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IMPLICATIONS OF SUBSTANTIALLY INCREASED DEVELOPMENT AID: THE CASE OF UGANDA

A high fiscal deficit directly undermines a number of economic conditions required for a strong private investment-export-led growth and structural transformation. However, Damoni Kitabire, in an article in the Institute of Development Studies (IDS) Bulletin argues that as Uganda's experience show, substantially increasing donor aid might not be the solution to sustainable poverty reduction.

THE Commission for Africa envisages that development assistance must be doubled if the Millennium Development Goals (MDGs) are to be met. To bridge the short to medium-term gap in financing, it is proposed that the International Finance Facility (IFF) uses the value of long-term donor commitments to the IFF to raise large sums by issuing bonds on international capital markets. By bringing forward the value of long-term donor commitments, the IFF would enable a critical mass of aid to be invested in the short-term ("front-loading"), while leaving current donor commitments unaffected. The IFF would use existing bilateral and multilateral mechanisms to disburse funds raised through the Facility and ensure that disbursements reflect donors' preferred delivery channels.

For Uganda, the prospect of doubling aid through donors' preferred delivery channels conflicts with a number of strategic objectives under the revised Poverty Eradication Action Plan (PEAP). The PEAP is Uganda's Poverty Reduction Strategy Paper (PRSP). The strategic objectives that conflict with increased aid are:

- Fiscal deficit reduction, private sector/export led growth and reduced aid dependency
- Improvements in efficiency/value-for-money of public expenditure and closer alignment to PEAP priorities
- External debt sustainability

Fiscal deficit reduction, private sector-export-led growth and reduced aid dependency

Since 1997/98, Uganda's fiscal deficit, excluding grants, has risen substantially by increasing expenditure (financed by donor aid) more rapidly than the growth in domestic revenues. The consequence of running a higher fiscal deficit, while at the same time maintaining inflation at or below 5 percent, has been to increase government's net issuance of securities (Treasury bills and long-term bonds) by over 500 percent over the past five years and to increase the Bank of Uganda's (BOU) foreign exchange sales by 1000 percent. The issuing of securities and foreign exchange sales are the two instruments that the BOU uses to mop up excess liquidity from the domestic economy if it is to meet the inflation level. As a result, interest rates have become sharply higher and more volatile, increasing the cost of private sector borrowing.

Although Uganda has enjoyed a sustained period of economic growth, this has been due largely to improved security, the restoration of macroeconomic stability, rehabilitation of existing production facilities and removal of economic distortions (“rebound growth”). These policy-induced improvements in resource allocation and resource deployment, reflected by high total factor productivity growth, have therefore been viewed as movements towards the production possibility frontier rather than as an outward shift in productive capacity. As Uganda enters its second and more challenging phase of growth, sustaining the high growth rates of the last 15 years require strong private investment to shift the production possibility frontier outwards, which in turn requires low and stable interest rates as a result of a reduction in the fiscal deficit.

A recent study suggests that Uganda exchange rate has been overvalued since the late 1990s. A considerable proportion of this overvaluation is attributed to the behaviour of aid flows. Since August 2003, the general trend of a depreciating nominal Shilling (against the US dollar) has been abruptly reversed. By December 2004, the shilling had appreciated by approximately 13 percent against the US dollar, caused primarily by the size of the government's fiscal deficit, rendering the tea, tobacco, maize and fish export sectors temporarily unprofitable and leading to lower farm-gate prices. The damage to the export sector caused by the appreciation and subsequent reduction in farm-gate prices has clearly illustrated that Uganda's large aid-financed fiscal deficit is not necessarily compatible with the objectives of poverty reduction and strong export-led growth, even though its purpose is to finance expenditures aimed at poverty reduction. While export competitiveness can be enhanced in the long term by improving infrastructure (roads, rail, air and electricity) financed by an increase in donor aid, exchange rate appreciation during this time lag could be sufficiently damaging to "kill" export sectors before any long-term gains are realized.

Thus it is clear in Uganda that a high fiscal deficit, based on current aid levels, directly undermines a number of the supporting economic conditions required for strong private investment, export-led growth and structural transformation. As a result, Uganda aims to gradually reduce its fiscal deficit over the medium and long term by prioritizing expenditure, mobilizing additional domestic resources and reducing dependence on donor aid. In other words, substantially increasing donor aid is not the solution to sustainable poverty reduction in Uganda.

However, to date, the impact on macroeconomic management has been grossly underplayed, especially in terms of monetary policy to "mop up" excess liquidity and reduce exchange rate volatility created by higher aid inflows-and consequently, the impact on the private sector and export sector has been understated. For countries contemplating an increase in donor aid, rigorous analysis should be undertaken to project inflation, interest rates and the nominal and real exchange rates to understand fully how private investment, exports, competitiveness and poverty levels are likely to be affected. Too much hope should not be pinned on increasing the import content of public expenditure as a way to mitigate some of the negative effects of increased aid. In Uganda for example, a large share of poverty-reducing expenditure is on non-importable/non-tradable goods and services. Programmes such as Universal Primary Education (OPE), Primary Health Care (PHC), the Road Sector Development Plan (RSDP) and the Plan for the Modernization of Agriculture (PMA) are primarily wage intensive, as they require the recruitment of skilled personnel such as teachers, health workers and extension workers. Government cannot therefore switch its expenditures in these programmes away from wages to imports in any significant way, without compromising its ability to deliver key services.

In addition, the capital components of these programmes involve expenditures that do not have high import content. Classroom construction, health centre construction, road development and maintenance require domestic non-tradable goods such as cement, bricks and timber. Shifting public expenditure towards imports would restrict procurement and undermine the local economy by reducing the multiplier effect of government expenditure.

Reduced aid dependency

Achieving a lower fiscal deficit is not the only factor behind Uganda's objective to reduce donor dependency from its current level of almost 50 per cent. High dependency on donor aid has increased the vulnerability of the budget to a sudden cutback in donor aid. While a temporary reduction in aid could be absorbed through a limited rundown of the central bank's foreign exchange reserves, a cutback in aid which lasted for much more than one year would force government to make severe budget cuts. In addition, excessive aid dependency inevitably impinges on the sovereignty of the aid recipient and constrains its economic and budgetary choices. This is not consistent with the development of a healthy and equal relationship between aid recipients and the donors. Reducing dependence on aid therefore is crucial for the development of democracy and improving the accountability of government.

While Uganda's position is clear on reducing and not increasing aid dependency, dependency will only be reduced gradually as there are limitations to the growth in domestic revenue. It would not be prudent to expect increased domestic revenue to "fill the gap" left by donor inflows after the initial "front-loading" of aid taps are off. The most likely outcome would be domestic revenue lagging behind over-optimistic projections, necessitating a large fiscal cutback and reduction in key spending programmes. For countries which decide to decrease aid dependency, it would be crucial to align increased aid-financed expenditure with domestic revenue performance to ensure at least some minimum level of fiscal sustainability. For example, countries should seriously consider reducing aid-financed expenditure if domestic revenue performance over the medium-term falls below expectations; otherwise budgets would become vulnerable to cutbacks in donor aid. Clearly incentives such as this are needed to encourage domestic revenue mobilization and avoid governments "free-riding" on the generosity of donors. In fact, Uganda's standpoint is heavily influenced by its own disappointing revenue performance since 1997/8 (revenue/Gross Domestic Product (GDP) ratio has only increased by 2 percent of GDP), the same period over which donor inflows increased substantially.

Improvements in efficiency of public expenditure and closer alignment to PEAP priorities

Uganda's deficit reduction strategy inevitably limits public expenditure growth (including donor aid), and consequently strong emphasis is placed on the quality rather than the quantity of expenditure, especially for donor projects. Any further increase in aid to Uganda would seriously impede government's efforts to improve efficiency/value-for-money and increase alignment to PEAP priorities. There are two main strands to this issue;

a) Absorptive capacity

First, increasing public expenditure, whether financed by domestic resources or donor aid, and maintaining or improving value-for-money require an equal rise in absorptive capacity, within both the public service and the domestic economy. In Uganda, the expansion of government expenditure in the mid-1990s, mainly funded by an increase in donor aid, undoubtedly helped to fund key government priorities. However, growth in public spending outstripped the implementation capacity in the public sector and in the wider economy, with the result that costs were driven up and the quality of many development projects was unacceptably poor. Capacity constraints have been particularly acute in the roads sector, where construction costs have risen rapidly, cost overruns are commonplace and there are long delays before donor-funded road projects can get off the ground. Even some of the money being channeled into key poverty-eradication programmes has not been well spent, resulting for example, in poorly constructed classrooms. Thus, even at current aid levels, Uganda cannot effectively absorb donor inflows; a doubling of aid would be disastrous for efforts to improve value-for-money and would set unit costs at unsustainably high levels. Although the Commission for Africa has proposed recommendations for enhancing the quality of public institutions and capacity to increase the effectiveness of extra funds, in practice, increasing absorptive capacity is a long-term process. The Commission should seriously re-examine the IFF plan to "front-load" aid in the short-term, as this would allow very little time for the public sector and economy to develop absorptive capacity.

On a practical level, the Commission must come up with a robust framework for assessing the absorptive capacity of each country, and all stakeholders must agree on a set of indicators to monitor value-for-money on a regular basis. This is far from a simple task. Although Uganda has had some success with tracking studies and strengthening formal accountability; unit costs of inputs and outputs are rarely measured nor scrutinized, and even in a sector as large as roads with substantial donor support, the sector has failed to develop a road construction price index. Similar to the issue of whether aid-financed expenditure should be adjusted downwards if domestic revenue performance is below target, there should also be a clear agreement to scale back aid-financed expenditure if there are clear signs of absorption constraints.

b) Delivery channel of aid

Given that the IFF would ensure that disbursements reflect donors' preferred delivery channels-and project support is the preferred channel for several donors, a large increase in aid could herald a proliferation of costly, misaligned projects. In Uganda, donor projects frequently comprise low priority expenditures that are not explicit objectives of the PEAP and have much higher unit costs than general government budget expenditure, including budget support. The counterpart funding and recurrent cost implications of such projects have to be met through the government budget and often crowd out essential spending in priority areas. A prime example is the roads sector where an imbalance between capital projects and operational expenditures has led to severe under funding of essential road maintenance.

To ensure better alignment of projects with development priorities, as well as to strengthen sector budgeting, Uganda is slatted to integrate project aid into medium-term sector expenditure ceilings. All sector expenditure ceilings are determined on the basis of allocating a centrally determined budget resource envelope for aggregate government expenditures, including donor projects, according to the government's strategic spending priorities, which reflect PEAP priorities. This means that sector expenditure ceilings are determined independently of the resources, which any donor would propose to give to a sector, whether through project aid or sector budget support. In the event that the sector takes on donor-funded projects greater than the value of these projects in its sector expenditure ceiling, its government budget ceiling would be cut accordingly to maintain the integrity of the overall expenditure ceiling.

All this makes it inevitable that an increase in donor projects financed by the proposed increases in aid would cause Uganda to turn down projects that are either not aligned with key priorities or are too costly within the sectors' predetermined ceiling.

External debt sustainability

The IFF is also likely to herald not just increased support for projects, but also an increase in loans to developing countries, since loans are the preferred delivery channel of aid for major donors such as the World Bank and the African Development Bank.) This poses a serious challenge to many developing countries as external debt management remains weak in terms of coordination between external debt contraction and development priorities and external debt sustainability strategies. In response to our external debt burden reaching unsustainable levels despite enhanced heavily indebted poor countries (HIPC) relief, Uganda has placed a cap on all new borrowings and will limit loans to only those that contribute directly to productive enhancement. Therefore Uganda will in future reject not just project aid, but loans that either do not contribute to productive enhancement or exceed the borrowing cap. Uganda is concerned by the Commission's proposal for debt relief, 100 percent debt service cancellation by 2015, as this could lead to public expenditure reaching unsustainable levels by 2015 when the resumption of external debt service would be felt as a "fiscal shock" leading to expenditure cutbacks. The Commission should focus more on immediately canceling a proportion of the outstanding debt of debtor countries, allowing them to service external debt at lower levels and maintain fiscal stability.

The way forward

Although poverty levels are still high in Uganda and government remains firmly committed to reducing poverty-and meeting the MDG targets as quickly as possible, substantially increasing donor aid is not the way to achieve these goals in a sustainable manner. Current aid levels in Uganda are already directly undermining a number of the supporting economic conditions required for strong private investment and export-led growth. Increasing the import content of aid-financed expenditure is not a viable option. The expansion of aid-financed public expenditure has outstripped absorptive capacity in the public sector and the wider economy and, together with a proliferation of donor projects, unit costs have been driven up, resulting in poor value-for-money and many projects have not been aligned to specific development priorities. The revised PEAP sets out how Uganda intends to improve capacity within the public service--a long-term process involving pay reform and capacity-building at both central and local government levels. Uganda is trying to rationalize public sector structures and make use of existing administrative structures. Therefore the creation of additional public agencies is not the path Uganda would take to increase capacity.

Uganda aims to gradually reduce its fiscal deficit over the medium and long terms by prioritizing expenditure on those activities that contribute directly to poverty eradication that is focusing on quality rather than quantity of expenditure, mobilizing additional domestic resources, and reducing dependence on donor aid. Uganda believes that this is the optimal strategy to reduce poverty sustainably and to meet the MDG targets.

Given that Uganda does not expect to escape aid-dependency quickly as there are limitations to the growth in domestic revenue, the major challenge in terms of development aid is to improve the quality of current levels of aid-financed expenditure. In order to improve effectiveness of aid by increasing alignment to development priorities and increasing efficiency, Uganda's preferred modality of aid is budget support grants, as they directly fund government's expenditure priorities, as guided by the PEAP--and further, do not contribute to Uganda's external debt burden. Uganda's policy therefore is to encourage donors to shift to budget support, and to be more selective about the projects it accepts through the integration of project aid into medium-term sector expenditure ceilings. However, this does not mean that Uganda would rapidly expand aid-financed public expenditure if all increased aid came in the form of budget support grants, as this would not be consistent with the country's deficit reduction strategy. Rather, government savings with the Bank of Uganda would increase and this amount would be drawn down in future years to finance resource shortfalls.

ECAPAPA was directed to this article by Geoffrey Ebong, WFP-Uganda. He is gratefully acknowledged.

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