Chapter 12. THE PROGRAMMING OF PUBLIC INVESTMENT AND THE MANAGEMENT OF EXTERNAL ASSISTANCE

Throughout this volume, we have pointed out the budgetary implications of dependence on external aid, which is typical of most developing countries. It is now time to tackle the major implications. First, the relatively large amount of funds flowing in from external aid calls for careful programming by the recipient country. As most external aid is for investment purposes, the Public Investment Program (PIP) has been elaborated and implemented in many developing countries with the aim of fitting the resources into overall public expenditures and development plans. Second, the effective management of external assistance requires a variety of organizational measures and should meet a number of criteria. The first section of this chapter describes the PIP and its uses and limitations, and the second section summarizes the lessons of experience in the management of external assistance.[1] (The next chapter reviews the technical aspects of a comprehensive Medium-Term Expenditure Framework (MTEF), toward which a well-prepared PIP is an intermediate stage.)

A. THE PROGRAMMING OF PUBLIC INVESTMENT

1. What is a Public Investment Program (PIP)?

In the 1970s, most developing countries prepared a four- to six-year development plan to define and implement their medium-term economic and social objectives. However, plans with a fixed horizon and established episodically were often unrealistic, and proved insufficiently flexible to take into account changes in the economic environment. In several countries, fixed plans originally designed in periods of high commodity prices or plentiful external aid contributed to destabilizing public finances, and without any appreciable impact on hastening growth. Such rigid medium-term planning is less widespread today, but in Asia several countries still prepare medium-term plans.[2]

Aside from the question of the unsound and unrealistic policies they incorporated, the major problems of medium-term development plans were: (i) lack of

flexibility and adaptability; (ii) insufficient coordination with the budget process, where actual expenditure decisions were made; and (iii) a “needs” approach which typically led to unrealistic plans.

Consequently, in the 1980s many developing countries moved to rolling public investment plans, generally with the encouragement and along the recommendations of the World Bank. These rolling investment plans are usually named Public Investment Programs (PIP). They are widely used in aid-dependent countries, since one of their aims is to improve aid coordination, and are less common in middle-income countries. Recently, with the assistance of the World Bank and the European Union, PIPs have been newly introduced in a number of transition countries.

In some developing countries, a PIP became a simple wish list, used to attract aid from donors and international financial institutions, or even just to fulfill a formalistic requirement of Consultative Groups and other donor meetings. Often such wish lists are prepared hastily for the meetings with the assistance of external consultants and little genuine involvement of local officials. The role of these wish lists of projects in the formulation of the budget is generally weak or nil. Worse, because these PIPs are shopping lists rather than programming tools, they invariably include a variety of weak, unsound, or undocumented project proposals. Even the marginal usefulness of these PIPs as documentation for a donor meeting is swamped by the risk of financing bad projects; by the implicit transfer of control over the development agenda from the government to the external donors; and by the generalized loss of credibility of the programming process. It would be better if they were not prepared at all (or externally requested).

One does not, however, dismiss an economic programming tool because it is often misused or abused in practice. The following discussion examines the utility of PIPs when they are genuine medium-term *programs* for public investment. If it is concluded that this tool is appropriate to a particular country, then it becomes necessary to assure that it is designed and used properly. In any case, the relatively large donor funding will either be appropriately programmed, in relation to the policy priorities of the recipient country, or *still* be distributed, but without *any* central scrutiny of project quality, consistency with policy, or coordination with the budgeting of domestic resources.[3]

A good PIP is aimed at ensuring five different (although interrelated) functions:[4]

- improving economic management, to ensure that macroeconomic sector strategies are translated into programs and projects;
- improving aid coordination and channeling external resources to priority areas;
- strengthening the hand of the government in negotiating with external donors;
- assisting public financial management, by balancing (partial) commitments and resources over a multi-year framework; and
- strengthening the project cycle by providing a framework within which project preparation, implementation, and monitoring can occur.

Perhaps the most significant benefit that aid-dependent developing countries receive from good PIPs is that the process of PIP preparation itself gives an opportunity to review, and then integrate into the budget, aid-financed expenditures that were previously nonbudgeted. (As chapter 2 stressed, the budget should be comprehensive and should include all government expenditures, however financed.) PIP exercises contribute also to extending the horizon of financial programming and planning beyond the annual budget, and the perspective of policymakers in a more realistic way than previous five-year plans. Finally, if conducted rigorously and with full local participation, the process can be an invaluable capacity-building tool, and a way to introduce financial discipline and the awareness of opportunity cost into the informal rules of the local bureaucracy. Finally, a good PIP process can set the stage for the eventual medium-term programming of all expenditure which is the optional way of incorporating the needed multi-year perspective into the budget process.

2. Coverage of PIPs and investment budgets

a. Hybrid investment budgets

Most developing countries have adopted a “management approach” to delimiting the boundaries of the investment budget (and the PIP, where it is prepared). In addition to investment expenditure proper, the investment budget (and the PIP) also includes current expenditures that are managed within the investment projects rather than directly by the

administrative divisions concerned[5]. Procedures for administering the recurrent budget are generally not suitable to the management of some categories of expenditure, particularly expenditures by external sources. Generally, regulations to implement the investment budget are much more flexible than those for the recurrent budget. Therefore, administrative considerations are in practice more influential than economic considerations on the decision of whether a given expenditure is included in the current or the investment budget. As a result, the recurrent budget usually contains some miscellaneous investment expenditure, while the investment budget almost invariably has a significant component of current spending.

The hybrid nature of “investment” budgets creates loopholes. Line ministries may try to include alleged projects in the investment budget to finance recurrent spending and obtain additional resources. Or, projects previously financed by external sources may be kept artificially alive after the closure date of the aid agreements, to avoid either increasing regular personnel expenditure or dismissing the project staff.[6]

The approach adopted in transition economies is generally more economic than the management approach mentioned above. In these countries, the traditional State Annual Investment Program has a narrower coverage than the investment budget in developing countries. It often covers only net investment, i.e. the creation of new capacities. Investments financed under the State Annual Investment Program are included in the “capital expenditures” items of the budget.

b. Is reclassification desirable?

To transform most “investment” budgets into "true" capital budgets would require a major reclassification of expenditures. In countries that finance investment mainly from their own resources, this should be systematically undertaken and will facilitate analysis of the budget and eliminate the loopholes mentioned above. However, improving the recurrent budget procedures, and making them more flexible (as discussed in chapter 6), may be a prerequisite for either establishing a more homogenous context for each of the two budgets, or merging the budgets altogether.

In aid-dependent countries, to separate out the “true” investment expenditure, it would be necessary to divide projects into two subprojects straddling two budgets. This would have significant inconveniences for project management, notably for donor-financed projects in the social sectors, which typically include a high share of current expenditure. Because external aid is normally channeled through projects, the only satisfactory way of identifying the “true” capital component of the budget is to implement an economic classification for both the current and the capital budgets, along the lines suggested in chapter 3.

This would be particularly appropriate to a before-and-after comparison in countries undergoing structural adjustment programs, if one wished to ascertain the true impact of the adjustment program on the composition of expenditure. Typically, some current expenditures are protected from austerity because they were hidden within the investment budget or shifted opportunely into the investment budget—with or without the consent of external donors. Therefore, the decline in current expenditure through the adjustment program is overestimated, and public investment in reality is curtailed by more than the figures show. Because, as noted earlier, the figures point to a contraction of public instrument in countries under structural adjustment, the reduction in public investment is significant—even under good public investment programming.

3. Preparing a good PIP

a. General characteristics

It is generally accepted that the PIP should be organized along the following lines:

- The PIP includes a period of three or four years in which annual costs of projects are shown, along with the balance of funds required to complete them, and hence also the total costs of each project;

- To adapt to permanent changes in the economic and financial environment, the PIP is prepared annually, on a rolling basis. For a 3-year PIP, in year t the program t+1 to t+3 is prepared, in year t+1 the PIP for t+2 to t+4 is prepared etc.;

- While the first year of the PIP includes only projects for which implementation has been firmly decided, the later years are indicative for both the estimates of costs and the list of projects included. The annual costs of ongoing projects and the previous list of new projects are of course to be revised when preparing the next PIP;

- The investment budget (also called "capital" budget or "development" budget) includes expenditure on the projects for the first year of the PIP financed by the central government, either from domestic or external resources;

- In aid-dependent countries, the following approach is often adopted: (i) the first year of the PIP includes only projects for which the financing has already been granted or is under well-advanced negotiation so that external financing for the annual segment of the PIP to be included in the capital budget is secure; (ii) the second year includes projects for which the financing has clearly been identified; (iii) the third year holds projects for which the financing is probable but the source has not yet been identified. As discussed below, a more restrictive approach for the second and the third year would be preferable;

- The first year of the PIP must be consistent with the Budget. Both the provision of adequate domestic resources and expenditures financed by external sources must be included in the budget. For the outyears needs for domestic resources must be compatible with the medium-term fiscal framework. With or without a PIP, sound estimates of the forward costs of projects and of needs for domestic resources are required for financial programming. These estimates are not easy, but they are essential;

- PIPs cover investments by the central government and investments by public entities that are financed fully or partly by the central government. In a few countries, PIPs also cover investments of public enterprises and/or local governments that are not financed by the central government. This practice is questionable, since these entities have (or should have) autonomy in management. However, showing these expenditures in the PIP for information

only, would give a more complete view of public sector investment;

- Ideally, only projects evaluated as economically sound should be included in the PIP. As for the financing, for the first planned year the economic analysis of projects must be imperatively complete and convincing; for the outyears, it is important to try to keep out altogether projects that do not meet at least the "double-sense criterion": development sense and common sense. No commitment should be taken for projects that have not been fully studied. The time to fight off bad ideas is when they first surface. This is because bureaucratic inertia (and vested interests, both internal and external) may eventually cause a bad project to be financed and executed. The hunt for white elephants should never be called off, but it's best if they are not born in the first place;

- Sometimes, both a "core" PIP and a "noncore" PIP are prepared. This practice is highly inadvisable: it skirts hard choices and increases the risk of including bad projects. (In fact, this is sometimes precisely the motivation for the practice.) If a project is good, it should be included in the "core PIP"; if it is not good, or insufficiently examined, it should not be included in *any* program. In many ways, a dual PIP is inherently a bad PIP.

Because aid is fungible, if the government would implement a particular project in any case, aid earmarked for it releases governmental resources to finance a "marginal project of which the donor knows nothing. The aid in effect finances the latter project, and the earmarking is an illusion. Hence, if the quality of governance or of public management is seriously deficient, donor control over the investment program as a whole may be the only way for aid moneys to have a positive development impact. (A far stronger impact, however, would result from assistance or insistence to improve governance in the first place.) In most developing countries, instead, donor financing for a project which the government does not consider a priority can distort resource allocation and create other adverse incentive problems and moral hazards which more than offset the direct positive impact of the assistance itself. Hence, strong coordination and direction by the recipient country's government are essential to the development impact of the assistance. The implications of aid fungibility for the investment program

under different assumptions have been examined long ago[7] and have been recently rediscovered.

b. Other general requirements

First, as noted, a good PIP must contain good projects, and improvement in project preparation and screening at sector level is generally needed. In aid-dependent countries a significant number of projects are appraised and screened with the assistance of donors. This alleviates the weakness in local capacity in appraising projects. Over the longer term, however, prolonged reliance on external expertise is not conducive to local capacity improvement, which is essential for economic development. In point of fact, inefficient allocation of resources and loose financial constraints are more serious risks of a bad PIP than weakness in local capacity in itself.

Regarding resource allocation, the linkages between the projects and government policy are often not systematically considered. The fragmentation of the budget into projects financed by donors with different policy agenda impedes a sound allocation of resources. Even without taking into account the “cosmetic PIPs” that are nothing more than wish lists, in such a weak PIP the total costs of the projects over the planned period often exceeds government capacities to finance these projects. Counterpart funding problems become inevitable, and the insufficient budgetary resources are allocated to projects financed by more influential donors (or worse, to salary bonuses or outright bribery) and not necessarily to the projects that are more valuable for the country’s development.

Regarding the loosening of financial constraints, since the second and third year of the PIPs are generally indicative, when confronted with excessive requests the Ministry of Planning follows an escape strategy that consists of systematically including poor projects in the second and third years of the PIP, with the intention of eventually dropping them. Therefore, the outyears of the PIP become simple wish lists, to which nobody pays attention. (Alternatively, and worse, some of the bad projects may in fact find financing and be carried out.) This problem is not confined to PIPs in developing countries. On the contrary, avoiding distortions in the annual distribution of expenditures is an important challenge in any multi-year expenditure framework system.[8]

To avoid an overloaded PIP, it is necessary to frame strictly the preparation of the PIP for each year of the planned period, with ceilings derived from the macroeconomic and fiscal framework. Of course, the outyears of the PIPs are inevitably indicative, and in fact doubly so, both for the cost estimates and for the list of projects included. Naturally, cost estimates beyond the fiscal year can only be indicative. However, concerning the projects to be included in the PIPs a more stringent approach for the second and the third year would be preferable, by including only projects for which a decision has been firmly made and the source of financing is certain (or at least highly probable). As a result, projects included would generally be of better quality, and the PIP would in effect incorporate only ongoing policies, as recommended for multi-year expenditure estimates (see chapters 4 and 13). For example, in Sri Lanka a cautious approach was adopted in including projects into the PIP. The PIP includes only funded projects, that is the projects included in the Budget of its first planned year and projects for which an external financing is already available. Therefore, the total annual costs of projects included in the PIP are slightly decreasing at end of the planned period. Besides, these funded projects the PIP includes a line “additional provisions to be identified”, in order to give an indication on the total amount of resources that the government intend to allocate to investment over the planned period.

This last suggestion may well diminish the role of the PIP as an instrument for negotiating additional project aid. However, in practice, overloaded PIPs are not conducive to successful external negotiations. The trick might work once, but not again. Presenting in the PIP only the costs of programs and projects already decided could facilitate the assessment of the margin of maneuver to include new projects. It is true that a partial contradiction exists between the documentary needs of a Consultative Group meeting and the requirements of sound financial programming, but the contradiction could be overcome by producing along with a stringent PIP a supplementary document of strategic orientations and directions of further development actions.[9] Furthermore, it is the responsibility of external donors, to encourage a move toward better country programming while assuring at the same time better donor coordination in the interest of the recipient country’s development.

Figures 12 and 13 show schematically the classic PIP process and its stringent variant.

[Please see attached Figure 12.xls and Figure 13.xls].

The preparation of a PIP includes two main processes:

- Project selection and overall investment programming.

- Project preparation and appraisal. The project cycle includes identification, preparation, and appraisal. Project identification is normally carried out by the line ministries and precedes the PIP process. As noted, it is important that bad project ideas be prevented from getting a foothold on the programming process. A few well-chosen and well-publicized rejections of projects proposed by line ministries can be very helpful in encouraging them to present only good project ideas in the future.

These two processes are interdependent. At different stages of the project cycle choices between projects must be made (i.e., when launching studies on identified projects, when appraising those studies, and when making the final go/no-go decision). Nevertheless, these two processes should not be confused. Sound investment programs require good projects and the preparation of good projects requires sound investment programs, but investment programming must be set in a broader policy-focused framework than the isolated analysis of individual projects. A good PIP is more than a mere collage of projects, examined in isolation, even if they are good projects, as explained below.

c. Strategic prioritization

Projects are a part of an overall development strategy, which they must fit. The government must allocate available resources between competing sectors and competing programs. Project analysis helps, but cannot be relied upon exclusively to achieve the optimal balance of objectives.[10] Criteria other than the quality of individual projects are needed when scrutinizing a Public Investment Program, e.g., Are balances between sectors and subsectors consistent with the government strategy? Is the investment program appropriate to the economic and social environment? Is it compatible with the

macroeconomic framework? Are externalities adequately taken into account?

A "strategic" approach to investment programming should involve three elements: (i) definition of objectives; (ii) determination of available resources; and (iii) identification of alternatives for using resources to meet the stated objectives. Thus, the programming process should aim to ensure that policies drive programs: that programs drive projects; and that the most efficient projects to implement the programs have been selected. This is of course, an ideal, but it is a guideline to be applied. And, like all economic and policy processes, a strategic PIP too, is iterative. For example, difficulties in preparing the "right" projects should feed back into scaling down the corresponding programs and objectives (and/or absorb a smaller amount of resources). Equally important, good new projects (i.e., economically sound, consistent with the policy goals, and with attractive external financing) might justify an additional domestic resource mobilization effort. Clearly, the right starting point does matter, and that starting point is the definition of goals and available resources. *However, the essence of a good programming process is the ease with which relevant information travels up and down the decision chain, in relationship of reciprocity among objectives, means, and activities.* Capacity building for investment programming (indeed, for public sector management in general) must therefore pay as much attention to strengthening the linkages among the components (and the actors) as it does to improving goal definition or resource forecasting or, for that matter, project preparation.

It should be evident by now that a good PIP preparation process is similar to a multi-year estimates process and to budget preparation, combining: (i) a top-down definition of financial envelopes in conformity with government strategy and compatible with fiscal targets; (ii) a bottom-up approach with line ministries submitting their draft investment budgets; and (iii) successive iteration and information exchange converging onto a *program* that is vertically and horizontally consistent with both policy and financial means.

Thus, whatever the institutional distribution of responsibilities in preparing the current budget, the investment budget and the PIP, the three processes should be integrated or at least closely coordinated—with the budget preparation calendar containing explicit and prescriptive steps, and bureaucratic incentives oriented to assuring that such

coordination happens.

d. Screening Projects

Economic analysis of projects, and selection of the most cost-effective variants, is required for projects to which cost-benefit analysis is applicable. Moreover, *every* project of any significant size must be screened to verify its consistency with government priorities, direct and indirect impact, sustainability, etc. The main screening criteria are as follows:[11]

- Is the project consistent with the role of the government in the economy?
- Is the project consistent with the sector strategy?
- Is the variant being considered the most cost-effective variant and (when the main benefits are tangible) is the economic rate of return of the project acceptable? Specifically, will the project increase external debt-servicing capacity by more than its financing and operation add to external debt?
- Is the project a feasible alternative to the rehabilitation of existing facilities?
- Are the recurrent costs realistically estimated?
- Are the overall recurrent costs compatible with budget forecasts (notably in the health and education sectors)?
- Is the project financially and institutionally sustainable?
- What are the project's external effects, negative (e.g., environmental) or positive (e.g., social-capital generation)?

For small projects, screening can consist of a quick qualitative judgment on the above criteria, based on realism and common sense. For large projects, more formal methodologies are appropriate. In any case, good screening is needed more for the

purpose of excluding projects from the PIP than for including them. Typically, the aggregate of “good” projects requires financing in excess of the available amount. When greater mobilization of resources is not considered appropriate, a difficult qualitative selection must be made. Therefore, the basic operational principle is to place the burden of proof on those who advocate including a project in the PIP, and not on those who believe it should be excluded.

Sometimes project-ranking methods have been suggested. In the 1970s it was often stated that projects could be ranked by rate of return, and the highest ranked selected in turn until the financial envelope was filled. This approach has been attempted, unsuccessfully, in a few countries. Comparing projects from different sectors according to quantitative criteria is always hazardous, and in fact impossible. Moreover, ranking a set of projects depends on the total financial envelope granted to the set of projects and not vice versa.[12] To reiterate: the choice of allocating investment resources among sectors cannot be based only on the analysis of individual investment projects.

4. Sector investment programs (SIP)

SIPs have attracted attention recently (Harrold et al. 1995; Jones, 1997). They provide a vehicle for implementing the “broad-sector” approach favored by several major donors. The World Bank recommends that “an SIP move away from the distinction between recurrent and capital expenditure and focus on overall expenditures”.[13] SIPs are intended to address weaknesses in the practice of development aid. An SIP is an integrated program agreed between donor(s) and the Government comprising a sector strategy, a government investment expenditure program, mutually agreed implementation procedures, and funding arrangements. It has six defining characteristics: sector-wide scope; a clear sector strategy; management by nationals; the participation of all main donors participating; common implementation arrangements; and the use of local rather than foreign capacity. SIPs are alleged to correct problems associated with donor assistance such as donor-driven agendas; diversion of funds to activities other than those intended by donors; fragmentation of government aid management; and generic developing-country problems such as weak sectoral performance, weak public expenditure management and lack of linkage between capital expenditure and its recurrent costs (Jones, 1997).

A positive view is that SIPs fill the gap between good individual projects and good macroeconomic investment programming. Also, the process of formulating a SIP may help in terms of the key issue identified above i.e., lack of coordination *within* line ministries. Of course, to the extent that donors are prepared to assist sectors via general budget support, an SIP can reduce some of the negative effects of project-tied assistance; however, general budget support not linked to good public expenditure management but not to specific sectors would be preferable. One could therefore view good sector investment programs as a step toward the comprehensive medium-term expenditure framework discussed in chapter 13. None of this is likely to happen, however, unless the recipient government exercises some control over the allocation and management of external assistance.

B. THE MANAGEMENT OF EXTERNAL ASSISTANCE

1. The context

Chapter 17 will discuss the “efficient nucleus” and “strengthening linkages” approaches to improving public expenditure management. These approaches are also applicable to the management of external assistance, because often such assistance provides the only degree of financial freedom to hard-pressed developing countries confronted with the need to control expenditures at a time of slow domestic revenue growth. In turn, this means that more efficient organizational arrangements in this area are particularly visible and are more likely source of positive demonstration effects.

The record of aid management is as mixed as the record of PIPs. In many developing countries, the organizational framework for aid management is weak or inoperative in practice, with external donors de facto determining expenditure priority. This is invariably the case when the PIP process is weak or purely formalistic. As already explained, a key advantage of a good PIP is its assertion of a measure of government control over the allocation of aid funds. Governments’ effective supervision over the aid process is essential to assure that external resources are integrated with domestic resources in pursuit of national fiscal policy.

The mobilization and effective use of external resources depends crucially on creating the institutions and the organizational capacity needed to coordinate internally and manage the different kinds of aid. The organizational arrangements for aid management should be country-specific (including the key issue of institutional location). However, past country practices and recent experience show that certain minimum criteria must be met. These “musts” of aid management are also consistent with the conceptual basis of the new institutional economics and with the lessons of institutional change in the key public sector areas, as discussed in chapter 1. Consequently, the key criteria are simply listed below with a minimum of elaboration and explanation. That many of these criteria are obvious and intuitive should not mislead the reader into thinking that they are normally applied.

2. The ten commandments of aid management

The following are not utopian recommendations. Even though they are followed effectively in a minority of developing countries (e.g., Sri Lanka), they call for neither large resources nor difficult administrative choices. They have been derived from the actual experience in developing countries over a long period of time.

i. *Responsibility for managing external resources rests with the recipient government.* External donors often have in practice undue influence on project choice and the allocation of assistance. This first commandment in no way excludes the requirement and utility of donor participation in the supervision of the use of aid funds and the implementation of aid-financed activities, especially when corruption is a problem.

ii. Aside from sovereignty considerations, the essential reason why aid management must be driven by the recipient government is that *external resources must be integrated within overall resource utilization,* in pursuit of national economic policy. It is clearly impossible for a government to formulate coherent economic policy if decisions on the allocation of a major portion of available resources are made elsewhere.

iii. At the central government level, there should be *one aid management entity*

covering all external economic assistance, including technical assistance. The only possible exception should be emergency aid and some humanitarian aid, even though there is still a need for linkages between such assistance and the budget process.[14] In theory, good coordination among different ministries charged with different aid management responsibilities is possible. In practice, such a system has rarely worked. Split aid management responsibilities have proven to be a recipe for confusion, waste and conflict. The frequent two-way split of responsibilities between a Ministry of Finance and a Ministry of economy may be problematic enough. (See chapter 3 for a discussion of "dual budgeting"). The occasional three-way split which includes a role for the Ministry of Foreign Affairs is next to impossible to administer. The practical outcome of split aid management responsibilities is that the government loses control of the exercise altogether, and aid decisions end up being driven by competing donor agendas.[15]

iv. The aid management entity should normally be an *office in a core ministry*. Because it is a key regular function of government, aid management should in principle be exercised by a regular organ of government. The preference here is for the Ministry of Finance, owing to its responsibility to develop a coherent budget covering all available financing. In transition economies, it is possible to consider an autonomous aid management agency outside the regular structure of government, provided it is placed high enough to perform its role credibly, and reports to a regular structure of government such as the Prime Minister or an interministerial body from which fiscal policy guidance legitimately emanates. However, longer-term institutional development requires that the autonomous agency solution itself be transitional and incorporate a sunset clause. As time and organizational capacity permit, the aid management function should devolve to the Ministry of Finance.

v. Aid management should be *organized along donor lines* (e.g., an "ADB desk", a "World Bank desk", an "EU desk", a "UN-system desk"), to build expertise on procedural requirements of different donors, match different terms of aid with different projects, and help keep all donors "in the tent"—collaborating with a single government organization on an equal footing with one another.

The tempting option of organizing aid management along sector lines (e.g., “social sector” desk, etc.) has not worked in practice mainly because it hasn’t created the local capacity to negotiate effectively with the different donors. However, the aid management entity can *also* contain a sector coordination unit structured along types of assistance, where investment projects and technical assistance can be more effectively integrated within and across sectors, thus facilitating the interface with the line ministries concerned.

vi. The aid management entity should be the *sole focal point* in the government for contacts with donors regarding aid programs, and must be systematically informed of ongoing activities by both donors and end-users. This does not in any way imply centralization of decision and a monopoly on information and contacts. On the contrary, as the next four criteria make clear, the purpose of having a single focal point for aid management is to support, not substitute for, the decision-making process of sector ministries.

vii. The aid management entity must function to *facilitate not obstruct* relations between donors and their counterpart ministries. It should assure the availability of timely and complete aid information, and regulate the flow of missions and delegations traffic in the interest of all concerned. Thus, while the entity must be regularly informed of donor missions and of ministries’ requests, it need not have authority to clear donor missions.

viii. It follows that the existence of a central aid management entity *does not exclude sectoral coordination mechanisms.* On the contrary, the effectiveness of the central entity depends crucially on good decision making in each sector ministry, which in turn requires an appropriate coordination capacity specific to the sector in question. This need for effective coordination has been stressed throughout the earlier chapters. On the other hand, to assure that the central aid management agency acts to facilitate and coordinate, and not to obstruct or supplant, careful limits on its role and provisions for accountability and transparency must be specified. At the same time, it is essential to have provisions that prevent sector ministries from making “end-runs” around the central agency, and to ensure that they work in cooperation

and in support of the central agency.

ix. Similarly, the aid management entity *should not interfere in budget proposals and project selection.* It does need to be regularly informed of such decisions; to have authority to approach the “right” donor for financing the various projects; and to routinely participate in budget discussions in order to help ensure the adequate provision of local funding complementary to aid resources. (The latter is one major reason for locating an aid management entity in the Ministry of Finance.) But sectoral budget proposals and project selection decisions are the responsibility of the sector ministry concerned, within the programmatic priorities of the country; the overall investment program is the responsibility of the competent core ministry (usually a Ministry of Economy or of Planning); and budget formulation, of course, is the responsibility of the Ministry of Finance.

x. Finally, the aid management entity should act to *strengthen links* with other agencies of government and help build financial planning and aid-coordination capacity in the sector ministries. Without such sectoral capacity, central aid management is built on sand, reform is a mere shuffling of organizational boxes and titles, and donor preferences in effect dominate the allocation of aid funds.

3. Organizational architectures

The actual organizational structure will normally be intermediate between the two depicted in the charts, depending on country-specific circumstances and capabilities. The links to other agencies of government (shown here as information/communication or guidance/instruction arrows) are not, strictly speaking, part of the organization of the aid management entity. It is important to stress once again, however, that the interagency links are essential ingredients of the aid management *function,* which must be exercised within the context of a coherent economic policy framework and public investment program. Thus, it would be futile to focus on the *organization* of aid management without at the same time defining and enforcing the rules—the *institutions*—of aid management, among which those governing the interaction with other agencies of government are

paramount.

4. The Four S's: Sensitivity, Selectivity, Stamina, and Staff

Whatever the arrangements for aid management by the recipient country, they are unlikely to function well without a measure of cooperation by the external donors. In addition to working within the organizational arrangements for aid management established by the recipient country, donors should follow four general rules.

First, sensitivity (understanding of the circumstances of the other parties, mutual respect, and open-mindedness) is even more important for the "ownership" of institutional change than in the general economic policy dialogue. One must particularly pay attention to the clarity of the message not only as it is broadcast, but also as it is received. This point leads, among other things, to the practical suggestion of asking the recipients of the technical advice to articulate *their* interpretation of the message being delivered—a simple but effective way to ensure that no misunderstandings occur.

Second, advice and assistance should be *selectively* focused in the areas where it can make a difference. The three main criteria are: importance of the area; feasibility of significant and identifiable regulatory or organizational change; and a potential for generalizing the change to include other parts of the public expenditure management system. (The last section of chapter 17 suggests priority actions to strengthen public expenditure management.)

Third, institutional change is slow by its very nature, and the concomitant organizational capacity can only grow over time (see chapter 1). Assistance with PEM, consequently, must be viewed as a long-term investment of time, imagination, and resources. The long-haul nature of institutional development requires commensurate commitment and stamina to stay the course. In general, this is true whether the intervention is by external donors or by the core government agencies vis-à-vis other public sector entities. While specific rapid improvements are sometimes possible, a general "quick-fix" approach invariably leads to trouble. It is possible, however, to conceive of external assistance as a catalyst—in the original and literal sense of the term—that can spark or facilitate an internal process of a potentially self-sustaining

character. It does not follow, therefore, that external agencies necessarily need to remain directly involved beyond the initial phase.

Finally, the fourth “S”, *staff*, is shorthand for resources. It is not worth elaborating on this obvious requirement, except for underlining the inverse correlation between the soundness of the design of assistance and the external and local resources required for its implementation and supervision. In particular, keeping PEM reforms simple will minimize the need for expatriate advisers and increase the chances that the reform will be sustainable. The best-designed assistance mechanism will still require sufficient material and human resources to be implemented. External assistance can help with the material side; it can also help somewhat with the human side, by providing competent advisers who understand their primary responsibility as including training of their local counterparts. External assistance cannot, however, provide the core staff charged with implementing and facilitating the process, nor create the incentive framework which is essential for their effectiveness. And when it is wrongly conceived, in pursuit of changes that are unnecessarily complex or unsuited to the local conditions, external assistance may well lead to *reducing* local administration and management capacity.

C. Key Points and Directions of Reform

1. Key Points

The latter approach is normally applied to “investment”, and has been common in aid-dependent developing countries under the name of Public Investment Program (PIP). PIPs arose in the early 1980s as a reaction to the rigidities of the “development planning” of the 1970s, and as a means to improve the programming of external aid—most of which is for investment purposes. PIPs are on a “rolling” basis and cover a 3-4 year period. When badly prepared and implemented, PIPs become wish lists of projects or shopping lists for donor moneys, and can harm the expenditure management process. However, like a good SEP, well-prepared PIP can improve the process as well as strengthen the recipient country’s control over aid. Ideally, a strong PIP should:

- include only economically sound projects that are clearly related to government policy. (For the out-years, the evaluation of projects may be

indicative, but projects must always meet the “double sense” criterion of “development sense” and “common sense” before they are included, in any form for any year);

- cover all central government investment and investments by other public entities which are financed by the central government;

- be strictly framed by the ceilings derived from the macroeconomic framework (but recall the iterative nature of macroeconomic programming—public investment should never be defined as a mere residual derived from the other targets);

- include in the first year only projects for which financing is *certain*;

- assure that adequate complementary local funding is included in the annual budget. “Counterpart funding” problems are likely in any event, but are a certainty if the aggregate budgetary provision for investment is insufficient;

- include in the outyears only projects for which a firm decision has been made and financing is highly probable. (In effect, the PIP would then comprise only “on-going policies”, as recommended for multi-year programming in general);

- prevent over-reliance on external expertise, and foster systematic improvements in local capacity. This may well be the most important requirement. External expertise is needed. However, if the PIP process becomes inadvertently a mechanism for replacing local responsibility with expatriate experts, it will neither improve the budget process, nor contribute to local capacity, nor, of course, lead toward a more comprehensive approach to multi-year expenditure programming. This risk, of course, exists in aid-dependent countries whether or not they have a public investment programming process.

For all three objectives of PEM require that the recipient government and not the donors should “drive” the allocation and utilization of aid funds—while respecting, of

course, the procedural and fiduciary requirements of the donors concerned. Experience worldwide shows that there are ten major requirements for robust aid management. Among these, the following are essential:

- external resources must be integrated with overall resource utilization, and thus included in the budget;
- there should be one, and only one, aid management entity (preferably in the Ministry of Finance) covering all external aid, including technical assistance;
- aid management should be structured along donor lines (e.g., an ADB "desk", a World Bank "desk" etc.) rather than sectoral lines (e.g., a "health assistance" desk);
- the aid management entity should function to facilitate, not obstruct, and avoid interfering in ministries' budget proposals or project selection.

2. Directions of Reform

The broad goals of public investment programming are to: (i) raise investment efficiency by improving project quality; (ii) bring investment allocation in line with country policies and priorities; (iii) assure consistency between investment programs and available financing at favorable terms; and (iv) lead in time to a more comprehensive multi-year expenditure framework.

All these goals require sufficient control by the recipient government over project selection and strategic allocation of aid moneys—assuming a reasonable degree of integrity and efficiency in the country's governance and public management. Conversely, a good public investment programming process is most often the best practical way in which the recipient country's government can get into the driver's seat and stay there.

The directions and sequencing of reforms in public investment programming and aid management stem directly from those four goals. For better project quality and investment efficiency:

- The first priority is to design ironclad procedures against the birth of "white elephant" projects. Once a project of large size is on the drawing board, the bureaucratic dynamics from both donor and recipient sides make it very difficult to stop it. Among these procedures, involvement of high-level policy makers (and, for very large projects, the Cabinet) must be built in at a very early stage.

- Also essential is the capability for economic appraisal of projects. Because of the need to economize on scarce capacity (and to minimize reliance on expatriate expertise), in developing countries simple appraisal methods are preferable, and selectivity is needed. Only projects of significant size should be analyzed in detail, with smaller projects "bundled" and the bundle evaluated only for its general correspondence with sectoral policies and common sense.

- Third, an agile procurement process that minimizes the opportunities for corruption, and effective physical monitoring of project implementation and completion are a must. Strengthening the audit function and obtaining systematic feedback from local entities can be extremely useful.

For the other three objectives of public investment programming:

- It is important to have a procedure for early decision of whether the investment allocation corresponds to aggregate and sectoral policies, and the ensuing preliminary definition of the sectoral expenditure envelopes.

- Also, through good aid management and coordination among donors, regulations are needed for assessment of the probability of financing for various projects, and strong regulation should be in place to assure that only projects with certain financing are included in the investment program.

- Finally, a realistic procedure and minimum capacity for estimating the total cost of investment projects and their recurrent costs is a must. This is always

preached but rarely done. The absence of these estimates, however, is sufficient in itself to cast a cloud on the usefulness and integrity of the public investment programming process. Conversely, the experience gained through these forward estimates can be invaluable for the eventual move to a comprehensive multi-year expenditure approach.

[1]The term “aid management”, instead of “coordination”, is used here to prevent confusion with the separable issue of coordination among donors. The second section is derived largely from Schiavo-Campo, 1994.
[2] See "The Control and Management of Government Expenditure". ESCAP. 1993.
[3] This is the main reason why countries such as Chile, which has substantially reduced the role of the state in the last two decades, have nevertheless kept variants of the PIP instrument (see Petrei, 1998, pp. 259 ff.).
[4] See Bird and Stevens, 1991.
[5] The share of current expenditures included in the development budget is estimated to be from 20% to 30% in Nepal and Bangladesh (ESCAP, 1993).
[6] In South Asian countries, legislative authorization is given for revenue and a capital/development budget. The distinction between the current and the capital components of these budgets remains entirely academic to the legislature, which, unless well-educated in the finer points of budget making generally does not discern and is not interested in the real size of the development component of their budget authorizations. (ESCAP, 1993).
[7] See Schiavo-Campo and Singer, 1970.
[8] Distortions were observed, for example, in the multi-year budget prepared in the United Kingdom in the 1970s: "The experience suggests that there is a bow-wave in expenditures implying higher expenditures for the immediate fiscal year and tapering outlays for future years… the spending units trade cuts in future years in order to maintain the present amounts". Premchand, 1983.
[9] If this document includes a project list, it would be similar to the "noncore” PIP criticized earlier. The project list, if any, should therefore have the status of a "data bank", disseminated for information only, and projects therein should never be automatically integrated into the PIP and the budget. On balance, however, the risk that the process degenerates into a wish list is high enough to avoid listing any projects in the supplementary document.
[10] Is one to conclude, for example, that a waste management urban project with an estimated rate of return of 20% is preferable to a rural transport project with a rate of return of 15%? Clearly, other criteria come into play.
[11] See also "Poland: Strategic Investment Review". World Bank. 1992.
[12] "The ranking issue...is a rather ambiguous notion. For a given investment budget... projects are either acceptable and should be included in the investment program or are not acceptable and should be excluded... The only ranking in such instances is between the 'ins' and the 'outs'... There is no single ranking of projects that are added or deleted from the program in accordance with variations in its size. Changes in the investment budget tend to affect its general composition and not simply marginal projects". Squire and Van der Tak, 1975.
[13] Public Expenditure Management Handbook. World Bank 1998.
[14] The IMF Code of Fiscal Transparency suggests a need for aid-in-kind to be recognized, reported and incorporated into the budget process in some appropriate way.
[15] Ministry of Foreign Affairs, however, does have the important role of negotiating framework agreements with donors, governing the diplomatic aspects of the relationship.