

Increasing Aid and Its Effectiveness

Developed countries can help developing countries achieve the Millennium Development Goals (MDGs) by providing more and better aid. Development assistance can ease the short- and medium-term resource constraints facing poor countries, enabling them to make much-needed investments in infrastructure and social services. In many low-income countries, especially in Sub-Saharan Africa, aid dominates external development flows. Accordingly, these countries are particularly dependent on higher levels of assistance if they are to achieve the MDGs—and are more vulnerable to aid shortfalls. The issue that arises is whether aid can be scaled up effectively in countries that need it most. Low-income countries that implement sound economic policies, strengthen institutions, and pursue good governance can absorb additional aid rapidly and effectively.

How aid is allocated and delivered is as important as its volume for achieving the MDGs. Aid is more effective in fostering growth and improving service delivery in countries with better policies and institutions. It is also more effective when it is aligned with recipients' priorities, when it reduces transaction costs through harmonized and coordinated donor processes, when it is predictable, and when there is a clear focus on results.

As a result of the 2002 United Nations Conference on Financing for Development in Monterrey, Mexico, donors committed to providing more—and more effective—aid. What progress has been made? The recovery in official development assistance (ODA) that started in 2001 is continuing, but recent levels and near-term projections fall far short of what is needed to meet the MDGs. Among members of the OECD's Development Assistance Committee (DAC), ODA as a share of national income remains low relative to the 1990s and before. Moreover, much of the recent increase in bilateral ODA reflects donor concerns about regional and global security. Donor attention to geopolitically significant countries appears to be crowding out assistance to countries that need the most help in achieving the MDGs. A better balance is needed between poverty reduction and other donor objectives. Aid policy should reflect the growing recognition that reducing poverty and human deprivation is perhaps the most effective way of promoting long-term peace and security.

Although the proportion of aid going to Sub-Saharan Africa is rising, much more could be done. On average, ODA equaled 6.2 percent of recipients' GNI in the region in 2003—high relative to other regions, but below the levels of the early 1990s. Most of

the \$8.5 billion nominal increase in bilateral ODA to Sub-Saharan Africa between 2001 and 2003 was in the form of debt relief; program and project assistance grew by just \$0.6 billion. While debt relief helps relieve problems associated with heavy debt burdens and creates fiscal space, it is not enough. Substantial increases in program and project financing are needed as developing countries scale up their efforts to achieve the MDGs. Sub-Saharan countries have seen a decline in ODA for infrastructure and rural and agricultural development. Investments in these countries' social sectors have also been inadequate (see chapter 3). Large shortfalls in financing for these sectors—which are key to spurring growth and scaling up MDG-related services—point to the need for much higher ODA.

Discussions continue on proposals to augment higher aid flows with innovative financing mechanisms, such as the International Finance Facility, global taxes, voluntary mechanisms, and blending arrangements. The International Finance Facility, proposed by the U.K. Treasury, is designed to frontload aid flows in the short term to help reach the MDGs. In addition, a wide range of proposals has been made on ways to raise additional resources through new global tax instruments. If technical and political challenges can be resolved, global taxes could complement the International Finance Facility, generating additional aid funds in the medium to long term, when flows under the facility would diminish.

Policies and institutions in developing countries continue to improve, promoting a better enabling environment for scaling up aid. Although low-income countries as a group can effectively absorb much more aid, the amount varies by country. A number of countries could manage a doubling of assistance in the short to medium term, but capacity constraints pose a significant obstacle in countries with weak policies and institutions. In all cases a country-specific approach, anchored in a poverty reduction strategy (PRS) framework, is required to assess exter-

nal financing needs, identify and address capacity constraints, and appropriately sequence incremental financing. Absorptive capacity is a dynamic concept, so even though capacity may be limited today, it can be built over time—and aid can play an important role in that as well.

Donors are allocating more aid to better performers—those with stronger policies and institutions—and to poorer countries. But there is considerable variation among donors, and some large donors are not very selective on these dimensions. A sharper performance-based focus by these donors could strengthen the overall quality of aid. Increasing attention is being paid to the special needs of difficult partnership countries (including low-income countries under stress), which receive less aid than predicted by their policy and institutional environments and poverty levels. Thus a modest increase in aid to this group might be possible without compromising the performance basis of aid. Recent evidence also suggests that well-coordinated and appropriately sequenced and directed aid can be effective in supporting the recovery of countries from conflict and from situations of exceptionally weak policies and governance. Appropriate and adequate support for capacity building is a priority in these situations.

Progress on harmonization and alignment has been mixed, and that on managing for results is just beginning. The 2003 High Level Forum on Harmonization in Rome and the 2004 Roundtable on Managing for Development Results in Marrakech strengthened the focus on aligning donor assistance with recipients' national strategies and priorities as articulated in PRSs or equivalent national strategy documents, harmonizing donor processes and procedures with those of partner countries, and managing aid programs for development results. Yet efforts to implement good practices in these areas have been slow and uneven. Progress on harmonization and alignment is most evident in countries where governments have worked longest and hardest to take ownership of the aid process. Some early progress on managing for results

is also evident, as the development community moves toward implementing the results agenda. Participants at the March 2005 High Level Forum on Aid Effectiveness in Paris reaffirmed their commitment to the global agenda on harmonization, alignment, and results. The forum's Paris Declaration defines 12 indicators for monitoring reforms of aid delivery and management.

The potentially large financing needs associated with the MDGs pose a challenge to low-income countries in maintaining sustainable debt positions. The enhanced Heavily Indebted Poor Countries (HIPC) initiative has lowered debt burdens for participating countries: 27 countries have reached their decision points and are receiving debt relief, and 15 of these have reached their completion points—when creditors provide the full amount of debt relief committed at the decision points. Nevertheless, continued measures are needed by HIPCs and their creditors to ensure that financing the MDGs will not lead to excessive buildup of new debt. This issue of debt sustainability is not limited to HIPCs; it extends to other low-income countries with existing or prospective debt pressures. The World Bank and International Monetary Fund (IMF) are developing a forward-looking debt sustainability framework for low-income countries that incorporates systematic analysis of the evolution of key debt burden indicators (under baseline assumptions and in the event of plausible shocks) and that establishes indicative thresholds for these indicators, based on the quality of a country's policies and institutions. In addition, G-7 members have recently offered a number of new proposals, beyond the HIPC initiative, for debt relief to low-income and highly indebted countries.

Looking ahead, there are numerous priority areas for action on aid:

- Donors need to implement their post-Monterrey commitments and substantially raise and extend them beyond 2006—say, to 2010—with a view to at least doubling ODA in the next five years. While several countries have committed to expanding aid efforts beyond 2006, half of DAC members have not, including some of the largest donors. They should do so in 2005.
- PRSs should provide the framework for scaling up aid—assessing financing needs, identifying and addressing capacity constraints, and appropriately sequencing incremental financing. Where absorptive capacity is an obstacle to scaling up, aid can still be effective by focusing on building capacity and improving service delivery through innovative mechanisms.
- Donors need to further sharpen their focus on providing aid to better-performing poor countries. For their part, recipient countries should expedite efforts to enhance their capacity to make effective use of incremental aid flows.
- Donors need to address more effectively the special needs of difficult partnership countries (including low-income countries under stress), exerting greater efforts to better coordinate, align innovatively, and sequence aid.
- Progress on implementing the harmonization, alignment, and managing for results agenda should be accelerated. Bottlenecks to progress—captured in the 12 indicators defined by the Paris Declaration—need to be addressed by donor and partner countries, and continued focus at the highest levels in these countries will be required to accelerate change. Developing countries need to take more ownership of the aid harmonization and alignment process. And donors need to encourage and support this process, especially through capacity building.
- On debt relief, continued effective implementation of the HIPC initiative remains key. On proposals for additional debt relief for poor countries with heavy debt burdens that are pursuing credible reforms, efforts should be made to reach closure in 2005. Additional debt relief should not cut into the provision of needed new financing, which for these countries should primarily be in the form of grants.

Recent Trends in Aid

Despite positive trends, donors' recent aid efforts lag those of the early 1990s. And though donor commitments announced at and after the Monterrey conference point to the prospect of higher aid, far more is needed. Moreover, much of the recent increase in development assistance reflects donors' strategic concerns. Only a modest amount is available in cash and more flexible forms to meet countries' financing requirements for the MDGs. Thus far more aid is needed to meet the MDGs, and a better balance is needed between donors' poverty reduction and other objectives.

As with overall ODA, flows to Sub-Saharan Africa have been rising. Aid dwarfs other sources of foreign financing for the region, underscoring its importance. Still, a major increase in aid will be required if the region is to achieve the MDGs.

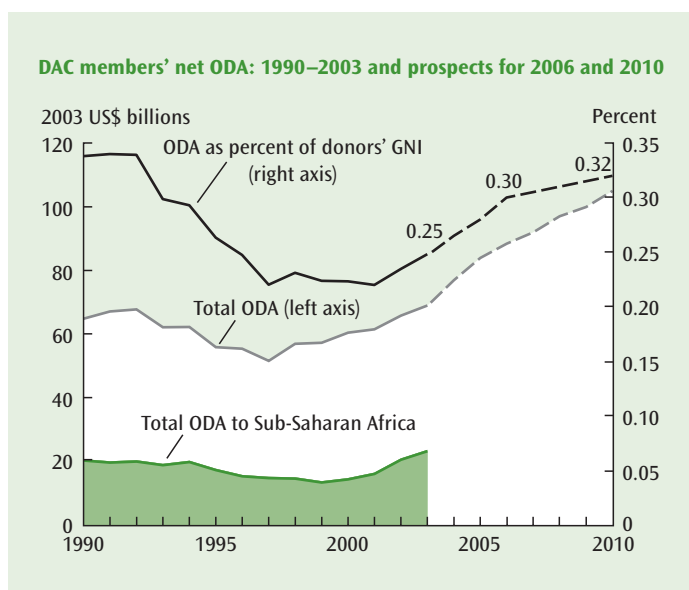
Aid—Rising But Insufficient for MDG Needs

The recovery in ODA that started in 2001 is holding as donors deliver on post-Monterrey

aid commitments.¹ Development assistance increased by 5 percent in real terms in 2003, down from 7 percent in 2002. Taking into account exchange rate movements and inflation, which accounted for nearly \$8 billion of the increase, nominal ODA rose by almost \$11 billion in 2003, to \$69 billion. Preliminary OECD DAC estimates indicate that net ODA rose to \$78.6 billion in 2004; the increase in real terms was much smaller—to \$72.2 billion (at 2003 prices and exchange rates). If announced aid commitments are delivered, ODA is expected to grow by nearly 30 percent in real terms between 2003–6 and could rise to more than \$100 billion by 2010 (figure 5.1).² Several countries have committed to higher aid efforts beyond 2006, the target date for the commitments made at the Monterrey conference, but some of the largest donors have not done so.

Despite the progress in expanding ODA since Monterrey, donors' aid efforts lag behind those of the early 1990s and before.³ At 0.25 percent in 2003, ODA as a share of donors' average gross national income (GNI) was three-quarters the level in the 1970s, 1980s, and early 1990s, and only about half the level in the 1960s.⁴ Five countries—Denmark, Luxembourg, the Netherlands, Norway, and Sweden—have achieved ODA shares of 0.7 percent of GNI or more (figure 5.2), and six—Belgium, Finland, France, Ireland, Spain, and the United Kingdom—have announced timetables for achieving that level. Implementation of such pledges will be vital to raising aid flows to poor countries; the target of \$5 billion in annual assistance by fiscal 2006 under the U.S. Millennium Challenge Account is now unlikely to be reached until fiscal 2007 (box 5.1). Even on announced pledges, DAC donors' aid effort is expected to reach only 0.3 percent of GNI by 2006 and 0.32 percent by 2010, below the level of the early 1990s. Among the actions being considered by the European Commission is the setting of new—and higher—interim targets for ODA relative to members' GNI for the period beyond 2006, with the goal of reaching the target of 0.7 percent as soon as possible.⁵

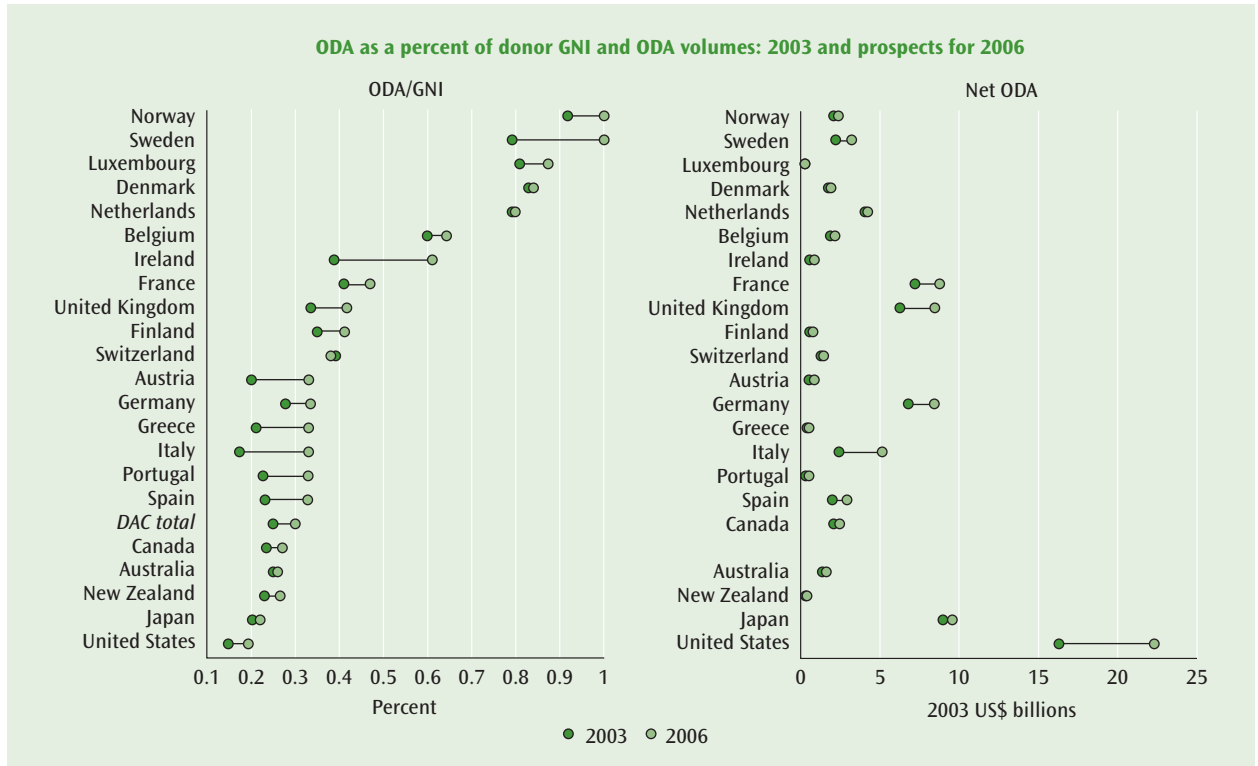
FIGURE 5.1 ODA is rising but is well short of what is needed; donors need to raise their post-Monterrey commitments and extend them beyond 2006



Source: OECD 2005a.

Note: Prospects for ODA in 2006 and 2010 are based on DAC members' post-Monterrey announced commitments. Not all DAC members have made commitments beyond 2006.

FIGURE 5.2 Wide variation in donor effort



Source: OECD DAC database.

BOX 5.1 The U.S. Millennium Challenge Account—poised to deliver

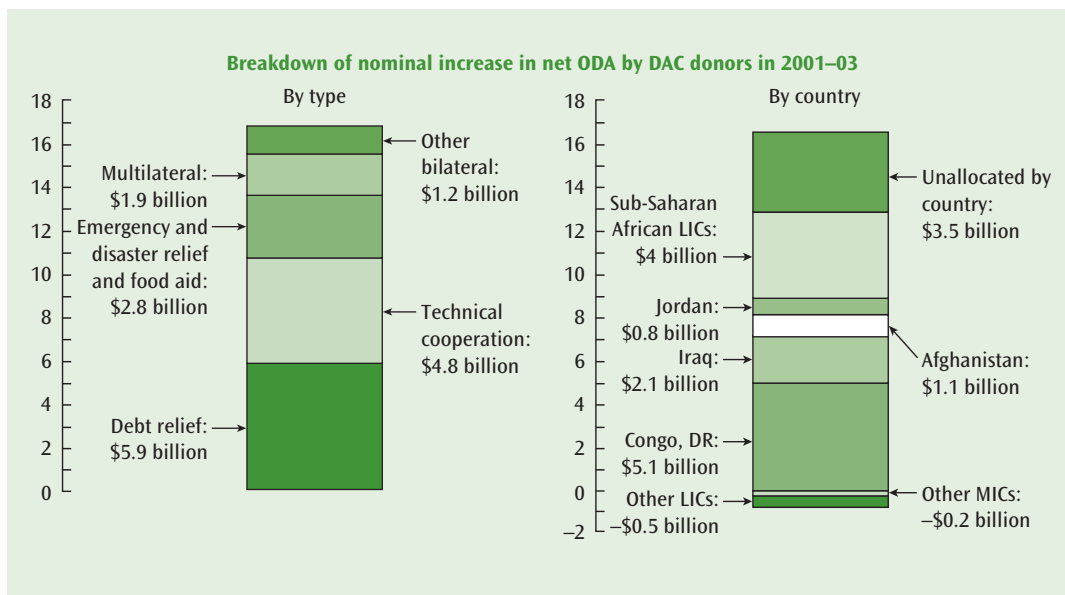
The Millennium Challenge Account (MCA) is a new bilateral aid mechanism, announced by the United States at the Monterrey conference and established in January 2004. It allocates new U.S. aid to poor countries based on their performance in three policy areas: governing justly, investing in people, and promoting economic freedom. To date, 17 countries are eligible to apply for MCA assistance. In addition, a threshold program encourages policy reform by offering 13 other countries help in areas where they fall short of qualifying for the MCA.

MCA-eligible countries identify their own priorities and develop their own MCA proposals, based on their assessments of the greatest barriers to their development and in consultation with civil society and the private sector. The Millennium Challenge Corporation evaluates MCA proposals based on their potential for reducing poverty through sustainable economic growth. The proposals are not restricted to any particular sector or area. MCA countries join with the Millennium Challenge Corporation in multiyear compacts to achieve shared development objectives. The compacts identify the responsibilities of each partner and contain clear objectives, benchmarks to measure progress, procedures to ensure fiscal accountability for the use of MCA assistance, and plans for effective monitoring and objective evaluation of results. Programs are designed to enable progress to be sustained after funding under the compacts has ended.

The initial target envisioned \$5 billion in annual assistance under the MCA by fiscal 2006. The U.S. administration's fiscal 2006 budget request of \$3 billion doubles the 2005 appropriation and envisions expansion of MCA funding to \$5 billion in fiscal 2007. The Millennium Challenge Corporation approved the first MCA compact in March 2005, with Madagascar (providing nearly \$110 million for a four-year project), and disbursements are expected to begin in spring 2005.

Source: Millennium Challenge Corporation 2003, 2005.

FIGURE 5.3 Debt relief and technical assistance dominate the increase in ODA



Source: OECD DAC database.
 Note: Total nominal increase in DAC members' net ODA in 2001-3 was \$16.6 billion. The corresponding real increase was \$6.6 billion in 2002 prices and exchange rates. Sub-Saharan African LICs does not include the Democratic Republic of Congo.

Again, donors need to commit to expanding aid efforts beyond 2006, to 2010 or beyond.⁶

Most of the increase in development assistance has been in the form of noncash assistance and debt relief.⁷ Debt relief and technical cooperation accounted for two-thirds of the \$16.6 billion nominal increase in DAC members' net ODA between 2001 and 2003, with \$5.9 billion allocated to debt relief and \$4.8 billion to technical cooperation (figure 5.3).⁸ At about 17 percent, emergency disaster relief and food aid also represented a significant portion of the increase. The increase in these categories cut into the shares of assistance available in cash and more flexible forms—for program and project assistance—to meet countries' financing requirements for meeting the MDGs. For example, bilateral ODA for program and project assistance increased by a modest \$0.6 billion during this period. This category accounted for just a quarter of bilateral ODA in 2003, down from a third in 2001 and well

below the roughly 60 percent average of the 1980s. Debt relief levels will remain high (and rise) in the near term as more countries reach their completion points under the enhanced HIPC initiative, and because of the recent decision by donors to forgive up to 80 percent of Iraq's debt to the Paris Club. Possible additional debt relief to poor countries beyond the enhanced HIPC initiative would also affect the size of this category. While debt relief is crucial to relieving problems associated with high debt burdens and to expanding fiscal space, donors will need to ensure that additional relief does not crowd out needed increases in financing for development (for further discussion, see the section below on debt relief).

Global and regional security concerns have boosted aid flows as well. Aid to Iraq was sharply higher at \$2.3 billion in 2003, up from \$0.1 billion in both 2001 and 2002. Between 2001 and 2003 aid to Afghanistan nearly quadrupled, to \$1.5 billion, and devel-

opment assistance to Jordan tripled. Pakistan received large amounts of net aid in 2001 and 2002 (about \$2 billion a year), but loan repayments on previously rescheduled debt lowered net flows in 2003. In addition, the Dayton Peace Accord countries—Bosnia and Herzegovina, Croatia, and Serbia and Montenegro—continue to receive large amounts of aid, averaging \$2.2 billion a year in 2001–3.

Non-DAC countries contribute significant assistance to developing countries, with such flows reaching \$3.4 billion in 2003, or 5 percent of DAC ODA—more than twice the level in 2001.⁹ Saudi Arabia continued to be the largest donor in this group; its ODA contributions jumped from less than \$500 million in 2001 to \$2.4 billion in 2003. Other non-DAC countries have also rapidly increased their ODA. For example, the Czech Republic more than tripled its development assistance during this period, providing \$91 million in 2003.

Important contributions to development efforts in poor countries are also being made through South-South cooperation, particularly through the sharing of experience and know-how. Comprehensive data on South-South development assistance are not available, but countries such as Brazil, China, and India have been particularly active in providing technical assistance to low-income countries.¹⁰ South-South assistance is expected to grow as these larger economies continue to record impressive economic and technological advances. Grants from nongovernmental organizations (NGOs), using their own resources, also continue to rise. These grants totaled \$10.1 billion in 2003, up from \$8.8 billion in 2002, and are expected to be sharply higher in the aftermath of the recent Asian tsunami.

Although multilateral ODA—comprising grants and net concessional lending—has grown in recent years, total multilateral flows to developing countries have declined. Multilateral ODA grew by 7 percent in nominal terms between 2001 and 2003, with higher grants offsetting a decline in net concessional debt flows. Nonconcessional lending by multilaterals, mostly to middle-income countries,

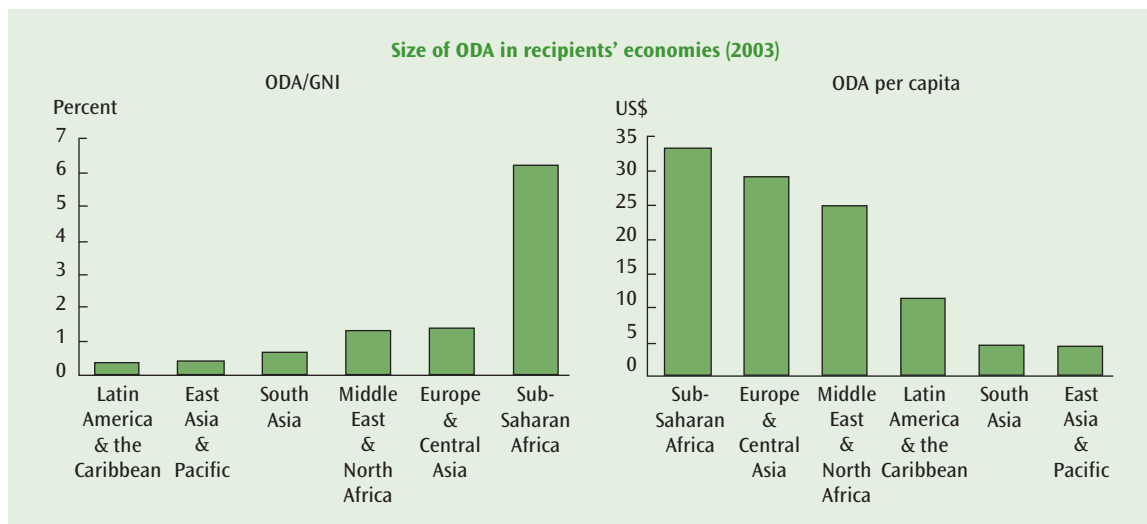
has exhibited considerable variation—reflecting less nonconcessional borrowing from the IMF, repayments on past crisis financing packages, and prepayments of loans to the World Bank.

Because of rising incomes in developing countries, higher aid volumes have translated into only a modest rise in the share of ODA in recipients' GNI. Indeed, in 2003 this share is only slightly above the low of 1997 and is expected to remain in a narrow range through 2006. The weight of aid in recipients' economies is largest in Sub-Saharan Africa, averaging 6.2 percent of GNI in 2003—at least four times that in other regions, signaling the importance of aid for Africa (figure 5.4). Globally, per capita ODA edged up in recent years, averaging about \$14 in 2003, though this was below the level of the early 1990s. Again, there was wide regional variation, with Sub-Saharan Africa receiving the most ODA per capita.¹¹

Improving Trend in Development Assistance to Sub-Saharan Africa

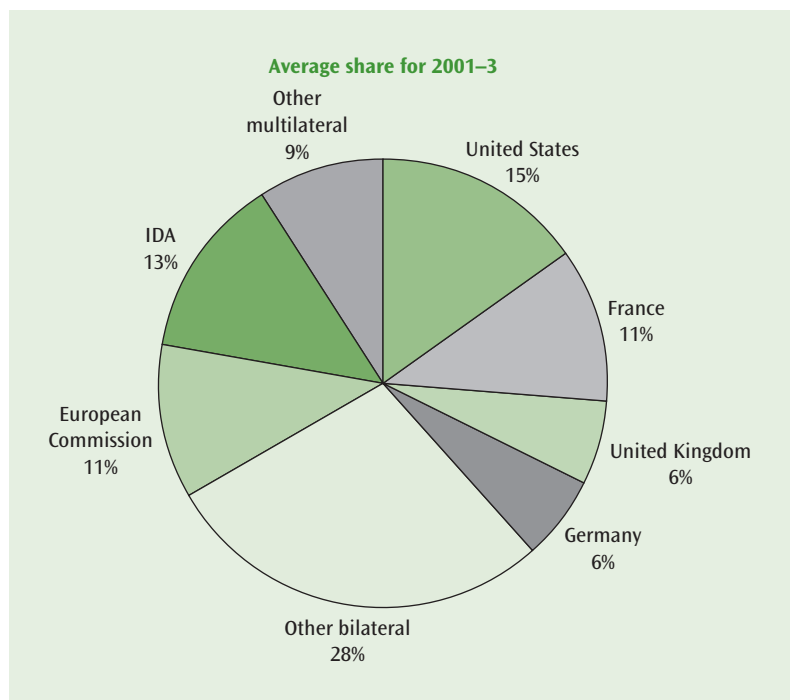
Mirroring the recovery in overall ODA, development assistance to Sub-Saharan Africa has begun to rise from its substantial slide of the 1990s. In real terms, aid to the region is higher now than in the early 1990s. The region is also receiving a larger share of net ODA (disbursements): At about \$24 billion, its share of total ODA was 33 percent in 2003, up from 27 percent in 2000. Most aid to the region is in the form of grants—bilateral donors provide nearly all their assistance as grants, and multilateral net ODA consists of highly concessional loans (60 percent) and grants (40 percent). In 2001–3 the United States and the International Development Association (IDA) were the largest donors to Sub-Saharan Africa (with the U.S. share sharply higher in 2003, at 20 percent), followed by France and the European Commission (figure 5.5). Several bilateral donors, such as Belgium, France, Ireland, Italy, and Portugal, allocate more than half of their bilateral net ODA to Sub-Saharan Africa.

FIGURE 5.4 Dependence on aid varies by region and is highest in Sub-Saharan Africa



Source: OECD DAC database.

FIGURE 5.5 Sub-Saharan Africa's largest donors



Source: OECD DAC database.
 Note: The shares may not add to 100 because of rounding.

While the positive trend in development assistance to Sub-Saharan Africa is encouraging, the increase in aid provided in cash and more flexible forms—program and project assistance—has been rather modest. Most of the \$8.5 billion increase in net bilateral ODA to the region between 2001 and 2003 was in the form of debt relief (\$5.6 billion) and emergency and disaster relief and food aid (\$1.5 billion).¹² The increase in program and project assistance (in cash) was only about \$0.6 billion.

The increase in total ODA—bilateral and multilateral—to the region was concentrated in a handful of countries. The Democratic Republic of Congo received an additional \$5.1 billion (most of it for debt relief operations), Cameroon \$480 million, Sudan \$436 million, Tanzania \$398 million, and Ethiopia \$389 million.¹³ Other countries in the region received about \$2.5 billion. Although the amount of aid allocated to social services has grown, that to infrastructure and rural and agricultural development has steadily declined.

Although aid to Sub-Saharan Africa is rising, much more will be needed to support its efforts to achieve the MDGs. Again, ODA averages 6.2 percent of recipients' GNI, and while this is high relative to other regions, it is well below the levels of the early 1990s and the estimated needs to meet the MDGs. There is also large variation in aid flows across Sub-Saharan countries. A handful of countries, such as Mozambique and Sierra Leone, have very high aid to GNI ratios. Indeed, in one-sixth of 42 countries in the region, bilateral ODA is equal to more than 10 percent of GNI. Yet in almost as many that share is less than 1 percent. In 1990 the corresponding distribution was nearly 40 percent and 2 percent, respectively.

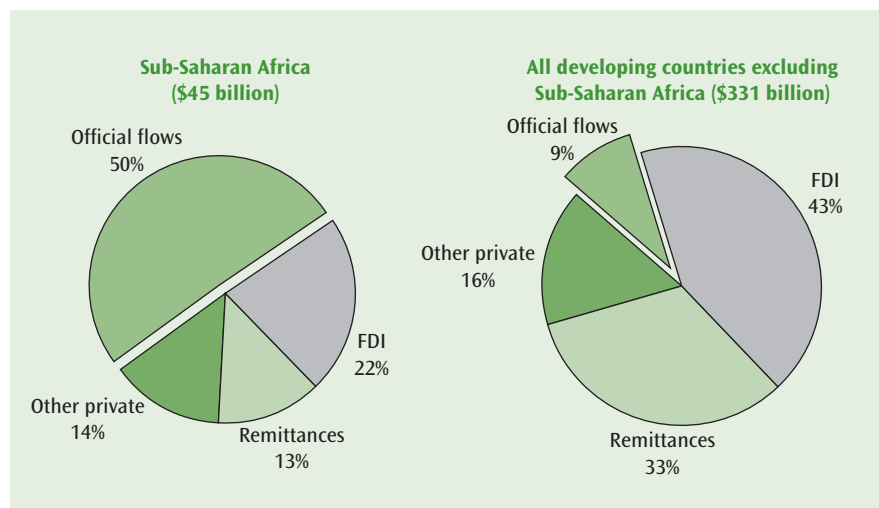
ODA accounts for nearly 55 percent of foreign financial flows to Sub-Saharan Africa (figure 5.6), up from the levels of the late 1990s.¹⁴ Foreign direct investment (FDI) is also a significant source of external finance for the region. In 2003 FDI was equal to 2.5 percent of GNI for Sub-Saharan countries, larger than the share for low-income countries (1.5 percent) and slightly higher than the average for all developing countries (2.3 percent). FDI is concentrated in a few large, resource-rich economies, with more than half going to Angola, Nigeria, and South Africa in 2001–3. In 2003 remittance flows to the region equaled just 1.5 percent of GNI.¹⁵ Remittances are also concentrated in a few countries, with Kenya, Nigeria, and Sudan receiving almost 55 percent of these flows in 2001–3.

Most Sub-Saharan countries have limited prospects for attracting FDI. While many countries have gone through tough reforms to liberalize their economies, promote macro-

economic stability, and rationalize taxes and tariffs, much remains to be done. FDI is strongly influenced by a country's investment climate—and among developing countries, those in Africa have the most regulatory obstacles to doing business.¹⁶

African countries perform especially poorly on the costs of starting a business, enforcing contracts, registering property, and labor regulation flexibility. The costs of a weak investment climate can be substantial. Data from investment climate surveys show that in terms of sales lost, such costs are two to three times larger in Kenya, Tanzania, and Zambia than in Brazil and China. The composition of these costs varies dramatically across countries: in Kenya and Tanzania weak infrastructure services are particularly burdensome, while in Zambia bribes are especially costly. Thus priority areas for reform also vary by country. Other country features, such as small size and geographic location (especially being landlocked), are further constraints to attracting FDI.

FIGURE 5.6 Official flows are the main source of external finance for Sub-Saharan Africa, twice as large as FDI and nearly four times as large as remittances
Financial flows (long-term), 2003



Sources: OECD DAC database; World Bank data and staff estimates.

Note: Official flows include ODA and non-ODA. Although remittances are classified as current transfers in the balance of payments, they are an increasingly important source of foreign exchange for developing countries and are included here as financial flows. Also included are NGO grants, which are current transfers. The shares may not add to 100 because of rounding.

Sub-Saharan countries need to accelerate reforms to enhance their investment climates. They also need to scale up investments in basic infrastructure. Over time, such changes will attract more FDI. But in the near to medium term, increases in ODA will remain critically important for the region.

Innovative Financing Mechanisms to Augment Traditional Aid

In the absence of sufficient traditional ODA, innovative financing mechanisms may be required to increase aid flows. Several proposals are under discussion.¹⁷

INTERNATIONAL FINANCE FACILITY

The International Finance Facility (IFF) is a proposal designed to frontload aid flows in the short term to help countries reach the MDGs. Donors would make off-budget pledges of future increases in aid commitments. The IFF would use the pledges as backing to issue AAA-rated bonds. Bond proceeds would be channeled through existing aid programs. Over time the IFF would draw down the donor pledges to pay off its bonds. Future aid budgets would thus be used to support aid disbursements as and when they are needed in the short term.

Technical aspects of the IFF proposal are being addressed through a pilot IFF for Immunization (IFFIm). This pilot facility would raise frontloaded, reliable funding over a number of years to expand global immunization efforts to help achieve the child mortality MDG.¹⁸ The IFFIm would largely rely on the governance structures and country programs of the Global Alliance for Vaccines and Immunization (GAVI) and the Vaccine Fund.

The frontloaded IFFIm funds would be used for two main purposes: accelerating production of new and existing vaccines, to stimulate private investment and competition and to reduce vaccine costs more rapidly than if there were no scaling up; and strengthening capacity to deliver vaccines to save children's lives immediately, reduce the risk of disease,

and support other health interventions by improving public health infrastructure.

The IFFIm is intended to be a small IFF, and if successful would serve as proof of concept for some aspects of the larger IFF: the capacity to garner donor support for such a mechanism, resolution of issues on the fiscal treatment of contingent donor pledges, and acceptance of IFF-generated AAA bonds by rating agencies and capital markets.

GLOBAL TAXES

A wide range of proposals has been made on ways to raise additional revenue through the introduction of global tax instruments. Global tax proposals should be judged by their revenue adequacy and stability, efficiency, equity, ease of collection, and minimum coalition size. Additionality must also be considered: allocating the proceeds of a tax to development spending may partially or completely displace spending from traditional sources. In addition, detailed aspects of implementation have received relatively little attention.

Increasing international attention on how to move forward on specific mechanisms may lead to more focused work on promising alternatives. One possibility recently put forward in the European Union would be an international airline fuel tax, which would address two externalities: the environmental damage caused by air transportation and the failure of international tax coordination in that airline fuel, unlike any other fuel, is generally untaxed. Such a tax could raise some \$9 billion a year, if levied globally at a rate of \$0.20 a gallon. As another example, it has been estimated that a tax on arms sales could raise \$2.5–5.0 billion a year.¹⁹ If technical and political difficulties can be resolved, global taxes could complement the IFF, generating additional aid funds in the medium to long term as IFF flows, designed to increase development funds in the short term, diminish while its bonds are being repaid.²⁰

VOLUNTARY CONTRIBUTIONS

Private contributions to finance development are increasing. They are made in a range of

ways that could be expanded, encouraged, and made more effective without impinging on their voluntary and private nature. Some mechanisms, such as the establishment of “affinity” credit cards that provide funding for development through voluntary surcharges, could be undertaken by interested banks or companies. Others, such as the creation of a special-purpose global lottery or premium bond, would require regulatory action by participating countries, either unilaterally or acting in concert. Given the relative lack of clear, consistent global data about these flows, the international community could benefit from a more systematic work program to explore what governments can do to encourage private and voluntary flows for development, and to foster their effective channeling and use in support of developing countries’ priorities.

BLENDING ARRANGEMENTS

Blending arrangements—that is, combining flows with different financial terms and characteristics (such as grants, loans, and guarantees) to increase concessionality or gain leverage—are a possible way to augment resources for the MDG agenda, fund global and regional public goods, and address individual country circumstances, such as creditworthiness constraints affecting gap countries.²¹ Blending mechanisms could be structured in a variety of ways to provide different types of funding based on country and program circumstances.

The Need for—and Challenges of—Increasing Aid

Current and near-term projections of development assistance fall far short of what is needed to meet the MDGs. Although recent estimates of the additional resources needed to achieve the MDGs vary widely, they all point to a significant financing gap (box 5.2). At the conservative end of these estimates, ODA must increase by at least \$50 billion a year, with the increases phased in alignment with growth in recipients’ absorptive capacity. The UN Millennium Project projects the additional exter-

nal assistance needed to directly support the MDGs in low-income countries at \$73 billion in 2006, rising to \$135 billion by 2015.²² Financing the MDGs and other needs would require nearly tripling net ODA. Because costing the MDGs is difficult, there is much debate on the amounts needed to achieve them.²³ Still, there is broad agreement that current development assistance is insufficient and that substantially more aid is needed.

At current trends, most developing countries will fall far short of achieving the MDGs for health and education. The financing needs for meeting these goals are large relative to available domestic resources, and significantly higher aid will be needed to fill the financing gap. Adequate progress by developing countries on the health goals, where projected shortfalls are greatest, will require at least \$25 billion a year in additional aid. Additional aid requirements for meeting the primary education goal in low-income countries are estimated to be at least \$3 billion a year (see chapter 3).

Developing countries also need to address serious gaps in infrastructure.²⁴ Annual spending on infrastructure—electricity, transport, telecommunications, water, and sanitation—is about 3.5 percent of GDP in these countries, against estimated needs of about 5.5 percent to reach the MDGs. The shortfall in infrastructure financing is worse in poorer countries. For example, Sub-Saharan Africa needs to double annual infrastructure spending from 4.7 percent to 9.2 percent of GDP (see chapter 2). Ethiopia shows just how large the infrastructure gap is: In 2001 its road density was 0.029 kilometers per square kilometer of land—about a quarter of the average for low-income countries. Scaling up Ethiopia’s road density by a factor of three, as part of a strategy to accelerate progress toward the MDGs, would cost some \$7.2 billion over 2005–15. This amount is more than three times what investment would be if current trends continued. Clearly, many low-income countries do not have sufficient domestic resources or access to global financial markets to finance such investment.²⁵ More aid will be critical to accelerating provision of infrastructure.

BOX 5.2 Estimates of MDG financing needs vary widely, but all point to the need for a major increase

The UN Millennium Project (2005) conducted detailed MDG-based needs assessments for five low-income countries—Bangladesh, Cambodia, Ghana, Tanzania, and Uganda. In Ghana, for example, per capita expenditure needs are projected at \$80 in 2006, rising to \$124 by 2015. The bulk of such spending will have to come from external financing: \$52 in 2006 and \$70 in 2015. (During this period domestic resource mobilization is expected to rise by about 4 percentage points of GDP.) The assessments for the other low-income countries suggest similar external financing needs: \$40–\$50 per capita in 2006, rising to \$77–\$98 in 2015. The study projects the MDG financing gap in low-income countries to be \$73 billion in 2006, rising to \$135 billion in 2015. The gap in middle-income countries is projected to be \$10 billion a year. Meeting the MDGs and other needs in low- and middle-income countries implies additional ODA over 2003 levels of \$66 billion in 2006 and \$126 billion in 2015—a nearly threefold increase in net ODA by 2015. This implies that the share of ODA in donors’ GNI will be 0.44 percent in 2006, rising to 0.46 percent in 2010, and reaching 0.54 percent by 2015.

Several other studies have tried to place a figure on the global cost of meeting the MDGs. These were discussed in detail in the *Global Monitoring Report 2004*, so their results are only summarized here. The range of estimates varies widely, but most point to the need to increase ODA by at least \$50 billion.

The Commission for Africa (2005) estimates that achieving the MDGs in Sub-Saharan Africa will require \$75 billion a year in additional financing. Two-thirds of the increase (\$50 billion) would come from external sources. The Commission recommends proceeding in two stages. In the first stage an additional \$25 billion a year would be required within three to five years (2006–2008/10)—doubling aid to Sub-Saharan Africa over 2004 levels. Implementation of the second stage would be based on an assessment of the improvements in governance and aid quality achieved in the first stage.

Estimates of additional ODA requirements vary widely

Study	Estimate of additional annual ODA required to meet the MDGs
UNMP (2005)	Increase over 2003 of \$66 billion in 2006, \$83 billion in 2010, and \$126 billion in 2015
Development Committee (2003, 2004)	Initial increment of at least \$30 billion (for MDG investment needs), rising to more than \$50 billion
United Nations (2001)	About \$50 billion (to directly support the MDGs)
Commission for Africa (2005)	For Sub-Saharan Africa, \$25 billion (doubling ODA) within 3–5 years, and \$50 billion by 2015

Recent evidence suggests that aid can boost growth if it is invested well, say, in infrastructure.²⁶ A cross-country study also finds that aid that directly supports investment has a positive influence on growth.²⁷ Thus budget support, balance of payments support, and investment in infrastructure and productive sectors like agriculture

appear to have a positive impact on growth in the short term. Aid to social sectors also contributes to growth, but its impact is longer term. Importantly, the case for more aid to education and health, apart from its “narrow” contribution to economic growth, derives from its impact on the nonincome dimensions of poverty.

Absorptive Capacity Constraints to Scaling Up Aid

Scaling up of development assistance will be effective only if poor countries have adequate capacity to absorb more aid. Capacity constraints to effective absorption of resources can manifest themselves at a number of levels—from national policy and public budget management to local service delivery—and in various ways—including macroeconomic management, institutional capacity, infrastructure, human capital, social, and cultural factors. But not all constraints are equally binding; some can be eased in the near term, while others may take longer.²⁸ Constraints related to the labor market (such as the supply of skilled health and education service providers) and the quality of governance (corruption) might take more time to resolve, while issues such as weak public expenditure management can be overcome more readily.²⁹ Moreover, changes can be mutually reinforcing, with improvements in one area serving as a catalyst in others. All these aspects imply that sequencing is central to capacity building: Interventions across the range of constraints should be prioritized, and public investments aligned with those priorities.

The complex, dynamic nature of capacity building points to the need for country-specific approaches to identifying, analyzing, and addressing capacity constraints. Box 5.3 provides a preliminary assessment of Ethiopia's ability to achieve the MDGs and of labor, macroeconomic, and infrastructure constraints to resource absorption. The modeling framework used helps capture country- and sector-specific constraints (such as skilled labor shortages), cross-effects from investing in related MDGs, and the role of sequencing investment. The simulation results show that it will be possible for Ethiopia to achieve the MDGs if aid (grants) roughly doubles (as a share of GDP) by 2015. They also help illustrate key absorptive capacity constraints, limits to frontloading of disbursements, and the importance of careful sequencing of increases in aid and associated investments.

An Improving Environment for Aid Absorption

The policy and institutional environment in developing countries has steadily improved in recent years, creating a better environment for scaling up aid. In addition to pursuing sound macroeconomic policies and better public sector management, developing countries have strengthened institutions, improved governance, pursued wide-ranging structural reforms, and adopted policies of social inclusion and equity. The overall improvement in policy frameworks and institutional performance has contributed to faster growth in these countries. The average quality of policies and institutions, as measured by the World Bank's Country Policy and Institutional Assessments (CPIAs), has risen over the past five years. Although improvements in some areas (such as institutions and public sector management) have lagged those in others, the overall upward trend is widespread. In tandem, output growth has more than doubled over the average rate of the 1990s, with low-income regions such as South Asia and Sub-Saharan Africa seeing much stronger growth.³⁰

A 2003 Development Committee report assessed the capacity of 18 well-performing low-income countries to effectively use more aid to achieve the MDGs. It found that the five large Asian countries in the sample (Bangladesh, India, Indonesia, Pakistan, Vietnam) could absorb an immediate doubling or more of aid. Some Sub-Saharan countries (such as Ethiopia and Madagascar) could, with substantial policy reforms, also absorb a doubling of aid. Overall, the Sub-Saharan countries in the sample were found to have the capacity to use additional aid productively if they continued and strengthened reforms. Of course, there was considerable variation in absorptive capacity across countries.

The UN Millennium Project recommends identifying well-governed low-income countries as fast-track countries that could receive large increases in assistance.³¹ Existing performance-based criteria—such as being eligible to

BOX 5.3 Addressing absorptive capacity in Ethiopia

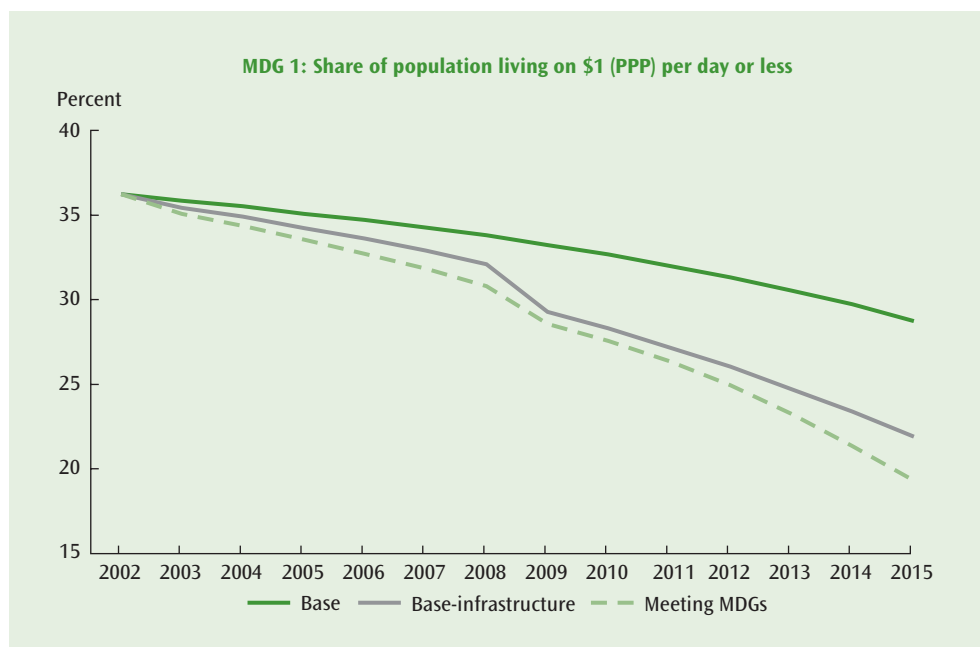
Government policies and the flow of foreign aid required to reach the MDGs have strong economywide effects that, through markets for labor, goods, services, and foreign exchange, feed back on the MDG targets. Measuring and projecting MDG costs and achievements must therefore be based on an economywide approach that complements in-depth sector studies. To examine these macro-micro linkages for Ethiopia—a very poor country for which the MDGs pose enormous challenges—a model has been calibrated to country data to capture select macro and sector-specific constraints. Simulations of progress toward the MDGs are possible that reflect, in particular, labor market, infrastructure, and macroeconomic constraints.

Projections of income poverty levels through 2015 under three scenarios are shown in the figure. The first scenario is a continuation of present trends. Annual GDP growth follows the trend rate over the past decade (3.6 percent), external aid increases marginally (by 1.5 percent a year) above the current level (\$16 per capita), and there is modest investment in physical infrastructure. Under this scenario Ethiopia will fall significantly short on all the MDGs, with poverty falling modestly—from its current 35 percent to 29 percent—and weak progress toward the other goals.

The second scenario adds public investment in basic infrastructure (roads, other transport, energy, irrigation), which is considered critical to growth. Infrastructure investment is frontloaded, growing by 10 percent a year until 2009 and 5 percent a year thereafter, reflecting network effects. Without this investment, Ethiopia cannot reach the first MDG of halving income poverty. The network effects from improved infrastructure enable returns to private sector activities—worker productivity, agricultural yields, and so on—to rise over time. Such investment would require a 15 percent increase in foreign grants relative to the base case. Productivity gains would help boost annual GDP growth to nearly 5 percent after 2009, and poverty reduction would be accelerated, falling to 22 percent by 2015.

Under the third scenario, investments in public services are set at the levels required to achieve the core human development MDG targets—universal primary education completion, two-thirds

Projected income poverty in Ethiopia, 2003–15 (Headcount index)



Note: The projections use the Ethiopia Maquette for MDG Simulation (MAMS) model, parameterized using data from the Ethiopian poverty assessment (World Bank 2005a).

reduction in under-five mortality, three-quarters reduction in maternal mortality, and halving the population share without access to improved water and sanitation services. This scenario requires a gradual but substantial increase in foreign grants, rising to around \$60 per capita, or about 40 percent of GDP, by 2015—roughly twice current aid as a share of GDP.

These scenarios illustrate several key points. It is possible to achieve the MDGs—provided there is adequate external grant financing, and expansion of MDG-related services is accompanied by investment in basic infrastructure to raise growth. Additional aid is essential. Relying on domestic resources to finance such investment would reduce income growth, lower household consumption, and deepen poverty, even though some of the human development MDGs might be achieved. Investment in basic infrastructure is key to supporting economic expansion. Without better growth performance, income poverty goals will not be achieved. In the short run this requires improving physical infrastructure, whereas investing in human development has a longer-term impact on growth.

This framework helps illustrate the important role of absorptive capacity and the lags inherent in expanding capacity. Consider investing to achieve the second MDG—universal primary education completion by 2015. Ethiopia currently has about 75,000 teachers and a student-teacher ratio of 75:1. To meet the goal with an unchanged student-teacher ratio, more than 52,000 additional teachers will need to be trained and deployed by 2015—while as many as 160,000 more teachers would be required for a much-needed reduction in the ratio to 40:1. Recruiting teachers will require increasing the supply of skilled labor—a gradual process with a lagged response—or raising real wages to hire skilled labor away from alternative uses. But raising wages to attract skilled labor raises the costs of public services, draws skilled labor from the private sector, and crowds out private growth.

Constraints to absorptive capacity are also evident in the macroeconomic impact of higher aid flows. Aid permits a larger trade deficit and increases the demand for goods and services. This puts upward pressure on the exchange rate and reduces the competitiveness of both exports and import-competing goods. Over time this may shift the economy away from production for export, make it more dependent on aid, and reduce growth (often called the “Dutch disease”). In the third scenario above, which requires roughly a doubling of aid to GDP by 2015, the real exchange rate appreciates and leads to shrinkage of the export sector. But if public investment made possible by aid increases productivity and removes constraints to growth, this potential drag on output can be offset. This underscores the importance of well-targeted investment and policy measures to offset these costs—particularly improvements in the business environment and trade reforms that improve market access and reduce behind-the-border barriers to export productivity.

The importance of investment sequencing is another lesson from these simulations. Priority must be placed on basic infrastructure investment because of its key role in raising the underlying growth rate and achieving network productivity effects. At the same time, investments must proceed in human services that address binding constraints—such as education to ease skilled labor constraints—and where production lags require earlier attention. Priority should also be given to investments that generate positive externalities and lower costs. Investments in water and sanitation, for example, accelerate improved health outcomes.

There are also implications for the pace of investing in the MDGs. Frontloading infrastructure investment helps accelerate growth through productivity gains. But frontloading expenditures on social and other MDG services runs into absorptive capacity constraints relatively quickly. Real wages rise, the exchange rate appreciates, and growth is compromised. Simulations suggest that for Ethiopia the cost-minimizing share of spending on MDG social services over the first five years is about one-fifth of total expenditures by 2015 (in present value terms) to meet goals related to these services. Note, however, that this calculation ignores the welfare gains of accelerated service delivery due to frontloading.

Finally, improved governance and institutional capacity are crucial to effective delivery of public (and private) services. Both strengthen absorptive capacity and can greatly reduce the costs of improving service delivery over time.

Sources: Bourguignon and others 2004, 2005; Lofgren 2004.

apply for assistance under the U.S. Millennium Challenge Account, having reached the completion point under the HIPC initiative, or participating in the African Peer Review Mechanism (APRM) of the New Partnership for Africa's Development (NEPAD)—could be used to assign fast-track status to countries.

As the relevance of the poverty reduction strategy (PRS) approach continues to grow, the enabling environment for growth and poverty reduction is expected to improve further. In low-income countries Poverty Reduction Strategy Papers (PRSPs) provide the strategic and operational framework for programs and policy reforms to promote growth and reduce poverty. The papers are now also broadly viewed as the key operational vehicle for achieving the MDGs. By the end of February 2005, 47 countries had prepared full PRSPs, and 12 others had prepared interim PRSPs.³² Of these, 33 were Sub-Saharan countries. Solid progress has been achieved in many aspects of the PRS approach, but a key challenge going forward is to deepen implementation on the ground. (See chapter 1 for further discussion of the PRS process and related agenda.)

Countries are paying more attention to improving public expenditure management, which is key for effective aid use. By strengthening such systems, public resources can be aligned better with development priorities, and budget processes can be made more transparent. Many countries have made or are planning significant changes in public expenditure management, and country strategies increasingly include measures to enhance it.³³ Sustained government commitment and strong, well-coordinated donor assistance can boost progress on strengthening public expenditure management capacity.

POVERTY REDUCTION STRATEGIES AND BUDGETS: PROGRESS IN DELIVERING AID IN SUB-SAHARAN AFRICA

Several recent studies have reviewed budgets in highly aid-dependent countries to assess how PRSPs have helped improve aid delivery.

The studies have found that the PRS process has fostered improvements, though there is much room for further progress.³⁴

Uganda saw foreign aid increase by nearly 5 percentage points of GDP between 1997/98 and 2001/02. The increase came in the form of budget support, with 60 percent in grants and the rest in concessional loans. Untied budget support was provided through World Bank Poverty Reduction Support Credits (PRSCs)—a series of annual credits supporting a three-year rolling reform program—and grants from other donors.³⁵ This approach made the overall budget envelope more predictable and helped boost service delivery, especially to poor people.³⁶ Between 1998/99 and 2002/03 the ratio of actual disbursements to amounts initially programmed rose steadily, from less than 40 percent to more than 85 percent. During this period deviations in budget outturns and allocations narrowed, with the discrepancy index falling from nearly 10 percent to 5.5 percent.³⁷ In addition, the share of the budget allocated to the Poverty Action Fund more than doubled, from 17 percent in 1997/98 to 37 percent in 2002/03.

In Tanzania foreign assistance more than doubled during 1999–2003, and donors now finance about 90 percent of the country's development budget.³⁸ Increases in donor financing were associated with increases in priority sector spending.³⁹ With PRS implementation, government spending on priority sectors increased continuously, and by fiscal 2002 such spending exceeded ODA (figure 5.7). But donor funding still exceeds spending on core priority areas, implying that there is scope for sharpening donor focus on these areas. As donors align with national priorities, there is also scope to better integrate their support with the budget.⁴⁰ Aid continues to be highly variable, and though this variability has declined in recent years, it still exceeds that of domestic revenues. Within-year variability of aid flows is substantial as well.

In Burkina Faso, with foreign assistance comprising 40 percent of the budget, donor

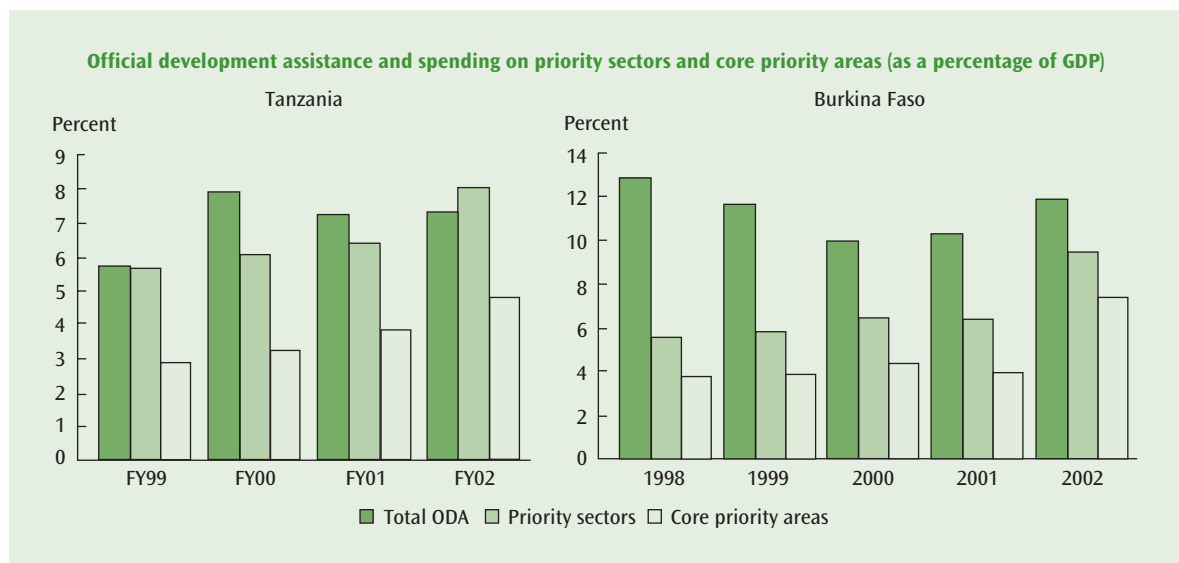
alignment with national priorities is crucial to successful implementation of the PRS. Aid is increasingly aligned with priority sectors, as evidenced by the narrowing gap between ODA and spending on priority sectors and core priority areas (see figure 5.7).⁴¹ Nevertheless, the gap between development assistance and spending on core priority areas remains high, at about 4 percentage points of GDP in 2002—implying that aid is being spent on noncore priority areas. Since the country’s PRS was developed, donors have been shifting the composition of aid toward budget support. As a result program loans and grants increased from 2.6 percent of GDP in 1998 to 4.0 percent in 2002, while project loans and grants fell from 8.5 percent of GDP to 6.6 percent. The in-year variability of aid is large, however: During 1996–2000 about 60 percent of aid disbursements were in the last quarter of the year. This bunching of assistance, which is usually not synchronized with the budget cycle, makes it difficult for the country to finance its budget effectively. Receiving funds

at the beginning of the fiscal year would contribute to better public expenditure management. Gaps between PRS projections and actual expenditures can be both large and variable. Gaps in primary education expenditure are in part due to a shortfall in foreign financing—that is, a gap between projected and actual financing. When foreign financing has been late or postponed, this is reflected in a gap between PRS projections and actual expenditures. When foreign financing has been delivered as projected, this gap is relatively small.

COUNTRY STUDIES ON SCALING UP

Development efforts are being scaled up at the national, state, and community levels. The Shanghai conference on scaling up poverty reduction, held in May 2004, showcased a broad range of successful country interventions to reduce poverty and expand access to health, education, water, and other key services (box 5.4). These experiences reinforce some of the factors shown by other evidence as common to successful scaling

FIGURE 5.7 Higher development assistance is increasingly supporting and catalyzing more spending in priority areas



Source: Alonso and Utz 2004; Alonso 2004.

BOX 5.4 Scaling up development efforts

The May 2004 Shanghai conference on scaling up poverty reduction presented a number of country cases of successful efforts to reduce poverty and scale up service delivery. In El Salvador, for example, education reforms have resulted in universal primary enrollment. Years of conflict had weakened the country's education system, and by the end of the 1980s more than a quarter of the population was illiterate, and a fifth of primary school-age children were not in the system. But in the early 1990s the country started reforming the system. The reforms transferred resources and decision making to stakeholders such as schools, communities, and parents. In addition, between 1992 and 2002 public spending on education rose from 1.9 percent of GDP to 3.3 percent. The reforms, which were supported by World Bank sector loans, targeted low-income and rural areas, and helped achieve a gross primary enrollment rate of 112 percent—and more than doubled the secondary enrollment rate, to 56 percent. El Salvador's successful education program has spurred similar innovations in Guatemala and Honduras.

In Indonesia the community-based Kecamatan Development Program has been used to develop infrastructure and alleviate poverty in rural areas. It started small in 1997, operating in 25 villages, and by 2003 it had been scaled up to 28,000 villages. The program provides rural communities with block grants to build small-scale productive infrastructure. The communities receive the transfers at the beginning of the planning cycle, providing certainty of funding. Execution is decentralized, with planning and decision making directly involving local communities. In its first seven years the program reached 35 million people. Other social funds that have involved communities in the planning and decision-making process—such as in Malawi, Yemen, and Zambia—have likewise had national scope and impact.

Source: World Bank 2004d.

up: institutional and policy change; innovation, learning, and adaptation; political leadership and sustained commitment; partnership with all stakeholders (which is key for service delivery); and a supportive external environment.

In sum, emerging country evidence, recent research, a better understanding of how to address absorptive capacity constraints, prospects for continuing favorable trends in policies and institutions, and a stronger focus on governance all show that countries have increased, and continue to increase, their capacity to absorb aid productively. Still, prospects vary by country. Many low-income countries are well positioned to absorb a scaling up of aid. But in some, especially difficult partnership countries, absorptive capacity can be a significant obstacle to scaling up, and innovative ways of channeling aid are needed. In all cases a country-specific

approach anchored in the PRS (or a joint needs assessment, such as the UN–World Bank Post-Conflict Needs Assessment, and results-based framework, such as the Transitional Results Matrix, a multidonor and national stakeholders' coordination and monitoring tool for difficult partnership countries) is required to assess financing needs, identify and address capacity constraints, and appropriately sequence incremental financing and investment.

Making Aid More Effective

The way aid is allocated and delivered is as important as its volume in achieving the MDGs. Broad consensus has emerged that development assistance is particularly effective in poor countries with sound policy and institutional environments.⁴² But even as donors are allocating more aid to better performers,

increasing attention is being focused on the special needs of difficult partnership countries and on seeing how to make aid effective in these economies.

In all countries, donors must provide assistance in ways that are aligned with country-based and -led development priorities as articulated in PRSs or equivalent national development strategies. They should also disburse aid in effective ways—reducing the burden of processes, procedures, and requirements and making aid more predictable. In addition, a stronger focus is needed on the results agenda. This calls for moving from “accounting by inputs” to practical ways of “accounting for outputs.” Equally important to improving aid effectiveness is the need for more coherent donor policies.

Aid Selectivity

Donors are becoming more focused on performance, with aid allocations increasingly determined by both policy performance and poverty. The policy selectivity index, which measures the elasticity of aid with respect to the quality of recipients’ policies and institutions (based on the World Bank’s CPIAs), shows a generally improving trend in 1999–2003 (table 5.1).⁴³ This trend has been fueled by the sharpening policy focus of multilateral assistance: The relationship between aid and policy performance is much stronger for multilateral than for bilateral aid. But bilateral aid does exhibit a significantly positive relationship with the quality of recipients’ policies and institutions—for more than 80 percent of bilateral donors this relationship is positive, and for more than half it is statistically significant. Still, some of the largest bilateral donors are not very selective. Donors’ poverty focus has strengthened as well, as reflected in the rise in the poverty elasticity index (elasticity of aid with respect to recipients’ per capita income). Thus more aid is being allocated to poorer countries by both bilateral and multilateral donors.

Since the various components of aid are far from homogenous, it is not surprising to

see substantial variation in the policy and poverty sensitivity of the different types of aid. The results for disaggregated aid indicate that flexible ODA is more sensitive to policy performance than technical cooperation.⁴⁴ On average, a 100 percent increase in the quality of recipients’ policies and institutions is associated with a more than 250 percent increase in flexible ODA. Technical cooperation, by contrast, is not sensitive to the quality of policies and institutions. This category of aid is also the least selective with respect to poverty, reflecting the fact that technical cooperation is provided to a broad range of countries—including special need and conflict countries with extremely weak institutional capacity, and middle-income countries with institutional capacity gaps in narrowly defined areas. Overall, the results suggest that the scope for improving the allocation of aid by altering its composition is potentially large.

Donor focus on performance is stronger in low-income countries. Thus some donors that are not very selective in overall aid allocations nevertheless tend to favor better performers

TABLE 5.1 Selectivity in aid allocation: Donors’ policy and poverty focus is improving, but bilateral donors could do more

Official development assistance net of emergency aid				
Flow	Policy selectivity 1999	Policy selectivity 2003	Poverty selectivity 1999	Poverty selectivity 2003
Total aid	1.57*	1.77*	-0.34*	-0.55*
Bilateral aid	1.15*	1.04*	-0.27*	-0.47*
Multilateral aid	2.09*	2.71*	-0.68*	-0.87*
Five largest donors				
United States	1.37	1.43	-0.77*	-0.88*
Japan	3.72*	1.74*	-0.23	0.01
France	0.65	1.27	-0.17	-0.32
Germany	1.99*	3.36*	-0.24*	-0.52*
United Kingdom	2.82*	3.89*	-0.47*	-1.21*

Source: Levin 2005.

* Significant at the 10 percent level or higher.

Note: Policy selectivity shows the policy selectivity index, which measures the elasticity of aid with respect to the quality of recipients’ policies and institutions. Poverty selectivity shows the poverty elasticity index, which measures the elasticity of aid with respect to recipients’ per capita income.

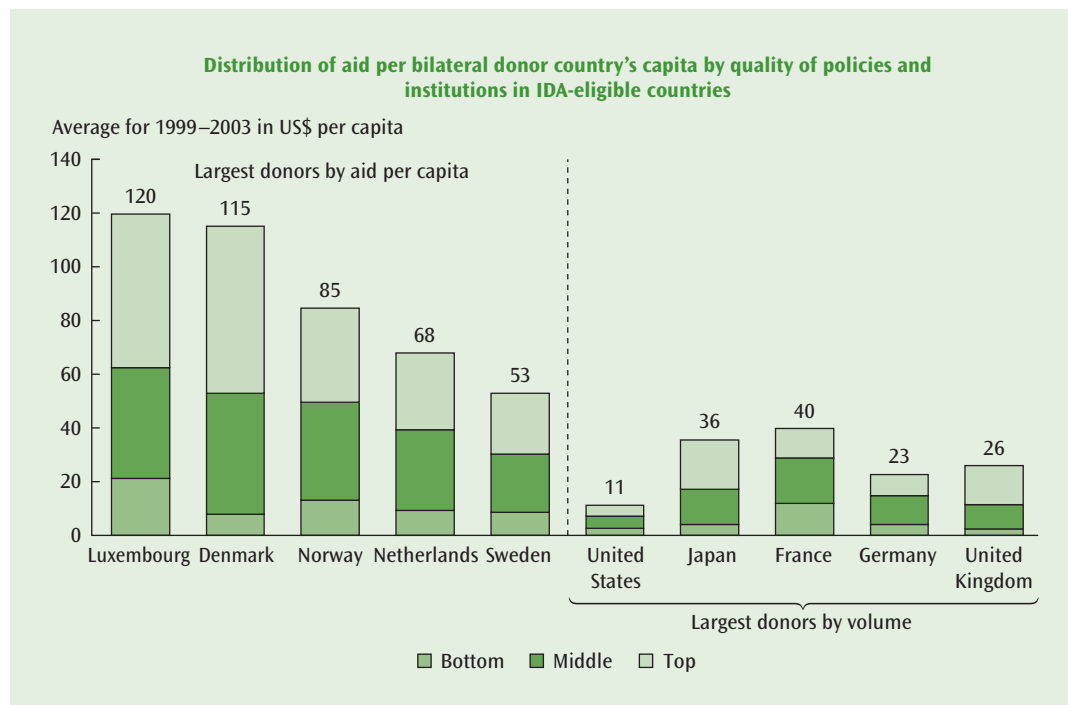
among poor countries. The best-performing third of recipients (as measured by the Bank's CPIAs) receive an average of 40 percent of aid allocations—while the worst-performing third receive 17 percent (figure 5.8). There is wide variation in donor effort directed at low-income (IDA-eligible) countries. During 1999–2003 countries that were consistently the top providers of assistance per donor country citizen to low-income countries were Denmark (with an annual average of \$62 out of a total of \$115 per Danish citizen directed to the top third of policy performers in low-income countries), Luxembourg (\$57 out of \$120), Norway (\$35 out of \$85), Netherlands (\$29 out of \$68), and Sweden (\$23 out of \$53). Comparable amounts for some of the largest donors are \$4 out of \$11 for the United States and \$11 out of \$40 for France. The more generous donors in terms of per capita aid effort are also generally more selective.

Aid Effectiveness in Difficult Partnership Countries

As bilateral donors move toward more policy and poverty selectivity in aid allocation, there is concern that difficult partnership countries may be underfunded.⁴⁵ Empirical evidence shows that these countries receive about 40 percent less aid than predicted by their policy and institutional ratings (figure 5.9).⁴⁶ There is wide variation, with the so-called “aid orphans” receiving much less aid and the “aid darlings” receiving much more than can be explained by policy and poverty criteria. While not all difficult partnership countries should receive more aid, the results suggest that an increase in overall aid to the group would not compromise the performance basis of aid.⁴⁷

Recent studies find that postconflict countries can absorb more aid than other low-income countries with similar levels of

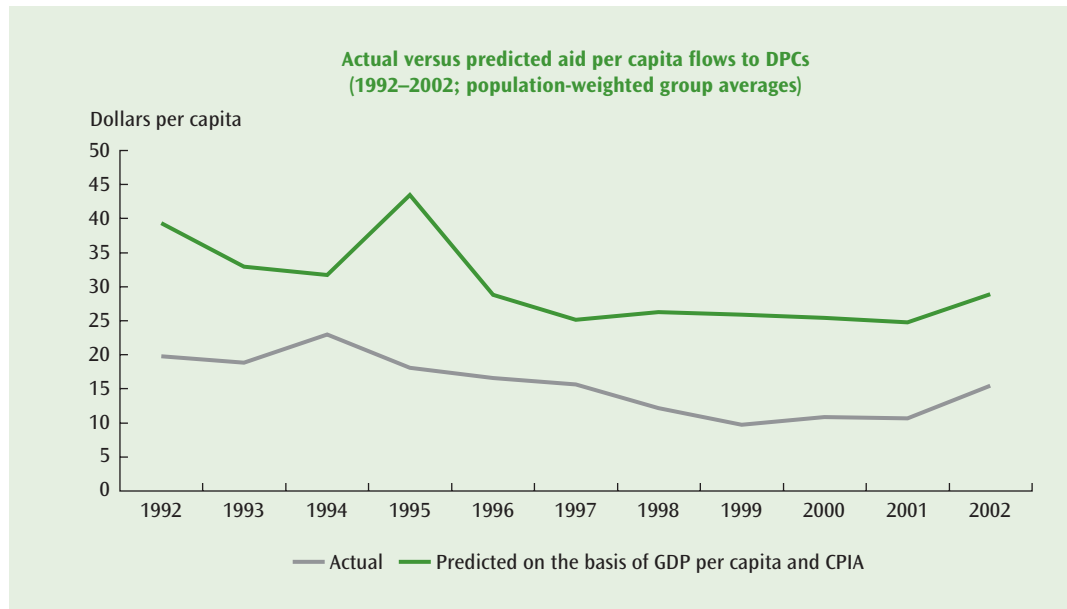
FIGURE 5.8 In low-income countries donors allocate more aid to better performers; more generous donors also tend to be more selective



Source: Based on Levin 2005.

Note: IDA-eligible countries are split into three groups—bottom, middle, and top—using the 33.3 and 66.7 percentiles of quality of policies and institutions as measured by the World Bank's Country Policy and Institutional Assessments (CPIAs).

FIGURE 5.9 Difficult partnership countries receive less aid than predicted by their policy/institutional quality and poverty levels



Source: Levin and Dollar 2005.

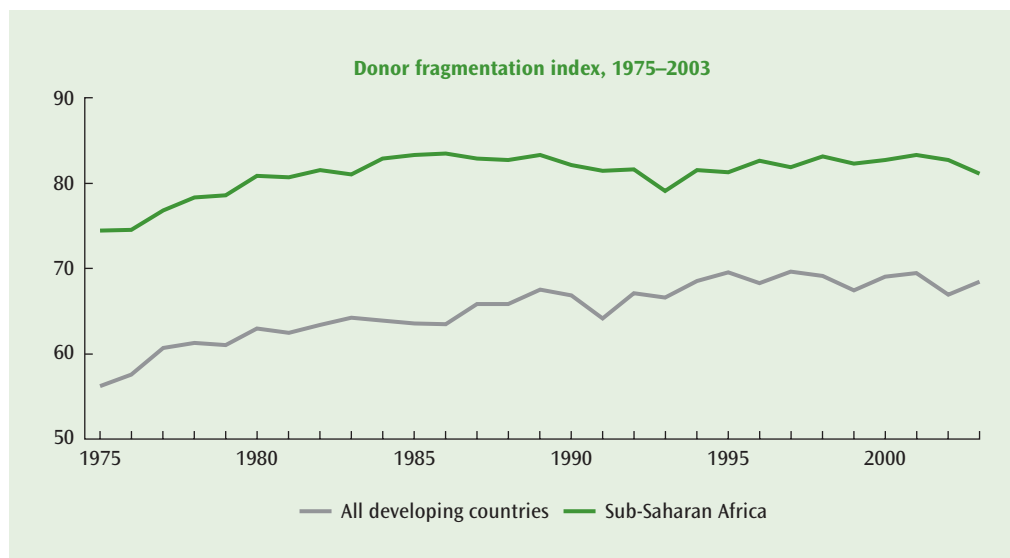
poverty and institutions. Aid allocation patterns in postconflict periods show an increase in the first few years after a conflict ends, followed by a dropoff. One study finds that relative to conflict levels, per capita aid is generally \$2 higher in the second year after conflict, then rises and peaks at around \$9 per capita higher in the fourth year after conflict.⁴⁸ Another finds that the increase is highest in the first two postconflict years, then falls off.⁴⁹ But postconflict countries can effectively absorb higher levels of aid in later periods when their absorptive capacity has increased, so higher aid sustained over longer periods is more desirable for ensuring turnarounds in these countries.⁵⁰ Thus donors need to provide assistance over a longer period—an example is Sierra Leone’s 10-year development plan—to rebuild weak capacity, restart growth, and reduce poverty. The Senior Level Forum on Development Effectiveness in Fragile States—organized jointly by DAC and bilateral and multilateral donors and held in London in January 2005—addressed the issue of how to improve effectiveness of aid in fragile states and the principles of good donor

practice in these countries.⁵¹

Because these countries have weak capacity and risky environments, delivering effective aid is a considerable challenge.⁵² Aid should be focused on building capacity and providing key services through innovative mechanisms. Some successful approaches are emerging, including those that use local institutions to deliver services and those that work with non-state actors in ways designed for eventual transfer to state delivery. (See chapter 3 for more on service delivery in countries under stress.) The appropriate aid modality is likely to vary by country situation. But to be effective, aid needs to be better coordinated to minimize the problem of aid darlings and orphans, as well as better sequenced and sustained.

Aid Fragmentation

Donor fragmentation remains high in developing countries. A donor fragmentation index, constructed from shares of individual bilateral donors in annual bilateral aid flows, shows that the degree of fragmentation in 2003 was largely unchanged at 68; in 2002 the index was

FIGURE 5.10 Aid fragmentation is high, especially in Sub-Saharan Africa

Sources: OECD DAC database; World Bank staff estimates.

Note: The indexes graphed are averages over groups of aid recipient countries. Donor fragmentation goes from 0-100; higher values imply more fragmentation.

67 (figure 5.10). High fragmentation can have negative implications for aid quality for several reasons: high transaction costs for recipients because more time is taken meeting donor requirements; too many small projects, with consequent limited opportunities to reap scale economies; and smaller or narrower donor stakes in overall country outcomes.⁵³ A large number of donors also compounds the challenge of donor coordination. A number of members of OECD's Development Assistance Committee (DAC) are considering measures to limit the number of countries on which they focus. Although the recent High Level Forum on Aid Effectiveness (held in Paris in March 2005) did not include fragmentation among the 12 indicators it adopted to monitor reforms of aid delivery and management, donors committed to delegating authority to lead donors, where appropriate, to reduce transaction costs.

The problem is especially severe in Sub-Saharan Africa, where the donor fragmentation index for 2003 is 81. The high degree of donor fragmentation is especially surprising given that aid tends to be concentrated in relatively few countries: 60 percent of bilateral aid to the region goes to 10 countries. But although donors have their

favorite countries, they like to be present in many countries in the region. On average, a recipient country in Sub-Saharan Africa received aid from 25 donors a year over the past two decades.⁵⁴ The number varies, ranging from 16 for Gabon to 37 for Ethiopia in 2003.

Untying Aid

Untying of aid significantly increases its effectiveness, yet large amounts of bilateral ODA continue to be tied. The DAC recommends untying all aid, excluding technical cooperation and food aid, to the least developed countries (LDCs).⁵⁵ Almost all DAC countries have largely implemented these provisions, but four donors, including the largest (the United States), do not report on the tying status of their bilateral ODA. Technical cooperation, which accounts for more than a third of bilateral ODA and is largely spent on source-country expertise, is essentially a form of tied aid. Although substantially smaller, food aid (excluding humanitarian assistance) is mostly tied as well.

Tying aid is costly for recipients. A recent OECD study finds that untied food aid can reach up to 50 percent more beneficiaries than

does tied aid.⁵⁶ Other studies have also found that untying (project) aid yields sizable savings.⁵⁷ More progress on untying categories of aid that are currently tied and broadening coverage to other developing countries would improve the effectiveness of aid. DAC members are considering several options to expand the scope of recommendations on untying aid. At the recent Paris High Level Forum on Aid Effectiveness, DAC donors agreed to continue to make progress on untying aid and to monitor this progress through an indicator that measures the share of bilateral aid that is untied.⁵⁸

Reliability of Aid Flows

Given the large size of official flows relative to the incomes of many countries, variations in these flows can cause problems. Volatile, unreliable aid flows can undermine budget management in recipient countries and efforts to develop medium-term expenditure frameworks. In poor countries aid shortfalls are typically offset by cutbacks in spending, and sometimes by tax increases.⁵⁹ Improving the reliability of aid is important to increasing its effectiveness. It is also important for effective scaling up of assistance: Countries that commit to sustained reforms should be assured of timely, more predictable, and longer-term aid commitments. The predictability of aid will be monitored using the indicators agreed under the Paris Declaration, to minimize gaps between aid commitments (under agreed schedules in annual or multiyear frameworks) and actual disbursements.

Although donors are beginning to pay more attention to aid volatility and predictability, cross-country data reveal no significant improvement in these areas. Cross-country data for 1995–8 and 2000–3 indicate that aid continues to be more volatile than fiscal revenue.⁶⁰ Moreover, the volatility of aid relative to revenue appears to have edged up: The measure of the volatility of aid relative to revenue in 2000–3 is nearly twice the median value of 1995–8. Aid to poor countries is also more variable than these countries' GDP.⁶¹ In addition, aid commitments remain poor predictors of disbursements, particularly for the poorest

countries—such countries receive only about half of promised aid. The data also show that aid does not counter large income shocks. Among countries experiencing adverse macroeconomic shocks equivalent to 5 percent or more of GDP, only a fifth saw higher aid.

Progress on Harmonization, Alignment, and Results

Aid is more effective when it is aligned with recipients' priorities, when it reduces transaction costs through harmonized processes and procedures and donor coordination, and when it is predictable. Related to such efforts is the need for a clearer focus on managing for development results. An overarching principle of the harmonization and alignment agenda is that donors should support country-owned strategies for growth and poverty reduction—in the form of poverty reduction strategies or equivalent national development plans—and base their programming on the needs and priorities identified in these strategies. In addition, development assistance should be provided in ways that build on partners' sustainable capacity to develop policies, implement them, and account for these activities to their people and legislatures.

IMPLEMENTING ALIGNMENT AND HARMONIZATION

The 2003 Rome High Level Forum provided an impetus for advancing alignment and harmonization, and this global agenda was the focus of the recent Paris High Level Forum—where ministers and senior officials from more than 90 developed and developing countries and 25 heads of multilateral and bilateral donor agencies reaffirmed their commitment to the Rome Declaration. Through the Paris Declaration, donors and partners agreed to mutual accountability in carrying out the partnership commitments made by both sides. The international development community has agreed to measure progress on aid effectiveness using 12 indicators (table 5.2). The indicators cover dimensions of ownership, alignment, harmonization, managing for results, and mutual accountability. To track and encourage progress at the global level

TABLE 5.2 Indicators of progress (on ownership, harmonization, alignment, and results)
To be measured nationally and monitored internationally

	OWNERSHIP	TARGET FOR 2010 ^a
1	<i>Partners have operational development strategies</i> —number of partner countries with national development strategies (including PRSs) that have clear strategic priorities linked to medium-term expenditure frameworks and reflected in annual budgets	At least 75% of partner countries
	ALIGNMENT	
2	<i>Reliable country systems</i> —number of partner countries with procurement and public financial management systems that adhere to broadly accepted good practices or have a reform program in place to achieve these	Target to be set by September 2005
3	<i>Aid flows aligned with national priorities</i> —percent of aid flows to the government sector that is reported in partner countries' national budgets	85% of aid hours reported on budgets
4	<i>Strengthen capacity by coordinated support</i> —percent of donor capacity-development support provided through coordinated programs consistent with partner countries' national development strategies	Target to be set by September 2005
5	<i>Use of country systems</i> —percent of donors and of aid flows that use partner country procurement and/or public financial management systems in partner countries, which adhere to broadly accepted good practices or have a reform program in place	Target to be set by September 2005
6	<i>Strengthen capacity by avoiding parallel implementation structures</i> —number of parallel project implementation units per country	Target to be set by September 2005
7	<i>Aid is more predictable</i> —percent of aid disbursements released according to agreed schedules in annual or multiyear frameworks	At least 75% of such aid released on schedule
8	<i>Aid is untied</i> —percent of bilateral aid that is untied.	Continued progress
	HARMONIZATION	
9	<i>Use of common arrangements or procedures</i> —percent of aid provided as program-based approaches ^b	At least 25%
10	<i>Encourage shared analysis</i> —percent of field missions and/or country analytic work, including diagnostic reviews, conducted jointly	Target to be set by September 2005
	MANAGING FOR RESULTS	
11	<i>Results-oriented frameworks</i> —number of countries with transparent, monitorable performance assessment frameworks to assess progress against national development strategies and sector programs	75% of partner countries
	MUTUAL ACCOUNTABILITY	
12	<i>Mutual accountability</i> —number of partner countries that undertake mutual assessments of progress in implementing agreed commitments on aid effectiveness, including those in this (Paris) Declaration	Target to be set by September 2005

Source: OECD 2005e.

a. Existing targets will be confirmed or amended by September 2005.

b. See OECD 2005e, appendix A.

and among countries and agencies, participants at the Paris forum also agreed to set targets for 2010 for 11 of the 12 indicators. Five preliminary targets were agreed during the forum, and these and the others will be finalized and adopted before the UN General Assembly summit in September 2005.

Evidence from an OECD DAC Working Party on Aid Effectiveness and Donor Practices

(WP-EFF) survey,⁶² Strategic Partnership for Africa (SPA) surveys, and the United Nations Economic Commission for Africa (UNECA)–DAC Mutual Review of Development Effectiveness in the Context of the New Partnership for Africa's Development (NEPAD) show that partner countries and donors are working together and taking actions to improve coordination and aid effectiveness (box 5.5). The

BOX 5.5 Alignment and harmonization: country examples show a wide variety of approaches

Cambodia. Establishing country ownership takes time, patience, perseverance, and resources. To address problems of poor aid management, Cambodia's government and donors have launched various initiatives since a new coalition government was formed in the late 1990s. The multidonor, three-year Technical Cooperation Action Plan was approved in 2001 to help the government strengthen its capacity to formulate and implement sound macroeconomic policies and manage public finances. In the past few years Cambodia has started to connect to the global debate and is now a signatory to the Rome and Paris declarations on harmonization. A number of recent developments have significantly improved prospects for moving toward more productive use of resources. For example, the government has committed to merge three donor-funded strategies—the Second-Socio-Economic Development Plan 2001–5 (supported by the Asian Development Bank), Cambodia's Millennium Development Goals (supported by the United Nations Development Programme), and the National Poverty Reduction Strategy (supported by the World Bank and IMF)—into one poverty-focused national development plan for 2006–10. Donors have responded with common country strategy development processes, joint analytic work, joint support for public financial management reforms, sectorwide approaches (SWAps), and other types of collaboration. In November 2004, together with local donors, the government developed a National Action Plan for Harmonization and Alignment to guide implementation of its commitment to the Rome and Paris declarations on ownership, leadership, capacity building, harmonization, and alignment. Government-donor collaboration on public financial management reforms was further strengthened under a SWAp launched in late 2004.

Ethiopia. In many countries where national systems are inadequate for donors to rely on, the donor community has bolstered collective action on capacity development efforts to help strengthen the systems. Recognizing that public sector capacity building efforts were largely supported by fragmented donor projects and ad hoc financing, the government launched a consolidated five-year program to rapidly scale up capacity building and institutional transformation efforts in six crucial areas: a regional decentralization program that rapidly transferred delivery responsibilities—with substantial fiscal and administrative authority—to rural jurisdictions; municipal reforms designed to restructure and empower urban centers; reformulated civil service reforms increasingly focused on strengthening the public sector fiduciary framework and service delivery results on the ground; initiatives to enhance connectivity and develop e-government applications and school Internet projects, efforts to reform the justice system (including the courts, lawmaking and law enforcement institutions, and the legislative process); and ongoing tax reforms that strengthen tax policy and administration at the federal and regional levels. In 2003 the scaling up process resulted in a SWAp: Seven donors combined their financial support under the program and aligned their procedures with the government's planning, budgeting, and disbursement procedures.

Honduras. The Honduran PRS provides a framework for donors to align around country priorities. An executive office has been established to unblock project implementation bottlenecks and accelerate the achievement of results, and the government has begun negotiating with donors to restructure some operations for greater program coherence. Donors have cooperated by making institutional changes such as decentralized funding approvals, accepting lead donor roles in some areas, carrying out joint analytic work, and coordinating fiduciary requirements.

Middle-income countries. Many middle-income countries have not elaborated formal harmonization and alignment efforts, but have simply pursued relevant aspects of the agenda. In Brazil, India, Mexico, and Morocco donor assistance often involves SWAps and increasingly relies on country systems for financial management, disbursements, and procurement. Brazil's Bolsa Familia SWAp, for example, integrates several pro-poor federal programs into one comprehensive program covering health, education, and nutrition, with program implementation streamlined into a single administrative and management mechanism. Poland's Road Maintenance and Rehabilitation Project is fully aligned with the government's program and budget cycles, and implementation relies heavily on country systems for financial management, accounting, and environmental safeguards.

Source: World Bank staff.

BOX 5.6 Mozambique's performance assessment framework— for donors

All African multidonor budget support arrangements define a framework for periodically assessing country performance. In an innovative twist, Mozambique's government and donors have agreed to establish a performance assessment framework for the donor community as well. The objective is to monitor donor behavior on commitments, expose noncompliance and weaknesses to peer pressure, and strengthen donor accountability to government. Key features of this arrangement include:

- Donors will identify the indicators to be assessed, which subsequently will be discussed with and vetted by the government.
- Donor performance will be assessed by an independent team and subject to periodic discussion by the government and donor peers.
- The donor performance assessment framework will be linked to an action plan and timeframe for its implementation.
- Annual donor performance reports will be released publicly.
- The framework will be continuously adapted based on collective and individual donor assessments.

Source: Gerster and Harding 2004.

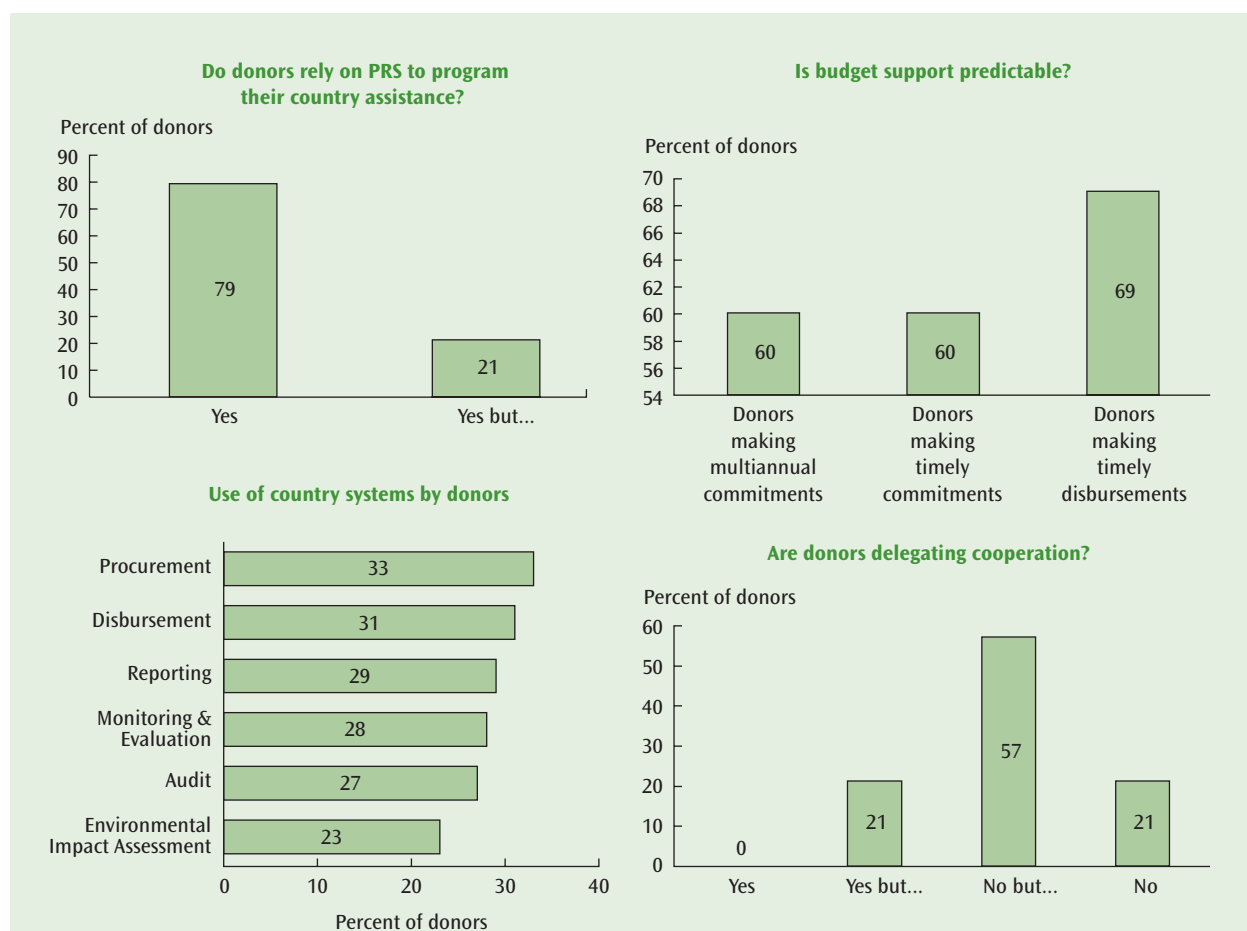
SPA surveys and the UNECA-DAC report find that while progress is being made in African countries, it has been uneven and concentrated in countries that have worked longest and hardest to take ownership of the aid process (box 5.6). By the end of 2004 more than 60 partner countries (worldwide) and 40 bilateral and multilateral agencies were engaged in harmonization and alignment activities. The challenge remains to ensure that the broad range of activities taking place, and the energy and creativity driving them, help increase aid effectiveness.

Aid management and alignment. The WP-EFF has begun to quantify progress toward the harmonization and alignment commitments adopted in the Rome Declaration in 2003. After the Rome meeting a set of country-level indicators were developed, and the WP-EFF surveyed harmonization and alignment in 14 partner countries self-identified at the Rome forum as being interested in pursuing harmonization efforts.⁶³ The working party's survey found that donors are internalizing the principle of aligning their program-

ming to the needs and priorities identified in PRSs. More than four-fifths of the donors consulted indicated they rely on PRSs to program their country assistance, and only a fifth expressed reservations (figure 5.11).⁶⁴ But the WP-EFF and SPA surveys found only a small number of collaborative approaches to harmonizing donor assistance around agreed country priorities, and little evidence that, overall, donors have adapted their programs in support of national growth or poverty strategy priorities. Furthermore, in a number of countries growth and poverty strategies are still broad, and while donors may be aligned on broad categories—that is, priority sectors—this may not imply alignment on core priority areas.

Aid flexibility and predictability. The WP-EFF survey found that for countries that receive budget support, 60 percent of donors provide multiyear commitments and timely commitments, and 69 percent disburse budget support on schedule (see figure 5.11). Effective public expenditure management is an important prerequisite for efficient use of budget support, and

FIGURE 5.11 Progress on alignment, harmonization, and predictability of aid needs to be accelerated



Source: OECD 2004b.

countries are making progress on strengthening these systems and public financial management (see above). Still, further progress on aid flexibility is hampered by insufficient clarity about country policy and investment priorities and the absence of a robust medium-term framework that links these priorities to country budget and spending decisions and timetables. Also, there is considerable variation in donor behavior across countries. While 93 percent of donors make multiyear commitments on budget support in Tanzania and 79 percent in Mozambique, only 40 percent do so in Bangladesh—and a mere 20 percent in Zambia.

The UNECA-DAC report finds that despite an increase in budget and sector support among good performers, there has been little overall change in the aid landscape in Africa.⁶⁵ Projects are still the dominant mode of aid delivery, particularly for bilateral assistance, and are often administered outside partner oversight and control. In addition, capacity development efforts continue to fall outside mainstream aid coordination and effectiveness efforts: They are still invariably piecemeal, atomistic, and supply driven. But coordinated multidonor budget support efforts are emerging in several countries, particularly where aid

relationships are characterized by mutual trust and accountability.

Limited use of country systems. Donors continue to make limited use of country systems. One of the main goals of the Rome agenda was to provide development assistance in ways that build partners' sustainable capacity to develop policies, implement them, and account for these activities to their people and legislatures. This means increased reliance on partners' systems and procedures to manage aid. Yet few of the donors active in the 14 countries surveyed by the DAC Working Party reported using partner systems (for financial reporting, disbursement, procurement, audit, monitoring, and evaluation), and there are significant disparities between them in this area. Of course, country systems must meet certain criteria for donors to rely on them.

On average, the donors reported that only 29 percent of their projects are managed using partner systems and procedures. Results ranged from 23 percent of donors who said they rely on country systems for environmental impact assessments to 33 percent who use country procurement systems. Additional technical work has been done since Rome and Marrakech to develop criteria for assessing and strengthening country systems and for harmonizing donor requirements around them. In several cases these criteria are guiding efforts among groups of donors to simplify and harmonize fiduciary, monitoring, and reporting arrangements.

Sectorwide approaches. Sectorwide approaches (SWAs) are used to provide comprehensive, coordinated support for country-led sector programs. In 2003–4 borrowers from multilateral institutions showed increased interest in SWAs as a means for aligning around sector priorities. A growing number of SWAs use existing country frameworks to channel and account for funds, becoming an integral part of the harmonization and alignment agenda. In Brazil (health), India (education), Mexico (rural infrastructure), and Poland (roads), SWAs use country systems for procurement and financial management.

The SPA survey shows that sector support operations are an important aid delivery mechanism for promoting and consolidating harmonization and alignment. The survey concludes that strong elements of harmonization in sector programs included joint consultations with stakeholders, analytic work, partner reviews and government reporting, and monitoring and evaluation. Harmonization was weaker on procurement arrangements, disbursement mechanisms, financial management, technical assistance, and capacity building.

Delegated cooperation. Donors are also pursuing delegated cooperation in some areas. The Rome Declaration encourages donors to intensify their efforts to work through delegated cooperation at the country level as a means of reducing transaction costs by making greater use of the comparative advantages of individual donors. For instance, in a delegated cooperation agreement being prepared for Ethiopia, Sweden will delegate its role in the health program to Norway, while Norway will delegate its role in the education program to Sweden. The level and form of delegation vary considerably, and the DAC Working Party survey found relatively few examples of delegated cooperation. Only 21 percent of donors across 14 countries reported that they were delegating cooperation, and less than 8 percent of donor missions were carried out jointly.⁶⁶

How recipients view donor efforts. The SPA Budget Support survey asked African governments to describe their satisfaction with donor behaviors in a number of areas. The results indicate that donors made some progress between 2002 and 2003 (table 5.3). There seems to be a higher degree of coordination (if not harmonization). Moreover, satisfaction rose in countries with more experience and higher budget support (Mozambique, Tanzania, Uganda) and fell in countries with less experience and lower budget support (Benin, Niger, Rwanda).

Partner countries also viewed donors positively in areas such as providing timely information on planned disbursements (with a

score of 3.8 out of 5.0), aligning disbursements with national budget cycles (3.6), disbursing at the intended time (3.5), and using government reports with minimal demands for other information (3.5).

MANAGING FOR DEVELOPMENT RESULTS

The development community has moved from conceptualizing to implementing the global results agenda. Some early progress in managing for development results is evident at the country and agency levels and across aid agencies. Partner countries are beginning to focus on results and are integrating results in their development strategies. For example, strong strategies for education and health in Ethiopia have helped set a well-prioritized and -costed PRS program.

Budget processes and public expenditure management efforts have the strongest results orientations. In all countries there has been a move to apply the principles of managing for results in line ministries, programs, or cross-cutting themes. Stronger links are observed in Brazil, the Philippines, South Africa, Thailand, Vietnam, and Uganda. A number of countries have also developed strategies to improve their monitoring and evaluation systems. Recognizing the importance of quality statistical systems for monitoring and evaluation, a few countries—Burkina Faso, Ukraine—have started programs for statistical capacity development, and strategic plans for statistical systems are being finalized in other countries—Albania, China, India, Kenya, Nigeria, Yemen.

Aid agencies are strengthening the focus on results in their country programs, financial instruments, incentives, and reporting systems. Many agencies are deriving country programming from PRSs and linking country support to a partner's medium-term expenditure framework. Emerging practices are being shared and analyzed in the DAC Joint Venture on Managing for Development Results. All aid agencies have strengthened monitoring and evaluations to better ascertain the quality and impact of their operations. They are also working to enhance staff ownership

TABLE 5.3 African governments are viewing donor behavior more favorably (scale of 1 to 5; 5 is highest)

Area	2002–3	2003–4
Conditionality coordinated	3.0	3.4
Joint missions or reviews	3.2	3.4
Reporting requirements minimized and coordinated	3.2	3.1
Coordinated support on public finance reforms	3.1	3.3
Coordinated support to strengthen statistical systems	2.7	3.1
Conditionalities seen as useful	3.1	3.6
Number of conditions minimized		2.1

Source: SPA Budget Support Working Group 2004.

of the results agenda through guidance, training, and information technology systems. Both bilateral and multilateral agencies have strengthened their development effectiveness work and corporate reporting.

At the global level, aid agencies are working more systematically in identifying actions that produce results, scaling up support for that work, and ensuring the availability of appropriate data. Work is under way on presenting existing experiences in a *Sourcebook on Emerging Good Practice in Managing for Development Results*. Aid agencies are seeking to harmonize results reporting requirements around national monitoring and evaluation systems that help countries manage for results. Progress is expected in four African pilot countries in 2005. Aid agencies are also beginning work on jointly assessing monitoring and evaluation settings in partner countries and aligning capacity building support with national strategies for monitoring and evaluation, which will be pursued by supporting communities of practice in managing for development results.

CHALLENGES AHEAD

Progress on harmonization and alignment has been mixed, and that on managing for results is just beginning. The pace of progress needs to be accelerated. It will not be easy, because achieving harmonization, alignment, and managing for results requires intensive work among

participants—donors and partner countries—to remove obstacles. Continued commitment at the highest levels to the harmonization, alignment, and results agenda will be needed for its successful implementation. Participants at the Paris High Level Forum acknowledged that enhancing the aid effectiveness is feasible and necessary across all aid modalities, and they committed to concrete actions to address challenges that impede progress.

In partner countries weaknesses remain in growth and poverty reduction strategies as well as in institutional capacities to manage these strategies for results. Progress in exercising country ownership and leadership of the development process can be broadened, deepened, and facilitated by strengthening the national development strategy process—for example, by integrating PRSs with budget processes and widening the participation of key stakeholders in developing the strategies. To ensure mutual accountability, donors should provide comprehensive, timely, transparent information on aid flows, and governments should commit to public financial reporting that includes clear, monitorable, outcome-based targets.

Among donor agencies, fragmented and uncoordinated assistance at the country level needs to be minimized and programs aligned with country priorities, processes, and systems. Also, donors need to help strengthen countries' capacities to implement national development strategies. Donors should streamline conditionality to focus on the priorities that governments set out in their development strategies. To increase donor complementarity, agencies should seek ways of improving cross-country balance and avoid major gaps and overlaps, applying comparative advantage principles between and among bilateral and multilateral agencies. The agreed aim is for donors to commit to use country systems, as soon as they jointly assess them as being robust enough, in at least four key areas: public financial management; procurement; monitoring and evaluation; and environmental and social safeguards. But in determining the most effective modalities of aid delivery, donors must ultimately be

guided by the development strategies and priorities established by partner countries.

In aid agencies, managing information and decision gaps between headquarters and field staff is critical to facilitate progress on harmonization. Agencies need to assess their accountability regimes and mandates to see how increased delegation of authority to the field can promote more effective aid at the country level. Creating incentives for harmonizing and aligning—at the political, institutional, and individual levels—is another critical variable on which more thought and action are needed.

Debt Relief

Most debt relief to low-income countries has occurred under the aegis of the HIPC initiative, including the enhanced version of the initiative introduced in 1999. But donor assistance for debt relief involves more than one-time reductions in developing countries' debt levels—it also requires ensuring that countries have the capacity and ability to ensure that debt remains at sustainable levels. In addition, recent proposals have suggested that donors introduce new approaches and programs to ease debt.

Progress on the HIPC Initiative

For heavily indebted poor countries, debt relief is crucial to create the fiscal space for much-needed increases in spending to promote growth and reduce poverty. Overall, substantial progress has been made in implementing the enhanced HIPC initiative. By March 2005, 27 HIPCs—more than two-thirds of the 38 countries that potentially qualify for assistance under the initiative, and accounting for about two-thirds of total expected debt relief in net present value terms—had reached their decision points and were receiving relief. Of these, 15 had also reached their completion points—when creditors provide the full amount of debt relief committed at the decision points on an irrevocable basis.

Progress on reaching completion points increased in 2004, and three more countries

are expected to reach their completion points by mid-2005. For many of the 12 countries in the interim stage between decision and completion points, maintaining macroeconomic stability remains a challenge. Although a number of countries are on track with respect to their macroeconomic programs, others that have experienced difficulties in program implementation are pursuing the policy measures needed to bring their economic programs back on track.⁶⁷ Most of the countries in the interim stage have finalized their PRSs and are making good progress in implementing them.

Of the 11 countries that have not reached their decision points, 2 are making significant progress and are expected to reach their decision points in 2005. For the others, significant challenges remain: These countries have been affected by domestic conflicts and have protracted arrears to various creditors, which has complicated the design and implementation of reform programs.

The sunset clause of the HIPC initiative has been extended by two years to the end of 2006, with its application ring-fenced to poor countries with unsustainable external debt based on end-2004 data. All IDA-only and Poverty Reduction and Growth Facility (PRGF)-eligible countries that have not benefited from HIPC debt relief and whose external indebtedness (based on end-2004 data) exceeds the enhanced initiative's thresholds after the assumed full application of traditional debt relief are potentially eligible for the initiative. World Bank and IMF staff are preparing a preliminary list of countries that meet this criterion for consideration by the institutions' boards in August 2005. As now, countries would receive debt relief based on the level of debt at the time of reaching the decision point.

HIPC relief is projected to substantially lower debt stocks and debt service ratios for most HIPCs that have reached their decision points. Net present values of debt stocks in the 27 HIPCs that reached their decision points by mid-March 2005 are projected to decline by about two-thirds once they reach

their completion points. HIPCs in the interim period have benefited from debt relief from the Paris Club as well as from several multilateral creditors. Ratios of debt service to exports and to fiscal revenues for the 27 countries that have reached their decision or completion points are estimated to have fallen from an average of 16 percent and 24 percent in 1998–9 to 7 percent and 12 percent in 2004, respectively (table 5.4). The near-term debt service ratios of these countries are below the average for non-HIPC low-income countries.

Debt relief under the HIPC initiative has helped countries increase poverty-reducing spending. In the 27 countries that have reached the decision point, such spending rose from an average of 6.4 percent of GDP in 1999 to 7.9 percent in 2004—about four times the amount spent on debt service.⁶⁸ In absolute terms, poverty-reducing spending is estimated to have increased from nearly \$6.0 billion in 1999 to \$10.5 billion in 2004, and is projected to increase to \$14.5 billion in 2007 (see table 5.4).⁶⁹

Although creditor participation has improved, some non-Paris Club bilateral and commercial creditors have not committed to providing HIPC relief. Most of the costs attributable to bilateral creditors continue to be borne by members of the Paris Club. Commercial creditors represent less than 5 percent of the net present value cost of relief, in part because of measures by the Debt Reduction Facility for IDA-only countries that have reduced the stock of commercial debt in HIPCs. Moral suasion remains the principal measure for encouraging participation and discouraging litigation by remaining commercial creditors. With respect to multilateral debt, 23 of the 31 multilateral creditors have indicated their intent to participate in the initiative, representing more than 99 percent of the total debt relief required.

A key premise of the HIPC initiative is that debt relief should be additional to other forms of external financing assistance. An important issue is whether countries receiving

TABLE 5.4 Debt service is falling and poverty-reducing spending rising among the 27 HIPCs that have reached their decision points (percent unless otherwise indicated)

Indicator	Actual						Estimated	Projected		
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Debt service (US\$ billions)	3.70	3.18	3.07	2.42	2.44	2.55				
Debt service after enhanced HIPC relief (US\$ billions)							2.63	2.49	2.55	2.78
Debt service/exports ^a	16.9	14.5	13.6	10.2	10.1	8.9	7.3	6.3	6.1	6.2
Debt service/government revenue ^a	25.2	21.8	21.9	16.5	15.0	13.4	11.7	9.5	9.0	9.0
Debt service/GDP ^a	3.9	3.4	3.3	2.5	2.4	2.2	2.0	1.7	1.6	1.6
Poverty-reducing expenditure (US\$ billions)		5.94	6.02	6.55	7.57	9.07	10.54	12.83	13.53	14.49
Poverty-reducing expenditure/government revenue ^a		40.9	42.9	44.8	46.6	47.6	46.8	49.1	47.5	46.7
Poverty-reducing expenditure/GDP ^a		6.4	6.4	6.8	7.4	7.8	7.9	8.6	8.4	8.4

Source: HIPC country documents and IMF staff estimates.

Note: Debt service data for 1998 and 1999 reflect debt relief already provided to Bolivia, Guyana, Mozambique, and Uganda under the original HIPC initiative. Data on poverty-reducing expenditure are not available for all countries, particularly for 2003–05. In aggregate, the last available period was used for future years, thus understating the likely level of poverty-reducing spending.

a. Weighted average.

HIPC debt relief are receiving additional resources, or whether debt relief crowds out other aid flows. Merely observing the size of flows does not provide conclusive evidence of additionality, as there is no way of knowing how much aid countries would have received without the HIPC initiative. There are also substantial difficulties in measurement because different donors account for debt relief in different ways. Debt relief is sometimes explicit, such as through grants for debt relief, and sometimes implicit, such as through debt service reductions.

The August 2004 HIPC status report, based on updates of debt stock and debt service indicators in post-completion point countries, found that the net present value of debt ratios had climbed since the completion points.⁷⁰ Most of the increase was due to interest and exchange rate changes, while high exports had significantly lowered debt ratios. Debt service ratios for these countries had also increased but remained close to 10 percent on average. While the low level was

due to HIPC debt relief and the high concessionality of new debt, the average change masked important differences between countries. Medium-term projections generally pointed to stable or declining trends in debt and debt service ratios. The review indicated that notwithstanding HIPCs' high vulnerability to shocks, sound economic policies and close monitoring—using the proposed debt sustainability framework for low-income countries (see below)—would help prevent the reemergence of unsustainable debt.

Debt Sustainability

Continued measures are needed by HIPCs and by creditors to ensure that debt sustainability is maintained after completion points, just as similar measures are needed for other low-income countries. The Boards of the IMF and World Bank have endorsed key elements of a proposed debt sustainability framework for low-income countries aimed at supporting these countries' efforts to achieve the MDGs

without creating future debt problems and keeping countries that have received debt relief under the HIPC initiative on a sustainable track. In guiding future financing decisions, the framework rests on three pillars:

- An assessment of debt sustainability guided by indicative country-specific debt burden thresholds related to the quality of their policies and institutions.
- A standardized, forward-looking analysis of debt and debt-service dynamics under a baseline scenario and in the face of plausible shocks.
- An appropriate borrowing (and lending) strategy that contains the risk of debt distress.

Building on initial Board discussions of the proposed framework in early 2004, and further considerations in September 2004, Bank and IMF staff are preparing a follow-up paper that attempts to resolve outstanding issues on the indicative debt burden thresholds, the interaction of the framework with the HIPC initiative, and the modalities for Bank-IMF collaboration in deriving common assessments of debt sustainability. It needs to be stressed, however, that debt sustainability is not only a resource flow issue. It also depends on increasing growth, diversifying exports, expanding access to global markets, and mitigating the effects of exogenous shocks.

IDA financial support to poor countries will now take systematic account of their vulnerability to debt. Debt sustainability will be the primary determinant of the grant and credit mix in IDA14, and the joint debt sustainability framework for low-income countries will form the analytical basis to link debt sustainability and grant eligibility.⁷¹ Countries facing the toughest debt problems—most of them in Sub-Saharan Africa—will get all their support in the form of grants, while countries less burdened by debt will receive IDA's highly concessional long-term loans, or in a few cases a mix of grants and loans. The resulting share of grants in IDA support over the next three years is expected to be about 30 percent.

Proposals for Additional Debt Relief

Some G-7 members have proposed mechanisms for additional debt relief (box 5.7). Further debt relief holds the promise of yielding additional development financing beyond what could be forthcoming in the form of additional gross flows, given the broad political support for debt relief. It could also reduce the remaining debt overhang and ease pressures to provide new aid to refinance existing debt service obligations (so-called defensive lending), enabling a more effective policy dialogue between donors and debtor countries. Debt relief also has the advantage that, to the extent that it is committed irrevocably up front, it can provide aid in a predictable and easy to use form.

There is a danger, however, that further debt relief might instead result in a diversion of resources that would have gone to increased direct aid flows. Furthermore, relative to the alternative of higher new aid flows, debt relief has a number of potential disadvantages. First, it allocates resources according to existing debt stocks rather than need or policy performance, and so may prove inconsistent with the principle of allocating assistance to countries where it would be most effective. Second, debt relief may reduce the scope for linking assistance to the maintenance of good policies, to the extent that an irrevocable commitment to debt relief is made upfront. Third, it may create expectations of further relief in the future, increasing the moral hazard associated with any subsequent lending and hindering the development of a credit culture. This could prompt creditors to reduce net lending in the future.

Any new debt relief initiative would leave an unfinished agenda. Further debt relief is inevitably only a small part of a broader agenda that involves stronger policies in developing countries, more and better-targeted development assistance, and a supportive international environment for growth.

BOX 5.7 Proposals for additional debt relief—moving beyond HIPC

Members of the G-7 have put forward a number of proposals for further debt relief beyond the enhanced HIPC initiative. Different motivations drive these proposals. Some proposals reflect a desire to provide additional resources to help low-income countries achieve the MDGs. Others see further debt reduction as a way of increasing the scope for new lending—under the proposed World Bank–IMF debt-sustainability framework—to low-income countries with relatively strong policies, to facilitate the development of a credit culture. Still others aim to eliminate the need for defensive lending and perpetual debt relief for HIPCs.

Motivations apart, the proposals differ importantly along several lines, including the scope and modality of debt relief, the conditionality to be applied, and the source or sources of financing. Differences include:

- Whether eligibility for relief should be restricted to HIPCs or be available to all low-income countries.
- Which institutions' debt should be relieved.
- What percentage of eligible debt should be relieved.
- Whether relief should take the form of reductions in debt stocks or debt service payments.
- The strictness of conditionality.
- How debt relief by international financial institutions will be financed—for example, with contributions from bilateral donors or by the institutions themselves. Some G-7 members have proposed that the IMF sell some of its gold reserves to cover its debt relief.

Source: IMF 2005.

Notes

1. DAC members' ODA consists of bilateral ODA—provided directly to developing countries that are on DAC's Part I list of aid recipients—and contributions to multilateral agencies. Disbursements of ODA by multilateral agencies may not equal the contributions they received from donors.

2. OECD (2005a). Paris Club (comprising bilateral donors) members recently agreed to forgive up to 80 percent of their debt claims on Iraq, adding \$12–\$17 billion to ODA flows in 2005–6 (in addition to the amounts discussed in the text). For many donors these flows will be in addition to their Monterrey commitments.

3. Between 2001 and 2003 military expenditures rose by 18 percent in real terms (Stockholm International Peace Research Institute 2005); such spending dwarfs aid flows. For example, in 2002 U.S. military spending was \$1,217 per capita and ODA was \$46 per capita. At \$358 per capita, EU military spending was also much larger than ODA per capita (Economists Allied for Arms Reduction 2004).

4. Oxfam International (2005).

5. European Commission (2004). In 2002 the European Commission adopted an interim target for ODA to average 0.39 percent of gross national income (GNI) by 2006.

6. Donors recently agreed to increase contributions to the International Development Association's 14th replenishment (IDA14) by more than 25 percent. Over the next three fiscal years—from 1 July 2005 to 30 June 2008—grants are expected to account for about 30 percent of IDA support.

7. Noncash assistance typically involves technical cooperation, emergency and distress relief, and food aid. Debt relief involves a net transfer of resources if debt is being serviced (that is, is not in arrears), but amounts to an accounting exercise if it is not.

8. The increase in real ODA between 2001 and 2003 was \$6.6 billion at 2002 prices and exchange rates. Debt relief increased by \$3.8 billion, technical cooperation by \$2.6 billion, and emergency and disaster relief and food aid by \$1.9 billion.

9. Data are for the 14 non-DAC donor countries for which the OECD collects data on development assistance.

10. The Forum on Partnerships for More Effective Development Cooperation, held in February 2005, brought together DAC members and a number of non-OECD countries involved in supporting development in developing countries. The forum sought to improve coordination and cooperation among the entire donor community, particularly through better information and knowledge sharing.

11. Middle-income countries receive about a third of aid. Although these countries are less dependent on aid, it plays an important role in catalyzing reforms, helping countries address issues of large pockets of poverty, and providing a buffer against shocks.

12. The increase in real net bilateral ODA between 2001 and 2003 was \$6.5 billion, with \$4.2 billion for debt relief and \$1.6 billion for emergency and disaster relief and food aid.

13. The corresponding real increase was \$4.4 billion in the Democratic Republic of Congo, \$225 million in Cameroon, \$344 million in Sudan, \$123 million in Tanzania, and \$199 million in Ethiopia.

14. All official flows (ODA and non-ODA) account for a slightly smaller share of resource flows—50 percent, as in figure 5.6—because non-ODA official flows are slightly negative.

15. Official data underestimate remittance flows, and unrecorded remittances may be larger than recorded remittances.

16. See World Bank (2004c) and chapter 2 for a detailed discussion of the private investment climate and its links to growth.

17. Development Committee (2005) analyzes the various proposed innovative mechanisms under discussion. See also Development Committee (2004) and Reisen (2004).

18. The IFFIm would be established as a U.K. charitable entity, essentially as a special-purpose vehicle for the Vaccine Fund. Negotiations are under way to establish a core group of donors to fund the pilot facility.

19. Reisen (2004).

20. Taxes that correct inefficiencies ultimately imply an increase in a country's real resources and the possibility of increased development financing. See Development Committee (2004) for a detailed discussion of the additionality of various innovative instruments.

21. Gap countries are countries that are ineligible for IDA financing (because their GNI per capita is above the IDA cutoff), other than on an exceptional basis, and that are not creditworthy

for normal borrowing from multilateral development banks.

22. UNMP (2005).

23. World Bank (2004b).

24. Some analysts have argued that developing countries often lack a minimum amount of capital—in terms of infrastructure, human capital, and public administration—to support modern production activity, so capital above a minimum threshold is needed to boost economic activity. According to that argument, the key to breaking out of such “poverty traps” is a large infusion of investment in physical and human capital, which must be funded predominantly by external sources given limited domestic capacity to save. See Sachs and others (2004) for a poverty trap perspective on Sub-Saharan Africa; see chapter 2 and Kraay and Raddatz (2005) for empirical evidence on poverty traps.

25. UNMP (2005) estimates that in Ghana the annual investment in roads required to meet the MDGs is 2.4 percent of GDP, over three times what the government can afford, and that in Uganda it is 5.4 percent of GDP, more than twice what can be financed domestically.

26. There is considerable debate in the recent economic literature on how aid affects growth. Some cross-country macro studies find an unambiguously positive relationship between aid and growth. Another set of studies shows more conditional results, with the effect dependent on the quality of policies and institutions or other country characteristics. A third set of studies finds no effect, or even a negative effect, of aid on growth.

27. Clemens, Radelet, and Bhavani (2004).

28. Development Committee (2004); Renzio (2004).

29. Levy (2004).

30. World Bank (2004a).

31. UNMP (2005).

32. Of the 47 countries with full PRSPs, 22 have produced at least one annual progress report.

33. See IMF and World Bank (2005) and chapter 2 for results from the just concluded World Bank–IMF poverty-reducing public spending tracking exercise for HIPCs.

34. See Alonso, Judge, and Klugman (2004) for a comparative analysis of PRSPs and budget linkages in four countries.

35. PRSCs have also facilitated donor coordination and increased aid for budget support. Bilateral donors providing budget support include Belgium, Ireland, the Netherlands, Sweden, the United Kingdom, and the United States.

36. Miovic (2004). Input-level data show that much larger amounts of resources have been channeled to basic health, education, and water and sanitation.

37. While the overall performance was stable, there were within-year fluctuations in some areas of the budget.

38. Alonso and Utz (2004).

39. Priority sectors are broad sectors—such as education, health, agriculture, and roads—that are assigned priority in budget allocations. Core priority areas are items within priority sectors, such as primary health care and primary school education. Per capita spending on priority sectors increased 53 percent between fiscal 1999 and 2002, while spending on core priority areas rose 77 percent. The much larger increase for core priority areas was due to the donor-funded Primary Education Development Program.

40. Tanzania has about 650 donor projects being implemented by sector ministries and local governments. One of the four priorities of the Tanzanian assistance strategy agreed to in 2003 by the government and development partners is to integrate donor funds, including projects, with the government budget. To that end, the government has created a mechanism linking donor funds to government accounts, for donors to use in channeling funds to projects, nongovernmental organizations, and the private sector. It has also provided relevant training to interested donor agencies. By August 2004, however, only four of Tanzania's development partners had indicated their readiness to use this mechanism. See Peretz and Wangwe (2004).

41. Alonso (2004). Although priority sectors are seeing higher spending, their share in the total budget is largely unchanged, even with HIPC funds earmarked for priority sectors. Real spending—including real per capita spending—on priority sectors and core priority areas increased between the start of the PRS, in 1999, and 2002. Between 1998 and 2002 real per capita spending on priority sectors and core priority areas doubled. Allocations of increased spending between core priority areas have been quite uneven, however.

42. As noted, there is considerable debate in recent literature on the impact of aid on growth. A recent study by Dollar and Levin (2005) adds micro evidence to the macro results in the literature. The study finds a strong link between institutional quality and aid-financed project outcomes. The results support the findings of other cross-

country analyses that find aid to be effective in good institutional environments. The study finds the most robust results for the rule of law. In addition, geography matters: Projects in Sub-Saharan countries have less successful outcomes (although tropical location does not significantly affect outcomes). The study also finds that different institutions have different effects on project success. For example, better democratic political institutions result in better outcomes for policy-based loans, whereas the success of project loans is facilitated by stronger property rights and rule of law. This is consistent with the growth literature, which finds a favorable link between property rights and economic growth.

43. Based on Dollar and Levin (2004).

44. Flexible ODA is defined here as total ODA less special-purpose grants—such as technical cooperation, debt relief, emergency and disaster relief, and food aid.

45. Difficult partnership countries (which include low-income countries under stress, or LICUS) are low-income countries with weak institutions, defined as those with Country Policy and Institutional Assessment (CPIA) scores in the bottom two quintiles.

46. Levin and Dollar (2005).

47. This model of aid allocation does not reflect the costs of conflict and the benefits of conflict prevention for growth and poverty reduction. See Chalmers (2004) and Chauvet and Collier (2004) for evidence on the potentially large effects of aid in difficult partnership countries. Aid reduces the risk of conflict by raising economic growth.

48. Kang and Meernik (2004).

49. Collier and others (2003).

50. By contrast, aid has typically been inadequate and mistimed, phasing out just when it should be phasing in.

51. See OECD (2005c) for a discussion of how donors are moving forward on improving the effectiveness of their aid to fragile states.

52. Difficult partnership countries, especially countries just emerging from conflicts and post-conflict countries, often need to rebuild basic state, civil society, and private sector institutions.

53. Knack and Rehman (2004).

54. Felix (2005).

55. A 2001 DAC High Level Meeting adopted recommendations to untie ODA to the least developed countries.

56. OECD (2004a).

57. Aryeetey, Osei, and Quartey (2003) find the savings to be in the range of 11–25 percent; Jepma (1991) estimates 15–30 percent.

58. See also table 5.2 and OECD (2005e).

59. Gemmell and McGillivray (1998).

60. See Bulir and Hamann (2003, 2005) and Bulir and Lane (2002).

61. World Bank (2005c); Pallage and Robe (2001).

62. OECD (2004b, 2005d). The WP-EFF is a group of bilateral and multilateral donors that formed after the Rome forum to monitor and assist global progress on harmonization and alignment.

63. The countries were Bangladesh, Bolivia, Cambodia, Ethiopia, Fiji, the Kyrgyz Republic, Morocco, Mozambique, Nicaragua, Niger, Senegal, Tanzania, Vietnam, and Zambia. These countries, along with Mali, are associated with the work of the Task Team on Harmonization and Alignment, a subgroup of the WP-EFF. In addition to the preceding 15 countries, South

Africa participates in the Joint Venture on Public Financial Management, another group under the WP-EFF.

64. This is similar, for example, to when donors disagree with specific aspects of partner country policies (such as resettlement policies).

65. The SPA Budget Support survey finds that for Africa as a whole, budget support increased from about \$1.5 billion in 2002 to about \$2.5 billion in 2003.

66. OECD (2004b).

67. IMF and World Bank (2004a).

68. The definition of poverty-reducing spending varies by country, but commonly includes primary education, basic health, and rural development.

69. Some countries are implementing public expenditure management systems to ensure the efficiency of poverty-reducing spending. See IMF and World Bank (2005).

70. IMF and World Bank (2004a).

71. IDA (2004).