

# Aid Predictability, Ownership and Development in Africa

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## I. Background

- Africa needs external resources to finance public investments required to meet the Millennium Development Goals (MDGs). The international community has recognized this fact and leaders of the G8 countries have increased foreign aid to the region in recent years.
- There is however concern amongst African policymakers that the manner in which aid is managed and delivered has reduced its effectiveness in recipient countries. There are therefore calls for reform of the aid management and delivery systems to ensure that the potential benefits of aid are realized in Africa.
- This presentation focuses on one consequence of the poor management and delivery of aid flows namely: the unpredictability of aid flows. It will also examine the implications of lack of aid predictability for Africa and offer suggestions on how to address the problem to ensure that it does not jeopardize the attainment of the broad development goals of African countries.

## II. Features of aid flows to Africa

- A very striking feature of aid flows is that they are highly volatile (see Bulir and Hamann, 2006). In particular, for Sub-Saharan Africa, recent evidence (see Vargas Hill 2005) suggests that aid flows are:

- Five times more volatile than GDP of Africa
- Seven times more volatile than GDP of OECD countries
- Volatility of aid receipts is twice volatility of tax revenue receipts in Africa.
- Aid flows are also unpredictable. In general, aid commitments exceed aid disbursements and, more interestingly, aid commitments are known to be bad predictors of disbursements. Note that it is the fact that aid flows are volatile and unpredictable that is of concern to policymakers. It increases the risk of policy errors as governments are forced to plan based on forecasts of aid.
- Aid flows are pro-cyclical---that is, countries tend to receive more aid in good times and less in bad times. The pro-cyclicality of aid implies that it does not have a stabilizing effect on an economy.

### III. Consequences of lack of aid predictability?

- One of the main consequences of aid unpredictability is that it makes fiscal planning and implementation of a recipient country's development agenda extremely difficult. This is because governments typically have a medium-to-long term development framework. But the time horizon for aid commitments tends to be short term. Clearly, this time horizon mismatch leads to inefficiencies and distortions in the use and allocation of resources.
- Another consequence of the lack of aid predictability is that it makes it impossible for recipient countries to own their development program, process, and outcome. This is particularly serious in the African region where aid often accounts for a significant fraction of the budget and GDP. The uncertainty associated with aid flows makes recipient countries vulnerable to actions of donors and this undermines their ability to take leadership of their development program. Mozambique, Rwanda, Tanzania, Sierra Leone, and Ethiopia are examples of countries in the region that are heavily dependent on aid.
- The lack of predictability of aid also increases the likelihood of fiscal and monetary instability. The idea here is that when recipient countries make fiscal plans based on their forecast of aid receipts, they are forced to run

fiscal deficits if actual aid is less than expected. If the deficit is financed through borrowing from the central bank this could lead to inflation and macroeconomic instability.

- When aid flows are unpredictable and pro-cyclical, they also increase output volatility and hence reduce growth.
  - Ramey and Ramey (1995) show that countries with high output volatility tend to have low average growth
  - Lensink and Morrissey (2000) have also shown that there is a negative relationship between aid volatility and growth. When a government receives less aid than anticipated, it can either reduce government spending or run a fiscal deficit to implement its fiscal plan. If it chooses to reduce spending this usually results in less public investments, for example in infrastructure, leading to a decline in private investment and hence growth.

#### IV. Why is aid volatile and unpredictable?

- A key reason for the volatility and unpredictability of aid flows is the fact that donor aid commitments, budget approval, and disbursements are often made by multiple actors or agencies. For example, the Prime Minister of a country can commit to providing aid to a given country but will need parliament to approve funding for the commitment and the Ministry to Finance to make disbursements. It is not unusual for Parliament to approve an amount less than what the executive branch promised leading to a lack of ability of the donor country to fully honour its commitments.
- The conditions imposed by donors also contribute to the lack of aid predictability. These conditions are sometimes process-related, for example when a donor insists on recipient countries using consultants from their country in executing projects they finance. There are also policy or performance based conditions.
  - While the imposition of conditionalities is understandable, they are costly. The key question therefore is whether the benefits outweigh the costs. Clearly, the answer to this question is not simple and will depend on country specificities.

- Given the existing trade-offs, donors need to take a fresh look at the use of conditionalities and eliminate those that have not led to desired changes in behaviour in recipient countries. Such conditions impose costs on recipient countries without leading to any significant change in behaviour. For example, there is growing evidence that policy conditionalities have generally not worked in recipient countries and so donors may want to avoid these types of conditionalities and focus more on performance or outcome based conditionalities.
- Donors need to understand that recipient countries will adopt policy reforms only if they feel it is in their interest to do so. It is therefore counter-productive to use policy reform as a condition for aid disbursement.

## V. How to deal with the unpredictability of aid?

- I see at least two ways of dealing with the issue of unpredictable aid flows in recipient countries. The first is to assume that something can be done about it and identify policies that can move us towards the attainment of this objective.
- The second approach recognizes that political realities in donor countries might make it difficult to have predictable aid flows and so the focus should be on finding ways to mitigate the adverse effects of aid volatility in recipient countries.

### Improving aid predictability

- Donors can improve aid predictability by using a multi-year framework for future aid commitments and providing information to recipient countries on the future path of aid disbursements. Such transparency will reduce the uncertainty associated with aid flows and improve fiscal planning.
- Reducing policy conditions associated with aid flows will also improve aid predictability. More emphasis should be placed on performance rather than policy-based conditionalities.

- Donors can also reduce disbursement delays by giving more power to their local offices and staff in decision making.
- Strengthening of partner country public financial management capacity will also create an incentive for donors to use these systems for aid delivery and reduce the need for conditionalities as donors will be more confident that partner country systems have enough checks and balances to ensure the effective delivery of aid.

### Mitigating the effects of aid volatility

- The use of foreign exchange reserves for mitigating the adverse effects of aid volatility is attracting attention. Such reserves will enable recipient countries to cover the gap between expected and actual aid and reduce the need for sharp cuts in public expenditure when aid flows fall below expectation.
- Another idea that has been put forward is that recipient governments should prioritize their spending programs and make them contingent on different scenarios for aid disbursement. This will ensure that when aid falls below expectation, spending on priority projects and programs will not be affected.

## VI. Concluding remarks

- Unpredictable aid flows undermine recipient countries' ability to own the development process and outcome. Transparency and provision of information on future aid disbursements will reduce the uncertainty associated with aid flows and make recipient countries less vulnerable.
- The cost of improving aid predictability is small for donors but the welfare gains to recipients are large.
- Making aid predictable will eliminate one of the explanations often given for poor performance by aid recipients. It will also put pressure on recipient countries to improve economic policies and lay the foundation for a brighter future for their people.

## References

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