DIIS POLICY BRIEF
Elites, Production and Poverty: A Comparative Analysis

# Recurrent cost boom threathens Millennium Development Goals

**November 2010**

**At the September 2010 UN summit on the Millennium Development Goals the Secretary-General stressed that tremendous progress in school enrolment, disease control and access to clean water had been achieved. This policy brief addresses a question that he did not talk about. How shall the achievements in relation to the goals be sustained beyond January 1, 2016?**

## THE OTHER SIDE OF SUCCESS

The long-term financing of the costs of the Millennium Development Goals – the MDGs – must urgently be addressed. Otherwise, present achievements can be undermined by a potential recurrent cost boom in many poor donor-dependent countries.

The overall gains since 2000 in reaching the goals are impressive, albeit uneven. Several poor countries have made substantial progress compared to the situation ten years ago, but some countries in Africa and elsewhere will not reach them fully – especially not the goal of halving poverty by 2015. At the recent UN summit on the Millenium Development Goals, however, Ban Ki-moon asserted that though ambitious, the goals are doable by 2015 if urgent steps are taken on aid, trade and debt relief. That is the encouraging side of the story.

Other aspects of the story attract much less attention. The future recurrent cost obligations a country faces grow much bigger the closer it comes to reaching the goals. In addition, the more success a poor country has in mobilizing aid to reach the goals, the more aid-dependent it becomes.

## RECOMMENDATIONS

- Focus on and support to productive sectors, without which the future tax base will be insufficient to sustain the real MDG gains already made

- Further strengthen efforts to improve domestic revenue mobilization (tax reform, improved tax administration)

- Combat illicit financial flows from poor countries – most of which aims to avoid local taxation

- Place the recurrent cost implications of budget and project aid support centrally in donor-recipient policy negotiations, and base them on better analyses

- Reduce the donor-dependency effects of the aid financing of recurrent costs by establishing more balanced and explicit rules for donor withdrawal of aid.

## WHO PAYS THE BILLS AFTER 2015?

For a poor country to reach the goals it needs, for example, to: 1) increase investments in infrastructure, water, education and health facilities; 2) hire more teachers, nurses, and doctors and pay them regularly thereafter; 3) provide funding for annual building repairs, drug supplies, teaching material, spare parts, and so on. New investments are primarily funded by donors. The *recurrent* expenses are eventually to be financed by the recipient country itself through its recurrent budget for wages and non-wages.

If the recurrent budget is too small compared to growing MDG-driven investments, or if funds leak from the budget to other uses – including corruption – the results are dilapidated educational and health infrastructure and services; water supply systems that run dry; roads and irrigation schemes that need regular rehabilitation soon after their construction (or since their last rehabilitation); poorer investment climate; too little staff to meet demand; lack of basic drugs, educational material and spare parts etc. Signs of poor services due to recurrent cost problems seem to increase with the distance from the capital or from the district headquarters, and with the poverty of inhabitants.

While financing of recurrent costs through private sector provision and user fees can be important, tax and aid financing of free services and infrastructure are also needed, if the poorest groups are to be reached.

## DEVELOPMENT AND DEPENDENCY

So, are the MDG achievements sustainable for poor countries? Recurrent cost problems are not new at all. They have existed for decades. The drive to reach the goals has merely amplified the challenges of operating and maintaining services of an acceptable quality. Many factors combine to make recurrent cost problems a threat to MDG sustainability. Unfortunately, very little reliable and comparable data is available on this and there is substantial cross-country variation, but several larger trends justify the concern.

### WHY DO RECURRENT COST PROBLEMS PERSIST?

The reasons for the persistent recurrent cost challenge in poor countries are manifold, but seven factors are important.

1) Recurrent cost problems in poor countries arise because of the budget-making process. Assumptions about future revenue and expenditure budgets are typically very optimistic and unrealistic (a bias often shared with donors). In addition, the link between investments and recurrent budgets is very weak. The former are dominated by donors. The latter are underfinanced because requirements are not linked to actual needs, and because domestic revenues are limited.

2) Problems with budget execution add to the underfinancing of recurrent costs. Public Expenditure Reviews show that funds earmarked for investment or for buying spare parts, school materials, drugs etc. (non-wage expenses) are often used to pay staff-related expenses instead (wages, bonuses, allowances etc). The end result is that non-wage items are severely underfinanced, while wage-related expenses seem to benefit from the day-to-day budget transactions that bureaucrats are involved in.

3) There are clear political dimensions to this. Poor countries prefer to over-budget investments and underestimate wages, since for a long time donors have preferred to provide funds for new investments, which they regard as the main drivers for development. New investments are also linked to increasing donor obsession with accountability and results. It is easier to show photographs of completed infrastructure than of service improvements due to a better spare part supply financed through budget support.

4) Recipient politicians have a similar bias. During elections, new roads/classrooms/clinics are promised to mobilise votes – not better funding of existing facilities – and this reflects what many voters think. In addition, new facilities make it possible for voters to assess that politicians deliver what they promise: facilities are visible and easily observed; hence the eagerness with which politicians want to spread them all over the country and hence their willingness to inaugurate new projects.

5) Politicians in poor countries typically try to establish good relations with powerful groups, so as to maintain power. In developed market economies it is the business interests which are important to keep on good terms with as they control economic resources. But in poor countries formal capitalist interests are few and weakly organised. Moreover, the intended beneficiaries of government-provided services rarely organise protests against poor schools, health facilities and infrastructure. In contrast, public sector employees are often well organised and more numerous than the number of people employed in the formal private sector - mainly because the expanding health and education sectors are labour intensive.

6) This particular nature of politician-bureaucracy relations in poor countries is an important explanation for the persistence of the recurrent cost problem. For public sector bureaucrats use their strong position to bargain for better employment conditions. They also often divert resources into wage-related expenses from other parts of the budget as documented in many countries by auditors, expenditure reviews and others. Politicians (and donors) apparently will not, or cannot, enforce compliance by the bureaucrats to prevent this divertion in the day-to-day execution of the budget.

7) A continued shaky domestic tax base provides an insufficient financial basis for sustaining the MDG achievements in many poor donor-dependent countries.

Obviously, the successful drive to reach the goals increases the future annual recurrent cost bills – especially in the social sectors. Budgets for salaries and operating expenses must increase significantly in order to reach the whole population. The rapid increase in aid to many poor countries over the last decade has helped to make this possible.

In addition, the partial abolishment of user fees gives poor people better access to services in many countries. Without this, significant progress towards the goals would simply be impossible. On the other hand, this rights-based approach amplifies the problem of financing because it reduces the resources available to pay for recurrent costs.

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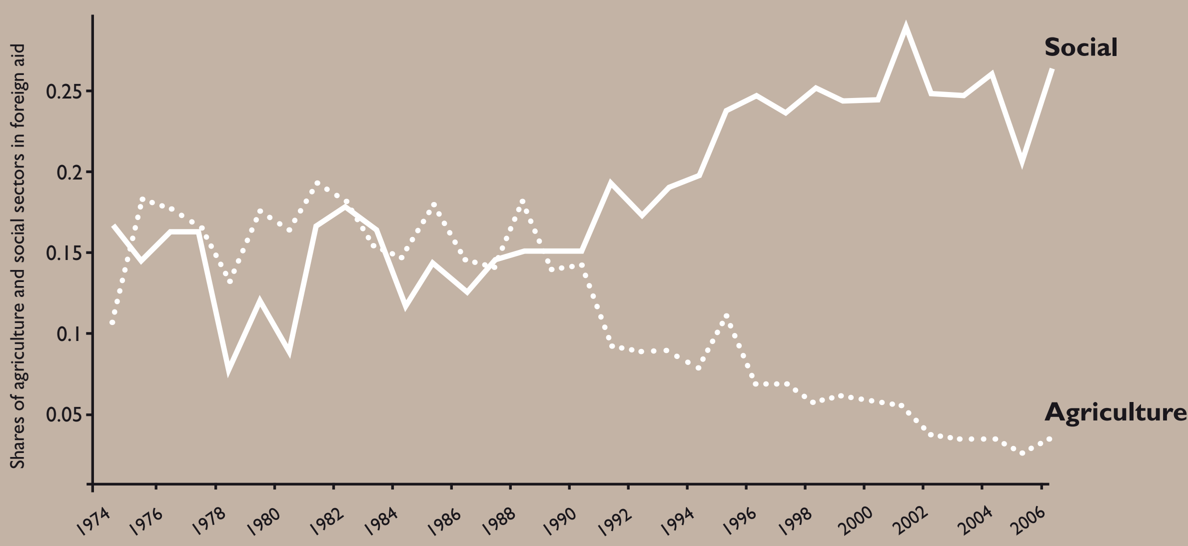
### Shaky tax revenues

Poor countries' longer-term ability to pay for their progress is generally shaky. Their tax base has not expanded significantly for decades. One reason for this is that donors and recipient countries alike have moved funds from the productive sectors towards the social sectors. While many social-sector expenditures are important for improving livelihood and future economic growth, the shift out of agriculture has been quite dramatic as the figure below illustrates. Yet, small holder agriculture is central for growth in the wider economy and for poverty alleviation. Efforts in poor countries to industrialise have also been very modest since the structural adjustment reforms of the 1980s. As a result, in most poor countries the transformation of the economy through increased productivity in agriculture and industry is slow, at best. This weakens the taxable economic base needed to help pay growing recurrent cost bills in the future.

International pressure has also been helped to lower trade and corporate taxes since the early 1980s – and only little effort has been made to combat illicit outflows of taxable incomes, especially from multinational companies. Indeed, the growth in tax revenues in sub-Saharan Africa has been modest, except for the few countries that exploit their natural resource base (although its existence is no guarantee for better public revenues), and some that have managed to improve tax collection. Strikingly, the number of countries with ratios of tax revenue to GDP of less than 15% has only fallen from 16 to 12 since the early 1980s. It is preferential trade agreements, improved global commodity prices and sometimes better tax administration – and not a transformation of the economy – that explain the slow improvements in taxation that have been recorded in some countries since the 1980s. Unfortunately, the global financial crisis threatens these modest revenue achievements.

**The shift out of agricultural aid into socal sector aid**



## THE ROLE OF DONORS

The number of donor-supported projects in developing countries is increasing rapidly, despite project aid's well-known recurrent cost problems. Donors typically require recipient country co-financing of project investments. This means that domestic funds for recurrent financing are reduced. In addition, a substantial share of project aid is not included in the recipients' budgets (although some progress has been made) and this makes it difficult to estimate and plan future recurrent cost needs. Past experiences show that when donors withdraw from projects, recipient governments – or beneficiaries – often fail to pick up the recurrent cost bill.

In 2007 developing countries hosted some 90.000 to 130.000 projects – the latter figure includes aid through NGOs and for refugees, food and humanitarian purposes etc. Sixty percent of these projects were in the social sectors. The five poor countries shown in the table below hosted around 8000 donor-funded projects in 2007.

**Budget support and number of aid funded projects, 2007**

| Country | Percent of total aid as budget support | Number of projects |
|---|---|---|
| Bangladesh | 31 | 1117 |
| Ghana | 35 | 882 |
| Mozambique | 29 | 2409 |
| Tanzania | 40 | 1601 |
| Uganda | 34 | 2110 |

These countries are included in the DIIS-coordinated research programme: "Elites, Production and Poverty: A Comparative Analysis". See www.diis.dk/sw79386.asp

Paradoxically, increased project aid has gone hand in hand with increased budget support, which makes it possible for recipient governments to use part of the latter to pay for recurrent costs. On average, one-fourth of the official development assistance is now provided as (sector) budget support, although there are significant differences across countries. Donors are therefore picking up part of the recurrent cost bill – more so than they did thirty years ago. This does help, here and now, to ease the recurrent cost problems generated by the MDG achievements. But it also increases donor dependency in a manner that project aid does not. The reason is that part of this aid is used to fund public servant salaries, allowances and perks. Reductions in budget support – typically when donors are dissatisfied with recipient policies or (governance) performance – therefore directly affect government expenditures for day-to-day provision of services. Thus, the MDG-drive has made many poor countries more donor-dependent, and in a more risky manner than before.

So, given these many factors, has the MDG-drive added to the age-old recurrent cost problems in poor countries? Any observer travelling in the cities and country-side would confirm that they face considerable recurrent cost problems already now. However, unreliable budget and expenditure data makes it very difficult to assess the financial magnitude of the problem. Cross-country quantitative comparisons of changes in the recurrent cost problem over time are therefore also difficult to make. What can be said with certainty is that all poor countries which have progressed towards the MDGs face substantial recurrent cost problems in the future. Unfortunately, the actions taken so far to deal with the problem even with the increased use of budget support, are not sufficient.

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## FURTHER READING

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