CHAPTER

6 Conclusions

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 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 to monitor short-term fiscal developments. Using this fiscal target would allow full spending of external grants while preventing the buildup of an unsustainable debt burden. 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 a 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 IMF-supported programs should be used selectively, that is, only when they are 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 low-income countries.

Closely monitoring spending is important for ensuring debt sustainability. Achieving the Millennium Development Goals 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 to avoiding long-term reliance on aid and maintaining fiscal sustainability. In most cases, this can best be 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 aid inflows fall short of expectations. They can also take steps to protect poverty-reducing spending from cutbacks, including by building elements of flexibility into spending programs. Multiyear aid commitments by donors would help reduce aid volatility.

Improving the efficiency of spending in low-income countries will require further strengthening of fiscal institutions, including public financial management (PFM) systems. By promoting transparency and enhancing governance, more effective PFM systems reduce waste and misappropriation of funds. Strengthened PFM systems also reduce the transaction costs of meeting donor requirements for recipient countries, while donors are assured that their funds are being used for the intended purposes. These systems help countries track public spending, thereby shifting 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 should 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 the capacity to prepare sectoral ceilings and 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 low-income countries will require substantial technical assistance, including from the IMF, to strengthen their PFM systems. Given the IMF's limited resources and specialized expertise in core areas, coordinating with other donors is essential to avoid wasteful overlap and mixed messages. The IMF should appropriately leverage staff resources and explore financing and partnership arrangements with the World Bank and other providers.