3

AID FOR THE 21ST CENTURY

"Hunger is actually the worst of all weapons of mass destruction, claiming millions of victims every year. Fighting hunger and poverty and promoting development are the truly sustainable way to achieve world peace....There will be no peace without development, and there will be neither peace nor development without social justice."

Brazilian President Luiz Inácio Lula da Silva [1]

CHAPTER 3

Aid for the 21st century

"This growing divide between wealth and poverty, between opportunity and misery, is both a challenge to our compassion and a source of instability."

US President George W. Bush [2]

International aid is one of the most powerful weapons in the war against poverty. Today, that weapon is underused and badly targeted. There is too little aid and too much of what is provided is weakly linked to human development. Fixing the international aid system is one of the most urgent priorities facing governments at the start of the 10-year countdown to 2015.

This chapter sets out an agenda for rethinking international aid that is relevant to rich countries and poor countries alike. Many people equate aid with charity—a one-way act of generosity directed from high-income countries to their low-income counterparts. That belief is wrong. Aid should be thought of as a hand up, not a handout—and as an investment in shared security and shared prosperity. By enabling poor people and poor countries to overcome the health, education and economic resource barriers that keep them in poverty, aid can spread the benefits of global integration, expanding shared prosperity in the process. It can also reduce the mass poverty and inequality that increasingly threaten the collective security of the international community.

Aid has not always played a positive role in supporting human development, partly because of failures on the side of aid recipients and partly because donor countries have allowed strategic considerations to override development concerns. But whatever the failings of the past, today there are new opportunities for reshaping development assistance. For the first time in history there is an international consensus that human development should be the primary objective of aid. That consensus was reinforced in March 2002 when world leaders, gathered at the International Conference on Financing for Development in Monterrey, Mexico, agreed to make aid one of the building blocks of a new "global partnership" for poverty reduction.

Three years later, the scorecard on delivery is, at best, mixed. It would be wrong to understate what has been achieved. When the Millennium Declaration was signed in 2000, international aid budgets were at an all-time low as a share of national income. Aid to Sub-Saharan Africa, the world's poorest region, was lower at the end of the 1990s than at the start. Allied to these problems in aid quantity, serious problems in aid quality were not being addressed, undermining aid effectiveness and imposing huge transaction costs on recipient governments. Today, aid budgets are rising despite the severe fiscal and public debt problems facing some donor countries, and an intensive dialogue is under way aimed at improving aid quality.

The rise in aid has been particularly marked. Official development assistance increased by $12 billion from 2002 to 2004. The United States, the world's largest aid donor, has announced the biggest increases in its national aid programmes since the 1960s. It accounts for $8 billion of the increase in development assistance, although admittedly the increase has been from a low base measured in terms of aid as a share of national income, and it includes large aid transfers for Afghanistan and Iraq. Meanwhile, countries in the European Union have also set targets for a step increase in development assistance.

In terms of targets set, the aid quality debate has also delivered some impressive results. In March 2005 donors agreed on a wide-ranging

As rich countries ratchet up aid flows, they need to ratchet down the transaction costs

framework for enhancing aid effectiveness through greater emphasis on harmonization, coordination and country ownership. The Paris Declaration on Aid Effectiveness incorporates some 50 commitments to improve aid quality, with progress to be monitored against 12 indicators.

These are encouraging developments. At the time of the Millennium Declaration the aid glass was three-quarters empty. It is now half full and rising. The Group of Eight (G-8) summit in 2005 provided a further boost to development assistance in the form of additional debt relief and new commitments on aid. Monitoring delivery against these commitments is a priority. But even a three-quarters full aid glass will not bring the Millennium Development Goals (MDGs) within reach, especially if resources do not come on-stream for several years. Having signed up for the Millennium Declaration, from which the MDGs emerged, donor governments have failed to align their development assistance programmes with the requirements for achieving the targets. The most immediate indicator of misalignment is a large—and growing—financing gap. Without an increase in aid, by 2010 the shortfall between aid needed to achieve the MDGs and actual delivery will reach more than $30 billion. Failure to close this gap will compromise progress towards achieving the MDGs. Yet several major donors have not put in place the necessary spending plans, calling into question their commitment to the MDGs.

The record on aid quality is also mixed. Poor countries need aid that is delivered in a predictable fashion, without too many strings attached and in ways that minimize transaction costs and maximize value for money. All too often they get aid that is unpredictable, hedged with conditions, uncoordinated and tied to purchases in donor countries. We estimate the costs of tied aid at $2.6 billion a year for low-income countries—a tied-aid "tax" of about 8%. That tax costs Africa alone $1.6 billion a year—a huge diversion of resources from investments in poverty reduction.

Not all of the problems in aid can be traced to the donor side of the equation. Many developing countries have put planning for poverty reduction and the MDGs at the heart of public policy. Too often, however, a failure to translate MDG commitments into effective action undermines aid effectiveness. Weak governance, corruption and a failure to adopt policies that sustain economic growth reduce the human development returns to aid investments. This chapter focuses on donors, but it recognizes that effective aid requires a partnership of shared responsibilities and obligations.

Two simple messages emerge from the analysis in this chapter, one on aid financing and one on aid structures. First, without a sustained increase in aid, the MDGs will not be achieved. The time for incremental change is past. If donor countries are serious about tackling global poverty, reducing inequality and securing a safer and more prosperous future for their own citizens, they need to set their sights firmly on the target of delivering 0.5% of their national income in aid by 2010 and 0.7% by 2015. More aid is no guarantee of development—and concerns about the capacity of poor countries to absorb and deploy aid effectively have to be taken seriously. But increased aid is a necessary condition for accelerated progress towards the MDGs—and there is clear evidence that many countries can absorb far more aid than they are now receiving.

The second message is that more aid delivered through current aid structures will yield suboptimal results. As rich countries ratchet up aid flows, they need to ratchet down the transaction costs that reduce aid effectiveness. That does not mean compromising on fiduciary responsibility to taxpayers. But it does mean ending tied aid, reducing the volatility and unpredictability of aid flows and rethinking the scope of conditionality. More aid will produce better results only if it is delivered though streamlined management structures that are more accountable to developing country governments and their citizens.

The case for increasing and improving aid is reinforced by the huge—and growing—potential benefits. In the past various factors have diminished the impact of aid on human development—cold war politics, the use of aid to promote commercial objectives in donor countries, the absence of effective national poverty reduction strategies, corruption and economic mismanagement all contributed. It would be naïve to claim that all of these problems have disappeared. Yet the policy environment has improved dramatically, as have the human development returns to aid. This is a moment when a step increase in aid could transform prospects for the MDGs.

The balance of responsibility and obligation between aid recipients and aid donors also needs attention. Developing countries wanting aid must set targets linked to the MDGs, undergo budget monitoring by the International Monetary Fund (IMF) and comply with extensive conditions. Yet donors, the other party to the "new partnership", can with impunity fail to meet targets for increasing aid quantity (including those that they have stipulated) and ignore the vague principles that they have set for improving aid quality.

New approaches to aid are affordable and achievable. The starting point is for donors and aid recipients to agree on a financial needs assessment that identifies the aid requirements for achieving the MDGs. Donors then need to provide predictable, multiyear funding to cover these requirements, and developing countries need to implement the reforms that will optimize returns to aid. Overcoming capacity constraints in recipient countries is vital.

At one level aid is a simple transfer of finance from rich to poor countries. At another it is an indicator of something more fundamental. The aid policies of rich countries reflect how they think about globalization, about their own security and prosperity and about their responsibilities and obligations to the world's most vulnerable people. Ultimately, aid policies are a barometer for measuring the rich world's tolerance for mass poverty in the midst of plenty.

Mahatma Gandhi, when asked how policy-makers should judge the merits of any action, replied: "Recall the face of the poorest person you have seen, and ask yourself if the step you contemplate is going to be any use to them."[3] With 10 years to go to the MDG target date, that advice should resonate in current debates on aid. Declarations of commitment to the MDGs are of little use to the world's poor people unless backed by real financial commitments and real improvements in aid quality. Having specified the ends in the Millennium Declaration, rich countries must now play their part in delivering the means.

The first section of this chapter briefly sets out the case for aid in an increasingly interdependent world. It highlights the pivotal role that aid can play as an investment in human development. The chapter then looks at the record on aid quantity and reviews trends since the Monterrey conference. The third section turns to aid quality, as measured by indicators of predictability, transaction costs and tied aid. The chapter concludes with a review of important governance issues raised by reform of international aid.

Having specified the ends in the Millennium Declaration, rich countries must deliver the means

Rethinking the case for aid

The current aid architecture, like the global security architecture discussed in chapter 5, was established more than half a century ago. Like the security architecture, it also suffered through the distortions of the cold war. Fifty years later, it is time to ask fundamental questions about the role of aid in meeting the challenges of the twenty-first century.

Aid as moral imperative and enlightened self-interest

Part of the answer can be provided by a report written 175 years ago. During the 1830s, Britain's overcrowded industrial centres were swept by a wave of epidemics, prompting a government inquiry led by the great social reformer, Edwin Chadwick. His report spelled out the human cost of neglect: "The annual loss of life from filth and bad ventilation are greater than the loss from death or wounds in any wars in which the country has been engaged in modern times."[4] Beyond these human costs the report drew attention to the efficiency savings of preventive measures: the expense of treating sickness and the losses associated with reduced labour productivity dwarfed the costs of providing public drainage. In an era of government aversion to raising taxes for public goods, it took another 20 years and a series of epidemics that threatened rich people as well as poor people to galvanize action. But Chadwick's report established the principle that social investment in a public good was imperative on grounds of morality and common sense economics.

The same logic underpins international aid today. Infectious diseases, security threats, illicit weapons and drugs, and environmental problems cross the borders separating rich countries from poor countries as readily as diseases crossed between rich and poor areas of Britain's major industrial centres in the 1830s. International aid in this context is an investment in public goods, such as reduced health and security risks.

Shared prosperity and reduced vulnerability provide other powerful rationales for aid. Episodes of crisis have acted as strong catalysts for the development of social insurance systems in industrial countries. US President Franklin D. Roosevelt responded to the Great Depression of the 1930s by establishing government employment programmes and income transfers, a "New Deal" providing millions of vulnerable people with employment and a source of security. The New Deal created the conditions for economic recovery, restored social cohesion and established a principle that remains central to human development: economic security has to underpin markets and individual freedom.[5] Thirty years later, in the mid-1960s, President Lyndon B. Johnson's "Great Society" programme declared an "unconditional war" on poverty, initiating a raft of legislation aimed at empowering people to work their way out of extreme deprivation (box 3.1). In both cases social protection went hand in hand with programmes to get people back to work.

Today, rich countries spend about a quarter of their wealth on social transfers.[6] These transfers are an investment in avoiding or reducing the waste and social dislocation associated with extreme deprivation. Global poverty also represents a massive waste of human potential and a barrier to shared prosperity. In a world tightly linked by trade and investment flows, poverty in one country diminishes the potential for prosperity elsewhere. Yet the international community lacks a credible global social insurance mechanism—a gap that development assistance could fill.

International aid is the point at which moral values and enlightened self-interest intersect. The moral imperative behind aid is reflected in many value-based systems of thought. Most major religions call on their followers to aid the poor. In Islam *zakat,* an obligation to give to those in need, is one of the five pillars of the

Box 3.1 The Great Society

US President Lyndon B. Johnson's Great Society speech in 1964 marked a new era in social legislation. It also set out principles that continue to resonate in debates on aid.

Underpinning the Great Society reforms was a simple idea: public action was needed to equip people with the skills and assets to escape cycles of poverty. Growth alone was not enough. Transfers to the poor were not just welfare payments but an investment in skills and in security against risk. Government programmes would empower people, providing a hand up, not a hand-out. As President Johnson put it: "It is not enough to open the gates of opportunity. All our citizens must have the ability to walk through those gates."

What followed was a raft of legislation—Medicare, Medicaid, the Economic Opportunity Act, education programmes for low-income groups and vocational training—aimed at supporting an exit from poverty and preventing entry into poverty. Between 1963 and 1967 the federal grant programmes behind the legislation doubled to $15 billion. The results were reflected in a period of falling inequality and rising mobility for previously excluded groups.

Good international aid has a similar rationale. It can equip poor countries and poor people with the education, skills and health assets needed to contribute to growth and to produce their way out of poverty and dependence. Assistance to economies such as Botswana, the Republic of Korea and Taiwan Province of China in the early stages of their development helped them escape dependence on aid and make the transition to higher economic growth and reduced poverty.

Source: Burnham 1989; Brown-Collier 1998; Johnson 1964; Advisory Commission on Intergovernmental Relations 1984 (table 75).

religion. The Christian tradition of the jubilee calls on creditors to write off debt. Other values systems also emphasize protecting vulnerable people and limiting inequality within communities. For the global community aid represents a mechanism for expressing human solidarity and for extending opportunity. Whether motivated by human rights, religious values or wider ethical systems, aid's role in eliminating mass poverty, hunger and avoidable child deaths is a moral imperative.

Enlightened self-interest underlies the security rationale for aid. Poverty does not automatically feed terrorism. Neither does inequality. Yet political leaders in rich countries increasingly recognize that failure to address the perceived injustices that perpetuate mass poverty in an increasingly prosperous global economy does pose a security threat. President Roosevelt in his last inaugural address in 1945 summarized what he saw as a central lesson of the Second World War: "We have learned that we cannot live alone, at peace; that our well-being is dependent on the well-being of other nations far away." That observation retains a powerful resonance. The threats posed by fragile and conflict-prone states are partly rooted in poverty but also in a perceived sense of injustice in a world order that allows wide divisions between haves and have-nots. As the current US National Security Strategy puts it: "A world where some live in comfort and plenty, while half of the human race lives on less than $2 a day, is neither just nor stable."[7]

Aid and human development

Controversies about the effectiveness of aid stretch back over several decades. Critics argue that the case for more development assistance is undermined by the limited benefits produced by the large amounts of aid disbursed during the past four or more decades. That claim demonstrates how a partial understanding of evidence can lead to flawed conclusions.

Assertions about aid's ineffectiveness based on the historical record are on shaky ground. Until the end of the cold war much of what passed as aid was, at best, tenuously connected to human development objectives. Brutal, corrupt and inefficient regimes were shown a benign tolerance by donors less interested in development than in geopolitical goals. President Mobutu Sésé Seko of Zaire and President Ferdinand Marcos of the Philippines got wealthy, while their citizens were left with large debts. From Afghanistan to Central America and the Horn of Africa aid was part of the rivalry between East and West.

The motivations for the aid distortions of the cold war collapsed with the Berlin Wall. All aid did not suddenly shift towards well defined human development goals, however. Large amounts of aid are still spent on non-development objectives, such as disposing of agricultural surpluses or creating markets for companies in rich countries. Moreover, the "war on terror" risks bringing a new set of distortions to aid allocation decisions: some countries with dubious human development records, at best, are receiving windfall aid. Even so, for the first time in history donor countries have an opportunity to direct their aid towards the central goal of improving the human condition.

The "war on terror" risks bringing a new set of distortions to aid allocation decisions

Reducing financing constraints

The MDGs provide benchmarks for measuring progress. However, as chapter 1 shows, on current trends most of the world's poorest countries will miss most of the targets. Financing constraints, rooted in low average incomes and pervasive poverty, limit the capacity of these countries to alter these trends. Aid can ease those constraints by providing governments with new investment resources.

To get a sense of the severity of the financing problem, consider the health sector. Average spending on health in low-income countries is about $11 per capita. In much of Sub-Saharan Africa the average ranges from $3 to $10. Meanwhile, the cost of providing basic healthcare is estimated at $30 a person. For a country like Mali, where more than half the population lives on less than $1 a day, it would cost an additional $26 per person—or about 10% of GDP—to finance this one goal.

Costing studies consistently point to a large financing gap for the MDGs, even if

Under the right conditions aid can advance human development

governments scale up spending and improve its efficiency. One study of financing requirements for universal primary education considered the financing implications if developing countries were to direct 4% of GDP to education, allocating half to primary education. For developing countries as a group the financing gap was about $5–$7 billion, with low-income countries accounting for $4 billion.[8]

Economic growth in developing countries can help to increase the domestic resources available for financing development. For many countries, however, capacity constraints impede economic growth. Inadequate access to basic infrastructure such as water, roads, electricity and communications limits opportunities for households, restricts private investment and constrains government revenue. The financing shortfall is greatest in the poorest countries. World Bank estimates suggest that Sub-Saharan Africa needs to double infrastructure spending as a share of GDP, from less than 5% to more than 9%. The UK-sponsored Commission for Africa puts the additional aid required at $10 billion a year for 10 years.[9] Failure to make this investment will perpetuate a vicious circle. Underinvestment in roads, ports, electricity and communication systems reduces growth, diminishes opportunities to participate in trade and lowers the revenue available to governments for future investment in infrastructure.

Factoring in financing requirements for the MDGs as a package demonstrates even more starkly the critical importance of external financing. Estimates by the UN Millennium Project, based on work in five low-income countries, put the financing requirements for achieving the MDGs at $40–$50 billion in 2006, rising to $70–$100 billion by 2015.[10] Tanzania, even with reasonable growth performance and increased government revenue collection, is facing a $35 per capita financing shortfall today—equivalent to more than 14% of average income. By 2015 the shortfall will be $85 per capita. In a country where the average annual per capita income is $100, this is a very large gap. Increased revenue collection from domestic resources could—and should—bridge part of this gap. But in countries with low average incomes and high levels of poverty there are limits to what can be achieved. If Ethiopia doubled the share of GDP it collects as revenue it would gain an extra $15 per capita—less than one-quarter of the estimated financing requirement for achieving the MDGs.[11] Ethiopia already raises 15% of gross national income (GNI) as revenue—far higher than the average for a country at its income level.

None of this diminishes the importance of national financing. Even with a severely constrained resource base, performance in developing countries varies. For example, Mozambique has mobilized 4% of GDP for public investment in health, which is more than double the level in countries such as Burkina Faso, Côte d'Ivoire, Mali and (at a far higher average income) Pakistan. In education Chad spends less than half as much of GDP as Ethiopia. However, in most regions—notably in Sub-Saharan Africa—there has been a clear upward trend in spending on health and education, partly supported by aid and debt relief.

The obvious question is whether aid is an effective complement to domestic revenues in countries unable to meet the costs of MDG financing. The answer is yes. Increased aid is not a panacea for low growth or for poverty. Not all aid works—and some aid is wasted. But under the right conditions (an important caveat) aid can advance human development through various channels. These range from macroeconomic effects—including increased growth and productivity—to the provision of goods and services vital for building the capabilities of the poor.

Increasing economic growth

Aid allows recipients to increase consumption and investment. It creates opportunities to raise living standards progressively through higher growth over time. Past cross-country research has tended to find a positive relationship between aid and growth.[12] That finding is strengthened when spending on emergency aid—by definition associated with countries in crisis—and spending on long-term assistance not linked to growth are removed. The Center for Global Development estimates that for the roughly one-half of aid flows that can be expected to generate "short impact" growth, every $1 in aid generates $1.64 in increased income.[13]

Country evidence confirms the potential for strong growth effects. High-growth economies in Africa such as Mozambique, Tanzania and Uganda depend heavily on aid to sustain investments in social and economic infrastructure. Mozambique has been growing at 8% a year since the mid-1990s, one of the fastest rates in the developing world. That growth could not have been sustained without net aid transfers per capita of $54—providing vital support for infrastructure and balance of payments.[14]

Improving the provision of basic services

Underfinancing of basic services such as health and education leads to weak coverage and poor-quality provision. Aid plays a critical role in financing the investments in health and education needed to build human capital.

Aid financing is a lifeline for basic service provision in many countries. In Tanzania external assistance constitutes more than one-third of social sector budgets. In Zambia health sector spending would fall from $8 per capita to $3 without aid, with devastating implications for the fight against HIV/AIDS and other public health problems. In Uganda foreign aid increased by 5% of GDP between 1997 and 2001, and per capita spending on health has tripled since 2000, with about half the health budget financed by donors. Several aid programmes have demonstrably reduced child deaths. In Egypt a national diarrhoea control programme supported by the US Agency for International Development (USAID) and the World Health Organization (WHO) helped reduce infant deaths by 82% in five years, preventing 300,000 child deaths.[15] Aid plays a central role in filling service delivery gaps. To achieve the 2015 MDG health and education targets, Sub-Saharan Africa alone will need an additional 1 million health workers, and eight countries in the region will need to increase the number of teachers by one-third or more.[16] Without increased aid, expansion on this scale is not feasible.

Cost barriers often prevent people from using basic services even when services are available. Aid can lower those barriers. In Tanzania an additional 1.6 million children enrolled in school after user fees were dropped in 2003 (box 3.2). In Uganda attendance at health clinics rose 80% when cost sharing in health was ended in 2002, with poor people capturing a large share of the benefits. Neither of these policy interventions would have been possible in the absence of aid financing. In Bangladesh aid has played a central role in financing school-based meals programmes designed to create incentives for parents to send their children—especially girls—to school. These programmes now reach more than 2 million children and have led to dramatic increases in school enrolments and progress towards gender parity.[17] Aid can also build demand by improving the quality of education. A recent review of World Bank support for education during 1988–2003 found that primary and middle school enrolments had risen by 10% and that test scores had improved by more than 60%,[18] gains in outcomes that were linked to improved classroom quality, access to textbooks and teacher training.

Box 3.2 Reducing cost barriers

The inability of poor people to afford basic services is a powerful driver of inequality—and a cause of poverty. Aid can increase demand for basic services by lowering costs.

In Tanzania an additional 1.6 million children enrolled in school between 1999 and 2003 because of aid-financed budget support to education. The government doubled per capita education spending and financed the transition to a system of free primary schooling.

Building on Tanzania's example, one of the first acts of the new Kenyan government in 2003 was to institute free primary education. Within a year an additional 1.5 million children were in school. Kenya has also created programmes to help poor households overcome cost constraints, such as the textbook fund and the school feeding programme. None of these investments would have been possible without increased aid.

In health, as in education, aid can reduce barriers by providing governments with the resources to reduce the cost of access. In 2001, as part of the national poverty reduction strategy, Uganda removed user fees for most lower level health facilities. In 2002/03 outpatient attendance rose by more than 6 million—an 80% increase over attendance in 2000. Attendance increased more sharply among poor people than among the better-off.

Source: Inyega and Mbugua 2005; Tanzania, Government of, 2004; World Bank and Republic of Kenya 2004; World Bank 2001.

Extending social insurance

The world's poorest countries have the greatest need for social insurance and the least capacity to finance it. Most low-income countries have exceptionally weak welfare provision. One consequence is that the poorest households are trapped in cycles of poverty, with low income, poor nutrition and vulnerability to shocks blocking exit from poverty.

Aid can help to break the cycle of poverty. Yet social insurance provision suffers from chronic underfinancing in aid. Programmes in this area have the potential to put resources directly in the hands of the poorest, most vulnerable households. Such programmes provide an international extension of the social welfare principle applied in rich countries, including the principle of enhanced equity. With donor assistance a pilot cash transfer scheme in Zambia targets the poorest 10% of the population, who cannot meet even the most basic nutritional standards. The transfer—$6 a month—enables beneficiaries to have two meals a day, rather than one, with large spillover benefits for child nutrition and household livelihoods (box 3.3).[19] In Viet Nam health inequalities are widening despite the government's strong record on human development. In response the government has created Health Care Funds for the Poor (HCFP) to provide social insurance to households unable to meet health costs. Working closely with donors, the government has developed strategies to target the poorest social groups and the poorest regions, such as the Central Highlands. Aid accounts for less than 4% of GNI in Viet Nam, but more than one-quarter of the HCFP budget.[20] Without donor support the investment in health equity would be heavily underfinanced.

Supporting reconstruction

In poor countries emerging from civil conflict, aid financing can help create the conditions for peace and human development. Mozambique shows what is possible. More recently, aid has been central to the rapid social progress achieved in Timor-Leste, with development assistance now representing more than one-half of GNI. In Afghanistan more than 4 million children enrolled in school as a result of the government's "Back to School" campaign, and the government has ambitious plans to restore the public health system. Donor financing has been a critical ingredient for success, financing more than 90% of social sector budgets in Afghanistan.[21] In Liberia and Sierra Leone long-term aid investment holds the key to moving forward after settlements that brought to an end two of the world's most brutal civil wars.

Meeting global health challenges

Some of the great achievements in global public health were made possible by multilateral aid initiatives. In the 1970s targeted aid of some $100 million, largely from the United States, led to the eradication of smallpox. The continuing savings on vaccinations and treatment heavily outweigh the initial investment. Polio has been eliminated as a threat in the Western Hemisphere. In West Africa a programme

Box 3.3 Aid for social insurance in Zambia

About half of Zambia's population of more than 10 million people live on less than the minimum energy standard set by the food poverty line. Malnutrition threatens lives, reduces opportunities for earning income, undermines the education of children and increases vulnerability to ill health.

Working with the Zambian Ministry of Community Development and Social Services, the German Agency for Technical Cooperation (GTZ) developed a pilot cash transfer programme in the southern Kalomo district. Covering 143 villages and 5 townships, the programme targets the 10% of households identified as most destitute on the basis of criteria agreed and administered through community-based welfare committees. Two-thirds of beneficiary households are headed by women, most of them elderly. Two-thirds of household members are children, 71% of them orphaned by HIV/AIDS.

Transfers under the programme amount to $6 a month. The pilot programme covers 1,000 households. Initial evaluations of the programme, which started in 2004, point to some successes. School attendance has increased and targeted households have been receiving regular monthly incomes.

Scaling up the transfer scheme to cover 200,000 destitute households would imply an annual cost of $16 million, or about 4% of total aid flows to Zambia. What this scheme demonstrates is the potential for such programmes to provide a conduit for poverty-focussed redistribution programmes. Very small transfers from rich countries can generate significant gains for poor households in countries like Zambia. However, the success of such social insurance schemes depends critically on donors and governments working together over a long time horizon.

Source: Goldberg 2005; Development Initiatives 2005a.

supported by 14 donors has halted the spread of river blindness at a treatment cost of about $1 per person. So far 60,000 cases of blindness have been prevented, and 18 million vulnerable children have been protected.[22] Donors have committed $1 billion through the Global Alliance for Vaccination and Immunization since 2000, averting more than 600,000 deaths from vaccine-preventable diseases.[23]

From a different perspective these multilateral success stories highlight the extent of failure in other areas. More than 27 million children miss out on immunizations in the first year of life, and 1.4 million children still die each year from vaccine-preventable diseases. Malaria results in another 1 million deaths annually, and yet the global initiative to reduce this death toll—the Roll Back Malaria Campaign—suffers from chronic underfunding and has achieved little as a result. As the UN Millennium Project argues, this is an area in which aid can deliver "quick wins". For example, a global initiative to ensure that every child in a malaria-endemic region in Africa receives a free anti-malarial bednet by 2007 would be a low-cost route to saving up to 60% of the lives claimed by malaria. USAID has been developing public-private partnerships to address this challenge. In Ghana, Nigeria, Senegal and Zambia a public-private partnership supported through USAID's NetMark programme sold more than 600,000 insecticide-treated bednets. However, these initiatives have yet to be scaled up to a level commensurate with the challenge.

Prevention through aid is a good investment as well as a humanitarian imperative. Apart from the human toll in lost lives and sickness, malaria reduces economic growth per capita by an estimated 1.3 percentage points a year in affected countries. This represents a severe handicap for achieving the MDG target of halving poverty. But the average figure understates the size of the handicap. Malaria cases are heavily concentrated among poor people: one study estimates that the poorest 20% of the world's population account for two-thirds of malaria cases.[24] In rural communities the malaria transmission season often coincides with planting and harvesting, leading to losses of output and income. Subsistence farmers suffer the heaviest burden because their margin for survival is so thin and their dependence on labour so critical. Even brief periods of illness can produce catastrophic consequences for households. Releasing households from the burden of malaria would generate high returns for poverty reduction as well as economic growth. Cutting malaria incidence by one-half in Africa would cost about $3 billion a year while generating an economic benefit of $47 billion a year.[25] That benefit is more than double total aid to Sub-Saharan Africa—and much of it would be concentrated in the hands of the poorest households.

Disease prevention through aid is a good investment as well as a humanitarian imperative

Financing aid—the record, the problems, the challenge

The people of this country are distant from the troubled areas of the earth and it is hard for them to comprehend the plight and consequent reactions of the long-suffering peoples, and the effect of those reactions on their governments in connection with our efforts to promote peace in the world. The truth of the matter is that Europe's requirements are so much greater than her present ability to pay that she must have substantial additional help or face economic, social and political deterioration of a very grave character.

—George C. Marshall[26]

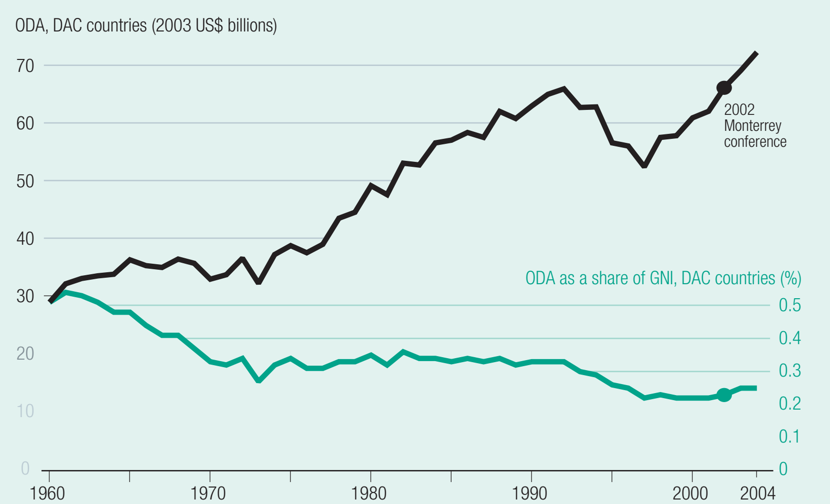
With these words at a Harvard University commencement ceremony in 1947 US Secretary of State George C. Marshall outlined his plan for European reconstruction. Over the next three years the United States transferred $13 billion in aid to Europe—equivalent to more than 1% of US GDP.[27] The transfers were driven partly by moral conviction, but also by the recognition that US prosperity and security ultimately depended on European recovery. The Marshall Plan provided a vision backed by a practical strategy for action.

At the end of the 1960s the Commission on International Development, convened by the World Bank under the auspices of former Canadian Prime Minister Lester Pearson, revived the spirit of the Marshall Plan.[28] It argued for donors to provide 0.7% of GNI in development assistance by 1975, asserting that "The fullest possible utilization of the world's resources, human and physical, which can be brought about only by international cooperation, helps not only those countries now economically weak, but also those strong and wealthy."[29] Thus, the case for the target was partly moral and partly enlightened self-interest.

Aid quantity

That argument retains relevance for current debates on aid. So, too, does the central principle of setting a target with a date for achievement. Without a schedule, targets risk remaining aspirations. In the 36 years since the Pearson report there has been no shortage of commitments to the 0.7% target, but rich countries have habitually failed to back promises with actions.

Figure 3.1 **The long view—trends in aid since 1960**



Source: OECD/DAC 2005f.

Aid targets and trends

Measured against the 0.7% target argued for in the Pearson report, let alone the standards set by the Marshall Plan, international aid in 2005 reflects a legacy of sustained underperformance. Aid is increasing, but from a low base—and financing still falls far short of what is needed to achieve the MDGs and wider human development goals.

At the 1992 United Nations Conference on Environment and Development (Earth Summit) in Rio de Janeiro, most donors revived their pledge to achieve the 0.7% target. They then spent the next five years cutting aid budgets as a share of national income to an all-time low of 0.22% in 1997. Aid flows stagnated until 2001, when a gradual recovery began. A key motivating event was the 2002 UN Conference on Financing for Development, where donors committed themselves to providing more—and better—aid.

Delivery on aid quantity commitments since then has been encouraging, but partial. In 2002 aid levels finally surpassed the 1990 benchmark. Provisional estimates for 2004 put aid at $78 billion, or some $12 billion higher than in 2000 in real terms. The recovery in aid volume looks less encouraging assessed against other benchmarks for generosity. In 1990 donors gave 0.33% of their GNI in aid. Since 2000 that share has climbed from 0.22% to 0.25% of GNI, highlighting the limits to aid recovery. From a longer term perspective those limits are even more starkly defined. As a share of GNI the weighted average for aid from Organisation for Economic Co-operation and Development (OECD) countries is one-third lower than at the start of the 1980s and one-half the level in the 1960s (figure 3.1). Translated into per capita aid receipts, much of the post-2000 recovery can be viewed as a process of restoring cuts. For Sub-Saharan Africa per capita aid fell from $24 in 1990 to $12 in 1999. In 2003 it was still just below the 1990 level.

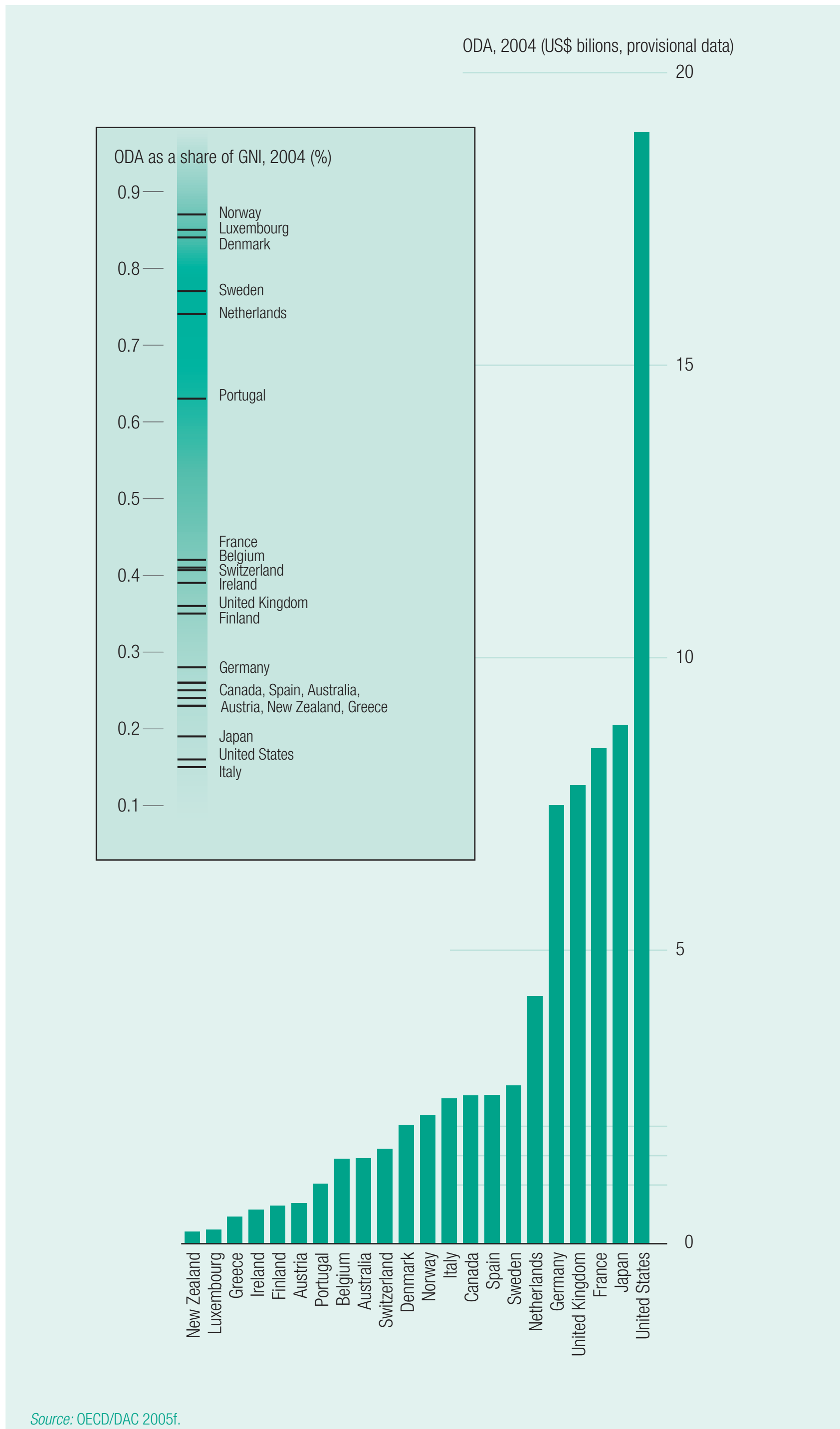
Development assistance comes through a variety of channels. Aid today is roughly divided at a ratio of 2:1 between bilateral aid allocated directly by individual countries and multilateral aid allocated to concessional finance facilities such as the World Bank's International Development Association (IDA), regional development banks and global mechanisms like the Global Fund to Fight AIDS, Tuberculosis and Malaria. The Group of Seven (G-7) leading industrial countries dominates international aid flows, accounting for three-quarters of development assistance. That gives them tremendous influence on prospects for closing the MDG financing gap. Measured by the standards of their wealth, some of the world's largest economies are among the least generous donors. Only one member of the G-7 is among the top 10 donors when aid is measured as a share of GNI. The bottom three places in the donor generosity league as measured by this indicator are held by G-7 countries (figure 3.2).

In financial terms the United States is the world's largest donor. Since 2000 its ratio of aid to GNI has increased from an exceptionally low base of 0.10% to 0.16% in 2004. The United States has climbed above Italy, but it remains second to last in the share of aid to GNI. The steady decline in Japanese aid, which fell by another 4% in 2004, has pushed Japan into the third slot from the bottom. At the other end of the list five small countries—Norway, Luxembourg, Denmark, Sweden and the Netherlands—have consistently met or surpassed the UN target.

A new category of donors is emerging: the transition economies of Eastern Europe, which have graduated from being aid recipients to being donors. Their contributions are still relatively small—the Czech Republic, which gives 0.1% of GNI, is the most generous. Since acceding to the G-7, the Russian Federation has also emerged as a donor and contributor to debt relief in low-income countries. The Russian government is working with the United Nations Development Programme (UNDP) to create an aid agency (called, for now, RUSAID), and it too is set to become a more important player in international aid. With oil revenues rising, Arab states are also making a greater contribution to aid flows, with transfers reaching about $2.6 billion in 2003. However, the G-7 countries still account for 70% of official development assistance, an obvious corollary of which is their influence on future aid levels and prospects for MDG financing.

Over the longer term rich-world prosperity has been inversely related to aid generosity. Since 1990 income per capita in rich countries has increased by $6,070 in constant prices,

Figure 3.2 **The aid donor league**



Source: OECD/DAC 2005f.

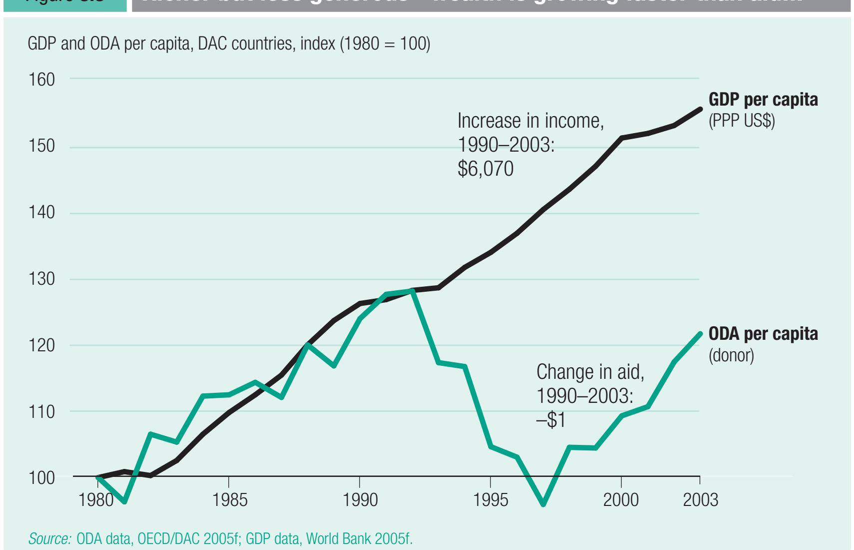
while aid fell by $1 per capita (figure 3.3). The winners from globalization have not prioritized compensating the losers or spreading prosperity. Investment in aid per capita ranges widely in donor countries, from more than $200 in Sweden and the Netherlands to $51 in the United States and $37 (and falling) in Italy (figure 3.4). At constant prices four of the G-7 countries—Germany, France, Italy and Canada—are still giving less today than they were in 1992. Italy's 2004 aid spending was roughly one-half of its 1992 level.

At the 2002 Conference on Financing for Development in Monterrey donors agreed to collectively undertake "efforts to reach" the 0.7% target—words that stop some way short of a commitment (and with different meaning to different donors). However, as the Pearson report correctly identified, broad pledges without target dates are of limited use. Because effective planning for poverty reduction requires that resources be predictable, donors need to translate broad targets for increased aid into tangible budget commitments. Some donors have incorporated the 0.7% target into budget planning. Apart from the five donors that have achieved the target, another six have now set timetables, with varying degrees of ambition, for joining this group: including Belgium by 2010 and the United Kingdom and France by 2012–13.[30] Others—notably Japan and the United States—have set no timetables. The United States has clearly stipulated that it does not see the 0.7% target as an operational budget commitment.

The galvanizing effect of the Monterrey conference is reflected in the fact that all donors have pledged to increase their aid budgets, though it took New Zealand until 2005 to make that pledge. The US Millennium Challenge Account was the centrepiece of a commitment to raise aid spending by 50%, or $4–$5 billion annually, by 2006. The European Union's 15 richest member states, building on a commitment made before Monterrey to achieve an aid to GNI target of 0.33% by 2006, agreed in 2005 to a supplementary minimum target of aid to GNI of 0.51% by 2010 as an interim step to meeting the 0.7% commitment by 2015. The 10 poorest members agreed to a 0.17% target for 2010 and 0.34% by 2015. The EU decision marks a bold step in the right direction. If honoured, the commitments could mobilize an additional $30–$40 billion in aid by 2010. Other commitments are more open ended. For example, Canada has set a target of doubling its 2001 aid level by 2010 and doubling aid to Africa by 2008. Even with these commitments, Canada's aid will reach only about 0.33% of GNI by 2010. While Japan has pledged to double aid to Africa, it has made no meaningful commitment on overall aid to GNI levels.

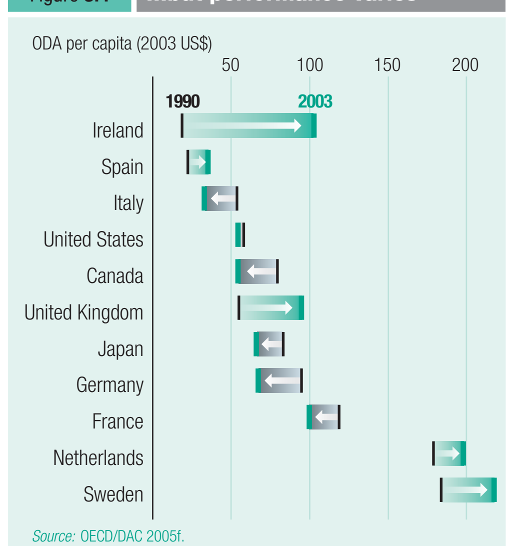
The impact of these pledges is already apparent in the increases in aid in real terms in every

Figure 3.3 Richer but less generous—wealth is growing faster than aid...



Source: ODA data, OECD/DAC 2005f; GDP data, World Bank 2005f.

Figure 3.4 ...but performance varies



Source: OECD/DAC 2005f.

year since 2002, an increase of $6 billion (in 2003 prices and exchange rates). Aid has clearly emerged as a more important public spending priority. But while the trend of rising aid budgets appears firmly established, it cannot be taken for granted that donors will deliver completely on their Monterrey commitments. Italy's aid has fallen back to its 2001 level, a 30% drop since Monterrey. It will have to more than double current spending next year to meet the European Union's 2006 commitment. Germany froze spending in real terms in 2004 and faces a considerable challenge in raising aid from its current level of 0.28% of GNI to 0.33% by next year. Japan has also cut aid spending and will have to find an extra $1 billion by 2006 if its limited goal of keeping aid at the 2001–03 average level is to be achieved.

While the United States has sharply increased its aid budget, allocations under the Millennium Challenge Account have fallen short of administration requests. In 2005 Congress authorized $1.5 billion against a request of $2.5 billion. While all countries with per capita incomes below $1,435 are eligible, as of mid-2005 only two grants had been allocated. These were a $110 million programme for Madagascar to be disbursed over four years and a $215 million programme for Honduras to be disbursed over five years.[31]

Given the short time since the Monterrey conference, it would be premature to draw strong conclusions from trend analysis. Much will depend on whether governments translate current aspirations into hard budget choices. If achieving the 0.7% goal by 2015 were used as a benchmark, current performance would appear in a less positive light. Figure 3.5 shows where aid levels would be today in a hypothetical world where all donors set an aid to GNI target of 0.7% by 2015, assuming that their aid budgets increased by equal annual increments of aid to GNI ratios from 2000. The size of the gaps between current levels and the stylized target are self-explanatory. Admittedly, the exercise is an artificial one because not all donors accept the 0.7% target. Even so, it provides a useful point of reference. Even for donors that have committed to the 0.7% target, the gap between performance and progress needed is large. However, the recent summit meeting of the G-8 leaders at Gleneagle in Perthshire, Scotland, proved that progress on bridging these gaps is possible (box 3.4).

Aid flows cannot be considered in isolation. This is especially the case for low-income countries facing debt service difficulties. In 2003 the 27 countries receiving debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative transferred $2.6 billion to creditors, or 13% of government revenue.[32] These transfers have been diverting resources from investment in human development and economic recovery. In 2005, almost a decade after the creation of the HIPC Initiative, creditors finally agreed to a plan for writing off 100% of multilateral debt. This represents a huge step in the right direction. However, the new deal on debt does not adequately cover several countries—including

Figure 3.5 Post-Monterrey progress towards the ODA target

Source: Development Initiatives 2005d.

3

Aid for the 21st century

Box 3.4 **From the G-8 summit to the General Assembly—following up words with action**

Group of Eight (G-8) summits have a long track record in delivering lofty promises, that are swiftly broken, especially to the world's poorest countries. Will it be different after the July 2005 summit in Gleneagle, Scotland?

The G-8 communiqué makes some important commitments. The pledge to increase aid by $50 billion over 2004 levels, with half the increase going to Sub-Saharan Africa, could close a substantial part of the MDG financing gap. Moreover, for the first time the G-8 leaders have signed a communiqué specifying concrete targets, which may reduce the risk of backsliding.

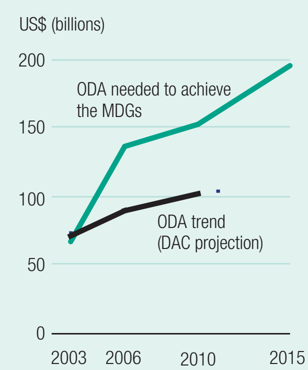
Looking ahead, there are three challenges on aid. First, G-8 leaders must be held to their word. There is a real danger that at least two EU members—Germany and Italy—will not translate G-8 summit commitments into public expenditure plans. Second, some countries need to go much further. Even with aid increases Japan and the United States will still be spending only 0.18% of GNI on aid in 2010 (putting them at the bottom of the OECD aid table)—and Canada is also an aid underperformer. Third, it is important that a sizeable share of the increased aid commitment be delivered up-front, not in five years time.

Beyond aid, the G-8 communiqué receives mixed marks. The commitment to free and compulsory primary education, free basic health care and "as close as possible to universal access" to treatment for HIV/AIDS could accelerate progress towards the MDGs. So, too, could the pledge to train and equip some 75,000 troops for African Union peace-keeping operations by 2010 (see chapter 5). On trade, by contrast, the G-8 communiqué makes for unimpressive reading. The general commitment to phase out a limited range of agricultural export subsidies within an unspecified time-frame will come as cold comfort to Africa's farmers.

Two critical ingredients combined to make the G-8 summit in Gleneagle different: political leadership and the political momentum generated by global campaigning and public opinion. The same ingredients will be needed if the UN summit in September 2005 is to consolidate and build on what has been achieved.

Source: G-8 2005.

Figure 3.6 **The MDG financing gap**



Source: ODA needed data, UN Millennium Project 2005e; ODA trend data, OECD/DAC 2005a.

Nigeria—for which unsustainable debt remains a barrier to achieving the MDGs (box 3.5).

The adequacy of current aid and debt relief efforts must be considered in the proper context. From an MDG perspective what matters is how current aid commitments square with the financing requirements for reaching the targets. Estimating MDG financing gaps is an inexact science. Cost structures vary widely from country to country, and there is a dynamic interaction among the MDGs: progress on, say, girls' education can reduce the costs of achieving progress on child mortality, for example. The UN Millennium Project estimates that overall aid will need to roughly double by 2006 and then rise by another 50% (to $195 billion) by 2015 to meet the MDG targets. Proposals set out in a report by the UK-sponsored Commission for Africa are broadly consistent with this assessment.[33] They recommend a doubling over the next three to five years of the $25 billion in aid currently provided to the region, with a further $25 billion increase to 2015. Current aid projections fall far short of these levels.

Financing gaps. One of the problems with estimating the MDG financing gap is that the budget targets set by donors may not be achieved. If acted on—and this remains a big if—the pledges made during and after the Monterrey conference would result in aid budgets rising to 0.30% of donor countries' national income by 2006, an increase to $88 billion (at 2003 prices and exchange rates). That figure falls $47 billion short of the $135 billion that the UN Millennium Project estimates rich countries should be spending next year to keep the world on track for the MDGs (figure 3.6). The financing gap increases to $52 billion by 2010. By that point, if rich countries fail to follow through on their commitments, developing countries will be unable to make the investments in health, education and infrastructure needed to improve welfare and support economic recovery on the scale required to achieve the MDGs. Admittedly, these figures do not factor in the European Union's 2010 target of 0.51%, but this target is not yet enshrined in concrete budget commitments. It is also important to bear in mind that not all of the additional aid mobilized since Monterrey will be directed specifically towards MDG financing gaps.

Real aid and headline figures

If anything, the financing gap figures may understate the problem. Closing financing gaps requires real money, but not all of the money counted as aid translates into a transfer of resources. This is especially the case for the three categories of assistance that accounted for more than 90% of the $11.3 billion increase in bilateral aid between 2000 and 2004: debt relief ($3.7 billion), technical cooperation ($5.2 billion) and emergency assistance ($1.7 billion; figure 3.7). Increases in these areas generate headline figures that are larger than real aid transfers.

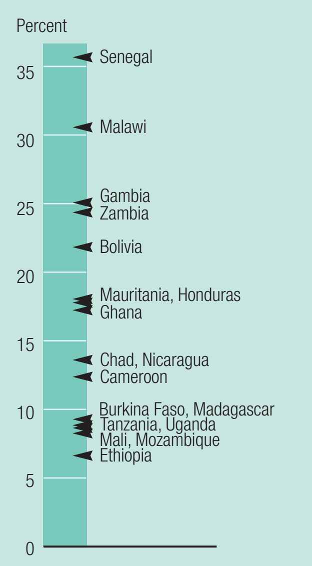
Box 3.5 Debt relief—going the extra mile

Twenty years ago, Julius Nyerere, then President of Tanzania, asked the governments of rich countries a pointed question: "Should we really starve our children to pay our debts?" Almost a decade after the launch of the Heavily Indebted Poor Countries (HIPC) Initiative was supposed to consign Africa's debt crisis to the history books, creditors have at last started to answer that question in the negative. While details of the debt relief deal agreed by the G-8 finance ministers in June 2005 remain sketchy, real progress has been made, though some important questions still have to be addressed.

Headline numbers on debt relief provided under the HIPC Initiative before the 2005 G-8 meeting were impressive. In total, 27 countries eligible for loans from the World Bank's concessional facility, the International Development Association (IDA)—all but 4 in Africa—were benefiting from debt stock reduction commitments valued at $32 billion (in net present value terms). The debt relief premium has helped advance progress towards the MDGs. According to the World Bank, public spending on health, education and other poverty reduction investments has risen by 2% of GDP in countries receiving debt relief. Savings generated through the HIPC Initiative have helped finance free primary education in Uganda and Tanzania, anti-HIV/AIDS programmes in Senegal, health programmes in Mozambique and rural development in Ethiopia.

The bad news was that the headline numbers on debt stock reduction obscured other parts of the balance sheet—notably the columns dealing with debt service and government revenue. In 2003 the 27 countries receiving debt relief still spent $2.8 billion in repayments to creditors. On average, that figure represented 15% of government revenues, rising to more than 20% in countries like Bolivia, Zambia and Senegal (figure 1). For a group of the world's poorest countries these were very large transfers, averaging some 3% of national income.

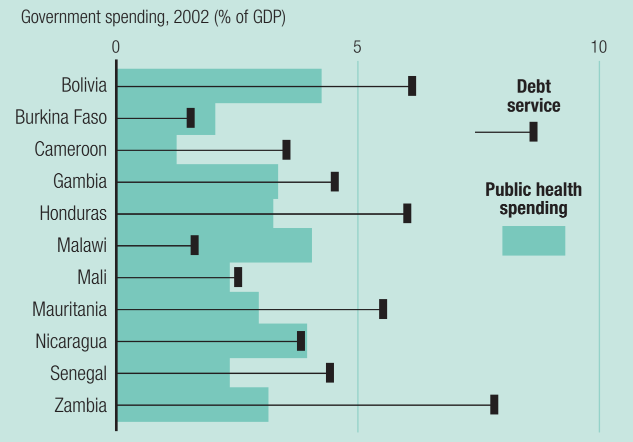
Figure 1 Debt as a share of revenue



Source: World Bank and IMF 2005b.

The upshot is that debt repayments have been diverting resources from social priority areas critical to progress towards the MDGs. For example, Zambia, with one of the highest levels of HIV/AIDS infection in the world, has been spending more than $2 on debt repayments for every $1 it allocates to health sector spending (figure 2). While aid flows continue to exceed debt payments (an important difference from the Latin American debt crisis of the 1980s), high levels of debt service have deprived HIPC governments of revenue and made them more dependent on aid—and their budgets more susceptible to the vagaries of donor priorities.

Figure 2 Debt service and public health spending



Source: Calculated on the basis of data on debt service and public health expenditures from indicator table 20, data on population from indicator table 5 and data on GDP from indicator table 14.

Delivery fell short of expectation under the HIPC Initiative for several reasons. First, the primary criterion adopted for debt sustainability—a debt stock threshold of 150% of exports in net present value terms—attached too much weight to export indicators and insufficient weight to the impact of debt on national budgets and capacity to finance progress towards the MDGs. Second, whereas most major bilateral creditors have been providing 100% debt relief, multilateral donors such as the World Bank, the IMF and the regional development banks have not, with the result that their share in debt service payments has been rising. Third, eligibility for full debt relief has been contingent on complying with IMF programmes and loan conditions. Interruptions to these programmes have delayed debt relief for a large group of HIPCs, including Honduras, Rwanda and Zambia.

Will the June 2005 agreement resolve these problems? The agreement provides for 100% debt relief for 18 countries that have passed through the full HIPC process to reach the "completion point". Crucially, it also stipulates that the costs for reducing multilateral debt owed to IDA and the Africa Development Fund will be met through additional finance from creditors, thereby avoiding the diversion of development assistance into debt relief. In the case of the IMF debt relief financing will be generated through internal resources, possibly including the sale or revaluation of part of the IMF's gold stock. Another eight countries will become eligible for 100% debt reduction in the next one to two years as they reach the HIPC completion point. This group includes countries embarking

(continued on next page)

Box 3.5 **Debt relief—going the extra mile** (continued)

on reconstruction—such as the Democratic Republic of the Congo and Sierra Leone—and countries like Cameroon and Chad that have had interrupted IMF programmes. For all of these countries the new debt relief deal has the potential to release new resources for development—and it is crucial for MDG financing that the resources be deployed efficiently to support social sector services and broad-based growth.

Implementation of the new agreement will need to be closely monitored to ensure that debt relief finance is genuinely additional. Particular concerns have been raised about the failure of the financing arrangements to cover the costs of debt reduction for the Inter-American Development Bank, which will need to meet part of the bill for financing debt relief in Bolivia, Honduras and Nicaragua. Nonetheless, for the 27 HIPCs now receiving debt relief the agreement is unambiguously good news.

More problematic is the question of how to deal with countries beyond this group. HIPC membership has now been closed on the basis of countries covered in 2004. Ironically, this means that some countries eligible for IDA loans have debt indicators that are worse than those of the HIPCs following HIPC debt relief and yet these countries do not qualify for debt relief on the grounds that they were not on the 2004 list. For example, Haiti, Kenya and Kyrgyzstan all have debt stock to export ratios that exceed 150%, yet they are not eligible for debt relief. So far, individual creditors have responded unilaterally to the anomalies in the HIPC framework. For instance, the United Kingdom has developed proposals for cancelling its share of debt service payments owed by countries such as Armenia, Mongolia, Nepal, Sri Lanka and Viet Nam. Looking ahead, what is needed is a more coherent strategy for reducing debt obligations to a level consistent with MDG financing requirements.

Nigeria's experience highlights other limitations in the current debt relief framework. In contrast to the HIPCs, Nigeria owes the bulk of its debt—some 80% of the total—to bilateral creditors rather than to the World Bank or the IMF. Creditors have cited Nigeria's oil wealth as grounds for refusing debt relief. Yet although Nigeria is the world's eighth largest oil exporter, it ranks 158 on the HDI, has one of the poorest populations in Sub-Saharan Africa and receives less than $2 per capita in aid—one of the lowest levels for the region. Nigeria's annual debt service bill is more than $3 billion a year—exceeding public spending on health. Moreover, because less than half the external debt is being serviced, arrears are accumulating. True, Nigeria's debt problems could have been avoided had previous governments not indulged in economic mismanagement and transferred oil revenues to Swiss bank accounts. But this hardly provides a rationale for penalizing poor Nigerians today or for undermining a government committed to reform.

Source: World Bank and IMF 2004c; Martin and others 2004.

Consider debt relief. A highly effective form of development assistance, it gives governments greater control over domestic revenues and reduces their dependence on aid. Forgiveness of debts that are actually being serviced releases budget resources for other purposes. However, OECD reporting arrangements allow governments to report the entire stock of debt reduction as aid given in the year it is written off. This inflates the actual value of debt relief since the real financial savings to the recipient country come in the form of reduced debt servicing.

In cases where the debts were not being fully serviced, debt relief is in part an accounting operation. Much of the $4 billion increase in aid to the Democratic Republic of the Congo in 2003 fits into this category. Ethiopia received debt stock reduction under the HIPC Initiative of $1.3 billion in 2003, for a reduction in debt servicing of $20–$40 million a year. This is not an argument against debt relief but against current accounting practices that give a misleading impression of how much aid donors are giving. Over the next few years large debt reduction operations are in prospect for Iraq and for countries under the HIPC Initiative. It is important that the high face value of these operations not divert attention either from the relatively modest budget savings that result or from the need to see debt relief as one part of a wider financing package for achieving the MDGs.

Many of the same arguments apply to technical assistance and emergency aid. Technical assistance accounted for $1 in every $4 in aid provided in 2003. Often, this assistance plays an important role in supporting development and building capacity, but much of it represents expenditure in donor countries—a problem compounded by tied aid (discussed later in this chapter). Aid to education demonstrates the problem. The greatest financing gaps are in training, remuneration and retention of teachers; construction of classrooms; and the provision of textbooks. Yet three-quarters of

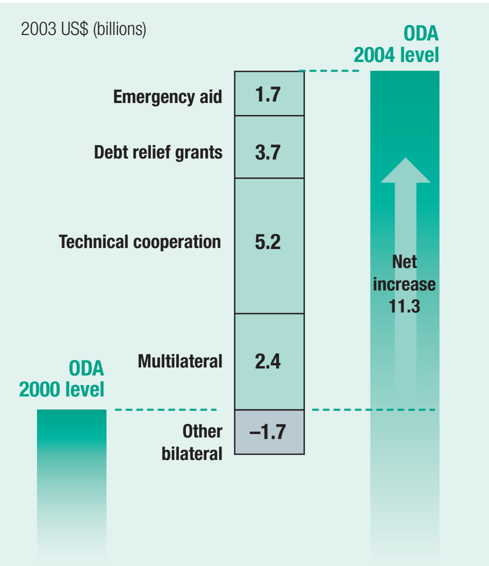


Figure 3.7 The composition of increased aid

Source: OECD/DAC 2005f.

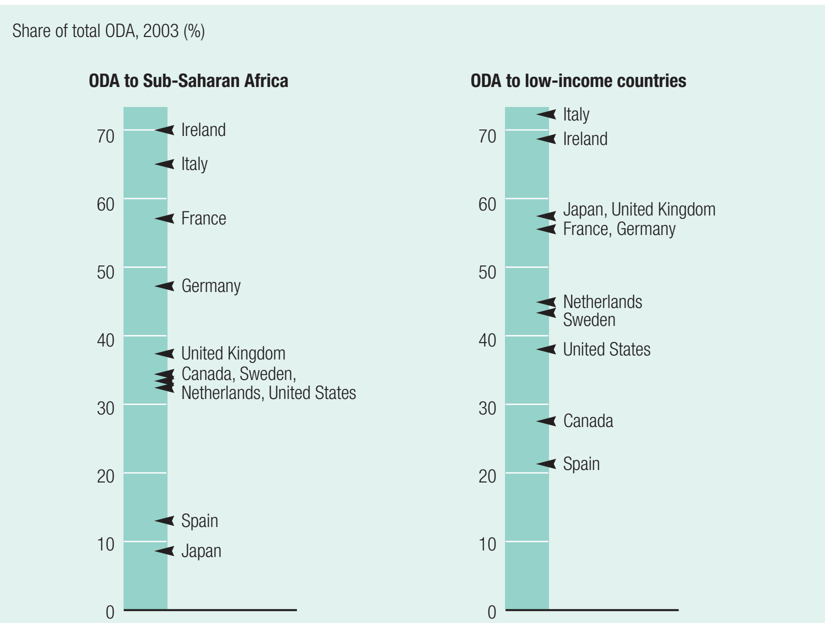
donor support to education comes as technical assistance. Much of this is swallowed up in payments for scholarships, external technical advice and consultancy fees. The quality of technical assistance varies widely, but as with debt relief the important point for MDG financing is that resources do not flow automatically into priority areas. Emergency aid, and assistance to fragile states, are a priority, but they are also a response to financing requirements over and above those estimated for the MDGs. Afghanistan and Iraq together accounted for $3.2 billion of the increase in official development assistance between 2001 and 2003—and for a large slice of the increase in aid from the United States. In fact, more than 40% of the $3.8 billion increase in U.S. development assistance in 2003 was earmarked for Iraq. To date, most of the increase in aid for emergencies has been through the mobilization of additional funds, though in practice additionality is hard to confirm. For example, Japan has combined increased aid for Afghanistan and Iraq with deep cuts in overall development assistance. Whatever the current position, the diversion of aid from MDG financing into post-conflict reconstruction or wider strategic objectives remains a real threat.[34]

Aid selectivity

Another reason that headline figures may understate the scale of the MDG financing problem is that donors vary in their aid allocation patterns. Low-income countries and Sub-Saharan Africa, which face the biggest financing gaps, figure more prominently in some aid programmes than in others (figure 3.8). Aid delivered through multilateral mechanisms such as IDA and the Global Fund to Fight AIDS, Tuberculosis and Malaria are probably the most strongly targeted at MDG financing gaps—in IDA's case because eligibility is largely restricted to low-income countries (box 3.6). This does not imply that aid to middle-income countries is not justified on human development grounds. But it remains the case that donors vary in the share of aid allocated to the poorest countries facing the most serious financing constraints for the MDGs.

Donor selection of preferred aid recipients affects the distribution of aid. A highly influential 1997 study argued on the basis of cross-country evidence that aid was effective only in "good" policy environments (fiscal stability, low inflation, open markets and other criteria).[35] That study led to the new orthodoxy that aid should be used selectively to reward strong reformers.

Figure 3.8 Donors vary in aid to the poorest countries



Source: Calculated on the basis of ODA data from OECD/DAC 2005f.

Box 3.6 **The future of the International Development Association**

As the international mechanism most effectively targeted to the poorest countries, the International Development Association (IDA) occupies a pivotal position in MDG financing: $1 given through IDA is more likely to reduce an MDG financing gap than $1 delivered through any other channel. Moreover, because IDA operates on a three-year budget cycle, it is less prone to the unpredictability associated with bilateral aid provided through annual budgets.

In 2005 donors allocated $34 billion to IDA through 2008—a 25% increase in real terms. This is the largest expansion in two decades, though far below the 40%–50% that most European governments wanted. Had the European proposals been adopted, that would have increased the multilateral share in aid and the share of aid earmarked for the poorest countries. IDA is the third largest source of aid to Sub-Saharan Africa (after France and the United States) and the main source of aid for education and health.

Important questions remain about IDA's future role in financing for development. About one-fifth of IDA loans are provided on grant terms to countries vulnerable to debt problems. The remainder is allocated as concessional loans: repayments over 40 years with a 10-year grace period. Some donors want to retain this balance. Others favour transforming IDA into a predominantly grant-based agency.

These are dangers in going down the grants-only route. Donors currently provide about one-half of IDA's income. Another 40% comes from repayments of past loans by countries like China, which have risen from low- to middle-income status. Moving to a grant system could choke off this flow of payments, reducing the resource base. Moreover, some countries—Bangladesh and India, for example—are in a position to use soft loans while others could use IDA to make a transition from reliance solely on grants.

There is another reason for caution. Donors could neutralize the financial effects by agreeing to compensate any loss of IDA repayments through binding commitments of increased grants. But no donors have done so. Without such guarantees of increased long-term financing, IDA flows would become dependent on unpredictable donor support.

Source: Rogerson 2005.

However, subsequent studies found that aid can also be effective in countries with a less favourable institutional environment and weaker economic reform record. This conclusion does not mean that the policy environment is unimportant: on the contrary, effective macroeconomic management is vital. But the evidence does caution strongly against using uniform "good policy" checklists as a basis for aid allocation.

Best evidence suggests that aid can be effective in a diverse range of environments—and that policy precondition blueprints are not helpful.[36] There is a danger of these blueprints dividing aid recipients into donor darlings and donor orphans based on flimsy evidence about their capacity to make good use of aid. This is already happening to some degree, with an overconcentration of donor darlings in Anglophone Sub-Saharan Africa (and Mozambique and Ethiopia) and an overrepresentation of donor orphans in Francophone Africa and Latin America.

Recent research using the World Bank's policy selectivity index, a measure of the correlation between aid and the quality of institutions in aid recipient countries, suggests that development assistance flows are increasingly sensitive to the quality of institutions (as defined in the index).[37] At the same time the donor focus on institutional performance is far more stringent in low-income countries than in middle-income countries. More worrying, some low-income countries receive aid at levels some 40% lower than their institutional capacity would indicate.[38]

None of this is to deny the obvious importance of the national policy environment in determining the effectiveness of aid. Countries as diverse as Bangladesh, Mozambique and Viet Nam are able to generate high human development returns for aid because they have effective strategies for poverty reduction. Conversely, endemic corruption, weak governance and economic mismanagement diminish the potential benefits of aid. Corruption undermines aid efforts in two respects. First, poor households suffer disproportionately from corrupt practices. A survey in Cambodia found that corruption cost low-income households three times as much of their income as it did high-income households, partly because low-income households depend more on public services.[39] Second, financial outflows associated with corruption can dwarf aid inflows: on one estimate public financial assets exceeding the value of Africa's external debt have been illegally transferred to foreign banks accounts.

Aid donors can most effectively address these problems through partnerships with governments committed to financial transparency and accountability rather than through the imposition of blueprints.

Aid and the MDGs: can rich countries afford them?

Can rich countries afford to deliver on their long-standing commitment to spend 0.7% of

GNI on aid? That question has a critical bearing on prospects for achieving the MDGs and wider human development goals.

In any democracy what governments regard as affordable will reflect an assessment of the costs and benefits of public spending. That assessment will be guided by judgements about political priorities mediated through political processes that lead to choices about the merits of competing claims. Aid budgets reflect how governments and the public view world poverty and their obligations and interests in combating it.

Affordable costs

Assessed against the wealth and resources of rich countries, the cost of achieving the MDGs is modest. More than 1 billion people in the world lack access to clean water and 2.6 billion to sanitation. Overcoming these deficits would cost just under $7 billion a year over the next decade. This investment could save some 4,000 lives each day as a result of reduced exposure to infectious diseases. It would address a problem that robs poor people of their health, undermines economic development and imposes huge demands on the time and labour of young girls and women. The investment required seems like a lot of money—and for low-income developing countries it is. But it is no more than the $7 billion a year that Europeans spend on perfume or the $8 billion a year that Americans spend on elective corrective surgery.

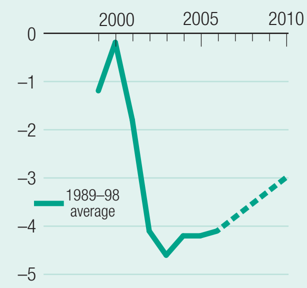
Such comparisons are not to deny the effort that will be required to increase aid on a scale commensurate with achieving the MDGs. In all of the G-7 countries—except Canada—fiscal deficits remain high—indeed, their fiscal position as a group has deteriorated (figure 3.9). The US fiscal deficit (as a percentage of GDP) is now the largest of any major industrial country except Japan. Current budget proposals envisage the halving of this deficit by 2009, with a reduction in non-military spending to its lowest share of GDP in over 40 years. Clearly, this is not a propitious environment for expanding aid budgets. The same is true for Japan, where the structural fiscal deficit is projected to decline only slightly, to just over 6% of GDP by 2006. Over the medium term Japan's budget plans envisage converting the deficit into a surplus by 2010—a target that will translate into intense pressure for cuts in public investment.

The position in the European Union is scarcely more encouraging. Although fiscal deficits are smaller in the euro area than in Japan or the United States, both France and Germany have fiscal deficits exceeding 3% of GDP, while Italy's projected deficit will reach more than 4% by 2006. The smaller scale of fiscal deficits in the European Union than in the United States or Japan conceals three other underlying pressures. Public debt levels are high in the euro zone. The fiscal pressures associated with an aging population are mounting. And rates of joblessness have forced unemployment to the top of the political agenda of some countries. Since 2003 unemployment rates have been locked at more than 9% in France, Germany and Italy. While reforms to the European Union's Stability and Growth Pact have increased flexibility, EU governments are facing intense fiscal pressures in the context of low growth, high unemployment and mounting pressure on public spending. Against this backdrop the European Union's decision to set an aid target of 0.51% of GNI was an important political statement of intent. However, an exceptional effort will be required to ensure that the target is translated into hard budgetary commitments.

While the fiscal pressures facing G-7 and other industrial country donors are real, it is important to recognize that aid budgets, even at expanded levels, represent a modest source of that pressure. For two of the G-7 countries—Italy and the United States—development assistance accounts for 1% or less of public spending, far below the OECD average. In 2004 total aid budgets were equivalent to only 3% of the overall fiscal deficit for both Japan and the United States and 5% for Germany. Even if all the G-7 countries were to increase their aid to the EU target level, any detrimental impact on their fiscal position would be limited. Conversely, constraining aid spending will have a similarly marginal effect on improving that position.

In practice, how governments prioritize public spending, just as how they respond to fiscal pressures, will reflect their ordering of political priorities, as well as policy judgements

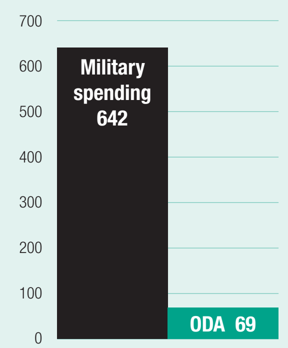
Figure 3.9 **Strained fiscal situation in G-7 countries**



Source: IMF 2005b.

Figure **3.10** Military spending vs. development assistance

Spending by OECD donors, 2003 (US$ billions)



Source: Development Initiatives 2005d.

Table **3.1** Military expenditure dwarfs official development assistance in rich countries

Share of government spending, 2003 (%)

Country	ODA	Military expenditure
Australia	1.4	10.7
Austria	1.1	4.3
Belgium	2.7	5.7
Canada	1.2	6.3
Denmark	3.1	5.7
Finland	1.6	5.4
France	1.7	10.7
Germany	1.4	7.3
Greece	1.4	26.5
Ireland	2.1	4.6
Italy	0.9	9.8
Japan	1.2	5.7
Luxembourg	3.9	4.8
Netherlands	3.2	6.5
New Zealand	1.2	6.3
Norway	4.1	8.9
Portugal	1.0	10.0
Spain	1.3	6.7
Sweden	2.8	6.4
Switzerland	3.5	8.5
United Kingdom	1.6	13.3
United States	1.0	25.0

Source: Calculated on the basis of data on ODA from OECD/DAC 2005f, data on military expenditure from indicator table 20 and data on government spending from World Bank 2005f.

on taxation, the scope of public investment and economic reform. If, as we argue in this chapter, increased aid is an imperative not just on moral and ethical grounds, but also in terms of the enlightened self-interest of rich countries, as reflected in the future prosperity and security of their citizens, then it is important to accord aid a far higher budget priority.

Military spending and aid levels

Comparisons with military spending are instructive. For every $1 invested in development assistance another $10 is spent on military budgets (figure 3.10). No G-7 country has a ratio of military expenditure to aid of less than 4:1. That ratio rises to 13:1 for the United Kingdom and to 25:1 for the United States (table 3.1). In a world where rich countries increasingly recognize that security threats are linked to global poverty, inequality and insufficient hope for large segments of the world's population, this 10:1 ratio of military spending to aid spending makes no sense. On any assessment of threats to human life there is an extraordinary mismatch between military budgets and human need. The amount that rich countries currently spend on HIV/AIDS, a human security threat that claims 3 million lives a year, represents three days' spending on military hardware.

Budget priorities in many rich countries reflect neither an adequate commitment to the MDGs nor a coherent response to the security challenges posed by mass poverty and deep global inequalities. The discrepancy between military budgets and development budgets puts the affordability of the MDGs in a different light. Had the $118 billion increase in military spending between 2000 and 2003 been allocated to aid, development assistance would now represent about 0.7% of rich country GNI. Just $4 billion—about 3% of the increase in military spending—is needed to finance basic health interventions that could prevent the deaths of 3 million infants a year. If the war against poverty is a priority, it is simply not credible for governments to attach so little weight to aid budgets aimed at saving lives.

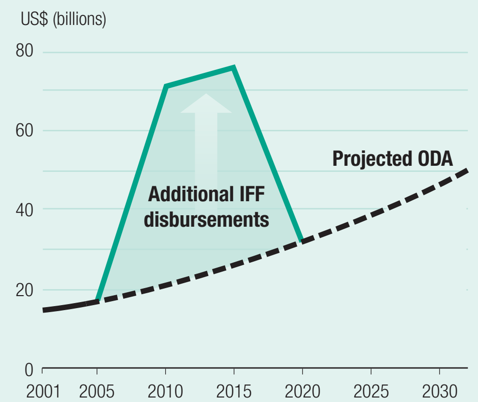
None of this detracts from the very real security threats that developed country governments have to address. These threats range from the proliferation of nuclear weapons to international terrorism. However, legitimate questions can be asked about whether military upgrading is the most effective response. For example, a comprehensive test ban treaty and a sharp reduction in operationally deployed nuclear warheads would eliminate the need for some of the extensive—and expensive—programmes now under way for modernizing nuclear forces and developing new launch vehicles. Investment of more political capital in negotiated disarmament and less financial capital in military hardware would enhance security and release resources for development.

Innovative financing

Various innovative proposals have been developed to bridge the MDG financing gap. These involve looking beyond public spending to private capital markets and new forms of financing.

The International Financing Facility (IFF) proposed by the UK government is one example. Underpinning the IFF is a simple idea:

Figure **3.11** **Frontloading aid through the International Finance Facility**



Source: Development Initiatives 2005c.

governments should use their ability to leverage resources in capital markets to provide additional aid. The IFF would use government pledges of increased aid to back the issuance of government bonds. Income from the sale of these bonds would be channelled through aid programmes, with the IFF drawing down future aid flows to pay off the bonds as they fall due.[40]

One of the strengths of the IFF is that it would frontload finance for investment in this critical period (figure 3.11). Even if all donors committed themselves to reaching an aid to GNI target of 0.5% by 2010 and 0.7% by 2015, there would be an MDG financing gap in the short term until the new resources came on-stream. Under the IFF, aid transfers could be expanded with immediate effect, while the budgetary costs to governments would be deferred. This frontloading would enable developing country governments to make key investments in health, education and infrastructure, while high-income countries could act on their MDG commitments without compromising fiscal stability (box 3.7).

Other proposals envisage raising additional revenue through international taxation mechanisms.[41] In practice, any international taxes would have to be implemented by national governments, as they are the only sovereign bodies with revenue raising powers—and the United States, in particular, is opposed to the approach. Support is strongest in the European Union. Several governments are assessing the implications of an international tax on aviation fuel. Even set at a low level, such a tax could raise $9–$10 billion a year.[42] Another proposal calls for a flat-rate tax on airline passenger tickets, with the revenue earmarked for prevention and treatment of HIV/AIDS. This proposal has been advocated by one G-7 country (France) and supported by two others (Germany and the United Kingdom), with several developing countries (including Brazil) backing the

Box **3.7** **The International Finance Facility**

To have a lasting effect on poverty, aid should meet three conditions. It should be sustained and predictable, large enough to facilitate simultaneous investment across sectors that reinforce each other's impact and rooted in viable development plans. In the absence of these conditions aid is less an investment in permanent poverty reduction and more an occasional compensation for being poor.

The importance of sustained and predictable aid is self-evident. No responsible private company would embark on a project to increase future returns until it had a fully financed multiyear plan. The same applies to governments in poor countries. If, like Senegal, a country depends on aid for 30% of public spending and 74% of public investment, a secure and predictable flow of aid is a condition for long-run investment. Countries cannot achieve universal primary education by abolishing user fees, constructing schools and training teachers unless funding is ensured to maintain schools and pay teachers beyond the first couple of years. And countries cannot be expected to sustain their investments in education unless they also have a financed health plan that prevents teachers from dying of HIV/AIDS faster than they are being trained or without a financed plan for water and sanitation without which girls drop out of school at puberty—hence the importance of simultaneous investments across sectors.

But the lesson donors have been the least eager to learn is that the need for increased aid is immediate and urgent. The longer they procrastinate, the more intractable the problem and expensive the solution. Frontloading aid can mean savings in the future. Malaria costs $12 billion a year in lost output. Paying to fully treat malaria would cost a fraction of that. Rates of return for infrastructure investment can be as high as 80%, dwarfing standard returns in private capital markets.

The International Finance Facility (IFF) is designed to meet the three conditions for effective aid. Through the sale of government bonds in rich countries, it would mobilize lump sum resources to finance a secure and predictable stream of aid. Because the financing would be frontloaded, it could provide the critical mass of investment needed across a range of sectors.

Could the IFF work in practice? Implementation details are being worked out through the International Finance Facility for Immunization (IFFIm), a pilot programme developed by the Global Alliance for Vaccines and Immunization (GAVI). In the past, GAVI's effectiveness has been compromised by fluctuating and uncertain financial flows. The IFFIm is a financing mechanism designed to provide secure frontloaded funding for vaccines and immunization services in the poorest countries. GAVI has estimated that an increased investment of $4 billion frontloaded over 10 years would save the lives of more than 5 million children ahead of the 2015 target date and would prevent a further 5 million adult deaths (mainly from hepatitis B) after 2015.

Source: Development Initiatives 2005b; GAVI and the Vaccine Fund 2005a, b; UK, HM Treasury 2003.

There is little hard evidence to support the claim that poor countries will be unable to use more aid effectively

idea. These countries and others have reached an agreement in principle to introduce a national air ticketing tax to finance development spending. Other countries have advocated a tax on currency transactions. Indeed, Belgium has already passed legislation on the adoption of a currency tax. Several other countries—including Finland and Norway—have explored using carbon taxes as a new financing mechanism.

Advocates for the use of international levies to mobilize financing for development claim that the approach would produce important benefits for the MDGs and beyond. These levies, so the argument runs, have the potential to bring together the financing of public goods and the financing of poverty reduction. The French government's Working Group on New International Financial Contributions, which reported in 2004, argues that the flow of resources from levies would provide a stream of predictable finance while complementing private capital market approaches, such as the IFF, by taking up the slack left as IFF flows start to diminish as bonds are repaid.

Can more aid be absorbed?

A major expansion of aid will produce results only if poor countries can use the increased flows effectively. Opponents of rapid aid scale-up argue that poor countries lack absorptive capacity—that large increases in transfers will overwhelm their ability to use aid effectively, creating economic distortions and undermining growth prospects. In fact, most of the problems are readily solvable through a combination of domestic policy prudence and improved donor practices. None of the objections raised weakens the case for a step increase in aid to accelerate progress towards the MDGs.

Several recurrent themes dominate the concerns of aid pessimists. One is that countries lacking social and economic infrastructure—roads, nurses, teachers—are not in a position to reap the benefits of higher aid flows and that diminishing returns for growth and human development will rapidly set in. Another is that aid brings its own distortions. Dependence on aid, so the argument runs, can undermine incentives for governments to develop national revenue systems, weakening the development of accountable institutions. Also cited are macroeconomic issues. Large inflows of foreign exchange can push up exchange rates, making exports uncompetitive, encouraging imports and creating balance of payments problems. The problem is known as Dutch disease, after the experience of the Netherlands in the 1960s when the sudden inflow of wealth from the discovery of North Sea gas pushed up the value of the guilder, crippling manufacturing exporters and stoking inflation.[43]

While each of these concerns raises important questions, the limits to absorptive capacity can be exaggerated. So, too, can the degree of aid dependence. Sub-Saharan Africa is the world's most aid-dependent region. Bilateral aid represents more than 10% of GNI for 23 countries in Africa, reaching more than 60% in Mozambique. But the regional average, at 6.2%, is below the level of the early 1990s.

There is little hard evidence to support the claim that poor countries will be unable to use more aid effectively. Precise circumstances vary, but aid dependence levels are a weak indicator of the ability of countries to harness development assistance to poverty reduction. Where absorptive capacity is a problem, the appropriate response is investment in capacity-building in combination with measures aimed at reducing transaction costs.

Diminishing returns?

Theoretically, diminishing returns to aid have to set in at some point, so that even with good management, marginal benefits will decline as aid increases. Cross-country research by the Centre for Global Development for 1993–2001 indicates that on average aid generates positive returns to growth up to the point where it reaches 16%–18% of GNI. Other studies put the figure at 20%–25%. But cross-country evidence on past performance is a weak guide to future outcomes. As aid quality, governance and economic policy improve over time, the benefits of aid can be expected to increase. Moreover, whatever the average threshold for diminishing returns, some countries are able to effectively absorb aid beyond this point. For example, Mozambique is both one of Africa's strongest growth performers and one of the world's most aid-dependent countries.

In any case many countries with aid to GNI ratios of 10%–15%—including Bangladesh, Cambodia, Tanzania and Uganda—are facing a financing gap for the MDGs. Detailed country-level research from the World Bank suggests that $30 billion in additional aid could be used productively in low-income countries, a conservative figure that does not take into account the scope for infrastructure investment.[45] It is also the case that aid to GNI ratios in developing countries are a limited way of looking at dependence. For example, Ethiopia has a relatively high ratio, at 19%, but receives $19 in aid per capita compared with an average of $28 for Sub-Saharan Africa and $35 for Tanzania.

Revenue effects

Rapid increases in aid will raise the share of national budgets financed through development assistance. An obvious danger is that this will institutionalize aid dependence, making budgets more vulnerable to volatile aid flows and shifting donor priorities.[46] Some critics argue that large inflows of aid weaken incentives for governments to mobilize domestic taxes, undermining the development of a sustainable revenue base. Evidence from some countries lends weight to this concern. For example, Uganda has not been able to raise its relatively low tax to GDP ratio despite high growth. However, counter-examples suggest that such outcomes are not inevitable. Ethiopia has increased its national tax to GDP ratio from 11% to 15% since 1998 even as aid receipts rose by a factor of three.

Dutch disease—and how to cure it

Dutch disease is a threat that has to be taken seriously. Rapid exchange rate appreciation would have devastating consequences for Africa, making it more difficult for small farmers and manufacturers to expand and diversify their exports, raising the spectre of further marginalization in world trade. In practice, the problems can be avoided.

The most serious problems arise when aid flows finance a consumer boom. If output stays constant and demand rises, inflation, with higher prices for non-traded goods, is inevitable. However, if aid is directed towards areas such as infrastructure, agricultural production and investments in human capital, the supply response can provide an antidote to Dutch disease.[47] Rising productivity can counteract inflationary pressures and maintain the competitiveness of exports. This helps to explain why countries like Ethiopia, Mozambique and Tanzania have been able to absorb increased aid without large-scale inflationary effects.

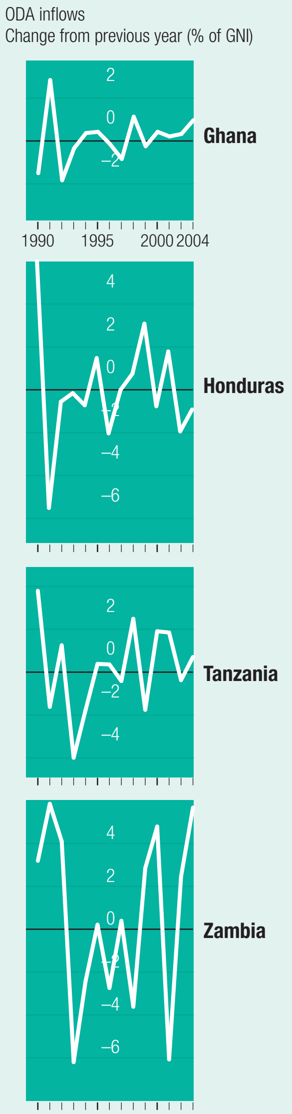
Governments can also influence the exchange rate effects of aid—for example, by deciding whether to use aid inflows to increase consumption, finance imports or build foreign exchange reserves.[48] Evidence from individual countries confirms that large inflows of aid do not inevitably cause Dutch disease. In Ghana net aid increased from 3% of GDP in the mid-1990s to more than 7% in 2001–03, yet the real exchange rate changed by less than 1% in the second period.[49] In Ethiopia aid has doubled to 22% of national income since 1998. There, too, the real exchange rate has remained stable.[50] In both cases export competitiveness has been maintained through prudent management of reserves. Ghana managed a surge of aid in 2001 not by increasing domestic money supply but by selling into foreign exchange markets to stabilize the currency following a terms of trade shock.

Using aid effectively

While rapid surges in aid are likely to produce suboptimal outcomes, it is important to understand that absorptive capacity is a dynamic process, not a fixed entity. Shortages of teachers and health workers, dilapidated transport infrastructure and weak institutions can constrain the effective use of aid. But government institutions can be developed through capacity building; teachers, health workers and engineers can be trained; and infrastructure can be developed. The critical challenge is to sequence these investments through coordinated national strategies. That is why MDG planning needs to be put at the centre of public expenditure frameworks—and why donors need to commit themselves to predictable, multiyear support.

MDG planning needs to be put at the centre of public expenditure frameworks

Figure 3.12 **Aid volatility in operation**



Source: Calculated on the basis of data on ODA volumes and GNI from OECD/DAC 2005f.

Weakness in the quality and effectiveness of aid

Increased aid is a necessary condition for accelerated progress towards the MDGs. Without it the 2015 targets will be missed by a wide margin. But simply increasing budgets without reforming the unproductive habits of donors will deliver diminishing returns. Creating the conditions for more effective aid means making aid more predictable, reducing excessive conditionality, increasing donor harmonization, ending tied aid and providing more aid as programme support through government budgets.

The volatility and unpredictability of aid

Effective poverty reduction planning in low-income countries requires aid flows that are stable and predictable. The introduction of Poverty Reduction Strategy Papers in 1999 was intended to provide a framework for support based on national plans that would make aid flows more stable and predictable. Unfortunately, those hopes have not been realized.

Predictable aid flows are especially critical in low-income countries where aid flows are large relative to government revenues and budgets. In Burkina Faso more than 40% of budget spending is financed through development assistance. Unanticipated shifts in aid flows can undermine budget management and threaten effective delivery of basic services by interrupting the investments needed to supply schools and health clinics and pay teachers and health workers and by creating balance of payments problems.

Cross-country research shows that aid is more volatile than GNI or government revenue—40 times more volatile on average than revenue.[51] IMF research comparing aid during 1985–88 and 2000–03 shows that the difference in the volatility of aid and government revenue has increased, suggesting that Poverty Reduction Strategy Papers have done little to change practice in this area.[52] Measured by variance from trend, aid volatility has doubled since 2000, and for some countries the annual variation is very large (figure 3.12). Particularly worrying, aid-dependent countries are most vulnerable to aid volatility, and aid volatility is especially high for these countries. Aid volatility in fragile states is twice the average for low-income countries.

Volatility might be less of a problem if aid recipients knew that donor commitments would translate into real financial flows. In fact, donor pledges are only a partial guide to aid delivery. Commitments may be disbursed over several years, with gaps between pledges and delivery smoothed out across several budget cycles. But such unpredictability can still impede fiscal planning. Decisions to undertake investments in, say, health or education create fiscal commitments for future years. Under the worst conditions unpredictability can give rise to stop-go financing as governments adjust to the delivery or non-delivery of aid pledges.

The gap between aid commitments and disbursements can be thought of as an "aid shock" to which public finances have to adjust. Measuring the scale of this shock is made difficult by sometimes less than comprehensive donor reporting on actual expenditure. Using the OECD Development Assistance Committee's reporting system for bilateral and multilateral flows for 2001–03, we looked at gaps between aid commitments and disbursements for 129 countries. The results are striking. For 47 countries disbursements fell short of commitments by more than 1% of GNI during one of the three years. For 35 countries the shortfall represented more than 2% of GNI. In 2001 both Burkina Faso and Ghana experienced aid shocks of 4% of GNI. Rich countries would struggle to adjust their budgets to fluctuations on this scale. In the case of Ghana and Burkina Faso the shortfall represented about one-fifth of all government revenue.

Shortfalls in aid flows can have a particularly damaging impact in key social sectors in heavily aid-dependent countries. Zambia finances more than 40% of its education budget through aid.

Consistently during 2000–02 donor disbursements amounted to less than one-half of commitments made at the start of the budget year. For Senegal, which relied on aid for one-third of public spending on health, annual disbursements for 1998–2002 fell short of commitments by an average of 45%. Slow and partial disbursements appear to have compromised funding for national immunization campaigns.[53]

Aid volatility and unpredictability might be partially explained if they reflected donor responses to economic shocks in recipient countries. Defining a shock as a decline in prices of at least 10% from one year to the next, the IMF calculates that low-income countries suffer such a shock on average once every three years. These shocks fall disproportionately on poor countries, reducing economic growth and government revenues, and disproportionately harm poor people, for example, by destroying the livelihoods of small farmers. However, there is no evidence that aid compensates for such economic shocks. During 1975–2003 only one in five countries hit by negative GDP shocks of 5% or more received increased aid.[54]

Countries can respond to shortfalls and uncertainty in aid in several ways, all of them with adverse implications for MDG financing. They can cut government spending, with adverse implications for reduced economic growth and social investment. They can maintain spending by borrowing and increasing the fiscal deficit, options with adverse implications for inflation and IMF conditionality. And they can use aid to build up cash reserves in anticipation of future income shocks, an avenue that implies lower levels of public spending.[55] None of these responses is helpful for long-term financial planning for poverty reduction.

The unreliability of aid flows is one reason that aid has not realized its potential. It is difficult for governments to develop stable revenue and financial management systems or to make long-run investments in infrastructure and basic services when they have little control over a large component of national financing. One of the most effective ways to enhance absorptive capacity would be to tackle the problem of unpredictable aid flows head on.

Conditionality and country ownership

All donors stress the virtues of "country ownership", of giving recipients more control over how aid is spent. Yet most link aid to stringent conditions. Country ownership is seen as a requirement for efficient use of aid, while conditionality is seen as a mechanism for leveraging policy change. In many cases the two objectives pull in opposite directions, with conditionality undermining country ownership and adding to the unpredictability and volatility of aid. One reason that donors' commitment to country ownership has failed to improve aid predictability is that it has yet to be put into practice.

Since the late 1990s there have been important changes in the administration of conditionality. Poverty Reduction Strategy Papers, drawn up by national governments, have created a new framework for cooperation. With that has come a streamlining of donor conditions. For example, conditions on IDA loans fell from an average of 30 per loan in the mid-1990s to 15 in 2003.[56] IMF loan conditions under the Poverty Reduction and Growth Facility have fallen to an average of 13. However, there are large variations across countries, and recent analysis of IMF programmes suggests that the number of structural conditions may be on the rise again.

Some of the changes have produced substantive results. But much of what passes for "streamlining" is simply a repackaging of conditionality or the transfer of responsibility for enforcing conditionality to other donors.[57] Aid still comes with a bewildering array of strings attached. Loan conditions linked to Poverty Reduction and Growth Facility programmes still set detailed budget targets—and sweeping targets for broader economic management. Doing business with the World Bank requires compliance with targets set in its country assistance strategies, Poverty Reduction Support Credits and other loan agreements. Bilateral donors and the World Bank have even picked up some of the structural loan conditions dropped by the IMF.[58] Meanwhile, countries seeking HIPC Initiative debt relief have to comply with a further set of spending and economic management targets.

The unreliability of aid flows is one reason that aid has not realized its potential

Loan conditionality continues to reinforce unequal power relationships

From the perspective of aid recipients, even slimmed-down conditionality resembles a very long shopping list. Consider Benin. Under its Poverty Reduction and Growth Facility Benin must provide the IMF with quarterly reports on spending in health and education, details of government wage bills and a timetable for privatizing the state bank. The (non-exhaustive) list of triggers for the World Bank's Poverty Reduction Support Credit includes accelerated progress in privatizing cotton; tangible progress in privatizing other public enterprises, including the creation of "sound regulatory frameworks in liberalized sectors"; preparation of a "coherent strategy" for private sector development; and a detailed list of quantitative outcomes in health, education and water. In all, the policy matrix includes more than 90 actions to be monitored. Meanwhile, to qualify for debt relief, Benin was required to meet targets for privatizing a cotton sector marketing agency.[59]

The merits of such specific policy prescriptions aside, individual loan conditions, by their sheer scale, scope and interlocking nature, inevitably diminish national ownership and increase the risk of aid cut-offs for non-compliance. Only one-quarter of IMF programmes are completed without interruption—a fact that helps to explain both the volatility and the unpredictability of aid.[60]

Some conditionality is inevitable and desirable. Aid recipients should report, above all to their own citizens, on public spending and budget priorities. National development strategies setting out clear poverty reduction goals and linked to medium-term financing plans are one vehicle for transparency. Effective auditing and legislative scrutiny of budgets are also vital. The problem with current approaches is the mix of macro-conditionality and micro-management. Loan conditionality continues to reinforce unequal power relationships that limit real progress towards country ownership.

Too many donors—too little coordination

The capacity problems created by excessive conditionality are exacerbated by the donor community's disjointed working habits. All too often, severely constrained government departments in aid recipient countries have to deal with large numbers of weakly coordinated donors, many of them operating overlapping programmes and unwilling to work through government structures. The high transaction costs that result diminish the effectiveness of aid and erode capacity.

When the Marshall Plan was implemented in Europe, a single donor interacted with countries with strong financial, judicial and public administration capacity and a large pool of skilled labour, entrepreneurs and managers. Aid success stories in the Republic of Korea and Taiwan Province of China followed a similar model of one dominant donor interacting with strong governance structures. Times have changed in the aid relationship. Of the 23 members of the OECD's Development Assistance Committee, only five give aid to fewer than 100 countries.

The flip side is that aid recipients are dealing with multiple donors. In 2002 the mean number of official donors operating in recipient countries was 23, though the typical country in Sub-Saharan Africa deals with more than 30 donors (and several dozen international non-governmental organizations).[61] The Ethiopian government received aid from 37 donors in 2003. Each donor may be operating dozens of projects supporting a variety of sector strategies. Tanzania has about 650 donor projects operating through either national ministries or local government.[62]

Meeting donor requirements for reporting, consultation and evaluation imposes a heavy burden on the scarcest of resources in developing country ministries: skilled people. Aid programmes in a typical Sub-Saharan African country will generate demands for thousands of reports to multiple oversight agencies, with hundreds of missions visiting to monitor, evaluate and audit performance. Line ministries may be required to generate not only departmental reports, but dozens of reports on individual projects as well.

Duplication adds to the problem. To meet legal obligations to their shareholders, the IMF and the World Bank conduct extensive annual reviews of budget management, public finance systems and public expenditure. Governments are required to submit accounts audited to international standards. Even so, donors such as the European Union, Italy, Japan and the United States require separate reporting to meet their own requirements—an arrangement that inflicts large and unnecessary transaction costs. Analytical work generates another layer of duplication. Donors conduct overlapping poverty assessments, public expenditure reviews, fiscal policy reviews, assessments of economic policies and fiduciary analysis and are often unaware of similar studies conducted by others or are unwilling to use them. In a case cited by the World Bank, five donors in Bolivia sponsoring a single poverty survey each required separate financial and technical reporting, so that the government official managing the project had to spend more time on reporting than on the survey.[63]

The burden of donor demands goes to the top of government systems. Demands created by weakly coordinated donor actions generate huge opportunity costs. Consider this lament by Ashraf Ghani, Finance Minister of Afghanistan from 2002 to 2004:

> *As Finance Minister more than 60% of my time was spent on managing donors, in terms of meeting visiting missions and representatives to reiterate government policy, raise funds…to enable the recurrent costs of government to be met, advocate for support to government-led programmes channelled through government financing, procurement, and accounting systems, and discuss and negotiate projects….This time could instead have been devoted to raising domestic revenue and managing internal reform.*

Zambia highlights some of the wider problems associated with donor coordination behind nationally owned programmes. Support for the education sector, formerly under a four-year investment programme, is now being channelled through a sectorwide approach, with $87 million in aid committed for 2004. With at least 20 donors supporting education, there is a premium on effective coordination.

The record is mixed. The Zambian government has been arguing for support to be channelled through pooled funds in the overall education budget, and that now accounts for around one-half of support. However, another one-third of support is allocated through funds designated for purposes specified by donors, with the balance allocated for specific projects. In all, there are 20 donor funding lines for amounts of $12 million to $400 million, each requiring separate reporting. There has been little discussion about how to reduce the number of donors without reducing funding. Several key donors that have pooled resources have yet to participate in a joint mission. Senior ministry officials continue to cite the length and frequency of reporting as a problem. While the new joint missions are reducing transaction costs for donors, for developing countries the missions still occupy senior staff for two to three weeks at a time, diverting energy from effective management.[64]

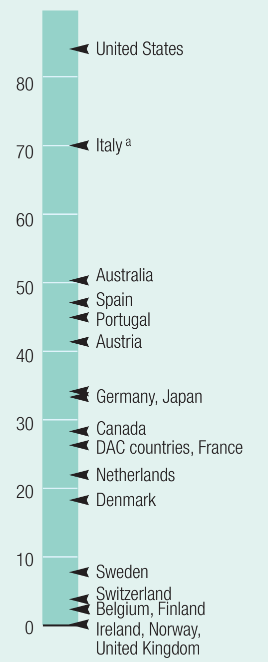
Zambia offers a window on broader problems associated with harmonization in countries perceived as lacking a strong system of public administration. Some donors have been unwilling to move to pooled funding arrangements, partly because of concerns over fiduciary responsibilities. Others have agreed to pool some funds, but with extensive reporting strings attached. Donor reluctance to harmonize is especially marked in countries where there is a perception that governments have failed to design effective harmonization strategies. Thus, while Senegal is one of 13 countries in a pilot OECD scheme to accelerate harmonization, there is little effective coordination even in sectors where sectorwide approaches are in place, such as in health.

Efforts are being made to reduce transaction costs. In March 2005 members of the OECD's Development Assistance Committee signed the Paris Declaration on Aid Effectiveness, much of it dealing with measures to reduce transaction costs. Pilot programmes to strengthen harmonization and coordination are being implemented in Ethiopia, Ghana, Tanzania and Uganda. Some transaction costs have declined, but progress has been uneven. Ugandan officials still cite transaction costs as a major problem. With an average of three missions (some with as many as 35 people) for Uganda's World Bank Poverty

Demands created by weakly coordinated donor actions generate huge transaction costs

Figure **3.13** **The tied aid league**

Tied aid to the least developed countries
Share of total ODA, 2002–03 average (%)



a. Data refer to the average for 1999–2001 ratios.
Source: OECD/DAC 2004b, 2005e.

Reduction Support Credit programme alone, it is not difficult to see why. Elsewhere, harmonization has also promised more than it has delivered. Reportedly, Senegal hosted more than 50 World Bank missions in 2002—roughly one a week. In 2003 Zambia hosted 120 donor missions, excluding those of the World Bank and the IMF. Of these, just 12—and none involving the European Union or the United Nations—were joint missions.[65]

Donors are also attempting to reduce some transaction costs through multilateral initiatives involving greater specialization and cooperation. Mechanisms such as the Global Fund to Fight AIDS, Tuberculosis and Malaria and the Education for All Fast Track Initiative enable donors to pool resources, deliver aid and delegate reporting to a single body. In recent years several donors—including Denmark, the Netherlands, Norway, Sweden and the United Kingdom—have announced intentions to streamline aid programmes around a smaller group of recipients. In theory, this opens the door to greater specialization and cooperation. In practice, the high-priority lists for each donor tend to concentrate on the same set of recipients, raising the risk of widening the gap between donor darlings and donor orphans. In one example of harmonization through greater specialization, Norway and Sweden are implementing a plan in Ethiopia under which Sweden will channel health funding through Norway, and Norway will channel education funding through Sweden. Such arrangements are the exception rather than the rule, however.

Implementing the agenda for improved coordination will be difficult if experience to date is a guide. The efficiency argument for greater specialization and harmonization is clear. But moving in that direction will require donors to share control of resources and to accept reporting systems managed by others—a move that implies major changes in the administration of aid programmes.

Inefficient resource transfers: tied aid

Not every aid dollar has the same value in financing poverty reduction. Much of what is reported as aid ends up back in rich countries, some of it as subsidies that benefit large companies. Perhaps the most egregious undermining of efficient aid is the practice of tying financial transfers to the purchase of services and goods from the donating countries.

Recipient countries lose out from tied aid on several counts. The absence of open market tendering means that they are denied an opportunity to get the same services and goods at a lower price elsewhere. Tied aid can result in the transfer of inappropriate skills and technologies. Price comparisons have found that tied aid reduces the value of assistance by 11%–30% and that tied food aid is on average 40% more costly than open market transactions.[66]

The full extent of tied aid is unknown because of unclear or incomplete reporting by donors. Procurement policies are often untransparent and biased towards contractors in the donor country. Two G-7 donors—Italy and the United States—do not fully report to the OECD on tied aid. Others also report on an incomplete basis. Reporting on the tying of technical assistance, most of it linked to suppliers in donor countries, is not required by the OECD. The upshot: the tying status of between one-third and one-half of aid to low-income countries is unknown. Tying is an area in which donors could usefully apply the principles of openness and accountability that they demand of recipient governments. Taxpayers in donor countries have a right to know how much of the aid that they finance is being used for non-development purposes, while citizens in recipient countries have an interest in knowing how much they lose as a result of aid tying.

While the precise amount of tied aid is unknown, donors clearly vary in the degree to which they tie their aid (figure 3.13). According to OECD reports on tied aid to least developed countries, the United States tops the tied aid list, with Italy close behind.[67] However, aid provided under the Millennium Challenge Account is untied, so the US tied aid ratio will fall as spending from this source increases. Germany and Japan also tie a relatively large share of aid.

The implied financial costs of tying are high. Estimating these costs is difficult because of the restricted nature of donor reporting and the exclusion of technical cooperation. For this Report we attempted to approximate the costs of tied aid. The tied aid ratio used is the average of tied aid reported for 2002 and 2003 by the OECD's Development Assistance Committee for transfers to least developed countries.[68] Gross bilateral aid disbursements for 2003 are used to establish aid levels to specific regions. Tied aid is then discounted at the rate of 20%–30% of face value, reflecting estimates for the costs of such aid against open market arrangements.

For developing countries as a group we estimate overall current losses at $5–$7 billion—enough to finance universal primary education. Low-income countries as a group lose $2.6–$4.0 billion, Sub-Saharan Africa loses $1.6–$2.3 billion, and the least developed countries lose $1.5–$2.3 billion (figure 3.14).

These figures understate the real costs by a considerable margin since they cover only bilateral aid and exclude technical assistance. Losses for individual countries vary according to the structure of their donors. In some cases value for money is severely compromised: 14 cents in every $1 of Italian aid to Ethiopia is spent in Italy. Currently, two-thirds of Australian aid to Papua New Guinea, its biggest aid recipient, is delivered through just six Australian companies.[69] Some forms of tied aid fly in the face of a serious commitment to the MDGs. In 2002–03 some $1 billion in bilateral aid was in the form of grants for university study in donor countries, heavily outweighing donor support for basic education in some cases.

Tied aid often raises transaction costs for recipients. Some donors apply restrictive procurement rules to meet their own requirements, creating multiple procurement structures and weakening coordination. Tying tends to skew aid towards capital-intensive imports or donor-based technical expertise, rather than towards activities with low input and capital costs, such as rural development programmes that draw on local expertise. The bias of some donors towards large-scale trunk roads rather than small-scale rural feeder roads is symptomatic of the problem.

Aid tying raises concerns at several levels. Most obviously, it diminishes the value of a resource in desperately short supply in the war against poverty. More than that, tied aid is incompatible with other stated donor objectives, including the development of national ownership. Many of the procurement policies operated through tied aid programmes suffer the same lack of transparency that donors criticize in countries receiving their aid. Aid tying represents a form of support to industry that most donors frown on in aid recipient countries. And tied aid is an inefficient use of taxpayers' money. While most industrial country taxpayers favour contributing to the fight against global poverty, there is less evidence that they endorse the use of public finance to create markets for large companies.

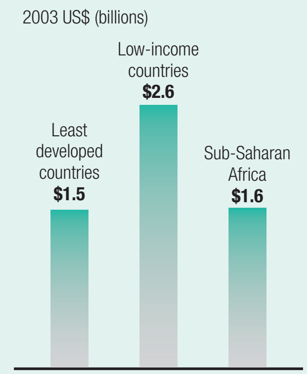
Project support rather than national budget support

Aid is most effective when it is channelled through budgets and expenditure frameworks that reflect priorities set out in poverty reduction strategies. As countries develop more transparent and efficient public financial management systems, the scope for building national ownership by supporting national budgets is increasing. However, many recipient governments complain that donors acknowledge national priorities in principle but undermine government processes in practice by directing aid towards individual projects—an approach that reduces efficiency, increases transaction costs and erodes capacity.

Project-based aid often reflects donor concerns about government capacity, budget management and financial reporting systems. The belief is that working through projects can circumvent failures in national governance systems. Ironically, project aid has a track record of intensifying problems in all these areas. In many countries donors operate hundreds of projects, many of them financed and managed outside of government systems.

The upshot is that a large share of public spending happens off-budget, weakening public finance management. Meanwhile, project

Figure **3.14** **The aid tax—costs of tying aid**



Note: Calculations assume 20% losses from ODA tying.
Source: Calculated on the basis of ODA tying ratios from OECD/DAC 2004b, 2005e and ODA volumes from OECD/DAC 2005f.

3

Aid for the 21st century

implementation units set up by donors operate as a parallel system, often attracting government staff to donor agencies and establishing a separate system of rules for procurement, financial management and auditing. Afghanistan's experience since the reconstruction process started shows how this approach erodes government capacity (box 3.8).

The creation of strong public finance systems linked to poverty reduction goals provides opportunities for donors to shift support from projects to the national budget. Over the past decade the Ugandan government has worked with donors to develop one of the strongest budget systems in Africa. Since 1997 priorities set out in the national Poverty Eradication Action Plan have been reflected in a medium-term expenditure framework and in annual budget allocations (see chapter 1). Some donors have responded by transferring aid from projects to the national budget. The share of aid provided through budget support has increased from 35% to 53%. This has made budgets more predictable: between 1998 and 2003 the ratio of disbursements to commitments rose from less than 40% to more than 85%.[70] However, some major donors—including Japan and the United States—are reluctant to shift aid programmes from projects to budgets, even in countries like Uganda.

And even when donors operate in support of national strategies through programme aid, the aid often arrives in forms that limit its effectiveness. Donors have encouraged aid recipients to develop medium-term financing frameworks to create stability and predictability in poverty reduction financing. To be fully effective, these frameworks need to be backed by multiyear donor commitments. Yet fewer than one-half of donors supporting the budget in Bangladesh make such multiyear commitments. A major strength of the Millennium Challenge Account is its framework for multiyear commitments. For example, under Millennium Challenge Account agreements, grants are provided to Honduras under

Box 3.8 **Undermining capacity through project aid—the case of Afghanistan**

After more than two decades of human development free fall, Afghanistan has embarked on a process of reconstruction and recovery. The challenges are immense. It has one of the highest child death rates in the world (257 deaths per 1,000 live births), and three-quarters of the rural population live below the poverty line. Recovery prospects depend heavily on aid, which accounts for more than 90% of spending. But some donor practices have obstructed the development of national capacity.

Two models for financing and implementing reconstruction were developed in Afghanistan. Under a state-supporting model donors channelled their financing into the Afghanistan Reconstruction Trust Fund, jointly managed by the United Nations Development Programme, World Bank and Asian Development Bank. From there it was channelled to the government under strict accountability rules.

Under a state-avoiding model donors implemented projects directly or through UN agencies or non-governmental organizations. Projects operated through parallel organizations and parallel rules for procurement, financial management and audit. There have been at least 2,000 such projects, though many more were unrecorded. More than 80% of donor funding went into this model during the first two years of reconstruction.

Aid through state avoidance posed several problems. Transaction costs were high. Government officials devoted considerable time trying to extract information from donors on what projects were under way and what resources were flowing into the country. Government staff also had to learn new rules and practices, which differ by donor, including multiple reporting systems.

This project-aid economy also introduced distortions in the labour market. Public sector staff were drawn away from core functions as teachers, doctors, engineers and managers to support positions in the aid system. Government managers or engineers could earn many times their standard salaries as drivers or translators in the aid system. National human capital reserves in public governance systems, nearly depleted after 23 years of civil war, were further eroded.

The new Afghan government has developed innovative responses for dealing with the donor community. Faced with the prospect of coordinating 30 donors, each operating across 30 sectors, the government has limited donors to involvement in a maximum of three sectors each. Attempts have been made to align reporting processes with the Afghan budget cycle rather than with individual donor cycles.

Source: Lockhart 2004.

a five-year budget framework and to Madagascar under a four-year framework to enable them to develop medium-term financing strategies with greater predictability. Some donors that provide budget support link support to specific projects or earmark funds for individual programmes—a practice that can give rise to onerous reporting requirements. The pooling of donor resources through sectoral programmes is often viewed as a first step towards budget support. However, pooling arrangements sometimes entail enormous transaction costs as donors seek to retain control over specific programme elements. Senegal currently has 23 sectoral groups, with associated reporting requirements.[71]

The rhetoric of country ownership needs to be translated into actions

Rethinking aid governance

Over the coming decade aid has the potential to play a central role in realizing the ambition set out in the Millennium Declaration. But realizing the potential of aid will depend on donors combining increased support with fundamental reforms in aid governance.

An immediate requirement for increasing the effectiveness of aid is basic budgeting. Developing countries have been pressed to adopt nationally owned poverty reduction strategies setting out clear goals linked to the MDGs. Donors, however, have made no commensurate effort to ensure that sufficient aid is available to meet gaps in public investment or to ensure consistency between MDG targets and IMF and other conditionalities. The outcome, as the UN Millennium Project puts it, is that "the public strategy has no direct link to actual public investment programmes". When it comes to the MDGs, donor governments desire the ends but shun the means.

The solution is for donor governments to adopt an aid financing strategy for the period expressly mapped to achievement of the MDGs by 2015. The financing strategy will be more effective if it is backed by a new relationship between aid donors and recipients. The rhetoric of country ownership needs to be translated into actions to empower recipient governments, coordinate donor activities and improve the quality of aid. The Paris Declaration on Aid Effectiveness takes a step in the right direction, with some 50 specific commitments for 2010. Progress will require fundamental changes in current practices.

Bilateral aid—some lessons from Africa

The aid relationship is still not a partnership of equal responsibility. Developing countries have set targets based on the MDGs and are complying with detailed aid conditions stipulated by donors. The donor community has set no binding targets on the quantity of aid financing and has adopted only broad—and vague—principles on aid quality. If the Millennium Declaration is to be a genuine partnership, new structures are needed to enable both sets of countries to monitor each other's performance.

Developing countries are already showing leadership by example. Aid recipients are developing innovative strategies for improving donor practices. They are creating institutional structures for improved coordination and harmonization and reduced transaction costs. This section draws on a UNDP research programme on capacity building and evidence from a detailed analysis of work by more than 150 officials in 16 aid-recipient countries working daily with donors.[72] The analysis provides insights into the perspectives and solutions in Sub-Saharan Africa and elsewhere.[73]

Concessionality

Aid recipients place a premium on concessional finance, which lowers their risk of future debt

Donors need to ensure a more stable and reliable flow of long-term support

problems. Under the Tanzania Assistance Strategy, a homegrown strategy for development assistance, Tanzania has set a minimum grant element of 50% for new government borrowing. Other countries, Rwanda, Senegal and Uganda among them, are reducing their exposure to Poverty Reduction and Growth Facility loans, which are less concessional than IDA loans, for example. There is a clear need for more concessional finance to support poverty reduction strategies.

Coordination

The presence of large numbers of donors can inflate transaction costs, as each donor imposes its own reporting requirements and aid conditions. Some aid recipients have been successful in pushing donors towards improved coordination.

Lessons from Botswana are instructive. Donor interventions are framed under the auspices of a National Development Plan. The plan integrates development assistance and domestic resources. To prevent a proliferation of projects and reporting demands, line ministries are not permitted to negotiate individually with donors. All technical assistance programmes are designed to ensure that local staff are trained, resulting in greater skill transfer than in more traditional arrangements. Botswana has severely restricted the scope for donors to create autonomous project units and parallel structures for reporting and procurement, helping avoid distortions in government pay structures and the loss of trained civil servants.

Other countries are developing similar models of active coordination. Notable examples are the Tanzania Assistance Strategy and the Uganda Poverty Eradication Action Plan. The Cambodian government is developing a Harmonization and Simplification Programme linked to the national poverty reduction strategy. In each case, donors have been supportive.

Programme aid and budget support

Most governments see aid directed through the budget as more efficient and more effective in tackling poverty and as less of a drain on capacity than aid channelled to projects through special units in line ministries or other organizations such as non-governmental organizations. Burkina Faso and Tanzania have improved coordination between government departments by passing a law requiring that all line ministries submit requests for loans and grants to the Ministry of Finance. Donors can reinforce national budgeting and management by reporting all aid to the appropriate ministry and channelling it to programmes that form part of the national strategy for poverty reduction.

Countries have developed other strategies to reduce transaction costs. In Sub-Saharan Africa governments have attempted to lower transaction costs by persuading donors to pool their resources. Eleven HIPCs have established multidonor budget support programmes that release pooled funds on a predictable basis to support poverty reduction expenditures.

These pooled financing approaches are not without risks, however. Conditions for disbursement can reflect the highest common multiple among donors, reducing flexibility and increasing the possibility of aid interruption—especially when disbursements require unanimous agreement that performance targets have been met. One risk is that all donors will suspend disbursements if the country goes off track in its programme with the IMF. Another is the time it takes to negotiate pooled arrangements. It took Mozambique a year and 19 drafts to arrive at a 21-page memorandum of understanding on pooling arrangements with 15 donors. Clearly, donors can do more to avoid such protracted negotiations.

Predictability

Developing countries see the predictability of multiyear aid pledges as essential to effective implementation of the medium-term expenditure plans that underpin their poverty reduction strategies. Mozambique and Rwanda report improvements in their access to multiyear funds. Tanzania has also had some success in pressing donors to provide resources up-front and to improve the predictability of budget support. But too many countries are still forced to adjust budgets to fluctuations in donor transfers. Donors need to ensure a more stable and reliable flow of long-term support.

Multilateral initiatives

Recent years have witnessed a renewed interest in global multilateral aid initiatives. The revival of multilateralism offers great opportunities for human development—and some risks.

There are three good reasons for building on multilateral approaches to aid. First, and most obviously, in some areas the international community faces problems and threats that are global in nature: HIV/AIDS is a case in point. Multilateral initiatives can help finance a range of public goods that would otherwise remain undelivered. One example is the use of pooled multilateral funds to create incentives for research, development and production of vaccines for HIV/AIDS, malaria and other diseases for which market demand is too constrained by poverty to attract large-scale private investment. Advance purchase commitments by governments can provide pharmaceutical companies with a market rationale for developing new medicines—this arrangement has already helped finance a breakthrough in malaria drug trials. Second, multilateral frameworks provide donors with opportunities to pool their resources and reduce transaction costs; not every donor needs to establish high levels of expertise in every sector it wishes to support. Third, international resource pools provide a mechanism for matching finance with needs, thereby overcoming some of the skewed patterns of bilateral aid distribution.

The Global Fund to Fight AIDS, Tuberculosis and Malaria is an example of a multilateral initiative that is starting to produce real results in the fight against HIV/AIDS. Commitments reached $1.5 billion in 2004. For the Roll Back Malaria Initiative, a partnership with more than 200 members—including the World Health Organization, World Bank, United Nations Children's Fund and UNDP—financial constraints and weak coordination have hampered effective action. The situation has improved somewhat. The fight against malaria has gained new momentum since the creation of the Global Fund. In 2003 about $450 million was allocated to fight malaria through the Global Fund. This still falls far short of the $2–$3 billion in additional finance needed to scale up interventions sufficiently to reduce deaths by 75% by 2015, however.

The Fast Track Initiative in education demonstrates some of the strengths of multilateralism—and some of the weaknesses. The Fast Track Initiative grew out of a commitment made at the 2000 World Education Forum in Dakar to ensure that "no countries seriously committed to education for all will be thwarted in their achievement of this goal by lack of resources". Governments were encouraged to draw up plans identifying education financing gaps, and donors committed to bridging these gaps by leveraging resources through bilateral and multilateral channels. By the end of 2004, 13 countries had drawn up national plans endorsed through the Fast Track Initiative process.[74] The external financing needed to cover the plans is estimated at about $600 million, but only a little more than half of this amount has been mobilized.[75] Commitments are also far short of the additional $6–$7 billion a year needed to achieve the MDG education target. Some countries that are farthest off track for the MDG targets of universal completion and gender equity do not receive adequate funds. Francophone West Africa receives far less aid per capita than Anglophone East Africa, for example.

Some very modest investments in multilateral initiatives have generated high returns. The Global Alliance for Vaccines and Immunization (GAVI), launched in 2000 to improve access to underused vaccines, has committed just over $1 billion in five years, averting an estimated 670,000 deaths worldwide. Yet financing has been highly variable and volatile, making long-term planning difficult. Until 2005 revenue levels fell far short of the $400 million annual target. Some 27 million children miss out on immunization in the first year of life, and low or falling coverage rates and the unaffordable cost of some vaccines still represent a threat to MDG progress.

Multilateralism offers advantages for aid governance. Contributions to the Global Fund and GAVI cannot be earmarked, reducing the risks of donor bias. While both funds have rigorous performance standards, neither is linked to the host of conditions demanded by donors through other programmes, thereby reducing the risk of vital

Multilateralism offers advantages for aid governance

Aid targets without binding schedules are not a solid foundation for poverty reduction planning

public goods being cut off because of failure to achieve targets. Both funds also provide multiyear funding, allowing for greater predictability. But there are dangers that global initiatives might create distortions of their own. Large financial flows could be directed towards a single disease, such as HIV/AIDS, while other diseases are neglected, distorting health budgets in the process. Another danger is that dealing with global initiative secretariats will lock recipients into another set of reporting requirements and high transaction costs.

Changing aid

We live in a globalized world. Security and prosperity cannot be contained within national boundaries. Yet we have no global social policy, no mechanism for social welfare or protection of the poorest. Social security and intracountry transfers in the interests of human security are a standard part of the domestic economies of most high-income countries. Now these principles and practices need to be applied globally.

Aid is a unique resource. It is the only international mechanism that can be directed to the poorest—to secure their rights to basic services, to promote equity, to address the enormous gulf in global living standards and to build human capacity, the foundation of wealth and opportunity.

To make aid more effective and efficient all donors need to recast their approach to aid:

- To make the most of its value as a keystone in the permanent architecture for achieving social justice.
- To recognize that half measures and incremental change will not overcome the scale and depth of global poverty.
- To shed dysfunctional orthodoxies and procedures.

As a starting point the donor community must stop devaluing the currency of aid pledges. For more than 35 years donors have been stating their commitments to quantitative and qualitative targets for aid. With a few exceptions, these have not been met. Donors urgently need to rebuild trust in the reliability of their commitments on international aid, following the lead of the proposed International Finance Facility in making pledges legally binding.

Years of aid cuts have resulted in a culture that rationalizes small and declining aid budgets behind a false logic. Claims about the limited capacity of developing countries, concerns over the economic effects of scaling up aid and publicly expressed fears about governance are often smokescreens behind which donors seek to justify the unjustifiable: a legacy of indifference, neglect and failure to deliver on past pledges. This is not to suggest that the issues raised are unimportant. On the contrary, they are too important to be used by donors as a pretext for weak aid policies.

With 10 years to go to the MDG target date the international aid system is at a crossroads. There is a window of opportunity to put in place the reforms needed to fulfil the potential of aid as a mechanism for achieving the MDGs. Among the key reforms needed:

Set a schedule—and keep to it

The target of 0.7% of GNI in aid was set in 1970. Only five donors currently achieve it. Another seven have committed to a timetable. Targets without binding schedules are not a solid foundation for poverty reduction planning. All OECD donors should take the next step and set a schedule for reaching 0.5% by 2010 and the 0.7% target by 2015 at the latest.

Back MDG and wider human development plans with real money

Each developing country has been urged to adopt national development strategies bold enough to meet the MDG targets. The MDGs reflect the shared aspirations of the international community. It follows that donors should ensure that no national plan fails for want of finance. Increased aid flows should be linked explicitly to achievement of the MDGs. Donor financing should be linked to national financing plans, including medium-term expenditure frameworks. This implies abandoning annualized aid budgeting and moving towards three- to five-year financing strategies that are part of longer term plans for financing the MDGs.

Focus on additionality

Any financing strategy needs to consider the large sums currently included as aid that never leave donor government accounts or donor countries, in particular debt stock cancellation and technical assistance. Realistic accounting is necessary to ensure that donors are meeting their commitments to provide resources for the achievement of the MDGs. Aid reporting should be adjusted to ensure that public statements are not simply an OECD accounting exercise but reflect real resource transfers.

End tied aid

Tied aid includes a hidden taxpayer return to companies in donor countries. That return should be deducted from reported aid, along with the tied component of technical assistance. All tied aid should be phased out between 2006 and 2008.

Link aid to need

There are good reasons for providing aid to countries that are on track for achieving the MDGs and that are not facing a financing gap. However, increments to aid must be targeted effectively to the countries facing the greatest difficulty, especially in Sub-Saharan Africa.

Resolve the debt problem

Unsustainable debt remains a barrier to MDG financing in a large group of countries. An immediate priority is to identify low-income countries that will not qualify for debt relief under the 2005 G-8 agreement but nonetheless face problems in debt servicing.

Tackle inequality

Aid policies should reflect a commitment to reduce inequalities in human capabilities and income. These policies should form an explicit part of poverty reduction strategies and donor strategies. The commitment to reduce inequality should include a strong focus on basic services. It has been 10 years since the World Summit for Social Development set the target of devoting 20% of aid to basic social services. Donors need to ensure that the statistical reporting is in place to make them accountable for spending on basic services—currently estimated at 17%—and to make a quantum leap in the resources going to education, health, water and sanitation, and nutrition, by further increasing this share of the growing total aid.

Improve aid quality

Donors have been calling for better coordination and harmonization of aid since the 1980s. In 2005, for the first time, they set quantitative targets on reforms to enhance aid quality.[76] This is a positive first step. However, the targets lack ambition. Ensuring the effectiveness of aid requires more:

- *Aid flows aligned on national priorities.* The suggested target is to ensure that 85% of aid flows to the government sector be reported through the national budgets of recipient countries. This should be increased to 100% to ensure that public finance reporting reflects expenditures and that financing reflects national MDG priorities.
- *Budget support.* Donors have suggested a 25% target for the share of aid provided as budget support. This is massively underambitious. Conditions vary by country, but the aim should be to maximize the share of aid delivered as budget support, with a benchmark target of 70% by 2010.
- *Fewer missions.* Donors should adhere to best practice models. They should also report on a country by country basis on the number of missions and on the separate reports they require.
- *Use of national procurement and public financial management systems.* Failure to use national systems adds to transaction costs and undermines national capacity. No target has yet been set. But the aim should be to use national systems as a first resort and to ensure that 100% of aid goes through national systems by 2010.
- *Predictability and stability.* Donors need to make reliable, multiyear commitments that can be used to underwrite the recurrent costs involved in meeting the MDGs. At a minimum they should cover 90% of disbursements in agreed schedules, and funds should be released on time.
- *Transparency.* All donors should take steps to make their aid transactions fully transparent. Donors should provide timely, transparent and comprehensive information on aid flows to enable proper accountability to the public and parliaments in donor and recipient countries.

All tied aid should be phased out between 2006 and 2008