



Working Group on IMF-Supported Programs and Health Expenditures

Critics of the International Monetary Fund (IMF) have alleged that the macroeconomic programs it supports in low-income countries unduly constrain a desirable scaling-up of health expenditures, even when external financing is potentially available.¹ There are two main strands to this criticism:

- The overall macroeconomic, and especially fiscal, policies in IMF-supported programs are too tight, in some sense (e.g. because the IMF takes a too conservative view of what is needed for macroeconomic stability or because assessments of the potential for scaling up aid are insufficiently optimistic). This, the critics argue, constrains desirable health spending.
- Policy instruments used in some programs to maintain fiscal stability have unintended, harmful side effects on the planning and implementation of effective health spending. In particular, critics argue that public hiring moratoriums or ceilings on government wage bills have disrupted planned expansions of the health workforce.

The IMF response to these criticisms is that choices on expenditure priorities, which are always necessary, are made by governments, not the IMF and that its program conditionality does not set targets on expenditures or wage bills in particular sectors; indeed programs often contain provisions designed to protect priority sectors.²

The issues concerning the IMF role are especially pressing as countries seek how best to utilize the big inflows of foreign aid for prevention and treatment of HIV/AIDS. Total multilateral and bilateral donor commitments for HIV/AIDS have risen from \$1.2 billion in 2000 to \$3.4 billion in 2004 and are heavily concentrated in a small number of countries; over 70 percent is allocated to 25 countries, mostly in Africa and the Caribbean (Lewis, 2005).³ Flows of these magnitudes are significant in relation to the size of GDP or the level of government expenditures and raise

¹ See, for example, Burkhalter (2004), ActionAid (2004, 2005, and 2006), Ooms and Schreker (2005), Oxfam (2003), and United Nations (2006), Wemos (2004).

² See, for example, the response to the ActionAid critique by the Director of the IMF External Relations Department at www.imf.org/external/np/vc/2004/093004.htm

³ Substantial further increases are expected. As noted in Lewis (2005), bilateral assistance, notably the commitment of \$15 billion over five years under the President's Emergency Plan for HIV/AIDS Relief (PEPFAR) is projected to grow fastest, with the Global Fund to fight HIV/AIDS, Tuberculosis and Malaria (GFATM), multilateral agencies such as the World Bank, and private foundations such as the Bill and Melinda Gates Foundation also providing substantial and growing support. Nevertheless, available financial resources are still likely to fall well short of what is needed for universal access.

important issues both for macroeconomic management and the functioning of domestic health systems. In these circumstances, effective use of the available resources requires not only strengthened institutions and policies in the health sector but also an effective integration with macroeconomic and fiscal management. A large proportion of low-income countries have IMF-supported programs, so the way in which program design addresses these issues has significant implications.⁴

This note sets out a project, under the Center for Global Development's (CGD) Global Health Policy Research Network, to explore these issues. A Working Group, consisting of experts and practitioners with diverse types of expertise in the formulation and implementation of macroeconomic and health sector policies, would seek to identify common ground as the basis for practical recommendations. Section A sets out the context for the Working Group and section B discusses the issues to be investigated.

A. Working Group Objectives and Responsibilities

1. Objectives

The Group will investigate how macroeconomic policies under IMF-supported programs have been integrated with the management of health expenditures in a context of scaled-up aid, with two broad goals:

- To establish the facts about what actually happened under programs on the key issues where the IMF has been criticized
- To make practical recommendations for improvements, which could cover the IMF, donors, or recipient countries

The project is not intended to explore the merits of different types of health sector strategies, except insofar as they might influence the integration with macroeconomic policy. Although the issues discussed are relevant to a wide range of countries, the focus will be on low-income countries, notably in Sub-Saharan Africa, because it is in these countries that the issues of scaling-up aid and related constraints are most relevant.

2. Working group products and types of evidence

The main output of the Working group would be a **Policy Report** that summarizes the available evidence on the key areas of debate between the IMF and its critics, explains any needed changes to improve the integration of macroeconomic and health sector policies, and makes recommendations on practical steps to implement these changes.

Background papers would be produced for the Working Group. First, two initial notes would be prepared prior to the first meeting of the Group:

⁴ For example, 31 Sub-Saharan African countries have had, or are currently engaged in, PRGF-supported programs since the introduction of the IMF's Poverty Reduction and Growth Facility (PRGF)—the IMF's revised lending arrangement for low-income countries-- in late 1999.

- (i) a brief note summarizing available evidence on what has actually happened to total health expenditures (and other fiscal components relevant to the debate—e.g., the overall wage bill) in low-income countries with IMF-supported programs; and
- (ii) a short non-technical summary of the implications of existing empirical evidence for the key elements of the debate between the IMF and its critics. For each issue, the note would briefly outline the key arguments of the critics and the IMF, summarize available evidence, and draw policy implications where the evidence is reasonably clear or identify areas where the evidence is insufficient to draw strong conclusions.

Second, additional background papers would be prepared for subsequent meetings of the Group drawing on two types of evidence:

- (i) cross-country information on what programs actually targeted (e.g. in terms of inflation, fiscal deficits, levels of public expenditures and aid) and what types of conditions they incorporated (e.g. when were ceilings on wages bills used).
- (ii) investigation of a small number of specific country cases. The aim would not be to produce detailed country studies but to examine in greater depth how aspects of program design interacted with health sector planning in practice. An important output of such investigations would be to clarify further what actually happened, including any unintended consequences for the health sector, on some issues of particular controversy between the IMF and its critics (e.g. what exactly was the role of wage bill ceilings in practice).

3. Responsibilities and timing

Working Group members will be expected to participate in meetings and to provide feedback on written products, including the final report. The Working Group is likely to meet about three times, and it will be possible to participate by telephone or by videoconference. Between meetings there will be documents to read and comment on, and discussions by email, web-board, telephone, or other forms of communication. The first meeting of the Working Group is expected to take place in September 2006 and the Policy Report is expected to be finalized by around April-May 2007.

Working Group members will be asked to help to communicate the objectives and progress of the Working Group as opportunities arise in professional meetings and other venues, both during and after the Working Group's period of activity.

B. Key Issues To Be Addressed by the Working Group

The nature of health spending (e.g., high recurrent costs, the importance of effective integration of different services, and the damage caused by disruptions to treatments of diseases such as HIV/AIDS or TB) makes its effectiveness especially vulnerable to two types of macroeconomic management problems faced by countries that rely significantly on foreign aid. First, medium-term planning of expenditures is critical to effectiveness, but donors typically do not make

long-run commitments on aid levels so that countries have reasonably firm projections of available aid only for short periods. Second, even within these shorter horizons, aid flows are generally much more volatile than other sources of funding (see Bulir and Hamann, 2003 and 2005). There is evidence that this volatility contributes to instability in public spending on health.⁵ Changes in donor behavior are important to improve the predictability of aid flows. But an equally important issue is whether the IMF approach to designing programs has adapted sufficiently to an environment in which, at least for a substantial number of low-income countries, the key macroeconomic policy challenge is no longer one of charting a reduction of unsustainable macroeconomic imbalances but of managing effectively a substantial increase in aid.

Of course, even with additional aid available, budgetary choices still involve difficult tradeoffs. So the fact that painful choices are being made—or that critics disagree with the *de facto* preferences revealed by a government when it makes such choices—does not in itself imply that there is anything wrong with the IMF’s approach.

With this background, the following issues could be explored by the Working Group.

1. Is the IMF unduly narrowing the policy space?

A fundamental question is whether IMF contributions to the design and implementation of macroeconomic programs go beyond the available evidence and thereby unduly narrow the “policy space” within which solutions could be found consistent with a country’s longer term objectives. This is a critical issue not only because of the IMF role in advising countries on the design of their macroeconomic policies but also because of its potential “gatekeeper” role in signaling to donors the suitability of these policies as a basis for stepped-up aid. There are three aspects of the IMF role in determining the policy space that are especially relevant to the debate about whether macroeconomic programs, notably the targeted fiscal paths, are “too tight”:

- Do IMF-supported programs incorporate targets for inflation and macroeconomic imbalances that assume a judgment on what constitutes macroeconomic instability that goes beyond the available empirical evidence? Essentially, this is an empirical debate over acceptable risk thresholds and the costs of over- or under-shooting those thresholds.⁶ To examine the issue, evidence could be collected on what programs

⁵ For example, a background paper for the November 2005 High-Level Forum on the Health MDGs found a positive and statistically significant relationship between aid volatility and volatility in public health spending. (See High-Level Forum, 2005a, chapter 4.)

⁶ The design of macroeconomic policies depends not just on judgments about where the threshold of stability lies, but also on an assessment of the costs of over- or under-shooting that threshold. If you know the costs of exceeding some target by even a small amount are large and the costs of undershooting (in terms of opportunities foregone) are relatively small, then you are justified in taking a cautious approach to preserving “stability.” The IMF typically operates as if this loss function is very asymmetric (i.e., like a cliff you risk falling off if you go too far, rather than a more gentle slope you can climb back up.) But this is an empirical question to which the answer is not obvious—and which depends on country circumstances including the credibility of policy-makers. It is also worth noting that the costs of undershooting could fall primarily on human development outcomes, for which the IMF is not directly responsible, while the costs of overshooting are primarily macroeconomic and do fall within IMF responsibility. So an appropriate balancing of risks necessarily involves some broader coordination and consultation, which was the purpose of the Poverty Reduction Strategy (PRS) framework.

have actually targeted and how this compares with the broader empirical evidence (e.g. on the links between inflation and growth and on desirable paths for the fiscal deficit).

- How the IMF makes forward-looking judgments about debt sustainability, absorptive capacity, and the risks of aid-induced exchange rate appreciation when there is inevitably considerable uncertainty about aid flows and how the economy will react them. This is also largely a debate about how to balance risks, but can be informed by empirical investigations of how economies would respond given a range of possible specifications for key economic relationships. (See, for example, Adam, 2005 and Adam and Bevan, 2004.)
- How are assessments of expenditure choices and the likely effectiveness of new health spending initiatives incorporated when setting the macroeconomic framework? The IMF rightly points out that advising on these expenditure allocation decisions is not its business and that it must rely on the comparative advantage of others, including the World Bank. But an understanding of what bottlenecks can, and cannot, be eased by additional spending and aid are critical to macro-level policy decisions (e.g., deciding how much “fiscal space” to allow will be strongly influenced by assessments of how effective any new spending will be).⁷ So how well these considerations are integrated in practice is important. One possible approach to investigate this issue would be to identify a small number of country cases where there have been tensions between judgments on the macroeconomic framework and assessments of potential additional expenditure opportunities and examine how these tensions were resolved. Is there evidence of “lost opportunities” in terms of productive expenditures foregone? In an environment of inevitable great uncertainty about the effectiveness of various potential expenditure options, how were judgments on these tradeoffs made in practice and what were the underlying incentives that appeared to drive the process? The intention would not be to undertake detailed country case studies, but to investigate, with the aid of structured interviews, how key decision-makers (e.g., finance and health ministry officials, IMF mission chiefs, and World Bank managers) viewed the decision-making process.

2. Does the design of IMF-supported programs take an overly conservative approach to managing risks? There is some evidence to suggest that the technical design of IMF programs in many countries—notably how programs respond to shortfalls or excesses of budget aid—has pushed fiscal policies to an asymmetric response in the short term, “saving” any higher-than-projected budget aid while cutting back on domestically financed investment expenditure when there is an aid shortfall.⁸ Even if such a design were justified when the countries involved faced

⁷ Different types of expenditures (e.g. for health services or physical infrastructure) are likely to have different timescales for payoffs, but this does not alter the basic point that key macroeconomic choices will be heavily influenced by the expected effectiveness of such expenditures).

⁸ For example, Celasun and Walliser (2005) examine the response to aid shocks in selected African countries with programs and show that episodes of higher-than-programmed budget aid are associated with lower-than-targeted domestic financing, while shortfalls in budget aid lead to lower domestically financed investment. This implies that, even if program forecasts of budget aid are not biased, the asymmetric nature of the adjustment response built into the design of many programs can lead to lower-than-expected public investment if, as seems inevitable, there

immediate macroeconomic instability risks, it may not be appropriate for programs designed to manage a scaling-up of aid. Therefore, one important issue to investigate would be whether recent programs have modified this approach and, if not, how they could do so.

3. Is the use of wage bill ceilings in programs appropriate? The use in programs of some form of conditionality on the wage bill ceilings has grown substantially in recent years, especially in Africa.⁹ Indeed, many of the most specific criticisms of programs in connection with the health sector arise from the use of such ceilings. Their appropriateness is a complex issue because *all* macroeconomic policy instruments tend to cause short-term distortions in the sense that they fall on some components of expenditures more than others and thereby may move the composition of expenditures away from some longer-term, desirable equilibrium. But some types of conditionality may be especially disruptive to the health sector, given its particular characteristics. A first step would be to establish when and in what circumstances such policies have been utilized in IMF-supported programs. The specifics of what happened in some country cases where the use of such conditionality has generated particular controversy could then be examined in greater detail to draw lessons.

4. What can be done to improve the predictability of aid flows in IMF-supported programs? Clearly, changes in donor behavior will be critical, including lengthening the timeframe and specificity of their commitments, but there may also be steps the IMF could take. One approach could be to increase transparency by the IMF about how it weighs different types of indications of donor support (e.g., how and why particular commitments are discounted), along with more explicit *ex-post* feedback on donor performance, which could improve incentives for greater donor predictability. In other words, the IMF could help to promote a more explicit “commitment technology,” perhaps in conjunction with a mechanism for more centralized forecasts of aid flows to particular regions, against which recipient countries could calibrate their own projections.¹⁰

5. Can the process by which IMF-supported programs are negotiated and modified be improved? There are two potential criticisms of current arrangements, both of which imply that the IMF could do more to change the way it operates in low-income countries and to open up its intellectual capital to broader debate:

- **First, some argue that the IMF has not sufficiently changed its way of doing business** in response to the introduction of the Poverty Reduction Strategy approach (see, for example, IEO, 2004). That approach implies a different role for IMF inputs based on: a country-driven strategy that sets priorities within a long-term timeframe; emphasizing contributions to informing a broader policy debate rather than traditional program negotiations; and operating within a partnership framework that recognizes more

are significant year-to-year errors in the forecasts of budget aid. The discussion in IMF (2005b; see Box 3) and in Fedelino and Zakharova (2006) confirms that programs are often designed to produce such an asymmetric response.

⁹ Forty percent of all PRGF-supported programs approved during 2003-2005 included some form of ceiling on the wage bill; all such cases were in Africa or the Central America/Caribbean region (see Fedelino, Schwartz, and Verhoeven, 2006).

¹⁰ These steps could build upon existing institutional frameworks such as the Special Program for Africa (SPA). An alternative approach would be to develop financing and insurance mechanisms to cushion aid shocks. For example, see Dervis and Birdsall (2006).

explicitly that IMF contributions are only one part of a broader picture. One of the underlying rationales for such approaches is that a more open process will help to identify a broader set of potential policy options when there is considerable country-specific uncertainty about the most effective options. This is likely to be especially true for the issues around how best to manage a scaling up of aid, including for the health sector, especially since judgments on the potential gains from alternative expenditure paths are not the IMF's comparative advantage and will inevitably be highly uncertain. But adapting the way in which programs are formulated and negotiated is a complex issue that will depend considerably on individual country circumstances. The Working Group could seek to establish some broad practical recommendations on “do’s and don’ts.”

- **Second, greater transparency about the rationale underlying programs could help to improve policy design and hence outcomes.** For example, greater transparency about how (and why) the IMF treats donor aid commitments in its program projections could help improve incentives for greater aid predictability (discussed above). Also, IMF program documents typically do not spell out sufficiently the underlying rationale for a particular program design, which makes it difficult for outsiders to comment on key program design assumptions and complicates mid-course corrections.¹¹ Even if the IMF shows considerable flexibility in modifying targets and conditions at mid-program reviews, it is often unclear how much such modifications reflect either mistaken *ex ante* assumptions about key economic relationships or policy slippages. The IMF could help dispel misperceptions about its role by being more transparent about the reasoning underlying the fiscal content of the programs it supports.

¹¹ See, for example, the evaluation of fiscal adjustment in IMF-supported programs conducted by the Independent Evaluation Office (IEO) of the IMF (IEO, 2003).

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