



Institute of Social Studies

Graduate School of Development Studies

**THE IMPACT OF PROGRAMME *versus* PROJECT AID ON
FISCAL BEHAVIOUR IN THE GAMBIA**

“IMPLICATIONS FOR AID FLOWS SUPPORTING THE PRSP”

A RESEARCH PAPER PRESENTED BY:

MORRO CAMARA
(THE GAMBIA)

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Members of the Examining Committee:
Professor Dr. Rob Vos
Drs. Jan Van Heemst

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Enquiries:

Postal Address:

**Institute of Social Studies
P.O. Box 29776
2502 LT The Hague
The Netherlands**

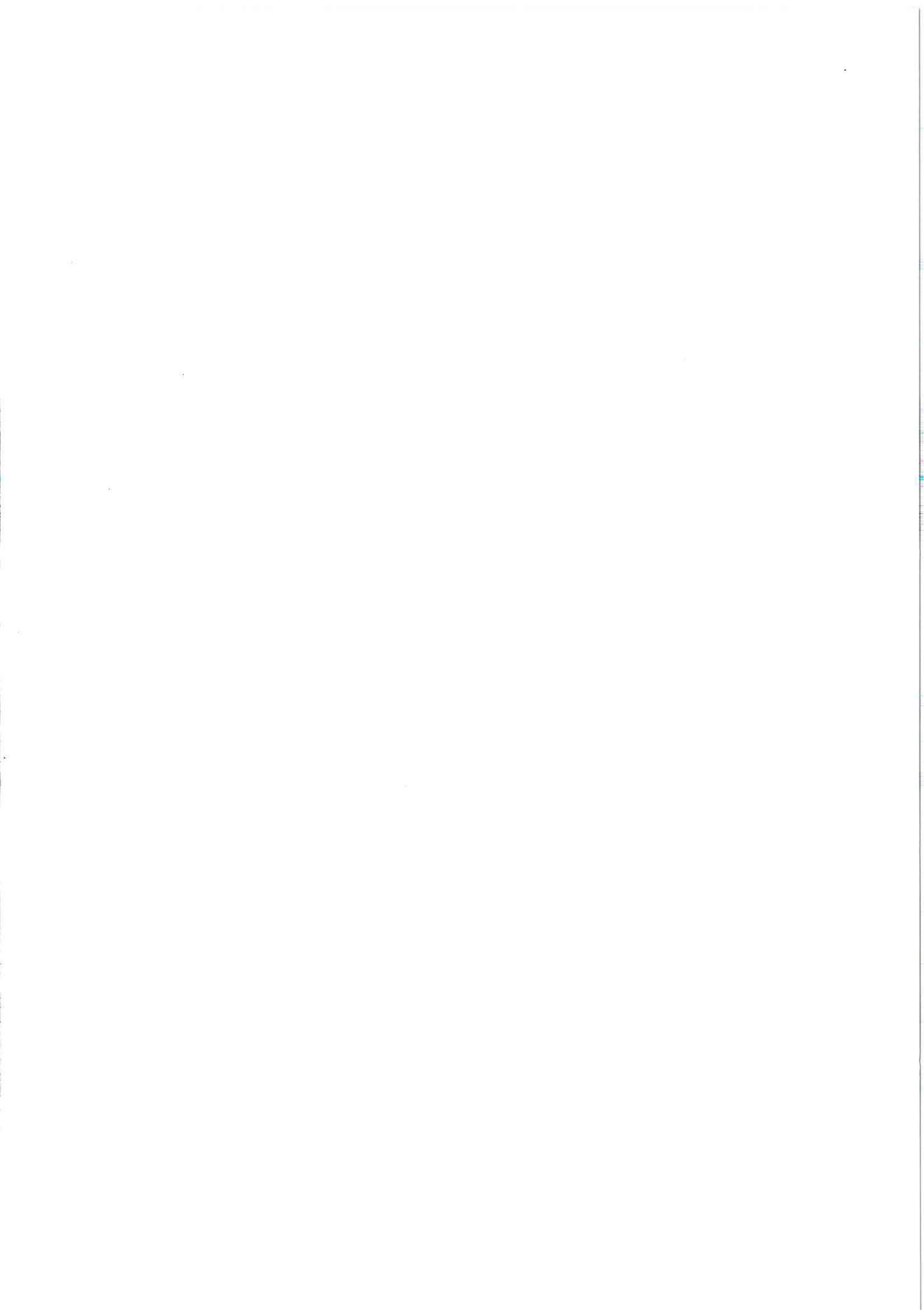
**Telephone: +31-70-4260 460
Telefax: +31-70-4260 799
email: zubli@iss.nl**

Location:

**Kortenaerkade 12
2518 AX The Hague
The Netherlands"**

DEDICATION

I dedicate this piece of work to the loving memories of my beloved parents: My stepmother Mrs. Majula Sanneh (died in August 1990), my mother Mrs. Wuday Jamba (died in March 1991) and my father Mr. Jonkunda Camara (died in June 2002). Only words can describe the happiness it would have been to enjoy this moment of achievement with you. You've been wonderful and caring parents, and I would always cherish these memories of you. May your noble souls rest in eternal peace (Amen).



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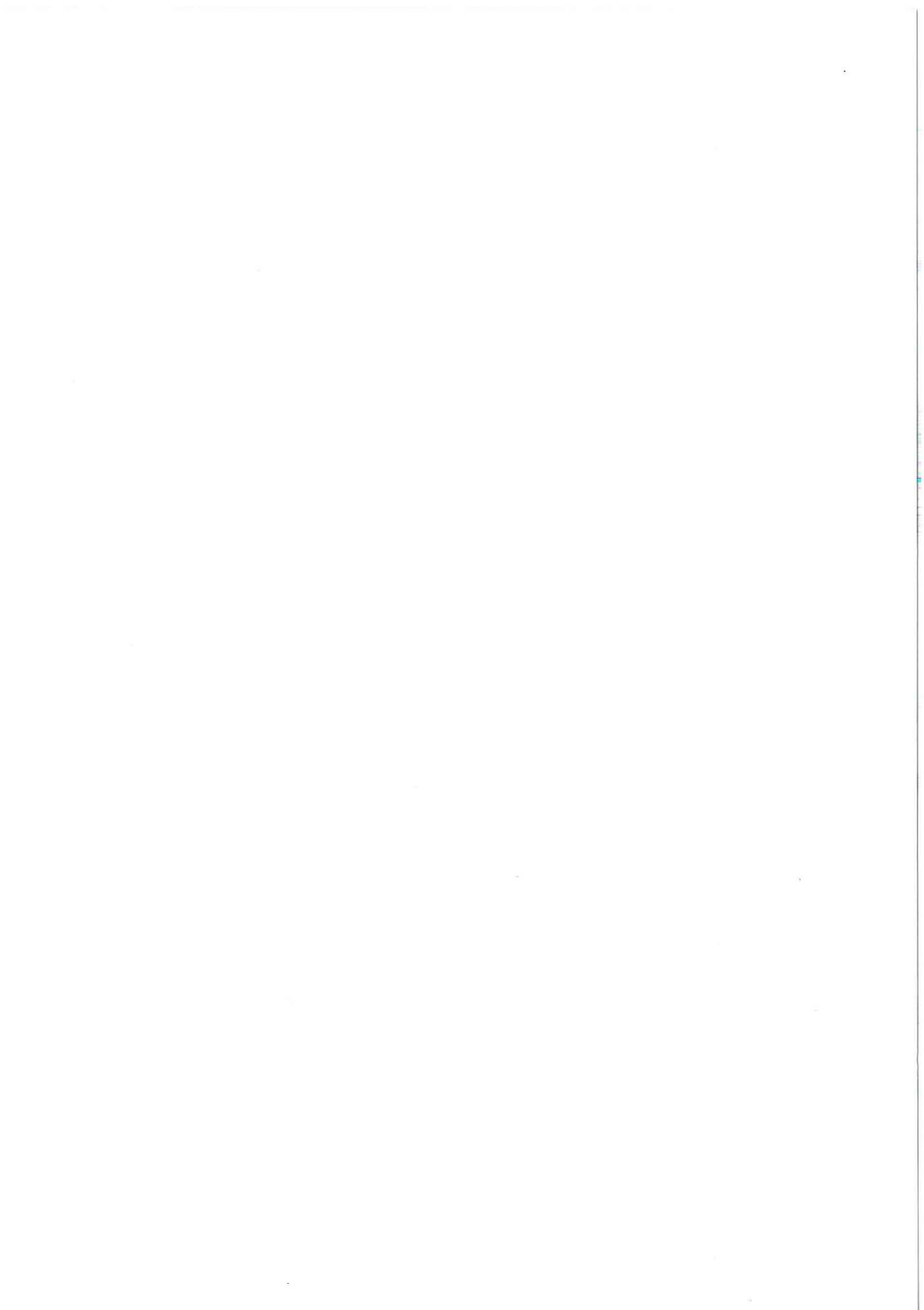
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CHAPTER 1: INTRODUCTION

1.1 General Background

Since foreign aid has existed, its experience has been a mixed one. Anecdotal evidence did show that foreign aid as a tool for development finance in the least developed countries and as predicted, did not bridge the gap between the richer countries mainly of the North and the poor countries of the South. A number of explanations have been given for what the World Bank 1998 report¹, referred to as the lack of spectacular success in many of the countries that received aid. One of these was the positive link between effective aid utilisation and sound policy reform. For instance, since early 1980s, virtually every African country has received large amounts of aid aimed at stimulating policy reform. The results have varied enormously among recipients. Ghana and Uganda were successful reformers that grew rapidly and reduced poverty. Côte d'Ivoire and Ethiopia (mixed reformers) showed significant reform in recent years, but it remains to be seen if this is sustainable, whereas in other countries, policies changed little or even got worse². Policy reforms were conceived of broadly as including effective macroeconomic policies, social service delivery, and democratic reforms (i.e. elections, effective government institutions, protection of human and property rights, and rule of law).

The traditional methods of disbursing aid have been either through project approach or programme approach. Under project approach, funds are provided directly to specific projects whilst under programme approach support is provided to the recipient government's budget (budget support) with conditionality on how to allocate the available resources. However, according to Van der Hoeven (2001) as quoted by Szirmai (2004:pp.7), the international economic climate of the 1980s forced many donor countries to adjust their economies in order to accommodate to external shocks. This led to a shift from project to programme aid in the form of structural adjustment programmes and conditionality. This period has also witnessed a growing restlessness among the

¹ World Bank report: *Assessing Aid, what works, what doesn't, and why 1998*: www.worldbank.org/aid

² World Bank report: *Aid and Reform in Africa, 2001*: www.worldbank.org/aid

donor countries over the effectiveness of aid in reducing poverty and stimulating growth. Much attention is focused on fiscal impact of aid, i.e. impact of aid on public expenditures. History shows that public expenditure has long been considered as one of the main channels through which foreign aid influences development outcomes. Accordingly, the donor community became increasingly concerned that development assistance earmarked for critical social and economic sectors is being used directly or indirectly to fund unproductive expenditures including those of defence. This has exerted pressure from public opinion on whether or not aid should in fact exist given its mitigated results in recipient countries, and questions being raised about aid modalities.

In the recent discourse on aid effectiveness, the debate is centred on which forms of aid have the greatest impact in promoting growth and reducing poverty. The major debate is between programme and project aids, with the former argued to be more effective than the latter. Proponents of programme aid argued that delivering aid through project approach led to a proliferation of parallel management systems (e.g. the Project Implementation/Management Unit) within or outside the public administration, thus hampering coordination, planning and budgeting, especially for the recurrent cost of investments. Project approach was also associated with policy inconsistencies as each project had its own agenda reflecting the views of the donor and the project staff. In addition, the project approach led to building of limited local capacity as it often contained a significant amount of technical assistance in the form of expatriate advisers for both technical and supervisory reasons. This clearly raised the transaction cost of aid delivery (i.e. salaries of expatriates, office space, and other logistics). Accordingly, even though projects were often designed to bypass macroeconomic, sectoral and administrative constraints, these proved to prevail only in the long-term. The overall result has been a loss of accountability in the management of public expenditures, thus limiting the effectiveness of the project approach (Christensen 2002:pp.1).

The limited effectiveness of project approach and the increased understanding of the importance of conducive macro-economic and sectoral frameworks led the development community in the 1990s to increasingly shift resources towards the sector-wide

investments, leading to new aid modality known as the Sector-wide Approach to Planning (SWAP). The SWAP modality is based on six essential features that include: (i) local stakeholders fully in charge (ii) Sector-wide in scope covering both current and capital expenditures, (iii) based on clear sector strategy and policy framework, (iv) all main donors sign on to the approach in a process led by government, (v) common implementation arrangements, and (vi) using local capacity rather than long-term technical assistance for design, management and implementation (Christensen, 2002:pp.2).

In a bid to popularise the SWAP, the international donors have worked to coordinate policies and harmonise procedures, at the same time assisted in strengthening recipient's leadership. For instance in 1996, the Development Assistance Committee (DAC) of the OECD clearly stated efforts in line with the strategies of partner countries to maximize the development effectiveness of aid resources. In 1997, the United Nations launched the first stage of its reform with the implementation of the UN Development Assistance Framework (UNDAF) and the Common Country Analysis (CCA). In 1999 the World Bank after launching the Comprehensive Development Framework (CDF), jointly launched the concept of Poverty Reduction Strategy Paper (PRSP) with the International Monetary Fund (IMF) as a framework of integrating nationally owned poverty reduction strategies in low-income countries (Claret de Fleurieu, 2003). These strategies are expected to be country-driven, results-oriented, comprehensive and long-term in perspective, and foster coordination and domestic and external partnerships. The initial aim of the PRSP is to link the debt reduction of Heavily Indebted Poor Countries (HIPC) and the attribution of concessional IMF and Bank loans, with a country-defined poverty reduction strategy. But its approach is intended to include a global framework for development assistance beyond the operations of the Fund and the Bank to promote coordination and complementarity among donors. Subsequently, other donors firmly supported the PRSP process.

The above issues of aid, no doubt raises important questions about the implication of development assistance on recipient countries, and The Gambia being an aid dependent

country is no exception to this. How will the shift from project to programme aid mean for The Gambia? Providing an answer to this question requires tracing the history of aid to The Gambia to see how each of the categories of aid (programme aid and project aid) affects government revenue and expenditure decisions (the so-called fungibility issue of aid). What will be the implication for the aid flows that support the PRSP that is claimed to provide better aid modality in the form of programme support and enhances donor coordination? These are the issues explored in this paper.

1.2 Statement of the Research Problem

Aid has been an important macroeconomic variable in the development of The Gambia. The percentage share of aid to the country's GDP is 12.4% (2001) and the net ODA per capita is US\$38 (2001, current prices). Contrasting these with those of Uganda, a prominent aid recipient country (13.8% of GDP and US\$34 per capita, 2001 current prices)³, shows that The Gambia relies heavily on aid to finance its macroeconomic policies. However, like most aid recipient countries, the impact of aid on The Gambia's development has been mixed. A major factor identified as responsible for this is the ineffective coordination of the country's aid with proliferation of parallel management systems. Since 1985, the country has dealt with large number of donors, often with different priorities and procedures for appraisal, procurement and disbursement of aid. However, the uncoordinated nature of the country's foreign aid has made development assistance ineffective in meeting the targeted goals. In particular, ineffective aid deliveries have among others, resulted to unsatisfactory flow of information and reporting on aid receipts and utilization, lack of strong linkages between macroeconomic planning and sectoral strategies; and the inability of government to combine, integrate and consolidate its sectoral policies into programmes to support the priorities for long-term development⁴.

Recently in line with the new thinking in development cooperation, the government has formulated and implemented a PRSP with a view to promote coordination and harmonisation among the donors and ensuring efficient utilization of limited development

³ See the African Development Indicators 2003

⁴ See the Draft Aid Coordination Policy Document for The Gambia, 2000: pp.3

funds, including the HIPC Initiatives. Currently, the government is on the second phase of its poverty reduction programme with the second Strategy for Poverty Alleviation (SPAII) in place. A major shortcoming of SPAI is ineffective aid coordination, which SPAII aims to address. The focus of this research is exploring this issue in the context of the debate of programme versus project aid and the likely implication on the PRSP.

1.3 Objectives and Contributions of the Research

The main objective of this study is to revisit the debate of programme versus project aid and re-examine the claim that the PRSP encourages a change in aid modalities towards programme aid and makes government expenditure more pro-poor. This requires two understandings. First, is to understand the past fiscal behaviour in the presence of aid i.e. understanding the fungibility of aid. Second, is to understand how the way programme aid is given under the PRSP could lead to (less?) fungibility. Against these basic objectives, the research hopes to make among others the following contributions:

1. It enhances understanding of the debate of reforming development cooperation, which is a major issue in the development discourse with both donors and receiving countries expressing concern over aid modalities.
2. It strengthens aid effectiveness literature and helps in understanding the fiscal effects of aid. There is a large literature on the effectiveness of aid⁵, but to our knowledge, there has been limited attempt to compare the different types of aid instruments in a formal model⁶. This paper particularly provides a formal test on the debate of programme versus project aid and the impact this may have on the PRSP process.
3. It lays foundation for future researches on aid to The Gambia that is currently limited. To the best of our knowledge, the research is also the first of its kind on the different types of aid to The Gambia.
4. Finally, the paper provides a useful insight on policy formulation regarding aid and poverty reduction strategy that helps in The Gambia's PRSP implementation.

⁵ See for example: World Bank reports (1998 and 2001); Dollar and Coulier (1999); Wilkes (2001), Foster and Fozzard (2000); White (1996); Paul (2002), among others.

⁶ See Cordella and Dell'Ariccia (2001); and Mavrotas and Ouaterra (2003).

1.4 Research Hypotheses and Questions

The main hypothesis for this research is that programme aid conditions the overall spending structure of the budget rather than just specific commitments as in project aid.

This hypothesis is tested on The Gambia by addressing the following questions:

- i. Is programme aid more fungible than project aid?
- ii. If the PRSP process encourages a change in aid modalities towards programme aid, will this make aid more fungible?

To find answers to the above questions, the paper addresses the following core issues:

- The rationale for programme aid in the context of: structure, local capacity and systems, transaction costs, ownership, fungibility, predictability, pro-poor budget setting, donor influence and policy change, sustainability, and unutilised donor funds. In addition, the underlying assumptions of programme aid, link between programme aid and PRSP, and the key risks of programme aid are discussed. These attempts to indicate the reasons that explain the shift from project to programme aid.
- The conceptual framework of aid fungibility: the definition of aid fungibility with illustrations of some stylised facts, and review of some empirical studies on aid fungibility.
- Policy dimensions of aid fungibility for the PRSP process.

1.5 Scope and Methodology

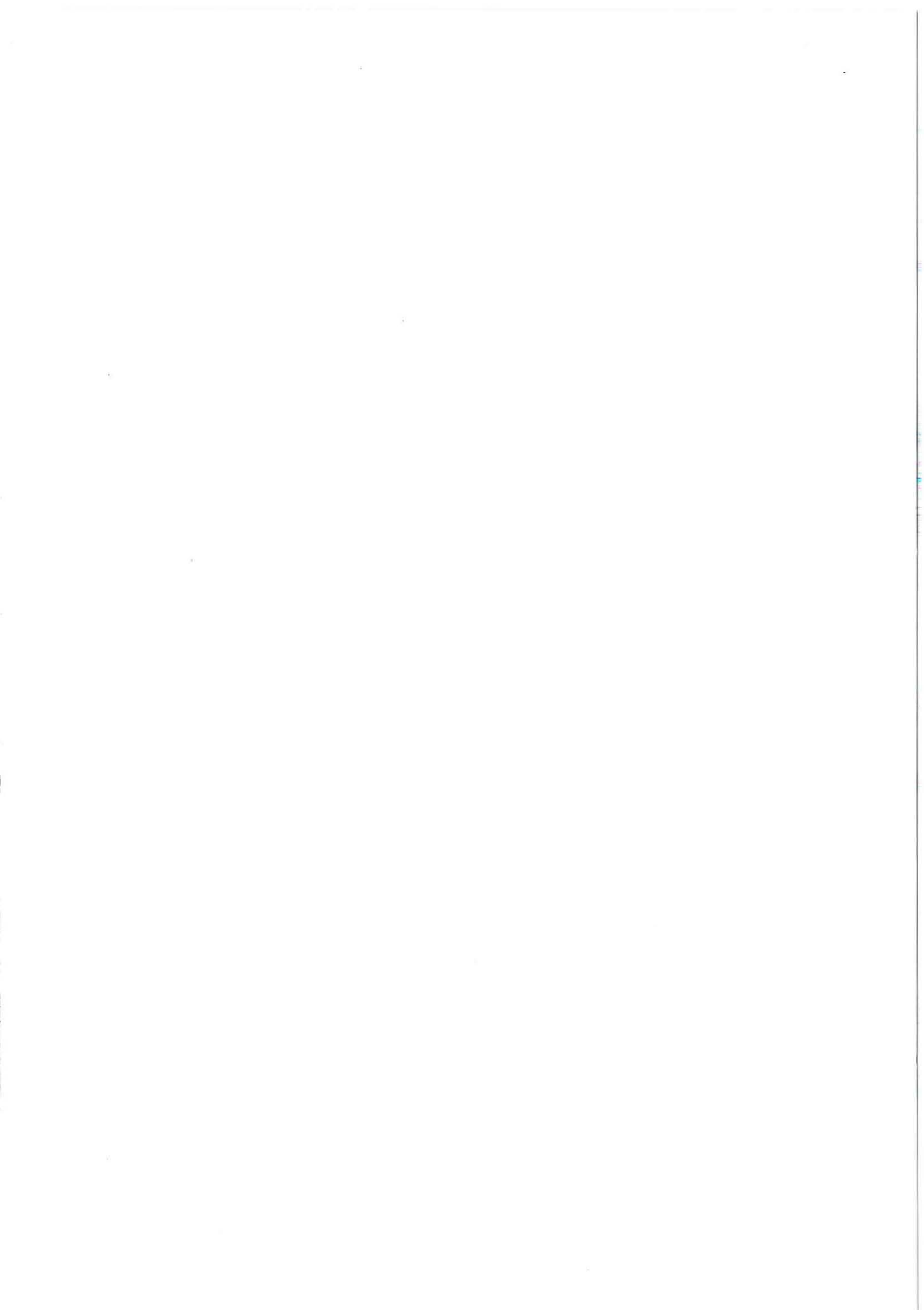
The methodology applied in this research is in line with the tradition of the so-called fiscal response literature (example Heller 1975, Mosley et al 1987, Gang and Khan 1991, Binh and McGillivray 1993, White 1993, Franco-Rodriguez et al 1998, and recently Mavrotas and Ouattara 2003). To test our hypotheses on The Gambia, we adopted the methodology applied in Mavrotas (2003) and Mavrotas and Ouattara (2003), which assesses the impact of different types of aid (programme, project, technical assistance, and food aid) on aggregate government spending and taxation in Uganda and Cote d'Ivoire respectively. This method has the advantage of showing how government reacts to different categories of aid and shed light on the importance of aid disaggregation approach for delving deeper into aid effectiveness issues. This notwithstanding, the results of the fiscal models may be limited by a number of theoretical and methodological

problems, and may not provide clear-cut link between aid and growth (Hjertholm et al 1998). Although technical assistance and food aid are not the focus of this paper, we have included them in our model to see how they too affect the fiscal behaviour. We did this for two reasons. One, as earlier mentioned, the project approach is criticised of containing large amounts of technical assistance and pays little attention to building local capacity. Two, both food aid and technical assistance are normally disbursed through either project or programme approaches of aid. Thus studying their fungibility compliments our analysis on project aid and programme aid and helps in telling the story under review i.e. the debate of programme versus project aid.

To analyse the implication of the fungibility of aid inflows on the PRSP, we examined briefly the new modalities that underlie the PRSP, which includes sound fiscal policies and allocation of HIPC funds that need to be pro-poor. This attempts to address the key question to the conclusion of the research: are the PRSP conditions of fiscal discipline and spending behaviour much different from what we had in the past (i.e. the results of our fiscal model) such that we will expect programme aid to be less fungible under the PRSP process than before or not. However, this analysis may also be limited by the fact that it does not provide a formal test on The Gambia's PRSP as the process is only in its third year (2001-2004).

1.6 Organisation of the Paper

The paper is organized into four sections. The rest of the paper is divided as follows: Section II covers the Literature Review; Section III covers The Fiscal Response Model, Data Issues and Estimation; and Section IV covers General Conclusions and Policy Recommendations. References and Annexes are attached. The annexes contain parameters and equations of the fiscal response model, and a brief presentation on The Gambia as the case study (i.e. socio-economic and political perspectives, the country's experience of aid, and the PRSP situation).



CHAPTER 2: THE LITERATURE REVIEW

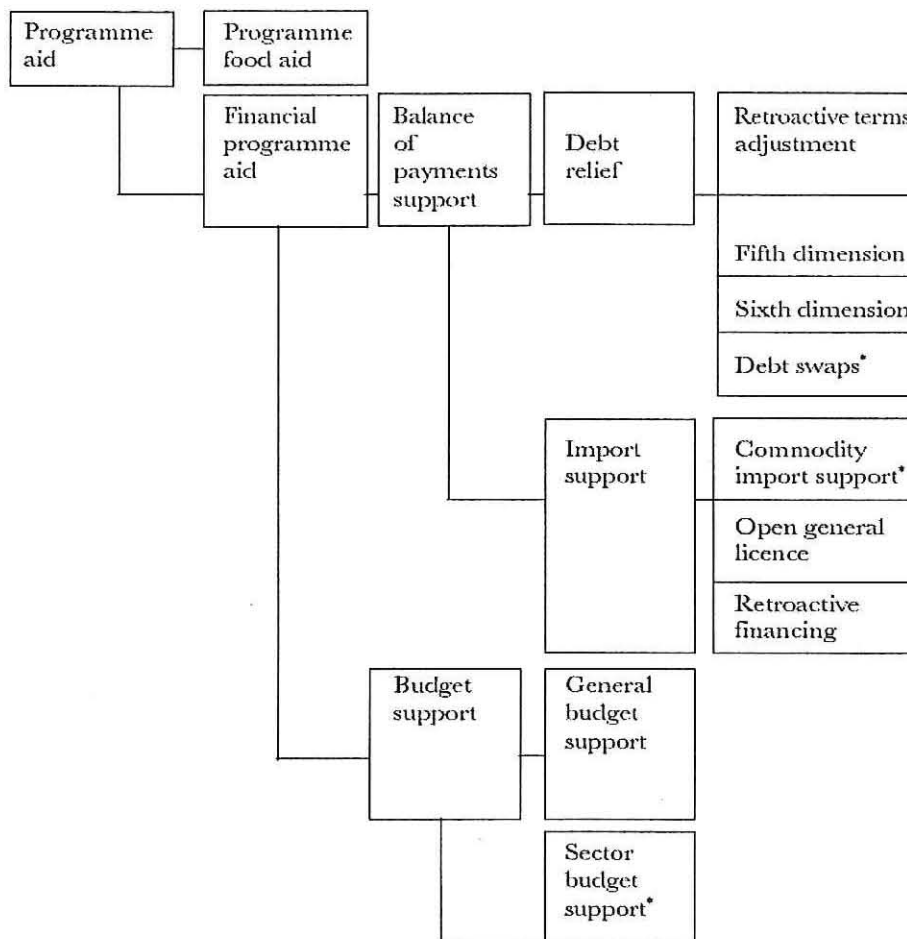
In chapter one, we highlighted that the shift from project to programme aid in the form of structural adjustment programmes and conditionality was triggered by the international economic downturns of the 1980s and the mixed experiences gained during delivering aid through project approach. The project approach was associated with high transaction costs, limited ownership and ineffective coordination, among others. There was also an increasingly concern among the donor countries that the development assistance earmarked for critical social and economic sectors is being used directly or indirectly to fund unproductive expenditures including those of defence. To address these concerns and to make aid more effective, the donor community shifted resources to new aid modalities in the form of Sector Wide Approaches. The SWAPs came to be popularised by the launching of Comprehensive Development Framework and the Poverty Reduction and Strategy Paper, both geared towards strengthening donor coordination and making aid more effective. In this literature review, we re-examined these issues in the context of programme aid, the rationale behind programme aid, and the fungibility issues of aid. The review ends up with a concluding summary that hints at the methodology applied in our analysis.

2.1 The Context of Programme Aid

Programme aid (PA) is aid that is not intended to finance a specific project. The DAC defined programme aid as aid consisting of all contributions made available to a recipient country for general development purposes i.e. balance of payment support, general budget support and commodity assistance, not linked to specific project activities (White 1996). Key characteristics of financial PA are that it: is channelled directly to partner governments; uses local accounting systems; is not linked to specific project activities; and quick disbursing. Debt relief is also considered part of the programme aid instrument, but this is not a method of direct budget support as the process of relieving debt bypasses the partner government (Wilkes, 2001). Programme aid focuses on improving the overall level of resources available to an economy and the effectiveness with which they are used to achieve development goals. The emphasis is whether the overall thrust of government

policies and expenditure programmes are worth supporting, rather than on the specific use of aid funds. Programme aid is usually conditional on a country reaching agreement on a macro-economic reform programme supported by the IMF. It also usually accompanies a programme of structural reforms agreed with the World Bank (Foster and Fozzard, 2000). A common characteristic is that it is linked to economic reform i.e. it is policy-based aid. The World Bank and IMF policy-based lending is programme aid and most bilaterals link their PA to IFI conditionality (White, 1999). **Figure 2.1** illustrates the different modalities of PA.

Figure 2.1: Schematic representation of Programme Aid



Source: White: 1999: pp: x.

Note: (a) * Some items under this heading may not be classified as programme aid

(b) The main points to note: (1) this evaluation is concerned only with financial PA; (2) the main distinction is between balance of payments support and budget support; and (3) budget support need not necessarily be PA, but much of it is (White, 1999).

On the other hand, project aid is aid under which support is provided for a consistent set of activities, with a specified duration and a well-defined objective. Project aid makes available specific capital assets or packages of technical assistance. An important component of project aid consists of infrastructural works, such as roads, harbours, dams, irrigation projects, energy projects, or telecommunications projects. In addition, projects include both large-scale and small-scale industrial projects, agricultural projects, integrated rural development projects, education projects, population projects, health projects, projects for women and so forth (Szirmai, 2004: pp.10).

Other forms of aid include food aid, emergency relief aid and technical assistance. Food aid is concerned with the provision of food in kind from the agricultural surpluses of the rich countries, whilst emergency aid is provided in case of natural disasters, e.g. flood, earth quakes, war etc. Technical cooperation on the other hand is defined as activities, the primary purpose of which is to augment the level of knowledge skills and technical expertise in developing countries. It involves providing technical services of experts, who contribute to engineering design and construction of capital projects, the transfer of knowledge, education and educational institution building, institutional development or technology transfer. Both programme and project aids provide technical assistances (Szirmai, 2004: pp.10).

2.2 The Rationale behind Programme Aid

The shift in focus from project to programme aid has occurred for many reasons, including the perceived failure of using 'money only' instruments to drive significant domestic reform and an acknowledgement of the limitations of projects as a vehicle for achieving sustained reductions in poverty levels (Wilkes, 2001: pp.5)⁷. The rationale behind programme aid is discussed along these lines of reasoning backed by analysis on

⁷ This analysis is taken from Wilkes, 2001: Programme Aid: what do we need to learn? pp. 5

the assumptions underlying the rationale, the objective of programme aid in poverty reduction (programme aid and PRSP linkage), and the risks involved.

2.2.1 The limitations of using 'money only' instruments

This reason rests on three connected but different conclusions that underlie the shift. One, policy based lending by IFIs and, by the same logic, programme aid grants by bilaterals, only work if there is an effective local constituency supporting reform. Where this has not been in evidence, reform has not been sustained. Two, where donors have proven to have some influence, this has occurred because of the depth and longevity of relationship with a government, the consequential increased access to informal channels of influence, and the appropriateness of other activities that accompany budget support. This implies that donors change from using conditionality as a 'stick' to using conditionality as an agreed set of milestones between a partner government and donors. Three, the focus for donors should not only be on improving economic management but also on how to make the government more effective at providing services, particularly in the social sectors. Taking this point further in the context of rewarding good PRSPs, direct budget support is used to support the government's approach to development that includes not only issues of expenditure but also revenue raising, links with the private sector, and legal and regulatory frameworks (Wilkes, 2001:pp.6).

Furthermore, White (1996: 21) as quoted by Wilkes (2001:pp.6) highlighted that the change also comes within the much broader movement towards poverty reduction becoming an overt central objective for all activities of many bilateral donor agencies and, in a more limited sense, becoming important within IFIs. It is said that direct budget support makes it easier to hold the recipient government accountable than does the import support previously channelled through often poor performing parastatals or the private sector, whereas SWAPs capitalize on the existing relationships with partner government and build consensus around policy priorities.

2.2.2 The limitations of projects in poverty reduction

This reason is based on a belief being more openly articulated that isolated projects do not always result in a significant and sustained reduction in poverty, particularly at the

national level. It is argued that even where projects are coordinated, they do not always have the perceived developmental benefits of channelling resources through local systems. Jones and Lawson (2000: 4) as quoted in Wilkes (2001:pp.6) argued that the project approach can lead to inadequate planning for the recurrent costs of investments, too many project management systems, too much/little technical assistance, and too little co-ordination among donors. Wilkes added that the project approach often has not focused on the most important issues because donors are in dialogue with sector planners rather than central decision makers. In a worst case scenario, this has resulted to problems such as donors funding school buildings with no guarantee that teachers would be paid because the sector level dialogue had focused on the short term need for capital assets whereas the overall and more pressing problem could in fact be a lack of recurrent expenditure to fund teacher salaries. Such a problem, it is argued, once diagnosed accurately, can be solved by a change in focus of dialogue from sector level to national level, e.g. from the Ministry of Education to the Ministry of Finance, and also to shift to a different aid modality because large sums of money to support recurrent expenditure cannot be delivered through a traditional project approach. However, it is important to acknowledge that different aid modalities work at different levels and are more/less effective at achieving different goals.

Against the above background reasons, the rationale for programme aid can be broken down into ten parts (see Wilkes: pp.9):

i. Structural: The structural view suggests that if a considerable proportion of the budget is financed from external sources then it becomes difficult to parcel this into projects without distorting spending. In direct budget support, potentially lesser distortions of aid delivery mechanism are provided.

ii. Local capacity and systems: Under project aid, local governments in aid dependent countries face an absorptive capacity constraint for aid. By offering better pay and conditions than the local civil service structures, project aid can drain government of key skills. Programme aid in all forms, utilises partner government accounting systems and allows staffs to remain in-post; thus local capacity is strengthened. SWAPs also seek to address local capacity and management issues.

iii. Transaction Costs: The project approach often contained a significant amount of technical assistance in the form of expatriate advisers for both technical and supervisory reasons. Limited local capacity was being built in this process, which clearly raised the transaction costs of aid delivery as local staff must implement and report on a whole range of donor-funded projects, all of which use different procedures. Under a more unified approach, budget support could enable governments to save transaction cost.

iv. Ownership: The concept of ownership emphasises that government commitment needs to be both deep and broad to ensure that the strategy has the endorsement of the whole government and not just a particular sector department. Because project approach usually involves different projects from different donors, this can lead to donor enclaves, inconsistent standards of provision and little government ownership. By driving reforms, budget support provides an opportunity for donor coordination to support government priorities and allows ownership of the development process.

v. Fungibility: The term fungibility describes the degree to which aid resources that are given for one purpose (say investment) are used for another (say consumption). In other words, aid is said to be fungible if the marginal increment in expenditure in response to an aid inflow is not the expenditure toward which the aid was targeted. Foster and Fozzard (2000) elaborated that the evidence of fungibility of aids tends to justify the increased use of programme aid. The authors highlighted that if governments are able to adjust the pattern of their own spending to offset donor project preferences then there is little point in earmarking donor support to specific projects. They added that it is more logical to appraise the overall pattern of policy and expenditure priorities, seek to influence both in directions which are thought to be more effective in reaching donor objectives and provide flexible levels of support. However, like other aid resources, programme aid funds are also subject to some degree of fungibility.

vi. Predictability: Project aid is often associated with inadequate government and/or partner planning for recurrent investment costs and serves as an incentive for managers to bypass the budget to secure resources directly from donors, which often resulted in a breakdown in the budget process. Isolated programme aid grants earmarked for balance of payments support within a certain year based on ex-ante conditionality, did not improve either the budget planning over time, as aid flows remained unpredictable. From

a partner government viewpoint, a budget support that tranches over three years for example (supporting government's own priorities and targets e.g. PRSP targets), should bring an added predictability to aid flows and synchronization between aid flows and private flows, especially if new forms of conditionality are utilised with achievable milestones discussed and agreed up front (Wilkes, 2001: pp.10).

vii. *Pro-poor budget setting:* Poverty reduction projects often had limited impact outside the project area and target group. From a donor point of view, budget support and dialogue is a channel through which to influence the national budget setting process on behalf of the poor by getting budgets better planned, ensuring that systems relate expenditure to resource availability and outputs and, ultimately, to re-focus government spending toward the poor (Foster and Fozzard, 2000 as quoted in Wilkes, 2001:pp.10).

viii. *Donor influence and policy change:* The influence of donors in aid relationship is not only direct public expenditure towards the poor but also support more general economic and social reform. At this level of influence, donors need and seek to participate in policy dialogue that is dictated by the aid modality. Project aid leads to dialogue between donors and those people and Ministries who manage projects, and fails to give donors the breadth of vision, influence and access to be serious participants in policy dialogue and hence programme aid is used instead (Foster and Fozzard 2000:6.2 as quoted in Wilkes, 2001:pp11). Wilkes added that sector level dialogue is valuable but can lead to recognition that obstacles to sustainable change are at the macro level rather than sector level. The focus within general budget support is to establish an on-going supportive dialogue with central decision makers.

ix. *Sustainability:* Sustainability is a term used to describe continuity of the process for a longer period. The aim of programme aid is to contribute to the sustainability of reform programmes and protect them from economic or political shocks. For instance, Wilkes highlighted the evaluation of DFID programme aid in different countries that shows that the use of budget support at goal level is linked to poverty reduction directly through the support of government spending to protect and improve service delivery to the poor (Ghana) or more indirectly through the support of general reform which brings stabilisation, growth and ultimately poverty reduction (Tanzania). Against this evaluation, Wilkes argues that the budget support, therefore, contributes to the

sustainability of reform programmes and partially insulates them from political and economic forces that can move them off course. It is argued that policy based lending has a greater likelihood of lasting change than short-term project aid, and that a grant is usually given in situations where the commitment to reform and/or poverty reduction is already demonstrated and so policy change precedes rather than follows the grant.

x. Unutilised donor funds: This is a further reason advanced by White (1999) in his study for SIDA (as quoted in Wilkes, 2001:pp.11). According to this argument, the fact that programme aid can be quickly disbursed is an advantage not only for the recipient who may have an immediate need for funds (for essential imports or debt service) but also to donors who may have surplus funds to utilise before the end of the budget year. Some donors, especially those who do not allow unallocated funds to be carried from one year to the next, disburse such amounts as programme aid.

2.2.3 Assumptions, Objectives and Risks underlying Programme Aid

The arguments highlighted above, points at a set of assumptions, objectives and risks that underlie the programme support, which are summarised in the following points (see Wilkes, 2001:pp.13).

2.2.3.1 Assumptions underlying the rationale behind programme aid

The assumptions underlying the rationale can be summarised at two levels as below:

Level 1: From projects to programme aid

- More use of local systems leading to stronger local capacity and stronger and more transparent local accounting systems;
- Lower transaction costs leads to greater efficiency in strategising poverty reduction;
- More ownership of and commitment to reform by the partner government leadership;
- Greater effectiveness of multi-donor co-ordination;
- Adequate provision for recurrent expenditure within government budget;
- Donor influence for sustainable policy change centred at the macro level leading to sustainable growth and poverty reduction.

Level 2: From balance of payments focus to government budget focus

- More ownership of and commitment to reform by the partner government leadership ultimately leading to reforms being more sustainable;

- Better predictability in donor funds leading to more effective, in terms of implementing pro-poor policy, national planning processes over the longer term;
- Better and more pro-poor budget planning, which links outputs and resource availability;
- Increased opportunities for donors to influence partner government and possibly, IFI's policy dialogues.
- Non-inflationary financing of the government deficit

2.2.3.2 Programme Aid and PRSP: goals of programme aid in poverty reduction

The assumptions of programme aid can be linked with those of the PRSP. The assumptions of the PRSP are based on the five underlying principles that explain the rationale behind the PRSP. These are summarised below:

- *Country-driven: Ownership, participation and responsibility:* poverty reduction strategies must be country driven, implying broad-based participation of civil society and private sector in all operational steps. It is assumed that this will enhance participation that will foster ownership and ensure responsible resource management.
- *Result-orientation:* based on in-depth analysis of poverty, the strategies must identify the desired outcomes and the ways to reach them. They should be translated into process and outcome indicators.
- *Comprehensiveness and long-term perspective:* analysis and policies must take account of the multidimensional nature of poverty and long timeframes necessary to reduce poverty.
- *Prioritization:* priorities must be chosen in order to design feasible policies and to adequately fund them.
- *Partnership:* the process is to be based on dialogue and partnership between the government and civil society as well as the donor community (implying donor coordination, which allows reduced transaction costs and more efficient aid).

In line with the above underlying assumptions of the rationale behind programme aid and PRSP, poverty reduction goals of countries can be supported through direct budget support in the following three ways (see Wilkes, 2001: pp.14):

- (a) Provision of support for stabilisation i.e. enabling government to reduce its deficit thereby contributing to macro-economic stability, growth and poverty reduction.
- (b) Facilitating higher pro-poor expenditure thereby contributing to poverty reduction (often proxied by higher allocations to priority sectors for poverty reduction).
- (c) Supporting implementation of Governments poverty reduction strategy with a focus on improving the effectiveness of government expenditure.

2.2.3.3 Key risks of Programme Aid

In spite of the insights gained from programme aid, some key risks are associated with its implementation that may prevent the predicted impacts (see Wilkes, 2001: pp.15).

- **Directional or policy risks** - a high level risk that the intervention is directed at unacceptable sectors in unacceptable ways e.g. where donors have different policies on what constitutes a prohibited sector or on bribery.
- **Developmental risks** - risk that the outcomes of the intervention are unsatisfactory.
- **Fiduciary/accounting risks** – risk that funds may not be used for intended purposes. These risks arise through the lack of visibility of funds once they are in the recipient Government's system.

2.3 Fungibility

The term fungibility is used to describe the degree to which resources ostensibly allocated to one purpose may in effect free up resources for other purposes. For instance, donor willingness to fund projects in certain sectors may allow governments in times of fiscal stringency to sustain funding in other sectors that are considered politically sensitive and unattractive to donors (Jones and Lawson: 4 as quoted in Wilkes 2001:pp.9). An important feature of aid that helps to explain its fungibility is that it is given to governments of recipients and so it should be expected to affect the fiscal behaviour. Fungibility also said to be connected to policy. For instance the World Bank report (1998) states that one of the reasons why policy matters is that aid is fungible. This means to say that project aid does not finance the sectors to which it is attached, so that government commitment to particular sectors is more than targeting aid.

Singer (1965) was the first to advance the traditional fungibility argument, which has not been conceived within the general fiscal response (Hjertholm et al 1998). He argued that the impact of aid should not be evaluated against the projects said to be 'aid-financed'. Hjertholm et al illustrated Singer's view as follows: Suppose a government has \$100 million to be allocated between two activities (both costing exactly \$100 million), for example rehabilitating rural health clinics or buying some military hardware (say, nice shiny tanks). Then after some deliberation, the government decides to prioritise the health clinics. Subsequently a donor offers the government \$100 million for any development project. Clearly the tanks are not eligible for donor finance, but so are the health clinics. So the government may ask the donor to finance the latter, freeing up its own resources to buy the tanks. Thus the actual impact of the aid (measured by a comparison of with versus without) is therefore to increase military rather than health expenditure (Table 2.1). In this case and as argued in Hjertholm et al, no diversion of funds is involved, but funding an activity that would have happened in the absence of aid frees up resources to be used elsewhere. The resulting marginal expenditure becomes related with the impact of the aid, implying that if the donor does not specify the use of funds it makes no sense to talk of fungibility. They elaborated that programme aid funds as discussed in studies of Mosley and Eeckhout (2000) are often called "very fungible", but that this is a miss-use of the term since there are no conditions as to what these funds should be used for. They said aid that has no designated purpose, is best referred to as free resources, whilst aid that does have a designated purpose, is effectively free resources if it is fungible. Accordingly, the authors argued that fungibility among different types of expenditure is observed when the item for which aid is intended does not rise by exactly the amount of the aid inflow. White (1998) (as quoted in Hjertholm et al: pp.8) has elaborated this definition further with a distinction between aggregate and categorical fungibility. The former is where the aggregate category (say, imports or government expenditure) does not rise in a one-for-one manner with an aid flow whose intended purpose is to increase that aggregate. Categorical fungibility occurs if the inflow increases any expenditure item within the aggregate other than those intended by the donor. It becomes obvious from the illustration that if the government initially intended to buy military equipment, clearly aid will be beneficial. But as discussed below, there are in any case limits to fungibility.

Table 2.1: Expenditure Patterns With and Without Aid

	Health expenditure (Rural health clinics)	Military expenditure (Tanks)
Without aid	100	0
With aid	100	100

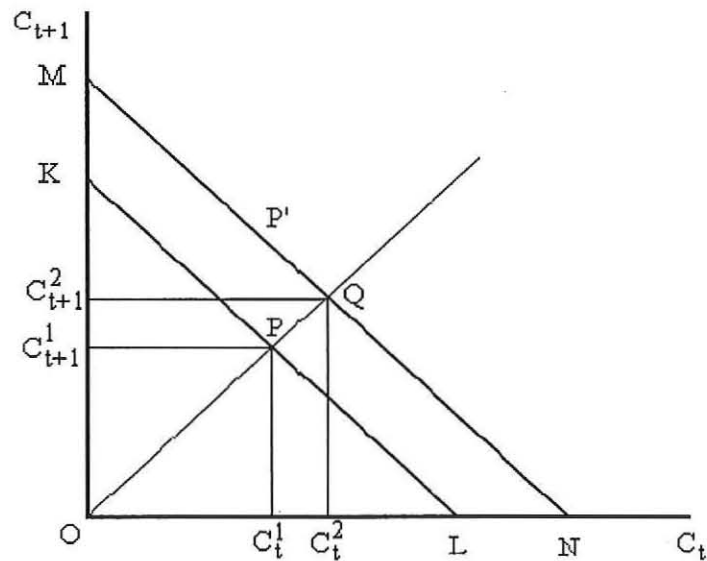
Source: Hjertholm et al 1998: pp: 9

2.3.1 Illustrating Aid Fungibility: a narrower perspective

The problem of fungibility can be illustrated using the narrower concept of fungibility inherent in the analysis of Griffin (1970)⁸, who looked at the relationship between aid and domestic savings (see **Figures 2.2 and 2.3**). The figures illustrate inter-temporal consumption decisions with and without aid. According to the illustration, income may be consumed in the current period (C_t) or saved, invested and consumed in the next period (C_{t+1}). Future consumption will be $(1+r)$ times the value of savings in time t (r being the return on capital). For a given level of income in **Figure 2.2** the budget constraint is KL , and by assuming standard preferences, the consumption bundle is at point P , with domestic savings of $L-C_t^1$. Now supposing that there is an aid inflow of value A , equal to LN , this shifts the budget constraint out to MN . In the two-gap model, this illustration shows no fungibility (Hjertholm et al). Thus, it is assumed that aid is used to increase investment only, whilst consumption in period t remains unchanged at point P . In contrast, and as done by Griffin, Hjertholm et al argued that aid will in reality be treated like any other income and shared between consumption and savings according to their respective marginal propensities. This would move consumption in period t to point Q , and domestic savings fall to $L-C_t^2$, and as a result, there is no longer a one-to-one relationship between aid and savings-investment; making aid fungible.

⁸ This illustration is from Hjertholm et al 1998: Macroeconomic Issues in Foreign Aid: pp.9

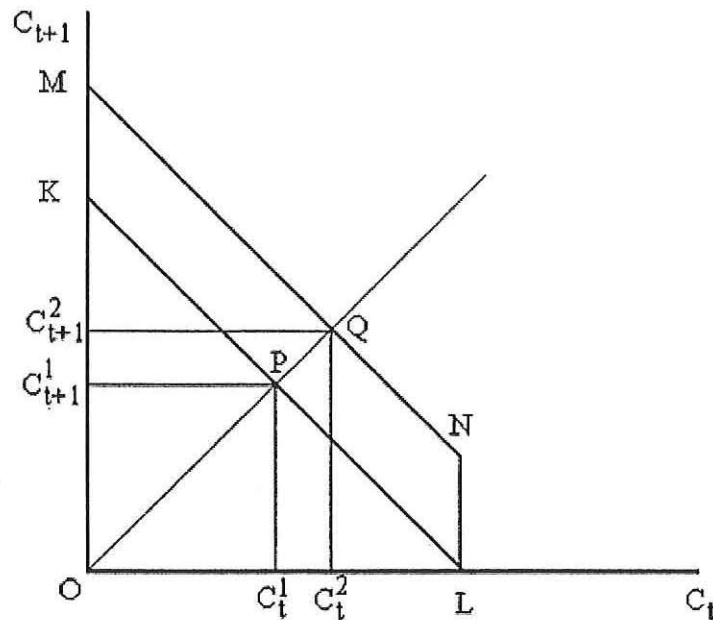
Figure 2.2: Griffin's analysis of aid and savings



Source: Hjertholm et al 1998: pp: 10

An underlying assumption behind the above argument is that it treats aid as a free resource (i.e. as part of income), which may be allocated exactly as the recipient wishes (Hjertholm et al). Assuming instead that the donor directs the aid towards investment in such a way that the budget constraint with aid changes from being MN in **Figure 2.2** to MNL as shown in **Figure 2.3**, it follows from the latter that aid remains fungible as long as the preferred consumption bundle lies along MN . Yet, if preferences dictate that a point to the right of N should be chosen this is no longer feasible, in which case aid fungibility is limited. All other things remaining equal, such situations appear when aid finance is large relative to domestic resources, or if few resources would be devoted to investment in the absence of aid. At the limit, assuming L is chosen without aid, there are no domestic savings, suggesting that aid geared at investment will result in a one-tone increase in investment, i.e. there is no fungibility. This also illustrates that aid will tend to be fungible only if it is allocated to a use to which the recipient accords high priority.

Figure 2.3: The kinked budget constraint



Source: Hjertholm et al 1998: pp: 11

Hjertholm et al 1998 summarises that the above illustrations clearly suggests that fungibility of aid is an important issue in understanding how aid impacts on government behaviour and growth in aid receiving countries. However, the authors highlighted that in some instances, fungibility might not necessarily be a problem. That if the aid recipient has more knowledge about how to maximise the impact of aid, then fungibility may in fact be growth enhancing, assuming, of course, that the aid recipient pursues growth and development objectives in an effective manner. Thus, they argued that whether fungibility should be seen as positive or negative feature of aid depends upon country specific circumstances and the interplay between donor and aid recipient objectives.

2.3.2 Illustrating Aid fungibility: A broader perspective

From a broader perspective, Devaranja and Swaroop (1998) illustrated the problem of fungibility when they evaluated the implications of foreign aid on development assistance. According to the illustration, suppose a donor gives money for building of a primary school in a poor country and if the recipient government would have built the school anyway, then the consequence of the aid is to release resources for the government to spend on other items. This means that while the primary school may still be built, the

no meaning. According to them, while the donor agency would like the aid funds to be spent on G_2 at the margin, for a variety of reasons, it is unable to monitor the intended pattern of public spending. It is said therefore that, upon receiving aid, the recipient country is able to make it fungible by changing both the level and composition of its public expenditure program.

Furthermore, it is illustrated that if the recipient country can treat the entire aid amount as a pure supplement to its domestic resources, then aid is fully fungible. From **Figure 2.4**, $B'C'C$ represents the post-aid resource constraint whilst the horizontal segment, $B'C'$, indicates that at least the aid amount has to be spent on G_2 . The point E gives the new optimal resource allocation, indicating that in spending the acquired aid resources on good G_2 , the country diverts some of its own resources from G_2 to C_p and G_1 . Assuming on the other hand that the recipient country does not divert any of its resources away from the aid resources while spending the earmarked aid on it (due may be to the donor agency's effective public expenditure monitoring process), aid becomes fully non-fungible. The illustration also indicates that the optimal allocation mix of the country's *own* resources is not influenced by the aid amount, in which case point A continues to be the country's preferred mix. However, aid to G_2 increases overall utility. The post-aid consumption point, D , is on a higher indifference curve U_2 . This, according to the authors indicates that even if the aid were fully non-fungible, the recipient country would still benefit. Finally, the authors illustrated that if the country can treat a portion, f ($0 < f < 1$), of the aid as a resource supplement, then aid is said to be partially fungible and the fungible portion of the aid is given by f . In such a case, the post-aid resource line (not drawn in **Figure 2.4**) moves out by the fungible amount. In choosing the optimal resource mix, the country includes the fungible amount as an additional resource supplement to be spent but disregards the non-fungible portion, $1-f$. Depending on the value of f , the final consumption point lies between points E ($f=1$) and D ($f=0$) in Figure 2.4.

2.3.3 Aid Fungibility: a research review

Since its existence, development economists have attempted to assess the impact or rather lack of impact of foreign aid on the development process of aid dependent countries. On aid fungibility, past researches⁹ were based on two main issues: fiscal effects of inter-governmental grants and subsidy programmes. In their research review, Devarajan and Swaroop highlighted how the effect of intergovernmental aid in federal systems has generally supported Gramlich's flypaper theory. This theory states that an addition to resources through grants will stimulate greater public expenditure than an additional dollar in local resources. Contrasting this to the fungibility definitions illustrated in 2.3.1 and 2.3.2 above and as argued by the authors, there is little evidence to support the view that aid from higher to lower tier government is fully fungible. Although the authors noted that the presence of a flypaper effect does not preclude partial fungibility. For instance, they reported that McGuire et al 1978, using data on U.S. local government expenditure on education for the period 1964-71, found that restrictions placed by donors were largely ineffective and a large fraction of education grants were converted into fungible monies. McGuire's analysis used data on the receiver expenditure to evaluate the impact of a grant into price and income changing components using a devised statistical method.

Devarajan and Swaroop also highlighted how in a federal structure of governance, foreign aid could influence the inter-governmental fiscal transfer mechanism. According to them, upon receiving aid on behalf of a subsidiary government, the federal government could make adjustments in its fiscal transfers to that lower level of government. An example of this system is the practice of Budget Offset in Ethiopia (a federal country), where as reported, the federal government reduces the budget subsidy to states based on a formula that includes weights for population, development indicators and state-owned revenue efforts by the full amount of expected external loans and grants that have been committed by donors towards projects in the respective states. In contrast, the authors reviewed a similar study on India by Jha and Swaroop (1998), in which no such direct

⁹ For example Gramlich et al 1997, McGuire et al 1977, Mieszkowski and Oakland et al 1979, Rosen et al 1988, and Zou et al 1996 (as quoted in Devarajan and Swaroop, 1998:pp.7, who made a comprehensive research review on aid fungibility).

budgetary mechanism exists. In the Indian case, it has been found that external assistance intended for development purposes merely substitutes for spending that governments (central and states) would have undertaken anyway; and that the funds freed by aid are spent on non-developmental activities in general and administrative services in particular. Moreover, the findings showed that that in passing external assistance to states, the central government makes a reduction in other transfers to states.

Using 20 years time series data from 14 developing countries, Feyzioglu et al 1998 (as quoted in Devaranja and Swaroop, 1998), found that roughly three-quarters of a dollar given in development assistance is spent on current expenditure and one-quarter on capital expenditure by the recipient countries. The authors further tested aid fungibility across public spending categories based on the constructed data series on the disbursement of sectoral concessionary loans. The findings were that concessionary loans given to agriculture, education and energy sectors are fungible whilst only the loans to transport and communication sectors are non-fungible. Based on these findings, the authors argued that (i) the success of an aid programme should not be judged by the proportion of assistance going to capital expenditure and should not be judged by, and (ii) because most aid fungible, the rate of return on a specific donor-funded project tells little about the impact of that assistance.

Furthermore, Devarajan et al 1998 (also as quoted in Devarajan and Swaroop, 1998), also analyses the experience of sub-Saharan Africa, a region with the largest GDP share of aid (as shown by anecdotal evidence). The authors used the data set of 18 sub-Saharan countries from 1975 through 1995 and explored two issues: (a) the extent of aid fungibility in sub-Saharan Africa, and (b) reasons why aid was fungible or not. In the first question, the results suggest that the broad pattern of aid fungibility observed in cross-country and country-specific studies found relatively little evidence that aid leads to greater tax relief in Africa, and every dollar of aid leads to a 90 percent increase in government spending. The results on the composition of public spending between current and capital expenditures showed a broad consistency with international evidence that aid in Africa leads to an increase in current and capital spending in equal amounts. The result that appeared as striking in the findings is that an almost equal amount of aid (equal to

the amount going for current and capital spending) goes towards repaying the principal on past loans. A rational argument for this is that the inability to meet debt-service payments would have threatened many African countries with a complete cut-off from foreign capital to use aid resources to relax this constraint. On the sectoral aid fungibility, the authors found that sectoral aid in Africa is partially fungible, i.e. governments do not spend all sectoral aid in that sector, nor do they treat such aid as merely budget support.

In Devaranja and Swaroop (1998), the evidence of aid fungibility indicated that a foreign aid or lending policy that focuses exclusively on project financing may have unintended consequences. The authors found that aid intended for crucial social and economic sectors often merely substitutes for spending that recipient governments would have undertaken anyway; the funds freed are spent for other purposes. They mentioned that one solution to this fungibility problem is that donors could tie assistance to an overall public expenditure programme of the recipient country that provides adequate resources to crucial sectors. To this end, they proposed a new lending instrument called a public expenditure reform loan (PERL) that would tie an institution's lending strategy with the achievement of a set of mutually agreed development goals of the recipient country.

Our review also found that most fungibility studies neglected the heterogeneity character of foreign aid by employing a single figure (aggregated) of aid, which is likely to provide misleading conclusions on aid effectiveness. Some recent studies have analysed aid fungibility using disaggregated aid. One such study is Cordella and Dell'Ariccia (2001), who made a theoretical appraisal of budget support versus project aid in poverty reduction programs, in a model in which altruistic donors have preferences not perfectly aligned with those of recipient governments. They found that project aid is a better (worse) instrument to alleviate poverty than budget conditionality when: (i) aid programs are relatively large (small) with respect to the recipient's country resources; and (ii) recipient governments are relatively less (more) socially committed. In addition, it has been found that when donors cannot observe the recipient's type, they may impose a higher level of conditionality on budget support programs as a device to separate socially committed governments from uncommitted ones. The findings also highlighted that the relative effectiveness of the two forms of aid depends crucially on the size of the aid

program (relative to the recipient government's own resources) and on the degree of misalignment between donors and recipient's objectives (which could be interpreted as a measure of lack of program ownership).

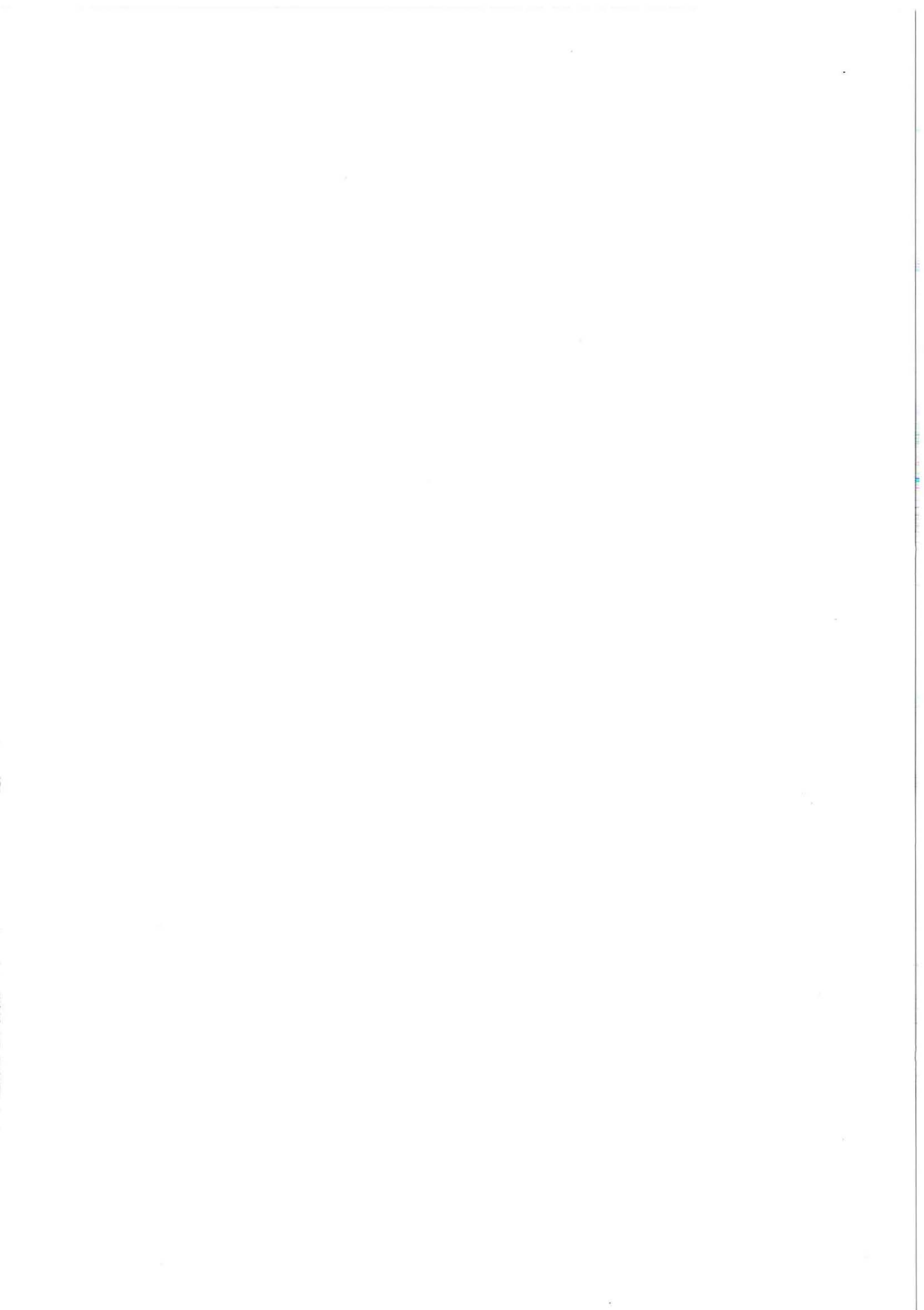
Mavrotas (2003), and Mavrotas and Ouattara (2003) also recently examined the impact of different aid types (namely project aid, programme aid, technical assistance and food aid) on the fiscal sector of Uganda and Côte d'Ivoire respectively, using the fiscal response model. In both situations, it has been found that governments respond differently according to the nature of the aid inflows. The findings also demonstrated the importance of the aid disaggregation approach for delving deeper into aid effectiveness issues.

In addition to the above, it is also important to note the link between aid and poverty reduction. Dollar (2002) explored this issue by highlighting some key issues that are known and those needs to be known about aid and poverty reduction. He asserts that while inevitably there remains some disagreement, we know about five matters that pertain to the effectiveness of aid in supporting poverty reduction: (1) The effect of aid on growth is conditional on policy: aid has more of an effect in a good policy environment; (2) The quantity of aid received has no systematic effect on policy; (3) Aid is often fungible and cannot be targeted to particular services or particular groups (such as the poor); (4) In low-income countries, there is a strong relationship between per capita income growth and the speed of poverty reduction; and (5) There are diminishing returns to aid. On the areas that we do not know and where further work is needed, Dollar pointed at the following: (1) Making the level of aid endogenous; and (2) Which policies promote poverty reduction. He argues that it would be good to know which policies are most important for poverty reduction, and how development assistance can systematically promote these. These issues clearly points at the heterogeneity and endogeneity issues of aid that are key to the analysis in this paper.

2.4 Concluding Summary

In the preceding analysis, we have discussed the reasons that explained the rationale behind the shift from project to programme aid. The analysis revealed key underlying assumptions that supports the view that programme aid is more a robust modality to

delivering aid and reducing poverty than project aid. However, this notwithstanding, some risks are associated with programme approach to aid, among which are inconsistent policies among donors, unsatisfactory interventions, and accounting risks. Our discussion on fungibility shows that if donor and recipient preferences differ, it is possible that the latter could convert aid into fungible resources. The discussion also highlighted the importance of aid disaggregation in delving deeper into aid effectiveness issues. Based on these discussions, the natural question that arises now is how would the above issues help in our analysis. In Chapter one we mentioned that providing answers to our hypotheses requires applying the fiscal response model to trace the fiscal behaviour in response to the two aid types under discussion. This is to be complimented by a brief examination of the new modalities that underlie the PRSP in order to analyse the implication of the fungibility of aid inflows on the PRSP. It goes without saying that the discussions on programme aid and fungibility issues highlighted here helps in the analyses to this paper. The discussions particularly helps in arriving at policy conclusions for this research.



CHAPTER 3: EMPIRICAL APPRAISAL OF PROGRAMME VS. PROJECT AID

The general aid effectiveness literature tells us that an important feature of aid to developing countries is that it is given to governments and so it should be expected to affect the fiscal behaviour. This is precisely what motivates the so-called fiscal response literature. McGillivray and Morrissey 1999b (as quoted in Hjertholm et al 1998:pp.12) mentioned that the fiscal response literature relies on more formal modelling to identify how aid inflows may result in government behaviour that undermines the intended growth effects of aid. The traditional approach to modelling the government response to foreign aid inflows follows the seminal paper by Heller (1975) whose approach starts from the observation that government allocates revenue among various expenditure categories subject to budget constraints. A number of studies came to follow Heller including Mosley et al 1987, Gang and Khan 1991, Binh and McGillivray 1993, White 1993, Franco-Rodriguez et al 1998, and Mavrotas (2003). However, most fungibility studies neglected the heterogeneity character of foreign aid by analysing only a single figure (aggregated) of aid, which is likely to provide misleading conclusions on aid effectiveness. Recently, a number of studies have analysed the fungibility of aid using disaggregated aid data. Mavrotas (2003) and, Mavrotas and Ouattara (2003) for example examined the impact of different aid types (project aid, programme aid, technical assistance and food aid) on the fiscal sector of Uganda and Côte d'Ivoire respectively. In both situations, it has been found that governments respond differently according to the nature of the aid inflows. Since fungibility of aid is known to be one of the reasons why policy matters in aid (as in WB, 1998), it is understood that aid disaggregation method helps in deriving significant policy implications. The methodology in this paper is in the tradition of the so-called fiscal response literature as applied in other studies. However, for our purpose, we adopted the methodology applied by Mavrotas and Ouattara to identify how the Government of The Gambia responds to the different aid inflows in order to derive the policy implications for the PRSP. As pointed out in Chapter one, we have also included into our model the other types of aid (technical assistance and food aid), since most of these aids are disbursed either through project or programme

approach; and because project aid is criticised of containing large amounts of technical assistance and pays little attention to building local capacity. Thus their analysis gives a useful insight in deriving policy implications for the PRSP.

3.1: The Fiscal Response Model: *Model of Heterogeneous and Endogenous Aid*

The fiscal response model (FRM) tries to identify the extent to which aid is used for purposes other than those intended by the donors. Generally, most fungibility studies consider whether aid intended for investment is redirected to consumption spending. Other studies are more specific, trying to assess if aid allocated (e.g. by donors) to particular categories of expenditure is in fact spent on those categories. The main difference is the degree of specificity in the disaggregation of expenditures. The second approach looks at fiscal response more broadly, specifically incorporating revenue into the utility (Osei et al 2002). Mavrotas and Ouattara (2003) went further to include government borrowing in addition to expenditure and revenue, as would also be seen later in our model.

The standard point of departure is a government utility function, where targets have been set for expenditure types (e.g. recurrent and capital), revenue (tax and non-tax) and borrowing (domestic and foreign). The government tries to maximise the utility function by attaining these targets, subject to a budget constraint in which aid inflows have traditionally been included as an exogenous variable (on the ground that aid levels are supply determined). Recent specifications of the utility function include aid as an endogenous variable (e.g. Franco-Rodriguez 1998 and Mavrotas and Ouattara 2003). Including aid as an endogenous variable is based on the premise that, once donors have committed the aid money, recipients can in practice determine actual disbursements (total and among different expenditure types). Estimation of the model is performed after deriving reduced form equations for each endogenous variable (Hjertholm et al 1998).

Fiscal response model has the advantage of allowing governments to raise revenues and allocate to expenditures according to the set targets. In this regard, aid is treated like the other forms of revenue with government setting target or expected value that is incorporated into its fiscal planning or behaviour. Despite these merits, the results of the

fiscal response model may be limited by some theoretical and methodological problems. The model is known for its ad hoc theory that does not attempt to explain how the targets or the parameters in the utility function and budget constraints are generated. Another problem is the difficulty in estimating fiscal response models and their high sensitivity to data quality that may undermine robustness of results. These problems limit the scope of the FRM to give clear-cut conclusions about the fiscal behaviours, for example the aid-growth link.

3.1.1 Assumptions and Descriptions Underlying The Model

In line with Mavrotas and Ouattara (2003)¹⁰, the model assumes that the recipient government aims at maximizing a utility function that can be presented as follows:

$$U = f(I_g, G, T, B, A_1, A_2, A_3, A_4) \quad [1]$$

Where, I_g is public investment capital expenditure, G is government recurrent expenditure, T represents tax and non-tax revenue, B is government borrowing from all sources, A_1 is project aid from all sources, A_2 represents programme aid from all donors, A_3 stands for technical assistance, and A_4 stands for food aid. It is further assumed that the government is a rational utility-maximizer setting annual targets for each of the above fiscal variables and trying to reach these targets. This government behaviour can be represented by a utility function without the linear terms as below:

$$U = \alpha_0 - \frac{\alpha_1}{2}(I_g - I_g^*)^2 - \frac{\alpha_2}{2}(G - G^*)^2 - \frac{\alpha_3}{2}(T - T^*)^2 - \frac{\alpha_4}{2}(A_1 - A_1^*)^2 - \frac{\alpha_5}{2}(A_2 - A_2^*)^2 - \frac{\alpha_6}{2}(A_3 - A_3^*)^2 - \frac{\alpha_7}{2}(A_4 - A_4^*)^2 - \frac{\alpha_8}{2}(B - B^*)^2 \quad [2]$$

where the starred variables represent the exogenous target variables, $\alpha_i > 0$ for $i = 1, \dots, 8$. The α_i 's represent the relative weights given to different terms in the utility function and, without loss of generality, these may be normalized so that they sum up to unity. If the government meets all its targets, the maximum unconstrained would be α_0 .

A distinctive feature of the model is that it endogenizes the components of aid, which follows Franco-Rodriguez *et al.* 1998 who argued that aid disbursement is influenced by

¹⁰ All model presentations (i.e. descriptions and derivations) follow that of Mavrotas and Ouattara (2003).

the recipient and, therefore, should be considered as a government policy variable. Based on this, it is then assumed that the government maximizes utility function [2] subject to the following budget constraints:

$$I_g + G = B + T + A_1 + A_2 + A_3 + A_4 \quad [3]$$

$$G \leq \rho_1 T + \rho_2 A_1 + \rho_3 A_2 + \rho_4 A_3 + \rho_5 A_4 + \rho_6 B \quad [4]$$

where $0 \leq \rho_i \leq 1$ and $i = 1, 2, \dots, 6$. The assumption underlying the budget constraint represented by Equation [3] above is that government total spending (investment + consumption) must be equalled to the sum of borrowing, tax and non-tax revenues and the different types of foreign aid. In other words, the government is assumed to run a balanced-budget. The rationale for the second constraint (Equation [4]) is that external forces (donors or domestic interest groups) will determine the way the government allocates its resources i.e. ρ_i 's in Equation [4] will be imposed on the government or those setting the targets and allocating revenue. Consequently, as in Franco-Rodriguez, there will be no guarantee that the targets are met even if total revenue equals total expenditure (Mavrotas and Ouattara).

As mentioned earlier, Mavrotas and Ouattara have also included borrowing in their model as can be seen in the specification of the second budget constraint. This is in contrast to a number of previous studies in this area that have assumed that the government prefers not to borrow for consumption purposes, as it is costly in relative terms. However, as argued such restriction should be the outcome of the estimation results i.e. if the government does not borrow to finance consumption then the coefficient of B in equation [4] would not be significantly different from zero (i.e. $\rho_6 = 0$). This view is also shared in this paper.

3.1.2 Derivation of The Model Solution

This involves deriving both structural and reduced-form equations, and following Mavrotas and Ouattara, the model solution is derived by applying the Lagrangean to the maximization problem as below:

$$\begin{aligned}
L = & \alpha_0 - \frac{\alpha_1}{2}(I_g - I_g^*)^2 - \frac{\alpha_2}{2}(G - G^*)^2 - \frac{\alpha_3}{2}(T - T^*)^2 - \frac{\alpha_4}{2}(A_1 - A_1^*)^2 \\
& - \frac{\alpha_5}{2}(A_2 - A_2^*)^2 - \frac{\alpha_6}{2}(A_3 - A_3^*)^2 - \frac{\alpha_7}{2}(A_4 - A_4^*)^2 - \frac{\alpha_8}{2}(B - B^*)^2 \\
& + \lambda_1(I_g + G - B - T - A_1 - A_2 - A_3 - A_4) \\
& + \lambda_2(G - \rho_1 T - \rho_2 A_1 - \rho_3 A_2 - \rho_4 A_3 - \rho_5 A_4 - \rho_6 B)
\end{aligned} \tag{5}$$

where λ_1 and λ_2 are the Lagrange multipliers.

Turning the inequality sign into equality and taking the first derivatives with respect to the endogenous variables and the multipliers leads to the following first-order conditions:

$$\frac{\partial L}{\partial I_g} = -\alpha_1(I_g - I_g^*) + \lambda_1 = 0 \tag{6}$$

$$\frac{\partial L}{\partial G} = -\alpha_2(G - G^*) + \lambda_1 + \lambda_2 = 0 \tag{7}$$

$$\frac{\partial L}{\partial T} = -\alpha_3(T - T^*) - \lambda_1 - \lambda_2 \rho_1 = 0 \tag{8}$$

$$\frac{\partial L}{\partial A_1} = -\alpha_4(A_1 - A_1^*) - \lambda_1 - \lambda_2 \rho_2 = 0 \tag{9}$$

$$\frac{\partial L}{\partial A_2} = -\alpha_5(A_2 - A_2^*) - \lambda_1 - \lambda_2 \rho_3 = 0 \tag{10}$$

$$\frac{\partial L}{\partial A_3} = -\alpha_6(A_3 - A_3^*) - \lambda_1 - \lambda_2 \rho_4 = 0 \tag{11}$$

$$\frac{\partial L}{\partial A_4} = -\alpha_7(A_4 - A_4^*) - \lambda_1 - \lambda_2 \rho_5 = 0 \tag{12}$$

$$\frac{\partial L}{\partial B} = -\alpha_8(B - B^*) - \lambda_1 - \lambda_2 \rho_6 = 0 \tag{13}$$

$$\frac{\partial L}{\partial \lambda_1} = I_g + G - B - T - A_1 - A_2 - A_3 - A_4 = 0 \tag{14}$$

$$\frac{\partial L}{\partial \lambda_2} = G - \rho_1 T - \rho_2 A_1 - \rho_3 A_2 - \rho_4 A_3 - \rho_5 A_4 - \rho_6 B = 0 \tag{15}$$

In line with Mavrotas and Ouattara we assume *ex ante* that the target for borrowing (B^*) is equal to zero. Solving the first-order conditions yields the following structural equations:

$$\begin{aligned}
I_g &= (1-\rho_1)\beta_1 I_g^* + (1-\rho_1)\beta_2 G^* \\
&\quad + (1-\rho_1)[1-(1-\rho_1)\beta_1 - \rho_1\beta_2]T^* \\
&\quad + [(1-\rho_2) - (1-\rho_1)(1-\rho_2)\beta_1 - (1-\rho_1)\rho_2\beta_2]A_1 \\
&\quad + [(1-\rho_3) - (1-\rho_1)(1-\rho_3)\beta_1 - (1-\rho_1)\rho_3\beta_2]A_2 \\
&\quad + [(1-\rho_4) - (1-\rho_1)(1-\rho_4)\beta_1 - (1-\rho_1)\rho_4\beta_2]A_3 \\
&\quad + [(1-\rho_5) - (1-\rho_1)(1-\rho_5)\beta_1 - (1-\rho_1)\rho_5\beta_2]A_4 \\
&\quad + [(1-\rho_6) - (1-\rho_1)(1-\rho_6)\beta_1 - (1-\rho_1)\rho_6\beta_2]B
\end{aligned} \tag{16}$$

$$\begin{aligned}
G &= \rho_1\beta_1 I_g^* + \rho_1\beta_2 G^* + \rho_1[1-(1-\rho_1)\beta_1 - \rho_1\beta_2]T^* \\
&\quad + [\rho_2 - \rho_1(1-\rho_2)\beta_1 - \rho_1\rho_2\beta_2]A_1 \\
&\quad + [\rho_3 - \rho_1(1-\rho_3)\beta_1 - \rho_1\rho_3\beta_2]A_2 \\
&\quad + [\rho_4 - \rho_1(1-\rho_4)\beta_1 - \rho_1\rho_4\beta_2]A_3 \\
&\quad + [\rho_5 - \rho_1(1-\rho_5)\beta_1 - \rho_1\rho_5\beta_2]A_4 \\
&\quad + [\rho_6 - \rho_1(1-\rho_6)\beta_1 - \rho_1\rho_6\beta_2]B
\end{aligned} \tag{17}$$

$$\begin{aligned}
T &= \beta_1 I_g^* + \beta_2 G^* + [1-(1-\rho_1)\beta_1 - \rho_1\beta_2]T^* \\
&\quad - [(1-\rho_2)\beta_1 - \rho_2\beta_2]A_1 \\
&\quad - [(1-\rho_3)\beta_1 - \rho_3\beta_2]A_2 \\
&\quad - [(1-\rho_4)\beta_1 - \rho_4\beta_2]A_3 \\
&\quad - [(1-\rho_5)\beta_1 - \rho_5\beta_2]A_4 \\
&\quad - [(1-\rho_6)\beta_1 - \rho_6\beta_2]B
\end{aligned} \tag{18}$$

$$\begin{aligned}
A_1 &= \beta_3 I_g^* + \beta_4 G^* - [(1-\rho_1)\beta_3 + \rho_1\beta_4]T \\
&\quad + [1-(1-\rho_2)\beta_3 - \rho_2\beta_4]A_1^* \\
&\quad - [(1-\rho_3)\beta_3 + \rho_3\beta_4]A_2 \\
&\quad - [(1-\rho_4)\beta_3 + \rho_4\beta_4]A_3 \\
&\quad - [(1-\rho_5)\beta_3 + \rho_5\beta_4]A_4 \\
&\quad - [(1-\rho_6)\beta_3 + \rho_6\beta_4]B
\end{aligned} \tag{19}$$

$$\begin{aligned}
A_2 &= \beta_5 I_g^* + \beta_6 G^* - [(1-\rho_1)\beta_5 + \rho_1\beta_6]T \\
&\quad - [(1-\rho_2)\beta_5 + \rho_2\beta_6]A_1 \\
&\quad + [1-(1-\rho_3)\beta_5 - \rho_3\beta_6]A_2^* \\
&\quad - [(1-\rho_4)\beta_5 + \rho_4\beta_6]A_3 \\
&\quad - [(1-\rho_5)\beta_5 + \rho_5\beta_6]A_4 \\
&\quad - [(1-\rho_6)\beta_5 + \rho_6\beta_6]B
\end{aligned} \tag{20}$$

$$\begin{aligned}
A_3 &= \beta_7 I_g^* + \beta_8 G^* - [(1-\rho_1)\beta_7 + \rho_1\beta_8]T \\
&\quad - [(1-\rho_2)\beta_7 + \rho_2\beta_8]A_1 \\
&\quad - [(1-\rho_3)\beta_7 + \rho_3\beta_8]A_2 \\
&\quad + [1-(1-\rho_4)\beta_7 - \rho_4\beta_8]A_3^* \\
&\quad - [(1-\rho_5)\beta_7 + \rho_5\beta_8]A_4 \\
&\quad - [(1-\rho_6)\beta_7 + \rho_6\beta_8]B
\end{aligned} \tag{21}$$

$$\begin{aligned}
A_4 &= \beta_9 I_g^* + \beta_{10} G^* - [(1-\rho_1)\beta_9 + \rho_1\beta_{10}]T \\
&\quad - [(1-\rho_2)\beta_9 + \rho_2\beta_{10}]A_1 \\
&\quad - [(1-\rho_3)\beta_9 + \rho_3\beta_{10}]A_2 \\
&\quad - [(1-\rho_4)\beta_9 + \rho_4\beta_{10}]A_3 \\
&\quad + [1-(1-\rho_5)\beta_9 - \rho_5\beta_{10}]A_4^* \\
&\quad - [(1-\rho_6)\beta_9 + \rho_6\beta_{10}]B
\end{aligned} \tag{22}$$

$$\begin{aligned}
B &= \beta_{11} I_g^* + \beta_{12} G^* - [(1-\rho_1)\beta_{11} + \rho_1\beta_{12}]T \\
&\quad - [(1-\rho_2)\beta_{11} + \rho_2\beta_{12}]A_1 \\
&\quad - [(1-\rho_3)\beta_{11} + \rho_3\beta_{12}]A_2 \\
&\quad - [(1-\rho_4)\beta_{11} + \rho_4\beta_{12}]A_3 \\
&\quad - [(1-\rho_5)\beta_{11} + \rho_5\beta_{12}]A_4
\end{aligned} \tag{23}$$

The computations of β 's are given in Annex A.

However, and as noted in Mavrotas and Ouattara, the above structural equations only capture the partial effects of the aid variables to the extent that they ignore the indirect feedbacks, operating through the simultaneous system formed by Equations [16] to [23]. To capture the total impacts (direct and indirect), which are crucial for policy purposes, it is important to derive the reduced-form equations, which is done by simultaneously solving the preceding structural equations and expressing each endogenous variable in terms of the exogenously determined variables as below:

$$I_g = \delta_1 I_g^* + \delta_2 G^* + \delta_3 T^* + \delta_4 A_1^* + \delta_5 A_2^* + \delta_6 A_3^* + \delta_7 A_4^* \quad [24]$$

$$G = \delta_8 I_g^* + \delta_9 G^* + \delta_{10} T^* + \delta_{11} A_1^* + \delta_{12} A_2^* \delta_{13} A_3^* + \delta_{14} A_4^* \quad [25]$$

$$T = \delta_{15} I_g^* + \delta_{16} G^* + \delta_{17} T^* + \delta_{18} A_1^* + \delta_{19} A_2^* + \delta_{20} A_3^* + \delta_{21} A_4^* \quad [26]$$

$$A_1 = \delta_{22} I_g^* + \delta_{23} G^* + \delta_{24} T^* + \delta_{25} A_1^* + \delta_{26} A_2^* + \delta_{27} A_3^* + \delta_{28} A_4^* \quad [27]$$

$$A_2 = \delta_{29} I_g^* + \delta_{30} G^* + \delta_{31} T^* + \delta_{32} A_1^* + \delta_{33} A_2^* + \delta_{34} A_3^* + \delta_{35} A_4^* \quad [28]$$

$$A_3 = \delta_{36} I_g^* + \delta_{37} G^* + \delta_{38} T^* + \delta_{39} A_1^* + \delta_{40} A_2^* + \delta_{41} A_3^* + \delta_{42} A_4^* \quad [29]$$

$$A_4 = \delta_{43} I_g^* + \delta_{44} G^* + \delta_{45} T^* + \delta_{46} A_1^* + \delta_{47} A_2^* + \delta_{48} A_3^* + \delta_{49} A_4^* \quad [30]$$

$$B = \delta_{50} I_g^* + \delta_{51} G^* + \delta_{52} T^* + \delta_{53} A_1^* + \delta_{54} A_2^* + \delta_{55} A_3^* + \delta_{56} A_4^* \quad [31]$$

Where the δ 's represent complex combinations of γ 's and α 's, not reported in this paper for reasons related to economy of space. From the estimation of each d we could deduce the total impact of aid of each type of aid on the other endogenous variables.

3.2 Data and Estimation Issues

The data used in this research is obtained from the databases of OECD-DAC Office in Paris, the Department of State for Finance and Economic Affairs (DOSFEA), The Gambia, and the World Bank and IMF databases. Running econometric models of this nature requires longer time series data of at least 20 years to give any meaningful

analysis. However, because of the well-known data problems and limitations relating to pre-1980 period and as experienced in some researches (including those of Mavrotas and Ouattara), the data for this research covered the period 1980 to 2001. Also due to data problems in The Gambia regarding aid flows, the data on the foreign aid variables were obtained from the OECD-DAC Office in Paris that covers only the official development assistance as reported by OECD-DAC database. Therefore, the definition of aid in this study is based on the OECD's concept of aid, which is official development assistance (ODA). Accordingly, based on OECD definition, project aid here refers to investment project aid and programme aid refers to sector programme aid (i.e. balance of payment and budget support). However, for our purpose and in line with our definition of programme aid given in Chapter 2, we included the debt relief/forgiveness as part of programme aid. This is also justified by the fact that programme aid is claimed to be the best modality for poverty reduction, and debt relief funds are among the key resources for our poverty reduction strategies. Technical assistance refers to technical cooperation projects, whilst food aid refers to programme food aid/food security. Total aid data have been obtained from the OECD-DAC online database, whilst data on project aid and programme aid are not available in disbursement form. These have been obtained with the help of the OECD's Credit Reporting System (CRS), which made it possible to construct these two types of aid for The Gambia through conversion from commitments to disbursements. The conversion is done through transforming the commitments into disbursements by applying the percentage share of the two types of aid (in total project + programme aid commitments) to total net aid disbursements from DAC minus food aid and technical assistance. This methodology follows that of Mavrotas and Ouattara.

Data on public investment (Ig), government consumption (G), and tax and non-tax revenue (T) were obtained from the DOSFEA and IMF databases of various years. Data on borrowing (B) is taken as the difference of revenue and expenditure excluding grants (i.e. tax and non-tax revenue *minus* public investment and government consumption). Although this definition includes money creation, we consider it okay because formally money creation involves government borrowing money from the Central Bank to finance its deficit. Government consumption (G) includes all government expenditure for

purchases of goods and services (including personal emoluments, pensions, and allowances of employees). It also includes most expenditure on education, health, national defence and security. Data on public investment (Ig) includes outlays such as land, dwellings, machinery, and other equipment. Government revenue (T) includes all revenue from taxes and non-tax revenues (other than grants). Tax revenue among others includes personal, corporate, capital gains, payroll, import duties, and sales tax, whilst non-tax revenue includes government services and charges, interest, dividends and property, and capital revenue, among others. All data were converted into 1995 constant Gambian Dalasi. Income (Y) and Private Investment (Ip) are other variables used in deriving the targets. The income is at GDP market price, whilst the private investment includes all types of investment undertaken by the private sector. GDP data was obtained from World Development Indicators (2003), whilst data on Private Investment was compiled from African Development Indicators, various years.

As mentioned earlier, one of the constraints of the fiscal response model is how to obtain the target variables in the theoretical model as these targets are not generally published in official sources and getting them from unpublished government sources is not always easy to come by. In view of this problem, the established practice in previous empirical studies is to approximate the targets through estimation. Although there is no agreed methodology on how to proceed with such estimations, Mavrotas and Ouattara derived their target variables from a co-integrating regression of vectors of exogenous regressors on each actual variable. Following this application, the fitted values were obtained as follows: the target for public investment (Ig^*) was obtained by regressing Ig on private investment (Ip); government consumption (G) target variable was derived by regressing G on its value in the previous year, and government revenue (T) was obtained by regressing T on income (Y) and aid commitments (Ac). The commitment values for aid were obtained OECD DAC database. Just as in the case for actual variables, all target variables were also converted into 1995 constant Gambian Dalasi.

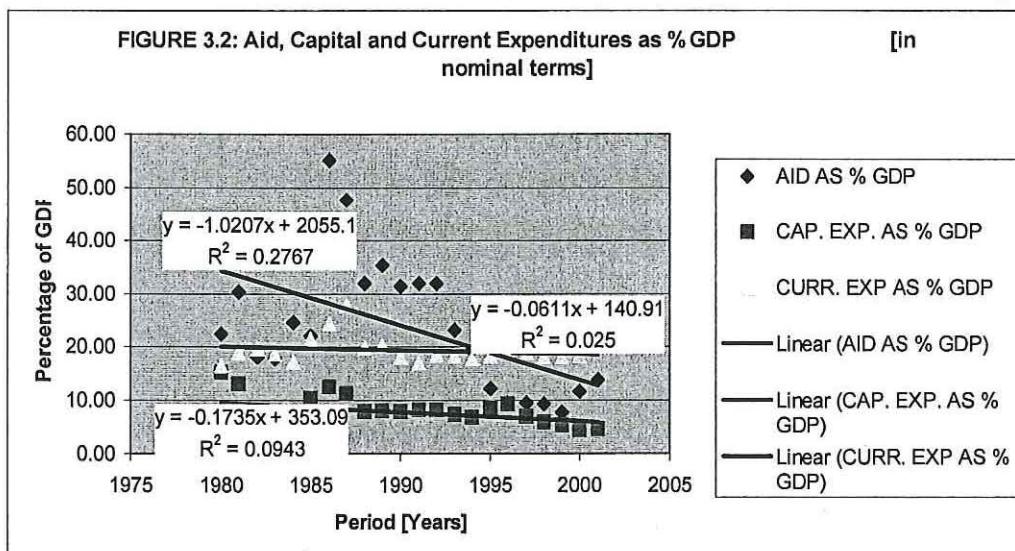
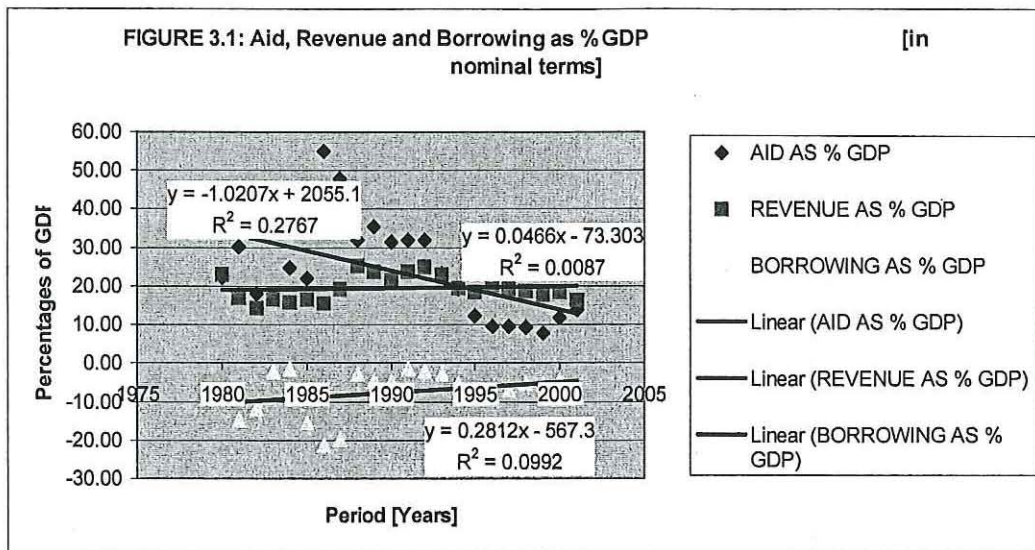
Furthermore, the targets for the aid variables are set equal to their commitments value. As argued in Mavrotas and Ouattara, the sense behind this approach is that government will start bargaining based on the commitments made by donors. It is argued that during the

bargaining process between donors and the government, the latter would try to convince the former to release the amount of aid committed. Thus overshooting this target is unlikely, as this would imply that the government could spend more money than it has been allocated. The authors added that there is no reason to believe that government will undershoot this target, as donors may not release the full amount of these commitments and government would rationally attempt to get all commitments to be disbursed.

Finally, the non-linear Three Stage Least Squares (N3SLS) estimation technique is employed for the estimation of the structural equations, using Time Series Processors (TSP version 4). This method of estimation is appropriate for the following reasons: (i) the systems of simultaneous equations, formed by the structural equations [16]–[23], although linear in the variables, are not linear in the parameters, and (ii) the models contain cross-equation restrictions with respect to the ρ s and β s. The N3SLS technique takes into account these restrictions and, provides more efficient estimates, using all the information available. In the second stage of estimation, the system formed by the estimates the structural equations is solved through to obtain the reduced-form equations.

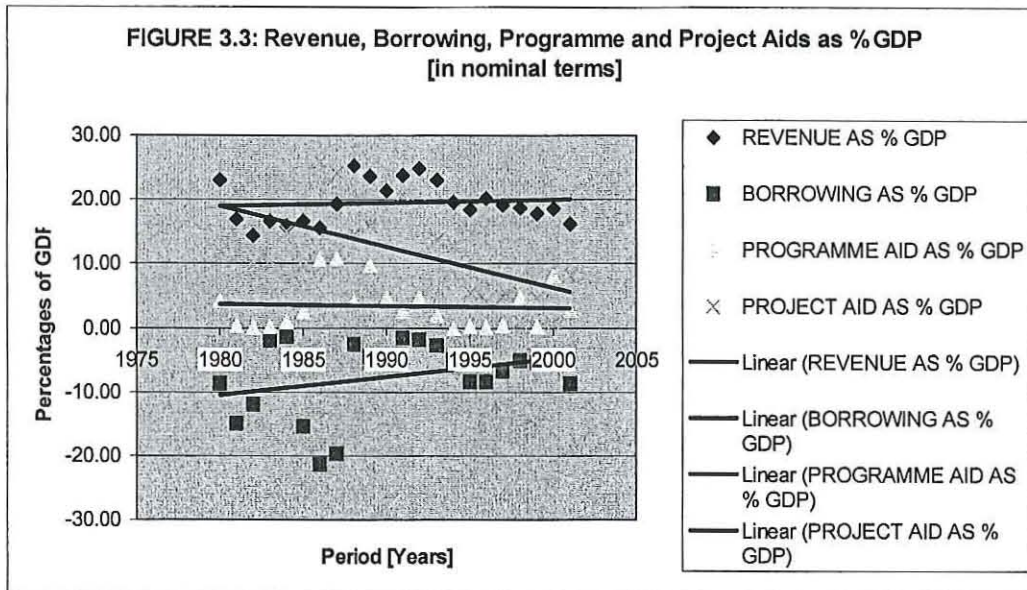
3.3. Descriptive Analysis of Aid and Fiscal Trends in The Gambia

Between 1980 and 2001, the trend in aid and Government fiscal behaviour in percentage GDP, show that whilst total aid declines, revenue and current expenditure remain almost constant. Borrowing on the other hand shows a steady rise, whilst capital expenditure decreases steadily over the period (**Figures 3.1 and 3.2**). However, all variables vary insignificantly in relation to time as shown by their respective R^2 's: R^2 (Aid)=0.277; R^2 (Revenue)=0.009; R^2 (Borrowing)=0.099; R^2 (Capital Exp.)=0.094; and R^2 (Current Exp.)=0.025. These indicate that total aid correlates more with time than the fiscal variables. This might explain the reliance on aid as an important macroeconomic variable for The Gambia, making the country an aid dependent one.



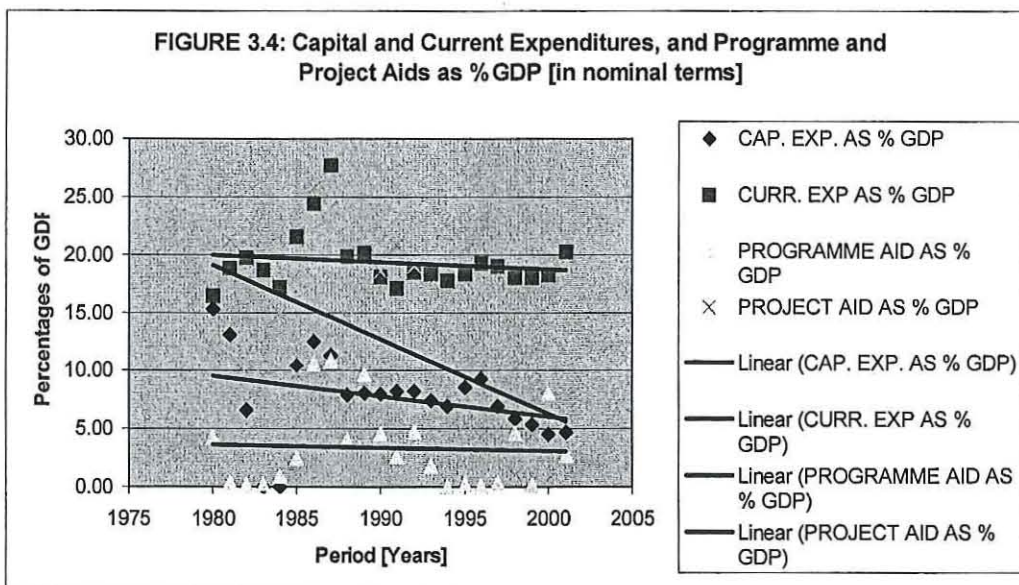
Similarly, in GDP percentage terms, programme aid shows an almost constant trend, whilst project aid shows a decreasing trend over the period (Figures 3.3 and 3.4)¹¹. However, just as in total aid, the trends in both aids show insignificant relation with time, as shown by the respective R^2 's: R^2 (Programme Aid) = 0.003 and R^2 (Project Aid) = 0.325. The R^2 's indicate that project aid is more correlated to time than programme aid, which may suggest that over the years, The Gambia received more project than programme aid.

¹¹ Technical Assistance and Food Aid are not included here for the sake of space, but are considered in the empirical analysis of the model that follows.



Regression results:

- Revenue: $y = 0.0466x - 73.303$; $R^2 = 0.0087$
- Project Aid: $y = -0.6397x + 1285.7$; $R^2 = 0.325$
- Programme Aid: $y = -0.0286x + 60.216$; $R^2 = 0.0027$
- Borrowing: $y = 0.2812x - 567.3$; $R^2 = 0.0992$

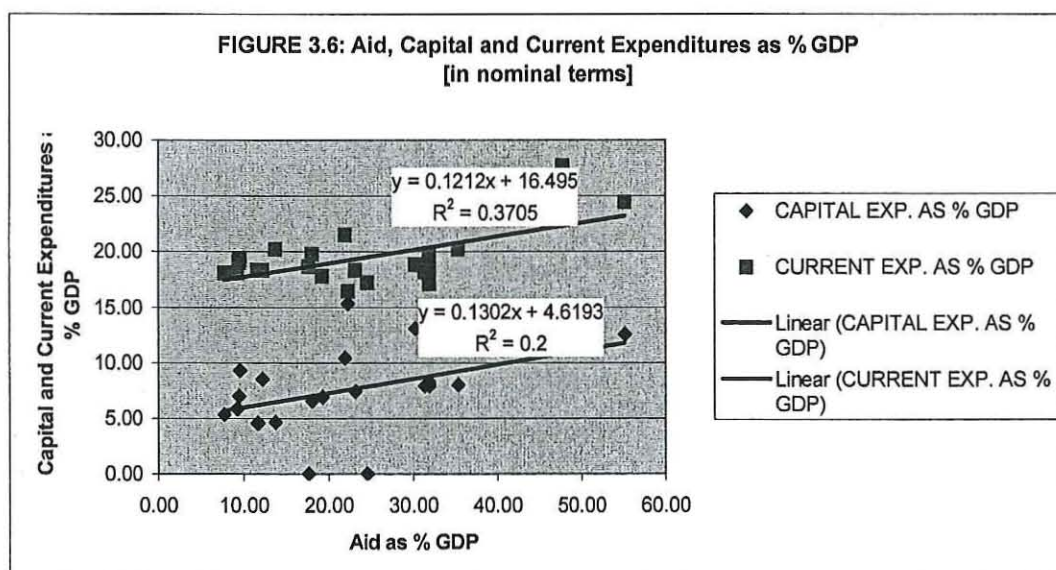
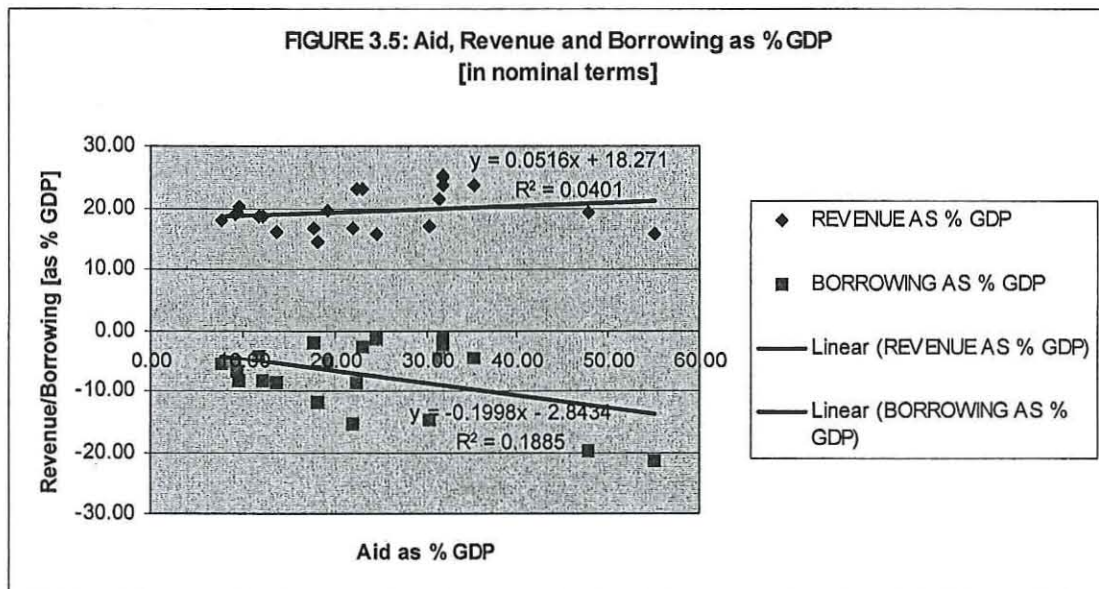


Regression results:

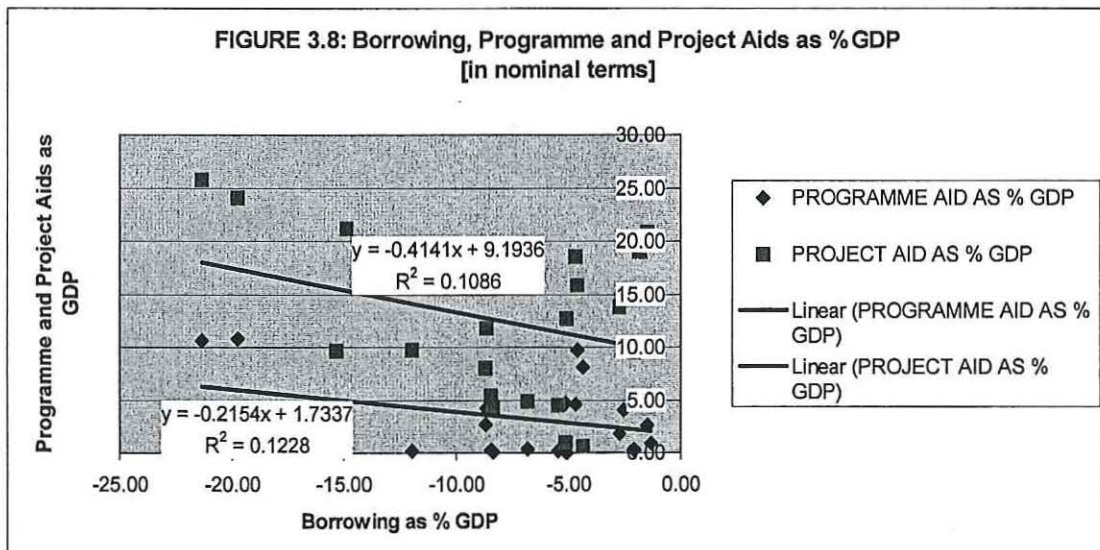
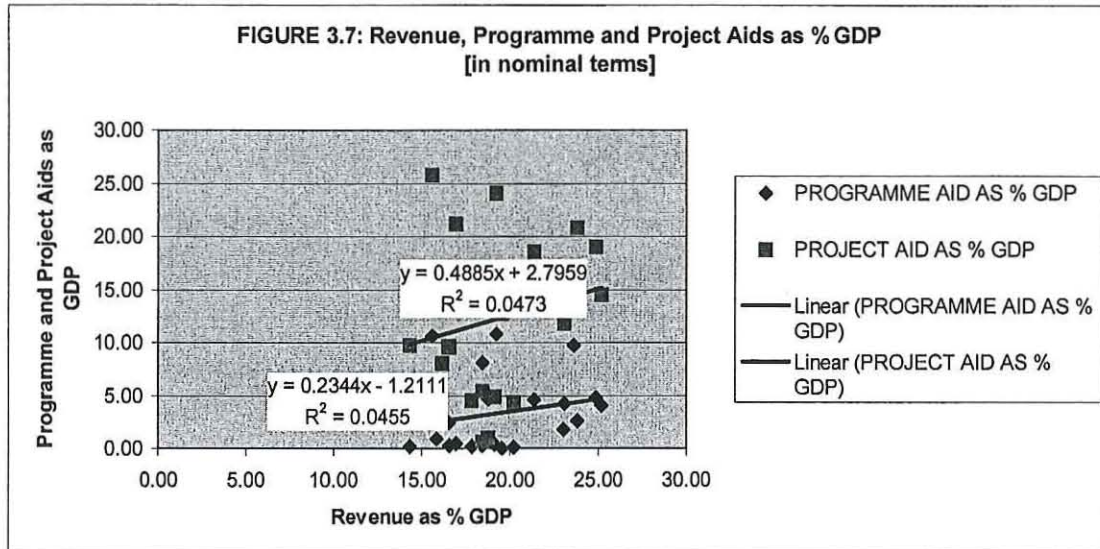
- Capital Expenditure: $y = -0.1735x + 353.09$; $R^2 = 0.0943$
- Current Expenditure: $y = -0.0611x + 140.91$; $R^2 = 0.025$
- Project Aid: $y = -0.6397x + 1285.7$; $R^2 = 0.325$
- Programme Aid: $y = -0.0286x + 60.216$; $R^2 = 0.0027$

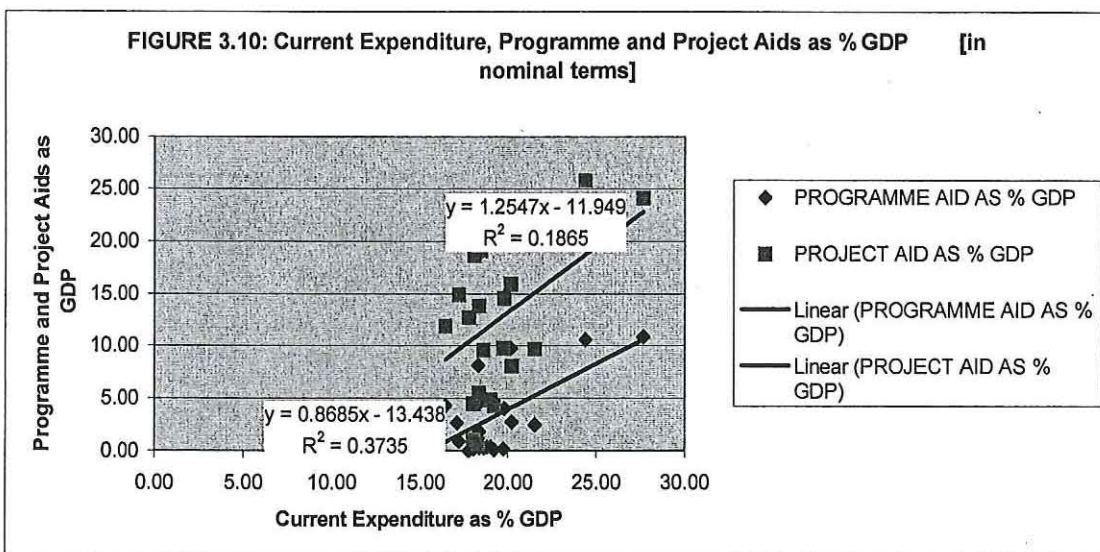
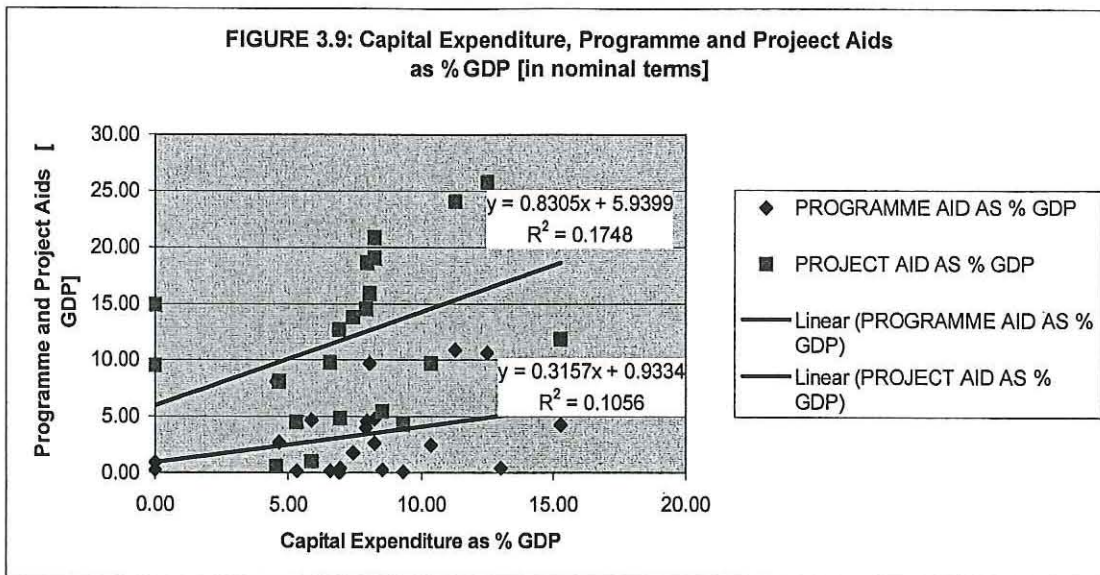
3.4. Descriptive Analysis of Fiscal Response to Aid in The Gambia

Fiscal response to aid in percentage of GDP shows that revenue and aid varies slightly positively, whilst borrowing falls in relation to aid over the period 1980 to 2001. Capital and current expenditures on the other hand vary positively with aid (Figures 3.5 and 3.6). However, the R^2 's show insignificant correlation between fiscal variables and total aid in GDP terms: R^2 (Revenue) =0.040 and R^2 (Borrowing) =0.189, R^2 (Capital Exp.)=0.20; and R^2 (Current Exp.)=0.371. The R^2 's though, show that aid is more correlated to expenditure than revenue and borrowing.



In the case of programme and project aids, the fiscal response in terms of percentage GDP shows that revenue and, programme and project aids show positive relationship, whilst borrowing and, programme and project aids show negative relationships over the period 1980 to 2001. Capital and revenue expenditures on the other hand vary positively with programme and project aids (Figures 3.7, 3.8, 3.9 and 3.10).





The above analyses indicate some striking results that are relevant to our analysis. The fiscal response theory treats aid like another form of revenue that allows government to set target or expected value that is incorporated into its planning or behaviour. Thus with more aid, the expectation is that revenue and borrowing would fall, whilst expenditure rises. However, in the preceding analyses, whilst this expectation appears to be true of borrowing and expenditure, it shows the opposite in the case of revenue. But these are preliminary analyses that are in nominal percentage GDP terms. In the next section we revisit this theory by running our model using real values to see if the results here hold.

3.5 Estimation Results

3.5.1 Results of Parameter Analysis

The results from the estimation of the structural equations [14 –19] are presented in **Table 3.1** below. The results indicate that all the parameters are consistent with the underlying assumptions of the model, that is the ρ -s are within the range [0, 1] and all the β -s are also positive as expected. The results of the parameters can be interpreted as follows: ρ_1 seem to suggest that about 68 percent of tax revenue in The Gambia is used for consumption purposes, whilst about 40 percent of Government borrowing is used to support consumption (ρ_6). The shares of project aid (ρ_2) and programme aid (ρ_3) directed to consumption are 38 and 39 percent respectively. The other forms that are delivered either through project or programme approach show that around 100 percent of technical assistance (ρ_4) is diverted to consumption, whilst none of the food aid appears to be diverted to government consumption (ρ_5). However the p-values show that the results of these two types of aid show statistical insignificance. The interesting thing about these results is that both project and programme aids appear to have equal influence on government consumption. Since, as from our preliminary analysis, project aid constitutes the greater share of aid inflows, these results should have important policy implications as would be seen later.

Table 3.1: Estimates of Structural Equation Parameters

Parameters	Estimates	P-values
Disaggregated Aid		
ρ_1	0.676***	0.000
ρ_2	0.380***	0.000
ρ_3	0.387***	0.002
ρ_4	1.000	1.000
ρ_5	0.000	1.000
ρ_6	0.396***	0.006
β_1	0.292**	0.106
β_2	0.314**	0.119
β_3	0.809***	0.000
β_4	0.002	0.992
β_5	0.997***	0.000
β_6	0.165	0.249
β_7	0.000	1.000
β_8	0.381***	0.028
β_9	0.088	0.542
β_{10}	0.222	0.323
β_{11}	1.081***	0.000
β_{12}	0.000	1.000

Note: *** implies that the coefficient is statistically significant at level 10%.

** implies that the coefficient is statistically significant at slightly above 10%

3.5.2 Reporting the Direct Impact of Aid Variables

In our model derivation we pointed out that the structural equations represent the direct or partial impact of the aid variables on each type of revenue and expenditure categories. These impacts are obtained using the substitution methods, by inserting the estimates of the parameters reported in **Table 3.1** into the coefficients of the structural equations [16]–[23]¹². The resulting impacts and the mechanisms (i.e. coefficients), through which they operate, are summarized in **Table 3.2** below:

¹² Full details of the equations are presented in Annex A. It is important to note that in deriving the structural and reduced-form equations, all other variables except the significant ones are set to zero.

Table 3.2: Direct Incremental Impact of Aid Variables

Impact	Mechanism	Estimate
<i>Investment</i>		
A ₁ on I _g	+ [(1- ρ ₂) - (1-ρ ₁)(1- ρ ₂) β ₁ - (1-ρ ₁) ρ ₂ β ₂]	0.523
A ₂ on I _g	+ [(1- ρ ₃) - (1-ρ ₁)(1- ρ ₃) β ₁ - (1-ρ ₁) ρ ₃ β ₂]	0.516
A ₃ on I _g	+ [(1- ρ ₄) - (1-ρ ₁)(1- ρ ₄) β ₁ - (1-ρ ₁) ρ ₄ β ₂]	0.905
A ₄ on I _g	+ [(1- ρ ₅) - (1-ρ ₁)(1- ρ ₅) β ₁ - (1-ρ ₁) ρ ₅ β ₂]	0.905
<i>Consumption</i>		
A ₁ on G	+ [ρ ₂ - ρ ₁ (1- ρ ₂) β ₁ - ρ ₁ ρ ₂ β ₂]	0.177
A ₂ on G	+ [ρ ₃ - ρ ₁ (1- ρ ₃) β ₁ - ρ ₁ ρ ₃ β ₂]	0.184
A ₃ on G	+ [ρ ₄ - ρ ₁ (1- ρ ₄) β ₁ - ρ ₁ ρ ₄ β ₂]	-0.197
A ₄ on G	+ [ρ ₅ - ρ ₁ (1- ρ ₅) β ₁ - ρ ₁ ρ ₅ β ₂]	-0.197
<i>Revenue</i>		
A ₁ on T	- [(1- ρ ₂) β ₁ + ρ ₂ β ₂]	-0.300
A ₂ on T	- [(1- ρ ₃) β ₁ + ρ ₃ β ₂]	-0.301
A ₃ on T	- [(1- ρ ₄) β ₁ + ρ ₄ β ₂]	-0.292
A ₄ on T	- [(1- ρ ₅) β ₁ + ρ ₅ β ₂]	-0.292
<i>Borrowing</i>		
A ₁ on B	- [(1- ρ ₂) β ₁₁ + ρ ₂ β ₁₂]	-0.670
A ₂ on B	- [(1- ρ ₃) β ₁₁ + ρ ₃ β ₁₂]	-0.663
A ₃ on B	- [(1- ρ ₄) β ₁₁ + ρ ₄ β ₁₂]	-1.081
A ₄ on B	- [(1- ρ ₅) β ₁₁ + ρ ₅ β ₁₂]	-1.081

The direct incremental results reported in **Table 3.2** indicate that all aid variables have direct positive impact on investment and direct negative impact on revenue and borrowing. However, the results for consumption are rather mixed. Whilst project and programme aids impact positively on consumption, technical assistance and food aid show negative impacts. In numeric terms, a 1000 Dalasi increase in project aid would increase investment by 523 Dalasis, and consumption by 177 Dalasis, whilst revenue and borrowing would decrease by 300 and 670 Dalasis respectively. In the case of the programme aid, a 1000 Dalasi increase would raise investment and consumption by 516 and 184 Dalasis respectively; where as revenue and borrowing would fall by 301 and 663 Dalasis respectively. Increase in technical assistance and food aid by 1000 Dalasis, on the other hand would lead to a respective equal rise in investment by 905 Dalasis, whilst consumption, revenue and borrowing would also respectively fall by 197, 292, and 1081 Dalasis. Recapping the definition of fungibility as meaning more aid, less revenue and more expenditure, these results suggests that both programme and project aids are fungible, whilst technical assistance and food aid show fungibility to all fiscal variables except consumption. The results also suggest that foreign aid to The Gambia is pro-investment, followed by and revenue and consumption. The result of this is budget deficit that is highly financed by significant amount of aid as can be seen in the borrowing figure. What is striking from these results is that the impacts of programme and project aids did not show any significant difference. Whilst slightly more project than programme aid is consumed on investment, the latter is slightly more consumed on revenue and consumption than the former. The results of the other types of aid that are normally disbursed either through project or programme approach seem to support this, with both technical assistance and food aid showing equal impacts on each fiscal variable. Also the results show that these two types of aid are highly more fungible than project and programme aids. Regarding the relationship among the aid variables, the results indicate that all aid variables relates negatively to each other i.e. more programme aid would lead to less project and food aids, and vice versa. Whilst more programme, project and food aids leads to less technical assistance, the latter shows no impact on the

former three aids. However, these results only indicate partial effects. For policy purposes, we need to look at the total impact, which takes us to the next discussion.

3.5.3 Analysing Total Impact of Aid Variables

The structural equations as discussed earlier represent partial effects of aid variables on each revenue and expenditure categories. The total effects that is represented by reduced-form equations, are deduced from the simultaneous solutions to the structural equations (through elimination methods) represented by equations [24]-[31]¹³ and presented in **Table 3.3** below.

Table 3.3: Total Impact of Aid Variables

	A1*	A2*	A3*	A4*
Ig	0.110	0.108	0.095	0.098
G	0.031	0.040	-0.229	-0.228
T	-0.059	-0.064	0.063	0.061
B	-0.338	-0.334	-0.298	-0.309
A1	0.823	-0.175	-0.154	-0.154
A2	-0.279	0.726	-0.247	-0.229
A3	-0.006	-0.007	0.502	-0.498
A4	0.000	0.000	0.000	1.000

The results in the Table 3.3 above indicate that all aid variables have positive total impact on public investment. An increase of 1000 Dalasi in the project and programme aids results in an increase in public investment by 110 and 108 Dalasis respectively. Similarly, a 1000 Dalasi increase of food aid and technical assistance results in a rise in public investment by 95 and 98 Dalasis respectively. Regarding government consumption, the results indicate that whilst project and programme aids show positive impacts on government consumption, food aid and technical assistance show negative impacts. These suggest that a 1000 Dalasi increase of project and programme aid results in a rise in government consumption by 31 and 40 Dalasis respectively. Where as a 1000 increase

¹³ Full details of these equations are presented in the Annex A.

of food aid and technical assistance results in a decline in government consumption by 229 and 228 Dalasis respectively.

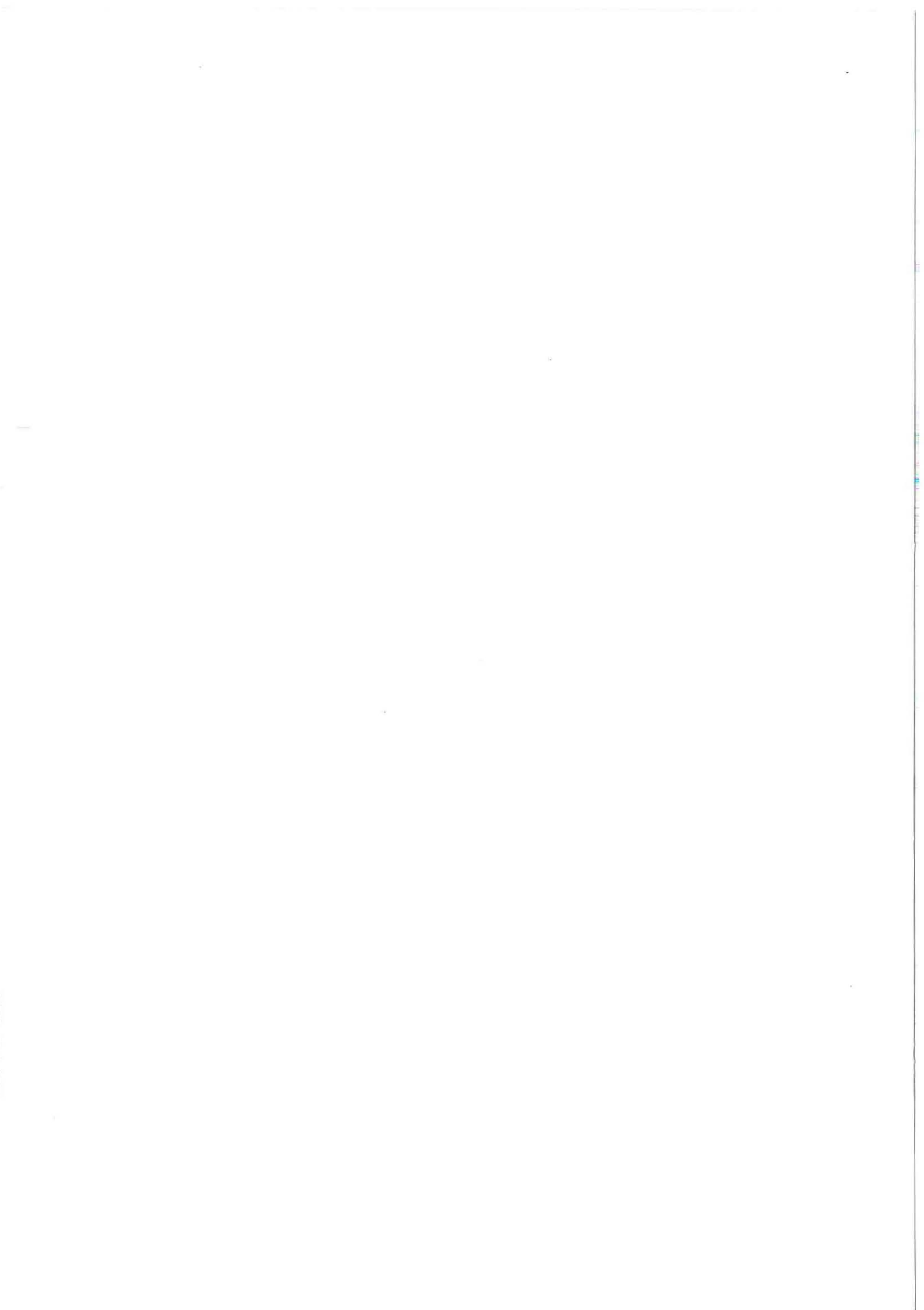
Furthermore, in terms of revenue, the results indicate that whilst project and programme aids impacts negatively on government revenue, food aid and technical assistance show positive impacts. An increase of 1000 Dalasis in project and programme aids results in a fall in government revenue by 59 and 64 Dalasis respectively. In the same token, a 1000 Dalasis increase in food aid and technical assistance results in an increase in government revenue by 63 and 61 Dalasis respectively. With respect to borrowing, the results show that all aid variables show negative impact on government borrowing. Thus a 1000 Dalasi increase of project and programme aids results in lesser government borrowing by 338 and 334 Dalasis respectively; whilst a 1000 Dalasi rise in food aid and technical assistance results in government borrowing falling by 298 and 309 Dalasis respectively. Like the direct impact, the total impact also indicates that aid inflows to The Gambia are pro-investment, followed by revenue and recurrent expenditure. The resulting outcome is higher borrowing as shown by the borrowing figures. However, it can be noted that food aid and technical assistance show mixed outcomes in government consumption and revenue. Whilst government consumption falls with a rise in food aid and technical assistance, revenue on the other hand rises. The direct impact of the two aid types show mixed results but only on recurrent expenditure.

Finally, regarding the impact of different aid variables on each other, Table 3.3 shows that the project, programme and food aids impact negatively on each other i.e. an increase in one result to a fall in the other. In the case of technical assistance, the results indicate that this form of aid impacts negatively on the project, programme and food aids, whilst the latter three show no impact on technical assistance (what a striking results?).

3.6. Conclusions

In this chapter we have tested the fungibility of the different aid variables on government behaviour and our results indicate that government responds to aid according to the category of the inflow i.e. project aid, programme aid, food aid and technical assistance. The direct and total impacts indicate that both project aid and programme aid appear to

increase public investment and government recurrent expenditure, and reduces revenue and borrowing. The results of food aid and technical assistance are mixed. Whilst the direct impact shows that both food aid and technical assistance appear to reduce government consumption and revenue, the direct impact appear to reduce the former and increase the latter. Contrasting these results with those obtained using percentages of GDP (in nominal terms), it can be seen that except for revenue all other variables show fungibility. In nominal percentage GDP terms, revenue shows no fungibility; but it does in the fiscal response model. What is more striking about the above results is that there is no major difference in the fungibility of the two aids under review (project aid and programme aid). This has some policy implications on the PRSP considering the fact that its modality calls for a shift from project to programme aid. The question that arises now is will this shift make any difference for The Gambia. Providing an answer to this question requires examining the PRSP modalities vis-à-vis its conditions to fiscal discipline and spending to find out if they differ from what we have obtained in our fiscal response model. This takes us to our second hypothesis that is discussed in the next chapter.



CHAPTER 4: GENERAL CONCLUSIONS AND RECOMMENDATIONS

4.1 General Conclusions

The experience of foreign aid has been a mixed one, with anecdotal evidence suggesting that aid as a tool for development finance in the least developed countries and as predicted, did not bridge the gap between the rich countries mainly of the South and the poor countries of the North. A number of explanations have been given for what many attributed success aid stories to the positive link between effective aid utilisation and sound policy reform. The aid utilisation discourse came to centre on the debate of programme versus project aid, with the latter argued to be weak in fighting poverty. Over the years, the policy reform came to include poverty reduction strategy paper (PRSP) as conditionality for giving aid and relieving debt. It has been argued that the PRSP provides a better aid modality in the form of programme aid. Starting from this as our point of departure, we examined the impact of the two forms of aid (project aid and programme aid) on the fiscal behaviour and the likely implication on the PRSP. The rationale behind this is that since aid is given to governments it is apparent that it affects their fiscal decisions on tax and expenditures. Our paper differs from others in that it uses the fiscal response model to explore the debate of programme versus project aid. In addition, we also tested the other two forms of aid (food aid and technical assistance) to beef up our analysis since literature shows that these two categories of aid are usually disbursed through project and programme approaches, and that project aid is criticised as containing too much technical assistance and pays little attention to building local capacity. Two hypotheses were considered: (1) Is programme aid more fungible than project aid? (2) Does the PRSP lead to more programme aid and make it more fungible? The first hypothesis is tested in the preceding chapter using the fiscal response model. The second hypothesis is tested based on the results of the fiscal model, as to be seen later in the discussion. First we recap the findings of our fiscal model and the economic interpretations behind the results.

We carried the fiscal response test using 22 years annual data over the period 1980 to 2001. The results suggest that the Government of The Gambia responds to aid inflows

differently depending on the category of aid in question (whether project aid, programme aid, food aid, and technical assistance). Project aid and programme aid appear to increase public investment and government consumption, with an increase in public investment higher than the government consumption. Regarding taxation, the results suggest that government revenue falls with increase inflows of project and programme aid funds, suggesting that government did not reduce its taxation effort, as opposed to the general belief of the fiscal behaviour of recipient governments under aid. With regards to borrowing, the results indicate that government will reduce borrowing with an increase in project aid and programme aid. However, the results of food aid and technical assistance appear to be mixed. An increase in both food aid and technical assistance increases public investment and reduces borrowing both directly and partially. On the indirect effects, increases in both aids reduce consumption and revenue, whilst on the total effect, revenue rises and consumption falls. These suggest that in the presence of food aid and technical assistance, government raises its taxation effort and reduces borrowing considerably to finance public investment and consumption.

The economic interpretation of the above results is that government would prefer to use project aid and programme aid funds to finance its capital and current expenditures rather than increase taxes. However, there are risks associated with this as to be seen later. To borrow from Mavrotas and Ouattara, the behaviour towards project aid may be explained by the fact that government does not judge this form of aid as essential to increase taxation effort given that funds necessary to finance specific projects comes from aid. Regarding programme aid, the behaviour suggest that the adjustments and stabilisation policies associated with this category of aid tends to favour a market approach to the economy, in which case tax decisions here can be seen to be distortionary and thus should be minimized. This may point to fiscal indiscipline on the part of government to raise revenue because aid funds are around, but as argued in Mavrotas and Ouattara, reduction in tax efforts may not be that bad since it might be beneficial to private sector or individual households. A reduction in tax for instance might lead to an increase in private investment, which may crowd out public investment. In the case of individuals, the reduction in taxation has the potential of increasing domestic consumption or savings,

which may insert positive impact on the economy. Reduction in taxation may also help to reduce civil unrest that is typical of many developing countries especially in Africa, where salaries are too low and taxes are almost unaffordable. In the case of food aid and technical assistance, the results suggest that these categories of aid do not appear to be associated with any decrease in taxation. A possible reason could be that the nature of these forms of aid (i.e. they are not ready-cash) may not permit government to replace them with tax revenue.

Another important economic interpretation could be seen in the borrowing behaviour of government in the presence of aid. The direct and total impacts of all categories on borrowing are negative, suggesting that government would reduce borrowing for each additional Dalasi of each of categories of aid. However, unlike the positive total impact on revenue of the food aid and technical assistance, the total impact of these two types of aid on borrowing is negative. Contrasting this with our argument above that because food aid and technical assistance are not disbursed in ready-cash, government may not replace them with tax revenue; this does not seem to be the case for government borrowing. Even though the two types of aid may not be in ready-cash, the total impacts suggest that their presence have some influence on government borrowing.

The above results show that fungibility of aid exists but suggests that programme aid and project aid do not differ in terms of their fiscal response, by the historical evidence of The Gambia. This could suggest that a shift from project to programme aid under the PRSP will not make any difference; but it is also important to note that the PRSP comes with a number of new modalities including fiscal discipline (more than before) and HIPC fund allocations that need to be pro-poor. The key question then becomes: are the PRSP conditions to fiscal discipline and spending behaviour much different from what we had in the past such that we will expect programme aid to be (less?) fungible under the PRSP process than before? This naturally takes us to the test on our second hypothesis.

In chapter one, we mentioned that the move towards programme aid in the form of sector wide approach is based on six essential objectives, that: (i) local stakeholders should be

fully in charge (ii) aid programmes must be sector-wide in scope covering both current and capital expenditures, (iii) aid modalities must be based on clear sector strategy and policy framework, (iv) all main donors should sign on to the approach in a process led by government, (v) there should be common implementation arrangements, and (vi) use should be made of the local capacity rather than long-term technical assistance for design, management and implementation. This move is popularised in the new modalities that came with the PRSP, which links aid to policy reforms that is broadly conceived as including sound macroeconomic policies, social service delivery, and democratic reforms. Paul (2002) gave a comprehensive insight on the PRSP as an incarnation for new aid modality. In this review, success of the PRSP is highly attached to prior economic reforms/policies of countries; efficient accounting and reporting system, sound budgetary policies that ensures that government spending is in line with expenditure priorities broadly agreed with donors.

Annex 2 gives a brief analysis of the PRSP modalities as applied to The Gambia. In addition, the annex gives brief background information on The Gambia as the country under study, which includes the socio-economic and political perspectives as well as its experience with aid. The analysis indicates that the country has made striving efforts to improve its macroeconomic management mechanism including putting in place fiscal and budget reforms, which qualified it for debt relief and produced full PRSP. However, coordination remains a major issue that should be addressed, as well as statistical issues. The review indicates that the country has weak statistical capacity as well as ineffective institutions to coordinate aid inflows, making it difficult to compile data on donor resources, thus hampering coordination and monitoring and evaluation. This notwithstanding, some efforts have been made to ensure harmonisation of donor procedures through for example the UNDP funded NATCAP and NEX projects. Under the PRSP, poverty reduction have been institutionalised with the establishment of a national coordination office at the Department of State (Ministry) for Finance and Economic Affairs that also involves a steering committee led by the High Level Economic Committee, comprising senior policy makers of the sectoral departments. The PRSP has shifted attention to the need of moving towards programme aid, which has

occupied the aid effectiveness discourse in the country. Government is also working hard to strengthen its partnership with donors and has taken steps through donor support to harmonise donor assistance. Examples include the harmonisation of UN assistance through UNDAF and a production of a procedures manual for UN assisted programmes in the country. Also under way is the Medium Term Expenditure Framework (MTEF) programme, which is also expected to instil fiscal discipline on government and make its expenditure pro-poor.

The above analysis suggests that the PRSP process could encourage a change in aid modality towards programme aid and make it less fungible. However, whereas this is the case, the mechanisms that accompany the implementation of PRSP remain to fully put in place. Key among these are the issues of coordination and statistical capacity that matters very much for any successful PRSP. Moreover, even though the theoretical arguments in this paper tend to support the view that programme aid better than project aid, the historical evidence of The Gambia indicates that both aids are equally important, which could suggest that moving to programme modality would make no difference. But the modalities under the PRSP suggest that the move could make difference but this means that in case of The Gambia, efforts should be made to incorporate projects into our poverty reduction strategies. The World Bank (1998) reports that since aid is fungible, donors need to examine a country's overall budget allocation and efficiency of public spending: the better they are, the stronger the case for budget support; and that countries with sound policies but weak capacity for delivering services, project aid is better. The information on The Gambia, seem to agree to this, as the country's capacity is weak for delivering services, which calls for continuous assessment of the overall budget allocation and ensuring that public spending is efficient and pro-poor. Finally, our fungibility analysis also suggests that: (a) aid is an important macroeconomic variable for The Gambia, and (b) The Gambia received more project than programme aid, and any other type of aid (food aid and technical assistance). With this general overview, we now shift attention to the likely policy implications.

4.2 Policy Implications and Recommendations

The implications of the above results on the PRSP are that government and donors first need to understand that the Government of The Gambia responds accordingly to all forms of aid, irrespective of the type. This may be because The Gambia has a small resource base and weak capacity that tends to favour project aid. Secondly, the PRSP tells us that if government revenue and consumption are fungible, then in order to increase programme aid, we need to increase taxes and raise the budget deficit. This means that reliance on aid requires strengthening tax and budgetary reforms. Without doubts, these have important policy implications on The Gambia. The research thus gives the following mutually reinforcing recommendations for future policies:

1. First given that aid is an important macroeconomic variable to our development process, the government should strengthen its tax and budget reforms further to avoid over-reliance on aid as a source of income that may make government fiscally indiscipline. Although increasing taxes may be difficult given the fact that this may cause political and social instability as it affects people's incomes and earnings. But this may be avoided if government becomes more accountable to the taxpayers and ensure that the taxes paid are yielding results. This also calls for financial governance that should accompany democratic and political governance.
2. Second, Government should also be highly fiscally disciplined by ensuring that all spending are tied to the overall strategy of the development goals of country. In this case, to operationalize the PRSP and solve the issue of fungibility, all resources should be tied to the PRSP that provide adequate resources to the important sectors. Equally, government should make sure that all expenditures relate to the availability of resources; that budgets are programme or output oriented rather than department oriented, and that cynical attitudes are not encouraged to allow spending agencies to bid high because they expect their proposals to be cut back. The MTEF Programme should be encouraged to ensure fiscal discipline.
3. Third, given the equal importance of project aid, efforts should be strengthened to ensure that they are fully incorporated into the poverty reduction strategy by ensuring that all disbursements irrespective of the aid type are passes through the national set plan. This also applies to the food aid and technical assistance that shows fungibility.

Projects should support local institutional and policy changes that improve the delivery of public service. Even if fungibility exists and projects do not make meaningful impact, the local capacity so created could make an impact.

4. Fourth, the issue of aid coordination needs to be resolved if the PRSP is to be effectively implemented. Coordination should be strengthened at all levels and in all sectors, and there is high need for a centralised aid coordination office that would report on the external assistance to The Gambia. This also points to the statistical issues that need urgent attention. The government should strengthen its statistics and other reporting units to ensure that reliable data system is in place and reports are adequately made available for policy design and research.
5. Fifth, institutional capacity building should not involve training of staff, but also to ensure that they stay within the system. There is a high rate of attrition in the public service that is due to low salaries and fear of intimidation. The frequent sackings and redeployment of civil servants weakens the system and undermines efficiency. If people live in fear they cannot stay, as well as if salaries are low staff get attracted to the private and/ or non-governmental sectors.
6. Sixth, given that over-reliance on aid may cause counterfactual effects on donors who may also have their own economic problems, efforts should also be made to expand the production base of developing countries through promotion of fair trade and diversification into other production commodities. The Gambia for instance could diversify its production into rain-fed and agricultural production, which is the main stay of the economy. Additionally, all debts of development countries should be forgiven to ease up constraints imposed by debt servicing on the domestic economies of these nations.
7. Seven, there is an urgent need to model The Gambia's economy that would provide linkage between sectors both horizontally and vertically.
8. Finally, the success of the PRSP rests on strong government that wishes to retain ownership. To successfully implement our PRSP, the Government should ensure that it is firmly in the driving seat and rightly intends to stay there. However, this cannot be achieved without strong local capacity with effective public service, among others. The above points therefore mutually reinforce one another for policy formulation.

4.3 Constraints and Recommendations for Future Researches

This paper suffered a major constraint in the data collection relating to aid and fiscal variables. Because of this, the paper relies on the data on aid from the OECD/DAC database. Thus there is possibility of leaving out some aid data that might have been put into the system. Also on the OECD database, there are other aid figures that could be not classified as either project or programme aid, or food aid and technical assistance. Another constraint is that target variables could not be obtained for The Gambia and so these were estimated using actual figures. Also important to mention here is the difficulty in running the model using the necessary software package. The model was run using the Time Series Processor version 4 that is not available at the base of this research. This has forced reliance on outside assistance from a sister university in the UK (University of Manchester). This thus sets a drawback to this research. These and coupled with the usual limitations of the fiscal response model, forms the constraints and/or limitations of this study. However, this notwithstanding, the study has significant contributions to aid effectiveness research and in particular to the debate of programme versus project aid. It has also shown that disaggregating aid gives a better picture of analysing aid effectiveness than using a single figure that is typical of some aid effectiveness research. The paper thus concludes with the following recommendations for future researches:

- i. Future researches should also consider the impact of total aid along side the different forms of aid considered in this study (project aid, programme aid, food aid and technical assistance) to give a broader perspective on aid.
- ii. Cross-country studies could also be conducted to see how fungibility exists in aid recipient countries, especially among those considered good reformers (e.g. Ghana and Uganda) and the moderate reformers (Ethiopia and Cote d'Ivoire).
- iii. Furthermore, future research could consider the impact of disaggregated aid on growth, poverty and policy. In a similar vein, the impact of aid could be examined on the debt burden and fiscal behaviour of governments, which may give important insight on aid allocation based on debt burden rather than policy.
- iv. Finally, considering the inability to run the model using the STATA software, it can be recommended here that the ISS secures the TSP version 4 to help in future researches that may use similar models

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ANNEX A: The Fiscal Response Model: Parameters and Equations

1. Parameters

$$\beta_1 = \frac{\alpha_1(1-\rho_1)}{\theta_1}; \beta_2 = \frac{\alpha_2\rho_1}{\theta_1}; \beta_3 = \frac{\alpha_1(1-\rho_2)}{\theta_2}; \beta_4 = \frac{\alpha_2\rho_2}{\theta_2}; \beta_5 = \frac{\alpha_1(1-\rho_3)}{\theta_3}; \beta_6 = \frac{\alpha_2\rho_3}{\theta_3};$$
$$\beta_7 = \frac{\alpha_1(1-\rho_4)}{\theta_4}; \beta_8 = \frac{\alpha_2\rho_4}{\theta_4}; \beta_9 = \frac{\alpha_1(1-\rho_5)}{\theta_5}; \beta_{10} = \frac{\alpha_2\rho_5}{\theta_5}; \beta_{11} = \frac{\alpha_1(1-\rho_6)}{\theta_6}; \beta_{12} = \frac{\alpha_2\rho_6}{\theta_6}$$

$$\theta_1 = \alpha_1(1-\rho_1)^2 + \alpha_2\rho_1^2 + \alpha_3; \theta_2 = \alpha_1(1-\rho_2)^2 + \alpha_2\rho_2^2 + \alpha_4;$$

$$\theta_3 = \alpha_1(1-\rho_3)^2 + \alpha_2\rho_3^2 + \alpha_5; \theta_4 = \alpha_1(1-\rho_4)^2 + \alpha_2\rho_4^2 + \alpha_6;$$

$$\theta_5 = \alpha_1(1-\rho_5)^2 + \alpha_2\rho_5^2 + \alpha_7; \theta_6 = \alpha_1(1-\rho_6)^2 + \alpha_2\rho_6^2 + \alpha_8$$

2. Structural Equations

Investment

$$I_g = 0.095I_g^* + 0.102G^* + 0.225T^* + 0.523A_1 + 0.516A_2 + 0.905A_3 + 0.905A_4 + 0.507B$$

Government Consumption

$$G = 0.197I_g^* + 0.212G^* + 0.469T^* + 0.177A_1 + 0.184A_2 - 0.197A_3 - 0.197A_4 + 0.193B$$

Government Revenue

$$T = 0.292I_g^* + 0.314G^* + 0.693T^* - 0.300A_1 - 0.301A_2 - 0.292A_3 - 0.292A_4 - 0.301B$$

Aid Disbursement

$$A_1 = 0.809I_g^* + 0.000G^* - 0.262T + 0.498A_1^* - 0.496A_2 - 0.809A_3 - 0.809A_4 - 0.489B$$

$$A_2 = 0.997I_g^* + 0.000G^* - 0.323T - 0.618A_1 + 0.389A_2^* - 0.997A_3 - 0.997A_4 - 0.602B$$

$$A_3 = 0.000I_g^* + 0.381G^* - 0.258T - 0.145A_1 - 0.147A_2 + 1.000A_3^* - 0.000A_4 - 0.151B$$

$$A_4 = 0.000I_g^* + 0.000G^* - 0.000T - 0.000A_1 - 0.000A_2 - 0.000A_3 + 1.000A_4^* - 0.000B$$

Borrowing

$$B = 1.081I_g^* + 0.000G^* - 0.350T - 0.670A_1 - 0.663A_2 - 1.081A_3 - 1.081A_4$$

3. Reduced-form Equations

Investment

$$I_g = 0.790I_g^* + 0.051G^* + 0.032T^* + 0.110A_1^* + 0.108A_2^* + 0.095A_3^* + 0.098A_4^*$$

Government Consumption

$$G = 0.494I_g^* + 0.111G^* + 0.440T^* + 0.031A_1^* + 0.040A_2^* - 0.229A_3^* - 0.228A_4^*$$

Government Revenue

$$T = -0.135I_g^* + 0.380G^* + 0.788T^* - 0.059A_1^* - 0.064A_2^* + 0.063A_3^* + 0.061A_4^*$$

Aid Disbursement

$$A_1 = 0.334I_g^* - 0.083G^* - 0.052T^* + 0.823A_1^* - 0.175A_2^* - 0.154A_3^* - 0.154A_4^*$$

$$A_2 = 0.513I_g^* - 0.130G^* - 0.083T^* - 0.279A_1^* + 0.726A_2^* - 0.247A_3^* - 0.229A_4^*$$

$$A_3 = -0.087I_g^* + 0.156G^* - 0.078T^* - 0.006A_1^* - 0.007A_2^* + 0.502A_3^* - 0.498A_4^*$$

$$A_4 = 0.000I_g^* + 0.000G^* - 0.000T^* - 0.000A_1^* - 0.000A_2^* - 0.000A_3^* + 1.000A_4^*$$

Borrowing

$$B = 0.658I_g^* - 0.161G^* - 0.102T^* - 0.338A_1^* - 0.334A_2^* - 0.298A_3^* - 0.309A_4^*$$

ANNEX B: Brief Presentation of The Gambia

1. Basic Social, Economic and Political Contexts

Geography: The Gambia is one of the smallest countries in Africa, with a population size of 1.4 million, three-quarters of which live in rural areas. The population growth rate is 2.8% per annum (table 1), one of the highest in Africa (2003 Census)¹⁴. The country is located midway on the bulge of West African coast and stretches 350 kilometers inland from west to east on either side of the River Gambia, varying in width from about 50 km near the mouth of the river to about 24km upstream. The country is bound to the north, south and east by the Republic of Senegal and to the west by the Atlantic Ocean. The River Gambia, which runs the entire length of the country from the Futa Jallon highlands in the Republic of Guinea to the Atlantic Ocean, divides the country's land area of 10,689 sq km almost equally into two halves – the South Bank and the North Bank.

Political Perspectives: After over two centuries of colonial rule under the British, The Gambia gained internal self-governance in 1963 and full independence with dominion status on 18th February 1965. The country became a sovereign Republic within the commonwealth in 1970. The Gambia has maintained a multi-party democracy with adherence to the rule of law and preservation of fundamental human rights, earning her the opportunity to be home to the African Charter for Democracy and Human Rights Headquarters. However, in July 1994, the country came under military rule following a coup d'état. After a two-year transition period, presidential elections were held in September 1996 and democratic civilian rule restored. Elections are held every five years to elect a President and members of the National Assembly. In addition, the country is divided into seven administrative areas (two Municipalities and five Divisions). The divisions are further divided into thirty-five districts locally administered by Chiefs.

The economy: Recent economic indicators show that The Gambia has a per capita Gross Domestic Product of US\$ 350 in 2001 that grew by 6 percent in the same year, while inflation was 4¹/₂ percent, owing to good agricultural performance. The external current account deficit (excluding official transfers) widened to 14.8 percent of GDP from 12.1

¹⁴ The Gambia Millennium Development Goals Report: 2003.

percent in 2000, mainly reflecting the onetime importation of electricity generators. The fiscal deficit (excluding grants) increased to $8\frac{3}{4}$ percent of GDP from $3\frac{1}{2}$ percent in 2000, owing to shortfalls in customs revenue and on lending to a public enterprise and election-related expenditures (IMF Country Report). The UNDP Human Development Index of 2003 indicates that the country is ranked 151st in the world out of 175 countries. Agriculture is the mainstay of the economy, accounting for 27 percent of the GDP in real terms in 2001, followed by tourism, at 12 percent (The Gambia MDG Report, 2003).

Progress in economic development: In 1985, The Gambia embarked on an Economic Recovery Programme (ERP), with the aim of correcting macroeconomic and structural imbalances. Over the period, economic performance has improved with inflation contained within single digit levels and economic positive growth gained in real terms, averaging at more than 5 percent per annum since 1998. Since this year, the per capita GDP growth has been positive derived mainly from agriculture, tourism and transit trade.

The characteristic of poverty: Recent poverty analysis indicates that in The Gambia poverty manifests itself in the form of multiple deprivations. The 1998 Household Poverty Survey (the latest household survey) revealed a high incidence of poverty in the country with an increasing proportion of the population living below the poverty over the past decade. Food poverty increased from 33 to 37 percent, while the overall poverty increased from 60 to 69 percent (**table 4.1**). Although poverty is predominantly a rural phenomenon in the country, urban poverty is rising fast, with regional disparities also evident. Among the poor also, women are the most disadvantaged (MDG Report: 2003).

Income inequality, measured by the Gini coefficient is high and is said to have increased from 0.180 in 1993 to 0.466 in 1998. This indicates an uneven distribution in income gained from the increased economic growth, favouring only a small segment of the population. This also indicates that the growth process has not been all-inclusive and pro-poor; and that good macro-economic performance has not been translated into improved welfare for the majority of the population who remain poor (MDG Report 2003).

Annex B: Table 1: Development Indicators

Indicator	Value	Year
Demographic		
Population size (million)	1.4	2003
Population growth rate (%)	2.8	2003
Life expectancy at birth (years)	53.0	1993
Economic		
Real GDP per capita (US\$)	350	2001
Per capita GDP growth (%)	1.91	2001
Inflation rate (%)	13.0	2002
Net Present Value of total debt (US\$ million)	276.6	2002
Total external debt/GDP (%)	108.9	2000
Total debt service (US\$ million)	42.0	2000
NPV of debt/exports (%)	224.7	2001
Poverty and social indicators		
Poverty head count ratio (% of population)	69.0	1998
Gini coefficient	0.466	1998
Overall poverty (% of population)	60.0	1998
Food poverty (% of population)	37.0	1998
Adult illiteracy rate (%)	37.0	2000
Net primary enrolment rate	60.0	2000
Ratio of girls to boys in primary education (%)	65.0	2000
Under-five mortality rate (per 1000 births)	75.0	2000
Maternal mortality rate (per 1000, 000 live births)	730.0	2001
Population without access to safe water (%)	16.0	2001
HIV-1 adult prevalence (15-49 years) (%)	1.2	2001

Source: The Gambia Millennium Development Report: 2003: pp: 8

2. The Country's Experience with Aid

Over the years, The Gambia has received a large inflow of aid as development assistance from its development partners. However, the continuous inflow of aid resources and the increasing demand for its effective management and coordination have created serious challenges to government. For example, in 1998, The Gambia received aid from fifteen UN Agencies, twelve bilateral, six multilateral and sixty NGOs, which together provided US\$64 million through more than 160 separate programmes and projects¹⁵. These poses a

¹⁵ The Gambia Draft Aid Coordination Policy Document (2000), pp1

serious burden to the country's various components of aid coordination that are dispersed among several institutions. The key institutions involved are the Departments of State for Finance, Economic and Foreign Affairs, Office of the President, and the Central Bank. Sectoral Departments of State, mainly Agriculture, Education and Health, through their planning and project implementation units also formulate and implement aid-funded projects. There is also an NGO Affairs Agency that co-ordinate NGOs and Voluntary Organisations in the mobilisation and utilisation of aid resources.

The Government have attempted through round tables with donors to provide an effective aid mechanism by trying to match the support available from aid donors with the resource needs for the country's development programme. Between 1985 and 2002, the government assisted by UNDP has organized eight Round Table Conferences at which eight programmes were presented to donors for implementation¹⁶. It is not surprising that at these round tables, aid coordination always arise as a major issue that needs to be addressed and donors have encouraged government to take the lead in the process. A major step taken in this regard was the presentation of the Technical Cooperation Policy Framework Paper at the 1990 donor conference that outlined the broad institutional roles for aid coordination as a means of building capacity and improving both overall aid management and development administration. These objectives were later pursued under a UNDP funded Regional Project on National Assessment of Technical Cooperation and Programme (NATCAP). The NATCAP sought to improve the aid management system through a continuous assessment of the impact of TC and information sharing. This led to an establishment of a Unit at the Office of the President, provided with the necessary equipment and training for the focal point on the management of the Development

¹⁶1985: Economic Recovery Programme
1990: Programme for Sustained Development
1992: Economic Management and Capacity Building Programme
1994: The Poverty Alleviation Programme-Phase one
1998: Macroeconomic and Social Sectors' Issues
1999: Trade and Investment and Private Sector Development
2000: The Governance Programme
2002: The Poverty Alleviation Programme-Phase two

Cooperation Analysis System (a UNDP corporate database software), as a first step towards establishing a government aid information system.

The second major step came after the 2000 donor conference, when a Consultancy was set up under the funding of a UNDP project on Capacity Building for National Execution (NEX) to produce a national aid coordination policy document aimed at providing a framework for aid coordination. A draft document was produced but never finalized, leaving the country aid coordination issue unresolved. Recently, under the new IMF MTEF programme, the government is working to harmonise all its expenditures into one unified framework for easy resource mobilisation and monitoring under the PRSP. Similarly, under the auspices of the NEX project, the government and UNDP have worked to produce an operations manual for the mobilisation and implementation of UN assisted resources under a unified modality.

3. The Country's PRSP Capacity¹⁷

I. Prior reforms: The anti-poverty background of The Gambia indicates that since the mid-1980s, government has pursued eight economic reform programmes supported by donors, geared towards maintaining macroeconomic stability and reducing poverty. Recently, under the PRSP framework, the government is working to strengthen its budget through *budgetary reforms*. The cabinet paper approved in September 2001 has outlined comprehensive budgetary reforms that trigger debt relief under the enhanced HIPC Initiative, and the PRGF-supported programme. These reforms are centred on the Accountant General's Office, aimed at improving the reporting and control of expenditure and expediting the reconciliation and closing of public accounts. The system is also expected to subsequently facilitate conversion to programme budgeting in line with the objectives of the PERs and eventually the MTEF, as well as to improve expenditure classification under the PRSP and enhanced HIPC priorities. The World Bank, UNDP, and DFID will support these reforms, which illustrate government's institutional capacity building process. In terms of *statistical capacities*, there are substantial weaknesses in The Gambia's economic, social and financial statistics. To address these in the spirit of the PRSP process, the authorities have taken steps to

¹⁷ This analysis are adopted from Paul (2002)

strengthen the Central Statistics Department to improve macroeconomic, social, and poverty data, partly through household surveys and a census, which are key to improving the capacity for undertaking poverty and social impact analyses. The government also benefited from the recent IMF technical assistance to strengthen the compilation of economic data. Notably, the Fund has supported to improve the staffing of the CSD on an interim basis, pending the longer-term restructuring of the department into an independent agency, by offering better incentives to retain staff. The country also benefits from participation in the Fund's General Dissemination System (GDDS) used as a framework to improve the quality, timeliness, and transparency of data provision (IMF). The reforms are complemented at the Auditor General's Office to expedite the audit of accounts. The budgetary reforms and the improvement of the statistical capacities will also enhance the *accountability* of resources.

II. Participation and ownership: The PRSP process in The Gambia attests a relative effort of *participation* on the field, characterized by civil society consultation process. A broad-based and prolonged consultative process that brought together the relevant stakeholders, government agencies and development partners led to the formulation of interim and the full PRSP. In terms of *ownership*, government is encouraged to be in the driver's seat to lead the process. The government has assumed full leadership of the process at the highest political level (led by Office of the President), with the Department of State for Finance and Economic Affairs chairing the process, and supported by sectoral departments, donors and NGOs. *Partnership* between government and its development partners has also been enhanced since the start of the PRSP. This is reflected in a number of agreements made with major development partners, among which include: the UN Country Cooperation Framework (CCF), 2002-2006; UN Development Assistance Framework (UNDAF), and the World Bank Group Country Assistance Strategy (CAS): CAS I in 1998, and CAS II, 2003-2005. Bilateral donors have also targeted various sectoral programmes (MDG Report 2003). In addition, UNDP is assisting Government in establishing a central aid coordination mechanism under the current PRSP framework. Other partnership supports include a capacity-building project with the World Bank and DFID to strengthen Government's public finance systems.

III. Monitoring & Evaluation: The monitoring and evaluation of the PRSP in The Gambia is being facilitated within an institutional framework that comprises a network of government ministries and departments, national and international NGOs, and multilateral agencies. At the core is the CSD, which is the principal agency for the collection of demographic, economic, social and other statistics. The other institutions that either play an active role or have an interest in poverty monitoring and analysis include SPACO, the Departments of State for Education, Health and Social Welfare, and Agriculture (Planning Units), Policy Analysis Unit (PAU), Departments of Planning and Community Development, the UNDP, UNICEF, Action Aid, the Gambia Family Planning Association (GFPA) and Gambia Food and Nutrition Association (GAFNA).

IV. Coordination: Prior to the PRSP process, the mechanisms for donor coordination in The Gambia have been very weak with responsibility of various components of aid coordination dispersed among several institutions. Attempts are being made under the current PRSP programme to facilitate a more coordinated, streamlined and coherent process for the monitoring of donor resources. The process is coordinated by the High Level Economic Committee (HLEC) that provides institutional guidance and political leadership to the implementation process, the inter-departmental Monitoring Committee comprising the Permanent Secretaries, (to ensure adequate flows of information between government departments on monitoring and evaluation activities; to capture trends, identify key issues emanating from monitoring processes and channel them for decision-making at the policy level; and to assess constraints and opportunities in monitoring in order to make decisions affecting resources) and SPACO.

