Essay on Development Policy

Implications of Providing Budget Support for Public Expenditure –
A Case Study from Uganda

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**Abbreviations**

<table>
<thead>
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<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>DFID</td>
<td>British Department for International Development</td>
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<td>HIPC</td>
<td>Heavily Indebted Poor Countries Initiative</td>
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<td>MDGs</td>
<td>Millennium Development Goals</td>
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<td>ODA</td>
<td>Official Development Assistance</td>
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<td>UPE</td>
<td>Universal Primary Education</td>
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<td>USE</td>
<td>Universal Secondary Education</td>
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Introduction

The effectiveness of official development assistance is heavily debated in aid recipient as well as in aid providing countries. The popularity of Dambisa Moyo’s book “Dead Aid” is a signal for the growing sense that development aid is not achieving what it is promising despite substantial efforts to increase aid effectiveness and show development results.

The last decade of development assistance has been shaped by a commitment to the Millennium Development Goals (MDGs), a debate around aid effectiveness that culminated in the Paris Declaration on Aid Effectiveness and the Accra Agenda for Action, and finally the rise of programme aid – particularly budget support\(^1\) - as the major aid modalities. A shift towards budget support has been justified by the following arguments: (1) Support of partner governments’ ownership through less intrusive conditionality and more freedom in the implementation of their poverty reduction strategies (2) more predictable and less distortive assistance for the budget process (3) promotion of the use of country systems and strengthening of partner countries capacity, and (4) high potential to scale up aid in good performing countries.

This essay provides an analysis of the impact of budget support on partner countries’ composition of public expenditure and the recipient countries’ reaction to receiving substantial amounts of budget support.

The first section will introduce a theoretical framework looking at governments’ choices with regard to the use of budget support. In the second section an economic analysis will demonstrate the choices taken by the Government of Uganda. The conclusions will be focusing on recommendations for recipient and donor governments.

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\(^1\) OECD-DAC (2008): Direct budget support is defined as a method of financing a partner country’s budget through a transfer of resources from a donor to the partner government’s national treasury. The funds thus transferred are managed in accordance with the recipient’s budgetary procedures. Funds transferred to the national treasury for financing programmes or projects managed according to different budgetary procedures from those of the partner country, with the intention or earmarking the resources for specific uses, are therefore excluded from this definition of budget support. This definition also includes sector budget support provided and general budget support.
This essay will leave out other areas where budget support might have intended or unintended impacts, like the balance of payments, reserves of foreign currencies or the exchange rate. Although budget support is used to mitigate effects of internal and external shocks, this will not be covered by this essay.

Uganda has been chosen as a case study because of its still highly aid-dependent economy and its reputation as a good performer. It has received budget support for over 10 years and has achieved an impressive reduction in poverty from 39% in 2002/03 to 31% in 2005/06. The macroeconomic and growth track records since the mid-1990s are impressive and development partners are committed to continuous support.

Uganda has proven to be highly innovative in its development policies resulting in high aid allocation and the piloting of new aid modalities. The on-budget aid flows received since 1998 amount to around USD 8 billion with a substantial, additional amount not captured in the national financial accounting system. It became the first country to receive debt relief under HIPC and is given large amounts of only notionally or completely unearmarked budget support since 1998. The contribution of budget support grants to the national budget has been USD 280m in the fiscal year 2008/09 equaling 9% of total public expenditure.
The use of and the reaction to budget support

The provision of budget support is highly debated among development specialists. On the one hand, it is the aid modality that allows for the highest ownership of recipient governments and alignment of development partners, on the other hand the fungibility aspect, budget support cannot be traced and can therefore be used for any type of expenditure, makes it highly vulnerable to political and fiduciary risks. Recipient governments have to plan their budgets with the knowledge on donor behavior in mind in order not to get trapped in unrealistic budgetary planning. By contrast, donor countries provide budget support under the assumption that recipient governments spend their money on poverty reduction related areas, such as health, education or infrastructure. This essay will look at recipient governments’ reaction to budget support in order to develop recommendations for recipient and donor countries.

In order to analyze governments’ reaction, a crucial distinction public expenditure has to be introduced. All government spending can roughly be divided into three categories: (1) Recurrent expenditure, (2) development spending or investments, and (3) interests.

1. Recurrent expenditure on goods and services is expenditure, which does not result in the creation or acquisition of fixed assets. It consists mainly of expenditure on wages, salaries and supplements, purchases of goods and services and consumption of fixed capital (depreciation). In Uganda’s case the recurrent expenditure also include costs to maintain the assets (e.g. maintaining roads, buildings, etc).

2. Development expenditure by contrast results in the creation of fixed assets. It is not consumed but is an investment for future production. Contrary to the current academic thinking, Government of Uganda is classifying expenditures such as teacher salaries as recurrent spending although, education is an asset that will be used for future production and creates increased returns. For the sake of this analysis, the essay will stay as closely aligned to the Government of Uganda’s classification.

3. Interests are the fee paid by governments for borrowing money from either domestic or external lenders.

This distinction does have implications on what a recipient government can finance out of what source and hence its reaction to budget support. The next section introduces a simple
model that provides an overview of a developing country’s fiscal framework and explains the constraints it faces.

**Governments budget constraint and the fiscal rule**

The figure below illustrates a developing country’s budget constraint. It needs to balance expenditures and revenues in the budget in order to maintain macroeconomic stability and fiscal sustainability.

**Figure 1: Developing country budget constraint**

![Budget Constraint Diagram](image)

Source: Own illustration.

Governments have been using fiscal rules since the 18th century. One of the most important rules, the “Golden Rule”, demands that over the economic cycle, the Government will borrow only to invest and not to fund current spending. Strictly speaking recurrent costs need to be covered by recurrent revenues, creating a so-called positive recurrent balance, whereas investments can also be financed through debt as the return on investment will bring the budget back into balance in the long run.

If this rule is applied in developing countries, it is often also influenced by cash management. As development countries mostly don’t have enough reserves, a shortfall in revenue can quickly result in the need for borrowing. Therefore the rule is often not interpreted in a way to look at an entire economic cycle but is tied to the fiscal year.
In order to keep a positive recurrent balance, domestic revenues have to amount to current expenditures plus interests in a country that has no other recurrent sources of income. This so-called Golden Fiscal Rule can be expressed in the following form:

**Figure 2: The Golden Fiscal Rule**

<table>
<thead>
<tr>
<th>Recurrent expenditures</th>
<th>Recurrent revenues</th>
</tr>
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<tbody>
<tr>
<td>Administration</td>
<td>Domestic revenue</td>
</tr>
<tr>
<td>Social expenditures</td>
<td></td>
</tr>
<tr>
<td>Defence</td>
<td></td>
</tr>
<tr>
<td>Other recurrent</td>
<td></td>
</tr>
<tr>
<td>Interests</td>
<td></td>
</tr>
</tbody>
</table>

Source: Own illustration.

The Golden Fiscal Rule originates from countries with no access to foreign grants in order to finance their budgets. In a developing country with foreign assistance such a fiscal rule may therefore assume different peculiarities.

The idea of fiscal rules raises two important questions for development assistance:

1. Do governments in developing country apply any kind of fiscal rule?²
2. If a rule is applied, do governments treat budget support grants³ like recurrent revenue, one-time resources or do they treat them as a mixed resource?

If governments strictly apply a fiscal rule similar to the Golden Fiscal Rule, it has consequences for development assistance. All budget support should automatically be used for capital investments or a reduction in debt levels. Only if the assistance given would be treated like recurrent domestic revenue, it could be spent on recurrent costs in the budget. Subsequently, the question has to be addressed whether budget support is predictable and sustainable enough to be treated like domestic revenue.

² These questions are only relevant for countries that: (1) do receive budget support and (2) are not in crisis which would require them to focus on cash management only.

³ This essay will focus exclusively on grants although developing countries could anticipate future debt relief and treat concessional loans like grants.
The treatment of budget support grants by recipient governments

From a financial perspective government can freely dispose of budget support funds. They are adding net worth to the country without creating an obligation for the future. They can therefore be treated similar to recurrent revenues. However, in reality, budget support grants cannot be modeled like tax revenues and remain substantially more volatile as demonstrated by Bulir & Hamann (2003). Furthermore, budget support is also a highly politically exposed instrument that is often used for political signaling by development partners, like cuts, because of high-level corruption or breach of human rights obligation.

The following graph illustrates the volatility of budget support grants for Uganda. It shows how the country received increasing levels of budget support grants up to 2003/04 before its share of total revenues started declining. The difference between the highest and the lowest share over this ten year period is more than 15% of total public expenditure. In light of these facts “it is unlikely, therefore, that any government would accept excessive exposure to dependence on higher risk income, such as budget support. Indeed, it would not be responsible for a supplier of such external transfers to argue that governments should put trust in predictability” (Penrose, 2008, p.20).

Figure 3: Budget support volatility in Uganda
Considering the arguments, it seems more likely that budget support is treated like loans. However, a deeper analysis of the case of Uganda in the next section will provide clarification.

If this argument stands after deeper analysis, it contradicts the general belief that programme grant aid is fully fungible and therefore can be used to finance all items in the budget\(^4\). Indeed, there is a short to medium term fungibility which allows governments to pay salaries with programme aid for a certain amount of time. This is particularly true if the level of current expenditures has been below the level of domestic revenue which allows a substantial expansion of current expenditures before the fiscal rule would kick in. But to mitigate the impact of a shortfall in donor grants on the public service, the fiscal rule described above prevents outright fungibility in the long run.

Under the assumption that a fiscal rule is applied and budget support can indeed only finance capital goods, one of the major constraints in financing development is domestic revenue collection. While development assistance could for example finance the construction of schools or health facilities, teachers’ salaries, textbooks and school maintenance would have to be financed from domestic revenues. This bias of budget support towards financing of public investment poses the question of absorption capacity. In order to provide adequate capacity, partner country governments need to finance the technical knowledge and the preparational activities required for the implementation of an infrastructure undertaking out of the current revenues. In addition, any investment financed through budget support is resulting in higher maintenance costs and thus higher recurrent expenditure that have to be covered by domestic revenues.

In conclusion, the discussed possible reactions of governments to budget support can take the following forms:

\(^4\) This argument does not address development partners concerns over fungibility between sectors. An increase in development spending can be allocated in pro-poor and desirable sectors like health or education or undesirable sectors like defence. This can result in concerns over the use of budget support by development partners.
1. Apply a strict fiscal rule that does not allow the use of budget support for spending on recurrent expenditures in the long term.

2. Apply some kind of fiscal rule which uses thresholds on how far budget support can be used to finance recurrent spending and take into account short to medium term deviations from the rule including cash management issues.

3. Apply no fiscal rule and treat budget support similar to domestic revenues.

After this short theoretical introduction, the next section will look at how the Government of Uganda reacts to the provision of budget support and what the reasons for this reaction might be.
A deeper look at Uganda’s budget

Uganda has been a recipient of budget support since 1998. With the World Bank and DFID piloting budget support in Uganda, a new period in development assistance has started. The reduced burden of debt interest payments through the HIPC debt relief programme and the provision of programme aid provided Uganda with increased fiscal space. The ambitious Free Primary Health Care, Universal Primary Education (UPE) and later on the Universal Secondary Education (USE) initiatives required a substantial reorientation of domestic resources plus additional external funding.

In the Partnership Principles in 2003, Government of Uganda stipulated its preference for programme aid and development partners like the World Bank, DFID, and the European Commission responded with higher programme aid allocations. The following table shows the increase of programme aid over the last decade. The share of budget support to total aid reported on-budget went up from 34% in 1998/99 to 69% in 2006/07.

Figure 4: The rise of budget support in Uganda

![Graph showing the rise of budget support in Uganda]

Source: IMF staff reports 1998-2009 under the PRGF and PSI programmes.

Whereas debt relief directly reduced current spending obligations through lower annual interest payments, the utilization of programme aid needs to be further explored. A short analysis done by Penrose (2008) is suggesting that Government of Uganda is applying a fiscal...
rule that caps recurrent expenditure at the level of domestic revenue (p.22). The following sections explore if Uganda is indeed applying such a fiscal rule.

Comparing the real domestic revenues with real recurrent spending over the last 12 fiscal years, Uganda Government seems not to be applying a strict fiscal rule as described in the last chapter. The following graph shows that the recurrent balance remained positive in 7 out of 12 years. The deviation never exceeded 15% of total recurrent domestic revenue with the highest negative deviation occurring in 2001/02. In that fiscal year, recurrent spending was UGX 182 bn higher than domestic revenue, equaling 6.8% of total public expenditure.

**Figure 5: A fiscal rule in Uganda?**

![Graph showing recurrent balance and deviation from domestic revenue]


The illustration shows how the Government prioritized recurrent spending over development spending in the period 1999-2006. The recurrent outturn not only overtook domestic revenue but increased dramatically in absolute and relative terms. However, after 2003, a change in the fiscal policy can be seen with recurrent spending taking a smaller size compared to GDP.

This analysis shows that the above mentioned possibility of an expansion of current expenditure before a strict fiscal rule would kick in is indeed a possibility. The current substantial lower current expenditure compared to domestic revenue would allow the
Government to expand current revenue by more than 1.5% of GDP before a strict fiscal rule would bite. This expansion could be financed out of budget support funding; however it is only a medium term option as a fiscal rule would prevent an unlimited expansion of current expenditure.

The questions arising from this analysis are what drove recurrent spending up in the early 2000s and what let development spending overtake recurrent spending over the last 3 years? Are these deviations driven by spending decisions despite a fiscal rule or is the Government of Uganda applying a fiscal rule with boundaries that allow a deviation to a certain extent, or is Government of Uganda not applying any rule? These questions will be answered in the next two chapters by analyzing public expenditures and Government’s financing strategy.

**Expenditure analysis**

Between 1997 and 2009, the size of public expenditure varied between 10.9% and 18.5% of GDP. The following graph shows that whereas Government of Uganda followed an expansionary fiscal policy from 1997 to 2003, it consolidated its budget from 2003 onward. Since 2003, the public expenditure to GDP ratio remained stable at around 15%, excluding donor projects.

**Figure 6: Size of public expenditure**

![Chart showing public expenditure as a percentage of GDP from 1997/98 to 2008/09]


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5 Public expenditure in this essay excludes on-budget donor projects. The financial data on these projects is generally fragmental, unreliable and for the purpose of this analysis irrelevant.
The expansionary fiscal policy up to 2003 was fuelled by higher development assistance and a doubling in the fiscal deficit before grants. However, the Government of Uganda acknowledged in its Poverty Eradication and Action Plan (2004) that “a cutback in aid which lasted for much more than one year, given Uganda’s current level of dependence on donor aid, would force the Government to make severe budget cuts (p.41).” And indeed, the overtaking of recurrent spending to domestic revenue from 2000-2004 represented a big risk if any cutback on aid would have happened as the Government would have had to reduce its services by shrinking the recurrent expenditure.

The splurge of the early 2000s can be equally attributed to recurrent spending and the investment in capital goods. The share of recurrent spending to GDP increased from 9.8% in 1997/98 to 14% in 2001/02 and the investment in capital goods went up from 1.1% to 4.5% over the same period. The fiscal consolidation then led to a reduction of these shares to 11% and 4.2% in 2008/09 respectively. As one can see in the graph below, the contraction mainly tackled the recurrent expenditure and left the development spending essentially untouched, thereby reestablishing the fiscal sustainability a fiscal rule would demand.

Figure 7: Development of budget components

![Graph showing development of budget components](Image)


During the fiscal expansion, the biggest raise was experienced by the health and education sector. These two sectors grew from 0.7% and 2.8% of GDP in 1997/98 to 1.6% and 4.4% in
2001/02. This indicates that there was a strong pro-poor lobby in Government during these years. Thereafter, the budgets of the social sectors declined significantly and the infrastructure push initiated by the World Banks’ Country Economic Memorandum in 2007 takes off. This development concurs with an expansion of the development share in the budget as can be seen in the figure above.

The excess of recurrent spending over domestic revenue in the years 2000-2004 can be associated with the increased spending necessities for the social programmes like UPE, USE and Free Primary Health Care. None the less, the expansion of public expenditure encompassed all sectors, although to a lesser extent. It is very likely that the general elections of 2001 also played its part in the spending splurge.

**Financing analysis**

In order to fully understand the strategy of Uganda’s Government to cope with its resource constraint and what the reaction of the Government to budget support is, a short analysis of the financing side is needed.

The following graph shows the size of domestic revenues, budget support grants and public expenditure as a share of GDP. From the illustration one can see that Uganda is not able to entirely finance its public expenditure domestically due to its low revenue collection, which is usually attributed to the lowly monetized economy and the narrow tax base. The financing gap varied between 0.2% and 6.3% of GDP in the period 1997-2009. However, budget support has been able to cover the fiscal deficit before grants in most of the years if projects are not taken into account for the analysis. To smooth short-term delays and shortfalls in donor funding, the Government also uses its ability to draw down on its foreign-exchange reserves (Brownbridge and Tumusiime-Mutebile, 2007, p. 208). However, this mitigation can only be used in the short term. Any significant reduction in aid allocation to Uganda results sooner or later in the widening of the financing gap.
Figure 8: Financing gap

![Graph showing the financing gap over the years from 1997/98 to 2008/09.]


The large fiscal deficit in 1999/2000 and 2000/01 which resulted in high borrowing from the domestic market must have been eye-opening for the Government. As the IMF noted in 2004 “the interest rate on domestic lending remained high and the growth of bank credit to the private sector was sluggish” (p. 6-7). The following 2 graphs below show the extent to which the Government of Uganda had to rely on domestic financing in 1999/2000.

Figure 9: Financing strategy

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6 The second illustration uses numbers including projects. Therefore it is not entirely consistent with the rest of the essay.
Additionally, the figure clearly shows the fiscal consolidation that took place between 2002 and 2009. The financing gap before grants was narrowing and the Government of Uganda relied to a lesser extent on the capital market. According to Brownbridge and Tumusiime-Mutebile, this was a clear policy choice “to alleviate the vulnerability of the budget to cuts in aid” (2007, p. 210).

According to the above analysis, budget support seems to be substituting financing from the capital market. However, compared to borrowing, the Government of Uganda cannot directly influence the level of budget support it receives. Programme aid is thus unable to finance substantial deficits because of its low predictability and the Government’s inability to influence the level of assistance provided.
In conclusion, budget support is unable to finance substantial and prolonged deficits. In order to finance a longer period of expansionary fiscal policy, the Government of Uganda has to rely on the capital market or mobilize more domestic revenues. In the long run, only the latter results in a sustainable fiscal policy.
Conclusions

In conclusion, Government of Uganda is not strictly applying a fiscal rule. It seems more likely that in the beginning the Government saw a widening primary fiscal deficit as unproblematic as long as it could finance it with donor grants. However, with budget support grants covering more and more non-discretionary expenditure, Government became concerned by the increase of aid dependency and the exposure to the risk of substantial cuts in donor funding. In consequence, it initiated a fiscal consolidation that ensured that recurrent expenditure and interest are again covered by domestic revenue, thereby reducing aid dependency.

The case of Uganda allows drawing some lessons for countries in similar situations:

- Development assistance is generally volatile and unpredictable. Budget support is the most visible and politically exposed instrument and therefore often the first choice when cuts have to be made.

- Recipient governments need to be aware that the reliance on a high-level of donor funding exposes them to significant risks. If donors reduce development assistant significantly, recipient government will be forced to cut their public expenditure. In order to mitigate this risk, the application of a fiscal rule that caps the share of donor funding through budget support grants at the level of the development/infrastructure budget makes sense. However, such a fiscal rule would need to be locally tailored in order to incorporate cash management issues and policy priorities. The recipient governments also need to take into account that investments financed through development assistance will add recurrent costs in the future as this investments need to be maintained.

- Recipient governments should try to reach agreements with development partners on the circumstances under which the level of budget support are reduced. In-year cuts should be ruled out and denounced as bad practice. Reductions to the level of funding provided should be phased in order to allow the recipient governments to adjust.
In the medium and long term, the best way to reduce the above described risks is to increase domestic revenue generation. Recipient governments have to accept that it is necessary to swallow the pill in order to become less dependent.

Development partners should be aware that it makes sense to have an upper limit to the level of funding that can be allocated to a specific country. Spending on recurrent expenditure such as social services in health and education cannot be expanded through higher level of budget support if the nature of budget support remains unpredictable and volatile. Development partner should therefore try harder to reduce volatility and announce decisions sufficiently in advance.
Bibliography


