Working Group on IMF Programs and Health Expenditures
Background Paper
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Promoting and Protecting High-Priority Expenditures

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Abstract

This background paper examines the issues that arise when some sectors of public expenditure are regarded as being of relatively higher priority than others. The issues range, *inter alia*, from concerns about how to change the level of spending in such a sector to concerns about how to protect it against budget shocks. The paper begins by providing a fairly general discussion of how these problems may arise and what sorts of actions and devices might be appropriate in attempting to deal with them. Throughout, it is assumed that macroeconomic stability and fiscal sustainability are joint imperatives, so that all attempted solutions to the prioritization problem must be consistent with achieving and maintaining these.

Section 2 provides a brief conceptual background, which stresses that careful diagnosis must precede any attempted intervention. Following from this, section 3 sets out to provide a taxonomy of the various types of underlying failure, and section 4 discusses possible responses to these, as well as likely consequences. It is clear that there may sometimes be a danger that the medicine is more harmful than the disease.

The paper then goes on to summarize some rather incomplete evidence of what has been attempted and achieved in practice. As far as the author is aware, there has been very little effort to conduct serious empirical studies of these questions. Section 5 highlights some aspects of experience in the three countries where case studies have been conducted as another part of this project. Section 6 summarizes what was learnt from a less intensive survey of a further 9 countries. Section 7 looks at related mechanisms used to handle problems of revenue volatility more generally, and section 8 concludes.

This paper informed the deliberations of the Center for Global Development's Working Group on IMF Programs and Health Expenditures.

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1. Introduction

This background paper examines the issues that arise when some sectors of public expenditure are regarded as being of relatively higher priority than others. The issues range, *inter alia*, from concerns about how to change the level of spending in such a sector, to concerns about how to protect it against budget shocks. The paper begins by providing a fairly general discussion of how these problems may arise and what sorts of actions and devices might be appropriate in attempting to deal with them. Throughout, it is assumed that macroeconomic stability and fiscal sustainability are joint imperatives, so that all attempted solutions to the prioritization problem must be consistent with achieving and maintaining these. The word 'donors' is used as shorthand for all those external agents who make resources available on less than commercial terms and/or try to influence domestic policy formulation and implementation. Section 2 provides a brief conceptual background, which stresses that careful diagnosis must precede any attempted intervention. Following from this, section 3 sets out to provide a taxonomy of the various types of underlying failure, and section 4 discusses possible responses to these, as well as likely consequences. It is clear that there may sometimes be a danger that the medicine is more harmful than the disease.

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2. Conceptual background

The very notion that a category of public expenditure is 'high-priority' raises some difficult issues. Since prioritization is all about relativities, the assignment of some expenditures to the high-priority category presupposes that others are assigned to a low-priority category. This indicates either some failure in the budget process, or some failure of governance more generally. If these were working satisfactorily, budget allocations would reflect the government's considered (and reasonable) judgement on priorities, and all forms of spending would be equally valuable at the margin. In principle, this would apply not only when expectations over resource availability were realized, but also when they were not. Any necessary adjustments to the level of spending enforced by surprises would be distributed across spending sectors so that the changed allocations remained equally valuable at the margin across sectors, albeit at a different value level. To the extent that volatility in spending is particularly costly to service delivery, financing would be used to smooth it. Hence the issue at hand implies some form of system failure, with an associated second best problem.

[1] Excellent research assistance was provided by Jennet Hojanazarova, who collected and analyzed material for nine countries; Burkina Faso, Chile, Ethiopia, Ghana, Honduras, Nicaragua, Peru, Tanzania, Uganda. While in no sense representative, these countries do range quite widely, both as regards per capita income, and as regards their perceived need to improve public expenditure management.

The general approach to second-best issues includes three precepts. First, it is best, if possible, to remove the original failure, as opposed to designing responses to it. Second, if that is not feasible, the designed response should generally be as 'close' to the original failure as possible.[2] Third, the nature of the original failure should be analyzed carefully, to ensure that the response is appropriate to that failure. This may sound too obvious to be worth stating, but the record is littered with examples of second-best interventions that were carefully designed, but in response to a misspecification of the problem. Before considering possible responses, it is necessary to start by considering what sorts of failure may be involved.

3. Types of failure

The basic failure is a failure to control spending so that it has equal benefit at the margin in all sectors. It is convenient to split this into two broad classes. In the first, there is a systematic failure to set spending levels in line with priorities – instead they seem to be stuck at the wrong relative levels. In the second, the problem is more to do with how change is handled. For example, a sector may have to absorb an excessive share of any volatility in aggregate resources. These two classes are distinguished by calling them 'level failures' and 'volatility and persistence failures' respectively.

3.1 Level failures

Since our concern is with priority sectors, it follows that the level is perceived to be too low, and the problem is to raise it. There seem to be at least four possible types of level failure. One arises from the practical difficulties of achieving desired shifts in composition, a form of inertia. A second reflects imperfectly developed mechanisms within government for balancing different claims in a way that reflects even the government's own objectives. Internal power relations are inadequately countervailed. The third arises when government objectives are poorly aligned with the preferences of the people it is supposed to represent. Short of an effective political process that can give effective voice to these preferences, donors may attempt to encourage such a process, or to substitute their own interpretation of these preferences in trying to influence government. The fourth is closely related, only it is the donors' own preferences that underlie this attempted influence. This is an example of the type of 'meddlesome' preferences which have been much discussed in the study of charitable activities in general. Hence, the failure may be more in the eye of the beholder than an objective failure like the others. However, the third and fourth types of 'failure' would be observationally hard to distinguish, so they are lumped together in what follows.[3] Of course, the distinctions between all of them are more than a little fuzzy, but it seems helpful to distinguish them nonetheless.

Inertia

It is notoriously difficult to contract established activities, particularly if they include substantial personnel costs. Many developing countries have a history of heavy state intervention in

[2] Of course, with the passage of time, what is feasible may shift.
[3] What is more, so are the operational - though not the welfare – implications.

productive activities, and are in transition to greater relative emphasis on the social sectors. Similarly, they may have acquired an excessively large number of unproductive civilian employees, or an excessive military or diplomatic apparatus. Provided the economy is achieving a high growth rate of GDP, or if the government's access to resources is growing rapidly for some other reason, it may be possible quickly to achieve a substantial shift in budget shares without having to enforce absolute contractions in the relatively declining sectors. Otherwise, the desired expansion may be slowed down by the requirements of fiscal prudence if contraction can only be achieved slowly.

Since the low level of spending in the sector of interest is a consequence of an excessive level in some other sector, the primary challenge is find a way of cutting back the latter. Devices that focus instead on forcing expansion of the favoured sector, if they work at all, may simply threaten the government's fiscal sustainability.

Relative political weakness

This is simply a reflection of the fact that governments are not unitary organizations; they are coalitions of disparate interests, and power relations between these interests play an important role in determining outcomes. The rationale for identifying a sector as having a high priority might now be that the interest groups in its 'corner' are disorganized or relatively weak; they are relatively ineffective either in securing allocations, or defending what allocations they appeared to have secured.[4] In this case, the desirability of increased resourcing of the sector might be widely acknowledged within government, but there might be no mechanism for redressing the imbalance. This involves a failure of the budget process actually to deliver and defend resource allocations that are in line with the government's own (majoritarian) viewpoint.[5] Once again, the solution has to lie in securing an improvement in this process. Substantial proportions of both donor technical assistance and government programmes of reform have rightly been devoted to trying to accomplish this. In addition, moves to greater transparency may play an important part in reducing the discrepancies. A more difficult issue arises over strategies of pre-commitment. If the government successfully pre-commits to a raised spending level in the priority sector, something has to give somewhere else. If it is the excessive spending in a politically well-connected but low-priority sector, the device will have achieved its purpose, but this may not be the outcome. This issue is returned to later.

Differential donor preferences

A rather different issue arises when donors take a systematically different view of prioritization from the government. There are three cases to consider. In the first two, donors may take the view that the government does not adequately represent the interests of its own people; it lacks legitimacy, and hence it is reasonable to try to distort (improve) government spending patterns away from those it would freely choose. The difference lies in the presumed source of these

[4] It might be expected that a politically weak sector would receive a small allocation of resources in the original budget. However, a characteristic of some budgetary processes is that even these small allocations get 'raided' subsequently by more powerful sectors, so the weak sector does not even receive all of its small allocation.
[5] The failure to defend an allocation may also be quite unpredictable. This is one of the sources of volatility, discussed later.

alternative patterns. In case 1, donors attempt to create a voice for the people themselves. Arguably, the purpose of making the Poverty Reduction Strategy process mandatory for debt relief was partly to find a means, however imperfect and incomplete, of creating some sort of internal political process to supplement the existing process with all its perceived deficiencies. In case 2, the preferences come from the donors themselves. In case 3, donors might not dispute the validity of the government position, but still 'beg to differ' as regards the use of the incremental resources they provide. Government preferences would determine the pattern of intra-marginal expenditures, but donor preferences could legitimately determine the pattern at the margin.

The tension between donor and government preferences, and the occasionally dubious legitimacy of either, poses a number of intractable problems. One is the question of fungibility. A second is the potential for distortion in process. A third is the problem of differential preferences given different time horizons.

The *fungibility* issue is well known, though its implications have not always registered. If a donor earmarks additional funding to a particular sector, the government can typically offset all or part of this increment by shifting its own spending away from the sector. For example, the analysis in the background note for the High-Level Forum on the Health MDGs (High Level Forum, 2005a) indicates that the marginal impact of higher aid on the share of health spending was relatively small - much smaller than notional earmarking.[6] The donor ends up financing a different activity entirely. Indeed this has been one of the major defects in the appraisal of particular projects or activities, however carefully it is undertaken; the project being appraised may not be the project that the project finance is actually financing. This process may also be self reinforcing. If donors are concerned that government is neglecting a sector, and earmark funds towards it, and the government responds by further reducing its own direct spend, then the perception of neglect is reinforced. What the government *would have spent* in the absence of earmarking is essentially unknowable. One of the perceived merits of shifts to budget support is that the whole expenditure pattern that it finances can be reviewed when the level of support is being negotiated. Differences in preferences over composition can be aired (and hopefully compromises reached) in an explicit and transparent manner.

The problem of *distortion in process* arises precisely because effective expenditure implementation requires political and bureaucratic commitment as well as finance. This commitment may be lacking if the spending pattern does not have the enthusiastic support of the recipient authorities. This has sometimes led to the construction of parallel delivery systems which can lead to a host of coordination problems, uneven provision by region or sub-sector, and a bleeding of scarce human resources from, and consequent deterioration in, the quality of the remaining government operation.

[6] Comparing net changes in public expenditure on health to changes in net aid disbursements during 1998-2002, they find a statistically significant relationship between changes in aid and changes in public health spending, although the coefficient is quite small, implying that only 3.6% of additional aid is used to finance health expenditures. (See Section 3.5 of High Level Forum, 2005a) Since, as Table 5 shows, low-income countries typically spend about 2.5 percent of GDP on government health spending, this implies that higher aid does increase the total share of spending going to health, but by much less than the share of development aid commitments earmarked for the health sector, which, according to estimates by the High Level Forum, rose from 9 percent in 1990 to 17 percent in 2003.

A differential *horizon* is inevitable since donors will eventually taper off their activities and exit over some sufficiently long future, whereas government will be operating indefinitely. This is true even if a government is myopic and is able only to plan to a short horizon; it or a successor government will have to pick up the pieces subsequently. However poor the forward planning and however lacking in inter-temporal cohesion public sector activities may be, they will continue indefinitely. Sooner or later, the importance of any differential donor preferences will wither. Looking forward to this certain if uncertainly timed event, there are three possibilities. First the differential prioritization of donors is essentially a matter of pump-priming. Once the pump has been primed, the rationale for both the donor presence and the differential preference will evaporate. On that view there is no problem. The second possibility is that, with the passage of time, or growing experience, the government's preferences converge towards the donors'. If the additional donor input is provided long enough for this convergence to occur, subsequent withdrawal would require no shift in prioritization. The third possibility is that the discrepancy in preference remains, and that spending patterns reflecting donor preferences will shift as donors become less significant. If this happened in a gradually tapering fashion, it would be easy to accommodate; if it happened abruptly, probably not. This question is considered further under 'persistence' failures.

3.2 Volatility and persistence failures

Here the problem is that the level of spending in the sector of interest is perceived not to be steady enough, either in the historical record, with the expectation that this will continue, or – even if not a feature in the past – one that may be so prospectively, due to changes in the economic or political environment. Volatility is taken here to be instability in the short run, for example within the annual budget cycle, or possibly within the medium term (say three year) horizon. The issue is not that the level of resources is unreliable in the long run, but that the timing of receipts is unreliable in the short run. Concerns about persistence, in contrast, reflect the risk that the level of resources will not be maintained in the long run, whether or not they also exhibit volatility in the short run. While the two problems often overlap in practice, it is convenient initially to separate them for purposes of discussion.

Volatility

Spending volatility within a sector may reflect volatility in the flow of overall resources, often due to volatility in the flow of aid; or it may reflect voracity of other sectors, making unpredictable raids on the sector's allocation, even when total resources are reasonably steady. These two very different sources of volatility have quite different implications. As regards voracity, the ideal resolution would be a strengthening of governance and the budget process. Failing that, some device for pre-commitment such as entrenched ring-fencing may have a role. The pros and cons of this type of approach are discussed in the next section. As regards the first type of volatility, there are three avenues to pursue.

(1) Can the volatility be reduced at source? Since much of it originates in donor behaviour, there is relatively little that the recipient government can do to achieve this. It requires a change in donor procedures; either to make the flows steadier in the first place, or to create financing or other mechanisms to enhance the possibility of expenditure smoothing.

(2) To what extent can the recipient government itself smooth the path of total spending? In a financially deep economy, with good access to international capital markets, some combination of internal and external financing would permit government to do so relatively completely. For most low-income countries, neither of these conditions is fulfilled. There is however one device that can still be used. This is to build up a level of government foreign exchange reserves that can be run down during temporary shortfalls. The traditional rationale for holding foreign exchange reserves was to be able to insulate import flows from volatility in export receipts, partly by preventing sharp fluctuations in the exchange rate. The current (supplementary) rationale is to insulate government expenditure from volatility in receipts, while preventing sharp fluctuations in domestic interest rates as well as in the exchange rate.

The implication of this strategy in the context of scaling up should be noted. Even if the prior level of reserves was adequate to permit smoothing in the face of existing aid flows, a substantial part of the initial enhanced flow should be devoted to a further build-up in reserves. If the enhanced flow was stationary, this would be a one-step event. If the flow continued to grow over some extended horizon, further deductions would be needed; in face of the persistence concern, these might have to be still more substantial.[7] Recent studies of government responses to aid suggest that they do often behave in this way.[8] However, cumulatively, this may strain donors' patience if the rationale for it is not well understood. Even if it is, donors' own procedures may make it difficult for them to acquiesce; this is particularly likely in the case of earmarked funds.

(3) Given whatever (partial) aggregate smoothing has been achieved, there remains the question of how to distribute the residual spending volatility amongst sectors. Sectors may differ in how damaging to their programmes interruptions or delays may be. However, the rationing mechanisms that have been used in practice tend to reflect the political or bureaucratic pattern of sectoral incompressibility rather than a technical judgement of this sort. Nor is this confined to allocations between sectors. There is also a cross-cutting issue, with capital expenditure, maintenance, and other operations and management expenditures being squeezed relative to wage costs and debt service. For these more discretionary economic categories, volatility may therefore be much higher than for the aggregate.

Persistence

For most industrialized countries, government resources depend overwhelmingly on the state's capacity to raise revenue; the issue as to whether this capacity may become compromised in future does not arise.[9] For some developing countries, this may not hold. The two major sources of possible sustained falls in the resource flow at some point in the future are dependence on

[7] What proportion of the flow should be set aside in this way depends not only on judgements about the nature and persistence of the aid, but also on the nature of the planned spending increase that it will finance. This is because the benefits of expenditure smoothing – or the costs of interruptions – will differ between different categories of expenditure.

[8] See for example Berg et al, 2005.

[9] Historically, there have been rare events – such as the imposition of war reparations on defeated combatants – that have drastically reduced the share of these resources available for a government's own purposes. Very high persistent deficits and the associated cumulative debt service can have similar consequences; but this is about the time pattern of the use of resources, not any failure in persistence of the resource flow itself.

natural resource rents and dependence on aid flows. For most purposes, it is the ratio to GDP of the resources available to government that provides the relevant metric, and the following discussion is in those relative terms.

Notice that these two resource flows may not only fail to persist; they are also likely to be highly volatile, on the one hand because resource prices are volatile, on the other because of the nature of donor behaviour, or as a consequence of the structure of conditionality and the nature of recipient government behaviour. Indeed, a major problem for any government in receipt of either type of inflow is to judge whether a current change should be treated as 'temporary' (volatility) or 'permanent' (persistence). Judgements have always to be provisional, and regularly revisited. To put matters somewhat differently, the issue under consideration compounds two difficulties, either of which would pose serious management problems for a government. The first is the inconstancy of the flow of resources over time. The second is that considerable uncertainty is associated with this inconstancy. For the present discussion, this substantial complication is set to one side; it is considered further later in the section. Initially, attention is restricted to the inconstancy aspect, with the uncertainty aspect suppressed.

Suppose that the government believes it is faced with an extended 'pulse' of additional resources, and that this pulse will eventually taper away, for example because the country ceases to attract favourable attention from donors, or because reserves of a mineral deposit become exhausted.[10] Also suppose the government had an existing fiscal programme given its expectations, prior to new information about this pulse, so that the pulse is an increment to previously anticipated resources. What would be the appropriate way for government to handle this known and predictable incremental inconstancy?

As is well understood, the government's economic choices are ultimately constrained by its inter-temporal budget constraint. If it is able to borrow and lend freely on the international capital market, implementation of revised fiscal planning under this constraint is (relatively) straightforward. The present value of the stream of government primary surpluses should fall by an amount equal to the present value of the resource pulse. This could be achieved by increasing the present value of public spending by that amount, reducing the present value of tax (or non-tax) revenues by that amount, or any present value-preserving combination of the two. While there may be a good case for including tax reductions in the policy mix, it will be assumed in this paper that attention is focussed on the expenditure side.

Under the assumption of full access to the international capital market, there need be no particular relation between the time pattern of government resources and the time pattern of its expenditures. If, for example, the optimum fiscal plan had expenditure set at a constant ratio to GDP, this would remain the case, but the ratio would rise. The plan would be to smooth the expenditure response to the pulse over an infinite horizon. During the pulse, part of the incremental resources would be saved in external assets, and these savings run down

[10] In both cases, this could reflect high growth in the economy, rather than an absolute fall in cash receipts.

subsequently. However, this would also be true, regardless of the desired path of spending or domestic revenue receipts.[11]

If the assumption of free access to international capital markets is dropped, the separation between the time pattern of receipts and expenditures fails. A low-income country with very restricted access may be credit constrained, in the sense that early expenditures are deemed to be more socially valuable than later ones, but there is no financing method of substituting the one for the other. In this case an early incremental pulse of resources may not only raise the level (present value) of spending, but also its 'shape', leading to a more front-loaded pattern.

One such circumstance would be where a lack of public infrastructure was acting as a brake on growth. Front-loading this expenditure may then generate more (domestic tax and non-tax) resources later, so that the current increase in spending need not be at the expense of future spending. Of course, this argument need not be restricted to physical infrastructure like roads, but could equally include all sorts of human capital, including the (productive) health status of the working population.

Persistence failure and uncertainty

In practice, the problem of persistence is inextricably bound up with uncertainty. Of course, this is not confined to the existence, scale, duration and profile of the pulse. It extends also to the government's existing plans, and the assumptions that are made, *inter alia*, about future GDP growth, revenue growth, interest rates, the exchange rate, and other major relative prices. However, the focus here is on the pulse itself. Finessing the problems that had to be faced in developing the base case fiscal plan, how should this be amended in light of an uncertain pulse?

Faced with an uncertain addition to resources, very crudely there are three possible responses. The government could set out to spend the maximum amount that it might receive, or the minimum amount, or somewhere in between. In most circumstances, the intermediate approach is likely to be adopted.[12] In this case, the crucial characteristic of uncertainty is that, however well judged the *ex ante* spending strategy is, it will only be validated *ex post* by a fluke. In general, it will be seen as either too high or too low, depending on whether the realized resource flow is lower or higher than that used as a planning assumption.[13]

If the discrepancy is significant, subsequent adjustment to the spending level may be required. This will impose adjustment costs, as programmes are cut back or discontinued on the one hand,

[11] There are a number of reasons for supposing that it may be optimal for the ratios of the main fiscal magnitudes to GDP to vary over time. For example, if the demand for public goods is income-elastic, or the deadweight burden of taxation falls with per capita income, the relative size of the public sector generally should rise over time.

[12] The policy of "wait and see", where the government waits until the uncertainty is fully resolved, and then sets out to spend the known realization, is only feasible for uncertainties that are very quickly resolved, and unlikely to be optimal even then.

[13] There is then the question of how government should respond when its planning assumption is falsified by events, for example by a higher than anticipated aid inflow. In many low-income countries, the IMF has been very influential in determining these types of response, since they are built into program targets for the spending or saving of additional aid inflows. The empirical results of the Independent Evaluation Office suggest that the IMF position has typically been very conservative. See IEO, 2006.

or scaled up inefficiently in mid execution on the other. Where spending is difficult or slow to cut back once started, the costs include those associated with a higher level of financing than originally planned. It is not clear *a priori* which direction of adjustment is most costly. If they are equally costly, so that the loss functions are symmetric, then the sensible strategy is for government to try to estimate the mean or expected value of the resource flow, and increase spending by that amount.[14]

Notice that the risk assessment may also conclude that the probabilities of higher or lower outcomes are asymmetric.[15] For example, it might be believed that there was virtually no likelihood that the aid flow would rise much above its 'most likely' (modal) value, but a tangible possibility that it would fall substantially short of that. In this case, the modal value is a very poor estimate of the expected value, and is biased upwards. Setting out to spend the expected value would look very conservative from the perspective of an observer who focussed simply on the outcome that was perceived to be most likely. Note that this type of discounting of the most likely outcome is needed *in addition* to the common practice of setting some arbitrary 'discount factor' to reduce pledges and commitments to the likely lower level of disbursements. The latter is really an exercise in deriving an unbiased most likely value. It is the first step of the two described here.

Hence there are two potential sources of asymmetry in the assessment. If both the loss function and the perceived probability distribution are asymmetric, and lie on the 'pessimistic' side, then a very cautious approach is indicated, and *vice versa*. The point is that it would pay for government to approach these decisions in a fairly systematic manner, and the appropriate response may vary from case to case. It should also be clear, as noted before, that a rolling update is appropriate, triggered automatically with an appropriate passage of time, or on an *ad hoc* basis if significant new information arrives.

The discussion so far has focussed tacitly on the case where expenditure can be cut at a cost, possibly after a lag, and possibly with some additional short term financing being required. However, some categories of spending may be impossible to reverse except in the very long run. If considerations of fiscal sustainability rule out recourse to additional financing, it will be necessary to raise general taxation to cover any shortfall. Since taxation is distortionary, perhaps highly so in low-income countries, this additional taxation may inflict a high deadweight loss. In other words, getting an additional dollar into the hands of the government costs the private sector substantially more than a dollar. This excess cost also needs to be factored into the assessment. The issue is discussed further in the next section.

[14] "The resource flow" and "spending" are to be interpreted throughout in terms of present value, not current value.

[15] Experience in other contexts suggests that much can be learnt from a very simple procedure, in the absence of fuller information. The first step is to decide on plausible 'most likely case', 'worst case', and 'best case' outcomes. The second step is to assume that the probability distribution is triangular, with the apex at the most likely value, and the base running from the worst to best case values. The expected value is then obtained directly. A slightly more ambitious second step is to assign probabilities to the three cases, and then calculate the weighted sum to obtain the expected value. In practice, it makes little difference which approach is adopted.

4. Possible responses and likely consequences

There are two broad classes of situation to consider. In one, the problems are not those of good governance, or discrepant donor preferences.[16] They are problems of execution. The first recourse would then obviously be to improve the budget process so that budget allocations adequately reflected government priorities and budget execution implemented these allocations. Since this may take a considerable time to achieve, there may be scope for temporary second best mechanisms that can improve performance in the interim. The other class is characterized by a divergence between the government's priorities and those of the donors.[17] This section focuses initially on the first and simpler class, before turning to the second.

4.1 Implementation problems

The government, or some key part of it, knows what it wishes to do, but finds it difficult actually to do it.[18] This will typically be because of political pressures of some type. These may operate through a powerful and entrenched interest group, within the wider government, or through populist pressures which may be myopic or ill-informed.[19] Until government can find direct ways of countervailing these pressures, there are at least four devices that might be adopted in the interim.[20] The first is to set up a virtual fund for the priority sector or sectors, within the budget, with the intention of ring-fencing their allocations, or at the least giving them a privileged position relative to other sectors. The second is to go somewhat further, and finance the sectors from dedicated funds outside the main budget. The third is to establish a priority sector-specific stabilization fund. The fourth is where donors establish a parallel delivery system, with separate financing. Each is considered in turn.

Virtual funds[21]

A virtual fund means that there is no true separation of the government's financial resources, so that they remain fungible in principle. However this fungibility is to be limited in practice by the government's own commitment to protecting the priority sector. As a pre-commitment mechanism, this is relatively weak, since it depends on a combination of transparency and the government's supposed unwillingness to be seen to be backtracking. If the government is not really committed to the sector, it is unlikely that this device would stand much strain. But if it is really committed it is not clear that the device is necessary

[16] The main parties have a working agreement on the goals of public policy and on the consequent expenditure priorities.
[17] Of course, there may well also be disagreements within government and within the donor group. Even if not, as noted earlier, which set of preferences better reflects the underlying interests and preferences of the governed is moot.
[18] The 'key part' would typically be the central economic authorities and might also include the office of the President, or equivalent. However, the latter may often constitute one of the interest groups alluded to in the text. This paper does not pursue the issue of legitimacy in this context.
[19] The converse case, where government has been captured by an interest group, but is somewhat constrained by democratic pressures, is considered later.
[20] The role of expenditure tracking as a device for imposing transparency, even when that is resisted, has been stressed by numerous commentators. See for example, de Groot, 2003.
[21] An early example of this device is the Poverty Action Fund in Uganda

Even if the device is successful, there are a number of concerns about how it would operate. Consider first the case where the problem is volatility of aggregate resources around a reasonably steady trend. The mechanics of the virtual fund typically specify how it will resist compression (e.g. 100% of the allocation is to be available, no matter what happens to the overall resource position) but are less explicit about what happens if resources are larger than anticipated. If the underlying argument for prioritization is that it is very costly to vary the resources available to the sector, then that would imply symmetry; the sector would be protected in bad times, but would not benefit proportionately if times were good. On average, across the cycle, it would get its allocation. If, instead, as a somewhat ill-defined 'priority' sector, it is not only protected in bad times, but shares at least equiproportionately in the good times, then over time its share in the budget will grow relative to its allocation. Its average rate of growth will be faster than intended, and its share of the budget will expand faster than planned – how much faster depends on the degree of volatility (its coefficient of variation). This point does not always seem to have been thought through.[22]

There is a quite different difficulty that arises when the source of the problem is powerful interests, or to use a convenient shorthand, powerful sectors encroaching on weak ones. The device of protecting priority sectors against the depredations of these powerful sectors fails to address the real imbalance of power. In consequence, it risks creating a three tier system, with an insulated priority group, a powerful group, and a residual unprotected weak group. As weak sectors are shifted from the unprotected to the protected group, there are two likely related consequences. The first is that the position of sectors in the unprotected group becomes still more parlous. It is possible that the real priority attaching to expenditures in these may leapfrog over that attaching to those in the 'priority' sectors. The second, evident in many countries, is that membership of the protected group is expanded over time, exacerbating the first outcome.

A final complication may be noted. Donors sometimes require that higher standards of accounting, monitoring, tracking, and audit are implemented in respect of such virtual funds. This implies two different systems running in parallel within the budget. On one view, this may be quite healthy, with the virtual fund acting as a trail-blazer, introducing techniques that will later be adopted more widely. On another view, it simply makes for duplication and inefficiency, and risks bleeding resources from the rest of the budget, so weakening the budget process overall.

To summarize: virtual funds may not work, and even when they do, they may distort allocations, either cumulatively, or stochastically, or some combination of the two.

Extra-budgetary funds[23][24]

In many respects, this is simply a more determined version of the virtual fund approach. It is more likely to be effective, since it is more difficult to dismantle when times are hard. However,

[22] For more detailed discussion, see Bevan, 2001.
[23] There is some ambiguity here. Extra-budgetary funds are often literally outside the budget and any sort of budgetary oversight. What is involved here is less extreme. Budgetary oversight remains feasible, but as a parallel rather than integrated exercise.
[24] An example is the channeling of HIPC debt relief to a special fund held in the Central Bank of Zambia.

when successful, it suffers from the same drawbacks as the virtual fund. In addition, it poses a further risk. It responds to the problem that fungibility may be abused by reducing or eliminating fungibility. But a major component of efficient fiscal management is the capacity to use fungibility constructively – to be able to transfer resources from sectors which are temporarily unable to use them to sectors that can. Restricting this capacity is to sacrifice efficiency for control.

This category includes some forms of parallel financing, such as the use in Zambia of Swap funds that are dedicated to specific health facilities, for example in the rural sector, but where the activity is implemented by government.

Sector stabilization funds

These would go a step further. When extra-budgetary funds ring-fence the allocations, these remain essentially separate in time – there is no mechanism, other than via direct intervention from the Ministry of Finance, for inter-temporal smoothing. In practice stabilization funds have been used in an attempt to smooth aggregate spending given volatile income, typically from resource rents. They suffer from high visibility during booms, and are prone to be raided in consequence. A sector specific stabilization fund would be less vulnerable to this, because smaller. It would clearly require to be extra-budgetary (in the sense of the previous footnote) with all the attendant drawbacks.

There would also be serious issues over who would exercise the discretion. If this was tightly controlled by the central economic authorities, it is unclear what the gain from this type of apparent decentralization would be. However, if it was really decentralized to the sector, that would raise two questions. First, what would be the implications for overall fiscal control? Unless the scale of the sectors is relatively trivial, this type of uncoordinated smoothing would be an unacceptable intrusion into the responsibilities of the central authorities to maintain macroeconomic stability and fiscal sustainability. Second, what would qualify those who are charged with operating an efficient sectoral delivery system to take a view over the sustainability of future resourcing? This is not restricted to assessing future aid flows, but also the future allocations likely to be made by government. Again, this does not seem to be a justified derogation of responsibilities from the centre.

Parallel delivery

This is still more extreme. It arises when a donor becomes distrustful of the government's capacity to deliver services, or confident that it (the donor) can provide more of these additively without compromising the government's own operations.[25] In either case, the temptation is to set up an alternative system in parallel. Not only is the finance separate, but so is the implementation itself. This has a number of dangers. The most obvious is the loss of any realistic hope of a coordinated, integrated, and balanced delivery. Since particular donors tend to focus on a subset of regions, or a subset of activities within a sector, and the government is usually unable to rebalance its own efforts in response, a very uneven form of provision may result.

[25] Or has not considered this possibility.

The other main danger is that the parallel donor activity is not really additive, but includes a large element of substitution. For example, skilled personnel are bid away from the government's own system into the parallel system by superior pay and superior complementary inputs. The output of the parallel system is purchased at the cost of deterioration in the public system. The major recent development in the donor financing of the delivery of health services has of course been precisely of this type, in the emergence of "vertical funds", notably those committed to attacking specific problems such as HIV/AIDS.[26]

4.2 Donor preferences

This is an altogether more difficult proposition. If there are discrepant preferences, and donors have some power (of the purse) to influence the level and composition of spending, then there is a real tension between the principals. It might be possible to deplore the meddlesome preferences of donors for over-ruling the legitimate authority of government, or to applaud donors for resisting authoritarian government, acting as surrogate representatives in a defective democratic process. Whatever the rights and wrongs of these discrepancies, and in either case, the outcome may be for expenditure to shift back and forth between these disparate preferences as time passes. Alternatively, the recipient government may find it difficult to reassert its preferences when donor finance tapers off, and be left to finance an expenditure pattern it would not have freely chosen.

Particular interest attaches to the case where donors initially finance programmes that have a high recurrent expenditure component, and where it is difficult to terminate or contract these if donor interest in them flags. This could be due to the difficulties in laying off an expanded labour force where the payroll is a large proportion of the expenditure, or due to the adverse consequences of discontinuing a programme once started. The first is likely to characterize the social sectors generally, while an HIV/AIDS programme, or expanded school enrolment, is likely to exhibit the second characteristic. The consequences are considered briefly.

Impermanent aid flows

One of the concerns about expansion in government recurrent spending, even when this is initially grant financed, is that at some point in the future the aid inflow will diminish or disappear, and the recurrent expenditure then becomes a claim against government revenues. Unless it is feasible and appropriate to discontinue the expenditure, government revenue effort will have to be raised, and this will increase the deadweight burden of the tax system. This means that the initial decision of whether or not to set up the incremental expenditure has to be submitted to a cost-benefit test, and this may be quite stringent.

To illustrate this general point, consider a very simple example. Donors offer to grant finance a particular incremental flow of, say, health spending, at a constant rate h, and it is believed that the flow benefit to private individuals can be valued at b. Obviously, if this arrangement were to last indefinitely, and the funds were unavailable for any other use, the recipient government should accept them provided $b > 0$, even if $b < h$. However the recipient government believes

[26] The problems posed by this approach have been eloquently analyzed by Lewis, 2005a, 2005b.

that the grant finance will disappear in future year *T*, and that it will be impossible not to continue with the expenditure subsequently.

Attention is here restricted to the simplest case, where the expenditure yields no additional monetary income, just a psychic benefit. Suppose the marginal deadweight loss from additional taxation is $\theta_m > 0$. In other words, the cost to private individuals of the government raising another dollar would be $\$(1+\theta_m)$. The government's discount rate, *r*, is assumed to be constant. It is assumed, not unrealistically, that the government only changes its revenue effort when the grant flow ceases.

Then it is straightforward to show that the government should accept the initial grant flow only if:

$$\frac{b}{h} > (1+\theta_m)e^{-rT}$$

This may be pretty harsh. Suppose that θ_m is 0.4. Then the benefit cost ratio would be 1.4 for recurrent spending undertaken wholly by government, falling to 1.09 for a programme that was grant financed for 5 years with a government discount rate of 5%, or to 0.70 if financed for 7 years with a discount rate of 10%. While this example assumes only psychic benefits, the arithmetic is little altered for reasonable parameter values even if the project generates taxable monetary income. These results can be compared to a debt-financed public investment which was able to recoup the debt service from charges, and would need only to satisfy a benefit cost ratio of 1. To the extent that the deadweight burden of the tax system is higher than suggested by these illustrative calculations, the tests would be correspondingly tougher.

The conclusion is that it is not axiomatic that a recipient government should accept earmarked but otherwise "free" grant aid, whether from bilateral donors or from private foundations, even when it is unencumbered by onerous conditions. If confidence is lacking that the flow will be maintained for a substantial number of years, and if it imposes serious continuing recurrent expenditure obligations, it may be better refused. Alternatively, donors who are serious about supporting such initiatives must find ways of ensuring a sufficiently long funding horizon. This may sit very uncomfortably with any form of conditionality, including even apparently well-designed performance criteria.

5. Experience in three case study countries

The three countries studied in depth as another part of this project were Mozambique, Rwanda, and Zambia. The primary aim of these case studies was to examine the recent interaction between IMF program design and health policies and spending in each country. Hence they were not primarily concerned to study the mechanisms, if any, used by recipient governments and/or donors to promote and protect priority spending in general, or health spending in particular. Nevertheless, they do cast considerable light on the prioritization of the health sector;

what follows is a brief summary of the parts of their findings that bear on this aspect. The summary quotes freely from the case study drafts, without giving detailed attributions.

5.1 Mozambique

The study covers the first and second PARPAs, Mozambique's version of the PRSP. PARPA I identified six priority areas, education, health, agriculture and rural development, infrastructure, and good governance, most of which were retained in PARPA II. Unpredictability of aid disbursements has been a problem, and a significant factor in constraining expenditure implementation, though apparently this has been getting better. However, the health sector relies on the government budget for only a fraction of its funding. This means that some of the macro constraints that the economy was subjected to meant little in terms of limiting overall sector funding, except for the important fact that most wage expenditure is still paid from the government budget component of health sector funding.

Mozambique's government has sought to give a pro-poor orientation to its budget since the 1990s by increasing allocations to education and health as well as basic infrastructure. This pattern continued under the PARPA, with the government committing to spend at least 65 percent of its total budget resources (excluding debt service) on these priority sectors. PARPA priority spending did rise substantially—to over 14 percent of (revised) GDP in 2005. But such a target is an unsatisfactory way of setting and monitoring priorities for several reasons : it takes a very wide and unfocussed view of priorities; the coverage of donor flows in the budget is very incomplete and therefore potentially misleading; given their numerical nature, there are strong incentives for government officials to adjust the figures to meet targets; and the focus on inputs and broad sectoral allocations distracts attention from identifying more specific actions that are most likely to yield better outcomes. A re-evaluation of these priority categories is now apparently under way, with a view to sharpening their focus on critical areas.

Within these overall priorities, total government expenditures on health, using the PARPA classification, were in the range of 2 ½ to 2 ¾ percent of GDP during 2003-2005—somewhat below target but a substantial increase was targeted for 2006, and initial estimates suggest that this was largely achieved, although part of the increase appears to reflect the efforts to bring "on-budget" existing aid to the health sector. Health spending has risen gradually as a share of total government spending, and appears to have reached the Abuja target in 2006. Recorded real government spending on health has risen sharply in the last two years, although an unknown part of this increase reflects the capturing of activities that were previously off-budget. These recent efforts at bringing more of the existing aid to the health sector "on-budget" have clarified the sector's reource envelope. However, the fact that about 40 percent of resources are still in the form of "off-budget" project funding, mostly earmarked for HIV/AIDS and other specific areas of intervention, means that prioritization within the sector suffers from a lack of control of the overall budget.

While there have been some improvements over recent years in addressing the shortfall of qualified personnel, the health sector's capacity to train, recruit and deploy additional staff is still limited. This is due not only to the limited capacity in the country's training facilities, but also to the lack of a clear human resources strategy for the sector as a whole. Overall numbers of

'frontline' workers in health and education, appear to be totally inadequate in terms of meeting the minimum requirements for service delivery expansion. This has led to some distortions, as sector donors have tried to respond to the need for additional recruitment by circumventing normal procedures.

There have been substantial variations between budgetary allocations and actual outturns for some expenditure categories and sectors. Budgetary allocations for personnel are consistently overspent whereas non-wage recurrent spending and capital spending fall short of the budget allocations. Moreover, the health sector has suffered from systematic, large shortfalls in spending of the resources channeled through the central budget.

There has been weak integration of planning and budgeting processes, with no effective mechanisms for making hard choices between alternative trade-offs on long list of objectives. Donors exacerbate this problem by fostering fragmentation of the budget. , and a lack of the requisite technical information. A recent study estimated that 29% of the total resources of the health sector remained off-budget at the programming stage and 60% at the execution stage, meaning that there is no systematic way of collecting data on their allocation across functional and economic classification.

The current state budget and its expenditure classifications still do not provide adequately comprehensive financial tracking of what is being spent on various health initiatives. This is especially the case for HIV/AIDS where large-scale expenditures, such as PEPFAR, are not only off-budget but are also "off-plan", in the sense of not being integrated into the overall planning and priority-setting framework for the health system.

5.2 Rwanda

Despite some recent improvements, the health status of the population has worsened over the last decade. Total health care funding has risen rapidly in recent years, reaching about US $14, or 6.6 percent of GDP in 2003. Government spending on health rose to 9 percent of total government expenditures in 2003, a substantial increase on earlier years but still short of the Abuja target of 15 percent. Funding by donors accelerated even more sharply, making it the largest source of financing (43 percent of total health expenditures in 2003), led by a large surge in grants from sources such as the Global Fund and PEPFAR. NGOs now manage the largest share of health care spending, reflecting in large part donor choices on how to channel their funding.

The Government began in 1998 to identify certain expenditures in the budget as priority programme areas (PPAs), starting with social sectors (health and education). The process of expenditure prioritization expanded with the understanding that budget savings from HIPC debt relief would be used to increase budget allocations to the PPAs, which were to be selected on the basis of high impact on social rehabilitation and poverty reduction. These allocations were to be protected from any cuts in mid-year budget reviews and could be increased if additional resources became available. The list of priority programs gradually expanded as the PRSP process advanced and now includes key programs in the health and education sector, HIV/AIDS prevention, gender equality, key economic services in agriculture and rural infrastructure, as well

as administrative services such as justice and law enforcement. The electricity sector was added as a priority area in 2005 in response to the adverse economic impact of power shortages.

The IMF programs with Rwanda were unusual since they included conditionality on minimum levels of recurrent spending on certain priority categories. However, the IMF role in this process was a passive one, taking the targets for priority spending that had been given to them by the authorities, including for the health sector. The budget support donors have taken more of an interest in the definition of priority spending, but do not use it themselves as a form of conditionality. Early PRGF programme design made it difficult to cushion expenditures against adverse shocks or to spend positive aid "surprises"; subsequent designs have shifted in favour of greater fiscal flexibility.

Overall, priority spending targets have contributed (along with several other factors) to increases in the flow and predictability of funding to priority sectors such as health. However, there are a number of problems with the priority spending concept:

- It has no basis in Rwandan law, as the categorization is not presented to Parliament, nor communicated to line ministries. With the introduction of the Organic Budget Law, which passes responsibility for budget execution to spending agencies, priority spending benchmarks will become difficult to meet, as they are no longer directly under MINECOFIN's control.
- The definition of priority expenditure is problematic. From the Government side, it risks becoming a list of donors' priorities rather than of government's priorities. From the donor side, the indicator risks becoming meaningless as more and more programmes are added to the definition. It also fails to take into account intra-sectoral issues, for example defining all health spending as priority. Attempts to redefine and formalise the definition of priority spending programs have met with Government resistance.

It is not possible to say how this process of setting priority spending categories affected overall expenditure allocations, but the following points are worth noting:

- Total spending on categories designated as priorities have risen sharply since 2000—and by much more than the budgetary savings from debt relief. Part of this increase reflects the expanding definition of priorities.
- Although the priority expenditure categories follow quite closely the broad objectives set out in the PRSP, in practice the definition of priority spending is weak. By 2005, the budget identified 25 priority areas, many of which were not closely linked to achievement of PRSP objectives or the Government's Vision 2020.
- Rwanda's systems for the planning and implementation of expenditures have improved considerably in recent years. However, the lack of sufficiently concrete sector plans in some areas has limited the ability to translate national strategic planning into prioritization of resources through the annual budgets. Moreover, in some areas (such as the health sector) where clear strategies exist, the activities of a wide range of donors still contribute to the fragmentation of planning and resource allocation.

In 2002, Rwanda's public health expenditure was very low by regional and international standards. The focus of expenditure was on secondary and tertiary care (particularly central hospitals). Primary health facilities received little or no funding from Government and had very

scarce human resources and equipment. Public health expenditure increased rapidly in the period from 2002, growing at an average annual rate of 35 percent from 2002-5. External financing (donor funded projects) account for most public health spending (63 percent in 2005) and most of the increase in spending. However, although resulting services are delivered from public sector facilities, most of these projects are not implemented through government systems and are not effectively under the government's control. The projects result in severe geographical inequalities, and are not aligned with the government's strategy. In 2005, 55 percent of external aid, or 39 percent of total public expenditure on health was in the form of donor HIV/AIDS projects, despite a prevalence rate of only 3.1 percent.

These donor financed projects (funded in large part by the US Government, the Global Fund and the Belgian Government) are largely recurrent in nature, and pose serious macroeconomic concerns, relating to the sustainability of expenditure and to the domestic demand impact (particularly if the currently large project account balances are spent).

Actual government expenditures relative to health sector allocations ran at around 83-85 percent over 2002-5, with the exception of 2004, when they reached 93 per cent. Trends in intra-sectoral allocations are particularly difficult to analyze, as a result of shifting budget classifications. However, some clear trends can be highlighted. In 2002, most government health expenditure was on secondary and tertiary levels of care (particularly central hospitals). Health centres received minimal government support, relying on user fees and donor project support. Since 2003, primary healthcare has however increased its share, with increased funds going to performance based contracting schemes, rural health workers' salaries, and promoting community based health insurance schemes ("mutuelles"). Poor execution of primary healthcare programs and over-expenditure on tertiary health programs in 2005 were flagged by budget support donors as a major concern. 2006 budget execution is reported to have been better.

Increases in recurrent allocations to health (particularly for primary health) were a result of a number of factors both internal and external to the government. Internal factors included political leadership; the sector's relative strength in planning and budgeting capacity; and innovative financing mechanisms – the development of performance based contracting schemes and community based insurance schemes. External factors included budget support donor pressure, notably from the World Bank's PRSC, the preparation for which began in 2003; the floors on priority spending contained in the PRGF program;

Budget support donors have significant influence over government expenditure on health, exerting pressure for health budgets to be increased (particularly for primary health) and on the IMF to accommodate these increases. However, this may have been at the expense of excessive micro-management and unofficial conditionality (demanding government makes specific allocations to specific budget lines and adopts WB devised institutional reforms). The health sector is characterized by the existence of numerous short term, uncoordinated and unaligned donor funded projects. This greatly complicates the planning and budgeting process – whilst planning (including financing strategies) includes all public spending, budgeting decisions only involve the 26 percent of resources under direct government control.

5.3 Zambia

Total spending on health fluctuated within a range of $18-26 per person (at market exchange rates) during 1995-2002, but increased to an estimated $34 per person by 2004, largely because of an increasing share of donor funding. By 2004, the last year for which National Health Account estimates are available, more than 40 percent of total health spending was being financed from external sources. The share has almost certainly increased further since then, because of a large expansion in financing from disease-specific "vertical funds," most notably PEPFAR. Government health spending per person showed little trend increase during 1995-2002, ranging around $12 per person. It declined thereafter as fiscal consolidation took place. By 2006, real government spending on health (excluding the vertical funds and donor-funded capital projects) was below the level of 2001. As a share of total health spending, government spending was declining through 2004, in part because of the increasing importance of external financing channeled through non-government agents. As a share of total government expenditures, health spending (excluding that financed by the vertical funds and donor-funded capital projects) has been around 10-11 percent in recent years, still well below the Abuja target.

Zambia entered the most recent set of IMF-supported programs with a history of public financial management that had done a poor job of protecting budget execution decisions from short-term political pressures. A so-called "cash budgeting" system had been in place since 1993 in an effort to control runaway inflation by keeping actual spending in line with revenues, but in practice, after some initial successes, the system was not successful in restoring fiscal discipline. The Government often took on additional expenditure commitments during the year, resulting in large budget overruns and payments arrears. Typically, the planned budget went off track early in the year so that the cash budget system led to ad hoc expenditure squeezes that fell most heavily on the ministries delivering social and economic services. The unpredictability of monthly cash releases also made the efficient planning and use of budgetary resources very difficult. As might be expected in such circumstances, the burden fell most heavily on non-wage and capital spending, with the health sector among the most affected.

A recent assessment of Zambia's PFM system noted similar issues. Spending ministries cannot reliably predict what resources they will receive. How much of a problem this creates for the Ministry of Health depends largely on the size of any unanticipated shocks to overall revenues and expenditures. The system seems to have worked well in 2005, but that there were greater problems in 2006 when adverse shocks disrupted budgetary releases; the Ministry of Health was adversely affected.

The initial definition of "priority poverty-reducing spending" adopted by the authorities was too narrow. Presumably the rationales behind the creation of such priority categories is that they (i) help to protect politically "weak" sectors with potentially high social returns from being unduly squeezed during budget implementation: and (ii) encourage a shift in resources toward these sectors over the medium term. The initial priority category, which included only a fairly narrow group of capital spending items, did not seem to match well with either of these rationales. In particular, it excluded all recurrent spending for health (and education)—even though non-wage health spending had been one of the major casualties of the cash budgeting system.

The conditionality used in the IMF program to support the floor on such priority spending was a benchmark on payments into the HIPC Initiative account in the Bank of Zambia which was used to fund these expenditures. But in practice, this mechanism was not sufficient to protect such spending from cash flow pressures. For example, in 2004, the government formally met this benchmark, but many of the commitment authorizations were only made in December, reflecting the late arrival of a large part of donors' budget support. As a result, a significant part of the spending did not take place.

A revised and much broader definition of poverty-reducing spending was agreed in time for the 2005 budget and includes a wide range of recurrent costs directly and indirectly related to poverty reducing programs, including wages of health workers. Actual outcomes have been close to or above the targets for such spending in 2005 and 2006. There is no formal budgetary mechanism for protecting specific expenditures (such as ring-fencing or a virtual poverty fund like that used in Uganda) linked to this designation of priority categories, although Ministry of Finance officials said there was an effort to avoid compromising the programmed monthly "profiles" of expenditure releases for health (and education) in the event of revenue shortfalls. Moreover, there is no clear relationship between these priority designations – which include health and education spending with heavy wage components – and the overall wage bill ceiling.

The debate within government over budgetary priorities was fragmented, with some spending Ministries (including health) devoting much of their attention to the dialogue with donors who were funding their sector rather than to the discussion with the Ministry of Finance, and Parliament providing no serious challenge on choices made. Donors have influenced the share of government resources going to health as well as allocations *within* the health sector through various channels: sector–specific financing, explicit conditionality (e.g., in the context of HIPC debt relief); as well as in the overall dialogue with the Government in the context of various sector working groups. The sector-specific funding has grown into a rather complex series of "basket funds" through which various donors provide support for specific activities. The most important is the District basket, which channels support to the decentralized district-level activities for everything other than personnel expenditures. But, there are also specific ring-fenced funds for provincial hospitals, training schools, human resource retention, as well as a drug supply line and others. This attempt to influence domestic priorities had grown overly detailed and could hamper the longer term development of stronger domestic budgetary institutions capable of setting and enforcing clear priorities. In addition, the large off-budget expansion of the various disease-based vertical funds (especially PEPFAR) had created a perception that there was plenty of money available for health initiatives in Zambia, and this might weaken the perceived case for greater budgetary priority.

Since the introduction of a number of health reforms in 1992, Zambia's health system has in principle emphasized the decentralization of health services planning and provision to the district level. The focus was on an "essential health care package" (or so-called the Basic Health Care Package (BHCP), which defined key health interventions that the public health system should provide within the available resources. Though a costing of the BHCP has been done, this costing has not been used effectively to inform the health sector about where resources should be prioritized.

The priorities within the health sector are to deliver the BCHP, control communicable diseases, address human resource constraints facing the sector and improve efficiency of resource mobilization and allocation. The sector is experiencing a human resource crisis that is undermining the capacity to provide basic health care services. Most estimates of the total annual costs of providing the desirable health interventions package are around 3 percent of GDP. However, the cost rises to 3 ½ percent of GDP if estimates for HIV-AIDS interventions are included. Even the lower estimate is still significantly higher than the allocation to health in the 2007 Budget (2.2 percent of GDP) or the Medium-Term Expenditure Framework (MTEF). These estimates do not take full account of the likely costs of addressing the human resource crisis, including through real wage increases.

The overall wage bill for the Ministry of Health has been about 1 percent of GDP in recent years and has generally accounted for a little under half of all health spending (including the basket funds).
The aim is to begin increasing the staffing levels of the most critical and essential cadres, but what that means in practical terms for the medium term is not yet clear. It is also necessary to create an effective incentive structure and to fit that structure within overall resource constraints. Salary levels are not the only factor influencing the recruitment and retention of health professionals.

There is an issue as to whether the sector is able to effectively absorb and utilize the unprecedented amounts of external resource inflows available to it. The rapid growth of the various vertical projects and interventions has created multi-faceted pressures as (i) the population's expectations about what the health system should be delivering are reshaped (upwards); (ii) the health system was disrupted since although vertical projects come with substantial financial resources, they come with limited human resources so that the resource gaps in the well paying and well equipped vertical projects are filled through human resource deflection from the public health system; and (iii) the timing of receipts and the volume of external resources going to health through the vertical projects are not incorporated into national medium-term planning and budget processes increasing the possibility of duplication of efforts.

5.4 Conclusion

In all three countries, there was overt prioritization of some sectors, including the health sector. It is clear that donors were highly significant in driving this process. While there does not appear to be evidence that any of the governments actively resisted either the principle of prioritization, or the choice of priority sectors, it is quite unclear whether they would have adopted such a scheme without donor pressure, and if so, what its content would have been.

The particular experience with prioritization, viewed as a dynamic process, was however quite different between countries. In Mozambique, it began as too wide and unfocussed, and was subsequently sharpened; in Zambia, it began with a very narrow focus on capital spending and was subsequently expanded to cover a wider array of recurrent expenditures; in Rwanda it began with an emphasis on the social sectors, but then diversified far more widely to include, for example, electricity and law enforcement. It is unclear whether this type of dilution represents a genuine widening of priorities, or is simply a reflection of political game-playing.

In all cases, the share of total health sector expenditures rose substantially, but this was frequently due more to the rise in donor-financed expenditures off-budget than to expenditures under the government's direct control. The common consequence was that a large part of health spending was off-budget with a host of issues concerning failures of coordination, competition for inadequate human resources, and potentially compromised service delivery. It is unclear whether the expansion of resources to the sector could have been more – or less – effectively deployed if a larger share of the expansion had been routed through the budget rather than though more or less parallel systems.

The success of prioritization in protecting against actual spending shortfalls relative to budget allocations, or against adverse resource shocks, is very difficult to establish. In Zambia, the operation of the earlier cash budget system led to substantial instability and unpredictability of budget releases. Earmarking of some external financing for particular categories of health spending that were "politically weak" probably helped to preserve a minimum level of spending for these sectors, although it is not possible to prove this definitively. In Rwanda, for most of the recent years for which data are available, only around five sixths of the budget allocation was actually spent. Matters may be improving in this regard, but it is notable that the case studies do not seem to have turned up any regular process of review of the operation of prioritization from this perspective. If the primary objective was to increase the sector's share in total spending, prioritization seems to have succeeded. If the objective was to reduce volatility and unpredictability, it has probably not succeeded, but we are not really in a position to be definite about this given the lack of evidence. This very lack suggests that expenditure smoothing may not have been high on the list of objectives.

6. Other experience

The survey of experience in the sample of nine other countries was a rapid desk study only, confined to readily available documentation for each country. In consequence, it may be misleading, since the absence of information in these documents about some discussion or process may not mean that no such discussion or process actually took place. With that caveat, the intention of the study was to look for evidence that prioritization had been a matter for explicit discussion and by whom, whether that discussion led to any action, and if so, what form this took, and how carefully the outcomes were monitored.[27] An annex table is attached that lists what emerged from this study, for each country, in respect of each of the dimensions discussed below.

The cases of Chile and Peru are rather different so they are considered separately. The main discussion refers to the low-income countries, Burkina Faso, Ethiopia, Ghana, Honduras, Nicaragua, Tanzania, and Uganda.

Political discussion of prioritization

[27] It should be noted that, whatever the subtext in all this, health spending in the LICs did increase. See for example, Goldsbrough et al, 2007.

All these countries obviously must have had some discussion of the prioritization issue, but it is usually impossible to recover, from the documents reviewed, who the main participants were, or what the balance of views might have been. Uganda is an exception, where there was a very wide-ranging set of exchanges between government, donors, and civil society. Even there, it is not feasible to separate the prioritization that actually emerged from what would have been chosen in a purely domestic dialogue.

Action taken

The action taken was typically embedded in the PRSP or whatever local variant of this was adopted, and in some cases, also the MTEF and longer run plans, such as those focussed on the MDGs.

Focus on expansion or smoothing

The documents are mainly silent on the primary focus of prioritization, as between attempting to expand the priority sectors, or trying to protect them from unpredictable changes. What little evidence there is suggests that expansion was the real concern, with smoothing being ignored or at least neglected.

Form and mechanism

The term “form” is meant to distinguish between, for example, some type of fiscal rule, a ring fence, or a stabilization fund. The term “mechanism” is meant to describe the way in which the form is implemented; for example, a ring fence could be implemented via a virtual fund within the main budget, or via a separate budget process. By the same token as before, the documents are silent on both the form and the mechanism for prioritization, with the exception of Uganda. In Uganda, the form was a ring fence, and the mechanism, a virtual fund.

Coverage

The coverage varied between countries, invariably including primary education and health; frequently including water and sanitation, rural roads, agriculture and rural development; occasionally including governance, justice, and private sector development. The percentage of total government expenditure also varied widely, from a fairly small minority share up to a figure of 70-80 per cent in Ghana. The tendency was for the share to grow quite rapidly over time, for example from around 20 per cent to around 40 per cent in Uganda between the late 1990s and the early 2000s.

Monitoring

Reporting on achieved expenditure shares is relatively common, but hard to interpret in light of the changing definition of the priority sectors. An increasing share is more or less inevitable given the progressively more inclusive definition both between sectors, and sometimes within. It is harder to determine the impact on any specific priority item. This difficulty is compounded by the uneasy operational and statistical relationship between what happens on- and off-budget.

There is virtually no reliable information on the success or lack of it in stabilizing the spending within a priority sector. As before, an exception is Uganda, which used to have a rather poor record in safeguarding social sector spending, but was able to shift to a pretty good one once it began to monitor sectoral outturns against allocations.

Chile and Peru

These countries differ from the others in the sample by being middle-income rather than low-income. In consequence, they do not have such substantial aid inflows, they are not tied into concessional borrowing and associated debt relief, and they are not required to produce poverty reduction strategies. Their problem, in common with many other Latin American economies, is pro-cyclical fiscal policy, which exacerbates rather than ameliorates the shocks to which their economies are subject. In both cases, these are rendered more severe by their unstable natural resource revenues.

Both countries have taken steps to address this issue. The Peruvian approach is basically a statement of intent. A more carefully articulated and committing mechanism is the fiscal rule adopted by Chile. This was adopted in 2000, and reconfirmed in 2006, and commits the government to maintaining a structural surplus (i.e. one that is adjusted for both the budget cycle and for shocks to the copper price) of 1 per cent of GDP. The evidence to date shows that this has been quite successful in stabilizing total government expenditure. However, within that stabilized total, the shares of particular sectors have remained very volatile. "The reduced volatility at the aggregate level does not translate to the disaggregated level".[28] This suggests that devices that concentrate on smoothing overall expenditure, even when they succeed, may not resolve the problem of current interest, which is to stabilize a particular sector's spending.

7. Conclusions

The previous discussion suggested that even when aggregate smoothing mechanisms were successful, this did not necessarily translate into adequate protection of a priority sector. However, it is clear that even these aggregate mechanisms are flawed.[29] In general, it does not seem promising for a low-income, highly aided government to attempt a more ambitious smoothing mechanism than a high foreign exchange reserve "float" which can be used flexibly. Even this may be compromised by IMF conditionality or other donor restrictions, though these difficulties now seem to be in retreat. In any event, this is a device for very short term smoothing. The longer run seems very intractable for the government of a country such as this.

The main alternative is for donors – whether government or private – to find ways of making more reliable and longer term commitments, or alternatively setting up effective stabilization mechanisms themselves. These options have been much discussed , but there is little sign that

[28]Fiess, page 195, in Burnside (ed) 2005. The volatility of aggregate social sector spending was also reduced, but not that of some of its components, such as housing and "other social expenditure", which includes health.
[29] See for example, Davis et al, 2001, Perry, 2003.

practical schemes for implementation are close, and earlier experience would suggest scepticism of this eventuality.

In the context of health spending at least, the practical choice for recipient governments, therefore, is whether to agree to accept massively increased resources which are not under their own control, but are provided in parallel, and which present serious problems of accommodation, or whether to refuse them. It does not seem plausible that they can bargain for a more integrated system. Given the desperate needs for increased funding, they probably have no option other than to accept an expansion of the parallel system, taking what steps they can to mitigate the consequences. [30]

For the most part, explicit prioritization seems a poor substitute for improved governance. It carries a host of dangers, of which the central ones are first, that it diverts attention from the real issue of how better to manage the budget; second, even so, it may fail to improve the underlying problem of allocation and execution; and third, if it succeeds, it may impart all sorts of undesirable inflexibilities into the allocation process.

In practice, prioritization has probably been driven more by donor preferences than by the recipient government. Whether or not this better represents the true interests of the people, it does threaten instability in the long-run management of the fisc. It seems clear that there are good reasons for recipient governments to acquiesce in the additional inflow of resources into the health sector, despite the problematic terms on which these resources are made available. There may be a range of problems in accommodating these inflows in the short term, and much more serious ones if they are subsequently withdrawn. However it would seem wrong to reject these badly needed resources on the grounds of real present, but hypothetical future, difficulties.

It remains to consider what role if any the government's own prioritization process should play in this scenario. The implication of the earlier discussion in this paper is that only sparing use should be made of explicit prioritization mechanisms, and these only as declared transitional devices.

These general conclusions may be summarized as follows.

As regards the actions of recipient governments:

- Prioritization is a second best device and should only be adopted, if at all, as a transitional measure.

- If adopted, it should be accompanied by a plan for identifying and directly tackling the failures that cause the second best problem in the first place.

- Expenditure smoothing for priority sectors needs to be carefully coordinated with external reserve policy. Assessing the uncertain tradeoffs between spending and saving additional external resources needs to take explicit account of the costs and benefits of

[30] These might include adaptation to the design of programmes to front-load expenditures and to make scaling-back less costly.

expenditure smoothing, and of the associated risks. For example, it may be necessary to target a rather high average level of reserves if the cost of disrupting expenditure is judged to be considerable.

- Low-income countries have no effective method of neutralizing the danger that aid flows will not persist over substantial horizons. Short of rejecting additional flows, they must be prepared for the possibility of large and – in terms of service delivery – costly reversals at some future date.

As regards the actions of donors:

- The earlier strictures on prioritization also apply to donors. To the extent that donor prioritization devices reflects distrust of governments' own procedures, they must be accompanied by concerted efforts to help improve these; to the extent that these devices reflect distrust of governments' own choices, there is no obvious resolution except perhaps via a more energetic dialogue.

- There has been much discussion of the problem of volatility of aid flows, though there has been relatively little progress in reducing it. Finding ways of ensuring persistence of aid flows is likely to be both a significantly greater challenge and an even more important one.

- To the extent that donors fail to address the volatility problem, they must either create devices for helping countries smooth expenditures, or be sympathetic to the countries' own efforts, such as by saving a share of any increased inflow as increased reserves.

Annex Table
Evidence on Prioritization from Published Information for Nine Countries

	Political Discussion?	Action taken?	Expansion or Smoothing?	Form and Mechanism?	Coverage?	Monitoring?
Burkina	**Seems to have been very limited**	**PRSP and MTEF**	**Expansion**	**?**	**9 sectors, including health, rural development, water, basic education**	**?**
Chile	**Yes**	**Fiscal rule, adopted in 2000**	**Smoothing**	**1% structural surplus**	**Not applicable (aggregate rule)**	**Yes**
Ethiopia	**Yes**	**SDPRP (PRSP) and MTEF**	**?**	**?**	**Agriculture, water, roads, education. Health (42%-50% of total)**	**?**
Ghana	**Yes**	**GPRS (PRSP) and MTP (MTEF)**	**?**	**?**	**Infrastructure, agriculture, social sectors, governance (70%-80% of total)**	**?**
Honduras	**Yes**	**PRSP (but poor performance)**	**Expansion**	**?**	**Ducation, health, rural infrastructure, water, roads**	**?**
Nicaragua	**In the PRSP**	**PRSP**	**?**	**?**	**Health, education, social security**	**?**
Peru	**Problem of pro-cyclicality**	**Legislation**	**Smoothing**	**Fiscal law**	**Not applicable**	**?**
Tanzania	**Within PRSP**	**PRSP an MTEF**	**?**	**?**	**Education, health, water, agriculture, roads**	**?**
Uganda	**Yes, extensive**	**PEAP (PRSP)**	**Both**	**Virtual fund**	**Primary education, primary health,, water, rural roads, agriculture (19%-36%)**	**Yes**

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