INTERNATIONAL MONETARY FUND

Fiscal Policy Response to Scaled-Up Aid

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(In consultation with other departments)

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June 5, 2007

Contents Page

Abbreviations and Acronyms

DAC	Development Assistance Committee
DSAs	Debt Sustainability Analyses
HIPC	Heavily Indebted Poor Countries
IFFIm	International Financing Facility for Immunization
LICs	Low-Income Countries
MDGs	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MTBFs	Medium-Term Budget Frameworks
MTDSs	Medium-Term Debt Strategies
MTEFs	Medium-Term Expenditure Frameworks
MTFs	Medium-Term Frameworks
MTFF	Medium-Term Fiscal Framework
MTS	Medium-Term Strategy
NGOs	Nongovernmental Organizations
ODA	Official Development Assistance
PEFA	Public Expenditure and Fiscal Accountability
PEPFAR	President's Emergency Program for AIDS Relief
PETS	Public Expenditure Tracking Surveys
PFM	Public Financial Management
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Papers
RTAC	Regional Technical Assistance Center
SSA	Sub-Saharan Africa
TA	Technical Assistance
UNAIDS	Joint United Nations Programme on HIV/AIDS
VAT	Value-Added Taxes
WAEMU	West African Economic and Monetary Union
WHO	World Health Organization

EXECUTIVE SUMMARY

Sound fiscal policies are critical for handling aid volatility as well as for making effective use of scaled-up aid and other flows. By easing resource constraints, these flows allow low-income countries (LICs) to increase spending aimed at enhancing growth and reducing poverty. Effective management of these policies, however, presents a host of macroeconomic challenges, many of them fiscal.

Expenditure plans financed by scaled-up aid flows should take a medium-term perspective. The decision on how much to spend should be based on country-specific circumstances including macroeconomic stability, absorptive capacity constraints, and debt sustainability. These plans should be consistent with available financing from all sources—public and private. Given the volatility and uncertainty of aid flows, one key objective should be to smooth the expenditure path so that all programs undertaken are adequately funded.

The overall fiscal balance, including grants, should be used for monitoring short-term fiscal developments. Using this fiscal target would allow full spending of external grants while preventing the buildup of an unsustainable debt burden. However, it would be useful to complement this measure with other fiscal indicators.

Casting the spending path in a medium-term context obviates the need for ceiling on wage spending. Although they have been designed as a short-term fix to address macroeconomic imbalances, wage-bill ceilings have tended to persist. Going forward, such ceilings in Fund-supported programs should be used selectively only when warranted by macroeconomic considerations, justified in program documents, sufficiently flexible to accommodate spending of scaled-up aid, and reassessed at the time of program reviews.

Effective use of aid flows may require that some of the aid be saved temporarily. Limited absorptive capacity—macroeconomic, sectoral, and administrative—may constrain countries' ability to use aid effectively in the short run. Saving part of the aid flows to finance higher expenditure in the future, when capacity constraints are less severe, may be an appropriate response for some LICs.

Closely monitoring spending is important for ensuring debt sustainability. Achieving the Millennium Development Goals (MDGs) will require both more spending and more efficient spending. Inefficient spending will add to debt burdens without significantly improving economic and social outcomes. Good governance and the quality of fiscal institutions have a strong positive correlation with the efficiency of spending. Strengthening fiscal institutions would help in this regard.

Strengthening domestic revenue mobilization should be an integral part of the fiscal policy response to scaled-up aid. Higher revenues are essential for avoiding long-term reliance on aid and maintaining fiscal sustainability. In most cases, this can be best achieved by broadening the revenue base by eliminating exemptions and improving revenue administration. Other elements of the exit strategy are strengthening debt management capacity and fiscal institutions.

Countries have several policy choices to counteract aid volatility. They can sustain spending by drawing down saved-up aid when the latter falls short of expectations. They can also take steps to protect poverty-reducing spending from cutbacks, including by building elements of flexibility into spending programs. Multi-year aid commitments by donors would help reduce aid volatility.

Improving the efficiency of spending in LICs will require further strengthening fiscal institutions, including public financial management (PFM) systems. By promoting transparency and enhancing governance, more effective PFM systems help reduce waste and misappropriation of funds. Strengthened PFM systems also help minimize the transaction costs of meeting donor requirements for recipient countries, while donors are assured that their funds are being used for the intended purposes. They help countries track public spending, thereby facilitating shifting of spending programs toward priority areas.

Countries should develop appropriately sequenced reform plans for strengthening their PFM systems. Such action plans should be based on a comprehensive diagnostic study of existing systems and be consistent with local capacity to undertake such reforms. In the short run, action plans should focus on improving the budget classification system and strengthening internal controls on budget execution, accounting, and reporting. Developing capacity to prepare sectoral ceilings and forward estimates should also be a short-term priority. Medium-term reforms include strengthening treasury systems, debt management and PFM systems in subnational governments, linking PFM reforms to broader public sector and governance reforms, and strengthening key accountability institutions such as national audit offices.

Most LICs will require substantial technical assistance (TA), including TA from the Fund, to strengthen their PFM systems. Given the Fund’s limited resources and specialized expertise in core areas, coordinating with other donors is essential to avoid wasteful overlap and mixed messages. The Fund should appropriately leverage staff resources and explore financing and partnership arrangements with the World Bank and other providers.

I. INTRODUCTION

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

2. **Although Official Development Assistance (ODA) to SSA, net of debt relief, remained broadly unchanged in 2005, some countries are receiving rising private and public flows.** Preliminary data suggests that total ODA declined slightly in 2006.[1] On the other hand, a wide range of other "emerging" donors are increasing their assistance to LICs. In many countries, the health sector is progressively receiving more assistance from the private sector, as well as from health funds.[2] Debt relief provided under the multilateral debt relief initiative (MDRI) and the Enhanced Heavily Indebted Poor Countries (HIPC) initiative has created space for new borrowing by LICs, and some countries (e.g., Ghana and Kenya) are using this opportunity to tap international capital markets. Remittances to LICs have increased by over 80 percent between 2000 and 2005, totaling twice the amount of ODA in 2005.[3] Moreover, many countries are benefiting from high commodity prices. Thus, resource flows to many LICs are increasing, enabling them to scale up spending.

3. **Effective and sustainable use of these flows—both public and private—requires sound fiscal management**. In an environment of scaled-up resource flows, countries need to frame their spending programs with a medium-term perspective in mind. In addition, they need to ensure that resources are used efficiently, both by ensuring alignment of budget priorities and those of donors and by strengthening critical fiscal institutions. The Fund's Medium-Term Strategy (MTS) calls on the Fund to assist LICs to put in place policies and economic institutions that help them to "absorb the projected scaling up of aid in a

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

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

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

sustainable way."[4] This paper addresses four questions that shape fiscal policy response to scaled-up aid:[5]

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

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

- **How should the budget deal with *aid uncertainty and volatility*?** Aid volatility and uncertainty have often complicated policy implementation, especially in countries where a large part of government spending is financed by aid.[6] These issues are likely to become even more relevant when external flows are scaled up.

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

4. **The rest of the paper is organized as follows**: Section II deals with establishing a medium-term resource envelope for the budget. Section III explains the considerations that influence the choice of a medium-term expenditure path and provides guidance for setting short-term fiscal targets. Section IV discusses the problems associated with volatility and uncertainty of aid flows and possible steps to mitigate them. Section V discusses basic reforms for strengthening fiscal institutions so that aid can be used more effectively, drawing on recent FAD TA. It proposes specific measures that will assist countries in this regard, as well as factors that should be taken into account in preparing an action plan for PFM reforms in LICs. Section VI suggests some issues for discussion by the Executive Directors.

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[4] IMF (2005c).

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

[6] Appendix I of background paper IMF (2007b). Also see Bulíř and Hamann (2006).

II. ESTABLISHING A MEDIUM-TERM RESOURCE ENVELOPE

5. **The first step in establishing a medium-term resource envelope is to collect information on the intentions of official and private donors**. Governments typically lack information on private aid flows, and a part of the aid from official sources is also provided outside the budget. The increase in the average number of donors per country, as well as an increase in the number of aid channels, has complicated the task of gathering accurate information on external flows. The average number of donors per country has increased from about 12 in the 1960s to more than 30 during 2001–05.[7] In some sectors, such as health, aid channels have also proliferated, stretching the already weak capacity of LICs. Governments should encourage private aid organizations to strengthen their representation in recipient countries, while official donors should reach out to key private donors and invite them to participate in existing donor coordination structures.

6. **Aid characteristics have implications for budget planning and formulation**. Earmarking by donors limits flexibility in the use of budgetary resources. When aid resources are earmarked, governments cannot readily reallocate these resources in response to changing macroeconomic conditions and priorities, which hampers the implementation of expenditure plans. Similarly, the requirement for counterpart funds reduces the budgetary resources available for other purposes. The terms of financing also have implications for budget planning and debt sustainability. Grants do not require any budgetary allocation for debt service payments, whereas loans do, and thereby establish a claim on future resources.

7. **Medium-term aid flow projections should reflect Fund staff's best estimates.** Aid flows (both loans and grants) should be projected based on all relevant and available information, including donor commitments and indications. Aid forecasts in Fund-supported programs also need to reflect debt sustainability concerns. Overly optimistic or pessimistic projections should be explicitly justified, as they may complicate fiscal management by creating mismatches between spending and available resources.[8] The costs of overly optimistic aid forecasts are likely to be higher than the costs of overly pessimistic ones, as aid shortfalls might entail fiscal adjustment. To mitigate such costs, spending should be anchored in a medium-term perspective, as outlined below. Aid shortfalls could then be smoothed out over time, as could fiscal adjustment.

8. **Sustaining and increasing domestic revenue effort is critical to achieving the MDGs**. Strengthening revenue-raising capacity is essential to guarding against aid volatility and preparing for an orderly exit from long-term reliance on aid. Moreover, projects financed by scaled-up aid flows will give rise to future recurrent spending, which will need to be

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[7] World Bank (2007a).

[8] IMF (2007a).

financed by domestic resources. Insufficient growth in domestic revenues will either constrain other spending or lower the productivity of existing programs and assets through inadequate provision for operations and maintenance outlays. Care has to be taken to ensure that scaled-up aid does not weaken the incentive to mobilize domestic revenues by relaxing the budget constraint, particularly when institutions are weak.[9] However, lowering distortionary tax rates may be part of the strategy of some LICs to promote private-sector led development.

9. **Trade liberalization is another important reason to strengthen domestic revenue base.** When trade is liberalized, aid absorption is facilitated, and pressures on the real exchange rate mitigated. However, this would lower overall revenues, since these countries on average derive one-third of their total revenue from trade taxes.[10] Therefore, trade liberalization would need to be accompanied by a strengthening of indirect taxes. International competition in tax incentives (including those offered to investors in free trade zones) has reduced both the corporate tax revenue and its base in many LICs, making it more difficult to recover revenue lost due to trade liberalization. Governments can adapt to this new reality by improving the efficiency of value-added taxes (VAT), which can raise significant revenues in many LICs.[11] This will require reducing exemptions and broadening the tax base for VAT.

10. **Policies for broadening the tax base and strengthening revenue administration are critical to raising additional revenues in LICs**. Low revenues are, in most cases, not a reflection of low tax rates—in fact, tax rates are high in many LICs — rather, they reflect narrow tax bases and weak administrative capacity.[12] A tax-to-GDP ratio of at least 15 percent is considered a reasonable target for most LICs.[13] The U.N. Millennium Project (2005) estimated that LICs could mobilize additional domestic revenues equivalent to 4 percent of GDP. Improved organizational structure of revenue administration, strengthened audit capacity, and fair tax enforcement all contribute to the expansion of the tax base. Revenue administration reforms are a particularly high priority in many countries in SSA.

III. Choosing an Expenditure Path

11. **The Fund's advice and program design encourages aid recipients to fully and effectively spend all aid.** How much and how fast scaled-up aid should be spent over the medium term is a function of:

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[9] Gupta and others (2004).

[10] Keen and Simone (2004).

[11] Selassie and others (2006).

[12] See background paper IMF (2007b) for details.

[13] Selassie and others (2006).

- the time profile of expected aid;
- the macroeconomic, sectoral, and administrative capacity of the country to absorb higher aid inflows;
- the likely impact of spending on growth and debt sustainability; and
- spending efficiency.

Time profile of aid

12. **Aid flows to a country can assume different time profiles.** They may be compressed over a short period; they may be volatile around a constant or rising trend; or they may rise and remain stable at that level. In the first case, a country may choose to spread higher aid-financed spending over a longer period by saving part of the initial surge in aid inflows. In the second case, the country would need to take aid volatility into account in its spending plans by smoothing fluctuations through domestic borrowing and reserve accumulation in a manner that is consistent with macroeconomic stability (see next section). In the third case, the country could have a rising spending profile depending on its absorptive capacity (see below). The choice of a particular spending path will also depend on a number of other country-specific factors, which are discussed in what follows next.

Absorptive capacity constraints

13. **Overall macroeconomic conditions determine how much aid can be spent immediately.** For instance, an initially high rate of inflation and low level of foreign reserves may call for a gradual scaling up of spending. In contrast, countries that have reached a mature stage of macroeconomic stabilization are better positioned to use scaled-up aid inflows rapidly.[14] Post-conflict countries that have not yet stabilized the macroeconomy, and have weak institutions, may need to save the initial surge in post-conflict aid until their absorptive capacity has improved over the medium term.[15] Aid provided in the context of humanitarian relief (e.g., food aid) to post-conflict countries would need to be spent as soon as their security situation stabilizes.

14. **The ability to absorb aid at the sectoral level may be limited in the short term.** The country may not have sufficient teachers or health workers to expand service provision. In this regard, some LICs are considering innovative approaches to overcome these supply-side constraints, such as Ethiopia's program to rapidly train and deploy semi-skilled workers to address basic healthcare needs.

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[14] Selassie and others (2006).

[15] Gupta and others (2005).

15. **Limited capacity to effectively design and administer spending programs can further constrain aid spending**. The share of education and health spending devolved to subnational governments is increasing, but the capacity of these governments to implement programs and to ensure that scaled-up resources reach the intended users may be limited. In some SSA countries, subnational governments are responsible for about 70 percent of poverty-reducing expenditure.[16] However, accountability for social and economic outcomes is often weak, and internal controls, auditing, and monitoring and evaluation are hampered by weak accounting, manual procedures, and human capital constraints (see below).

16. **The implication is that some aid may need to be saved in the short term.** Studies of recent aid surges in SSA indicate that many countries saved part of the aid.[17] The remainder of the higher aid flows boosted public savings, which was used in many cases to retire domestic debt. However, there are limits to the scope for saving: donors are reluctant to continually provide aid that is saved, and there are pressures in the recipient country to spend higher aid in an effort to improve economic and social outcomes. Furthermore, aid tied to specific projects is difficult to save. Ultimately, the capacity of governments to utilize aid effectively needs to be strengthened over time.

17. **Some aid might be delivered in a regional context.** This could be the case for regional institutions, such as the West African Economic and Monetary Union (WAEMU).[18] In this instance, member countries would still channel aid through their domestic budgetary systems, but would need to be cognizant of the convergence criteria set in the monetary union.[19]

18. **A preferable approach would be to smooth spending over the medium term**. A stable spending path as a share of GDP is viewed as the optimal response to an increase in anticipated resources.[20] An expenditure smoothing approach would imply that spending increases to a new higher level that is calibrated to be sustainable indefinitely given the expected value of new aid inflows. This approach would allow for higher spending in the face of natural disasters and national emergencies. Public spending could be front-loaded if there is evidence that (i) the returns to public investment are high;[21] (ii) investment is subject

[16] IMF (2006a), Chapter 5.

[17] Aiyar, Berg, and Hussain (2005) and Foster and Killick (2006).

[18] The WAEMU is expecting significant resources from international donors, including the World Bank and EU, to finance its Regional Economic Plan, which foresees investment in infrastructure, human capital and governance.

[19] The WAEMU is considering proposals for alternative convergence criteria to accommodate expenditure financed by aid flows.

[20] Barro and Sala-i-Martin (1995).

[21] For example, Takizawa, Gardner, and Ueda (2004) find that spending oil wealth upfront can be appropriate when the initial capital stock is far below its steady-state level and the return to investment is therefore high.

to increasing returns, due, for example, to "poverty traps" that require a large boost in public spending to overcome multiple, interconnecting barriers to development at once;[22] or (iii) the benefits of government consumption are significantly higher today than in the future, for example, during a famine or health crisis. However, both expenditure smoothing and front-loading could entail borrowing from the domestic banking system, which may not be consistent with the government's macroeconomic and debt sustainability objectives. Poverty-reduction strategies that incorporate a front-loaded approach in public spending would be most appropriate if underpinned by front-loaded aid commitments from donors, to minimize fiscal risks.

Spending and debt sustainability

19. **The implications of the spending path for debt sustainability need to be assessed.** For example, a front-loaded expenditure path would affect a country's debt profile.

20. **Besides growth, higher aid inflows entail broad macroeconomic effects, including on the real exchange rate, and interest rates.** These, in turn, have consequences for debt sustainability through their effect on domestic interest rates and the exchange rate. For instance, if aid inflows are largely sterilized to prevent Dutch disease effects owing to a real exchange rate appreciation, then domestic interest rates could increase significantly, putting pressure on public debt dynamics. On the other hand, a sudden decline in aid inflows could result in a real depreciation, increasing the burden of the external debt. Moreover, the need to ensure a sustainable public debt path becomes even more essential to the extent that scaled-up aid inflows are provided as loans, even on concessional terms. Sustainability can also be affected by the impact of spending on growth, which is in turn related to its composition and efficiency.

Spending and growth

21. **The composition of public spending can influence growth.[23]** The higher aid-financed public spending could affect both growth and the sustainability of public debt (see above). Expenditure composition can potentially affect growth, e.g., by "crowding in" private investment with increases in public infrastructure spending, but also via other channels that relate to social spending on health and education. The crowding-in effect has been identified using different datasets and approaches in the literature, and reflects complementarities between public infrastructure and private investment.[24] The empirical link

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[22] Azariadis and Stachurski (2005).

[23] For a detailed discussion of these issues, see World Bank (2007c).

[24] Strengthened domestic financial intermediation is also important in this regard to marshal increased private savings into productive investment projects.

between public investment and overall growth is sensitive to the methodology and data used. For instance, estimates of the response of growth to higher public investment range from no impact at all to an increase of 0.7 percentage points in cross-country econometric studies.[25] However, these studies might not shed adequate light on the short-term impact of higher public investment, or capture the potential impact of a substantial scaling up of public investment.[26] The success of higher public investment ultimately depends on introducing effective institutions to channel resources into projects that eliminate growth bottlenecks. The growth effects of education and health spending, which have a long-term impact, are more difficult to estimate. The estimates in the literature suggest that a 1 percent of GDP increase in such spending can have a long-term effect ranging between 0.5 to 1.0 percent of GDP, provided resources are spent efficiently and fiscal institutions are strong.

22. **Different aid-financed spending programs can have different consequences for growth.** Aid flows can be broadly categorized according to whether the associated activities: (i) can be reasonably expected to enhance growth over the short to medium term; (ii) are focused on long-term growth; and (iii) are not directly related to growth.[27] External project assistance for infrastructure can boost growth over the short- to medium-term provided sound capital budgeting procedures to prioritize projects with high rates of return are adopted as described above. Increased public spending to halt environmental degradation, support better governance or judicial systems, and improve health and education outcomes would act indirectly to increase long-run growth through higher labor productivity. On the other hand, spending associated with humanitarian aid sustains consumption following negative shocks. In this manner, the modality for scaling-up aid can affect the allocation of public spending, and thereby growth and the sustainability of public debt. However, appropriate caution is required in projecting growth effects of spending in debt sustainability analyses (DSAs),[28] especially in countries where fiscal institutions are weak.

Spending efficiency

23. **The relative efficiency of public spending can also affect growth and debt sustainability.** Inefficient spending only adds to future debt burdens without a commensurate improvement in social and economic outcomes. Further, improving economic and social outcomes through scaled-up aid requires both spending more, and spending more

[25] Gupta, Powell, and Yang (2006) and IMF (2005a).

[26] Growth studies typically consider the impact of an incremental increase in public investment. See Gupta, Powell, and Yang (2006) for details.

[27] See Clemens, Radelet, and Bhavnani (2004), as well as Gupta, Powell, and Yang (2006).

[28] For a more detailed discussion see IMF (2006b).

efficiently. In this context, an initial analysis of health and education spending found significant room for increasing efficiency in many LICs.[29] Three results stand out:

- There is significant variation across countries and regions in the relative efficiency of health and education spending.

- Good governance and the quality of fiscal institutions have a strong positive correlation with the efficiency of spending.[30] Countries with better governance and fiscal institutions have higher relative efficiency scores.

- Volatile aid flows have not generally been passed through into public spending, contributing to relatively stable efficiency scores.[31] This evidence suggests that as long as aid volatility does not translate into higher volatility in spending, the relative efficiency of spending is not affected.

Expenditure path and fiscal targets

24. **The medium-term spending path should anchor the fiscal framework.** Typically, medium-term fiscal planning begins with a target for the fiscal balance that is consistent with a sustainable path of public debt and macroeconomic stability. In this situation, the ceiling on public expenditure is derived residually given the forecast for domestic revenues and a sustainable fiscal balance. Scaling up of aid increases the available resources, creating a range of spending paths that are consistent with the medium-term fiscal framework (MTFF). Countries should choose a stable medium-term spending path consistent with absorptive capacity constraints and debt sustainability.

25. **Annual fiscal balance targets should be consistent with the medium-term expenditure path.** The choice of the precise fiscal indicator to be targeted should be decided on a case-by-case basis. To focus on the overall balance including external grants would allow scaled-up aid to pass through into higher public spending without deterioration in the reported fiscal position. However, it is still useful to complement this indicator with other measures of fiscal sustainability.[32] For instance, the overall balance excluding grants is a key

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[29] The results should be interpreted with caution. First, sectoral outputs/outcomes depend on more than just sectoral spending—there are factors that can only be partially captured through control variables. Second, the focus on quantitative inputs and outputs/outcomes fails to fully account for qualitative factors. And third, in a cross-country analysis, efficiency is measured in relative terms. A country with a better "efficiency score" is only relatively more efficient than others—not necessarily in an absolute sense.

[30] This part of the analysis was limited to health spending due to data limitations.

[31] See Appendix I of background paper IMF (2007b) for details.

[32] If grants are volatile and countries smooth expenditures, then the overall balance including grants could be a relatively volatile indicator. In such circumstances, it would be useful to also look at other, more stable, fiscal indicators for monitoring short-term fiscal developments.

indicator of fiscal policy's effect on aggregate demand. In addition, countries should carefully monitor the debt-stabilizing primary balance to avoid incurring an unsustainable debt burden during the scaling-up process. The domestic balance is another fiscal indicator that is used in several countries to anchor the fiscal framework.[33] However, the domestic balance may be problematic, since scaled-up aid would result in higher domestic spending in priority areas (e.g., health and education), which would in turn result in a significant deterioration of the reported domestic balance. This may indicate the extent to which the import component of spending should be increased to facilitate the absorption of scaled-up aid.

26. **Casting the spending path in a medium-term context obviates the need for ceilings on specific expenditure categories such as wages.** Wage bill ceilings have been used in government programs that were supported by the Fund's poverty reduction and growth facility (PRGF) when wage-bill dynamics threatened macroeconomic stability and budgetary processes were weak. They were designed as a short-term measure when first-best mechanisms to control wage spending were not available, including in post-conflict countries and to protect critical nonwage spending (e.g., on books and medicines). Wage-bill ceilings have typically covered the overall government; in no instance have they targeted a specific sector, such as education and health. A recent review suggests that wage bill ceilings have not restricted the use of donor funds for meeting the MDGs.[34] Moreover, their incidence in Fund-supported programs is declining. Going forward, such ceilings in Fund-supported programs should be used only in exceptional cases, when warranted by macroeconomic considerations. In such instances, they should be clearly justified in program documents and should be sufficiently flexible to accommodate spending of scaled-up aid, particularly in education and health. Finally, their need should be reassessed at the time of program reviews. Formulating fiscal policy in a medium-term context and strengthening of payroll and budget systems would allow governments to better manage their employment and its cost. This would over time obviate the need for wage bill ceilings.

Updating baseline and alternative scenarios

27. **The baseline projection should be updated as new information is obtained.** The medium-term fiscal policy framework (see Section 4) should be informed by the authorities' projections for external aid, domestic revenue, expenditure, and public debt. While small, temporary shortfalls in aid can be smoothed out through additional domestic borrowing and/or drawing down buffers, a substantial aid shortfall calls for revising the expenditure path by cutting low-priority outlays. As anticipated aid inflows change, baseline expenditure

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[33] The domestic balance excludes external grants, foreign interest payments, and externally financed project spending.

[34] Fedelino, Schwartz, and Verhoeven (2006)

projections should be updated to ensure that the medium-term expenditure path remains consistent with a sustainable public debt profile.

28. **Countries may also want to develop alternative "scaling-up scenarios" to facilitate more ambitious aid inflows compared to baseline expectations.** Alternative scaling-up scenarios enable recipient countries to assess the implications of higher recurrent spending and the sustainability of the fiscal framework. They can also help countries identify the policies required to alleviate Dutch disease effects, skills shortages, and other bottlenecks.

IV. Dealing with Aid Uncertainty and Volatility

29. **Aid volatility complicates fiscal policy implementation**. Aid flows are 40 times more volatile than tax revenues,[35] have remained more volatile than tax revenues, and significantly more volatile than remittances. Moreover, such volatility has increased over time and can translate into expenditure volatility.[36] This problem is likely to worsen, for two reasons. First, even if the volatility of aid does not change, a larger aid volume implies that a larger portion of the budgetary spending would be aid-financed and thus subject to volatility. Second, the volatility of aid itself may increase due to shifts in the composition of aid away from project aid and toward budget support/program loans. A rising share of budget support can aggravate aid volatility because of the inability of donors to make long-term commitments for budget support.[37]

30. **Aid recipient countries can take several steps to mitigate the effects of aid volatility and uncertainty:**

- **Stress-test baseline projections to assess the impact of aid volatility**. Subjecting medium-term frameworks (MTFs) (and DSAs) to periodic stress tests can help identify short-term financing risks. The impact of aid shortfalls on the budget should be assessed regularly through such tests.

- **Build up reserve buffers to sustain spending if shortfalls materialize**. Countries can also self-insure against aid volatility by accumulating reserves that can be drawn down in the event of a temporary aid shortfall. The size of the buffer should be determined on a case-by-case basis but could vary from 50 to 100 percent of annual aid-financed spending.[38] Such a buffer would supplement other reserves that countries might accumulate to provide cover for imports and/or short-term debt, and enable

[35] Bulíř and Hamann (2006).

[36] See Appendix I of background paper IMF (2007b) for details.

[37] See background paper IMF (2007b) for details.

[38] Eifert and Gelb (2005).

countries to smooth expenditures without recourse to costly bridge financing from their domestic banking systems in the event of an aid shortfall.[39] However, building up reserve buffers also requires that countries have in place appropriate strategies to invest and manage the reserves efficiently during aid windfalls.

- **Identify priority spending to be safeguarded from cuts in the event of an aid shortfall**. This would ensure that critical programs are not starved of funds in the face of aid volatility. This policy is easier to adopt when such spending is defined in the PRSP or similar country documents, and when the PFM systems are capable of monitoring budgetary allocations to specific spending programs and their outturns.

- **Build elements of flexibility into spending programs**. Designing spending programs so that they can be scaled up or down in response to fluctuating aid disbursements can also help mitigate the adverse effects of aid volatility. For example, wage spending could be made more flexible by using temporary and flexible employment contracts; contracting out services could be another option.

- **Include appropriate adjustors in Fund-supported programs to fully or partially accommodate aid volatility**. Recent studies have shown that LICs respond to aid volatility by adjusting domestic financing and expenditure, but that this response appears to be asymmetric—in particular, aid shortfalls lead to cuts in domestic investment spending while governments do not increase such spending in response to aid windfalls.[40] Accordingly, adjustors in Fund-supported programs should be designed to avoid a cutback of critical spending, such as domestic investment, when aid falls short of program projections. The degree to which shortfalls should be financed and windfalls saved depends on country-specific considerations, such as macroeconomic stability, absorptive capacity, and debt sustainability.

31. **Long-term donor commitments can also help reduce aid volatility**. The international community has pledged to provide more predictable and multi-year commitments on aid flows.[41] Implementing the agreed-upon steps would help reduce the uncertainty and volatility of aid. Some bilateral donors are moving toward longer-term aid commitments. For example, the United Kingdom has provided a 10-year commitment on development assistance to Rwanda and Ethiopia. Similarly, DFID has agreed to provide six-year program support for the health sector in Malawi under the Sector Wide Approach. In addition, initiatives such as the International Financing Facility for Immunization (IFFIm),

[39] Bulíř and Hamann (2006) show that negative aid shocks coincide with negative income shocks, and propose building a reserve cushion to insure against aid shortfalls.

[40] Celasun and Walliser (2006). Background paper IMF (2007b) discusses these findings in more detail. Our analysis, however, indicates that health and education spending is relatively unaffected by aid volatility.

[41] Paris High Level Forum (2005).

which is designed to provide "front-loaded, reliable funding over a number of years," can help reduce aid volatility.

32. **Certain types of arrangements facilitate long-term donor commitments.** Simple, formalized partnership agreements between aid recipient countries and donors help to deliver multi-year aid commitments in a systematic fashion. Recent examples of such successful collaboration are donor groups in Mozambique, Tanzania, Ghana, and Burkina Faso. Typically, such donor groups serve to jointly monitor both aid commitments and disbursements regularly, within a predefined performance framework. This has improved aid predictability and fiscal programming in these countries.

33. **Countries should strive to ultimately avoid long-term reliance on aid.** Besides strengthening domestic revenue base, the other elements of this strategy are strengthening countries' debt management capacity and fiscal institutions, including PFM systems (see below). This would ensure that resources are used both efficiently and effectively.

V. Strengthening Institutions to Promote Effective Utilization of Aid[42]

34. **Ensuring efficient public expenditure calls for strengthening fiscal institutions, including PFM systems.** Sound and effective PFM systems are important for several reasons: (i) to increase the prospects of achieving key economic and social priorities; (ii) for transparency and accountability reasons—to ensure that the government is held responsible for managing public resources and that donors and taxpayers have access to information about the allocation and use of such funds; and (iii) to reduce the transaction costs of aid-related donor requirements. Weaknesses in PFM systems can undermine budgetary planning, execution, and reporting and result in leakage of scarce public resources. Most PFM systems in LICs require substantial upgrading.[43] It is therefore critical that countries focus on strategic PFM reforms and sequence them appropriately, consistent with the country's capacity to undertake them. Continued capacity building in public debt management, to help countries develop their own medium-term debt strategy (MTDS), is also crucial.[44]

[42] This section draws from the background paper IMF (2007c).

[43] IMF (2005d). Of 26 countries assessed in the report, 19 still required substantial upgrading of their public expenditure management systems.

[44] For a detailed discussion see IMF (2006b).

Medium-term expenditure frameworks and extrabudgetary funds

35. **The annual budget process should be linked to the MTFF and the poverty reduction strategy papers (PRSP).** In general, MTFs set the overall spending limit; allocate the annual spending envelope across different sectors; and then allocate sectoral spending across different programs and projects. The instruments corresponding to these three tasks are:

- **Medium-term fiscal frameworks (MTFFs).** The MTFF outlines the fiscal framework based on projections for broad fiscal aggregates that are consistent with key macroeconomic variables and fiscal targets. Broad fiscal aggregates (e.g., revenues and expenditures) are projected based on the expected evolution of macroeconomic variables (e.g., growth and inflation) and policy measures. Projecting a realistic path for scaled-up aid is essential to underpin overall spending growth. As noted earlier, the MTFF should be reexamined and updated at least annually to reflect recent developments and shocks to the macroeconomic outlook.

- **Medium-term budget frameworks (MTBFs).** The MTBF goes further than the MTFF by allocating the overall spending envelope across sectors (e.g., health and education), based on the country's development priorities, as set out in the PRSP.

- **Medium-term expenditure frameworks (MTEF).** The MTEF outlines the sectoral allocation of spending across programs and projects according to government priorities, based on detailed costing from sectoral analysis. The MTEF also involves a more detailed indication of performance objectives and measures.

36. **Most LICs lack adequate capacity to adopt a comprehensive MTEF**, but many have the rudimentary form of an MTFF and MTBF in place. Those countries that lack MTFFs could draw on the macroeconomic scenarios developed in the context of DSAs for a basic MTFF. To develop MTBFs, important steps include strengthening the government's strategic decision-making procedures regarding the budget (e.g., by involving the cabinet), improving the relationship between the national planning and budget processes (and between the ministries of finance and planning), and strengthening capacity to prepare sectoral ceilings and forward estimates on the basis of an improved economic and functional classification of budgetary revenues and expenditures.

37. **Aid disbursed through extrabudgetary channels should be coordinated with budget priorities**. According to a recent survey, on average only 37 percent of external aid is channeled through country PFM systems.[45] This complicates fiscal management. For

[45] OECD (2006b).

example, the "3 by 5 Initiative"[46] mobilized substantial extrabudgetary resources to expand the number of HIV/AIDS patients receiving antiretroviral drug treatment from 400,000 in 2003 to around two million in 2006,[47] and the US President's Emergency Program for AIDS Relief (PEPFAR) has a provision for US$15 billion over five years (beginning in 2004) largely for nongovernmental organizations (NGOs) with spending increased in line with local implementation capacity. Donor preferences for specific programs affect the composition of health spending, although these programs are targeted to diseases that have high mortality.[48] In addition, earmarking of aid could introduce inefficiencies in expenditure allocations as noted earlier, straining the capacity of already weak PFM systems, reducing the flexibility of governments to reallocate resources in response to changing conditions and priorities, and hampering the implementation of expenditure smoothing. Extrabudgetary flows hinder comprehensive budget planning and could lead to duplication and waste in the absence of a well-functioning coordinating mechanism. However, extrabudgetary aid and expenditure might be warranted in the short term in fragile and post-conflict states, where resources cannot be channeled through institutions in an efficient and effective manner.

Building PFM systems including their capacity to track poverty-reducing spending

38. **The emphasis should be on building capacity in budget execution and reporting to ensure efficient and effective use of resources**. These include: budget classification, accounting, public procurement, payroll management, and internal control systems. Such reforms will help countries avoid both ad hoc decision-making on the allocation of budgetary resources, and frequently encountered problems such as expenditure arrears and low-quality and untimely fiscal reports. Efforts to strengthen PFM systems, promote greater transparency, improve budget procedures and reporting, and prepare MTFs should also reassure donors that aid will be used effectively and encourage them to channel more aid through the budget.

39. **Special attention needs to be paid to tracking poverty-reducing public spending[49] to ensure that it reaches the intended recipients.** The key PFM areas identified above are critical to achieving desired expenditure allocations. Techniques such as the use of Public Expenditure Tracking Surveys (PETS) and audit reports can help identify persistent

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[46] In 2003, World Health Organization (WHO) and Joint United Nations Programme on HIV/AIDS (UNAIDS) jointly launched the "3 by 5 Initiative" to treat 3 million people living with HIV/AIDS by 2005.

[47] WHO (2007).

[48] The share of donor support for certain infectious diseases has doubled during 1999–2004 compared to 1990-98, while allocations for basic health have remained broadly unchanged during the same period (OECD-DAC, 2006a).

[49] Countries typically define "poverty-reducing" expenditure in their PRSPs. This implies that some variation in the definition is likely across countries. However, most countries regard spending on basic health, primary education, agriculture, infrastructure, housing, basic sanitation, and HIV/AIDS as poverty-reducing.

weaknesses in the expenditure chain by estimating the amount of public funds that actually reaches front-line service delivery units through the budget system.[50] These techniques can be helpful in assessing the quality of cash management and internal control systems, and focus attention on the need for reform in these areas and, eventually, strengthened mechanisms of internal and external audit. Uganda initiated a PETS to assess potential leakage of funds following a dramatic increase in primary education spending that failed to boost enrollments. The survey found that 87 percent of the nonwage resources were diverted to other uses.[51] Several lessons emerge from similar tracking surveys in Ghana, Honduras, Madagascar, Mozambique, Papua New Guinea, Rwanda, Senegal, Tanzania, and Zambia. In particular, poor resource management can result from excessive discretion in budgetary procedures in an environment with weak internal controls, imperfect information, and vested interests.

40. **All poverty-reducing spending should be monitored because of fungibility in resource use.** If resources are fungible, then a recipient country can offset the scaled-up aid that is intended for additional poverty-reducing programs by lowering its own spending in those areas.[52] This problem is compounded by the difficulty of determining a counterfactual, that is, what a government would have spent on poverty reduction in the absence of higher aid flows. Moreover, substantial earmarking of resources for certain poverty programs by vertical funds would require their sustained support to ensure that these programs are maintained over time.

41. **A gradual move toward a results-oriented budget would help strengthen accountability and help assess the effectiveness of different programs.** Advanced forms of results-oriented budgeting are not appropriate for LICs. Still, some initial steps in this direction can be useful, such as identifying key program objectives and associated "responsibility centers"; defining the intended program outputs; strengthening the link between performance and rewards/sanctions; and implementing pilots in performance evaluation and results-oriented budgeting in selected ministries such as health and education, where much donor aid has been focused.

Formulating and implementing PFM action plans

42. **LICs should prepare an action plan for strengthening PFM systems based on a comprehensive diagnostic study such as the public expenditure and financial**

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[50] However, it is not possible to track all types of spending in this way, such as certain large-scale infrastructure spending.

[51] World Bank (2004).

[52] Feyzioglu, Swaroop, and Zhu (1998) have shown that earmarked project aid to developing countries is largely fungible.

accountability (PEFA) framework.[53] Reforms should be sequenced in line with government capacity, for example by following a properly defined "platform approach" so that core building blocks precede more advanced reforms. The platform approach entails identifying indicators of success for each stage of the overall reform process to determine when to move on to the next stage. This approach strengthens the linkage between the functional components of the reform.[54] The action plan may also need to be tailored to the unique circumstances of post-conflict countries, which usually face weak legal and regulatory frameworks (e.g., tax and budget laws); an ill-defined fiscal authority (the ministry of finance) and inappropriate PFM systems.[55] The action plan for *short-term* measures should:

- **Focus on key PFM areas for aid utilization.** These include the capacity to prepare sectoral ceilings and forward estimates based on improved functional and budget classifications and strengthened internal controls on budget execution, accounting, and reporting at the central level.

- **Decompose reforms into a core set of functional components.** Where appropriate, PFM reforms should be broken down into functional blocks, such as the core design elements, required changes to legislation, IT procedures, and training. Monitoring progress in each area is essential so that problems can be addressed before they become obstacles to the overall reform process.

- **Take initial steps to give the budget a results orientation.** This would allow the governments to get a sense of whether scaled-up spending is having the desired effect on economic and social outcomes.

43. **In addition, the action plan should recognize *medium-term reform*s where change will occur more gradually, such as**:

- **Developing capacity in treasury systems, cash management, and debt management** to strengthen budget execution and help countries build their own MTDS.

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[53] PEFA is a partnership whose members include the World Bank, the IMF, the European Commission, and several bilateral donors. The initiative aims to promote assessment and reform in the areas of public expenditure, procurement, and financial accountability.

[54] The platform approach has been used to help avoid initiating specific reforms for which the preconditions for success are not yet in place. For example, the implementation of a government financial management information system has often been undermined by an exclusive focus on IT systems without sufficient consideration of other functional components of the reform, such as the review and re-design of business processes, as needed, and the identification of user requirements. Similarly, MTEFs have often been established in LICs before essential preconditions are in place, thus undermining their purpose and effectiveness.

[55] Gupta and others (2005).

- **Strengthening the capacity of subnational governments:** As noted earlier, delivery of services such as education, health, and sanitation is increasingly being delegated to subnational governments, which typically have PFM systems that are weaker than those of the national government. Effective use of aid for such services would require strengthening PFM systems at the subnational level also.

- **Linking PFM reforms to broader public sector reforms:** The reforms of PFM systems can be strengthened if they are part of broader public sector reform of the civil service, governance and transparency, and the legal framework.

- **Gradually increase the role and capacity of accountability institutions such as the national audit authority**, whose mandate should include undertaking value-for-money audits of key expenditure programs.

44. **The international community should support implementation of the action plan through TA that targets the priority areas noted above.** Recent evaluations of the TA provided by the IMF and World Bank have highlighted common problems in reform programs supported by donor TA. These include overloaded reform agendas; improper sequencing of reforms; political-economy constraints; poorly selected experts and inadequate quality control of their work; and insufficient coordination among different TA providers. In addition, TA recommendations require sustained follow up by donors to monitor progress on achieving short- and medium-term goals.

45. **Strengthening PFM systems is essential to enhancing transparency and governance.** Well-functioning PFM systems can improve governance by making the budget process and government expenditures more efficient and transparent to the public and donors. They also help governments scale-up expenditure in priority areas. Transparency in public spending can be enhanced by strengthening rules governing budget procedures and reporting, and by preparing MTFs. The introduction of well-functioning PFM systems would also reduce the transaction costs of meeting donor-specified reporting requirements.

46. **Effective coordination between TA providers and the authorities is critical to the success of PFM reforms.** Use should be made of tools such as the PEFA framework. Given the Fund's limited resources and specialized expertise in core areas, coordinating with other donors is essential to avoid wasteful overlap and sending mixed messages. Moreover, there are often numerous donors providing TA in LICs, further underscoring the need for effective coordination.[56] While the country authorities should ultimately be responsible for coordinating donor activities, limited capacity or scarce human resources can require that a major donor assume this role.

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[56] For example, there were more than 25 donors providing TA on PFM issues in HIPCs.

47. **The Fund has an important role to play in helping countries implement PFM action plans in collaboration with other donors.** The Fund has expertise in many of the areas that are critical to support the short-term capacity building effort in LICs—for example, budget classification, accounting, internal control, and fiscal reporting. Such assistance should put emphasis on country ownership of the reforms; learn from lessons of the past to use TA more effectively; where appropriate, make effective use of external finance and partnership arrangements with the World Bank and other TA providers; and leverage the resources of staff from headquarters and the regional technical assistance centers (RTACs). Given the Fund's limited resources and specialized expertise in core areas, coordinating with other donors is essential to avoid wasteful overlap and mixed messages.

VI. Issues for Discussions

- Should aid recipients seek to smooth public spending over the medium-term subject to their macroeconomic, sectoral, and administrative absorptive capacity and debt sustainability? Is saving part of the scaled-up aid an appropriate strategy under certain circumstances?

- Should the strategy for avoiding long-term reliance on aid entail higher domestic revenue to cover the increase in recurrent program costs as well building appropriate fiscal institutions, including capacity to manage debt?

- Do directors agree that countries should develop a PFM action plan focusing on core areas that are important for the effective utilization of resources? In the opinion of the directors, should such a plan prioritize, in the short term, strengthening the framework of strategic planning and budgeting, improving budget classification, and strengthening budget execution and reporting systems?

- Do directors agree that the Fund should focus its PFM TA on its specialized expertise in core areas while leveraging staff resources and financing arrangements with donors and other providers? Do directors have suggestions for improving coordination between donors and recipient countries to help strengthen budgetary management in the use of scaled-up aid and the effectiveness of TA activities?

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