REMARKS BY E. TUMUSIIME-MUTEBILE, GOVERNOR, CENTRAL BANK OF UGANDA AT THE MEETING OF THE ADVISORY PANEL FOR HDR2003, 11-13 NOVEMBER 2002

Over the last decade, many low income countries have implemented major reforms to ensure sound macroeconomic and budgetary management to improve the efficiency with which public services are delivered, to ensure that fiscal policy is consistent with macroeconomic stability, to rationalise their budgetary systems to ensure that sectoral budgetary allocations reflect medium to long term strategic priorities, and to enhance national ownership of the budget. A lot more can be achieved in terms of development outcomes with the limited resources that are available, provided that there is a better integration of planning and budgeting and improved budget execution and implementation. Certainly increased funding as a substitute for better planning and fiscal discipline is not the answer; this would be like pouring water into a colander. Increased aid can contribute to the achievement of development goals in the low income countries, but only if increased aid meets certain conditions.

Unfortunately, there is a real danger that, in the rush by multilateral and bilateral donors to expand their aid programmes in response to international commitments, donors will undermine the important economic, financial and budgetary reforms which low income countries have implemented over the last decade. To avoid this, it is essential that at least three conditions are met.

Aggregate Expenditure Control

First, the governments of aid recipient countries must retain control over the overall level of public spending, to ensure that excessive increases in public spending, financed by aid, do not undermine macroeconomic stability or the sustainability of public finances. Low income countries should not be pressured by aid donors to absorb more aid than can prudently be used in these countries, simply to meet international targets. I want to emphasise this point, because some of the aspirations voiced by international organisations for increased aid to low income countries lack realism. For example, the World Health Organisation's Macroeconomic Commission

on Health recently called for an increase in donor funding for health expenditures in Least Developed Countries (LDCs) which amounts to an average of 7% of these countries GDP per annum. It is simply inconceivable that an increase in public spending equivalent to 7% of GDP for one single sector would be feasible, let alone an optimal allocation of public resources, for most of the LDCs. There appears to be a belief among some donors and NGOs that a lack of finance is the main constraint to providing the public services needed to achieve development goals. What has not been fully understood is that the bulk of public services consist of non traded services which must be produced, by definition, in the domestic economy of the aid recipient. Increased aid alone cannot deliver more non traded services. There has to be an expansion of the production of these services within the economy of the aid recipient, or a transfer of non traded services from the private to the public sectors within these countries. This inevitably has consequences for the growth and development of the private sector, especially for the producers of traded goods such as exports.

Sectoral Budgetary Allocations

The second condition that must apply to any increase in aid is that it should not distort the allocations of resources between different sectors of the budget. These sectoral budgetary allocations should rightly be determined through the national budget process, and should correspond to nationally agreed budgetary priorities. In countries such as Uganda, the national budget process, and the identification of strategic priorities through the Poverty Eradication Action Plan, already incorporate extensive consultation with stakeholders, including donors and NGOs. These are the appropriate fora for determining the overall sectoral composition of the national budget, so that the budget reflects a rational allocation of scarce budgetary resources among competing sectors.

What is not compatible with rational budgeting is for donors to provide additional aid and to insist that this aid is allocated to a specific sector, or even specific expenditures within that sector. Unfortunately, that is the logic behind the global funds, such as the global funds for health and education, which have recently been set up. The WHO's Macroeconomic Commission on Health is an example of this flawed thinking. The Macroeconomic Commission on Health advocated setting up a National Commission

on Macroeconomics and Health in each LDC, to mobilise resources from donors, and to scale up health spending with these resources. This mechanism would effectively take health spending out of the normal budget process in LDCs.

It has been argued by some commentators that increased Government spending on health, financed by donor aid, will not appreciate the real exchange rate because most of the expenditure will consist of imported goods, such as drugs and equipment. This is unrealistic, because even if we import more goods such as drugs, it will be necessary to incur spending in the domestic economy to deliver the drugs to the patients or to provide appropriate storage for the drugs and the staff to dispense them.

Global Funds

The so-called global funds are a response to what is clearly a large deficit in the capacities of developing countries to attain internationally recognised targets for social indicators. The rationale behind these global funds is that, because the developing countries cannot afford to finance the desired level of services to combat poverty, finance should be made available from the global funds and channelled directly into the relevant services in the developing countries. Hence, if it is determined that a developing country should spend $30 per capita on health, but can only afford to spend $10 per capita out of its existing budgetary resources, the global fund should finance the $20 per capita shortfall. Besides the global fund for health, global funds are also being considered for the education and water sectors.

While global funds are superficially attractive, they are in fact highly sub-optimal as a means of supplementing budgetary resources in developing countries. It is erroneous to believe that health spending in a developing country can at a stroke be increased many times simply by attracting more donor finance. Even if unlimited donor funds were available, there are limits on the degree to which the domestic economy can absorb these funds in the health sector without adversely affecting other sectors of the economy, because most health services consist of non-traded goods which must be produced within the domestic economy and cannot be imported. The capacity of the economy to produce goods and services is not infinitely elastic. Therefore, if spending on health increases, it will inevitably crowd out spending on other sectors.

The global funds risk creating the dangerous illusion that developing countries can afford to expand their government budgets on social services far beyond the level, which is prudent and compatible with other, equally important, economic objectives.

The financing of health services or other social services cannot be determined in isolation from the rest of the government budget, because optimal public expenditure planning must consider the relative benefits of spending in each of the different sectors of the budget. Also we need to take into account inter-sectoral linkages. This is particularly important for the health sector where more and better spending on water, sanitation and education in nutrition could have better health outcomes more than spending on curative medicine. It will never be optimal to increase spending in the health sector just because donors are prepared to finance spending in that sector, through a global health fund, irrespective of the needs of other sectors. Government should attempt to utilise all of its available budgetary resources in a manner which maximises returns across all sectors of the budget and best meets the country's strategic priorities. That is the rationale behind the Medium Term Expenditure Frameworks which many LDCs are increasingly adopting, but it is a rationale that is not understood by those who advocate global funds. If global funds come to play a significant role in the allocation of donor aid to developing countries, the result will inevitably be a distortion of rational budget management in these countries.

While it is likely that the health sector deserves more resources in most LDCs, how much money is allocated to the sector cannot be determined in isolation from the rest of the Government budget. How much extra money should be allocated to health, and to other sectors such as education, should be determined through the national budget process on the basis of national budgetary priorities and absorptive capacities, not by the volume of financial resources that can be mobilised from a global fund, or from other forms of donor aid which are earmarked to specific sectors. I am not arguing that donors should have not have a right to a say in how their resources are allocated in the budgets of aid recipients, but the donors' views should be articulated collectively through the appropriate fora in the budget process, such as the Public Expenditure Reviews.

Predictability of Resource Flows

The third condition that increased aid should meet is that it must make aid flows more, and not less, predictable. Disbursements of aid are volatile and unpredictable, even in countries which have a good track record of good governance broadly defined or which have maintained satisfactory performance under IMF programmes. Many low income countries now plan their budgets on a medium term basis, using Medium Term Expenditure Frameworks. Effective medium term budget planning will be undermined if resource flows are unpredictable, because Finance Ministries and individual sectors cannot draw up predictable spending plans if the resources required to fund this spending cannot be relied upon. I think everyone here will appreciate how damaging it will be for the sustainability of public finances in low income countries if governments in these countries increase public spending on the basis of promises of more aid which subsequently prove over-optimistic.

What sort of financial assistance meets these conditions and is, therefore, fully compatible with maintaining national ownership of budgetary policies in aid recipients and with maintaining sound public finances?

The most optimal form of aid is general budget support, because this allows the recipient the greatest flexibility in determining budget allocations, and it also ensures that the aid is channelled through the normal budget procedures. Many donors, including the World Bank, recognise the optimality of general budget support over other forms of aid and are gradually switching more of their aid into budget support from the traditional project aid modality. However, the benefits of this switch into budget support will be undermined if donors attempt to earmark aid to specific sectors, such as education and health, and thereby distort optimal budget allocations.

Conclusion

I will conclude by briefly summing up the points I have made. Increased financial assistance can contribute to development in low income countries but the modalities of this aid are crucial. Governments in the aid recipient countries must retain control other the aggregate level of public spending, and the amount and timing of any

increases in public spending funded from aid. The benefits of increased funding for social services must be balanced against the possible costs to other sectors of the economy. Governments must also retain control over the sectoral composition of their budgets, through the national budget process. Greater long term predictability of aid flows is essential if larger transfers of financial resources to low income countries are to be the basis of increased public spending in these countries.