred in many countries was an important pre-condition for growth. But empirical studies suggest that the growth-inflation link is non-linear: so that at a certain point further reductions in inflation are bad for growth. This is a policy issue of great relevance in many countries in which **Sida is supporting anti-inflationary policies which may be detrimental for long-run growth by undermining investment in physical and human capital.**

4.4 Investment can spur growth and affect the pattern of growth. Investment in infrastructure facilitates the agricultural supply response and promotes the geographical dispersion of growth. But a key indicator of infrastructure – road kilometres per person – has been stagnant in Africa since the early 1980s and road quality has deteriorated greatly over this period. This is one reason why **the agricultural supply response has been mixed** – despite agricultural liberalisation being the first measure undertaken in most countries – and defies easy generalisation. However, with the exception of Vietnam, **what response there has been has not been uniform across crops or geographically.** Examination of constraints on the supply response support the view that market liberalisation is unlikely to be sufficient for sustained sectoral growth.

4.5 The story is also mixed with respect to manufacturing performance, but **there is no evidence for widespread de-industrialisation as a result of liberalisation.** Several countries, mainly in Asia, have made rapid gains in producing for export, but Uganda has shown that growth can also occur in import-substituting sectors. However, many commentators would argue that in other countries adjustment has been unnecessarily severe by allowing inadequate time for firms to adjust, and point to the East Asian model which relied upon a measure of state intervention.

4.6 **The picture with respect to poverty is not encouraging in all but the most rapidly growing countries.** Not only is growth insufficiently high to reduce the number of poor but all available evidence suggests that contrary to early claims by the World Bank, **liberalisation has increased inequality.** Relying on market-led growth will not be sufficient to reduce poverty in the foreseeable future. However, despite talk of supporting pro-poor growth, policies proposed by donors focus on influencing growth rather than the pattern of growth.

4.7 There has been political reform although this has typically started later than economic reform. Some Sida programme countries have done little in this direction and others have suffered reversals. The evaluation results support the view that there is no straightforward relationship between economic and political liberalisation in either direction.

5. The impact of PA funds

5.1 PA is forex the sale of which raises local currency (counter-value). That is, a single PA transaction provides both forex and local currency ("the circular flow of PA"). Since any restrictions apply to the designated modality, **import support provides tied forex and free local currency, and budget support provides free forex and tied local currency.** The circular flow of PA means that it makes no sense to say that import support fills an external gap and budget support an internal one. Indeed, inappropriate conditions may mean that import support is better at filling the internal gap than the external one and *vice versa* for budget support.

5.2 Moreover, the concept of gaps has dubious economic validity. *Ex post* gaps can be observed, and these are created by the aid flow, rather than *ex ante* gaps existing which need aid to fill them. It is more useful to focus on the marginal impact of aid, rather than notions of "gap filling". This approach implies that there are no bottlenecks, aid's impact coming from a variety of channels rather than relaxing a critical constaint.

5.3 In examining the marginal impact of aid an important distinction is that between fungibility and free resources. Fungibility describes a situation in which a donor provides funds for an activity that would have been carried out anyway, thus freeing up the government's own resources to be used as it wishes. Although the donor's funds are accounted against its chosen activity it is in effect making possible the marginal activity to which the government diverts the resources freed up by the aid. If the donor does not specify the use of the funds then there can be no fungibility. Rather the aid should be called free resources. Much programme aid, such as retroactive finance and some debt relief, is recognised by donors as being free resources.

5.4 The academic literature has proved how difficult it is to establish methodologically sound and robust conclusions about aid and growth, though many recent studies do find a significant positive relationship. The approach in this study is to examine how aid affects a range of variables. The main findings are:

- Aid in general has supported both imports and debt payments; without aid imports would have been between 20 to 50 per cent less in most years for most of the countries studied, and even then they would have been unable to meet external debt obligations.

- Aid, in particular counter-value, has not resulted in equivalent increases in expenditure, and so had an anti-inflationary effect by offsetting deficit financing.
- The anti-inflationary impact also works through increasing the supply of goods with higher imports and by providing the reserves which give credibility to an exchange rate anchor (or, more generally, avoiding the necessity for inflationary devaluation when liberalising forex markets). The second of these effects is particularly associated with PA.
- The anti-inflationary impact of aid, combined with conditionality and systemic effects of PA, mean that it has been associated with depreciation of the real exchange rate rather than appreciation.
- Private investment response is weak in most countries, so the potential positive links from aid (through both policy and impact of funds) remain to be realised.
- The story with respect to government expenditure is mixed, but in most countries restructuring of public spending to social sectors remains limited, suggesting that aid may not have played much of a role.
- **Effective conditionality will determine aid's macroeconomic impact by influencing the use of funds.** The extent to which aid is used to reduce deficit financing or increase expenditure, rather than offset taxes (and the sort of expenditure), can be influenced by the conditions attached to aid, in particular the spending limits associated with IMF credits. However, the conditions are not always effective and may not have been the right ones – in several cases a more liberal attitude to spending may have been appropriate.
- There can be no doubt that aid has improved welfare through supporting expenditure and imports. But the evidence adds up to suggest that aid will have had some impact on growth, but that the impact is neither particularly strong, nor sustainable – which requires more focus on the fundamentals.

6. Conclusions and recommendations

Main messages

6.1 The main messages to emerge from the evaluation in the five areas of study are:

- Modality: different modalities make sense for their systemic effects, rather than reference to an internal or external gap. However restrictions and reporting requirements have sometimes been excessive and lagged behind changes in the recipient country – a fact which holds lessons for donors in the move to budget support, emphasising the importance of donor harmonisation and the dangers of attempting to micro-manage domestic processes.

- Management: the divorce of PA from the main body of the aid programme by the greater role accorded MFA may undermine PA in various ways, of which the most notable element is the vulnerability of PA to cuts following its removal from the country frame. But the common characterisation of programme aid as "political" is a related issue. Finally, understanding of the workings of PA is often weak, or at last not well articulated in official documentation.
- Impact of reform: substantial liberalisation has taken place; however the evidence does not support the view that further liberalisation is either necessary or sufficient for sustained growth, but rather suggests that some measure of complementary policies are required to correct for market failures (e.g. state support for credit and extension, labour-intensive public works, and investment in infrastructure and basic services).
- The role of donor agencies in policy change: policy dialogue is often narrowly conceived as the formal negotiations over a PFP or, more specifically, a particular adjustment credit. In fact policy dialogue should be seen as a wider set of processes taking place through both formal and informal channels. Donors have had a more limited role in policy change than they imagine, mainly as domestic politics are the prime factor in shaping the reform effort. However various roles for bilateral influence do exist which have perhaps been under-utilised, partly to question the Washington consensus and partly to facilitate a broader debate. It is not clear if Sweden wishes to exert an independent influence, though several actions lead us to conclude that it does; however there is no clear "Swedish position" and it is not, as may have been expected, associated with a more "human face".
- The impact of aid funds: it is notoriously difficult to reach firm conclusions with respect to the impact of aid funds, however, data analysis suggests that aid (in general) has supported imports and debt service, and that programme aid has both supported government expenditure and played a role in stabilisation. There is support for the view that effective policy dialogue can enhance aid impact.

Recommendations

6.2 Following from above the following recommendations can be made:

- Modality: Sweden should use available channels to pursue harmonised, stream-lined sector programmes, but retain a substantial share of debt relief (whose share may rise above its current 50 per cent whilst sector programmes are sorted out) to act as quick disbursing assistance. Sectoral and intra-sectoral expenditure patterns should be influenced through policy dialogue, rather than restrictions on the use of funds.

- Management: PA should be put back in the country frame, exploring ways of doing this which utilise *ex post* conditionality. Whilst the details of this new form of conditionality remain to be worked out, there is a widespread feeling that *ex ante* conditionality has not worked. A better understanding of how PA inputs are intended to achieve their intended outcomes of growth and poverty reduction is desirable.
- Impact of reform: Sweden should support the pursuit of complementary policies (listed in the previous paragraph) to enhance prospects for growth and to improve the distribution of growth.
- Role of donor agencies in policy change: Sweden should actively develop its image as an independent agency that will support initiatives to facilitate domestic debate on policy issues. This does not require a break with formal policy conditionality, but recognises the limited role that this aspect plays. A more active involvement on policy issues is implied by this stance, which support the view that PA should be focused on a smaller number of countries.
- Impact of funds: pay due attention to conditionality to promote the right macroeconomic impact of funds, without becoming involved in micro-management of the use of funds.

In conclusion, there is a future for PA. Indeed, **there are good grounds for reversing the declining trend in PA**. But expanding the PA budget should be done in the context of a new strategy for enhancing PA effectiveness, which draws on the recommendations of this report.

Chapter 1
Evaluating programme aid's impact: a conceptual framework

Programme aid (PA) is aid not linked to any specific project, but which is conditional upon policy changes by the recipient. PA thus has two inputs: funds and policy dialogue. How are these inputs intended to achieve growth and poverty reduction? To answer these questions requires an examination of both the management of PA and channels for impact. Three areas of impact are identified: effect on policy outcomes, impact of policy changes and impact of PA funds. A logical framework can be applied which links these inputs to specific activities and, so, to outcomes which relate to Sida's development objectives.

1.1 The three research questions

How does programme aid (PA) work?[1] How does the provision of import support, debt relief or budget support bring about poverty reduction?

As will be documented in Chapter 2, PA is most closely related to the growth objective: PA is meant to reduce poverty through the promotion of economic growth. Understanding how this is so involves first the recognition that each PA agreement has two inputs: funds and policy dialogue. On the one hand a PA flow consists of actual dollars or SEKs (or in the case of some import support and food PA, commodities). But, on the other hand, linked to the PA of most donors, including Sweden, are associated policy conditions. PA is intended to act as a lever for economic and political reform and, hence, bring about economic growth.

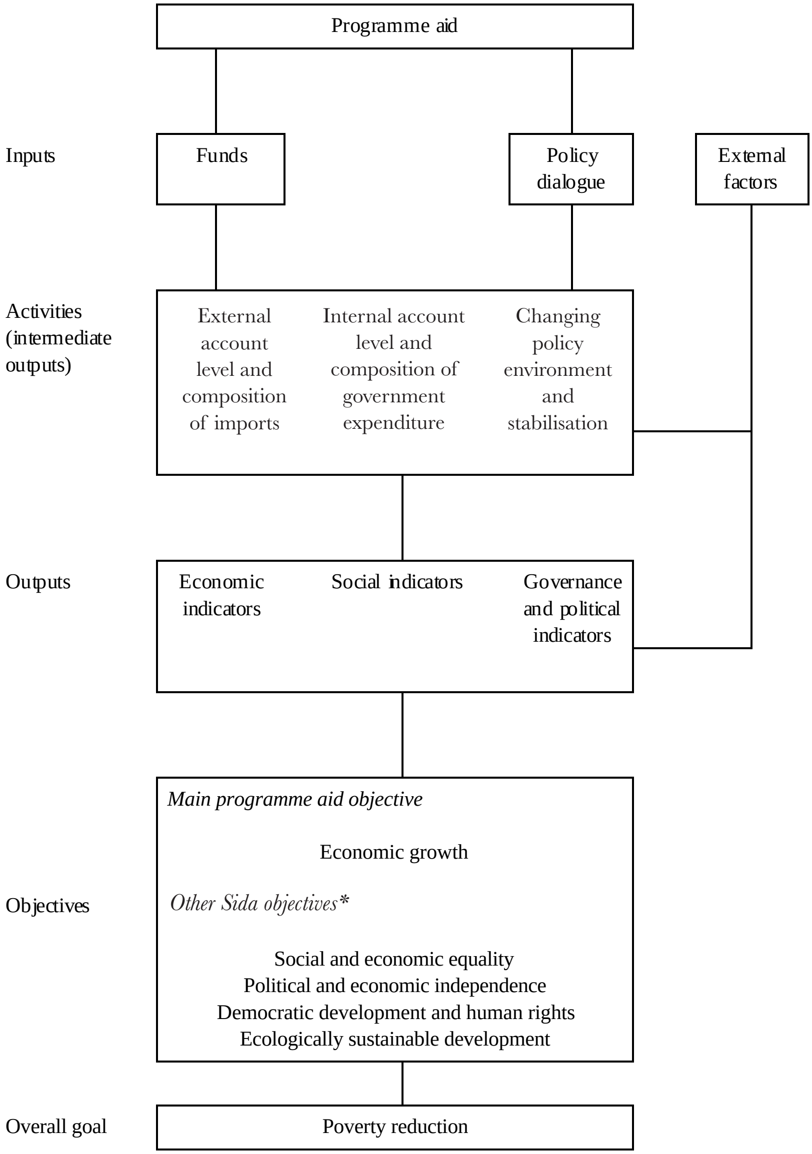
The two channels of PA raise two sets of questions. The first relate to the management of PA, the selection of PA modality (import support, debt relief or budget support) and the application of policy conditions. The second set consists of three questions on PA impact. These three are:

[1] The definition of PA is discussed in more detail in Chapter 2.

- how has donor policy dialogue affected the pattern and pace of reform, i.e. policy outcomes (and what has been the contribution of PA to this process)?
- what has been the socio-economic impact of reform programmes?
- what has been the impact of the PA funds (on imports, government expenditure, investment etc.)?

This chapter first lays out the conceptual framework to be used to address these questions (section 1.2), and provides a brief overview of the remainder of the report (section 1.3).

Figure 1.1 Logical framework for the analysis of programme aid



Note: * the objective of gender equality was added only recently and so is not shown amongst the objectives for the purposes of this evaluation. Nonetheless, gender-differentiated impacts are considered insofar as they relate to the other objectives.

1.2 A conceptual framework

The overall conceptual framework is the logical framework (log frame), shown in Figure 1.1. The motivation for the log frame is that one can trace back from objectives to output indicators, and so to the activities needed to get those outputs and, finally, the inputs required to carry out those activities. Theory based evaluation (TBE) can be viewed as a restatement of the log frame which examines how the various links (from inputs to activities etc.) are meant to work and the assumptions underlying these links, and how they work in practice.

As explained above, PA has two inputs: funds and policy dialogue, and these are shown at the top of the figure. Both of these inputs relate to the three activities shown: changes in aggregates on external and internal account, and the changing policy environment.[2] For the former two activities there are both levels and composition effects: PA can affect, *inter alia*, the level of government spending and its distribution across sectors, and both the level and composition of imports. Disentangling the effect of PA from other factors is the common problem of the counterfactual, which needs to be taken into account in analysing each of the three questions.

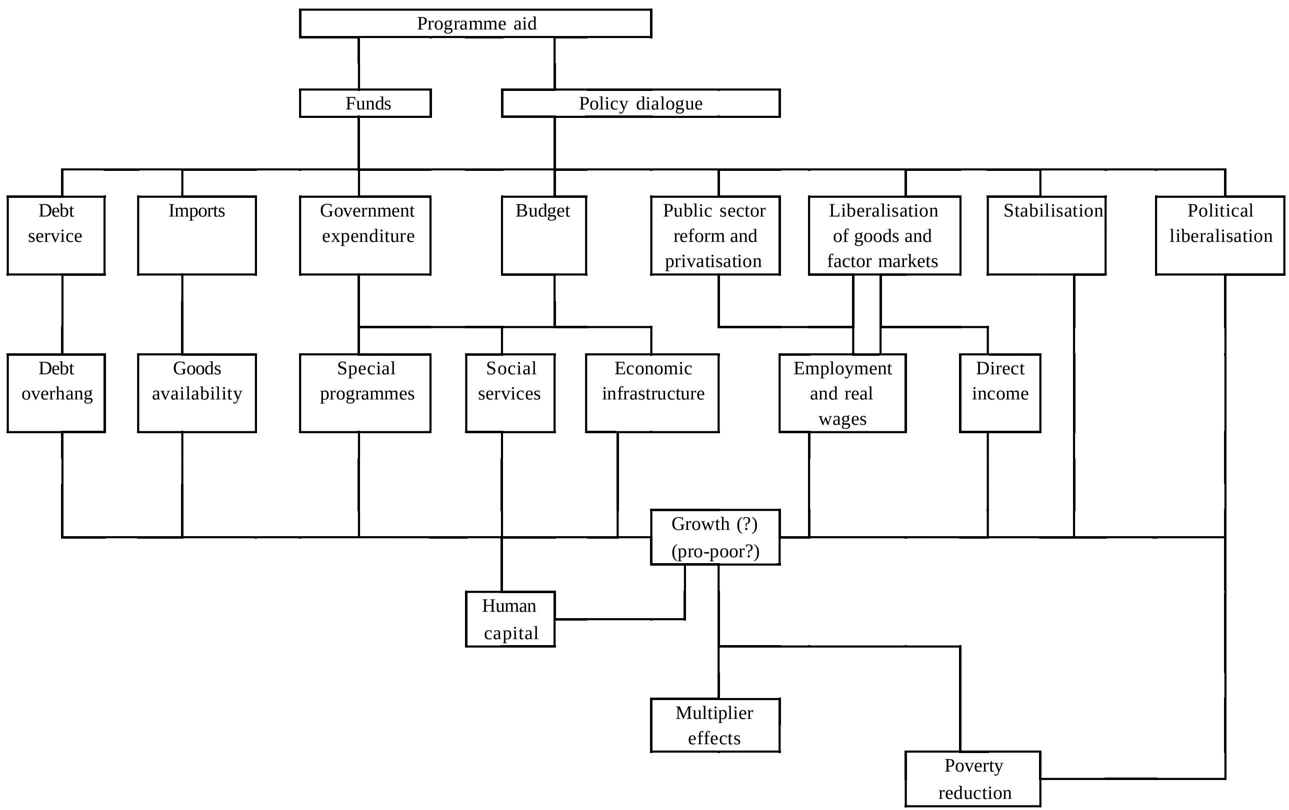
These activities should deliver outputs (or impact) in terms of improved economic, social and political indicators. We include the last of these as governance concerns have entered the donor agenda in the nineties, and political conditionality with PA is often the chosen instrument to achieve this objective. A distinction is made between governance and politics, the former relating to the workings of the government system, such as budget transparency, and the latter to the political process, such as a free press and the electoral system. The three sets of outputs shown are not of course independent; the extent to which one is achieved may well depend on the others. The evaluation also considers evidence relating to these links, in particular that between political and economic liberalisation. These output indicators show the extent to which the objectives have been realised, and so contributed to the overall goal of poverty reduction.

The framework lists five of Sida's six objectives (that of gender equality was added too late to be included in the evaluation). The growth objective is separated out as that most relevant for PA (see Chapter 2) and is the main focus of attention in this report. The other objectives are mentioned mainly insofar as they matter for growth and its relationship to poverty reduction.

Figure 1.2 presents a more detailed framework for the links between PA and growth. As in Figure 1.1, both funds and policy dialogue may be expected to affect both policy and economic aggregates. Beyond that some specific channels to be investigated are identified, such as how stabilisation and the reduction

[2] There is no significance in the relative placing of the inputs and activities. It is not intended to suggest that policy dialogue cannot affect, say, the external account, nor that funds cannot affect the policy environment.

Figure 1.2 Evaluating the growth and poverty reducing impact of programme aid



of debt overhang can increase growth. The figure also picks out those components of government expenditure – infrastructure and social spending – considered most important for growth and poverty reduction.

1.3 The purpose and scope of this evaluation

During the 1990s over SEK 7 billion of programme aid (PA) have been disbursed, corresponding to 12 per cent of total Swedish aid in this period.[3] There have been many separate evaluations of Swedish programme aid since the late 1980s (reviewed in de Vylder, 1996). But various shortcomings may be identified in each of these, and there has been no attempt to present a synthesis which abstracts from specific country circumstances to draw general conclusions on Swedish programme aid.[4] This report attempts to fill that gap.

The Evaluation of Swedish programme aid has taken place during 1998 and early 1999. Thirteen working papers have been produced. The core of these papers have been eight country studies – three field studies (Nicaragua, Uganda and Vietnam) and five desk studies (Bangladesh, Cape Verde, Mozambique, Tanzania and Zambia) – supplemented by literature reviews and conceptual papers.

This paper summarises the findings of the evaluation. The second chapter deals with the first set of questions related to the management of PA, opening with a discussion of its workings. Chapters 3 to 5 deal with the three questions of PA impact: how donors have affected policy outcomes, the impact of policy changes, and the impact of the PA funds. The final chapter concludes and presents recommendations.

[3] PA's share of Swedish aid for 1990/91-1997 was 11.9 per cent (reporting switched from a financial to a calendar year in 1997).

[4] De Vylder (1993) synthesised evaluations from four countries, and Aguilar (1997) discusses support to reform, rather than PA more generally, in three countries.

Chapter 2
What is programme aid?

Over SEK 7 billion of programme aid (PA) has been disbursed during the 1990s, corresponding to 12 per cent of Swedish aid. But PA has fallen in both relative and absolute terms, accounting for only 5 per cent of total aid in 1997, compared to 20 per cent at the start of the decade. There is no developmental rationale for this decline, indeed current trends in donor policy and rhetoric suggest that the opposite trend may have been expected. Within this decline there have been major changes in Swedish programme aid: from import support to budget support (with a continuing role for debt relief), and from the Sida-administered country frame to the Economic Reform and Debt Relief window, over which the Ministry for Foreign Affairs has a much greater say. The role of the Ministry of Finance has also increased. One constant has been that PA has been most strongly associated with achievement of the growth objective, often through the intermediate objective of supporting reform. But Swedish documentation gives little insight into how PA is intended to achieve these objectives, nor how the various rationales for PA (mainly the presence of an internal or external "gap") are linked to these objectives. Greater familiarity with "how PA works" by Sida officials is likely to increase the effectiveness of this aid, *minimising* the negative systemic effects that have been present, promoting positive *ones* and enhancing Sweden's role in the policy process.

2.1 The meaning and purpose of programme aid

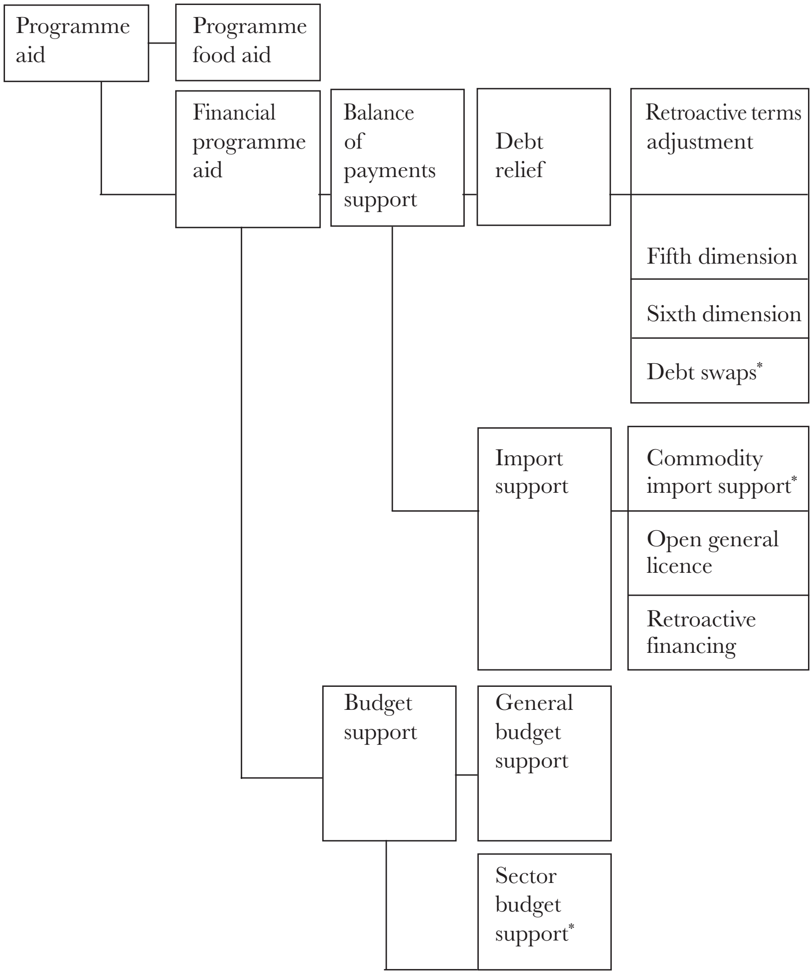
Programme aid (PA) is aid that is not intended to finance a specific project. This defining characteristic is spelt out in the definition given by DAC's *Principles for Programme Assistance*:

> *Programme assistance consists of all contributions made available to a recipient country for general development purposes i.e. balance-of-payments support, general budget support and commodity assistance, not linked to specific project activities.*
>
> (OECD, 1991: 5)

The DAC definition distinguishes several forms – called here modalities – of programme aid, which are shown schematically in Figure 2.1. The first distinction is between financial programme aid, where the donor gives cash, and commodity aid, where actual commodities are given (most often food). This evaluation is concerned with financial programme aid. Financial PA may be further sub-divided into balance of payments support, in which the donor gives foreign exchange (forex), and budget support, in which the donor "gives local currency". All three of import support, debt relief and budget support are broken down yet further, in ways which are elaborated upon below.[1]

[1] Under SPA bilateral debt relief (i.e. on own debt) is called Fourth dimension. The first three dimensions are IDA adjustment credits, IMF ESAF and bilateral import/budget support respectively.

Figure 2.1 Schematic representation of programme aid



Note: * some items under this heading may not be classified as programme aid.

Of course the donor does not have local currency to give in the case of budget support, so that it gives forex which is converted to local currency. This latter transaction is part of "the circular flow of programme aid" (i.e. that every PA flow has both a forex and a local currency component) which underpins the equivalence of different forms of PA. The order in which the typology has been presented here also largely corresponds to the historical evolution of PA through different modalities.

The defining characteristic of programme aid is that it is not intended for a specific project. A common characteristic is that **PA is linked to the**

implementation of policy reform in the recipient, that is it is policy based aid or subject to conditionality. The rise of financial PA in the 1980s was linked to the rise of structural adjustment. The money the World Bank and IMF lend linked to their adjustment and stabilisation programme is almost entirely programme aid.[2] Most, though not all, bilateral donors link their PA disbursements to the conditions of the World Bank and IMF (called collectively the International Financial Institutions, IFIs). Sweden is an example of this. Except in Cape Verde and Vietnam which have not had IFI approved programmes in much of the 1990s, Swedish PA has usually been conditional upon fulfillment of conditions agreed with one or both of the IFIs. The fact that PA is not linked to particular projects makes it easier to "turn on and off" so that it can be used in this way. By contrast non-PA flows are only halted in more extreme circumstances.[3]

The objectives and rationales for programme aid

There are six objectives for Swedish aid: economic growth, social and economic equality, political and economic independence, democratic development and human rights, ecologically sustainable development and gender equality; all of which relate to the overall goal of poverty reduction.[4] An analysis of various official documents shows that **Swedish PA is mostly linked to the growth objective**, although this fact is not always stated explicitly since many official statements, including programme aid agreements, couch the objective in terms of support to reform rather than the output of higher growth.

Although programme aid had been part of Swedish aid since the 1970s, SIDA's 1985 *Guidelines for Import Support* (SIDA, 1985) were the first time import support was characterised as being to facilitate economic and political reforms. The 1989 *Guidelines for Commodity Assistance* gave "support ongoing reforms in the recipient country" as the sole rationale for import support, and the 1993 *Guideline for Swedish Import Support* stated this as "the prime aim of import support is to support a programme of economic reform in the recipient country" (SIDA, 1993: 19).

These sentiments are echoed in general statements such as the budget bills and specific programme aid agreements. Hence the Budget Bill for 1997 states that "balance of payments support is the most important instrument for supporting economic reform programmes" (Government of Sweden, 1996:

[2] In a World Bank adjustment credit perhaps 5 per cent will be for technical assistance. Other donors may classify technical assistance related to the administration of PA under the PA budget, but it is typically around 2 per cent of the total.

[3] Sweden suspended aid to India and Pakistan in 1997 when both countries resumed nuclear testing. Neither country was in receipt of PA, so that suspending only PA was not an option.

[4] There is however often little or no explicit link to poverty reduction in Sida's activities. A recent review concluded that: "a large number of projects and programs supported by Sida do not specify poverty reduction as an explicit objective... Swedish development co-operation is largely driven by objectives other than (direct) poverty reduction" (Tobisson and de Vylder, 1997: 21-2).

84). An analysis of the agreements for seven of Sweden's programme aid countries over the 1990s show that support to reform is mentioned 25 times, economic performance (growth, restructuring and stabilisation) 19 times and other objectives (typically longer term development or something similar) six times (Danielson and Nilsson, 1999). Hence a typical statement would be to give the objective as "to support the economic reform process" (Vietnam 1989/90) or "to support the ongoing economic reform programme" (Tanzania, 1991/92).

In three cases the social sector is also mentioned amongst the objectives. The first such case was in 1993/94 (Tanzania), but so few occurrences do not justify calling this a trend. Despite the fact that political conditionality has been applied on several occasions in the 1990s, political reform is not explicitly mentioned in any of the agreement. However, in the case of Vietnam, where budget transparency is seen as a governance issue, the budget process is.[5]

The link between support for reform and growth is sometimes made, but this is far from always the case. The 1998 Budget Bill stated, for the first time, that "economic reform is a precondition for long term economic and social development and efficient poverty reduction" (Government of Sweden, 1998: 49). Of the 25 mentions of reform in the programme aid agreements mentioned above, four of these are linked to economic performance, and in a further three cases improved economic performance is also mentioned as an objective. The agreement with Uganda in 1992/93 is an example of the former: to support the country's economic recovery by support for the economic reform policy.

Somewhat similar conclusions may be made with respect to other agencies (see Appendix 2 for a summary). In general PA is seen as being linked to the growth objective, although, as in the case of Germany, this is implicit by saying that PA supports reform. There is an increasing tendency to link PA to other objectives – notably that of poverty. In the cases of the Netherlands and UK this link has been made with the move to budget support.

To summarise on objectives. Of Sida's six objectives, PA is most clearly identified with the growth objective. However, in many documents, the link is not made directly with growth but rather with support to reform, which is thus implicitly, and sometimes explicitly, assumed to result in growth. Indeed since the mid-eighties support for reform has been identified as the objective of programme aid in successive *Guidelines*, the annual budget bill and a majority of programme aid agreements. From the agreements analysed for the 1990s there is no discernible change across time in the objectives for Swedish PA. The 1998 Budget Bill is the first to link PA to poverty reduction, though this change was not reflected in any of the agreements analysed for this evaluation.[6]

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[5] This practice contrasts with that of the UK. A study of Zambia found that in the early 1990s, when political conditionality started to be applied, it was absent from agreements but was the subject of official correspondence. However, by the middle of the decade "satisfactory progress on governance" had become an explicit condition in UK PA agreements (see Seshamani and White, 1998).

[6] The cut-off date for the evaluation is formally 1997, though one agreement for 1998 (Uganda) was included in the analysis.

A number of reasons can be advanced in favour of programme aid:[7]

- A main rationale for PA is a shortage of foreign exchange, which may be called a forex gap.[8] Although project aid also provides foreign exchange, the argument is that, being more flexible, programme aid allows the importation of items to support intermediate, recurrent and maintenance expenditures to enhance capacity utilisation (there is little point in investment projects to create additional capacity if existing capacity is under-utilised). The forex gap may also be caused, or exacerbated, by large debt obligations.
- PA can be quickly disbursed.[9] This fact is an advantage either if the recipient has an immediate need for funds (for essential imports or debt service), or if the donor has surplus funds to utilise before the end of the budget year. Some donors, especially those who do not allow unallocated funds to be carried from one year to the next, disburse such amounts as PA.
- The link between PA and reform means that the aid may be justified in terms of general economic problems. PA is seen as particularly suitable for policy-based aid as it is easier to turn on and off than is project aid. PA may also be given as "a reward" for countries that have already performed well.
- Given that PA also makes available local currency, the rationale may be an internal gap (government budget deficit) rather than an external one. Moreover, non-project aid gives greater power to the recipient in the use of funds and can avoid the institutionally destructive effects from the proliferation of donor projects, such ideas being part of the motivation behind the rise of the sector approach.

Swedish agreements usually often contain little that may be called rationale for the provision of PA, so for this we turn to the various memos pertaining to PA. Table 2.1 summarises these, showing that an external gap (general forex shortage, need for imports or debt burden) is the most common rationale offered. However, an analysis of the rationale across time (Danielson and Nilsson, 1999) shows that the external gap has been replaced by the internal gap as the most common rationale in the last two years. As will be seen below, this shift corresponds to that from import support to budget support – that is import support has been rationalised with reference to an external gap and budget support by an internal one. There is no particular pattern in relation to the other rationales.

Responses from staff in other bilateral agencies suggests similar rationales for programme aid (Table 2.2). The presence of reform (and support for reform) emerge as the most important reasons, along with that of a financing constraint.

[7] The list is an update of that in White (1995) (which is itself based on Winpenny (1989) and de Vylder,1993), modified to reflect the analysis of Swedish rationales by Danielson and Nilsson (1999).
[8] The notion of gaps is discussed in Chapter 5.
[9] Indeed, PA is sometimes called Quick Disbursing Assistance (QDA).

Table 2.1 Rationales for Swedish programme aid		
Rationale	Share of cases	Examples
External gap	58	Supply the country with necessary foreign exchange (Tanzania 1992/93). "The country will need untied foreign exchange to support its people" (Cape Verde, 1991/92). "Severe debt situation" (Zambia, 1995/96).
Internal gap	14	Finance the budget deficit that would otherwise have to be financed by increased taxes (Uganda, 1997). Counter-value important for government current account (Mozambique, 1994/95).
General economic problems	14	"Through this [PA] the possibilities for self-sufficiency will increase in the long-run" (Cape Verde, 1993/94).
Surplus donor funds	9	Reallocation to Fifth Dimension in Zambia of slow disbursing import support funds.
Reward	5	Appreciation of Zambia's commitment to economic recovery programme (Zambia, 1990/91).

Note: paraphrase of agreement unless in quotation marks. *Source:* Danielson and Nilsson (1999).

Table 2.2 Motivating factors behind programme aid for selected donors (1 is not at all important and 4 very important)

	Germany	Japan	Netherlands[1]	Norway[2]	UK
Rapidly disburse funds to country with binding forex/budget constraint	4	4	4	2/1	4
Easily disbursed funds for country programmes with unutilised balance	1	1	–	2/2	2
Recipient country faces absorptive capacity constraint for project aid	2	1	–	1/3	4
Recipient country is undertaking economic reform	4	4	4	3/3	4
Recipient country is undertaking political reform	3	–	–	3/3	3
Government requires external support to sustain reform programme	4	4	4	3/4	2[3]

Note: 1/ These are formal criteria; in practice quick disbursement has also been a factor; 2/. Response from NORAD and Ministry for Foreign Affairs, respectively; 3/ Except in extreme cases, and some bits (e.g. civil service reform) may need financing. *Source:* questionnaires returned by agency staff.

2.2 Trends and patterns in Swedish programme aid

Trends in Swedish programme aid

There are two notable features of Swedish programme aid in the 1990s:

- it is a significant component of the aid programme; disbursements totalled close to SEK 7 billion from 1990/91 to 1997, accounting for close to 12 per cent of total aid
- there has been a secular decline in Swedish PA in the 1990s, both in absolute terms and as a share of total Swedish aid.

Figure 2.2 Total Swedish aid and programme aid

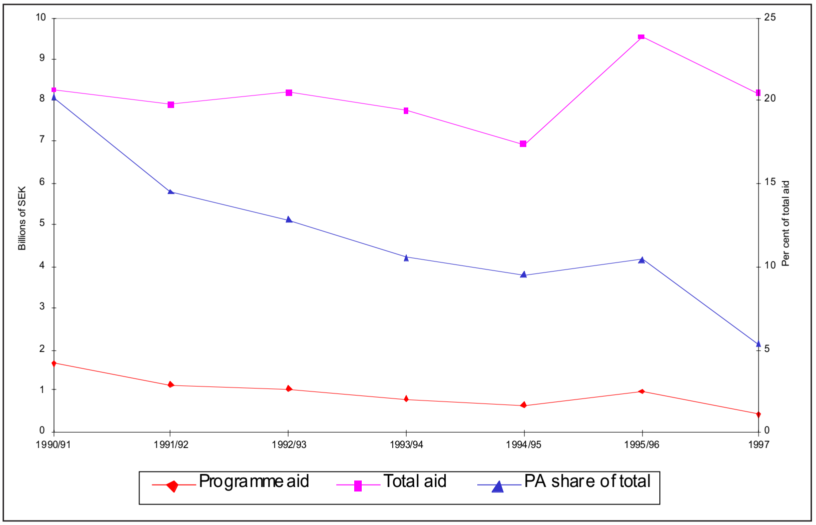
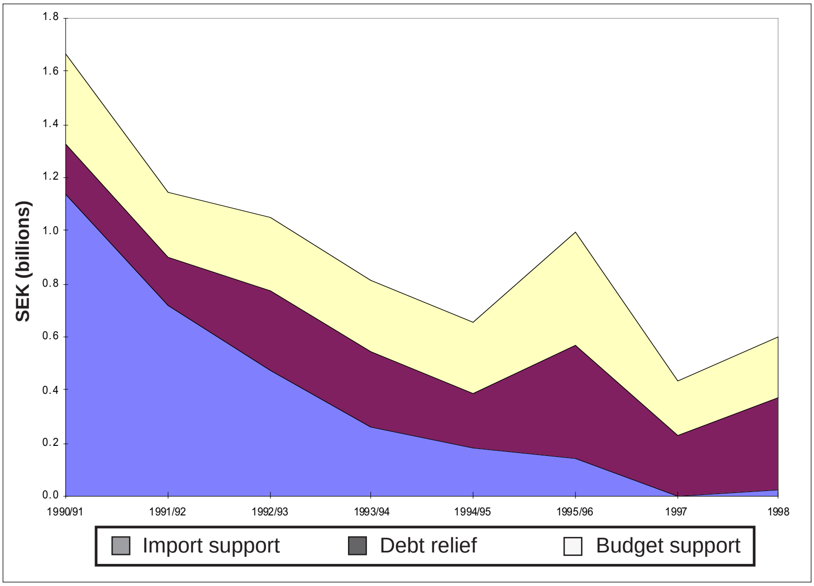


Figure 2.2 shows these trends. From a peak of SEK 1.7 billion, PA disbursements fell to under SEK 0.5 billion in 1997, corresponding to a reduction from 20 per cent of total aid to only five per cent. Looking at the trend for total aid supports the view, expressed by a number of officials in both Sida and the Foreign Affairs, that PA has been squeezed as the aid budget has fallen. Analysis of these trends shows that **programme aid is vulnerable, meaning that it experiences a larger percentage cut than that in the aid budget as a whole**. Indeed, in 1991/92 the fall in PA compared to the previous year exceeded that in the total aid budget, and it continued to fall the next year although total aid recovered. In the three subsequent years in which total aid fell the percentage reduction in PA was two to four times greater than that in total aid. This trend is contrary to what may be expected from many policy statements, such as the Africa Partnership

Programme and Sida's support for the Special Programme of Assistance for Africa (SPA), which would suggest an increased role for PA.

Figure 2.3 Programme aid modalities



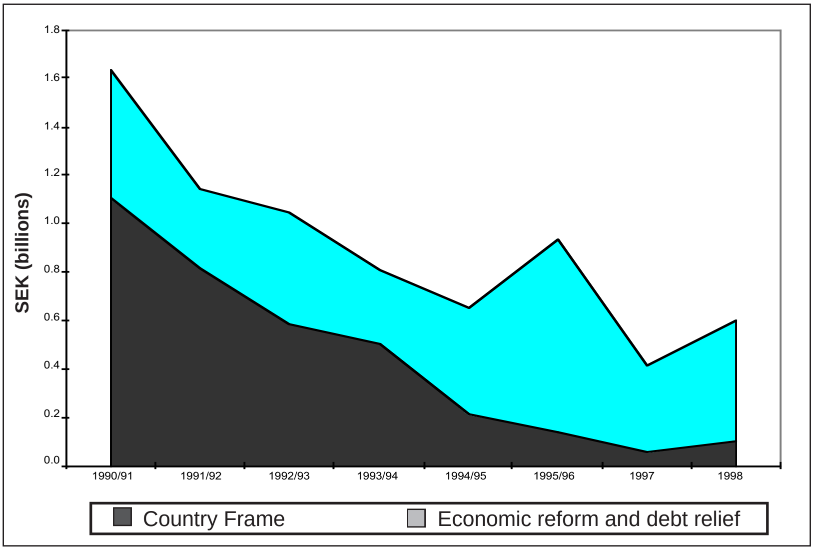
Underlying this overall decline has been a marked shift in the composition of PA, as import support has taken the whole of the cut, having dwindled to virtually nothing in the last two years (see Figure 2.3). Debt relief has increased slightly and budget support has been quite constant.[10]

The management of Swedish programme aid

The Swedish tradition is for an autonomous agency operating within guidelines set by a parent ministry. This situation accurately describes the relationship between Sida and the Ministry for Foreign Affairs (MFA), with two caveats. First, there is a close day-to-day relationship between MFA and Sida on many matters, and MFA has a direct control over disbursement of some PA funds. Second, the Ministry of Finance is also a player with respect to PA, with responsibility for the World Bank (but not IDA which is under MFA), IMF and export credits, though the central bank, Sveriges Riksbank, assumes main responsibility for relations with the IMF. Sida is in the first instance responsible for preparing its budget proposal, indicating the main budget headings, which is discussed with government. Once approved by parliament, Sida and MFA discuss the details of how the aid shall be allocated, which is in the end approved by government.

[10] The vagaries of Sida's data system mean that what is classified as budget support may have changed over time, so that there has been a move toward forms of budget support which are more properly classified as PA.

Figure 2. 4 Programme aid windows



PA channels have changed greatly in the 1990s. At the start of the decade the bulk of PA, of any modality, was disbursed by Sida from the country frame. The alternative window, created in 1985/86, is Support for Economic Reform and Debt Relief, from which the funds are disbursed either by Sida, again for any modality, or debt relief disbursed by MFA, the latter accounting for just under 10 per cent of total PA in the 1990s.[11, 12] However, whoever disburses the funds, the allocation of aid by recipient and modality from Economic Reform and Debt Relief is made by MFA, who have to approve any subsequent reallocation (e.g. as occurred from import support to debt relief in Zambia).[13] There is more flexibility in the MFA part of the account, which indeed is the point – the incentive effect from PA (i.e. rewarding "good performers", and punishing"bad ones") is potentially far less if the amount is built into the country frame. The fall in PA has been fully absorbed by the country frame window, which by 1997 accounted for only a small share of the total (see Figure 2.4). This fall in part reflects a decision in FY 1994/95 to remove all PA from country frames, however this decision was reversed in order to allow reservations (i.e. unutilised balances) to be utilised as PA.

There are different views on the importance of the apparent shift in control to MFA during the 1990s. **Some officials describe programme aid as "political",** a description which refers to this shift for one of three reasons:

(1) MFA gives greater weight to governance issues than does Sida – for example, on the advice of the economist in the Swedish Embassy in Lusaka,

[11] The debt relief from Sida is solely Fifth dimension, as 4th and 6th are the exclusive preserves of MFA.

[12] Small amounts of PA are also disbursed by Sida from other windows.

[13] MFA also has to approve reallocations from the country frame in excess of SEK 35 million, which is most likely to affect PA.

Sweden's Ambassador to Zambia wrote to MFA in Stockholm suggesting that the PA suspension from 1997 on governance grounds was becoming detrimental to the country's economic performance. In the light of point (3) below, it is interesting to observe the view of Ministry of Finance officials that they share common ground with Sida in resisting MFA's political orientation.

(2) the on/off nature of PA, combined with its allocation outside of the country frame, means that it may be used for Sweden's own political advantage – one case of this use, but only one, has been mentioned by several officials; and

(3) the rise of Economic Reform and Debt Relief gives greater weight to MFA, and some to the Ministry of Finance, in the use of aid funds – a trend reinforced by the reorganisation in mid-1996 under which aid programming is treated as an integral part of Sweden's overall political and commercial dealings with the recipient (Danielson and Nilsson, 1999: 21). Although Sida proposes the allocation of programme aid, a high proportion of these proposals (around half) are rejected or modified by MFA. The decision to suspend programme aid to Nicaragua during the constitutional crisis (see Chapter 3) was taken by the Ambassador and a visiting MFA official without any consultation with Sida. However, officials on both sides (particularly in MFA) dispute this view, claiming that there are no disagreements of note between Sida and MFA; this is much consultation on issues of substance, so that there has been no real change in the relationship in the 1990s. Rather, officials from both Sida and MFA, suggest any real disagreement is with the Ministry of Finance which is seen as taking a too pro-IFI line (but see the view of Finance officials mentioned under point 1).[14]

The issues just raised underlie ongoing discussions as to whether programme aid should be put back into the country frame. The arguments against doing this are the flexibility accorded to a separate fund. A counter-argument against a separate PA fund is that aid can thus be spent in countries in which Sweden has no track record and so will do little for Sweden as a donor, and may anyhow be an ill-informed decision. Perhaps more central to this debate is a turf struggle between the agencies involved, which will become particularly acute if sector support becomes equivalent to PA. The incentive argument means that PA should not be reinstated in the country frame in the traditional manner. But it is increasingly recognised that the traditional conditionality associated with PA has not been a good tool for achieving deep-rooted policy change (see Chapter 3), so that *ex post* forms of evaluating performance need be found. There are alternatives, including multi-year and regional budgeting, which should be explored.

[14] A senior ranking MFA official said that Finance regards most of the aid budget as "lost money", and so is eager to use its position to ensure that PA, at least, is well spent.

About 90 per cent of Swedish programme aid goes to a group of countries which receive PA on a regular basis; these countries are Bolivia, Cape Verde, Ethiopia, Guinea-Bissau, Mozambique, Nicaragua, Tanzania, Uganda, Vietnam, Zambia and Zimbabwe. Rather more countries have received PA only once or twice. In all, of the 100 countries receiving Swedish aid, 35 have received PA during the 1990s. What are the criteria by which they have been selected?

Since the mid-eighties PA has been intended to support growth in the context of economic reform, and it is indeed the case that many such countries do receive PA. But there are others with no formally-approved IFI programme (e.g. Cape Verde and Vietnam) which have also received PA. Both the creation of Support for Economic Reform and Debt Relief and Sweden's support for HIPC make a link between PA and debt burden. Many, but not all, of Sweden's PA recipients are highly indebted, and there are of course many countries which are highly indebted that are not recipients. The point being made here is that it is clearly not the case that recipients of Swedish PA are identified by the systematic application of a set of eligibility criteria to all developing countries. This is not so for two reasons. First, there are no firmly established eligibility or allocation criteria. Second, the pool of eligible countries is not all developing countries, but mostly draws on a smaller sub-set of countries with an established aid relationship.

However, PA is more progressively allocated than total Swedish aid. In 1990/91 the bottom 20 per cent of the world's population received nearly 70 per cent of the Swedish PA, compared to about 40 per cent of total Swedish aid. In 1997 these figures were 80 per cent and just over 30 per cent respectively – but the greater progressivity does not reflect a trend. Analysis of the year-to-year pattern reveals no trend, but annual fluctuations sensitive to large changes (for example the 1997 results are affected by the temporary PA suspensions to Vietnam and Zambia for political reasons).

A close link to reform can be made by co-financing of World Bank operations. Co-financing can be either joint, in which case the funds are given to the Bank to disburse, or parallel, so that the donor disburses the funds direct to the recipient but in the context of a World Bank agreement. Parallel co-financing is the norm for Sweden, though there have been exceptions. One of these was Uganda until 1991, where the low level of Swedish representation has led to a reliance on co-financing also in project aid (indeed joint co-financing is sometimes called "the Uganda model"). Joint co-financing has also been used in Vietnam, in which case the rationale offered was to signal how seriously the agreement with the IFIs was taken. There is a view that joint co-financing is cost effective and allows a greater role in policy dialogue. The latter is a somewhat untested proposition, and was found not to be so in an evaluation of Dutch co-financing of World Bank operations in Ghana (see Sowa and White, 1996).

2.3 Programme aid modalities

The fact that PA is not linked to a specific project does not mean that the funds are necessarily "free resources". Aid is free resources if the recipient may do as they wish with the money. But each of the different modalities of programme aid involves restrictions on the use of funds, as well as reporting requirements as to how the funds have been used. But, as is explained below, these restrictions and requirements do not always actually affect the use of funds. The restrictions may however have either adverse effects from the administrative burden or positive ones through attention to improving allocation or budgeting mechanisms (what are called in this report systemic effects).

Each of the various modalities has changed over time. **In most countries there has been a shift between modalities over time, away from import support towards debt relief and budget support**. However, the pace of this evolution has varied according to both domestic circumstances and the make up of the donor community. In Cape Verde Sweden has moved to providing all its PA as budget support, whereas in most other countries it has relied heavily on debt relief in recent years. In general Sweden has made these changes along with other donors – sometimes it has lagged but at others led. In Tanzania Sida entered the Open General Licence (OGL) system for import support slowly and somewhat reluctantly two years after it had started, but in Nicaragua Sweden moved to import support *via* retroactive finance whilst many donors inappropriately retained administrative import support after the foreign exchange market had been liberalised.

Import support

Much early import support was commodity import support (CIS),[15] meaning that either specific commodities were given, or the money given to purchase imports of a specific commodity or small list of commodities. These commodities were often intermediate goods (e.g. paper or fertiliser) and the specification of the commodities usually dictated the sector that would benefit. The selection of commodities may even dictate the specific enterprise to benefit (if only one enterprise used that commodity), or the agreement may specify the sectors or enterprises to benefit, such as Sweden's support for the Fund for Imports for Manufacturing Industry (FAIM) project in Nicaragua. Beneficiary enterprises or sectors are often those with which the donor already had some association. Under CIS there was not usually any question of the recipient enterprise paying for the goods received, so that the recipient effectively received a subsidy.

The next stage in the development of import support (also called CIS) was to provide foreign exchange which could be used to purchase any of a range of

[15] Terminology in this area is not precisely established. This report labels as CIS import support schemes in which the donor exercises control by specifying either the commodities or the sector.

Too cheap forex, combined with import regulations, could result in inappropriate usage: clear examples being the importation of vehicles to Zambia rather than only the tyres which needed replacing. Photo Charlotte Thege/Phoenix.

items from a list, called a positive list. Allocation of the funds was made by a committee, which may be specially constituted for that purpose, such as GCPI in Mozambique, (and usually involving the Ministry of Finance, other ministries and a donor representative), or by an already existing committee for allocating forex, such as FEMAC in Zambia in the late 1980s, and Vietnam until 1989 where the funds were allocated by ministries in accordance with the Plan. Recipient enterprises were sometimes required to pay the government local currency (called counter-value) for the foreign exchange at the official exchange rate.[16] Since official rates in recipient countries were at that time considerably over-valued, companies received an implicit subsidy compared to if they had to buy imports using forex purchased on the parallel market. In fact it was a triple subsidy since there was no penalty or interest for late payment and many enterprises paid counter-value only in part if at all. Donors required evidence that the imports had taken place, some checking value for money through pre-shipment inspection (PSI) or independent audit, but were not vigorous in chasing up counter-value payments.

Inefficiency could arise by virtue of the allocation system or as a matter of deliberate policy. Proponents of the market would argue such systems to be inherently inefficient, since the best allocation will result from letting price signals (a market-based exchange rate) determine the allocation of the forex.

[16] The local currency payment for import support goods or forex is also sometimes called counterpart funds. Since this expression is also used to apply to government contributions to project budgets it is not used here to avoid possible ambiguity.

Too cheap forex, combined with import regulations, could result in inappropriate usage: clear examples being the purchase of new agricultural equipment in Nicaragua rather than the parts to repair it, and the importation of vehicles in Zambia rather than only the tyres which needed replacing. Against this view it may be argued that government has to take into account strategic considerations, or areas in which private and social returns may differ – a commonly-cited example is that of medical drugs. However in practice the majority of CIS went to parastatals who were frequently poor-performers, and the CIS was seen as a way of subsidising them.[17] Where funds were also allocated to the private sector then the system was clearly prone to corruption. In Tanzania about one quarter of Swedish CIS was allocated to the private sector and the press frequently contained stories of corrupt practices. The expert brought in to help run the accounting system for the EU's import scheme confirmed the prevalence of over-invoicing, false *pro forma* invoices and similar practices.[18] The Japanese have persisted with allocative systems long after other donors have abandoned them, for example in Zambia, where stories of corruption and misuse of the funds continue.

Inefficiencies also arose out of donor procedures. Slow disbursement as a result of restrictions on the use of funds is a common theme in evaluation reports.[19] A World Bank report stated that ìone of the key obstacles to the effective implementation of SNAAD [Mozambique's first attempt to liberalise the forex market] was certainly the restrictive conditions attached to donor assistance... donor conditionality (particularly the tying of aid to particular products or particular product sources and particular procurement rules) provided a major blockage (World Bank, 1995:20). A later Swedish report argued that ìthe attempt [to liberalise the forex market in 1992] foundered because of most donors' unwillingness to untie and de-bureaucratize their balance of payments support (Gustafsson, 1996:10). Discussing import support to Cape Verde the same author remarked that various bureaucratic factors had "conspired to slow down the utilisation of the Swedish support" (Bartling and Gustafsson, 1993:4), citing as an example the delay of more than three years in purchasing patrol boats as Sweden required an external consultant to be involved who did not approve the purchase.

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[17] Donors were aware of this problem and sometimes specified that a certain proportion should go to private enterprises – e.g. Swedish PA agreements with Vietnam – though donors also condoned the practice, especially if they were enterprises with which they had a historical association.

[18] If the supplier over-invoices then the donor funds a payment in excess of the value of the goods, leaving a surplus to be shared by the individuals involved in the deal on the side of both the purchaser and the supplier. To ensure a competitive price donors typically required between three and six *pro forma* invoices (i.e. price estimates from different companies); in some instances the three came from three different companies which had the same fax number (or VAT code).

[19] An illustration of slow disbursement is that one of three addenda for PA to Mozambique signed in February 1996 referred to funds from an agreement signed in 1993. In both Uganda and Zambia import support funds were converted to debt relief and in Tanzania into support for the electricity sector in order to spend unutilised balances.

For these reasons of corruption and inefficiency donors favoured a change toward a market-based window for the purchase of foreign exchange.[20] These windows, which operated from the late 1980s and for the first years of the 1990s, usually went under the Open General Licence (OGL)[21] heading and may have existed as a government scheme prior to donor involvement (or government may have joined them once started). The donor paid the funds to a government account at the central bank sold the funds to commercial banks who then on-sold the forex to the importers who met the necessary requirements.[22] The central bank thus collected the counter-value direct from commercial banks, which more or less put an end to problems in the collection of these funds from the government's perspective.

These schemes spanned several years in which countries moved from fixed exchange rates to quite liberalised market-based systems. OGL schemes adapted to these changes, and in some countries can be argued to have led the way up to a point. In the presence of import licensing obtaining a licence was a requirement for accessing OGL funds, though as markets were liberalised licences were intended to be automatic for eligible transactions. The range of permissible transactions was also expanded over time, with positive lists of eligible goods being replaced by negative lists of prohibited ones (usually consisting of items which were prohibited for import anyway such as dangerous items – arms and drugs – and those over which government retained an import monopoly such as oil, plus some luxury items).

The requirements on importers under the OGL window were thus quite onerous. Although they lessened over time, as they did so other windows became available (forex bureaux) which required rather less administration. Donors and government had their own accounting requirements, and despite some attempts at harmonisation under the auspices of the SPA, these requirements differed by donor for much of the time.[23] In cases where the donor required dollar-by-dollar accounting of the use of their funds (although this could not be done in a meaningful way as there was a pool of funds) then the resources required to manage OGL were considerable. In many cases donors were involved in what was seen as an *ex ante* approval of the use of funds, which complicated matters considerably. These restrictions slowed the use of funds from this window for two reasons. First, it simply took time to get funds through. Second, demand diminished once alternative sources became available, notably forex bureaux. A study in Zambia in the early 1990s

[20] Nicaragua is a notable exception in this regard, with administrative import support continuing to be prevalent in the mid-90s.

[21] Or, alternatively, Open General Import Licence (OGIL), as in Zimbabwe.

[22] Some donors, including Sweden, would not disburse the funds until the allocation to the importer had been made, after which Norbanken would pay the supplier directly. The rationale for this stance was that Sweden, rather than the recipient government, should enjoy the interest on undisbursed balances.

[23] SPA agreements of course covered only Africa. The Nicaragua evaluation found several practices relating to PA, such as the continuation of tied import support and double-tying, that would be considered somewhat "backward" in the African context (the same has not been true of Vietnam, but it has not had PA for several years).

estimated the transaction costs of using the OGL window at 15 per cent: if the margin between the official and bureaux rates was less than 15 per cent importers would prefer the latter (Aron and Elbadawi, 1992). Although reporting requirements lessened over time so did the gap between the market and official rates. Once the rates were unified there would be no demand for OGL funds, as forex could be had at the same price on the open market with none of the additional restrictions. Exchange rate unification thus heralded the end of OGL schemes.

It is easy, with the benefit of hindsight, to be critical of OGL schemes for the excessive administrative burden they imposed on both government (who often did not have the capacity) and donors (who also lacked capacity in cases). To an extent this criticism is justified and should be seen as holding important lessons for donors as they get more closely involved in the government budgeting process as more PA goes to budget support and sector programmes are increasingly fashionable. But when they started, OGL schemes often played an important systemic role in introducing a market-based forex window where none had previously existed. Indeed an evaluation of Vietnam, where there was no formal programme with the IMF and World Bank until 1993, and Sweden took the initiative in 1989 to switch from a system allocated by ministries to one involving the commercial banks, found these systemic effects to be key feature of Swedish PA:

> *it is not an exaggeration to describe Sweden as being at the cutting edge of the policy dialogue mainly through the negotiations it conducts around the modalities for operating the CISP [Commodity Import Support Programme].*
>
> (Faber, 1992: 50).

It was only toward the end of their lives that OGL schemes had become anachronistic and were a drag on the development of a market based system, rather than promoting it.

Post-OGL, import support has become very flexible with retroactive finance providing funds to be sold through auction or onto the intra-bank market.[24] Even before the demise of OGL some donors switched to retroactive finance, which means that donors pay for imports which have already taken place.[25] That is, the government gives the donor the receipt it has obtained against imports for which the government has already paid and the donor reimburses the government this expense.[26] The donor accounts its aid against these imports and the recipient may do as it wishes with the forex it has received.

[24] This transition has not always eased the situation. When Uganda introduced a Dutch auction for forex in 1992 donors set different conditions on the use of funds thus slowing down disbursements (and some required funds to be sold at the parallel rate, which the government refused to do).

[25] In fact OGL was being operated retroactively in many cases toward the end of such schemes.

[26] Retroactive finance was used against large items, usually oil or maize.

Box 2.1 What is fungibility?

Fungibility is the idea that aid pays not for the items against which it is accounted but for the marginal expenditure it makes possible.

Consider the simple example of a government with $100 million to spend. There are two projects to choose between: rehabilitating rural health clinics or buying a new fleet of tanks. Both cost $100 million. After much deliberation the government decides to rehabilitate the clinics. But before it does so a donor comes along offering $100 million for some suitably worthy project. The government cannot ask the donor to buy the tanks so it says to the donor "our rural health clinics are in desperate need of rehabilitation, but we cannot afford to do it". So the donor pays for the health clinics. The government can now use its own money to buy the tanks after all.

There is no corruption or misuse of funds here. The donors funds are indeed spent on the health clinics as intended and accounted against this expenditure. But, as the donor is paying for something the government would have done anyway, the government's own resources are freed up for something else, in this case the tanks. This is fungibility.

Government expenditure with and without aid

No aid	Health clinics
Aid	Health clinics and tanks

Compare government expenditure with and without the aid it can clearly be seen how the aid has in effect paid for the tanks even though it is accounted against the health clinics.

It is very clear in the case of retroactive finance that the donor funds are not actually paying for the goods which they are accounted against: it is an accounting fiction to say that the aid paid for the, say, oil. This is <u>not</u> the same as saying the funds are fungible (see Box 2.1), they are clearly free resources.[27] The same is true for the import support systems that followed whereby money was given to the central bank and then sold at auction or *via* the intra bank market. In such cases there is no economic argument, nor one on grounds of aid efficiency, for requiring any reporting from the recipient on the use of the funds. Finally there have been cases in which PA has been explicitly free resources. The World Bank dropped the requirement to account for the money against particular imports in 1997, as has always been the case for IMF programme assistance. Sweden has not disbursed PA without requiring some documentation to account for the use of funds (e.g. import invoices) – although this accounting is not always closely followed up.

[27] The inception report (White, 1998) drew this distinction between fungibility and free resources. Fungibility can only occur when the donor attaches a condition to the use of the funds. Where there are no such conditions then the funds are free resources.

Debt relief

A donor may give debt relief on debt to its own agencies (export credits or previous loan aid) or debts to a third party. Debt rescheduling or forgiveness on own debt is carried out through the Paris club in which official creditors deal with debtors on a case-by-case basis.[28] Under the Special Programme for Assistance to Africa (SPA), two windows have been created for donors to relieve third party debt: the Fifth dimension for World Bank debt and Sixth dimension for that to private creditors. Further relief has become available from the Highly Indebted Poor Country initiative (HIPC), from which both Mozambique and Uganda have benefited. HIPC has been criticised for providing insufficient relief – debt service ratios can remain high after completion: Nicaragua is the only country to have realised a substantial reduction in its debt stock.[29]

Debt relief is also conditional. A country needs an agreement with the IMF to be in place in order to go to the Paris Club. Sweden treats contributions to the Fifth and Sixth dimensions as other balance of payments support, conditioning them upon progress on reforms.

Debt relief is very likely to be fungible. This is especially so in the case of Fifth dimension, as a recipient will try to meet IFI debt if at all possible. Hence, as the government would have paid the debt anyway, a donor paying these obligations frees up the equivalent amount of resources for the governments' own use.[30] Relief on multilateral debt is thus very likely to be *de facto* free resources. The cases of bilateral debt relief and Sixth dimension are less clear, since many countries are regularly in arrears on such payments.

In general, **debt relief will be rapidly disbursing** – exceptions can occur if it is tranched and difficulties occur in implementing conditions. This contrasts with the experience of import support and the likely experience of budget support under Sector Programmes, and thus constitutes a case for retaining at least some portion of debt relief in total PA. Ease of disbursement has been one reason for favouring this modality – in both Uganda and Zambia import support funds have been converted to debt relief so that they can be disbursed. Both the reporting and market conditions for debt relief are less onerous, although since – if the debt would have been paid anyway – it is equivalent to free resources there are arguments for restricting its use to good policy environments. Hence Uganda has enjoyed debt relief as the sole form of PA since 1992, whereas other countries have continued to receive other modalities for some years after that. All countries covered by the evaluation

[28] Debt rescheduling allows the debtor longer to pay but may increase, rather than reduce, the debt burden; see the background paper on *Modalities* for a longer discussion. The London Club, which plays an equivalent role for private debt, is not of concern here.
[29] At the time of writing HIPC II is being discussed following additional relief announced in Cologne in June 1999.
[30] The amount freed up may be thought of as "shadow countervalue". Donor attempts to link aid to poverty reduction have focused on tying the shadow countervalue to approved spending. This trend is discussed in the next section.

have, however, received Swedish debt relief with the exception of Cape Verde which does not have an external debt problem.

Counter-value

Counter-value is the local currency raised by the sale of the forex. In the case of budget support the matter is straight-forward, the government should receive the local currency equivalent of the goods or forex sold, either direct from the importer or from the financial intermediary who sells the forex (under OGL, commercial banks pay the central bank, which deposits the funds in a government account). For debt relief there is "shadow counter-value" equivalent to the money the government saves by not having to pay the debt itself. This shadow counter-value may not be equivalent to the full amount of the debt relief, since the government may not have met its full debt service obligation had relief not been forthcoming. In the case of budget support there is no counter-value as such, since the donor provides forex to sell to provide local currency for the government budget (which could equally well be stated as "the counter-value is the PA"). Three issues related to counter-value are discussed here: (1) the exchange rate used to calculate the amount owed; (2) collection performance; and (3) the use of counter-value.

In the words of Sida's *Principles of Import Support,* the aid "is a grant to the country, but not to the importing agent" (1993: 12): that is, the user of the funds should pay for these in local currency, called counter-value or counterpart funds. In practice the counter-value has had to be paid for at the official rate, so that as long as this rate was overvalued there was an official subsidy. Donor attempts to require forex to be sold at the parallel rate (as in Uganda) were resisted by government. But this issue mattered less as margins declined and disappeared altogether once rates were unified.

The implicit subsidy was reinforced by low payment rates. All evaluations of CIS find a poor record: Sharpley (1991) suggested about two-thirds counter-value was paid in Mozambique, and a Sida memo noted that funds were being allocated to firms who could not afford to pay. A Norwegian evaluation in Nicaragua in the early 1990s found that 70 per cent of counterpart funds were collected, in Cape Verde in 1993 only 45 per cent of those due over the period 1987–93 had been paid and in Tanzania the rate was only 22 per cent in 1990/91, though it rose to 62 per cent the following year when the relative importance of OGL increased. This last example illustrates that problems of counter-value collection should have been resolved through the introduction of the market element involving commercial banks, and this indeed appears to have been the case.

A second finding is that **Sweden has not usually paid much attention to the collection of counter-value** – reflecting the more general finding that many of the conditions attached to PA are not that closely monitored (though there are important exceptions). A report by the Swedish audit office (RRV) commented on this phenomenon with respect to Mozambique, and an evaluation of PA to Cape Verde commented on the "very cavalier attitude towards the payment of counterpart funds" (Bartling and Gustafsson, 1993). There have been exceptions when counter-value has become an issue for the donor community as whole, as in the case of Tanzania in 1993.

Since donors restrict the use of the forex in the case of import support, to also place restrictions on the use of the counter-value is called "double-tying". Although condemned by the OECD (DAC) guidelines, double-tying remains quite common. This is particularly the case in Nicaragua,[31] where the Nordic donors (and Dutch) are the main exceptions – for example Canada requires that the counter-value be passed to NGOs. In Mozambique double tying is also common practice, even being used by the EC who chaired the SPA Working Group that produced the guidelines on counter-value which condemn the practice. In accordance with its own *Guidelines* Sweden does not double tie.[32]

Debt relief is an exception. To the extent that government would have paid the debt in the absence of the relief then the savings may be called "shadow counter-value". In a manner reminiscent of debt swaps, it is increasingly fashionable to tie the shadow counter-value – as Sweden did in Mozambique with the funds accruing to Foreign Debt Alleviation Fund – with the intention that the savings be used for social expenditure. Experience with these funds is limited as yet. An argument in their favour is that they can provide protection to social expenditure from internal pressures. However, there is a danger that donors may devise procedures and accounting requirements that impose a heavy burden on recipient governments. Harmonised procedures are a minimum requirement, but better still is to finance the budget through Sector Programmes.

Budget support and sector programmes

Two reasons may be given for providing budget support rather than balance of payments:

- With a flexible exchange rate regime there is no forex constraint
- Donors should pay closer attention to budget allocations and procedures.

In macroeconomic terms the first argument does not make sense; this argument is dealt with in Chapter 5 below. The far more persuasive reason for shifting to budget support is that, despite formal equivalence in macroeconomic terms, there are systemic effects from donors focusing on one side (forex) or on the other (local currency). This rationale is captured in the Dutch guidelines on budget support, which state that sectoral budget support is a specific form of programme aid in which, in contrast to regular programme aid, poverty alleviation is the main policy aim (Foreign Affairs, 1996).

[31] A donor conference in 1995 condemned the practice, but this appears to have had little effect.

[32] Nicaragua and Vietnam carry out *ex post* accounting of use the countervalue even though they are not required to!

Budget support can operate in a very similar way to the simplest form of import support schemes. For example, UK programme aid, starting in Zambia in 1995, now retroactively finances items from the budget such as teachers' salaries or releases to district health bodies. However, there is an increased emphasis on sector programmes, which might be viewed as the latest incarnation of programme aid. Whether this is a correct view of sector programmes depends on how they are managed.

Sector programmes go under a variety of names – Sector Investment Programmes (SIPs), Sector Expenditure Programmes (SEPs), Sector Wide Approaches (SWAPs) and simply Sector Programmes (SPs) – though it is not clear that any difference in approach is intended by these different labels. The important difference relates to the way in which the sector approach is seen.

We may characterise two broad extreme views of sector support (recognising that practice falls between these two). One extreme sees sector support as the next generation of programme aid (rather like a World Bank Sectoral Adjustment Loan, SECAL, but which is called here the envelope finance approach). It is sector budget support as the dialogue relates to a particular sector, but the funds are simply programme aid – budget support is thus a better approach to programme aid. At the other extreme, sector support is little more than a project list, with a bit of policy dialogue thrown in. The rationale for the latter approach is that traditional projects have failed as the approach has been uncoordinated, fragmented and, thereby, unsustainable. This view has been stated as follows:

> *Traditionally, donors have provided assistance primarily through free standing investment projects. Unfortunately the development of these projects has often been disappointing [as] the underlying conditions constraining the effectiveness of development assistance – sector policy distortions, institutional weaknesses, the affordability of the public expenditure programme, conflicting implementation arrangements of different donors, and inadequate institutional capacity – are rarely addressed through conventional projects the programme-based approach can better address the constraints to development and can therefore be more effective in fostering development.*
>
> (Okidegbe, 1997: ix).

Related to these two differences in approach are **four important, and unresolved, questions on the nature of sector support**:

- First, there is some ambivalence as to the extent to which budget support is intended to finance incremental expenditures. Is it intended to finance items already in the budget (so the aid is 100 per cent fungible, unless the government made the plan assuming the aid would be forthcoming), or should the receipt of the funds allow additional expenditure?
- Second, if government expenditure planning is supposed to be based on aid flows, then there needs to be some assurance in the stability of those flows – which conflicts with both donor reluctance to lock themselves into multi-year expenditure planning and more specifically with the intended

on-off nature of PA, which may by turned off on account of "unrelated developments".

- Third, the extent to which a donor is identified with particular components of the programme. As with flexible forms of import support, envelope financing will not allow identification of the donor with specific expenditures.
- Fourth, whether or not such aid is quick disbursing assistance (QDA). It is accepted that there are preconditions for budget support, both in terms of macroeconomic environment and the budget process. But ensuring that such conditions are satisfied will delay disbursements, so what to do if a country needs funds quickly?

There is an alternative view which disputes the sharp dichotomy made here between the two approaches to budget support, which is claimed to address some of these issues.[33] In this view the important thing is that government makes an expenditure plan which clearly identifies capital and recurrent expenditures (including the recurrent implications of all capital expenditures), and thus calculates the amount required for the sector. Following this approach it does not matter if some donors adopt a project-based approach to sector support, provided others use envelope financing or are willing to disburse against recurrent costs to ensure that both capital and recurrent expenditures are fully covered. Implicit here is the view that sector support is mostly, if not entirely, expected to lead to additional expenditures and that some donors, at least, will still fund projects with "their name on" under the sectoral umbrella. However, there are at least two difficulties with this conception. First, to the extent that donors do retain their projects then the expenditure programmes remain donor-driven, with all the problems it brings. Second, one can easily foresee political difficulties in a system whereby some donors fund the recurrent costs for other donors' projects. A more general problem is the extent and nature of donor involvement in budgeting processes, which brings us to the question of the choice of modality.

Sweden's involvement in budget support has been somewhat tentative, and amongst the countries covered by the evaluation it is only present in Cape Verde as the dominant form of PA.[34] Sweden is, however, an active supporter of Sector Programmes. Amongst the case studies, the Zambian Health SIP is the most prominent, but only a very small part of support of this programme is in fact PA (it remains dominated by the project approach).

Are there links between objective, rationale and modality?

Do different modalities correspond to different objectives or rationales? It was shown above that the objective of programme aid is dominated by growth,

[33] Under the approach being adopted by the SPA a donor may contribute to a sector programme in up to four ways: sector budget support, project assistance, technical assistance, and disbursement to third parties (e.g. NGOs).

[34] Some other countries have received smaller quantities of budget support, whilst receiving the bulk of PA as import support of debt relief.

and the related objective of support to economic reform, and that this focus has not changed over time. Hence we should not expect to observe any relationship between the objective and either modality or rationale. A more formal statistical test bears this out (Danielson and Nilsson, 1999: Appendix C). The conclusion here is thus quite striking. **Sida documentation does not make the link (or where it does so, does so only weakly) between the provision of PA and the attainment of Sida's objectives**. Rationales are rarely offered in the PA agreements, and in the documentation where they are provided are not linked to the intended objective. Put bluntly, Sida officials seem to have a poor understanding of how PA works.[35] Specifically, there is no articulation of how the main rationale of gap filling can contribute to either economic reform or growth, or less still the overarching goal of poverty reduction.

On the other hand, and unsurprisingly, there is a link between rationale and modality, with the external gap rationale occurring most frequently with respect to import support and debt relief, and that of an internal gap being more common for budget support.[36] However, the dual nature of programme aid means that aid must simultaneously fill both internal and external gaps by the same amount (see Chapter 5), so that the distinction between the two gaps – and certainly as a basis for rationalising the choice of modality – is artificial. That is, there is no good macroeconomic argument for linking the rationale and modality in this way. However, as argued above, systemic effects would provide such a rationale. For example, it would have been right to argue that Sida should give import support as this will assist development of a liberalised forex regime. Unfortunately such a rationale is rarely given, indicating a general lack of awareness of the importance of such effects.

Does modality matter?

> *A USAID review of support to economic reform in Africa stated that the first lesson learned was:*
>
> *AID should put its time and energy into the development of analytically sound reform programmes and worry less about the type or form of assistance it provides.* (USAID, 1991: ix)

In a similar vein a recent ODA document argues that "the macroeconomic impact of providing balance of payments support is identical to that of providing budgetary support" (ODA, 1995: para. 2.4). Is it so that the label given to programme aid is merely a matter of administrative, and perhaps political, convenience?

[35] As with all generalisations, there are at least partial exceptions. Documentation for PA for Tanzania in 1997 (Memos 5/12/96 and 27/11/97) come closest to linking objective to rationale, though not in the same document and with some ìlogical gaps" remaining.

[36] The statistical test for an association yields a higher test statistic, although it is still not significant. There are a relatively small number of observations, which may explain why the test statistic is insignificant.

In a very important sense, balance of payments support and budget support are equivalent. In the case of balance of payments support the government receives forex, with some limitations on the use of that forex, which is sold thus raising local currency which the government may use as it wishes (unless there is double-tying or earmarking of counterpart funds). In the case of budget support, the government receives forex which it sells (with no restrictions from the donor) to get the local currency, which is designated as the budget support. In the cases of both balance of payments support and budget support the same set of transactions takes place (receipt and sale of forex, and expenditure of local currency): these transactions are designated as one form of programme aid or another depending upon which transaction the donor restrictions relate to – the forex side or the local currency side.[37] Indeed, in the absence of double tying, import support provides free budgetary resources, and budget support provides free forex.

This equivalence may suggest that the label attached to the programme aid does not matter. But, in fact, from the donor's point of view **the label attached to the aid does matter as it directs attention to a particular sphere** – toward the foreign exchange sphere for balance of payments support and to fiscal behaviour and budgetary mechanisms for budget aid. The design of agreements and the content of evaluation reports will vary according to what the aid is called. There are both advantages and disadvantages to this link.

The advantages are the systemic effects discussed above in relation to import support. Donor attention can both help rationalise procedures, and can help develop allocation and management systems. These same benefits may be felt with budget support, as donors provide TA to clean up wage bills (eliminating ghost workers etc.) and improve the openness and efficiency of budget processes. But associated with this donor attention is an administrative burden on both donor and government. In the case of import support up to and including OGL this burden was far greater than had been anticipated and frequently resulted in slow disbursement of funds. By contrast, debt relief is free of such complications and can be rapidly disbursed. As a result Sweden in some instances converted import support to debt relief in order to utilise undisbursed balances. Systems for budget support are currently being developed. The experience of the excessive administrative burden imposed by donor import support programmes holds important lessons for the design of budget support today.

It is of great importance that donors harmonise their approach to budget support, as they only partially managed to do with import support. Donor attempts to trace their funds resulted in complicated systems which yielded results which were anyhow most likely to be an accounting fiction. These attempts also led to systems trying to micro-manage the recipient's foreign exchange allocation system which may be inappropriate and eventually

[37] Complications in this story arise in the case of debt relief (though the government may then "pay itself countervalue") or when countervalue is used to offset deficit financing.

became a drag on the development of the market. Some agencies may have been forced to adopt such procedures for domestic political reasons, though a better response would be to educate decision-makers on how programme aid works.

2.4 Concluding comment

Programme aid covers various modalities, of which the main three have been import support, debt relief and budget support. There has been a shift over time from the first to the last of these, which is seen as related to the "disappearance" of the external gap with the liberalisation of the foreign exchange market. The fact that this rationale for changing PA modalities does not make sense in macroeconomic terms provides a basis for the two conclusions from this chapter deserving emphasis.

First, the way in which PA is to achieve its intended objective of growth, let alone poverty reduction, is poorly articulated in Sida documentation. Why is this so? Perhaps there is a hidden agenda for PA, so that the stated objective is unimportant. Or perhaps Sida staff do not have either the time or training to specify these links. Either way, the absence of such arguments may be unimportant, if PA can anyhow achieve the desired objective without Sida staff being aware of how it is being done.

But, unfortunately, the second point is that there are good reasons to expect PA effectiveness to be linked to PA design. One aspect of this is the importance of systemic effects. PA modality can have either positive or negative systemic effects depending on both design and timing, the latter requiring good knowledge of the working of local markets and budgetary systems. But PA is also expected to have effects through supporting reform, so that some idea of how Sida is to engage in the reform process and which reforms are necessary for growth and poverty reduction are also important. Traditionally Sida has relied on the IFIs to provide this expertise, but it will be argued in the following two chapters that such trust is misplaced.

Table 2.3 Programme aid from selected bilateral donors

	Germany	Japan[1]	Netherlands	Norway	United Kingdom
Objectives	Support for adjustment, debt swaps linked to poverty and environment.	General objective of economic development.	Growth in general, though budget support linked to poverty reduction.	PA linked to 3 of Norway's 5 objectives: fighting poverty and improving quality of life, sustainable administration and development of natural resources, and equal rights and opportunities for men and women.	Key objective is economic growth, but through policy and budget effects can contribute to other international development goals.
Allocation	Debt relief and food aid outside country budget, other PA in country budget.	Within country budget.	Debt relief always outside, as has been other PA since 1996.	Both inside and outside country budget.	Within country budget, although some left unallocated in Africa Division to allow flexibility.
Eligibility	Commitment to reform (economic and some weight to political), except CIS (forex restriction).	Following reform programme.	Economic reform and good governance.	Poor countries implementing reform (same as HIPC criteria).	IFI-supported economic reform plus attention to public expenditure priorities.
Conditionality	Other than CIS, always linked to economic reform. No own-conditionality, but political conditions implicit in country-programming.	Usually linked to IFIs, though may be own-conditionality.	Always linked to reform, possibly with own conditionality.	Nearly always conditional, in which case linked to IFIs.	Always linked to IFI programme, may be own-conditionality but consistent with IFI programme (e.g. increasing priority expenditures).
Disbursement	Support for adjustment may be tranched, disbursed against items according to negative list (positive list for CIS).	Against imports using negative list. Can be tranched if cofinancing.	Shifted from imports to budget support and debt relief. Likely to be tranched.	Shifted from imports to budget support and debt relief.	Against budget items.
Countervalue	Neither usually tied nor monitored.	Uses specified in agreement and regular reporting required from government.	Monitoring varies from country to country.	Intended to monitor use, but not always done in practice.	No countervalue as such as giving budget support - no restrictions on use of forex.

Note: 1/ Answers supplied by OECF, may not apply to all Japanese aid. Source: questionnaires returned by agency staff.

Chapter 3
The role of donor agencies in policy change

Donors believe the policy environment matters, both for achieving development and for the effectiveness of their own aid. Programme aid is thus linked to economic and political reform and donors seek to influence policy outcomes through a variety of channels. However, little thought has been paid to explicit influence strategies and less still to evaluating influence. The framework adopted here places donor influence firmly in the context of domestic political economy. Within that setting, policy dialogue is seen as a set of processes by which donors seek to affect policy outcomes. The eight country studies provide support for the view that domestic politics plays a dominant role in driving policy change. Donors do have a role in this process – though their contribution is just one factor amongst many. This contribution is best understood by broadening the focus from negotiating conditionality to the broader range of ways in which donor influence can be felt. This broadening allows an appreciation for the role of individual bilateral donors. Instances can be found in which Sweden has played a central role in supporting policy change. The cases where Sweden's influence has been greatest are those where there has been a strong historical association with the recipient country. But more generally, Sweden does not have a thought out influence strategy, nor often the capacity to support one at the country level.

3.1 Evaluating influence

Programme aid is linked to policy change. Whilst it is undoubtedly the case that there has been widespread economic and political liberalisation in developing countries during the last two decades (documented in the next chapter), what has been the role of international donors in this process? Has donor conditionality been the driving force behind the changing policy environment? Or have donor efforts merely been pushing on an open door, requiring changes that would have happened anyway?

Negotiations with the World Bank and IMF for structural adjustment and stabilisation loans have been the focus of donor efforts at changing policies.

What role has there been for a bilateral donor, such as Sweden, in this process? Has Sweden managed to influence the course or content of policy dialogue or played any significant part in affecting policy outcomes?

Conceptual framework

Despite the importance placed by donors on the policy environment, and the emphasis they have placed on bringing about policy changes, **there has been very little attention paid to the role of donors in policy processes – still less the appropriate methodology by which this influence may be evaluated**. Most PA evaluations focus on the impact of policy changes which have taken place: implicitly assuming that such changes are the result of donor intervention (otherwise why discuss their impact in an evaluation of PA?).

Some academic studies (e.g. Mosley *et al.*, 1991) have assessed the effectiveness of conditionality. But they typically do this by examining the percentage of conditions implemented, which ignores the possibility that the relevant policies may have been put in place without donor intervention (i.e. the counterfactual). Besides which, such an approach does not allow analysis of the role of different donors. Recent work by the World Bank on aid and economic reform in Africa has addressed such issues (though focusing on the IFIs), but with no explicit conceptual framework.

The study of donor influence for this evaluation is thus something of uncharted territory, for which a new conceptual framework has had to be developed. There are two elements to this framework. The first is to locate donors' role firmly in the wider political context. The second is to map the wide array of mechanisms through which policy influence may operate.

It is unlikely to be possible to establish a convincing policy counterfactual, i.e. what policy outcomes would have been in the absence of donor involvement.[1] This is not an area in which the word "proof" can be used. Rather the approach has to be one of an argument which weighs up the balance of the evidence. What were the forces supporting and opposing reform and how do donors fit into this picture? The recent political economic history of the country is thus the starting point for the analysis. Once this overall framework has been established then the analysis can move to the role of donors. And it should be only then that the donors are considered – conducting the whole analysis from a donor perspective will almost inevitably over-state their role. This first part of the analysis takes donors as a whole, rather than attempting to attribute outcomes to the actions of any individual donor. The second part of the framework considers the influence a single bilateral can have.

This second element of the conceptual framework revolves around defining policy dialogue as a set of processes which seek to influence policy outcomes.

[1] The modified control group approach to analysing the impact of adjustment proposed by Goldstein and Montiel (1986) and used in some World Bank reports estimates "counterfactual policies" based by economic variables. This is an unduly economistic approach to policy outcomes.

The stress on a set of processes highlights the fact that negotiations with the IFIs are only one part of policy dialogue, and not that in which bilateral influence may be strongest. The inception report for the evaluation identified two dimensions of donor influence. The first is the degree of formality. Negotiations, annual bilateral aid talks and Consultative Group (CG) meetings are all formal channels through which influence may occur.[2] But there are informal contacts – ranging from discussion in the corridors at CG meetings to meeting on the golf course – through which influence may also occur. Between the two are what may be called semi-formal channels, such as communications from an Embassy to a Minister on a specific issue. The second dimension of policy dialogue is the channel through which influence is exerted: direct on government, on the IFIs, or on or with other bilateral donors. Table 3.1 combines these two dimensions, giving examples in each of the resulting nine cells.

[2] CG meetings are held, usually on an annual basis, between government and major donors to that country. The first day consists of presentations on progress, at which donors can present their concerns, and on the second day pledges are made for the coming year. Traditionally these meetings have taken place at the World Bank office in Paris, though some have shifted to the recipient country. The meetings are chaired by the World Bank, who produces the minutes from the meeting. An alternative forum has been Round Table meetings organised by UNDP, which can play the role of CG meetings where there is no World Bank programme.

Table 3.1 Two dimensions of donor influence

	Formal channels	Semi-formal channels	Informal channels
Direct influence on government	Annual aid negotiations CG meetings Local consultative groups Collective donor representation to Head of State/Minister Briefing sessions called by Head of State/Minister Own conditionality Commissioning of policy-oriented studies	Direct communication donor head of state/development minister to recipient head of state Message from minister to head of state Messages to/meetings with recipient ambassador Individual meetings of donor ambassador with head of state (or written communications)	Margins of CG meetings Impact of donor financed TC
Indirect influence via IFIs	Board SPA CG meetings Trust Funds	Direct communication from Minister to IFI President Washington Delegation enquiries to IFI staff Mission briefings in recipient country Finance/participate in studies/reports (JEMs, PERs etc.)	Informal contacts IFI/own agency staff Margins CG/SPA meetings
Influence on other donor agencies	SPA CG meetings Local consultative groups Joint programmes (e.g. SIPs)		Social/informal contacts of agency staff in country Margins CG/SPA meetings Leadership "by example"

Methodological issues

The framework being adopted implies a reliance on qualitative methods. The political economy of the country can be studied through published academic material and grey material from donors, government and other agencies. These sources are supplemented through the information gained through interviews with key informants and, for recent developments, analysis of local newspapers.

Interviews were held with staff from a range of agencies, government officials and members of civil society (academics, NGOs, business community, political opposition and religious leaders).

Within government, interviews covered those with direct responsibility for PA (Ministry of Finance and the Central Bank) and those with responsibility for policy in main areas of interest (Finance, Agriculture, Industry etc.), and related agencies (such as those for privatisation or social funds). The point of contact is usually a senior civil servant such as Principal Secretary though in some cases technical staff may be contacted and, in the case of Nicaragua, ministers were also interviewed, as were personnel from the previous government (which was not an issue in either Uganda or Vietnam); these interviews were carried out for all three field studies. Interviews were also conducted with the main donors in the country, including the World Bank and the IMF, the point of contact usually being the economist.[3] These interviews were carried out in all three field studies, though to a more limited extent in Nicaragua owing to unavailability of several officials (however the multilaterals were all covered and phone interviews were later held with Dutch officials). Assessing Swedish influence has involved a range of interviews with Swedish aid officials (either face-to-face or by e-mail), recipient government officials and questions to key informants in other agencies.

There are methodological problems related to the use of interviews, related to how to interpret information and balance differing accounts. For example, local expertise is essential in conducting such an evaluation. But it must be remembered that local experts are situated in the domestic political scene, and their contribution interpreted in this light. Differing accounts reflect differing perspectives and can be understood in a framework which does not rely on a single construction of reality. Such a stance brings us back to the point that a single line of causation cannot be proved. Rather, contributory factors can be identified. What, then, have been the main factors driving policy changes?

The rest of this chapter begins to address this question with a discussion of the domestic political economy of reform (section 3.2). The role of the international community is then considered (section 3.3), followed by a closer look at Sweden's part in the process (section 3.4). Section 3.5 concludes.

3.2 The political economy of reform

The substantial body of literature on the political economy with reform – notably Haggard and Kaufman (1992), Nelson (1990) and Rodrik (1996) – pay little attention to the role of donors. The international community is the subject of one chapter of seven in Haggard and Kaufman. Neither "donors" nor "conditionality" appear in the index of Nelson's collection, although there are some entries for the IMF and the World Bank; and the review paper of

[3] Interviews with IFI staff were also conducted in Washington.

Rodrik discusses only the positive role aid funds may play in supporting reform rather than policy dialogue.[4]

The role of donors is also put in perspective by the fact that in **all but two (Uganda and Zambia) of the eight countries covered by the evaluation initiated reform prior to formal engagement in policy dialogue** (Table 3.2), and countries have introduced measures more far-reaching than advised by the donors, such as the cash budget in Uganda.[5] In the two cases in which reform coincided with external support – Uganda and Zambia – a case can be made that these changes were home-grown; representing a conversion in the case of Uganda, and the coming to power of the MMD on a pro-liberalisation manifesto in Zambia. It should be admitted, and is discussed at greater length in the next section, that in some cases less formal channels of policy dialogue were in place in the earlier periods. However, these facts point to what really should be obvious: **an understanding of what has determined policy change rests, in the first instance, on an analysis of domestic political economy**.

Table 3.2 The timing of reform and policy-based lending

Country	Date of reform	Date of first IFI policy-based lending
Bangladesh	Initial steps toward reform in early eighties, intensified from 1986.	IMF stabilisation from 1980, adjustment from 1987
Cape Verde	First steps to reform second half of 1980s, intensified by new government in 1991.	1997
Mozambique	Initial liberalisation in 1983, intensified from 1987	1987
Nicaragua	Attempted stabilisation and price reform under Sandinistas 1988-89, more far-sweeping reform with new government in 1990	1990
Tanzania	Structural Adjustment Plan 1982-85 designed with World Bank assistance but agreement not reached so government initiated on its own; reforms from 1986 were continuation of this earlier effort	1986
Uganda	Government initiated reforms in 1987 (one year after assuming power)	1987
Vietnam	Three waves of reform, starting in 1979, 1986 and 1993	1993
Zambia	Aborted reform 1985-87, re-initiated 1991.	Both episodes supported by policy-based aid

Source: country studies.

[4] Curiously Rodrik does say in a footnote that the World Bank "shaped development policy in many countries during the 1990s" (1996: 17 n.11), but if he really believed this to be so then one would expect the fact to occupy pride of place in an article devoted to explaining reform, rather than being relegated to a single footnote.

[5] The Ugandan government introduced a cash budget in 1993 against the advice of the IMF who believed it would not work. In Zambia the capital account was liberalised earlier than donors thought should be the case.

Analysis of why such substantial change in economic policy has occurred in the last two decades may be carried out at three levels: the international environment, the national economic context and the interests and alignment of domestic political forces.

The renaissance of liberal economics that followed the collapse of the Bretton Woods system in the early 1970s provides the backdrop for the spread of liberal policies to developing countries. The global and developed country interests that prompted these shifts have been widely debated. But the fact that shifts in economic policy predated the coming to power of avowedly market-oriented governments indicates that there was some material basis to these changes.[6] One consequence of the end of the Bretton Woods system was that the rationale for the existence of the IMF, whose primary purpose had been management of the fixed exchange rate system, was put in doubt. By the mid-seventies the IMF was in danger of becoming a redundant institution, a remnant from a defunct system of economic management. But rather than retrench itself, as some commentators suggested, the IMF reinvented itself as manager of external problems in developing countries, assigning itself a key role in the debt crisis as it emerged in the 1980s.[7]

The debt crisis is an important part of understanding the changing policy environment for three reasons: (1) why countries had to adjust; (2) the interest of developed countries that they should do so; and (3) the nature of adjustment supported by developed countries. A first point to make about the debt crisis was that it was <u>not</u> a symptom of a deep-seated development crisis. Other than some African countries (and indeed SSA in aggregate), developing countries enjoyed respectable growth rates until at least the end of the seventies. All regions enjoyed improving social indicators. Certainly in Latin America, it was the cure applied for the debt crisis that caused the growth slowdown, rather than the failure of the economic model followed in the run-up to the debt crisis. Furthermore, Rodrik (1996) shows that debt problems were associated with macro mismanagement (loose fiscal and monetary policy) rather than price distortions such as high tariffs. Hence, liberalisation was far from being the obvious response to the debt crisis.

Developing countries were faced with the option of defaulting or agreeing to the terms on offer to reschedule their debt.[8] The governments of the creditor countries (much of the debt being to private creditors) were keen to avoid default, as the reckless over-exposure of many banks meant that a single default

[6] In the UK, for example, the change from social democracy to monetarism is most accurately dated as 1976, not when Margaret Thatcher assumed office in 1979. The Labour government went to the IMF in 1976, but this is widely regarded as case of scape-goating by the government rather than one of IMF influence.

[7] Until the 1970s the bulk of IMF lending was to developed countries, since 1980 it has lent <u>only</u> to developing ones.

[8] Why more countries, indeed any, did not default is a bit of a puzzle. The "divide and rule" tactics adopted by the creditors are clearly part of the explanation.

[9] Some banks had loans to a handful of countries equivalent to several times the bank's capital base.

could cause collapses and subsequent financial panic.[9] Western governments thus needed to provide sufficient inducement for developing countries not to default, in terms of new money, whilst getting them to continue to repay. New money was made available from donor governments, the IMF (and later the World Bank) and forced lending from the commercial banks. Accessing these funds required an agreement on rescheduling, the arrangements for which have become formalised in the Paris Club, requiring an agreement with the IMF, thus according the Fund a key role. Standard IMF conditions cover fiscal and monetary policy to reduce inflation and exchange rate policy. Partly through the latter, and partly through the substantial deflation which was part of Fund programmes in the 1980s, current account deficits were reduced, or even turned to surpluses, thus allowing debt to be repaid.

By the mid-eighties the developed world was taking more money out of developing countries than it was putting in (though net transfers to Africa always remained positive). Doing this required that developing countries run current account surpluses, which is something import substitution policies were unlikely to do. Debt repayment demanded a greater degree of outward orientation to increase export earnings, providing developed countries with a material interest in the ideological shift toward greater openness that took place at the same time.

This international context is important, but is not to be read as overstating the role of the international community. International management of the debt crisis aimed in the first instance to avoid financial crisis in the creditor countries and the risk of this passed by the late 1980s: the debt crisis was over for the developed world but not the developing one. The main interest of the international community thus focused on the most indebted countries and on a subset of the policy menu being offered. How the rest was taken depended on the other factors mentioned above: country economic context and domestic political situation.

The eight countries covered by the evaluation had diverse economic backgrounds as they embarked on reform. Table 3.3 shows four key features: long-run economic decline, macro instability (high inflation), a heavy debt burden and whether the country had been reliant on the Soviet Union for economic support. The presence of these four factors varied from country to country. In perhaps only one case, Nicaragua, were all four on a "crisis setting". In one case, Cape Verde, there was no apparent problem with respect to any of them.[10] Poor performance on these indicators alone need not imply market-based reform: as Rodrik (1996) says, a first response to crisis may be to tighten controls rather than relax them, as did NRM when it took power in Uganda in 1985 (and as the PNDC did in Ghana during 1982). But in several cases the controls were associated with poor living standards so that removing them was seen as a way to re-vitalise the economy. However, whether, or the way in

[10] A World Bank report claimed that Cape Verde was forced to reform as planning resulted in poor performance. This statement was based on poor growth in a single year. Growth in the 1970s and eighties was in fact rather higher than has been experienced in the 1990s.

which, these possibilities were acted upon depended upon the country's political configuration.

Table 3.3 Economic conditions in the case study countries

Country	Long-term economic decline	Macroeconomic instability	Debt problem	Reliant on Soviet Union
Bangladesh	No	Some	No	No
Cape Verde	No	Emerged in 1990s	No	No
Mozambique	Yes	Yes	Yes	Yes
Nicaragua	Yes	Yes	Yes	Yes
Tanzania	Yes	Yes	Yes	No
Uganda	Yes	Yes	Yes	No
Vietnam	No (but emerging problems)	Yes	No	Yes
Zambia	Yes	Yes	Yes	No

Source: country studies.

Three cases may be identified (some countries provide examples of more than one case): (1) where an active political opposition force favours reform; (2) grassroots support for reform; and (3) reform from the top.

The first two cases are more widespread than is probably appreciated. Cape Verde, Mozambique, and Nicaragua are all cases in which attempts to pre-empt opposition prompted liberalisation by previously socialist governments. In Mozambique Frelimo successfully stole Renamo's platform first on economic policy and later on political liberalisation. By contrast, the Sandanista government failed to hold onto power by steps toward reform from 1988. The PAICV similarly failed in its attempts to remain in government in Cape Verde by pacifying the overseas Cape Verdean community through opening up the economy to foreign investment and soft-pedalling on control measures.[11] Political liberalisation has even more often been an attempt to forestall opposition: Mozambique and Cape Verde are once again examples, but so is Kaunda's abandonment of a referendum on multi-party democracy in Zambia in 1990 by announcing elections.

Other cases illustrate the less vocal or politically focused opposition to controls from the grassroots. Vietnam is the most obvious example. Collectivisation was never successful in the south, and much of the country's reforms, in both agriculture and state-owned enterprises, have been what is called "fence-breaking", that is legislation retroactively recognises changes that have already taken place on the ground. But there are less well-known (and documented)

[11] As many Cape Verdeans live off the islands as on them, and the community in the US (New England) has been particularly concerned with domestic politics (indeed, Cape Verde's independence was first declared in Boston). Following the independence struggle against the Portuguese the importance of the diaspora waned as politicians forged an African identity. But the break with Guinea-Bissau in 1980 resulted in a reorientation toward a European focus, and increased influence from a younger generation of European educated politicians and the overseas community.

cases of grassroots support for reform. In Mozambique peasants resisted collectivisation, especially after Frelimo retreated into being a vanguard party in 1977. Tanzanian peasants had also resisted *ujamaa* (collective villages) and supported the liberalisation which would bring rationed goods back into the countryside. Tripp (1997) argues that Tanzanians engaged in passive resistance to controls and, in an African version of fence-breaking, diversified their livelihoods into the informal economy which was not bound by government regulations (i.e. informal liberalisation).

In other cases – notably Uganda and Zambia – reform has seemed to come more from the top, though in both cases the extent of this should not be overstated: in Uganda considerable local ownership of the programme has developed since 1992 and in Zambia the pro-market MMD has twice been voted into office on this platform. In several cases reform has been initiated by new governments: Uganda and Zambia are again examples.[12] Or in others a new government has intensified reform: Bangladesh, Cape Verde and Nicaragua being cases from our sample of countries. But in several cases reforms have been initiated by governments who previously oversaw state control: Mozambique, Tanzania and Vietnam are the obvious cases, but we can add the partial or reversed reforms in Cape Verde, Nicaragua and Zambia. However in all cases, even where new governments have assumed power, there is greater continuity in the political elite than there is change. There may be cases in which a charismatic outsider with no roots in the rent-seeking class can forge a populist alliance to force through reform – Museveni in Uganda may be a case in point, though the more obvious example is that of Rawlings in Ghana – but there are not many instances. In the majority of countries reforms have been introduced by the class, or often the very same people (or at least party), who presided over different policies for years.

There are two explanations for this apparent paradox. First, political support for the control regime was based on the political economy of rent seeking, what has been aptly named the vampire state in the case of Ghana (Frimpong-Ansah, 1991). When economic decline is so severe there are no more rents to seek then even the rent-seekers will seek change instead. This explanation carries most weight in African countries such as Tanzania, Uganda and Zambia. Second, economic liberalisation opens up new opportunities for wealth which have proved to perhaps even exceed those from rent-seeking. It is hard to measure corruption, but no one claims it has declined in recent years, and several commentators argue that it has increased with liberalisation. An obvious example is privatisation, where asset stripping, under-valuation and kickbacks can combine to reap rich rewards for those controlling the process. Where the press is free to broach such issues, as in Uganda, accusations that privatisation has benefited the political elite are common. But import liberalisation, and the relatively large margins in some of the new export lines, can also bring large incomes.

[12] There was a reform programme in Zambia from 1989–90 which was abandoned before the elections (in the face of food riots in the copper belt). The then ruling party, UNIP, had a record of many failed reform attempts, making Zambia a case in which the change in power made a difference.

These arguments may make one wonder why reform did not happen sooner. In fact, as Table 3.2 shows, all the countries in our sample have adopted a gradualist approach. There have been no big bangs. These facts fit a model advanced by Rodrik (1996) to explain why reforms may not take place even though there will be net gains from them. The model rests on uncertainty over who will benefit. Individuals who are not sure if they will gain or lose will, depending on the balance of probabilities, oppose reform. Gradualism is thus not just a case of "wearing down opposition to reform", but of removing uncertainty so that the winners are identified and support for reform mobilised. The lifting of restrictions on market activity by party members in both Mozambique and Vietnam should be seen in this context, since it builds support for market reform amongst those in positions of power. As one Mozambican cadre remarked, party officials become "born again entrepreneurs".

3.3 External actors in domestic politics

A new consensus has emerged in the academic community regarding the failure of conditionality, which is summed up in Killick's statement that "conditionality is not an effective means of improving economic policies in recipient countries" (Killick *et al.*, 1998: 165). To an extent the World Bank's new report, *Assessing Aid*, has embraced this position. The "to an extent" is important as there are two caveats. The first is that the report in fact concludes that "policy-based lending has a mixed record", so that some successes (e.g. Bolivia and Ghana) are identified. Second, there is a strong argument that there is a role for donors, even in the absence of government commitment, in building reform.

The evidence from this evaluation comes to somewhat similar conclusions to *Assessing Aid*, but with important caveats. Considerable evidence is found in support of the new consensus over the limited role of conditionality. However, there are also versions of the two qualifications given in the World Bank report. First, rather than talking of some successes and some failures, a role for donors in policy change can be identified under certain circumstances, and these include inducing reforms which would not have taken place in the absence of donor pressure. However, such a situation should not be seen as donors forcing unwanted policies on unwilling populations; rather it is often the case that conditionality resolves the collective choice dilemma. There are widespread gains to liberalisation, but a reluctance to take the radical steps – and bear the costs – necessary to realise them. But once the change has been made they are irreversible. Few people would suggest that African countries would readily return to exchange control, with or without donor attentions. Second, policy dialogue is a far broader process than the legal covenants attached to policy-based lending; an assessment of donor influence on reform needs to take into account this broader process. A corollary of this second point is that bilateral donors have an important, under-recognised and hitherto un-researched role in policy dialogue; this point is pursued in part 3.4.

This study did not find evidence for the view, which was often heard in the late-eighties and early nineties, that donors had helped delay reform continuing to provide generous aid to non-reformers. Such arguments over-state the role of donors. It may be that in some high aid recipients temporary postponement was possible during the 1980s. But by the 1990s the weight of political forces had shifted strongly toward reform, pushing governments down this road even if donors were not doing so. There is, however, credibility in the view that **high overall aid levels allow governments to adopt a stronger position with respect to donors in PA-related policy negotiations** – we argue that this has been the case in Bangladesh and Vietnam.

Policy dialogue is not just conditionality but a set of processes including both formal and informal channels. Bill Clinton the President of the USA and Yoweri Museveni the President of Uganda, 24 March 1998. Photo AFP/Pressens Bild.

Evidence in support of the new consensus on the failure of conditionality

The argument that conditionality has failed is based on evidence that many conditions agreed to are not implemented, or implemented late and then reversed, or countervailing actions taken. Various World Bank studies have reported compliance rates of around 60 per cent; i.e. that around 60 per cent of agreed conditions are implemented (meaning that 40 per cent are not). However, several authors (e.g. Mosley *et al.*, 1991 and Killick *et al.*, 1998) have argued that such figures over-state the impact of conditionality for the following reasons (illustrated with examples from the case studies for this evaluation):

(1) some measures would have been undertaken anyway, so that a record of what has happened does not capture the effect of conditionality (the problem of the counterfactual): each of our country studies with a home-grown reform programme illustrates this point with the clearest examples being Nicaragua from 1990–91 with the election to power of a government with a strong liberalisation platform and Vietnam in which far-reaching reforms considerably pre-dated IFI involvement.

(2) some so-called policy changes are very weak conditions, such as a study being undertaken or statement of intent by government, and only these may be done, whereas genuine reforms are in the 40 per cent that are not undertaken: Vietnam has only had one World Bank adjustment credit; it contained ten conditions, only two of which required actual policy changes;

(3) World Bank staff may collude to agree that a measure has been implemented when in fact it has not: this is necessarily difficult to document, though there is some doubt that Vietnam ever satisfied the condition to reduce tariffs, and is more generally illustrated by the fact that the same condition re-appears in several agreements – as happened with Zambia Airways (and in Kenya where the same set of agricultural reforms were agreed to five times, World Bank 1998), or where the goal posts are shifted, as happened in Zambia in the early 1990s when IMF benchmarks were continually revised to accommodate what had actually happened (Mwanawina and White, 1995).

(4) a measure may be undertaken on paper, but later reversed or countervailing measures put in place: if Vietnamese tariffs were reduced they were certainly shortly after increased, in the early 1990s Tanzania laid off several thousand public sector workers in the run up to a CG meeting only to re-employ most of them a week later;

(5) compliance is taken to mean carried out at any time, whereas Killick's analysis shows that at least half of all programs encounter serious delays: only a quarter of second or third tranches from 100 World Bank adjustment credits were paid as scheduled and only five of 25 ESAFs studies were completed on schedule – all the country case studies include at least one case of delayed tranche release, for example as a result of delays in privatisation of Telcor in Nicaragua or the more severe dispute over Zambia Airways. Delays have occurred most frequently in the case of privatisation and public sector reform. Privatisation in both Nicaragua and Bangladesh are examples of governments lacking domestic support for policies agreed with the IFIs, resulting in delayed implementation. However, since the mid-nineties there has been accelerated privatisation in all cases studied (though still limited in Vietnam), with rather less progress on public sector reform.

Alternative perspectives can lead to rather less optimistic conclusions than indicated by the World Bank's 60 per cent figure. For example, Killick *et al.* (1998) analyze the countries covered by the World Bank's *Adjustment in Africa* report: the 11 countries whose policies were deemed to have <u>deteriorated</u> during the 1980s had had 19 adjustment credits (and the nine countries with only a small improvement in policies 25 such credits). Similarly, using the classification in a follow-up study by the World Bank, seven of the eight countries whose policies deteriorated in 1992 had an adjustment program in that year (and five had an IMF agreement covering that year). As Killick says: "the analysis shows the ineffectiveness of the Bank's (and the IMF's) adjustment conditionality" (*ibid*: 36).

If a country is deemed to be on track by the IFIs then there is a tendency to not highlight difficulties in conditionality, so that an accurate record of slippage is hard to compile. Whilst IFI staff may go to their Board to seek a waiver, so that it is clear that a condition has not been complied with, there seem to be rather many cases in which their is non-compliance and no waiver is sought. These are cases of weak compliance, often fulfilling the letter but not the spirit of the condition. Despite the difficulties in capturing these various aspects, the evidence presented above illustrates that the country studies provide ample evidence that all is not well with conditionality. Straightforward non-compliance is observed in several cases, and in Bangladesh and Vietnam this has led to the suspension of the IFI programmes. But more usually conditions have been partially or selectively implemented.

The focus here has been on economic conditionality, but similar conclusions can be reached with respect to political conditionality. The mixed nature of the record is best shown by the case of Zambia, where donor pressure did achieve something in 1993 and again in 1998, but failed to do so in another episode despite a two year suspension of programme aid from 1996–98. The precipitating factor in the latter case was changes to the constitution which prevented Kaunda from running for president, though these were seen as the final straw as there had been growing abuses, such as restrictions on the press.[13] However, two years later donors were preparing to disburse PA although the government had not shifted its position at all; Selbervik sums up this period by saying: "what did the donors achieve? They achieved nothing" (1997: 70). Some donor officials commented that the 1998 CG meeting for Vietnam was particularly important as they finally managed to get human rights on the agenda; but a senior Vietnamese official declared the meeting a success as the donors hadn't mentioned human rights! The main example of success, and one involving Swedish leadership, was the constitutional crisis in Nicaragua. Parliament proposed a change to the constitution which would reduce the power of the executive in 1995, and for a while government could not function with parallel constitutions, a situation which delayed a key privatisation. In

[13] This statement is not necessarily to support the donors' stand. The constitutional change made required that presidential candidates be of Zambian parentage, which is not an absurd requirement. Besides the changes were passed by parliament, so the donors were asking government to overturn a decision by a body democratically elected in a process the donors had supported.

order to put pressure on government to resolve the situation Sweden decided not to sign a new PA agreement (the decision was taken by the MFA official who had come to sign the agreement together with the Ambassador); other donors followed suit. Subsequently the Support Group to Nicaragua, of which Sweden was a member, mediated in negotiations which brought the episode to a successful conclusion. In this case the role of the PA suspension was one of the factors contributing to the resolution of the situation – the Swedish action was certainly noticed as the Ambassador was invited to a lunch with the Minister of the President and six other ministers at which they expressed their dissatisfaction.[14]

More generally, Crawford (1997) examines 29 developing countries in which at least one of the four donors in his study (Sweden, UK, US and the European Union) have undertaken politically-motivated aid sanctions in the period 1990–95.[15] He finds that in under half of these cases there has been an improvement in political and civil liberties. However, there are only two instances (Guatemala and Malawi) in which aid may be deemed to have played a significant role in this process, and a further three (Haiti, Kenya and Zambia) in which aid may be said to have made a modest contribution.[16] Crawford's results are thus in line with the mixed picture for political conditionality found in the evaluation case studies: some successes but also failures.

The failure of conditionality has three main sources. First is the primacy of domestic politics in policy processes. Second is the need of donors to disburse funds, so that they may disburse even in the face of poor performance. Finally, donors may pursue additional objectives with their aid which can cause them to send confused signals.

The central role of domestic politics is stressed by some writers in the new consensus: "domestic political calculations dominate decisions about economic policy changes and donor agencies are relatively powerless in the face of this" (Killick *et al.*, 1998: 151–52), and, as Killick points out, is no surprise to anyone familiar with the literature on the politics of adjustment. There is strong evidence in support of this view from the evaluation. First, as noted above, six of the eight countries initiated reform without formal IFI programmes.[17] Second, even where IFI programmes are in place there are good reasons to be sure that changes in government would have ensured the adoption of reform anyway; Nicaragua from 1990, Cape Verde and Vietnam are all obvious examples where this is clearly so, but the same case can be made to varying degrees for all the case study countries – including Zambia. Third, which reforms are carried out and which are not (particularly the slow pace of civil service reform in most countries) is clearly linked to domestic factors rather

[14] This incident is described more fully in Dijkstra (1999).

[15] Crawford uses the Freedom House political indices reported in Chapter 4.

[16] His analysis for Zambia refers only to the 1993 episode in which ministers implicated in drug trafficking were replaced at donor insistence.

[17] In many cases IFI documents incorrectly date the reform programme to the start of their own involvement, say 1986 in Tanzania and 1987 in Mozambique. This mis-dating, aside from betraying a lack of familarity with the country's history, serves to over-state the importance of donor involvement.

than any difference in emphasis from the donors. Fourth, as a generalisation of the last point, the extent of reform is poorly correlated with donor efforts to promote reform. Finally, each country study is able to identify a number of factors leading to reform, so that donor pressures can be said to be, at most, one factor amongst several. In some cases conditional aid can be argued to have played little role in the direction of policy change – this statement clearly applies to Cape Verde and Vietnam and to some extent to Nicaragua. More generally it is just one of the factors. For example, the Mozambique country study identifies the following five factors as being important in the initiation of reforms in the early 1980s: (1) the failure of socialist policies, notably the state farms; (2) rural resistance to both collectivisation and the usurpation of traditional rural power; (3) the intensification of the war; (4) weakening support from the Soviet Union; and (5) the availability of further support from Western donors conditional upon a reorientation toward the private sector.

A further cause of the failure of conditionality, related to the primacy of domestic politics, is the extent to which negotiators are in a position to carry out the policy changes to which they agree. This point is argued most strongly in the case of Vietnam, where the political process of consultation and consensus building means that a system of formal agreements with the IFIs is unlikely to yield results. This problem is evident more generally. A newly elected government with a large majority will be able to carry through measures agreed to, especially if these same measures were a part of their election platform, as was the case in Cape Verde and Zambia – but need not necessarily be so, which underlies the slippage that occurred in Nicaragua in 1991. Governments in mid-term trying to implement policies which have not had some public exposure will be in a more difficult situation; in Bangladesh promises made to the donor community on privatisation were the opposite of what had been promised to the electorate.

The pressure to disburse has two sources. First is an institutional imperative: aid agencies exist to give away money, and there is an ample literature documenting that individual and agency performance are assessed on the quantity of aid rather than its quality. Second, it was argued above that the origins of adjustment lending must be seen in the context of the need of the creditor countries to get money to debtor governments so they could service their debt to private banks. In the case of low-income highly-indebted countries this argument has changed somewhat, since the bulk of the debt is owed to official creditors, in several cases over half being to the IFIs. Donor governments need to ensure an adequate flow of finance so that amounts to themselves are repaid. Whilst bilateral donors have tended to reschedule or forgive much of this debt, this has not been an option for the multilaterals.[18] Empirical analysis has shown that slippage is greatest when there is a large outstanding debt to the IFIs and many would see IFI tolerance of countries such as Zambia in this light. Neither Bangladesh nor Vietnam, the two cases

[18] The caveats needed here are that the IMF's Rights Accumulation Programme (RAP) is rescheduling in all but name, and that the World Bank has contributed "IDA reflows" (i.e. repayments) to the Fifth Dimension.

in which there has been a longer-term suspension of policy-based lending, have an external debt problem. Pressure to disburse to help service debt is one manifestation of the adverse selection problem, that is bad performers – by reason of large deficits or debt obligations – require, and usually get, more money than good performers.

This tolerance partly manifests itself as slippage which bilateral donors may be reluctant to condone. There is a feeling amongst many bilaterals that the IFIs "have been soft on Zambia" and attempts to enforce a harder line. But other aspects of tolerating non-compliance require the complicity of the bilaterals. An obvious way in which this can happen is where a programme goes off-track but the IFIs ask bilaterals to continue disbursing, as happened in Nicaragua in 1995. Of course such cases can also be construed as the recognition of some adverse circumstances which bilaterals have greater flexibility to take into account than do the IFIs. A less remarked on form of condoning slippage is providing high levels of project aid resources to non-performers. It has been said that the World Bank helped Zambia keep up with external debt obligations during the bilateral PA freeze in 1996–98 by accelerating its own project aid disbursements. In both Bangladesh and Vietnam IMF programmes were not completed in the first part of the 1990s and several years have followed with no IFI policy-based lending and the majority of bilaterals also withholding PA. But both these countries enjoy high levels of aid per capita, which must raise doubt as to the extent to which PA would be additional, or even if it is, if the promise of marginal increments of PA will have much impact on high aid recipients.

The dual role of the IFIs as the gate-keepers for conditional finance and as major creditors clearly opens up the possibility of what economists call "moral hazard"; that is, people lie. The results of this evaluation suggest that **we should question whether the IFIs should be assigned this role of sole keepers of the knowledge of international development wisdom** on two grounds. First, it is not clear that the policy package recommended is the right one – not that liberalisation has been wrong, but that the state/market mix has been oriented to the latter at the expense of complementary policies necessary for growth and poverty reduction. The policies being pursued on the ground do not reflect the nuances and developments recognised in documents produced by the IFIs for donor audiences. This argument is developed in the next chapter. Second, **the institutional culture of the IFIs is not one which fosters debate within the donor community and may prove ill-suited to do so in recipient countries: they are better suited to policy monologue than policy dialogue**. Both the World Bank and IMF are eager to present a public persona which will not admit to the possibility of current failings (past failings are admitted to), and this institutional stance carries over to the conviction shown by the staff of these institutions. IFI documentation nearly always presents issues and solutions in black and white and papers over any cracks. One country study for this evaluation found that the "letter from government" requesting an adjustment credit was worded identically to large sections of the World Bank report to which the letter was an appendix. The report on Mozambique contrasts the disharmony in the donor community, and even amongst World Bank staff, with the picture of togetherness suggested in World Bank documentation. These facts raise serious questions about genuine transparency and the reliability of such documentation for donor decision making.[19]

The pressure to disburse is one reason why donors may send confused signals, by disbursing when they should not and *vice versa*. The pursuit of other objectives may also have this effect. This point is often raised in relation to aid allocation, in particular double standards in the application of political conditionality – so there is pressure over human rights issues on Kenya but not China, on Surinam but not Indonesia. There are several cases – such as Nicaragua in 1992 and 1995 and Zambia in 1994 and 1996–98 – when PA was suspended for reasons of political conditions which some observers believed could threaten economic reform.[20] Donors of course refute this view by stating that political liberalisation is necessary for sustained economic reform and growth. Such a link is in fact far from clearly established, a point which is returned to below. Confused signals may also result from lack of donor co-ordination: cases where the bilaterals continue to disburse at the request of the IFIs although the latter cannot do so are an example of this, as are the instances when the bilaterals suspend and the IFIs do not.

Evidence in favour of conditionality

Although the evaluation produces evidence in favour of the failure of conditionality, there are also signs that conditionality has had some effect. There are two main arguments here. First that some policies have been implemented that clearly would not have been in the absence of conditionality. Second, that donor support may help solve the collective choice dilemma.

Whilst the evaluation shows that the general trend toward a more outward-oriented and market-based strategy must be understood in the context of the domestic political situation and the country's past history, there are specific policies which have been carried out only at the insistence of donors. Privatisation is in many countries a case of this, although support for the policy has grown as the process progressed. Closure of unprofitable enterprises, and public sector reform (which has been limited in most cases), are clearly instances, as best exemplified by the liquidation of Zambia Airways.[21]

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[19] The discussion by Uvin (1995) of the Rwanda case is a tragic example of the potential importance of this issue.

[20] In the case of Zambia the potentially damaging effect of the aid embargo was argued in a Sida country economic study (Mugerwa, 1998) and communicated from the Swedish Embassy in Lusaka to the Ministry for Foreign Affairs in Stockholm. The relative importance given to economic and political conditions was identified in Chapter 2 as a difference between Sida and MFA.

[21] The Zambian privatisation turned around from being declared by the World Bank to have been seriously derailed in mid-1994 to the "best in Africa" by 1997. What happened? A likely explanation is that the government offered up privatisation to the donors to reduce the pressure they were exerting on political conditions. It seems that this strategy would have worked had it not been for the coup attempt.

The previous chapter showed that in most cases economic performance has improved with economic reform. Why then was reform resisted when these benefits were waiting to be realised? One argument was suggested in the last section: people are unsure of the benefits they will obtain, but an initial partial liberalisation allows them to identify these and so build their support for reform. A development of this argument is that the political economy of countries has been fundamentally restructured from one based on rent seeking to one based on the sources of wealth in a liberalised economy, so that the nature of policies which enjoy political support has changed. The collective choice dilemma is somewhat different: although it is recognised that there will be widespread gains from liberalisation it is not possible to mobilise the support to dismantle the current means of generating income. Donor insistence on these policies provides the context in which this change can be made.

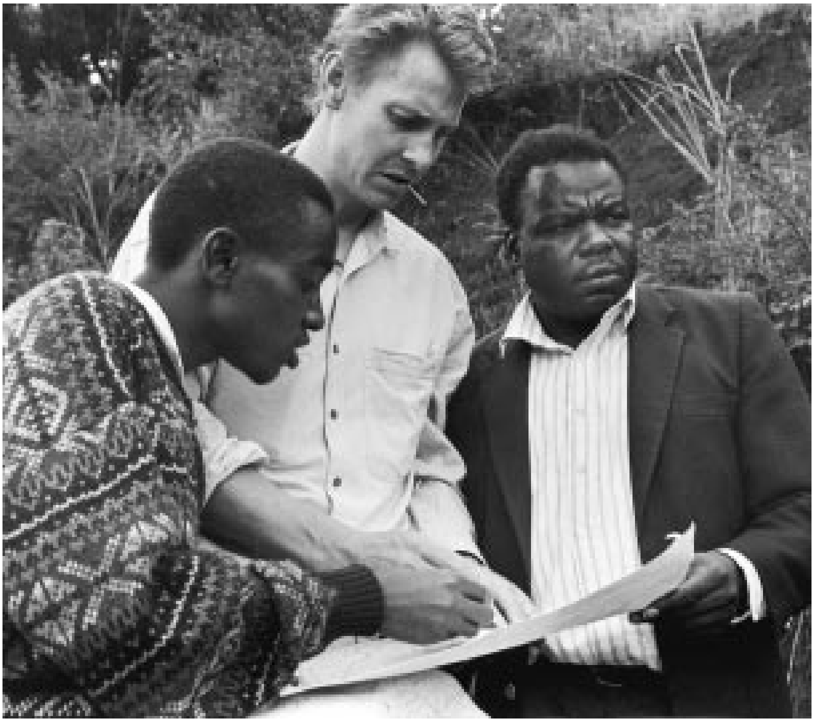
But even where conditionality does work it can be a dangerous game. In trying to make governments more accountable there is in fact a great danger that donors are subverting accountability. Too often "open and transparent" means telling the donors but not the affected population. Policy changes have been discussed first with donors – or even agreed with them – without consulting the affected population, or even where they run contrary to promises made to the electorate, as was the case with privatisation in Bangladesh. The committee which manages the common basket for the Zambia Health SIP has representatives from government and donors, but not civil society (even through the health reforms have created participatory management structures that could be used for this purpose). The Ugandan experience is a fortunate partial exception, with NGOs involved in the monitoring of the Poverty Action Fund. For all their talk of the importance of ownership, donors are reluctant to let go, and make the space necessary for domestic policy debate. Hence they subvert accountability rather than build it.

3.4 How has Sweden affected policies?

Evidence in favour of the view that donors have played a part in supporting reform is increased if the focus shifts from formal conditionality to the broader process of policy dialogue. Making this step redirects attention from an almost exclusive focus on the IFIs to the part played by bilateral donors.

The four dimensions of the policy dialogue process

Section 3.1 proposed a framework for analysing the ways in which bilateral donors can affect policy outcomes. The work for this evaluation expanded this typology to cover four dimensions. In each case policy-based lending is just one end of a spectrum of possible interactions. The four dimensions are:



The evidence suggests that semi-formal and informal channels are of great importance in the policy dialogue process. Technical assistance has been identified as one of five channels of Swedish influence. Swedish technical assistant and colleagues, Kenya.
Photo Charlotte Thege/Phoenix.

- degree of formality: conditionality is the most formal aspect of policy dialogue, and there are other formal channels such as annual aid talks and CG meetings; but there exist a number of semi-formal and informal channels, such as more *ad hoc* meetings and social contacts – the evidence suggests that these informal channels are of great importance, but that formal channels provide the context for them, e.g. there is often a flurry of activity in the run up to CG meetings which is more important than what happens at the meeting itself.
- directive versus non-directive: conditionality is directive, in that it lays out which policies should be followed, so that the word "dialogue" is something of a misnomer; but donors may also engage in dialogue which is more suggestive, or which facilitates dialogue – these latter strategies having been pursued most obviously by Sweden in the cases of Nicaragua and Vietnam.

- channel: the IFIs are at the centre of formal, conditionality-based policy dialogue, but bilaterals also have an important role to play in the policy dialogue process, especially through less formal channels.
- choice of instrument: programme aid is used for conditionality, but policy dialogue may also be carried out in the context of projects or technical assistance, in both directive and non-directive forms though non-PA instruments can be well-suited to non-directive dialogue.

Taking into account all the possible combinations of these four aspects of policy dialogue opens up a wide range of possible channels for policy dialogue which have not been considered in the literature on conditionality. An evaluation of UK programme aid to Zambia found that these channels had been important (see Box 3.1). It is argued here that they have also been in the case of Swedish aid, though they have not been exploited as fully as they might. By way of initial illustration, the country study for Vietnam, where Swedish influence has perhaps been at its strongest, identifies five channels of influence: (1) the systemic effects from import support (described in Chapter 2); (2) publication of regular economic studies; (3) related events, such as seminars and training; (4) technical assistance (both experts and training) and (5) projects.[22]

[22] Vietnam has been home to Sweden's largest aid project, the Bai Bang paper mill, which was argued in a recent evaluation to have had substantial systemic effects on enterprise reform (Centre for International Economics, 1999).

Box 3.1 British influence on Zambian reform

The UK was one of the first bilateral donors to link its programme aid to IFI-sponsored reforms and has retained this close link. Nonetheless, official documentation and agency staff argue that their support allows for a unique British influence ("added value"). Zambia represents an interesting case both on account of the sizeable British aid programme, over half of which has been programme aid during the 1990s, and because of a belief expressed in several British documents that other donors in Zambia look to Britain for leadership, especially on issues of governance.

It is readily apparent, that despite believing programme aid to afford some specific UK influence, the British have no explicitly thought out influence strategy (this statement is true in general, not only with respect to Zambia). That being said, the full range of channels have been utilised, and there is clearly an awareness of different channels being appropriate under different circumstances. The decision to suspend PA in 1995 was not announced at the Bilateral Aid Talks which followed soon after the decision was made, nor was dissatisfaction with the pace of privatisation communicated to the responsible government minister. In both cases the UK government waited until their views could be put directly to the Zambian president. Semi-formal and informal channels seem to have been particularly important (there is a remarkably high degree of communication within the donor community in Zambia). Particularly in the case of the privatisation programme, technical assistance has been used to get an insider position. But formal structures such as CG meetings are important in providing both a framework and reference point for informal channels. On several occasions, upcoming CG meetings in Paris have given a deadline which has provoked heightened donor-government interactions. These attempts at specific influence have occurred most often in relation to governance issues, though there were also incidents during the privatisation experience.

Other donors do not in general seem to share the UK's perception of itself as a lead donor, though there have been instances in which it has been a prime mover on governance which have, at the very least, reinforced tendencies in the donor community. Attempts to influence the IFIs on specifically Zambian issues seem to have been rather less successful.

Source: Seshamani and White (1998).

Swedish influence: an introductory overview

Does Sweden seek to influence the policies of the countries to which it gives aid? There are two parts to this question. First, does Sweden seek to influence policies at all? Surprisingly, some Swedish officials deny that this is the case. This position seem strange, since Sweden does subscribe to IFI conditionality and links its PA to these reform programmes. There can thus be no denying that **Sweden does seek to affect policy outcome in recipient countries**. Second, does Sweden seek to exert some specific Swedish influence? This second question is harder to answer since, unlike the case of the UK, it is not possible to find documentation providing an explicit answer. However, it seems that it must be the case that there is this intention since programme aid agreements include the possibility for Sweden to make an independent assessment in order to give or withhold aid. But ambiguity remains since this option is not exercised; cases of divergence from the IFIs are when political conditionality is introduced in unison with other bilaterals (though with a leading role in Nicaragua). There is only one case of separate economic conditions, this being the short-lived Matching Funds experiment in Tanzania. A partial case is the support of the Embassy in Maputo for the bilaterals' stand against the IMF, though the Swedish Ambassador was prevented from signing the letter of support for the government by the intervention of the Ministry of Finance in Stockholm. However, ambiguity as to whether Sweden intends to exert influence appears less once other policy dialogue channels are considered, since Sweden has been active in many of these.[23]

If Sweden is attempting to exert influence, what is the "Swedish position?". It is difficult to talk of such a position for three reasons. First, **there is no explicit articulation of how Sweden intends to influence policies, and certainly nothing amounting to an influence strategy at the level of individual recipient countries**. Second, the various agencies responsible for aid in general and aid in particular may disagree over what position to take. As discussed in Chapter 2, Sida and the Ministry of Finance believe Ministry for Foreign Affairsto be "too political". On the other hand, Sida and Ministry for Foreign Affairsare less inclined to be as supportive of the IMF as Finance and the Central Bank (as illustrated by the incident in Mozambique just mentioned). Third, given **the absence of any centrally defined position, there appears a considerable degree of latitude for desk officers and Embassy officials as to their position in policy dialogue**.[24]

Whilst there is no Swedish position as such, the areas in which Sweden has been active have been in supporting the implementation of IFI conditionality,

[23] The country studies evaluated programme aid rather than Swedish influence, so that some relevant information may not have been collected on project activities.

[24] There are presumably limits to this process, so that, for example, an Embassy economist advocating widespread nationalisation would be censured from above. The processes for such censure, and the networks to ensure some uniformity of position, appear to operate largely through informal and semi-formal channels.

plus attention to governance issues along with other bilateral donors. There is nothing "uniquely Swedish" about the views taken, which are common at least to those donors commonly falling under the like-minded label (Norway, Denmark, the Netherlands, United Kingdom and sometimes Germany). Given Sweden's social democratic tradition and Sida's historical focus on poverty and distribution it may be thought that a "human face" would be promoted. Whilst this has been so to some extent through SPA, there is very little evidence of it at the country level. There are two reasons for this finding. First, it is to some extent so that Sweden accepts the IFI position of getting stabilisation first, then putting in place the pre-conditions for growth and only then turning to poverty (and not worrying about distribution at all).[25] But the second reason is at least equally important. That is that Sweden has had little capacity to develop alternatives. Even where desk officers and Embassy staff are of high quality, they are burdened with an administrative load which allows little time for engaging in debate on the content of policy dialogue.

However, this argument does not mean that there are not examples of influence. Some are shown in Table 3.4, which fills in the cells from the conceptual framework presented in Table 3.1. From the information presented in the table, five issues are picked out for discussion: presence, influence on the IFIs, the role of the SPA, like-minded groups and work to facilitate policy dialogue, focussing on the country economic reports. Finally, other channels are briefly discussed.

[25] Although some IFI staff deny it, and their position does appear to be shifting, this is an accurate summary of IFI policies in the 1980s and nineties.

Table 3.4 Channels for Swedish influence

	Formal channels	Semi-formal channels	Informal channels
Direct influence on government	Formal channels, such as annual aid negotiations and CG meetings, seem to have a relatively limited role insofar as direct influence on government is concerned for individual bilaterals. CGs are, however, important as a focal point for policy dialogue, providing an opportunity for co-ordinated bilateral action (e.g. in 1998). Sometimes disagreements may become formalised, the constitutional crisis in Nicaragua being the most prominent example in which Sweden has played the lead role. In other cases, such as Zambia, Sweden has acted as a part of the donor community. An exception to this general statement is where PA modalities have been a subject of these discussions and are playing a leading role in market development: Vietnam is perhaps the only case. Sweden has not in general adopted own conditionality independent from the IFIs; the exception being the experiment with Matching Funds in Tanzania.	"Presence" determines effectiveness of direct semi-formal links: very evident in Vietnam, and has been an important factor in other countries studied except Bangladesh and, possibly, Cape Verde. Studies and seminars have been used to good effect in several countries (notably Vietnam and also, though not part of this evaluation, Guinea-Bissau), and impact is assisted by presence – though this is not sufficient condition in cases where there is much competing material (as seems to be so for Tanzania). Policy seminars for civil society, as regularly held in Zambia, are a special case here. Semi-formal (and informal) links between ambassador/embassy officials and head of state/ministers are uneven. In cases where presence is high then ambassador has had strong and important links.	Swedish TA supports policy advice through the expertise it provides, but there was not evidence of using TA as an additional channel to exert pressure (indeed there was some opposition to the idea). The margins of CG meetings provide an important opportunity for intensified informal contacts with government officials.

	Formal channels	Semi-formal channels	Informal channels
Indirect influence via IFIs	The main formal channel, the Board, is commonly agreed to be ineffective. Opinions vary on impact *via* SPA, though difficult to find evidence at country level. The content of policy-conditionality has not strongly reflected SPA concerns on poverty or gender. JEMs were important for the management of programme aid, but cannot be held up as an instance of bilateral influence. No evidence was found of influence at the country-level *via* Trust Funds.	Less formal channels, as enquiries by Delegation staff and direct high-level communications do not appear to be much utilised. Contacts with in-country and visiting IFI missions, though often good (e.g. Tanzania and Vietnam – though in other places the IFI Resident Mission is seen as weak) is not seen as a channel for influence.	There are informal contacts from agency to IFI staff, but no instances were found in which these contacts can be said to have had influence. This is a general finding (i.e. applies to other bilaterals) and reflects the culture of the IFIs.
Indirect influence via donor agencies	There are few formal channels through which one bilateral can influence others; aid co-ordination bodies (DAC, SPA, CGs) present some opportunity, but it is not marked. The activities of like-minded groups may sometimes become more formalised	Sweden is often active in like-minded groups, e.g. in Mozambique and the non-group of donors in Zambia. Studies can help inform other donors in cases where there is a dearth of material; Guinea-Bissau is such a case, as was Vietnam in the late 1980s.	Informal links between bilateral agencies are clearly of great importance. In cases where the donor community is close-knit – which is most countries but in some, e.g. Zambia, more than others – then there is a common position which emerges rather than being set by a specific donor. Hence there are few instances of "leadership by example" (but the Nicaragua constitutional crisis is one), but to emphasise this lack would be to understate influence through these channels. Similar comments may be made concerning influence through informal channels associated with formal aid co-ordination, such as the margin of CG and SPA meetings.

The importance of Swedish presence

In most of the countries covered by the evaluation Sweden has a long history with the country, having supported it during an independence struggle (Cape Verde, Mozambique and Vietnam) or been the largest (or only) Western donor supporting socialist transformation (seven of the eight to a degree, but notably Mozambique, Nicaragua, Tanzania and Vietnam – the exception is Uganda). This historical association may be expected to give Sweden a "special relationship" with the country, which can perhaps be called upon at difficult points in the policy dialogue. Alternatively, it may be thought that being identified with now rejected policies, often implemented by a party no longer in power, would taint Swedish advice. The evaluations found considerable support for the former view, and none for the latter. Both government and other donors felt that Sweden occupied a special position, though some felt its importance was waning and others that not enough was done to exploit it. The clearest example of this relationship being exploited was the role Sweden played in the constitutional crisis in Nicaragua in 1995,[26] but it is also evident in Mozambique, Tanzania and Vietnam, and even Zambia where the ambassador in the early 1990s developed a particularly close relationship with government. Vietnam is perhaps the clearest case, though Nicaragua can also be used as an example. A common theme amongst Vietnamese respondents was that Sweden was not seen as pursuing its own vested interests, which was not so for other donors, and that its historical association implied a commitment to Vietnam's development. This position meant Sweden was well placed to promote platforms for policy debate (described below).

Cape Verde and Uganda provide contrasting examples in which there is little presence. The programme for Cape Verde is administered from Stockholm, and that for Uganda was run from Nairobi until 1995 and the level of representation remains low. Uganda is also the exception in that there is no historical involvement with the country. It is thus unsurprising that examples of Swedish influence are most difficult to find in these cases. Indeed, there seems to be virtually none in Cape Verde. In Uganda, Sweden has been amongst donors supporting initiatives on debt and poverty reduction, and is also associated with the health sector. But its profile is lower than in other countries where it has a more established presence.

The evidence presented above supports the view that **Swedish influence on policies will be more effective if focused on fewer countries**, where Sweden has a historical presence and where efforts are made to maintain this presence by building up Swedish expertise on the country and developing and maintaining a network of contacts.

[26] One informant said that Nicaraguan officials asked "how can you do this to us as you are our friends", but also that relationship was not afterwards damaged by the incident – if anything it improved.

Influence on the IFIs

During the 1970s Swedish aid went largely to countries pursuing a socialist path to development. As we have seen, in the 1990s Sweden is a supporter of the market-led development strategies promoted by the World Bank and the IMF. It is thus clear that a change took place during the 1980s, though it is surprisingly difficult to date with any precision. It began in the early 1980s, but there was still some reluctance to join the SPA when it was formed in 1986, as this was seen as too close an association with the IFIs, the policies of which many officials wished to distance themselves from. In the event Sweden did join the SPA, and several senior officials identify this as a turning point in Swedish policy. Although it is now thought of as a way for bilateral donors to influence the IFIs, in the first instance the SPA had the effect of bringing Sweden into line.[27] Despite formally subscribing to adjustment policies Sweden is one of those donors who is seen as having a somewhat critical perspective, particularly in regard to poverty and gender issues.[28] Hence it may be expected that Sweden has attempted to influence the IFIs to change the content of conditionality.

The first point to make with respect to assessing Swedish influence is that attempts at influence are not as may be expected, and there seem to be differences in stance between the country desks and embassies on the one hand and the policy department on the other. In some countries, such as Tanzania and Zambia, there is a feeling amongst bilaterals that the IFIs are "being too soft".[29] Rather than try to mollify conditionality, bilaterals wish it to be tighter and more strictly enforced; Sweden has been a part of these moves. At the country level there is not, as may have been expected, evidence of efforts to soften conditionality (Mozambique being the exception here) or to put greater emphasis on social aspects. Sweden has not been active in attempts to create a human face for adjustment at the country level.

The main finding with respect to influence on the IFIs is how limited it is. A senior Sida official remarked that Sida had "not even marginal influence on the Bank and the Fund", and these feelings were echoed by other respondents. The formal channel for this influence is the Board. From the point of view of an embassy or Sida official influence through this channel is a remote possibility. A position must first be communicated to MFA, who must then communicate with Finance who is responsible for Sweden's IFI Board members. MFA and Finance may not agree (as the case of Mozambique already mentioned illustrates), but even if they do, Sweden is one of several countries represented by a single Board member so that those countries have also to agree. In addition, many decisions (such as the content of a PFP) are effectively made

[27] Three factors may be identified behind the move toward market-based development: (1) the change in the international climate, (2) a corresponding shift in domestic political thinking, and (3) the influence of the experience of living in planned economies on the thinking of Swedish officials (this last point was made by an official who worked on Tanzania during the 1980s).

[28] Staff from other agencies confirmed this perspective in a survey carried out for this evaluation.

[29] A possible exception to this position are views on the continuation of the cash budget.

before the document comes to the Board. The Executive Director's (ED's) office is a less formal route for channels of official representation, but no evidence was found of it being used to exert influence.[30] Other channels, such as CGs, are not seen as being ways of influencing the IFIs. The SPA is something of a special case, which is discussed separately below. Informal contacts with World Bank staff are often said to be good, although it is less clear that these are believed to be a way in which influence can be exerted, since IFI staff see their role as informing bilateral staff of the state of affairs, rather than seeking their opinion.[31]

A related issue is that of capacity, raised above. It is clearly only sensible to seek influence if Sweden can offer an informed opinion. The staffing of embassies and the pressures on desk officers (and their frequent rotation) can prevent the building up of the necessary expertise. This problem can be addressed partly by stronger country focus and partly by building up expertise as the country economic reports have sought to do.

Promoting policy debate: the role of studies

What passes as policy dialogue is better described as policy monologue, as donors set down the policies to be implemented. Such an approach may be called directive policy dialogue, whereas a less directive approach would be to facilitate debates on key issues without dictating what the content of that debate should be. Sweden has adopted such an approach in Nicaragua and Vietnam: in both cases in the late 1980s when few other Western donors were involved. In the former case, Sweden financed a number of expert studies on macro policy issues, and created a group to design a debt strategy with a view to strengthening the government's negotiating position. In Vietnam, Sida financed studies and related seminars in the 1980s, including Fforde and de Vylder's *From Plan to Market* which is the most prominent published work on Vietnamese economic policy.[32] Elsewhere Sweden has also promoted debates, such as the lunches held for the business community at the Embassy in Lusaka (Zambia) and financing studies on various issues – in Zambia the Economics Department provides an annual commentary on the budget. The most systematic and sustained initiative has been the studies commissioned by Sida's Policy Department.

Since the late 1980s the Sida Policy Department has commissioned a series of macroeconomic studies from Swedish academic institutions on several of the main recipients of Swedish aid. These reports, initially prepared on an annual basis, are expected to follow the general economic situation and reflect upon policy issues. Following an evaluation of the series in 1994 the

[30] This finding contrasts to that from an evaluation of UK PA to Zambia, where memos mentioned putting pressure on Bank staff *via* the ED's office over perceived laxity on privatisation conditions.

[31] This perception has frequently been confirmed implicitly in interviews with IFI staff, and sometimes explicitly.

[32] The book of this name was published in 1996, but was a revision of earlier Sida-financed work by the two authors.

management style has changed to give the Sida Regional Departments greater say over the reports, with the requirement for an annual report replaced by a more flexible relationship in which the consultant on each country responds to specific requests (e.g. to comment on papers in the run up to a CG meeting).

These reports may have a role in Swedish influence in several ways:

- they may directly inform Swedish thinking in the country and thus impact the policy dialogue with the government and the IFIs
- the report may directly influence government, or other influential opinion leaders in the country
- the reports may provide a basis for discussion and influence amongst the donor community
- at a systemic level, the reports may create a Swedish presence in policy issues and a network for utilising this presence.

The general conclusion in relation to these points is that the macro studies can and have had each of these roles. But the experience is extremely uneven and more often they have not done so.

To elaborate upon this conclusion, several points may be made. First, the change in the management of the reports since 1994 does appear to have resulted in an improved possibility for impact. Although there are cases in which reports exerted influence before this date, several officials who have dealt with the reports in the earlier period found them too academic, with both the timing and content insufficiently tuned to their needs.

The possibility for impact appears to depend crucially on how actively dissemination is pursued and experience here appears extremely variable. Whilst a seminar is commonly held, it is clear that in some countries this has been a more active process involving the creation of a network for a continuing dialogue. Several officials pointed to the work of Renato Aguiller in Angola as an example of what can be achieved when serious attention is paid to these issues.[33] In the early 1990s in Vietnam widely publicised seminars were held including international journalists (from, for example, *Far Eastern Economic Review*) – and T-shirts were produced of the most recent report title! Of course the possibilities for impact are to an extent determined by the relative importance of Sweden as a donor. Hence less impact is expected from these studies in countries such as Nicaragua and Zambia, where a wealth of material is available, compared to say Guinea-Bissau (where the USAID office classifies the Sida studies under BAD, meaning "best available document").

The extent to which local networks are created depends also on the role played by the consultant. If he or she tries to solicit and respond to a range of local opinion then useful contacts can be built up on which the Embassy economist can call on at other times. In the case of Guinea-Bissau the country officer

[33] Of course the most important question is on the subsequent impact such dissemination had. This cannot be judged from this study, but, given the setting in Angola, may have been unfortunately small.

consulted with local economists on the terms of reference for upcoming studies. But in some other countries little attention appears to have been paid to developing such networks.

Whilst concluding that the reports can have some influence, this influence is most usually in providing a platform for debate. Very few cases emerge of specific policies which have come about as a result of issues raised in the reports, although exceptions are the Debt Fund in Guinea-Bissau and Matching Funds in Tanzania. Other channels for influence are limited since although the reports are distributed to other Nordic donors, other mechanisms, such as the SPA, are not used to promote the reports' findings. Nor has there been an attempt to synthesise the various reports to develop an overall Swedish position on policy reform (at the same time the authors of the reports are not constrained to adopt a "Swedish position"[34]). In some cases the reports pursue the liberalisation agenda – three recent reports on Vietnam are examples (and ones which are widely cited in both donor and Vietnamese circles) – but this is not always the case.[35]

This discussion indicates that there remains something of a missed opportunity from these reports in many countries, and that this opportunity is being missed by insufficient attention to the processes surrounding report preparation and dissemination, although there are many examples of best practice from various countries. It is recommended that the Sida policy department undertake a review of these processes and produce a guidance note for the Regions on dissemination, which should include a recommendation that funds be explicitly set aside for this purpose.[36]

The role of the SPA

The Special Programme of Assistance for Africa (SPA) was created in 1986 to mobilise resources for adjustment in Africa and to provide a forum for discussion of the relevant policy issues. Members are all donors providing support for adjustment, i.e. PA, so that SPA is rightly seen as one of the channels for PA impact. The SPA is a channel through which the donors may influence the World Bank (and to a lesser extent the IMF, which is also a member but not with the degree of active involvement of the Bank).[37] It is not a channel for direct influence on African governments since they are not represented.

There are differences in perception to how the SPA has operated, but it is generally accepted that it has failed to make its identity widely known (which is not necessarily the same as saying its presence was not felt). Agency officials

[34] One official did suggest that the reports for Mozambique in the early 1990s were too far removed from the IFI position to be useful for dialogue, although another official working on Mozambique at that time said that these reports were generally well received.

[35] It is the author's view that it is unfortunate that the recent report on Cape Verde is uncritical of the IFI prescription, which seems to ill suit a country clearly in need of some strategic thinking.

[36] Apparently a single dissemination workshop is not even budgeted for on the assumption that "workshops don't cost anything"!

not directly involved in the SPA often believe it to be a World Bank body, rather than one in which the Bank is an equal member with other donors. By the mid-90s some donors, with Sweden and the UK playing a lead role, felt some dissatisfaction as to whether the SPA was an efficient channel for bilateral influence and proposed an independent evaluation of the mechanism. There was some resistance to this proposal from the Bank, who, once it accepted that an evaluation would take place, offered to undertake the evaluation itself.[38] Since the bilaterals wanted an independent opinion a compromise was reached by which the Bank's Operations Evaluation Department (OED) would manage the evaluation but the donors would be able to nominate team members. Disagreement continued over the focus of the evaluation with pressure having to be brought to bear for the study to address the issue of bilateral influence.

As a part of the evaluation field trips were made to several African countries. These trips confirmed the view that SPA was not widely known, and that its various guidelines had not had much of an impact. For example the consultant visiting Mozambique reported that "all of the persons I met in the Mozambican government had never heard of the SPA" (Anon. n.d.: 1). The position was not much different amongst the donor community: "SPA is hardly known amongst the donor community. SPA is apparently never discussed nor even mentioned in the various co-ordination meetings taking place in Maputo… its guidelines are even less known and no reference is ever made to them in the course of the frequent co-ordination meetings and policy discussions taking place in Maputo" (Anon. n.d.: 7) .

The bilaterals reacted to early drafts of the evaluation by saying that it did not matter so much if the SPA did not leave visible footprints, since much of its activity was "behind the scenes" and that it played a role in developing the adjustment agenda, especially with respect to poverty and gender issues. However, many members of the evaluation team felt the SPA had been just one of several fora in which such issues were discussed so that it could be accorded no special role, and that it was difficult to establish links between decisions taken at the SPA and changes in Bank (or Fund) practice. A counter-example cited by donors – the establishment of three pilot gender-sensitive adjustment programmes – rather supports the critics' case. One of the three countries did not have a programme at the appropriate time so the idea of a pilot was dropped and in the second nothing was attempted. Only in Mozambique was a gender-sensitive adjustment programme attempted – although the interviews during the course of the SPA evaluation revealed that no one in government was aware of this fact (Anon. n.d.). The gender component to the programme was a condition to monitor the impact on small

[37] Although difficult to document, it seems clear that the Bank stressed the first objective of resource mobilisation whereas bilateral donors were keener on discussing the policy agenda. It was originally intended that support to adjustment would be largely cofinancing for the World Bank, but this did not come about – illustrating the bilaterals' desire to maintain some distance.

[38] The report author was in regular contact with the relevant officials from several of the SPA donors during this period and, subsequently, a member of the evaluation team.

holders and women of liberalisation of prices and trade in the cashew sector. The paper for the SPA evaluation notes that this may seem a rather negligible incorporation of gender concerns, but in defence points out that the instruction from the Vice-President to do this only came once credit design was mostly complete, and that the conditions concerned privatisation and banking restructuring, which are areas "where gender is not easily introduced". The World Bank's Country Assistance Review (CAR) states that "attention to gender issues has been sporadic" (World Bank, 1997: 33), and does not mention that the Mozambican programme had been redesigned to be gender-sensitive (the authors of the CAR appear unaware of this fact).

This rather negative picture certainly means that the role of SPA should not be over-stated. But neither should it be under-estimated. The evaluation did point out the useful role played by the various guidelines and the Joint Evaluation Missions (JEMs) which helped harmonise import support procedures, the importance of which should be clear from Chapter 2.[39] This evaluation adds weight to this finding in a way not possible from the SPA evaluation: namely that in Nicaragua, which is of course not covered by the SPA, there are "backward" PA modalities (see Chapter 2). Moreover, even if it was just one voice speaking for greater attention to poverty and gender, the more voices the better, and the fact that it represented the main donors must have given it some importance.

Like-minded groups

In many of the countries studied Sweden is active in like-minded groups, the core of which is usually the Nordic countries and often includes the Netherlands and UK. These groups have played an active role in policy dialogue, most usually on the political side, but sometimes venturing into economics as in Mozambique. The advantages of such groups are that they allow a co-ordinated stand on the part of the donors and allow the participating agencies greater influence than they may have by virtue of their aid budgets alone. In principle groups could co-ordinate many aspects of policy dialogue, but this has not in general happened. An approach by Norway to share in Sweden's country economic studies met with a lukewarm response, and an attempted joint evaluation of import support in Tanzania was not realised. However, a joint review of macro support was recently undertaken in Mozambique.

Some successes from these groups can be pointed to. The like-minded group in Mozambique was behind the donors' confrontation with the IMF in October 1995, in which a letter signed by several Ambassadors was sent to government supporting it against IMF criticisms that it had gone off-track.[40] In Nicaragua a "non-paper" was prepared which was successful in having a condition

[39] Guidelines were issued by the SPA on a number of topics, including import support procedures and counterpart funds. JEMs were multi-donor missions, whose impetus came from the SPA, to review forex and related procedures, largely for the purposes of the management of programme aid.

removed from an ESAF loan that US citizens (Nicaraguans who had left in the Sandanista period) be given priority in compensation land confiscated in the 1980s – though this is more a case of one group of bilaterals counteracting the influence of another bilateral; some softening on expenditure constraints on the social sectors was also achieved.

The United Kingdom explicitly uses technical assistance as a source of influence, seeing it as an opportunity to "get someone on the inside" and to have access to information and exert pressure. British technical assistant and colleagues, Tanzania. Photo Charlotte Thege/Phoenix

Other channels for influence

Influence may also be exerted through other types of aid, such as project aid and technical assistance (TA). There appears to be a difference between Swedish and British aid as the latter explicitly use TA as a source of influence, seeing it as an opportunity to "get someone on the inside" and so have access to information and exert pressure (see Box 3.1). By contrast Sweden seems to use this channel in a less conscious manner if at all – and several Sida officials expressed the view that it would be wrong to do so. On the other hand, influence can be exerted through projects. The Bai Bang paper mill project in Vietnam is the best documented example of this, which introduced a Scandinavian management model, which was emulated by managers from other companies (Centre for International Economics, 1999). The rise of sector programmes represent a new way and more explicit attempt to exert influence outside of PA.[41]

[40] As already mentioned, Sweden was active in this episode, although the Swedish Ambassador was prevented from signing the letter by the intervention of the Ministry of Finance from Stockholm.

[41] Budget support provided under sector programmes (SPs) is PA, but most support to SPs remains project-specific (see Chapter 2).

3.5 Conclusions on policy dialogue

The following conclusions emerge from this chapter:

- *Domestic political considerations are the prime factor in determining economic and political reform*: most countries initiated reform without donors, and have carried out some measures not required by them whilst ignoring others that have been required.
- *Donors over-state their own importance at the expense of understanding the political dynamic*: IFI documents often date reform from their own involvement rather than when the first changes were initiated and in general pay scant attention to possible implementation constraints. A corollary is that transparency is often measured by government sharing information with donors rather than civil society, which can serve to subvert accountability rather than support it.
- *Policy dialogue is a set of processes*: conditionality is only the formal, directive end of policy dialogue, other parts of the policy dialogue have been at least as important, partly as the formal and informal channels complement on another.
- *Formal conditionality has a mixed record*: there is ample evidence from the evaluation for the view that conditionality has failed, and of the reasons for this failure; but there are also cases where conditionality has influenced policies and reasons to believe why this may have been so.
- *Bilateral donors have played an increasingly important role in policy dialogue:* in the 1980s bilaterals signed up to the conditionalities of the IFIs, although they still do this formally their role has increased partly with the development of political conditionality and partly as the policy dialogue processes have deepened. Although Sweden does not formally incorporate political conditionality into its PA agreements, it has applied it in several cases (Nicaragua and Zambia, and budget transparency linked to governance in Vietnam).
- *Bilateral donors have had little influence on the content of IFI programmes:* formal channels for influencing the IFIs appear not to work, and the informal ones are also weak.
- *The content of reform should not be entrusted to the IFIs alone*: traditionally bilateral donors have left the content of economic reform programmes to the IFIs. But there are problems of moral hazard in entrusting major creditors with the reform process, and evidence supports the idea that the IFIs can be hard or soft depending on a country's debt status. For these reasons, IFI documentation should not be the sole source of information – the Sida economic reports are a good example of an attempt to generate alternative viewpoints, although they don't always play this role. It is not being proposed that every donor should have their own conditionality, but that (1) to the extent that there is conditionality a broader process should be employed to

determine these conditions, and (2) that areas of policy debate rather than predetermining the outcome of the debate should be given more emphasis.

- *There has been a learning process on all sides*: bilaterals, the IFIs and governments have an evolving understanding of what is possible with conditionality.
- *Sweden's role in policy dialogue at the country level does not reflect what may have been expected from a "progressive donor"*: Sweden's involvement in policy dialogue has revolved around political conditionality, and there is no evidence of trying to put poverty more strongly on to the conditionality agenda at the country level (though it has been one donor doing this through SPA).
- *Sweden has no explicit "influence strategy"*, that is, although programme aid and other related activities are intended to affect policy outcomes, this is not done in a clearly-articulated and systematic manner.
- *Sweden's influence is strongest where it has presence, and it seems well placed to assume a facilitating rather than directive role.*
- *Sweden's capacity for conducting the analysis required to support influence is often weak*

The last set of points suggest a policy conclusion as to the role Sida can best pursue in policy dialogue. The role of policy dialogue should be precisely that, to have a dialogue – it is virtually unknown for donors to acknowledge that government had a different, but ultimately legitimate, view. The most useful role donors can play is to support a process in which options are put forward and debated domestically. The "new consensus" on conditionality is that force will not work: you can change people's behaviour but you can't change their minds. Promoting debate is a way of changing minds and so ensuring deeper-seated reform. There will still be a role for formal conditionality, but it will not involve dozens of conditions each year. The focus should be mainly on process and a small number of benchmarks. **Sweden can play an important role in transforming conditionality drawing on its respected position in several countries and perceived independence from the IFIs**.

Chapter 4
Have reforms worked?

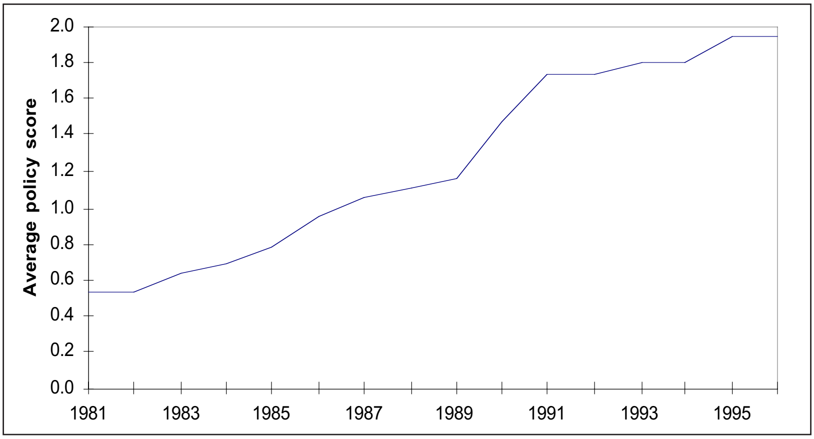
Since the 1990s virtually all developing countries have engaged in substantial reform towards market-led development. Analysis of the economic impact of these changes suggests three main results. First, countries operating a control regime performed significantly worse by most indicators than those with both partial and more complete liberalisation. Second, for many indicators there were no significant difference in performance between economies which were partially liberalised and those with a firmer market orientation. Finally, whilst some countries have experienced improved economic performance from liberalisation, other countries have failed to do so. The last two of these points, combined with the historical experience of East Asian countries (including Vietnam), suggest that policies are needed to complement the market. The 1990s have also seen political liberalisation, although this has been somewhat uneven. There is no straightforward relationship between opening up politically and economic success.

4.1 Policy change in Swedish programme countries

There has been a dramatic change in policy stance in virtually all developing countries over the last twenty years. At the end of the 1970s nearly all had a substantial degree of state intervention in the economy. Swedish aid was to an extent focused on some countries – Guinea-Bissau, Mozambique, Nicaragua, Tanzania and Vietnam – who had gone furthest in their attempts to establish a centrally planned economy. Today all these countries have introduced market-based economic reforms; the number of countries retaining Marxist-inspired central planning can be counted on one hand (Cuba, Burma and North Korea). What has been the nature of these policy changes and what have been their effects?

A review of policies in Swedish programme countries shows how far-reaching these reforms have been (see White and Leavy, 1999, a summary table from which is reproduced as Appendix 2). Price controls on virtually all goods have been abolished; exchange rates have been massively devalued and foreign exchange markets liberalised to varying degrees; the state has ceased to allocate credit and interest rates are now market-determined; quotas have been abolished and tariffs greatly reduced; there has been widespread privatisation, although it has come at the tail-end of reform and there has been rather less public sector reform; and most countries have introduced a substantial measure of fiscal discipline, though some achieved stabilisation and then lost it. A simple scoring system was applied to Sweden's programme countries and an average policy index calculated.[1] The result, shown in Figure 4.1, demonstrates a monotonic rise in the policy index, although a measure of state control remains in some countries, notably Vietnam and also to an extent Bangladesh.

Figure 4.1 Average policy score of Sida programme countries



The index shows its strongest rise in the 1980s, the rate of increase slowing as it neared its maximum possible value of two. But there have been some regional variations. Many African countries only began to implement sustained reform in the 1990s, although there have been a number of significant exceptions.

There is, then, no doubt that countries have undertaken major changes in economic policy. What has been the impact of these changes on performance? This debate has focused on aggregates such as growth and poverty, and the analysis here starts with growth. Given the inconclusive nature of this discussion it is necessary to go beyond that to look at regional and sectoral variations in response. Part of the analysis is based upon a control-group analysis of Sida programme aid countries, with annual values of performance indicators averaged across countries with the same policy score. These results are shown in Table 4.1.

[1] A score of 0 was accorded to heavily interventionist policies, 1 for some market-orientation (weak reform) and 2 for strong market-orientation.

Table 4.1 Economic performance for Swedish programme countries classified by policy index (median scores)			
	Controlled economies	Partially liberalised	Market-based
Growth	1.7	3.8	4.9
Inflation	30.2	13.0	11.8
Investment rate	15.3	21.8	21.4
Export growth	–1.1	4.9	7.8
Agricultural growth	3.4	3.1	2.9
Manufacturing growth	0.0	4.5	4.7

Note: The table is based on the median scores calculated across the period 1981–96. Each Sida country is awarded a score of 0 to 2 for each of the sixteen years (so that a country's score changes over time as it moves from one policy regime to another). *Source:* White and Leavy (1999).

The main result to emerge from Table 4.1 is the superior performance of market-oriented economies over non-market oriented ones.[2] But the degree of market orientation does not matter so much (i.e. strongly market oriented do not systematically perform better than relatively market oriented). For three of the indicators – inflation, investment and manufacturing growth – there is no significant difference in performance between partially and more fully liberalised economies, and for agricultural growth no difference across all three groups. Only in the case of export growth is there a marked difference in outcome between partially liberalised and market-based economies, there is also a smaller difference in aggregate growth performance.

4.2 Policy change and economic performance

Macroeconomic indicators

There has been much debate on how market-based reform affects growth. As for other aspects of policy analysis, there are four possible approaches: before versus after, control group, modelling and case studies.[3] The first two are the most extensively applied, but are unable to adequately cater for other factors. They do however describe what has happened and so can raise questions to be answered. This report thus uses a control group analysis as the starting point, before going into the story more deeply by drawing on material from the eight country case studies.

[2] Interpretation of these results cannot extract the role of external factors. World market conditions, when more economies had a score of zero, were less beneficial for growth than in the 1990s, when more countries had policies rating one and two.

[3] The before versus after method compares a performance indicator after the policy change with that before it, attributing the difference to the policy; the control group approach compares performance in countries with the policy in those without it; and modelling attempts to identify the determinants of performance. Case studies are detailed discussions of country experiences, often relying on narrative argument rather than formal testing.

The control group analysis for Swedish programme countries suggests that growth performance is significantly better in countries with more market-based systems: mean growth was 5 per cent in strong reformers compared to around 2 in those with no reform, and a similar result is obtained for the median.[4] Such results have also been obtained in several studies (e.g. World Bank, 1994), but a number of others (e.g. Eldawabi, 1992 and Mosley *et al*. 1995) find no significant difference – though there is no study which claims a stronger performance in non-reforming economies than reforming ones. There is thus some evidence that reforms improve performance, but it is far from conclusive. This lack of conclusiveness means that some caveats must be introduced to the view that reform is good for growth. The first is that reforms appear to have restored growth in some countries but not in others. Most notably, Zambia has not experienced GDP growth across the 1990s; but also Nicaragua and South Africa are experiencing only modest growth, and growth rates of Cape Verde and the South Asian countries are not appreciably higher than those from pre-reform days (indeed lower in the case of Cape Verde).[5] Since non-reformers mostly do less well, a safer general conclusion would be that reform is necessary but by no means sufficient for improved growth.[6] The second caveat is that the evidence supports reform away from heavily interventionist policies, but is far less clear as to the extent to which substituting state control with the market is the recipe for success. The problem is to identify the appropriate policy set for particular countries for particular points in time, rather than to label any given set of policies as "good" or "bad".

The search for the impact of reform on growth thus requires some unpacking of the story, by looking at the determinants of growth, and how these may be affected by reform. Regression models have been extensively used for analysing growth determinants, with policy measures frequently used as explanatory variables. A recent World Bank study on aid effectiveness argues that "the relationship between per capita growth and the economic management index reconfirms that sound management – at both the macroeconomic level and institutional levels – is important for growth" (World Bank, 1998: 33). But such results can be questioned on a number of methodological grounds (see Lensink and White, 1999), and the use of a policy index does not provide insights into either which policies are effective or the channels through which these effects may be felt. In particular, the evidence for macro stability seems good, but that in favour of full scale market liberalisation much weaker. An

[4] The median is used rather than the mean as the latter may be an unsatisfactory measure if the distribution is badly skewed. One reason for a skew may be the effect of countries suffering natural disasters or war. White and Leavy (1999) conduct the analysis for various sub-samples to exclude these exceptional cases, but there is no substantive difference to the results shown here.

[5] Such comparisons can be very sensitive to the periods chosen. A World Bank report demonstrated the success of reform in Cape Verde by noting "annual growth has averaged 4 per cent during 1992–96, compared to about 1 per cent between 1990–91"; but growth was close to 5 per cent for 1985–90. The Bangaldeshi and Indian economies show a modest rise, although this can look stronger (or in the Indian case also weaker) depending on the years chosen.

[6] A substantial caveat to this caveat is that South Asian countries (Bangladesh, India and Pakistan, and to an extent Sri Lanka) enjoyed reasonable growth before reform and that it has not improved since.

example is the much-cited Sachs-Warner openness index. There are several different measures of openness, which are only loosely correlated with each other and so yield different results, i.e. some show no link between openness and growth. Besides, the Sachs-Warner index is a composite of many different things, and a decomposition shows that it is not the trade policy part of the index which is correlated with growth (Rodrik, 1999).

Indeed, it is a striking result that there is no strong evidence in favour of liberalistion: that is not what is being measured there. The donor community tends to endorse the World Bank's view that "good policies" are required – but there is little theoretical or empirical support for the view that good policies should be equated with market-led development. At the theoretical level the rationale for the market does not extend beyond the efficiency gains explained in the basic model of perfect competition. But renewed attention is being given to issues of market imperfections and market failure, which undermine reliance on the price mechanism. At the empirical level, data to support these efficiency gains has never been strong and appear absent from the growth literature.

The regression results do support the view that the key determinants of growth – primarily investment in human and physical capital – are important for growth, as is macroeconomic stability (meaning reasonably low inflation). The analysis of the link between reform and growth should thus examine how these determinants have performed.

During the 1980s many countries experienced very high or hyperinflation: reaching 33,000 per cent in Nicaragua in 1988. These high levels of inflation have been brought under control, which is undoubtedly a prerequisite for growth. The relevant policy question today is not whether stabilisation was necessary but the extent to which it should be pursued. Regression analysis shows that growth has a non-linear relationship with inflation:

whilst high inflation <u>is</u> bad for growth, it is likely that once it reaches a certain level then further reductions in inflation may even be bad for growth. Empirical support for this view depends on how "a certain level" is defined:[7] Levine and Zervos (1993) find this effect with a cut off at 40 per cent (but the opposite if it is put at 80 per cent). The mechanisms by which excessive stabilisation damages growth are quite clear: deflation drives down demand for domestic output, and lack of investment in human and physical capital undermines the supply response. Some countries that have enjoyed a good response (Ghana and Sri Lanka) have done so by expanding spending at the same time as liberalisation, whereas in several countries (Zambia and Mozambique in the first part of the 1990s) it has been argued that spending limits have constrained growth. Uganda has recently persuaded the IMF to relax its spending limits, which many would agree is a necessary step to sustaining that country's growth.

[7] But the evidence for non-linearity is strong, Sala-i-Matin's (1997) definitive "2 million regression" paper finds no significant effect from inflation on growth using a linear specification.

Table 4.2 Recent regression results for determinants of growth of GDP per capita

	World Bank	Mosley *et al.*	White	Savvides	Ojo and Oshikoya	Easterly and Levine	Lensink and White	Easterly and Rebelo	Barro	Otani and Villanueva	Calamitsis *et al.*
Lagged growth/GDP	-ve	-ve	-ve	-ve	-ve	..	-ve	-ve	-ve	..	..
Investment	..	..	..	+ve	+ve	..	+ve	..	..	..	+ve[4]
Population growth	..	..	..	-ve	-ve	..	..	..	-ve	-	-ve
Human capital[1]	..	..	+ve	-	+ve	+ve	+ve	+ve	+ve	-	+ve
Inflation	-	-	-	-	-ve	..	..	..	-ve	..	-[5]
Growth of exports/trade ratio	..	..	..	+ve	..	..	..	..	..	+ve	+ve
Growth in government consumption	..	..	..	-	..	..	..	..	-ve	..	..
Fiscal policy[2]	+ve	-	+ve	..	..	+ve	..	..	..	..	+ve
Financial development[3]	..	..	..	-	..	..	..	..	..	..	..
Real exchange rate	+ve	+ve	-	..	+ve	..	..	..	..	..	+ve
External debt	..	..	..	..	-ve	..	-ve	..	..	-	..
External transfers	-	-	+ve	..	..	..	+ve	..	..	..	..
Terms of trade	-	-	+ve	..	..	..	..	..	+ve	..	+ve
Political freedom	..	..	..	+ve	..	..	..	..	+ve	..	+ve
Conflict/political instability	..	..	..	..	..	-ve	..	-ve	..	..	-ve
Domestic Savings Ratio	..	..	..	..	..	..	..	..	..	-	..
Sustained adjuster dummy	..	..	..	..	..	..	..	..	..	..	+ve

Key: +ve significant positive effect; -ve significant negative effect; - insignificant; .. not included in regression. Notes: dependent variable is growth turnaround for first three studies and growth for the remainder; (1) including health and education indicators, see papers for definitions of variables; (2) measure of fiscal balance and revenue collection, +ve indicates deficit is harmful for growth; (3) Ratio of quasi liquid liabilities of the financial system to GDP; (4) public and private investment included separately and both significant; (5) regression also includes standard deviation of inflation, which is also insignificant. *Sources:* Calamitsis *et al.* (1999), Mosley *et al.* (1995), Ojo and Oshikoya (1995), Savvides (1995), White (1997), World Bank (1994), Easterly and Rebelo (1993), Easterly and Levine (1997), Otani and Villanueva (1990), Barro (1997), Lensink and White (1999).

Sustained growth requires investment in both physical and human capital, and both of these can be adversely affected by spending restrictions. Having said that, the picture with respect to social spending in adjusting countries is mixed – and it is clear that the largest falls were experienced during prolonged economic decline under the control regime. But many Sida programme countries, especially in sub-Saharan Africa (SSA), have low levels of human development. Illiteracy in SSA is over 40 per cent (over 50 per cent for women), no country has achieved development or sustained growth with literacy at such levels.

Evidence shows that government capital expenditure is likely to suffer most when spending is under pressure. Tanzania and Zambia are clear examples of this fact: in the former the development budget's share of expenditure fell from over 20 to less than 5 per cent during the 1990s. In Zambia non-interest expenditure has fallen as a per cent of GDP in response to application of the cash budget and the out-goings of many ministries are almost wholly consumed by wages and related payments. Non-wage recurrent costs are also being squeezed. Such a tendency accentuates the decades of under-investment in key productive capital, again especially in SSA where infrastructure remains woefully underdeveloped. The slowness, or simple failure, of a private investment response means that the bulk of any rise in investment will come in the first instance from the public sector – as was the case in Sri Lanka following liberalisation and has been so for Nicaragua and Uganda more recently. The predominance of public investment can be justified since it can stimulate private investment in several ways (known as "crowding in"), such as creating demand and the provision of infrastructure. The importance of improved infrastructure for the agricultural supply response is commonly stressed, and confirmed in the country studies from countries with as diverse experience as Vietnam and Zambia. But it also matters for manufacturing: a survey of the private manufacturing sector in Uganda found that firms lost on average 90 days a year owing to power cuts. It seems that many years of reform are required to restore confidence for private investment to take place on a substantial scale (particularly in activities with a long-term return), especially foreign investment. Both Uganda and Vietnam have enjoyed enlarged inflows, including from ex-residents who are re-investing. But these two examples follow on from ten years of sustained reform (and had the overseas communities to support such investments), so that other countries cannot be expected to follow down this track so readily. (Cape Verde has encouraged such investment, but lacks investment opportunities and Nicaragua tried unsuccessfully to do so in the early 1990s).

A more positive picture emerges with respect to exports, for which Table 4.1 suggests that stronger reformers have markedly better export performance.[8, 9] This is a finding in much of the literature, including studies in general

[8] Rodrik's point should be noted that exports are just a means to an end. It is imports that matter for growth, not exports *per se*.

[9] Good export performance has not necessarily been accompanied by reduced current accont deficits, since high capital inflows (including aid) mean that such deficits persist. More worrying is that external debt remains high in most countries, and has been reduced in the 1990s only in Nicaragua.

somewhat critical of adjustment (e.g. Mosley *et al.*, 1991). There is a strong tradition of export-led growth in East Asia and considerable debate over what is necessary for other countries to emulate this experience. The World Bank (1993) has argued that macroeconomic stabilisation and an open economy are the key messages from East Asia's success. Many commentators, and Asian governments, disagree (e.g. Amsden, 1989 and Rodrik, 1999), pointing to the role that strategic intervention has played. It may be responded that the Asian crisis has exposed the corruption and inefficiency which underpinned the close-knit network of government and financial institutions – but the current crisis will not reverse the decades of rapid growth and social improvements which these countries have experienced. In various of the countries studied there has been export growth in both manufacturing and agriculture. This growth has undoubtedly come about from liberalisation, but this is not always the whole story. One of the most remarkable successes, that in the Bangladeshi garment sector, was achieved also with the help of subsidised credit, duty drawback and bonded warehouses. In other cases, notably Mozambique and Uganda, the response is a result of peace, and in most cases agricultural output remains strongly wedded to fluctuations in the weather.

Finally, mention should be made of the debt burden which remains high. Of the eight countries studies, total external debt has fallen only in Nicaragua – which has received extremely substantial debt relief – in all other cases it has risen. Much of this debt is to the IFIs, and the need to start servicing these debts is one reason why debt service payments will not decline greatly, if at all, even for those countries completing HIPC.

An examination of main determinants of growth thus throws some light on the mixed picture that was found. A stable macroeconomic environment is important, but excessive zeal in pursuing stabilisation may be detrimental where lack of investment is a binding constraint on the supply response. There is also, especially in Africa, a need to build up the stock of human capital for sustained growth to be achieved, and this is not something which reforms can achieve in the short-term (and in some cases may even harm).

In addition to the level of growth, the pattern of growth is also important, especially in regard to growth's impact on poverty. The pattern of growth can be considered in various ways: across income groups, occupations, regions or sectors. Unfortunately data are not available on many of these. Regarding the first, distribution may be expected to worsen in liberalising economies, and available data show greater inequality in Africa in the 1990s than 1980s. Data not often available are economic activity at the regional level – Vietnam is an exception in this regard, and probably also exceptional in that output growth has been spread across all regions (although most rapid in Ho Chi Minh City and neighbouring Van Tau province). More generally it is likely that current centres of economic activity have grown fastest and that remote communities remained least well placed to benefit from economic liberalisation. In some cases, such as Uganda and Sri Lanka, these regional differences also stem from localised conflicts.

Data are available on sectoral patterns of growth, where the general pattern has been a declining share for agriculture and a growing one for the service sector.[10] For example, of 27 per cent aggregate growth in Bangladesh in the period 1991–97, 17 per cent came from the tertiary sector and only 4 per cent from the primary and in Cape Verde services contributed over 100 per cent of growth from 1991–97 as the agricultural sector declined; in Uganda agriculture's share of GDP fell from 40 to 26 per cent from 1985 to 1997, whilst that of services rose from 33 to 43 per cent. This pattern of growth can partly be explained by the suppression of the tertiary sector under the control regime. But financial liberalisation also plays a role, as this policy tends to increase the share of lending to commerce at the expense of the productive sectors. For example, in Uganda agriculture's share of commercial credit fell from 26 to 16 per cent from 1988 to 1996, whilst that of commerce rose from 22 to 38 per cent. Such trends may be regretted as agriculture remains the source of income for a large share of the population in developing countries.

Agricultural supply response

Agricultural price liberalisation has been the first stage of economic reform in many countries. The evidence for a supply response is mixed, with no apparent difference in performance according to a country's policy stance (Table 3.1). Some countries have seen little or no response from the agricultural sector. More usually there has been a response from some crops but not others. Few countries – of which the most notable is Vietnam, but also including Uganda – have seen growth across the bulk of the agricultural sector. It is not the case, as is sometimes claimed, that the response is only in export crops. Although rice exports have grown at close to 50 per cent a year in Vietnam (turning the country from a rice importer to the world's second largest exporter), this is also of course the main staple. In both Tanzania and Mozambique food production has risen, with a corresponding sharp decline in the absolute value of food imports. Where there has been a supply response this has been helped by the cessation of conflict (particularly Mozambique and Uganda). A summary of the experience of Swedish programme countries bears out this general picture of a mixed, but generally uninspiring, response (Table 4.3).

[10] Nicaragua is an exception to this general picture, with the primary sector growing fastest and the secondary ranked next (the contributions to growth of the three sectors are not, however, greatly different from one another).

Table 4.3 Agricultural supply response in Swedish programme countries

Country	Response
Africa	
Angola	None
Botswana	Weak: none in food crops but some in export crops (meat products, food and tobacco)
Cape Verde	Very weak
Eritrea	Weak, some in food crops
Ethiopia	Moderate to strong, with growth in coffee production
Guinea-Bissau	Weak, uneven in export crops
Kenya	Moderate to strong, notably tea and horticultural products
Mozambique	Moderate to strong response across range of crops (especially since end of war)
Namibia	Weak: none in cereals and uneven in livestock
South Africa	Weak, mainly in maize
Tanzania	Strong in food and some export crops (but not others)
Uganda	Strong, particularly in export crops (coffee, cotton, tobacco and horticultural) and less so for food crops
Zambia	None in main crop (maize), but some in tobacco and horticultural products
Asia	
Bangladesh	Moderate, becoming strong for some export crops in 1990s
India	None
Laos	Weak, none in main crop (rice), some in cotton and coffee
Sri Lanka	Mostly weak though improved in tea in 1990s
Vietnam	Strong across all regions and most crops
Latin America	
Nicaragua	Strong since 1993, particularly in export crops

Source: White and Leavy (1999).

These differences are due to the fact that it is changes in relative profitability that matter to producers and that this may be little affected by price liberalisation for a number of reasons. First, there may be a rise in the general price level as price controls are relaxed and as a result of devaluation, so that output price does not rise relative to that of consumption goods. This effect is not likely to be that strong where rural residents have not benefited greatly from price controls on consumer goods. Second, profitability may not improve if input costs also rise, as they will if input subsidies are removed, and devaluation raises the cost of imported items (such as fertiliser or its component parts). Third, there may be constraints that the market is ill equipped to deliver, or does so at a higher than optimal cost, such as credit or extension services (or these services are available to men rather than women who are responsible for the bulk of production). The failure of the private sector to take up maize marketing in Zambia is an example of this. In Bangladesh and Vietnam the state has played an important part in supporting rural finance, but there are other countries in which, partly at the behest of donors, this support has not been provided. Fourth, increased margins may not be sufficient after liberalisation if there are substantial transaction costs, so that the higher price is absorbed by intermediaries. Finally, women do the bulk of agricultural work in many countries (e.g. 80 per cent in Uganda on traditional export crops and 60 per cent on non-traditional ones; in Nicaragua the figure is 65 per cent for the sector as a whole). Since they already work for 12–16 hours, or more, they have little time for additional production. Women may also make production decisions based on food security rather than marketable surplus – so that they were resistant to vanilla in Uganda. Finally, world prices for many products have been weak in the 1990s, off-setting gains which may otherwise have been realised by liberalisation.

These arguments add up to a strong case that price liberalisation will not be sufficient to ensure a substantial and widespread affect though it may enable a more concentrated one in some high value crops. Evidence on the need for complementary investments is particularly strong in Africa, where roads per square kilometre are less than one-fifth those in India four decades earlier (when India had comparable population density to SSA today). Irrigated cropland in tropical Africa is one-tenth what it was in India in the 1950s (Hayami, 1997: 94–95). Transport costs add 30 per cent to the price of coffee, cotton and sugar exports from Uganda if they go by land and twice that if they go by air, compared to an export tax of only 1.3 per cent. Improving infrastructure, not further tariff reform, is the way to improve incentives to Ugandan farmers (Milner *et al.*, 1998). Africa has not experienced anything like the yield increases achieved in Asia following the Green Revolution; some commentators argue that such increases are achievable, but that the market will not deliver the necessary inputs and credit (e.g. Mosley, 1999).

Agricultural price liberalisation has been the first stage of economic reform in many countries. However, several arguments support the case that price liberalisation will not be sufficient to ensure a substantial and widespread effect on agricultural production. Photo Heldur Netocny/Phoenix.

Manufacturing

There has been considerable concern that reform will cause de-industrialisation. Clearly in some countries the manufacturing sector has been unable to withstand liberalisation – the most notable example being the effect of second hand clothing imports on domestic garment makers in Africa,[11] so that in some countries – Mozambique and Zambia – the sector as a whole has declined. But it is not clear that these changes constitute de-industrialisation; the point of adjustment, as the name suggests, is to move resources from less efficient uses to more efficient ones. Closing down inefficient enterprises is part of this process. The sector as a whole may decline if resources are re-deployed to agriculture or services, or experience a J-curve if recovery takes some time.

The data do in fact show stronger manufacturing performance in reforming economies than non-reforming ones. There are some notable areas of success, such as garments in Bangladesh and Sri Lanka – both of which had vigorous export promotion policies. Vietnam has also enjoyed rapid manufacturing growth, as has Botswana (an African country which has combined relative openness with an industrial strategy). The Ugandan experience confounds the notion that the import-substituting sector necessarily experiences decline, though these have not been fully exposed to liberalisation of trade and finance.[12] Several other countries have experienced "growth spurts" in manufacturing as capacity utilisation picks up from the extremely low levels experienced under foreign exchange rationing. It can be questioned whether growth will continue after these initial spurts. Vietnamese manufacturing has, for example, enjoyed several years of high growth, but one well-informed observer suggests it is entering a period of cyclical slowdown (Fforde, 1997: 64). The structural weaknesses in the sector are generally recognised with disagreement as to whether the appropriate response is more state intervention (the government's view) or less (the donor's view).

Against this positive picture must be set the record of low, or even negative, growth in many countries, even after some years of reform. There has been large-scale retrenchment where state enterprises have been restructured prior to privatisation. In Vietnam over one million people were laid off from state enterprises in the early 1990s, though total employment has risen. In Zambia 20 per cent of employees have been laid off from privatised enterprises, and their employment prospects less rosy than those of their Vietnamese counterparts.[13] Some commentators, notably Lall (1995), have argued that these adverse consequences are not necessary, as firms could compete in an

[11] Which is not to say that such imports should be prohibited as the welfare effects of affordable clothing are substantial.

[12] Some import-substituting sectors have declined, notably textiles and garments, but large increases have been recorded in chemicals, steel and steel products, plastic products and vehicle accessories.

[13] Studies of retrenchees have suggested that most gain re-employment in a growing economy, whereas this is far less likely in one with weak growth, such as Zambia. The skilled are more likely to find employment that the unskilled (Sahn *et al.*, 1997: 164–180).

open economy if given the time to adjust in the context of a selective industrial strategy. In a modern restatement of the infant industry argument, Lall argues that firms need to develop their technological capability. The Zambian Chamber of Commerce and Industry has been making similar arguments since the early 1990s. Failure to allow such restructuring will condemn the economy to collapse of the manufacturing sector to the detriment of overall growth performance.

Poverty

The debate on the poverty impact of economic reform is complicated by the frequent absence of comparable data for income-poverty measures. In Uganda, where as thorough an analysis as the data will permit shows a fall in the headcount from 56 to 46 per cent, poverty trends remain disputed. One study for Tanzania showed a comparable decline from 65 to 51 per cent from 1983 to 1991, although this comparison is almost certainly problematic. An alternative is to resort to social indicators, though these show a general upward trend for factors largely unrelated to economic reform, although in some cases a combination of conflict, HIV/AIDS and prolonged decline have brought about stagnation or even reversal (e.g. Uganda, Zambia and Zimbabwe). As with growth, it is helpful to explore more closely the channels through which reform may affect poverty.

There are several channels through which reforms can affect poverty. The one most commonly highlighted is that of growth. There is no disagreement that growth is necessary for sustained poverty reduction. Rather, debate focuses on what, if anything, should be done to ensure that the poor benefit from growth.

The poverty elasticity is an indicator of how responsive poverty is to growth. Table 4.4 uses available estimates for Swedish programme countries to calculate the growth required to reduce the absolute number of poor: in five of the nine cases growth is insufficient. This result may understate the problem, since the calculation assumes distribution to be constant, whereas the small amount of available evidence suggests distribution to be worsening. In SSA as a whole the Gini coefficient rose for 0.44 to 0.47.[14] It is estimated that the Gini in Vietnam rose from 0.30 to 0.34 in the decade from 1984 (Dollar and Litvak, 1998). At current growth rates, distribution needs to improve if poverty is to fall. But instead distribution is worsening.

[14] The Gini coefficient is a measure of inequality, ranging from zero for perfect equality to one for extreme inequality.

Table 4.4 Growth required to reduce the absolute number of poor

	Elasticity	*Population growth*	*Growth (1990–96)*	
			Required	*Actual*
Bangladesh	–2.9	1.7	2.3	4.4
Botswana	–0.9	3.1	6.5	5.9
India	–0.8	1.8	4.1	5.7
Kenya	–0.9	2.7	5.7	2.7
Sri Lanka	–2.9	1.3	1.7	4.3
Tanzania	–0.6	3.0	8.0	..
Uganda	–0.8	3.2	7.2	7.0
Zambia	–0.2	3.0	18.0	–0.4
Zimbabwe	–0.9	2.5	5.3	2.0

Source: elasticities from Jayarajah *et al.*(1996) and other data from *World Development Indicators.*

The original view from the World Bank was that reform would improve distribution by eliminating urban bias by shifting the internal terms of trade in favour of agriculture, reducing the explicit and implicit subsidies enjoyed by the better off and putting an end to rent seeking. Models estimated for four African countries by a team from Cornell seemed to bear out this view: the urban non-poor gained least from reform, in fact experiencing large falls in income in three of the four countries (Sahn *et al.*, 1994). The reality is obviously somewhat different, and even the most non-observant visitor to a liberalising economy will see how it creates a class of "new rich" who are obviously extremely wealthy by their country's standards. At the same time, large parts of the population, especially those living in off-road communities, and vulnerable groups such as the sick and disabled, are in no position to benefit and are, at best, by-passed by growth. Even in a country with such rapid growth as Vietnam critics argue that the position of vulnerable groups is actually worsening. It is clear that the benefits of growth are not being equitably shared.

If poverty reduction is to be achieved there is a need for additional policies, to both directly alleviate poverty reduction and to draw the poor into the growth process. Investment in human capital and ensuring access for the poor to these services is clearly one area of policies. Donors have paid attention to protecting social spending in some countries – such as the condition in Zambia that social spending should be 34 per cent of the total, though they have not done so in all cases (e.g. Nicaragua). However, the experience of social spending in reforming countries is mixed. It is not generally so that it has fallen, and in several cases (e.g. Zambia) it can be shown to have been protected during expenditure cuts. In other growing economies such as Uganda and Vietnam social spending has claimed a growing share of expenditure. But real spending may have been stagnant – e.g. in Zambia where the share has risen – and so spending per capita fallen. Moreover, in many countries resources remain heavily skewed toward services used mainly by the better off. With better targeting and quality improvements there is great scope for improving service provision to the poor. Access is also increased by investment in infrastructure, which has already been mentioned in relation to agricultural supply response. Remoteness is a strong correlate of poverty; reducing remoteness opens up opportunities.

Social Funds (SFs), or their equivalent, have been set up in many countries with the intention of protecting the poor from any adverse consequences of adjustment. In practice they have been more generalised project windows which have tended to be poorly targeted, often in part because of political interference (e.g. the early years of FISE in Nicaragua). SFs are usually autonomous agencies, which may have appeared desirable when they were intended to run for a few years at most, but clearly create problems once they are given an indefinite lease of life. The Funds continue to rely on donor support, though it may be expected that they will be supplanted over time by the move to the sector approach.

Asset redistribution is believed by many to enhance both growth and poverty reduction. However, the current trend in reforms is in the opposite direction, as the introduction of land markets results in the privatisation of common property resources and ends inter-generational re-distributive measures. Evidence suggests that the substantial redistribution of land, which occurred in Nicaragua in the 1980s is being reversed in the 1990s. Re-distributive land reform has not been proposed in policy dialogue, although market liberalisation has.

4.3 Governance and political reform

Following somewhat later than economic reform, there has been dramatic political change in many, but not all, countries. Table 4.5 reports the political rights and civil liberties ratings produced by the US body Freedom House. These ratings range from one to seven, with one representing the highest degree of political freedom.[15]

Four observations may be made with respect to these indicators: (1) both indices have improved across time; (2) the improvement is most marked with respect to political rights, showing sharp increases with the start of democratic elections (e.g. Cape Verde in 1990–91 and Zambia the following year); (3) some recipients of Swedish PA have continuing poor performance, notably Angola and Vietnam; and (4) some countries have witnessed reversals, notably Zambia and to some extent Nicaragua.

[15] Any rating system such as this will be subject to criticism with respect to individual cases. The country case study for Vietnam argues that political structures are more representative than they appear on the surface.

Table 4.5(a) Political liberalisation indicators (ranks 1 to 7): political rights											
	88-89	*89-90*	*90-91*	*91-92*	*92-93*	*93-94*	*94-95*	*95-96*	*96-97*	*97-98*	*98-99*
Angola	7	7	7	6	6	7	7	6	6	6	6
Bangladesh	4	4	5	2	2	2	2	3	2	2	2
Botswana	2	1	1	1	1	2	2	2	2	2	2
Cape Verde	5	6	5	2	1	1	1	1	1	1	1
Ethiopia	6	7	7	6	6	6	6	4	4	4	4
Guinea-Bissau	6	6	6	6	6	6	3	3	3	3	3
India	2	2	2	3	3	4	4	4	2	2	2
Kenya	6	6	6	6	4	5	6	7	7	6	6
Mozambique	6	6	6	6	6	6	3	3	3	3	3
Namibia	–	4	2	2	2	2	2	2	2	2	2
Nicaragua	5	5	3	3	4	4	4	4	3	3	2
South Africa	5	6	5	5	5	5	2	1	1	1	1
Sri Lanka	3	4	4	4	4	4	4	4	3	3	3
Tanzania	6	6	6	6	6	6	6	5	5	5	5
Uganda	5	6	6	6	6	6	5	5	4	4	4
Vietnam	6	7	7	7	7	7	7	7	7	7	7
Zambia	6	6	6	2	2	3	3	3	5	5	5
Zimbabwe	6	6	6	5	5	5	5	5	5	5	5
Average	5.1	5.3	5.0	4.3	4.2	4.5	4.0	3.8	3.6	3.6	3.5

Source: Freedom House website (www.freedomhouse.com).

Table 4.5(b) Political liberalisation indicators (ranks 1 to 7): civil liberties											
	88–89	*89–90*	*90–91*	*91–92*	*92–93*	*93–94*	*94–95*	*95–96*	*96–97*	*97–98*	*98–99*
Angola	7	7	7	4	6	7	7	6	6	6	6
Bangladesh	5	4	5	3	3	4	4	4	4	4	4
Botswana	3	2	2	2	2	3	3	2	2	2	3
Cape Verde	6	5	5	3	2	2	2	2	2	2	2
Ethiopia	7	7	7	5	4	5	5	5	5	5	4
Guinea-Bissau	7	6	5	5	5	5	4	4	4	4	5
India	3	3	3	4	4	4	4	4	4	4	3
Kenya	6	6	6	6	5	6	6	6	6	6	5
Mozambique	7	7	6	4	4	5	5	4	4	4	4
Namibia	–	3	3	3	2	3	3	3	3	3	3
Nicaragua	4	5	3	3	3	5	5	4	5	5	5
South Africa	6	5	4	4	4	4	3	2	2	2	2
Sri Lanka	4	5	5	5	5	5	5	5	5	4	4
Tanzania	6	6	5	5	5	5	6	5	5	5	4
Uganda	5	4	5	6	5	5	5	4	4	4	4
Vietnam	7	7	7	7	7	7	7	7	7	7	7
Zambia	5	5	5	3	3	4	4	4	4	4	4
Zimbabwe	5	4	4	4	4	5	5	5	5	5	5
Average	5.5	5.1	4.8	4.2	4.1	4.7	4.6	4.2	4.3	4.2	4.1

Source: Freedom House website (www.freedomhouse.com).

The question of the extent to which the donor governance agenda has influenced policies was touched upon in the last chapter. It was argued there that the experience is mixed. Whilst it is undoubtedly the case that donors pay attention to these issues in a way they did not in previous decades, there continue to be discrepancies in their behaviour (Vietnam is favoured despite the absence of democracy and the no-party system tolerated in Uganda, whereas Zambia is penalised for perceived shortcomings in democratic processes). Application of these conditionalities has sometimes yielded results and sometimes not: Zambia illustrates both cases, with the government resisting donor pressures not to effect changes to the constitution, but giving way to specific demands in 1998 on activities in the wake of the coup attempt of the previous year.

The deeper issue than the extent of reform is the appropriateness of the donor agenda in this area. A first question is whether the political systems being developed are the right ones. As with economic policy, there has been a substantial shift in donor thinking. In the 1970s donors accepted one party states and arguments that African political systems were not compatible with Western style democracy, having their own systems of representation. But during the 1990s the position is strongly held that the Western system should be emulated. One reason for the change in donor thinking is the view that open government is a prerequisite for sustained economic development. This view seems to fly in the face of evidence of long periods of growth under undemocratic governments (which then become subject to democratic pressures). A review of the literature on economic and political liberalisation suggests that no simple statements can be made as to causality in either direction. The case studies bear this position out: Zambia is more democratic than Uganda, but the latter flourishes whilst the former has stagnated. The most rapidly growing country, Vietnam, is the least democratic. These examples are not cited to suggest that political liberalisation is wrong – it can be important in its own right – but that to indicate that it is not the panacea for poor growth performance.

4.4 Concluding comment

The evidence presented in this chapter suggests that market-based adjustment has resulted in some improvement in performance. But it does not necessarily do so, and it does not appear that extensive liberalisation is better than selective liberalisation. Some parts of market-led development are beneficial for growth, but others less so and in some settings may even be harmful. These findings are consistent with the newly emerging "post-Washington consensus" and with the views recently expressed by two of the currently most influential economists writing on development issues. Rodrik has stated that:

> *Countries that have done well in the postwar period are those that have been able to formulate a domestic investment strategy to kick-start growth and those that have had the appropriate institutions to handle adverse external shocks, not those*

that have relied on reduced barriers to trade and capital flow. The evidence from the last two decades is quite clear: the countries that have grown the most rapidly since the mid-1970s are those that have invested a high share of GDP and maintained macroeconomic stability… Policy makers therefore have to focus on fundamentals of economic growth – investment, macroeconomic stability, human resources and good governance – and not let international economic integration dominate their thinking on development (1999: 4).

Stiglitz has argued that

many of the most successful countries (representing the largest part of growth within the low income countries) have not actually followed the "recommended" policies… the Washington consensus failed [owing to] a failure to understand the subtleties of the market economy, to understand that private property and "getting the prices right" (that is, liberalisation) are not sufficient to make a market work. An economy needs institutional structure… Perhaps had [the East Asian] countries followed all the dictums of liberalisation and privatisation, they would have grown faster, but there is little evidence for that proposition" (1998: 5, 9 and 10).

The development strategy to be followed should not rely on the market alone. This position was argued strongly in the evaluation report for Cape Verde. The report for Vietnam suggested that donors should give more credence to the government's reasons for resisting liberalisation in all areas, and the issue arises in various ways in other reports. However, as the previous chapter documented, donors have moved toward supporting market-based development rather than away from it.

Chapter 5
The impact of programme aid funds

The substantial volume of PA transfers should be expected to have significant macroeconomic effects. Despite a sizeable literature on aid's macroeconomic impact, it is surprisingly difficult to measure these effects with any degree of certainty. The dominant gap filling view of aid is misleading (aid actually creates gaps) – a focus on the marginal impact of aid is more appropriate. A methodology for analysing marginal impact is proposed, which is rooted in an accounting framework. The analysis is focused on the external account, where a clear link between imports and debt service is established. It is also demonstrated how aid – and PA in particular – can help stabilise the economy, and evidence presented from the eight countries of where this has happened. Links from imports, lower debt service and stabilisation to higher growth are well established. Aid can also support government expenditures, but the pattern of that expenditure also matters for its growth effects. In line with the argument of the previous chapter, there has perhaps been too little in the way of complementary investments to enhance the prospects for pro-poor growth.

5.1 Introduction

What has been the direct impact of the SEK 7 billion of Swedish PA, and the many billions more of PA from other donors? That is, what have the funds been used for? This question may be addressed at both the micro and macro levels. At the micro level one can try to trace the use of funds. However, doing so is a useless exercise in the case of PA – as explained in Chapter 2, the documented "use" of the funds is often an accounting fiction, especially as systems became more liberalised – this is aside from the issue of fungibility. The use of PA funds can only be meaningfully addressed at the macroeconomic level. For example, how has the level and composition of imports been affected by the receipt of PA?[1]

[1] The answer to this question can only refer to total PA. The separate impact of Swedish PA cannot be sensibly addressed.

Section 5.2 introduces some broader conceptual issues, before moving to a presentation of the methodology in section 5.3. This methodology is applied to the external account (5.4) and some conclusions also offered on the internal account (section 5.5). Section 5.6 concludes.

5.2 Approach to the analysis

Two background points to the analysis deserve elaboration. This chapter begins by elaborating two points. First, the limitations of our knowledge are stressed: any attempt to determine causality using shaky data over a short time period in which there have been large structural changes can at best point to likely outcomes and contributory factors. Second, the irrelevance of the notion of "gap filling" is explained, with a digression on the important policy implications of the fact that aid is gap creating rather than gap filling.

The difficulty of saying anything

The macroeconomic analysis of aid has proven a difficult area to obtain firm results. The most common technique in the literature is regression analysis – a technique which attempts to "explain" variations in one variable by the variations in other variables. Typically, growth has been regressed on aid and some other relevant variables such as exports, investment and literacy. Although there are many problems in the approach (documented in White, 1992 and 1998) it remains the most popular, being used as the mainstay of the World Bank's recent work on aid effectiveness, *Assessing Aid*.

The World Bank report argued that aid could increase growth, but only when policies were right. The introduction of this focus on policies only serves to introduce additional problems, so that it is difficult to agree with the World Bank's findings on the basis of their econometric evidence (these arguments are elaborated in Lensink and White, 1999, see also Hansen and Tarp, 1999), although, as seen in Chapter 3, the evidence from the evaluation does support similar arguments.

The fact that the results from a large-scale World Bank research programme into aid effectiveness command weak support illustrates the difficulty of coming to firm conclusions in this area. Rather than the regression approach, the evaluation uses country-level studies which trace how programme aid has affected certain macroeconomic aggregates, such as imports and government spending, and thus infers an impact on growth. The evaluation team believe that this approach yields more robust conclusions. We would be the first to admit to some of the weaknesses in this approach, but believe that it allows us to say the most that can be said.

A final point to note here is that it has been argued in the literature (e.g. White, 1992) that the macro effects of different types of aid will differ – and this is of course the point of PA! In practice, however, it is often difficult to get accounts which allow the separate identification of PA. Where possible this has been done, but much of the empirical analysis remains at the level of aid as a whole.

Gap filling versus marginal impact

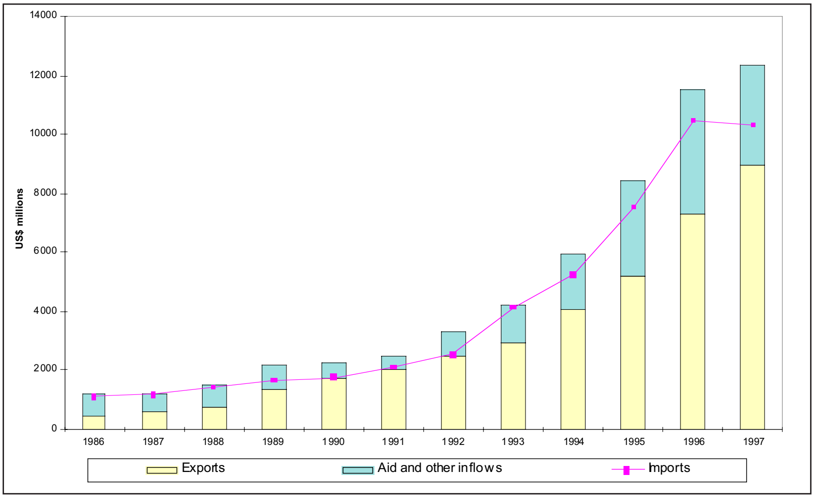
Much of the discussion of the macroeconomic impact of aid has been dominated by the two gap model and the notion of gap filling. Gap filling is not a useful way to conceptualise aid's macroeconomic impact, and should be replaced by an analysis of the marginal impact of the aid funds.

The two gap model has been a powerful force in the macroeconomics of aid, and the related concept of the financing gap has been important in programming programme aid. Yet many economists claim that there are no gaps. Here it is argued that, whilst it is so that there are no gaps in an objective sense, the idea of lack of aid being a constraint on growth (which was the motivation for the two gap model) can be defended. But the identification of those constraints means that the most important issue is the impact of aid on the aggregates which determine growth, so that this should be the focus of our analysis.

First it is necessary to remind ourselves of what the two gap model was. The core of the model was the Harrod-Domar equation in which capital accumulation is the sole constraint on growth. To grow a country needs investment. There are two constraints on investment:[2] investible resources, i.e. savings, and investment goods which have to be imported and so require forex. Hence there is a savings gap and a trade (forex) gap and aid can simultaneously fill both these gaps. But where is the "gap"? The gap comes from choosing a target rate of growth, which thus implies a required investment rate, which in turn implies a level of savings and a level of imports. If domestic savings are not sufficient there is a savings gaps, and if export earnings are insufficient there is a trade gap. The binding constraint is the larger of these two and aid will have to fill this larger gap if the target growth rate is to be achieved. Hence, and this is the important point, the gaps only exist with reference to a target rate of growth. In the words of the literature, the gaps are *ex ante* as the *ex post* (actual) gaps can only be what the aid allows them to be: if there were no aid there would be no gap. Aid is gap creating rather than gap filling.[3] In the absence of capital inflows imports must equal exports and so the gap will close through some sort of adjustment (either price or quantity).

Figure 5.1 illustrates this argument. Vietnam in 1992 had no current account deficit: imports and exports were equal.[4] The following year, when capital flows restarted, it had one of US$ 1.4 billion. Simply put, if aid is used to increase imports it will worsen the current account and if aid is used to increase government expenditure it will worsen the government deficit. It is not unusual to find statements bemoaning large deficits in countries with large aid inflows. But these deficits must appear by virtue of the fact of receiving aid.

Figure 5.1 Exports, imports and inflows for Vietnam



But the gaps created by aid may not only result in increased imports, investment and government expenditure. Other variables may adjust to accommodate the aid inflow. The accounting approach adopted in our analysis (see White, 1998) allows for the fact that other variables, such as exports and taxes may also be affected. Most variables which will be affected mean that aid will still have a gap creating effect (the exception being if aid is added to reserves).

A second caveat to this discussion is whether the current account and the government deficit is reported before and after grants (official transfers). This apparently technical distinction is of considerable practical importance, as Table 5.1 illustrates with respect to government expenditure.

Table 5.1 Impact of aid on government deficit with and without spending limits

	No aid	*Aid*	*Aid with spending limit on deficit before grants*
Revenue	60	60	60
Expenditure	80	100	80
Aid	0	20	20
Deficit (before grants)	20	40	20
Deficit (after grants)	20	20	0

The first column shows the government account in the absence of aid. Expenditure exceeds revenue by 20 units. In the second column there is an

[2] The seminal paper of Chenery and Strout (1966) also mentioned the "capacity to invest" but it was given lesser importance and ignored in most subsequent work.
[3] Of course, aid simultaneously provides the resources to "fill" the gap. But for concessional loans, a gap will appear in the external current account and the governments accounts (as it will in these accounts before grants for the case of grant aid).
[4] The small capital inflow in that year was offset by capital account outgoings.

aid flow of 20 units which is all spent. Expenditure rises by 20 units so that the deficit before grants (expenditure minus revenue) rises by the same amount, illustrating the gap creating nature of aid. The deficit after grants, which adds aid to the revenue side, is unaffected – which is a more accurate picture of the government's fiscal performance. It would be wrong to take the increase in the deficit before grants as an indicator of fiscal laxity, as it simply reflects the fact that the government is spending the aid it receives. If the spending limit is set with respect to the deficit before grants then the aid money cannot be spent. Suppose the aid flow comes in with a condition that the deficit before grants must not increase – hence expenditure cannot go up, nor revenue go down. The last column of Table 5.1 shows this situation. So what has happened to the money? The last line shows that the deficit after grants is zero, which tells us that the aid has offset deficit financing (and so had an anti-inflationary effect). This can be a useful role for aid to play, and is often the intended consequence of the countervalue from programme aid. But the same mechanism is at play with project aid in the presence of such a spending limit, meaning that if donor projects go ahead they are crowding out other expenditure choices of government. This issue has been much discussed in Mozambique – where the need for spending for reconstruction was felt to be great, but that IMF spending limits prevented donors financing this.[5]

The purpose of the two gap model of Chenery and Strout was to calculate aid requirements (and the allocation of that aid) to achieve 5 per cent growth. The two gap model may be criticised for being excessively structuralist[6] – in that case the model may be modified (or discarded and a new one built) but the original rationale remain intact. That is, we construct a macroeconomic model with aid flows as an exogenous variable, and for which higher aid delivers higher rates of growth. A base run of the model may tell us that without aid the economy would grow at 2 per cent, and simulations will allow us to determine the required level of aid to achieve a 5 per cent growth rate. This story may rather test our modelling capabilities, but the implication of the logic of the argument is that what we should be looking at is the marginal impact of aid on growth (and the channels through which this occurs) rather than the gaps.

Recasting our approach to aid also allows the incorporation of other ways in which aid can increase growth. The two gap model focuses on imports and investment, but a number of the country studies suggest that programme aid's link to growth does not come through this traditional route of supporting imports and investment, but by supporting stabilisation. Programme aid can help stabilisation by providing a non-inflationary form of finance and through its role in exchange rate management. In the case of the former, government does not use the aid to either increase expenditure or reduce taxes but to offset deficit financing. Alternatively, if the country has imposed a deficit cap (e.g. a cash budget, which does not allow expenditure to exceed revenue

[5] Within the last year the IMF has adopted a more flexible approach in some countries (e.g. Uganda).

[6] A structuralist economic model is one which accords little or no role to the market mechanism (prices).

collected) then programme aid will allow expenditure to rise without violating that rule.[7, 8] The question then is how to determine the ways in which aid has been used. It is to this issue that we now turn.

5.3 Analysing marginal impact: methodology

The economic impact of funds and policy is perhaps best judged through a modelling approach that allows for estimation of a counterfactual. Modelling was rejected at the outset for this evaluation. Econometric estimation of meaningful economic relationships at the required level of disaggregation is virtually impossible for the countries under consideration; certainly in the context of this evaluation, and possibly at all, given the frequency of structural breaks. This evaluation develops two approaches.

The first is an *ad hoc* approach which starts by identifying aid in a consistent set of internal (government finance) and external accounts (balance of payments). From that starting point a "no aid" counterfactual set of accounts is constructed. Chapter 1 rightly warned about the difficulties of obtaining the counterfactual. The analysis of the impact of funds is the area where this can be done with the most confidence, and the approach adopted here certainly gives some idea of the order of magnitude of aid's effects. However, precise behavioural functions cannot be identified. Where possible PA is separately identified, though this can rarely be done with any confidence. Throughout this evaluation the PA of <u>all</u> donors is considered, as it is not in general sensible to attempt to separate out Swedish aid.[9] This methodology was previously applied to Zambia by Mwanawina and White (1995) and Ghana by Sowa and White (1996). This evaluation thus extends the analysis to seven more countries, and updates that for Zambia.[10 a]

The second approach in this evaluation is to analyse the under-explored issue of the link between PA and stabilisation. This is a virtually new area of analysis, and the evaluation results are suggestive of the route that future methodological developments could take.

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[7] This point is the motivation for the third gap of the three gap model, though that model also requires the assumption of crowding in so that government spending can become the binding constraint on growth.

[8] However, there are two possible cases when this advantage of programme aid may not be realised: (1) if the deficit limit is set <u>before grants</u>, which has been the IMF norm, or (2) if budget support is disbursed after government has agreed an expenditure programme which made no allowance for the programme aid inflow (in which case revenue will fall if there is no deficit to offset). Under the Sector Programme approach, governments are expected to make multi-year expenditure plans whereas programme aid flows are uncertain – under such circumstances the inflow cannot be expected to result in incremental expenditures.

[9] The two exceptions to this statement are the discussion of modalities (Chapter 1) and in identifying a unique bilateral influence (Chapter 3).

[10a] The "SASDA studies" reported in White (1998) used the same accounting framework as a starting point, but did not attempt to construct counterfactuals.

The accounting framework and counterfactual accounts

We can analyse marginal impact in three areas: external account, internal account and government finance; the last being a sub-set of the second and the one which receives the greater attention. The starting point for the analysis is the accounting identity, which is summarised in the three columns in Table 5.2.

Table 5.2 Accounting identities for the analysis of aid impact

External balance	Internal balance	Disaggregated internal balance
+ Exports	+ Savings	+ Government Revenue
+ Official transfers		+ Private savings
+ Private transfers		
– Imports	– Investment	– Government expenditure
– Interest payments		– Private investment
Equals	*Equals*	*Equals*
– Long-term capital	– Long-term capital	– Long-term capital
– Other capital	– Other capital	– Other capital
– Change in reserves	– Change in reserves	– Change in reserves
– Errors and omissions	– Errors and omissions	– Errors and omissions
	– Official transfers	– Official transfers

The external account column shows the current account in the top half and the capital account plus financing (reserves) in the bottom half. With the exception that official transfers (OT) are added in the second two columns, the bottom half remains the same throughout, which is indicative of the link in accommodation of an aid inflow between the three accounts. This link will become apparent as we discuss each in turn.

Aid flows may be either grants (official transfers) or concessional loans, which appear in long-term loans. The balance of payments of most countries do not distinguish between concessional and non-concessional funds, so that aid cannot be identified exactly. However, for most low-income countries, the majority of long-term inflows will be aid (although short term and FDI, which are under other capital inflows, will be private). Hence the expression "aid" here refers to grants plus long-term capital. The capital inflows are shown in Table 5.2 in net terms. In practice our analysis will use gross inflows, and classify amortisation with interest payments as debt service (DS).

The first column of Table 5.2 could thus be written as:

$$M = AID + PCT - DS + X + OKI + \Delta R + EO \qquad (5.1)$$ [10b]

[10b] M Imports
PCT Private Capital Transfers
DS Debt Service
X Exports
OKI Other Capital Inflows
DR Change in Reserves
EO Error and Omissions

What this identity shows is that if aid increases then one of the other items in the identity must change. This change could be an equivalent increase in imports, but it may also be higher debt service, an increase in reserves (which is a negative DR), or reducing exports or other capital inflows (or EO may change if this captures capital flight). The identity we observe will be that once all effects have worked through – so whilst it is easier to think about first round effects, there will be second and further rounds (such as feedback through income effects) which will complicate the picture.

Table 5.3 Monitoring aid impact through the accounting identity

External balance		Internal balance		Disaggregated internal balance	
Aid	100	Aid	100	Aid	100
Equals		*Equals*		Equals	
Imports	60	Investment	50	Government expenditure	40
				Private investment	10
Debt service	20	Debt service	20	Debt service	20
OKI	–5	OKI	–5	OKI	–5
Reserves	–5	Reserves	–5	Reserves	–5
Exports	–10	Savings	–20	Government revenue	–10
				Private savings	–10

Table 5.3 shows one possible set of outcomes. Two points to note here are: (1) the table should be read as showing marginal impacts: that is higher aid of 100 results in an incremental increase in imports of 60 etc.; and (2) the signs show if a variable rises or falls (remembering that a negative sign on reserves is an increase in reserves) so that the items below the line don't add to 100, since those with a negative sign are being reduced to accommodate the aid inflow (but the absolute values do sum to 100).

The results shown here suggest that 20 of the 100 pays debt service (that wouldn't have been paid anyway), and five each reduce other capital inflows and the draw down of reserves. Exports fall by 10 on account of Dutch disease effects, leaving 60 to increase imports.

The 30 used for debt service, reserves and offsetting other capital inflows are common to all three accounts, thus providing a link between them. Given what was observed on the external account, we know that there are 70 units to be spread over higher investment and savings displacement (although the relative degrees of export displacement and higher imports do not necessarily correspond in their amounts, though the two will be linked through the behavioural equations which reflect the relative import intensities of investment and consumption). As shown here, investment rises by 50 and savings fall 20.

The same 30 units of course carry over to the disaggregated internal account, and in this case the changes in savings and investment must correspond to those observed in the public and private sectors. We see also in these accounts the reduction in the public sector deficit, which is the key to stabilisation (basically the countervalue from programme aid was used to finance expenditures that would have occurred anyway, thus allowing stabilisation to be achieved).

It may seem that the argument has been approached "from the wrong end", since the funds come to government, and so we should start with the disaggregated internal account and work from there. There is some merit in this argument, but it should not be over-stated for two reasons: (1) there is not an exact correspondence in the accommodation mechanism in the internal and external accounts (the mix of savings-investment and exports-imports adjustment can vary), and (2) the government decision making process is the first round effect. An important exception against this argument is where the aid is wholly or mostly used to pay incremental debt service, in which case there can be no other effects.[11]

Consider another example, starting this time with the disaggregated internal account. Suppose government decides to use an inflow of 100 to pay an additional 25 of debt service, not borrow 10 that it would have done from private sources and let reserves be 5 higher than they otherwise would have been. It further decides to increase expenditure by 40 and leave revenue unchanged.[12] Twenty (20) units are thus available to offset deficit financing, that is in the absence of aid there would have had to be a private surplus of 20 to transfer to the public sector which is no longer required, this can thus either allow private investment to rise or savings may fall. These figures may be translated directly to the aggregated internal account. To construct the external account, it is known that 60 are available to increase imports or reduce exports, but not the breakdown between the two.

An illustration: the case of Mozambique's balance of payments

The method used depends on (1) obtaining a consistent set of balance of payments data and from them calculating the course and uses of forex; (2) identifying major items which may be responsible for major changes; (3) observing behaviour in periods when there have been large increases or drops in aid, or before and after major step changes in aid; and (4) estimating a counterfactual sources and uses in the absence of aid. This procedure is illustrated with the example of Mozambique (Tables 5.4 and 5.5).

A first point to note is that arrears have been accumulated in every year except 1992, when they were reduced by $222 million. That year saw a large increase in debt relief (of $280 million compared to the previous year and $450 million higher than the following two years), and the settlement of arrears is directly attributable to this higher debt relief. Non-aid inflows in 1992 were not

[11] More accurately, there can be no other levels effects, there can be composition effects if donors use debt relief to influence the composition of government expenditure

[12] Since the aid inflow must affect the tax base there is unlikely to be any real world case in which the revenue effect is zero: this is the distinction between initial and final effects.

sufficient even to meet current debt service (without any imports at all) so domestic resources could clearly not have been used to settle arrears. If the country had received the aid actually received in that year apart from debt relief then, if all current debt service obligations had been met (not including the settlement of arrears), imports would have to have been cut to less than half that actual level, thus reaffirming the idea that arrears would not have been settled without this relief.

Table 5.4 Balance of payments ($ millions) (Mozambique)

	1991	*1992*	*1993*	*1994*	*1995*
Exports of goods, services, and income	365.1	362.0	371.7	395.4	470.5
Merchandise exports	162.3	139.3	131.8	149.5	169.0
Service exports	202.8	222.7	239.9	245.9	301.5
Imports of goods, services, and income	1211.2	1210.4	1321.2	1427.1	1254.2
Merchandise imports	898.8	855.0	954.7	1018.5	783.6
Service imports	312.4	355.4	366.5	408.6	470.6
Net current transfers	609.3	610.4	628.3	702.1	439.2
Official current transfers,	501.7	499.4	503.3	564.6	339.2
Official current transfers, payments	0	0	0	0	0
Official current transfers, receipts	501.7	499.4	503.3	564.6	339.2
Private current transfers, net	107.6	111	125	137.5	100
Current account balance	-236.8	-238.0	-321.2	-329.6	-344.5
Capital account	-187.5	-155.1	-107.0	-22.1	60.6
Foreign borrowing	144.1	169.8	185.5	260.3	282.3
Amortization	354.1	350.2	324.5	317.4	266.7
Direct investment	22.5	25.3	32.0	35.0	45.0
Short-term and EO	-33.6	-13.5	-8.1	10.4	-4
Overall balance	-457.9	-406.6	-436.3	-341.3	-287.9
Financing	457.9	406.6	436.3	341.3	287.9
Change in arrears	85.7	-222.2	177.8	161.3	233.4
Increase in assets	15.9	106.3	-13	58.4	69.1
Increase in liabilities	3.2	66.5	33.2	6.0	9.5
Debt relief	384.9	668.6	212.3	232.4	114.1

Source: country report.

Looking across the period, if all inflows (official transfers, borrowing and debt relief) were zero then available resources would never have been sufficient to meet the import bill, and would have in all years (but 1995) been less than, or close to, debt service. Thus, if there had been no aid then imports would have had to fall even if no debt had been paid. Of course it is more likely that the impact of not having aid would have been spread across both imports and debt service. To consider the respective impacts it is useful to look at the two years which have seen a large change in total aid flows: 1991–92 and 1994–95.

Aid rose by over $300 million from 1991 to 1992; this increase was mostly debt relief with a mild rise in borrowing and official transfers keeping the same level. The largest change in the uses of forex in this year was the settlement of arrears already discussed and debt relief also rose. Imports in fact fell slightly. It thus appears that the higher aid was used to finance both current and past obligations on debt and not on imports. This view is reinforced by consideration of the years 1994–95 when aid fell by nearly $350 million. Actual debt service (debt service minus arrears accumulation) fell by $60 million, but a far larger change was a fall in imports of $235 million.

Table 5.5 Sources and uses of forex (US$ millions) (Mozambique)

	1991	*1992*	*1993*	*1994*	*1995*
Sources					
Exports	365	362	372	395	471
FDI	23	25	32	35	45
Aid	984	1285	939	1015	672
Increase in arrears	86	0	178	161	233
Private transfers	108	111	125	138	100
Total	1565	1783	1646	1745	1521
Uses					
Imports	899	855	955	1019	784
Debt service	667	706	691	726	737
Payment of arrears	0	222	0	0	0
Total	1565	1783	1646	1745	1521
Memo items					
Actual debt service	581	706	513	565	504
As a percentage of total uses					
Exports	23	20	23	23	31
Official transfers plus borrowing	38	35	44	45	37
Debt service	43	40	42	42	48
Debt relief and arrears/debt service	71	95	56	54	47

Source: Table 5.4.

These considerations can be used to construct some tentative counterfactual scenarios for imports and debt performance in the absence of any aid (Table 5.6). The first two scenarios show two extremes: in the first, debt payments are slashed to 10 per cent of their actual level, whereas in the second all available resources are devoted in the first instance to meeting debt obligations. Even in the case when debt payments are more or less halted then, in the absence of aid, Mozambique would have had to halve the level of its imports in every year but 1995 – and arrears accumulation would have been over five times greater than actually occurred. If it attempted to meet all its debt obligations then imports would have had to be reduced to nothing (or close to it). The reality would be somewhere between these two extremes, which is captured by scenario 3. In this scenario the foreign exchange constraint is relaxed somewhat by allowing some borrowing and assuming improved export performance on account of the more depreciated exchange rate in the absence of aid. Nonetheless, imports are less 40–50 per cent their actual level of 1991–94, and 3.5 times as many arrears would have been accumulated than was actually the case.

Table 5.6 Counterfactual imports and arrears accumulation

			Imports			*Arrears accumulated*
	1991	*1992*	*1993*	*1994*	*1995*	*1991–95*
	US$ millions					
Scenario 1	437	428	477	511	565	3462
Scenario 2	0	0	16	3	112	1173
Scenario 3	264	163	386	405	533	2291
	As a per cent of actual					
Scenario 1	49	50	50	50	72	526
Scenario 2	0	0	2	0	14	178
Scenario 3	29	19	40	40	68	348
	Marginal impact					
Scenario 1	0.47	0.33	0.51	0.50	0.33	..
Scenario 2	0.91	0.67	1.00	1.00	1.00	..
Scenario 3	0.64	0.54	0.61	0.60	0.37	..

Source: calculated from Table 5.5.

The overall counterfactual indicates the importance of aid as an order of magnitude: what is the impact on imports of having no aid at all? The counterfactual results may also be used to calculate the marginal impact of aid on imports, i.e. how much do imports rise for a one dollar increase in aid?[13] These results are also shown in Table 5.6. Unsurprisingly, when the country is trying to meet its debt obligations (scenario 2) then there is a greater marginal impact on imports. By contrast, under scenario 1, since some aid goes to debt service there is a lesser impact on imports. The intermediate scenario suggests that typically a little over half of aid goes to finance higher imports – in the case of the Mozambique, most of the rest is going to pay external debt.

The data for this analysis come from national sources in the case of the countries in which fieldwork was undertaken, and international ones in other cases. The standard international sources, such as *World Development Indicators*,

[13] The marginal impact is calculated as the difference between actual imports and counterfactual imports, expressed as a ratio to total aid in that year. This formula gives the average propensity to import out of aid funds, which is equal to the marginal propensity for behavioural functions passing through the origin.

In the case of Mozambique a little over half of aid goes to finance higher imports most of the rest is going to pay external debt. Workers at the harbour in Beira, Mozambique. Photo A.F.P / Pressens Bild.

which it had been planned to use, were not much relied upon as some series were not available and the most recent year was too distant a date. Rather IMF and World Bank documents have been used in most cases, with some additional data from the Economist Intelligence Unit country reports.

As already mentioned, the analysis frequently has to be conducted at the level of total aid, rather than just PA. Since much PA is *de jure* free resources it may be expected to have a rather different impact to project aid, which can have varying degrees of fungibility. PA is less likely to result in incremental expenditure, especially where spending limits are restricting the utilisation of aid funds – and so more likely to offset deficit financing or be added to reserves. PA is also more likely to be linked to debt payment (and the analysis below is able to establish a link from debt relief to debt payment).

Stabilisation effects[14]

The Inception Report for this evaluation (White 1998), proposed to analyse the impact of programme aid flows on stabilisation by looking at the effect of this aid on the money supply, or high-powered money (see also Bruton and Hill, 1990). If all countervalue funds are spent by the government, the budget deficit remains the same as does the money supply, while the deficit falls if not all countervalue is spent (Table 5.7). And if all programme aid is used for imports (or capital flight) the money supply will remain the same, while it will increase if part of the aid money is added to reserves. Depending on these two dichotomies, there are four scenarios. Programme aid may be inflationary, deflationary or neutral (if positive and negative effects cancel each other out).

[14] This section was written by Geske Dijkstra.

All this of course assumes that budget deficits cannot be financed in non-inflationary ways, for example by borrowing on the domestic capital market or by other external capital inflows. Out of the eight case study countries, only in Bangladesh is the domestic capital market sufficiently developed for domestic borrowing to be possible. In one other case, that of Nicaragua, private capital flows played a role in financing the deficit but only since 1997 (see also below). In the other countries, and in Nicaragua before 1997, it is realistic to assume that if deficits come about that cannot be financed by aid (but see below), they will be monetised.

Table 5.7 Effect of counterpart funds on high-powered money

		Reserves	
		Constant	Increase by value of CF
Government deficit	Falls by value of CF	Decrease by CF (Scenario A)	No effect (Scenario B)
	Constant (all CF "spent")	No effect (Scenario C)	Increase by CF (Scenario D)

Note: CF is counterpart funds; government deficit includes receipt of CF as a plus item.
Source: based on Bruton and Hill (1991: 31, Table A).

Apart from this qualification, there are two major problems with establishing the stabilisation impact according to the above framework. First, the relation between money supply and inflation is more complex than the simple quantity theory of money assumes. The well known equation of the quantity theory of money holds:

$$M\,v = P\,Y \tag{5.2}$$

where M is the money stock, v the income velocity of money, P the price level, and Y (national) income. It has been shown that in the long run, there is a positive relationship between M and P (as is the central thesis of the monetarists). However, in the short run, equation (5.2) should be read as a behavioural equation. The relation between M and P only holds if v and Y are constant. If programme aid results in a lower v, that is, a higher money demand, an increase in M does not necessarily lead to a higher P. The overall effect of programme aid on inflation reduction may then be positive, even if the stock of money increases. (Note: the same happens if Y increases more than M). It is shown below that one of the likely positive contributions of programme aid is precisely to increase demand for domestic currency.

A second problem is that of establishing whether countervalue funds (or budget support) leads to *additional* expenditure, and whether programme aid leads to *additional* imports. In many cases this is not the relevant issue for the stabilisation impact. On the external side, all countries in our evaluation now have a liberalised foreign exchange market. Programme aid will then just add to the supply of foreign exchange. The private sector decides on the use of this foreign exchange. There is no explicit government decision making involved. Of course, the Central Bank usually targets for a certain *stock* of foreign reserves. But it can be assumed to do this anyway, irrespective of the origin of the supply of foreign exchange.

The analysis with respect to government expenditure is in one aspect similar, and in another, different from the analysis of the external accounts. It is different in that there is explicit government decision making on all expenditure. But it is similar in that programme aid just adds to government revenues, albeit that part of it may be earmarked to specific expenditure. Whether or not conditions are set for the use of the countervalue (or for the budget support), or whether or not debt relief is given for debt payments that would have been made anyway, will determine whether or not programme aid leads to additional expenditure. If there is equivalent additional expenditure the impact of programme aid on stabilisation will be neutral, but if there is a less than one-for-one impact on expenditure the stabilisation impact will be positive since the budget deficit will be reduced.

However, this reasoning assumes that governments are not committed to avoiding inflationary financing of the deficit, or, even more generally, that they do not target for certain levels of expenditure, revenues, or the deficit. Some of our countries studied, however, apply a cash budget (Tanzania, Uganda and Zambia), and others are supposed to stick to expenditure limits (Nicaragua and Mozambique). In these countries the stabilisation effect does not depend on whether or not conditions are set for the budget support. In the presence of these conditions, budget support may replace (or "crowd out") "own" government spending, as donors have been well aware in Mozambique. There is no impact on the money supply or stabilisation, but there may be a growth effect depending on the type of spending that increases as compared to the spending that is crowded out.

However, if governments are committed to not having inflationary financing of budget deficits, the stabilisation effect of programme aid does depend on another characteristic of it, namely its *predictability*. If the government knows the amounts of (programme) aid in advance, programme aid can be taken as part of revenues, and expenditure can be planned in accordance with this total income. A sudden fall in programme aid will either lead to inflationary financing or to *ad hoc* cuts in spending, which are probably not welfare enhancing. A sudden increase in programme aid is less harmful from a stabilisation point of view, but may be equally bad for growth since *ad hoc* spending decisions will not enhance the best use of resources.

So what then *is* the impact of programme aid on stabilisation? Programme aid may have three different effects; two through the external accounts and one through the internal account. In the first place, it allows more imports than would otherwise have been possible. In an inflationary economy, i.e. an economy where demand tends to exceed supply, the increased imports have a dampening effect on the domestic price level. This effect is reinforced if the exchange rate is fixed and somewhat overvalued: foreign prices will then be lower than domestic prices. In Nicaragua, for example, a fixed exchange rate was introduced in 1991 after a period of a floating rate. The exchange rate served as a "nominal anchor" in order to combat inflation. In this very open and highly dollarised economy, fixing the exchange rate immediately stopped inflation. Although policies were different, the same price dampening effect of programme aid was visible in Uganda and in many other African countries during the period of the gradual liberalisation of the exchange rate. In these countries, the exchange rate was already fixed before programme aid came in. It remained fixed after, although devaluation took place. But programme aid allowed a liberalisation of the foreign exchange market with much less devaluation (and thus price increases) than would otherwise have been the case.

The second effect of programme aid is its impact on the markets for domestic currency and foreign exchange. Expectations play an important role in the relative demand for domestic and foreign currency. If people expect a devaluation or high inflation, they will demand more foreign currency and will sell domestic currency as soon as possible. This means the income velocity of demand for local money will be high. The use of the exchange rate as a nominal anchor requires a certain level of foreign reserves. It will take some time before this policy becomes credible, and demand for foreign currency will not decrease immediately. Reserves are needed in order to maintain the exchange rate. If these reserves are available, inflationary expectations will diminish and people will be more willing to hold domestic currency. This means that the v (the income velocity of money) declines. The reserves needed to maintain the fixed exchange rate may be supplied by a boom in exports or other foreign income, by private capital inflows, or by foreign aid. However, in most of our countries foreign aid was the only feasible option.

The third effect of programme aid is through the reduction of inflationary financing of the government deficit. In the short term, it is often very difficult to make the large cuts in the budget deficit that are needed for inflation reduction. With programme aid, no such large cuts have to be made since expenditure can be financed from foreign grants or loans. Programme aid solves this immediate problem and then facilitates a gradual process towards increasing taxes and/or decreasing expenditure. In some of our countries, however, the budget deficit hardly shrank, i.e. the external financing of it continued. But this may not be a bad thing: it depends on the feasibility, and the growth effects of increasing taxes, and on the growth enhancing effects of government spending. Several of our country case studies conclude that government expenditure should not be reduced and that aid should continue to finance part of it.

At first sight, it may be concluded from this analysis that once inflation is under control, programme aid is mainly important for growth: it leads to a higher import level and a higher level of government spending which are supposed to be growth enhancing. However, even if governments are committed to a low inflation, or if they are complying to IMF spending limits, programme aid may still influence expectations and therefore the supply and demand for domestic and foreign currency (the second contribution of programme aid). In addition, the predictability and stability of programme aid is important. If programme aid is suddenly reduced, inflation may spring up again either because budget expenditure and revenues cannot be adjusted rapidly enough and part of the resulting deficit is financed by printing money, and/or because the reduction in aid leads to an expected devaluation. This may explain why inflation in Zambia is still rather high. The reduction in programme aid in around 1995 increased expectations of a more rapid devaluation. That in itself is sufficient for raising the demand for foreign currency and lowering it for domestic currency, thus leading to higher inflation and more rapid devaluation. A more structural problem in this country is the fact that programme aid is used for financing multilateral debt service. It cannot be used for price-reducing increases in imports.

In summary, PA's impact on stablisation depends on how it affects imports, the exchange rate (and perceptions of the credibility of exchange rate policy) and government expenditure. The next section addresses the first of these.

5.4 Aid's impact on the external account

The ultimate objective is to establish the impact of PA on growth, and hence on poverty. The conceptual framework in Chapter 1 (and the discussion of the impact of reforms in Chapter 4) laid out various determinants of growth, so the purpose here is to see how aid has affected these. The external account is examined first, establishing the extent to which aid has increased imports and reduced the debt overhang.

The analysis focuses on imports and debt service. These are the largest uses of forex and where aid may be expected to have the most impact. This is not to say that reserves are unaffected – the counterfactual situation is almost certainly higher with aid than without it (a link to reserves is noted in some cells of the summary table discussed below), and this effect will be stronger for programme aid than project aid. Moreover, as just explained in the previous section, this use of aid can have important beneficial macroeconomic consequences.

Another theoretical possibility is that aid substitutes for private capital flows. Other than short-term borrowing (and that substitution is a good thing) this possibility is unlikely to be the case. Rather to the contrary, successful economies such as Uganda and Vietnam are seeing growing inflows of both DFI and remittances – and it can plausibly be argued that aid, over the medium-term, has helped stimulate these flows. The less successful countries would be unlikely to be able to access foreign investment to take the place of the aid.

The previous section laid out four ways in which the sources and uses of forex could be analysed. Table 5.8 summarises this analysis for the eight countries. Tables 5.9 and 5.10 provide more detail of the counterfactual analysis.

The cases clearly divide in two ways which influence the extent and nature of aid's impact on the external account: (1) those with a large external debt and those with a lesser debt burden – Bangladesh and Cape Verde are clearly in the latter category, and Vietnam and to an extent Uganda have larger debt but it has not dominated the uses of forex); (2) those in which aid is a dominant source of forex and those in which it is relatively unimportant – aid is very important in Mozambique, Tanzania and Zambia, it has become less so in Bangladesh, Nicaragua, Uganda and Vietnam (as exports and other inflows have grown in all three) with this decline being recent in Uganda and Nicaragua and most marked in Vietnam; Cape Verde lies in the middle with aid being important but not dominant (remittances are the main source of forex).[15] The second of these points is listed in the first row of the table.

The number of countries in our sample which appear to be "weaning themselves off aid" deserves to be underlined. It contrasts with a general global rise in indicators such as aid per capita and aid to GNP (see Lensink and White, 1999b) and refutes the view (as historically has Korea and more recently Botswana) that large aid flows necessarily create a situation in which other sources of forex will be neither sought nor forthcoming.

The second row identifies particular items that stand out from the balance of payments. These are nearly all cases of debt relief, often paid by donors to clear arrears with the IFIs so that a new programme could begin: Figure 5.2 illustrates this case for Nicaragua with a peak in both debt payments and debt relief in 1996. As a variation on this theme, the Zambian Rights Accumulation Programme (RAP) was debt relief in disguise: by staying on track Zambia accumulated the right to borrow from the IMF an amount equivalent to its outstanding arrears to the Fund. Hence when it qualified for a new ESAF these funds were immediately repaid to the IMF. These special cases establish a clear link between substantial debt relief and debt repayment at levels which could not be afforded by the country alone – as the counterfactual analyses show, attempts to do so would in some years have compressed imports to zero!

In the other five countries – Mozambique, Nicaragua, Tanzania, Uganda and Zambia – aid's magnitude is such that a clear link can be established with imports, and any reduction in aid could lead to quite dramatic import compression (Table 5.9), although this link has weakened in Nicaragua and Uganda in recent years. As explained in section 5.3, the increase in goods availability from higher imports will check inflation.

[15] Though in Nicaragua at least, aid is being replaced by volatile, high interest rate (and consequently high-risk) capital inflows.

Table 5.8 Summary of analysis of sources and uses of forex

	Bangladesh	Cape Verde	Mozambique	Nicaragua
Magnitudes of items in the sources and uses of forex	Aid's share of sources has declined from close to half in 1987 to under 20% in 1997, as exports have gone up four fold and remittances by a factor of three. Debt service is small, so that imports account for over $^3/_4$ uses of forex.	Aid is about 1/3 of sources (remittances are largest item, exports are negligible). Imports are virtually only use; debt service very small. Hence a large part of aid is going to imports.	Aid is largest source of forex (around 2/3), with no strong growth from other sources (other than growing arrears to mid-90s). Imports and debt service are of roughly equal importance in uses (though imports always the larger of the two).	Debt is dominant, although most debt service is covered by debt relief and arrears accumulation. Looking at aid net of debt relief and commensurate debt payments, aid was main source of forex until 1995, since when exports have been greater. Imports (in these accounts) predominate use of forex.
Major single year items.	None.	None.	Substantial debt relief in 1992, in which year substantial settlement of arrears.	Higher debt relief 1991, 1995 and, particularly, 1996 corresponded to large arrears payments.
Large increases or declines in aid	Aid fell in 1995, when there was a large call on reserves, but this was mainly linked to increase in imports that year.	Large increase in aid in 1992 saw corresponding increase in imports, and similar with fall in aid the following year.	Large increase in aid corresponded to increased debt service (payment of arrears). Fall in aid in 1995 saw higher arrears, but larger decline in imports.	Higher aid in 1992 some increase in imports, but also higher net debt payment. Fall in aid in 1993, some reduction in imports and drawing down of reserves, imports restored following year with higher aid and some addition to reserves. 1997 large fall aid offset by higher private capital inflow.
Counterfactual analysis	Even if debt service is met in absence of aid reduction in imports never much more than 20 per cent, and often less.	Imports will clearly fall if aid is reduced, but even if debt service obligations met in absence of aid import reduction is only about 20 per cent.	Trying to pay debt service would mean no imports at all; substantial reduction in imports even if no debt service. No aid implies imports at least half and far greater accumulation of arrears.	Very low imports (even negative) if try to meet debt service; in recent years 60–70 % of actual if restrict debt payments.
Summary	Although aid clearly does finance imports its relatively small magnitude in recent years is such it is difficult to pick up a close relationship.	There is a close marginal link between aid and imports. However overall magnitudes mean that aid is important but not overwhelming.	Close link of aid and debt service, though aid is obviously also paying a large share of imports and changes in aid are reflected in import levels.	Aid closely linked to debt payment, but has also made a significant contribution to imports.

Source: country studies.

Table 5.8 (ctd)

	Tanzania	Uganda	Vietnam	Zambia
Magnitudes of items in the sources and uses of forex	Aid and exports are major uses, with increase in relative importance of latter (from $^1/_4$ to $^1/_2$). Imports and debt service account for nearly all use. There has been a rise in FDI, but fall in PCT.	Aid fell from + to 1/3 of sources from early to late 90s. Exports rose from under + to close to 1/3 and remittances and FDI rose from mid-90s.	Imports are the main use of forex, debt service accounting for less than 10%. Aid 1/3 to + of sources in 80s, but fallen to less than 10% since 1994, with large increase in exports and some in remittances and FDI.	Aid and exports each account for about + sources, with some fluctuations. Imports typically + uses and debt service another 40 per cent.
Major single year items	Large debt relief in 1996/97 corresponded to settlement of arrears (start of new IMF programme).	None.	Debt relief in 1993–95 corresponded to years in which arrears paid (accumulated in all other years), though some debt relief also paid for imports.	1995 saw the completion of the RAP and so a large ESAF inflow which corresponded to settlement of arrears in that year.
Large increases or declines in aid (from one year to next)	Large reduction aid plus debt relief (no debt relief) from 93/94–95/96 had little apparent impact on imports or debt service. But reserves were run down (whereas increased in other years).	No large changes in aid. Large increase in imports in 1994/95 corresponded to higher exports that year.	Falls in aid in 1991 and 1993 not matched by fall in imports (in 93 exports rose by twice the fall in aid).	Higher aid in 1992 saw an equivalent increase in imports, and corresponding reduction the next year. Large increase in 1995 was to pay arrears, so reduction in following year did not affect imports.
Counterfactual analysis	If pay debt service imports substantially reduced, but a more realistic scenario puts them at 60–80% of actual with no aid.	Impact on imports larger in early 90s than second half of decade – no imports at all in early years if try to meet all debt service, rising to half actual later on. Probable scenario puts imports at 40–60 % of actual if no aid.	If imports reduced by whole amount of aid then fall 10–20%; more likely scenario shows fall of some 10%	Trying to meet debt service obligations reduces imports to 70–80% of actual, though rather more in 1991 and 1995 (years in which donors financed arrears settlement). If don't meet debt service much less impact on imports, though questionable how much adjustment can be achieved through exchange rate.
Summary	Aid has helped pay debt and has been linked to the reserve position. The growth of exports (and to a lesser extent FDI) has allowed import growth even without aid, though there would also be an impact on imports.	Aid has played a role in supporting both imports and debt service, though its importance has declined in recent years.	Aid is not irrelevant, but it has been less important to Vietnam's dramatic import growth than the rise in exports.	Aid has paid debt service, with some additional contribution to imports.

Source: country studies.

Table 5.9 Counterfactual imports as a per cent of actual imports									
		1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Bangladesh	Minimum	64	71	74	81	82	81	87	..
	Maximum	73	81	84	91	91	88	98	..
Cape Verde	Minimum	..	63	60	65	70	70	70	74
	Maximum	..	79	68	70	73	80	73	87
Mozambique	Minimum	..	0	0	2	0	14	..	..
	Maximum	..	49	50	50	50	72	..	..
Nicaragua[1]	Minimum	25	-24	5	0	23	30	51	46
	Maximum	32	25	25	37	50	64	69	62
Nicaragua[2]	Minimum	51	-32	31	64	58	63	78	72
	Maximum	58	-32	30	62	48	59	72	72
Tanzania	Minimum	..	39.	49	63	56	56	-3	..
	Maximum	..	69.	83	100	90	94	74	..
Uganda	Minimum	4	-1	-7	19	44	41	50	38
	Maximum	40	51	23	40	58	52	60	45
Vietnam	Minimum	80	92	78	74	79	84	90	92
	Maximum	85	104	93	88	88	89	92	96
Zambia[2]	Minimum	..	30	63	83	74	-6	83	..
	Maximum	..	..	100	137	124	103	97	..

Notes: 1/ calculation for total aid; 2/ for PA only. *Source:* country reports.

The third and fourth lines try to capture how imports and debt service (and sometimes reserves) have responded to changes in aid. The counterfactuals summarised in the fourth row, and reported in the two tables below, have been constructed in various ways, but with key common elements. One simulation is to assume that all debt service obligations would be met in the absence of aid and debt relief. Imports are then calculated as a residual (as sources minus the sum of all other uses of forex). This simulation results in the largest impact on imports – if aid is paying for all of debt service and some of the import bill then the results can show negative imports in the absence of aid. If the simulation is constructed exactly as stated here then the marginal impact of aid on imports will appear to be unity (as is sometimes the case in Table 10). However, most the simulations assumed some other effects, for example (1) without aid export growth may be a little higher; (2) FDI may be lower;[16] and (3) reserves may be run down to a greater extent (and certainly will not be accumulated where this had happened). A second common simulation is impose a debt moratorium – the impact of imports is now less as some of the aid will go to debt service. If aid was insufficient to pay debt service, counterfactual imports can be higher than actual under this scenario. The Zambia results considered both quantity adjustment and market clearing. The market clearing results showed that exports would indeed increase in the absence of aid, but the required depreciation of the RER was very substantial (possibly over 100 per cent) which casts doubt on the feasibility of such a solution. In most cases the analysis covers all aid, though for Nicaragua and Zambia PA is covered.

[16] If the net effect of "no aid" on other inflows is negative, then the marginal impact can exceed unity.

Table 5.10 Marginal impact of aid on imports

		1990	1991	1992	1993	1994	1995	1996	1997
Bangladesh	Minimum	0.74	0.60	0.63	0.53	0.61	0.96	0.65	..
	Maximum	0.55	0.39	0.40	0.26	0.33	0.62	0.09	..
Cape Verde	Minimum	..	1.21	1.00	1.00	1.00	1.00	1.00	1.00
	Maximum	..	0.69	0.80	0.86	0.89	0.67	0.88	0.48
Mozambique	Minimum	..	0.91	0.67	1.00	1.00	1.00	..	..
	Maximum	..	0.47	0.33	0.51	0.50	0.33	..	..
Nicaragua[1]	Minimum	0.74	0.33	0.78	0.98	0.51	0.26	0.09	0.68
	Maximum	0.67	0.20	0.61	0.61	0.33	0.13	0.06	0.48
Nicaragua[2]	Minimum	0.68	0.93	0.99	1.58	0.79	0.91	0.70	1.46
	Maximum	0.58	0.93	1.00	1.68	0.99	0.99	0.88	1.46
Tanzania	Minimum	..	0.63	0.54	0.33	0.44	0.34	0.24	..
	Maximum	..	0.51	0.29	0.00	0.23	0.15	0.26	..
Uganda	Minimum	1.04	0.99	0.96	1.02	0.92	1.18	1.05	1.25
	Maximum	0.65	0.48	0.69	0.76	0.68	0.96	0.84	1.11
Vietnam	Minimum	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
	Maximum	0.71	-0.46	0.33	0.47	0.55	0.68	0.78	0.50
Zambia	Minimum	..	0.76	0.46	0.27	0.51	0.82	0.45	..
	Maximum	..	..	0.00	-0.57	-0.48	-0.03	0.08	..

Notes: 1/ calculation for total aid; 2/ for PA only. *Source:* calculated from country reports.

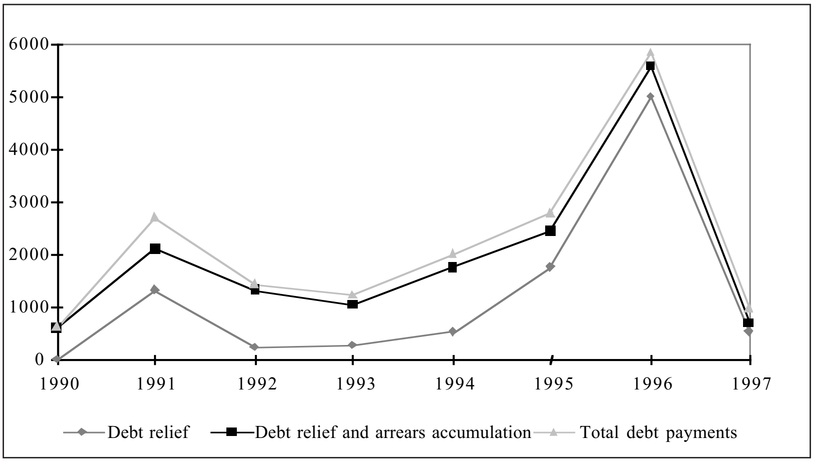
The relationships captured here depend on the two aspects mentioned above: the relative magnitude of aid and the debt burden. Bangladesh, Cape Verde and Vietnam do not have a large external debt so that does not enter the picture; in the first two cases a clear link between aid and marginal changes in imports can be established, though for Bangladesh the importance of aid is not so great and declining. In the case of Vietnam, aid's relative unimportance is such that its impact cannot be discerned in year to year changes: export growth has allowed imports to increase even when aid has fallen. Figure 5.1 showed how Vietnam's imports have risen over the years largely on account of higher exports, though with a trade gap opening up post-1992 by virtue of higher inflows.

These countries also have a link from aid to debt payments. This relationship is most clear in the case of Nicaragua, as illustrated in Figure 5.2. The pattern of debt payments for Nicaragua closely traces that of debt relief – and the service for which there is not relief is mostly not paid i.e. it is met out of arrears.[17] Net debt payments, i.e. debt actually paid out of own resources or from other inflows (including aid) has been very small. In other countries, such as Mozambique, Uganda and Zambia, there has been substantial debt relief, but this has been insufficient to pay all actual service so that other aid and inflows have been covering this part of the external debt. The link between debt relief and debt payment is clear, but other forms of balance of payments support are also used to meet debt obligations.[18]

[17] The balance of payments accounting convention is to record scheduled debt service, rather than actual, as an outflow with arrears accumulation appearing as a financing item.

[18] In both Nicaragua and Zambia all balance of payments support has been accounted for by the respective banks as funds for debt relief since at least the mid-90s (regardless of the accounting requirements of the different donors).

Figure 5.2 Debt relief and debt payment for Nicaragua



As mentioned above, the simulations presented above assume some effect of aid in reducing exports. What is the evidence that there are Dutch disease effects from aid?

Dutch disease

It is often claimed that aid causes Dutch disease. This argument can be put in various ways, but the basis of it is that aid creates additional demand, some of which falls on domestic output, so that home prices rise relative to world prices which is the same thing as saying the real exchange rate appreciates. Domestic output thus becomes less competitive, causing exports to fall.

There are three reasons for rejecting this argument, all three of which are particularly pertinent to programme aid. First, aid can be anti-inflationary. Fungible project aid can have this effect, but it is far more likely to apply with PA (as was found to be the case in Tanzania where the distinction between project and programme aid is made in the government accounts, see Doriye *et al.*, 1993). Second, through conditionality aid supports a policy of devaluation, or forex market liberalisation, which has resulted in substantial devaluation.[19] Finally, in addition to conditionality, PA has supported forex market liberalisation through the systemic effects of import support schemes and by providing the foreign exchange to allow these systems to function: you can't set up a forex auction if you don't have any forex. At the same time, the availability of aid has reduced the extent of devaluation consequent on liberalisation; or, if the exchange rate is still managed, to eliminate

[19] Chapter 3 argued that the importance of conditionality should not be overstated. However, Killick *et al.* (1998) argued that the exchange rate was one area where there had been some impact. In addition, Chapter 2 pointed to the systemic effects from import support in achieving forex market liberalisation.

overvaluation. For all these reasons, PA is likely to be associated with real exchange rate depreciation rather than appreciation.[20]

The second and third of these points is linked to a second crucial role aid can play in stabilisation. In small open economies a devaluation will have significant inflationary consequences, and be a part of an inflationary spiral, fuelled by expectations of further price increases. In the first instance aid can help finance a nominal anchor on the exchange rate, putting a stop to the spiral. Aid can be crucial here as for the anchor to have credibility, which is essential for inflationary expectations to be reduced, the government must have the reserves to support the exchange rate. The clearest example of this effect is from Nicaragua. Inflation was running at 13,500 per cent in 1990. A stabilisation plan was introduced in March 1991, with a devaluation of the new currency to a rate that was then fixed. The same year saw the first large increase in aid. There was a modest draw down on reserves in 1991 – but total sources of forex practically tripled from 1990 to 1991 (or doubled excluding debt relief), the bulk of the increase being from aid, so that there was no perceived risk of reserves running dry. In Uganda the suspension of programme aid resulted in the re-emergence of inflation in the early 1990s (see next section).

These arguments do not dispute that large aid inflows will mean that the exchange rate (certainly for the real and probably also nominal) will be more appreciated than in the absence of the aid. Rather it is suggested that there are beneficial effects from this situation: namely to limit the pace of devaluation and so restrict inflation. As economies have established liberalised forex markets and achieved stabilisation PA continues to underpin this success – its withdrawal would certainly threaten it. But PA can also move to assume a more positive role of building reserves, reducing debt and supporting investment-enhancing expenditures.

If large devaluation were to be necessary the costs would outweigh the benefits in all cases. Devaluation occurs to bring sources and uses of forex into line. Imports are more expensive and so reduced, whereas export production is more profitable and so increased. However, if countries have structural constraints on their exports, most of the work will be done through import compression, which will have a detrimental impact on the country's growth. Of the eight countries we have studied, Bangladesh is the only one in which it can be convincingly argued that devaluation would have a significant impact on exports, and this also appears more likely for Vietnam given the relative reduction in the country's competitiveness consequent upon devaluation across the region. Certainly in Cape Verde and Zambia, and most likely in Mozambique, Nicaragua, Tanzania and Uganda, the improved relative margin to exporters from devaluation will not be enough to elicit a supply response, whilst it is clear that there are other policies which will, notably improved human and physical capital.

[20] This argument is time-bound. That is, during the period in which PA facilitates liberalisation of the forex market then it is associated with devaluation. But it facilitates this process in part by allowing a more appreciated equilibrium exchange rate.

The extent to which aid contributes to capital accumulation is critically related to a more general conception of Dutch disease which is of greater concern than exchange rate effects. This more general view is that aid-financed activities, including working in an inflated civil service or the administration of aid projects, provides a better income than private sector activity. The pattern of production is thus distorted so that a country will not build up its own productive base, remaining reliant upon aid. An important caveat should be made here. Aid is of course meant to sow the seeds of its own destruction and the main task for aid workers is to put themselves out of a job. The record here is rather poor, though it was illustrated above that Bangladesh, Nicaragua, Uganda and Vietnam are all reducing their relative reliance on aid. The extent to which this is possible depends on the extent to which aid fosters growth, which includes the role of project aid in creating the physical, institutional and social base.

Of the countries studied, Cape Verde is the extreme example which exemplifies this manifestation of Dutch disease, though remittances are at least as responsible as aid for this state of affairs. The challenges facing Cape Verde are unlikely to be overcome by the market alone; aid can play a role in facilitating whatever development path is chosen, but appears not to be doing so as yet.[21] Zambia has historically suffered Dutch disease from its copper wealth, and mismanagement turned this into a yet larger burden. But the economy remains faced with a massive task of adjustment – it is one of the most urbanised countries in Africa with no reason to remain this way (see White and Edstrand, 1994 for a development of this argument). Again aid could play a role in diversifying the productive base but does not seem to be doing so.

A final version of the Dutch disease story is that aid allows countries to postpone making difficult decisions. Many commentators apply this argument to Vietnam, suggesting that "good times make bad policy and bad times make good policy". In respect of aid this argument seems to apply to a very short period of time. In the 1970s countries followed import substitution policies, and these policies were supported by the donor community, including the IFIs. By the mid-80s pressure was being brought to bear to change policies. Thus there was only a window for a brief period in the early 80s when donors were financing what were starting to be thought of as "bad policies". Of course, donors have in practice sent ambiguous signals through their disbursement patterns, but Chapter 3 showed that other factors than aid alone have shaped domestic policies. The stronger argument to make in respect of this version of Dutch disease would appear to be that sustainable growth prospects are undermined as aid does support inappropriate policies: but the inappropriate policies are the ones the donor community wishes to see implemented.

[21] But given the country's relative wealth and access to international capital aid volumen should be limited.

Debt burden

The fact that debt relief has been linked to debt payment does not mean that the debt burden has been reduced. The total debt stock of all Swedish programme countries has increased over time, with the exception of Nicaragua (Table 5.11). A country such as Uganda began the 1980s with comparatively little debt, but this debt has accumulated over time through borrowing from the IFIs which account for over half of the country's debt. Although these are concessional funds there is still a repayment burden.[22]

Table 5.11 Total long-term debt (period average, US$ billions)

	1980–84	*1985–89*	*1990–94*	*1995–96*
Angola	0.5	4.7	8.3	9.5
Bangladesh	4.4	8.6	13.3	15.4
Botswana	0.2	0.5	0.6	0.6
Cape Verde	0.1	0.1	0.1	0.2
Ethiopia	2.6	6.7	9.0	9.6
India	21.8	46.8	81.3	84.4
Kenya	2.6	4.3	5.9	6.2
Lao PDR	0.4	1.1	1.9	2.1
Mozambique	0.4	3.5	4.7	5.4
Nicaragua	2.8	6.3	9.2	6.8
Sri Lanka	1.8	3.9	5.9	7.0
Tanzania	2.5	4.5	5.9	6.2
Uganda	0.6	1.4	2.5	3.1
Vietnam	0.0	4.0	21.7	22.2
Zambia	2.4	4.0	4.9	5.2
Zimbabwe	1.2	2.2	3.2	3.8

Source: World Development Indicators.

5.5 Fiscal response, stabilisation, savings and investment

Fiscal response

Aid may either increase expenditure, reduce revenue or offset deficit financing. An academic literature, known collectively as the fiscal response literature, addresses this issue (for reviews see, for example, White, 1998: Chapter 2, and for a critique, White, 1994). Data limitations mean that the models from this literature may not be applied. But their partial approach and methodological problems mean they are anyhow probably not appropriate. Rather, the more *ad hoc* approach already applied to the external account is applied, with some rather strong results.

[22] The recent IDA Education Sector support for Uganda has been given as a grant. Since the value of reflows to the Bank is low there is a strong case for making all IDA credits grants (which the bilaterals can surely influence at replenishment).

If aid increases with no change in revenue or expenditure then it is clear that the aid is being used to finance the deficit. Project aid can only have this effect if it is fungible, whereas PA (with no restrictions on the use of the countervalue) is readily available for deficit reduction. This story is most clear in Mozambique, where grants as a per cent of GDP rose from 15 to 20 per cent between the late eighties and early 90s with no appreciable change in revenue and expenditure. Doriye *et al.* (1993) observed a similar phenomenon in Tanzania during the 1980s, when the rise in counterpart funds (separately identified as a financing item in the government accounts) corresponded to a reduction in borrowing from the domestic banking sector.

Reducing the need for deficit finance provides PA with a deflationary impact, and it can be argued to have played this role in both Mozambique and Tanzania for the reasons just stated. This link was also illustrated in Uganda when (as described earlier) donors halted disbursements of PA owing to disagreement over import support procedures: government did not cut back on expenditures, so that the cut back in PA was directly linked to the subsequent inflationary surge. Since 1992/93 Uganda, which has enjoyed sustained high inflows of PA, has not resorted to deficit financing: grants are over 100 per cent of financing, indicating that aid must be paying for retirement of the government's debt to the domestic banking sector.

The deflationary impact of PA would be undermined if it were instead used to offset revenue collection. There is no evidence of this being the case, and there are several cases of higher revenues with higher aid inflows. Vietnam is the most extreme example of this phenomenon. During the 1990s expenditure has risen from around 15 to nearly 30 per cent of GDP whilst the deficit has <u>fallen</u> from about 10 to 2 per cent of GDP. This has been achieved by a large increase in revenue and turning transfers from SOEs from negative to a positive 8–10 per cent of GDP. Aid thus has a rather modest part to play in the Vietnamese story, it's share of government expenditure having fallen from 15 to around 6 per cent of government expenditure in 1990s. Tanzania, Uganda and Zambia are all instances of improved revenue collection with higher aid. This success may be in part attributed to conditionality and assistance in the establishment of revenue authorities. But PA has also played an important role in expanding the revenue base. In the first instance by allowing higher imports, but also from generating higher levels of economic activity, in particular the growth spurts in manufacturing experienced in countries such as Tanzania and Vietnam as manufacturing output responded to higher levels of capacity utilisation.

There are also cases in which higher expenditure has come about. Vietnam is again the most obvious case (and Ghana though not part of this evaluation), but there are others. Zambia is something of an exception, as overall expenditure fell in the 1990s, partly as grants fell (suggesting expenditure and aid are positively related) but mainly as the budget deficit was cut. The composition of expenditure was discussed in Chapter 3: the story with respect to inter-sectoral spending is mixed, although there are cases – e.g. Vietnam and Zambia – with marked improvements in social spending shares. However, intra-sectoral spending patterns remain poor (Vietnam is something of an exception), and evidence reviewed in Chapter 4 revealed shifts away from investment and development spending.

Savings and investment

Investment is the single most robust determinant of growth.[23] It was argued in Chapter 4 that public investment has a role to play in leading this response, but that ultimately the private sector response must kick in for sustained growth.

It has long been held that aid displaces savings, so that the contribution to investment is less than would have been the case if this effect did not occur. In part this argument rests on perhaps an inappropriate look at gross domestic savings, when gross national savings may be the more appropriate measure. But more importantly it is a partial argument, where any displacement can be offset if aid has income and output increasing effects. There is thus no straightforward relationship between aid and savings, and many of our case study countries show increased savings rates in association with higher aid, e.g. Mozambique and Uganda, although the rate remains low in Uganda.

PA may increase investment directly through the government budget or indirectly by creating an investment-friendly growing economy and reducing the debt overhang. The evidence does not suggest that these effects have been that strong. It has been shown that much PA has been used to reduce deficit financing. What expenditure increases there have been are more likely to be recurrent (as has shown to be so for Tanzania) than capital. Although Uganda and Sri Lanka are cases where aid helped increase public investment, and this has been associated with higher private investment. It has also been shown that debt reduction has only occurred in Nicaragua (Table 5.11), so effects from reducing overhang will not be observed in general. Aid may also enhance investment by creating a good policy environment, but it was argued in Chapter 4, and above, that some form of strategic intervention may be required rather than rely on market forces alone to lead the investment response.

5.6 Some concluding comments

The above analysis leads to the following conclusions:

- Aid in general has supported both imports and debt payments; without aid imports would have been between 20 to 50 per cent less in most years for most the countries studied, and even then would have been unable to meet all external debt obligations. The supply of additional goods has both growth-increasing and inflation-reducing effects.

[23] Whilst this statement is undoubtedly so, it should also be borne in mind that developing countries have had both over-investment, manifested in low rates of capacity utilisation, and bad investment, illustrated by high, or even negative, incremental capital-output ratios.

- Aid, in particular countervalue, has not resulted in equivalent increases in expenditure, and so had an anti-inflationary effect by offsetting deficit financing.
- The anti-inflationary impact of aid, combined with conditionality and systemic effects of PA, mean that it has in the first instance been associated with depreciation of the real exchange rate rather than appreciation. Subsequently aid has supported the exchange rate (which is one way in which it facilitates forex market liberalisation) and so had a deflationary impact by limiting devaluation.
- Private investment response is weak in most countries, so the potential positive links from aid, through both policy and impact of funds, remain to be realised.
- The story with respect to government expenditure is mixed, but in most countries restructuring of public spending to social sectors remains limited, suggesting that aid may not have played much of a role.
- Effective conditionality will determine aid's macroeconomic impact by influencing the use of funds. The extent to which aid is used to reduce deficit financing or increase expenditure, rather than offset taxes (and the sort of expenditure), can be influenced by the conditions attached to aid. However, the conditions are not always effective and may not have been the right ones.
- There can be no doubt that aid has improved welfare through supporting expenditure and imports. But the evidence adds up to suggest that aid will have had some impact on growth, but that the impact is neither particularly strong, nor sustainable – which requires more focus on the fundamentals.

What can be concluded about overall growth effects? Two strong channels have been identified: (1) higher imports, and (2) stabilisation. The link from both of these to higher growth is well established, and will be the main factors laying behind the established link between aid and growth in cross-country studies (e.g. Hansen and Tarp, 1999). In some countries PA may also finance non-inflationary increases in public expenditure, though this useful role has been under-exploited on account of IMF spending limits. The limited impact on private investment has also been noted. The link from higher imports to growth is clear. Eliminating high levels of inflation can also contribute to higher growth by reducing transaction costs associated with rising prices, and reducing uncertainty.[24] These effects are sufficiently strong for us to be confident of PA's positive impact on growth. It is far more difficult to quantify this effect with any precision.

[24] Reducing inflation is to be expected to have positive distributional effects, partly as the poor are particularly vulnerable to inflation.

Chapter 6
The future of programme aid

Should Sweden continue to give PA?

Yes. This report has demonstrated that PA has beneficial macroeconomic effects, both through the funds and, potentially, through policy dialogue. Hence, the fall of PA's share in Swedish aid should be reversed to re-establish it as a core component of the aid programme. It should not be seen as a residual component to be cut at will. But this argument is dependent upon better exploiting PA's potential advantages.

One clear message of this report is that the workings of PA are poorly understood, even by some of those responsible for drafting PA agreements. Explicit attention to understanding how PA works will enhance its effectiveness.

Should PA stay outside of the country frame?

No. Being outside of the country frame is a reason why PA has acquired its residual category status (another being that multiple responsibility for PA means it has no "home"). PA should be an integral part of the assistance provided to partner countries. Swedish aid needs the flexibility to enter into multi-year commitments where appropriate, but also to withhold money from the country frame when it is not desirable to disburse PA owing to changed circumstances. Putting PA back in the country frame will reduce the number of countries receiving Swedish PA, and this is seen as a desirable outcome.

What sort of PA should Sweden give?

PA should be a mixture of debt relief and budget support. New modalities are being developed under Sector Programmes which will be a suitable channel for quick disbursing budget support provided donors resist the temptation to place excessive burdens on the administration of this aid. The experience of import support shows that donor attempts to micro-manage PA must be avoided. But it will take some years to put these systems in place (the time required varying from country to country) so that debt relief may be expected to be the dominant form of PA for most countries in the near future. Part of the systems which need to be put in place are on the part of donors to allow multi-year programming, avoiding the on-off nature of PA except in extreme circumstances.

Can debt relief still be given to countries which have completed HIPC?

Yes. Post-HIPC debt burden levels remain high so that the arguments for debt relief remain valid.

Should PA be conditional on IFI reform programmes?

A conditional yes. The nature of IFI programmes needs to be changed. The evidence in this report shows that, whilst removing controls has been good for growth, full market liberalisation need not be. Rather there is a need for complementary policies, which implies a limit to stabilisation so that, for example, infrastructure can be provided. The package of complementary policies will vary from country to country, but is likely to include public works and investment in basic health and education. These views support the post-Washington consensus view that there is a greater role for the state in the development process than that promoted by the development community over the last two decades.

De-linking PA from IFI programmes may prove necessary if the IFIs are recalcitrant to change, and will signal the seriousness with which Sweden regards this matter. But that should be a last step, as proliferation of donor conditionality is not a desirable state of affairs. There should, anyhow, be a more active awareness on the part of Swedish officials, that influence operates through a large number of channels – technical assistance, projects and studies can call influence policy outcomes – and deliberate use made of these channels.

Should Sweden seek to make its own voice heard in policy dialogue?

Another conditional yes. It is <u>not</u> appropriate to proliferate conditionality. But the nature of policy dialogue needs to change – to become more of a dialogue and less of a monologue. Swedish influence has been strongest where it had facilitated domestic discussion on strategic policy issues – notably in Vietnam and Nicaragua, but in other countries also. However, such an approach suggests concentration of these efforts on a handful of countries – partly to build up Sweden's own knowledge but also to exploit the advantage of a historical relationship. Experience shows that it is those countries with an established Swedish presence which are most amenable to such interventions. Without pursuing a single viewpoint, the market-oriented development strategy still touted by the IFIs can be put into question.

Can Sweden really influence the IFIs?

Experience mostly says no, but common sense says yes. And Sweden did play an important part in advancing multilateral debt relief. There are political

Looking into the future, this report concludes that Sweden should continue to give programme aid since it has been demonstrated that programme aid has beneficial macroeconomic effects, both through funds and policy dialogue.
Photo Ekström/Pressens Bild.

constraints to be overcome both domestically and within the international community, so that a combined effort of like-minded donors is more likely to succeed. The Board is only one channel through which this influence may be exerted and others should be used. A more deliberate effort is needed to build up an alternative intellectual centre of gravity. However, Sweden's capacity to play this role is at present weak, and this weakness needs to be addressed first if such a strategy is to be pursued.

What are the main issues on which Sweden should seek to have influence?

Within the international community Sweden should push forward the agenda of the post-Washington consensus so that it is reflected in IFI policies on the ground. If the IFIs are allowed to colonise and internalise this issue (having resisted these critiques for many years) the actual policy shift will be rather less. Sweden should also take a stand on PA modalities, although its own record in this area is not that strong. Specifically, Sweden should attempt to shape Sector Programmes so as to maximise the extent to which they are incorporated into government expenditure activities with a minimum of donor control and restrictions. A continued active engagement in SPA is one channel for this activity, but will not benefit non-African countries, where Sweden may wish to raise the issue in donor co-ordination bodies.

At the level of partner countries Swedish influence is best directed at creating space in national and international fora for policy debates.

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Appendix 1
Terms of reference for an evaluation of programme aid

1. Background

Balance of payments support has constituted a considerable part of Swedish aid in the 1990s, but its share of total aid has declined in recent years. In 1990/91 balance of payments support represented over 20% of the aid channelled through Sida, or 1,607 million Swedish Kronor. It has then decreased to a total amount of 663 million Swedish Kronor in 1995/96, decreasing to 6% of total aid through Sida. Even though decreasing in volume and percentage, balance of payments support remains a substantial part of total aid.[1]

The overriding objective of Swedish balance of payments support has, except for some minor changes over time, been: *economic growth and sustainable development*. Swedish balance of payments support has primarily been given to the poorest, most indebted, Swedish programme countries implementing a structural adjustment program with support from the Bretton Woods institutions[2] . Since the majority of the least developed countries is found in Sub Saharan Africa the lion part of the assistance has been aimed to this region. While both bad economic management and external shocks have adversely affected the stability of the recipient countries, Swedish disbursements of balance of payments support have as a consequence been low and resulted in high balances.

[1] Swedish balance of payments support through Sida has been given both within the so called country frames and as special allocations in support of economic reforms. In addition to the Sida channel the Ministry for Foreign affairs directly supplies the World Bank and IMF with funds to support their credit schemes which also can be regarded as a balance of payments support. These funds are not included in the above figures.

[2] Programme countries are: Nicaragua, Ethiopia, Eritrea, Uganda, Kenya, Tanzania, Mozambique, Zambia, Zimbabwe, South Africa, Botswana, Namibia, Angola, Guinea Bissau, Cape Verde, India, Sri Lanka, Bangladesh, Laos and Vietnam. The concept of *programme countries* has now changed but we will stick to this term since we are looking back a few years to the time when they were still classified as programme countries.

There are different forms of balance of payments support. Some of the resources have been diverted to support the purchase of imported goods, other to pay off debts. Balance of payments support is also closely linked to the concepts of "budget support" and "sector programme assistance". Budget support and sector programme assistance also provide the recipient country with untied resources. The collective term used for balance of payments support, budget support and sector programme assistance in this text is "programme aid".[3]

This study is *mainly* concerned with balance of payments support, i. e. focuses on supplying the country with foreign exchange to sustain the balance of payments situation. However in today's debate it has been increasingly important to discuss the use of the local currency generated by the forex. When a donor puts more emphasis on the fiscal situation and the use of local currency the term "budget support" or "sector programme assistance" is used. In this evaluation we will pay *some* attention to these forms of assistance.[4]

2. Reasons for the evaluation

In Government decision dated 1996-11-18 Sida was tasked with evaluating Swedish balance of payments support to selected countries. In accordance with these directives the Department for Evaluation and Internal Audit started an evaluation process aimed at assessing the effects of balance of payments support on economic growth to some recipient countries of Swedish assistance.

The globalisation of the economy has changed the conditions for giving balance of payments support in the 1990s, perhaps to a greater extent than for other forms of aid. It is therefore of interest to assess how the changing economic conditions have affected the possibility of this type of aid to achieve its objectives.

Balance of payments support has effects on foreign exchange availability, fiscal behaviour, monetary variables, economic growth and income distribution. In addition, balance of payments support is usually a vehicle for policy conditionality, which in turn also affects the above mentioned variables

Few assessments and evaluations have thoroughly reviewed how the *various* forms of balance of payments support help to achieve the objective of *economic growth and sustainable development*. One of the aims of balance of payments support has been to sustain reforms so that the country can adjust and reach stability. Another aim has been to create favourable effects in the economy through the resource transfer itself. How different forms of balance of payments support may contribute to economic growth is rarely elaborated on in the

[3] In Sida terminology "budget support" is sometimes found under the heading "balance of payments support".

[4] The reason why focus is on balance of payments support in this evaluation and not equally focused on budget support is lack of many existing examples of budget support. Countries which have experienced this kind of assistance include Cape Verde, Mozambique and Uganda.

Sida memorandums preceding the choice of support, or in Swedish government decisions.[5]

3. Purpose and scope of the evaluation

The *purpose* of the study is to evaluate the impact of the resource transfers on economic growth. Furthermore, the purpose is to see how the change in economic policy in recipient countries of Swedish programme aid has changed the preconditions for achieving economic growth. Moreover the evaluation will assess whether the conditionality package attached to the support has been fulfilled in accordance with the timetables and, lastly, the evaluator are to review the literature on how reforms have affected economic growth.[6]

The study shall present *recommendations* on the use of different forms of balance of payments support, the use of budget support and the use of sector programme assistance as instruments for enhancing growth. Recommendations should be directed to Sida and to the Ministry for Foreign Affairs. Information about the evaluation findings is to be communicated to the recipient countries.

The evaluation shall consist of case studies and desk studies. The objects for the *case studies* are Uganda and Nicaragua. An additional Swedish programme country constituting a third case study is left to be suggested by the evaluators to complement the two predetermined ones. The two countries, Uganda and Nicaragua, represent major recipients of Swedish balance of payments support with untenable balance of payments situations as main obstacles to self-sustained development. The purpose of conducting case studies is to enable the evaluators to search for primary data and conduct interviews with key persons (in addition to the use of data bases and existing literature).

The selection of countries for the desk studies, and a third case study, will be a matter for the Tender Invitation. The selection will have to be confined to Swedish programme countries receiving programme aid . The desk studies are to make use of existing data bases and review the literature to complement the case studies in search for general conclusions.

The evaluation shall cover all forms of balance of payments support, budget support and sector programme assistance provided by Sida. There is no point in distinguishing Swedish support from other donors' balance of payments support because of fungibility. The evaluation shall mainly concentrate on support given in the 1990s.

[5] In an open economy situation with perfect capital mobility this is less interesting since the forex most probably is fungible, but looking back a few years this was not the case in many countries.
[6] In most countries the conditionality package means the Policy Framework Paper prepared by the Bretton Woods Institutions.

4. The Assignment

The study shall comprise of the following tasks;

(A) The rationale behind the Swedish support
The assessment in (A) and (B) will be based on all Swedish programme countries that received Swedish programme aid 1990-1997.

1) Distinguish between the explicit objectives of different forms of Swedish balance of payments support (import support and debt relief), budget support and sector programme assistance through Sida to the programme countries since 1990 until 1997 and analyse how these objectives have changed over time[7]

2) Assess the relevance of the stated objectives for Swedish balance of payments support, budget support and sector programme assistance in relation to the support form[8]

3) Examine the Sida memorandums sent to the Swedish government, and the Swedish government decisions on balance of payments support, budget support and sector programme assistance, to assess the *rationales* behind giving support and analyse how they have changed over time

(B) Reviewing different forms of Programme Aid
1) Review the different Swedish forms of balance of payments support, budget support and sector programme assistance, and their respective categories, to determine how much of the funding has been disbursed between 1990 and 1997.[9]

2) The evaluators are also to elaborate on how the balance of payments support and budget support/sector programme assistance relate to each other *conceptually and in practice*.

(C) Concluding fungibility
The assessment will be based on findings from both the case studies and from the desk studies concerning a total of eight selected countries. This also applies to D and E. The findings are to be based on empirical work.

1) Examine how economic policy, affecting the effectiveness of programme aid, has changed in the selected Swedish programme countries during the 1990s.

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[7] There are a limited number of cases where budget support and sector programme assistance have been the targeted form of support, and the comparisons between balance of payments support and these "newer" forms will therefore be restricted by the availability of data.

[8] In case of lack of relevance in the stated objectives the evaluators are to suggest an additional set of objectives relevant to and adequate for this kind of support in order to carry out the evaluation in relation to appropriate objectives

[9] Forms of balance of payments support; import support and debt relief. Categories of import support; consumer goods, intermediate goods and capital goods.
Categories of debt relief; e.g. fifth dimension, multilateral debt funds.

2) Examine the various sources and uses of foreign exchange, including balance of payments support given by donors.

3) Conclude to what extent fungibility exists in the balance of payment identity when there is an inflow of balance of payments support, and under what economic policy conditions the degree of fungibility may change.

4) Conclude to what extent fungibility exists in the categories for debt relief and import support, and under what economic policy conditions the degree of fungibility may change.

5) Analyse how budget support may affect the country's balance of payment situation and vice versa, i. e. how balance of payments support may affect the country's budget situation given at least two scenarios, viz: a) a regulated economy b) an open economy.[10]

(D) Assessment on how balance of payments support may have contributed to growth

1) Examine the possible *chain of effects* between the balance of payments support and economic growth:

a) when there is high probability of fungibility (open economy- no restrictions on aid),

b) when there is low probability of fungibility (regulated economy- restrictions on aid).

In (a) an assessment on how an increment of "untied" foreign exchange has affected growth is to be carried out. In (b) an assessment will be carried out specifying the different forms of balance of payments support (and their categories) and their respective impacts on growth via intermediary variables. The following relationships are to be considered in the evaluation for both (a) and (b):[11]

– how balance of payments support forms may have affected growth via macro stability (prices, real interest rate and real exchange rate),

– how the balance of payments support forms may have affected growth via movements in the real exchange rate,

– how balance of payments support may have reduced the debt overhang and have affected growth via increased investments

– how balance of payments support may have affected growth by an increase in imports,

[10] Above all theoretically, but also empirically if the availability of primary data allows to.

[11] It might be useful for the evaluators to distinguish between the short-term objectives of the support (intermediary variables) and its long-term objectives (growth in output). The evaluators are to try to

[12] For import support and debt relief the evaluators are also to distinguish between the effects from different categories i.e. in a low probability of fungibility of funds scenario (b).Appendix 2quantify the impact of the support on intermediary variables and (if possible) on growth.

– how balance of payments support may have affected growth by an increase in international reserves.[12]

It is important to clarify under which economic policy conditions the conclusions are valid (regulated economy vs. open economy).

It is also important that the evaluators make clear in the report which factors they respectively control for and not do control for.

2) The evaluation shall discuss whether the chosen form (and category) of balance of payments support, in comparison with other forms (and categories) of balance of payments support, has been an effective and relevant mean to achieve a favourable impact on intermediary variables and a contribution to economic growth.

3) Examine empirically (if possible) the possible *chain of effects* between the budget support and sector programme assistance and economic growth, also taking into account relevant intermediary variables

(E) The implementation and the effects of reforms

1) Examine how many and which of the reforms conditioned to the balance of payments support have been implemented in accordance with the timetables. The evaluation shall also make an assessment on the implementation status of the reforms that lagged behind time schedules – how far/close to fulfilling the schedules they were.

2) Examine if in general any specific groups of reforms lagged behind timetables and if in general any specific groups of reforms were implemented in accordance with the timetable.

3) Review the literature to summarise the findings about how policy changes – due to the conditionality package – have affected growth; generally in developing countries and specifically in the Swedish programme countries.

(F) Present lessons learned as well as recommendations related to the findings on above issues

1) Compare the *impact* of the various forms of balance of payments support on growth and conclude under which policy conditions one type of support is to be preferred to another.

2) Compare balance of payments support with budget support and discuss under which policy conditions the donor shall focus on the balance of payments situation rather than the fiscal situation or vice versa, and when it is of equal importance to focus on the balance of payments situation and the fiscal situation.

3) Compare the conclusions from the above – the actual results from the case studies and desk studies – and assess the relevance of the stated objectives and rationales in Sida memorandums.

4) Discuss *briefly* the impact on economic growth of programme aid in relation to the impact on growth of other forms of assistance, including project support

(G) Statistical data and methods
1) Discuss the statistical basis used and assess the extent to which lack of data, economic models and other knowledge about constraints in the data and methodology affects the results. Discuss how this uncertainty may affect the conclusions and recommendations.

5. Methods, Evaluation Team and Timetable

The evaluation shall be undertaken in close cooperation with Sida and the relevant authorities in the countries selected for the case studies. The three case studies require field studies in the respective countries. Contact persons have been identified in the Nicaraguan and Ugandan administrations. The Department for Evaluations and Internal Audit also reserves the right to take part in one of the field visits by agreement with the contracted team.

The study should take into consideration earlier evaluations of balance of payments support (see especially Evaluating Programme Aid, Volume III, Annotated Bibliography, ISS) and other relevant documents, specifically the ongoing evaluations of "The Special Program of Assistance for Africa (SPA)" and IMFs evaluation of the ESAF.

National statistical sources and comparable international sources will be used along with interviews and discussions with key-informants. Under (A) and (B) a Swedish-speaking team member is necessary. For foreign firms this might mean linking a Swedish researcher or consultant to the team. For the fungibility assessment (C) both *a quantitative and a qualitative* approach will have to be applied. Much emphasis will have to be put on collecting primary data in the respective case studies. To sustain the quantitative work in assessing fungibility the qualitative work will have to be built on systematic interviews with key officials in the administrations. Both *quantitative and qualitative* work have to be employed in (D) as well, specifically the qualitative work will have to encompass systematic interviews with the private sector to determine what factors influence private investments (the World Bank is now preparing a survey on this issue in Uganda and the evaluators may possibly be able to use some of their findings).

We recognise the difficulties in concluding fungibility, especially for the desk study countries. Naturally, we only expect the evaluators to carry out qualitative work in the case study countries (in addition to quantitative work). For the desk study countries we encourage the evaluators to make use of available data for the quantitative work and findings from previous studies to conclude fungibility and assess the impact on growth.

When statistical methods are employed the evaluators should attempt a consistent use of sensitivity analysis using different assumptions.

The evaluation will be carried out by a team with profound knowledge of and experience in:

– macroeconomics analysis,
– national accounts and balance of payment statistics,
– economic policy and government systems in developing countries,
– ability to speak and write in English and Spanish.

The team-leader is to have documented experience of evaluation in a team-leading position.

The study is envisaged to require an estimated 80-100 man weeks.

The *tentative* time schedule for the evaluation is:

Nov 1997:	Tender for consulting services.
Dec/Jan 1997:	Contracting the winning tender for the evaluation.
Feb 1997:	Preparation of inception report, including work plan.
Oct 1998:	Submission of annexes or background reports. A seminar to be held at Sida in Stockholm.
Nov 1998:	Submission of a main report and the annexes or background reports.

6. Reporting

a) An inception report shall be presented to Sida commenting and interpreting the terms of reference for the assignment. The inception report shall include a work plan for how and when the work will be carried out.

b) In connection with the field visit a debriefing shall be held reporting to relevant parties in the recipient country.

c) A main report with findings, conclusions and recommendations from the case studies and the desk studies is to be prepared. The main report shall keep an educational format and the more technical discussions are to be left in the annexes or background reports.

d) Draft reports for the desk studies and the case studies, showing the analysis made and methods used, findings and conclusions, shall be presented together with the main report. The case studies, building on field visits to three countries, shall be presented in different reports for each country. The desk study for the five countries can either be presented in one report or several reports depending on the methods employed by the evaluators. The reports can then either be appended to the main report or separate background reports.

The main report shall be written in English and should not exceed 80 pages each, excluding annexes. The outline of the reports shall follow Sida Evaluation Report – a Standardised Format (see Annex 2). Five (5) copies of each of the draft case studies and draft desk studies shall be submitted to Sida no later than October 30, 1998. Within five weeks after receiving Sida's comments on the draft reports, a final version of each case study and a main report in two copies each and on diskette are to be submitted to Sida. Subject to decision by

Sida, the reports will be published and distributed as publications in the Sida Evaluations series. The evaluation reports shall be written in Word for Windows or a compatible format and should be presented in a way that enables publication without further editing.

The evaluation assignment includes production of one summary according to the guidelines for Sida Evaluations Newsletter (Annex 3) and the completion of Sida Evaluations Data Work Sheet (Annex 4). The separate summary and a completed Data Work Sheet shall be submitted to Sida along with the main draft report.

Appendix 2
Policy reform in Sida programme countries

Policy reform in Sida programme countries

	Exchange rate	Trade reform	Price policy	Financial sector
Angola	Currency reform in 1990, with frequent subsequent devaluation, but dual rate remains in place.	Domestic and external trade opened to competition in 1991-92 but protection remains.	Most price controls removed 1991-92.	Banking sector reform 1991-92
Bangladesh	Devaluation from late 80s, exchange rate unified in 1992 with managed float thereafter (gradual depreciation).	Liberalisation in mid-80s.	Price controls gradually relaxed during 1980s (in 1990s only fertiliser and energy remain controlled).	Denationalisation of two banks in early 80s.
Botswana	Peg with occasional devaluation, some capital account liberalisation in 1990s.	Relatively open trade policy	No price controls	Relaxation of interest controls in late 80s and liberalisation in 1991.
Cape Verde	Pegged to basket of currencies and then Portuguese escudo (and hence the Euro from 1999)	Successive trade liberalisation since 1991 1991 (with some reversal 1995-96) with all quantitative restrictions removed 1997.	Price controls removed during 1990s	Banking sector reform in 1993 and liberalisation in 1996.
Eritrea	Linked to Ethiopian currency until own currency introduced in 1997 which was floated the following year.	Liberalisation in 1993, although restrictions remain.	Most controls abolished 1993-96	All financial sector institutions are government owned.
Ethiopia	Devaluation in 1992, with forex auction starting following year. Exchange rate unification in 1995 with continued devaluation.	Tariff reform since 1994.	Prices liberalised during 1990s.	Private banks permitted since 1994.
Guinea-Bissau	Unification of exchange rate 1992, joined CFA zone 1997.	Abolition of cereal monopoly in 1987-89. External trade liberalisation begins 1986.	Price liberalisation 1987-89	Banking sector reform in 1989.

Policy reform in Sida programme countries

India	Devaluation in 1990s, partial current a/c convertibility since 1994.	Some export incentives in 1980s, but first main deregulation 1991-94. Liberalisation continues throughout decade with sharp annual tariff cuts planned from 1998.	Minimum support prices for agricultural products	Capital market liberalisation in 1990, increasing interest rate sharply in 1991 with liberalisation beginning in 1998.
Kenya	Devaluation during 1993. Dual exchange rate abolished in 1993 and official rate set to float. Since 1993 currency has remained stable.	Quantitative restrictions removed 1988-91, with further liberalisation from 1994.	Price controls in agriculture lifted in 1990 and others in early 90s.	Interest rate liberalisation in 1990s.
Lao PDR	Exchange rate unification in 1988 with depreciation in 1990s; restrictions introduced in 1997.	Quantitative restrictions removed 1987-88, reduction in import tariffs 1988-89 and export taxes abolished 1994. Further import liberalisation 1995-98 (preferential tariff to ASEAN members).	Price setting removed from 1986.	Interest rates liberalised in 1989. Foreign banks allowed to open branches 1992.
Mozambique	Devaluation and introduction market window 1987 with unification in 1992.	Tariff reform started in 1989 and continued through 1990s.	Price controls start to be removed in 1986, with domestic trade in many goods permitted. Further liberalisation in 1988, with minimum prices replacing fixed prices. Most prices liberalised by 1994.	Increased interest rates since 1987, with liberalisation in 1996.
Namibia	Part of Multilateral Monetary Area, so linked to rand.	Very little. Some export incentives. Significant South African control.	No significant price controls.	Open financial system.
Nicaragua	Unsuccessful currency reform 1988-89, but successful in 1990 with devaluation and crawling peg since 1993.	Liberalisation started in 1990.	Many prices liberalised 1988-89, and most subsidies eliminated 1990.	Private banks permitted since 1990. Interest rate liberalisation 1991.

Policy reform in Sida programme countries

South Africa	Abolition of dual exchange rate (financial rand) in 1995; forex regulations relaxed 1997/98.	Tariffs replaced quotas in 1994 with tariff reductions (in accordance with WTO) since 1998.	Few controlled prices.	Fairly open sector, with interest rates set by Reserve Bank.
Sri Lanka	Liberalised in 1977, forex controls further relaxed in 1989.	Initial trade liberalisation 1977-82, further intensified after 1989.	Prices liberalised since 1977.	Interest rates liberalised 1989.
Tanzania	Various steps toward market starting in 1984, with full liberalisation in 1996. 1986, with final controls on fertiliser	Liberalisation since 1986, continuing in 1990s.	Phasing out of price controls since and petrol removed in 1995 and 1998 respectively.	Increased openness and interest rates liberalised, though privatisation of banks not done.
Uganda[1]	Exchange rate unified in 1993; capital account convertibility since 1997.	Import tariffs reduced 1992-97.	Controls abolished since 1993.	Financial sector reform, including interest rate liberalisation, in 1993.
Vietnam	Some liberalisation since 1988, but controls remain.	SOEs allowed to engage in external trade since 1981, tariffs replace quotas 1988-89. Import and export permits mostly abolished 1994-95.	Price controls removed on most commodities in 1987.	Positive real interest rates since 1989, but banking sector reform not carried out.
Zambia[2]	Official market window introduced in 1990 and rates unified at market rate in 1992. Capital account liberalised in 1994.	Substantial liberalisation 1991-93, with further liberalisation in later years.	Most price controls (and consumer subsidies) abolished 1990-91.	Interest rates liberalised in 1993.
Zimbabwe	Exchange rate unified in 1994 and current account convertibility established the following year.	Trade liberalisation since 1990.	Price controls removed 1993-94.	Interest rates liberalised 1993.

Notes: (1) Uganda policies refer to 1987 onwards not the 1981-86 episode interrupted by civil war; (2) Zambia reforms refer to 1990s only, not the mid-80s reform episode.

Policy reform in Sida programme countries (ctd.)

	Fiscal policy	Private sector development	Privatisation	Public sector reform
Angola	Lax, with periodic attempts to reduce deficit.	None.	Limited amount of privatisation in 1992, subsequently halted.	None (though 500% pay rise in 1995 postponed as not enough bank notes!)
Bangladesh	Reform of taxation: VAT introduced 1992, lowering of company tax. But exemptions and evasion persist.	Foreign investment encouraged during 80s, though main inflows (to EPZs) in 1990s. Domestic deregulation in 1990s.	Slow progress since 1991 (16 of >200 SOEs privatised).	Little or none.
Botswana	Run budget surplus since 1983.	Private sector orientation with incentives since 1980s	Slow progress in 1990s.	Maintained relatively efficient public sector
Cape Verde	Lax in mid-90s but deficit subsequently reduced.	Foreign investment first encouraged in mid-80s, with stronger measures in 1990s. Revision of labour codes in mid-90s.	Started 1992 by accelerated from 1997	Public sector reform discussed but not implemented during 1990s, with perhaps some progress since 1997.
Eritrea	Prudent and several tax reforms.	All sectors of economy opened to private capital in 1994.	None.	Establishing new government bureaucracy since independence in 1993.
Ethiopia	Some reduction of deficit (increased with war 1998).	New investment code in 1992.	Law enacted in 1992 and privatisations begin in 1995.	Acute shortages of skilled personnel, establishment of regional civil servants' college
Guinea-Bissau	Tight monetary policy in late 1980s but more lax in 1990s.	Encouragement of foreign and national direct investment through Office of Private Investment Promotion, subsequently disrupted due to conflict.	Some start in late 80s accelerated in 1995.	Slow start in late 80s, with some reduction in 1992 and major reforms begin 1997.

Policy reform in Sida programme countries (ctd.)

India	Attempted stabilisation in early 90s, but fiscal policy generally lax with many subsidies remaining.	Removal of entry barriers, 1991-96, reform of labour regulations.	Focus on gaining private sector entry to sectors such as infrastructure and energy.	Little or none.
Kenya	Fiscal discipline since 1993, with creation of Kenya Revenue Authority in 1995.	Easing of restrictions on private sector prices, production plans and salaries.	1988 partial privatisation, accelerating after 1990. slowing after 1993.	Planned reduction in civil service, as yet no progress
Lao PDR	Fiscal discipline since 1992, with several subsequent tax reforms.	Restrictions on private sector relaxed since 1986. Foreign investment liberalised 1988. Labour law relaxed 1990 and 1994.	Partial privatisation from 1988, accelerated from 1990-93 (then slowed).	Large reduction in size of civil service from 1988.
Mozambique	Fiscal stringency since 1991.	Encouragement of foreign investment.	Privatisation of small-scale enterprises begun 1988. Privatisation law in 1989, and large-scale privatisation over following decade.	None.
Namibia	Moderate fiscal position.	Private-sector oriented with incentives, foreign investment encouraged.	None	None.
Nicaragua	Cuts in expenditure since 1988, deficit is externally financed.	Deregulation and encouragement of foreign investment in 1990s.	Privatisation of SOEs 1990-95, and telecoms and utilities underway.	Phased reform during 1990s.
South Africa	Quite loose, but attempts at both revenue raising and expenditure reduction since late 90s.	Removal of subsidies.	Privatisation in 1990s but slow.	Little or none.
Sri Lanka	Fairly loose in 1990s, tightening from 1997.	Encouraged since 1977, with encouragement foreign investment and later deregulation.	Begun 1989.	Little or none.

Policy reform in Sida programme countries (ctd.)

Tanzania since	Stabilisation in late 80s, deteriorates in early-mid 90s. Cash budget introduced 1995 and Tanzania Revenue Authority created.	Increased role for private sector since early 1980s.	Carried out since 1995.	Failed retrenchment in early 1990s, but carried through 1995.
Uganda[1]	Uganda Revenue Authority created 1991. Cash budget introduced in 1993.	Attempts to promote private sector, including foreign investment, since late 1980s.	Planned since 1987, but begun 1993.	Retrenchments, 1992-94.
Vietnam	Subsidies abolished and revenue reform in 1990s.	Private sector increasingly allowed to operate since 1979.	Not done.	Little reform in core civil service but substantial retrenchment in army and SOEs in early 1990s.
Zambia[2]	Cash budget introduced in 1993. Zambia Revenue Authority created 1994.	Private trade in all commodities on 1990, except mealie-meal which followed three years later.	Privatisation agency created 1992, with acceleration of privatisation programme in 1996.	No substantial reform despite many plans for such.
Zimbabwe	Lax fiscal management.	Deregulation (eg marketing boards) since early 90s and more open attitude to private sector.	Begun 1996.	Little.

Notes: (1) Uganda policies refer to 1987 onwards not the 1981-86 episode interrupted by civil war; (2) Zambia reforms refer to 1990s only, not the mid-80s reform episode.

Appendix 3 Executive summaries of the working papers

There are no executive summaries for the following working papers:

99/17:11 Programme aid, Policies and Politics. Programme aid and conditionality
99/17:12 From Commodity Aid to Budget Support. Programme aid and its modalities
99/17:13 Assessing Aid: a Manifesto for the 21st Century?

All thirteen working papers may be ordered from:

Infocenter, Sida
S-105 25 Stockholm
Phone (+46) 8 795 23 44
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99/17:1

Development by Default Programme aid to Bangladesh

Executive Summary

1. Programme aid is of decreasing importance to Bangladesh as compared to other aid flows, notably project aid. Whereas bilateral donors used to give a large part of aid as balance of payments support, which was often tied import support, in the second half of the 1980s this has shifted to project aid specifically targeted at the poor. In the 1990s, programme aid was only given by the International Financial Institutions. The reasons given for this shift included that a liberalised foreign exchange regime made this modality of balance of payments support irrelevant, and that that these donors did not agree with the government's development

priorities. However, another important reason probably was that Bangladesh did not have a serious multilateral debt problem. There was no pressure from the IFIs on the bilaterals to continue programme aid.

2. Economic reform was already initiated early on since the military came to power in 1975. These reforms implied a gradual liberalization of agricultural marketing and prices, more freedom for SOEs, and an export retention scheme as well as a parallel exchange market for foreign exchange. However, structural adjustment came formally on the political agenda in 1986 in an agreement about a three-year Structural Adjustment Facility with the International Monetary Fund, which was also supported by the World Bank. From then on, donors have been pushing for other reforms such as privatization of SOEs, tax reform, trade liberalization and financial reform. In 1990, an agreement was concluded about an ESAF, which was implemented after democratisation in 1991. To date, no agreement on a new ESAF has been reached after its conclusion in 1993.

3. A forum for donor co-ordination was already set up in the 1970s: the annual meetings of the Bangladesh Aid Group. In spite of their limited amounts of programme aid in the 1990s, bilateral donors continued to have some leverage in this policy dialogue. First, the Bangladeshi government was heavily dependent on aid for its development budget and for financing the budget deficit. Secondly, many bilateral donors were important as export markets for the rapidly increasing ready-made garment exports.

4. Inflation was reduced from levels above 10 per cent before 1990 to one-digit figures in the 1990s. The government achieved more control over the budget deficit and over monetary expansion. Tax income increased in 1992 due to the introduction of a value added tax. In 1992, the exchange rate was unified. In these areas the policy dialogue was successful. Aid flows also played a role in stabilization, since about two-thirds of the budget deficit could be financed from aid. But the increase in revenues was also important for stabilization. Further tax increases stagnated, however, and the implementation of other reforms was very slow and uneven. Small steps were combined with many exemptions and countervailing actions. The recent aid reduction is already leading to a higher budget deficit.

5. Aid flows have allowed a higher level of imports than would otherwise have been possible. This has probably led to a higher growth rate. However, the impact of aid on imports and thus on growth was relatively small. Other sources of foreign income were quantitatively much more important, such as rapidly growing exports and private remittances. The impact of programme aid was even smaller than that of aid in general.

6. While structural adjustment as such is not in debate in Bangladesh, the implementation of reforms affects vested interests. Trade unions are especially strong in the public sector. Managers and workers of SOEs face lower incomes, banking reform is stalled because of the bad performing debts,

many of which are due to SOEs, high government officials, and bank directors themselves. Further trade liberalization would reduce effective protection for domestic industries. In the weakly institutionalized democracy of Bangladesh, vested interests easily shift political alliances. Whatever party is in the opposition capitalizes on discontent in order to (re-)gain state power. Labour unrest and other protesting actions are the order of the day. While aid dependence makes the government of the day comply with donor demands, actual implementation is an entirely different matter.

7. The economy performed quite well. Macroeconomic stabilisation was successful after 1991 and the currency was relatively stable. Economic growth was at about 4 per cent for more than a decade, and increased to 5 or 6 per cent in recent years. The most important success has been achieved with respect to exports. They have increased spectacularly since the 1980s. This is mainly due to ready-made garments, but also other textiles, leather products and fish farming (shrimps). The balance of payments situation also improved by rapidly increasing remittances from Bangladeshi working abroad. Private savings and investment rates have also risen in recent years.

8. The export success can only partially be ascribed to policy reforms, however. It began with subsidized credits and the introduction of an export retention scheme, and special bonded warehouses. These measures reduced the anti-export bias and, in the case of directed credit, stimulated specific export sectors. Bangladesh could so benefit from the reduced access to OECD markets that hit other, earlier, successful Asian exporters. Paradoxically, some of the subsidized credits now form part of the large portfolio of non-performing loans of the banking sector. These non-performing loans lead to credit restrictions that hamper further growth in the export sector.

9. Agricultural production, which is dominated by the production of food grains, has risen over the years although at a very slow pace in the 1990s. Since the vast majority of the population lives in the countryside (80 per cent) and 60 per cent of the labour force is employed in agriculture, this also implies a slow growth in average rural incomes. Self-sufficiency in food seems to remain elusive; there is a persistent shortfall between consumption and production.

10. A frequent comment in policy dialogue is that economic growth is not sufficient for the needs of Bangladesh. Population growth of about 2 per cent per year makes the income growth per capita still relatively small. Although the (relative) incidence of poverty is decreasing since the early nineties, the effects of economic growth on poverty are uneven. Economic growth undoubtedly lifts a group of people out of poverty, but it leaves the lives of the extreme poor untouched. The incidence of poverty is related to access to land, education and off-farm employment. Evidence points to an increase in the number of landless rural families, and to an increase in

the absolute number of poor. The evidence with respect to social indicators may also point in the direction of an uneven impact of economic growth. These indicators improve, but continue to lag behind those of neighbouring countries.

11. In 1998, the negotiations on a new ESAF broke down. The main reasons included the failure to privatize state-owned enterprises, to increase tax revenues, and to make progress on financial reform and reforms of the public sector. Nevertheless, the policy dialogue is important. Donor influence may help to overcome the collective choice problems that are involved in implementing further reforms.

12. Bilateral donors are not only concerned with progress on institutional reforms, but also with the targeting of government expenditure, which is considered to be not sufficiently in the interests of the poor. The result of these considerations is a move to sectoral programmes in which the Government of Bangladesh works together with a consortium of donors in an attempt to better reach the poor.

99/17:2

Supporting Success
Programme aid to Cape Verde

Executive Summary

1. Cape Verde is a lower-middle income country with apparently bleak development prospects. Yet despite limited natural resources, poor infrastructure and frequent prolonged drought the country has enjoyed a good growth record since independence in 1975 and has avoided a large external debt. This good performance is explained by substantial inflows of both remittances from the Cape Verdean diaspora and aid, both amounting to about 20 per cent of GNP. This translates to aid of over $300 per person, making the country one of the highest aid recipients in the world.

2. Sweden is amongst those countries giving a disproportionately large amount of aid to the country, which may seem odd given the lack of any historical ties and that there remains no Swedish representation in the country (the programme was first administered by the Embassy in Guinea-Bissau and now directly from Stockholm). Furthermore, 80 to 90 per cent of Sweden's aid has been financial programme aid, whereas few other donors have used this sort of aid (though there has been substantial food aid which the government has monetised). Moreover, programme aid has been used despite the fact that until 1997 there was no formal policy dialogue with the International Finance Institutions (IFIs), so that the channels by which Sweden links its aid to reform were not available.

3. The modality of Swedish programme aid has evolved as elsewhere. As elsewhere, administrative import support was used for some time, even though the cumbersome procedures that go with this type of aid slowed disbursements and lagged behind the development of a market-based forex system. However, Sweden has since shifted to a far more flexible form of budget support, but has only done so by putting in several conditions intended to prevent the mis-use of government funds on items such as corruption and military expenditure. Whilst the move to budget support is to be applauded, the value of the additional conditions can be questioned. The absence of IFI policy-based lending for most of the period has meant that there has been no formal policy-based conditionality, and this has not been introduced since the start of IMF lending in 1998.

4. Economic and political reform were initiated in the second half of the 1980s by the ruling and formerly-socialist *Partido Africano de Independencia de Cabo Verde* (PAICV), (the party in fact retains its socialist orientation, but oversaw policies such as an opening up to foreign investment and the

introduction of multi-partyism). The pace of change has accelerated since the *Movimento para Democracia* (MPD) was elected to power in January 1991 (which introduced a reform programme named Mundança). There is no doubt that the reform programme is "home grown". The politics of reform are understood by the country's torn identity, part African and part European, with the latter reinforced by the fact that there are more Cape Verdeans overseas than there are in the islands themselves. The coup in Guinea-Bissau in 1980 ended plans for unity, simultaneously weakening the African part of the country's identity and undermining the power-base of the PAICV who had been a part of the successful independence war there. Accommodation was thus sought with dissident elements, including those overseas, who favoured reform.

5. The role of the donor community in the reform process has necessarily been limited. Although there has been no adjustment programme there have been various World Bank technical assistance credits (for privatisation and public sector reform) which have supported the reform process with varying degrees of success (plans for retrenchment in the civil service have not taken effect). However, the fact that the country has been carrying out reforms of its own accord has meant that donors interactions have largely been restricted to some specific issues, such as counterpart funds. Sweden is no exception in this regard, and Swedish influence on Cape Verdean policy may be fairly safely stated to have been nil. Indeed, it is not clear that there has been much attempt to exert any influence (nor even that it was the objective of Swedish assistance), although Sweden has now entered the macro arena with a mission and a macro study in 1998.

6. Whilst aid has undoubtedly helped to increase income levels (and can clearly be shown to have increased both imports and investment) it is less clear whether the aid is helping Cape Verde establish a diversified, self-sustaining development path. One question to be confronted is therefore whether such high aid to a middle-income country with which Sweden no longer has any sort of special relationship can be justified. This report concludes that it cannot and that Sweden is correct to pursue its current policy of pre-announced and phased disengagement, although a shift to INEC credits may be appropriate. However, if Cape Verde is to meet its development challenge it is quite likely that it needs a stronger vision of its future than liberalisation alone. Rather than simply support the liberalisation agenda in the years that remain of Swedish aid, some attempt may be made to facilitate debate on the country's development path (Sweden has more explicitly entered the policy arena in the last couple of years, though not in this role of questioning the reform strategy).

99/17:3

Reform, Rehabilitation and Recovery Programme aid to Mozambique

Executive Summary

Introduction

1. Mozambique presents something of a conundrum. Since 1987 the country has received very high levels of aid, reaching over 100 per cent of GNP for three years in the early 1990s. These are way above the levels of aid at which donors may be expected to grumble about aid dependence. Recent research, by the World Bank amongst others, presents evidence that such high levels of aid may well be detrimental rather than beneficial for the recipient. Despite all this, there are calls for higher levels of aid for the purposes of debt relief. Not only that, but critics argued that IMF spending limits prevented the country rebuilding infrastructure after the war and donors seek ways around these limits so that they may spend their aid, rather than it simply being used to offset the deficit finance. So which is it? Would Mozambique be better off with more aid or with less? And what form should this aid take?

2. This report approaches these questions as an evaluation of programme aid during the 1990s. As an evaluation the report reviews issues which operational agency officials may feel have been long-resolved. Yet past experiences hold important lessons for today. It is demonstrated here, as has been well documented in many sources, that donor restrictions on the use of import support turned supposedly quick disbursing assistance (QDA) into difficult to utilise pots of money, tied up scarce government and donor administrative resources and, in the end, impeded the very liberalisation they were intended to support. It is argued here that the same dangers are being confronted in the current treatment of sector programmes and the tying of the countervalue from debt relief. Moreover the imposition of donor restrictions means that the aid will have the sort of institutionally destructive effects which can mean that more aid is worse not better. But this situation can be avoided. Whilst donors are legitimately concerned that their aid should not be misappropriated, they should avoid getting too heavily involved in the day-to-day management of what are meant to be free resources. Hence the report argues that, subject to certain conditions being satisfied, Mozambique should receive debt relief with untied countervalue and basket (i.e. non-earmarked) funding for sector programmes.

3. This report also considers how the policy dialogue process has affected Mozambique's development. There are two questions here: how have donors influenced policy, and what have been the effects of policy change?

Programme aid modalities

4. Import support was disbursed first as commodity import support through allocative mechanisms, then through quasi-market schemes and finally into a mostly liberalised forex market. Many donors imposed restrictions on the use of their funds for an excessive period which undermined government's attempts to establish a liberalised market and slowed up the disbursement of the donor funds. Donors have also earmarked their countervalue to a large degree, and continue to do this with debt relief. In the presence of spending limits this practice can distort spending patterns. It is likely, and to be hoped, that the funds received by Mozambique under the Enhanced HIPC initiative will not be restricted in this way.

Policy dialogue

5. Mozambique began reforms in 1983. The International Finance Institutions (IFIs) more usually date the reforms from 1987 (the year of the first IMF and World Bank adjustment credits), and thus over-state their own importance. A number of factors drove Mozambique to reform - the recognised failure of central planning, including resistance to it in rural areas, the lukewarm support of the Soviet bloc and the need to accommodate the West so as to reduce their backing for the Renamo rebels. Western pressure was thus just one of a number of factors. The momentum of reform has been maintained by an emerging domestic constituency for reform.

6. Adjustment policies have been controversial, as they have elsewhere. However, as an economy emerging from decades of war with a ravaged infrastructure, Mozambique does appear something of a special case. In particular it seems that more consideration should have been given in the early 1990s to arguments that IMF spending limits were too tight given the need for reconstruction, and hence hinder the possibility of restoring growth (and so fuel inflation by tightening supply bottlenecks). Growth performance was very uneven in the first half of the nineties and concentrated in services, rather than agriculture or industry (although there has been something of an agricultural supply response). These arguments did not seem to have been greatly considered by the IFIs although they are supported by a range of opinion. With the exception of one notable incident, the bilaterals have not made much attempt to introduce a debate on this matter.

7. In the second half the 1990s the country's performance has improved markedly, with growth averaging 10 per cent and stabilisation having finally been achieved. Whether this is the outcome of sustained reform, good weather, or the effects of rehabilitation (partly indicated by a remarkably high investment rate) remains a matter for debate. Critics of the IFI stance continue to argue against the extensive application of a market-based philosophy (e.g. with respect to cashew nut processing, which has been the subject of some controversy). On the hand, IMF conditions have become "laxer", with the limit on spending before grants finally being lifted, allowing aid dollars to be used to increase government expenditure. In summary, the Mozambique policy dialogue story seems to be have surrounded by some acrimony (more than is evident from IFI documentation), but with some eventual accommodation by the IFIs.

8. The government and several civil society actors, such as trade unions, are active in calling for the total cancellation of external debt. Even post enhanced HIPC (the terms of which will be retroactively applied), debt service will be considerable (equivalent to annual spending on health). Whether debt relief for bilaterals is still an option is an issue of some controversy (this report argues that it should be continued).

9. Other objectives of poverty, gender and the environment have not received much attention in the policy dialogue process. Indeed, environmental issues appear to have received none. Mozambique was selected by the SPA as a pilot for gender-sensitive adjustment, but few people seem aware of this fact and the relevant modification to the programme (monitoring the impact on women of liberalisation in the cashew market) rather modest. Poverty has received more attention, especially social sector reform (which may not be that poverty-focused) which is central to the highly indebted poor country (HIPC) conditions although rather marginal before. Under Enhanced HIPC, poverty is of course central, though this was not anticipated in the most recent PFP.

10. The policy dialogue process in Mozambique has been dominated by the IFIs to an even greater extent than is usually the case. Nonetheless, this is a case in which some Swedish influence can be discerned. There have been several cases of Swedish actions that have related to policy matters (of varying importance and effectiveness); this role to some extent reflects Sweden's historical association with Mozambique. During the 1990s Sweden's presence has mostly been felt through its activities with the like-minded group. However, the areas of influence have not in general been notably motivated by a "Swedish position".

Impact of programme aid funds

11. Programme aid funds have supported several macroeconomic aggregates. Exports remain a very low share of imports, so that aid inevitably finances a large share of the latter. In the late 1980s incentive goods were important,

though that argument is less easy to make in the 1990s. Much aid has also gone to debt service. With aid to GNP ratios in excess of 100 per cent it is inevitable that some aid is consumed (indeed quite a lot goes to recurrent expenditures), which makes a short run negative impact on domestic savings likely, though not inevitable since the no aid counterfactual also has lower income. The budget deficit was reduced at a time when grants increased. In the presence of IMF spending limits this fact meant that the increase in aid went to offset domestic deficit financing, which should have a counter-inflationary effect. However, as indicated above, a counter-inflationary effect may also have been realised if the funds were spent relieving supply bottlenecks. Donor attempts to earmark countervalue crowds out government's own spending priorities. Since donors now earmark to social sectors adverse inflationary effects may be expected.

99/17:4

Debt, Dependence and Fragile Development Programme aid to Nicaragua

Executive Summary

1. Aid to Nicaragua in the 1990s was large, both relative to GDP (at about 30 per cent) and to imports and exports. Programme aid, including balance of payments support, import support and debt relief, constituted 64 per cent of total aid over 1990–1997. The country succeeded in controlling hyperinflation in 1991, but economic growth did not come about until 1994. Nevertheless, this report concludes that aid was very important for both stabilization and growth. In the absence of aid, stabilization could only have been achieved at much higher costs in terms of growth.

Programme aid

2. Although programme aid in general was a large share of total aid, the share of freely spendable programme aid was more limited. A large share of balance of payments support was tied to import support or commodity import support. Many donors continued to use this relatively inefficient system of deciding on the kind of imports, while the Nicaraguan government had by 1990 already liberalized access to foreign exchange. This created and maintained inefficiencies. Sweden was one of the first bilateral donors to apply more a flexible balance of payments support (retroactive financing), but many other donors continue tying their import support to this day.

3. In 1991, several bilateral donors paid the accumulated debt service to multilateral institutions, thus freeing the way for new programmes. Debt relief for multilateral debt service was limited in later years. In practice, most freely spendable balance of payment support was also used for multilateral debt service and other "priority debt service". There was no explicit "budget support" to the Nicaraguan government, but debt relief was of course at the same time budget support. In addition, freely spendable balance of payments support and countervalue funds from import support can also be considered budget support. However, the amount of freely spendable countervalue funds was limited. Many bilateral donors applied and continue to apply "double tying": they set conditions for the import side *and* for the use of local countervalue funds. Most donors do not seem to trust the use of the funds by the government. In 1998, the government made a proposal for sectoral budget support in the form of a Supplementary Social Fund, which seemed to be well received by several bilateral donors.

Impact of aid funds

4. Debt relief and debt forgiveness given for the restructuring of debt by the bilateral creditor itself are not included in the regular aid figures, but amounts given in this way are considerable. The debt stock was reduced from US$11 billion to US$6 billion between 1990 and 1996, mainly due to a reduction of bilateral debt, while US$ 1,6 billion was cleared by a commercial debt buy-back financed by bilateral donors. As a result of this debt stock reduction, debt service *due* declined considerably. However, more of the remaining debt service is now "priority debt service", so actual debt service has not decreased. Debt/GNP and debt service/export ratios are still at unsustainable levels. The reduction in debt overhang may have been important in increasing the (perceived and real) government's willingness to pay the remaining debt, and so freeing the way for new loans including private loans.

5. In Nicaragua's stabilization strategy, the exchange rate played the role of a "nominal anchor". This required foreign reserves to be available both for increasing the credibility of the anchor, and for allowing imports to come about. In addition, aid was used to finance the budget deficit. For the latter, it holds that the more the aid was freely spendable, the more effective it was for stabilization. Project aid, and the setting of conditions for countervalue may have led to additional spending if these projects would not have been carried out anyway.

6. The impact of aid on growth can be assessed by examining what would have happened to imports in the absence of aid. This analysis of the "counterfactual" shows that even if the country had paid no arrears and had serviced no debt at all, imports would have fallen to about one-third of actual levels in 1990–1993. In this scenario, assumptions about other balance of payments flows are still rather optimistic. In the absence of programme aid only, imports would have been 30 to 70 per cent lower than actual (with a negative figure for 1991). The high dependence on imports, and the actual trends in imports in the period 1990–1997 show that there is a close relationship between imports and growth. For these reasons, we can assume that the country would have fallen in a severe economic crisis in the absence of (programme) aid. Furthermore, the recovery of imports in 1994 and later years in this counterfactual scenario can be questioned: this recovery is based on the higher export figures of the factual, which can be assumed to be the result of stabilization at relatively low cost in terms of economic growth – which was possible because of the use of the exchange rate as nominal anchor.

7. The use of the exchange rate as nominal anchor does normally lead to some overvaluation of the exchange rate. This proved to have happened also in Nicaragua during 1991–1993, thus hampering somewhat the growth of exports in these years. In this respect, there was an unavoidable trade-off between stabilization and export growth, not well understood at the

time by, for example, the World Bank. World Bank staff expected a low and competitive exchange rate, fostering exports, both to be achieved within one year (World Bank, 1990).

8. Aid not only allowed a higher import level, but in 1991 and 1992 it also led to an increase in imports of consumer goods. This was partly the result of the overvaluation, but also proved to be some necessary recovery from very low consumer goods imports in the 1980s. After 1992, the share of consumer goods came down. Aid definitely helped to increase public investment in the 1990s. Although there was some underexecution in the beginning, this investment was important in rehabilitating the country's physical and social infrastructure. In the medium term, this will have a positive effect on growth. Aid in general (including programme aid) does not seem to have been used for an increase in government social spending, nor were there any conditions on this social spending.

9. Given the still large trade deficit and budget deficit, the stabilization of Nicaragua is extremely vulnerable. In 1993 and 1997 the country experienced a drop in aid and in particular in programme aid, and stabilization was in danger. In 1997, reduced programme aid forced the Central Bank to attract private foreign capital. In 1993, this way of coping with less programme aid was not yet possible: a formal reason was that capital account convertibility had not yet been introduced. A more substantive reason is that private inflows would not have come about yet: political and economic stability was still perceived as fragile, and the economy was stagnating. However, private inflows of short-term capital in itself may endanger stabilization. The bonds (CENIS) were exchange rate-indexed and had a high interest rate, so a large flow of short-term capital came about. In combination with a relaxation of domestic monetary policy this led to an expansion of private domestic credit and to a large trade deficit. This required very strict fiscal and monetary policies in 1998, even though aid flows in that year were higher again.

Policy dialogue

10. The policy dialogue in Nicaragua was not very effective. First, some important reforms, such as the liberalization of the foreign exchange market and the privatization of many state enterprises, would have been carried out anyway, given the political orientation of the new government in 1990. Second, although agreements with IMF and World Bank were concluded (1991, 1994 and 1998), the government only complied with the targets for about one year (for the 1998 agreement we still do not know of course for how long the government will comply).

11. Overviewing the process of decision-making over macro-economic policies, a kind of cyclical pattern can be observed. The agreements with IMF and World Bank include strict monetary and fiscal targets and structural reforms. But after both the first and second agreements (1991 and 1994,

respectively) the government only met the set targets for about one year. The agreements were important in triggering large amounts of programme aid. But in the following year, programme aid was reduced. The reasons why the targets were not met include:

- The government was under very strong pressure to reach an agreement with the IFIs, due to high aid dependence and the large official foreign debt. This led to agreeing perhaps too easily to IFI demands.
- World Bank and IMF underestimated the magnitude of the institutional changes that Nicaragua had to go through and the strength of the opposition to particular measures.
- The lack of a stable democracy complicated domestic decision-making. There was a continuous struggle between elites and, especially in the first years, also between elites and the lower social strata. The latter were the losers in stabilization and privatization policies; the former fought each other over the benefits, in particular, of privatization. Domestic support for measures that followed from IFI agreements could often not be secured.
- "Moral hazard" occurred on the part of the government: once the (programme) aid was received, there was an incentive not to carry out the reforms (fully). On the other hand, aid also facilitated the compensation of potential losers from stabilization and reform, in particular, the leaders of the Sandinista party.
- Weak donor coordination. The US suspended programme aid in 1992 for political reasons that had nothing to do with macroeconomic policies. In 1995, a group of bilateral donors and the World Bank, each for their own reasons, suspended programme aid which also made it difficult for Nicaragua to meet the IMF targets.

12. On the other hand, aid was not completely withdrawn because of non-compliance. Although the IMF did not disburse anymore on its ESAF in 1995, it convinced other donors to continue disbursing programme aid. Apparently, the IMF itself had multiple objectives: on the one hand, it wanted to signal to the Nicaraguan government that slippage had occurred, on the other, it did not want to reduce programme aid.

13. Bilateral donors left the setting of macroeconomic conditions to IMF and World Bank, and focussed more on other issues. When it came to assessing the macroeconomic situation after non-compliance with IMF and World Bank conditions, bilaterals were often more comprehensive and continued disbursing programme aid. Bilaterals were very concerned with the delicate political situation and feared new civil strife. However, this comprehensiveness gave "mixed signals" to the Nicaraguan government. It would have been more effective if this comprehensiveness for the political situation had influenced the agreements themselves, so that the chances of compliance had been greater. At the same time, bilateral donors stressed that social effects should be taken into account in macroeconomic policies,

and that transparency of the budget be improved. However, these issues were not taken up by IMF and World Bank; only in the most recent ESAF, expenditure targets were softened in the case of social expenditure, provided it would be financed from foreign aid. A more active engagement in the debate on macroeconomic policies and reforms, and/or a more active role in *fostering* the debate on these reforms would have led to more realistic macroeconomic targets, and probably also to a better reform strategy. Apart from the lack of attention to the social effects of reforms, one can also wonder about growth-enhancing effects of the reforms as designed in the agreements with IMF and World Bank (for example, privatization of public utility enterprises, trade and financial reforms).

14. Bilateral donors did have some success in influencing the political situation. This holds, in particular, for the Support Group for Nicaragua, installed by the General Assembly of the UN, of which Sweden was a prominent member. The activities of the Support Group were important for domestic political reconciliation and stability, which was a necessary condition for achieving economic stability.

Supply response and poverty reduction

15. In the first years, 1990–1993, there was hardly any supply response to the liberalizations of the foreign exchange market, of domestic prices, and of the financial sector. Some delay could be expected, given the low productivity level of the economy, and some disruptive effects of the reforms themselves. Another problem was the lack of political stability which affected private investment. In addition, the overvaluation of the *córdoba* in these years hampered exports. This was to some extent unavoidable given the priority for stabilization. However, the rapid reduction in import tariffs (in combination with overvaluation) led to large volumes of imports of consumer goods destroying local production.

16. After 1993, the economy grew at about 4 per cent per annum. The largest production increases are registered in export crops like coffee, in basic grains production, in fisheries, in manufacturing exports and in urban sectors like commerce and services. Growth is to a large extent export driven, and the share of private consumption in GDP decreased in recent years. This means that some real adjustment has taken place. Production in the manufacturing industry declined in the early 1990s, and recovery is slow. This is mainly due to the stagnation in domestic private demand.

17. With respect to sustainability, a worrying factor is that private investment is still rather low. Only in the rather peculiar year 1997 (because of large private capital inflows) did private investment surpass public investment. Until 1997, a lot of private investment was directed to the construction of hotels, restaurants, shopping malls, banks and private dwellings. Although this contributed to economic growth, it did not enhance sustained economic development. Another problematic factor with respect to sustainability is

the extensive nature of the growth in basic grains production. It is particularly extensive on land; more and more rainforest is burnt, and little is done to restore or improve soil fertility.

18. In coffee, the expansion of production comes from large producers who benefited from state-directed investment credits. Increases in sugar, soya, peanuts and other non-traditional primary exports also benefitted mainly the larger producers. Small farmers benefited from expansion in basic grains production and in the increased production of milk, cheese and eggs. Construction and commerce activities are to a large extent urban and concentrated in large enterprises. However, they led to an increase in employment. In the early 1990s, unemployment increased rapidly. It is still high (13 per cent, and including underemployment, 26 per cent) but it has declined from the 18 per cent of 1993. However, the expansion in employment is accompanied by falling real wages. In rural areas, incomes increased in some regions but decreased in others. In general, poverty is more severe in rural areas than in urban areas.

19. Some other indicators also point to a deterioration of income distribution. The allocation of credit in the 1990s has favoured large scale producers. Although many formal land titles have been given to beneficiaries of land reforms of the 1980s and of the redistribution of state farms in the 1990s, many small farmers have been forced to sell these lands. With a shift from direct to indirect taxes, the tax system has become more regressive. Public expenditure for health and education did not increase and it decreased in real per capita terms. In addition, spending is not targeted to the poor. Primary school enrolment rates have decreased in the 1990s. Although infant mortality rates decreased according to official figures, other evidence points to increased incidence of malnutrition and diseases such as measles and dengue. The aid-funded Emergency Social Investment Fund (FISE) has become rather effective in constructing a social infrastructure, but coordination with the relevant ministries is weak and it is partly used for propaganda purposes. On the whole, liberalization brought greater income inequality and very uneven "trickling down" of benefits from growth.

Programme aid from Sweden

20. In the course of the 1990s, the amount of Swedish programme aid to Nicaragua fell. Over time, Swedish balance of payments support has become increasingly flexible: as of 1991, a large part of import support was retroactive financing of oil imports, and debt relief has become more important within programme aid in later years. Since most Swedish programme aid was either debt relief for servicing priority debt, or provided freely spendable countervalue, it fully contributed to stabilization.

21. Largely as a consequence of its active involvement in macroeconomic policies in the late 1980s, Sweden did attempt to influence macroeconomic policies, at least until about 1995. Sweden financed advisory missions and

created a group to design a debt strategy, with a view to strengthening the Nicaraguan government's negotiating capacity. At least one of these expert missions had some influence on macroeconomic policy.

22. With respect to the conditions for programme aid, Sweden followed the IMF and World Bank agreements. However, Sweden was one of the few bilateral donors in 1993 to continue programme aid (when there was no agreement with the IFIs), and one out of several bilateral donors continuing programme aid in 1995 and 1996, when IMF targets were not met but the IMF was discussing a bridging programme with the government. At the same time, Sweden was very concerned about the political situation. In 1995, Sweden was the first donor to suspend programme aid in order to put pressure on the government to solve the constitutional crisis. This suspension was announced publicly. Other bilateral donors followed, but did not make it public. As a prominent member of the Support Group for Nicaragua (see above), Sweden actively contributed to promoting the dialogue that led to a solution for the constitutional crisis. The suspension of programme aid may have played a role as well.

23. Already in the early 1990s, Sweden expressed concerns over the social consequences of adjustment measures and the lack of transparency of government accounts. Apart from a small success in relation to the 1998 ESAF agreement, very little progress has been achieved in this area.

99/17:5

Counting the Donors' Blessings Programme aid to Tanzania

Executive Summary

1. Tanzania has an image of resisting the influence of the international financial institutions and donor community with respect to economic reform. However, this view overlooks the fact that structural adjustment and economic reform were already under way when agreement was reached with the international community about adjustment and reform in 1986. This agreement was followed by large flows of aid - especially Programme Aid - which tailed off in the early nineties as policy dialogue became stuck. Public finance was central to this stagnation of policy dialogue and issues were only resolved after the elections of 1995.

2. In the first stage of negotiations with the donor community (1986-1992) attention was only given to deepening reforms which were already under way. Market forces were opening up while vested interests in the state sector were left untouched. In fact, the latter could benefit from the opening up of the economy. Donors thus played a useful role in this period through policy dialogue, though very arguably not a crucial one. The funds helped what measure of stabilisation there was and provided both the forex and the mechanism for liberalising the foreign exchange market (although some donors stayed too long with schemes which dragged behind the pace of reform, this comment certainly applying to Sweden).

4. However the deterioration of public finance in the 1990s brought issues to the fore in deteriorating government-donor relations, and started to hit vested interests through measures such as improved tax collection and the introduction of hard budget constraints on parastatals. These issues were being slowly handled in an IMF shadow programme (i.e. the government agreed to conditions without receiving IFI funds) monitored by a group of donors, but the big breakthrough came after a new government came to power in 1995.

5. A cash budget was introduced after 1995 and government finances were brought under firmer control than before. These changes were accompanied by a decline in the rate of inflation, a drop in interest rates and relative stability of the currency. Gradual reforms in the exchange rate regime were followed after 1995 by a complete liberalisation of the foreign exchange market. The budget deficit was turned into a surplus - which was needed to reduce government debt (although the surplus is after external grants, as may be expected in the presence of continuing high levels of expenditure-raising aid flows). Programme aid was therefore

instrumental in macro economic stabilisation through the budget and the availability of foreign exchange helped stabilise the exchange rate.

6. Policy dialogue changed its focus from issues of macroeconomic stabilisation to more institutional concerns over the course of time. Privatisation and civil service reforms have been the major issues at stake. Significant reductions in the size of the civil service have taken place, but have not lead to significant reductions in expenditure, thus raising important questions of the effectiveness of spending. There is also progress in privatisation but it is stuck on reform in the banking sector, which almost led to a breakdown of negotiations for a renewed Enhanced Structural Adjustment Facility in 1998.

7. Within the Tanzanian political system there is consensus about the need for reform as well as on other issues in policy dialogue like corruption. What open criticism there is tends to be on the way in which reforms - for example privatisation - have been carried out. But stagnation in progress on reform, especially with respect to public finance, is indicative of hidden resistance of affected groups. Policy dialogue seems therefore to have been instrumental in breaking the influence of powerful partial interests in order to overcome collective choice dilemmas. Under such circumstances it is difficult, if not misleading, to attribute a role to any single donor (certainly any single bilateral). We find little evidence of a unique Swedish role, but this is not the same as saying that Sweden's support for policy reform has been irrelevant.

8.. Policy outcomes are thus obvious with respect to macroeconomic stabilisation, but less clear with respect to the supply response. However, it is undoubtedly so that there has been a supply response in the Tanzanian economy. Exports are growing and the deficit on the trade balance remains large, but it is narrowing (of course the balance is largely aid-financed and aid had been falling). The supply response differs in various sectors. Food production is widely seen as particularly responsive to liberalisation. Cotton production is also a clear example of a supply response, which followed quickly after reform set in. Some sectors do not show a supply response at all despite reforms, notably coffee and sisal. Other sectors showing a supply response in the 1990s were tea, tobacco and cashew nuts. The reasons for this differential response are however, not particularly clear.

9. Poverty has decreased since liberalisation, but the mechanisms through which this has taken place are not obvious. There is in the Tanzanian case no documentation as to whether a bigger share of the world market price reaches the producer after liberalisation. The income effects of economic reform are therefore not precisely known. This opaque situation is compounded by the fact that the role of the informal sector is allotted a big place in poverty reduction, but the precise nature of this influence is not particularly clear either. Programme aid is given a role in poverty reduction as a reduction in the price of imports made a cheapening of wage goods possible. Protection of social sector spending is imperfect in Tanzania and the effects on social indicators of reform are yet to be determined.

99/17:6

What Does the Showcase Show? Programme aid to Uganda

Executive Summary

1. This report assesses the impact of Swedish programme aid in Uganda. Uganda is widely seen as one of the few success stories in Africa, where the structural adjustment programme seems to have led to high economic growth. It is therefore interesting to examine to what extent the relative success of Uganda indeed can be ascribed to programme aid and the attached reforms. Since it is difficult to separate the effect of Swedish programme aid from that of other donors, the study looks at the impact of programme aid in general.
2. The evaluation applies the logical framework approach. Inputs for the evaluation are the programme aid itself and the accompanying policy dialogue, defined as the process by which donors attempt to influence government policies. The study further distinguishes intermediate outputs such as inflation rates, level and composition of imports and government expenditure, and policy reforms, from final outputs. Final outputs include economic and social indicators, as well as indicators of governance and of the political situation.
3. The study focuses on the period since 1987. This is when the NRM government began to cooperate with World Bank and IMF in its Economic Recovery Programme. The preceding two decades were characterized by political and economic disorder, declining production, increasing informalization of the economy, declining morale and standards for government service, increasing poverty and worsening social indicators. In the early 1980s, an IFI-supported attempt at stabilization had been carried out, but the results of this had been wiped out by new political and military unrest.
4. Over the whole period under study, 1987-1998, aid has been high, and programme aid took an important share of total aid, although this share declined over time. Within programme aid, there has been a shift from import support to debt relief and budget support. Import support was dominant in the first period, until about 1993, while debt relief and budget support became more important after 1993.

The impact of aid funds

5. Following a macroeconomic accounting framework, it is clear that aid can relieve resource external and internal (government) resource constraints)

simultaneously. This also holds for programme aid. In the case of import support, the countervalue funds may help to finance the budget deficit. Debt relief for debt service payable by the government alleviates both the balance of payments constraint and the budget constraint. Budget support also provides foreign exchange to the economy since it is given in foreign currency. In the absence of other flows and assuming that private savings equal private investment, aid must be equal to the external and the internal gap. Programme aid has an impact on stabilization and on growth.

6. Regardless of the positive effects of aid on the Ugandan economy, aid has also produced a large increase in external debt. Virtually all foreign debt is official debt incurred since 1981, and more than three quarters of the current (1996) debt is due to multilateral creditors including the IMF. Although debt indicators have improved since 1993, and access to HIPC since 1998 also has a positive influence, the debt service is still very high. Programme aid for this purpose continues to be necessary.

7. In Uganda, programme aid contributed to stabilization by providing external finance (grants and loans) for the budget deficit. Before 1992/93 the government was not yet committed to reducing inflation, and the countervalue funds from import support were used to finance part of the deficit. After 1992/93 the government was committed, and programme aid helped to allow higher government expenditure than would otherwise have been possible. Programme aid was more effective than project aid in this respect, since project aid may lead to higher spending or to crowding out of other government spending if the projects would not have been carried out anyway. Setting conditions for the use of budget support or countervalue funds also makes it less effective in this respect.

8. On the external side, programme aid (import support) allowed for a gradual liberalization of the exchange rate between 1987 and 1993, without making very large devaluations necessary that would have led to large increases in the domestic price level. The real exchange rate depreciated gradually between 1987 and 1993. In practice, import support (the dominant modality of programme aid at the time) gave priority to the stabilization objective, and not that of liberalization or growth. Import support helped maintaining inefficient forex allocation systems such as CIS and OGL.

9. Programme aid definitely had a positive impact on economic growth. In the first period the positive influence on inflation also helped restoring growth. A more important effect, and one holding for both periods, is that aid allowed higher levels of imports and of government expenditure than would otherwise have been possible. Under some rather optimistic assumptions on other balance of payments flows, and even if no debt service would be paid, we show that imports would be more than halved in most years in the absence of aid and debt relief. If the country would only miss programme aid but would still pay debt service, the reductions in imports would be between 16 and 50 per cent.

10. The impact of aid on growth and poverty reduction also depends on the composition of imports and on the composition of government expenditure. No recent figures on the composition of imports are available. But government accounts show that (programme) aid has allowed the maintenance of public investment. In more recent years, (programme) aid also helped increase government social spending and so contributed to a reduction in poverty. The growth effect of aid is also reflected in increases in exports, especially since 1993, and increases in private transfers and private investment. Tax revenues also increased. Aid dependence thus reduced over time.

The policy dialogue

11. The impact of the policy dialogue on outcomes in Uganda has been less notable than that of programme aid itself. In this respect it is useful to make a distinction between a first period with little reform and a second at the beginning of which some crucials reforms were implemented but only partly on the behest of donors, while other reforms followed more slowly. Before 1993, expenditure always exceeded IMF targets and was partly financed by borrowing from the Central Bank. No reforms came about until 1990, when the forex bureaux were officially allowed. This was not part of conditionality. Between 1990 and 1993, the government gradually diminished the difference between official and parallel rate. In 1992, there was a major clash between government and donors. It began with some donors suspending programme aid because they required donor money to be sold at the parallel rate. When the Minister of Finance continued spending (in spite of lower donor income) and heavily borrowed from the Central Bank, the IMF also suspended programme aid. The President reacted by unifying the exchange rate, sacking the Minister of Finance, and introducing a cash budget in order to eliminate monetary financing of deficits. The introduction of the cash budget, however, was not part of conditionality.

12. Donor influence played a role in the liberalizations of coffee and cotton marketing, implemented between 1991 and 1994. Other reforms, such as the privatization of parastatals, reduction of tariffs and financial reforms were carried out only slowly, and often slower than originally agreed upon. However, the role of donors was important in being patient and in supporting the rehabiliation (rather than reform) process of the Ugandan economy in the first period, instead of insisting on rapid institutional reforms. This has built up credibility of the IFIs in the eyes of the government and the public at large, thus enhancing reform acceptance later on. On the part of donors, the main reason for this patience was the high growth rate in that period. Donors were rewarding *outcomes* rather than *processes*. The government gradually became convinced that reforms were a good thing; the high growth rate helped in convincing them. Acceptance of reforms was also enhanced by the fact that reforms hardly

endangered vested interests of the political elite and that aid often benefitted this elite. From 1992 onwards, the government was fully convinced of the need for macroeconomic stability and for establishing a market economy- although implementation was not always followed up quickly.

13. In recent years, ownership of the government with respect to macroeconomic policies is considered to be outstanding. In view of its long term compliance with adjustment programmes, Uganda was the first country to qualify for the HIPC initiative, which was implemented in 1998. However, it is widely felt among donors that real ownership of the programme is in the hands of a few high-level government officials only: the President, the Permanent Secretary of the Ministry of Finance, Planning and Economic Development, and a few others. This makes structural adjustment in general, and macroeconomic stability in particular, vulnerable. They are vulnerable, in particular, to an opening up of the political system by which tribalism and patronage relations may re-dominate Ugandan politics. In this sense, the Ugandan no-party democracy may be related to the macroeconomic successes.

14. Topics such as the composition of government spending, the budgeting process, decentralization of government services, improvement in service delivery, and the fight against corruption have recently entered the dialogue between donors and government. Bilateral donors are more active in this dialogue than they were in the discussions on macroeconomic policies.

15. Often these issues come together in the discussion on sectoral budget support in the form of Sectoral Investment Programmes, a new aid modality which is somewhere in between programme aid and project aid. This conditionality encounters many problems, since civil service reforms, quality improvements, and decentralization do pose a threat to the vested interests of the elite in Kampala, especially high government officials. Although the size of the civil service was reduced between 1993 and 1996, improvements in transparency and accountability are hardly notable and donors speak of a slow and difficult process. In 1997 and 1998, corruption became a major issue. Many high government officials appear to have benefitted, in particular, from the privatization process.

16. The two problems mentioned in the conditionality literature are visible here. First, most reforms are not in the interest of government officials. The shift from general budget support (countervalue funds of import support) to sectoral budget support in exchange for sectoral plans, implies less discretion for government officials. The same holds for the shift from projects to sectoral support. Projects, and especially investment projects involving construction, allow officers to supplement their income. Sectoral plans tend to show more balance between investment and recurrent costs. In addition, the emphasis on implementation and output oriented budgeting also reduces the chances of using government money for private purposes. Obviously, a decentralization is not in the interest of the officers

in Kampala. Their tasks and staff will be reduced. Given these conflicting interests, government officials are subject to moral hazard: they accept sectoral budget support and then fail to implement the conditions. Donors already observed that this occurred.

17. Second, donors committed to continuing programme aid for macroeconomic reasons are not likely to withdraw aid for reasons of governance, so the threat of withdrawal is not effective. Nevertheless, we conclude that programme aid in the form of debt relief or (sectoral) budget support and the accompanying conditionality have proven to be the way to keep these issues on the agenda. Unlike project aid, these aid modalities stengthen the government's own capacity for better governance rather than weakening it.

18. In Uganda there has not been any conditionality with respect to the political situation. Donors have accepted the no party democracy; and they have been satisfied with the elections, the relative freedom of press and the tolerance for opposition. They have also accepted the human rights situation, although abuses have been found.

The impact on growth and poverty reduction

19. In the first period, economic growth was about five per cent per year. This relatively high rate was mainly due to a restoration of law and order and to the impact of foreign aid. Aid helped to secure imported inputs for manufacturing industry and to maintain public investment, among other things. In the second period economic growth was 6 or 7 per cent per year. The liberalization of the foreign exchange market played a role, as well as other factors such as high demand for Uganda's exports, and high prices for coffee and some other export products, and, again, foreign aid.

20. While the impact of aid on growth was notable in both periods, the impact of the policy dialogue on growth is less obvious. In the first period, few reforms were carried out and the only growth-enhancing reform for which donor conditionality was important was the liberalization of coffee marketing. In the second period, reforms that were important for economic growth include the internal stabilization, the liberalization of the foreign exchange market and the further liberalization of marketing of coffee and cotton. The influence of donors was important for the latter, but less so for the first two. It is too early to tell whether other reforms that were part of conditionality in recent years, such as privatization, trade reform and financial sector reforms will have positive effects on growth. Privatization seems to have benefitted the political elite, and the financial sector currently is a constraint on growth rather than contributing to it. But this has little to do with the liberalization process to which it is subject but more to the history of political allocation of credit which led to an accumulation of bad loans.

21. In order to maintain high growth rates, exports will have to be diversified and this requires investment. Private investment in Uganda is still rather low. A major factor hampering investment is the poor state of physical infrastructure, in particular electricity, roads, and water supply and sanitation. In addition, a reduction in the administrative burden is important, while the government will have to invest in institutions that provide market information, develop quality standards and provide other institutional support for the private sector.

22. Poverty is still widespread in Uganda and social indicators are very poor. However, the policy dialogue can be said to have had some positive impact on poverty reduction in the second period. The supply response (to liberalizations) in coffee, cotton, tobacco, many non-traditional crops and fishing helped increasing rural incomes. Programme aid, through its impact on economic growth, also helped to reduce poverty. Surveys carried out between 1993 and 1996 confirm this reduction in poverty. They also show that almost all poverty reduction is due to growth, and not to an improved distribution. However, poverty in Uganda was not due to an unequal distribution of income, but mainly due to overall low levels of income and productivity. Attention for poverty reduction has only recently come up in the policy dialogue with donors. Social spending increased in the past couple of years, and the government came up with a Poverty Eradication Action Plan, including not only plans for health and education but also for roads and agricultural extension.

23. The maintenance of high levels of aid is crucial, both in view of the debt that has to be paid and that still takes a large share of government expenditure, and in view of continuing need for public investment in physical and social infrastructure. Sustainability of economic growth will also depend on successes in improving the domestic financial sector and in policies that give priority to alleviating time constraints in the countryside, especially for women. The rehabilitation and expansion of the rural feeder roads network is also important in this respect. Furthermore, in some regions specific policies are necessary to counteract soil depletion.

Programme aid from Sweden

24. Sweden began disbursing import support via the (joint) co-financing of World Bank structural adjustment programmes. This was import support, allocated through the Open General Licence and later via an auction. Disbursements were slow due to cumbersome procedures. Indirectly, Sweden contributed to the maintenance of inefficient forex allocation systems. Sweden was one of the first to see the importance of debt relief. Already in the early 1990s Sweden began to give part of programme aid as debt relief (5th dimension), and as of 1994 all programme aid became debt relief. From 1995-1997, all debt relief was disbursed to the Multilateral Debt Fund. In 1998, a switch was made to budget support via the Poverty

Action Fund (PAF). It is hoped that contributions to this fund will help maintain and increase social expenditure.

25. If we assume that the government would have paid the multilateral debt service anyway, and that it would carry out the social spending anyway, there is no difference between these two modalities of programme aid in the impact of the aid *funds*. However, a contribution to PAF could help in maintaining priority for social spending if this spending is threatened. A PAF may also have some *systemic* effects, giving Sweden and other donors some influence on how social spending is carried out.

26. Before 1995, Swedish aid was administered from Nairobi, and Swedish influence was limited. As of 1995, Sweden has become a more important participant in the donor community in Kampala. Sweden was one of the first donors to call attention for Uganda's multilateral debt burden, and helped setting up the multilateral debt fund. In 1995, debt relief was made conditional upon the elaboration by the Ugandan government of a debt management strategy. To the extent that the government indeed did so, this "conditionality" can be considered successful. In all other programme aid agreements, no particular conditions for macroeconomic policies are set. Sweden follows the multilateral institutions, as testifies the recurrent phrase "Sweden may suspend … if IDA suspends".

27. The Sida representative in Kampala has some influence on government policies via participation in sectoral discussions between donors and government, especially in the health sector – where Sida is seen as an important player by other donors. Other issues emphasized by Sweden include poverty reduction and governance issues.

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Fostering High Growth in a Low Income Country
Programme aid to Vietnam

Executive Summary

During the last two decades Vietnam has undergone the transition from one of the poorest countries in the world, with apparent aid dependence and bleak development prospects, to one of the most rapidly growing economies with an impressive record of lifting people out of poverty. Economic performance in the early 1990s was particularly remarkable as inflation was brought down as growth was simultaneously lifted to the level of 8 to 9 per cent and this was maintained for the following years. How has this been achieved, and what has been the role of aid?

Following the invasion of Cambodia in 1978, Vietnam was shunned by most of the international community, and a US embargo prevented lending by the International Financial Institutions (IFIs), the IMF and World Bank. Most aid in the 1980s came from the Soviet Union, although SIDA and UNDP also continued support. Soviet aid collapsed from 1990, so that by 1993 aid inflows were one quarter of their level a few years earlier. The Soviet withdrawal allowed Sweden to assume particular importance as one of the sole donors, accounting for around one-quarter of total aid in the early 1990s. However, following the lifting of the US embargo in 1994 aid has surged, as many donors have started aid programmes and the IFIs have embarked on substantial lending. Sweden's aid contribution has thus fallen back to that of a middle-ranking donor, although it enjoys higher status by virtue of the historical association between the two countries. Vietnam enjoys more than $11 of aid per person, which is a high level for a country of its size, though aid is not that high relative to some other aggregates, such as imports and investment, since the country enjoys access to other sources of forex from foreign investment, remittances and rapid export growth.

Just over one-third of Swedish aid to Vietnam in the 1980s was programme aid, this share increasing in the early 1990s, but then falling back and there being no programme aid in recent years following Vietnam's failure to conclude an agreement for the third year of the ESAF in 1997. In the 1980s Swedish import support conformed to the allocative mechanism of the Vietnamese planning system, and then was no question of countervalue since the funds were seen as part of the state's support for state-owned enterprises (SOEs). But from 1989 a number of changes were introduced to make the system more market-oriented: enterprises were to pay countervalue and the funds were to be disbursed (and hence allocated) by the commercial banks (Sweden

providing technical assistance to the banks for them to be able to play this role). In the absence of formal policy dialogue around policy-based lending, discussions over import support modalities thus played an important role in the liberalisation of the foreign exchange and credit markets.

There have without doubt been major changes in economic policy in Vietnam in the last twenty years. Three phases of reform may be identified. The first, started in 1979, was primarily liberalisation in the agricultural sector (including recognition of the fact that collectivisation had never really succeeded in the South), though there was also some limited autonomy accorded to state enterprises. By 1982 the first wave of reforms had ended and there were some attempts to reverse them. But the launch of *doi moi* in 1986 saw the removal of price controls and yet further relaxation of controls on SOEs, and the start of their restructuring. Liberalisation was intensified from 1989: subsidies to SOEs were ended and over one million workers laid off as the number of enterprises was halved, and market-oriented measures introduced in the foreign exchange and credit markets. This third wave of reforms is perceived to have ended around 1993, and some (including donors) argue that there should be a fourth wave of reforms of further tariff liberalisation, privatisation, and financial sector reform.

A few facts suggest that the traditional role played by programme aid in supporting reform has been of limited relevance in Vietnam. There was no formal policy dialogue until the US lifted its veto on IFI lending in 1993 (a year before the lifting of the US' own embargo): hence policy-based lending began just as the third wave of reforms was petering out. Correspondingly aid flows themselves did not increase substantially until 1994 (there was a large inflow in 1993, but this was to pay off IMF arrears and so flowed straight out again), by which time stabilisation and increased growth had been achieved. Aside from these "surface facts", a closer examination of the political economy of Vietnamese reform further supports the idea that policy dialogue has been of limited relevance.

The reforms clearly have a strong internal dynamic, many having been driven by a bottom-up process (called "fence-breaking") by which new policies are an *ex post* recognition of changes that have already taken place. Given the strong performance of the economy there have clearly been very many more winners than losers (there have been some losers, perhaps particularly amongst marginal groups), which has created a strong social basis for reform. A reversal of market-orientation would not be politically possible today. Donor influence is thus limited on the one hand by the fact that donors would have been going along with the tide - it was not even a question of pushing on an open door, the Vietnamese had taken the door off its hinges before most donors arrived on the scene. But in addition to the strength of these domestic pressures, donor influence is limited by the nature of Vietnamese political processes.

The policy making process in Vietnam is diffuse, and does not follow the formal structures that a political scientist may map out. The system is one of consultation and consensus, with many different bodies being involved in a single decision - not just ministries but also agencies, such as the Women's Union, and the multitude of think-tanks (over-laying which is the government/ party divide and the relationship between the two). In one way such a system ideally enables donors to enter the dialogue either as an actor or influencing key actors (if they can be identified) - but it mitigates against the "usual way" in which donors do business by discussing with a single authority who has the power to carry out agreements reached with donors. Donor influence is necessarily restricted when it will formally engage only with government, but the Party and, in particular, the Army are important political forces with whom they will not engage (having said that, the blurring of roles between these different components is such that donors probably do engage with Army, but without it being clear that such is the case).

Finally, the nature of policy discourse in Vietnam is rather different to that which many agencies are used to. Many categories used by outside agencies are not seen as applicable by the Vietnamese: distinctions between government and party and private and public being two of the most obvious and currently important cases. Moreover, form often replaces substance, so that there is great attention to introducing legislation (often without repealing existing, contradictory, laws), but rather less explicit attention at the policy level to sorting out problems which may arise, which is done on the ground by the forces of experience.

There has been little formal policy dialogue: one World Bank adjustment credit, an IMF stand-by arrangement, an uncompleted ESAF and two ADB sectoral adjustment credits (for agriculture and finance). The World Bank credit contained only ten monitorable conditions, only two of which required actual changes in policy and one of which (maximum tariff) was reversed almost as soon as it was complied with (indeed there is doubt that it ever was). Hence there has been little scope for formal policy dialogue and there has not been much of it anyway. What donor influence there has been has come through informal channels.

The World Bank and the IMF began work in Vietnam in 1989, there being a Staff Monitored Programme from the IMF and economic and sector work from the World Bank, who also provided the expertise for UNDP projects and thus had a formal entree into macroeconomic issues. There are differences of opinion as to the importance these actors played: the economic reports, training and policy seminars clearly fed into the Vietnamese policy process, and policy-makers were grateful for guidance on implementation being unfamiliar with the specifics of a market-oriented policy. Some also say that the IMF played an essential role in the design of the 1990s stabilisation programme, though evidence from other well-informed actors in the donor community would suggest that "essential" is putting it too strongly. It must always be remembered that the Vietnamese political system is based on plurality, and that the government will seek advice from several quarters (often asking several donors for advice on the same issue); under such circumstances it is difficult to ascribe a single actor a decisive role.

As one of the few donors with an established presence, Sweden was in a position to play a role in the crucial years of reform in the eighties and early nineties, and there is a general appreciation amongst Vietnamese actors and agency staff that they did indeed do so. Five channels may be identified through which Swedish aid impacted upon the policy process: (1) systemic effects from the evolution of import support described above; (2) publication of regular economic studies; (3) related events, such as seminars, training and study visits; (4) technical assistance (both experts and training) through projects specifically aimed at policy reform; and (5) other projects, of which the Bai Bang paper mill is a notable example.

In summary, formal policy dialogue has played little role in economic reform in Vietnam to date. However, the input of ideas has supported policy change and allowed it to be carried forward, and this is precisely the sort of input which may be expected to be most successful in Vietnam given the way the political system works. It would of course be disingenuous to claim that this is a case where "donors got it right", since it was the US embargo that prevented them introducing formal policy-based aid at an earlier stage.

It is clear that the impact of policy changes has been largely positive. Macroeconomic performance has been good, with low inflation in the 1990s and a good growth performance. Some commentators are concerned about the large current account deficit and that savings lag behind investment - but both of these are a necessary consequence of the large aid and other capital inflows during the 1990s, not a manifestation of a weak economy. The agricultural supply response has been substantial and can be observed across most crops and all regions. The country has gone from being a rice importer to being the world's third largest exporter. There have also been huge increases in the production of coconut, rubber, tea and cashew nuts, with very large increases in yield in a short space of time. These achievements have fed through to improvements in rural welfare. Qualitative research from rural areas finds that the periods of hunger, which have been a persistent feature of the country's history, are now a thing of the past. At the national level, poverty has fallen from around three-quarters in the first part of the 1980s to around one-third today.

There have also been large increases in output in the manufacturing sector, although there has also been substantial restructuring and large lay-offs (though total employment has risen). Nonetheless, some manufacturing appears to remain inefficient and would be unable to withstand a move closer to the market through more liberalisation.

Despite strong growth in agriculture and manufacturing, the share of the former in output is falling, and that of manufacturing staying roughly constant as the tertiary sector has displayed the most rapid growth. This is the sector about which we know the least, although even a visual impression testifies to its growth and importance. There are thus some reasons for questioning for how long growth will be maintained, or more specifically, if further liberalisation will enhance growth or impede it. Liberalisation will require at least a temporary setback in the manufacturing sector. It is not clear how much longer the agricultural supply response can continue without some attention to the constraints (credit and infrastructure) on that sector, constraints which liberalisation may tighten rather than relax.

Additional concerns may be raised about gender and environmental issues. Whilst much of the former rhetoric of gender equality may have indeed been just rhetoric, it seems plausible that there was greater political attention to gender issues in the past than over the past ten years. Whilst women have benefited from the overall increase in economic prosperity there have been gender-biases skewing these benefits toward men, to the extent that some women have indeed been left worse off. Resource use is an inevitable consequence of rapid growth, but the question is whether prices encourage excessive resource use, which the evidence suggests is indeed the case. These are both areas which have been paid little attention in the formal policy dialogue.

The importance of aid's macroeconomic effects is limited by its scale - at around 5 per cent of GDP it pays for less than one tenth of imports and about 15 per cent of GDP. Closer analysis of the balance of payments suggests that export earnings have indeed been the driving force behind imports. Without any aid in the 1990s imports would have been around 5 to 15 per cent less, depending what assumptions are made about debt service, and arrears would of course accumulated rather more rapidly. The data also suggest a limited role for aid in the government budget, where the most remarkable changes are (1) a large increase in revenue, (2) a switch from non-tax to tax revenue, (3) increased expenditures, (4) substantially reduced net transfers to SOEs, and (5) a large increase in the expenditure share of the social sectors. The order of magnitude of all these changes is such as to accord a relatively small role to aid.

Aid has played a useful role in Vietnam's development in the 1990s, but it is not credible to argue that substantial progress would not have been made in the absence of aid. The Vietnamese themselves seem to attach particular importance to the expertise that comes with aid (and indeed with FDI), and we would agree that this has been where aid's contribution has largely lain. Whilst high aid seems set to continue, the nature of that aid is in some doubt. Donors wish to give budget aid, but believe the conditions (in particular budget transparency) are not met for them to do so. The alternatives are to scale back aid or to allow projects to expand. Current donor thinking, quite rightly, is not in favour of over-reliance on projects, and there seems little call for them in a country with a well-established government programme and a commitment to poverty reduction. Flexibility of approach, which allows continued support to the country's development, is called for.

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A Black Sheep Among the Reformers Programme aid to Zambia

Executive Summary

1. Programme aid comes in a variety of forms. In the late 1980s and 1990s it has evolved through a variety of import support schemes to more liberal forms of balance of payments support and contributions toward multilateral debt relief. Since the mid-90s there has been a move toward sector support, which may under certain circumstances be viewed as a form of programme aid. Swedish programme aid has been balance of payments support, with a move toward debt relief in the mid-90s.
2. The effects of programme aid may be felt through both the policy change it supports and the macroeconomic effects of the funds themselves. The issue of the impact of the policies breaks down to two separate questions: (1) to what extent has policy dialogue brought about policy change, and (2) what impact have any reforms had? There are thus three questions to be addressed.
3. The Zambian reform programme began promisingly, with the newly elected MMD government quickly implementing some wide-sweeping changes in trade and exchange policy, and, after only one year, introducing a fairly determined effort at stabilisation. However, from 1993 the programme stalled somewhat, and there has been an air of dissatisfaction in the donor community since then. There have been three main areas of contention. Privatisation got off to a very slow start, with signs of what can at best be described as wavering government commitment. However, the last few years have seen substantial progress in this area, with the notable and rather important exception of ZCCM. A second area of disagreement has been public sector reform, where any meaningful initiative on the part of government is still awaited (although many have been promised). The relationship of the government with the donor community first began to turn sour on the issue of governance, and this has continued to be a sticking point.
4. The role of the donors has to be located in the context of domestic politics. There have been losers from reform (notably retrenchees receiving little or no compensation and maize producers, especially those away from the line of rail) but these have not formed effective opposition to reform. Other groups who may have been expected to oppose reform have either been "bought out" or, for reasons of local political economy, have supported liberalisation. Hence there is in fact little debate over the need for economic reform. Political debate focuses rather on governance issues, highlighting

practices by MMD that may ensure their capture of excessive benefits from power (including reaping the benefits of liberalisation). These forces, combined with the independence of the judiciary, have acted as a constraint on mal-practices by MMD and provide the basis for what success there has been on the agenda shared by donors on governance issues.

5. Donors may contribute their own programme aid both to support the reform effort and to gain "added value", i.e. to have their own unique influence on the reform programme. This report considers the variety of formal, semi-formal and informal channels through which a bilateral donor can seek to influence recipient policies. Sweden is a "middle rank" donor in Zambia, and its role in policy dialogue reflects this position. It has been one of a number of vocal donors in Zambia, who have on occasion joined together to successfully put pressure on government (e.g. Zambia Airways and the 1998 governance crisis). The bilateral donors, either individually or collectively, have been less successful in influencing the IFIs.

6. Two conclusions may be drawn with respect to policy dialogue. First, whilst there has undoubtedly been reform in Zambia, there have been sufficient departures from the donor's agenda for many in the donor community to feel that the government is not seriously committed to reform. Whilst carrying out sweeping changes, the Zambian government has indeed prevaricated on, reversed and ignored some policies not to its liking. Second, there has been very little attention indeed paid to poverty issues as a part of the policy dialogue. The main exception to this statement is the protection of social spending (at 34 per cent of total expenditure) since 1995.

7. A major channel, perhaps the main channel, for programme aid's poverty reducing effect is through growth. However, Zambia's growth performance can at be at best described as haphazard, thus undermining the potential for poverty reduction (as borne out by a range of indicators which show a stagnant or deteriorating social situation in the 1990s). Of course the factual is not the counter-factual: maybe things would have been worse in the absence of programme aid. There are good grounds to believe this is so, if only as by paying external debt (which would not have been possible in the absence of programme aid), policy-based aid allowed Zambia to maintain what reforms there were. But there are also good grounds for arguing that things could have been better. It is unlikely that a strong supply response, if any, to liberalisation can be expected from most of agriculture, mining and manufacturing, and a wide range of opinion argues that there were design problems in the reform package, at least in terms of sequencing, but possibly also in the extent to which stabilisation has been pursued.

8. To elaborate on this last point: non-interest expenditures fell by over 6 per cent of GDP in the 1990s (1990-96). The two main factors behind this drop have been a decline in grants (suggesting that aid had supported expenditures) and a 4.5 per cent reduction of the overall balance. Higher spending may have allowed some in-roads at facilitating the supply response

and both direct and indirect poverty reduction. Having said that, the government's fiscal behaviour has not been good, and so it cannot be taken for granted that more spending would mean better spending.

9. One way in which programme aid has supported government spending is by paying external debt service which the government would otherwise have had to pay. Resources are thus freed up for government to spend elsewhere, or the budget deficit can be reduced (the evidence suggests that a combination of these two has occurred). At the same time, imports have also been higher than they would have been in the absence of aid, with an increase in the share of both capital and consumer imports.

10. The macroeconomic effects of the programme aid inflows are undoubtedly beneficial in principle and should have allowed greater growth (and thence poverty reduction) than would have been possible in the absence of the funds. But we must again point to the poor record and conclude that Zambia us still a long way from a sustainable growth path - nor is it likely to get there by liberalisation alone. This fact alone raises questions as to whether the SEK 800 million of programme aid in the 1990s has been utilised as effectively as may be wished. The channels through which programme aid has supported poverty reduction in Zambia have not been particularly direct: but more importantly, they have not worked very well.

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Trends and Turns in the 1990s Programme aid and the Swedish experience

Executive Summary

1. Sweden's long tradition of development co-operation is characterised by stability, manifested in the programme country concept and the establishment in 1968 of a one-percent commitment target. Recent years have seen some changes with regard to that stability, both in the temporary abandonment of the one-percent target and substitution of three-year country strategies for country programmes.

2. Programme aid constitutes on the average about ten percent of total Swedish aid in the 1990s. The share has been falling throughout the period, from almost 20 percent in 1990 to a little over 5 percent in 1997. This is a trend that is mirrored in DAC commitments.

3. Swedish programme aid is disbursed through three modalities: import support, budget support and debt relief. Import support was the dominating form in the early 1990s. It has been gradually replaced particularly by debt relief and accounts in 1997 for little over ten percent of total programme aid. The reasons for the decline of import support are several, including problems of administration and countervalue collection in the Commodity Import Support (CIS) scheme, a trend towards liberalisation of foreign exchange markets in recipient countries and a global trend in the donor community acknowledging external debt as a serious obstacle to economic growth. The increased role of the external debt as a factor explaining economic stagnation, and the proposal to use debt relief to alleviate this suggest a lack of understanding regarding the functioning of programme aid.

4. Swedish programme has been disbursed through two major channels, or accounts: the country frames, administered by Sida; and the account for Economic Reform and Debt Relief from which disbursements are made both by Sida and the Ministry for Foreign Affairs. The role of the account for Economic Reforms and Debt Relief has become more important over time.

5. There are also some indications that the balance of power has shifted over time, at the expense of Sida. The evidence, though somewhat circumstantial, is nonetheless manifold. They include a formal shift of decision-making power from Sida to the Ministry for Foreign Affairs as manifested in the shift of programme aid out from the country frames; an increase in the number of rejections by the Ministry for Foreign

Affairs of Sida suggestions for programme aid allocations; and the emergence of the Ministry of Finance as a increasingly active partner in the decision-making process.

6. The over-all objective of Swedish programme aid is the alleviation of poverty in the poorest countries. This is to be achieved through economic growth and economic reforms; these are the intermediate objectives of programme aid. The mechanism through which this is to be achieved remains absent from most country documents; rationales for programme aid emphasise gap-filling and vague references to general economic problems. The link from gap-filling to economic growth is almost never discussed.

7. A similar point can be raised with regard to the relation between programme aid and poverty reduction: possible links are not discussed, so monitoring of programme aid's relative efficiency remains difficult. Moreover, country documents on programme aid fail to emphasise poverty alleviation as the ultimate objective.

8. In theory, the links between programme aid and poverty reduction run along two lines: from programme aid to economic reforms to economic growth to poverty reduction; and from programme aid to investments (either directly or via macroeconomic stabilisation) to growth to poverty reduction. These links are long and, thus, fragile. For this reason a better framework within which programme aid can be analysed is warranted.

9. The need for a coherent framework for Swedish programme aid is also obvious when the selection of countries and the application of specifically Swedish conditions are analysed. Here emerges a picture in which there are no explicit eligibility criteria (and it is difficult to find any criteria that would explain the pattern of Swedish programme aid), and conditions bind (i.e., aid is frozen because of non-compliance) irregularly.

10. A general message from this report is that Swedish programme aid is in need of a coherent framework. Programme aid has developed from a complement to project aid into an aid form of its own, which partly emphasises different channels through which poverty alleviation may be achieved. The theory behind programme aid as a separate aid form does not appear to be widely known within the authorities; accordingly, the analysis of what, how and when programme aid is supposed to accomplish is rudimentary, if existing at all.

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Programme Aid, Policies and Politics Programme aid and conditionality

Executive Summary

1. One of the objectives of programme aid is to induce policy reforms in the recipient countries. These reforms are supposed to lead to higher economic growth and to a reduction of poverty. This paper aims to answer the question of whether the conditionality attached to programme aid is effective in bringing about the reforms, and what the factors are on which this effectiveness depends. Conditionality is defined as the setting of conditions for policies, both economic and other, that the government would not carry out in the absence of this aid. On the basis of a review of the literature, the paper elaborates an evaluatory framework which is then used to assess the experiences of our eight countries: Bangladesh, Cape Verde, Mozambique, Nicaragua, Tanzania, Uganda, Vietnam and Zambia.

2. Policy conditionality has three inherent contradictions. The first paradox, initially formulated by Streeten, is that recipient countries get aid to do something which is good for them anyway. The second is that the aid funds that accompany the policy agreements may induce moral hazard on the side of the recipient governments: once they have the money, it is more easy for them not to carry out the agreed policies. The third paradox is specific for political conditionality: the setting of policy conditions by donors conflicts with one of the demands made, namely that of more democratization and more accountability.

3. Many empirical studies agree that policy conditionality is not very effective. Although formal compliance with stipulated conditions may range from 40-60%, some conditions are merely formal, others are complied with but their effect nullified by countervailing actions, or policy reversals occur immediately after receiving the last tranch on a conditional loan.

4. With respect to economic conditionality, several models have recently been presented that explain the factors on which its effectiveness depends. In this paper, most attention is given to two models: Killick's principal-agent framework and Mosley and Hudson's bargaining model, because these two have led to testable propositions. Both models are based on conflicting objectives between donor and recipient. The principal-agent model stresses asymmetric information: the principal (donor) wants the recipient (agent) to do something but cannot have full information about the agent's actions. The bargaining game stresses uncertainty for both donor and recipient, and analyzes expected pay-offs in different situations.

5. Combining these two models, and adding insights from other studies, the paper elaborates an "augmented" principal-agent framework. Basically, the effectiveness depends on two sets of factors. First, there are the "participation constraints", or the factors influencing the "taste for compliance" of the recipient. These factors include the objectives of the recipient government, and expected gains and losses of policies, but also who has the power to implement policies and how they perceive costs and benefits, including possible benefits of aid. Secondly, the system of enforcement is important. The effectiveness of sanctions depends, among other things, on the financial or other pressures on donors to continue lending – these pressures are exacerbated by the adverse selection problem (countries with larger deficits need more aid) - , on donor coordination and the existence of multiple donor objectives, and on growth performance of recipient countries.

6. Although political conditionality has always existed, it has increased in importance after 1990, when "cold war" strategic interests became less important. In the context of adjustment programmes, bilateral donors began to add demands for a democratic system, human rights observance, and good governance. The latter involves pleas for a more effective civil service, usually with a view to enhancing poverty reduction, and a plea for more transparency and accountability of government performance including a fight against corruption. The World Bank came out in favour of limiting political conditionality to these more technical, governance issues.

7. The literature on effectiveness of political conditionality only includes studies of conditions involving the political system and observance of human rights. It concludes that political conditionality is not very effective, but that donors have more influence on recipient countrys' politics the more aid-dependent a country is, the less other commercial and strategic interests the donor has, the better donor coordination is, and the more specific the demands are.

8. The more different conditions are set, the more difficult monitoring and enforcement becomes. There may also be a tension between economic and political conditionality. A more democratic system does not necessarily lead to better policies. In practice, donors have often given priority to economic conditionality, leading to inconsistencies in the treatment of different countries. Even more than with economic conditionality, these tensions raise the issue of the legitimacy of setting political and governance conditions.

9. Our country experiences show that it is by no means always true that IFI directed adjustment programmes are a response to external and internal disequilibria, and that these programmes *set in* a process of reforms. In most of our eight countries, reforms were well under way before the IMF and World Bank came in. Furthermore, in two of them (Cape Verde and Vietnam; Bangladesh could be added) there were no macroeconomic disequilibria. In spite of these circumstances, IFI programme countries

always implied the setting of conditions for new policy reforms: a loan had to "buy" new policies.

10. The hypotheses of the augmented principal agent framework help to explain what happened in the different countries, why compliance was often weak and why sanctions were not very effective. Some recipient countries were under strong pressure to reach an agreement (Nicaragua, Mozambique, Zambia, Tanzania and to some extent Uganda as well). In the Vietnamese context, conditionality could hardly have been effective given the diffuse decision-making process in the country, and the lack of clearly defined objectives and policies. The country experiences also reveal that, as in the "augmented" principal agent framework, a broad political economy perspective is necessary to explain whether stabilization and reform measures will be carried out. It is important to analyze who the winners and losers of the reforms are, and how strong they are. In some countries, programme aid played an important role in the possibility for compliance, but it also allowed slippage.

11. Sanctions were less effective if donors had different objectives, and if one donor had multiple objectives – as proved the case with the IMF in Nicaragua. The lack of donor coordination in that country also affected the success of the programmes itself. In many countries, donors proved to be under strong pressure to continue lending or to reach new agreements: the large outstanding debt of these countries is an important factor, but also the need for aid (adverse selection). A separate factor is the credibility of both donor and recipient. If economic growth is high, albeit due to good luck, both donor and recipient credibility increase – Uganda is a case in point. However, our country studies also provide evidence of *real* "uncredible" policy advice: policies that have led to lower growth.

12. The donor's political and governance demands were effective in some cases, but only if demands were specific. Demands with respect to the political system were not honoured in any country. Multiple objectives and weak donor coordination were important factors.

13. The chapter reviews proposals for alternatives to conditionality that have been made in the literature. Given the ineffectiveness of the "buying of reforms" and of political conditionality, several authors suggest to substitute conditionality *ex ante* by selectivity *ex post*. The concerns about the legitimacy of conditionality, both because suggested policies may not be the (only) correct ones, and because of the conflict with domestic democratic decision-making, lead to the recommendation that performance indicators should be *outcome-oriented* and should be kept *limited and simple*. Although selectivity applied in this way leads to more "ownership" and may solve the participation constraints, it does not solve all problems related to the ineffectiveness of the sanctions: pressures to continue lending, adverse selection, multiple objectives and weak donor coordination. There may remain some scope for conditionality *ex ante* or persuasion, but also in this case the paper recommends keeping demands as limited as possible.

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Dollars, Dialogue and Development

Does Swedish debt relief contribute to economic growth? Does economic growth reach the poor? Does Sweden influence policies in partner countries? Have donors supported the “right” reforms? These are some of the questions discussed in this evaluation of programme aid, with an emphasis on the Swedish experience.

Programme aid – that is, import support, debt relief and budget support – has constituted a considerable part of Swedish aid in the 1990’s. However, the volumes of programme aid have fallen both in relative and absolute terms during this same period. Few evaluations have assessed how different modalities of programme aid further economic growth and sustainable development. Sida therefore commissioned an evaluation of programme aid with a twofold purpose. Firstly, to assess the impact of aid on the policy dialogue, as well as on the outcome of the policies. Secondly, to assess the impact of aid transfers on economic growth including the distributional effects. Thirteen working papers have been synthesised into this one final report “Dollars, Dialogue and Development”. The working papers comprise field studies of three countries; Nicaragua, Uganda and Vietnam and desk studies of five countries; Bangladesh, Cape Verde, Mozambique, Tanzania, and Zambia. Furthermore, three thematic studies have been carried out on conditionality, impact of adjustment policies and modalities of programme aid respectively. Finally, there is a study of the management of Swedish programme aid.

The evaluation was commissioned by Sida’s Department for Evaluation and Internal Audit which is an independent department reporting directly to Sida’s Board of Directors. The evaluation has been carried out by the Institute of Social Studies (ISS), The Netherlands.

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