

Poverty In Focus

International Poverty Centre

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Does Aid Work? — for the MDGs

FROM THE EDITOR

Poverty in Focus is a regular publication of the **International Poverty Centre (IPC)**. Its purpose is to present the results of research on poverty and inequality in the developing world.

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Front page: A crate is unloaded from a container ship on the collapsed quayside at the Freeport of Monrovia, Liberia. The quay was damaged when a boat carrying foreign aid supplies crashed into it. The Freeport was heavily contested throughout both of Liberia's civil wars. Photo by Tim A. Hetherington, Panos.

Editor's note: IPC acknowledges the roots of the title of this issue as well as substantial inspiration from the seminal book *Does Aid Work?* by Professor Robert Cassen, London School of Economics, Oxford U Press 1986 and 1994. We are grateful to all the authors for generously contributing their intellectual products without any monetary remuneration.

IPC is a joint project between the United Nations Development Programme and Brazil to promote South-South Cooperation on applied poverty research. It specialises in analysing poverty and inequality and offering research-based policy recommendations on how to reduce them. IPC is directly linked to the Poverty Group of the Bureau for Development Policy, UNDP and the Brazilian Government's Institute for Applied Economic Research (IPEA).

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In 2005, the G8 leaders promised to double aid to Africa and the UN World Summit to increase total official development assistance (ODA) by around \$ 50 bn. a year by 2010 to reach at least 0.5 per cent of donor countries' gross national product (GNP). The Summit recognised that such increases in ODA were required for achieving the Millennium Development Goals (MDGs).

Aid volume targeting is not new; even in 1970 the UN set the ODA target of 0.7 per cent of the GNP of each economically advanced country, so far met by only five donor countries.

The announcements of sharp increases in aid to developing countries have not been received only with cheers all around. An intense debate is taking place on whether this is the right road to take, considering the perceived macroeconomic risks and the large amounts of aid that have already been provided during several decades, while massive poverty persists in developing countries. The aid critique and the signs of political 'aid fatigue' have intensified in recent years; many point to free trade and private investment as better options.

Yet, the decades of ODA have seen the largest poverty reduction in the history of mankind. The evidence indicates mostly that aid has contributed significantly to this, both via its impact on economic growth and through more direct interventions for human development (see page 10).

In this issue of *Poverty in Focus*, various features of the current international aid system are discussed critically and constructively, with references to recent research literature on aid effectiveness and sharing of important and policy-relevant results.

Roger C. Riddell summarises his new book explaining why the current aid system is no longer fit for purpose and needs a radical overhaul. He provides a sketch of an alternative as a basis for discussion.

Stephen Browne aims his critique at the traditional volume targeting of aid and at its supply-driven mode, proposing a shift of focus to human development at country level.

Nancy Birdsall focuses on the impact of aid on the middle class, including skilled workers. She advocates reforms of aid to reduce its risk of undermining weak institutions in aid-dependent Africa.

Finn Tarp reviews the evidence from aid effectiveness studies and finds the single most common result to be that aid has had a positive impact on per capita income growth.

Edward Anderson discusses how different principles for allocating aid across countries affect global MDG achievement, involving a trade-off between equity and effective use of aid.

Patrick Guillaumont argues that aid is most effective as volatility insurance in the poorest and most vulnerable countries, where it helps pro-poor growth by stabilising the economy.

Rainer Thiele et al. examine the large variations across donors in the sector targeting of aid, especially in the share of social sectors that are key to achieving most of the MDGs.

David Goldsbrough and Ben Elberger find that IMF conditionality has unduly constrained aid spending in poor countries in favour of using aid for reducing debt rather than poverty.

John Serieux stresses that such a response to the fear of Dutch disease is unjustified, since many countries have shown that aid surges can be managed and used for its intended purposes.

Terry McKinley shows that such fears have meant that only about a quarter of disbursed aid to Africa was actually spent as intended; the lion's share went into reserves and debt buy-backs.

Pierre Jacquet analyses the aid grants vs. loans issue in the light of the resolution of the debt crisis of poor countries, supporting the use of modernised models of ODA loans.

Jan Cedergren reports on the response by development cooperation partners to the many challenges of aid effectiveness and on the intensive reform process and its monitoring.

May these articles contribute to the ongoing analytical and policy debate on aid effectiveness and thus to the changes in aid modalities and procedures that are most likely to enhance advancement towards the MDGs.

Dag Ehrenpreis

Effective Aid Requires New Structures

by Roger C. Riddell,
Oxford Policy Management
and The Policy Practice

If the international community is serious about wanting to improve the effectiveness of aid, it would focus its attention principally on addressing the central systemic problems which continue to impede the greater impact of official development assistance (ODA). Today's system of raising, allocating and deploying official aid remains effectively the same as that created more than 50 years ago. Especially in relation to the poorest countries, this system is no longer fit for purpose. It needs to be radically overhauled.

International conferences at which donors jointly pledge to increase their aid—and international organisations' statistics on the total amount of aid given and the share of ODA to gross national income (GNI)—create the impression of common purpose, joint action and shared goals. The reality is sharply different as the following characteristics of the aid 'system' strikingly show.

Aid is provided by individual donors on an entirely voluntary basis. Each donor chooses and determines itself how much aid it will give. Repeated pledges at international conferences and summits to increase official aid are not binding on donor countries. No sanctions are imposed on countries which fail to honour their promises, only mild criticism in the peer reviews of OECD's Development Assistance Committee (DAC), which they are at liberty to ignore.

There is no clear and predictable link between the overall amounts of aid provided and the aggregate aid needs, though the crude and partial assessments made suggest a huge gap. Hence, the potential impact of aid is reduced because insufficient aid is provided. Indeed, there is no necessary relationship between the aid requirements

of individual poor countries and the amount of aid each receives.

To qualify as ODA, official aid funds must have the promotion of economic development and welfare as their main objective. However, ODA continues to be influenced by the commercial, strategic and short-term political interests of donors, reducing the share of aid to the poorest countries and raising its costs.

A major consequence is the extreme volatility in the flow of aid funds to particular countries. Recipients do not know whether the aid they will receive this year will continue to be provided five, three or even one year hence, and historical experience confirms that the amounts provided vary markedly from year to year. Aid volatility makes recipients extremely reluctant even to spend the aid they receive, particularly on recurrent costs, reducing still further its potential impact.

Nearly seven years after the UN Millennium Summit there has yet to be a country case where aid is being significantly scaled up to support a medium-term programme to reach the Millennium Development Goals (MDGs), as the World Bank pointed out in the *Global Monitoring Report 2007*.

Aid effectiveness is severely reduced by the growing complexity of donor-recipient relationships. Today, there are over 200 official donor agencies, more than double the number 40 years ago, and the numbers continue to rise. At least 30 recipient countries must deal with more than 40 donors.

Why does official aid continue to be provided in ways which seriously impede its potential impact? The answer lies in history. For more than 50 years, most aid-giving has been determined by the

The international aid system is no longer fit for purpose, especially in relation to the poorest countries. It needs to be radically overhauled.

Aid is still influenced by the commercial, strategic and political interests of donors, reducing the share of aid to the poorest countries and raising its costs.

Aid is needed most in precisely those countries which are least able to use it efficiently.

Concrete proposals are presented to focus attention on the key issues and encourage further discussion of a different aid system.

decisions of individual donors. In recent years, this approach has been complemented by what could be termed the international co-operative approach, led by the United Nations and the OECD/DAC, both concerned at the large gap between aid's impact and its potential. However, in relation to the list of problems just outlined, both the scope and pace of reform of the aid system have been extremely limited.

In its 2005 *Human Development Report*, UNDP argued that "fixing the international aid system is one of the most urgent priorities facing governments...". The main focus of attention needs to be the world's poorest countries, those whose need for aid is the greatest. The following comprise the core building blocks of an aid system for the poorest countries in tune with the core principles of our contemporary world:

a) The acceptance by all nation states, but particularly by the wealthier nations, of the obligation to provide assistance independent of their own commercial strategic and short-term political interests, and channelled to those countries unable, on their own, to ensure the fundamental rights, basic needs and core freedoms of their own citizens.

b) Compulsory contributions by the rich countries, provided on the basis of their relative wealth, and pooled into an aid fund of a size sufficient to meet the total aid needs of the poorest countries, based on the aggregate assessments of their individual aid requirements. Aid funds from such a common pool would be channelled to each of the poorest countries to help meet their needs and address the financial, skills and other requirements upon which the assessment of aid needs was based.

The main challenge in creating such a system lies less in agreeing its broad principles and core building parameters and far more in debating and agreeing precisely how a workable system might be established, and to gain the support of all nation states, both donor and recipient governments. Here, the greatest hurdle is unlikely to be the switch from voluntary to compulsory donations or the distancing of

aid-to-the-poorest from the commercial and short-term political interests of the donors. Rather, it is likely to hinge on the confidence of the main donor governments that the recipient countries accessing aid funds from the common pool will make good use of the aid funds provided. This issue goes to the heart of the following twin paradoxes of aid:

Aid is needed most in precisely those countries which are least able to use it well. The less unfavourable the context into which aid funds are channelled, the higher the likelihood that donors will wish to apply a range of conditions to try to ensure that 'their' aid funds are well spent. However, the impact of aid tends to be linked directly to the commitment and capability of the recipient to use it well, and the greater the degree and intensity of conditionality applied by the donors, the more recipients are likely to feel that they are not in control, so they will be less committed to ensuring the funds are used as effectively as possible.

Many wise women and men have grappled with these issues over the more than five decades that official aid has been provided. Based largely on their work, the following clusters of inter-related proposals provide the basic ideas for how current aid relationships might be altered, most especially to address the core paradoxes of aid and the tensions surrounding aid conditionalities. These proposals are presented in order to focus attention on the key issues, and encourage further discussion of a different aid system.

A new International Development Aid Fund (IDAF) for the poorest countries should be established. The monies to be raised for the operation of the Fund would equal the total amount of (official) development aid required by each qualifying poor country. The resources required would be funded by compulsory contributions made by each of the world's wealthiest countries, with the amounts contributed by each determined by their relative wealth.

IDAF funds would be earmarked for, but not initially allocated to each qualifying recipient country in relation to their aid requirements. In order, particularly, to satisfy donor governments that the funds were being spent as well as possible, a new International Aid Office (IAO) should be established, whose roles and responsibilities would include overseeing and ensuring the effective functioning of IDAF. While, ideally, the establishment of the IAO would be based on a 'balanced' agreement between the governments of donor and poor countries, what is crucial is that it be created with the full support of donor governments, otherwise—as discussed below—donors would be unlikely to support the new mechanisms for overseeing the spending of aid funds.

On the basis of consultations with each recipient country and with key donors, the IAO would determine which of two possible ways these earmarked funds would be disbursed: (i) if the IAO was satisfied that a qualifying poor country government had the commitment, competence and capacity to use the

Is aid effective and focused on poverty reduction?

The 63 poorest countries of the world receive less than half of total ODA.

Afghanistan, Iraq and Pakistan received less than two per cent of all ODA in 1999; this share rose to a quarter of all ODA in 2005, a thirty-fold increase.

Aid tying is estimated to add over 20 per cent to the costs of providing aid, amounting today to some \$7 bn.

Most aid is still managed by donors: less than 40 per cent is disbursed through recipient government channels; half of all multilateral aid is earmarked for particular uses; and only a third of aid provided by UN aid agencies is aligned to national priorities.

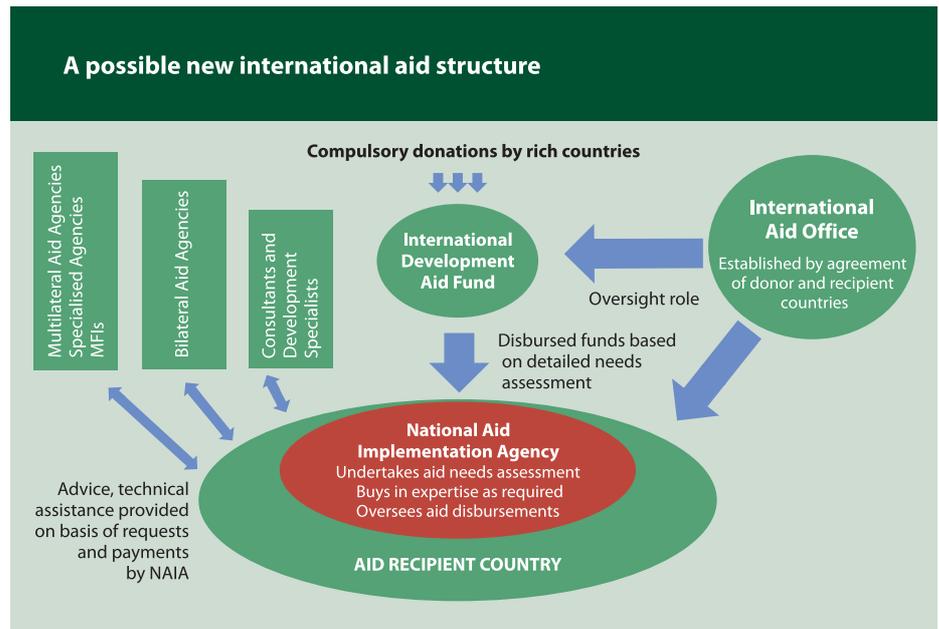
In 2005, the number of separate aid transactions recorded, in aggregate, by all official aid agencies was estimated at 60,000—three times the number less than ten years ago—while the average size of each transaction has progressively fallen.

aid funds effectively, it would allocate the earmarked funds directly to the recipient government; (ii) if the IAO had doubts about the commitment, competence or capacity of the recipient government to use the aid funds effectively, a National Aid Implementation Agency (NAIA) would be established for the purpose of allocating and overseeing the spending of aid funds earmarked for the country by the IDAF.

As its name suggests, the NAIA would be *national*—recipient country-based—and not a donor aid agency. Its operations would be overseen by a group of eminent and competent recipient country nationals, drawn from a cross-section of society, including civil society, and staffed by a mix of nationals and international staff as required to ensure aid funds are spent well, in an accountable and transparent way. It is likely that in many poor countries and fragile states, funds would be channelled into training and technical support as needed.

Why would a poor country government agree to 'its' aid funds being overseen by the NAIA? For two principle reasons: firstly, because otherwise it would not receive official aid funds; and secondly, because a significant share of the aid which passes through the NAIA is highly likely to end up in state-based projects and programmes.

The IAO would play the key role in assessing whether the NAIA was competent to allocate and monitor the use of the funds provided, and, where necessary, it would draw on international expertise, usually on a temporary basis, to provide support to NAIA—the channelling of aid into a common pool and IAO approval for the NAIA removing the requirement now made by donors to apply their own conditions to the aid they individually provide. The IAO would also be responsible for ensuring that reviews of the status of each recipient country take place, and would be open to representations from parliamentary, civil society or other groups from recipient countries, and from donors, who have substantive concerns that aid funds are not being used as effectively as they might.



If individual donors wanted to provide aid to recipient countries additional to that provided through the auspices of the IDAF, they would be at liberty to do so, provided recipients were willing to accept such aid, and any conditions attached to its provision. It would be up to the relevant donors and recipients themselves, and no one else, to determine how to make use of the aid funds offered.

Under these proposals, both recipient country governments and, where applicable, the different NAIA established in aid recipient countries would be encouraged to make use of and draw directly upon the skills and experiences currently residing in existing aid agencies, international financial institutions and aid consultancy firms to assist in ensuring that aid funds are effectively used. Any supportive technical assistance provided would normally be contracted on the basis of a transparent tendering process. Both recipient governments and NAIA would be at liberty to contract either one, or a number of donor agencies to manage and oversee the use of all, or part of a recipient country's aid programme, provided the agency was willing to sign such aid contracts and accept the conditions laid down by the recipient country government or NAIA. The figure illustrates what an aid structure based on these initial ideas might begin to

look like in countries where a NAIA was deemed necessary.

These proposals should be viewed more as a *vision* of what a different aid system might begin to look like, and *not as a blueprint* for immediate implementation. Their principal purpose is to stimulate discussion of what might be. The most important proposal is for nation states to begin the serious discussion of how the aid system could change, and no longer continue to park such discussions in their 'far too difficult' pending trays.

Repeatedly over the past decades statesmen and women and international commissions and scholars have called for a radical reform to the current aid system replacing it with one which is fit for purpose. For too long, politicians have avoided facing head-on the challenges involved in trying to change the aid system. They need to be encouraged, or shamed, into trying, if they really believe that extreme poverty is the most serious form of human rights violations in the world today and requires urgent attention. For, as all donors agree, aid can contribute to making a difference—if it is provided in ways which seek to maximise its impact.

■
R. Riddell: *Does Foreign Aid Really Work?*
Oxford: Oxford University Press 2007.
<http://www.oup.com/uk/catalogue/?ci=9780199295654>

by Stephen Browne,
International Trade Centre, Geneva

Target the MDGs— Not Aid Amounts

Traditional targeting of aid levels follows a false scent in development terms.

Supply-driven aid is worth less, driven by the instincts of rich country politicians and donor self-interest.

Aid has more meaning and legitimacy when it is focused on human development outcomes at country level.

Donors should reduce the harmful effects of conditioned aid and distorted trade, while creating a more propitious global environment.

Two years ago at Gleneagles, the G8 countries promised to double their aid to Africa. Since then, they have written off a substantial part of the external debt to the largest and oil-richest country, Nigeria. But new aid to the continent has stayed flat. In 2006, while Europe increased its aid, the two largest G8 economies, USA and Japan, reduced theirs. Africa, quite rightly, commands the growing attention of donors. But aid amount targets, both for Africa and globally, are often missed. Does that matter?

This article makes four propositions: (i) traditional aid amount targeting is following a false scent in development terms; (ii) supply-driven aid has questionable value; (iii) aid should be more concerned with genuine country-based development goals; and (iv) rich countries should use aid as a means of facilitation, not as patronage.

Targeting aid amounts is nothing new. In 1970, the UN set the target of 0.7 per cent of rich countries' Gross National Product (GNP) for Official Development Assistance (ODA). Since then a growing number of donor countries have stated their intention to reach it¹. The main purpose for setting such targets for aid is to create and sustain a momentum for ODA. While most donors haven't met the target, many have agreed that they should increase assistance to the poor countries. For the politicians of the rich countries and their constituents, therefore, aid volume targeting plays a useful role in reminding governments of their obligations. The two largest donors, however—USA and Japan—are exceptions.

But apart from providing momentum, what does such targeting really mean? Is it based on a realistic estimation of the resources actually required for development? When it was first set,

development—often equated with economic growth—was supposed to depend mainly on capital, which developing countries lacked and the developed countries could supply. Today, there is no such developmental basis, for various reasons.

First, the resources represented by the target in 1970 would be a very different—and a much smaller—percentage today. Even if we include private external finance, as in the previous 1 per cent target, it was exceeded many years ago; total private foreign direct investment flows from North to South are several times greater than ODA.

Secondly, even if we still imagined that development depended critically on external resource transfers, there are many sources besides aid: export proceeds and remittances from abroad, for example, which have grown appreciably.

Third, experience long ago confounded the facile assumption that more resources resulted automatically in more development. If that were true, then just based on oil revenues, Angola and Nigeria would already be advanced countries, whereas they rank 159th and 161st out of 177 countries on the human development scale. As the Center for Global Development puts it (Working Paper 68): “the 0.7 per cent target was calculated using a series of assumptions that are no longer true, and justified by a model that is no longer considered credible.”

A fourth reason for questioning the correlation between aid and development derives from the quality of aid itself. There is a growing body of evidence that traditional forms of development aid do not make a major difference. If volume targets only help to ratchet up the same aid on a larger scale, then more

1. Only five countries have done so: Norway, Sweden, Denmark, Netherlands and Luxembourg.

development will not result. Here are some of the distortions, which are related to the supply-driven nature of aid:

- Most aid is administered by many large and expensive public bureaucracies each with procedures of their own.
- Supply is excessive, duplicative and pre-financed.
- Recipient countries are chosen according to the instincts of northern politicians and donor self-interests.
- The content and terms of aid are strongly influenced by the needs and interests of the suppliers rather than the recipients, and the solutions do not stick.

Foreign solutions are not fully absorbed. More often they are grafted on to local institutions without strengthening them from within. Or they remain as enclaves. The proliferation of donor-funded 'project implementation units' provides widespread evidence of these grafts. Such PIUs are there to ensure that the donors' projects are carried out to donor specifications. They employ foreign and local staff who are remunerated at levels well above local scales. When the project has run its course, the PIUs disband leaving little behind in terms of sustainable capacity. Enclaves are similar. They include, for example, some of the withering fruits of capital assistance: empty schools and hospitals, crumbling highways and silted dams.

More valid targets for donors would be the eight Millennium Development Goals to which the international community unanimously signed up at UN summits in 2000 and 2005. The first seven goals relate to poverty reduction, education, health, HIV/AIDS, gender equality and the environment. They can be applied at the country-level since they specify proportionate improvements in standards by the year 2015, e.g. halving national income poverty rates. The eighth goal relates to donor responsibilities to facilitate the other seven.

The merits of the MDGs are the obverse of the flaws of global aid volume targeting. The MDGs are measures of progress in human development, albeit partial ones. They are about development ends, rather

than crude aggregates of financial means. They are relatively easy to measure and there are data available on them for most countries.

Aid has more meaning and legitimacy when it is focused on human development outcomes at country level. Rather belatedly, the development community is recognizing the wisdom of national plans and strategies which help to map paths towards the achievement of MDGs, taking into account the individual circumstances of each country. The proponents of aid volume targeting want to calculate 'MDG financing gaps' again using the facile assumption that aid can somehow miraculously purchase development ends. The MDGs are the right focus, but aid—on condition that it is the right kind of aid—will be only one of the many, many conditions that need to be in place if development is to progress.

Beyond traditional aid, the rich countries need to show a stronger commitment to development. That would mean easing some of the impediments which they place—or continue to perpetuate—on developing countries.

First, they could forgive more debt. For the poorest countries this should mean wiping out external indebtedness entirely, and not lending more either bilaterally or through the multilateral system, such as the World Bank. External funding should be in grant form and should be used to finance mutually approved programmes aimed at promoting growth and meeting human needs, including the Millennium Development Goals.

Second, they could facilitate global trade by dismantling the barriers in the way of exports from the poorest countries. There is much talk of 'aid for trade' these days, but still developing countries face unfair, heavily subsidised competition and high tariffs on their exports of goods to which they try to add value.

The so-called 'donor' countries collect much more in import tariffs from developing countries than they provide in aid. For example, the USA in 2006 imported \$37 billion from France and collected \$367 million in tariff revenues;

it collected exactly the same amount of tariff revenues from Cambodia from \$2 billion of imports. The USA collected similar tariff amounts from the UK and from Bangladesh, although the former's imports were worth seventeen times as much. And while global trade rules try to prevent developing countries from subsidising their farmers, agricultural protection in the richest countries still runs at about three times the level of annual ODA, viz. \$300 billion.

In addition to lifting these impediments, rich countries could do more to finance and propagate global public goods, which poor people in developing countries need more than hand-outs. More funds should go into vaccines and medicines against the diseases that attack millions of children and adults. The Global Fund for AIDS, Tuberculosis and Malaria (GFATM)—three diseases which kill 6 million people per year in the developing world—needs more funds, as does the Global Alliance for Vaccines and Immunization (GAVI) to reduce mortality. These are meaningful targets, because they lead to monitorable results. Other public goods could help eliminate the public 'bads' of conflict and violence, trafficking of people, drugs, small arms and landmines.

There is also a rapidly mounting concern for responsible environmental management to turn back global warming, the most deleterious consequences of which will fall on the poorest countries. Funds are needed to accelerate the development and deployment of technological solutions which will wean the world from hydrocarbons.

If donors want to do more good for the world, they need to review their broader development footprint: reducing the harmful effects of conditioned aid and distorted trade, while creating a more propitious global environment.

Traditional aid targeting won't cut it.

■
S. Browne: *Aid and Influence: Do Donors Help or Hinder?* Earthscan, 2006.
<http://shop.earthscan.co.uk/ProductDetails/mcs/productID/587/groupID/7/categoryID/7/v/2>

by Nancy Birdsall,
Center for Global Development

Do No Harm: Aid and the Missing Middle in Africa

Africa is caught in a 'weak-institutions trap' signaled by the small share of middle-class income.

The state in many cases fails to protect the property rights—except of the few insiders—that sustain private investment.

Donors need to avoid harm to the fragile middle that fuels growth and strong, accountable democratic institutions.

The impact of volatile aid on skilled labour, interest rates, investor confidence and domestic revenue generation must be closely monitored.

Donors' implicit assumption is that Africa is stuck in a poverty trap and that massive aid is necessary to escape from the trap. I suggest an alternative assumption: that Africa is caught in an institutional trap, signaled and reinforced by the small share of income of its independent middle-income population. Theory and historical experience elsewhere suggest that a robust middle-income group contributes critically to the creation and sustenance of healthy institutions. If external aid is to be helpful for institution-building in Africa's weak and fragile states, donors need to emphasise not providing more aid but minimising the risks more aid poses for this group in Africa.

The key to understanding Africa's poor long-run growth record—and limited poverty reduction—may be the weakness of its 'institutions', including its institutions of the state. With neither the institutional structure that provides sufficient 'autonomy' from interest groups nor the democratic arrangements and habits that make the state accountable to the citizens, the state in many African countries fails to protect the property rights—except of the few insiders—that sustain productive private investment and risk-taking; indeed in the worst cases the state actually abuses the property rights of citizens.

Thus, rather than a poverty trap I would call this a 'weak-institutions trap'—a WIT! The poverty trap idea supports an emphasis on increasing the quantity of aid as the key to sustained growth. The idea of a weak-institutions trap, and the failures of past aid programs that led to high debt burdens without growth in many countries, supports emphasis on the quality of aid, including the nature of aid programs and their impact on political and other institutions in the recipient country.

The donor community is not unaware of the constraint to effective aid of weak institutions of the state, including in Africa. Indeed much of the discussion of increasing aid to Africa has been in the context of a 'compact' in which more aid from donors would be matched by increased attention to 'good governance' by recipient governments.

Countries where average incomes are low because long-run growth rates have been low can easily be identified and also what aid should pay for: infrastructure and social investments that a country is too poor to finance itself. Identifying the countries that are victims of a WIT is not so straightforward. Growth is a poor indicator since there is probably some lag between an improvement in institutions and subsequent growth, and since recent growth is a poor proxy for adequate institutions given the frequent growth reversals after periods of growth accelerations. Moreover, absent an *ex ante* definition of what constitutes weak 'institutions'—or how these can be strengthened—it is not clear what aid should pay for.

There is strong research evidence that institutions, variously described, matter for growth. The problem is that 'institutions' covers many rules, habits, customs, cultural and social factors and more; the state of a country's institutions is harder to describe let alone measure than is the extent of its poverty. The links from specific policy actions or aid programs to the institutional outcomes they measure are complex; it is hard to differentiate among the many institutions—rule of law, control of corruption, free press—that might matter now for subsequent growth, nor explain how changes in institutional strength in a country may affect subsequent growth.

In short, we have no reasonably predictive measure of a country's institutions and thus its WIT status. But recent political and economic theories of the role of state institutions in growth suggest possible current indicators that combined with the systematic measures of governance should be warning signs.

Among likely underlying causes of a country's suffering a WIT are:

- Heavy dependence on mineral and oil exports, leading to Dutch disease and limited investment in human capital, high income inequality, limited creation of productive jobs, and little state accountability to the majority of citizens.
- Low natural openness; landlocked, limited access to the sea and non-trading neighbours. That reduces opportunities for trade and thus for export-driven growth.
- Problematic borders combined with ethnic heterogeneity, which together undermine the legitimacy of the state.

Among symptoms of a WIT likely to reinforce such causes are: Primary commodity dependence and associated

economic volatility, recent experience of conflict and/or current inability of the state to effectively control all of its own territory, low non-trade tax revenues, prevalent corruption, and lack of executive accountability.

Some evidence suggests an additional salient indicator: an unequal distribution of income with a small 'middle', i.e. where the 60 per cent of households in middle receive a small proportion of national income. This should more systematically affect decisions about the amount of aid a country can absorb, and the type of aid that makes sense.

Most middle-income households in Africa are actually poor by international standards, or at risk of becoming poor. While maintaining their concern for the 'poor' as conventionally defined, donors need also to avoid harm to the fragile 'middle'. Of special concern should be the implications of high and unpredictable aid inflows for small entrepreneurial activity and job creation in the private sector.

In the more than 20 countries already highly dependent on aid—where aid constitutes 10 per cent or more of GNP and as much as 50 per cent of total

government spending—donors and recipient governments should monitor more closely the effects of aid and of planned aid increases on the labour market, particularly for skilled workers; on interest rates and other macroeconomic variables; on domestic investor confidence, given the volatility of past aid; and on incentives for domestic revenue generation.

Many countries in Africa that are highly dependent on aid have the symptoms of a weak-institutions trap. Strengthening their local institutions, particularly state institutions, is key to their sustaining growth. Proposals for reform of aid to make it compatible with institution-building exist. But even in the case of 'capacity development'—the first and often last resort of donors—caution is warranted given the failures of the past. In the end experience suggests that the institution-building process is a local task; it is not particularly amenable to outside help.

A first step for donors is to reduce the risk that aid from outside undermines existing and incipient institutions. Broad reforms of aid practice would help—harmonisation would reduce poaching, and greater predictability would avoid the volatility that discourages domestic investment.

But ambitions and rhetoric about broad donor reform are way ahead of the reality of how donors actually now behave. Donor reforms may yet take hold, but in what may be a long 'meantime' official donors active in aid-dependent countries ought to focus on a more modest goal: while doing good for the poor, do not do harm to the productive middle. After all, in the advanced economies and in developing countries that have sustained growth for several decades, it is the productive 'middle' that not only fuels sustained, private sector growth but provides the ballast of accountable, democratic and strong state institutions. ■

Payments for progress...

... is a proposed hands-off approach to scaling up foreign aid that would explicitly be aimed at strengthening local capacity and institutions, including in fragile states. It would link additional aid to clear evidence of progress already achieved on the ground. This approach would give flexibility and autonomy to local institutions, providing an opening for experimentation, while at the same time ensuring that aid pays only for real, measurable achievements. Donors would bind themselves as a group to pay a specific amount for clear evidence of progress against one or more agreed goals in low-income developing countries.

Developing country governments would present an independently audited statement reporting their progress on the measures, and donors would pay the agreed amount. Payments would be determined as a function of the outcomes, and not linked to the implementation of any particular policies, any other intermediate outputs, or 'tied' to purchases from particular suppliers or companies. Governments that found ways to provide services efficiently and so reduce the costs of providing them would benefit from a larger surplus. Such an approach raises issues in setting the benchmarks against which progress is measured, in avoiding cheating, and in managing unintended negative consequences of an incentives-based approach. But it entails important advantages for both donors and recipients.

Owen Barder and Nancy Birdsall: *Payments for Progress: A Hands-Off Approach to Foreign Aid*. Center for Global Development Working Paper No. 102, December 2006.

<http://www.cgdev.org/content/publications/detail/11550>

Nancy Birdsall: *Do No Harm: Aid, Weak Institutions, and the Missing Middle in Africa*. Center for Global Development Working Paper No. 113, March 2007.

<http://www.cgdev.org/content/publications/detail/13115>

by Finn Tarp,
University of Copenhagen

Aid Does Work, but Beware of Great Expectations

Looking for stable and predictable impacts of aid on growth and development is no simple task.

A careful review of the evidence indicates a positive impact overall, but aid alone will not turn the wheels of history.

'Good policy' can be a misleading criterion for aid allocation, and simplistic rules-of-thumb may make things worse.

There is much to criticise in current aid practices, but a lot of progress is being made.

Foreign aid remains squarely on most policy agendas concerned with growth, poverty and inequality. Yet controversy about aid impact is rampant. This is not surprising. Even a cursory look at history shows that development over the past 50 years has been a complex and variegated process. There have been interrelated changes in resource accumulation, population, knowledge and production technology—all in the context of frequent and dramatic change in policies and institutions. Looking for stable and predictable impacts of foreign aid on growth and development is no simple task under such circumstances. Analysts and policymakers are well advised to be wary of the dangers of oversimplification.

In particular, one cannot conclude that aid has been a fiasco just because growth in Africa has been less than desired, or because some development projects have failed. Development is, and will always be, a risky business. Unsuccessful investment projects and public sector activities abound in even the best of political, social and economic circumstances. If all investments were successful, investors are likely to have been too risk-averse.

Serious aid impact analysis must (i) try harder to uncover whether foreign aid has on average had a positive impact on development in recipient countries or not; and/or (ii) identify the mechanisms through which aid impacts e.g. on growth, including all potential positive and negative effects. A recent paper (see end-reference) reviews the evidence on whether aid has been effective in furthering economic growth and development.

It is easy to find a negative association between aid and growth in simple correlation analysis. Yet, there is no

inconsistency between little growth and low aid inflows. Over the past decade the mode of annual aid per capita in recipient countries amounted to less than \$20 and the median was under \$35. Moreover, the simple correlation coefficient between growth and aid may be insignificant, or even negative, because donors allocate more aid to poorer countries, subject to difficulties and shocks of many kinds, including natural and man made calamities. When countries have done well for a while so average income has gone up, donors tend to transfer less aid and eventually they withdraw. While such 'graduation' may take a while, simple correlations are thus likely to show a negative relationship, but they do not reveal the 'true' impact of aid.

Aid allocation matters, as does the major changes that have taken place in the global economy and affected the environment in which aid is implemented. Targets for aid have also been changing from one decade to the next. Hence, simple correlation analysis or story telling cannot—and should not—settle the causality debate about aid's potential impact on development.

Similarly, it is never straightforward to generalise from case studies; this helps explain the surge of macroeconomic cross-country studies of the aid-growth link from the mid-1990s. Such an approach makes it possible to move beyond simplistic aid-growth correlations, where the analysis of causal effects is rather primitive. Much of the modern empirical aid-effectiveness literature has focused on whether the impact of aid is conditional on policy or whether aid can be expected to have a separate and positive impact, independent of policy.

This has involved a mixture of concerns, ranging from technically demanding econometric modelling issues to fundamentally different approaches to development strategy and policy. Thus, it is clear that the 'true' aid-growth relationship is far from easily established. In any case, aid is of much too limited a size to turn the wheels of history.

Yet, this does not justify rejecting aid as a useful instrument in the fight against poverty. Nuanced and subtle assessments are advisable with the empirical evidence in hand; and the single most common result in the modern aid-growth literature is actually that aid has had a positive impact on per capita growth. No excessive claims about aid impact should be made on this basis—complacency is not called for. Still, these established results should not be overshadowed by the aid criticism.

Turning to the debate about aid allocation, there appears to be merit in more sophisticated versions of arguments for selectivity. Structural adjustment lending makes little sense when the macro policy environment is 'bad' and there is little possibility for policy reform. However, the empirical work on aid effectiveness has made it clear that macro criteria should not stand alone in assessing aid effectiveness and determining aid allocation.

'Good policy' can be dangerously misleading as the fundamental criterion for aid allocation, and simplistic macro rules-of-thumb may make things worse. Many of the world's poorest people suffer under substandard governance and lack the means for changing it. It would be gravely ironic for aid agencies to compound the misfortunes of these people with discriminatory aid allocation.

Overall, based on the research results it is justified to argue for increased aid, but expectations about its impact on growth should be kept at reasonable levels. It would be unfortunate if unrealistic expectations about aid impact are once again built up as in the early stages of international aid. At the same time, asserting that aid has a positive impact

and should be 'scaled up'; and that its impact does not appear to be conditional on 'good policy', in no way contradicts suggestions that future aid should be carefully redesigned.

Much is indeed already happening on the foreign aid scene. Major shifts have taken place in aid modalities over the past 15 years, and the general rise of a culture of transparency and accountability is more than superficial.

The single most common result in the modern aid-growth literature is actually that aid has had a positive impact on per capita growth.

The March 2005 Paris Declaration on Aid Effectiveness codifies best-practice experience and it is now being implemented (see below, page 26).

Three sets of critically important but unresolved issues remain:

- Foreign aid has been associated with both development successes and failures. The basic analytical problem in assessing its impact is to identify the underlying development model. We therefore continue to work with debatable reduced form models, while the data suggest that aid effectiveness is very uneven. The conditions for aid having a more positive development impact remain disputable. It remains a challenge to better understand what drives the different impacts of foreign aid, e.g. the potential interaction with policies and structural characteristics.
- We lack the necessary understanding of the complex, country-specific links between aid, growth and development objectives such as poverty reduction to justify selectivity as the basic approach to aid allocation. This does not mean that I favour old-fashioned ex-ante conditionality, but a better understanding of the intricacies of the

donor-recipient relationship in theory and in practice would be valuable.

This would as key elements include addressing issues such as how to best (i) channel resources to the poor when national governments fail to do so; (ii) ensure that aid delivered directly to national governments does not undermine local accountability; (iii) establish the appropriate balance between aid to the government and to private sector entities; and (iv) strengthen incentives for genuine domestic policy leadership with learning-by-doing adjustments. Furthering accountability and transparency *vis-à-vis* local populations is a demanding but crucial task.

- In the present drive to scale up aid, it is critically important to avoid making the mistake of the past of promising too much, i.e. contributing to the misconception that aid can on its own turn history. Based on history aid has much to offer, but managing expectations is far from easy. A major challenge is to make sure promises made are actually kept. There are many unresolved issues here, including how to design incentives in aid agencies to meet this challenge alongside topics such as the role of independent evaluation, of donor coordination, and of the need to sharpen the incentives for recipients to maximise reform efforts.

In conclusion, it would be gravely ironic if disagreement about overall development strategy and the macroeconomic impact of aid got in the way of pursuing practical and useful aid funded activities in poor countries. There is much to criticise in foreign aid, but possibilities for constructive and forward looking action should be kept in mind throughout. There are in my experience lots of them out there in practice. They deserve to be uncovered more precisely and implemented effectively to the benefit of those in need. ■

F. Tarp: *Aid and Development*, Swedish Economic Policy Review, vol. 13, 2006, pp. 9-61. http://www.ekonomiskaradet.se/Panda_ekonomiska/Data/Documents/sepr2006_2/Tarp.pdf

by Edward Anderson,
University of East Anglia

Aid Allocation and the MDGs

The global poverty reduction impact of aid varies with its allocation across countries.

This affects donors' allocation criteria: should they go for maximum global poverty reduction or for reaching the MDGs in each country?

Should aid compensate disadvantaged countries and try to create equal opportunities for all?

These alternatives have a substantial cost in terms of foregone global poverty reduction.

How donors decide to allocate aid across countries is an important and highly political policy issue. It concerns fundamental principles for the allocation of aid as well as the evidence on the extent to which aid promotes development objectives in different country contexts. This article discusses these issues and how they affect approaches and strategies for achieving the MDGs.

One principle which can guide aid allocation decisions is that of 'poverty-efficiency'. This principle can be stated simply: aid should be allocated so as to achieve the largest possible reduction in poverty at the global level, which is consistent with the view that the over-riding purpose of aid is to eradicate poverty. Nevertheless, it does have its critics.

One concern is that its strict application would cause donors to neglect poor countries in which the effectiveness of aid at reducing poverty is considered to be very low, due for example to substandard governance.

Another concern is that the principle fails to take into account the different opportunities that developing countries face for reducing poverty. For example, poor countries which are geographically isolated, or which have few natural resources, will typically find it harder to achieve sustained growth and poverty reduction than other countries. Many would argue that such countries should be allocated additional aid, so as to compensate for their relative lack of opportunities.

Alternatives to the poverty-efficiency principle, which address these concerns, do exist. One alternative would be to allocate aid so as to achieve a targeted

reduction in poverty in each recipient country. Another alternative would be an 'equal-opportunity' aid allocation, which would allocate aid in a way which compensates countries facing fewer opportunities for growth and poverty reduction.

Which of these different principles—poverty-efficiency, country-by-country targets, or equal-opportunity—is right is of course a normative question involving philosophical and moral considerations. It is, however, a question certainly worth thinking more about, not least to see how much consensus exists on which principle is considered to be right.

To apply any aid allocation principle in practice, estimates are required of the likely effects of aid on things like economic growth, poverty and governance, in different country contexts. Some studies have shown that the effect of aid on poverty, via its effect on economic growth, is greater in countries with a more favourable policy and institutional environment. However, there are now upwards of 60 different estimates of the effect of aid on economic growth. Many of these find that aid's effect does not vary much across recipient countries, or that it varies according to country characteristics other than the policy and institutional environment.

Because there is relatively little consensus about precisely how aid affects poverty, or other relevant outcomes, and about how these effects vary across recipient countries, there is a lot of disagreement about what a poverty-efficient aid allocation, or an equal opportunities aid allocation, would look like in practice. Possible ways of resolving this dilemma are proposed below. First however, it is worth considering the conflict between

alternative aid allocation principles in the context of attaining the MDGs.

In debates building up to the MDG Review Summit in 2005, the uneven progress towards each goal across countries and regions became immediately apparent. For instance, while East and South Asia were either on-track towards, or had already met, the target of halving \$1-a-day poverty by 2015, progress in Sub-Saharan Africa had been negative.

The main reaction to this uneven progress was to recommend a large scaling-up of aid, precisely to accelerate progress in those countries and regions where progress was lagging. This was backed up by an interpretation of the MDGs as country-level targets as well as global ones, most prominently by the UN Millennium Project, which in its main report *Investing in Development* interprets the MDGs as country goals, “since this is the spirit in which they are pursued the world over”.

Clearly, a country-level interpretation of the MDGs requires donors to allocate additional aid to lagging countries, even if that aid could have a larger impact on poverty elsewhere. It therefore departs from the principle of global poverty efficiency, and involves a sacrifice—an ‘opportunity cost’—in terms of the amount of progress

towards the MDGs achieved at the global level.

How large is this opportunity cost? Recent research has estimated its size in relation to MDG 1, that of halving \$1-a-day poverty by 2015. It calculated (i) the total amount of aid required if each low-income country is to achieve MDG 1; (ii) the amount of aid each low-income country would receive if this total amount were instead allocated on a global poverty-efficient basis; and (iii) the overall level of the \$1-a-day poverty measure for all low-income countries through to 2015 under the two allocation systems. The difference between the two estimates gives the opportunity cost of a country-by-country approach to meeting MDG 1, viz. the amount of poverty reduction at the global level which is sacrificed as a result of departing from a poverty-efficient allocation.

The results of this research show that the opportunity cost of a country-by-country approach to meeting MDG 1 could be very significant: it is unlikely to be less than 10 million people, and could be as high as 70 million people (see figure). The additional reduction in poverty under a poverty-efficient allocation would be achieved in two main ways. The first would be by allocating relatively more aid (compared to a country-by-country allocation) to South Asia, and relatively

less aid to Sub-Saharan Africa. The second would be by allocating relatively more aid within each region to countries in which the effectiveness of aid at reducing poverty is seen to be higher.

Of course, these findings do not necessarily imply that interpreting the MDGs on a country-by-country basis, and allocating aid accordingly, is wrong. Such an approach may be justified, for instance because it avoids the possibility that countries in which the effectiveness of aid is considered to be very low are by-passed by aid. In this case, the opportunity cost of the approach would be a price worth paying. The fact remains, however, that donors should be aware of the size of this cost, even if they regard it to be offset by other normative considerations.

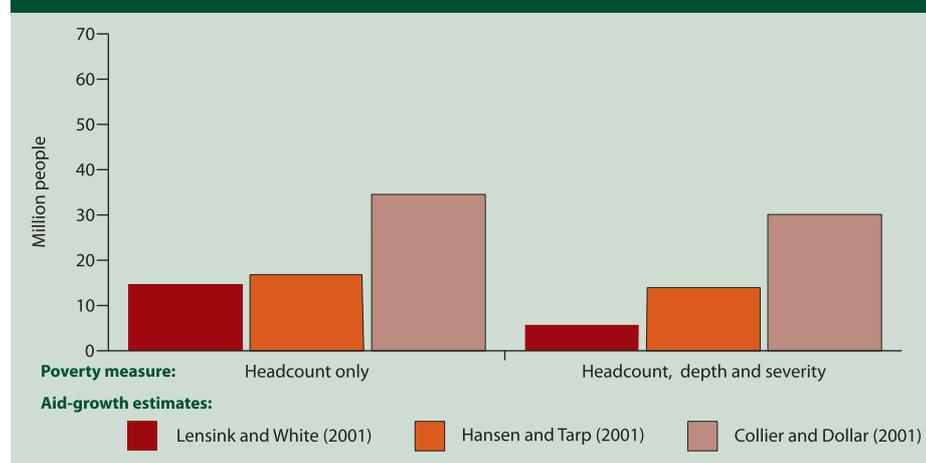
Two main implications arise from the issues discussed here. First, donors seeking to implement any allocation principle in practice should consider alternative estimates of the effectiveness of aid in different country contexts. Different estimates may well suggest different ‘optimal’ allocations, though it may still be possible to identify countries which are currently under-aided (or over-aided) whichever estimates are chosen.

Second, there is a need for more clarity and debate about the underlying principles on which aid allocation decisions should be based. One issue is whether aid should be allocated so as to help achieve the MDGs on a country-by-country basis or at the global level only. Another is whether an equal-opportunity aid allocation is preferable to a poverty-efficient allocation.

Overall, the large scaling-up of aid volume called for and agreed during 2005 need not come at the expense of a sound approach to its allocation across countries, as long as donors engage in an open discussion about the principles according to which allocation decisions are made, and apply those principles wisely in practice.

■ **E. Anderson: *Aid allocation and the MDGs. How much should different countries get and why?* Briefing Paper No. 19, Overseas Development Institute, London, April 2007. http://www.odi.org.uk/publications/briefing/bp_april07_aid_allocation.pdf**

Additional poverty reduction in low-income countries by 2015 under a poverty-efficient aid allocation



Notes: Figures refer to the 41 low-income countries with recent \$1-a-day poverty estimates (89% of total population of low-income countries in 2002). The additional amount of poverty reduction is calculated relative to a country-by-country approach to meeting MDG 1. References: See ODI Briefing Paper No. 19.

by Patrick Guillaumont,
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Aid Works Best in Vulnerable Countries

Aid effectiveness is linked much more to the economic vulnerability of countries than to their policies.

Export volatility has a negative impact on growth, while aid tends to have the opposite effect.

Aid increases stability and growth, while also making growth more pro-poor by protecting from poverty traps.

Aid should increase more, balance directly productive and social sectors, and serve as insurance against external shocks and export volatility.

The overall impact of aid on income poverty has been examined mainly through its effect on economic growth. According to the most influential paradigm, this impact is considered as mainly depending on policy. The resulting message—that priority in aid allocation is to be given to countries with ‘good’ policies and institutions—met a moral and political sentiment not always grounded on a robust assessment of aid effectiveness.

The sometimes intense debate on such selectivity in allocating aid, initiated by World Bank research some 10 years ago, has at least made clear that aid effectiveness is likely to depend on some specific features of the recipient country. But which features are most important?

One strand of empirical research has shown that a major factor conditioning aid effectiveness at the macro level in recipient countries is the economic vulnerability they face. In vulnerable countries, foreign aid has a high marginal productivity in avoiding collapses when shocks occur, sometimes followed by long lasting recessions. Aid can smooth public expenditures and lower the risk of fiscal deficit. Consequently the marginal contribution of aid to economic growth is shown to have been significantly higher in recipient countries exposed to external shocks.

There is not much debate about the negative impact of ‘one-sided’ natural negative shocks such as earthquakes, typhoons or floods. The damage caused by these events is often huge, first by the number of deaths, second by the destruction of physical capital. The debate is rather about the measurement of the size of these losses. Many shocks are ‘two-sided’, in particular external economic volatility, such as a succession of booms and slumps of export prices, external demand, rainfalls etc. Therefore,

to assess vulnerability over a long period it is appropriate to consider the impact of instability or volatility rather than the impact of separate shocks.

The effects of export instability, a main source of structural vulnerability in developing countries, have been discussed for many years in the literature on growth regressions. There seems to be now a consensus emerging from several studies to conclude that export instability, or in some studies terms-of-trade instability, has a negative effect on growth. This effect comes mainly through the instability of the rate of investment and that of the real exchange rate, either by its impact on public finance when retained at the government level or by its impact at the producer level.

Economic instability also affects growth by triggering political instability that sometimes can lead to armed conflict, which is a very important cause of economic decline. The instability of exports is higher for countries exporting unprocessed primary commodities subject to large price volatility. Other exogenous shocks have been shown to have similar effects on the risk of conflict, for example rainfall instability.

At the project level, aid has been shown to have stabilising effects that are not directly perceived by the evaluators of each project, since it cannot be easily observed at that level. Indeed the vulnerability of a country harms the success of the projects, but less so when the level of ODA received by the country is high, which leads to the conclusion that aid reduces the negative effects of economic instability. Research results substantiate the macro-micro linkages and provide further support that more aid should be given to vulnerable countries because it can dampen the negative effects of shocks. This can be

1. Centre d'Études et de Recherches sur le Développement International.

done by taking into consideration a measure of vulnerability in the criteria used for aid selectivity.

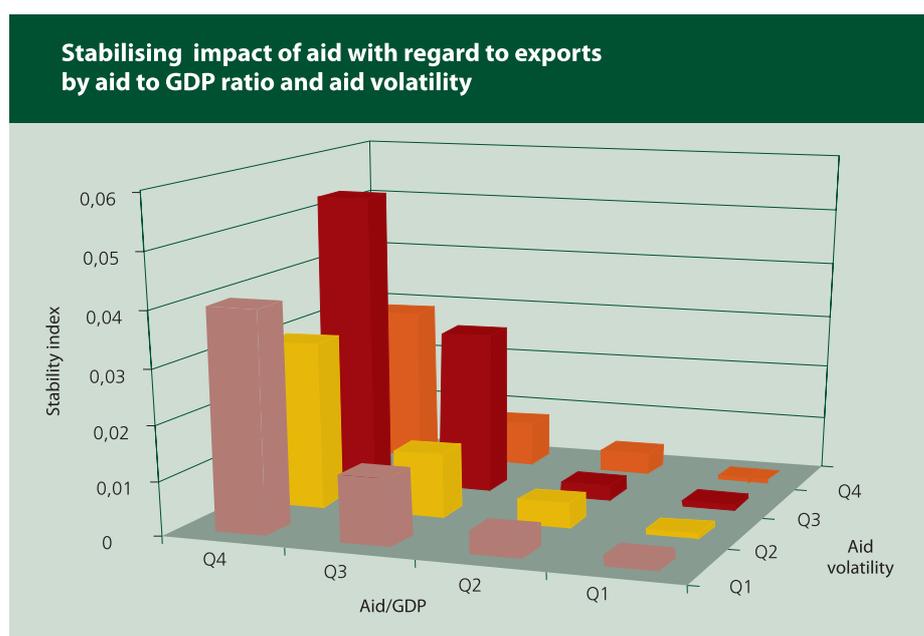
By lowering growth, instability has deleterious consequences on the pace of poverty reduction. It also has direct social effects independently of its effects on growth. Two reasons make these direct effects likely.

One is the feeling of frustration generated by a shortfall of income following a rapid expansion which creates new needs and exaggerated expectations, as illustrated above by the risk of civil war or of crime. The other reason is due to poverty traps, linked to the asymmetry of reactions of health, education, employment to income fluctuations. As far as instability lowers growth, it slows down poverty reduction normally expected from growth, but also results in an anti-poor bias for a given average rate of growth.

There is evidence that instability of income worsens the social situation in low income countries, and tends to increase—or hamper the otherwise occurring reduction of—the mortality of children under five. Furthermore, instability of income pushes people into poverty traps; poor people contract lasting health handicaps, their children leave school, laid-off workers get excluded from the labour market, etc. Thus, the poverty impact of a rise of average income is less than the impact of a fall. This asymmetrical effect lowers the average impact of growth on poverty, and increases poverty independently of income growth and inequality change.

The current concern about aid volatility notwithstanding, aid seems to have a stabilising impact in the medium term; first with respect to exports volatility, second and more generally as a dampening factor of income volatility. Aid volatility may lower and possibly cancel this effect when it is procyclical with regard to exogeneous shocks, and even, but less likely, when it is contra-cyclical and very high compared to other sources of shocks. Pro-cyclical aid can still be stabilising if it is relatively less volatile than exports.

To assess the impact of aid on stability, we consider an index corresponding to



Note: The level of stabilising effect of aid as defined in the text is represented for 16 groups of developing countries classified by the quartiles of the aid to GDP ratio and the quartiles of aid volatility (Hodrik-Prescott measure).

the difference between the volatility of (i) exports and (ii) the total inflow of aid plus export revenues. If the difference is positive, aid is stabilising; if it is negative, aid is destabilising. The results for a sample of more than 100 developing countries over the period 1970–99 show that, on average, it has been stabilising and more clearly so during the 1990s than previously; the indicator represents 18 per cent of the average value of the instability of exports, and 28 per cent for a sub-sample of African countries. On the whole, aid was destabilising in less than one tenth of cases.

The graph above illustrates the result in terms of the net stabilising impact of aid, measured by the above-mentioned volatility difference index. It shows that for any level of aid volatility overall stability improves with higher aid/GDP ratios. At the same time, overall stability is not significantly influenced by the level of aid volatility.

The stabilising effect of aid is due to the mix of: (i) a level effect; (ii) a contra-cyclical effect; (iii) a relative volatility effect.

It explains why aid seems more efficient in terms of growth in countries more affected by export instability.

Aid is likely to promote poverty reduction by its stabilising impact through two different channels: by increasing the pace

of growth and by avoiding poverty traps and thus making growth more pro-poor.

There are three major implications for aid policy:

- First, there is a need to balance the utilisation of aid between directly productive and social sectors, in order to avoid poverty traps and transitory loss of competitiveness.
- Second, aid should be designed more to function as insurance against exogeneous shocks, in order to contribute to a faster and more pro-poor long term growth.
- Third, due to the higher marginal impact of aid in vulnerable countries and in particular the Least Developed Countries (LDCs), where the need of a big increase of aid is the largest, priority should be given to these countries in aid allocation. To implement such a new selectivity it is possible to use the Economic Vulnerability Index (EVI) set up at the UN for the identification of LDCs. ■

P. Guillaumont, S. Jeanneney Guillaumont: *Big Push versus Absorptive Capacity: How to Reconcile the Two Approaches*, UNU-WIDER Conference "Aid, Principles and Policies" Helsinki, June 2006. CERDI, Document de travail de la série *Etudes et Documents* E 2006.14. http://cerdi.org/Public/ED_Detail.asp?id=806

by Rainer Thiele¹, Peter Nunnenkamp¹
and Axel Dreher²

Sectoral Aid Priorities: Missing MDG Targets?

The overall share of the social sectors has nearly doubled in 15 years, but this varies a lot across donors.

Unless the sector targeting of aid is better focused on MDG needs, even much larger aid may not be enough.

The prospects for achieving the Millennium Development Goals (MDGs) look bad in various developing countries, notably in Sub-Saharan Africa. To turn the tide, recent reports by the UN Millennium Project and the Commission for Africa issued urgent calls to increase official development aid substantially and, thereby, close the gap between donor rhetoric and reality.

Qualitative aspects of aid allocation have received considerably less attention even though they may be as important for effectively meeting recipient needs. In particular, a needs-based targeting of aid in priority sectors such as health and education should have an important say on whether donors help achieving the MDGs. Hence, in addition to the usual

ranking of donors according to their overall 'generosity', the structure of aid portfolios offers interesting insights as to whether aid has been prioritised in line with the MDGs.

The sectoral composition of aid by all donors taken together has changed quite dramatically since the early 1990s. Most notable in the context of the MDGs, the share of aid devoted to the social sector has almost doubled (to about 35 per cent in 2002-04), with higher spending on education, health and population programs, though not on water and sanitation.

However, this overall pattern masks substantial variation across donors. In recent years, social sector aid ranged from 23 per cent of total aid in Japan to 50 per cent in Norway. France and Germany put a strong focus on education but spent very little on primary education, even though the MDGs would require donors to concentrate on this sub-category. The United Kingdom stands out in that education and health-related aid was focused on basic services from which poor population segments might benefit most. Denmark and Germany were the only donors that provided a non-negligible share of total aid for basic water and sanitation. Environmental protection and gender equality, which both explicitly correspond to MDGs, were largely neglected by almost all donors.

Different aid priorities of donors must not necessarily imply inappropriate targeting. While a multi-dimensional objective function follows from the MDG project, coordinated donor efforts may have resulted in a division of labour with specific donors concentrating on specific MDGs. Coordination and harmonisation indeed figure high on the policy agenda of donors. The Paris Declaration on Aid

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Matching MDGs, indicators of need and aid categories

Indicators of need	Aid categories
Target 2: Hunger	
undernourishment malnutrition of children	developmental food aid emergency food aid
Target 3: Primary schooling	
net primary enrolment primary completion rate average years of schooling	education basic education
Target 4: Gender disparity in education	
ratio girls/boys in education literacy ratio, males/females	education basic education
Target 5: Under-5 mortality	
under-5 mortality rate immunization, measles	health basic health
Target 6: Maternal mortality	
maternal mortality ratio births attended	health basic health
Target 7: HIV/AIDS	
prevalence of HIV	health population programs
Target 8: Malaria, other diseases	
incidence tuberculosis malaria ecology	health basic health
Targets 10/11: Water & sanitation/ slum dwellers	
access to improved water access to improved sanitation	water supply & sanitation basic drinking water

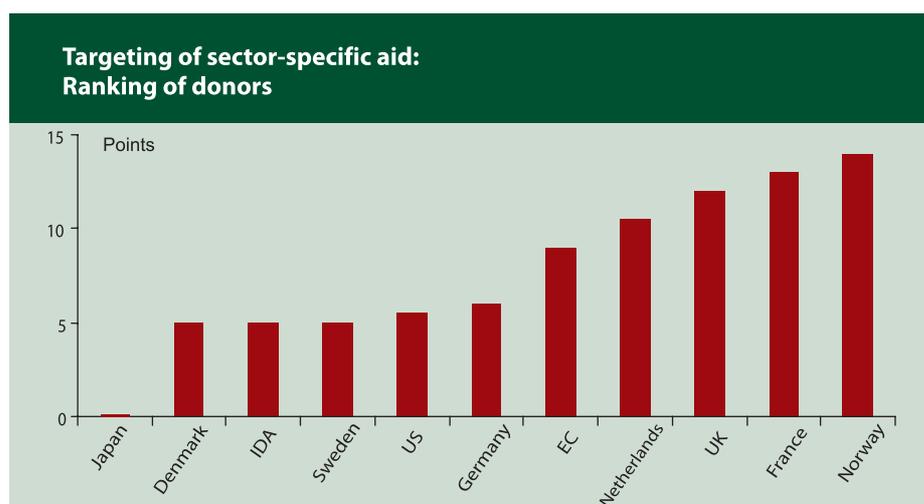
Effectiveness emphasized the need “to eliminate duplication of efforts and to rationalize donor activities to make them as cost-effective as possible.”

Yet donor coordination remains elusive. Donors tend to favor the same ‘aid darlings’. Comparing pairs of major donors with regard to the allocation of aid across 140 recipient countries, most of the correlations turn out to be positive and very few are significantly negative. This applies not only to total aid per capita of the recipients’ population, but also to sector-specific aid for health, education, and water and sanitation.

It is against this backdrop that we assess whether donors allocated aid according to specific needs of recipients. We analyze the impact of ‘indicators of need’ related to the non-income MDGs on the distribution of sector-specific aid across 140 recipient countries. We control for the per-capita income of recipient countries and democracy indicators in order to isolate the impact of the indicators of need listed in the matching table below.

It is important to note that all explanatory variables are weighted by the recipient countries’ population. This implies that the unit of observation is the individual, rather than the country. This approach is taken because of the global character of the MDG concept; success or failure depends on the percentage of the worldwide population, rather than the number of countries reaching a particular target. Obviously, the results may be driven mainly by China and India. Therefore, we perform additional estimations by excluding these two heavyweights to test for the sensitivity of results.

We compare eleven bilateral and multilateral donors on the basis of their aid commitments in 2002-2004. The aid categories under consideration are supposed to be most relevant for aid to be effective in contributing to the MDGs. This is not to deny that other aid categories such as humanitarian and multi-sector aid may also promote the MDGs. In addition, it should be stressed that addressing the question of whether donors paid sufficient attention to the



MDGs by allocating aid according to related indicators of need does not allow strong conclusions on the effectiveness of aid. Well targeted aid is a necessary, though not a sufficient condition for aid to be effective.

We rank the eleven donors under consideration as follows. Each donor may achieve a maximum of 64 ‘credit points’: one point for each significant coefficient of the specific indicator of need in the allocation of sector-specific aid (see table); 0.5 extra points when a significant coefficient is robust to the exclusion of China and India; another 0.5 extra points when the per-capita income of recipients enters significantly negative at the same time, revealing a general poverty orientation of aid. A similar procedure is applied for comparing the targeting of sector-specific aid across the MDGs.

No donor comes close to the maximum. Yet there are striking differences (see graph). It appears to be in line with conventional wisdom on particular donors’ performance that Japan ranks at the bottom and Norway at the top. However, the group of donors with weak targeting includes not only a nother donor widely blamed to be low-performing—the United States—but also countries usually regarded as superior donors like Denmark, IDA and Sweden. The latter donors are more MDG-oriented in terms of granting more aid to poorer recipients, including humanitarian and multi-sector aid. However, more sector-specific targeting has played a minor role for them, too.

On the other hand, France ranges close to the top in allocating aid to MDG-related priority areas. The fine-tuning of French aid according to specific indicators of need qualifies earlier verdicts that the poverty orientation of its aid allocation is particularly weak. Likewise, there are striking differences in targeting sector-specific aid across the MDGs under consideration (not shown in the graph). The fight against HIV/AIDS (Target 7) clearly stands out, with almost half of the maximum of possible ‘credit points’ being reached. This implies that almost all donors focused on this target. Target 2 comes second, though at a considerable margin—22 per cent of possible credit points. By contrast, various targets were largely neglected, namely Targets 3, 4, 5 and 10/11. The targeting is particularly poor with respect to the objective of achieving universal primary education (Target 3). The allocation of aid in education was shaped by the corresponding indicators of need for just three donors—France, Germany and Norway—and only weakly so.

All this invites the conclusion that the current focus on substantially increasing aid in order to turn the tide and try to achieve the MDGs misses an important point: Unless the targeting of aid to MDG-related priority areas is improved, increasing the amount of aid is unlikely to have the desired effects.

■
R. Thiele, P. Nunnenkamp, A. Dreher: *Do Donors Target Aid in Line with the Millennium Development Goals? A Sector Perspective of Aid Allocation. Forthcoming in Review of World Economics.* <http://www.uni-kiel.de/ifw/pub/kap/2006/kap1266.pdf>

by David Goldsbrough and Ben Elberger,
Center for Global Development (CGD)

The IMF and Spending for the MDGs

IMF conditionality has erred on the conservative side, leading to less aid delivery and less effective use of aid, e.g. for MDG-related spending.

It tends to favour domestic debt reduction or external reserve increases over additional public spending.

It has not done enough to help countries explore and adjust to the macro-economic consequences of higher aid.

The current approach is untenable. IMF should focus more on analysis and less on specific conditionality.

A major problem facing both the International Monetary Fund and its critics is the limited knowledge about key economic relationships that determine how macroeconomic policies will influence growth and poverty outcomes in a particular country, e.g. how different types of public spending will affect future economic capacity and competitiveness, how private investment might respond to lower fiscal deficits or how long any increase in aid flows will last.

What key actors assume about these relationships influences fiscal policies. For example, whether higher aid-financed spending may cause adverse macroeconomic effects of concern for the longer term depends critically on the likely supply response to such spending. If higher aid-financed spending on non-traded goods pushes up the real exchange rate in the short-term—i.e. causes some temporary ‘Dutch disease’ effects—we should not be too concerned provided the spending improves competitiveness in the longer term.

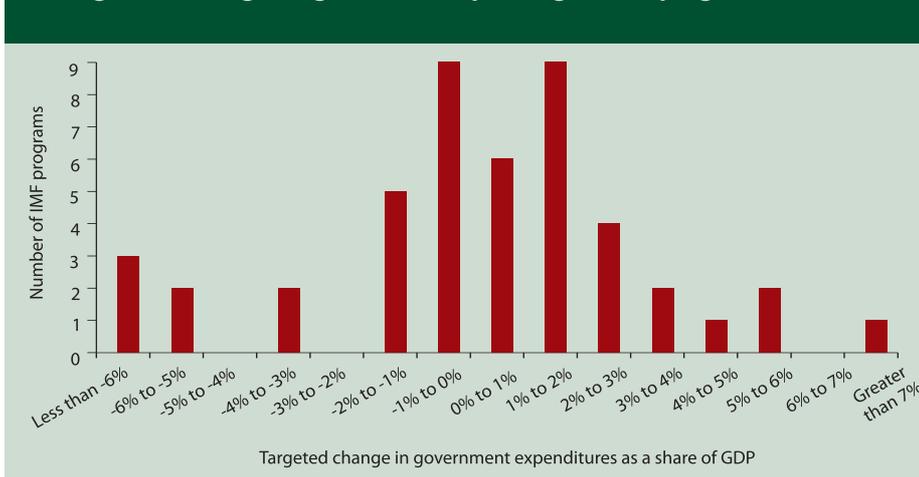
So, the most important challenge facing aid-dependent countries is often not a

‘macro’ one at all. It is to ensure that additional spending is used effectively, which requires good governance, sound public financial management, and strong sector-level policies. If those are right, the more narrowly ‘macro’ challenges will be manageable.

In fact, different judgments about the likely effectiveness of higher spending may underlie many of the disagreements between the IMF and its critics on macro frameworks with respect to the Millennium Development Goals (MDGs). With some recent exceptions, the IMF has not done a good job of incorporating supply-side responses into its country-level macroeconomic analysis and can implicitly assume that additional public spending will have little impact on growth. In contrast, those who produce MDG-costing scenarios often assume that the ‘technical’ costing ratios around the MDGs can be scaled up without the huge governance problems and ‘leakages’ common to other types of spending that have been a fact of life in many low-income countries. Neither assumption is likely to be correct.

In practice, we can never know, without trying, what the impact of more ambitious spending strategies will be. So countries are forced to make policy choices under considerable uncertainty and balance the costs of different potential mistakes; between threats to macro ‘stability’—i.e. inflation, Dutch disease, and fiscal deficits all worsen due to weak supply responses—and foregoing expenditure opportunities that might improve the lives of the poor and raise growth. How these risks are balanced should depend on the macroeconomic situation—which in most countries is much better than a decade ago—as well as on governance and sector-specific policies that influence the likely effectiveness of additional spending.

Targets for changes in government spending for IMF programs



Since the IMF does not have the expertise to judge these sector-specific issues, it should be humble in its macroeconomic pronouncements if sufficient information is unavailable. Furthermore, even if these economic relationships were fully understood, many fiscal policy decisions—especially for the health sector—involve fundamental social choices that should be left to national political processes. The IMF job, therefore, is to help countries explore the consequences of feasible policy options to clarify the trade-offs involved.

In this context, the IMF has not done enough to explore more expansionary but still feasible options for higher government spending. As a consequence, the initial fiscal content of some 'IMF programs' has been too conservative. In particular, programs tended to favor domestic debt reduction or external reserve increases over additional spending, even when macroeconomic conditions were quite favorable. Faced with huge uncertainty about key economic relationships, many IMF programs implicitly assumed with insufficient justification that the balance of risks was against additional spending.

The problem is not that the IMF is pursuing a 'one size fits all' approach, imposing the same squeezes on deficits and spending in all countries. In fact, IMF programs vary considerably in the size of targeted changes in fiscal deficits and public spending (see graph). Reflecting better macroeconomic starting conditions, recent programs, on average, targeted small *increases* in fiscal deficits and overall spending, compared with targeted cuts in earlier programs. For example, programs negotiated between 2003 and 2006 targeted average expansions in the fiscal deficit before grants and in spending of about ½ - 1 per cent of GDP in the first program year.

Despite this shift toward moderate fiscal expansion, both a recent study of IMF programs in Africa by the IMF Independent Evaluation Office (IEO) and the detailed country case studies for the CGD Working Group (see end-reference) found that the IMF has tended to favour additional domestic debt reduction or external reserve increases over additional public spending.

The IEO study found that, across all programs in Africa, each additional dollar of expected aid was associated with a targeted fiscal expansion, i.e. additional spending, of only 27 cents. Only when external reserves were quite high, above 2½ months of imports, and domestic macroeconomic conditions highly stable—represented in the IEO study by inflation under 5 per cent—did programs aim to channel the bulk of additional aid to higher spending.

While the IMF is right to take account of the level of reserves and domestic macroeconomic conditions when designing fiscal policies and how aid will be used, the degree to which these factors influenced the fiscal strategy seems too conservative. A wider range of paths for the fiscal deficit and spending is now possible, following debt relief and with the prospect of higher aid, but there was often little analysis—at least in publicly available IMF documents—of the rationale underlying the specific path chosen for the fiscal deficit and overall government spending.

With some commendable recent exceptions, the IMF has also failed to explore the macroeconomic consequences of scenarios for scaling up aid. In some earlier programs in the case study countries, IMF aid projections were oriented around goals of reducing aid dependency—e.g. Mozambique in 2002-2003—or avoiding borrowing even on concessional terms—e.g. Rwanda in 2003-2004—without convincing macroeconomic arguments for the prescribed approach. The IMF programs did eventually adapt when substantially higher aid was forthcoming but it is not possible to say whether the initial negative signals discouraged any aid.

The IMF approach seems to be slowly changing: in the last couple of years, in-depth analyses of alternative scenarios for 'scaling up' aid have been undertaken in several countries, e.g. Ethiopia, Madagascar, Zambia and, very recently, Mozambique and Rwanda. However, expectations of IMF staff by the IMF Board remain unclear and much seems to depend on the initiative of individual mission chiefs.

This ambiguity causes two problems. First, the IMF has not done all it could do to help countries explore the macroeconomic consequences of higher aid. Second, it risks sending confused signals to donors. For example, if only conservative scenarios are presented, does this mean the IMF thinks more resources cannot usefully be absorbed from a macroeconomic perspective or only that the IMF does not think more resources will be forthcoming?

In fact, projections of aid to Africa in IMF programs remain conservative, reflecting skepticism by IMF staff—which may be justified—on donors' resolve to deliver on their commitments to double aid by 2010. Of the 27 IMF programs and reviews in Sub-Saharan Africa that were completed in the 18 months after the Gleneagles Summit, aid projections in only two were as optimistic as the Gleneagles commitments.

A fundamental message of the Working Group is that if the IMF is to continue being heavily involved in these countries once macroeconomic stability has been achieved—advising governments on longer-term macroeconomic challenges and signaling to donors on the suitability of macroeconomic frameworks—it needs to adapt its analytical approach and way of doing business. Clearly, an alternative division of labour is possible in which the IMF confines itself to short-term stability issues and makes no pretence of pronouncing on the longer term challenges of scaling up aid and expenditures. The IMF Board could make clear that the IMF role in post-stabilisation low-income countries will be much more limited and scale back its involvement and policy pronouncements accordingly. But, if the IMF is to continue to play the broader role that the international community seems to want, its current approach is untenable and the institution should transition to a role focused more on exploration and less on specific conditionality. ■

Does The IMF Constrain Health Spending in Poor Countries? Evidence and an Agenda for Action. Report of the CGD Working Group on IMF Programs and Health Spending.
<http://www.cgdev.org/section/initiatives/active/ghprn/workinggroups/imf>

by John Serieux,
University of Manitoba

Aid and Dutch Disease: Nothing to Fear but Fear Itself?

Fear of 'Dutch disease' has made some poor countries shelve aid rather than use it as intended for poverty reduction.

Such a response to the promised rise of aid is a real threat to the prospects for achieving the MDGs.

It is also uncalled for. Many examples show that increased aid can strengthen the economy with the right policies.

The onus is on donors to reduce aid volatility and increase aid predictability.

The prospect of large increases in the flow of resources from wealthy to poor countries in support of efforts to achieve the MDGs is viewed with some trepidation by Ministries of Finance and Central Banks in some poor countries. In fact, in the past few years, many countries have actively tried to reduce the rate at which resources have been transferred into their economies. While there may certainly be real concern about several different kinds of negative side-effects of large aid inflows, the dominating fear in the recent economic literature is that of aid-induced 'Dutch disease'.

What do economists mean by 'Dutch disease'? The theory is that high and sustained aid inflows have much the same effect as a natural resource windfall, which can lead to an appreciated exchange rate and wage inflation, and thus to a loss of markets and unemployment in export and import-competing sectors. This effect appeared in the Dutch economy when massive North Sea gas revenues upset the macroeconomic balance—hence the name. The fear is that high inflows of aid may thus prove to be a 'curse' by contributing to the immiserisation of their export sectors.

If the Dutch disease scenario were likely, there would be good reason for fear. It would not only mean that countries may become unable to produce significant amounts of exportable goods—there may also be very real adjustment costs. For example, cash crop producing farmers who are unable to maintain their livelihood may not easily transform themselves into construction or service sector workers. Thus such an economy may have large pockets of increasing despair and poverty even as other areas, as well as the broader economy, appear to be doing well.

Yet, despite its prominence in the development literature, there is no explicitly documented case of aid-induced Dutch disease. Some researchers have found cross-country evidence suggesting that very large increases in aid may lead to slower growth of export sectors, but no single-country study has been able to demonstrate a link between large increases in aid inflows and a contraction in tradable goods producing sectors. While this paucity of evidence does not amount to a refutation of the hypothesis, it does suggest that the fear is exaggerated.

Let us look at a few concrete country examples from published research papers: (i) Tanzania in the period 1985–93 received a significant increase in ODA flows in relation to GDP, which were associated with accelerated export growth, strong economic growth and a real exchange rate that depreciated—more sharply than in the previous nine-year period; (ii) Botswana between 1960 and 1980 experienced a depreciating exchange rate and a stellar growth rate while ostensibly receiving a windfall from its rapidly expanding diamond mining industry, as well as aid equivalent to an average of fifteen percent of its GDP. Botswana would thus appear to have been a perfect test case for the *combined* Dutch disease effects, but none appears to have been present; (iii) Foreign aid inflows to the 12 countries¹ of the West African CFA Franc zone were associated with a real depreciation of their common currency.

Despite the absence of compelling evidence of aid-induced Dutch disease, the fear of that outcome seems to be the dominant concern of policymakers and researchers when poor countries face aid surges. The desire to avoid currency appreciation, the expected precursor

1. Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Congo (Republic of), Côte d'Ivoire, Gabon, Mali, Niger, Senegal and Togo.
2. Ethiopia, Ghana, Mozambique, Tanzania and Uganda.

to the disease, often seems to override the need to ensure that aid is used effectively for its intended purpose.

Take the case of Uganda in 1998-2000, when aid inflows essentially doubled, mostly in the form of budget support; a major preoccupation of economic policy makers was avoiding an exchange rate appreciation. The response was continuous reserve accumulation and sale of government treasury bills to keep inflation low. The real effective exchange rate in fact depreciated through most of that period, and both real and nominal interest rates became very high with predictable domestic effects. Furthermore, Uganda had to cope with a significant net private capital inflow in 2003 as the high domestic interest rates led to foreign purchases of Ugandan treasury bills. This not only made matters worse but clearly indicated that this approach to handling aid inflows can be self-defeating if the capital account is even partially open.

The Ugandan experience is one of five similar episodes reviewed by the IMF for the period 1998-2003. The IMF study concludes that the optimal approach to aid in the form of budgetary support is to allow a current account deficit equal to the size of the aid inflow, and to increase government expenditure by an amount equal to the domestic value of aid inflows. Neither the expected real appreciation of the currency, nor additional relative prices shifts that may imply higher inflation were expected to be large since both effects will be moderated by the use of foreign exchange to purchase imports and by supply responses in the non-traded goods sectors. Yet, none of the five countries examined² quite achieved that ideal.

The failure to make maximum use of aid appeared to have come largely from fears about real appreciations, inflation, and large fiscal and current account deficits. In general, the predominant concerns were assuaged—real exchange rates depreciated or stayed constant, inflation was kept down and government budget deficits were moderate or small—but this was at the cost of very high real domestic interest rates and, most tellingly, a general failure to fully utilise aid for its intended

purpose or, in the case of Ghana and Ethiopia, to use it at all.

To understand what might amount to a 'cure' for Dutch disease, let us go back to the description of Dutch disease. This economic 'malady' occurs essentially because two things are happening simultaneously: a fall in the domestic value of foreign currency resulting from the aid inflow, and wage hikes resulting from increasing domestic demand for non-traded goods. These effects combine to squeeze the profits out of tradable goods production. The cure: designing policies to moderate or reverse one or both of these effects without exacerbating the other.

Wages need not increase if there is readily available labour to meet increased demand and/or an increase in labour productivity.

If there is a high level of unemployment in the economy, then an increase in domestic demand can be met without increasing wages or prices. There will be, essentially, no wage effect and the output price effect for tradable goods producing firms will be significantly smaller—because real exchange rates do not rise as much—thus reducing any profit squeeze. An IMF research paper confirms that the Dutch disease need not materialize in low-income countries that can draw on their idle productive capacity to satisfy the aid-induced increased demand.

If workers are more productive, i.e. producing more units of output per unit of labour, labour cost per unit of output will generally not increase even if wages rise. Thus, the producers of tradable goods are not squeezed from the cost side and may even experience lower unit costs. Profits may remain largely unaffected or increase.

What might come closest to a 'cure' for Dutch disease would be a conscious attempt to use aid receipts to increase productivity in the economy. What is critical here is whether aid related to MDGs can be translated into increased productivity. There are strong reasons to believe that the answer to that question is 'yes'.

While the long term link between such MDG-related attributes as education and child mortality and future productivity has long been understood, the link between most of the human development achievements represented in the MDGs and *current* productivity is perhaps less often appreciated. For example, aid for poverty reduction can have immediate benefits in terms of increased worker productivity, reduced morbidity and increased enterprise. Similar effects would be obtained by reducing the incidence and impact of AIDS, e.g. through anti-viral therapies.

More importantly, though, MDG-related initiatives require the development of physical and institutional infrastructure that has important multi-sectoral effects. Good examples would be improved roads that improve access to both health facilities and markets for remote communities, and the use of institutions to engage communities in broader development goals. Thus both the *achievement* of MDGs and the *process* related to that achievement can result in specific and generalised increases in productivity.

However, these achievements are not a given. It will likely require planned sequencing of aid spending, coordinated across MDG-related initiatives as well as with other development initiatives. This is by no means a minor challenge but it remains feasible for most countries.

The true potential curse of large aid flows may not be Dutch disease but aid volatility. In the absence of effective attempts by donors to manage volatility in aid flows, countries may have to create reserve buffers that allow for some decoupling of the timing of disbursements and the timing of domestic spending of such disbursements. This would diminish the utility of aid. The onus is on donors to reduce aid volatility and increase aid predictability.

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John Serieux: *Managing the Exchange Rate Consequences of an MDG-Related Scale-up in HIV/AIDS Financing*, IPC Conference Paper No. 1. March 2007.
<http://www.undp-povertycentre.org/pub/IPCConferencePaper1.pdf>

Terry McKinley,
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Use Aid for Investing in the MDGs— Not for Reserves and Debts

Much of the recent debate on aid effectiveness has focused on the danger to macroeconomic stability of a projected aid surge.

An IMF evaluation reveals that only a minor part of ODA to Africa was used to finance public spending, while nearly three-quarters went into reserves or debt buy-backs.

This is not the way to use aid as a means to reach the MDGs. This requires importing real resources and investing in infrastructure and human development.

ODA is needed for building national capacities to mobilise domestic savings and raise public revenue.

Much of the recent debate on aid effectiveness has focused on the danger to macroeconomic stability of a projected aid upsurge. This article seeks to shift the debate from this short-sighted preoccupation to how ODA can contribute to long-term development.

For gauging the macroeconomic impact of a scaling up of ODA, the IMF's new 'spend-and-absorb' analytical framework is a useful starting-point although it is designed for macroeconomic accounting, not for highlighting development objectives.

The IMF framework has helped underscore how little of ODA has been either spent or absorbed. The 2007 evaluation 'The IMF and Aid to Sub-Saharan Africa' by the IMF Independent Evaluation Office documents these shortfalls for low-income countries with support from IMF's Poverty Reduction and Growth Facility (PRGF).

During 1999-2005, 36 per cent of ODA went, at the margin, into reserve accumulation—i.e. was *not* absorbed—and another 37 per cent was used to retire

domestic debt—i.e. was *not* spent (graph below). That left only a modest 27 per cent of ODA to finance fiscal expansion.

For promoting long-term growth and human development, such an allocation is clearly suboptimal. In the short term, since absorption ($100\% - 36\% = 64\%$) exceeds aid spending (27%), the potential growth of aggregate demand will be constrained and any rise in inflation minimal.

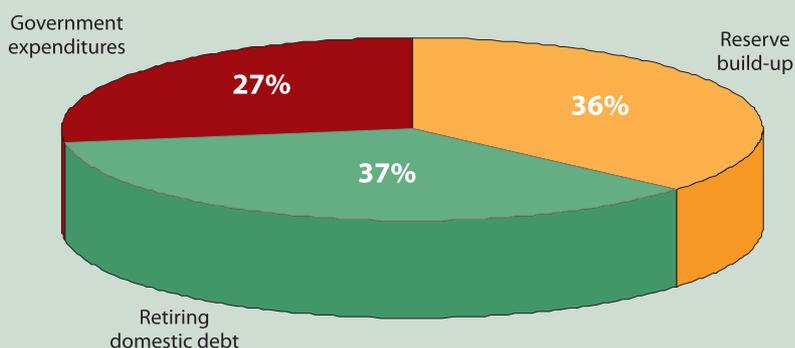
There is, of course, no shortage of apologists ready to justify such a skewed distribution of ODA. Unquestionably, domestic and external financial liberalisation have exposed developing countries to recurrent financial crises. So they need a credible stock of reserves to ward off the effects of probable terms-of-trade or capital-outflow shocks.

But reserve accumulation has become excessive, if not counter-productive, by forestalling an expansion of public investment. What is worse: the IMF evaluation does not address the bleaker possibility that ODA financed net private capital outflows, rather than reserves of foreign securities. The financing of such a circuit of capital would be doubly demoralising—conducive neither to stability nor development.

In addition to excessive stockpiling of reserves, why has 58 per cent (37/64) of the non-reserve financing available for fiscal expansion been diverted into paying off domestic debt? During the 1990s, when ODA was falling, low-income countries had to resort, understandably, to other means to finance government expenditures. Domestic debt was a major option. But it provided only short-term relief while exacting high interest payments.

Now that net ODA is on the rise, domestic debt is still demanding to be paid off.

The real use of ODA in Sub-Saharan Africa
PRGF countries, 1999-2005



The result: a strong negative correlation between ODA and domestic debt. Thus, ironically ODA is merely compensating in the 2000s for its relative absence during the 1990s.

Advocates of private-sector led development might applaud such an ODA allocation. After all, when central banks purchase back government securities, will this not inject more liquidity into the private sector? Will interest rates not tend to fall?

Evidence suggests, on the contrary, that interest rates have remained high in low-income countries in sub-Saharan Africa. The share of such countries with real rates of interest higher than six per cent has risen to about 80 per cent. And the gulf between deposit and lending rates of interest remains unusually wide.

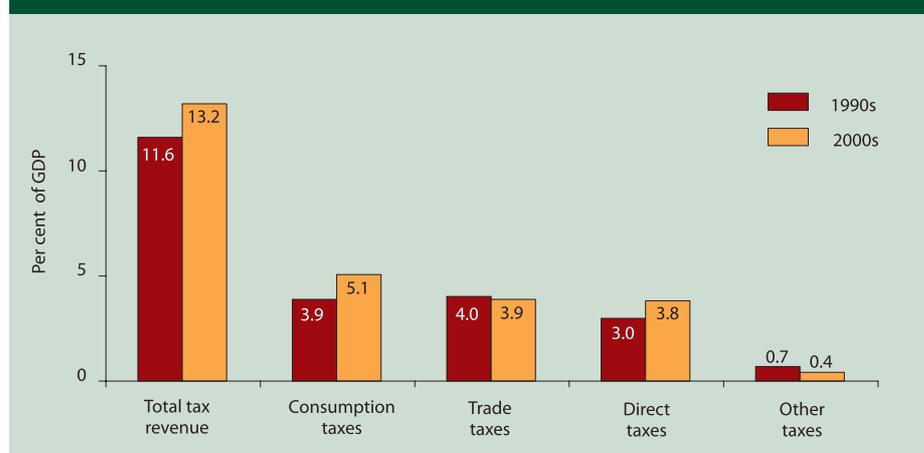
Such investment-depressing conditions—for both public and private investment—are prominent features of the financial sector in sub-Saharan Africa. As long as financial institutions remain riveted on short-term profits, there is little prospect for accelerated capital accumulation, a driving force for long-term growth and human development.

Capital markets remain shallow in sub-Saharan Africa and lending remains risk-averse, particularly in the wake of financial liberalisation. This is why government borrowing also remains mired in the short term. ODA could play a pivotal role in helping countries break this gridlock—by building up the capacity of domestic financial institutions to mobilise domestic savings and direct it to productive public as well as private investment.

Because of the high cost of government borrowing, it is not surprising that public investment has been in secular decline in sub-Saharan since the early 1980s—falling from roughly 10 per cent of GDP to seven per cent by 2000—after having risen from about six per cent in the early 1970s.

Until recently, public investment has been treated like a poor orphan in development circles. Poverty reduction

Tax trends in low-income Sub-Saharan Africa Early 1990s to early 2000s



programmes did not appreciably improve its status in the 1990s, except perhaps for some investments in social infrastructure. But the MDG framework has put a hefty expansion of public investment back squarely on the development agenda.

There is also greater acknowledgement that increased public investment could 'crowd-in' private investment, instead of 'crowd it out'. This impact is more likely when the capital stock has been allowed to deteriorate over decades, as has been the case in sub-Saharan Africa. Under such conditions, initial investments can have dramatically increasing returns.

The case for public investment is strengthened if a large boost in public investment is needed in order to propel countries out of a 'poverty trap'. This has been a major rationale for the proposed MDG-oriented scaling up of ODA in low-income countries.

But ODA has proven to be volatile and unreliable. And, clearly, incurring domestic debt is not a viable alternative. So a preferable long-term solution for public finances is to mobilise more domestic revenue. In fact, instead of dampening the incentives for mobilising revenue—as some analysts have claimed—ODA should be channelled into strengthening national capacities to mobilise much more.

Unfortunately, low-income countries in sub-Saharan Africa have made only

meagre progress in raising tax revenue. As a share of GDP, total tax revenue rose between the early 1990s and the early 2000s from 11.6 per cent to only 13.2 per cent—a mere 1.6 percentage points (graph above).

Trade liberalisation has prevented a rise in trade taxes despite increasing imports in the 2000s. And direct taxes have risen slowly despite an upturn of economic growth. Moreover, the value added tax, though widely adopted, has failed to live up to its promise to improve taxation of consumption.

It is clear that ODA is not being optimised. No wonder that people fret about its effectiveness. It caters mainly to a short-term preoccupation with macroeconomic stability.

And when disbursed, ODA is not directed to priority development objectives, such as building national capacities to mobilise domestic savings and raise domestic revenue.

Consequently, public and private investments continue to languish, particularly in poorer regions, such as sub-Saharan Africa, where a substantial scaling up of investment is most needed.

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T. McKinley (2007): (i) *Raising Domestic Revenue for the MDGs: Why Wait until 2015?*, IPC One Pager No. 39; and (ii) *Why Have Tax Reforms Hampered MDG Financing?*, IPC One Pager No. 42. <http://www.undp-povertycentre.org/site/PublicationShow.do#one>

by Pierre Jacquet,
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Grants versus Loans— Post Debt Crisis Redux

After the debt crisis of poor countries, donors are tempted to replace aid loans by grants.

Grants may just serve to repay other debts, which perhaps have been less effective for development.

The choice of aid terms should be addressed in the wider context of development finance.

Aid modalities can be modernised to better fit the risk profile of borrowers; information and coordination have to be improved.

As the process of debt cancellation slowly unfolds and brings the lengthy developing country debt crisis to a welcome end, new debt seems to be more than ready to replace the old—from new public donors sitting on huge resources or even from private investors lured by the rise in oil and commodity prices.

Among the mainstream donors in the DAC¹, however, the doctrine on concessional loans remains marred by the experience of the debt crisis: rather than lending aid money is it not safer to give it away as grants? For the layman, grants look more generous and more morally appropriate. Aid campaigners see loans as a way to enslave debtors, but tend to ignore the impact of grants on the dependency of the recipients.

The degree of misunderstanding on this issue is enormous. Clearly, the principle behind official development assistance (ODA) is to transfer resources from rich countries to developing countries. These resources are effective grants, paid for by the taxpayers in donor countries. However, the way in which they are transferred does matter. For example, giving ODA through grants might feel safer—notably after a major debt crisis—but it means that donors leave debt concerns to others. Donors may also fear the ‘beggar-thy-neighbour’ effect of having their grants finally serve to repay debts possibly unduly contracted from others.

Moreover, there is an interesting behavioural anomaly in being more willing to give away resources than to risk them through careful lending. Different financial instruments carry different sets of incentives, as documented by the theoretical and empirical literature on grants versus loans. This will not be the focus here, as there will be grants and loans to

developing countries even if official donors resort to grants only. The choice of instruments should therefore be addressed in the wider context.

Concessional loans should be thought of as a combination of market loans and of subsidies—the ‘grant element’. A typical ODA lending institution such as AFD borrows from capital markets with its AAA rating and on-lends to targeted beneficiaries with various degrees of subsidisation. A natural question to ask, therefore, is whether this intermediation provides any value added compared to the unfettered functioning of financial markets. Some argue that aid agencies should make grants only, and let financial market actors do the lending, because they are superior to public agencies in deciding when and how to lend and in assessing risk.

For example, a critique often raised against ODA loans is that lending agencies indulge in ‘defensive lending’, i.e. lending to their debtors the money that allows them to service past loans. Empirical evidence confirms that there was some defensive lending in the 1990s but shows no indication of such lending in the 1980s.

The validity of the grants-only argument, though, depends on whether developing countries have access to financial markets. If not, they could not complement the ODA grants they receive by borrowing from financial markets; ODA loans can then usefully leverage the amount of grant resources available. Arguably, in a steady state with a constant flow of ODA loans, the real resource transfer to developing countries would simply consist in the grant-element of these loans, and thus a grant-based and a concessional-loan-based approach would be equivalent. But we

1. The Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD).

are not in a steady state as there is a recognized shortage of ODA. Anyhow, the transition from one approach to the other is problematic if developing countries do not have full capital market access.

Economists such as Bulow and Rogoff have argued that developing countries lack access to capital markets because they are unlikely to repay their debts. If that is the case, resorting to public lending to compensate for this lack of access would be unwarranted and inefficient.

Poor governance and a lack of credible institutions indeed limit developing countries' access to financial markets. However, a number of market imperfections may also explain this lack of access and may justify public intervention. Consider the well-known 'Lucas paradox' asking why capital does not flow from capital-rich to capital-poor countries. One explanation is that returns to capital in capital-poor countries depend on complementary assets such as infrastructure and human capital. Another could be that insufficient international trade integration raises the local relative price of capital.

Yet another explanation is the high volatility in resource flows, which translates into an increase in perceived risk and into higher spreads that discourage capital inflows. The exclusion of poor countries from international financial markets is not necessarily a consequence of bad governance, but may instead result from vulnerability to external shocks, e.g. commodity price shocks or natural disasters. For a sample of 24 highly indebted poor countries (HIPC), export revenues fluctuated between 42 per cent and 205 per cent of their average level between 1970 and 2005. More than two thirds of the total exports of the least developed countries are unprocessed primary commodities.

Here, the market imperfection stems from the lack of an efficient procedure for dealing with debt crises in case of negative shocks. Yet, a grant-only approach would be inefficient. For example, if there is one chance out of two that a country will repay its loans, it is still preferable to make a loan rather than a grant, of the same nominal

amount: in present value, this will entail half the cost for the donor country taxpayer. However, if a new debt crisis is to be avoided, care must be taken that debt is automatically cancelled when a negative shock beyond a certain threshold occurs.

Thus, responsible lending should internalise the risk of debt default so that debt remains sustainable. A logical approach would have ODA lenders use their aid budgets to provision that risk and react swiftly with debt cancellation in the event of a shock of agreed proportions. The size of the provision would be modulated according to a detailed country risk analysis that would penalise poorly governed countries—by using a greater proportion of available ODA resources in the form of provisions against risk—and limit the moral hazard inherent in any such insurance scheme.

However, such use of taxpayers' funds is difficult in the current framework because it would not count as ODA—even though debt reduction would count as ODA if and when it occurs. There is a case for modernising the statistical definition of ODA, but this will be a long and protracted process. Alternatives exist, that consist in developing contingent loans.

For example, AFD has introduced a highly concessional, contracyclical loan that allows the borrower to benefit from additional grace periods—beyond a fixed initial 5 year grace period—should its export revenues fall below 95 per cent of their five-year moving average. Such a yardstick embodies both price and quantity crises. Its measurement can be based on exogenous data, free from manipulation. The optional right is equal to the present value of five additional years of grace from year 6 to 10. If the country has no occasion to draw on it during these years, or refrains from doing so, the right is capitalised and the length of this additional grace period thus increases. If the country never experiences a shock, its rights for suspension are redeemed in the form of a shortening of the loan maturity.

The resumption of lending to post debt relief HIPC countries bestows a heavy responsibility onto lenders. As we have

The validity of the grants-only argument depends on the access to financial markets.

argued, lending responsibly does not entail no ODA lending. There are two dimensions to this responsibility. First, current ODA, consisting in outright grants and concessional loans, is unduly constrained because its rather rudimentary instruments are not allowed to benefit fully from innovation on financial markets. Modernisation is called for, but even with the current definition, instruments can be modernised to better fit the risk profile of potential borrowers, thus responding to one of the reasons for excessive debt build-up.

Second, there is a real coordination problem between lenders and borrowers if the risk of excessive debt is to be properly managed. To assess solvency, potential investors and debtors need access to information about the existing debt level and need a forum to share that information, maintain collective discipline, and provide for an orderly mechanism to deal with incipient crises. This is not easy, as was amply demonstrated by the aborted debate on a sovereign debt restructuring mechanism. This is one further reason for developing debt instruments that internalise the risk of default, as suggested above.

As for collective discipline, the Bretton Woods institutions have developed a debt sustainability framework that has the potential to become a useful coordinating instrument, but this requires willingness from these institutions to act as facilitators and coordinators, rather than as non negotiable standard-setters, and an ongoing effort to disseminate and share the framework with all potential lenders and borrowers. ■

D. Cohen, P. Jacquet and H. Reisen: *After Gleneagles: What Role for Loans in ODA?* OECD Development Centre Policy Brief No. 31, Paris: Organisation for Economic Co-Operation and Development, 2006. https://www.oecd.org/LongAbstract/0,3425,en_2649_33731_37903769_119696_1_1_1,00.html

by Jan Cedergren,
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Chair, DAC Working Party on
Aid Effectiveness

We're Working on it: Development Partners' Efforts for Effective Aid

The 2005 Paris Declaration on Aid Effectiveness is an ambitious plan to reform the system of aid delivery.

It rests on five pillars: ownership, alignment, harmonisation, managing for results, and mutual accountability.

Most aid agencies have taken important steps to implement the Paris Declaration and field missions have increased their efforts to align and harmonise programmes.

A monitoring survey of progress shows that partners and donors still have a long road ahead to meet their joint commitments.

OECD countries invest more than USD 100 billion per year to advance wellbeing and eradicate poverty in developing countries. If this official aid is to do as much good as possible, it must be used effectively—meaning very different things depending on which side of the aid fence you are on.

For recipient countries, it means allocating resources to their development priorities. For countries and organisations that provide aid, it means allocating funds to countries that need it most and are likely to make best use of it. But the true test of aid effectiveness is improvement in people's lives.

A layperson observing today's aid industry might be understandably baffled by the sheer number of actors, funds and programmes. The last time the OECD counted, there were more than 200 bilateral and multilateral organisations channelling official development assistance. Many developing countries

have more than 40 donors to more than 600 active projects, and may still not be on track to achieve the Millennium Development Goals.

More than 100 countries and donor organisations recognised the imperative of managing aid more rationally when they endorsed the Paris Declaration on Aid Effectiveness in 2005, an ambitious plan to reform the system of aid delivery. The Paris Declaration rests on five common-sense tenets, that aid is more likely to promote development when:

- Developing countries exercise leadership over their development policies and plans (*ownership*).
- Donors base their support on countries' development strategies and systems (*alignment*).
- Donors coordinate and minimise the cost of delivering aid (*harmonisation*).
- Donors and partner countries orient their activities to achieve results (*managing for results*).

Key policy recommendations

1. Developing countries need to deepen their ownership of the development process by engaging their citizens and parliaments more fully in planning and assessing their development policies and programmes. They should also link their plans much more closely to their budgets and results frameworks.
2. Donors need to support these efforts by making better use of partners' national budgets to align their programmes with country priorities. They also need to improve the transparency and predictability of aid flows by sharing timely and accurate information on intended and actual disbursements with budget authorities.
3. Recipient countries need to take the lead in determining priority programmes of capacity development, especially those needed to improve country systems. Donors can help by better co-ordinating their technical assistance with country priorities and fully involving partners when commissioning technical assistance.
4. To further harmonisation, donors must reduce the transaction costs of delivering and managing aid, in particular by rationalising the division of labour, increasing use of local harmonisation and alignment action plans; increasing use of programme-based approaches; expanding reliance on delegated co-operation; reducing the number of project implementation units and better integrating them into ministries; and increasing efforts on untying aid.
5. To promote managing for results, countries and donors should make greater use of performance assessment frameworks and more cost-effective results-oriented reporting. This, too, will require donors to invest further in capacity development and increase their use of country results reporting systems.
6. To begin addressing mutual accountability commitments, countries and donors should clearly define a mutual action agenda and discuss aid effectiveness progress and development results more explicitly at country level by using country dialogue mechanisms and developing credible monitoring mechanisms where needed.

- Donors and partners are accountable to each other for these reforms (*mutual accountability*).

A 2006 survey of 34 self-selected countries and a comprehensive set of donor organisations covering 37 per cent of aid across the developing world shows that partners and donors have a long road ahead to meet their joint commitments. The Paris Declaration has stimulated an important dialogue at country level on how to improve aid. Donor agencies have made major efforts to implement it within their organisations and communicate its importance to their staff, and there has been at least some implementation activity in over 60 countries.

The quality of partner countries' national development plans or poverty reduction strategies is one concrete measure of *country ownership*. The survey findings show that national development strategies need substantial strengthening if countries are to meet the 2010 target. In 2005, only five countries met the criteria for sound operational development strategies. The most common failing was weakness in the mechanisms linking budget formulation and execution to national plans, policy priorities and results.

Improving transparency and accountability of the use of development resources is also an important objective of the Declaration. Strengthening the credibility of the budget as a tool for governing the allocation and use of development resources—domestic and external—can not only improve the alignment of donor support, but also permit parliamentary scrutiny of government policies on development, which is key to deepening ownership. The survey indicates for nearly all countries that the credibility of development budgets is undermined by inaccuracies in the budget estimates of aid flows.

The Paris Declaration encourages donors to increasingly use strengthened country systems for public finance management, procurement, monitoring and evaluation etc. so that partner countries are empowered to develop institutions that can implement and account for their development policies and resource use to citizens and parliaments.

On average, the survey shows, nearly 40 per cent of aid flows to the government used country systems of public finance management and procurement. The degree to which donors rely on country systems varies with the quality of the systems and the existence of reform programmes etc. Progress will depend on greater understanding of the development benefits and risks of using these systems, and sustained and long-term efforts to strengthen capacity. Recipient countries need to take the lead in defining capacity development priorities, and donors should direct their technical and other assistance to implementing coordinated strategies.

A key aim of the aid effectiveness agenda is *harmonisation* in order to decrease the transaction costs of delivering aid, reducing the burdens of developing countries required to manage multiple programmes and different donor procedures.

The survey provides clear evidence that the cost of managing aid is high for partner countries. It can be expected to increase further as the volume of aid is scaled up, new donors become more active and further special initiatives are created. Donors will need to work hard to reduce the transaction costs of delivering and managing aid. They should give special attention to: increasing complementarity and rationalising division of labour; making greater use of local harmonisation and alignment action plans, and of sector-wide and programme-based approaches; expanding use of delegated cooperation and other innovative approaches; and reducing the number of project implementation units and better integrating them into ministries.

The *management for development results* tenet calls for donors and partner countries to focus on achieving results, and using information on results to improve decision making and programme performance.

The survey suggests that translating evidence on results into processes of policy reform remains a major challenge in the large majority of surveyed countries. Countries and donors should

use performance assessment frameworks and more cost-effective results-oriented reporting. This, too, will require donors to invest in capacity development and rely more on country results reporting systems.

Mutual accountability is important for better aid management, and also for informing the respective publics of the use of resources to achieve development results. The survey shows that the work to establish specific mechanisms for joint monitoring of aid effectiveness commitments at country level is just beginning, and more efforts will be needed to achieve the target by 2010. Aid effectiveness issues and results need to be discussed more explicitly at country level, and credible monitoring mechanisms need to be developed.

Most development agencies have taken important steps to advance implementation of the Paris Declaration and field missions have increased their local efforts to align and harmonise their programmes. Nevertheless, the survey suggests that a number of hurdles work against donors' ability to meet the commitments.

For example, in many agencies the Paris Declaration is still principally owned by policy staff at headquarters, while at country level harmonisation tasks are sometimes seen as getting in the way of efforts to achieve tangible development results. Incentive structures still imply pressure to commit and disburse funds. Limited flexibility for staff to devote time to coordination and high staff turnover also reinforce short term perspectives.

The High Level Meeting in Accra in September 2008 will take stock of advances made and remaining challenges. It will not be a smooth ride ahead. But every step forward, realised at country level, will be important in creating a more effective development cooperation framework that can lift more people out of poverty.

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 OECD/DCD: 2006 Survey on Monitoring the Paris Declaration – Overview of the results. http://www.oecd.org/document/20/0,3343,en_2649_15577209_38521876_1_1_1_1,00.html



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