

# **FUNGIBILITY, PRIOR ACTIONS AND ELIGIBILITY FOR BUDGET SUPPORT**

by

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## **Abstract**

A number of donors advocate providing general budget support as an alternative to aid-financing of projects or sector programmes. The basic principle is that if donors approve of a recipient's expenditure allocation plans it is appropriate to provide aid as budget support. This begs the question of how donors determine which recipients should be eligible for budget support. Typically, recipients are required to demonstrate for a period that they can and do allocate spending in the way agreed with donors, and they then become eligible. This can be termed 'selectivity', where prior actions are used as conditionality to determine eligibility so that budget support is only granted to those countries that allocate spending appropriately. This paper identifies some problems with selectivity to suggest that reliance on prior actions does not ensure that budget support is allocated optimally. A simple model is used to inform the discussion by demonstrating that selectivity based on prior actions imposes excess costs on deserving recipients and may not generate the efficiency gains in aid allocation posited by proponents of targeting. This weakens the argument for selectivity (of the form commonly proposed), and we argue that it is not necessary to require prior actions. Opposition to general budget support reflects, at least in part, concerns over fungibility and over the effectiveness of aid-financed government spending. The second part of the paper provides a critique of fungibility as an argument against budget support. The paper concludes by arguing that budget support can safely be granted if recipients allocate spending in a manner broadly agreed with donors. The issue that donors should focus attention on is the effectiveness of spending, not on conditionality or fungibility.

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## 1. Introduction

Most aid is given to the governments of recipient countries and is used to finance public expenditure. In the poorest countries, aid accounts for a large share of government spending. For example, in low income countries in 1997, aid accounted for almost a third of general government consumption on average, although it was over 100% for some African countries (e.g. Ghana, Senegal, Tanzania and Uganda),<sup>1</sup> whereas in lower middle income countries the share was about six per cent (McGillivray and Morrissey, 2004: 74). Clearly, the impact of aid in developing countries depends on how it affects government spending and fiscal behaviour more generally. Two issues are especially important: the effect of aid on the allocation of spending, and the effectiveness of that spending in delivering public goods and services (e.g. does health sector spending deliver improvements in health status). For example, aid has a greater impact on growth if it increases spending on public investment, even though the productivity (effectiveness) of public investment in sub-Saharan Africa is low (Gomanee *et al*, 2006). Recent research shows that aid increases spending on social sectors (health, education and sanitation) and this contributes to poverty reduction (Mosley *et al*, 2004) and improving aggregate welfare, although again in the poorest recipients the effectiveness of social spending in delivering welfare improvements is low (Gomanee *et al*, 2005).

To enhance the effectiveness of aid, it is important to ensure that aid is allocated to the most appropriate areas of spending, and to increase the effectiveness of such spending. Donors have tended to be most concerned about the former issue, although recent work has addressed the effectiveness of spending (Devarajan and Reinikka, 2004; Reinikka and Svensson, 2004). A number of approaches have been adopted to restrict or influence the areas of spending financed by aid. At one extreme is the idea of creating a special ring-fenced fund that can only be used for designated expenditures, e.g. under HIPC-II the aid and savings from debt relief may be placed in a Poverty Action Fund to be spent on headings identified in the PRSP (Morrissey, 2004). At the other extreme, donors may give aid in kind (e.g. medicines) or stipulate that recipients have to match aid-financed spending in specified areas, through matching grants or counterpart funds (McGillivray and Morrissey, 2000, 2001). Underlying all of these measures to influence the allocation of aid to expenditures is donor concerns with fungibility – is aid allocated to the areas of spending that donors want to support?

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<sup>1</sup> Aid may be equivalent to more than 100% of government spending if the measure includes aid that is not delivered through the budget, such as technical assistance or donor-financed projects.

Three elements of fungibility can be distinguished (McGillivray and Morrissey, 2004, provide a review). General fungibility arises where aid intended for a general purpose, investment spending, is actually used for a different purpose, consumption spending. If donors believe that aid must finance investment if it is to impact on growth, they will believe that aid redirected to recurrent spending undermines the (growth) effectiveness of aid. A more specific case is categorical fungibility, where aid intended for a particular spending heading, such as health, is used for a different heading, in particular one that the donor does not intend to support, such as security or wages. Again, donors will believe that this undermines the development effectiveness of their aid. The third issue is additionality: even if the aid is all allocated to the intended expenditure, government's own (tax) resources previously allocated to that expenditure may be reallocated elsewhere so that spending on the intended area does not increase by the full amount of the aid (McGillivray and Morrissey, 2000). It is important to note that fungibility *per se* is not concerned with the misuse of aid (such as corruption), but simply with misallocation, or specifically non-additionality. The misuse of aid is a concern, but it is relevant to the effectiveness of aid and spending rather than to fungibility.

Concern about fungibility is one reason why many donors are reluctant to support providing aid in the form of General Budget Support (GBS). Cordella and Dell'Ariccia (2003) use a 'fungibility model' to compare GBS, where donors influence the overall allocation of resources (through conditionality) but fungibility may arise, to project aid, where donors can target an area of spending but do not influence overall allocation. In an environment where only some expenditures are subject to conditionality, they argue that budget support is preferred if i) aid levels are small relative to the budget, and ii) donor and recipient preferences are aligned. These conditions may not often hold together in practice for the poorest countries for which aid is most important. For example, aid is significant in Uganda (as shown above), so the first condition is not met even if the second is. Furthermore, as White and Morrissey (1997) show, the latter condition is only one of at least four possible cases (if preferences are defined over both aid levels and conditions).

A core argument of this paper is that this fungibility critique of GBS is misplaced. If donor and recipient preferences on allocation are aligned, then fungibility is not an issue. Irrespective of the importance of aid in spending, recipients will allocate aid more or less in the way donors' desire and GBS is appropriate. Furthermore, as White and Morrissey (1997) show, conditionality serves no useful purpose in this case, and may be counter-productive (because unintended non-compliance with conditions may appear as intentional). On the other hand, if

preferences are not aligned, conditionality is ineffective (White and Morrissey, 1997) and fungibility is less likely to undermine GBS if aid is a *large* share of the budget. The intuition here has two elements: i) it is easier to monitor the allocation of spending over broad headings than actual spending on many particular projects, and ii) if aid is a large share of the budget recipients have fewer own resources to reallocate. Thus, fungibility arguments do not undermine the case for GBS to poor countries; fungibility is a ‘red herring’, in the words of McGillivray and Morrissey (2000). A more important issue in choosing GBS over project aid relates to the effectiveness of public spending – donor projects may be more effective than government spending in poor countries – an issue we return to in the conclusion.

Aid comprises a large share of the budget in poor countries, and clearly the impact of aid on fiscal behaviour is an important determinant of the development effectiveness of aid (McGillivray and Morrissey, 2004). The remainder of this paper concentrates on two issues. First, how can donors decide which recipients should receive GBS? Donors cannot be certain of which recipients will allocate and spend aid effectively, i.e. make the best use of GBS, but these are the ones they want to target for GBS. Donors often resolve this problem by selecting for GBS those recipients that implement required prior actions, a form of conditionality. This approach is assessed in Section 2. Second, is concern with fungibility a valid argument against GBS? What do we know about the effects of aid on the allocation and efficacy of government spending, is fungibility a serious problem and what are the implications for aid delivery? These questions are addressed in Section 3. Section 4 concludes that donors should focus attention on how to increase the effectiveness of spending rather than on the allocation of aid across expenditure headings.

## **2. A Model of Selectivity through Prior Actions**

Assume donors only want to give GBS to those countries that will allocate the aid and government spending in the manner approved by donors and in which government spending is effective. Assume further that some recipients are less able to monitor and guarantee the allocation and effectiveness of spending than others because of factors they cannot alter (at least in the medium term), such as administrative inefficiency or low-level corruption, and that donors cannot identify those factors with certainty. In other words, among recipients that could be given GBS there are at least some for which donors are uncertain if they would use GBS appropriately and effectively. Our interest is in how donors can use prior actions (a form of *ex ante* conditionality) to acquire information on the distribution of types of recipients so as to

allocate GBS to the most deserving. We are not here concerned with how prior actions are decided and indeed the model abstracts from the issue of implementing actions; we assume countries will comply if they perceive a benefit, and won't otherwise. Thus, 'undeserving recipients' will not commit to prior actions and will not receive GBS and in this way they are selected out so that GBS is targeted to the most deserving recipients.

We sketch an interpretation of the model proposed in Bougheas *et al* (2005). Consider three types of developing country recipient ( $D$ ) about which donors are uncertain, i.e. they do not know if expenditure would be properly allocated and effective, but they know there are three possible types.<sup>2</sup> The first type ( $s$ ) have strong capacity (i.e. expenditure is allocated as planned and is effective), implying the ability to use GBS effectively. The second type ( $w$ ) has the willingness to allocate GBS as planned but weak capacity to ensure allocation and effectiveness. The third type ( $u$ ) is unwilling to allocate spending as donors wish and expenditure tends to be ineffective; this type can be treated as undeserving of GBS. Assume that the benefit of GBS aid is maximised only if spending is effective and allocation is as agreed with donors (one could think of this as maximising joint utility from spending).

Conceptually, at the beginning of the period, recipients face an *expenditure allocation* ( $e$ ) financed by aid. If  $s$  types implement  $e$  they receive a return of  $X$  at the end of the period, whereas if  $w$  types invest  $e$  their return is  $X - \alpha$  (where  $\alpha$  is a measure of their expenditure inefficiency, in allocation and effectiveness, relative to  $s$  types). However, if  $w$  types undertake adjustment by implementing a set of *prior actions*, which cost  $c$ , then they can increase the return from their expenditure. The parameter  $c$  measures both the extent and the cost of these actions, such as costs of improving expenditure monitoring and management systems. Specifically, if  $w$  types spend  $e$  having implemented the prior actions they receive  $(X - \alpha + g(c))$ ,  $g(0) = 0, g' > 0, g'' < 0, g'(\bar{c}) = 1, g(\bar{c}) = \alpha$ . Evidently the efficient level of adjustment is at cost  $\bar{c}$ ; at this level, spending by  $w$  types yields the same return as spending by the  $s$  types. Adjustment activities have to be performed at the beginning of the period, *prior* to spending (hence, in this model, prior to receiving aid). Type  $u$  economies receive zero benefit if they spend, regardless of whether they undertake prior actions or not (zero benefit is the extreme; it is only necessary that the benefit of GBS is very low).

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<sup>2</sup> We assume only three types for convenience; adding more types increases complexity without providing new insights. Note also that the discussion here is a specific interpretation of a quite general model in Bougheas *et al* (2005).

Each  $D$  economy's type is private knowledge. For any  $k \in \{s, w, u\}$  the proportion of  $k$  types in the pool of  $D$  economies, assumed constant over time, is  $\pi_k$ .  $N$ ,  $X$ , and  $e$  are common knowledge, as is the function  $g(\bullet)$ , but individual outputs are unobservable (e.g. even if expenditure allocation can be monitored, effectiveness is not observed). Adjustment cost,  $c$ , is only observable over intervals, either because government actions exhibit indivisibilities or because a donor's ability to measure adjustment activities is imperfect. As  $(\alpha > \bar{c})$  for  $w$  types, adjustment is worthwhile, but for  $s$  types prior actions impose a net cost (because they are not necessary).

The donor knows some upper bound for  $\pi_u > 0$ , i.e., knows some value  $\lambda \in (0,1)$  such that  $\pi_u \leq \lambda$ . This also implies knowledge of some lower bounds for the deserving types, i.e., that  $(\pi_s + \pi_w) \in [1 - \lambda, 1)$ . The donor does not know the actual proportions, but has prior beliefs about these proportions, given by a subjective distribution function  $H(\pi_s, \pi_u)$ , that need not correspond to the objective distribution. Let  $\theta = \frac{\pi_s}{\pi_u}$ , and let  $F(\theta, \pi_u)$  be the donor's subjective distribution function for  $\theta$ , generated from  $H$  and assume that  $F$  is independent of  $\pi_u$ . In simple terms, donors can have separate views about the proportion of  $u$  types and about the distribution of types. This implies the support of  $F$  must be some subset of  $\left[0, \frac{1-\lambda}{\lambda}\right]$ . Such distributions must exist: for example,  $\theta$  may take the values  $0, \frac{1-\lambda}{\lambda}$  with equal probability.

$$E(\theta, \pi_u) = \theta_E \in \left[0, \frac{1-\lambda}{\lambda}\right]. \quad (1)$$

The donor has a total budget of:

$$B = \kappa N e, \text{ where } 0 < \kappa = \delta(1 - \pi_u) < 1 - \lambda. \quad (2)$$

Since the donor knows  $\pi_u \leq \lambda$ , she knows  $\delta \in (0,1)$ , though she does not know its exact value. Thus, the donor knows her budget is not large enough to award GBS to all effective

economies.<sup>3</sup> Note that the donor would not know this unless she knew some upper bound for  $\pi_u$ . The donor's objective is to distribute the budget among  $D$  economies, so as to maximize their expected total (or average) benefit.

Suppose the donor offers GBS of  $e$  provided the recipient carries out prior actions costing  $\bar{c}$ . All  $u$  types will reject this but all  $s$  and  $w$  types would be willing to implement the adjustment, accept the aid, and use it for spending with a return  $[X - \bar{c}]$ . As  $\delta < 1$ , not all potential recipients can be funded. Assuming funds are allocated randomly, average conditional benefit ( $G_C$ ) therefore is:

$$G_C = \delta[(1 - \pi_u)(X - \bar{c})]. \quad (3)$$

Thus, prior actions succeed in screening undeserving applicants out of the application process, and thereby eliminate 'leakage'. This efficiency in targeting GBS (implementing selectivity, albeit of a self-selection form) comes at the cost of unnecessary adjustment by  $s$  types, which leads to a total wastage of  $\delta\pi_s\bar{c}N$ .

If  $e$  is distributed non-selectively all  $D$  economies will then wish to receive GBS and the equilibrium involves pooling. Given the donor's budget constraint (2), only  $\delta(1 - \pi_u)$  proportion of each type will receive the aid. Average realised benefit ( $G_R$ ) is:

$$G_R = \delta(1 - \pi_u)[(1 - \pi_u)(X - \bar{c}) + \bar{c}\pi_s + e\pi_u]. \quad (4)$$

Thus, non-selective GBS diverts resources away from some  $s$  or  $w$  types, but eliminates waste from unnecessary adjustment. Note that (3)-(4) yields:

$$G_R - G_C = \delta\pi_u(1 - \pi_u)[\theta c - (X - e - \bar{c})], \text{ where } \theta = \frac{\pi_s}{\pi_u}. \quad (5)$$

If the term in square brackets is zero,  $G_R = G_C$ ; if positive  $G_R > G_C$ , and if negative  $G_R < G_C$ . We can define the value of  $\theta$  for which the term in brackets is zero using (5) to get:

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<sup>3</sup> This simplifies exposition, but we only need the budget to be insufficient to cover all  $D$  recipients, i.e.  $\kappa < 1$ .

**Proposition 1.** Let  $\hat{\theta} = \frac{X - e - \bar{c}}{\bar{c}}$ . Given the assumptions:

- (i) there exist distribution functions for  $\theta$  which would make a risk neutral donor prefer prior action selectivity,
- (ii) if  $\lambda$  is believed to be high, then  $\theta_E$  is expected to be low ( $\pi_u$  high relative to  $\pi_s$ ), therefore  $\theta_E < \hat{\theta}$  (implying  $G_R < G_C$ ) and the distribution function for  $\theta$  would make a risk neutral donor prefer prior action selectivity
- (iii) if  $\lambda$  is believed to be low, then  $\theta_E$  is expected to be high ( $\pi_u$  low relative to  $\pi_s$ ), therefore  $\theta_E > \hat{\theta}$  (implying  $G_R > G_C$ ) and there exist distribution functions for  $\theta$  which would make a risk neutral donor prefer non-selective allocation.

By Proposition 1(i), regardless of the values of the known parameters  $X$ ,  $e$ ,  $\bar{c}$  and  $\lambda$ , there will always exist prior beliefs which would justify selectivity. Intuitively, the donor need only expect the proportion of  $s$  agents to be sufficiently small. If the upper bound for the proportion of  $u$  types is sufficiently high, then it is not possible to hold beliefs involving very high proportions of  $s$  types. Consequently, all possible prior beliefs regarding the distribution of  $\theta$ , which are independent of the proportion of  $u$  agents, must justify selectivity (Proposition 1(ii)). If it is believed that the proportion of  $u$  agents is relatively low, i.e.  $\lambda$  is low, then one may expect the proportion of  $s$  agents to be high. Such beliefs would justify non-selectivity (Proposition 1(iii)). Proposition 1(i) implies there would exist other beliefs in this situation that would justify selectivity.

Under plausible restrictions on the prior distribution of beliefs, when individual outputs are unobservable and recipient costs are sufficiently indivisible, donors favouring prior action selectivity would not receive any additional information from the equilibrium. They may learn which recipients are  $u$  types, but they would not get information on the distribution of  $s$  and  $w$  types. Consequently, they would have no reasonable grounds for revising their beliefs and requiring prior actions becomes self-perpetuating. In the context of this paper, the implication is that allocation according to prior actions reveals no objective information on the distribution of types that would facilitate more efficient selection of eligibility for GBS.

In this context, whether a donor advocates prior actions will depend on beliefs about the proportion of recipients for which they imply significant net (excess) costs, and about the proportion that would not utilise GBS effectively. If a donor believes the first proportion is low (i.e., prior actions impose few excess costs on the productive), and/or the second is high (i.e., potential gains from targeting are large), they would advocate prior actions. In this way, it is beliefs regarding the distribution of types of recipient that lead donors to prefer selectivity to non-selective allocation of GBS (where non-selective here means that eligibility is not based on required prior actions). Evidently, the first best allocation involves ensuring that as many of the  $s$  types are covered as possible, without any adjustment. Remaining resources should be used to cover as many  $w$  types as possible, with adjustment, while no  $u$  type should receive any aid (in the form of GBS). However, as type is private information, the first best allocation cannot be attained. The simple point is that requiring prior actions may deliver the targeting benefit of excluding  $u$  types but does so by imposing an excess cost on  $s$  types.

A solution is possible if donors could identify some observable recipient characteristic that is common and specific to each type. Of course, if unique indicators could be identified for each type, donors would face no uncertainty regarding recipient type and this model would not be applicable. Bougheas *et al* (2005) argue that it is not generally possible to identify such indicators for aid or charity in general, but perhaps it is easier in the case of GBS. What information on performance and characteristics of recipients would allow donors to identify those that can make the greatest use of GBS? This is the issue we now turn to by considering fungibility. Note that if one has such information, this determines eligibility and prior actions (conditionality) are not required.

### **3. Government Spending: Fungibility, Allocation and Effectiveness**

In the context of broad conditionality and policy reform, it may be reasonable to assume that donors are relatively uncertain about the type of (most) recipients. In the case of budget support, donors may have sufficient information to identify recipient type (as suitability for GBS), at least to classify under one of the three types we consider. Of course, if they can do so prior action conditionality is not required. Donors do not start from a blank canvas. Although aid modalities and the nature of donor-recipient relations have changed over the past two decades, donors have a long and well-established working relationship with the majority of recipients. Furthermore, while governments may change, the same senior officials usually remain in place, at least in Ministries of Finance. While policy reform is a slow and difficult

process influenced by many economic and political factors, budget and expenditure processes are more clearly defined, both in terms of what is done and of who is responsible. Such processes have also been improved over the past ten years or so, for example with widespread adoption of Medium Term Expenditure Frameworks (MTEFs). In principle, donors are reasonably well informed about how well recipients monitor and allocate expenditure, and are party to the monitoring process; they know where aid goes, even if they don't know how effective spending is. In practice, it may only be the 'lead' donors, the World Bank and IMF, and those large bilateral donors that engage with Ministries of Finance (such as the British and Dutch) that feel well informed about expenditure allocation and monitoring.

Even if donors are collectively fairly well informed about expenditure management, many have reservations about budget support. Typically, as argued above, these reservations relate to concerns about fungibility. In the remainder of this section we argue that such concerns are misplaced, and may even be misleading (there may be other reasons to be concerned about GBS, but here we are only concerned with fungibility). There are two elements to the argument. First, fungibility is a very static concern; it ignores the dynamics of the evolution of spending, and the broader context of the effects of aid on fiscal behaviour (spending, taxation and borrowing). This literature is reviewed in McGillivray and Morrissey (2004), and we only consider the core issues here. Second, fungibility is assumed to be an *action* of recipients – they decide to use aid to achieve an allocation of expenditures that differs from what donors intend. McGillivray and Morrissey (2001) demonstrate that what appears to be fungibility can arise for a variety of reasons and may not be due to purposeful actions of recipients. We sketch their model as they specifically consider ways of delivering aid, such as in kind or matching grants, that are intended to minimise fungibility.

There are many problems with studies of fungibility (McGillivray and Morrissey, 2000, 2004). Typically, analysts focus on the sector allocation of aid in a particular year, ignoring dynamic (or lagged) effects. Given the problems of measuring sector aid (there is rarely good data on how donors intended the aid to be allocated), slow disbursement and the many implementation problems that will occur in spending ministries, it is not surprising that studies find a weak, if any, correlation between sector aid and sector expenditure in any given year. The studies do not explicitly allow for the effect of aid on tax effort or borrowing (the fiscal effects) or on the evolution of total or sector spending. 'It may well be the case that in any given year expenditure outcomes by sector do not correspond closely to aid allocations. If, over time, spending on the headings favoured by donors do increase, then how much of a concern is

fungibility?’ (McGillivray and Morrissey, 2004: 80). If one takes a longer term view, it is the evolution of expenditure that is important, and whether this is in the direction (and at a speed) acceptable to donors. Donors only need to monitor expenditure, such as the MTEF, rather than exercise concerns over fungibility.

Building on the public choice literature on fiscal illusion, McGillivray and Morrissey (2001) propose the concept of ‘aid illusion’ whereby failures in the transmission of information from donors through government policy officials to spending officials (often at the local government level) weaken the links between aid and spending. They propose two levels, negotiation of the ‘parameters’ of aid (e.g. block grants versus matching grants) between donors and recipient policy-makers, and implementing associated spending (a relationship between recipient policy and spending officials). Aid illusion can be shown to generate, *inter alia*, apparent *ex post* fungibility even where preferences are aligned (i.e. policy officials did not intend fungibility) or over—spending (total spending increases by more than the amount of aid, analogous to a flypaper effect, an effect observed in some studies of the fiscal impact of aid).

Conventional treatments of fungibility consider interaction between donors and recipients, where the latter incorporates both the officials who ‘make’ spending plans, and in doing so may treat aid as fully fungible, and those who implement the plans. A richer analysis is provided by treating both ‘levels’ separately. McGillivray and Morrissey (2001) focus on the actions of the implementing official with ultimate responsibility for expenditure on specific headings. These officials are responsible for allocating a given amount of aid within a spending category, but need not know the share of aid in the total revenue pool at their disposal and may not be fully informed of the budget terms on which aid was granted. The finance ministry, or policy officials, draw up the budget and set expenditure plans; they may, or may not, wish to treat aid as fully fungible. The paper allows for possibilities that have been observed in empirical research on the impact of aid on public sector fiscal behaviour. Aid can lead to greater than proportional increases in total expenditure, tax and other recurrent revenue can rise or fall simultaneously, and the conditions for full fungibility can be present. They consider aid in kind and two scenarios for matching grants:

- 1) Donors give aid in kind (e.g. medicines) to ensure it is allocated in the intended area. Policy officials intend fungibility, by planned reallocation of their own resources. However, spending officials perceive aid in kind as reducing the price of a good they require or distribute, increase their demand and overall spending on the sector increases by at least the amount of the aid. *Ex post* there is no fungibility, although it was intended.

- 2) Donors offer a matching grant and policy officials agree with the donors' spending allocation. However, spending officials misperceive the matching grant as a block grant and therefore do not spend as much as intended. *Ex post* there is apparent fungibility although it was not intended; apparent fungibility can arise from implementation rather than intentions.
- 3) Donors offer a matching grant but policy officials intend fungibility. However, spending officials perceive the matching grant correctly and spending increases by more than the value of the aid. intended. Again, *ex post* there is no fungibility, although it was intended. This highlights the fact that it is the action of the spending officials that really matters.

The aim of the analysis is to demonstrate that unintended outcomes can result from misperceptions or illusions regarding either the real or nominal value of the aid inflow, or the way in which the aid is delivered. The analysis is not intended to describe what does happen, rather to highlight the complexity that arises when many levels of officials are involved,<sup>4</sup> specifically that observed fungibility may not be due to purposeful actions. The implications of the arguments in this section are that a focus on conditionality may i) lead donors to incorrectly infer that aid is misallocated because it detracts from considering the evolution of expenditure allocation over time and ii) lead donors to attribute misallocation to the intentions of officials when it is actually due to the complexity of expenditure management and implementation. This does not suggest that intentional fungibility never occurs, but does imply that is sufficient for donors to monitor the evolution of expenditure plans and outcomes.

#### **4. Conclusions and Policy Implications**

This paper addresses two issues related to providing aid in the form of general budget support. First, is conditionality (requiring prior actions) an effective mechanism for selecting which recipients should be eligible for GBS? Second, are concerns about fungibility solid reasons for not providing GBS? The model in section 2 was simply used to demonstrate that, when donors are uncertain about recipient types, the requirement for prior actions (conditionality) is an imperfect selection mechanism. It may exclude the least deserving recipients but does so by imposing an excess cost on the most deserving recipients, and does not help in identifying the

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<sup>4</sup> Note that complexity is increased when there are many donors with different preferences and requirements for aid delivery and monitoring, and also when spending is more decentralised.

latter. The argument in section 3 was that undue focus on fungibility can detract attention from what is really happening. It is useful to draw a distinction between fungibility, where donor and recipient spending preferences differ (by definition), and aid illusion where both donors and recipients have imperfect processes for allocating and monitoring aid expenditures. Most importantly, the analysis highlights that what really matters is ensuring that the officials responsible for spending have full and correct information.

Taken together, the argument is that donors need only be concerned that recipients share their spending allocation preferences. This can be determined by observing expenditure allocation plans and outcomes, a monitoring process that has become almost a routine feature of donor-recipient relations. If preferences are aligned, GBS can be granted: conditionality is not required (and is not even helpful) and fungibility concerns are not relevant. If preferences are not aligned, then GBS is not appropriate, and again conditionality is unlikely to serve a useful purpose (as it will not align preferences). If donors want to deliver aid through the budget, they can use mechanisms such as aid in kind or matching grants to minimise fungibility (but it is important to ensure that spending officials are fully aware of the aid modalities). Alternatively, donors could choose to fund projects directly.

The argument in section 2 is an example of a more general critique of conditionality for selection. Morrissey (2005b) uses the model to discuss conditionality and selectivity more generally, and builds on Morrissey (2005a) to argue that a partnership built on dialogue and monitoring the use of aid is preferable to selectivity based on conditionality. The World Bank is also adopting more flexible, simple and transparent approaches to conditionality, advocating ownership and partnership and ‘an approach based on reputation and results’ (Koeberle, 2005: 66). However, prior actions are still viewed as an important element of conditionality, if only to signal commitment to a particular direction of policy. Emphasising ownership does not necessarily resolve the inefficiency of prior actions as a basis of conditionality outlined in Section 2. For example, a recipient may commit to a particular policy action not because it believes it is the best option but because it knows the donor favours that action. Furthermore, although monitoring is seen as important, it is not usually interpreted simply as monitoring the way in which aid is used but rather ‘monitoring has typically focused more on compliance with ex ante conditionality than on progress, outcomes and poverty impacts’ (Koeberle, 2005: 74). Conditionality may have a role to play, but our argument is that it should not have a role in determining eligibility for GBS.

Even if preferences are aligned, GBS is not necessarily better than project aid as this depends on the effectiveness of public spending – donor projects may be more effective than government spending in poor countries. For example, Gomanee *et al* (2005) show that although aid increases government spending on social sectors in low income countries, government social spending is not effective in delivering welfare improvements, whereas aid is effective (perhaps through projects). On the other hand, government social spending is effective in middle income countries, but aid has no discernable effect on the level of social spending (perhaps because aid is a small share of spending). This is an empirical question, and we are not aware of much evidence comparing the effectiveness of donor project spending versus government spending. The practical implication is that donors could continue with project aid (where they can demonstrate that it is effective) even where much aid, or some donors' aid, is channelled through GBS. This may appeal to some small donors who are reluctant to commit to budget support. Belgium, for example, prefers project aid because that is where the aid agencies experience lies and they feel unable to play an influential role on general budget allocation (Holvoet and Renard, 2005: 143).

In conclusion, the argument of this paper is that it is appropriate to give aid as GBS in those countries where expenditure allocation is monitored and seen to be broadly aligned with donor preferences. Donors should have sufficient experience and information to be able to identify such countries. Prior actions or conditionality for receiving GBS are unnecessary, and there is no need to be concerned with fungibility. However, it is important that donors focus attention on improving the effectiveness of government spending to ensure that GBS is used effectively. There will continue to be a role for donor project aid in countries where government spending has low effectiveness, although donors should be able to demonstrate that their project spending is effective. In countries where donor and recipient expenditure preferences are not aligned, there is little justification for GBS; the implication is that in these countries more effort and dialogue is needed to align spending and, most likely, improve expenditure planning and monitoring. Conditionality will not necessarily improve this process. There are still ways that donors can influence where aid is spent, such as by providing aid in kind and matching grants, but the success of this will depend on getting correct information to officials responsible for spending. Budget support is not always and everywhere appropriate, but increasing the effectiveness of spending is a priority in all recipients.

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