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Briefing note:

Economic impact of increased aid flows for HIV/AIDS in developing countries

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"For example, when I hear that countries are choosing to comply with medium-term expenditure ceilings at the expense of adequate funding of AIDS programs, it strikes me that someone isn't looking hard enough for sound alternatives. And I recognize that such principles of fiscal discipline are in place for good reason, but surely there must be means of accommodating vast new inflows without stirring economic demons." Peter Piot[1]

Introduction:

This quote clearly illustrates the perceived tension between the (economic) rational for increased investments, of human and financial resources, to tackle the impact of AIDS and the potential economic implications of such increased aid flows.[2] Though they are interrelated, this note distinguishes between the (i) macroeconomic, (ii) budgetary and (iii) sectoral implications of increased new aid flows for AIDS.

The note concludes that the discussion about the potential negative effects of increased aid flows for AIDS is more relevant with regards to the credibility and predictability of donor financing, than to the macroeconomic problems of absorbing new aid flows. The way in which existing and new donors deal with the national budgetary process is crucial to ensure effective funding with limited distortion of the economy.

1. Macro-economic implications of increased aid flows for AIDS

An increase in domestic income from an external source, such as development aid, will lead to an increase in the aggregate demand in a country, both for imports and for domestic, non-tradable goods and services, including public services. Unless production is already high enough to cover the increased demand ("overcapacity"), an increase in demand will cause the prices of domestic goods and services to rise.[3]

Such increase in the price of domestic goods and services will make these products relatively expensive in comparison to what could be purchased abroad.[4] Because of this relative price difference, the export sector will become less competitive. There will be less demand abroad for the products from the export sector and subsequently financial resources and mobile labour will prefer to be employed in the production of goods and services for the domestic market (or in the context of aid flows, in the sector in which external aid is invested). Given the important role of the export sector in many countries, this process can lead to an overall reduction in investment, production and employment.

This phenomenon is often referred to as the "Dutch Disease", because of the unexpected economic implications of the exploitation of gas in the Netherlands in the sixties. At that time, the international sale of gas did not immediately lead to economic prosperity, but initially caused higher unemployment, lower overall exports and inflation. Any inflow of foreign funds,

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[1] Presidential Fellows Lecture, World Bank, November 2003
http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20140527~menuPK:34476~pagePK:34370~piPK:34424~theSitePK:4607,00.html

[2] Since the call from the United Nations General Assembly Special Session on AIDS (UNGASS) in 2000 there has been a significant increase in the resources for AIDS. For example, the World Bank has committed US$ 1 billion, the Global Fund for AIDS, TB and Malaria (GFATM) US$ 1.5 billion for 93 countries, and the President's Emergency Plan for AIDS Relief (PEPFAR) US$ 12.5 billion in bilateral aid over 5 years.

[3] Section 3 will deal with the implications of price increases, or upward pressure on wages, in the health sector.

[4] This is effectively an appreciation of the real exchange rate.

from gas or development aid, could potentially lead to the "Dutch Disease", regardless of the way in which the foreign financial resources are delivered (e.g. project/programme, private/public, commercial/non-profit).[5]

Under these circumstances, monetary and fiscal policy is a hard task, especially if it is uncertain when and how much external financial resources will be received. Moreover, it is crucial to know whether the inflow is permanent or temporary. If the central bank and the financial authorities respond too little, i.e. allow the money supply and the demand for goods and services to expand, the increase in prices could lead to too much inflation. If the authorities react too much and limit the money supply and demand by selling foreign exchange or government debt, there is a risk that the exchange rate appreciates too much and the interest rates increase, what could emphasise the negative impact on the export sector and overall investments and employment.[6]

However, there is little reason for governments to refuse development aid from reliable sources on the basis of the "Dutch Disease". If aid is well managed and effectively spent, the returns to aid (e.g. improvements to productivity thanks to improved health status of a country) should be able to offset the above-mentioned short-term, negative effects, and enhance economic growth and development in the longer term.[7] Moreover, the larger the proportion of aid that is spent on imports rather than on domestic goods, the smaller the initial negative impact will be. This is often the case with investments in the health sector (e.g. drugs, medical equipment).[8] The predictability and the transparency of aid flows (especially in the context of budgetary support as this will affect the overall budget of the government) are important for managing the economic implications of increased external financial resources and for safeguarding macro-economic stability.

These considerations certainly apply to prospective new aid for **HIV/AIDS**, depending on how the money is spent. For example, aid for preventative programmes should be high return (e.g. avoids the cost of illness and saves productive lives of those who avoided infection) and boost competitiveness in the medium to longer term by much more than any initial negative impact of aid. Treatment programmes are lower return because of the higher costs of treatment (prevention is better than curing). However, these programmes will have a more immediate positive impact on competitiveness compared to preventative programmes, by directly reducing the impact of AIDS on the productivity of the workforce. Moreover, the inevitable large import component of HIV/AIDS treatment programmes (e.g. drugs) in many countries could further mitigate the negative macroeconomic impact of the large aid flows to fund these programmes.

2. Budgetary implications of increased aid flows for AIDS

Governments need to consider macroeconomic stability when determining the kind and level of government income, including taxation and deficit-financing. There will also be limitations on

[5] It is also relevant for aid flows delivered outside of government as this will just as well lead to an externally-induced increase in demand for domestic goods and services. The risk of negative economic implications might even be higher if the government is not able to anticipate and sterilise the effects.

[6] Monetary authorities, as the central banks, have the task of adapting the money supply to the demand for money, in order to control inflation. If government uses the external aid flows to increase expenditure, this will lead to an expansion of the money supply. As a response, the central bank or fiscal authorities may decide to sell either foreign exchange or domestic debt for domestic money. This reduction of the domestic money supply will counteract the increase due to government expenditure. However, these interventions risk increasing the nominal exchange rate and the interest rate (i.e. price of domestic money).

[7] See also IMF Working Paper 04/49 March 2004 "Aid and Dutch Disease in low income countries", March 2004

[8] Though there is a limit to how many imports can be absorbed by the existing domestic infrastructure and human resources.

the public expenditure (for the total budget and for each sector), including for the expenditure that is financed by foreign resources. Donors play an important role because of the predictability and transparency of their commitments and timing of the disbursements, but also because of the (often implicit) influence large donors can exert on the national priority setting within the public expenditure of a country.[9]

The overall budget limit of government is most often set centrally for several years, for example in the so-called "medium term expenditure frameworks" (MTEFs). It can in principle be revised each year at specific times according to the national budget cycle. Most public expenditure, including that which is funded by external aid, is recurrent (e.g. salaries and costs of non-durable consumption goods) rather than investment spending (purchase of assets), which reduces the flexibility of budget allocations (see also section 3). Even in growing economies with extra resources to deploy each year, changes in the composition of the budget are therefore normally effected only gradually.

In this context, significant aid flows, often unpredictable and volatile, might have a destabilising impact on the budgetary process and allocations. Commitments might be earmarked for specific purposes, regardless of the overall income of government from other sources. Commitments do not always lead to disbursements, and disbursements might be delayed by years. Moreover, it is often unclear whether the increase of external financial resources is temporary or permanent, which makes it difficult to incorporate the expected level of aid in a budget and the macroeconomic programme. If a government makes spending plans for substantial aid that does not materialize, it must resort to crude spending cuts or inflationary financing (e.g. increase in budget deficit). This undermines the credibility of the budget process and cause macroeconomic and political instability. If a country decides not to immediately spend an apparently unreliable new flow of aid, it only risks saving that aid if it does materialize, which is much less damaging.

The fact that aid levels below expectations cause more problems (extra borrowing and reduced spending) than aid levels in excess of expectations (costs of possible short-term macro instability) tends to drive countries to be cautious to adapt spending plans for aid through relatively new channels (like GFATM, PEPFAR), without a reliable track record of disbursing in a predictable and non-erratic way. With some channels, the risk is that new flows will not be reported to government at all, which leads to additional activities (i.e. net aid for HIV/AIDS increases) but may cause unwanted macroeconomic impact, as governments cannot anticipate and manage its effect. Only if there were a proposal to increase net flows of aid from a credible source in a predictable and permanent way, would an increase in the expected level of aid and therefore the programmed (aid-financed) budget deficit seem justified.

Moreover, it is important to note that only rarely do "new" or "additional" aid flows earmarked to a particular area, such as AIDS, lead to an actual increase in the net flows of aid to AIDS-affected countries.[10] Even the total expenditure on the earmarked area might not necessarily

[9] This briefing note does not address the additional economic impact of development funding in the form of loans rather than grants, i.e. the increase of debt. However, these are important, for example with regards to the earmarking of the World Bank's IDA grants for AIDS. The note will also not discuss the disruptive influence of "aid dependency", though this might have economic implications as well, e.g. high transaction costs or inefficient expenditure due to distorted incentives for allocating expenditure.
[10] Though it is very difficult to establish the counterfactual, i.e. how much aid would have been available in each country in the absence of these large earmarked funds, there has been a general downward trend in overall development assistance, regardless of increased resources for AIDS. For example, average annual per capita aid declined from US$ 13.0 in 1990-94 to US$ 9.8 in 2000-01 in low-income countries. As a percentage of national income (GNI) the annual average declined from 3.4% in 1990-94 to 2.3% in 2000-01. World Bank, World Development Indicators 2003.

increase in reaction to increased aid flows allocated to this priority. The national authority, not to mention other donors, will allocate their resources around that earmarked commitment in pursuit of their own priorities. Every priority is under-financed and donors' habit of switching the earmarking of aid makes it difficult for national authorities to sustain efforts in priority areas, but they will try to. Therefore, if donors increase aid for AIDS, government might increase the allocation of external resources to AIDS, but reduce the allocation of its own resources to this priority. Thus, aid earmarked for all but the lowest priority activity for government will be at least partially fungible in its impact on net resource allocation.

3. Sectoral implications of increased aid flows for AIDS

As discussed, there is little reason to limit permanent and predictable increases in aid on the grounds of macroeconomic absorptive capacity. However, absorptive capacity at a sectoral level, for example in the health sector, does warrant more attention. This relates to the capacity of governments' systems and processes to efficiently manage an expansion of financial and human resources ("management capacity"). It also involves the capacity in priority sectors to design and effectively implement interventions ("implementation capacity"). A key issue in this regard is, for example, the limited availability of skilled personnel in the health sector to absorb the increasing demand for treatment and care for people living with AIDS. The following discusses how the extent to which limitations to absorptive capacity can be overcome, will determine the risk of negative macroeconomic consequences.

The previously discussed increase in the price of domestic goods and services, generated by the higher aggregated demand due to external financing, will inevitably also affect the goods and services in the health sector. This is expressed in, for example, upward pressure on the wages of health staff, if the demand for personnel (at least of a specific skills level) exceeds the supply. Such upward pressure on public sector personnel in any specific sector needs to be handled with care because of the difficulty of containing such pressures within one sector of the civil service and the need to carefully manage (inflexible) recurrent costs such as the government's wage bill.

The upward pressure on the wages can only be counteracted by long term investments in expanding the capacity of the health sector, such as improvements in efficiency of current resources, retention of current personnel or training of new personnel and attraction of foreign labour. However, governments will find it hard to commit to such long term commitments unless there is some degree of certainty that the external financing for these investments is permanent and predictable, so that in the long term the increase in recurrent costs remains affordable. As discussed previously, the net benefit of such investments will depend on the long term positive impact of the government policies and the development financing in this area, which are needed to compensate the short term inflationary effect of increased public expenditure in the health sector.[11]

Without doubt, the absorptive capacity varies between countries, depending on, for example, the general institutional capacity of the public sector, the level of decentralisation and the cooperation with the private sector. Moreover, capacity problems can be overcome by taking a sector-wide approach to priority interventions as HIV & AIDS, by devoting sufficient attention to the health systems as a basis for enhancing capacity in the health sector and by placing sectoral programmes within the wider context of development. For example, public sector

[11] The WHO's Commission Macroeconomics and Health (CMH) has undertaken extensive research into the positive economic impact of investments in the health sector.

reform programmes that are effective in improving the implementation and management capacity of government, will subsequently contribute to the mitigation of the impact of AIDS.

4. Conclusions

The macroeconomic impact of increased aid flows is manageable and rarely a reason for delaying or refusing stable and predictable increases in aid. The long-term benefits of aid should be able to offset any initial negative impact of large inflows of external financing. However, the fact that aid levels below expectations cause more problems (higher debt and spending cuts) than aid in excess of expectations will cause countries to be cautious when the anticipated increase in aid consists of large, but potentially volatile or short-run pledges with limited credibility regarding disbursement or sustainability. Predictability and transparency of external resources are crucial in order to avoid economic instability.

Moreover, active engagement with national government and alignment with the government's resource allocation process is probably more effective in ensuring that sustainable new flows of aid result in expanded expenditure for priority programmes than trying to influence spending patterns by insisting on demonstrations of "additionality" of aid or earmarking external funding.

The way in which aid is delivered also plays an important role with regards to the sectoral absorptive capacity. Practices as donor harmonisation and alignment have the potential, when implemented effectively and on a large enough scale, to reduce the burden on existing capacity in the public and private sector. Moreover, external financing that is aimed at improving the long term capacity of the health sector, for example through sector-wide approaches and health system improvements, will further reduce the risk of macroeconomic instability.

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