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DEVELOPING YEMEN'S AID POLICY

Working Paper 6: Aid Absorption Capacity Study

Draft for discussion

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Executive Summary

This study puts forward a number of preliminary suggestions with regards to aid absorption capacity in Yemen. From a macroeconomic perspective, Yemen is able to absorb a significant increase in aid before any ‘Dutch Disease’ effects will start making a negative impact on various macroeconomic indicators. From a microeconomic perspective Yemen is also able to absorb more aid resources than it is currently doing without triggering decreased effectiveness of this step-up in aid and undermining incentives for further reform.

This study points to a degree of variation between different sectors, and within sectors, in the speed and quality of aid absorption – and there is a number of encouraging examples of GoY making significant progress in addressing and eliminating these various key bottlenecks that impede progress towards development objectives. Significant progress in aid management, including an improvement in confidence between the GoY and donors, is made where there is a coherent (sector) strategy in which roles and responsibilities of each stakeholder is clearly defined.

Nevertheless, it is critical that the GoY further refines its reform programmes in the areas of civil service reform, decentralisation and public finance management to address important governance constraints and delivers on these. Decisions by the donor community on a scale-up in aid are likely to be strongly influenced by the deliverability of these reforms.

Abbreviations

AACS	Aid Absorption Capacity Study
AFMIS	Accounting and Financial Management Information System
AHA Unit	Aid Harmonisation and Alignment Unit (MoPIC)
APP	Aid Policy Paper
CG	Consultative Group
COCA	Central Organisation for Control and Audit
CPIA	Country Policy and Institutional Assessment (World Bank)
DCR	Development Cooperation Review
DLDSP	Decentralisation and Local Government Support Programme
DFID	Department for International Development (United Kingdom)
EC	European Commission
FMR	Financial, Procurement and Physical progress reports (World Bank)
GDP	Gross Domestic Product
GoY	Government of Yemen
HSRP	Health Sector Reform Project (World Bank funded)
IDA	International Development Association (IDA)
IMF	International Monetary Fund
LAL	Law on Local Authorities (2000)
MDGs	Millennium Development Goals
MoPIC	Ministry of Planning and International Cooperation
MTEF	Medium Term Expenditure Framework
NBEDS	National Basic Education Development Strategy
NGOs	Non Governmental Organisations
NWSSIP	National Water Strategy and Investment Programme
ODA	Official Development Assistance
OPEC	Organisation of the Petroleum Exporting Countries
PWP	Public Works Project
PEPA	Petroleum Exploration and Production Authority
PFM	Public Financial Management
SFD	Social Fund for Development
UNDP	United Nations Development Programme

1. Introduction: objective of the aid absorption study and relation to the aid policy process

The objective of this study is to provide an analytical overview of aid absorption capacity in Yemen including current status and identification of challenges, obstacles, as well as opportunities at the macro and micro levels. This study also provides recommendations and practical guidelines to improve the absorption capacity and hence increase aid flows to Yemen. This aid absorption capacity study (AACCS) should be seen as an integral part of the preparation of the Aid Policy Paper (APP), since it provides the most detailed analysis of the challenges that the APP will need to address.

2. Conceptual framework for addressing aid absorption capacity

The existing literature on aid effectiveness is largely focused on the impact of aid flows on economic growth rates and subsequent impact on poverty levels. At the same time, many argue that the impact of aid depends as much on the quality of the recipient country's institutions and organisations. In this respect, there are indications that aid, like all other investments, has diminishing returns. If this is true, then it is reasonable to expect that the bigger and faster an increase in aid flows, the sooner diminishing returns will set in, as it will put additional strains on existing systems. The rationale behind aid absorption capacity is to identify those obstacles that are limiting aid effectiveness.

A 2005 ODI Briefing Paper¹ sets out a useful framework for assessing aid effectiveness constraints and identifies four areas of potential bottlenecks: (i) macroeconomic constraints, (ii) institutional and policy constraints, (iii) technical and managerial constraints, and (iv) constraints generated by donor behaviour. The sub-sections below describes each of the four constraints (borrowing from ODI's analysis).

2.1 Macroeconomic constraints to aid absorption

Macroeconomic constraints can have an impact on the effectiveness of aid in four ways. First, large and sudden aid increases in the form of foreign currency can cause an appreciation of the exchange rate and subsequent harming of export sector competitiveness, i.e. Dutch Disease effects. Second, there may be concerns regarding debt sustainability when increased aid flows are in the form of loans, even if they are concessional. Third, aid flows are often unpredictable and volatile and may negatively influence macroeconomic stability, by triggering inflation, interest-rate and exchange rate volatility. This is particularly relevant when the aid is in the form of direct budget support – when aid disbursements are delayed it not only affects programme implementation but the government may need to borrow funds to cover for the period within which disbursements had to take place. Fourth, in some countries aid increases can cause labour market pressures by increasing demand for skilled labour and driving up wages. Potential macroeconomic constraints to aid absorption capacity are discussed in section 4 of this note.

2.2 Institutional and policy constraints to aid absorption

Institutional and policy constraints determine the capacity of countries to generate positive development outcomes. In this respect, countries must be able to generate credible strategies, policies and programmes to transform higher aid levels into better development outcomes. Other relevant factors are: the transparency and efficiency of the budgetary system, patterns of public expenditure, the degree of decentralisation of resources and responsibilities, clarity in institutional roles and mechanisms to define policy priorities and accountability systems to hold governments responsible. The combined functioning of these different systems may be inadequate to absorb

¹ ODI (2005) *Scaling Up versus Absorptive Capacity: Challenges and Opportunities for Reaching the MDGs in Africa*.

increased aid without increasing wastage and resource leakage. Increasing levels of aid dependency can also provide negative incentives for much needed reforms.

2.3 Technical and managerial constraints to aid absorption

Technical and managerial constraints are related to institutional and policy restrictions. This has several dimensions: the need of quality human resources should not be overlooked when investing in schools and health care services; a lack of appropriate infrastructure and equipment prevents access to goods and services; a significant boost in the availability of public services might be confronted with a lack of demand from the intended service users, as i.e. socio-economic factors may still prevent poor families from sending female children to school.

2.4 Constraints to aid absorption generated by donor behaviour

Finally, constraints generated by donors may be a source limiting absorptive capacity. A lack of predictability in timing and disbursement may hamper efforts at medium and short-term planning and programme implementation. Donor interventions may not be aligned to government priorities and there may be challenges around a coordinated approach between different donor organisations. Donors, for a variety of reasons, may also impose specific financial management and reporting procedures. Such fragmentation may can impose substantial transaction costs and distract attention of civil service managers from their core tasks.

The above categorised constraints can be binding in the short and long term. Box 1 depicts a non-exhaustive list of issues that impact on aid effectiveness.

Box 1: Aid absorption capacity constraints: short and long-term

Short-term constraints	Long-term constraints
<ul style="list-style-type: none"> • Large increase of aid flows may impact country competitiveness • Aid volatility • Inadequate public finance management and accountability systems • Perverse incentives in public officials' performance, undermining incentives for reform • Lack of adequate infrastructure and equipment • Uncoordinated donor interventions 	<ul style="list-style-type: none"> • Debt sustainability • Major deficiencies in institutions and policy processes, inability to address resource leakage • Levels of aid-dependency • Technical and managerial skills of public officials • Social/cultural factors determining demand for services • Difficulties in bringing about a full donor shift to improved practices

This table is adapted from ODI (2005) Scaling Up versus Absorptive Capacity: Challenges and Opportunities for Reaching the MDGs in Africa.

3. Measures of absorptive capacity

A partial and imperfect way to measure a number of aspects of aid absorptive capacity constraints is a comparison of actual with planned (scheduled) disbursement rates of donor funds. It is partial insofar that it does not examine the quality of aid (in terms of results achieved) disbursed, it equally does not address macroeconomic constraints and only captures the unexpected element of constraints since it measures the difference between planned and actual aid disbursements. Furthermore, the ratio of disbursement versus commitments may not necessarily reflect aid absorption capacity as constraints might already have been taken into account in conservative plans and

commitment figures. Nevertheless, a comparison of disbursement rates is a useful indicator for comparing performance for different sectors, different donors and different modes of aid delivery and so *identifying particular problem areas*.

This section compares disbursement versus commitment figures for different donors and highlights programmes where disbursement ratio was very high (equal or greater than commitments) or very low.

INSERT RESULTS FROM OECD-DAC PARIS DECLARATION MONITORING SURVEY IN YEMEN

In Yemen, there is currently a lack of reliable information on commitment and disbursement rates – per donor and per programme and project. A review of the Development Cooperation Review (DCR) compiled by the AHA Unit revealed that while some donors provided information, usually downloaded from their own systems, it is difficult to compare figures as different financial years, inconsistent use of terms and definitions, i.e. disbursements, commitments are used. There are some clues to be found in several donor reviews, such as the World Bank's Country Performance Portfolio Review, but these only assess World Bank- funded projects. Therefore, any conclusions regarding status and trends would be preliminary. The patchiness of information was because of the unwillingness of a several donors to provide information but also to the lack of targeted requests by the team compiling the DCR.

Nonetheless, access to information that would allow some judgement on aid absorption capacity constraints will become available shortly (August 2006) – and this section will subsequently be updated according to the results from the OECD-DAC Paris Declaration Monitoring Survey. The point of the Survey is to track progress against the principles of: ownership, alignment, harmonisation, managing for results and mutual accountability. The OECD-DAC Survey has been adapted to the Yemeni context and it complemented by data requests for specific projects.

The outputs of the Survey are likely to reveal, amongst others, the following points:

- Whether aid flows are aligned to *national priorities* through measurement of the percentage of total ODA disbursement was for the government sector;
- How much technical cooperation disbursed was part for coordinated technical cooperation in order to *strengthen capacity*;
- How much ODA was disbursed through using *national* budget, financial reporting, financial auditing and procurement systems?
- A measurement of the *predictability* of aid through measurement of total ODA for the government sector that was scheduled for disbursement in the previous financial year. Disbursement figures are then compared to original commitment figures;
- Specifically, the Yemeni-adapted Survey is likely to provide a comprehensive picture to which sectors and governorates aid funds are targeted to.

4. Macroeconomic framework and constraints

The purpose of this section is to assess whether there are any aid absorption capacity constraints at the macro level. This section is organised in the following manner: first it provides information on the status and outlook of the macroeconomic environment; it then provides some theory on aid absorption capacity at the macroeconomic level, followed by some thoughts on aid absorption issues in Yemen.

The macroeconomic framework addresses issues such as long-run debt sustainability, prudent levels of aid dependence, aid volatility and potential appreciation of the exchange rate and subsequent impact of export competitiveness. These issues are important for taking a longer-term view on aid absorption capacity and are likely to be a central focus of attention in the November 2006 Consultative Group (CG) Conference particularly because of concerns regarding Yemen's long-run debt sustainability as oil revenues are projected to fall. The macroeconomic side of scaling up aid is critical but often overlooked, with potential conflicts between strategies to

achieve the Millennium Development Goals (MDGs) and prudent macroeconomic management (and sometimes fiscal constraints imposed by the IMF).

4.1 Yemen Macroeconomic Status and Outlook

4.1.1 Macroeconomic Status

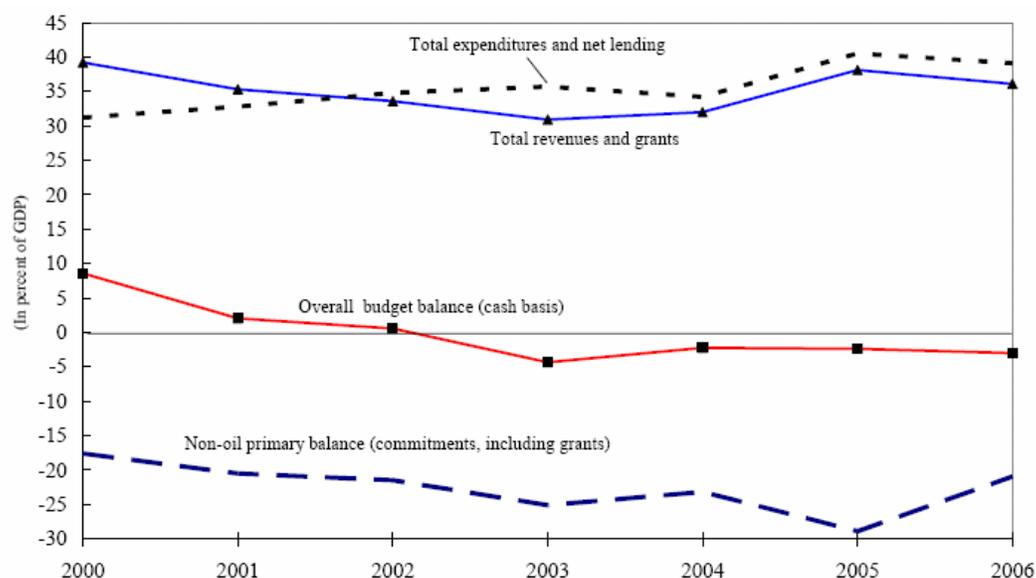
Table 1 provides several macroeconomic indicators for the period 2002-2006 (information for this section is extracted from the 2006 IMF Article IV report which is still embargoed). The macroeconomic indicators for 2005 turned out better than expected due to high oil prices, which resulted in 45 per cent more oil revenues than originally projected. While high oil prices kept the overall fiscal deficit relatively stable compared to 2004, the underlying non-oil deficit deteriorated (see figure 1). The central government overall fiscal deficit was estimated at 2.4 per cent of GDP in 2005, compared with 2.3 per cent in 2004. Inflation increased sharply, from 14.5 in 2004 to 20.2 per cent in 2005 predominantly reflecting the GoY's decision to raise domestic fuel prices.

Table 1: Selected Macroeconomic Indicators 2002-2006

	2002	2003	2004	Est. 2005	Proj. 2006
(Change in percent)					
National income and prices					
Real GDP	3.9	3.1	2.6	3.8	3.9
Real non-oil GDP	4.6	4.0	4.1	4.5	5.4
Real oil GDP	0.4	-1.8	-6.9	-0.9	-6.3
Core consumer price index (end-of-period) 1/	4.5	12.1	14.5	20.2	12.0
(In millions of U.S. dollars)					
External sector					
Exports, f.o.b.	3,584	3,923	4,662	6,624	7,026
Of which: crude oil	3,134	3,417	4,046	5,830	6,118
Imports, f.o.b.	3,083	3,557	3,858	4,538	6,198
Current account, incl. official transfers (in percent of GDP)	5.4	-0.1	1.9	4.7	-4.6
Overall balance (deficit-)	752	583	604	306	231
(In percent of GDP)					
Financial variables					
Overall fiscal balance, commitment basis (deficit-)	-1.2	-4.8	-2.3	-2.4	-3.0
Primary non-oil fiscal balance, commitment basis (deficit-)	-21.5	-25.1	-23.2	-28.9	-26.4
(12-month change in percent)					
Broad money	18.0	20.0	15.0	14.4	15.4
Credit to private sector	14.3	26.3	33.5	21.3	22.3
Benchmark deposit interest rate (percent per annum)	13.0	13.0	13.0	13.0	...
Central bank own gross foreign reserves 2/					
In millions of U.S. dollar	4,056	4,445	5,108	5,370	5,762
In months of next year's imports of goods and services	12.1	12.5	12.6	9.6	9.8

Source: embargoed IMF Article IV Report, 2006

Figure 1: Trends in Budgetary Indicators



Source: embargoed IMF Article IV Report, 2006

The non-oil primary deficit increased by nearly 6 percentage points – to 28.9 per cent of GDP (see table 2). Much of the increase in government revenues from higher oil prices was used to finance the subsidy on domestic fuel prices (about 9 per cent of GDP). In addition, virtually all other areas of current expenditures rose, with the sharpest increases seen in defence and civilian wages and salaries.

Table 2: Central Government Finance 2002-2006 (in per cent of GDP)

	2002	2003	2004	2005 (estimated)	2006 (projected)
Overall Fiscal Balance	-1.2	-4.8	-2.3	-2.4	-3.0
Primary non-oil fiscal balance	-21.5	-25.1	-23.2	-28.9	-26.4
Total Revenues and Grants	33.6	30.9	32.0	38.1	36.1
Oil and gas revenues	22.3	22.1	23.1	29.0	25.8
Tax revenues	7.5	6.7	7.1	7.4	7.7
Direct taxes	3.2	3.1	2.8	3.3	3.6
Indirect taxes	4.2	3.5	4.3	4.1	4.1
Grants	1.6	0.4	0.7	0.0	0.6
Total Expenditure and net lending	34.8	35.7	34.2	40.5	39.1
Current Expenditure	27.7	26.7	24.7	31.2	30.6
Transfers and subsidies	7.2	8.1	9.2	13.2	12.0
Wages and salaries (civilian)	7.7	6.6	6.4	6.8	7.3
Goods and services	2.6	2.4	0.6	0.9	1.0
Interest obligations	2.0	1.7	2.2	2.4	2.4
Development capital expenditure	7.1	9.1	7.9	7.3	7.0

Source: IMF estimates, March 2006. Note: Primary non-oil is derived by subtracting interest obligations and oil and gas revenue from overall balance (commitment including grants).

4.1.2 Medium Term Macroeconomic Outlook

The medium term outlook is clouded by the projected deterioration in oil output. Yemen relies on oil for some 80 per cent of export receipts and 75 per cent of government revenue. Unless, significant discoveries are made, oil reserves could be depleted in about 12-15 years and in the meantime production would fall sharply. The reserves-to-production ratio which indicates how long reserves would last if production were to continue at the current pace is only 5 years for proven reserves (measured in 2005); and 10 years for probable reserves. Adjustment to the

expected sharp decline in oil production and revenue, and the shift to a non-oil economy will likely require some depreciation of the Yemeni Rial in real effective terms.

The projected decline in Yemen's oil reserves over the medium term presents a considerable challenge. To illustrate the consequences of inaction, the IMF estimated a non-adjustment scenario for the medium term. The scenario assumes minimal changes to current policies and little headway in structural reforms. The share of budgetary oil revenue to GDP would decrease by more than half by 2011. The overall budget deficit would grow to about 20 per cent of GDP by 2011, while the current account balance would balloon to a deficit of 4.2 per cent. International reserves would likely decline to slightly above half a billion dollars, equivalent to about a month of prospective imports. Critically, the debt-to-GDP ratio would rise to unsustainable levels. To finance such large deficits in the future, the government would have to:

- rely on issuance of domestic debt, which would crowd out private sector investment;
- accumulate debt to unsustainable levels; and,
- resort to monetary financing, leading to high inflation rates and a sharp depreciation of the Yemeni rial.

4.1.3 Debt Sustainability

The IMF together with the World Bank undertook an analysis of debt in Yemen and likely scenarios going forward. Currently, Yemen's total external public debt was slightly over US\$5 billion at the end of 2005 (35 per cent of GDP), of which US\$1.3 billion is owed to the Russian Federation and US\$0.6 billion in arrears. Other external obligations (49 per cent of total external debt) are most to multilateral creditors, primarily the World Bank (US\$1.7 billion to IDA). Yemen benefited from a series of rescheduling arrangements under the Paris Club. The stock of domestic debt is equivalent to about 7 per cent of GDP.

External debt dynamics are particularly vulnerable to a slowdown in growth or a sharp depreciation of the exchange rate. According to analysis done by the IMF and the World Bank, the risk for Yemen of debt distress is moderate, but the preponderance of risks is on the downside. Without a strong commitment to growth enhancing policies and careful debt management, Yemen's external debt sustainability could be compromised over the long term. In the words of the IMF and the World Bank: a cautious approach towards debt, coupled with a strategy of seeking a higher level of grant financing seems warranted.

4.2. Aid Absorption at the Macroeconomic Level

4.2.1 International comparisons of aid at the macroeconomic level

There are indications that aid, like other forms of investments, has diminishing returns. Most studies indicate that an 'aid saturation' point could be reached anywhere between 15 and 45 per cent of GDP. Extending this cross-country analysis, it would appear that Yemen is 'under serviced' in aid, particularly in comparison to other least developed countries and countries with low human development scores, see table 3. From this perspective, Yemen should be able to absorb significantly more resources.

Table 3: Yemen Receives a Comparatively Low Amount of ODA, selected countries and indicators

	Aid per capita (US\$), 2003	Percentage of GDP, 2003	Net FDI inflows Percentage of GDP, 2003	Debt Service as Percentage of GDP, 2003	Debt service %age exports goods, services & net income from abroad, 2003
<i>Yemen</i>	<i>12.7</i>	<i>2.2</i>	<i>-0.8</i>	<i>1.6</i>	<i>4.0</i>
Least Developed Countries	33.4	18.7	3.6	2.1	7.5
<i>Lao PDR</i>	<i>52.8</i>	<i>14.1</i>	<i>0.9</i>	<i>2.3</i>	<i>10.3</i>
<i>Nepal</i>	<i>18.9</i>	<i>8.0</i>	<i>0.3</i>	<i>1.9</i>	<i>10.0</i>
<i>Papua New</i>	<i>40.1</i>	<i>6.9</i>	<i>3.2</i>	<i>9.3</i>	<i>7.3</i>

Guinea					
Timor-Leste	186.1	44.2
Arab States	27.5	1.6	1.7	2.5	15.5
Egypt	13.2	1.1	0.3	3.4	...
Jordan	232.5	12.5	3.8	11.7	22.6
Lebanon	50.8	1.2	1.9	17.1	81.5
Oman	17.1	8.6	5.3
Sub Saharan Africa	32.9	18.6	2.2	2.9	9.6
Ethiopia	21.9	22.6	0.9	1.4	7.3
Mozambique	55.0	23.9	7.8	2.0	3.9
Rwanda	40.2	20.3	0.3	1.3	10.0
Tanzania	46.5	16.2	2.4	0.9	5.8
Low Human Development	27.9	18.7	2.8	3.3	10.2
Djibouti	110.4	12.5	1.8	2.5	...
Eritrea	70.0	40.9	2.9	1.6	13.0
Haiti	23.7	6.8	0.3	1.8	10.8
Sierra Leone	55.7	37.5	0.4	3.2	10.9

Source: UNDP Human Development Report 2005

4.2.2 Distinction between absorption and spending of aid at the macro level – what does it mean?

When aid is transferred to an economy, the foreign exchange reserves accrues in the first instance to the Central Bank reserves, while the recipient government is credited with the value in domestic currency. The utilisation of foreign exchange is denoted as ‘*absorption*’ and the utilisation of the domestic counterpart as ‘*spending*’ of aid. In other words:

- *Absorption* is defined as the widening of the Balance of Payments deficit (excluding aid) due to more aid. Absorption depends both on exchange rate policy and on policies that influence the demand for imports.
- *Spending* is defined as the widening of the fiscal deficit (excluding aid) due to additional aid.

The importance of this distinction is that aid only enables an economy to invest and consume more than it otherwise would, by financing an increase in net imports of goods and services. If the aid is only spent on domestically produced goods and services, it does little to increase their supply, and could drive up inflation through its impact on relative prices. Unless there is spare capacity in the economy, extra domestic expenditure financed by aid will squeeze out existing customers for the goods and services bought with the aid. If the increased expenditure financed by aid does not result in increased net imports, it achieves little that could not be achieved through more expansionary domestic fiscal and monetary policy.

Absorbing the aid requires the Central Bank to sell the foreign exchange to finance imports. This may require some appreciation of the real exchange rate to persuade the market to buy the foreign exchange. Large and sudden increases in aid flows in the form of foreign currency could provoke a Dutch Disease effect - an appreciation of the real exchange rate that harms the export sector. When aid flows are in the form of loans, they can raise concerns about debt sustainability, by triggering inflation, interest-rate and exchange rate volatility. Finally, aid increases can cause labour market pressures, by increasing demand for skilled labour and driving up prices.

4.2.3 Managing aid absorption at the macroeconomic level requires access to good information

If improved coordination of fiscal and monetary policies at the macroeconomic level is to be feasible, it has to be evidence-based – and information needs to be available to support this. Unfortunately, in Yemen there is a poor record of donor agencies providing the government with comprehensive, up-to-date statistics on actual (disbursements) and intended (pledges, commitments, planned disbursements) levels of support. It is difficult for the government to coordinate fiscal and monetary responses if a significant amount of an increase in aid continues

not to be unreported to government or is unpredictable. In this respect, the government should also know the *total* amount of ODA flows to the country, including funds for NGOs², for it to formulate a macroeconomic strategy.

4.3. Aid Absorption Issues at the Macroeconomic Level for Yemen?

The purpose of this sub-section is to put forward some thoughts about how a significant step-up in aid might affect the macroeconomic environment in Yemen. Currently, the level of aid resources flow to Yemen is relatively low and significantly below the threshold where further increases in aid result in diminishing returns. In this regard, concerns regarding the macro economic impacts of increased aid would not appear to be of a first order problem.

However, this still means that Yemen should consider the following issues:

- Given that scaling-up should be accompanied by increased absorption if it is to avoid undesirable macroeconomic consequences, there should to be agreement as to how the foreign exchange will be absorbed, as well as how budget resources will be spent. For example, decisions will have to be made regarding: tradeable and non-tradeable sectors, between consumption and investment and between its direct use for public sector development or its re-challenging to the private sector through the banking system. In addition, there are a range of circumstances under which it makes sense for the government to use all or part of an aid surge to add to reserves, external or domestically or to address arrears and reduce indebtedness.
- International experience suggests that increases in aid are usually spiked and are not consistently higher in the future. This means that spending increases and commitments have to be managed appropriately and not result in increased spending, when extra aid resources are not forthcoming.
- Understand the effects of the scheduling of aid disbursements – when aid is disbursed later in the year than originally agreed, the government may have to borrow funds. This can push up inflation and increased indebtedness.
- Considering debt sustainability risks confronting Yemen, the government should focus on securing grants and not on concessional loans.
- Come to a clear understanding on the criteria when donors may suspend or delay aid disbursements. In the past, the IDA has slashed its assistance to a weakening of Yemen's relative performance in the CPIA indicators – decreases in aid and non-disbursements should be done in conformity with criteria established prior to the aid commitment.

5. Case studies: aid absorption capacity constraints at the micro level

5.1. Analytical framework for the case studies

The previous sections have set the framework within which aid absorption can be analysed. Thus far it is argued that from a macroeconomic perspective, Yemen is likely to be able to absorb a significant increase in aid resources without impacting on its competitiveness or increase indebtedness depending on the choice of modality. The purpose of this section is to explore any bottlenecks that might impede aid absorption at the micro level. Due to a limited availability of time, inferences about aid absorption capacity are made through a number of concise case studies (Health, Education, Social Fund for Development, Public Works Project and Water) in combination with secondary source material. The aim was to examine lessons from experiences both where there has been success in using aid effectively and overcoming absorption capacity constraints, and from cases where absorption capacity has proved to be a constraint. In particular, this section will attempt to highlight how Yemen is addressing

particular constraints and discuss positive experiences that might be replicated in other ministries and organisations.

The case studies were done through semi-loosely structured interviews with questions around: procurement, reporting to donors, financial management, project design and preparation, counterpart funding and staffing resources. The questions focused on internal capacity of organisation; discussions did not focus on actual services delivered. Information on results can be found in annual reports, several monitoring and evaluation studies and internal donor documents; information on management (financial, procurement, human resources) and constraints is frequently not part of publicly accessible sources. All interviewees were given scope to highlight other areas in which they felt there were constraints to absorption capacity or scope for additional aid. Several interviews were also conducted with the main donor organisations active in Yemen. While these were not part of the aid absorption study per sé, they did provide a useful point of reference.

The rationale for choosing internal management capacity issues is that this is the area where donors and aid recipient governments interact. Donors have their own procedures and policy direction and domestic accountability requirements. Recipient governments and its entities have their own institutional capacity and policies. These two may not necessarily meet, therefore donors have a tendency to earmark funds for specific sectors and prescribe strict project and financial management procedures.

5.1.2. Procurement

Public procurement is at the centre of the way public money is spent. Transparent competitive procedures are critical to ensuring value for money. Budgets get translated into service in large part through the workings of the procurement system. Inefficient use of funds can be generated from problems across the entire procurement process – from the definition of needs and formulation of bidding documents, to a lack of transparency and competition in the process followed for announcement, bidding, evaluation and award of contracts to poor contract supervision. Donors have fiduciary responsibilities to their stakeholders for the use of funds – and have frequently acted to mitigate these fiduciary risks by imposing their own procurement rules on governments for the funds they contribute.

The case studies pointed to a variety of procurement systems across public sector organisations. The variety in the procurement systems is primarily explained in areas and programmes where there is substantial donor involvement; this is largely because donors have limited confidence in Yemen's public procurement system as the perception is that it is riddled with inefficiencies and opportunities for resource leakage. It is important to emphasise however that procurement problems are not simply because of corruption and nepotism; reasons are also found in cumbersome procurement procedures, inadequate staff numbers with experiences in procurement and the unavailability of supporting materials. The inability to specify tender documents also contributes to procurement problems.

It appears that most donor funded programmes are following World Bank procurement procedures. In this situation, the World Bank still has sign-off, or non-objection, rights on all purchases above a certain threshold. The 2005 World Bank Country Portfolio Performance Review points to various challenges in procurement. Most of the specifications of contracts are written by consultants, as there is a lack of capacity of regular civil service staff to specify contracts and it is thus considered speedier for consultants to handle this. However, it is also noted that some of the World Bank's procurement procedures by itself are a source of delay, particularly when contract awards require World Bank clearance and key staff is out of the office.

Some of European Commission (EC) procurement rules for Yemen have also been a source of delay, through a requirement for preferential purchasing of EC goods and services. SFD managed to resolve the issue of EC funding through recourse to a World Bank Trust Fund through which the EC could pass funds without needing the use of a 'Buy-EC' rule. There is however, a 3 per cent administration fee to the World Bank.

The SFD has its own procurement system, which is compatible with that of the regular public sector. SFD's system follows international good procurement practices in terms of flexibility and below-the-threshold rules, transparency, non-discrimination and competition. Purchases of goods and services have generally been made more quickly and at cheaper prices than similar purchases by line ministries. An important reason for this is that the SFD has been able to address resource leakage and enforce procurement standards. In recent years, donors have been gaining confidence in SFD's system and are increasingly willing to channel funding through it. Similarly, the PWP has autonomous procurement arrangements and its rules satisfy both government and World Bank procedures which appear to be working reasonably well.

The relatively smooth operation of SFD's procurement system stands in contrast to the Ministry of Health's and World Bank funded Health Sector Reform Project (HSRP) procurement experiences. The Ministry of Finance now handles procurement in the Ministry of Health because of a number of alleged cases of corruption. There are equally problems with the procurement procedures, inadequate number of staff with procurement experience and the unavailability of supporting materials. The situation appears to be somewhat better in the Ministry of Education. In the case of an education grant from DFID to the Ministry of Education, government procedures are used but the funds are nevertheless still used managed by a project implementation unit. The Ministry of Education has drafted new procurement policies, but they still need to be implemented.

5.1.3. Reporting and financial management

Reporting and monitoring of development assistance is a critical function of effective aid delivery. It provides essential data along with insights for drawing lessons, setting priorities and managing development activities. It also offers assurance that funds are used for the agreed purposes. Furthermore, it supplies information on whether a policy, development strategy or a project is being implemented as planned and reaching its objectives. Similarly, good quality financial reporting is critical to the effective implementation of development programmes and to accountability in the use of development resources. Achieving this effectively is in the interest of donors and the GoY. A common problem is that reporting and monitoring systems have often been designed to meet donor's information needs rather than support the priorities of the government. In particular, duplicative monitoring and reporting systems are making competing demands on limited resources.

The Yemeni civil service is plagued by a number of problems that impact on the quality of reporting and financial management arrangements, such as: a de-link between policy-making and budgeting processes, poor quality and lack of timely financial reports, different public sector entities using different accounting systems, poor public finance management information systems (no computerisation), poor internal audit and control systems and a lack of compliance to formal rules.

The above mentioned constraints play out differently in different organisations. Perhaps as a consequence, the donor community has encouraged special management and reporting arrangements for donor funded programmes. At the same, the donor community has been attempting to address various constraints in public finance management and reporting through supporting the GoY Public Finance Action plans, see the section six on reform efforts.

World Bank funded projects are required to complete Financial, Procurement and Physical (FMR) progress reports. However, FMRs are commonly not generated or prepared nor sent to the Bank in accordance with the required periodic base. Where the FMRs are automatically generated, they were not reviewed for accuracy, and hardly ever were physical progress or procurement reports prepared. In most cases, disbursement plans by projects were not prepared or updated. Due to a lack of a disbursement plans, the planned figures in the financial reports were not accurate and calculated variances were meaningless.

The SFD has developed its own financial management system, capable of accounting for the spending of different funds and generating the different reports required by the GoY and donors. There are quarterly financial management reports to the World Bank, more simplified reports to other donors and separate reporting to OPEC and the Arab Funds. There is a single consolidated Audit Report for all donors. Donors appear to have a reasonable degree of trust in SFD's financial management and reporting procedures, similarly for PWP. In this respect, the PWP reported that reporting and financial management arrangements are not considered by their organisation to be a constraint on aid effectiveness.

5.1.4. Project design and preparation

Questions under this heading were to probe the way donor funded-projects and programmes were designed and whether the design in itself formed a constraint to aid absorption capacity. A particular relevant issue here is whether the project's objectives were aligned to the GoY and the entity's priorities. It is not the aim of this sub-section to describe the policy-making process and subsequent planning activities; it instead highlights some of the issues in relation to the design and preparation of donor-funded projects. Nevertheless, it is worth mentioning that policy-making and planning activities appear to be fragmented and uncoordinated but improving through the DPPR process and enhanced capacity of MoPIC.

A particularly well-formulated programme appears to be the National Basic Education Development Strategy developed by the Ministry of Education and supported by several members of the donor community, see box 2.

Box 2: National Basic Education Development Strategy: an example of a well-designed and coordinated GoY strategy supported by donors

The Ministry of Education's National Basic Education Development Strategy (NBEDS) was launched in 2002. Subsequently, a Partnership Agreement on a subset of the NBEDS was signed between the Ministries of Education, Finance, Planning and International Cooperation, Civil Service and Social Security, Local Government Administration, SFD, PWP and the World Bank, DFID and the Netherlands. The partners agreed to forge much closer co-ordination between all the efforts undertaken to achieve the objectives as laid down in the NBEDS with the objective of harmonising strategies, aligning and effectively using all resources programmed for basic education. It was intended to guide the transition from separate projects in the education sector to the ultimate goal of jointly supporting a common programme following the improved procedures of the GoY.

The Ministry of Education, in co-ordination with donors, has moved forward to an elaboration of NBEDS based on a Medium Term Results Framework for 2006 – 2010, on which a Medium Term Expenditure Framework (MTEF) and subsequently annual budgets will be based. An overall education funding ceiling will be negotiated between the different partners through the MTEF process. Decisions on resource availability and the allocation will be made in collaboration with all partners, in particular the ministries of finance, local administration, planning and international cooperation, civil service and social security and relevant members of the donor community. The process for developing the MTEF will provide a coordinated framework for parties to agree on the ceilings for funding education, the allocation of available funding between programs and coordinating financing from the different sources to achieve the programme's financing needs.

For both SFD and PWP, donors earmark their contributions to particular governorates and thematic areas. Most the earmarking is done by the donors themselves and not always in close cooperation with the organisation which has resulted in a number of gaps and overlaps. The PWP design and selection of projects is transparent, well-targeted and can be considered an example for other organisations, see box 3.

Box 3: Project design and implementation: PWP funds activities directly responding to community needs

PWP has a transparent method for the design, preparation and implementation of projects. Budgets are allocated to governorates according to the following criteria: (i) 50 per cent for population density, (ii) 30 per cent for poverty indicators according to Central Statistics Office, and (iii) 20 per cent for remoteness and deprivation. Other criteria for the selection of projects are: (i) the labour content of the project should at least by 30 per cent, (ii) the entire cost of the project should be no more than US\$200,000, (iii) sustainability of the project, (iv) improve environmental conditions of the beneficiaries, and (v) the community should contribute to the cost.

The Project Management Unit receives requests from predominantly local communities but also through NGOs and local council members of parliament. These requests are entered into the Management Information System and subjected to a preliminary screening based on budget available for governorate, district, eligibility, is the project in a deprived area and is it labour intensive. Through this process, sub-projects are selected and grouped into annual and quarterly investment programmes which are subsequently submitted to the Steering Committee for Approval. These programmes are also submitted to the SFD for coordination purposes. Consultants are appointed to verify the project is indeed a priority for the local community. For example, PWP representatives would talk to the women of a locality about water projects; even it was submitted by the men of a locality. After the site verification, quarterly investment programmes are submitted to the IDA for approval.

The coordination mechanisms of the PWP are relatively robust. The Steering Committee is chaired by the Deputy Prime Minister and consists of several ministers, the Yemeni Economists Society and several NGOs. On a day-to-day basis, the PWP attempts to coordinate with the Social Fund for Development and the Ministry of Education, evidenced by sharing the consultants and contractor database.

The World Bank Country Portfolio Performance Review reviews all World Bank funded projects and identifies problem projects in terms of whether the development objectives and implementation progress are satisfactory. An 'unsatisfactory' score for development objectives would indicate an ill-designed project; the HRSP in the Ministry of Health received this mark in the past (but has since the Review in August 2005 improved its score to a 'moderately satisfactory'). The Review further calls for the need to better assess project preparedness for implementation at entry and retrofitting adequate performance indicators in projects requiring improved monitoring and evaluation indicators.

It can be stated that donor funded projects, specifically, and government programmes more generally are most successful when they are derived and coordinated from a well-formulated national or sector strategy. In this respect, the water sector is making substantial progress, with support from donors, in formulating a coherent sector strategy and planning large scale investments in order to address the scarcity of water resources and overexploitation of aquifers in Yemen, see box 4.

Box 4: Formulation of National Water Sector Strategy and Investment Programme (NWSSIP) is likely to result in better project design and preparation

In 2003, the Yemen water sector was reorganised under of the Ministry of Water and Environment which is responsible for policy making and planning for the following agencies: Water Resources Authority, the Environment Protection Agency, the General Authority for Rural water Supply and Sanitation and the General Authority for Urban Water Supply and Sanitation.

The Ministry of Agriculture and Irrigation has responsibility for the use of water for irrigation. The key in the improved management of water resources is co-ordination between the authorities within MWE and, perhaps more significantly between Ministry of Water and Environment and the Ministry of Agriculture and Irrigation. Following the reorganisation, the Ministry of Water and Environment began a multi-stakeholder process of preparing a consolidated strategy, action plan and investment program for the water sector as a whole). The Ministry of Agriculture and Irrigation actively participated in its preparation of NWSSIP. Five working groups working groups, corresponding to the policy areas above, drafted a proposed strategy and investment program, which was then discussed with a broad base of government, civil society and donors; through a national workshop that was held in June 2004.

The NWSSIP is a cogent presentation of the challenges facing Yemen and requirements to solve them. It spells out the approach to implementing the plan as comprising:

- consolidating the Ministry of Water and Environment's institutional structure;
- improving the quality of sector investment and financing;
- formulation of a clear policy on institutional responsibility of each concerned body

regarding water quality and its suitability for various uses, and regarding the assessment and control measures of such quality;

- follow-up of implementation of the necessary measures to establish control over groundwater abstraction through an integrated package that includes economic incentives, regulatory measures, clear definition of water use rights and assisting farmers to enhance the economic and financial returns from water.

5.1.5 Counterpart funding

Donors often ask governments to provide part of the funding for a programme, project or activity as a measure of goodwill or commitment. In order to ensure that government has funds available, the counterpart funding should be part of the national budgetary process. It is not unlikely that counterpart funding can be a source of delay, particularly when there are shortfalls in the national budget or when the budget is reprioritised during the year.

For most SFD and PWP projects there is local counterpart funding. For PWP projects, the local counterpart, i.e. community contributions, should at least be 5 per cent of the value of the project. Counterpart funding from the GoY is provided to the SFD for three types of activity: (i) to top-up resources in certain sectors, occasionally used to finance legitimate cost overruns, (ii) to cover initial expenses such as the preparation of an SFD operational manual, and (iii) to meet obligations under compulsory co-financing agreements. Neither SFD nor PWP appear to have had any significant problems in receiving counterpart funding. This is in contrast to the experiences of the Ministry of Water and Environment which in the past has had difficulties in the government honouring counterpart funding agreements. The HRSP project in the Ministry of Health has not experienced any significant problems in receiving counterpart funding.

In general there does not appear to be a major problem with counterpart funding for World Bank funded projects and the quarterly estimated budget is regularly deposited in the project special accounts. However, even when counterpart funds are available their release to contractors is delayed by long disbursement procedures and by subjecting all payments to many reviews by the Ministry of Finance and the Central Bank of Yemen. Currently, there are some 19 steps required to release payments.

The current practice enforced by the GoY in all projects is that for all disbursements made from the IDA Special Account, the following cycle is used: (i) a request for payment is prepared and approved by the Project Direct and the Finance Manager, (ii) this request is then forwarded to the MoPIC for first approval, then (iii) to the Ministry of Finance for final approval and clearance by the Central Bank of Yemen for final payment. In some cases, an additional approval of the line ministry is required to sending to MoPIC.

5.1.6 Staffing resources

Staffing resources is relevant for absorption capacity in several ways. There may be concerns about the quality of human resources in the relevant ministry or entity overall. In situations where the quality is deemed to be inadequate, donors have often insisted on attracting local staff to work on a donor-funded project outside the regular civil service regulations. Technical assistance may be part of the project; this can either develop and complement local capacity or is inappropriate as it may result in a lack of government involvement in decision-making and programme delivery mechanisms.

Both SFD and PWP are able to hire and fire according to different rules than the regular public service and both offer significantly higher salaries. This has attracted the best and brightest civil servants from other ministries; while good in terms of building capacity in the two organisations it has had a number of adverse incentives on staff in the line ministries (for a discussion see next section). This similarly applies for staff in various project implementation units in line ministries. Both SFD and PWP operate through a wide network of consultants at the local level which has resulted in an added benefit of building human resource capacities at the local level. It was commented that the extensive network of consultants is a powerful tool for both organisations to significantly ramp-up aid absorption capacity.

In the NWSSIP of the Ministry of Water and Environment it was noted that 'the shortage of qualified human resources constitutes the biggest constraint to building capacities for sound water management'. These gaps pose a real risk to the successful implementation of the strategy. Similar gaps exist across the public sector.

5.2 Implementing Agencies: Social Fund for Development and Public Works Project

SFD is an administratively and financially autonomous agency run by a Board of Directors. The central objective of SFD is to reduce poverty by increasing access to basic services, providing income generating activities and building capacity of its partners in development. To the end of 2004, a total of US\$418 million had been committed of which well over 70% has been disbursed. The PWP was set up in 1996 by the GoY with support from the World Bank (IDA) and has similar autonomous arrangements as SFD. The key objectives of the PWP are: (i) creating job opportunities for both skilled and unskilled labour; (ii) providing basic infrastructure services for poor communities; (iii) improving the economic and environmental conditions of poor groups; and, (iv) enhancing the level of community participation. A secondary aim of the PWP is to rely and develop local contracting and consulting firms, in order to cultivate local businesses.

Box 5: Social Fund for Development – Contributing to community development objectives and facilitating robust systems for governance at the local level

The SFD has in a number of evaluation studies been noted as a successful example of a Yemeni organisation that is able to organise activities that reach the poor effectively. In terms of development outcomes: 17 per cent of its resources went to the poorest docile, SFD's education projects increased enrolment from 60 to 68 per cent from 1998 to 2003, with a particular increase in female enrolment from 42 to 56 per cent in the same period. Furthermore, through the activities of the SFD, the proportion of households with tap water in their dwellings increased by 23 per cent.

The success of SFD is predominantly attributed to its institutional autonomy and dynamic organisational structure which allows for a relatively quick response and flexible approach to communities. SFD operates a relatively decentralised structure, which has empowered front line staff of regional offices to take decisions. Since its establishment, SFD has evolved into a successful organisation operating on a nation-wide basis which has broadened participatory development efforts to rural and remote areas. A particular strength has been its contribution to nurturing governance structures and the decentralised and local level for planning and implementing development initiatives. In sum, SFD is considered by many to make a robust contribution to governance through: (i) adopting a demand-led approach, (ii) pro-poor allocation of resources on a nation-wide basis, (iii) use of verified data as a basis for decision making, (iv) participatory community processes, (v) transparency, and (vi) well developed and open procurement systems.

Most stakeholders would agree that the central strength of both SFD and PWP is that they are good at delivering services. However, the position and role of SFD and PWP in relation to the central and local government responsibilities and the implementation of the NDP raises a number of issues in the medium and long term. Autonomous agencies can distort public sector incentives. In order to attract qualified staff, autonomous agencies are often given exemptions from the government's personnel regime to offer higher salaries scales as well as other attractive benefits. This creates an uneven incentive structure within the public service and makes it difficult to attract and lure back competent individuals to line ministries. At the same time, it makes those who remain in the non-autonomous parts of the government resentful of their peers receiving better incentives and benefits in the autonomous agencies. More generally, there is a danger that autonomous agencies create parallel structures to government and as multi-functional agencies they cut across the responsibilities of local authorities and line ministries. This may raise a number of coordination challenges.

Despite this, there is a general interest by MoPIC and the donor community to apply the successful experiences of SFD and PWP elsewhere in the public sector. This needs careful study to identify the factors contributing to the success of the SWP and PWP and how these can be incorporated into the wider service modernisation programme, including the decentralisation process. In the short term, SFD and PWP are likely to be able to absorb a substantial amount of more aid.

6. Overview of reform initiatives impacting aid absorptive capacity

There have been a number of on-going and planned reform initiatives in the areas of civil service modernisation, decentralisation and public financial management that are likely to impact absorptive capacity and address important governance constraints. This section discusses the highlights of these reform initiatives with a view to making an assessment of the extent and timescale over which improved performance might be achieved (and risks of failure).

There has been a degree of disappointment with the progress of the GoY reform agenda in the past. In the view of many stakeholders, a wide range of reforms are needed in Yemen performance in economic growth and poverty reduction. In broad terms most areas needing reforms have been identified in many analyses and in most cases technical approaches have been proposed. However, most the changes that are needed are institutional, i.e. not those that can be undertaken swiftly by a small number of key civil servants with support of targeted technical assistance. Therefore it is not surprising that donor have a measure of concern about the political deliverability of reforms going forward. It has been voiced that there is scope for more grants, concessional loans or debt forgiveness in the future, but only on the basis of a credible reform package and evidence of progress in achieving these reforms. Nevertheless, there appears to be some momentum for the implementation of reforms which might bode well for addressing a number of key constraints to aid absorption at the micro level.

6.1 Civil Service Modernisation

Under the leadership of the Ministry of Civil Service and Social Security, the GoY has embarked on a Civil Service Modernisation Strategy (also referred to as 'Framework') which is supported by several donors, including the World Bank, the EC and the Netherlands. The impetus behind the Strategy is the recognition that the civil service is beset by a number of problems: the 400,000 employees with an additional half a million military and security forces represent a large drain on public resources and there are serious concerns with regards to the quality of staff where recruitment and promotion is not done a merit-basis and presence a large number of ghost workers and 'double-dippers'.

The primary purpose of the strategy, when it framework was established in 2000, was to focus on the creation and enhancement of institutions, capacity and systems of sustained human and financial resources development in the public sector. Components of the project are: (i) computerisation of core systems and skills, including financing and training for human resources and personnel information management development such as payroll and accounting information practices, (ii) development of a framework for retirement, redundancy and severance options, (iii) a re-engineering process to streamline and rationalise organisational structures, simplify business processes and establish basic information systems, and (iv) enhancing skills to manage the public civil service. Since the strategy's conception, staff reductions and improved salary structures have become important components of the framework. Recently, efforts have been made to establish a biometric and employee database that is linked to the payroll.

A project implementation unit, supported by the World Bank, was established in the Ministry of Civil Service and Social Security, to support the implementation of the civil service modernisation programme. There have been a number of problems which has resulted in a long gestation period and low disbursements; the accounting and financial management component (AFMIS) has had particular difficulties, discussed below. Under the framework, the EC is supporting 3 pilot ministries with strategic planning and management, human resource management, professional development and capacity development and the design and implementation of information systems and technology.

The Accounting and Financial Management Information Systems (AFMIS) project, funded by the World Bank, and located within the Ministry of Finance, has been problematic. The project has been consistently behind schedule; delays are explained to have happened because the conceptual design had to be approved by all relevant stakeholders who in certain cases did not fully understand the objectives of particular components or accounting

concepts. Nevertheless, improvements seem to be in the offing, evidenced by the commencement in 4 pilot ministries (Finance, Education, Health and Housing) of a roll-out of AFMIS. For further information on the AFMIS project, refer to www.afmis.gov.ye.

Despite these difficulties, progress appears to be underway. For example, in May 2006, the Ministry of Civil Service and Social Security started the implementation (in Hodeidah and Aden) of the Biometric ID system aimed at eliminating ghost workers and double dippers.

6.2. Decentralisation to Local Authorities

The 2000 Law of Local Authorities (LAL) kick-started the decentralisation process in Yemen. Local councils were elected at district and governorate levels. Follow-up regulations made functional assignment more specific and indicated how these functions would be financed. The Ministry of Local Administration and some of the central line ministries initiated or continued institutional changes and launched district-level or governorate-level capacity development efforts. The Ministry of Local Administration subsequently established the Decentralization and Local Development Support Programme (DLDSP), funded by UNDP, to further the aims of decentralization. The LAL envisages a significant range of important services and other functions to be assigned to the district level, with the governorate taking up functions that have significant externalities. Furthermore, the LAL gives considerable discretion to local authorities in service delivery, including related planning, financing, implementing and monitoring and reporting functions.

In general, decentralisation holds promise for improving the delivery of services, as most public services are consumed at the local level. A process of decentralisation is often justified in that it enhances the responsiveness of policy-making and the effectiveness of poverty reduction initiatives. In other words, decisions taken closest to a locality are expected to better reflect the preferences of the inhabitants of the locality. For decentralisation to be successful there should be strong central guidance to regulate, provide an overall framework to manage the reallocation of responsibilities and resources in a predictable and transparent way and to assist local government capacity strengthening. International experience has shown that it takes time for decentralisation processes to develop and take root.

The Ministry of Local Administration commissioned a series of studies and functional reviews to take stock of current and evolving institutional arrangements that were intended under the LAL in anticipation of the formulation of a National Decentralisation Strategy. From these studies (i.e. the GoY, Sector Decentralisation and Functional Assignment: Support Study for the Formulation of a National Decentralisation Strategy, 2006 funded by the UNDP) it became clear that line ministries have different approaches in reacting to the LAL, several of which have engaged in sector reform and restructuring efforts. In general, decentralisation is yet to be fully entrenched. Particularly problematic is that the LAL and sectoral legislation are not harmonised. The functional assignment in Yemen is complex, with multiple arrangements in the same sector (education) and corporate forms (water) alongside local authorities with unclear connections between these. This issue has been compounded by donors too readily accepting sectoral frameworks over the LAL. The arrangements of project implementation units often do not keep with the LAL and interact with various actors that are counter to the spirit of decentralisation. This issue partly reflects a lack of a clearly articulated implementation strategy of how to make the principles contained in the LAL a reality.

The Ministry of Local Administration is attempting to give a renewed impetus to decentralisation through the formulation this year of a National Decentralisation Strategy. A coherent and well-formulated strategy may well put conditions in place for increased aid absorption capacity.

6.3. Public Financial Management

In the past few years, several diagnostic reviews of public financial management in Yemen carried out by the World Bank, IMF and other donors have pointed to a range of issues that need to be addressed before Yemen is

considered to have a robust PFM system. Several donors have been providing technical assistance and financial support to the GoY in a range of projects and activities to promote improvements in PFM.

In August 2005 the Cabinet approved a PFM reform strategy containing two phases and a number of components. Phase I objectives are: (i) adoption of modern government principles, (ii) enhancing control and financial accountability, (iii) reduce resource leakage, (iv) improve financial reporting integrity and timeliness, and (v) improved transparency. This phase includes the introduction and anchoring a Medium Term Expenditure Framework, including capacity for better macroeconomic forecasting. Phase II objectives are: (i) budget reform to facilitate performance measurement, (ii) adoption of modern government accounting principles, (iii) completion of the roll-out of AFMIS to line ministries and governorates, and (iv) securing timely and accurate financial reporting from line ministries.

As part of the PFM Reform Strategy an inter-ministerial Steering Committee was established, chaired by the vice-minister of Finance to lead the process of PFM reform. The inter-ministerial Task Force, with members from the Ministry of Planning and International Cooperation, Ministry of Local Administration, Ministry of Civil Service and Social Security and the Central Bank of Yemen, will manage and direct the process of reform on a day-to-day basis. The Task Force will be supported by a number of technical committees in the areas of: policy prioritisation, budget decision-making, budget execution, accounting and reporting, internal control and internal audit and public procurement. One of the technical committees will focus on issues of institutional development, change management, capacity building, training and information technology. An important activity of this particular task force will be to work together with the Civil Service Management Project housed under the auspices of the Ministry of Civil Service and Social Security and the AMFIS project.

A Partnership Agreement on Public Financial Management has been signed between the GoY and several members of the donor community in May 2006. The Partnership Agreement has been inspired by a joint workshop a year earlier which resulted in greater mutual awareness of the benefits of (i) aligning donor activities in PFM reforms to a government-led action plans and (ii) the links between PFM reform and wider public sector management reforms.

The Partnership Agreement emphasises that the GoY has overall responsibility for the implementation of the PFM reform programme and the performance of the proposed governance arrangements (task force and technical committees). As part of the agreement, donors may seek a ministerial meeting to address impediments in case the reform programme loses its momentum. Donors are under obligation not to withdraw their funds unilaterally in event of a slow-down in the reform process; funds can only be withdrawn jointly if problems are not resolved at the ministerial level.

The next steps will be for the GoY to approve the process for a detailed implementation plan of the PFM reform programme, the GoY and donor community signing of project documentation, the approval by the Ministry of Finance of a long-term internationally experienced PFM expert to commence work as soon as possible and the establishment of the PFM Unit in the Ministry of Finance to spearhead the implementation of the reforms.

Box 6: Corruption and addressing resource leakage: design of a multi-pronged approach in Yemen

Resource leakage has been a concern of reform-minded government officials and the donor community. Progress in addressing corruption is likely to influence donor community decisions on a step-up in aid. Particularly as a number of donors are of the view that entrenched corruption must be addressed head-on as a priority and deliver results soon before any significant pledges of increased aid are made.

There are perceptions of wide prevalence of corruption in Yemen corroborated by studies by Transparency International and the World Bank's Control of Corruption Indicators. For example, using the control of corruption indicator Yemen scores a -

0.84 in 2004 in the range of -2.5 to 2.5. While Yemen's scores are on average not every different from many countries in sub-Saharan Africa, a score of -0.84 is significantly below other countries in the Middle East³.

Control of Corruption on a scale from -2.5 to 2.5 (2004)

Algeria	- 0.49
Bahrain	+ 0.76
Jordan	+ 0.35
Kuwait	+ 0.71
Lebanon	- 0.51
Libya	- 0.91
Oman	+ 0.78
Qatar	+ 0.55
Russia	- 0.72
Saudi Arabia	+ 0.15
Syria	- 0.74
Turkey	- 0.23
Yemen	- 0.84

Encouragingly however, it appears that the GoY is implementing and weaving-in a number of anti-corruption strategies as part of both a national awareness raising campaign and part of on-going reform initiatives in civil service reform and public financial management.

In 2005, the GoY drafted and approved an anti-corruption law, but this has been held up after consultations with civil society and the donor community which revealed a number of shortcomings in the proposed law. Transparency International was invited to review and make recommendations to the draft law which the GoY subsequently approved. The amendments were presented July 2006 to the financial committee of parliament.

There are a number of changes underway in the procurement law. A number of amendments were proposed by a ministerial committee to the institutional arrangements of the public procurement system with assistance by a number of international experts. Cabinet has yet to vote these amendments after which the draft law will be referred to parliament. In the meantime, the new public Procurement Manual and Standard Bidding Documents were put into effect in July 2006.

The Cabinet approved PFM Reform strategy provides for: (i) enacting an administrative penal code to promote compliance with accounting procedures and the management of tenders and bidding guidelines, (ii) establishing an administrative penalties law to encourage compliance with financial administration and procurement processes, and (iii) establishment of specialised administrative courts.

There also appears to be some efforts by the Ministry of Civil Service and Social Security in addressing corruption issues through proposing legislation. Similar the Supreme Committee for Combating Corruption and Protecting the Public Fund in the President's Office seems to want to make some headway in this area. In late 2005, the Ministry of Finance established an internal control and internal audit working group and training has been provided to strengthen the Control and Inspection Department. In July 2006, the president issued a directive to the Cabinet to increase the independence of the Central Organisation for Control and Audit (COCA). The GoY is considering whether to join the Extractive Industries Transparency Initiative. Finally, substantial improvements to transparency in terms of bidding procedures and access to up-to-date information on oil production were introduced in the oil exploration sector and made publicly available through the website of the Petroleum Exploration and Production Authority (PEPA). To complement these efforts, the GoY in June 2006 embarked on a public National Anti-Corruption Campaign, the aim of which was to raise awareness of the effects of corruption on development and to start popular momentum in support of upcoming anti-corruption measures.

Related, a number of reforms are underway in the judiciary. The Supreme Judicial Council has been restructured and is now headed by the head of the Yemeni Supreme Court and is resuming its weekly meetings after a long period of inactivity.

³ For information on how these figures are calculated refer to World Bank's governance work, accessible at: http://info.worldbank.org/governance/kkz2004/indicator_report.asp?indicatorid=6

Women are for the first time admitted into the Higher Judicial Institute and four judges have been referred to the internal Accountability Board for various charges of misconduct.

These reforms are promising, but it should be emphasised that technically-driven reforms such as enhancing the internal audit function of COCA are important and necessary when the conditions are right; their effectiveness is likely to be limited if they are not based on serious politically driven efforts. It is therefore not surprising that there is some scepticism whether a step-up in aid will have a meaningful impact (which will also affect the choice of aid modality). The GoY is thus also advised to formulate a strategy to stamp out corruption in donor financed projects and programmes.

7. Options and proposed actions to increase absorptive capacity

On the basis of the brief analysis of aid absorption constraints at the macro and micro level in this paper and ongoing and planned reform initiatives, this section puts forward several suggestions to unlock the various bottlenecks. These suggestions are likely to be discussed as part of the APP preparation process and the outcome of these discussions will be reflected in the APP.

This study argues that the various aid absorption constraints are at the micro level, not the macro level. Countries at similar level of economic and social development receive vastly more aid resources and are not experiencing an adverse impact on their macroeconomic indicators. Instead, the GoY will need to concentrate on addressing the bottlenecks in institutional and policy arrangements, technical and managerial capacity constraints and in collaboration with the donor community resolve limitations generated by donor behaviour. Leadership in all these areas must be taken by the GoY, but with strong and well-coordinated support of the donor community.

Several of these immediate and medium-term actions are:

- Adopt a credible macroeconomic adjustment and microeconomic restructuring strategy in view of a steep decline in oil revenues;
- Step-up progress in the civil-service reform agenda, particularly in terms of addressing lack of productivity of civil servants, but ensure that this is done in socially-sensitive manner in case of redundancies;
- Make further progress in coordinating donor activities and increasing the information base on these activities (AHA Unit);
- Develop coherent and prioritised sector strategies which donors can align around;
- Develop an action plan for integrating the SFD and PWP's current functions and processes for service delivery into the structure of Government;
- Approve the detailed PFM reform implementation action plan and renew efforts to improve transparency and comprehensiveness of budgetary processes;
- Address inconsistencies in the Law on Local Authorities and sectoral strategies in order to put conditions in place for increased aid absorption capacity at the local level;
- Deepen anti-corruption efforts already undertaken by approval and implementation of the anti-corruption law, and formulate strategies for combating corruption in donor-funded project to enhance confidence of donors in GoY reform programmes.

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