



# Rethinking the Millennium Development Goals for Africa

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**HARVARD Kennedy School**  
JOHN F. KENNEDY SCHOOL OF GOVERNMENT

# Rethinking the Millennium Development Goals for Africa

## Faculty Research Working Paper Series

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Stephen Peterson

Harvard Kennedy School

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## Rethinking the Millennium Development Goals for Africa

Stephen Peterson\*

November 24, 2010

### Abstract

The global economy and especially its poorest members, face a perfect storm. The crisis has been created by a Global LIE: *leverage* this is unfathomable, *institutions* that are discredited, and, *experts* who are uncertain about the uncertainty. The poorest countries have been the hardest hit by the crisis, and their recovery may be years away. Under these circumstances, the Millennium Development Goals (MDGs) are not a best bet development strategy for Africa. As a financing decision, developed countries have never adequately resourced the MDGs and are unlikely to do so in future as they face more pressing priorities: entitlements, terror, climate, stimulus, and unwinding. As an investment decision, the MDGs focus on social services not infrastructure, which creates fiscal stress on the budget. The failure of the MDG to address revenue mobilization means that this strategy is fiscally unsustainable. A better strategy for foreign aid are DIGs (Decade Infrastructure Goals) that focus on the investment in growth promoting infrastructure (revenue, roads, power, and agriculture) rather than social services.

**Keywords:** economic development, millennium development goals, public financial Management, foreign aid, budget support,

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### **Takeaways Budgets and the African Child**

- The global economic crisis has changed the agenda of global development for developed and developing countries alike
- At the heart of this crisis is the failure of financial management both public and private, to manage risk
- The MDG's which focus on social sector service provision add significant fiscal stress and thus risk
- Sustainable development requires sustainable fiscal policy
- The development dilemma for Africa is the cruel choice between a stagnant present or a better future—investment priority of social services or infrastructure
- Social services are long term liabilities (principally salaries) and should not be funded by domestic revenue not volatile foreign aid
- A 'better bet' for using foreign aid in Africa is to have it focus on the Decadal Infrastructure Goals (DIGs) (revenue, roads, power) which have proven growth multipliers that can in turn expand domestic revenue for social services
- If African societies want social services, then they must rely on their own pockets, not those of foreigners—taxes are the price of living in a civilized society

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## Acronyms

<b>MDGs</b>	The Millennium Development Goals
<b>MEGs</b>	The Millennium Entitlement Goals
<b>MCGs</b>	The Millennium Climate Goals
<b>MSGs</b>	The Millennium Stimulus Goals
<b>MTGs</b>	The Millennium Terrorist Goals
<b>MUGs</b>	The Millennium Unwinding Goals
<b>DIGs</b>	The Decade Infrastructure Goals
<b>DTGs</b>	The Decade Tax Goals
<b>DRGs</b>	The Decade Road Goals
<b>DPGs</b>	The Decade Power Goals
<b>DAGs</b>	The Decade Agriculture Goals

## I. Africa Alone

When Hobbes referred to the dire state of human beings having ‘nasty, brutish and short’ lives, he also pointed, in the same sentence, to the disturbing adversity of being ‘solitary’. Escape from isolation may not only be important for the quality of human life, it can also contribute powerfully to understanding and responding to the other deprivations from which human beings suffer. There is surely a basic strength here which is complementary to the engagement in which theories of justice are involved. Amartya Sen<sup>1</sup>

50% of African children perish in the first 24 hours of life. The child mortality rate in Sub-Saharan Africa is 30 times that of industrialized countries. Maternal mortality ratios per 100,000 are over 1000 in Africa, 500 in South Asia, 130 in Latin America, and 8 in industrialized countries.<sup>2</sup>

Risk is the gravity of public financial management. It is always there, difficult to measure, but ignored at one’s peril. Risk is the core of financial management for both the public and private sectors. The crisis of our age is the mismanagement of financial risk within and between these sectors. The failure to manage risk has decimated global economies and shaken the foundations of the dismal science that guided policy.

This paper presents two theses. First, the global economic crisis has brought unprecedented fiscal stress and has taxed our understanding of the interplay between public and private financial management. The uncertainty of the uncertainty of this interplay continues to vex policymakers and the market. Second, the disciplines that

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<sup>1</sup> Amartya Sen, *The Idea of Justice*, (Cambridge, Mass: The Belknap Press, 2009), p. 415.

<sup>2</sup> Africa Child Policy Forum, ‘Child Rights at the Crossroads,’ Proceedings of the Global Conference on Research and Child Rights, November 30 to December 2, 2009, Addis Ababa, Ethiopia, pp. 25-26. The appalling and deteriorating condition of Africa’s children is documented in Jaap E. Doek, A.K. Shiva Kumar, David Mugawe and Shimelis Tsegaye, eds., *Child Poverty: African and International Perspectives* (Antwerp: Intersentia, 2009); The African Child Policy Forum, *The African Report on Child Wellbeing 2008: How Child-Friendly are African Governments?* (Addis Ababa: ACPF, 2009).

have shaped the strategies of economic development have been discredited and some might argue, are in full retreat. Crises can create innovative responses or at least a rethink of principles. I have less confidence in the former occurring but am assured of the value of returning to principles.

Facing the worst global economic crisis since the depression of the 1930's, there are stark resource constraints to promoting development, especially in Africa. The embarrassment of riches of the earlier years of this decade, some of which trickled to Africa, are unlikely, if ever, to be available again. While the top billions of the world are starting to see relief from this crisis, the bottom billion, many of whom are African children, are not seeing relief and are sliding back in to poverty—'they are being left in the burning house.'<sup>3</sup> See Box 1.

We live in financial times. Financial management *is* the issue of the day and our cloudy future. Public and private financial management have failed spectacularly and have caused the greatest pain to the most vulnerable global citizens—the children of poor countries. It is estimated that 89 million people have slipped below the \$1.25 a day poverty line as a result of this crisis—most of who are African children. Over one billion people go to bed hungry. While the stock markets of many countries have recently experienced heady gains, the economic crisis is likely to linger for years. The global economy and especially its poorest members, face a perfect storm. Resources have been leveraged and have evaporated, experts (if there are any at this stage willing to take a position) are uncertain about uncertainty, and most important, the institutions that

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<sup>3</sup> Ahead of the October 2009 G-20 meeting, Robert Zoellick observed that 'While some [countries] are moving towards the exits, many are still being left behind in the burning house....We're entering a new danger zone, not of freefall but of complacency,' *Financial Times*, September 17, 2009. Ahead of that meeting, the World Bank released its report on the precarious state of development poor countries face going forward. See, The World Bank, 'Protecting Progress: The Challenge Facing Low-Income Countries in the Global Recession,' (Washington, D. C., September 16, 2009).

## Box 1

### The Global Crisis

- 1%** (the decline in global GDP in 2008—first decline since the depression)
- 9%** (the decline in global trade in 2008—the largest in 15 years)
- \$10.5 trillion to \$1.9 trillion** (82% decline in capital flows from 2007 to 2008)
- \$30 billion to \$13 billion** (net capital flows to low income countries from 07-09)
- \$11.6 billion** (funding gap or social services for the poorest countries)
- 40%** (decline in exports from Africa in 2008)
- 7.9%** (decline in remittances to Africa)
- \$59 billion** (external financing needs of low-income countries)
- 89 million** (more people living in extreme poverty by end of 2010)
- 350 million** (out of 650 million, the number of African's living below \$1.25 per day)
- 122 million** (out of 163 million, the number of Africans who are ultra poor)
- 1 billion plus** (number of people who go to bed hungry)
- \$21.8 billion** (projected 2009 bonus pool at Goldman Sachs)

Sources for Box 1.<sup>4</sup>

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<sup>4</sup> The following lines in Box 1 beginning with \$11.6 billion, \$59 billion, 89 million, 350 million are from The World Bank, 'Protecting Progress: The Challenge Facing Low-Income Countries in the Global Recession, (Washington, D.C., September 16, 2009). The line in Box 1 beginning with 1 billion plus is from 'How to Feed the World,' *The Economist* November 21, 2009, p. 14. The line in Box 1 beginning with 122 million is from Shimelis Tsegaye, *Child Poverty in Africa: An Overview*, (Addis Ababa: African Child Policy Forum, 2009), p. 2. [The 'ultra poor' are defined as people living on less than USD 0.50 a day. Ahmed et al., *The World's Most Deprived: Characteristics and Causes of Extreme Poverty and Hunger*, International Food Policy Research Institute, 2020 Discussion Paper 43, October 2007]. The line in Box 1 beginning with \$21.8 billion is from 'Goldman apologizes for role in crisis,' *Financial Times*, November 17, 2009. All other figures are from Martin Wolf, 'New Dynamics,' *Financial Times*, November 9, 2009, pp. 2-3.



should ameliorate the crises are weak and discredited.<sup>5</sup> The globe faces and must address, a LIE (Box 2).

## Box 2

### The Global LIE

#### Leverage

- 🍏 *Private sector*
  - √ \$600 trillion in derivative contracts in 2008 up from 100 trillion in 2000
  - √ 25% of all mortgages in the US exceed asset value
- 🍏 *Public sector*
  - √ \$12 trillion in bonds which OECD countries must issue in 2008, up from \$9 trillion in 2000
  - √ 13% of GDP, Russia's loan guarantees to state companies
  - √ 10% of GDP, Turkey's loan guarantees to state companies
  - √ 53% of GDP, UAE's loan guarantees to state companies

#### Institutions

- 🍏 *Financial, accounting and audit firms*
  - √ Central banks
  - √ Credit agencies
- 🍏 *Regulatory agencies*
- 🍏 *Bretton Woods agencies*
- 🍏 *Accounting and Audit standards agencies*
- 🍏 *The Academy*

#### Experts

- 🍏 *Accountants and Auditors*
- 🍏 *Academics in public and private financial management, economists*

Sources for Box 2.<sup>6</sup>

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<sup>5</sup> See Paul Krugman's discussion on 'Malign Neglect,' in his *The Return of Depression Economics and the Crisis of 2008* (New York: Norton, 2009), pp. 162-164. On the US Federal Reserve, Martin Wolf has opined that it is 'an antihero....a serial bubble-blower, has distorted asset markets, and has inflicted monetary emissions on trading partners around the world....' Martin Wolf, *Fixing Global Finance*, (Baltimore: Johns Hopkins University Press, 2008), p. 109. Claudio Borio, head of research for the Bank for International Settlements, warned the October 2009 G-20 meeting that policy makers have so focused on past risks that they will fail to spot new dangers—especially default of sovereign debt (*Financial Times*, 'Will sovereign debt be the new subprime?'), p. 11.

<sup>6</sup> The estimate of the level of derivative contracts see, The Bank of International Settlements, 'Numbers Game,' *Financial Times*, November 2, 2009, p. 4. On the level of US mortgages underwater see, Paul Krugman, 'The Big Zero,' *The Global Edition of the New York Times*, December 29, 2009, p. 7. On the level of 2008 OECD bonds see, Martin Wolf, 'New Dynamics,' *Financial Times*, November 9, 2009, pp. 2-3. On the percentages of select country loan guarantees to firms as

In summarizing the cause of a financial crisis of an earlier age, Walter Bagehot, editor of *The Economist*, opined that it was due to ‘stupid people’ with ‘stupid money.’<sup>7</sup> Perhaps it is different this time. The crisis has been caused by clever people with other people’s money who were stupid. It is different this time.<sup>8</sup> What emerges from the salmon sheets of the *Financial Times* is the uncertainty of uncertainty. We are in uncharted waters with severe global imbalances, with government’s taking on unprecedented debt and the public good of credit markets in the hands of firms who have known for decades that their financial innovations had risk that could not be measured, yet failed to disclose these risk in search of ‘above’ market returns.

Academe has much to blame for the crisis. Eminent professors of finance knew for nearly a quarter of a century before the sub-prime mortgage crisis that the risk of mortgage-back securities, one of the premier financial innovations of the 20<sup>th</sup> century (certainly the most lucrative), could not be measured.<sup>9</sup>

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a percent of GDP see, Graham Bowley and Catherine Rampell, ‘Looking for the Next Debt Bomb,’ *International Herald Tribune*, December 2, 2009, p. 16.

<sup>7</sup> Walter Bagehot (editor-in-chief of the *Economist* in the 1860s), described many years ago the crisis of our age: ‘Much has been written about panics, and manias, much more than with the most outstretched intellect we are able to follow or conceive, but one thing is certain, that at particular times a great deal of stupid people have a great deal of stupid money....At intervals,...the money of these people—the blind capital, as we call it, of the country—is particularly large and craving; it sees for someone to devour it, and there is a “plethora”; it finds someone, and there is “speculation”; it is devoured, and there is “panic.”’ Cited in Wolf (2008), p. xi.

<sup>8</sup> One consolation of the crisis is that we may have a clearer rearview mirror—economic history. See, Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton: New Jersey, 2009). The problem is the windshield is still foggy.

<sup>9</sup> In 1985, an eminent professor of finance from UCLA’s Anderson School of Business took leave for a year to develop an asset pricing model for Solomon Brothers for a new financial instrument—mortgage back securities. When he returned to UCLA the following year, he noted to his students in his advanced finance class (one of whom was me), that he was able to model interest rate risk, but not default or prepayment risk of principal. One reason the risk could not be modeled is the limitations of the APL computer language, which became a cult for investment bank quants, but could not hold a large enough matrix. Richard Bookstaber recounts the thirty year origin of the current crisis including the inability to model risk and Solomon Brother’s foray into securitizing debt see, *A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation* (Hoboken: John Wiley and Son, 2007), pp. 35-50. Perhaps the best assessment of the financial innovation of securitized debt was Warren Buffet’s description of Solomon Brothers—as a casino with a restaurant outside (Buffet was the firm’s largest shareholder). The cornerstone of corporate finance, the capital asset pricing model, assumes that there is a linear

Many call the current crisis, the 'Minsky Moment' after Hyman Minsky who predicted this twenty-five years ago in his analysis of Keynes. Minsky contends that there are two reasons for the current crisis: the gap in the toolbox of economists and the experience of economists. The deficiency in the toolbox is:

[T]he missing step in the standard Keynesian theory...the explicit consideration of capitalist finance within a cyclical and speculative context. The missing experience was that unlike Keynes who had experience in the operations of capital markets, careers of most economists were made by combinations of purely academic work and government service.<sup>10</sup>

If Allan Greenspan's Federal Reserve fully understood the inability to model the risk of collateralized debt obligations, would the chairman have maintained his belief that capital markets would self-regulate?

The crisis has shaken the foundations of economics and raised questions about its ability to effectively guide public policy.

Today, not only is our economy in a shambles, but so too is the economic paradigm that predominated in the years before the crisis—or at least it should be. Joseph Stiglitz<sup>11</sup>

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relationship between risk and return. With mortgage-backed securities, the x axis, is clearly unclear. A former quant from Solomon Brothers, Emanuel Derman reflecting on his work at the firm, 'that mortgage valuation models involve a witch's brew of assumptions....and compared with the elegance of the Black-Scholes formalism, mortgage valuation is ugly.' See, his *My Life as a Quant: Reflections on Physics and Finance* (Hoboken: John Wiley and Sons, 2004), p. 193. See also, Sanford Grossman, 'An Analysis of the Implications for Futures and Stock Volatility of Program Trading and Dynamic Hedging Strategies, *Journal of Business*, 61 no. 3, 1988, pp. 275-298. Prior to the 1987 market crash, John Kenneth Galbraith wrote 'that the market is inherently unstable,' because of 'the present commitment to seemingly imaginative, and eventually disastrous, innovation in financial structure,' 'The 1929 Parallel,' *Atlantic Monthly*, January 1987, cited in Bookstaber, p. 16.

<sup>10</sup> See, Hyman P. Minsky, *John Maynard Keynes* Second Edition (New York: McGraw Hill, 2008; First Edition, New York: Columbia University Press, 1975), pp. 126-127. See also his *Stabilizing an Unstable Economy* (New York: McGraw Hill, 2008; First Edition, Yale University Press, 1986). In his analysis twenty-four years ago of the work of Maynard Keynes, Minsky warned that Keynes had stressed in his *Treatise on Money*, which preceded *The General Theory*, that financial markets are subject to collapse and they drive economic growth.

<sup>11</sup> On the occasion of the founding of the Institute of New Economic Thinking (INET) as an advisory board member of the INET, 'Needed: A New Economic Paradigm,' *Financial Times*, August 19, 2010.

Has development economics lost its way? ....Too often research economists seem not to start with the key knowledge gaps facing development practitioners, but rather search for questions that can answer with the industry's currently favorite tools. The big questions facing policymakers are extremely complex. But is our present day research too narrowly focused—and too weak on external validity or scalability—to provide the kinds of insights policymakers need? I believe we need a more practical approach—one that is firmly grounded in the key knowledge gaps for development policy. Robert Zoellick<sup>12</sup>

And if the failure of economics to inform policy were not enough, the bedrock of capitalism, accounting failed.

If you ask why the American financial system succeeds....at least my reading of the history would be that there is no innovation more important than that of generally accepted accounting principles: It means that every investor gets to see information presented on a comparable basis: that there is discipline on company managements in the way they report and monitor their activities.<sup>13</sup>

**The stove piped institutional framework of financial markets (academe, investment firms, accountancy firms, and government) failed.**

The financial crisis of our age may, must, have a silver lining—a rethink of economic growth in all countries, not just poor countries, in terms of less is more, and the need for responsible sovereignty which holds agents (firms, foreign aid and governments themselves), accountable. Real growth, not passing bubbles, cannot be purchased on credit and must be based on savings and prudent borrowing for

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<sup>12</sup> 'Democratizing Development Economics,' Speech at Georgetown University, September 29, 2010, emphasis added. The recent exchange between Paul Krugman and Niall Ferguson on the respective strengths of economics versus history for understanding the current crisis highlights humorously the decline of the dismal science. Ferguson opines, 'A cat may look at a king, and sometimes a historian can challenge an economist.' Gideon Rachman, 'Sweep Economists off their Throne,' *Financial Times*, September 7, 2010.

<sup>13</sup> Paul Krugman cites a speech by Lawrence Summers, Deputy Secretary of the Treasury, given in 1999, See Krugman, 2009. Krugman argues that 'just about everyone in a policy-making position at the time—believed in 1999: America has honest corporate accounting; this lets investors make good decisions, and also forces management to behave responsibly; and the result is a stable, well-functioning financial system.' Goethe called double-entry bookkeeping one of the finest inventions of mankind and it is viewed by economic historians as a key innovation that facilitated the rise of capitalism.

productive assets, which are fiscally sustainable. There are 'no shortcuts to progress' for developing or developed countries.<sup>14</sup> Economic growth needs to be rethought, as does our understanding of financial markets, which underpin a capitalist economy.<sup>15</sup>

Financial markets are the fundamental driver and disrupter of a market economy.

The heterodox economist, Erik Reinert, concurs with Zoellick's view that development economics has lost its way. Instead of focusing on the fundamentals of growth, development economics has focused on 'palliative economics' best exemplified by the MDGs.<sup>16</sup>

## II. Rethinking Development for the Bottom Billion (most of who are the children of Africa)

The Leverage of the Global LIE will take years to clear, and it awaits to be seen what the knock-down effects to Institutions and Experts will be. A silver lining of this crisis is that development for the bottom billion has to be rethought and done so quickly. Further, the financial crisis puts in sharp relief the need to consider the fiscal implications of foreign aid and the fiscal stress created by the MDGs. The hard budget constraint must drive development strategies. Hopefully a second effect of the crisis, which has decimated growth for the bottom billion, is the need to restart it and make it a priority. Unemployment is the worst disease in Africa and can only be addressed by growth.<sup>17</sup>

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<sup>14</sup> Goran Hyden, *No Shortcuts to Progress: African Development Management in Perspective* (London: Heinemann, 1983).

<sup>15</sup> Christopher Cramer, Deborah Johnston, and Carlos Oya, 'Briefing: Africa and the Credit Crunch: From Crisis to Opportunity?' *African Affairs*, 2009, pp. 652-654.

<sup>16</sup> Erik S. Reinert, *How Rich Countries Got Rich...and Why Poor Countries Stay Poor* (New York: Carroll and Graf, 2007).

<sup>17</sup> Paul Collier's work on the bottom billion published before the financial crisis criticizes the MDGs on two grounds: the focus on social services not growth, and lumping the five billion poor together rather than singling out the bottom billion. He argues that while four billion poor maybe in a position to expand service provision, the bottom billion need growth. See his *The Bottom Billion: Why the Poorest Countries are Failing and What Can Be Done About It* (Oxford: Oxford University Press, 2007), pp. 11, 191-192.

This is not the first, nor will it be the last, critique of the Millennium Development Goals.<sup>18</sup> What is different and dire this time, is that the global economic crisis has placed developing countries, particularly the poorest, in an even more precarious situation, which places an even higher premium for *certainty* and greater return from public resources (provided domestically and externally). Growth should be purchased the ‘old fashioned way’—you earn it, not borrow it—with prudent fiscal management. The only sustainability mentioned in the MDGs is environmental, not fiscal.

Following Zoellick’s warning about complacency, complacency should not be addressed by reinvigorating past approaches which had dubious or limited impact. This paper concludes with a proposal to replace the MDGs by the DIGs—Decade Infrastructure Goals which would promote the certainty needed for development.

### **Thesis**

*The Millennium Development Goals (MDGs) are not the best bet for the bottom billion: they have never been adequately funded, are unlikely to be adequately funded, are fiscally unsustainable, and not the best investment for poor countries in terms of level and certainty of return. The global economic crisis requires a rethink of development, a return to fundamentals, a return to growth and a return to fiscal probity.*

### **III. The Significance and Current Realities of Public Financial Management for Aid Dependent Countries**

Prudent public financial management is at the heart of a country’s development, which promotes and protects its future—its children. Africa ‘is a continent of children, where over 51% of the population is under 18 years and some countries like Nigeria,

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<sup>18</sup> Arvind Subramanian, ‘A Farewell to Alms,’ *Wall Street Journal*, August 22, 2007; William Easterly, ‘How the Millennium Development Goals are Unfair to Africa,’ *World Development*, Vol. 37, No. 1, 2009.

Ethiopia, and Uganda have 55-60% of the population as children.<sup>19</sup> Understanding how public financial management supports the rights of the African child, indeed the rights of Africa's citizens, must begin with an understanding of endogenous and exogenous factors of growth. Foreign aid is primarily an international intergovernmental fiscal transfer—it is exogenous. How do these exogenous resources combine with endogenous resources and affect a country's development path? Public financial management is at the core of understanding this relationship. Public financial management needs to be demystified if governments are to maintain the sovereignty of their systems and civil society organizations are to press for transparency and accountability for those who will inherit the future. Public financial management can be summarized by three principles and two decisions (Box 3).

<p style="text-align: center;">Box 3</p> <p style="text-align: center;"><b>Principles and Decisions of Public Financial Management</b></p> <p style="text-align: center;"><u>First principle</u></p> <p style="text-align: center;"><i>pursuit of public policy within a hard budget constraint</i></p> <p style="text-align: center;"><u>Subsidiary principles</u></p> <p style="text-align: center;"><i>optimal allocation between policies</i> &amp; <i>efficiency of policy implementation</i></p> <p style="text-align: center;"><u>The two decisions</u></p> <p style="text-align: center;"><i>Financing &amp; Investment</i></p>
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Aaron Wildavsky's seminal work, *The Politics of the Budgetary Process*, sums up the political complexity of the above principles and thus the need for simplicity in the financial systems to execute policy.<sup>20</sup> Another classic in public finance but written by a

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<sup>19</sup> Africa Child Policy Forum, 'Child Rights at the Crossroads,' p. 25.

<sup>20</sup> Aaron Wildavsky, *The Politics of the Budgetary Process* Fourth Edition (Boston: Little Brown, 1984). Aaron also stressed the value of simple and clear budget formats in his 'A Budget for All Seasons: Why the Traditional Budget Lasts,' *Public Administration Review* 38 (6), 1978.

practitioner (Hugh Dalton, former Chancellor of the Exchequer), notes the dualism, and thus challenge of this field:

Every writer, who aims at organizing a general discussion of public finance, must be conscious of a conflict between two personalities, those of the practical and of the analytical man. And, in seeking to resolve this conflict, he is in danger of getting the worst of both worlds, missing both the perfection of theory, boldly guided by pure reason, and the wisdom of statesmanship, cautiously guided by administrative officialdom.... Studies in public finance have.... a special fascination, but for the same reason, an excess of abstraction is apt, in this sphere, to seem especially unreal and an excess of conventional rule-of-thumb especially half-witted.<sup>21</sup>

Public Financial Management is the management of illusion.<sup>22</sup> There is never enough. It is also an elusive balance between abstraction and calculation. A development strategy, however, should not be an illusion.

Financial management, public and private, involves two decisions: *financing* and *investment*. The distinguishing feature between public and private sector financial management is the relative weight of the two decisions. The finance decision outweighs the investment decision in the public sector while the obverse holds in the private sector.<sup>23</sup> For the private sector, the investment decision predominates while the capital structure tags behind and can be accessed with market share. Despite the long debate

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<sup>21</sup> Hugh Dalton served as a Minister of the Crown for eleven years and through two turbulent years (1945-1947), was Chancellor of the Exchequer. See his *Principles of Public Finance*, first edition 1922, fourth edition 1954, London, and Routledge & Kegan Paul, pp. 3-4.

<sup>22</sup> I am indebted to Perran Penrose for this insight. Aaron Wildavsky made a similar argument. See Wildavsky (1984), p. 10.

<sup>23</sup> The financing decision for the public sector refers to the aggregate level of resources and their composition (domestic revenue/loan; external grant/loan). Our reference here is broader than financing as 'below the line' funding of the deficit either through external grant or domestic/foreign loan.



over the capital structure of the firm, (the composition of equity, debt and retained earnings continues), it is assumed to be a straightforward calculation.<sup>24</sup>

In public financial management, the financing decision predominates. The public budget, which is the most important policy document of a government, begins with an *appropriation*, the legal authority to raise revenue, which in turn provides the legal authority to spend.<sup>25</sup> Taxes are compulsory; the revenues of a firm are not. Public financial management, thus begins with the first principle above—pursuit of policy within a hard budget constraint (a finance decision) and in turn allocating revenues between policies (an investment decision) and efficiently implementing policy (an investment decision). While capital structure may be irrelevant to the firm a la Modigliani, it is of enormous consequence to fiscal sustainability of developed countries, and is a defining decision for aid dependent countries.

Ironically, the MDGs promote a private not public sector balance to the finance and investment decision. For the MDGs, the investment decision (social sector expenditure) outweighs the financing decision as sustainability going forward is left for the future.<sup>26</sup>

#### IV. The MDG Financing Decision

The entire logic of foreign aid is explicitly on the basis that not only does aid provide additional resources to a country, it provides additional fiscal resources. If those additional resources are made conditional on fiscal expansion and that expansion is in the recurrent budget, and if because of the constraint that [conditional increases in government

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<sup>24</sup> Franco Modigliani and Merton Miller, 'The Cost of Capital, Corporate Finance and the Theory of Investment,' *American Economic Review* 53, 1958, pp. 261-297. They postulated that the capital structure of the firm was irrelevant because the risk of bankruptcy from debt is balanced by the tax shield of debt.

<sup>25</sup> Distinguishing public and private financial management can best be seen in the dominance of the budget in the former, and marginal cost of the latter.

<sup>26</sup> As Arvind (2007) notes, 'Aid advocates...act as if the long-run problems caused by aid can be fixed independently.'

expenditure must be financed by increases in domestic revenue or reductions in other government expenditure] the resources do not fund recurrent expenditure expansion, the aid may cause serious management problems for the recipient country.<sup>27</sup>

The MDGs finance decisions focuses on how resources (domestic and foreign) are brought to the budget. The finance decision can not be divorced from the investment decision, as prudent management of the budget requires a sustainable aggregate and composition (balance of recurrent and capital expenditure) with a matching of appropriate sources of finance (domestic/foreign; grant/loan). As summarized in the quote by Penrose above, foreign aid programs, especially those focused on MDG priorities, have largely ignored how external resources are incorporated in the budget and the fiscal stress of conditionalities that focus on social expenditures (MDGs) that require recurrent outlays and domestic revenue mobilization. The most expensive MDG, education, exacerbates fiscal stress and diverts resources from capital investments, which promote a virtuous cycle of sustainable growth: *capital investment* leading to *growth* (profits, wages, employment), which generates *domestic revenue* that provides *resources* (more investment, more revenue, absorption of foreign aid, more social services).

The MDGs pose three serious issues to the already precarious fiscal position of poor countries: (1) they focus on social expenditures that have questionable returns to growth (e.g. primary education); (2) they don't focus on infrastructure investments which have demonstrable effects on growth that can generate domestic revenue (assuming the installation recurrent costs can be covered); and, (3) they ignore the need for domestic revenue to absorb the foreign aid targeted to social expenditure and supportive of capital expenditure (domestically and/or foreign financed). The

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<sup>27</sup> Perran Penrose, 'European Commission Budget Support Programmes: Nature, Dialogue, and Design,' June 2008, p. 39. My analysis of the financing and investment decisions of the MDGs draws on this work.

'governor' which limits the expansion of a sustainable budget, *is* domestic revenue, which constrains the recurrent budget. Foreign aid often focuses on the capital budget and neglects the impact of its grants and loans on the recurrent budget—SEP--someone else's problem—and payment.<sup>28</sup> Lawrence Summers has opined that fiscal sustainability is one the three pillars of economic growth.

I would suggest that the rate at which countries grow is substantially determined by three things: their ability to integrate with the global economy through trade and investment; their capacity to maintain sustainable government finances; and their ability to put in place an institutional environment in which contracts can be enforced and property rights can be established.<sup>29</sup>

So a prudent fiscal policy, or fiscal consolidation, is according to Summers, essential for growth. Ricardo Hausmann has disagreed and argues that 'macro policies are not a growth strategy...but are really about avoiding crises.'<sup>30</sup> He argues further that macro policies 'are about keeping the economy close to its potential, to its speed limit...but it is not about raising the speed limit.'<sup>31</sup> Hausmann's analysis does not address heavily aid dependent African countries which have Poverty Reduction Strategy Programs (PRSPs) as part of their aid conditionalities. While he accepts in principle that there are different paths to development, he has not examined the role and composition of foreign aid and fiscal consolidation thereby missing much of the African development story. As Hausmann notes, the 'Perotti' effect that expenditure cuts lead to growth is not proven.<sup>32</sup> But for aid dependent countries restraining the growth of expenditures that add fiscal

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<sup>28</sup> In Harvard's Executive Program in Public Financial Management, Perran Penrose has reminded government officials that the heart of public financial management *is* the management of fixed costs as they drive the deficit.

<sup>29</sup> Lawrence Summers, Godkin Lecture, Harvard University, 2005, emphasis added.

<sup>30</sup> Ricardo Hausmann, 'Economic Growth: Shared Beliefs, Shared Disappointments?' *Faculty Research Paper*, Harvard Kennedy School, July 2006, p. 10.

<sup>31</sup> Hausmann, p. 10.

<sup>32</sup> Hausmann, p. 9.

stress with little or no (and possibly negative) contributions to growth and focusing on a prudent investment program, does promote growth.<sup>33</sup>

## V. The MDG Financing Decision: Budget Support

In terms of the financing decision, how does foreign aid enter the budget? There are two issues here: what expenditures should it fund and not fund; and, how should it be treated in government financial statements? Foreign aid is typically delivered through two vehicles--project or budget support. Project support may or may not be brought to the budget and some multilaterals provide other forms of off-budget support (e.g. social rehabilitation funds).<sup>34</sup> A separate macroeconomic issue, which will be discussed below, is whether foreign aid is even brought to the budget.

The principal means of funding the MDGs, which is preferred by governments and foreign aid alike, is budget support. The treatment of foreign aid loans is clear, it is located 'below the line' in government financial statements as a source of financing for capital or recurrent expenditure. The treatment of foreign grants is not clear as they can be placed above the line as a source of *revenue* (similar but still different) from domestic

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<sup>33</sup> Hausmann's analysis ignores the government reaction function to foreign aid, see fn. 48.

<sup>34</sup> In 1996 in Ethiopia, I introduced the concept of 'channels' in terms of three capillaries of public money: channel 1--treasury, channel 2--foreign project support, channel 3--earmarked foreign transfers (e.g. Productive Safety Nets Program, HIV / AIDs programs). As the financial reform project I directed was closing, the relative size of the capillaries at the 'front line' of service delivery (the weredas--districts) was approximately 30% in #1, 12% in #2, and 58% in #3. As I noted at that time to the Minister of Finance, the twelve year PFM reform we implemented with the government, was covering less and less of public resources. Unfortunately the channel framework, was elaborated and distorted with some foreign aid agencies claiming their money was channel #1a, etc. The channel framework was meant to describe funds flow notwithstanding the fungibility of money. The concern of foreign aid agencies with 'tracking *their* money' under budget support which comingles external grant and sometimes external loan with domestic resources produces some rather odd discussions. One potential groundbreaking innovation in public financial management emerging from a perceptive colleague of mine attending one of the endless public expenditure reviews in Ethiopia, was to 'bar code the birr' which had been converted from the foreign exchange of foreign aid, and then do comprehensive aerial mapping of Ethiopia to see where the funds went. This PFM innovation unfortunately is at odds with host country security concerns about over flights by foreign governments.

revenue, or below the line like loans as a source of *financing*.<sup>35</sup> The principal argument for treating grants above the line is that like domestic revenue, they increase the net worth of government. Foreign grants, however, are not always delivered on schedule, which disrupts government budgeting.<sup>36</sup> In Ethiopia, grants from multilateral foreign aid are notoriously unreliable. Viewed often by recipient governments as ‘free money,’ the complementary government resources needed to install and maintain grant-funded activities are not free. Government borrowing for grant funds that have not arrived but for which their intended programs have begun, is also not free. To the extent grants reflect the agenda of foreign aid and are not part of a synergistic budget, they can fragment and weaken the budget. The treatment of the grants as revenue or source of

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<sup>35</sup> Peter Heller noted the problem of grant financed recurrent wage expenditure but argues that the principal problem with grants being treated above the line as revenue rather than below the line as financing, is aggregate demand pressures. He goes on to argue that treating grants as revenue should be ‘heavily weighted toward highly productive, growth-engendering investments in physical infrastructure and *human capital* (‘Pedantry or How Does the IMF Account,’ *Finance and Development*, December 2004, p. 28).’ While this argument can be made for lumpy capital investments where recurrent maintenance costs can be deferred or ignored until another grant, the same can not be said about investment in recurrent wage expenditures (teacher salaries) supporting human capital investments which would be very difficult to defer or ignore. Heller does not specify what he means by investments in human capital nor does he engage in the debate about the returns to growth of investment in education.

<sup>35</sup> One technique for adequately budgeting services is to look at the recurrent cost coefficient of particular services. These coefficients can have wide variations by service and are not hard and fast rules. They do provide rules of thumb to allow rapid scanning of a budget bid to determine its composition.

<sup>36</sup> In fiscally devolved countries with significant vertical imbalance, the difference between domestic revenue and foreign grants is stark. In Ethiopia, the transfers from the central government to regional government comprise approximately 85% of their revenue. If a region is allocated a foreign grant, the local currency component is offset (though not fully). Given the uncertainty of the grant, several regions started to refuse foreign grants—a birr was better than a buck—because it was reliable, unconditional, and could be used for any expenditure including salaries. By 2003, the grants from the African Development Bank were so unreliable and thus so costly to regions through the offset, the Ethiopian government decided to not include them in the calculation of the inter-regional transfer, effectively excluding them from the budget. In mid-decade, the European Commission initiated a program to transparently discuss its aid program with recipient governments and their development partners. The EC hosted a conference in Addis to conduct this *gem gema* (self-criticism), and the Belgian consulting firm conducting the review ended its presentation with a striking slide—‘the EC: an important, but unreliable partner.’ During this period, the EC was the largest provide of grants to Ethiopia (approximately \$140 million per year). Of course another source of uncertainty of foreign aid grants are the conditions that recipients not be in conflict—a condition that is not always achieved on the continent.

finance is also at the discretion of the IMF, which behooves recipient governments to be conservative in their treatment (locate grants below the line).

Having established where to place grants in the financial statement, prudent financial management requires matching appropriate sources of finance (domestic/foreign) to the four types of expenditure: *Recurrent/wage*, *Recurrent/operating and maintenance (o&m)*, *Recurrent/statutory* and *Capital*. Since budget support is comingled with treasury funds, planners and budgeters cannot easily match the composition of expenditure with the source of finance. Prudent financial management should observe the following guidelines of matching expenditure and source of financing. R/wage and R/statutory expenditures should be funded only by reliable domestic revenue (not domestic loans or foreign aid). R/o&m is more complicated as essential maintenance should be financed by domestic revenue but small lumpy items (e.g. nursing supplies, drugs, teaching materials) that can be easily stockpiled may well be funded by foreign aid, especially grants. Capital expenditures, with some exceptions, can be funded by all sources of financing (domestic/foreign; grant/loans).<sup>37</sup> Even if grants are treated as above the line, they should not be used to fund R/wage or R/statutory expenditures (these are long-term liabilities).

Public expenditure should be viewed in terms of quality as well as quantity. Quality is a function of sectoral allocation and composition. A primary school needs a balanced composition of the four types of expenditures—Rwage, Rstatutory, Ro&m and Capital. Most services in poor countries are not adequately provided both in quantity or

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<sup>37</sup> The traditional definition of a capital expenditure is based on its source of financing (non-current revenue) rather than its character (asset with a life of more than one year with a threshold value).

quality as wages often crowd out vital o&m.<sup>38</sup> Even where wages predominate, the salary bill may be inadequate if the pupil/ teacher ratio is too high.

The MDGs focus on pro-poor expenditures in the social sectors where recurrent wage expenditures (e.g. teacher and health care worker salaries) predominate.<sup>39</sup> While the goal of expanding social services is laudable (though education, especially primary, is questionable in terms of growth), the current financing strategy is not viable. It is imprudent to finance long-term recurrent liabilities with short-term volatile financing (foreign aid, especially loans). Budget support, which arguably can be turned off quicker than it can be turned on, reinforces this volatility. Prudent financial management requires that a government not run a structural deficit (the gap between domestic revenue and recurrent wage and statutory expenditures, and operating and maintenance).<sup>40</sup> While there are creative strategies to match the expenditure exposure of salaries to the receipt of external assistance, (e.g. placing employees on conditional contracts tied to aid flows), the culture of employment in most African countries is one of permanence.<sup>41</sup> The social and political turmoil that might be created by the redundancy of large numbers of educated teachers and health care workers especially in the rural areas, is a political calculus recipient governments (and military planners), should ponder.<sup>42</sup>

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<sup>38</sup> One technique for adequately budgeting services is to look at the recurrent cost coefficient of particular services. These coefficients can have wide variations by service and are not hard and fast rules. They do provide rules of thumb to allow rapid scanning of a budget bid to determine its composition.

<sup>39</sup> Perran Penrose has informed my thinking on this topic.

<sup>40</sup> The domestic revenue should be conservatively estimated and exclude one-time non-tax revenue such as sales of assets.

<sup>41</sup> The Government of Kenya is now placing new teachers on fixed contracts.

<sup>42</sup> Ted Robert Gurr argued that a major precipitating factor of social unrest is when rising expectations are not met. See Ted Robert Gurr, *Why Men Rebel* (Princeton: Princeton University Press, 1970). Are the MDGs raising unrealistic expectations and thus the prospect of revolutions in poor countries, which in turn divert the very resources needed to fund them to the Millennium Terrorist Goals (MTGs)?

Table 1<sup>43</sup>

Country	Fiscal Year Actuals	Structural Surplus & (Deficit) (%)	Capital to Recurrent Ratio (%)
Ethiopia	2006/07	21.2	52
Ghana	2005	21.4	64.2
Liberia	2007/08	13.7	13.8
Rwanda	2005	(25)	44
Tanzania	2005/06	(50.1)	32.6
Uganda	2004/05	(1.5)	60

Table 1 presents the fiscal position of six African countries in terms of their structural surplus/deficit and the capital to recurrent expenditure ratio. Two observations can be made from these fiscal snapshots from the latest actual, not projected, data garnered from an IMF Article 4 consultation. First, the donor darlings (Rwanda and Tanzania) ran significant structural deficits although their capital to recurrent expenditure ratios presents a mixed picture (Tanzania is close to the 30% rule of thumb while Rwanda exceeds it).<sup>44</sup> For fiscal year 2000/01 when Uganda was a donor darling, it ran a modest structural deficit of 5.2% but its capital to recurrent ratio was an unsustainable (79%).<sup>45</sup> The other countries in Table 1 are running structural surpluses but unsustainable capital/recurrent expenditure ratios. A single fiscal year snapshot of actual expenditure and revenue does not tell a complete story and one must look at trends over time. Short-term spikes in capital investment may be sustainable overtime (e.g. expansion of Ethiopia's hydroelectric capacity). Beyond the statement of government operations, one would also have to examine the utilization rates of capital

<sup>43</sup> Sources for Table 1 are from the Summary of Central Government Operations from the most recently publically available IMF Article 4 consultations: Ethiopia 2008, Ghana, 2007, Liberia 2008, Rwanda 2006, Tanzania 2007, Uganda 2006. The trend to present the SOG in terms of a category of 'pro-poor' expenditures is unfortunate since it lumps together the composition of expenditure (Rw, Ro&m, Rstat and Capital), which prevents assessing the structural deficit.

<sup>44</sup> A rule of thumb in budgeting is that capital expenditures should not, on average, exceed thirty percent of expenditure for an activity, in order to leave headroom in the budget for complementary recurrent expenditures. I am indebted to Mike Stevens for this observation.

<sup>45</sup> Summary of Central Government Operations, IMF Article 4 consultation, Uganda 2002.



investment and maintenance of prior assets. Tanzania's structural deficit is simply imprudent.

The ambitious five-year sector development programs (SDPs) in education, health and water introduced in Ethiopia in 1997 illustrate the effects of capital imbalances created by a foreign aid shock. These SDPs featured capital to recurrent ratios that ranged from fifty-four to over one hundred thirty percent a year over the five year program. Five years later, a good portion of the resources had not been absorbed, but more seriously, a number of facilities that were built stood abandoned and pad locked for lack of staff and funds for operating and maintenance.<sup>46</sup> These five-year plans morphed into six and then eight year plans. This picture may well be repeated on a grander scale on the continent should the MDG social sector targets be pursued.

The MDGs promote imprudent management of recurrent and capital expenditure. As a lumpy investment, capital can be a candidate, with some exceptions, for foreign aid funding (grant and loan). The heterodox economist, Erik Reinert, appropriately describes these imbalanced foreign funded social expenditure programs:

One novelty of the MDGs approach lies in the emphasis on foreign financing of domestic social and redistribution policies, rather than on domestic financing by the developing countries themselves. Disaster relief, which used to be of a temporary nature, now finds a more permanent form in the MDGs....[T]his approach will put a large number of nations permanently 'on the dole'—a system similar to 'welfare colonialism.'<sup>47</sup>

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<sup>46</sup> In one discussion about the health SDP, an aid official noted that 'all the program simply needed was an additional 10,000 nurses.'

<sup>47</sup> Erik S. Reinert, *How Rich Countries Got Rich...and Why Poor Countries Stay Poor* (New York: Carroll and Graf, 2007), p. 240. Reinert echoes Peter (Lord) Bauer's argument that 'external doles...tend to bias the development process in directions based on external prototypes which are often inappropriate...[which] retards development rather than promotes it....' See Peter Bauer, *The Development Frontier: Essays in Applied Economics* (Cambridge: Harvard University Press, 1991), pp. 103,105.

The costing studies of the MDGs focus on whether foreign aid will be there to fund the MDGs. What is not addressed in this literature is how expanded social services can be sustained long term with domestic resources. The assumption is that the ramping up of these services will have been initiated and sustained by foreign aid.<sup>48</sup>

## VI. The MDG Financing Decision: the Government Reaction Function

Even if it is assumed that the MDGs are an appropriate strategy and direct budget support is an appropriate instrument for their implementation, will recipient governments respond appropriately? Can budget support in some, if not most circumstances, delay the flow of foreign aid targeted for the MDGs? The government 'reaction function' to an aid resource shock can be viewed as a four-cell matrix: Absorb/Not Absorb forex, Spend/Not Spend local currency.<sup>49</sup> A study by the IMF showed how five African countries (Ethiopia, Ghana, Mozambique, Tanzania and Uganda) managed their MDG/Budget support aid shocks.<sup>50</sup> These governments either did not absorb and built reserves, or did not fully absorb and did not fully spend. Ethiopia, which is the poorest and most populous of the five, and on a relative basis would be the largest recipient country if MDG goals were funded, pursued a strategy of not absorb, not spend.<sup>51</sup>

To absorb and spend is the textbook response to aid: the government  
Increases investment, and aid finances the resulting rise in net imports.

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<sup>48</sup> Nancy Birdsall, 'Seven Deadly Sins: Reflections on Donor Failings, in William Easterly, ed., *Reinventing Foreign Aid* (Cambridge: MIT Press 2008), p. 536; Michael Clemens, Charles J. Kenny, and Todd Moss, 'The Trouble with the MDGs: Confronting Expectations of Aid and Development Success,' *Working Paper 40* (Center for Global Development, September 2004).

<sup>49</sup> Perran Penrose presented the 'government reaction function' to resource shocks in the Public Financial Management Executive Education program at Harvard University, July 2007.

<sup>50</sup> International Monetary Fund, 'The Macroeconomics of Managing Increased Aid Inflows: Experiences of Low-Income Countries and Policy Implications,' August 8, 2005.

<sup>51</sup> Peter Heller and Sanjeev Gupta, 'Challenges in Expanding Development Assistance,' *IMF Discussion Paper 02/05* March 2002. They estimated that if Ethiopia received their MDG entitlement, the foreign aid budget would be five times the domestically funded budget.

...In the sample countries, however, a full absorb-and-spend response was found to be surprisingly rare. Typically, there was a reluctance to embrace absorption—and the consequent real appreciation—due, at least in part, to concerns about competitiveness.<sup>52</sup>

These five countries demonstrate that fiscal sustainability is often a higher priority than the MDGs for recipient countries. Given the likelihood of diminishing foreign aid going forward, and the bottom twenty-five countries remaining in the burning house, what little budget support is made available, will in all likelihood be husbanded by governments to manage liquidity shocks first, with social sector expenditures a distant priority.

#### VII. The MDG Financing Decision: Public Financial Management Reform as a Conditionality

While one does not want here to get down in the ‘weeds’ of how to change PFM systems, it is essential to understand that the budgeting process itself becomes important as a precondition of the flow of aid. Budget support has heightened the concerns of foreign aid agencies with fiduciary risk and thus the overall ‘ratings’ of a recipient country’s public financial management.<sup>53</sup> Budget support was promoted in part, as a means of reducing the transaction costs of delivering foreign aid. Budget support,

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<sup>52</sup> IMF, ‘The Macroeconomics of Managing Increased Aid Inflows,’ 2005, p. 3.

<sup>53</sup> The expanded use of the Public Expenditure Financial Accountability (PEFA) framework and its evolution from a diagnostic, to an implicit conditionality, illustrates this trend. The PEFA framework has many deficiencies but the most relevant here is its failure to consider the quality of the capital and recurrent budgets. A PEFA is a partial instrument for measuring the ‘throughput’ performance of a country PFM system. It does not consider the sources of performance, systems and their execution, nor does it examine the outcome of—quality and impact of expenditure. PEFA’s do not measure fiduciary risk. A ‘Country Integrated Fiduciary Assessment’ (CIFA) instrument has recently been introduced in the PFM field to measure risk. One example a CIFA methodology is DFID, ‘Managing Fiduciary Risk When Providing Financial Aid,’ *How to Note*, December 2009.

however, brings the transaction costs of conditionalities one of which is reform of the recipient country's public financial management—often to their detriment.<sup>54</sup>

Foreign aid often promotes, indeed requires, African governments to adopt dubious reforms under the guise of 'international best practice.' While extolling the virtue of the 'getting the basics' of PFM implemented, foreign aid often undermines the very basics with prescriptions of advanced techniques that are difficult for even developed countries to adopt and have not proven their utility.<sup>55</sup>

While one always takes risks in generalizing, especially in a topic as contextual as public financial management, Ian Linert's comparative study of Francophone and Anglophone public financial management in Africa is instructive.<sup>56</sup> Linert contends that the systems are sound but lack discipline. My experience from over two decades of hands-on, field-in work on PFM on the continent as well as directing an executive program in PFM at Harvard to senior government officials, many from Africa, supports Linert's argument.

Foreign aid should promote, not undermine, the discipline of recipient government PFM systems. The all too-frequent practice by foreign aid agencies of tinkering or parachuting in duplicate systems, is disruptive, increases risk and erodes sustainability. These interventions are particularly detrimental when they accelerate the

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<sup>54</sup> When foreign aid introduced the Sectoral Development Programs in health and education in Ethiopia in 1997, they also introduced a completely parallel reporting system with separate budget classification, chart of accounts, and computer system. This activity effectively segmented the local finance offices into a foreign aid shop and a domestic shop. The segmentation not only made it difficult to have a comprehensive picture of the region's finances, it also delayed by at least two years, the implementation of the government's civil service reform in public financial management.

<sup>55</sup> The assessment of the use of accrual accounting in the National Health Service in the United Kingdom has shown very mixed results. See, Howard Mellett, Neil Marriot, and Louise Macniven, 'Devolution, Accruals Accounting and Asset Management in NHS Wales,' *Financial Accountability and Management*, Volume 25, No. 4, pp. 435-450.

<sup>56</sup> Ian Linert, 'Comparison between Two Public Expenditure Management Systems in Africa,' *IMF Working Paper* 03/2 (Washington D.C., March 2002). Mike Stevens made the same argument a year earlier, 'Institutional and Incentive Issues in Public Financial Management Reform in Poor Countries,' The World Bank, October 12, 2004.

departure of the best officials to foreign aid programs. Government financial systems should not be used for the perceived need for quick conditionality hits or as a quid pro quo for budget support. PFM is sovereign territory. As sovereign territory, boundaries need to be clearly defined and if need be, aggressively protected. The basics work.

Public financial management is an essential service. As with teacher and health care worker salaries, its recurrent operations should not be resourced or dependent upon volatile foreign resources. When Ethiopia unveiled its in-house designed Civil Service Reform Program to the foreign aid community in 1996, it requested assistance, but also pursued a very clear strategy of 'divide and manage' of foreign aid to their financial reform. The government wanted to remain firmly in the driver's seat and wanted no single donor/lender to have undue influence nor did they want to borrow for the reform.

National ownership of PFM is not an academic issue. Not only does it go to the heart of sovereignty, it refocuses attention to national development priorities, not external preferences. African governments need basic financial control *now* to deliver the limited, and quite possibly, declining resources to the remotest capillaries of rural development. They need *plateaus* of financial management that are stable and understood, managed and funded by African governments.<sup>57</sup> African governments don't need *summits* of financial management--cutting or bleeding edge financial management. Sophisticated systems raise risk, often don't work, or take years to make function (e.g. the Integrated Financial Management Information Systems--IFMISs).<sup>58</sup> By

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<sup>57</sup> Stephen Peterson, 'Chapter 4: Reforming the Regions: A Model Emerges,' in *Its Possible (Yitchalal) Reforming Ethiopia*, forthcoming. This book presents the Four Drivers of Public Sector Reform (context, ownership, purpose and strategy) which explains reform writ large as well as the PFM subset.

<sup>58</sup> Stephen Peterson, 'Automating Public Financial Management in Developing Countries,' in Anwar Shah, editor, *Budgeting and Budgetary Institutions* (Washington, D. C.: The World Bank, 2007). The failure or under performance of IFMISs and large-scale financial information systems have been extensively documented: William Dorotinsky, 'Technology and Corruption: the Case of FMIS,' The World Bank The World Bank (2002); 'Design and Implementation of Financial Management Systems: An African Perspective,' Africa Region Working Paper Series No. 25; Jack

some estimates, it takes ten to fifteen years to implement a PFM reform and seven to nine years in Africa to implement an Integrated Financial Management Information System (IFMIS).<sup>59</sup> What is most important and often overlooked, is that whether a country's accounts have been changed from modified-cash to accrual accounting has little or no, and quite possibly negative, impact in the short, medium and long term for the quality of life of its children.<sup>60</sup>

There is considerable confusion in the PFM field about reform. I would submit that there are two dimensions of PFM reform, First, PFM reform has four components: recognition, improvement, change and sustainability (RICS).<sup>61</sup> The need (a deficiency) has to be recognized, which in turn requires a decision of whether to address it by improving or changing the system. Once the deficiency is addressed, then the new configuration has to be sustained. Much of the thinking about PFM reform is focuses on change rather than the other three components. The second dimension of PFM reform is separate out systems from their execution.<sup>62</sup> To often, the tendency of the PFM conditionalities of aid, and PFM reforms, have focused on systems, especially the introduction of techniques of international best practice.

Financial reform does not have to cost a lot and indeed is often about improving the execution of existing systems. The amounts of foreign assistance allocated in some countries to financial reform could be better spent on tube wells, or other needed infrastructure, with change to spare. Financial reform is critical; however, rather than

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Diamond, Pokar Khemani, 'Introducing Financial Management Information Systems in Developing Countries,' IMF Working Paper No. 05/196, 2005.

<sup>59</sup> SIDA, *Public Finance Management in Development Co-Operation – A Handbook for Sida Staff*, 2007.

<sup>60</sup> See fn. 55.

<sup>61</sup> Stephen Peterson, 'Chapter 4: Reforming the Regions.'

<sup>62</sup> Ibid.

overspending on it, governments and foreign aid agencies should pursue cost effective approaches, and get down to the business of delivering resources to services. Children count, accrual accounting doesn't. There are diminishing and even negative returns, to public financial management reform.

Ironically while improving the management of public expenditure is frequently a conditionality of budget support, improving domestic revenue mobilization is not. While recognizing the political correctness of foreign aid not raising the bill of sustaining the investment, improving domestic revenue mobilization goes to the heart of fiscal sustainability and should be a quid pro quo of foreign resource transfers.

Finally, budget support, like the MDGs, picks winners and losers. Budget support sidesteps civil society organizations (CSOs). With the decline of global resources, would it not be prudent to build a portfolio of channels (government, CSOs, corporate responsibility), to finance and deliver services, especially to the most vulnerable groups? Reducing the channels for delivering services to the hard to reach rural poor reduces redundancy and increases risk. To what extent has budget support also weakened the advocacy and targeted assistance to children in Africa?

Given the likelihood of diminished, non-terrorist tied foreign assistance, there will be strong pressures for CSOs to fill the gap. Diversifying aid delivery from budget support to forms which strength CSOs, promotes an institutional safety net that may help the bottom billion and those in the burning house, weather the storm.<sup>63</sup>

### VIII. The MDGs Financing Decision (There is no There There)

Jeff Sachs has argued that the core problem with development is the woefully inadequate level of foreign aid to developing countries (using a garden hose when a fire

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<sup>63</sup> The role of budget support in strengthening regimes that are hostile to CSOs is a topic for another paper.

hose is needed).<sup>64</sup> Even if one agrees with this analysis, the global resource reality is that the resources simply are not there, and are likely to decline, and developing countries will have to do more with less foreign aid.

Peter Heller and Sanjeev Gupta pointed out seven years ago two financing problems with the MDGs: that poor countries would not be able to effectively absorb the resource shock, and that the resources would not be forthcoming.<sup>65</sup> They predicted that developed countries were unlikely to achieve the MDG contribution target of seven tenths of one percent of their GDP, and by 2012 they would have to reduce their foreign aid budgets going forward to fund their entitlement programs.<sup>66</sup> Entitlements in the OECD countries are a resource goal that is clearly on the agenda for the millennium—the Millennium Entitlement Goals (MEGs). Heller and Gupta did not foresee other demands on the public resources of developed countries: terrorism, climate, stimulus, and unwinding global leverage (Box 4). The 800-pound gorilla in the room are the MUGs (the Millennium Unwinding Goals), reducing public and private debt, which will be the number one priority for global resources for years, if not decades to come. If this

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<sup>64</sup> Jeffrey Sachs, *The End of Poverty: Economic Possibilities of our Times* (New York: Penguin, 2005). He also points out the inappropriateness of the extensive list of conditionalities.

<sup>65</sup> Heller and Gupta (2002). When writing their paper in 2002, they noted that OECD countries would be pulling out of the 2000 recession within a few years and could possibly meet the seven-tenths of GDP contribution target from mid-decade to 2012. Their predication did not last five years. As an example of the current crises, Ireland Aid has reduced its foreign aid in their 2010 calendar year budget by 25%.

<sup>66</sup> In analyzing the level of ODA flows, one has to separate out military assistance, relief, development assistance, and trade credits.



Box 4

**More Pressing Millennium Goals**

**MEGs: Millennium Entitlement Goals**

✓ For the U.S.: 10% of GDP in 2008; 18% in 2050

**MTGs: Millennium Terrorist Goals**

✓ War in Afghanistan (for the U.S. alone, approximately \$209 billion to date)  
✓ War in Afghanistan (going forward? But US, German, French troop buildup)  
✓ War in Iraq (possibly \$trillions to date)

**MCGs: Millennium Climate Goals**

✓ Copenhagen Commitments (\$75 to \$150 billion a year?)

**MSGs: Millennium Stimulus Goals**

✓ U.S. Stimulus (\$787 billion +)

**MUGs: Millennium Unwinding Goals**

*Private sector*

✓ \$600 trillion in derivative contracts in 2008 up from 100 trillion in 2000

*Public sector*

✓ \$12 trillion in bonds which OECD countries must issue in 2008, up from \$9 trillion in 2000

✓ 13% of GDP, Russia's loan guarantees to state companies

✓ 10% of GDP, Turkey's loan guarantees to state companies

✓ 53% of GDP, UAE's loan guarantees to state companies

Sources for Box 4.<sup>67</sup>

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<sup>67</sup> U.S. public debt in 2008 was 41% of GDP and will double in the next decade (*The Economist*, November 21, 2009, p. 13). While the sums are staggering, the global implication is dire—'in a few years, the AAA rating of Treasury bonds, the world's most important security, could be in jeopardy (Ibid.)'. Interest on the US debt will triple by 2019 from the current 5% of spending, the Millennium Entitlement Goals (MEGs) of the United States Government are estimated to increase from 10% of GDP in 2011 to 18% by 2050 (*Ibid.*, p. 27). It is hard to get a firm figure on the Millennium Terrorist Goals (MTGs), but the US military down payment on Afghanistan alone has been \$209 billion since 2001. In terms of the Millennium Climate Goals (MCGs), the European Union has proposed in advance of the December 2009 Copenhagen climate summit that developed countries should commit between 22 and 50 billion Euros a year (*Financial Times*, November 3, 2009, p. 9). On the Millennium Stimulus Goals (MSGs), see 'Stimulus Sustains 30,000 Jobs,' *Financial Times*, October 16, 2009. But the largest and most immediate expenditure facing several OECD countries are the Millennium Unwinding Goals (MUGs)—recapitalizing their financial infrastructure. The MUGs have exceeded several trillion dollars in outlays and contingent liabilities, and there is little certainty as to the final price tag.

goal is not addressed, there will be no playing field, level or not, for developed or developing country alike. The central and confounding issue of our age—what is a sustainable deficit—is the core issue of public financial management. The IMF projects that ‘ten years of cuts and tax rises lie ahead for developed countries’—hardly encouraging for the expansion of foreign aid to developing countries.<sup>68</sup> Given that only a handful of developed countries have ever met the seven-tenths of one percent GDP contribution target for the MDGs under favorable global economic conditions, it is unlikely that the aggregate target will be met going forward with the current conditions and new priorities.<sup>69</sup> That the MDGs are not fiscally sustainable should not surprise us—it is the broader picture of global finance. Until the global economy recovers, resources devoted to foreign aid are unlikely to recover, but more important, remittances, direct investment, and trade with poor countries, will not recover.

#### IX. The MDG Investment Decision

Having addressed the financing decision, we now examine the MDGs as an investment decision. The MDGs are the triumph of the short term over the long term.<sup>70</sup> The fiscal gap in Africa is the worst in the world which makes crafting a development strategy rough, very ‘rough justice.’ Africa needs growth promoting investments that create real and sustainable jobs more than it needs social services. The first right of

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<sup>68</sup> The G20 nations’ debt has reached 118% of GDP and the IMF estimates that it would take spending cuts and tax increases equivalent to 8% of GDP over a decade across the industrialized G20 to bring the debt to GDP ratio back down to 60%. See *Financial Times*, November 4, 2009, p. 3.

<sup>69</sup> While estimates vary on the cost of the MDGs, one estimate is that aid flows of \$80 billion to \$140 billion are required. For a review of the costing studies see Michael Clemens, Charles J. Kenny, and Todd Moss, ‘The Trouble with the MDGs: Confronting Expectations of Aid and Development Success,’ *Working Paper 40* (Washington D.C.: Center for Global Development, September 2004).

<sup>70</sup> Commission on Growth and Development, ‘The Growth Report: Strategies for Sustained Growth and Inclusive Development (Washington, D.C.: World Bank, 2008), p. 35 cited in Penrose, p. 50.

children should be something to eat and then employment which sustains that right.<sup>71</sup> Getting agriculture moving through infrastructure and input purchasing power through wage employment should be priority over social services (especially unsustainable ones with universal coverage that compromises quality-- primary education which has unproven growth multipliers). The public investment decision facing Africa is a cruel choice between a better future or a stagnant present. The meager resources created by global economic crisis makes the choice crueler. A generation of the continent's children may simply not leave the burning house.

From 1970 to 1993 African public expenditure shows positive growth in services and negative growth in agriculture, mining and manufacturing.<sup>72</sup> Countries with high sustained growth rates invest 25% of their GDPs with 5-7% of GDP going into infrastructure while many developing countries invest 2% or less.<sup>73</sup> Again, Erik Reinert succinctly states the development problem:

[I] shall argue that this palliative economics [the MDGs] has, to a considerable extent, taken the place of development economics. Indeed, the balance between development economics (i.e. radically changing the productive structures of poor countries) and palliative economics (i.e. easing the pains of economic misery) is key to avoiding long-term negative effects. It is important to note that this change for the worse has happened while, at the same time, responsibility for world development has been shifted from the UN organizations to the Washington institutions.<sup>74</sup>

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<sup>71</sup> Josette Sheeran, executive director of the United Nations World Food Program argues 'that every child deserves a least one humble cup of food a day.' 1.02 billion people, one-sixth of the world's population, go hungry and a child dies of hunger every six seconds. *The Daily Monitor*, Addis Ababa, Ethiopia, December 19, 2009, p. 3. Article 6 of the Convention on the Rights of the Child states that every child has the right to life.

<sup>72</sup> Codrina Rada and Lance Taylor, 'Developing and Transition Economies in the Late Twentieth Century: Diverging Growth Rates, Economic Structures and Sources of Demand,' *DESA Working Paper 34*, UNDP, September 2006, cited in Penrose, pg. 47.

<sup>73</sup> Commission on Growth and Development (2008), p. 35.

<sup>74</sup> Reinert, 240.

The MDGs are easy goals. They do not require political elites to make the hard choices and painful adjustments necessary for growth. They allow regimes to tread water.

#### X. The MDG Investment Decision: Picking Winners and Losers

A long debate in the development field is whether governments and foreign aid agencies should target resources and pick winners and thus losers (the investment decision). Ironically, while competitiveness is proposed for market-based development, the MDGs erode competitiveness, if not impose a monopoly, on public resource allocation, domestic and foreign. A core assumption of the MDGs is that the ‘pro-poor’ investments it has identified are the winners. The MDGs are rigid and reinforce the existing stove piping of service delivery and fail to build synergies. It does not promote, much less fund, a ‘whole of government’ approach to service delivery. Improvement of public health may well be best achieved by investing in access to water rather than in the health sector. Provision of a reliable source of water has ripple effects across many sectors in part because it supports the principal caregivers, agriculturalists, nutritionists and educators—rural women. While water is one of the stated MDGs, our point is that it should not be eclipsed by a focus on achieving other MDG goals (e.g. universal primary education). Nearly half the tube wells in the southern region of Ethiopia need rehabilitation. Would tube wells not be a better investment in that region than expanding primary education? The dilemma of development is that the tradeoffs are stark. In this case, education versus water—they can’t do everything.

The MDGs are not the best *investment* decision in terms of pro-poor growth multipliers. Investment in education, for example does not have a clear impact on

growth whereas, there is considerable evidence that tertiary roads have significant growth multipliers and pro-poor outcomes.<sup>75</sup>

Education is the most expensive MDG and is hallowed ground in discussions on the rights of the child. It illustrates one of the cruelest choices in development—the hopes of the current generation, or the future of their children—intergenerational equity. In the recent ACPF conference in Addis Ababa on the financial issues for promoting children’s rights in Africa, I emphasized that education is on shaky grounds in terms of its impact on growth and fiscal sustainability. I argued that if you want to educate the kids, you have to tax the people—particularly those that can pay and do not do so currently. I do not believe the message was accepted or considered by the advocates in the room.<sup>76</sup> For advocates of the rights of the child, education is a sacred cow. The case for education, especially universal primary education must, but hasn’t been made.<sup>77</sup> If one accepts the literature that investment in education has little or not impact on growth, one has to question the appropriateness of the universal primary education MDG. There is a voluminous literature on the subject but I defer to the conclusions of a specialist who has worked on the topic for over thirty years.

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<sup>75</sup> Some studies have found that investments in human capital are significant but negative. See, George Psacharopoulos and Harry Anthony Patrinos, ‘Returns to Investment in Education: A Further Update,’ *Policy Research Working Paper* No. 2881 (Washington, D.C.: The World Bank, September 2002), p. 1. On the pro-poor effect of rural roads, see Shahidur Khandker, Zaid Bakht, Gayatri Koolwal, ‘The Poverty Impact of Rural Roads: Evidence from Bangladesh,’ *Policy Research Working Paper* No. 3875 (Washington, D.C.: The World Bank, April 2006).

<sup>76</sup> See Urban Jonsson, ‘The Economic Significance of Investing in Children,’ paper presented to the African Child Policy Forum, December 1-2, 2009, Addis Ababa, Ethiopia, p. 44. See also his *Human Rights Approach to Development Programming*, (Nairobi: UNICEF, 2003), pp. 1-14.

<sup>77</sup> A recent paper which child rights advocates cite that counters the view that education does not promote growth is Edward Anderson and Sarah Hague’s, ‘The Impact of Investing in Children: Assessing the Cross-Country Econometric Evidence,’ *Working Paper* 280 (London: Overseas Development Institute, June 2007). Their study found ‘that an increase of 20 percentage points in the primary enrolment rate would raise growth by 0.3 percentage points per year, while an equivalent increase in secondary enrolment would raise growth by 0.2 percent per year,’ section 4.4. The authors do caution that simply increasing enrolments does not generate growth.

Although the subject is complex, I think there is sufficient reason to suggest that conditions requiring expansion of education enrolments are not appropriate for budget support operations, without careful analysis. This statement may seem shocking, and it certainly does not imply that education should not be a focus. The questions are much more about education policy in the presence of fiscal constraints, accepting that foreign aid does not fill the fiscal gap; and about the balance between mass education, in particular its quality, and good quality higher and technical education. In other words, the MDGs in the case of education not only cause fiscal problems, but may also distort sectoral priorities.<sup>78</sup>

The MDG winners are also narrow. The exclusive focus on primary education leaves out secondary and tertiary education and there is evidence that there are growth multipliers from education beyond the primary level.<sup>79</sup> The macro-economic model of the Kenyan economy developed by the CIDA funded Long-Range Project in the Kenyan Ministry of Finance and Planning, found that there were growth multipliers from secondary education. Even if one assumes that the MDGs sectors are winners (e.g. primary education), success is often viewed in quantitative rather than qualitative terms though the two can be related.<sup>80</sup> One must be careful what one wishes for. Many African countries cannot afford universal primary education and the attempt to achieve this goal, even with the generosity of strangers, is likely to distort and degrade the quality of

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<sup>78</sup> Perran Penrose, pp. 42-43.

<sup>79</sup> While the returns to education, especially primary, may not have a direct impact on growth, the employment effects of education do contribute to growth. Under the Harvard DSA project in Ethiopia, an assessment of the economic potential of the southern region found that regional growth came only from public sector employment and teachers were by far the most numerous employees. See Decentralization Support Activity Project, 'Regional Economic Policy Review—Policy for Growth and Competitiveness in the Southern Region—Background Paper for the 1998 budget planning cycle,' *Project Report* No. P-64, December 2004. The importance of ramping up public sector employment ahead of an election, especially teachers in the rural areas, has a significant political effect with knock on effects to stability and possibly growth.

<sup>80</sup> It is the kind of education rather than the quantity that is important, but the MDGs focus on only primary education and its quantity. Ron Dore, 'The Importance of Education Traditions: Japan and Elsewhere,' in D.H. Whittaker, ed., *Social Evolution, Economic Development and Culture: What it Means to Take Japan Seriously* (Edward Elgar, 2001) cited in Penrose, p. 43. The EC's Growth Commission's report also states that using quantitative indicators of enrollments and facilities is a 'bad idea', p. 69, cited in Penrose, p. 43.

the education system. Meeting MDG goals with irresponsible pupil teacher ratios is not development.<sup>81</sup>

#### XI. The MDG Investment Decision: What Happened to the MAGs (Millennium Agriculture Goals)?

One billion people go to bed hungry yet there is not an MDG goal for agriculture. By 2050 there will be 3 billion more people to feed. Agriculture has long been neglected. A straw poll of a recent conference of the Food and Agriculture Organization found that 85% of attendees predicted future spikes in food prices and one-third believed the world could not feed itself by 2050.<sup>82</sup> The era of cheap food is over and food riots have occurred in sixty-three countries over the past year. Agriculture provides the livelihood for seventy-five percent of the poor and is the engine of sustainable growth for poor countries. Between 1980 and 2006 foreign aid to agriculture declined by three-quarters; in 2005 developing countries invested approximately 5% of public revenues in farming; and while in the 1960s Green Revolution staple-crop yields were rising by 3-6% per year, they are now 1-2% and in poor countries yields are flat.<sup>83</sup> Ominously, it is predicted that yields in agriculture globally will decline by 50% over the next decade.<sup>84</sup> The omission of agriculture, and thus food security, further illustrates the weakness of the MDGs as a development strategy and/or performance system.

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<sup>81</sup>Tanzania is considered by some as an MDG success story. Net enrollment has dramatically increased but this has led to much higher pupil-teacher ratios (54-1 for primary and 37-1 for secondary). The MDG benchmarks are quantitative not qualitative and the increase in the p/t ratios is reducing quality. See Ruth Carlitz, 'The Education MDG: Is More Better?' *The Open Budget Blog*, October 8, 2009. The Harvard DSA project in Ethiopia found pupil-teacher ratios on average, exceeding 70.

<sup>82</sup>'Investors in rush to feed the world,' *Financial Times*, Special Report: Commodities, November 25, 2009, p. 5.

<sup>83</sup>'How to Feed the World,' *The Economist*, November 21, 2009, p. 14.

<sup>84</sup>Josette Sheeran (2009).

It would require another paper to leach out the roots of why agriculture has been neglected from the development agenda for more than two decades. A few observations. The rural poor lack voice while the urban dwellers have voice beyond their numbers. The MDGs offer short-term welfare to those who can access it best and have the most significant political impact. Developing rain-fed subsistence agriculture with growing population pressure is extremely difficult and significantly different, and much harder, than developing irrigated agriculture.<sup>85</sup> Sequencing the development of rain-fed subsistence agriculture goes against many of the tenets held by foreign aid—subsidies of inputs (seeds, fertilizer, credit—even if only for the short and medium term) and price supports.<sup>86</sup> The complexity, risk, and long time scales needed to have an impact on subsistence agriculture are daunting challenges and are a less attractive investment to recipient governments and donor/lenders when compared with other low hanging fruit which have rapid and visible benefits, especially political.

Julius Nyrere summarized the difficulty of promoting development in rural Africa: ‘While the United States was reaching the moon, we were trying to reach our villages and we had the harder task.’

Finally, food aid provides Western government’s a win-win resource allocation—an outlet to dispose surpluses from their farm support in lieu of additional aid outlays that promotes regime support. Recipient governments also have a win-win for it provides them discretionary resources to reward support and punish opposition

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<sup>85</sup> Arturo Israel, *Institutional Development: Incentives to Performance* (Washington, D.C.: World Bank, 1987).

<sup>86</sup> Charles Mann, ‘Malawi’s Starter Pack: A Smarter Subsidy to Empower the Poor with Science-Based Agriculture,’ *Africa Policy Journal*, August 2008. See also, Robert Chambers, *Rural Development: Putting the First Last* (Harlow: Pearson Education, 1983).



and it delays the hard choices needed to get agriculture moving with its attendant risks of political mobilization and opposition.<sup>87</sup> Food aid can keep failed regimes in power.

## XII. The MDG Investment Decision: What Happened to the MRGs (Millennium Revenue Goals)?

There were none. MDGs are about foreign aid, not domestic resource mobilization. Taxes are the price of living in a civilized society—a society that wants social services. Building a growing and sustainable tax base is essential for expanding the social services of a country and probably has the highest return of any investment—public or private. Domestic revenue mobilization is the heart of development, endogenous based growth. The MDGs do not address this issue.

Much is said about development being a partnership. The resource rappers (rock stars and their academic showmen) ignore the resource partnership—again—not understanding that short run palliatives can well lead to long term fiscal stress and failed expectations. Beyond promoting fiscal sustainability, domestic revenue is the other side of the ‘development partner’ equation.

Domestic revenue determines the level of resources (domestic and foreign) available for sustainable capital and recurrent expenditure. The ‘governor’ of sustainable growth in social service provision (the MDGs), *is* domestic revenue mobilization, not foreign aid. Prudent financial management requires that the dominant expenditure of these services, recurrent wage and statutory payments, should only be financed out of domestic revenue.<sup>88</sup> There are proven multiples to investment in revenue mobilization especially tax administration. A rule of thumb by tax experts is that the return to investment in tax audit is a multiple that ranges from seven to nine. While social cost

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<sup>87</sup> See ‘Aid Groups to Probe Charges by Opposition: Aid Workers Say Government Controls System and Opposition Says Food is Used as a Political Weapon,’ *The Daily Monitor*, Addis Ababa, December 22, 2009, p. 1.

<sup>88</sup> This should exclude non-tax asset sales.

benefit analysis is difficult at best, there is no MDG investment that can even come close to a multiple of the return to investing in a country's revenue system. Further, there is no MDG that comes close to the investment in revenue capacity that promotes sustainability of development. In even in the poorest areas of Ethiopia, studies show that the limited capacity of revenue administration was not effectively managed and with simple redeployment of existing staffs, yields could be significantly increased.<sup>89</sup>

Many tax experts agree that tax administration is tax policy.<sup>90</sup> This finding means that one does not have to entertain a 'big bang' approach to reforming a country's revenue policy and in turn its revenue administration.<sup>91</sup> Improvement of revenue systems need not, and should not, be viewed as a distant up-stream process that takes years to provide resources to vulnerable groups. As with the reform of public expenditure systems, marginal changes in existing tax systems can have rapid and significant effects.<sup>92</sup>

Another reason poor countries need to ramp up domestic revenue mobilization, especially non-tariff revenues, is the potential losses of revenue from the NAMA liberalization of the WTO Doha Round. These negotiations assume that tariff losses for developing countries can be replaced by consumption taxes.<sup>93</sup>

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<sup>89</sup> James Warner, 'Estimating the Current Revenue Potential for the SNNPR,' *Decentralization Support Activity Project Report M-56*, July 2005.

<sup>90</sup> Milka, Casanegra de Jantscher, 'Administering the VAT,' in Malcolm Gillis, Carl S. Shoup, and Gerardo P. Sicut eds., *Value Added Taxation in Developing Countries*, (Washington, D.C.: The World Bank, 1990), p. 179.

<sup>91</sup> Faced (and ignored) by a glacial tax reform by the Federal Government assisted by multilateral aid institutions, the Addis Ababa municipal finance bureau contracted a local firm to develop a simple but effective tax collection information system (name?). It was rapidly developed, implemented and the municipality enjoyed a leap in revenues. The DSA PFM reform project which I directed, which focused on expenditure not revenue management, was asked by the head of the Southern Region Bureau of Finance and Economic Development, to 'borrow' the Addis tax information system and assist the Bureau in implementing a tax reform. Mindful of scope creep, the project had to decline.

<sup>92</sup> Rental income from expatriate development workers is a significant transfer of foreign aid to host nationals in poor countries. Is it taxed?

<sup>93</sup> South Centre, 'Is Development Back in the Doha Round?' *Policy Brief* No. 18, November 2009, p. 4. Another loss to developing countries in NAMA (Non Agricultural Market Access) negotiations

Given the belt tightened ‘new normal’ created by the global crisis, would it not be equitable, and ethical, to extend the MRGs beyond revenue mobilization in poor countries to those who work in the poverty business?

### XIII. Old development goals never die, they just fade away

In Spring 2009, the Secretary General of the UN addressed the Harvard Kennedy School. In the question and answer session that followed his remarks, a student enrolled in my public financial management class asked him about his view on the fiscal sustainability of the MDGs. The Secretary General argued that while there are ‘issues,’ with the MDGs, one hundred and fifty plus countries had signed on to them. Is the justification for the MDGs simply that they are a least common denominator of what countries can agree on?

By not maximizing the foreign aid that exists, and in most likelihood will diminish in the coming years, the MDGs may well accelerate the decline and/or diversion of foreign aid. In this era of diminishing resources, successful advocacy for protecting, much less increasing, foreign aid for development of the bottom billion, will have to demonstrate relatively rapid (not millennial) effects, local ownership, stingy overhead, and steps to sustainability—the pressures most charities face.

Discussions on foreign aid often elicit extremes of rhetoric from (it does not work and should be stopped—Moyo) to (it really hasn’t been tried and should be ramped up—Sachs).<sup>94</sup> These debates miss the real issue—that foreign aid resources for development, not military assistance, are likely to be reallocated to entitlement (MEGs),

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is the terms of trade. It is projected that the tariff losses from the Doha Round for poor countries would be on the order of \$63.4 billion, ‘Is Development Back.’

<sup>94</sup> Dambisa Moyo, *Dead AID: Why AID is Not Working and How there is Another Way for Africa* (New York: Farrar, Straus, Giroux, 2009); Jeffrey Sachs, *The End of Poverty: Economic Possibilities for Our Time* (New York: Penguin, 2005).

terrorism (MTGs), climate (MCGs), stimulus (MSGs), and the more immediate, though truly millennial, and the more costly, the unwinding goals (MUGs).

As an unstructured strategy for an increasingly marginalized recipient, the MDGs cannot hope to compete for resources of structured strategies of their patrons (the MEGs, MTGs, MCGs, MSGs, MUGs). Debating whether the MDGs are symbolic or practical while the house burns gets us nowhere.

Foreign aid to Africa is needed and can work. It can provide foreign exchange needed for growth, and food when needed for survival. Foreign aid as finance works. Foreign aid as investment is where it often goes off track. The opportunity costs of the MDGs as an investment strategy has not been adequately scrutinized as there are clearly better investments, which promote growth. Even if the MDGs were reached, they are not sustainable and thus not appropriate.

#### XIV. A Proposal: Decade Infrastructure Goals (DIGs)

This is a challenging time for rethinking the dominant development strategy. Development has to be located within an economic crisis that has not been experienced since the 1930s. There is uncertainty, it is different this time, and a different strategy of development is needed.

The MDGs should be replaced with the following strategy: DIGs (Decade Infrastructure Goals). DIGs has four components:

- DTGs: decade tax goals
- DAGs: decade agriculture goals
- DRGs: decade road goals
- DPGs: decade power goals

Given the uncertainty of the times, the central feature of a development strategy for Africa should be the promotion of certainty and reduction of risk. All decisions

involve factual and valualational premises, and uncertainty can be viewed in terms of two dimensions: facts and values as illustrated in Figure 1.<sup>95</sup> One could debate endlessly about where the MDGs would be located in this matrix. In education for example, there is uncertainty on the *facts* (the impact of primary education on growth) and *values* (whether secondary or vocational education should be part of the mix). The lack of consensus on how to manage the global economic crisis means that development strategies for Africa are also not located in Quadrant 1.

We would propose a *Decade Infrastructure Goals* (DIGs) strategy for Africa, as it would be squarely located in the certainty of Quadrant 1. By starting *D* for *decade*, DIGs avoids the shifting fads that blow through development and will force a discipline of direction with a time scale that promotes accountability. With *I* for *infrastructure* (roads, revenue, power, agriculture) the DIGs focus on investments that are proven to have growth multipliers, alleviate poverty and promote sustainability.

The DIGs, particularly, physical infrastructure, can utilize all sources of finance (domestic/foreign; loan/ grant) and by being project based, reduce the volatility of foreign aid. Unlike expanding social services, foreign aid financed infrastructure can improve not impair a country's competitiveness. The DIGs reduce the risk of development as we know how to design, implement, and finance them and their value and impact are certain (Quadrant 1).

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<sup>95</sup> Herbert Simon, *Administrative Behavior* (New York: The Free Press, 1997), pp. 4-5.

Figure 1

**Thompson Tuden Decision Matrix<sup>96</sup>**

*Values*

	Agree	Disagree
Certainty	Programmed 1	Negotiated 3
Uncertainty	Pragmatic 2	Chaos 4

Are the DIGs in essence, the 'China Model' of development. China's emphasis on building infrastructure can in many ways be a win-win for African countries and China. As is often the case, the problems emerge in how a strategy is implemented. Chinese infrastructure projects often do not promote as much local employment that the could nor is there sufficient attention to twinning and upskilling local labor. In the 1980's when Chinese foreign aid built the Kasarani sports stadium in Kenya, the anecdote circulated that they had brought there own laborers and the rocks and sand.<sup>97</sup>

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<sup>96</sup> James D. Thompson and Arthur Tuden, 'Strategies, Structures, and Processes of Organizational Decision,' James D. Thompson and Arthur Tuden, eds., *Comparative Studies in Administration* (Pittsburgh: University of Pittsburgh Press, 1959), pp. 195-216.

<sup>97</sup> It speaks volumes that the Ministry responsible for foreign aid in China is Commerce. In 2009 the Vice Minister of Commerce visited Harvard University to discuss how China could better engage in development in Africa. I disagreed with my colleagues who advocated that they study Western foreign aid and I argued that their infrastructure strategy was a best bet for the continent and for themselves. I did stress the need for improved labor policies in development projects and

## XV. Reviving Project Support

Budget Support has been the foreign aid flavor of the month for several years. Even if one discounts all of the difficulties of this policy instrument listed above, there is a consensus in the field of public policy, that policy instruments are weakened when they are used for multiple objectives.<sup>98</sup> To diversify the risk of delivery, a portfolio of instruments should be used: budget support, project support as well as non-public money channels—civil society support. Limited budget support should be continued to assist Africa with reserves to manage shocks and smooth out domestic revenue and foreign aid flows. Project support should be revived principally to reduce the volatility of foreign aid, but also to focus on infrastructure investments. The difficulties and cost of budget support have been overly discounted and the virtues of project support overlooked. Projects are contractual and commit foreign aid over a multi-year time frame—something Medium Term Expenditure Frameworks (MTEFs) have largely failed to do. Project support is arguably less intrusive. Budget support has meant that foreign aid agencies have to assess and reduce overall fiduciary risk which has often meant the introduction of questionable and diffuse long-term PFM reforms. With project support, financial risk can be clearly and closely monitored (physical progress, line item reports, continuous audit). Finally, projects can keep recipient and funder focused on capital investment, notwithstanding the fungibility of money.

A final observation about the relative risk to foreign aid agencies of project versus budget support. Budget support programs while seeming to have fewer transaction costs, are often by their scale, more difficult to slow down and indeed terminate. A discrete project can be closed down for mismanagement but it does not reflect on a broader political indictment of the government. Slowing or terminating a

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the development impact of building secondary roads with their concessionary funds that connect to the trunk roads they were building on a commercial basis.

<sup>98</sup> Prior to the 2005 elections in Ethiopia, foreign aid agencies were planning to massively ramp up assistance and they wanted to diversify instruments.

large budget support operation can have sector and multi-sector effects and by their scale are political.

## XVI. and Copenhagen?

Others will ponder the effects, meteorological, political, developmental of the recent discussions in Copenhagen. Perhaps it is the end of the beginning or the beginning of the end. Climate change is the best and most ominous sign of the global LIE. Climate is the most comprehensive form of leverage, it is seemingly beyond the capacity of national and global institutions to manage, and the experts are divided on technical and financial solutions—though progress seems to have been made on a scientific consensus. If one were to locate it in the decision matrix presented above, the management of climate change is certainly not in Quadrant 1 hopefully, it is not in Quadrant 4.

What does Copenhagen portend for Africa and its children? Will Green Greed (the Millennium Climate Goals—MCGs) replace MDGs as the new strategy to shame developed countries to transfer more resources? If the MDGs were not financed, why should it be assumed that the MCGs earmarked for developing countries will be financed? The leader of the African negotiating team at the conference argued that Africa needs trillions of dollars but accepts the figure of \$10 billion as the start up donation for the upcoming three years.<sup>99</sup> As with the MDGs, the MCGs are silent on the topic of domestic revenue goals, which are needed to make the green transfers sustainable. As with the MDGs, the immediacy of the MCGs discounts future fiscal

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<sup>99</sup> The leader of the African delegation to the Copenhagen conference on climate, Meles Zenawi of Ethiopia, said that Africa benefitted most from the climate deal, and ‘though Africa’s financial need for the climate change compensation would be in trillions, due to the current financial crisis the developed nations are not in a *position to be bounced,*’ *The Daily Monitor*, Addis Ababa, December 22, 2009, p. 1, *emphasis added*. The President of the African Development Bank argued at the conference that Africa needs \$40 billion a year for climate aid, *The Daily Monitor*, Addis Ababa, December 9, 2009, p. 1.



sustainability--sustainability is viewed as now. Even more than then MDGs, Africa views the MCGs as a one-way transfers because climate change has be caused by the emissions of the North. Development under the MCGs becomes an entitlement relationship, not a partnership. The MCGs may well further polarize North-South and South-South differences leading to beggar thy neighbor policies.

If a green hat transfers more resources than an open palm, so much the better. But what resources? Africa does not need high tech, expensive and unproven technology. Bleeding edge green technology should be installed by the highly polluting countries and indeed there may well be an argument for transferring earlier generation technology at deep discount which gets growth going on the continent.<sup>100</sup> As green technology is proven and becomes discounted, transfer to Africa will occur. To the extent that green technology brings greater dependence on foreign technical assistance and dependence on external patrons, but most importantly does not address the most critical problem in Africa--employment, the opportunity costs of green development must be carefully weighed.<sup>101</sup> Attention to sustainable agriculture, which would include agro-forestry, would address some of the serious ecological deterioration that is in the hands of African's to reverse.

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<sup>100</sup> There are striking possibilities combining green technology with low cost implementation. A program in Ethiopia modeled after the Bunker Roy approach to development based on the Barefoot College model in India, introduced solar energy into some of the remotest regions of Ethiopia using unskilled staff, even widow, which provided extremely low cost implementation. See Thomas Chupein, Jamshed Kazi, Marija Kuzmanovic, Beke Ncube and Ghanshyuam Tiwari, 'Copouts, Washouts and Dropouts—the First Barefoot Solar Engineers in Africa,' case study presentation in my course, *The Management of Development Assistance Projects*, Fall 2009, Harvard Kennedy School.

<sup>101</sup> An example of a non-green technology driven development strategy has been Ethiopia's run for the roses. The flower farms that have sprouted up with a half-million dollar grant from the Netherlands government and generous five-year tax holidays as well as tailored public infrastructure are not a best bet. The strategy has anemic employment benefits, diverts enormous water resources from subsistence and food crop agriculture, and is a proven polluter. Some observers have also noted the ethnic preference in granting land leases, which underscores the political dimension of picking economic winners and losers.

Africa does face a serious climate problem. Governance. No other factor comes close in retarding the continent's development. Governance is essential to attracting investment, expanding trade and prudent fiscal management—three pillars of growth.

## XVII. Summary

As the most vulnerable global citizens, Africa's children have been the most harmed by the global economic crisis.

The damage that resulted from utter reliance on the invisible hand of the market is different from that of the more intrusive appendages of the state, but both have given us plenty of reason to distrust final solutions. Eclecticism seems both smarter and saner than any alternative.<sup>102</sup>

The global crisis forces Africa to make even crueler choices. What is worse—broken promises or cruel choices? Public financial management is about making cruel choices—executing political will—who gets what, when and where. Development is about 'rough justice' and at best is 'making everyone equally unhappy.'<sup>103</sup> The MDGs promote the false hope that an 'acceptable' quality of life can be achieved by poorest of the planet in a short period of time. This is of course an illusion, and more so today given the unfavorable resource climate for increasing transfers to poor countries. Public Financial Management is also the management of illusion. There is never enough. A development strategy, however, should not be an illusion. Hardheaded and creative policies are now needed—not more of the same--or final solutions.

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<sup>102</sup> Susan Neiman, *Moral Clarity: A Guide for Grown-Up Idealists* (Princeton: Princeton University Press 2009), p. 72.

<sup>103</sup> Allan Morris, head of the Australian Grants Commission, summarized his job in setting the allocations between sub-national governments as 'making everyone equally unhappy'—a moniker most budget directors can appreciate.

The MDGs are perhaps the best example of ‘the big plan’ in development. Big plans run the risk of what Aaron Wildavsky and Naomi Caiden observed 20 years ago that plans in poor countries are designed to ‘satisfy everybody, spread it around, postpone the evil day and be vague.’<sup>104</sup> Best to get DIGging.

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<sup>104</sup> Aaron Wildavsky and Naomi Caiden, *Planning and Budgeting in Poor Countries* (New Brunswick: Transaction Books, 1990).