Draft Paper for Discussion, June 2007

‘Aid effectiveness’ in middle income countries

Lessons from Brazil?

Key points:

- Lending from multilateral development banks to MICs is becoming more flexible in response to declining borrowing and low loan execution rates.
- ‘Aid effectiveness’ principles and SWAps are part of the new lending framework to MICs, although the motivations are different from those found in LICs.
- Some aspects of the emerging aid relationship in MICs are relevant to LICs, particularly the blend of fiscal management and sector policy objectives linked to a results orientation.
- But the balance of interests found where aid dependency is low is an important aspect of effective aid which might not be replicable in aid-dependent countries.

Brazil: there are 3 ongoing SWAps and plans for further expansion both at federal and sub-national levels.*

Over the last few years, there has been renewed consideration of the position of middle-income countries (MICs) in the aid debate. This is not only because of the proportion of the poor that live in them (nearly 40% of the world’s poor living on less than US$ 2 per day, according to the World Bank’s definition), or the scale of aid that goes to them (about 36% of net concessional loans and grants), but also because of their emerging role as aid providers and their contribution to global public goods, including clean energy and environment protection, international financial stability and trade integration.

MICs make up a highly diverse group. They include a wide range of income levels and aid dependency ratios, developing and transitional economies with and without access to capital markets, small islands as well as the world’s largest and most populated countries (Table 1).

Table 1. MICs – a highly diverse group

Indicator	Top of range	Bottom of range
Population (million)	1,296 (China)	0.02 (Palau)
Surface (squared km)	17,098,240 (Russian Federation)	180 (Marshall Islands)
GNI per capita (US$, Atlas method)	9,480 (Antigua & Barbuda)	930 (Angola)
Mortality rate, under-five (per 1,000)	4 (Czech Republic)	260 (Angola)
Literacy rate, adult total (% of people ages 15 and above)	99.8 (Cuba)	52.3 (Morocco)
Aid dependency ratio (% of GNI)	-3.2 (St. Lucia)	37.9 (Marshall Islands)
Lending interest rate (%)	5.1 (Chile)	82.3 (Angola)

Source: World Development Indicators 2006

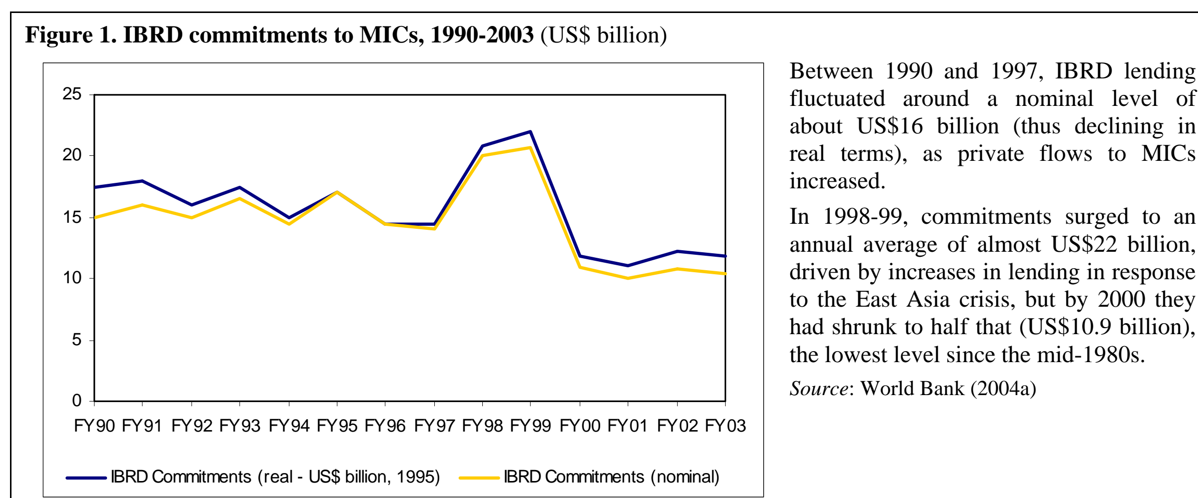
MICs are different from low-income countries (LICs) in several ways which make the nature of the relationship between donor/lending agency and recipient quite distinct. They are generally less aid dependent (despite large variations) and have more access to capital markets. Bilateral agencies are present on a smaller scale and, unlike in LICs, aid fragmentation and lack of coordination between

agencies are not usually significant problems. Furthermore, most MIC governments do not suffer from critical shortages of human and financial resources and management capacity. Nevertheless, the aid effectiveness principles (as laid out in the 2005 Paris Declaration: country ownership, alignment with country systems, harmonisation, management for results and mutual accountability[1]), or at least some of them, have relevance to the management of aid relations in these countries. This paper explains why this is the case. It draws on the Brazilian experience with Sector Wide Approaches (SWAps) to illustrate differences in the aid relationship in MICs and discusses implications for the understanding of aid effectiveness.

Aid to MICs: declining volumes, increasing flexibility and the use of SWAps

The last decade witnessed a reduction in the volume of lending to MICs. IBRD lending to MICs[2] declined by more than one quarter, between the early 1990s and the early 2000s (Figure 1).

Figure 1. IBRD commitments to MICs, 1990-2003 (US$ billion)



Between 1990 and 1997, IBRD lending fluctuated around a nominal level of about US$16 billion (thus declining in real terms), as private flows to MICs increased.

In 1998-99, commitments surged to an annual average of almost US$22 billion, driven by increases in lending in response to the East Asia crisis, but by 2000 they had shrunk to half that (US$10.9 billion), the lowest level since the mid-1980s.

Source: World Bank (2004a)

The World Bank Task Force on MICs reported (in 2001 and 2004) that the Bank had become a relatively unattractive partner for many countries. This was due to lack of alignment with country development priorities (more oriented to growth and infrastructure investment than to poverty reduction or achieving the Millennium Development Goals), excessive loan conditionality, complex implementation procedures, rigid commitment to Country Assistance Strategies and inability to respond quickly to new opportunities. In response to the decline in the volume of lending and low execution rates of approved loans, an Action Plan was devised which proposed more flexible and country-tailored financing mechanisms to make World Bank loans more effective and responsive to the changing needs of borrowers (Box 1). Other multilateral development banks (MDBs) followed suit. In 2004, the Inter-American Development Bank (IADB) approved an *Approach for Further Development of Lending Instruments and Operational Policies* which set the direction towards more flexible lending instruments to support government-led programmes and better harmonise policies with those of other MDBs (IADB 2005).

SWAps are part of the new lending framework in MICs and emphasise flexibility, adaptability to country circumstances, and the building of partnerships and joint approaches. Despite having originated in very different contexts (Box 2), SWAps have been found attractive in countries where aid dependency is low, there are few donor agencies (and hence little need for harmonisation) and

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[1] The Paris Declaration on Aid Effectiveness and its guiding principles can be found at http://www.oecd.org.

[2] World Bank lending to country governments is provided either by the International Bank for Reconstruction and Development (IBRD) or the International Development Association (IDA), depending on several eligibility criteria (such as income level and access to capital markets). IBRD provides loans at competitive market rates while IDA lending is concessional (with almost no interest over longer periods of time). Countries are eligible for IDA lending on the basis of relative poverty and lack of creditworthiness. Most MICs are eligible for non-concessional IBRD funding or a blend of IBRD with IDA financing.

where government structures and capacity are relatively strong. However, whereas in LICs SWAps have largely concentrated on improving donor coordination and building government capacity, in MICs they have focused on aligning MDBs' support to recipient governments' programmes and systems, and linking macroeconomic management with sectoral support.

Box 1. Seven elements of the new World Bank lending approach in MICs

Distinctive elements of the new World Bank lending approach to MICs include:

1. More aligned assistance programmes with recipient countries' own development vision (e.g. using the CAS framework more flexibly and tailoring it to country context),
2. Streamlined policy conditionality, choosing as conditions or triggers a few actions deemed critical for achieving the results and which are part of the recipient government's agenda rather than being project specific,
3. Use of, whenever possible, recipient country's systems (such as safeguard, procurement and financial management rules and procedures), including the pooling of funding with government,
4. Blending of financial with analytical and advisory support, providing the latter even in countries with little or no borrowing from IBRD,
5. Use of results-based disbursement with support to results-oriented management in government systems,
6. Expansion of the range of IBRD financial services (e.g. risk management products),
7. Enhanced partnerships with bilateral donors and other multilateral agencies, exploring comparative advantages of various actors, through joint operations and the use of mechanisms such as Sector Wide Approaches.

Source: World Bank (2004b)

Country evidence: experience with the use of SWAps in Brazil

World Bank-funded SWAps can be found in several MICs, including Brazil, Mexico and Poland. Brazil has three ongoing World Bank-funded operations using a SWAp framework, two managed at federal and one at state level. Since 2002, *Family Health Extension* has received a World Bank loan (US$275 million for a 7 year period) to support the extension to large urban centres of, and pilot improvements to, the government's family health programme. This programme aims to convert a passive provider and facility-based health care system into an active provider with an outreach model in which health teams deliver basic services. Created in 2003, *Bolsa Família* is amongst the world's largest cash transfer programmes (transferring funds to poor families, with a total budget of US$8.5 billion and benefiting 44 million people) and benefiting from both IADB (US$1 billion for the period 2004-07) and World Bank (US$572 million for the period 2004-06) loans. The *Ceará Multi-Sector Development Programme* is a state-level multi-sectoral programme which has benefited from a World Bank loan since 2005 (US$240 million until 2007); it aims to assist the Government of the State of Ceará (in northeast Brazil) to deliver better social services for the poor while preserving fiscal sustainability.

Box 2. The concept of Sector Wide Approach: flexible or ill-defined?

SWAps originated in the mid-1990s in low income and aid dependent countries. They developed first in the social sectors in response to problems of fragmentation and weak coordination of proliferating donor-funded development interventions and of poor government ownership. These problems compromised the effectiveness and cost-efficiency of aid and public spending.

SWAps represent the process of developing 1) a single, comprehensive and coherent sector policy framework, 2) bringing together all or most significant sources of funding, 3) under government leadership, 4) using common planning and financial management rules and procedures, which are 5) progressively aligned with government financial management systems. These five characteristics should be seen as indicating an intended direction of change rather than a blueprint.

One of the often praised virtues of the SWAp concept is its dynamic and flexible nature which has allowed the approach to be applied creatively beyond the social sectors and beyond low-income and aid-dependent countries. But its flexible character should not be overstated – otherwise the risk is to end up with an ill-defined concept of little use to an objective understanding of the aid relationship.

How Brazil's circumstances have shaped the SWAps

Brazil provides an atypical context for a SWAp, at least in its original shape. Aid dependency is the lowest in Latin America (0.05% of GNI). There are strict limitations to expansion of borrowing and public spending, due to the government's strict debt management and fiscal policy (with a primary budgetary surplus target set at 4.25% of GDP) initiated by President Cardoso's Government and

sustained under President Lula. Brazil also has an unusually rigid budget structure with an extraordinarily high level of legally earmarked public revenue (estimates indicate that 81% of federal budget revenue is tied to specific uses). Combined with the fiscal discipline policy, this significantly constrains resource availability for public investment, as well as counterpart financing of loans. In its turn, this limited fiscal space implies that, in practice, resources legally committed in the budget are retained by the Treasury to generate fiscal surpluses and to service domestic and external debt. The austere fiscal policy has had harmful effects on investment, especially at State level where the burden of debt has been particularly heavy.

Facing such a tight macro-fiscal environment, a financing mechanism was necessary which combined both development/investment objectives and macroeconomic management objectives (of fiscal discipline and debt management). Greater flexibility and simplicity of loan conditions and management procedures were also a much needed response to reverse low execution rates of traditional MDB loans. The relative strength of government's financial management systems demanded greater alignment of MDBs with domestic rules and procedures.

The concept of SWAp was found appealing because of its 'flexibility'. This gives room-for-manoeuvre in which the parties can define the mechanisms which suit their interests (Box 3). At the same time, SWAps are closely associated with the principles driving contemporary aid relationships, particularly support for government leadership, alignment with its budgeted priorities and systems and management for results.

Box 3. Stakeholder motivations for SWAps in Brazil

Government of Brazil	• Greater control and more flexibility in fiscal management to overcome fiscal constraints (high level of earmarking, debt and fiscal discipline policy), • Flexibility in accessing loans and simpler management mechanisms, • Support for consolidation of ongoing government priorities on a long-term basis, • Legitimacy given to programmes (with high visibility and which are sometimes politically controversial) by having the endorsement of external partners, • Focus on an entire sector/programme rather than isolated activities, • Access to MDBs' technical expertise helps to improve design and implementation of government policies, • Results-based framework creates incentives for core agencies to press line ministries for better performance.
MDBs	• Raise level of lending, • Better disbursement and execution rates – which the greater flexibility and simplicity of conditions and procedures, • Longer-term lending framework in a strategic country, • Entry point into policy making and implementation (e.g. through support to results-based management), • Provision of intellectual capital (technical advisory inputs) – with the focus on programme performance and systems improvements providing legitimacy to the loan, • Testing ground for new aid approaches to apply elsewhere (particularly in LICs).

Source: Batley et al (2007).

<u>*Features of SWAps in Brazil*</u>

The three Brazilian SWAps are distinct from each other. Each programme has its particular sectoral dimension and scope of intervention, as well as specific implementation channels and devices. But despite the differences, the mechanisms used for supporting these programmes share a number of characteristics which together make up the Brazilian version of SWAp. Six common features stand out:

- *Support to the existing government policy framework*: loans are provided to support and add value to an existing government-initiated and led policy framework, rather than initiating new programmes.
- *Centrality of government's macro-fiscal policy objectives*: the loans are 'macro responsible' in that they do not result in an expansion of public expenditure. Instead, loans match (to an agreed extent)

government's own spending in government programmes and accrue to the Treasury for fiscal management, therefore not upsetting the government's fiscal discipline objective.

- *Pooled funding*: intermingling of MDB and government funds through the use of budget support.
- *Use of country systems*: loans are disbursed and managed using, to a large extent, government financial management systems.
- *Emphasis on technical/advisory support*: the development of management capacities is a central element of the programmes, although accounting for a small proportion of the funding. Access to MDBs' intellectual capital is considered to be a major attraction of their loans.
- *Results-based management*: a concern with management for results is present in all three programmes. This is built-in both through a capacity-building loan component to support monitoring and evaluation systems, and through the incentives generated by the budget support component of the loan. The latter reimburses the Treasury for allocations made to selected sectors/programmes on the basis of agreed sector/programme performance criteria.

These are not 'normal' SWAps, which raises the question of whether they should be referred to as SWAps at all. Differently from experiences elsewhere, Brazilian SWAps are not about promoting donor coordination and government capacity, which have been so central to the development of SWAps in aid dependent LICs. Also, whereas in LICs SWAps have normally created pools of funds for line ministries, thereby reinforcing their position vis-à-vis planning and finance ministries, SWAps in Brazil benefit primarily the management of fiscal policy.

What has been the impact?

Brazilian SWAps have had positive impact at least at five levels.

Fiscal management: SWAps have contributed to widening the government's fiscal management space by helping to circumvent budget rigidities (high level of earmarking and debt servicing obligations) and to meet the primary surplus objective while freeing up resources for key priority areas.

Lending performance: SWAps offer advantages over traditional lending modalities because (i) the conditionality framework is based on government's own policy objectives and targets, (ii) the programmes supported represent the government's top priority interventions that are already being implemented, (iii) there is no requirement for government counterpart funding (which has often been a major obstacle to loan disbursement, due to government's liquidity constraints), and (iv) the implementation mechanisms are simpler and better adjusted to Brazil's own financial management systems.

Government fiduciary systems: the pooling of resources and use of country management systems constitutes an important change in the nature of the fiduciary relationship with the MDBs. This reflects increased confidence about the proper use of funds through domestic systems and has had a positive impact on government's fiduciary system.

Results orientation: The emphasis on performance incentives (directly linked to government's own policy objectives) is helping to promote a results-based management culture. It is also encouraging dialogue and coordination between central and line ministries. Since loan disbursements to the Treasury are dependent on programme/sector performance, the Treasury and line ministries have an incentive to work together to ensure good performance and hence access to the loan.

'Aid effectiveness': Brazilian SWAps are broadly consistent with the Paris principles on aid effectiveness in that: (i) they support and build on government-initiated and led policies, (ii) they make use of (are aligned with) domestic financial management systems and procedures, and (iii) they promote the development of results-based management. The question which remains, however, is to what extent these ways of providing aid actually deliver better policy results?

Drawing lessons and further enquiry

Are there lessons to be drawn for other MICs or LICs?

At one level, the SWAp as practised in Brazil is a solution to a specific set of governmental problems – in particular, fiscal and budgetary constraints and the need for support for high priority poverty-focused programmes that might otherwise have been threatened. But that is a lesson in itself. This approach demonstrates the case for an aid modality which is flexible enough to respond to particular needs.

For their part, the multi-lateral development banks have apparently found an instrument that is sufficiently responsive to make their lending attractive to middle income countries that are not dependent on aid or extremely short of resources and capacity.

The fact that both sides had something to gain made for a balance of power in the aid relationship. This has allowed a form of aid delivery to be devised which suited the country's own view of its interests. In the Brazilian case these interests happen to be strongly dominated by the government's fiscal management objectives. However, the study offers the more general lesson that aid *can* be delivered in a way that genuinely respects national ownership where the right conditions exist.

There are also some substantive lessons for other countries in the Brazilian version of a SWAp. The blending of fiscal management and sectoral investment objectives is worth highlighting. The financing mechanism ensures that borrowing is fiscally responsible – because it does not expand public expenditure and therefore does not upset the fiscal surplus target. It generates incentives for central and line ministries to work collaboratively – because lending is released to the Treasury on the basis of sectoral performance and the Treasury can challenge line ministries against agreed results. The mechanism is of particular relevance to contexts where forms of budgetary support and associated performance assessment frameworks are in use (as increasingly in LICs).

There is however an important caveat. The Brazilian case assumes some underlying pre-conditions which are more likely to be found in countries where (i) government has sufficient resources to fulfil budgetary commitments and has resource liquidity; (ii) government ownership and capacity are strong and external funding is not significant; and (iii) international agencies have confidence in domestic financial management systems.

Coming back to the aid effectiveness debate, cases of this sort present the possibility of investigating what happens when the principles of the Paris Declaration are already in place rather than having to be built *through* aid. In countries where millions remain in poverty but where there is already ownership, alignment, mutual accountability and a wish to move towards management by results, *is aid more effective*?

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* **Photo credit**: Google Images – World Bank's former President Paul Wolfowitz visiting *Bolsa Família* beneficiaries in Vila Varjão, Brasília.