
Increased Aid vs Absorptive Capacity: Challenges and Opportunities Towards 2015

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1 Introduction

The year 2005 promises to be an important year in the global struggle to fight poverty and underdevelopment. In the run-up to the UN Conference in September, which will assess progress in reaching the Millennium Development Goals (MDGs), a number of policy initiatives are being discussed, such as the creation of an International Finance Facility (IFF) and proposals on global taxes to finance development. These will be at the top of the agenda for the UK's presidency of the G8 and the European Union, with a specific focus on the problems faced by the African continent.

Since the MDGs were agreed to in 2000 by the General Assembly, increasing attention has been devoted to calculating and defining the level of resources needed to allow countries to reach them by 2015, and to mustering the necessary support from the international community. In the Monterrey Conference on Financing for Development, in 2002, rich countries renewed their pledge to increase development assistance towards the goal of 0.7 per cent of national income, provided poor countries took concrete steps to improve governance and adopt sound policies for growth. In the Rome Declaration on Harmonisation, signed in 2003, donor countries agreed to improve their levels of coordination, in order to enhance aid effectiveness and minimise the negative effects of fragmented and unpredictable aid flows.

Both the quantity and the quality of development assistance have received attention, on the premise that adequate, predictable and more effective aid flows are critical to reaching the MDGs. Estimates of necessary resources have varied substantially. The Zedillo Report, released before the Monterrey

Conference, put the additional cost of achieving the MDGs at about US\$68bn, roughly double the present level of aid, including humanitarian aid and the provision of "global public goods". A study carried out by the World Bank in 2003 (*Supporting Sound Policies with Adequate and Appropriate Financing*) found that progress towards the MDGs at country level could be accelerated through a combination of better domestic policies and improved governance, higher aid levels, more effective aid delivery, and improved market access to developed country markets. The study estimated that an additional US\$30bn was needed, which could be effectively spent by doubling aid to Asian countries with large shares of the population living in poverty (such as Bangladesh, India and Vietnam), and devoting sizeable, but smaller increases to more aid-dependent countries in Africa and elsewhere with less effective government systems.

The most recent of these assessments, which has received much public attention, is the UN Millennium Project Report (2005), coordinated by Jeffrey Sachs. It argues that substantial increases in aid-financed investment are needed to allow poor countries to break out of their "poverty traps" and create the conditions for self-sustaining economic growth. The report quantifies the amount of additional aid required to meet the MDGs on the basis of five country case studies where MDG needs assessments were carried out. Their results 'suggest that in a typical low-income country with an average per capita income of \$300 in 2005, external financing of public interventions will be required on the order of 10–20 per cent of GNP' (p. 55). Indicative figures put the projected aid needs at US\$135bn in 2006, growing to US\$195bn in 2015,

Table 1: Aid Dependence in Africa: Country Examples

	Population (million)	GNI p/c (US\$)*	Aid/GNI (%)	Aid p/c (US\$)
DR Congo	51.9	100	15	16
Ethiopia	67.2	100	22	19
Malawi	10.7	160	20	35
Mali	11.4	240	15	42
Rwanda	8.2	230	21	44
Sierra Leone	5.2	140	47	67
Tanzania	35.2	290	13	35
Sub-Saharan Africa	688.9	450	6	28

Source: World Development Indicators (2002 data).

* per capita

which represents 0.54 per cent of donor countries' national income.

According to the report, aid needs to be tailored to specific country circumstances. Middle-income countries will mostly need further debt cancellation and access to rich world markets. Well governed low-income countries caught in poverty traps are the ones towards which additional aid flows can be most productively channelled, but assistance should also go to countries poorly governed due to weak public administrations. Special arrangements should be adopted for countries that have experienced conflict, that are of urgent geopolitical importance, and that have special needs, such as vulnerability to natural disasters. Where conditions allow, aid should be "scaled up". The report identifies a number of countries that are already in a position for a massive "scale-up" on the basis of their good governance and absorptive capacity. These countries should qualify for "fast-track" status in 2005, gaining access to substantial additional aid.

So far the promises made by donor countries in Monterrey and Rome have failed to concretise, even though some progress has been made. A number of countries, including the UK, France, Spain and Ireland, have adopted specific deadlines to reach the 0.7 per cent target, and recently published figures from the Organisation for Economic Co-operation and Development/Development Assistance Committee (OECD/DAC) indicate that in 2003 aid increased substantially, reaching US\$69bn. The harmonisation and alignment agenda is less advanced, as donor countries struggle to turn their commitment to

improved aid practices into concrete behavioural changes at international and country level.

The prospect of substantial additional amounts of aid therefore depends crucially on the ways in which the international community will decide how to react to the UN Millennium Project Report in the run-up to the September MDG Summit, and to the UK Chancellor's efforts to convince donor countries to sign up for the IFF. This would allow for a significant front-loading of aid in the next few years, by raising funds on the international financial market against the promise of future commitments, and consequently for a substantial increase of aid flows, in particular to Africa. If this happens, the key question will be: 'Under what circumstances can increased aid be most effective in promoting development in Africa?'

The existing literature on aid effectiveness (surveyed in McGillivray 2005), largely focuses on the impact of aid flows on growth rates in recipient countries and is consistent in finding positive evidence that aid increases growth, and that consequently, it may have a significant impact on poverty levels. Another consistent finding, at the base of new approaches to "selectivity", is that aid's impact on growth depends on the quality of the recipient country's institutions and policies (Burnside and Dollar 2004). An interesting recent paper by the Center for Global Development (Clemens *et al.* 2004) also finds that particular types of aid, termed "short-impact aid" (which includes budget support, investments in infrastructure and aid to productive sectors), have a much stronger impact on growth than aid taken as a whole. This

Box 1: Constraints on Increasing Aid in the Health Sector

In the context of the work carried out by the Commission for Macroeconomics and Health, established in 2002, a team of researchers focused on the analysis of the factors hampering the widespread implementation of a set of interventions which could significantly improve the health of poor people in a relatively short time. They found that access to health interventions is hindered not just by an absolute lack of resources but also by a number of problems at different levels:

- At community and household level, lack of demand and physical, financial and social barriers to access
- At health service delivery level, shortage of qualified staff, weak management, and lack of adequate infrastructure and supplies, including accessibility
- At health sector policy level, weak systems and regulations, weak incentives to use inputs efficiently, lack of inter-sectoral partnerships, aid dependency and donor practices
- At the overall public policy level, overly bureaucratic and centralised systems, and lack of communication and transport infrastructure
- At the environmental level, governance issues such as corruption, political instability and lack of accountability, and issues related to climate and geography. Some of these constraints are more amenable to improvements through additional funds than others. For example, while shortages of inputs (e.g. staff, drugs and supplies, infrastructure and equipment) can be addressed with additional expenditure, other constraints linked to the overall governance and policy framework, and those imposed by geography and climate, cannot be easily solved.

Source: Hanson et al. (2003).

basic result, contrary to the selectivity arguments, does not depend on levels of income, strength of institutions or quality of policies. There are, however, clear indications that aid, like all other investments, has diminishing returns. Most studies indicate that an “aid saturation point” could be reached anywhere between 15 and 45 per cent of GDP, beyond which the marginal benefits of additional aid inflows become negative. This finding poses important questions about providing significant additional aid to Africa, where a number of countries are already highly aid-dependent (see Table 1). It is also reasonable to expect that the bigger and faster the increase in aid flows, the sooner diminishing returns will set in, as they will put additional strain on existing systems.

2 Absorptive capacity

What are the possible factors which cause diminishing returns? A small but growing literature (Heller and Gupta 2002; Clemens and Radelet 2003; World Bank 2004) refers to the term “absorptive capacity”, identifying some of the obstacles which may be limiting aid effectiveness, causing declining marginal returns and, ultimately, limiting the potential role of increased aid flows in reaching the

MDGs. Despite the general lack of clarity about the meaning of the term, a possible typology of absorptive capacity constraints would certainly include the following categories.

2.1 Macroeconomic constraints

Large and sudden increases in aid inflows in the form of foreign currency could provoke a “Dutch disease” effect, causing an appreciation of the exchange rate and therefore harming the export sector. When aid flows are in the form of loans, they can raise concerns about debt sustainability. Aid flows are often unpredictable and volatile, and can therefore negatively influence macroeconomic stability, by triggering inflation, interest-rate and exchange-rate volatility. This is often more the case when aid is in the form of budget support, which is often the first type to be reduced for political reasons, and can cause serious fiscal imbalances. Finally, aid increases can cause labour market pressures, by increasing demand for skilled labour and driving up wages.

2.2 Institutional and policy constraints

Recent research has highlighted and confirmed the view that “institutions matter” for development. In

Table 2: Classification of Absorptive Capacity Constraints

Short-term constraints	Long-term constraints
<ul style="list-style-type: none"> ● “Dutch disease” effects ● Administrative constraints due to lack of adequate infrastructure and equipment ● Perverse incentives in public officials’ performance ● Post-conflict and post-emergency constraints ● Inadequate public expenditure management systems ● Uncoordinated and unharmonised donor interventions 	<ul style="list-style-type: none"> ● Debt sustainability ● Major deficiencies in institutions and policy processes ● Technical and managerial skills of public officials (doctors, teachers, accountants) ● Social/cultural factors ● Difficulties in full donor shift to improved practices

low-income countries, more capacity is needed to generate credible strategies, policies and programmes to transform higher aid levels into positive development outcomes. The transparency and efficiency of budget systems, patterns of public expenditure, the degree of decentralisation of resources and responsibilities, mechanisms to define policy priorities and accountability systems to make governments answerable are but a few examples of institutional and policy factors that can determine a country’s performance in generating positive development outcomes. In many countries, such systems may not be adequate to absorb large increases in available resources without increasing wastage or fuelling leakage and corruption. High (and increasing) levels of aid dependency can also provide negative incentives for much-needed reforms, and shift government accountability from domestic to international actors.

2.3 Technical and managerial constraints

Related to the point above, there are a series of more concrete capacity constraints that need to be addressed urgently if increased aid is to make a difference not only in terms of institutions and policy-making processes, but also in terms of actual quantity and quality of service delivery. The human capital factor is crucial in this respect. Many poor countries are finding it difficult to recruit, train and retain qualified doctors, nurses, teachers, managers and administrators. In Africa, this is compounded by the effects of the HIV/AIDS pandemic. Moreover, lack of adequate infrastructure and equipment prevents access to goods and services and a more efficient transformation of public spending into

improvements in the standard of living. Large increases in aid can address some of these absorptive capacity factors, but potential falls in the productivity of public expenditure should not be overlooked, as unit costs of inputs and staff may rise, technical efficiency may fall and intended beneficiaries may be difficult to reach. Finally, a significant boost in the availability of public services (such as through the elimination of user fees) may not trigger sufficient demand, as socio-cultural factors may still prevent families from sending their children to school or to local clinics.

2.4 Constraints generated by donor behaviour

The way the aid system is organised, and the behaviour of donor agencies more specifically, can also be a source of absorptive capacity constraints. Fragmented interventions, whereby recipient countries have to deal with a plethora of donor organisations, each imposing uncoordinated and burdensome practices through small, dispersed projects. Such fragmentation imposes heavy transaction costs on scarce government capacity, taking time and resources away from potentially much more productive uses. Finally, the lack of certainty and predictability of aid flows can seriously hamper a government’s efforts at medium- and long-term planning, making sure resources are available for development programmes and public investments.

Absorptive capacity constraints, as seen above, can be of a very different nature. Some of them are likely to be more binding than others, in both the short and the long term. Table 2 attempts a

Box 2: Introducing Antiretroviral (ARV) Therapy in Botswana

Botswana has one of the highest reported HIV-prevalence rates in the world. In 2000, the Government established a partnership with the Bill & Melinda Gates Foundation and the pharmaceutical company Merck, Sharp & Dohme to make antiretroviral treatment available in the public sector. A feasibility study was carried out to respond to three key questions:

- What is the estimated number of patients who would require ARV therapy?
- How well is the country situated to be able to provide ARV therapy from human, financial and physical resource perspectives?
- What is the best way to tackle the issues and logistics associated with providing effective ARV therapy nationwide?

The assessment adopted a demand–supply model which combined clinical research, public health and business principles, and accurately identified the additional resources needed for a successful roll-out (see Table 3), which highlighted the lack of pharmacists, lab technicians, viral load tests and storage capacity, and the need to train and involve community health workers in the programme. Subsequently, a detailed launch strategy was developed, focusing first on specific patient groups with the highest need (e.g. HIV-infected women, children and tuberculosis patients), and grouping activities by work stream, such as recruitment and training, laboratory capacity, counselling and community mobilisation, drug distribution, etc. Specific cost estimates were also produced, along with a monitoring system that allowed for gradual implementation, determined by operational readiness of new sites, and verified through a minimum requirement check list.

Source: WHO (2004).

preliminary classification of absorptive capacity constraints, evaluating the relative difficulty of relieving them in a reduced timeframe.

3 The agenda for action

Given the constraints described above, which pose serious questions for the proponents of substantial increases in aid levels, what possible approaches can help to create the conditions for the more effective use of additional aid resources? What can donors do to address these issues in a productive way?

3.1 Do your homework

Much of the existing evidence on absorptive capacity constraints is scanty and inconclusive. Donors should invest more resources in understanding the specific dynamics which allow for the effective translation of public resources into development outcomes. In particular, donors need to understand the political systems of the countries they are working with, and support accountable domestic institutions. This could help tackle problems related to corruption, elite capture and unrepresentative government. Donors should also strive to adopt a more flexible approach which fits local circumstances, and to

improve their awareness of the possible perverse effects of aid modalities and donor behaviour.

3.2 Harmonisation and alignment

Addressing more forcefully issues related to fragmentation, high transaction costs and unpredictability is one of the most important things donors can do. Ensuring that the aid system actually facilitates development processes, rather than hindering them, will depend crucially on radical changes in simplifying procedures, eliminating burdensome practices, relying more on country systems, reducing the overall number of donors acting in any one sector or country, and more generally provide a bigger share of aid through multilateral agencies. Defining the way in which the IFF will function will be important in this respect. Broader reforms of the global aid architecture should also be considered.

3.3 Careful design of interventions

Development interventions should be designed taking absorptive capacity constraints into account, rather than assuming that more resources will immediately translate into improved outcomes.

Box 3: Cash Transfers as an Alternative Aid Delivery Mechanism

There is growing evidence of the effectiveness of direct cash transfers in reducing poverty. Evaluation results from the first generation of Conditional Cash Transfer programmes in Brazil, Mexico and Nicaragua showed clear evidence that they contributed to increasing enrolment rates, improving preventive healthcare and raising household consumption. Evidence from cash transfers to demobilised soldiers and flood victims in Mozambique also pointed to their low administration costs and their contribution to improving livelihoods of recipients. While in rich countries more than 80 per cent of the population is covered by one or more forms of cash transfer programmes, in Africa and Asia such programmes cover less than 10 per cent of the population. This is due to a widespread belief in development policy circles that income transfers to the poor do not work. This belief needs to be revisited, with more focus given to issues of the design (e.g. targeting) and implementation (e.g. feasibility and delivery channels) of potential effective interventions. Experiences with poverty reduction schemes in India have identified recurrent features of relatively successful schemes. These include small and regular payments (which attract less misappropriation), high levels of automaticity (with reduced discretion among local officials) and strong awareness among intended beneficiaries of their rights (linked to simplicity of design). These mechanisms have the potential to deliver great poverty reduction benefits with lower administration costs.

Source: Hanlon (2004); Farrington et al. (2003); Rawlings and Rubio (2003).

Short-term and long-term constraints should be considered in the design phase. Country by country and sector by sector, recipient governments should be assisted in developing sound strategies for dealing with increased aid. Innovative approaches which harness the capacities of the private and voluntary sectors can contribute to such efforts (see Box 2).

3.4 Macroeconomic management

The macroeconomic implications of increased aid are often overlooked, with potential conflict between strategies to achieve the MDGs and fiscal constraints imposed by the International Monetary Fund. The limited evidence available shows that sensible macroeconomic management can deal with increased aid inflows, but this will crucially depend on the nature, scale and speed of such increases. One way to avoid “Dutch disease” effects is to spend aid resources on import commodities in kind, such as drugs to treat malaria or HIV/AIDS. Careful investments to bring down production costs, such as in transport infrastructure, may reduce the risk of a loss of competitiveness due to exchange rate appreciation.

3.5 Renewed focus on infrastructure

Infrastructure, and the productive sectors more generally, have been largely overlooked in recent years as far as the distribution of aid is concerned. Both the UN Millennium Project and the

Commission for Africa report are putting great emphasis on reversing this trend, especially in Africa, where the expected increase in the role of the private sector did not materialise. A substantial boost to aid-financed investment in infrastructure could provide an important contribution to increased sustainability of long-term development efforts.

3.6 Innovative delivery mechanisms

A major increase in aid to assist poor countries in reaching the MDGs should also spur some thinking about alternative arrangements which could either provide better incentives for recipient governments to use resources effectively, or test new delivery mechanisms to reach poor people directly. For example, trust funds could be set up with additional resources for countries to draw down from as they gradually relax absorptive capacity constraints, or as they manage to improve their overall governance systems. Also, a system of direct transfers to poor people could be devised in order to set up something similar to a “global welfare system” (see Box 3).

4 The agenda for research

While the suggestions presented above provide some initial food for thought in terms of taking absorptive capacity constraints into account, there is a more general need to shed additional light on some of the more controversial issues. Several specific areas for research could help in creating a better understanding

Table 3: Additional Needs for Treating All Patients Requiring ARV

Key resource	National capacity	Incremental ARV capacity required	National capacity increase for ARVs
Doctors	514 FTEs	150 FTEs	29%
Nurses	4,416 FTEs	330 FTEs	8%
Pharmacists	29 FTEs	50 FTEs	179%
Lab technicians	164 FTEs	90 FTEs	115%
Community health workers	–	1,000 FTEs	–
ELISA tests	1,464 per day	700 per day	48%
CD4 tests	100 per day	2,500 per day	2500%
Storage	10 m ³	42 m ³	420%

Source: WHO (2004).

FTE – Full-time equivalent; ARVs – antiretrovirals.

of the conditions under which a major increase in aid is a feasible and more effective strategy.

4.1 Macroeconomic impact

More and better evidence is needed on the impact of increasing aid flows on macroeconomic variables, on the structure of prices and economic output, and on monetary and fiscal management, in order to avoid possible counter-productive effects and to influence changes in the guidance that institutions such as the IMF give to poor countries. This will help in developing macroeconomic strategies that are more conducive to growth and development.

4.2 Politics and institutions

A deeper understanding of the political economy factors driving countries' development strategy

choices, including the incentives created by domestic politics and by the aid relationship, could help shed light on the shortcomings of current donor interventions, and identify better entry points for assisting in the nurturing of development-oriented states.

4.3 Past success stories

In order to guide other experiences, research focused on looking at past success stories, where large increases in external inflows were successfully integrated and utilised for development purposes. Cases of particularly effective sectoral strategies, of the use of natural resource rents and of reform efforts that allowed for a significant step-change in public sector performance could be drawn upon.

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