

**The Nature of the Debate Between the IMF and its Critics**  
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**Abstract**

This paper provides a non-technical overview of a number of issues on macroeconomic policy design in low-income countries that lie at the heart of the debate between the IMF and its critics over whether IMF-supported programs unduly constrain government spending on health. It does not attempt to give a comprehensive discussion of the theoretical analysis or empirical evidence on each issue. Rather, the aim is to summarize the key arguments of the critics and any IMF response; identify what the available evidence seems to suggest with regard to these arguments; and indicate potential policy implications where the evidence seems reasonably clear or identify areas where the evidence appears insufficient to draw strong conclusions.

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The potential criticisms of the IMF role concern four fundamental issues:

- The macroeconomic frameworks underlying the programs supported by the IMF are said to be “too tight,” thereby constraining desirable expenditures, because they take too conservative a view of what constitutes macroeconomic stability. This might be because they aim to achieve unjustifiably low inflation rates or target fiscal deficits that are lower than what is needed for stability purposes.
- In its “gatekeeper” role (i.e., signaling to donors on the suitability of the macroeconomic framework as a basis for aid flows), the IMF is said by some critics to go beyond the available evidence in making judgments about issues such as absorptive capacity, the risks of “Dutch disease,” or debt sustainability.
- The IMF is criticized for not take a sufficiently “needs-based” approach to assessing the macroeconomic framework and aid requirements (e.g., linked to what is needed to achieve the MDGs).
- The design of programs is said by some critics to take insufficient account of the costs of achieving short-term macroeconomic adjustment. A particular concern is that some of the policy instruments and conditionality used in some programs, such as ceilings on the wage bill, can cause adverse effects for the health sector.

Each of these issues is examined from the perspective of how well the current IMF approach is suited to dealing with the macroeconomic challenges of a scaling-up of aid in countries where the initial starting position is often, although not always, a reasonable degree of macroeconomic stability. One question underlying most of the issues discussed is whether the IMF, in practice, goes beyond the available evidence on what macroeconomic policies are good for growth and poverty reduction and thereby unduly narrows the “policy space” available to national governments.

### **1. Are the macroeconomic frameworks underlying programs too tight?**

There are two related strands to the criticisms of the macroeconomic frameworks [see, for example, ActionAid (2004, 2005) and Oxfam (2003)]: first, that programs aim to achieve excessively low inflation targets, going beyond the available evidence of what inflation thresholds are harmful to growth and poverty reduction; and second that, despite statements made at the time the PRGF was introduced, programs still show insufficient fiscal flexibility, especially with regard to aid-financed expenditures.

### **a. Inflation targets.**

The nature of the debate about the appropriate targets for inflation rates in low-income countries revolves around two arguments: (i) somewhat higher inflation than is typical in IMF-supported programs would make available additional fiscal space, via additional monetary financing of the fiscal deficit, at a lower cost than would be incurred by raising additional taxes or foregoing expenditures;<sup>1</sup> and (ii) a greater susceptibility by these countries to exogenous shocks makes it harder to accommodate the short-term effects on prices within very low inflation targets. Consequently, short-term monetary management may involve greater output volatility and a lower trend growth rate when it is guided by very low inflation targets.

The evidence on the association between inflation and growth from a large number of cross-country studies (see IMF, 2005 and Chowdhury, 2005) indicates that the relationship is non-linear: at low initial rates, higher inflation may have no effect on growth or the effect may even be positive, but after some threshold higher inflation is typically associated with poorer growth outcomes. There is considerable debate as to exactly where this threshold lies; some results suggest a threshold around 5-10 percent while some suggest 10-20 percent or even higher. The precise magnitudes estimated in these various cross-country studies should be taken with a grain of salt because the benefits of more stable prices for an economy are likely to depend considerably on people's expectations of whether they will last, which could vary enormously from country to country depending on the credibility of institutions and each country's past history with inflation. But there is a broad measure of consensus on at least the first two of the following:

- Inflation targets should be set to avoid the risk of an unintended contractionary stance. Since such risks can be greater in low income countries because they typically suffer from larger shocks, programs in low income countries should avoid pushing inflation to very low levels-- say, below 5 percent.<sup>2</sup>
- Inflation rates above about 30 percent are likely to be harmful for growth.
- There is much less consensus on the middle range. IMF policy papers have taken the position that the evidence supports the use of single-digit ranges for inflation targets in low-income countries (see IMF, 2005) while a number of critics argue that higher ranges—say, 15-20 percent—would be acceptable.<sup>3</sup>

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<sup>1</sup> Some naïve versions of this argument appear to suggest that the resources generated by additional money creation are essentially “free,” but that is typically not the case (unless the economy is operating at below capacity and additional output can be stimulated by a more expansionary monetary policy). Additional monetary expansion leading to higher inflation involves a redistribution of resources toward the government (via the inflation “tax” on those holding currency) and, like most other taxes, imposes a further cost on the economy by distorting decision-making. Whether it is worth bearing those costs depends on how high they are in comparison with the costs of raising other taxes or forgoing expenditures, which is an empirical question.

<sup>2</sup> An exception to this lower threshold may be necessary in countries that are part of a common currency area, where the inflation rate is determined by the exchange rate arrangements. For example, the West African Economic and Monetary Union (WAEMU) has a target of no more than 3 percent average annual inflation, based on the objective of keeping the inflation differential with the Euro, to which they are pegged, small.

<sup>3</sup> The inflation rate is one of 16 indicators considered by the U.S. Millennium Challenge Corporation in determining eligibility for the Millennium Challenge Account. To pass the indicator, a country's inflation rate needs to be under a ceiling of 15 percent.

**Implications.** These remaining differences in judgments about the appropriate inflation targets, while not negligible, do not seem large enough to be the central issue in the debate on the appropriateness of IMF-supported macroeconomic frameworks. The most significant question is whether programs have targeted very low inflation and thereby incurred risks of an overly contractionary demand management stance in the event of unexpected shocks. Beyond this question, there is certainly no evidence that targeting substantially higher inflation is actually *good* for growth. Moreover, going from a 5- to a 15-percent inflation rate would not generate very large additional resources for the budget because the initial stocks of money in relation to GDP are small in low-income countries and higher inflation would have some disincentive effect on currency holdings. Typical estimates suggest that the additional revenue could be around ½ percent of GDP.<sup>4</sup> While such additional resources could have an impact if devoted to high-priority activities, the magnitude is relatively small.

But have IMF-supported programs in practice gone beyond the generally accepted evidence (and recent IMF policy pronouncements) and actually targeted very low inflation rates? Background research for the Working Group will investigate this issue, with a focus on what has been targeted in programs approved in recent years.<sup>5</sup>

#### **b. Fiscal targets**

A number of critics argue that the IMF presses for reducing fiscal deficits, even in post-stabilization countries, to levels that are not justified by requirements of macroeconomic stability or expectations of aid flows (see, for example, Oxfam, 2003). IMF policy papers generally recognize that there is now greater room for fiscal flexibility, at least in countries that have succeeded in restoring a reasonable degree of macroeconomic stability (IMF, 2005). A related concern of some critics is that the IMF may focus too much on a measure of the fiscal deficit before grants (i.e., with grants treated as a financing item) and thereby impose undue constraints on spending that donors could be willing to finance without any consequences for debt.

In discussing how to judge the appropriate path for the budget deficit, it is useful to distinguish between the concepts of sustainable and optimal paths. This aspect is addressed first, before turning to the issue of measuring deficits before or after grants.

***Optimal and sustainable deficit paths.*** A sustainable deficit path is one that is not likely to lead to debt distress, even in the event of future adverse shocks of a reasonably likely size. An

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<sup>4</sup> The revenue generated by money creation—called *seigniorage*—comes from the fact that those who hold currency or similar domestic claims on the central bank are giving an interest-free loan to the bank. This is transferred to the government as central bank profits or below-market loans. Total *seigniorage* earnings have typically been in the range of 1-1 ½ percent of GDP for low-income countries not experiencing very rapid inflation. Adam and Bevan (2005) identify a “threshold” effect, beyond which higher *seigniorage* tends to have a negative effect on growth, at about 1 ¼ percent of GDP, but note that these effects depend on how the resources are used.

<sup>5</sup> Timing and country coverage are important because two earlier investigations came to somewhat different conclusions. Oxfam (2003) reported that 16 of the 20 3-year programs they examined had inflation targets below 5 percent at the end of the period whereas the IEO (2004, see Box 4.7) reported that when initial inflation was above 10 percent, programs always targeted a decline but that when initial inflation was below 5 percent, the majority of programs projected inflation would rise; in those cases where inflation was between 5 and 10 percent, about two thirds of programs targeted lower inflation.

optimal deficit path is one that maximizes the welfare (however defined) of a country's people. Clearly, an optimal path has to be sustainable, but there are many additional considerations to take into account, including the impact of the deficit and its financing on growth. Key considerations include the effect of the deficit on private sector behavior, especially private investment.

Evidence is limited on what is the optimal path for fiscal deficits and public debt in low-income countries once there is no major threat to macroeconomic stability or debt sustainability. The transmission channels through which fiscal deficits influence economic growth are complex, but there is some evidence to suggest the following:

- The relationship is nonlinear [i.e., the gains to growth from lower deficits are most marked as the deficit falls from high levels and taper out well before the economy reaches a balanced budget position (see, for example, Adam and Bevan, 2005).
- One of the most common transmission channels—the “crowding out” effect as higher deficits displace private investment through higher interest rates or other channels—appears to be less strong in low-income economies (see Balducci and others, 2003).<sup>6</sup> And IMF-supported programs tend to overestimate the speed at which a reverse “crowding in” will take place as deficits are reduced (IEO, 2003). One reason why the positive effects of fiscal consolidation on private investment are often weaker than anticipated is that it can take the private sector and domestic credit markets considerable time to recover in “post-stabilization” phases. This can have major implications for the conduct of fiscal policy during such periods: *“realistically there is likely to be a recovery phase in which the private sector occupies less ‘economic space’ than it would in a more equilibrium configuration. The balance between government expenditures and any associated deficit financing may be struck differently during such a phase than they will subsequently”* (Adam and Bevan, 2001).
- A major determinant of the link between deficits and growth is the quality of public expenditures and hence of the underlying governance processes. Where institutions and expenditure systems are weak, higher public spending has less effect on social indicators and higher deficits tend to be associated with worse growth outcomes (Balducci and others, 2003; Tanzi and Davoodi, 2002).

Most IMF assessments of the fiscal path tend to focus on the narrower question of debt sustainability. Based on cross-country evidence of the circumstances in which various countries have run into debt problems, it is possible to make some statements about when levels of debt are reaching levels that in the past have been associated with a greater risk of debt distress in similar countries. This is the basis for the IMF/World Bank Debt Sustainability Assessment (DSA) framework, which is discussed in more detail later. The IMF is right to pay attention to such issues. After all, many low-income countries did fall into debt traps in the past and no one wants to see the recent efforts to mobilize debt relief become the starting point for a new cycle leading to debt distress. But in practice it is difficult to extract concrete operational guidance for the

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<sup>6</sup> A few studies, such as Christensen (2005), do find evidence that higher domestic public debt causes a decline in the ratio of private sector credit to broad money, which suggests there are significant constraints on using such debt to finance a fiscal expansion in countries where domestic financial markets are thin, which is the case in most of Sub-Saharan Africa.

appropriate fiscal path from such assessments. They are only useful as a general guide for reasons that complicate the setting of fiscal targets within the relatively short timeframe of IMF-supported programs:

- While fiscal policy needs to satisfy a long-term inter-temporal budget constraint, the exact nature of that constraint is not at all clear in countries receiving significant aid.<sup>7</sup> The difficulty of projecting the future levels and degree of concessionality of aid makes judgments about sustainability especially fuzzy—since current levels of borrowing and grant-financed spending may or may not be sustainable depending upon whether donors will continue their soft loans and grants in the future. This uncertainty raises a fundamental question of what represents a “prudent” approach to fiscal strategy in an environment where most donors only make relatively short-term aid commitments to specific countries, but there is now a fairly broad international undertaking to expand aid generally.
- Debt relief, including under the recent Multilateral Debt Relief Initiative (MDRI), has put more countries in a situation where current debt is now well below any thresholds associated with risks of debt distress. So sustainability judgments, which are about medium- and long-term fiscal paths, provide a less obvious guide for judging *current* fiscal policies—e.g., for concluding that a particular level for this year’s deficit is inappropriate. Projections based on the assumption of constant policies are of only limited use in such circumstances.
- Future policies can and should adjust when circumstances change, but it is often difficult for countries to commit credibly now that they will implement any necessary changes when the time comes.<sup>8</sup> This also makes for difficult judgments on the appropriate level of “prudence” to pursue in the short term. For example, countries could increase aid-financed spending in the near term, with the intention of either scaling back the spending or raising additional domestic revenue whenever the aid declines. Such a path would be sustainable, but the key judgment is whether it could be implemented when the time comes. Making this judgment requires more than an analysis of the numbers. For example, important factors to take into consideration could include whether institutions to collect domestic revenues and manage expenditures are being strengthened and how costly would be unforeseen cutbacks in the additional spending
- An understanding of the longer-term fiscal dynamics requires an analysis of the uses and effectiveness of additional spending. This interaction is likely to be especially important for the health sector because of the long-term nature, and high recurrent cost component, of most health interventions. But such judgments are not the IMF’s comparative advantage. This underscores the importance of integrating macroeconomic and sector-level expenditure planning. In practice, however, decisions on macroeconomic

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<sup>7</sup> Indeed, the potential volatility of private capital inflows raises similar difficulties for judging sustainability in middle-income countries.

<sup>8</sup> The problem that governments may have good incentives for backtracking on earlier policy promises when the time comes is referred to as “time inconsistency.” The eight members of the West African Economic and Monetary Union (WAEMU) have tried to address this issue by adopting convergence criteria, including on a measure of the basic fiscal balance and public debt/GDP ratio, as well as on indicators such as a ceiling on the wage bill as a ratio of tax receipts (Dore and Masson, 2002). In fact, the criteria adopted for the fiscal balance --that revenue excluding grants minus expenditure excluding foreign-financed investment should be zero or positive--imposes a significant constraint on aid-financed spending and is being reviewed.

frameworks often will have to be made with very incomplete information on the longer-term consequences of higher spending. How the IMF handles this uncertainty in its actual operations is of considerable importance.

These considerations indicate that setting the fiscal deficit path within a program involves a complex set of considerations that have to be decided on the basis of inevitably incomplete information. However, IMF country documents are generally not transparent about these considerations. A 2003 evaluation of the role of fiscal adjustment in programs by the Independent Evaluation Office (IEO) of the IMF concluded that the rationale for the proposed fiscal adjustment path was typically not discussed in any systematic way in program documents (IEO, 2003). Moreover, even though programs often showed considerable flexibility in adapting to new circumstances at the time of reviews, the underlying rationale for any modifications, in terms of changes to program design assumptions, was rarely spelled out.

***Treatment of grants in judging the fiscal deficit path.*** In formulating macroeconomic frameworks, the IMF looks at fiscal balances both before and after grants.<sup>9</sup> According to Heller (2004), the IMF approach is to put more weight on the measure of the deficit *after* (i.e., including) grants when grants are likely to be prolonged and stable and more weight on the deficit *before* (i.e., excluding) grants if the level of grants is likely to be volatile or, together with the associated spending, may risk creating undue demand pressures.

There does not seem to be any fundamental macroeconomic reason why a large fiscal deficit before grants should be regarded as a problem if (and it is a big *if*) the grants are expected to be sustained.<sup>10</sup> There may well be questions about the longer-term consequences of aid dependence for the robustness of domestic institutions, but these are not questions on which macroeconomic judgments can throw any particular light and would not justify targeting a particular path for the deficit before grants. While it is true that grant-financed spending is likely to have a bigger impact on domestic aggregate demand than spending financed by taxes, the grants themselves also represent additional resources. So while some smoothing may be needed to manage the potential consequences of sudden surges in spending, there is no reason for prospects of a stepped-up level of grants to be rejected on demand management grounds.

However, assessments of the appropriate medium-term fiscal path should take account of projected movements and likely volatility in all major fiscal components. If grants are subject to especially large uncertainties (relative to other fiscal components) on their availability, timing, and duration, then it makes sense to pay special attention to them when making medium-term fiscal assessments.<sup>11</sup> This is an *empirical* question that may well differ from country to country and requires a careful assessment of what are reasonable prospects for sustained grant levels in

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<sup>9</sup> The IMF does not include formal conditionality on the deficit before grants in any of its programs with low income countries. Its review of conditions in all programs supported by the IMF under the PRGF found not a single case where such conditionality was used. Fiscal conditionality most typically involved a ceiling on domestic financing of the deficit along with a ceiling (often of zero) on the contracting of debt on “non-concessional” terms.

<sup>10</sup> The possible “Dutch Disease” aspects are discussed later.

<sup>11</sup> The evidence put forward by Bulir and Hamann (2003 and 2005) suggests that this is the case. Hudson and Mosley (2006) conclude that, while aid is indeed volatile, it is not counter-cyclical and note that the reasons underlying the volatility need to be analyzed in more depth before concluding that more volatile aid is necessarily less effective. (For example, aid that offsets adverse shocks, such as natural calamities, is by its nature volatile)

the current more pro-aid environment. Such an assessment of prospects requires going beyond concrete short-term aid commitments, so cooperation by donors is needed if they are to be meaningful. However, even if grants are less predictable and more volatile than other fiscal components, this does not mean it would be better to do without the grants. Rather, the appropriate fiscal strategy should take account of the uncertainty by smoothing expenditures over time (i.e., via fiscal and external reserve cushions) and by adapting, wherever feasible, the nature of expenditures and related contracts to the uncertainty.

**Implications.** Three central messages emerge from this discussion. First, the policy space available to governments—in the sense of the range of viable options for the paths of fiscal deficits—is considerably wider for countries that have succeeded in stabilizing their economies. For countries suffering the macroeconomic consequences of a history of fiscal indiscipline, the choices were much more limited—to how quickly deficits needed to be reduced, consistent with limited available financing options. This was the traditional environment in which many IMF-supported programs were designed, but it is no longer the case for an increasing number of countries. In this new environment, the empirical evidence does not give any precise guide on what is the “right” deficit level. Of course, returning to a path of large deficits financed by heavy domestic and external borrowing would soon put countries back in debt-distressed situations. But, ruling out such scenarios, countries do have broader policy choices. A key question to investigate, therefore, is whether in practice IMF-supported programs have allowed for greater flexibility in making these policy choices.

Second, program targets for the fiscal deficit need to be set in a medium-term context that takes account of the composition of additional expenditures and their likely consequences. The quality of public spending—and the underlying sector-specific policies and budget management systems that determine them—has major macroeconomic implications. This means that judgments on macroeconomic frameworks need to incorporate assessments of the likely effectiveness of additional expenditures. For the IMF, an important test will be how well it incorporates available assessments of additional spending opportunities in such circumstances. For recipient countries, well-formulated and adequately costed plans for scaling up activities in sectors such as health are needed not only to contest effectively for budgetary priority but also because they are an essential input to good macroeconomic decisions. For donors, improving the predictability of their aid will not only improve the effectiveness of particular spending programs, but will also reduce the macroeconomic uncertainty that can impede absorption of the aid.

Finally, if the uncertainty associated with the future path of grants is relatively high—as it often is—then it makes sense to keep track of a measure of the deficit before, as well as after, grants. But the main reason for doing so is to ensure that grant-financed expenditures are not subject to sharp disruptions that can undermine their effectiveness. Apart from a prudent approach to dealing with this uncertainty, there is no strong macroeconomic reason why programs should target a particular *level* of the fiscal deficit before grants; in particular, if there are reasonable prospects of additional grant aid being available over the medium term, programs would be justified in targeting rising deficits.

## 2. Is the IMF going beyond the available evidence in its gatekeeper role?

To a considerable extent, the donor community has subcontracted assessments of countries' macroeconomic policies to the IMF, drawing upon its signals about the appropriateness of the macroeconomic framework when making decisions about aid. Much of this signaling takes place through the presence or absence of an IMF lending arrangement.<sup>12</sup> While donor responses to these signals can be nuanced, IMF assessments are likely to influence the level of aid flows.<sup>13</sup> This raises the question of how the IMF arrives at its judgments on the macroeconomic framework in an environment where there is great uncertainty about how economies will respond to a scaling-up of aid. Some critics of the IMF argue that it goes beyond the available evidence in making such judgments, leaning unduly toward the side of caution by overemphasizing the macroeconomic risks (e.g., Eurodad, 2005). The IMF responds that it is taking a more flexible approach to the macroeconomic challenges of scaling up aid, but that many of the countries involved have endured long periods of macro instability, with high costs, so that prudence is justified so as not to undermine recent gains. Three specific aspects of the macroeconomic assessments are discussed here—debt sustainability, “Dutch Disease,” and absorptive capacity. Another strand of criticism—that the IMF approach is not sufficiently needs-based—is taken up later.

### a. Debt sustainability

The new framework for assessing debt sustainability adopted in 2005 is based on the setting of indicative thresholds of debt and debt service burdens (IMF and World Bank, 2004 and 2005). These thresholds vary with assessments of the quality of a country's policies and institutions, as measured by the World Bank's Country Policy and Institutional Assessment (CPIA) Index. Countries with lower CPIA scores (i.e., policies and institutions assessed to be weaker) are assigned lower debt thresholds (Table 1). The sustainability assessments then compare projected debt-burden indicators (under a baseline scenario and with stress-testing for plausible shocks) to these thresholds. If the indicators rise above the thresholds, this is a signal of possible vulnerability to future debt distress suggesting that borrowing—even on soft terms—should be limited and future aid should be provided largely in the form of grants. The IMF Executive Board has stressed that the thresholds should be seen as guideposts for informing the assessments rather than as rigid ceilings, and that individual country circumstances need to be factored in.

Nevertheless, the new framework has major implications for the IMF's “gatekeeper” role. For example, the IMF has modified its approach to setting external debt limits in programs to reflect the new framework, implying greater restrictions for borrowing on soft terms by some countries (IMF, 2004b).<sup>14</sup>

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<sup>12</sup> The IMF's own review of the history of its signaling concluded that various attempts in recent decades to provide other forms of signaling (through intensified surveillance etc) had not been successful because of the ambiguity of the signals provided (IMF, 2004). The recently introduced Policy Support Instrument (PSI) is intended to perform a similar signaling role for countries that do not need IMF financing.

<sup>13</sup> For example, general budgetary support is likely to be more sensitive to IMF assessments of the macroeconomic framework than is project-related lending.

<sup>14</sup> Previous limits were typically a ceiling on non-concessional borrowing (defined as a grant element of less than 35 percent). The IMF Executive Board has called for greater use of conditionality related to the net present value (NPV) of debt. In addition, the minimum grant element in loans is being tailored to country circumstances, with

**Table 1. Debt-Burden Thresholds in the IMF/World Bank Debt Sustainability Assessment Framework**

	NPV of debt in percent of			Debt service in percent of	
	Exports	GDP	Revenue	Exports	Revenue
<b>Weak Policy (CPIA&lt;3.25)</b>	100	30	200	15	25
<b>Medium Policy (3.25&lt;CPIA&lt;3.75)</b>	150	40	250	20	30
<b>Strong Policy (CPIA&gt;3.75)</b>	200	50	300	25	35

Source: IMF and World Bank (2004).

Assessing debt sustainability is always a complex issue because it involves making forward-looking estimates (which can often be little more than guesses) about how key economic variables, including policies, will evolve over long periods. The problem is even bigger for low-income countries because the behavior of donors also has to be projected—will they continue to provide concessional financing on similar terms in the future? So sustainability assessments can only make probabilistic judgments. Moreover, any operational framework has to make enormous simplifying assumptions, which raise difficult questions about the applicability of the framework in specific cases. Put simply, is the framework robust enough to be relied upon to say that a low-income country with enormous development needs should turn down aid with, say, a 50-percent grant element? The issues involved are complex, but the following points are worth noting:

- Whatever the problems with such assessments, maintaining a sustainable external and public debt position *is* important. There is evidence that debt overhangs are bad for growth (because they create uncertainty and act as an implicit tax on the resources generated by a country, thereby discouraging investment).<sup>15</sup>
- There is some empirical basis for the approach to debt thresholds used in the IMF-World Bank framework. The risks of debt distress do seem to rise with the debt level and vary with the quality of underlying policies and institutions (e.g., Kray and Nehru, 2004). But going from a cross-country regression that can, at best, explain only a small proportion of the probability of debt distress (about one quarter in the case of Kray and Nehru, which is

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higher minimums for countries judged to have a risk of debt distress. (Minimum grant elements of 50 percent were used in recent programs for Niger and Rwanda, and an indicative ceiling on the NPV of public debt was used in the case of Guyana).

<sup>15</sup> See Cordella and others (2005) for a review and an investigation of debt overhangs in HIPC countries. They conclude that there is a negative marginal relationship between debt and growth at intermediate debt levels, but not at very debt high levels (i.e., above a debt “irrelevancy” threshold at which no-one expects the debt to be repaid).

pretty good for such regressions) to using the results to set specific debt thresholds inevitably builds in very large margins of error. Putting all countries into just three groups according to the strength of their policies increases the approximation of the exercise. This is not to say the approach used is necessarily wrong—all operational frameworks have to simplify—but it does underscore the highly approximate nature of the exercise and the risk of “false positive” signals.

- The particular debt thresholds chosen were somewhat arbitrary. Indeed, in implementing the framework, the IMF Board decided upon more conservative thresholds than those originally proposed.<sup>16</sup> The choice of thresholds must balance the risk of debt distress against the costs of applying tighter constraints on access to concessional loans. These costs may be borne by donors (if they choose to replace the loans by grants) but, realistically, the recipient countries will bear some of the costs, in the form of foregone development opportunities, if—as seems likely-- the total level of aid declines as a result of the constraints.<sup>17</sup>
- The sustainability assessments take a very simplistic approach to considering how policies might react to debt build-ups. All such forward-looking exercises face the problem that any level of debt accumulation will look sustainable now if there is a credible prospect of achieving sufficiently large surpluses in the future to pay for it. But when the future arrives, governments may have good reasons for backtracking on these promises, which makes it very difficult to model future policy responses in sustainability assessments. So baseline projections often assume that recent policy trends will continue in the future and stress-testing around that baseline usually assumes that governments do not react to adverse shocks. But governments typically do respond to a rising public debt by strengthening fiscal consolidation, so the assumption of no policy response again leans on the conservative side.

*Implications.* The IMF is rightly concerned with assessing that countries’ policies are consistent with a sustainable debt path, but the intrinsic nature of long-term, forward-looking sustainability exercises means that any particular debt thresholds are subject to very wide margins of error as predictors of potential debt distress. So they need to be used cautiously as a “gatekeeper” device. This is especially the case if donors’ constraints on the substitutability between grants and loans mean that restrictions on borrowing at concessional rates would result in a significant cut in the overall level of aid flows. How the sustainability assessments are used in practice will be critical. Experience with the first round of assessments suggests that IMF staff judgments were

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<sup>16</sup> See IMF and World Bank (2005). The thresholds chosen are consistent with about an 80-percent probability that a given country will not experience any of the indicators of debt distress for the next 5 years. The chosen thresholds were also influenced by those adopted under the earlier HIPC debt relief exercise, which were in turn heavily influenced by what donors were willing to finance at the time.

<sup>17</sup> This is especially likely if there are institutional constraints that make it difficult for some donors to substitute between grants and loans. In Japan, for example, the decisions on grants and loans are taken by different agencies, following different considerations. In the case of the World Bank’s IDA allocations, the tradeoffs between a higher grant element and the volume of financing have been made explicit. IDA-only countries classified as at high risk of debt distress receive 100 percent grant financing from IDA while countries classified as at moderate risk receive 50 percent grant financing. The volume of grants provided is reduced by 20 percent (i.e., \$100 of concessional loans translates into \$80 in grants.)

often used to give a more favorable rating of potential debt distress than that suggested by the mechanistic calculations.<sup>18</sup>

## **b. Dutch Disease**

The so-called Dutch Disease refers to the potential appreciation of the real exchange rate that can occur as a result of higher aid inflows.<sup>19</sup> To the extent that aid proceeds are used to purchase non-tradable goods and services, the resulting increase in demand drives up the price of such goods relative to that of the tradable (i.e., the export plus import-competing) sectors of the economy. In other words, the real exchange rate tends to appreciate, which in these circumstances is a necessary relative price shift to create room for the additional external resources to be absorbed. Whether this is a cause for concern—i.e., whether the “disease” label is justified—depends on the consequences of the relative price shift for longer-term growth. In theory, the effects could be detrimental for several reasons. A resulting decline in the relative size of the export sector could adversely affect productivity growth through the loss of positive externalities (e.g., learning effects) that can be especially strong in this sector. Or shifts in domestic production caused by the higher exchange rate could be hard to reverse once aid falls and the real exchange rate depreciates again.

There is a very large theoretical and empirical literature on the implications of aid flows for Dutch Disease, but the following key messages emerge:

- The theoretical case for the Dutch Disease is ambiguous, since the longer term effects will depend on the attributes of the particular economy. For example, autonomous productivity growth could be equally strong in the non-traded sectors, or investments in physical and human capital financed by the aid could offset any initial loss in competitiveness.<sup>20</sup> Simulations with different types of expenditures and productivity responses show that a wide variety of outcomes are possible over the longer term. Therefore, once again, the macroeconomic impact of aid is likely to depend crucially on how the aid is used.
- Studies of countries that have experienced episodes of growth accelerations do suggest that the exchange rate is important. For example, Hausmann and others (2004) and IMF (2005a) find that countries experiencing sustained growth episodes generally avoided exchange rate appreciation during those episodes.<sup>21</sup> However, empirical evidence on the aid/exchange rate part of the link is more mixed. A number of cross-country studies show generally small effects of aid-induced real exchange rate appreciation, while

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<sup>18</sup> In 6 out of 21 cases, the staff judged that the mechanistic calculations would have implied an unreasonably negative rating; in no case did staff judgments result in a less favorable rating of the risks of debt distress (IMF and World Bank, 2006).

<sup>19</sup> It takes its name from the upward appreciation of the Dutch real exchange rate as a result of the exports of North Sea gas.

<sup>20</sup> For example, Adam and Bevan (2003) develop a model showing that public infrastructure that generates a productivity bias in favor of non-tradable production delivers the largest aggregate return to aid, with the real exchange rate appreciation reduced or reversed

<sup>21</sup> Rajan and Subramanian (2005b) look at the effect of aid flows on exports without attempting to trace the impact through the real exchange rate channel and conclude that higher aid has been associated with slower growth of export and labor-intensive manufacturing industries.

individual country studies show varied results. (See IMF, 2005b as well as Gupta and others, 2006 for brief surveys.) This may be because many countries try to resist the exchange rate appreciation by accumulating reserves.

- Whatever the effects on longer-term output trends operating through shifts in relative prices, the higher aid does allow an initial increase in consumption and investment. The aid would probably have to be very badly utilized for these initial benefits to be outweighed (see Barder, 2006).
- It is useful to distinguish between fiscal *spending* of additional aid (i.e., widening the fiscal deficit by the amount of the aid) and *absorbing* it (i.e., widening the external current account deficit through higher net imports). The latter is heavily influenced by the response of monetary and exchange rate policy to the aid inflows. A study of five African countries in IMF (2005b) showed that aid was more likely to be spent than absorbed, which is not a desirable long-term outcome. Governments often spent the fiscal proceeds of the aid but were reluctant to sell the foreign exchange because they wanted to avoid appreciation of the domestic currency.
- But some policy responses to the aid inflows that may be feasible or desirable in the short term, such as resisting an appreciation of the exchange rate, become harder to maintain as the aid flows continue. In the longer term, the only sustainable strategy would be an “absorb and spend” one. In the shorter term, a “no absorption, no spending” response, to help rebuild low external reserves could be justified (if donors would go along). So would one of “absorb but don’t spend”—i.e., selling the foreign exchange and using the proceeds to pay down domestic debt and thereby channel the extra resources to the private sector, through lower interest rates. In practice, the latter option is rare because donors want to see a concrete counterpart, in terms of public spending, to their aid.

*Implications.* The potential adverse effects on competitiveness from large aid inflows are a significant concern and reinforce the importance of a careful analysis of how aid proceeds will be used, and especially their longer-term consequences for the supply side. But the IMF will rarely be in a position to judge, *ex ante*, on theoretical or empirical grounds that a country should not avail itself of additional aid because of concerns about the longer-term consequences for the real exchange rate. Rather, the IMF role should be to ensure (i) the consistency of monetary, exchange rate and external reserves policies with fiscal policy (i.e., avoiding “spend but not absorb” outcomes); and (ii) that macroeconomic and expenditure-composition decisions are properly integrated.

### **c. Absorptive capacity and the effectiveness of expenditures**

There is broad agreement that absorptive capacity constraints could significantly reduce the impact of higher aid unless potential constraints are taken into account from the outset in the design and sequencing of additional public expenditures. Key constraints include the availability of different types of skilled labor--which is likely to be of particular importance for the health sector --as well as the capacity of governance and public expenditure management systems to cope efficiently with the increased resources. Donor behavior, including fragmented

interventions and multiple reporting requirements that pose a heavy burden on scarce administrative capacity, can also be a major constraint.<sup>22</sup>

For the IMF role, however, the key question is how judgments on absorptive capacity are taken into account in assessing the macroeconomic consequences of scaling-up aid. Robust empirical evidence on the macroeconomic effects of absorptive capacity constraints is limited, but the following points are relevant:

- Cross-country evidence provides only limited guidance on the likely diminishing returns to additional aid and the thresholds at which they would begin to occur. A number of studies derive estimates of an “aid saturation point,” at which the marginal benefits of additional aid for growth declines to zero.<sup>23</sup> The estimates range from 15 to 45 percent of GDP, with countries that have good policy environments possibly able to absorb more. But these estimates are too broad and uncertain to form the basis for judgments about individual countries. There is also some evidence that the initial capacity to absorb aid will be lower in post-conflict countries, but that it can rise significantly after three to five years, suggesting that donors need to time their aid accordingly (Collier and Hoeffler, 2004).
- In principle, judgments on the level and composition of public spending should be guided by evidence on expected social rates of return. In practice, however, there is considerable uncertainty about such returns, especially for the health sector, since cross-country evidence provides only limited guidance on the links between overall public health expenditures and health outcomes.<sup>24</sup> Some studies find a statistically significant link while others do not, although there tends to be more robust evidence on the positive effect of increased spending on some specific health interventions. There is also some evidence that health outcomes of the poor are more strongly affected by public health spending and that the efficiency of health spending, in terms of its association with better health outcomes, varies substantially across countries. (See the articles by Gupta and others, 2004a-c.)
- Since there is no uniform blueprint linking aid flows to growth performance or health outcomes, individual country circumstances must be assessed to identify strategic priorities and binding constraints. Some of these constraints will be more amenable to improvements through additional funds than others. Hanson and others (2003) develop a framework for analyzing the constraints on access to priority health interventions,

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<sup>22</sup> For example, a case study by WEMOS (2004) concludes “*From the experience of Uganda it does not appear that the PRSP is leading to a culture change among donors—coordination of health sector aid appears to be getting more difficult at the moment. While most commentators would argue that linking Medium-Term Expenditure Frameworks with PRSPs has been helpful in enabling greater planning of expenditures, the increasing proliferation of donor initiatives is undermining this.*” They propose agreeing on a code of good practice, which would outline ways in which disease control programs can be integrated with the broader health system, including more flexible use of funding to support functional improvements in the rest of the health system.

<sup>23</sup> These estimates are typically derived from cross-country regressions that attempt to isolate the effect of aid on growth; inclusion of a quadratic term for aid allows for testing nonlinear effects. Clemens and Radelet (2003) summarizes a number of such studies. Rajan and Subramanian (2005a) take a more skeptical view on whether cross-country evidence shows any significant effects of previous aid on growth.

<sup>24</sup> This bullet draws heavily on the discussion in a background paper for the High-Level Forum on the Health MDGs (High Level Forum, 2005a, pages 23-25). Roberts (2003) and Gupta and others (2004a) give summaries of the econometric evidence on the effects of public expenditures on health outcomes.

structured around the level at which each constraint operates (i.e., household, health services delivery, health sector policy, more general public sector policies, or broader environmental characteristics) and the degree to which it can be relaxed through additional funding.

*Implications.* A good understanding of absorptive capacity constraints and their implications for an effective sequencing of additional expenditures is critical for managing a scaling-up of aid. But there is little that the IMF can say, on a priori macroeconomic grounds, on the issue unless it is able to incorporate more detailed, country-specific analysis of specific constraints into its assessments. This suggests the need, first, for humility (since the IMF will typically not be able to say that a country can absorb efficiently an amount “*x*” of aid but could not absorb, say 1.5*x*) and, second, for close coordination with those—in the recipient country, the World Bank, and other development agencies—who do have the necessary sector-specific knowledge. Even with such coordination, there are likely to be practical limits to the ability of forward-looking diagnoses to identify all critical capacity constraints in advance.

### **3. Should the IMF be pursuing a more “needs-based” approach?**

Some critics fault the IMF for not taking a more explicit “needs-based” approach to formulating macroeconomic frameworks so as to identify the specific requirements for additional aid to help countries achieve the MDGs—or whatever specific targets related to the MDGs a country chooses to adopt. They argue that, as a result, the IMF is not playing the catalytic role that it should and may signal to donors that a medium-term framework built around relatively low expectations (for both improvements in poverty-related indicators and aid) is acceptable when a more ambitious scenario would be feasible. (See, for example, Oxfam 2003, Eurodad, 2005, and McCord, Sachs and Woo, 2005.) The IMF response is that the formulation of a government’s spending programs has to take account of budget constraints, including reasonable expectations of available aid, and that “*it doesn’t do low-income countries any favors to pretend that they will receive more aid than they actually will—in a world where commitments still usually exceed disbursements.*”<sup>25</sup>

To a large extent, this is a debate about the IMF role in the international aid architecture. Economic analysis alone cannot provide the answer, which ultimately depends on how much of a role donor and recipient countries want the IMF to play in coordinating donors and providing catalytic signals about desirable levels of aid. But the following considerations are worth noting:

- There is no straightforward measuring rod for determining the “desirable” level of aid for a country. However, the MDGs provide global social targets that have received broad international endorsement and therefore are a natural starting point for judging performance, both of donors and recipient countries. Indeed, the IMF Managing Director’s recent report on the Fund’s medium-term strategy explicitly calls for more emphasis on the MDGs.<sup>26</sup> But translating the MDGs into estimates of overall aid “needs”

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<sup>25</sup> Speech by the Managing Director of the IMF on “Renewing the IMF’s Commitment to Low-Income Countries,” July 31, 2006.

<sup>26</sup> The medium-term strategy recognizes the MDGs as the “*defining objectives of the world community for the next decade*” and states that “*in future, staff papers will not only assess whether macroeconomic policies support the*

involves many complications. First, there is no obvious division of the necessary efforts to achieve the MDGs between better domestic policies and higher aid.<sup>27</sup> Second, our knowledge of what specific policies are best for growth and poverty reduction is limited and often depends on particular country circumstances.

- The various global estimates that have been made generally involve highly simplifying assumptions that limit their applicability to specific countries. For example, many such estimates involve variants of a model incorporating an investment-savings ‘gap’:<sup>28</sup> the growth rate necessary to achieve a specific poverty or other MDG outcome is estimated, the total investment necessary to achieve that growth rate is derived, some estimate of the domestic saving effort is subtracted, and the residual is the aid “requirement.” An alternative approach estimates the costs of scaling up specific health (or education) initiatives. But such estimates need to take account of the particular constraints and costs that will be encountered in scaling-up expenditures in the health or system of a particular country, which are likely to vary enormously (see Lewis, 2005)<sup>29</sup>.
- Progress toward the health-related MDGs will be greatly influenced by the effectiveness of interventions in non-health areas, even if some of these links are difficult to quantify. For example, improved schooling of girls is closely associated with better outcomes on many health indicators. Country-specific plans need to take account of these linkages in sequencing the expansion of different types of interventions.<sup>30</sup>
- Although simplistic estimates of aid “requirements” are of limited use in deriving macroeconomic frameworks for specific countries, this does not mean that the IMF should not incorporate into such frameworks assessments of what it will take to achieve better growth and poverty outcomes, including those related to health. Unless the IMF does this, its assessments risk being extrapolations of past behavior that add little to the discussion of the challenges of scaling up aid. But such assessments will require the identification of the specific binding constraints to growth, poverty reduction and better health outcomes in individual countries, along with an analysis of how higher aid, and alternative options for using it, can help ease those constraints. One recent example where such an analysis was undertaken is Ethiopia (IMF, 2006 and Sundberg and

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*MDGs, but will also frankly report the assessment of the World Bank and donors on the achievability of the MDGs under what the Fund would consider to be realistic macroeconomic scenarios and financing envelopes.” (IMF, 2005c, page 9.)*

<sup>27</sup> Although it is possible to make some simplifying assumptions and these could be couched on the ambitious side for illustrative purposes. For example, the Millennium Project assumes that domestically mobilized resources will rise by 4 percentage points of GDP by 2015 to support spending on MDG-related interventions (Millennium Project, 2004).

<sup>28</sup> Two principal difficulties with such approaches are (i) it is hard to predict the returns from additional spending even when detailed expenditure plans are available; and (ii) estimating the impact of higher aid on domestic savings. Many estimates assume that the higher aid will all go to finance additional investment in physical or human capital, but this is unlikely. Theory and practice suggest that part of the aid will finance additional consumption.

<sup>29</sup> As noted by Pritchett and Woolcock (2002), one of the fundamental reasons for this great cross-country diversity in the costs of scaling up public service delivery is that most such services are transactions-intensive and involve many discretionary actions. They require the collaboration of many individuals and groups who make highly discretionary choices in an environment where many key actions are difficult to observe or monitor, which makes them intrinsically subject to deep incentive problems. The empirical link from health spending to outcomes therefore depends critically on how these problems are addressed in each country and is likely to greatly outweigh any direct macroeconomic considerations.

<sup>30</sup> The Millennium Project approach does try to take account of such linkages. (See Sachs and others, 2004.)

Lofgren, 2006). At the level of the health sector, one potentially useful approach involves identifying and costing packages of interventions that focus on relieving country-specific bottlenecks that constrain coverage and effectiveness of health services delivery. (See Soucat and others, 2002.)

*Implications.* Macroeconomic frameworks that merely extrapolate past levels of aid, on the grounds of prudence, will not fulfill the IMF's undertaking to help countries manage the macroeconomic challenges of absorbing increased aid flows. So, provided coherent expenditure plans can be formulated, medium-term frameworks and financing scenarios should avoid a too conservative approach to balancing risks, by taking the donor community at their word that increased aid will be available beyond the period covered by specific commitments. What magnitudes such an 'optimistic' scenario would imply in individual cases will obviously require some consultation with donors on likely availability. But it is not realistic to expect the IMF to provide a signal to the donor community that a very specific amount of aid is "needed." Rather, the IMF needs to coordinate closely with others to identify specific constraints and expenditure opportunities in individual countries and to incorporate these into macroeconomic scenarios to show what can be achieved with higher aid. If the IMF is not yet in a position to undertake such detailed assessments, it should acknowledge this in its communications to donors and be careful not to signal that a scenario built around status quo estimates of aid levels is somehow the desirable or appropriate one. Again, the best response would be humility about what can be said without concrete, country-specific evidence. Moreover, the macroeconomic assessment is only one input, and probably not the most important one, in judging what aid is needed or can be usefully absorbed. For the health sector, the most critical test will be at what pace health systems can absorb higher spending in a reasonably efficient manner to achieve improved health outcomes. Clear understandings (between the recipient country, the IMF, World Bank, and other donors) are also needed on "who does what and by when" in particular cases to ensure that the necessary information is available to integrate macroeconomic and sector-specific assessments.

#### **4. Issues with short-term program design**

The previous discussion has underscored the importance of the medium-term framework underlying IMF-supported programs. But programs involve much more than this framework. They represent detailed understandings on how macroeconomic policies will be conducted in the short-term. For many programs, some aspects of the detailed design have been controversial. The discussion here focuses on two aspects that are especially important for health spending. First, does the response of programs to unanticipated changes in aid flows reflect an appropriate balancing of risks between threats to macroeconomic stability and disruptions to expenditures? Second, is conditionality on the wage bill used appropriately in programs?

##### **a. Do programs adapt appropriately to unanticipated shocks to aid?**

Many programs incorporate an asymmetric fiscal response to positive and negative shocks to aid. The technical design of the program—in particular, the way in which ceilings on domestic financing of the budget are adjusted for unanticipated deviations in foreign financing—often limits the extent to which expenditures can be smoothed in response to adverse shocks. In contrast, programs often include adjustors that limit additional spending in response to higher-

than-anticipated aid, even in countries with no pressing macroeconomic stabilization concerns (Table 2).

The rationale for this approach is discussed in the chapter on macroeconomic issues in the PRSP Sourcebook:

*“Adjustment will typically be necessary if the source of instability is a permanent... external shock... If the source of instability can be clearly identified as a temporary shock...it may be appropriate for the country to merely accommodate it. Identifying whether a shock is temporary or is likely to persist is easier said than done, however. Since uncertainty often surrounds such a judgment, it is usually wise to err on the side of caution by assuming that an adverse shock will largely persist and by basing the policy response on the appropriate adjustment.”<sup>31</sup>*

**Table 2. How Program Targets for Domestic Financing of the Budget Adjust to Unanticipated Changes in Aid Flows**

<b>Country</b>	<b>Program response to excess aid</b>	<b>Program response to aid shortfall</b>
<b>Ethiopia</b>	<i>Domestic financing reduced by 100% of excess</i>	<i>Domestic financing raised by 50% of shortfall</i>
<b>Ghana</b>	<i>Domestic financing reduced by 100% of excess</i>	<i>Raised by 50% of shortfall up to specific dollar thresholds</i>
<b>Mozambique</b>	<i>No adjustor (Domestic financing unchanged)</i>	<i>No adjustor (Domestic financing unchanged)</i>
<b>Tanzania, 1996-2000</b>	<i>Domestic financing reduced by 100% of excess</i>	<i>Domestic financing raised by 60% of excess</i>
<b>Tanzania, 2001-2004</b>	<i>No adjustor (Domestic financing unchanged)</i>	<i>Domestic financing raised by 100% of excess, but with specific dollar cap on the adjustment</i>
<b>Uganda</b>	<i>Domestic financing reduced by 100% of excess</i>	<i>Domestic financing raised by 100% of excess</i>

Source: IMF (2005b).

A detailed examination of how macroeconomic policy responded to aid fluctuations in eight African countries with IMF-supported programs (Celasun and Walliser, 2005) suggests that these design considerations can be of considerable significance. Episodes of lower-than-programmed budget aid led to lower public investment while higher-than-projected aid did not lead to higher investment, being saved instead. This implies that the asymmetric nature of the adjustment response would lead to lower public investment over the medium term if, as seems inevitable, there are significant year-to-year errors in the forecasts of budget aid.

The balancing of risks implied by such an approach does not seem justified if the costs of under- or over-shooting targets are no longer asymmetric. If there is a reasonable cushion of reserves

<sup>31</sup> Section 12.3.2. The discussion makes clear that somewhat greater policy flexibility may be appropriate for countries that enjoy more stable macroeconomic conditions.

and the costs of disrupting medium-term expenditure plans are high, the appropriate policy response would be to smooth fluctuations by saving some of the aid in high-aid years and drawing down reserves when aid shortfalls emerge. Of course, donors can help by making longer term, more predictable aid commitments. Various proposals for donor-financed buffer funds could also smooth the impact of such shocks.<sup>32</sup>

*Implications.* Once macroeconomic instability is no longer an immediate threat, program design should give more emphasis to facilitating expenditure smoothing. The use of an asymmetric response to aid shocks in program design should be restricted to cases where countries have insufficient reserves. Where reserves are comfortable, programs should allow greater flexibility for countries to smooth the impact of adverse shocks, including their fiscal consequences.

#### **b. Are the policy instruments appropriate: use of wage bill conditionality**

Some critics of the IMF argue that ceilings on the government wage bill in programs have prevented countries from using aid to expand employment in priority sectors such as health and education (see, for example, ActionAid International, 2004, WEMOS, 2004 and 2006, and Save the Children, 2005). The IMF response is that when high wage bills have been a significant source of macroeconomic imbalances they need to be addressed and that reforming wage and employment conditions in other sectors will be needed if the necessary expansion in health and education is to be sustainable. They also note that the specific wage bill ceilings that are adopted typically allow for projected new hiring in health and education.<sup>33</sup>

Some form of IMF conditionality related to the wage bill was included in about half of recent programs with low-income countries (Table 3).<sup>34</sup> In some cases the conditions were related to specific structural actions (e.g., develop a payroll roster, consolidate allowances into the salary schedule) but 17 out of the 42 countries with PRGF-supported programs during 2003-2005 included some form of ceiling on the wage bill; all were in Africa or the Central America/Caribbean region (Table 4).<sup>35</sup> Such ceilings were especially common in Africa (13 out of 24 cases during the period). They usually included some mechanism that attempted to protect donor-financed expansions of employment and pay in priority sectors, often by trying to build such projections into the baseline ceiling. For example, the ceiling in the 2004 Zambia program was set to allow for new hiring of teachers and health staff. Of course, if the ceilings are used up by unanticipated hiring in “non-priority” areas, employment in health and education could still be constrained. Only one program (Malawi) allowed for explicit adjustment to the wage ceiling for donor financing linked to the health sector, under a Sector-Wide Approach (SWAp) arrangement.

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<sup>32</sup> See, for example, Eifert and Gelb(2005).

<sup>33</sup> See, for example, the response by the Director of the IMF’s External Relations Department to the ActionAid report (IMF, 2004c).

<sup>34</sup> This paragraph draws heavily on information contained in a recent IMF Working Paper on the subject by Fedelino, Schwartz, and Verhoeven (2006).

<sup>35</sup> About half were performance criteria (PC), which if breached imply an automatic interruption of access to IMF financing unless the Executive Board grants a waiver, and the remainder were indicative benchmarks, which have no such explicit link.

**Table 3. Wage Bill Conditionality in PRGF-Supported Programs, 2003-2005**

	<b>Countries with PRGFs</b>	<b>Countries with some form of wage bill conditionality</b>	<b>Countries with quantitative conditionality</b>	<b>Of which: performance criteria*</b>
<b>Africa</b>	24	14	13	4
<b>Western Hemisphere</b>	4	4	4	4
<b>Other regions</b>	14	3	0	0
<b>Total</b>	42	21	17	8

\*Performance criteria (PC) refer to formal conditions that, if not met, result in an interruption to disbursements under the program unless a waiver is granted.

Source: Fedelino, Schwartz, and Verhoeven (2006).

**Table 4. Wage Bill Ceilings in PRGF-Supported Programs, 2003-2005**

	<b>Coverage</b>		
	<b>Central government</b>	<b>General government</b>	<b>Non-financial public sector</b>
<b>Quantitative PCs</b>	Chad, Ghana, Kenya, Malawi, Dominica, Honduras, Nicaragua		Guyana
<b>Quantitative benchmarks</b>	Burundi, Mozambique, Niger, Sierra Leone, Zambia	Benin, Burkina Faso, Mali, Senegal	
<b>Total</b>	12	4	1

Source: Fedelino, Schwartz, and Verhoeven (2006).

The *implications* of the two main rationales for the use of explicit wage bill ceilings are worth discussing:

*As an instrument of macroeconomic policy.* If rising wage bills are a principle source of potential macroeconomic instability, is it a good idea to use conditionality to address directly the problem rather than relying on broader macroeconomic targets such as the fiscal deficit and its financing? It is certainly true that some countries pursued policies that led to a surge in the wage bill that had little to do with a scaling up of delivery of social services. See, for example, the discussion of the case of Zambia in Lewis (2005) where the wage bill surged in recent years in large part because of a loss of basic controls over hiring and salaries in all sectors. In such situations, the set of policies adopted by governments would need to address the underlying problems with the wage bill in non-priority sectors, but that does not necessarily mean that such policies are suitable for quantitative macroeconomic conditionality. As a general principle, it is usually better to focus such conditionality on broader macroeconomic variables (e.g., the deficit)

because the latter are usually more closely linked to the stability objectives and because targeting a narrower variable could rule out some feasible policy combinations. There may be circumstances where, as a practical matter, a wage bill ceiling may be useful in helping a country to contain a severe problem that threatens a loss of macroeconomic control and cannot be solved using broader fiscal targets. But one would normally expect such ceilings to be relatively infrequent and imposed for only short periods. This is especially so if it is not practical to design such ceilings in a manner that protects hiring in priority areas such as the health sector where interruptions to recruitment can cause costly disruptions to longer term plans.

*As a link to broader structural reform of public sector employment and wage systems.* Wage bill ceilings have also been used as a temporary proxy, and incentive, for broader civil service reform. But the actual track record in transiting to such broader reforms has been poor, reflecting their intrinsic political difficulties. Consequently, only one of the wage ceilings introduced in programs since 2003 (that in Mozambique) has been phased out yet. This experience raises questions about the usefulness of such ceilings as indirect instruments of structural reform, especially since their prolonged maintenance is likely to generate distortions of their own.

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Also see country case studies (Kenya, Uganda, Zambia, Ghana) available at <http://www.wemos.nl/en-GB/Content.aspx?type=news&id=2483>