Aid, Debt Relief and Development in Africa

African Development Report 2006

African Development Bank

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FOREWORD

The African Development Report this year focuses on the theme of Aid, Debt and Development in Africa. The Report takes an in depth view of issues and looks at the implications for economic growth, poverty reduction, macroeconomic management and governance in Africa. These are not new issues, but they are made topical by the prospects of aid "scaling up" following commitments made during the "Year of Africa 2005".

By augmenting resources for public investment and priority expenditures, aid and debt relief bridges temporarily for the savings and, provided conditions are in place, it not only contributes directly to poverty reduction and the achievement of the Millennium Development Goals (MDGs), but also, if well-targeted, private investment is also stimulated thereby laying a basis of reduced aid dependence in the longer term.

We are learning more everyday about how large aid inflows can be absorbed without compromising macroeconomic stability. We know that long term predictability and presence of a strong macroeconomic environment to some degree addresses this issue.

Concern has been expressed that despite the renewed commitments, debt relief may not be followed by additional aid flows. Political and fiscal constraints in donor countries, make it increasingly difficult to raise official development assistance (ODA) at least to the critical mass required for the MDGs. I am convinced the international community can mobilize energies to overcome these constraints. I welcome nonetheless the Report's attempt to review alternative development financing instruments such as remittances, carbon taxes, the international finance facility, air-ticket levies, global lottery, etc. and assess their potential, taking into account the global trends. Already, in a number of our countries, remittances are beginning to bypass foreign aid and export earnings.

While volume of aid is important, so is its quality. I very much welcome the emphasis in the Report on the importance of implementing the Paris Declaration on Aid Effectiveness underpinned by the principles of ownership, predictability, long term commitments and strengthening the capacity of recipients thereby reducing the transaction costs and boosting capacity of absorption.

In some African countries, external aid now accounts for more than a third of the development budgets, hence the concern about the issue of aid over dependency. While for many countries this level of dependence on external aid may be a fact for the foreseeable future, efforts must be made to step up mobilization of domestic resources as well as accelerating and diversifying exports to provide greater access to foreign exchange earnings, thereby providing increased autonomy and less

reliance on the outside world. It is evident of course that countries, recipients of aid, are diverse in terms of challenges they face. For instance external aid is definitely vital to kick-start and stabilize economies of countries emerging from conflicts.

Over the past decades, the African Development Bank Group has stepped up its role aiming at becoming the premier development financing institution in Africa. By the end of 2005, the Bank Group cumulatively approved over 3,000 loans and grants worth over $55 billion, forty percent of which commitments were financed on concesional terms.

The Bank Group has participated in the enhanced HIPC Initiative and the Multilateral Debt Relief Initiative (MDRI). At end 2005, 24 of the 33 African countries classified as HIPCs were benefiting from such debt relief. Out of a total of US$ 2.3 billion mobilized to finance interim and completion point under enhanced HIPC, a total of US$ 1.7 billion had been delivered. In 2006, the Bank Group approved its participation in the MDRI, of which the total cost is estimated at about US$ 8.5 billion in nominal terms.

But, as we all know, aid and debt relief should only be temporary palliatives. Trade and investment are the keys. I sincerely hope, the impasse in the Doha round can be broken. Doha was, and remains, an historic opportunity to generate prosperity for all and deliver where past multilateral agreements have not done so. Trade is the long term key to Africa's graduation from aid. We are aware that Africa's plight is in part, the result of low trading capacity, high internal barriers and a poor business climate. We, and other partners, are working with our member countries to address the issue of better infrastructure, promoting good governance and sound institutions. But, it remains that, lowering international barriers and subsidies is critical for Africa. We are convinced that a win-win outcome is feasible and can only come from a multilateral agreement, not the asymmetric bilateral arrangements.

The Bank is taking steps to increase the quality of its operations and enhance its effectiveness. This is underpinned by four basic principles; country focus and ownership; greater selectivity; strategic partnership with other development partners and scaling up the knowledge area to provide its members with alternative perspectives in terms of how best to overcome the challenges they face. In this regard, the Bank aims to provide leadership in support of NEPAD, the African Water Initiatives, the Infrastructure Consortium for Africa as well as promotion of good governance and investment climate.

The momentum generated by past reforms in our countries, combined with increased international focus on the development challenges facing Africa, has created new opportunities for the Bank to play an expanded role. It is a role we are repositioning to play. I commend this Report.

Donald Kaberuka
President
African Development Bank

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ABBREVIATIONS

AAPAM	African Association for Public Administration and Management
ADB	African Development Bank
ADF	African Development Fund
AERC	African Economic Research Consortium
APRM	African Peer Review Mechanism
ATM	Automatic Teller Machine
CDF	Comprehensive Development Framework
CMI	Crisis Management Initiative
CPA	Country Performance Assessment
CPIA	Country Policy and Institutional Assessment
CSP	Country Strategy Paper
CTT	Currency Transaction Tax
DAC	Development Assistance Committee
DBSLs	Development Budget Support Loans
DFID	Department For International Development
DSAs	Debt Sustainability Analyses
DSF	Debt Sustainability Framework
EDA	Effective Development Assistance
ESW	Economic and Sector Work
EU	European Union
FDI	Foreign Direct Investment
FX	Foreign Exchange
G8	Group of 8 countries
GDP	Gross Domestic Product
GMM	Generalized Method of Moments
HAMfR	Harmonization, Alignment and Managing for Results
HIPC	Heavily Indebted Poor Countries
HPI	Human Poverty Index
ICOR	Incremental Capital-Output Ratio
ICT	Information & Communications Technologies
IDA	International Development Association
IDS	International Development Statistics
IEO	International Evaluation Office
IFF	International Finance Facility
IFIs	International Financial Institutions
IMF	International Monetary Fund
MCA	Millennium Challenge Account

MDB	Multilateral Development Bank
MDGs	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MENA	Middle East and North Africa
MTEF	Medium Term Expenditure Framework
MTOs	Money Transfer Organisations
NEPAD	New Economic Partnership for Africa's Development
NGOs	Non Govermental Organisations
NTF	Nigeria Trust Fund
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PAF	Poverty Action Fund
PCCF	Post-Conflict Country Facility
PIUs	Project Implementations Units
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
RAS	Regional Assistance Strategies
RBCSPs	Result-Based Country Strategy Papers
RBM	Results-Based Management
RMCs	Regional Member Countries of the ADB
SAP	Structural Adjustment Plan
SDR	Special Drawing Rights
SIDA	Swedish International Development Agency
SIPs	Sector investment programs
SSA	Sub-Saharan African
SWAPs	Sector-Wide Approaches
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
US	United States of America
USAID	United States Agency for International Development
VAT	Value Added Tax
WIDER	World Institute for Development Economics
WTO	World Trade Organisation

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CHAPTER 1

An Overview of Aid, Debt Relief, and Development in Africa

Introduction

By all accounts, the dependence of African economies on aid[1] is significant and has intensified with time. Total commitments made by development assistance committee (DAC) members to African economies declined sharply in the 1990s[2] but rose again—from $17.3 billion in 1990 to $34.2 billion in 2004. During the past three decades, Africa has cumulatively received more than $500 billion in aid from the international community. The estimated new official development assistance (ODA) that Africa can effectively use in both infrastructure and human development ranges from $14 billion to $18 billion per year for 2006–2008. This amount is expected to rise to $24 billion to $28 billion by 2015 (Gupta et al. 2006).

The industrialized world appears to be more sympathetic to increasing aid now than it was a decade earlier. During its 2005 summit in Gleneagles, the G8 agreed, among other things, to commit an additional $25 billion in annual aid to Africa by 2010 and to give Africa substantial debt relief. Because several years of aid have hardly transformed African economies, the last decade has seen a rise in the number of debates about the effect of increased aid on Africa. It is often argued that large volumes of aid have not prevented Africa from having the slowest per capita income growth in the world.

Not surprisingly, the past decade has seen a considerable increase in the number of studies on whether, and how, aid and debt relief affect economic growth and development. Recent developments in this discussion stem from changes in the environment for giving aid and other relief. This environment changed as the rationale for giving aid became less complicated with the end of the cold war and the entrance of new players on the donor scene. Indeed, relationships between donors and recipient governments are no longer simply motivated by the cold war or by the parameters of old colonial alliances that shaped bilateral aid for many years. Similarly, the bilateral-multilateral aid "dichotomy" has undergone a considerable transformation in different countries as bilateral donors have developed closer relationships with multilateral institutions in the pursuit of reform. Donor-recipient interactions are now dominated by new networks motivated by fresh geo-political and economic interests on both sides, leading, for example, to the emergence of Japan as one of the most important donors in Africa today.

[1] Aid refers to official development assistance in this paper.

[2] Aid transfer per capita fell from $32 in 1990 to $19 in 1998 (World Bank 2002).

As the aid environment became less complicated, aid flows to poor nations began to decline and the questioning of aid became more common in the 1990s. As the non-economic reasons for providing aid decreased, the impetus for defensive lending also declined. Indeed, as questions arose about why donors give aid, the pressure to justify the giving of aid mounted, and the studies that followed appeared to justify the continued giving of aid or its discontinuation. Growing talk of "aid fatigue" and "aid dependency" led to more studies on the impact, if any, of aid on the development of poor nations. If aid did indeed have an impact on development, it was considered important to understand the processes and the conditions under which it occurred.

Efforts to understand the impact of aid have led to keen discussions about what constitutes aid effectiveness and how it can be assessed. Studies of aid effectiveness have changed from the traditional evaluation of direct project outcomes and aggregations of these to a more comprehensive assessment of the long-term sustainability of resource flows within countries as a result of aid, while improving human development. The focus has also shifted from whether aid fills a necessary financing gap to achieve particular growth rates to whether the economies of recipient nations can perform better in future and harness domestic resources more effectively because of current inflows of aid. While questions may persist about the need for countries to eventually wean themselves from aid, the tendency is to view aid as a critical resource that should increasingly help transform economies.

The most well-known studies in the new aid effectiveness debate are probably those associated with World Bank economists. These studies were the first to suggest a weak link between economic growth and aid, especially in poor policy environments (Burnside and Dollar 1997). A World Bank official report was the second to suggest that the link between aid and policy reform is unclear, and that aid will nurture policy reform primarily in a relationship where aid is provided in the form of ideas rather than in the form of money (World Bank 1998). Collier and Dollar (2000) took the discussion a step further, stating that the link between conditionality and policy reform is very weak at best. Their position is based, first, on studies that review the effectiveness of conditionality (Moseley et al. 1995; Collier, 1997; Dollar and Svensson 1998); second, on studies of the impact of aid (Devarajan, Dollar and Holmgren 1999), and third, on econometric work on the impact of aid (Alesina and Dollar 2000). In sum, while aid works best in environments with appropriate policies that boost growth and development, there is little evidence that most aid and the associated conditionalities have facilitated an effective policy reform process in recipient countries. As a result of the preceding studies, a number of works have contested the validity of the conclusions drawn[3], sometimes disputing the underlying econometric work Hansen and Tarp, 2001).

[3] See Berg (2002) for a detailed summary of studies that challenge the policy implications of the World Bank studies.

At the beginning of this decade, the reports on the weak link between aid and policy reforms seemed to have a significant impact on the official discussion about the future of the donor-recipient aid relationship (Hansen and Tarp 2001). Indeed, the main policy outcome of that effort was a new emphasis on greater selectivity in allocating aid to countries and a move away from conditionality as a means of fostering policy reform. In this regard, Collier and Dollar (2001) suggest that "since the overall allocation of aid has been indiscriminate with respect to policy, it should come as no surprise that aid has had no systematic effect on policy. If donors change their allocation rule and begin to favour policy, then of course it may have an influence. If the allocation rule changed from something previously unobserved, then of course past experience can provide no guidance as to the likely impact on policy" (pp.540).

Recent improvements in aid and debt relief flows to Africa as a result of the Gleneagles summit and other initiatives have not put paid to questions about whether scaling up aid would lead to longer term sustainable development. However, the environment within which aid and debt relief have been premised on earlier policy outcomes, as implied by the Heavily Indebted Poor Countries' (HIPC) Initiative, indicates the increasing selectivity that has crept into current arrangements. Nevertheless, a number of crucial questions still need to be considered before new ways of allocating aid are fully adopted. In particular, it is unclear whether greater selectivity should be a substitute for conditionality, following earlier criticisms of poorly structured conditions. This is even more so as many case studies show evidence of clear links between *ex-post* policy reform and aid (Devarajan, Dollar and Holmgren 1999).

Sachs (1994) suggests that aid supports policy reform in some cases and sustains poor policy in others. Indeed, the case study approach used by Devarajan, Dollar, and Holmgren (1999) was intended to elicit the conditions that bring about these different outcomes in different countries. While this approach has led to a more nuanced discussion of the relationship between aid and policy in different countries, the attempt to draw an all-embracing set of conclusions on the impact of conditionality on the policy process appears to be over-extended. Devarajan, Dollar, and Holmgren agree that conditionality brings significant policy reform in some countries, but they argue that "conditionality is also less useful once a country has achieved sustained good policy, as in the case of Ghana and Uganda". (p.35). Clearly, a number of questions remain about what makes aid and other forms of assistance effective and about how these should be reflected in aid policy.

Questions also remain about how aid and other assistance affect the capability of African governments to manage their economies and the capacity of these economies to absorb more aid. In this regard, there is a growing view that aid absorption in the new development environment should not pose an insurmountable problem. Another crucial issue

that must be addressed is why some countries absorb aid better than others do.

This chapter provides a comprehensive assessment of the volumes, sources, and destinations of aid and of debt relief. Itattempts to tease out the justification for the provision of assistance, including the political economy of aid. The chapter also assesses the relationship between official assistance and growth and development. It also reviews aid and debt relief management institutions, assessing donor-recipient relationships, including coordination, the capacity of local institutions, and how they are managed in different countries for specific outcomes. It will try to determine whether aid and debt relief have facilitated development in Africa.

The Magnitude, Sources, and Destinations of Aid Flows to Africa

The primary objective of aid, according to early literature on the subject, was to bridge the gap between a country's investment targets and its domestic savings. Aid was also expected to bridge the foreign exchange gap in import-dependent economies. Given that most African economies are dependent on low-income agriculture and continue to export a narrow range of primary commodities with low exchange values, it is easy to see how financing gaps originate. Largely because aid was expected to fill a foreign exchange gap in facilitating imports, not surprisingly, a lot of aid to Africa over the years has been tied. Table 1.1 shows the total amount of ODA commitments from all OECD donors to Africa and the total amount of tied aid from 1990 to 2004.

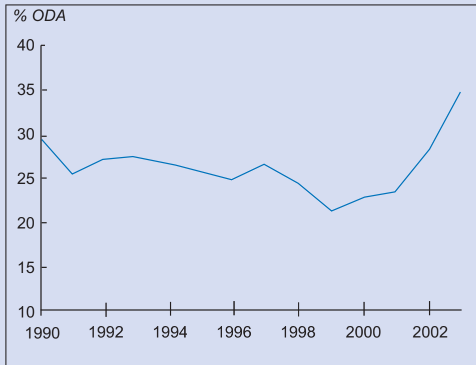
Table 1.1: Total ODA Commitments from All Donors to Africa, 1990–2004

Year	Total Commitment ($ million)	Amount Tied ($ million)	Amount Partially Tied ($ million)
1990	17,352.3	5055.5	1093.5
1991	21,979.0	6177.2	332.6
1992	18,940.9	4288.1	1683.5
1993	16,110.5	3214.7	1012.4
1994	14,911.5	2847.3	624.1
1995	15,143.7	3154.6	561.4
1996	15,067.3	3079.3	919.6
1997	13,924.7	2861.8	1175.6
1998	18,280.5	3269.2	1352.6
1999	16,502.1	732.7	1025.7
2000	19,613.9	666.8	1152.9
2001	17,957.0	561.7	1056.9
2002	22,067.6	483.6	862.5
2003	30,896.0	781.0	4121.6
2004	34,284.4	913.1	3980.9

Source: IDS, OECD Development Assistance Committee

According to the *Global Development Finance* (World Bank, 2005), the percentage of ODA disbursed to sub-Saharan Africa increased between 1998 and 2003 (see Figure 1.1). Over this 5-year period, sub-Saharan Africa received 60 percent of increases in ODA disbursements, raising its share of total ODA disbursements by DAC donors from 24 percent to 34 percent. However, most of these funds were allocated to countries in post-conflict situations. It is projected that more of the new development assistance could be directed to African nations that

Figure 1.1: Percentage of Total DAC/ODA Disbursed to Sub-Saharan Africa, 1990–2003

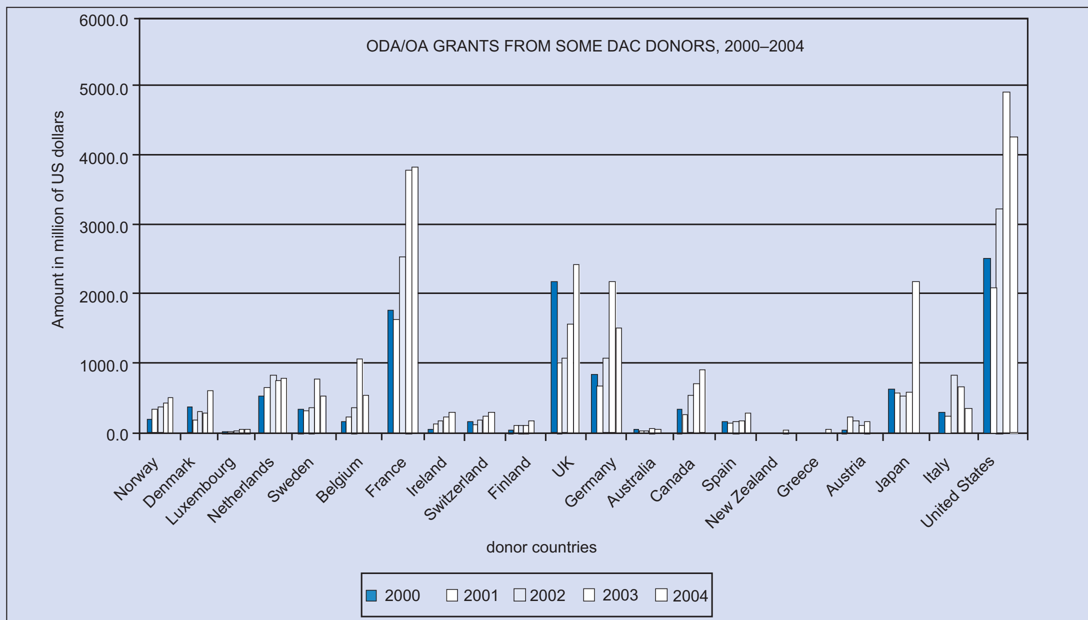


Source: OECD Development Assistance Committee.

govern justly, invest in their own people, and also promote economic freedom.

African countries receive aid from diverse sources and there is often a discrepancy between commitments made by donor countries and their actual disbursements. Indeed, this disparity is often blamed on the recipient country's poor absorptive capacity or on its inability to meet various conditions. Figure 1.2 shows that between 2003 and 2004, the United States made the largest ODA commitment to developing countries in Africa — accounting for 15.6 percent of total commitments to Africa. The second largest commitment was made by France,

Figure 1.2: ODA Commitments from Selected DAC Donors to Africa, 2000–2004



Source: OECD, IDS

Table 1.2: Aid Destinations in Africa

Country	Year					
	2000	2001	2002	2003	2004	2005
Algeria	154.9	175.1	178.9	238.5	299.6	–
Angola	179.3	242.9	382.2	534.4	355.8	73.4
Benin	140.0	128.1	146.6	353.1	366.3	36.4
Botswana	13.5	30.9	61.3	56.4	40.5	–
Burkina Faso	250.1	251.1	384.7	493.1	429.4	32.7
Burundi	45.3	77.4	159.3	195.3	390.1	9.2
Cameroon	424.6	405.1	451.3	854.1	677.7	3.7
Cape Verde	62.9	68.8	66.6	102.6	103.8	–
Central African Republic	105.6	55.2	48.3	131.6	75.8	10.6
Chad	122.0	74.3	84.1	254.6	240.9	–
Comoros	24.8	13.5	12.6	15.1	25.5	–
Congo DR	86.0	251.3	519.1	5201.3	1678.6	62.9
Congo — Rep.	40.7	54.1	94.5	49.9	139.0	–
Cote d'Ivoire	598.4	178.7	779.9	395.6	302.2	0.4
Djibouti	46.1	34.3	51.7	75.4	43.5	7.3
Egypt	1729.1	1002.1	1192.1	856.3	1254.2	3.7
Equatorial Guinea	33.2	18.2	15.3	20.5	46.6	4.4
Eritrea	52.5	151.6	116.0	253.6	179.6	8.5
Ethiopia	677.7	510.0	721.8	1458.9	1701.1	260.6
Gabon	92.9	55.3	107.7	114.4	73.2	–
Gambia	13.3	22.5	8.0	20.0	41.1	3.2
Ghana	467.4	361.5	427.3	904.1	1977.6	123.0
Guinea	214.7	177.1	185.1	170.9	207.0	4.2
Guinea-Bissau	27.7	37.7	58.5	100.4	50.4	–
Kenya	191.6	352.8	252.1	510.9	693.0	106.9
Lesotho	30.2	50.1	38.4	77.2	56.2	–
Liberia	87.6	43.0	49.6	164.3	265.5	3.7
Libya	0.8	–	–	–	–	–
Madagascar	385.7	185.8	200.4	476.9	931.3	87.0
Malawi	400.3	222.2	367.2	385.3	364.8	234.2
Mali	315.4	299.7	318.6	461.0	610.5	84.5
Mauritania	131.4	92.8	169.6	206.3	214.6	30.1
Mauritius	41.6	18.0	23.3	51.2	20.0	–
Mayotte	1.3	115.9	127.1	168.5	209.8	–
Morocco	438.6	389.5	426.1	526.0	687.2	3.7
Mozambique	641.8	781.1	1892.3	935.3	852.4	59.7
Namibia	131.0	84.9	74.3	128.9	197.4	–
Niger	171.4	157.4	194.5	474.1	421.9	34.0
Nigeria	65.3	240.3	274.1	353.3	881.3	11.7

Table 1.2: *cont.*

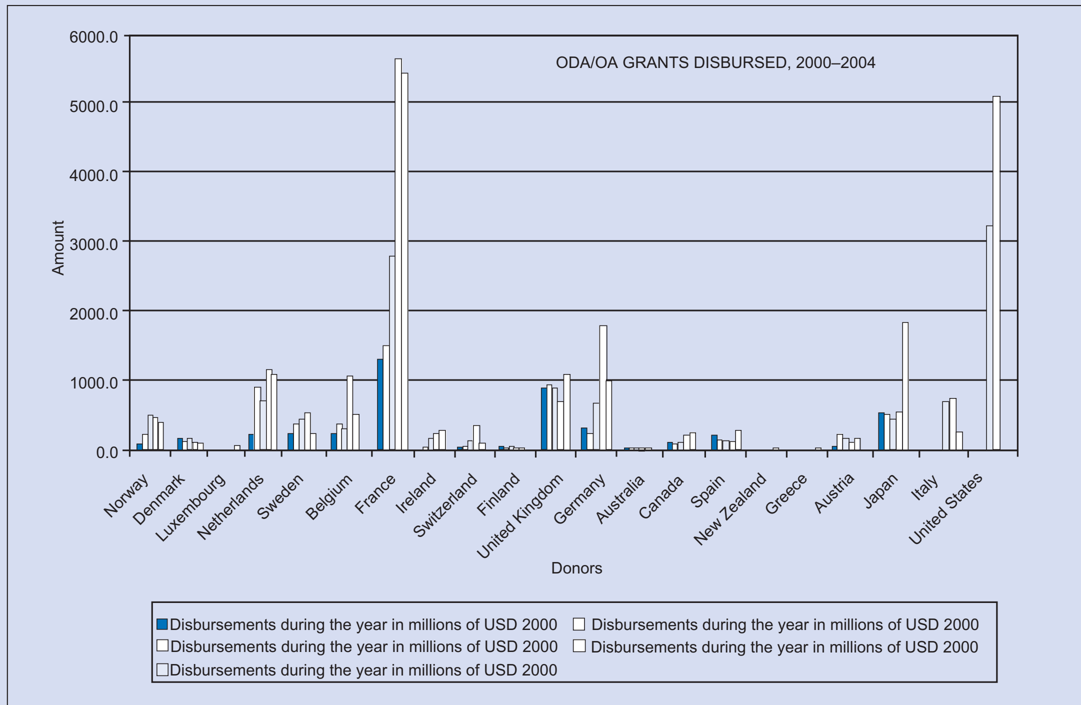
Country	Year					
	2000	2001	2002	2003	2004	2005
Rwanda	269.5	141.0	227.4	528.9	255.7	36.2
Sao Tome & Principe	7.5	19.5	23.1	25.6	39.4	1.9
Senegal	310.8	267.7	322.0	327.4	920.5	118.3
Seychelles	9.0	6.8	4.1	6.0	7.6	–
Sierra Leone	71.8	211.2	183.6	384.2	314.2	24.0
Somalia	46.8	104.5	140.2	248.6	172.2	18.2
South Africa	385.2	403.5	476.1	645.7	546.8	18.1
St. Helena	0.5	1.9	14.1	13.3	6.1	159.2
Sudan	210.2	176.9	264.1	378.3	1156.9	151.7
Swaziland	17.4	6.6	19.9	56.6	14.9	16.4
Tanzania	850.9	1022.5	1123.6	1159.3	1238.6	286.2
Togo	97.9	43.1	61.4	87.2	57.1	17.6
Tunisia	84.4	178.3	178.7	190.4	186.0	–
Uganda	553.1	339.1	402.2	924.8	1247.1	176.6
Zambia	400.1	261.7	477.9	968.6	872.7	255.7
Zimbabwe	219.7	115.1	222.8	188.2	160.6	25.9

Source: OECD, IFD

with 12.3 percent of the total commitment in 2003. Other major DAC donors to Africa include the United Kingdom, Germany, and Japan. Available figures from DAC countries show that ODA commitment to Africa from DAC countries declined rapidly in 2005. Some of the countries that have benefited from significant shares of aid include Ethiopia, Malawi, Tanzania, and Zambia (Table 1.2). Although the United States made the highest commitment, Figure 1.3 shows that actual ODA grants disbursed to Africa by France were the highest and that there were no disbursements from the United States in both 2000 and 2004. The United Kingdom also disbursed only about half of its commitments over the same period.

Considerable aid has been directed to most African countries during the past decade. It is unclear why donors commit and disburse particular amounts of aid to specific countries. The assumption in the general current literature is that donors provide aid out of concern about poverty (Wood 2006). These donors use a number of yardsticks to determine which environment is most likely to facilitate a significant reduction in poverty after receiving aid. This explains the recent emphasis on good governance in countries as a condition for receiving aid. Most donors perceive African

Figure 1.3: ODA Grants Disbursed by Selected DAC Countries



countries as corrupt and unlikely to put aid to good use. In some instances, donors have withheld aid to countries whose domestic policies are considered unacceptable and unlikely to facilitate growth and poverty reduction. A case in point is Zimbabwe, where western countries and the Bretton Woods institutions have withheld support because of their strong opposition to the political regime. In 2000, the International Monetary Fund (IMF) and the World Bank withheld official disbursement of the Poverty Reduction and Growth Facility (PRGF) to Kenya after the country's High Court ruled that the Anti-corruption Authority, created three years earlier, was unconstitutional (Ong'wen 2001).

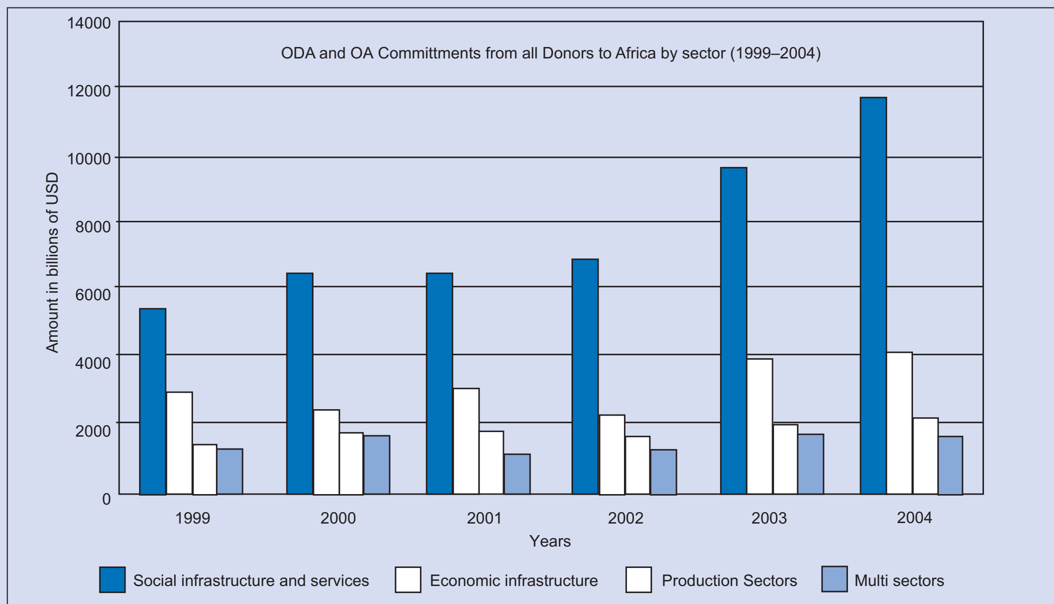
Despite the growing sense that aid is intended to promote growth and development, thereby reducing poverty, there is considerable scepticism about this motive. The old arguments about geo-politics, commercial interests, and so on still prevail. Aid is seen more as a foreign policy instrument and also as an instrument to further donors' self-interest (Nyamugasira 2000; Gunning 2005). Indeed, the suggestion that the United States, Japan, and European

nations have political and security motivations for giving aid ties in with the arguments by Alesina and Dollar (2000) that the amount of aid that a country receives depends more on political and strategic considerations than on its economic needs and policy performance. Alesina and Dollar found that strategic considerations, such as a country's colonial past, were a contributory factor in determining aid receipts and that colonial ties were still important in determining foreign aid receipts. They observed that while more open and more democratic countries receive more aid, aid is also sometimes used by a small number of countries to "buy" political support at the UN.

It is interesting that Ghana became one of the major recipients of aid during the last decade, and, indeed, the largest recipient in 2004 (in absolute dollar terms). Many donors often associate this fact with continuing reforms, much in line with what has become the new orthodoxy in poverty reduction, as captured by a poverty reduction strategy. Increasing aid to Ghana may be seen as a reward for good behaviour manifested through continuing policy reforms.

Apart from the variation in aid flows by country, flows to different sectors also vary. Figure 1.4 shows that the social infrastructure and services sector has attracted the most aid from donors. A large part of

Figure 1.4: ODA Commitments from all Donors to Selected Sectors (1999–2004)



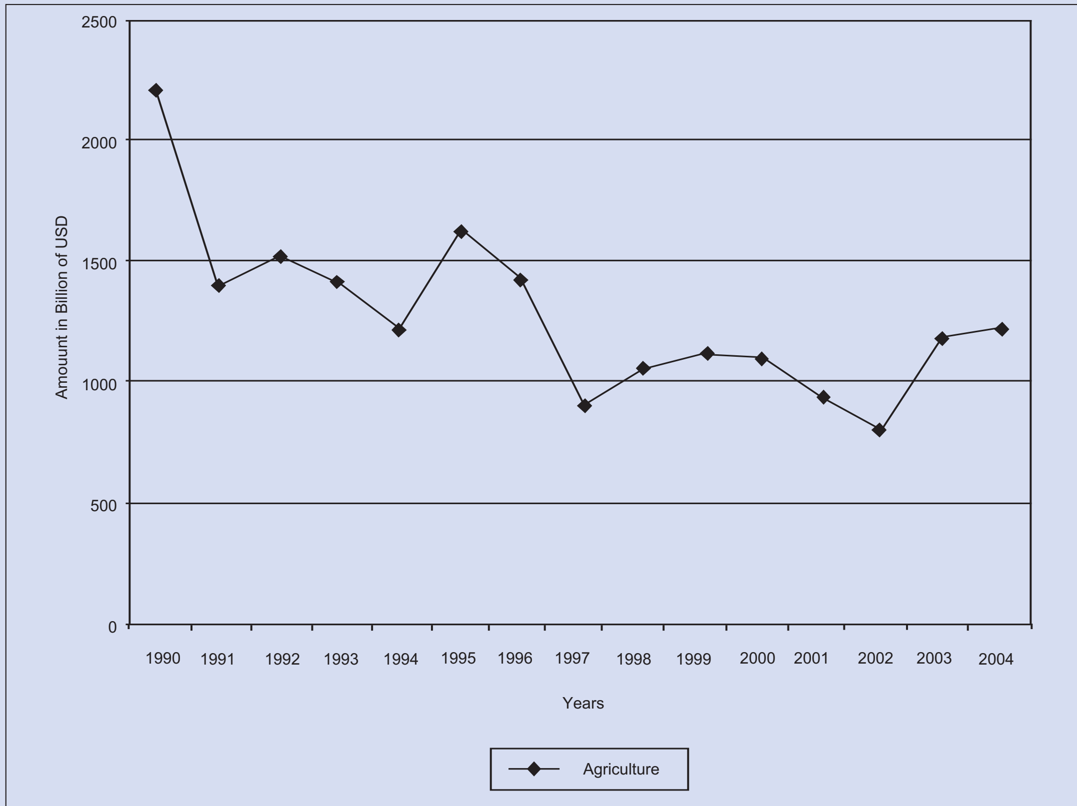
Source: OECD, IDS

the allocation to social infrastructure goes to education — these allocations rose steadily between 2000 and 2003, then dropped marginally in 2004. There were no major changes in the allocation to health during the period. Indeed, education received more than twice the aid allocated to health. Allocations for general budget support, commodity aid, and general programs, as well as economic infrastructure were also sizeable but did not see much growth during the period as the flows fluctuated considerably. Indeed this has been the trend since 1990. Figures 1.5 and 1.6 show the trend in aid commitments from all donors to the basic health

Figure 1.5: Total Aid Commitment to Africa for Basic Health (1990–2004)

Source: OECD, IDS

Figure 1.6: Total Aid Flow from all Donors to the Agriculture Sector (1990–2004)



Source: OECD, IDS.

and agriculture sectors, respectively, in Africa.

In light of global efforts to achieve the Millennium Development Goals (MDGs), see Box 1.1, it is surprising that aid allocation to the health sector declined after 2003. This may also be seen against the backdrop of increasing flows to global health programs. Tension is definitely growing between aid to African countries and aid to global initiatives.

Flows to the agriculture sector also declined until 2002 before witnessing a sharp rise that was only short-lived. In general, since the shift from large project support, donors have been less interested in the direct production of goods and services; this explains why it has not

Box 1.1: The Millennium Development Goals

The International Development Goals of the 21st Century, adopted by the global development community and developing countries, sets targets for "poverty reduction, education, health, gender equality, and environmental sustainability by 2015". In total, there are 8 goals and 18 targets, as follows:

1. *Eradicate extreme poverty and hunger*
   - Halve the proportion of people whose income is less than one dollar a day by 2015;
   - Halve the proportion of people who suffer from hunger by 2015;
2. *Attain universal primary education in all countries by 2015*
   - Ensure children of both sexes everywhere will be able to compete a full course of primary education;
3. *Promote gender equality and empower women*
   - Eliminate gender disparity in primary and secondary education, preferably by 2005, and at all levels of education no later than 2015;
4. *Reduce child mortality*
   - Reduce by two-thirds under-five mortality by 2015;
5. *Improve maternal health*
   - Reduce by three-quarters the maternal mortality ratio by 2015;
6. *Combat HIV/AIDS, malaria and other diseases*
   - Halt by 2015, and begin to reverse the spread of HIV/AIDS;
   - Halt by 2015, and begin to reverse the incidence of malaria and other major diseases;
7. *Endure environmental sustainability*
   - Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources;
   - Halve by 2015 the proportion of people without access to safe drinking water;
   - Achieve a significant improvement in the lives of at least 100 million slum dwellers by 2020;
8. *Develop a global partnership for development*
   - Develop further an open, rule-based, predictable, non-discriminatory trading and financial system;
   - Address the special needs of the least developed countries;
   - Address the special needs of landlocked and small island developing States;
   - Deal comprehensively with developing countries' debt problems through national and international measures to make debt sustainable in the long term;
   - In cooperation with the developing countries, develop decent and productive work for youth;
   - In cooperation with pharmaceutical companies, provide access to affordable essential drugs in developing countries;
   - In cooperation with the private sector, make available the benefits of new technologies — especially information and communications technologies.

Source: ADB (2006), *Annual Report 2005* (Tunis ATR: ADB Group)

featured much in the poverty reduction strategies of African countries.

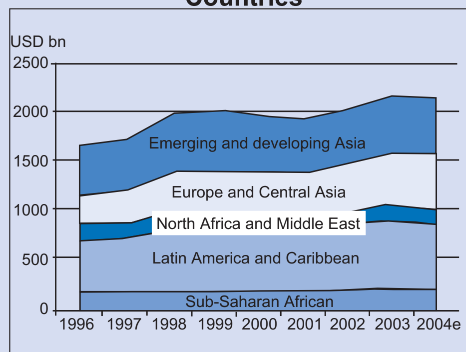
Debt and Debt Relief for Africa in Perspective

Debt relief for Africa has managed to find its way onto the agenda of most major international meetings that discuss global development, including meetings of the G8 countries. Debt relief for impoverished nations was one of the most urgent issues on the minds of leaders at the UN Millennium General Assembly. Largely because of pressure from a consortium of NGOs, governments, and several humanitarian international agencies, considerable attention has been focused on debt relief in different forms, including debt cancellation. However, inasmuch as debt relief now figures on the agenda of meetings, the resulting initiatives, if any, are often perceived as inadequate in view of the magnitude and scope of debt problems.

Africa's debt burden has been a major obstacle to its prospects for increased savings and investment, economic growth, and poverty reduction. The continent's debt overhang has inhibited public investment in physical and social infrastructure. It has also hampered private investment, as investors could not be assured of policy continuity in an environment marked by severe external imbalances. There is now a consensus that a permanent solution to the external debt crisis is critical to sustainable growth and development and to meeting the development challenges facing the African continent, including the MDGs, in particular, that of halving poverty by 2015.

High debt stocks and high interest rates have combined with increasingly adverse terms of trade to make debt service unmanageable for Africa since the 1980s. Despite repeated debt rescheduling facilities, the total external debt of sub-Saharan Africa rose 175 percent, from $84.1 billion in 1980 to $231.4 billion in 2003. African debt is smaller in magnitude and grew more slowly during the last decade than the debt of South East Asia (see Figure 1.7). However, there is much difficulty in debt management in Africa, as reflected by its higher debt burden. While the present value of debt as a proportion of the exports of goods and services exceeded 200 percent for most African countries in the 1990s,for Malaysia, it was only 33.6 percent in 1995, and for Thailand, 77.6 percent. Also, most African debt (77.5 percent) is long-term debt and 74 percent of it is public; the problem is worsened by the

Figure 1.7: Medium-and Long-Term Debt of Developing and Emerging Countries



Source: World Bank, Global Development Finance

capitalisation of interest and principal arrears. These comprise almost 25 percent of the current total external debt.

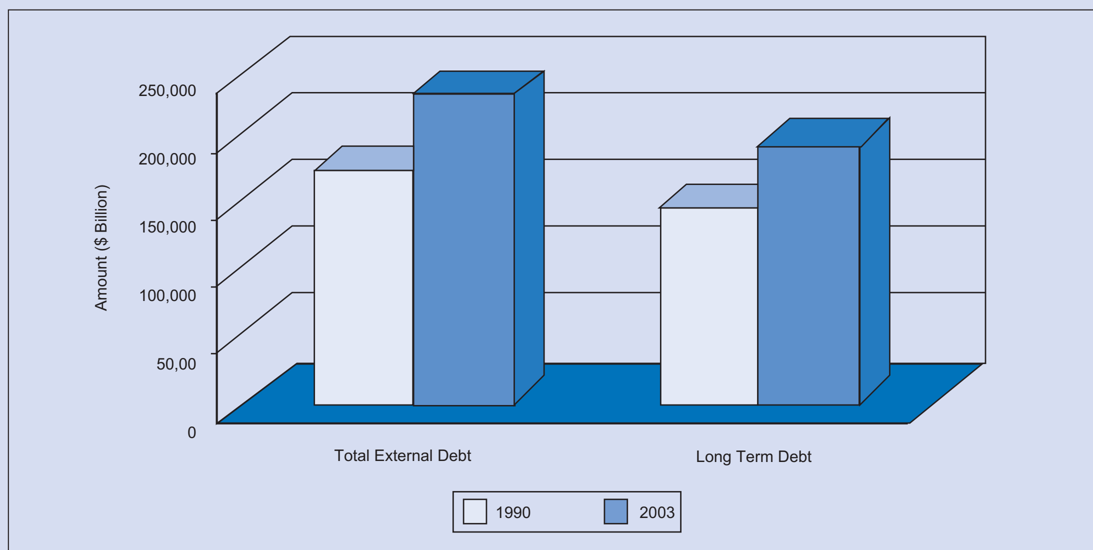
Current Trends in External Debt of African Countries

As stated earlier, Africa's total external debt stock, which was US$84.1 billion in 1980, jumped to US$165 billion in 1988 and then to US$190.2 billion in 1990. By 1995, Africa's total external debt stock amounted to US$223.3 billion, increasing to $231.4 billion by 2003 (World Bank, WDI 2005). With the rapid build-up of external debt and the poor economic performance of the domestic economies, Africa's debt crisis has deepened and its debt burden has become even more crushing. Figures 1.8 and 1.9 present an overview of the debt situation in Africa.

Africa's total debt service on long-term debt rose from US$6.4 billion in 1980 to US$12.3 billion in 1990 and then dipped to US$8.8 billion in 1995 — due largely to rescheduling and some amount of debt forgiveness. The debt service ratio (measured by the ratio of actual debt service payments to exports of goods and services), a mere 5.4 percent in 1970, jumped to 21.3 percent in 1985 before falling to 14.7 percent in 1995. It further decreased to about 12 percent in 2000, remaining at that level for the next three years.

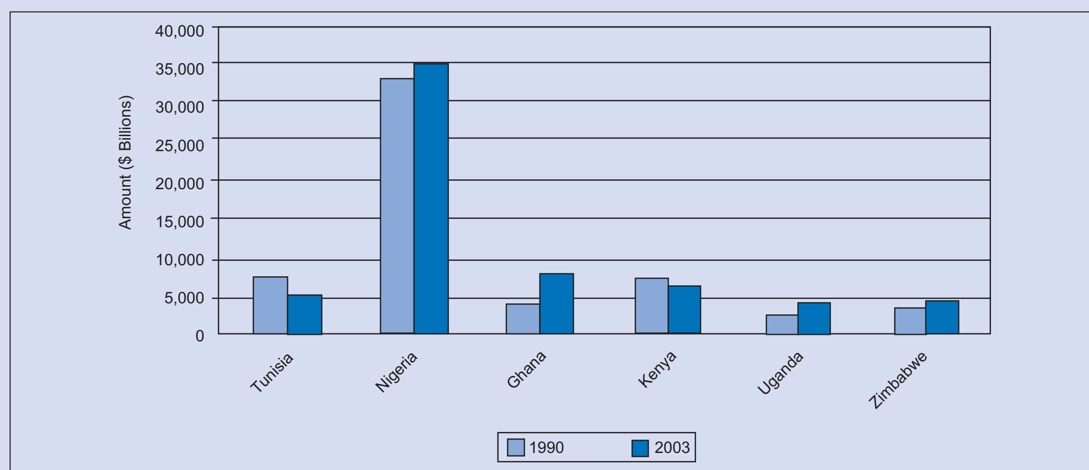
However, debt relief under the HIPC Initiative and bilateral debt cancellation

Figure 1.8: Total External Debt and Long-Term Debt of African Countries in 1990 and 2003



Source: World Development Indicators, 2005

Figure 1.9: Total External Debt of Selected African Countries in 1990 and 2003



Source: World Development Indicators, 2005

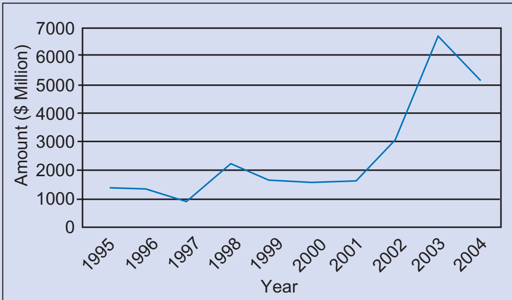
measures have helped improve the external debt situation in Africa as a whole. The external debt declined from a peak of 74 percent of GDP in 1994 to 48 percent of GDP in 2003. In general, flows (largely official debt disbursements) to African countries have fluctuated from $21 billion in 1993, for example, to $13.5 billion in 1998 and $16.0 billion in 2002. Figure 1.10 shows the trend in total debt forgiveness grants from DAC countries from 1995 to 2004. The amount of debt forgiveness grants rose sharply from 2001 to 2003, then fell slightly in 2004. Figure 1.11 shows that France has consistently accounted for the highest amount of debt forgiveness grants given to African countries.

Debt Relief in Practice: The HIPC and MDRI Initiatives

The HIPC Initiative

In 1996, the international financial community accepted the need for a comprehensive approach to the debt problems of the poorest low-income countries. The first major coordinated effort in this respect was the launching of the Heavily Indebted Poor Countries' (HIPC) Initiative by the international financial institutions (IFIs), led by the World Bank and the IMF. The Initiative was launched in response to concerns that many low-income countries would face unsustainable external public debt burdens even after receiving traditional debt relief. Against this background, the goal of the HIPC Initiative

Figure 1.10: Total Debt Forgiveness Grants from DAC Countries (1995–2004)

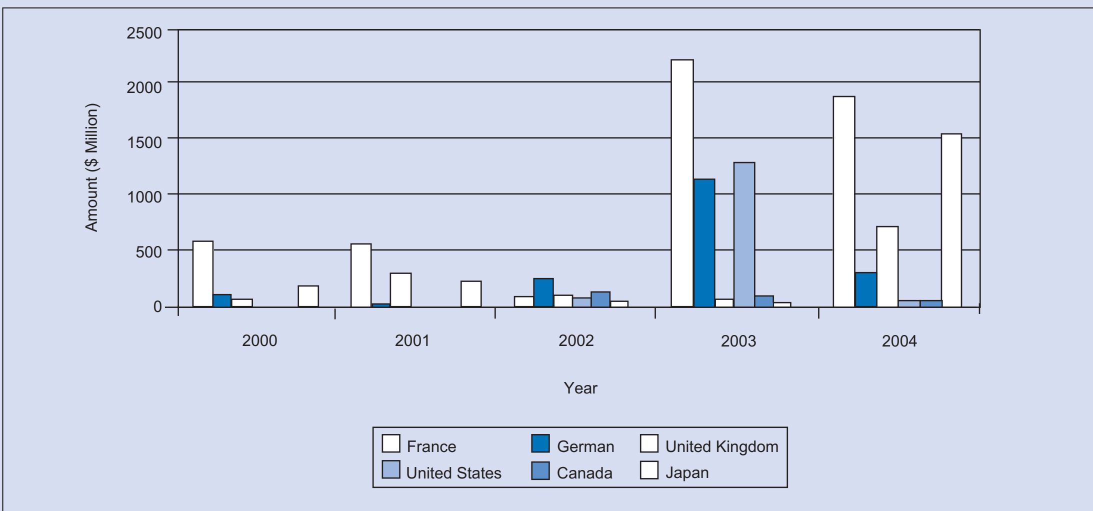


Source: Joint BIS-IMF-OECD-World Bank statistics on external debt

was to reduce the external public debt burden of all "eligible" HIPCs to sustainable levels in a reasonably short period of time. The Initiative sought to make it possible for all designated HIPCs to meet their "current and future external debt service obligations in full, without recourse to debt rescheduling or the accumulation of arrears, and without compromising growth" (IMF and World Bank, 2001a, p. 4).

The HIPC initiative, however, raised a number of questions in the development community, and, after a series of consultations with various stakeholders by the Bretton Woods Institutions, the HIPC debt relief initiative was enhanced in 1999. The enhanced HIPC was expected to provide deeper and faster relief and to help fight

Figure 1.11: Total Debt Forgiveness Grants from Selected Countries (2000–2004)



Source: Joint BIS-IMF-OECD-World Bank statistics on external debt

poverty. One of the basic principles of the enhanced initiative is that the resources released should be in addition to other existing resources being provided, including aid. Because the enhanced HIPC Initiative aims to expedite poverty reduction, recipient countries are expected to adjust macroeconomic policies to accommodate the resources freed by debt relief. (See Box 1.2 for the features of the enhanced HIPC Initiative.) Indeed, the implementation of the HIPC Initiative has helped free up fiscal resources from debt service; these resources will be used to increase essential poverty reducing expenditures, including basic health, education and rural infrastructure. It is estimated that 80 percent of the relief received by African countries is allocated to poverty-related spending (Elbadawi and Gelb, 2003).

Box 1.2: Features of the Enhanced HIPC Initiative

The enhanced HIPC Initiative (1999) modified the 1996 HIPC Initiative in two ways. First, the enhanced initiative provides deeper, broader, and faster debt relief by (a) qualifying countries for relief when the net present value of debt to exports ratio reaches 150 percent. Previously, this ratio was 200–250 percent at the initiative's completion point; (b) commencing debt relief from the decision point, with irrevocable relief to be delivered at the completion point. Previously, relief from multilateral debt service began only at the completion point; (c) basing the length of the interim period on achieving key development actions rather than on a pre-specified period.

Second, the enhanced HIPC Initiative is expected to link debt relief to poverty reduction programs by (a) grounding debt relief — and indeed all assistance from the IFIs — on poverty strategies to be developed by each country through a consultative process and to be agreed in the Poverty Reduction Strategy Paper (PRSP); and (b) clearly monitoring the use of the resources freed through debt relief — particularly how they are reflected in spending on key elements of the poverty reduction programme, as well as the results of the programme.

Source: World Bank, *Can Africa Claim the 21st Century?* (Washington DC: World Bank, 2000: 250).

Multilateral Debt Relief Initiative (MDRI)

To improve the long-term debt sustainability of many developing countries, additional debt relief is needed to augment resources for MDG financing. In light of this, at its July 2005 summit in Gleneagles the G8 proposed a new debt relief initiative that would leadto a 100 percent cancellation of debt owed to the World Bank's IDA, the IMF, and the African Development Fund (ADF). The G8 proposal, widely known as the Multilateral Debt Relief Initiative (MDRI), applies only to countries that reach their completion points under the enhanced HIPC Initiative. The aim of the MDRI is to deepen the HIPC debt relief process by providing more resources to help all poor countries make substantial progress towards the MDGs. This proposal could result in total debt forgiveness of at least $57 billion, to be covered, dollar for dollar, by donor payments to the IDA and the ADF, and mostly by internal resources,

Box 1.3: The Multilateral Debt Relief Initiative and "Free-Riding" Risks

The MDRI provides for post-HIPC irrevocable debt stock cancellation and hence will significantly lower debt stock burdens for debt relief recipient countries. Because of this relief, which is in addition to HIPC debt relief already committed, the debt stock ratios in most of the recipient countries will be significantly lower than that of many middle-income countries, which primarily borrow on nonconcessional terms. This will increase the risk of "free-riding" — situations, in which nonconcessional lenders indirectly obtain financial gain from debt forgiveness, grants, and concessional financing activities of IFIs. This situation may lead to an excessive build-up of debt unless nonconcessional borrowing is carefully managed.

Lower debt ratios alone would not necessarily lead to changes in commercial risk ratings for these countries as other factors such as political risk would also be considered. However, credit rating agencies have been paying attention to this new reality, and Standard and Poor's (S&P) announced its plan to assign sovereign debt ratings for many post-MDRI countries. Following a 2002 initiative by the United States to encourage African countries to apply for sovereign debt credit ratings so as to boost African participation in capital markets, several sub-Saharan African countries obtained ratings: Burkina Faso, Cameroon, Madagascar, Mali, and Mozambique were issued ratings by S&P in 2004. Ratings represent a move toward transparency; they will help markets evaluate risk and can help attract private investors.

Although increased FDI would be welcome in MDRI countries, lower debt stock ratios may result in a higher risk in the next few years that the fiscal space freed up by debt relief could be filled with new nonconcessional sovereign borrowing. This raises concerns for the long-term development of the MDRI-recipient countries, as excessive amounts of nonconcessional borrowing could potentially erode the benefits of the debt relief provided by multilateral creditors, namely sustainable debt burdens and additional fiscal space to support achievement of the MDGs. Most MDRI recipients, especially the post completion point HIPCs, have had low and infrequent nonconcessional borrowing, most notably since the original HIPC Initiative was announced. In addition to the discipline imposed by the IMF arrangement itself, a condition of HIPC assistance, continued high debt burdens, and the likelihood of countries benefiting from HIPC and future debt relief initiatives may have been strong deterrents for commercial creditors to extend nonconcessional loans. This may no longer be the case after MDRI.

Source: Global Monitoring Report 2006 (Box 3.4)

in the case of the IMF[4]. If fully financed as promised, debt forgiveness would provide additional resources for allocation to poor countries based on performance. One of the major concerns of the MDRI relates to potential risks of "free-riding" situations (see Box 1.3).

Debt Relief Assessment

A growing body of literature suggests that debt relief is the most efficient and effective form of resource transfer, with many indirect benefits for the macro economy, growth prospects, prudential management

[4] The G8 Debt Relief Proposal: Assessment of Costs, Implementation Issues, and Financing Options, SecM2005-0466, September 6, 2005.

of public resources, and development policy as a whole. Debt relief minimises the unpredictability of aid flows as many bilateral aid programs are still bedevilled by problems of low stability and low predictability. However, there is ongoing debate about whether debt relief is really growth enhancing.

World Bank and IMF assessments of the enhanced HIPC Initiative present spectacular headline figures on debt reduction. The HIPC Initiative has led to demonstrable social and economic gains as it has reduced the debt burden of a number of African countries and freed resources for increased spending in social and economic sectors. Overall, debt service represented 7.3 percent of exports at the end of 2004, compared with an average of 15.7 percent in 1998/1999 (IMF and World Bank 2004a)[5].

In spite of all this, the debt burden of many HIPC post-completion-point countries is still unsustainable. According to IMF and World Bank analyses, the debt ratios of some completion-point countries (notably Uganda) currently exceed sustainable levels, as defined by the HIPC Initiative. These high debt ratios are attributable to a number of reasons, which include the drastic fall in commodity prices from the late 1990s to the end of 2002, over-optimistic assumptions for economic and export growth and, in some cases, new borrowings (IMF and World Bank, 2002a). This highlights the difficulties involved in attaining sustainable debt levels as defined by the Initiative.

Indeed, the sustainability of most of Africa's debt has for long been one of the critical issues on the international development agenda, as most countries have had to continuously deal with several intractable external debt issues. The region's debt is deemed unsustainable, particularly in relation to current growth requirements. For example, Uganda's debt to exports ratio in 2002/2003 was 209 percent; even 12 years after reaching the HIPC completion point, it is predicted to decrease, but only to 150 percent.

Debt sustainability assessments are increasingly recognized by the IFIs as an important means of judging potential solvency risks associated with the external borrowing of low-income countries. However, since they are often not calibrated to country circumstances to reflect the different levels of debt intolerance, there is the danger that these assessments may not give the true picture (IMF, 2006). Heller et al. (2006) have suggested other strategies, such as the use of scenario analyses, expanded stress-testing, representing shock on aid flows, and broader debt sustainability analyses, including simulations on alternative assumptions that to strengthen the IMF-style debt sustainability assessments.

The continent's debt problems and its resource requirements are inextricably

[5] According to a study conducted by UNCTAD (2004), the IMF and the World Bank appear to have over-estimated the impact of debt service reductions. Their calculations overlook the fact that the debt service payments in the years immediately preceding the decision point were higher than in the years before, since HIPCs were not authorised to accumulate arrears before reaching the decision point.

linked to the capacity of African countries to generate capital accumulation and growth. There is an emerging consensus, however, that many African countries continue to suffer from a debt overhang despite the HIPC Initiative and various actions in the context of the Paris Club. The fact that even those countries that have reached (or are about to reach) completion point will soon find themselves in an unsustainable debt situation gives credence to the arguments advanced by critics on the inappropriateness of the criteria applied in debt sustainability analysis. In addition, the fact that several more debt-distressed African countries are not eligible for HIPC debt relief reflects the lack of objectivity in the eligibility criteria.

In recent years, debt reduction measures in favour of Heavily Indebted Poor Countries have helped relax the financial constraints of beneficiary countries. However, although these measures alleviate the debt burden in the short-term, they do not guarantee the sustainability of the debt in the longer term. Successful debt reduction depends on the ability of governments to implement medium-term reforms. With the link-up between the HIPC Initiative and the Poverty Reduction Strategy Papers implemented under the trusteeship of the IFIs, governments have few alternatives in the choice of their reform programs. Despite the good intentions and substantial efforts of bilateral and multilateral creditors to ease Africa's debt burden, the HIPC Initiative has not in any significant way enabled African countries to achieve debt sustainability. HIPC has not gone far enough and fast enough to allow many deserving African countries to escape the crushing burden of debt and to invest more of their limited resources in health and education. A recent OECD report evaluating the poverty reduction strategy initiative corroborates many of the findings of UNCTAD on the weaknesses of the PRSP process (World Bank 2004b). In light of the possible adverse macroeconomic impact of domestic debt, the possibility of HIPCs attaining sustainable high rates of growth consonant with long-term debt sustainability and poverty reduction is likely to be overestimated.

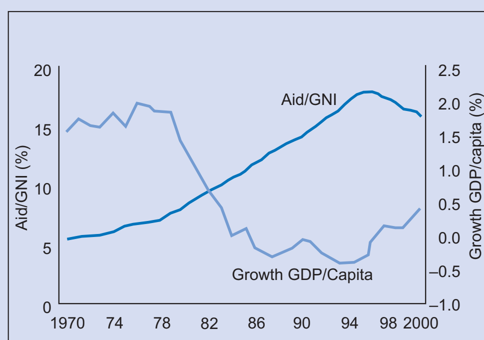
Aid, Debt Relief, and Development

Recent debates about the extent to which aid and debt relief facilitate growth and enhance poverty reduction, particularly in reference to the views of Sachs (2005) and Easterly (2006 a, b) have drawn more interest to the subject. Jeffrey Sachs strongly supports the idea of a "big push" in aid and debt relief with a view to finding an "end to poverty". He believes that a massive injection of new aid and the provision of debt relief should help Africa to grow and move out of the poverty trap. The opposing view of Bill Easterly is that not much good can come out of planned massive injections of aid. These views are not entirely new.

Controversies about aid effectiveness have existed for decades. Indeed, many researchers have tried to assess the impact of foreign aid on growth and development in Africa and in other developing countries. Even though many of the studies have

relied on cross-country growth regressions, the scope of the studies is considerably more diversified. The scepticism about the role aid plays in development is captured by Nyamugasira (2000) who observes that despite the high aid flows, Africa's average output per capita in constant prices was lower at the end of the 1990s than it was 30 years earlier, and its debt was greater than its gross national product. Erixon (2005) suggests that Africa's growth was higher in periods when the aid-to-gross-national-income ratio fell, as reflected in Figure 1.12. Chapter 3 of this report explores the theoretical and empirical literature on aid effectiveness. It analyses evidence from a wide range of studies to determine whether or not aid promotes growth and development in Africa.

Figure 1.12: Aid and Growth in Africa (10-year Moving Average)



Source: Erixon 2005

Debt Relief and Economic Growth in Perspective

The theoretical literature on debt and growth suggests that a heavy debt burden can affect growth in several ways. Investigations into the relationship between debt and growth in developing countries have been dominated by tests of the debt overhang disincentive effect (or the debt overhang hypothesis), which works, either through expected future taxes (the narrow view), or through fear of future macroeconomic instability (the broader view). However, there are reasons to believe that this effect may not be uniform across countries. According to the narrow (or traditional) view, private economic agents in a debtor country (and potential foreign investors) see a very high debt burden as a future tax on the return to capital (Krugman 1987, 1985; Sachs 1984, 1986). The heavy debt burden means that the government will have to increase taxes in the future to finance the high debt service payments. An increase in taxes means a lower after-tax return on capital and a reduced incentive to invest. Lower investment leads to slower growth.

The broader approach argues that the future high debt-servicing costs implied by the higher external debt increase the likelihood that the government will engage in inflationary financing and/or precipitate a currency depreciation/devaluation because of excess demand for foreign currency created by debt-servicing needs. Even the current administrative costs of government efforts to seek debt rescheduling and related uncertainties about the

future debt profile can also weaken administrative capacity and create further uncertainty (Hjertholm et al. 1998). These uncertainties about the future also dampen the incentive to invest and result in low investment and slow growth.

A heavy debt burden can affect investment and growth through other avenues (Serieux and Samy 2001). The debt burden can have a depressing effect on growth through the government budget by crowding out public investment and effecting both a reduction in private and total investment and a fall in the productivity of investment. This is often referred to as the "crowding-out" effect. Reduced public investment can ultimately lead to lower growth rates through three possible avenues:

(i) a reduction in total investment (since public investment is often a significant proportion of gross domestic investment);
(ii) a reduction in private investment, because some private investment is complementary to public investment (Diaz-Alejandro 1981; Taylor 1983); and
(iii) a fall in the productivity of investment because of lost externalities from certain types of public investment (such as physical infrastructure).

A heavy debt burden can also depress growth through the external account by causing import compression (through increased demand for limited foreign currency). This may cause a direct fall in output — by reducing imported inputs — or an indirect fall — by reducing imported capital goods — and, therefore, investment (Ndulu 1991, Moran 1990). This is particularly so for countries with non-traded currencies. External debt-service payments require the purchase of foreign currency that must be earned from exports or capital inflows, or for drawing down reserves. The growth effect of a heavy debt burden mediated through the external account is known as the "import compression" effect.

A heavy debt burden may also result in reduced investment in human capital, leading, ultimately, to a slower rate of increase in physical capital and growth. The demands of debt service financing on the government budget may not only crowd out public investment; they may also crowd out social investment spending. If this is the case, the reduced spending on education, health, and so on, is likely to cause human capital to grow more slowly; this is also likely to slow output growth directly because, as new endogenous models have shown, human capital is a major determinant of output. Slower human capital growth may also have an indirect effect on output by reducing the productivity of new investment (in physical capital).

Using 1970–1999 data for 55 low-income countries classified as eligible for the IMF's Poverty Reduction and Growth Facility — which provides concessional loans at low interest rates (0.5 percent a year) — Gupta et al. (2003) estimated equations to identify the key determinants of the growth of real per capita income (GDP). The results indicated that although

high levels of debt can depress economic growth in low-income countries, external debt slows growth only after its face value reaches a threshold level estimated to be about 50 percent of GDP (or, in net present value terms, 20–25 percent of GDP). These findings imply that the substantial reduction in external debt projected for countries participating in the HIPC Initiative would directly add 0.8–1.1 percent to their per capita GDP growth rates and may provide positive effects of debt relief already reflected in some of the healthier growth rates achieved by these countries in the past few years, relative to their poor performance in the 1990s (Gupta et al. 2003).

These two issues — debt and lack of growth — are clearly interrelated. Currently, all indications are that the excessive stock of external debt is retarding growth and hampering socio-economic development in sub-Saharan African (SSA) countries. The large debt stock and debt service burden have now introduced a new vicious circle to the analysis of the development problems of these countries. In many SSA countries, debt servicing in the face of inadequate foreign exchange earnings leads to severe import strangulation; this holds back export growth, thus perpetuating import shortages. The debt overhang and other uncertainties created by the debt situation further depress investment, combining with shortages of essential imports to retard growth of real output. Furthermore, declining output and escalating current account deficits lead to increasing debt and rising debt service obligations. Given the structural weaknesses of most SSA economies, their low incomes, low savings, and low investments, high levels of debt and debt servicing will ultimately militate against rapid economic growth and development.

Indeed, many analysts and international policy makers appear to have reached a consensus that a satisfactory recovery of investment and output growth in indebted SSA countries will remain difficult, perhaps unattainable, as long as these countries are saddled with a debt-servicing burden that requires a sizeable net transfer of resources abroad.

The main challenge is how to make debt relief growth enhancing in order to facilitate the achievement of sustained poverty-reduction. Unless debt relief is structured to significantly reduce the amount of borrowing that beneficiary countries have to endure and to also promote growth, it is unlikely that current initiatives can lead to significant financing of African development. It is important to channel part of the freed-up resources from debt relief to the private sector for job creation. Governments have to exploit mechanisms such as debt-equity swaps in as far as they promote private investment.

Assessing the Donor-Recipient Relationship

In 2005, donors adopted the Paris declaration on aid effectiveness, which emphasizes the principles of ownership, alignment, and harmonization. This declaration represents the most advanced and credible international attempt at promoting mutual accountability in aid (Mulley and de Renzio 2006). However, it reflects the fact that the

donor-recipient relationship is still evolving.

The nature of the donor-recipient relationship in the early 1980s was mainly motivated by the parameters of old colonial alliances and the cold war that shaped bilateral aid for many years. Results from seven country studies that reviewed aid effectiveness in Africa in the 1990s suggest that the aid relationship between African governments and donors is unequal and is characterized by the passivity of recipients and the dominance of donors (Carlsson, Somolekae and van de Walle 1997). Donors dominate aid decisions, leaving recipient governments without any sense of ownership over their own development efforts. The imbalanced nature of the relationship probably contributes to misunderstandings, resentment and, quite often, conflict between partners (SIDA, 1996).

The literature on aid effectiveness often highlights how aid practices continue to undermine the development goals of aid. Aid coordination, capacity building, and ownership have been key themes in aid effectiveness debates for at least a decade. Yet, these issues remain at the top of donor agendas because the problems they are meant to address persist (van de Walle 2005). Several works on the impact of aid, based on country case studies, identify the aid relationship between donors and recipients as an important determinant of aid effectiveness in Africa (Carlsson, Somolekae and van de Walle 1997; Lancaster and Wangwe 2000).

The last few years have seen an improvement in the donor-recipient relationship, increasingly acknowledged as a partnership between donors and recipients. The most cited development in this context is the preparation of poverty reduction strategies for various countries. According to African governments, however, a partnership has not yet been fully achieved because there is no equality in responsibility. They argue that although developing countries have set targets based on the MDGs and are complying with detailed aid conditions stipulated by donors, the latter has set no binding targets on the quantity of aid financing and has adopted only broad and vague principles on aid quality. If the Millennium Declaration is to be a genuine partnership, as stipulated by donors, then new structures are needed to enable both donor and recipient countries to monitor each other's performance. Aid recipients are developing innovative strategies to improve donor practices; they are creating institutional structures to improve coordination and harmonization and reduce transaction costs.

CHAPTER 2

Can Africa Absorb More Aid?

Introduction

As highlighted in the preceding chapter, the donor community has made several recent attempts and renewed commitments to scale up aid to Africa (for example, the 2005 G8 Gleneagles' Declaration on aid and debt relief, the US Millennium Challenge Account, the 2005 UN Millennium Project Report, the 2002 Monterrey Consensus). But does Africa have the capacity to absorb more aid? Specifically, what factors limit the effectiveness of increased aid flows and can governments overcome these constraints if they are binding? How does the nature of aid flows affect fiscal and monetary policies in recipient countries, and what can be done about possible adverse consequences? This chapter addresses these and other related questions by analysing the consequences of scaling up financial assistance to Africa. The analysis focuses largely on absorptive capacity issues and on the macroeconomic challenges of aid.

Absorptive Capacity

Questions on absorptive capacity take different forms, but they all address the same basic issue: Are recipient countries able to put each dollar of aid money received to "good" use? The different forms of the question include (i) can more aid promote growth and reduce poverty? (ii) How can recipient countries prevent aid money from turning into a curse? For instance, can these countries minimize the unintended consequences of aid on the economy to avoid neutralizing the expected benefits of such aid? It is quite possible for aid to provide perverse incentives that can deactivate an economy's productive sector. If so, what can be done to prevent such an outcome and do African governments have what it takes to counter this threat?

The Theoretical Literature

One View of Absorptive Capacity

The theoretical literature is based on the reasoning that, like any other variable input into a productive process, aid is subject to the law of diminishing marginal returns.[1] Consequently, a string of empirical studies have sought to pinpoint a saturation value for aid. So far, the values seem to fall within a rather wide range, which, as reported in de Renzio (2005), fall anywhere between 15 and 45 percent of GDP. It is useful to note that if other inputs into the types of

[1] The implicit assumption is that returns to giving are strictly concave in the amount given; this is usually normalized in the empirical literature on the national income of the recipient country, which is a convenient transformation that allows for comparison across countries.

productive activities that aid money is presumed to support can be varied, then the estimated saturation value can be elevated. In other words, the point at which the additional benefit from aid money becomes negative is delayed. It is therefore relevant to identify the crucial factors of production that combine with aid money to deliver results. The nature of the additional inputs depends on the type of aid, its purpose, and its delivery methods (Boxes 2.1 and 2.2).

The conventional literature identifies macroeconomic constraints, institutional

Box 2.1: What is Aid?

"Foreign aid" is a broad term. It refers to any money or resources that are transferred from one country to another without expecting full repayment. Official development assistance (ODA) includes all grants and concessional or soft loans that are intended to transfer resources from more developed countries (MDCs) to less developed countries (LDCs) with the intention of fostering economic development. Most studies consider concessional loans as loans that have a grant element of 25 percent or more. This does not include commercial or non-concessional loans, private foreign direct investments such as inward investment by multilateral corporations, nor does it include preferential tariff reductions offered by MDCs to LDCs, allowing easy access for their exports into the markets of the MDCs.

To be considered foreign aid, a flow of funds should meet two simple criteria:

1. It should be non-commercial from the donors point of view
2. It should be concessional so that the interest and repayment are less stringent or softer than commercial terms

Although official development assistance has grown in absolute terms, it has declined sharply as a percentage of donor countries' GDP in recent years. Despite the commitment to ODA of 0.7 percent of national income made by the rich countries at the United Nations in 1970, only the Scandinavian countries, the Netherlands, and Luxemburg had met this target by 2003.

Foreign aid can be divided into public development assistance and private development assistance:

1. Public or official development assistance
   - Individual government assistance, known as bilateral aid
   - Multilateral donor agencies such as the ADB, IMF, and World Bank offering multilateral aid

2. Private development assistance
   - Private non-governmental organizations (NGOs) such as the Red Cross and Oxfam

A considerable amount of foreign aid is tied aid. In other words, the donor country lays down conditions on how the money from grants or concessionary loans should be used. Tied aid by source means that the recipient country receiving the aid must spend it on the exports of the donor country. Tied aid by project means that the donor country requires the recipient country to spend it on a specific project such as a road or a dam. Often this might be to the commercial or economic benefit of firms in the donor country.

Source: Opati (2006)

Box 2.2: *Quo Vadis Aid*?

To a large extent, what aid does depends on where it goes. Some scholars have argued that more attention should be paid to what aid finances. According to one view, it is time for a *renewed focus on infrastructure*. In general, infrastructure and the productive sectors have largely been overlooked in recent years, in so far as the distribution of aid resources is concerned. Both the UN Millennium Project and the Africa Commission Report emphasize reversing this trend, particularly in Africa where the anticipated increased private sector role in infrastructure (post-privatisation) did not materialize.

A substantial boost to aid-financed investment in infrastructure presents a potentially fruitful way to contribute to sustainable development efforts, provided that the incentives to maintain the installed facilities are in place. Therefore, the role of the private sector and the capacities of governments to both outsource and manage contractors effectively are complementary necessary conditions. If the problem is that government has too short a time horizon, outside donors with longer perspectives may serve as external monitors; indeed, the conditionality packages of the 1980s seemed designed with this idea in mind. If public management were the issue, donors could design technical assistance packages that built or transferred expertise in this area, except that experience has shown that engineering and technology transfers are not very popular in donor capacity-building initiatives.

Source: Ndulu and O'Connell (1999); de Renzio (2005)

and policy weaknesses, technical and managerial shortcomings, and donor practices as relevant factors that affect absorptive capacity (see Clemens and Radlet, 2003; Hanson et al, 2003; Heller and Gupta, 2002; and Svensson, 2006). In particular, these constraints include a fragile export sector; human capital shortage, including excess demand for skilled labour and the challenges of attracting, training, and retaining skilled labour; deficient infrastructure, which tends to reduce the productivity of private sector production; and other government failures, such as lack of transparency and accountability. The latter is crucial because it is considered critical for the generation of desirable developmental outcomes and hence contributes to aid effectiveness. Donor practices also seem to have become a significant source of additional administrative burden on governments, exacerbating an already dysfunctional governance system.

One of the important contributions to the analysis of issues concerning aid to Africa is a collection of papers in a volume published in 2001 by the African Economic Research Consortium (AERC), in cooperation with the Economic and Social Research Foundation, the World Bank, and the Norwegian Agency for Development (AERC, 2001). Of particular relevance in this volume are Botchwey and Brantigam (2001), who examine the impact of aid dependence on governance and on institutions in Africa. Botchwey and Brantigam conclude that the effect of aid on institutional capacity cannot be predicted a priori. Aid can strengthen

institutions through learning-by-doing, as is the case in technology transfer or process innovation. However, the sufficient condition for this to occur has not been fully articulated. In contrast, aid can weaken institutions by crowding out scarce administrative skills or complicating missions by expanding the dimensionality of a relationship — from a ”single-task-single-principal” to a ”multi-principal-multi-task” setup, with all its attendant problems.[2]

According to the *multitask agency theory*, how bureaucrats allocate their efforts among multiple goals is determined by the relative benefits being derived from the various goals and by the complementarity or substitutability of the tasks. The standard solution to the multi-principal-multi-task problem may be difficult to achieve in practice because it may be more feasible to deal with one donor exclusively or to cluster tasks. Responsible ministries may attempt to outsource, but outsourcing increases the cost of delivering aid and represents another source of inefficiency (by increasing the input/benefit ratio). Worse still, competent staffers are hired away from governments, further weakening institutions even as more demand is made on the residual administrative capacity. This incipient “adverse selection” generates a low equilibrium into which governments get trapped because “anybody who is somebody does not work for the government.”[3]

On balance, the nature of the institutions in recipient countries depends on how aid is managed, particularly on whether or not the roles of benefactors (donor nations) and beneficiaries (recipient countries) are complementary or antagonistic and on the character of the organizations involved in the aid process. A review and analysis of these phenomena raise the following interesting questions: What shapes conditionalities? What is the nature of conditionalities? What are the supporting structures for the delivery mechanism? It also raises questions about the private agenda of aid bureaucrats (see Boxes 2.3 and 2.4). As a component of aid, the amount and nature of technical assistance can be an additional strain on absorptive capacity because technical assistance is often a prequalification for other forms of aid (see, for instance, Wuyts, 1995). Moreover, technical assistance is provided, as it were, independently of the planning priorities of governments.

Aid strengthens institutions and promotes development “Where recipient governments have been led by individuals committed to development and disciplined…” and where capacity to coordinate donor activities exists (Botchwey and Brantigam, 2001, p.25). In contrast, where capacity is weak or commitment is

[2] See Dewatripont, Jewitt, and Tirole (2000) for a summary of this literature.

[3] “Adverse selection” is a problem of *precontractual opportunism* that arises from informational asymmetries between parties to a bargain. By *signaling*, the privately informed parties take the lead in trying to credibly reveal their options to the other parties.

Box 2.3: Looking for good examples: why do "Tropicanas" import fruit juices and such?

Finding successful stories of transition from aid dependency — where large increases in external flows have been successfully integrated and utilized for development — is challenging. The major drawback with this task is that a large proportion of aid is not geared to development or poverty reduction. If aid were intended for the latter, the literature would revolve around foreign direct investments, technology transfers, and localized diffusion. The necessary condition for these to occur is basic infrastructure, which donors cannot sustain by themselves without commitment from recipient countries. Nonetheless, it is inconceivable to discuss development without talking about science and technology and research and development (R&D). Yet the discourse has continued so far in utter silence on these critical requirements, often discussing capacity and human resource development by way of technical assistance, which consists of sending accountants and bookkeepers to keep tabs on how money is spent. For this reason, a different way of rating donors is welcome.

The type of aid, the purpose of aid allocation, what aid finances, and the difficulty of achieving donor alignment all help explain why, despite the central role of agriculture in Africa, agro-processing is still weak in the continent. According to one study, the retail value of food items purchased in the United States consists of 25 percent of their original value on the farm and 75 percent of value added by processing and marketing. Because of this value added, the value of the farm product represents a small percentage of the retail price paid by ultimate buyers, making the demand for raw farm products even less elastic. In this context, it is not surprising that studies of agricultural supply response to market reforms (as part of the structural adjustment without technological improvement) failed to find convincing success stories.

The abiding questions are: Why are Ghana and Cote d'Ivoire not yet home to cocoa processing and to the art of chocolate making? Why is the hugely popular Palmers Cocoa Butter product not exported to the rest of the world from Takoradi or Abidjan? Where do Botswana and Namibia process their diamonds? The same question could be posed for Uganda and Ethiopia with regard to coffee; Kenya with regard to tea and nuts; Nigeria with regard to cosmetics, petrochemicals, and peanut butter; and Zambia with regard to wood products. The tree (for making paper pulp) on which Sweden rules supreme grows faster in its natural state in Zambia, yet Zambia receives generous foreign aid from Sweden but no ideas on how to develop this competing potential.

African countries cannot escape blame merely by pleading donor non-alignment with development priorities set by governments, since it is not clear that science and technology and R&D are prominent features in African state budgets. It is not acceptable to plead either that R&D cannot occur in Africa or that there are no science and technology facilities on the continent. Universities exist and prominent facilities such as the International Institute for Tropical Agriculture and the National Institute for Veterinary Research in Vom Nigeria have survived the political vicissitudes in Nigeria even as tertiary institutions have atrophied.

Additional source: Suits (1990).

Box 2.4: Aid Bureaucracy — Easterly Captures it all — the Altruism, the Smokescreen, the Real Agenda

Well-meaning national and international bureaucracies dispense foreign aid under conditions in which bureaucracy fails. The environment that created aid bureaucracies led them to (a) define their output as money disbursed rather than service delivered, (b) produce many low-return observable outputs (glossy reports and "frameworks") and few high-return, less observable activities like ex-post evaluations, (c) engage in obfuscation, spin control, and amnesia (always describing aid efforts as "new and improved"), exhibiting little learning from the past, and (d) put enormous demands on scarce administrative skills in poor countries. To change this unhappy equilibrium, policymakers in rich and poor countries should experiment with decentralized markets, matching those who want to help the poor with the poor, with the latter freely expressing their needs and aspirations.

Source: Easterly (2002)

lacking, servicing aid is a source of additional stress on an already fragile system. This proposition raises more questions than it answers. In particular, questions on how some countries find purposeful leaders or acquire capacity to manage, whereas others completely fail to land on any of the desirable paths to prosperity.[4] Finding answers to these questions poses an interesting challenge to scholars of institutional economics, anthropology, and history.

An Alternative View of Absorptive Capacity

Others disagree with what they view as exaggerated concern about the capacity of needy African countries to usefully deploy increased aid flows. For instance, the UN Millennium Project and the Commission for Africa take a more sanguine view of the situation. According to the UN, the real issue is not solely about absorptive capacity; it is a compound question on how to deliver aid that works and delivery capacity — devising mechanisms that recognize binding constraints and are therefore feasible and compatible with incentives. The Commission for Africa extends the range of issues relevant to the question of absorptive capacity to include — in addition to those enumerated by the UN — the question of what aid is earmarked for in recipient countries. Collectively, these views about absorptive capacity remind one of an old African proverb: "the river should never become the impediment to building the bridge.[5]" The message from these contrarians seems to be that, working together, donors and beneficiaries alike can make and unmake capacity.

The purpose of aid and how it is packaged make different demands on administrative capacity. Nowhere is administrative capacity completely elastic;

[4] Extending Wangwe (2001) one can identify four typologies of states; countries that are committed and capable, capable but lacking commitment, committed but incapable, and neither capable nor committed.

[5] Credit goes to John Ohiorhenuan for this Nigerian proverb.

indeed, organizations are brittle and have breaking points. Therefore, what some donors call an absorptive capacity problem, others view as a collective action problem. The real issue is to identify what prevents the forging of a solution — solution that makes recipient-countries' breaking points more resilient, even in an environment of increased aid flows, thus making the capacity debate less relevant.

The Empirical Literature

In the empirical literature, there is an apparent lack of *ex ante* litmus test for the link between aid and absorptive capacity, making the latter a 'straw man.' It is often claimed that aid is aimed at alleviating poverty. According to the literature, aid works when it contributes positively to growth, notwithstanding the fact that growth is not a sufficient condition for poverty reduction. For instance, Ndulu and O'Connell (1999) highlight the growing view in the empirical literature that aid has had a minimal effect on policy outcomes in Africa and that its contribution to growth is strongly conditioned by the quality of the institutional environment (Isham and Kaufman, 1999; Burnside and Dollar, 2000, 2004). Furthermore, bilateral aid is often used as a foreign policy instrument that supports political or ideological clients.

Other scholars, such as Ake (1996) and Gordon (1993), have argued that one of the most telling impacts of aid in the 1980s was that it "manufactured" crises for change. The controversial impact of aid also intensified the debate on whether or not aid was undermining institutional capacity in Africa (Ndulu and O'Connell, 1999, p.59). Given that in the aid literature the quality of the institutional environment is a condition for growth, it is surprising that some positive growth effects were found (Box 2.5).

This questions the basis of the selectivity approach to aid.[6] Ndulu and O'Connell express concern about the reverse causality argument, arguing that if aid allocations go to the most needy, who most likely possess weaker institutional environments, then it is possible to observe higher aid and low levels of growth. Taking institutions as a given, Collier and Dollar (2002) solve a single-dimensional donor-optimisation problem from which they derive a poverty-efficient allocation that can double the productivity of aid. However, as noted by these authors, and by several others (Ndulu and O'Connell, 1999; Hopkins, 2000; Woods, 2005; Svensson, 2006; Berthélemy, 2005, 2006), donors pursue multiple objectives. The crucial message from the strand of empirical and case study literature is that donors' incentives influence the behaviours of recipients and their ability to use aid effectively, primarily through the impact of donor activities on institutions.

Overcoming Disbursement Constraints and Incentives to Reform

Aid Bureaucracy

Since absorptive capacity is a workout between donors and beneficiaries, a review of the strand of literature on donor and

[6] Selectivity is the channeling of aid conditional on the recipient's policy record.

Box 2.5: Aid Allocation and What Aid finances — Budget Game is the Real Deal

Power and politics are said to come together in the budget game. To explain the composition of a budget, one must explore the political process by which the budget is chosen. Therefore, a deeper understanding of the political economic factors driving the policy choices of recipient countries and the incentives created by aid relationships are important ways of understanding the inadequacies of donor interventions as well as how to restructure politics in order to yield desirable outcomes.

Adopting a more realistic view of some of the political constraints, such as the structure of domestic political competition that confronts beneficiaries, as well as the motivations that shape benefactor aid allocations and their conditionalities, would go a long way in facilitating the design of a feasible aid intervention strategy. At least, it would represent a first step towards an open and transparent approach to the entire aid game, which, at the moment, is a mix of grandstanding, smokescreen, and altruism. For instance, in 2005, a high-level donors' meeting in Paris renewed pledges made in the 2003 Rome Declaration on Harmonization to improve levels of coordination and minimize the negative effects of volatile aid flows and fragmented donor practices. de Renzio et al. 2004 observe that the harmonization and alignment agenda is less advanced, as donor countries struggle to transform their commitments to improved aid practices into observable behavioural changes at international and country levels.

In line with the proposed new aid architecture, an international finance facility that allows for bridge financing, the front loading of substantial additional aid resources, and reduction in variability of aid flows is a priority. According to Nancy Birdsall, such a common pool creates a clear framework with incentives for donor selectivity and recipient-country ownership of their development strategies. This idea, which traces back to Kanbur, Sandler and Morrison (1999), is also embedded in the declaration of nations at the Monterrey Conference on financing for development.

Sources: Bates and Deverajan (1999), de Renzio (2005), and Birdsall (2002)

recipient behaviour should be illuminating. Svensson (2006) analyses some of the key incentive constraints that confront aid stakeholders in a multi-agency framework, not unlike other agency problems in organizations, while Easterly (2002) illuminates aid bureaucracy.

Svensson notes that the volume and outcomes of aid are not necessarily correlated, although the volume of aid is more clearly observed by voters in donor countries. The political focus on volume rather than on impact thus influences how aid agencies operate. Also, consultancy companies, technical and other experts, and suppliers of aid-financed goods are part of the patron-client relationship in donor countries. As direct beneficiaries of aid, they seek to increase their direct leverage on decision makers and therefore have a huge influence on how aid programs are designed and implemented (they shape conditionalities). There is ample evidence that recipients are well

aware of this triadic relationship in the aid game. In a recent paper, Villanger (2006) cites the field experiences of aid disbursement officers, which suggest that third parties to the donor-recipient relationship influence aid disbursement.

Aid Politics

Reforming the bureaucracy and the recipient country machinery cannot resolve the capacity problem entirely. A full resolution must also take into consideration the political motivations of those in power in donor as well as in recipient countries. Hopkins (2000), in his analysis of the future of foreign aid, focuses on the problem of low equilibrium trap that poses a dilemma to aid and development. Many needy countries are burdened with weak institutions. Therefore, attempting to link aid to improved governance is a contradiction in terms. His central message is that resolving this conundrum may require a highly innovative or even unconventional approach. de Renzio (2004, p.4) makes the same point in summarizing the views of participants at a DFID seminar on the challenges of absorptive capacity.

The following suggestions in Hopkins (2000, p.36–7) are persuasive:

- For states to "own" a set of policies, including the use of aid, there must first be a state structure. Aid to provide a transition from anarchy must first precede aid for transition to a stable development path.
- Aid for political construction requires delicate balancing in which the trade-off between conditionality and ownership is acknowledged.
- Countries with the greatest needs, often those most troubled by political upheavals, will not continue to be the ones least able to absorb aid efficiently.

Lessons from the Literature

Further research into precisely how the factors identified above constrain the effective use of more aid resources and into the role of actors in the remediation process is warranted. To improve aid delivery mechanisms through more constructive donor practices, donors must adapt aid modalities to country-specific circumstances and demonstrate a willingness to change. It will therefore prove useful to conduct country case studies to discover the nature of binding constraints and to consider alternative remedies. It will be difficult, however, to change the politics of aid, namely the type (project aid, tied aid, programme aid and all its varieties[7]), the purpose, and manner of transfer, and the accompanying inputs, including the conditions attached to finance, the incentives for bureaucrats, and the opportunity costs of such a reform at the donor country level. Nonetheless, there is reason to be optimistic.

At a high-level forum in March 2005, donors agreed to adopt a programme-based approach as an indicator of progress

[7] These include food programmes and financial programmes. The latter include budget support (general and sector) and balance of payments support (debt relief and import support).

Box 2.6: Are Donors and Recipients Moving Forward? Tales from Malawi and Mozambique

Malawi: According to the World Bank's definition, 60 percent of Malawians live below the poverty line. The country is heavily aid dependent, although aid dependency can be linked to the proportion of the fiscal budget financed by aid rather than to the proportion of national income.

Two periods can be identified in the aid relationship during 1994–2000: In the 1990s, the IMF and the World Bank pushed for trade liberalization and structural reforms; and in the new millennium, they focused on the Poverty Growth Facility (PRGF) agreement with key bilateral donors (the Nordic states, the UK, and the EC) promoting a coordinated approach with the PRGF under the Common Approach to Budget Support Framework.

Since Malawi was considered to lack fiscal discipline during these periods, the PRGF was considered off track at the signing time in 2000 and hence actual releases of general budget support were limited. This ensued in mutual recrimination between government and donors.

Mozambique: By its own assessment, over 53 percent of Mozambicans subsist below the poverty line, and the country is heavily aid dependent. Since 1992, the country has cycled through multi-party democratic elections, but governance issues have affected the government-donor relationship.

Three periods of aid relationship are germane to the period 1994–2000: Post-war emergency relief and food aid between 1992 and 1996, tapering off sharply in 1994; gradual increase in multilateral and NGO roles, with increasing donor participation in recurrent expenditure; and the new millennium, marked by the introduction of partnership general budget support.

Of the plethora of donors active in Mozambique, 17 of them have signed on to a joint donor program. Although it had to be endorsed by the IMF and the World Bank, Mozambique's development plan [PRSP] was evaluated under a common Performance Assessment Framework in 2003.

Except for the United States, all the large donors and many of the smaller bilateral donors now participate in the principal grouping, G16, which provides general budget support. Even outsiders like the United States and Japan participate as "observers" in G16 meetings. The volume and proportion of aid that is piped through the budgetary process has increased consistently over the last seven years.

Source: Lister and Carter (2005)

in harmonization.[8] Other stakeholders remain less sanguine, particularly with regard to the behaviour of major donors intent on pursuing their own priorities and implementing their own new mechanisms (Woods, 2005; see Box 2.6). Institutional inertia also interferes with harmonization, as demonstrated in Burkina Faso where the World Bank's bureaucratic hurdles became an artificial obstacle to progress in donor cooperation (Gerster and Sawadogo, 2003).

An insightful analysis of the politics of foreign aid by Hopkins (2000) gives much hope for change. Hopkins notes that the

[8] *Paris Declaration on Aid Effectiveness*, High Level Forum, March 2005. There is some skepticism on aid effectiveness given donors' multiple objectives, of which, despite the rhetoric, poverty reduction may not be the overriding concern (see for instance, Berthélemy, 2005, 2006 and the references therein).

institutionalisation of aid as a practice in international affairs has resulted in adaptive capacity. When necessary, it has reinvented itself to ensure relevance and thus continuity. To demonstrate his point, the author cites the push for increased donor harmonization by the Development Action Committee (DAC) and the even louder call for the reorganization of multilateral institutions and bilateral aid agencies.

Until researchers can control for the influence of inappropriate aid modalities or donor practices, it is difficult to understand the nature and extent of absorptive capacity constraints intrinsic to each recipient country. Consider, for instance, that although the political economy literature emphasizes the two-way interaction between donor and recipient country strategies, the empirical literature is almost silent on its impact on studies of aid effectiveness. de Renzio (2004) reports a general understanding among the aid observer community that donor activities and the policies they push (either via conditionality or otherwise) can have an adverse impact on capacity — for instance, the encouragement of "parallel governments" (see Malawi, Box 2.7).

It would take time to fully understand the nature of country-specific constraints and clarify obfuscation by bureaucrats (Easterly, 2002). The specific country examples cited in the literature reveal-mixed outcomes (see Box 2.8). Regardless of the different experiences, if the international community is to improve its aid delivery mechanisms, it must engage in broader reforms of the global aid architecture along the lines already noted in the literature, but with more focus on donor harmonization and alignment and a move towards a donor consortium. Although aid surges are not the preferred scenario, they can nonetheless be fully accommodated if channelled to a common pool. The consortium would then act as a modulator by tailoring disbursements to the operable capacity in each country.

Macroeconomic Challenges

The main issues here revolve around aid and fiscal management. First, the dependency between donors and recipients, discussed under disbursement constraints, applies equally to managing the fiscal dimensions of aid. Specifically, how can donor uncertainty in meeting pledges and in designing "appropriate" fiscal policy be mitigated? Second, the nature of aid (for example, general budget support, tied aid, or both) matters, as does the relative proportion of the type of aid. Third, the provision of aid under a framework in which donors align with the recipient country's PRSP and submit plans well ahead of time matters. Other related issues include possible changes in relative prices and their probable impact on the structure of production, commonly discussed under the moniker of Dutch Disease.

The Dutch Disease Syndrome: Real Exchange Rate Effects

The effect of aid flows on relative prices depends on the specifics of each country and on the period under consideration. Simply put, Dutch disease is nuanced and is likely to affect countries differently, depending on their specific circumstances.

Box 2.7: Voices from Malawi

The current institutional framework for fiscal, monetary, and exchange rate management in Malawi seems to indicate that the economy can effectively absorb considerable amounts of additional aid. Recently, there has been a high degree of policy coordination between the government and the Central Bank due to the PRGF programme with the IMF, which can only be good for the economy, albeit with some negative political influence.

Looking at a five-year period, for comparison purposes, the response to incremental aid has been different, reflecting on institutional and policy soundness and credibility. During 2001–2003, Malawi abandoned the three-year PRGF arrangement with the IMF — which automatically signalled the withdrawal of aid, except for humanitarian assistance from other donors. This resulted in a significant drop in aid levels, a rapid build up of domestic debt, high inflation rates, depreciation of the exchange rate in real terms, and a huge fiscal deficit.

In terms of macroeconomic management, this period was characterised by a spend and not absorb response to any aid and foreign currency that came into the country. Foreign currency went into building international reserves while domestic spending was financed through either domestic borrowing (with a crowding out effect on private investment) or printing money.

The period from 2004 to date is characterized by the resumption of the PRGF programme with the IMF; this has, in a way, restored donor confidence. Aid has increased considerably as a result. However, significant amounts of aid are expected once Malawi reaches the HIPC completion point (July 2006) and qualifies for the Multilateral Debt Relief Initiative. The PRGF arrangement, whose continuation depends wholly on Malawi meeting some agreed quantitative targets, has greatly enhanced Malawi's absorptive capacity. The central bank has had some degree of latitude in terms of adhering to its monetary and exchange rate policies.

The response to incremental aid has been to spend and absorb at the same time. The central bank has managed to keep aid money (forex) with a view to building international reserves, which have been relatively low for the most part (around 1–2 months of import cover). When there is excess liquidity in the system, the central bank tries to normalize the situation by mopping up the excess liquidity through open market operations, including selling off forex. Increases in foreign exchange holdings have led to an appreciation of the currency (that is 4–5 months of import cover). Using counterpart funds, the government has managed to spend the incremental aid (Balance of payments support); there are inherent problems with project aid, dedicated grants and other types of tied aid. Where aid has been less tied, like BOP support, absorption has been relatively high. However, a more detailed analysis is required to determine the levels of absorption and spending responses to incremental aid vis-à-vis Dutch disease effects.

Government institutions have massive capacity constraints because they lack adequate skills and human resources to deal with the many demands related to the different procedures and rules of each donor. Some donors have tried to avoid this problem by using other implementers such as NGOs, the DFID, and USAID. The EU likes creating parallel structures in order to ease absorptive capacity problems. It has parallel structures in the agriculture, finance, and transport sectors.

Donors should consider adopting the following measures:

a) Help build capacity in government institutions rather than create separate institutions to deal with implementation problems for ownership purposes;
b) Establish a consolidated development fund where resources can be pooled. Under this

Box 2.7: *cont.*

> scenario, the accounting system, as well as the procurement and disbursement procedures, would be combined and would not be too much for government officials to handle. Good examples are BOP support and Health SWAp (Sector Wide Approach) arrangements that pool resources from a lot of donors and use one system.

The UN tried this approach under the District Development Fund (DDF), whereby interested donors poured resources into the DDF if they were interested in a particular district, rather than each donor financing "bits and pieces" of development projects in an area.

Author: Kamwendo (2006)

Ceteris paribus, a large influx of aid money can cause the exchange rate to appreciate and hence alter relative prices. Side-stepping econometric problems (see Adam, 2005), mixed evidence of exchange rate changes in response to aid flow has been documented for African economies (Elbadawi, 1999; Atingi-Ego and Sebudde, 2000; Nyoni, 1998).[9] But how the real

[9] In single country studies, one is basically estimating a time series model subject to regime changes and considerable volatility of the series. Considerable volatility is implicit in the focus on aid surges and its impact. The estimation methods rarely address these issues, which casts doubt on their findings. Sample size poses an additional problem. Many of the countries have series for only a very short time period, making it difficult to address econometric problems using more sophisticated techniques.

Box 2.8: Courting Donor Alignment — Uganda and Malawi

Uganda: Uganda has made impressive strides in securing some degree of donor alignment. The following donors are spearheading alignment assistance with the government's development strategies — the World Bank, the UK, the EU, Ireland, the Netherlands, Norway, and Sweden. The country's poverty reduction strategy paper (PRSP) is the operational document governing aid. The Government proactively engages donors to submit their disbursement plans and intended projects well in advance so that they can be integrated into the national budget.

Several factors are viewed as responsible for this relatively successful experience with donor alignment: (i) Rigor of the budget process linking the Poverty Eradication Action Plan to the medium-term expenditure framework; (ii) Increased effectiveness of the Aid Liaison Department and the Development Committee in screening and reviewing projects; (iii) Increased budget support by donors; and (iv) Efforts by donors still providing project support to ensure alignment with the PRSP. Evidently some of these factors are reinforcing; increasing donor buy-in encourages others to join the bandwagon; and a purposeful government signals capacity to deliver on commitments and encourages buy-in (at least until proven otherwise).

Malawi: In contrast, donor alignment has not progressed appreciably in Malawi due to issues in the country's administrative machinery which donors view as problematic. The following five major problems have been identified: (i) No comprehensive record of financing agreements is available; (ii) Negotiations occur outside established procedures, namely the budget process; (iii) Agreements are signed without informing the core ministries; (iv) No information on project execution is available; and (v) No sharing of information between management and budgeting departments.

Source: Nilsson (2004)

exchange-rate changes feed through the system depend on the assumed structure of the economy and on the parameters of the model. Therefore, exchange rate appreciation due to increased aid flows is both a theoretical and an empirical possibility, but its distributional effect on balance of payments is an empirical question that is context-sensitive.[10] There is no *a priori* reason for that effect to be adverse. In fact, barriers to trade and other imperfections in an economy could be much more pressing than Dutch Disease (Bulíř and Lane, 2002, p.12).

Where is the Evidence of Dutch disease?

The type of aid inflow that causes real exchange rates to appreciate for a sufficiently long period is yet to be seen in the context of aid giving to Africa. The empirical literature suggests that temporary relative price changes have occurred in several countries at different times. But none of the studies has tested for evidence of the expected expenditure-switching effects of price changes, which would normally precede later structural changes such as adjustments in the distribution of economic activities. If there is evidence of expenditure switching but no structural changes, it could either mean that the magnitude of the changes is insignificant or that the real exchange rate effect is perceived to be temporary. These are empirical issues.

Furthermore, economic models of real exchange rates, at least in the context of developing countries, assume these countries to be small open economies facing world prices for their exports. In practice, this is not far fetched, as most African countries are persistently primary commodity exporters. This includes South Africa, the region's largest economy in terms of gross domestic product. Export commodities are priced in the international markets, invoiced in foreign currencies, and subject to the familiar commodity cycles (booms and downturns). So, just as empirical studies have not addressed the predicted consequences of real exchange rate movements — *expenditure-switching effect* — they have also not provided reliable estimates of the price elasticity of demand for export commodities in international markets. Perhaps, other non-price factors play a more significant role in the position of African countries in world trade.

Exchange rate appreciation no doubt reduces the local value of export revenue even when export volumes remain unchanged. This is a wealth redistribution effect from exporters to importers. To the extent that some exporters also consume imported goods, the overall net effect cannot be determined *a priori*, but an appreciating exchange rate can have a positive balance of payments effect on import-dependent economies (most African countries fall within this category). Even if the pattern of production is altered

[10] Imagine a situation of economic malaise in which overall economic performance is a result of high transactions costs. If a surge in aid is used to improve infrastructure, reduce export taxes, and purchase peace and security, then improved economic fundamentals equally lead to an appreciated exchange rate but that would not be viewed as a bad outcome.

in favour of domestically consumed goods, such a switch is not necessarily bad. In South Africa, the tertiary sector contributes close to 70 percent of value-added to the GDP and has increased its share over time. The definition of what constitutes tradables is evolving with WTO rules on openness. Long-distance voice communication services (with virtual call origination and termination), as well as distributed data processing via satellite links across customs borders, are now part of international services; so are banking, insurance, tourism, and air transportation. Moreover, these services could either be physical capital, human capital, or labour services. The traditional distinction no longer applies as the literature assumes — technology has leapt ahead of modelling strategies. Adam (2005, p.14–16) makes essentially the same point in his criticism of the empirical proxies for tradable and non tradable goods as well as of numerous other concerns about the evidence of Dutch disease-like effects, which he judges as yet unproven.

Management of Fiscal Challenges in an Aid Environment: Policy Alternatives

By far the most serious aspect of aid and fiscal management is volatility and unpredictability of aid flows. This problem is rooted in a complex interaction between disbursement constraints and donor country circumstances such as cut backs in aid budget. Bulíř and Lane (2002) report a 1998 survey by Bulíř and Hamann (2001) who find aid disbursements to be invariably over predicted, with more countries experiencing unexpected declines in aid flow than pleasant surprises by way of aid surges.

The literature prescribes two major options for dealing with the problem: contingent budgeting or expenditure smoothing by either drawing down reserves or domestic borrowing, or a mixture of both.

Contingent budgeting: Under this scenario, expenditure is prioritised according to the source of financing. Crucial budget lines are financed from core funds (tax revenues), whereas low priority budget items are financed with aid money. The challenge in this approach is that ranking may not be one-dimensional. Prioritisation may involve taking into account the nature of the expenditure: recurrent, once-off, fixed costs with recurrent expenses, lumpy, or incremental (cash flow characteristics). If the aid money is coming from various sources, the quantum of money from these sources and their characteristics also matter — the nature and size of the aid, the purpose, donor volatility rating, and disbursement characteristics. Even if countries could design such a budget, there is still the self-control problem in following the program with the required resolve (the problem of time inconsistency of optimal plans). It is tempting to fall into the trap of spending as if all disbursement expectations will be realized despite accumulated evidence to the contrary.

Expenditure smoothing: If countries had reserves to draw down in the first place; if donors were more accommodating of the use of aid money to accumulate reserves; if

there were no danger of short-term capital surges (sudden reversals of capital), then expenditure smoothing would be tantamount to *bridge financing*. Of the options listed above, drawing down reserves and borrowing locally are the two immediate plausible paths to follow.

A reserve acts as insurance in times of dire need, so drawing down reserves to smooth temporary fiscal shortfalls is a better option than borrowing locally. However, the problem with this seemingly attractive solution is that aid shortfalls are invariably chronic and unpredictable and so require a more permanent solution outside reserve contingencies. Besides, as stated earlier, most countries in dire need of financing are short on reserves and are most likely to be subject to higher aid volatility because, as noted in the literature, volatility increases with aid dependency (Bulíř and Lane, 2002). Also, depending on the degree of capital control, running down reserves could precipitate a more serious financial crisis and hamper future borrowing that inevitably becomes necessary when reserves are insufficient to cover shortfalls or are unable to cover gaps without violating binding IMF conditionalities. Although IMF-supported programs include stabilizers by way of bridge financing, they cannot be relied upon as a general remedy because they perpetuate the inability of countries to own their programs. Using reserves to cover revenue shortfalls also presents a moral hazard problem because such a practice can lead to profligacy and undue optimism in budgeting.

Conclusion

This chapter analysed the various issues related to the challenges of increasing aid flows to Africa. Africa currently faces a number of development challenges, which will require substantial amounts of human and financial resources. Increased aid flows to Africa will fill in some of the resource gaps, but many African countries do face absorptive capacity constraints. This is likely to create macroeconomic challenges because of the impact on fiscal, monetary, and exchange rate policies. This calls for innovative ways of managing the increased aid money to avoid adverse side effects such as the Dutch disease syndrome. Aid volatility is also a real issue that requires attention by aid recipient countries. However, it is noteworthy that if African countries could control the ravages of aid volatility, they would probably no longer need aid; trying to be poor and strong leads one to wonder why that strength is not harnessed to overcome the challenge of poverty. Many African countries have recently instituted a number of reforms, including economic and political governance reforms, which have now started to bear fruit. Strengthening this process and continuing to pursue prudent macroeconomic management will help overcome some of the key potential challenges that may be associated with increased aid flows to the continent.

CHAPTER 3

Making Aid More Effective in Africa

Introduction

Although Africa has witnessed a long and substantial influx of foreign aid, with a few exceptions the economic growth performance of the continent over the past decades has been rather lacklustre and lower than that of other developing regions. There are a number of explanations for Africa's poor growth performance, but aid effectiveness features prominently among them. Indeed, controversies about aid effectiveness abound, and a plethora of studies have been conducted to assess the impact of foreign aid on growth and development in Africa and in other developing countries. The outcomes of these studies have proven inconclusive and the debate continues. The 2005 Paris Declaration on Aid Effectiveness was largely inspired by the growing concerns that have arisen from the empirical research findings on aid effectiveness.

This chapter revisits the debate on aid effectiveness and identifies the channels through which aid can be made more effective in Africa. The issue of aid effectiveness and that of formulating an appropriate strategy to ensure that aid flows meet the stated objective of promoting growth and development is fundamental to the alleviation of poverty in developing countries. This chapter first reviews the theoretical and empirical literature on the aid-growth relationship. It then examines the factors that make aid ineffective in Africa and how aid to Africa can be made effective. Issues such as aid selectivity, conditionality, ownership, and coordination will form the core of the discussion in this chapter.

The Theoretical Basis for Aid Effectiveness

As already stated in Chapter 1, foreign aid was originally intended to bridge the gap between planned investment and domestic savings and to close the foreign exchange gap in import-dependent economies. The theoretical motivation for this relationship has its roots in the Harrod-Domar (HD) model, which assumes that the rate of growth of an economy depends solely on its productivity and on investment. The underlying notion of the HD framework is that, holding the incremental capital-output ratio (ICOR) constant, growth is determined by investment. Since investment is financed by savings, and as long as the savings rate is lower than the required investment rate, the economy will experience a savings gap, which can be filled by foreign aid. Given the linear relationship between investment and growth, it is expected that aid channeled to investment will promote growth. This was

also the idea behind the foreign exchange[1] gap model of Chenery and Bruno (1962) and Chenery and Strout (1966), which formed the basis of giving aid to developing countries in the 1960s. In addition to the dual gap (savings and foreign exchange) framework, recent studies such as Bacha (1990) and Taylor (1990) have identified a fiscal gap, which can also be filled by foreign aid. The fiscal gap originates from a situation where some developing countries lack the revenue-raising capacity to undertake targeted investments; foreign aid can play a pivotal role in this regard, provided the aid is directed to investment (Addison et al., 2005).

Empiricism

The gap approaches provided the impetus for many empirical studies on aid effectiveness. Indeed, many of the studies lent credence to the hypothesis that foreign aid has a positive impact on investment and economic growth. However, a number of the studies found no discernible evidence in support of the propositions underpinning the gap models. In fact, many of the earliest studies that focused on the link between foreign aid and savings (Rahman, 1968; Griffin, 1970; Griffin and Enos, 1970; Gupta, 1970; Weisskopf, 1972) did not find any statistically positive relationship between the two variables, as implied by the HD model[2]. Similarly, using standard aid-growth approaches, a number of econometric studies conducted in the 1980s also found inconclusive evidence for the gap hypothesis. Using various estimation periods for a sample of 63 developing countries, one such study, Mosley (1987), found no statistically significant relationship between aid and growth.

Evidence from empirical studies in the 1990s and 2000s also tended to cast doubt on the effectiveness of aid in promoting the economic growth of recipient countries. For instance, using panel data for 91 aid-recipient countries for the period 1971–1990, Boone (1996) found insufficient evidence of the impact of aid on investment and growth. More recent studies by Easterly (1999, 2001 and 2003) have also corroborated the findings of his earlier studies. In his 1999 study, Easterly argued that there was no empirical basis for a short-run proportional relationship between growth and investment requirements. In his subsequent studies, Easterly (2001 and 2003) empirically tested the gap hypothesis which postulates that foreign aid promotes investment and growth;here again, he found no discernible relationship between foreign aid and investment in all but six of the 88 aid-recipient countries in his sample. Even some of the six remaining countries in the sample, which exhibited a positive association between aid and investment, had received negligible amounts of foreign aid.

[1] In the foreign exchange gap model, countries are unlikely to have the required export earnings to import essential capital goods for investment. Here, it is argued that foreign aid could help fill this foreign exchange gap.

[2] See Addison et al. (2005) for a detailed review of the empirical literature.

Other studies of aid effectiveness have emphasised the importance of the policy environment. In other words, policy is important in the aid-growth relationship. This assertion was first made by Burnside and Dollar (1997). In a subsequent study (Burnside and Dollar, 2000), they found that aid has a positive impact on economic growth in countries with good fiscal, monetary, and trade policies. In contrast, they found that aid is ineffective in developing countries with poor policies. The findings from the Burnside and Dollar (2000) study generated further controversies in the aid effectiveness literature, but gained prominence in the multilateral donor community, shaping their aid policies to developing countries.

Within the research arena, Durbarry et al. (1998) was one of the aid effectiveness studies that first tested the policy hypothesis of the Burnside and Dollar (1997) study. Controlling for macroeconomic policy environment in an aid-growth equation, Durbarry et al. (1998) found strong evidence to support the view that foreign aid has a positive impact on growth in countries with a stable macroeconomic policy environment, but that this largely depends on factors such as the income level of the aid recipient country, the amount of aid, and the geographical location of the country. They also uncovered a range of critical values for aid flows, determined by threshold and optimal values, within which foreign aid appeared to promote growth more effectively. For the sample of developing countries in their study, the threshold value of aid-to-GDP ratio was around 13 percent; Below this value, the growth-enhancing effect of foreign aid does not kick in. The optimal level of aid-to-GDP ratio for the set of countries in the sample was 40–45 percent; above this level, foreign aid tended to retard growth.

In spite of the importance of the policy environment in aid effectiveness, a number of empirical studies have produced results that run counter to Burnside and Dollar's findings. For instance, Rajan and Subramanian (2005) found no evidence that aid works better in better policy environments. Asra et al. (2005), focusing on the link between aid and poverty, also arrived at a similar conclusion. However, using a new measure of aid known as Effective Development Assistance (EDA)[3] and controlling for initial conditions, macroeconomic policy, and quality of governance, Asra et al. (2005) found a statistically significant relationship between aid and poverty reduction. They also confirmed the existence of "optimal" levels of aid above which diminishing marginal returns to aid set in, thereby making the poverty reduction impact of foreign aid less effective. For the sample of countries in their model, the "optimal" value of aid was estimated at 17 percent of gross national income, much lower than that found by Durbarry et al. (1998).

The approach in some of the recent studies on the impact of aid on growth is to disaggregate the components of aid and establish how each of them affects macroeconomic variables. In one such

[3] The EDA reflects the overall grant equivalence of official development assistance flows.

study, Mavrotas (2003) adopted an innovative research method to assess the effectiveness of different types of aid on the key macroeconomic variables of savings, investment, the exchange rate, and growth in Uganda. The results showed that, in the short run, exports and other financial flows such as program aid affect growth positively, project aid has a negligible impact on growth, is and technical assistance and food aid have a negative impact on growth. However, in the long run, growth responds positively to changes in project aid, technical assistance, and food aid, but responds negatively to program aid.

Using a slightly different definition of disaggregated aid, Clemens et al. (2004) also found that not all aid is directed at growth. They therefore categorised aid into three classes ("short-impact" aid, "long-impact" aid and humanitarian aid) and concentrated on aid that can stimulate growth in four years. This includes budget and balance of payments support, investments in infrastructure, and aid for such productive sectors as agriculture and industry, which constitute about 45 percent of all aid flows. Using panel data over a four-year period, they found a non-linear relationship between short-impact aid and growth, in which such a relationship is subject to diminishing returns. Their study showed that the maximum growth effect of aid occurs when short-impact aid represents 8.1 percent of GDP and this declines thereafter. They concluded that on average short-impact aid causes growth, regardless of income or quality of institutions and policies. They also found a significantly negative relationship between debt repayments and growth.

Moreira (2003) also used a different set of common econometric tools and the generalized method of moments (GMM) estimator to examine a large sample of developing countries covering a 29-year period. The results achieved are in line with the micro results, which show that foreign aid is beneficial to the economic growth of developing countries. The results of Moreira's study show that the immediate and overall impacts of aid on growth differ in terms of magnitude and also stress the importance of time lags in the aid-growth relationship. Program aid was found to have a more rapid impact on growth than project aid. Indeed, aid effectiveness studies are moving progressively towards the conclusion that foreign aid has a positive impact on development.

Is Aid to Africa Effective?

Aid flows to Africa have increased substantially in recent years and will likely continue to increase given the commitments of the G8 and the international donor community to scale up aid to Africa. On average, annual inflows of official development assistance (ODA) to sub-Saharan Africa exceeded 6 percent of the region's GDP during the last two decades (Schaefer, 2006). Furthermore, ODA to sub-Saharan Africa, including debt relief, averaged about $17 billion per annum during the first three years of the new Millennium. The question, however, is whether or not the increased resource flows to Africa have been effective in promoting economic growth and development. This is

a particularly important question in view of the fact that, with few exceptions, the growth in real per capita incomes in SSA countries declined during periods of increased ODA and debt relief. It was this seemingly negative correlation between aid and economic growth that led many to question the effectiveness of foreign aid in Africa.

With respect to donors, discussions on aid effectiveness have led to recommendations for improved conditionality, greater selectivity, increased policy dialogue, and a shift away from project-based support to general budget or sector support. In general, donors are linking aid allocation to assessments of the quality of recipient country policies and institutions, in the belief that aid works better in countries that perform well in terms of these assessments.

Studies on the impact of aid on growth in Africa have increased in recent years, but the results from these studies have produced mixed outcomes. For example, one such study on the fiscal impact of aid in Uganda, Zambia, and Malawi, conducted by the Overseas Development Institute, found the strongest discernible growth impact of aid in Uganda but not in Malawi and Zambia (Fagernäs and Roberts, 2004). The difference in results was attributable to the persistent allocation of foreign aid to specific development programs in Malawi and Zambia even though these programs do not often have the highest growth impacts (Gupta, Powell and Yang, 2006).

Another recent study by the *Agence Française de Développement* et al. (2005), which examined both the impact of aid on growth and the ability of the poor to participate in the growth process, found that aid inflows fostered higher growth in the 1990s in the African countries in the case study. Here again, the impact of aid on growth was strongest in Uganda, operating through reconstruction, improved economic management, social sector programs, and improvements in public administration. Aid also played an important role in relaxing constraints on growth due to debt burdens. Similarly, a case study of Ghana showed that aid played the twin roles of supporting macroeconomic stabilization and boosting social sector programs that might otherwise have been impossible due to resource constraints.

Mozambique also provides another good example of a success story where foreign aid has been effective. For instance, using a growth accounting technique, Arnt et al. (2006) found that foreign aid played a pivotal role in the promotion of growth in Mozambique (see Box 3.1).

Why Aid to Africa may not be Effective

In spite of these rare cases of effective aid utilisation in Africa, the overall experience of the 1980s and the early 1990s shows that increased aid flows to the continent were associated with a decline in real growth. The reason for the apparent lack of aid effectiveness was not entirely clear then, but a number of factors featured frequently in the debate.

Box 3.1: Aid Effectiveness: The Case of Mozambique

For two-and-a-half decades, Mozambique has been one of the most aid-dependent countries in Africa. Aid per capita averaged $66 per annum during the past decade, corresponding to nearly 40 percent of its national income. Mozambique is a classic example of a country that foreign aid has helped overcome many of its development challenges, including long periods of civil conflicts and low growth. In a recent study, Arndt et al. (2006) highlighted a number of specific channels through which foreign aid has had an impact on development in Mozambique. One such channel is the financing of foreign exchange and political governance reforms, thereby contributing directly to economic and political stability. In addition, external aid has played an important role in creating a more growth-conducive environment, as was confirmed by the lagged effect of private investment in growth accounting analyses.

According to Arndt et al. (2006): "Beyond the stabilising effects of external aid, we can identify more direct long-term growth effects via external financing of government investment, essentially in its entirety both prior to and throughout the post-war period. The most immediate and quantified example of this is found in the expansion of education, which has seen substantial progress since 1992… While the growth impact of investment in roads and health infrastructure has not been quantified in a similar fashion, it is reasonable to conclude that the direct contributions to economic growth of government and private sector investment in the post-war period, ... would have been substantially reduced in the absence of such external finance. Most obviously, growth in commerce, tourism and construction has been strongly supported by government investment in public infrastructure financed by external aid." (pp.67–68). They continue: "The Mozambican experience represents a shift from a vicious to a virtuous cycle, marked by the end of civil war and the emergence of sustained growth supported by external aid. Importantly, as the evidence shows, the end of the civil war coincided with the rapid relocation of displaced populations and a swift restart to growth, assisted by improved climatic conditions from 1994 onwards. In virtuous episodes, however, the aid-growth relation is not likely to be stable. Rather it will depend on the interaction between the changing nature of developmental challenges and the changing aid-growth lag structure associated with the composition of net aid. " (p.69)

Source: Arndt, Jones and Tarp (2006)

Aid is only one of the Factors that Contribute to Growth

In examining aid-growth relationships, it is important to recognize that, in addition to aid, a host of other factors contribute to economic growth. Many African countries experience low growth because they are especially vulnerable to economic and natural shocks such as declining terms of trade, droughts, floods, and other natural disasters. Many of these countries, particularly the land-locked countries, face high transaction costs in accessing regional and international markets — one of the key constraints to their economic performance. Other internal as well as external factors also impede the growth of many countries on the continent. Aid can only compensate for some of them; it cannot, by itself, overcome them (Morrissey, 2002a).

Aid Coordination

Over the years, sources of aid for many African countries have been diversified. Most African countries now receive aid from numerous bilateral, multilateral, and non-governmental organisations (NGO), which have different priorities, objectives, procedures, planning cycles, and conditionalities. These multiple donor requirements have led to management burdens stemming from the varied and complex administrative, accounting, and monitoring requirements of donors. In 2002, the mean number of official donors operating in aid-recipient countries was 20, though the typical sub-Saharan African country deals with more than 30 donors and several dozens of international non-governmental organizations (NGOs). This multiplicity of donors has created coordination problems and posed serious concerns for aid-recipient countries (see Box 3.2). For example, in Mozambique, the Ministry of Health alone operates about 405 projects, each involving different reporting requirements for each donor, and separate links between parts of different aid agencies and their counterparts in the various ministries (Wuyts, 1996). In Tanzania, about 650 donor projects are being implemented through either national ministries or local governments.

These different donor objectives and procedures have serious implications for aid-growth relationships, as lack of coordination among donors often leads to unnecessary duplication and waste. Donor projects that are poorly integrated into national budgetary processes and that are not subject to much transparency or effective control help sustain anti-development practices within the state apparatus and have minimal impact on growth. The uncoordinated receipt of large amounts of aid in highly aid-dependent economies may make it difficult for good governance and economic institutions to emerge. This may invariably inhibit the development of growth-promoting structures.

There has been little discussion about how to reduce the number of donors without reducing funding. Several key donors that have pooled resources have yet to participate in a joint mission. Senior

Box 3.2: Aid Coordination Problems in Zambia

Zambia provides a good example of some of the wider problems associated with donor coordination. Support for Zambia's education sector, formerly under a four-year investment program, has recently been channelled through a sector-wide approach, with $87 million in aid committed for 2004, including $20 million for education. With at least 20 donors supporting education, there has been a premium on effective coordination. The record is mixed. The Zambian government has been arguing for support to be channelled through pooled funds in the overall education budget, which now account for around one half of support. However, another one third of support is allocated through funds designated for purposes specified by donors, with the balance allocated for specific projects. In all, 20 donors are funding various sectors and each requires separate reporting procedures.

ministry officials continue to cite the length and frequency of reporting as a problem. Meeting donor requirements for reporting, consultations, and evaluations imposes a heavy burden on the scarce resources of public servants. Aid programmes in Africa generate demand for thousands of reports to multiple oversight agencies, as well as for hundreds of missions to monitor, evaluate, and audit performance.

Donor-aid coordination may come in three forms; namely, intra-governmental coordination, inter-donor coordination, and government-donor coordination. Intra-governmental aid management is currently perceived as extremely weak with regard to the overall aid management process. The problem is worsened by the relative strength of donor aid management in the form of parallel administrative controls and project management. With respect to inter-donor aid coordination, donors' activities are coordinated by the donors themselves or by the recipient government. Both options are very weak in most countries, even though the first is obviously a little better managed. In many countries, poor coordination has affected the effectiveness of aid and also undermined national planning. African governments have failed to effectively coordinate the aid endeavour (Knack 2006). A major constraint to the achievement of aid coordination is the lack of demand for it. Over the years, African countries have had to accept the need to adapt their methods and procedures to suit the management requirements of donors (Valdelin 1998).

Aid coordination remains the primary responsibility of the recipient. Effective aid coordination can be achieved by formulating a clear national aid strategy. Some of the key elements of a national aid strategy would include: national objectives, strategies, and priorities; articulation of the roles of recipients, donors, and implementing agencies; stipulation of modes of disbursement and accountability; and areas of focus and concentration. This is lacking in most African countries.

This clearly calls for a concerted coordination strategy. However, it should be noted that recipient countries have often played donors against each other, reducing incentives for donor coordination. Without coordination, donors can also freeride on each other by leaving the difficult tasks to the other donors (Elbadawi and Gelb, 2003).

The Issue of Tied Aid

Tied aid refers to development financing that is conditioned upon the procurement of some or all goods or services from suppliers in the donor country or in a limited group of countries[4]. This type of practice diminishes the development impact of aid (see Box 3.3). For instance, according to the 2005 Human Development Report (UNDP, 2005), tied aid undermines the effectiveness of development programmes as goods and services cost up to 20 percent more in donor countries than on the open market. This translates into an equivalent of a tax on aid in the range of $5–$7 billion a year, with

[4] According to the OECD criterion, tied aid to developing countries must be at least 35 percent concessional.

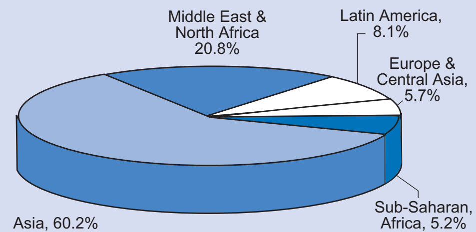
Box 3.3: Consequences of Tied Aid

Tied aid seems to be increasing as business interests become more assertive in influencing the shape and use of aid. Thirty percent or more of development aid is fully or partially tied. When aid is tied, recipient countries are likely to pay more — in some cases, 20 percent more — than the prevailing market rates for goods and services.

More disquieting, tied aid delays or distorts development, as inappropriate goods and equipment are purchased to suit the interests of business enterprises in donor countries. Examples of huge waste of money on capital-intensive projects that are unsustainable because of lack of local skills, ineffective demand, or paucity of domestic funds to meet recurrent costs are not confined to sub-Saharan Africa. According to a report from Tokyo, a children's hospital in Pakistan had to discard sophisticated equipment, purchased with development aid, because no one could handle the machinery. In the Philippines, a maritime polytechnic built with aid money and equipped to train 700 seamen, had few seamen enrolled. In October, 37 Japanese companies were fined $1.7 million for forming illicit cartels to carve up aid funds for projects that served their interests more than those of the recipient countries. Tied aid and a restricted bidding system foster such abuses. When this happens, aid becomes a breeding ground of corruption in both donor and recipient countries. Examples abound. Although some aid funds now reach non-governmental institutions, most aid goes to governments. When a particular government is corrupt or dictatorial in the use of power, aid money gives it additional leverage to pursue its abusive policies and suppress democratic opposition.

Source: Bimal Ghosh, "Aid for Development Makes at Least as Much Sense as Ever", International Herald Tribune, Tuesday 6 February, 1996.

Figure 3.1: Tied Aid Notifications by Region, 2003



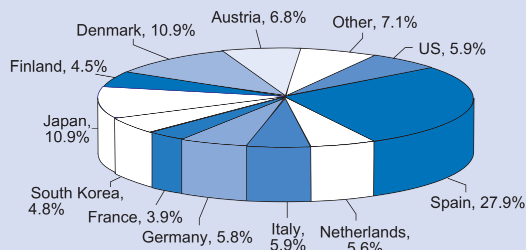
Africa alone paying $2.6 billion a year (UNDP, 2005).

Figure 3.1 shows the distribution of tied aid by region in 2003:. Much of the tied aid was on account of Asia, which accounted for over 60 percent of tied aid; This was followed by the Middle East and North Africa (MENA), with approximately 21 percent; whilesub-Saharan Africa accounted for the least proportion of tied aid, with 5.2 percent.

In terms of donor countries, Spain had the highest proportion of total donor tied aid in 2003, with close to 28 percent, followed by Denmark and Japan with 11 per cent each. See Figure 3.2.

However, a breakdown of tied versus untied aid from individual donor countries shows that a considerable proportion of aid from Australia, Austria, Canada, Denmark, Finland, New Zealand, and Spain is tied (Table 3.1). Although the UK has a relatively low reporting rate, the available data shows that 100 percent of its aid is untied. The United States, the Netherlands, Luxemburg, and Italy have not reported on

Figure 3.2: Tied Aid Notifications by donor, 2003



the tying status of their aid programs. However, a 1995 study conducted by the Freedom Support Coalition noted that "80 percent of U.S. foreign aid is spent in the United States buying food, equipment, expertise and services" (*The Washington Times*, 1995). Similarly, more than 50 percent of the $26 billion total overseas development assistance made available by European Union member states in 1997 was tied to goods and services from donor

Table 3.1: Tied Status of ODA by Donor Country (in %), 2003

	Untied	Partially Untied	Tied	Reporting Rate
Australia	67.2	0.0	32.8	100
Austria	51.4	0.0	48.6	100
Belgium	99.1	0.0	0.9	99.4
Canada	52.6	0.0	47.4	98.1
Denmark	71.5	0.0	28.5	100
Finland	85.8	0.0	14.2	100
France	93.1	3.9	3.1	100
Germany	94.6	0.0	5.4	100
Greece	93.8	1.2	5.0	100
Ireland	100	0.0	0.0	100
Italy	—	—	—	Not Reported
Japan	96.1	0.5	3.4	100
Luxemburg	—	—	—	Not Reported
Netherlands	—	—	—	Not Reported
New Zealand	81.4	0.0	18.6	100
Norway	99.9	0.0	0.1	100
Portugal	93.7	0.0	6.3	100
Spain	55.8	0.2	44.0	100
Sweden	93.6	6.4	0.0	100
Switzerland	96.4	0.0	3.6	100
United Kingdom	100.0	0.0	0.0	67.2
USA	—	—	—	Not Reported
Total	92.0	1.2	6.8	64.9

Source: OECD (2004)

country companies (*The Reality of Aid Report*, 2004).

Aid not Granted with Prudence

According to one school of thought, one of the reasons for the ineffectiveness of aid in Africa is the failure by donor governments and development agencies to exercise prudence in granting aid and loans to African governments. A great proportion of bilateral aid to Africa is used to finance grandiose projects (Ayittey, 1999). This partially explains why aid contributes little to economic growth. For example, Ayittey reports that in 1983 the United States built silos in Senegal, placing them in locations that peasant farmers never visited. He also reports that Canada funded a fully automated modern bakery in Tanzania — but there was no flour to bake bread. In Somalia, Italy funded a banana-boxing plant, but the production capacity needed to make the plant breakeven exceeded the country's entire output of bananas. In northern Kenya, Norwegian aid was used to build a fish-freezing plant to help the Turkana people. The only problem was that the Turkana people do not fish; they raise goats.

The Question of Aid Fungibility

Fungibility is a problem in aid flows; it is particularly relevant if the objectives of donors are different from those of recipients. However, as emphasized by the World Bank (1998), full fungibility does not mean that none of the aid money is spent on the intended projects. Rather, the effect on total spending on the intended project is the same as if the aid were provided as general budget support.

There are two types of aid fungibility: aggregate and categorical fungibility. Aggregate fungibility occurs when expenditure on a given activity falls short of the amount of aid intended for that activity. Categorical fungibility occurs when the aid increases other categories of expenditure rather than those for which it was intended (White 1998). For example, if aid provided to support the import of capital goods leads to a rise in total imports by less than the value of the aid, then this constitutes aggregrate fungibility, which can also occur when foreign aid leads to a fall in taxes or government borrowing. But if foreign aid intended for imports of capital goods is diverted to imports of consumer goods, then this obviously typifies categorical fungibility.

Aid fungibility constitutes a real problem in many African countries. As stated earlier, aid is intended to supplement domestic savings and foreign exchange earnings to increase investment and imports. However, Dollar and Pritchett (1998) posit that "fungibility helps explain why large amounts of aid have had no lasting effect" in countries with distorted allocations of expenditures and inefficient public sectors. An indirect transfer of funds occurs when an aid recipient renders aid fungible by reducing its own resources in the sector that receives the aid, transferring those resources to other sectors in the budget (Feyzioglu et al. 1998). This situation may arise when aid is targeted to sectors that a recipient government had previously marked for government spending. In such instances, aid may replace project or programme spending

that would have otherwise been included in the public budget. The replaced funds can then be used in a variety of ways. At the micro level, project funds can be reallocated to other projects within the same sector. At the meso level, the resources can act as general budgetary support, which may include a reallocation to other programmes, whether they are development-related or not. In the final analysis, both types of fungibility involve indirect spending of funds in ways not intended by the donor. When aid does not transfer into increased government spending, it is considered fungible at the macro level. In this case, funds are used to substitute for tax revenues, hence, aid transfers into tax relief (Jones et al., 2004).

There are two major implications of fungibility for the aid process. Pack and Pack (1993) suggest that aid fungibility increases a government's current expenditures (meso level fungibility) or reduces tax revenue (macro level fungibility). In both instances, it reduces national savings. This obviously runs counter to the expectations of the two-gap analysis, where aid serves to supplement rather than displace savings. Also, diverting aid to less productive sectors may reduce its contribution to economic growth.

Different Types of Aid have Different Impacts on Growth

Not all foreign aid is targeted at stimulating growth. Therefore, the growth-enhancing effects of aid may differ significantly depending on the type of aid. As Radelet, Clemens, and Bhavnani (2005) rightly point out, not all aid is alike in its impact on growth, suggesting that most research on aid-growth relationships is flawed with respect to both substance and timing. For instance, aid to build infrastructure (transport, telecommunications, energy) or to support agriculture and industry is more likely to promote growth than food and humanitarian aid or aid to support judicial or democratic reforms (see Box 3.4). In spite of this, "almost all studies look at the relationship between total aid and growth, even though large portions of aid are not primarily directed at growth" (Radelet, Clemens and Bhavnani, 2005: p.3). This partly explains the apparent lack of positive and significant relationships between aid and economic growth in many of the empirical studies on Africa, as the bulk of foreign aid to the region consists of aid that is not primarily directed at growth.

For example, in 2001/2002, 54 percent of total ODA to Africa went to the social services sector, 21 percent to economic infrastructure and services, and 13 percent to production activities[5]. Similarly, a breakdown of the UK's aid to Africa between 1988 and 2004 shows a big shift away from the economic sector to the social services sector (Table 3.2).

In view of the shifting nature of aid composition in Africa, it is not surprising that economic growth in many countries reflects the changing nature of sectoral aid allocation. Since a smaller proportion of aid is allocated to the productive sector, the rate of economic growth is likely to be constrained. A review of the experience of 46 sub-Saharan African countries during the

[5] See NEPAD and OECD (2005).

Box 3.4: The Type of Aid Matters for Economic Growth

Different types of aid have a different impact on economic growth, depending on whether or not they are directed at productive activities. Radelet, Clemens and Bhavnani (2005) classify aid into three broad categories: aid for disasters and emergency-related purposes, including food aid; aid that might have only indirect, long-term impact on growth ("late-impact" aid); and aid that has a direct impact on growth relatively quickly ("early impact" aid). They used these three aid categories to estimate the relationship between aid and economic growth for a group of 67 countries over the period 1974–2001. In the first group of countries, they found a negative relationship between aid and economic growth. This is to be expected because "disasters simultaneously cause growth to fall and aid to increase". This implies that without isolating aid categories from total aid flows, regression results are likely to be misleading!

In the second aid category ("late-impact" aid – aimed at such issues as democratic reform, judicial strengthening, human development, including education and health services, and environmental protection), Radelet, Clemens and Bhavnani (2005) found a weak positive relationship between aid and growth. This again is to be expected since this type of aid impacts on growth only after some time has elapsed — after at least a four-year period, in the case of aid support to democratic or judicial reforms; and after many years, in the case of human development aid.

The final aid category ("early impact" aid) consists of support to build infrastructure, support to productive sectors such as agriculture, manufacturing, services, and aid for budget or balance of payments support. This category of aid affects economic growth fairly immediately. As expected, Radelet, Clemens, and Bhavnani found a robust positive relationship between the "early impact aid" and economic growth. Their results show that, assuming plausible discount and depreciation rates at 35 percent, a $1 increase in "early impact" aid leads to a $1.64 increase in income in net present value (NPV) terms in the aid-recipient country. "This country-level return roughly corresponds to a project-level rate of return of around 13 percent" (ibid, p.6). In the case of sub-Saharan Africa, the authors found that "higher-than-average early impact aid raised per capita growth rates by about 1 percentage point over the growth that would have been achieved by average aid flows", suggesting that "while growth in sub-Saharan Africa has been disappointing, it would have been worse in the absence of this kind of aid" (ibid, p.6).

Source: Radelet, Clemens, and Bhavnani (2005)

period 1960–2002 reveals that, on average, targeting social spending was ineffective in promoting growth (Davoodi, Tiongson and Asawanuchit, 2003). However, subsequent studies appeared to cast doubt on this finding. For instance, results from case studies in Zambia, Senegal, and Burkina Faso stress the importance of foreign aid in financing health and education programs which support the human capital component of the growth process (*Agence Française de Développement* et al., 2005). This may be attributable to the fact that education aid is almost totally non-fungible (Devarajan et al., 1999) and that education and health sectors mostly receive aid in the form of grants rather than of loans (Jones et al., 2004).

Table 3.2: UK Aid to Africa by Sector, 1988–2004 (percentage of total)

Period	Economic	Social Services	Environment	Governance	Rural Livelihoods
1988/89–1989/90	66.4	17.2	2.6	3.5	10.4
1993/94–1994/95	56.3	23.0	3.3	8.4	8.5
1998/99–1999/90	23.7	36.0	3.4	28.7	8.2
2003/04	24.9	53.5	1.5	14.4	5.8

Source: Court (2005)

The issue, therefore, is not the ineffectiveness of social services aid, but rather the distinction between its short-run and long-run effects on growth. Aid in the context of social infrastructure may have long-term effects on labour productivity and growth (Clemens, Radelet, and Bhavnani, 2004), but foreign aid directed at physical infrastructure such as roads, irrigation, ports, and electricity is likely to promote growth within a fairly short period of time (for example, four years). It is against this background that the Commission for Africa Report (2005) called for the doubling of aid to infrastructure in Africa.

Issues of Aid Conditionality

With relatively weak institutions and many aid-dependent economies, Africa has the highest incidence of aid conditionalities. These conditionalities became increasingly ubiquitous and demanding during the structural adjustment programs of the 1980s and 1990s, when a host of conditions were imposed by donors. These conditionalities have shifted from the traditional economic frontier towards political issues such as multi-party democracy, political governance, and human rights. More conditions have recently emerged, including trade, security, and environmental issues.

Owen (2005) identifies three distinct reasons why aid may be made conditional. First, conditions on aid may increase incentives for policy reform by developing country governments. Second, allocating aid to countries with good policy environments may increase the impact of aid spending. Third, aid conditions may increase the ability to account for aid disbursement and its effects.

However, aid conditionality can be problematic for a number of reasons. First, these conditions tend to increase transaction costs for both donor and recipient countries. Second, conditions may reduce predictability, thus reducing the effectiveness with which aid is used. Third, some of the policy prescriptions may be misleading due to errors committed by donors, or to poor policy advice given by international consultants. Fourth, the conditions may undermine internal govern-

ment systems for prioritising, allocating, managing, and accounting for public spending. Fifth, the imposition of external conditions may contribute to poor accountability of developing country governments to their own citizens.

In spite of these problems, international financial institutions, led by the Bretton Woods Institutions, have utilised aid conditionality as an important instrument for aid delivery. In particular, they have switched from project aid to programme aid conditional upon a wide range of policy reforms (Raffer and Singer, 1996). Governance-related conditionalities represent the bulk of the conditions imposed by multilateral donors. For example, the average number of World Bank conditions in each sub-Saharan African (SSA) country rose from 32 during the early 1980s to 56 by the end of the decade. In 1999, the World Bank and the IMF imposed an average of 114 conditions on 13 SSA countries that embraced structural adjustment programmes at that time, with Senegal and Tanzania receiving 165 and 150 conditions, respectively (Table 3.3). It is noteworthy that the proliferation of aid conditionalities in Africa coincided with the rapid decline of ODA to the continent, forcing countries in the region to increasingly depend on loans from the IFIs (Mutume, 2001).

Table 3.3: IMF and World Bank Conditionalities in Sub-Saharan Africa, 1999

Country	Total Number of conditionalities	Of which institutional governance	Of which financial governance
Cameroon	92	56	21
Djibouti	134	77	29
Gambia	121	65	26
Ghana	80	42	19
Guinea	125	61	27
Madagascar	137	81	22
Mali	105	45	22
Mozambique	74	36	22
Rwanda	135	73	26
Senegal	165	72	27
Tanzania	150	67	37
Uganda	74	28	26
Zambia	87	43	16
Total	114	57.4	24.6

Source: Nyamugasira (2000)

Despite the increase in policy-based conditionalities, the results of lending based on those conditions are mixed. An evaluation of World Bank structural adjustment operations found that compliance with the policy conditions was low (World Bank, 1998). This problem is particularly severe in sub-Saharan Africa, where 14 of the 37 countries in the region that took advantage of the structural adjustment lending facilities have a very poor compliance record (World Bank, 1997).

In a detailed case study of 10 African countries that received substantial amounts of programme aid, Devarajan et al. (2001) found that only three of these countries (Mali, Ghana, and Uganda) reformed successfully; whereas, aid postponed policy reform in four other countries (Congo, Kenya, Nigeria, and Tanzania). These findings support the results of earlier studies, which found that a number of

African countries did not implement the policy conditionalities agreed upon with donors. For instance, Botchwey et al. (1989) cited the case of Zambia where the government did not abolish price controls as agreed upon with the IMF. Similarly, Killick et al. (1998) found that slippages occurred in more than 75 percent of 100 World Bank adjustment programmes. Indeed, the World Bank itself has admitted that "policy conditionality, in the sense of compliance with conditions attached to loans, has failed" (World Bank, 2005b). This is echoed by Verschoor (2006) who states that "there is plenty of evidence that, by and large, compliance with SAP conditions has not taken place".

The failings of conditionality reside in its inability to create an incentive system that can induce recipient governments to implement reforms they otherwise would not undertake or would undertake more gradually (Killick, 1998). This suggests that conditionality fails when it attempts to induce changes in behaviour that recipients are not committed to, or when it seeks to "micromanage" the aid process. However, well-defined performance targets are fundamental to good public policy. Conditions that are limited, jointly negotiated with policy makers, and consistent with learning by all parties can support donor aid constituencies while enhancing the quality of policy formation and implementation by the recipient government. To the extent that they build recipient institutional capacity, such conditions have an important role to play in aid agreements.

Aid and Political Conditionality

Ever since the end of the cold war, the world economy has witnessed a rapid growth in market-oriented reforms and in the democratisation process. Political conditionality has been increasingly used in the aid delivery mechanism to encourage a transition to electoral democracy. Donors have also sought to explicitly promote accountability and participation through a number of mechanisms, such as the principle of mainstreaming the private sector and civil society into national development strategies, including the PRSP process (Moss, Pettersson and van de Walle (2005).

The new political conditionality is a *volte-face* in development aid theory (Raffer and Singer 1996). But here again, the empirical evidence from Africa is mixed. Indeed, Dunning (2004) found no significant relationship between ODA and the level of democracy in 48 African countries during the period 1975–1986, but noted a positive and statistically significant relationship for the period 1987–1997. This is not surprising, as the latter period coincided with the era that marked the beginning of the intensification of globalisation and democratisation. In a recent study, however, Scholl (2005) found no evidence that donors show selectivity in giving foreign aid to more democratic countries.

In general, the immediate effectiveness of political conditionality has very often been disappointing. If not properly managed, political conditionality can often undermine nascent democracies and can

forment unhealthy political or ethnic rivalries, at times unleashing inter-ethnic or religious violence in the struggle to retain or achieve power (as in Kenya, Rwanda, Nigeria, and Burundi). Thus, in some African countries, democracy, *per se,* is not the problem; rather, the absence of an established process for the peaceful transfer of power is a source of political instability. Such instability can stifle reform and undermine growth (Morrissey, 2001).

Aid Selectivity

Aid selectivity refers to the quality of aid allocation and its effectiveness. It is a recent phenomenon that emerged following the inherent problems associated with aid conditionality and absorptive capacity in aid-recipient countries, coupled with the declining trends in foreign aid in the 1990s. The World Bank began the process by advocating a strategy of aid selectivity for countries with good policies aimed at poverty reduction (World Bank, 1998). Such a proposal gained popularity among major bilateral aid donors, with countries such as the UK and the Netherlands adopting a formula-driven aid-allocation mechanism to guide the distribution of their aid budget (Oxford Policy Management, 2005).

The literature on aid selectivity tends to perceive it in terms of either the optimal allocation of total aid from all sources or of the degree to which each source of aid conforms to the criteria of optimal allocation (Amprou, Guillaumont and Jeanneney 2005). Selectivity of the total amount of aid relies heavily on poverty criterion using the MDG of halving poverty by 2015 as a key benchmark (Collier and Dollar, 2001, 2002). The poverty selectivity indicator is essentially a needs-based approach. Thus, selectivity should be based on the expectation that aid contributes to the achievement of the MDG goal of lowering poverty through its impact on growth[6]. Another dimension of aid selectivity is based on policy selectivity, which has two dimensions: institutional capability (with respect to administration and budgeting) and policy priorities (Abegaz (2005). Collier and Dollar (2001, 2002) also investigated the policy aspect and found that the positive effect of aid on growth depends on the quality of the economic policy, as measured by the Country Policy and Institutional Assessment (CPIA). They developed a mechanism for optimal aid allocation to developing countries, based on three key ingredients[7]: (i) the diminishing marginal effect of aid on economic growth, (ii) the initial conditions of poverty in each country, and (iii) the quality of economic policy in each country. Based on this aid allocation framework, Collier and Dollar conducted a number of simulations to suggest that it is possible to use aid to reduce by half the number of the poor by 2015.

[6] Most studies on poverty selectivity with respect to the achievement of the MDG of halving poverty by 2015 assume income elasticity of poverty to be the same across countries.

[7] The allocation formula is aimed at equalising the marginal contributions of aid to reduce the absolute number of people living below the poverty line in each country.

In the case of donor selectivity, a number of studies have recommended a wide range of criteria. While McGillivray (1989, 1992) used the per capita income of aid-recipient countries as the single criterion for aid selectivity, other researchers, such as Dollar and Levin (2004) and Roodman (2004) diversified the indicators. For instance, they considered a number of factors that correspond to "good criteria", including the level of GDP per capita and the economic policy (proxied by the CPIA). They used these variables in an aid regression equation, controlling for the size of the recipient country's population. The estimated per capita income elasticity of aid is expected to capture the sensitivity of each donor to the level of poverty, while the CPIA elasticity of aid is intended to measure the responsiveness of aid to the quality of the receiving country's economic policy. The combined elasticities of the CPIA and per capita GDP then constitute the indicator of each donor's aid selectivity. The aid selectivity indicator proposed by Roodman, however, differs slightly from that of Dollar and Levin as it abstracts from the econometric estimation of functions of aid allocation[8]. In Roodman's approach, the aid selectivity for each donor depends on the recipient country's per capita income and on a governance indicator, using Kauffmann and Kraay's (2002) governance indicators.

Jones et al. (2004) provide a comprehensive survey of donor allocative behaviour, arguing that aid allocations and policies have become more poverty-driven as international consensus regarding support for the MDGs has grown. They found that donors had become more selective as they became more aware of evidence suggesting that policies were important for aid effectiveness. McGillivray (2004) looked at evidence from time series data over the period 1968–1999 and found evidence of selectivity in seven of the ten recipient countries under consideration.

Using data from 41 aid agencies, Dollar and Levin (2004) analysed whether there is selectivity in giving foreign aid to countries with sound economic policies. They argue that aid is now more selective compared with the indiscriminate policies of donors in the past. They also found that the UK, Austria, the Netherlands, and the Nordic countries are more favourably inclined towards both policy selectivity and poverty selectivity indicators. However, large bilateral donor countries such as the United States and France scored low on these selectivity indicators, while the multilateral donors appeared to be guided more by poverty considerations.

These variations between donors' choice of aid selectivity indicators, coupled with the likely trade-offs between poverty (need) and policy (effectiveness), underscore the difficulties associated with aid selectivity. Striking a balance between poverty-driven and policy-driven criteria is a tough call. As Shirley (2005) points out: "Selectivity demands a focus on the poorest countries, those that need aid the most yet still have sufficiently developed institutions to use it effectively. Given the current state of our knowledge, it is often difficult or

[8] See Amprou, Guillaumont, and Jeanneney (2005) for detailed explanations of this procedure.

impossible to judge which countries are on this margin" (p.27). She also states that the US "Millennium Challenge Account (MCA) illustrates the difficulties of determining whether countries are reforming their institutions enough to use aid productively" (ibid, p.27). See Box 3.5.

Box 3.5: The US Millennium Challenge Account

Created in 2002, the Millennium Challenge Account (MCA) aims to provide financial assistance to poor developing countries. However, disbursement of funds is based on the following three fundamental performance indicators for controlling corruption: "governing justly", "investing in people", and "promoting economic reform". Aid selectivity requires that countries score in the top half of all potentially eligible countries on the control of corruption criteria and on half or more of the other criteria under each of its three performance dimensions.

The MCA performance dimensions and criteria are as follows: The performance dimension of "governing justly" has six performance criteria: civil liberties, political rights, voice and vote, government effectiveness, rule of law, and control of corruption. "Investing in people" comprises four performance criteria: immunization rates, public expenditures on health, primary education completion rate, and public expenditures on primary education. Finally, the "promoting economic reform" dimension has six performance criteria: country credit rating, inflation rate, days to start a business, trade policy, regulatory quality, and fiscal policy.

Source: Shirley (2005).

As of 2006, 14 African countries were deemed eligible for the Millennium Challenge Account (Table 3.4). This is perceived as a testimony to improved economic policy changes, improved governance, and investments undertaken by African governments in key social sectors during the past decade. A number of African countries are currently being evaluated to determine their threshold qualifications. Seven sub-Saharan African countries are currently designated as close to the threshold for eligibility. The threshold countries and a number of other countries that are still far from eligibility have, nonetheless, demonstrated steady good performance, worthy of assistance in transformational development under the principles of aid effectiveness (USAID, 2006). As such, the number of African countries accessing this account might increase in the future.

Aid Selectivity Problems

There are several problems with selectivity. First, aid selectivity is difficult to implement in practice, especially when judged with respect to the achievement of the Millennium Development Goals. Reducing poverty remains the core of the MDGs, but it is extremely difficult to devise and apply consistent and even-handed criteria to measure country performance in terms of governance in this respect. High levels of poverty are often associated with weak governance. Therefore, denying weak governments the aid needed to alleviate poverty may simply worsen the situation. Poor performance is not always voluntary but may be caused by a wide range of

Table 3.4: African Countries Eligible for the Millennium Challenge Account

Country	Value ($ million)	Performance with respect to: 6 "Ruling Justly" Indicators	4 "Investing in People" Indicators	6 "Economic Freedom" Indicators
Benin	307.0*	> median on all	> median on 2	> median on 4
Burkina Faso	12.9[@]	> median on 5	> median on 3	> median on 3
Cape Verde	110.0[@]	> median on all	> median on 3	> median on 2
The Gambia	n/a*	> median on all	> median on 2	> median on 3
Ghana	3.0[#]	> median on all	> median on 3	> median on 3
Lesotho	n/a[#]	> median on all	> median on 3	> median on 5
Madagascar	110.0[#]	> median on all	> median on 3	> median on 4
Mali	n/a[#]	> median on all	> median on 2	> median on 4
Morocco	n/a[@]	> median on 5	> median on 3	> median on 4
Mozambique	n/a[#]	> median on all	> median on 2	> median on 3
Namibia	n/a*	> median on 5	> median on 2	> median on 4
Senegal	6.5[#]	> median on all	> median on 1	> median on 4
Tanzania	11.5*	> median on all	> median on 2	> median on 4
Zambia	24.3*	n/a	n/a	n/a

Source: Centre for Global Development (2006)
Year of Eligibiliy: * (2006), [@] (2005), [#] (2004).

factors affecting a developing country's capacity to implement reforms.

Second, an earlier evaluation by Collier and Dollar (1998) found that better policies and improved performance lead to decreasing levels of development aid. This sends the wrong signals to recipient governments.

Third, selectivity is a highly contestable concept, considering the existing limited understanding of the interplay between aid, macroeconomic policy, and political economy variables. In this context, using past performance as an indicator of future performance may be problematic.

Fourth, the fact that very few African countries have qualified for the Millennium Challenge Account means that many African countries are deprived of the much-needed assistance to promote infrastructure development, economic stability, policy reform, and capacity-building. This approach has also been criticized as having the potential to subject development aid to a potentially large degree of arbitrariness and volatility. This may reduce its effectiveness. Aid selectivity also remains silent on how to improve policies, institutions, and governance in poorly performing countries. However, if aid

selectivity encourages countries to improve their policies, it may contribute towards enhancing aid effectiveness.

Conclusion

This chapter reviewed the salient features of aid effectiveness. The analyses of the copious theoretical and empirical literature on aid effectiveness suggest that while foreign aid can, in general, promote economic growth and development in poor countries, it has not done so effectively in the case of many African countries. This limited effectiveness may be attributable to a number of factors, including inadequate institutions to make aid more productive, lack of absorptive capacity, and low level of human capital development. Other problems include multiplicity of donors with different requirements and objectives, lack of coordination and harmonization of donors' policies, and limited consideration of recipient countries' national development priorities in formulation of aid policies by donors. The issue of aid selectivity also poses an additional constraint to effective aid utilisation on the continent.

These factors call for a holistic approach to aid effectiveness to address the key constraints that militate against optimum utilisation of aid in Africa. It is not just a question of volume; the quality of aid must be improved if aid is to make a meaningful contribution to growth and development in Africa. The Paris Declaration on Aid Effectiveness provides food for thought on the way forward, but, unless it is fully implemented, the growth-enhancing impacts of increased aid to Africa, in line with the G8 Declaration and with commitments by other bilateral donors, may be seriously constrained in the near future. This would make it difficult, if not impossible, for Africa to achieve many of the Millennium Development Goals by 2015.

The international donor community must agree on satisfactory criteria for aid allocation. Given the complex nature of the relationship between development aid and poverty reduction, a diversified aid allocation approach cannot be wished away. However, there is an urgent need for flexibility in utilising the aid selectivity criteria to address the different institutional capacities and capabilities of African countries. Aid should increasingly be channelled to the productive sectors as well as towards building institutional capacities that will enable African countries to use foreign aid more productively and to create conditions necessary for attracting both domestic and foreign investments.

CHAPTER 4
Aid, Debt Relief and Poverty Reduction

Introduction

Poverty reduction is now a top priority on the policy agendas of African governments and of the international donor community. The enhancement of the Heavily Indebted Poor Countries (HIPC) Initiative in 1999, the adoption of the Millennium Development Goals (MDGs) in 2000, and the G8 Gleneagles' Declaration on aid and debt cancellation are important developments that have placed poverty reduction in the development policy limelight. The first paragraph of the introduction of the New Economic Partnership for Africa's Development (NEPAD) document contains "a pledge by African leaders based on a common vision and a firm and shared conviction, that they have a pressing duty to eradicate poverty and place their countries both individually and collectively on a path of sustainable growth and development…"[1]

The MDGs, as discussed in Chapter 1 (Box 1.1), have emerged as the yardstick with which to measure progress in poverty reduction as well as to assess the effectiveness of aid and debt relief. Many see increased aid and debt relief as necessary if major inroads are to be made in reducing Africa's poverty and in attaining the MDGs. Aid and debt relief are needed because African countries will not be able to generate the needed resources internally within the period set for the achievement of the goals. The Commission for Africa considers that "aid is the only credible source"[2], and the United Nations (UN) Millennium Project recommends "increased aid as an exit strategy from the poverty trap" (Sachs et al 2004:144). NGOs such as OXFAM have called for an increase in the quantity of aid and for debt cancellation.[3]

Aid per capita, measured in current US dollars, to African countries declined from an average of US$47 in 1997 to US$42 in 2003. Between the two periods, aid per capita increased to 18 countries, declined in 26 countries, and did not change in 2 countries. This trend in aid per capita suggests a need for external financial flows if poverty is to be reduced. Several estimates of the cost of achieving the Millennium Development Goals by 2015 have been prepared. Sachs et al (2004:185) of the UN Millennium Development project estimate that "African countries need an additional US$40 or so per capita per year in development assistance." This amounts to an additional US$25 billion of aid that will be required each year.

At the Financing for Development Summit in Monterrey in 2002, donors

[1] NEPAD, p.1.

[2] Commission for Africa (2005: 58).

[3] Oxfam (2005).

pledged to increase aid to 0.7 percent of their gross national product. The G8 has made commitments to double aid commitments to Africa by 2010, and initiated a Multilateral Debt Relief Initiative (MDRI), under which the African Development Fund, the International Monetary Fund (IMF), and the World Bank's IDA would cancel 100 percent of their debt claims on countries that have reached, or will reach, completion point under the enhanced HIPC Initiative. The MDRI is intended to help beneficiary countries attain the MDGs. The Commission for Africa recommends that aid to Africa should be doubled within the next three to five years.

If the pledges and commitments come through, then aid will be scaled up by enormous proportions. This raises a number of questions: Will these vast increases in external financial resources help Africa achieve the Millennium Development Goals at a faster rate than is currently the case? Will these increased flows significantly reduce the incidence and depth of poverty? Does Africa have the capacity to absorb the increased amounts of aid and debt relief that are envisaged? Will Africa be able to effectively manage the macroeconomic impact of these flows?

The Role of Aid and Debt Relief in Poverty Reduction

In response to the question on how low-income countries can achieve self-sustaining growth, Walt Rostow proposed, over half a century ago, that aid would have to finance a significant increase in net investment. In addition, one or more manufacturing sectors of the economy should have a high growth rate and there must be institutions that will ensure that the growth impulses are transmitted to the entire economy. In 1966, Chenery and Strout recommended a simultaneous increase in human skills, investment, and savings; the adoption of more productive technologies; changes in the composition of employment and output; and the development of new institutions, if poor countries were to achieve sustained growth. Countries may not be able to achieve target growth rates either because domestic savings are insufficient to provide funds for the needed investment or because export earnings are not enough to finance the needed imports. Aid would therefore fill whichever gap was the binding constraint and, given that the other conditions existed, would ensure that the target growth rate was achieved (see Chapter 3).

In the 1980s and 1990s, the thinking about the role of aid in the growth and development process changed. Increasingly, aid was no longer perceived only as an instrument for closing financing gaps; it was being used as an instrument to bring about policy reform in recipient countries. Conditionality has not been successful in bringing about significant and sustained reform. A re-thinking of how aid can be made more effective highlighted the need for country ownership of reforms, transformation of the aid-donor relationship to that of a partnership, and greater emphasis on outcomes rather than on inputs. This new thinking on aid and conditionality informed the parameters of the Poverty Reduction Strategy Papers that

were introduced in 1999 under the enhanced HIPC Initiative (see Box 4.1).

The recommendation of the UN Millennium Project to double aid flows to Africa is based on the observation that Africa's capital stock is lower than the critical level required for rapid growth. A minimum quantity of capital is needed for growth. To illustrate, production requires supporting investment such as transport networks, utilities, and a skilled workforce. Without these supporting investments, investment in productive activities is unlikely to happen and the economy could experience a slow-down if not negative growth. In addition, the low savings rates and the rapid population growth rate, because of low incomes, together create a vicious circle of low income and a poverty trap. The objective of the increased aid flows is to raise Africa's capital stock above the critical threshold level required for higher growth rates. The UN Millennium Project recommends that increased aid flows should be directed at prioritised public sector investments and should not be used to support consumption.[4]

Heavy debt burdens that require increases in taxation to service them can discourage investment and implementation of policy reform and have a negative impact on growth.[5] From a poverty reduction perspective, debt relief has two major advantages. First, the removal of the debt overhang can encourage investment. Second, debt relief makes available to the country resources that would have otherwise been transferred abroad. Whether additional resources will be made available to a country for spending on poverty reduction because

Box 4.1: Principles of the PRSP Process

Countries participating in the enhanced HIPC Initiative are required to prepare Poversty Reduction Strategy Papers (PRSPs). The principles of the PRSP approach are as follows:

- Being country-driven involving broad-based participation by civil society and the private sector in all operational steps;
- Being results-oriented focusing on outcomes that will benefit the poor;
- Being comprehensive to recognize the multi-dimensional nature of poverty;
- Being prioritized so that implementation is feasible, in both fiscal and institutional terms;
- Being partnership-oriented involving the coordinated participation of development partners (bilateral, multilateral, and non-governmental); and
- Being based on a long-term perspective for poverty reduction

Source: David Booth, *PRSP Processes in Eight African Countries: Initial Impacts and Potential for Institutionalization.* Discussion Paper No. 2001/121 (Helsinki: United Nations University/World Institute for Development Economics Research, 2001)

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[4] Kraay (2005) presents a dissenting view. He questions the existence of poverty traps as described by the UN Millennium Development Project. He argues that there is little evidence to show that savings rate and productivity rise sharply with an increase in development. Easterly (2005) also dismisses the poverty trap argument for increasing aid flows. He finds that the growth rate of low-income countries over the period 1950–2001 was not significantly different from that of other countries.

[5] Patillo, Poirson and Ricci (2002).

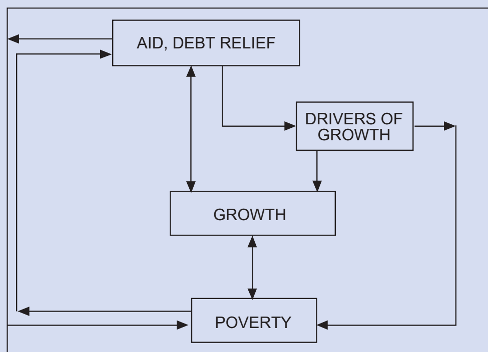
of participation in the enhanced HIPC Initiative will depend on whether or not the country was meeting its debt service obligations. The total debt service payments of African HIPCs were slightly higher in 2003, compared with 2001, and total debt service due after HIPC relief is projected to be higher in subsequent years. The global figure masks the varied experiences of individual African countries. In Uganda, one of the few African countries to access HIPC debt relief in its early years, debt service payments declined continuously between 2000 and 2002 and began to rise in 2003 and 2004. Debt service payments of later entrants such as Ghana, Mauritania, Niger, and Senegal were lower in 2004 than they were in 2001. In Burkina Faso, Chad, Gambia, Madagascar, and Mali, however, the reverse was the case.

The Centrality of Growth in the Aid-Poverty Reduction Nexus

The aid-growth relationship is one of the four channels through which aid can influence poverty (Box 4.2). Growth is

Box 4.2: Possible Channels through which Aid and Debt Relief can reduce Poverty

The causal relationship between aid and poverty reduction is not a simple one. Aid impacts poverty reduction through in several ways. The first and most frequently discussed is its impact on growth. Aid inflows can be growth enhancing if they finance investments in physical capital. Growth that is not accompanied by a worsening in income distribution will be poverty reducing. The expansion in government revenue due to growth in the economy will make available increased resources for pro-poor spending.



A second channel through which aid can bring about a decline in poverty is through aid's influence on other determinants of growth. The recent growth literature has identified institutions and governance as important drivers of growth. Aid flows that support institutional reforms that are efficiency improving will have a positive impact on growth and therefore on poverty reduction. Third, some cultural, social and political norms and practices can constrain the options available to individuals and groups and thus cause and/or perpetuate poverty. Aid flows can provide the resources that may be needed to reduce resistance to efforts to adapt or remove these norms, rules and practices. Fourth, aid flows used to finance increases in pro-poor spending that will reduce the incidence of infant and child mortality and stunting and wasting amongst children, for example, will have a direct poverty-reducing effect that will be independent of income.

central to the link between aid and poverty reduction because it is necessary for sustained poverty reduction. In addition, as the arrows in the diagram in Box 4.2 show, poverty can constrain growth. Srinivasan (2000,15) cautions that "a one-way stable relationship between growth and poverty and vice versa need not exist… In principle, there could be factors that generate growth while at the same time reducing poverty and inequality, and others which promote growth at the cost of increasing poverty and/or inequality. In turn there could be factors that reduce poverty and/or inequality while improving growth performance or alternatively reduce poverty and/or inequality at the cost of slower growth".

Several empirical studies have found a significant negative relationship between growth and poverty irrespective of how poverty is measured.[6] African countries have a lower poverty reduction rate for a given growth rate, compared with the average for other countries (Kraay, 2005; Ravallion and Chen,1997). In the 1990s, a 1 percent increase in growth would have reduced poverty in Africa by 0.77 percent. This contrasts with a 2.3 percent decline in poverty in developing countries (Ravallion and Chen, 1997). This evidence of a lower responsiveness of poverty reduction to growth in Africa suggests that the pattern of growth and country-specific conditions are important in shaping the responsiveness of poverty to a given growth rate. Income inequality and unequal access to land, credit, skills training, inputs, utilities, roads and markets can result in a differential impact of growth on poverty over time, across space, and amongst different groups. These inequalities reduce, if not completely limit, the ability of the poor to participate in the growth process. The overwhelming evidence seems to suggest that unless growth worsens inequality, it will reduce poverty (Box 4.3).[7]

Box 4.3: Growth and Inequality and Poverty Reduction

Uganda's impressive growth led to a large reduction in poverty, but an increase in inequality over the same period worked against further poverty reduction. If inequality had not changed, poverty would have been lower in 2003 with the rate of growth. Burkina Faso showed more modest overall growth and, therefore, a smaller contribution of growth to poverty reduction, but the decline in inequality also reduced poverty. Poverty reduction in Ghana was due almost entirely to growth because the change in inequality over the period was small.

Source: Excerpt from Patillo et al (2006) "Growing Pains" *Finance and Development*, Vol. 43, No. 1.

Africa's per capita growth rate averaged 1.1 percent in the period 1998–2002, rising to 2.1 percent in 2003. Per capita growth rates increased in 39 countries but declined in 12 of them in 2003. Twenty countries had per capita growth rates of more than 3

[6] Roemer and Gugerty (1997), Ravallion and Chen (1997).

[7] Ravallion (1997), Mosely et al. (2004).

percent. Growth in per capita income will have to exceed current rates if sustained poverty reduction is to be achieved.

The centrality of growth to poverty reduction therefore suggests that the aid-growth link will be crucial to ensuring that increased aid flows yield the targeted reductions in poverty reduction and achieve the Millennium Development Goals.

The link between aid and growth has been highly debated in the literature. Empirical investigations into the relationship between aid and growth have not always shown a positive significant relationship (see Chapter 3). The mixed findings on aid and growth may be attributable to a number of factors, including the type of aid, the scope of the analysis (times series versus cross-country studies), methods of estimation and influences of other growth determinants.

Aid and the Proximate Determinants of Growth

Aid and debt relief can also influence poverty through their effect on growth drivers. Aid can be growth–enhancing, thus contributing to poverty reduction if it favourably affects other determinants of growth. Most empirical growth studies have found that inflation, the size of the budget deficit, openness to trade, the exchange rate, the quality of institutions, governance, the degree of ethnic fractionalisation, the climate, and political stability are all significant determinants of growth.

In the recent past, aid conditionality has been directed at inducing policy reform and changes in governance and institutions. Can aid bring about policy reform? The answer would appear to be "not all the time". A study on aid and market-liberalising reforms — using data from 76 countries for the period 1980–2000 — found that, on average, aid discourages market-oriented policy reform. However, when the sample was restricted to the period 1990–2000, aid was not found to be significant.[8] Evidence from 10 African case studies suggests that there is no systematic link between aid and policy reform. Policy reform is determined largely by domestic players and not by aid conditionality. The lacklustre performance of aid conditionality in bringing about policy reform has brought to the fore issues of ownership, partnership, and donor-recipient relations as critical influences on the effectiveness of aid (see Chapter 3). These three themes have featured quite prominently in the aid rhetoric in the last five years or so and form the principles of the poverty reduction strategy paper process.

Counteracting Factors

Several studies investigating the aid-growth nexus include a quadratic term for the aid variable. It is expected that increases in aid will initially be accompanied by an increase in growth until a critical level of aid is reached where diminishing returns set in.[9] The non-linear relationship may be explained by absorptive capacity constraints

[8] Heckelman et al. and Knack (2005).

[9] Gormanee et al. (2004), Hadjimichael et al (1995), Hansen and Tarp (2000), Lensink and White (2001).

that become binding after a critical level of aid is received, as discussed in Chapter 3 of this report. Diminishing returns may set in because low-income countries do not have the institutions or technical capacity to design, implement, and monitor policies and strategies to ensure that the increased aid flows will translate into growth and poverty reduction. The slow pace towards an effective and efficiently coordinated and harmonised aid system also imposes absorptive capacity constraints on recipient countries. Hadjimichael et al. (1995) include a squared aid term in their regression analysis of 31 African countries over the period 1977–1992. The aid term has a significant positive coefficient and the squared aid term has a negative significant coefficient, thus suggesting the existence of absorptive capacity constraints.

A second counteracting factor is the possible appreciation of the real exchange rate. An increase in aid flows can cause an appreciation of the real exchange rate, creating a disincentive to production in the tradable goods sector. A real exchange rate appreciation will slow down growth if the tradables sector, in particular exports, are the major source of productivity improvements and technological change. The exchange rate changes brought about by aid inflows and debt relief will depend on a number of factors. This first is whether aid and debt relief are spent on domestic goods or on imports. If the additional resources are spent on domestic goods, then the existence of usable capacity and unemployed labour in the economy for the expansion of the domestic sector becomes important. If this excess capacity does not exist, then the prices of factors of production will increase as the demand for them increases in the domestic goods sector. It is this increase in the price of nontraded goods relative to traded goods that is measured by the appreciation in the real exchange rate. The tradables sector is placed at a disadvantage since wage increases will squeeze profit margins and erode competitive advantage. A study investigating the possible negative effects of aid using data from 47 developing countries found that labour-intensive industries grow slower in countries that receive more aid, irrespective of the type of aid.[10] However, a number of studies on African countries found that increased aid inflows were associated with a depreciation of the real exchange rate. In part, this was because in addition to an increase in aid flows, policy reforms included nominal adjustments aimed at depreciating the real exchange rate.

Will aid generate growth under any or all conditions? Early writers on aid and growth, such as Rostow and Chenery and Strout, were explicit about the conditions needed to acheive growth targets. Country-specific conditions, domestic policy, and the quality of institutions determine a country's growth and poverty reduction trajectory when aid is received. Empirical investigation by Burnside and Dollar (2000) confirm the relevance of policy, although their findings suggest that aid will only be growth enhancing if the right policies are in place.[11] The findings of Burnside and Dollar,

[10] Rajan and Subramaniam (2005).

[11] Burnside and Dollar (2000).

however, are not robust. The significance of the aid-policy coefficient disappears when the non-linear aid-growth relationship is controlled for[12], when the time period of the study is extended, when the definition of policy is changed, when the country coverage is expanded, and when different definitions of aid are used.[13] Recent research has found that "the same reform measure can yield highly varying outcomes depending on country circumstances"[14].

Aid can therefore promote growth. Increased aid flows may have diminishing returns, and the efficacy of aid on growth and on poverty reduction may depend on whether the "right" policies are in place. However delicate the link between aid and the policy findings of Burnside and Dollar may be, the existence of absorptive capacity constraints and the varying poverty elasticity growth rates amongst different country groups, simple intuition and anecdotal evidence suggest that country conditions — that is, institutions and policies — are important in the aid-growth nexus. Micro-level studies of aid have revealed the relevance of policies, institutions, and other variables on the achievement of the intended objectives of aid-financed projects and programmes.

Aid and Non-Income Poverty Correlates

Aid and debt relief can make available additional resources for spending on health, education, water and safe sanitation (Box 4.4).[15] Pro-poor spending in HIPCs in Africa has increased with their participation in the HIPC Initiative (Figure 4.1). Regression analysis reveals that aid flows can explain the increases in pro-poor spending in low-income countries (Mosley et al., 2004).

Econometric analysis on the relationship between aid, pro-poor spending, and poverty reduction is mixed. While Mosley et al conclude that pro-poor spending reduces poverty, Gormanee et al. (2003) do not find a significant relationship between pro-poor spending and poverty reduction.

Box 4.4: Debt Relief and Pro-Poor Spending in Uganda

Uganda's Poverty Action Fund (PAF) was established in 1998 to protect funds for poverty eradication from budgetary cuts. The PAF is funded by HIPC savings, "earmarked" donor funds, and government revenues. HIPC savings doubled between 1998/99 and 2002/2003 — this was accompanied by an expansion in pro-poor spending. The resources saved from HIPC debt relief that were channelled to the PAF allowed Uganda to increase the budget for primary education, primary health care, rural roads, safe water and sanitation, and agriculture.

Source: Kuteesa, F. and R. Nabbumba (2004) "HIPC Debt Relief and Poverty Reduction Strategies: Uganda's Experience" in J. Teunissen and A. Akkerman (eds) *HIPC Debt Relief. Myths and Reality* FONDAD

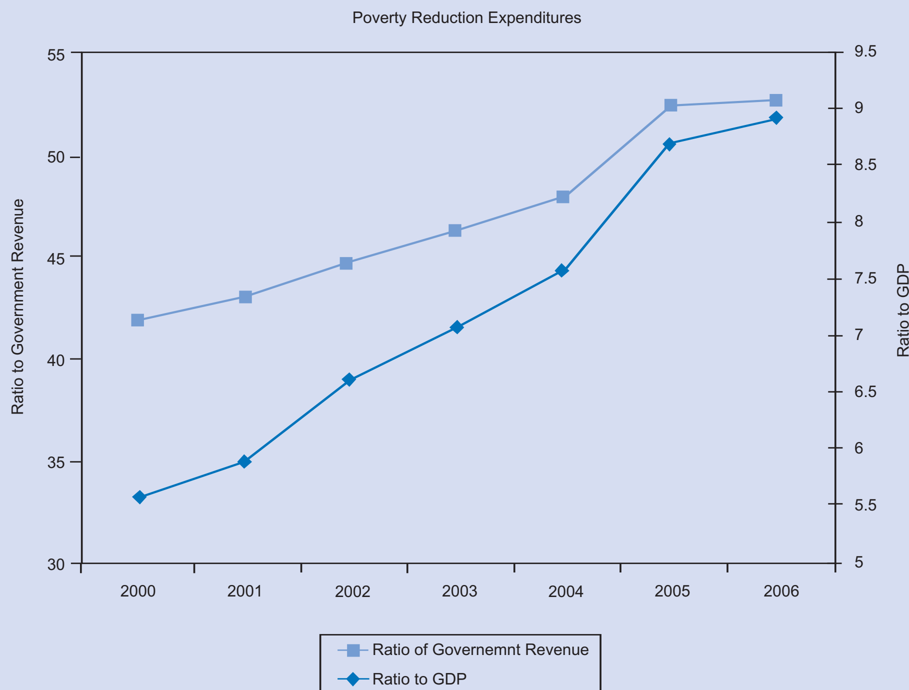
[12] Hansen and Tarp (2000), Lensink and White (2001).

[13] Easterly (2003).

[14] Leipziger and Zagha (2006:).

[15] The debt service payments of some African countries have not declined substantially since they joined the enhanced HIPC Initiative.

Figure 4.1: Poverty Reducing Expenditures in Africa



Source: IMF and IDA (2005) *Heavily Indebted Poor Countries Initiative — Status of Implementation.*
1/ Data is not available for all countries for all years.

However, Morrissey et al. find that aid has a positive significant effect on welfare as measured by the Human Development Index of the UNDP. Fielding et al. (2006) find that, on average, aid has a positive effect on access to improved sanitation and a negative effect on child mortality. A casual look at data reveals that social sector spending has not always translated into an improvement in non-income poverty indicators in Africa. Spending on health as a proportion of the gross domestic product rose from an average of 3.5 percent in 1990 to 5.7 percent in 2001. Out of a sample of 32 African countries for which data on health spending is available for 1990 and 2002, maternal mortality rates declined in 17 countries and child mortality rates declined in 23 countries between the two periods. Increased spending on health and education does not always translate into improved health indicators.

Whether an increase in pro-poor spending improves non-income poverty correlates depends on how well-targeted the expenditures are. The increased spending must be directed at locations where the poor are found. In addition, the cost of accessing the services provided must not make it inaccessible to the poor (Box 4.5).

Poverty in Africa

The incidence of income poverty in Africa in the mid 1990s was high. In 9 out of 21 countries for which data is available, more than half of the population was below the national poverty line (Table 4.1). In addition to the high incidence of poverty in some countries, a substantial number of households move in and out of poverty over time (Box 4.6). This high frequency of movement above and below the poverty line suggests pervasive vulnerability to poverty amongst a significant proportion of the population. There is also evidence that some households remain in poverty for extended periods. Aid flows and the associated programs must be directed at tackling the twin problems of reducing vulnerability to poverty and pulling as many of the chronic poor as possible out of poverty.

Box 4.5: How Aid can Directly Impact on Non-Income Measures of Poverty

Adimponso is a cocoa-producing rural community in the Western Region of Ghana with a population of about 3,000. Its nearest health facility was 29 kilometres away. As there was no regular means of transport, it could take up to two hours to reach the nearest health service. Maternal and child mortality rates in the community were the highest in the district. Despite the numerous needs of the community, an application was made to the Social Investment Fund for the construction of a clinic and nurses' quarters.

As a result of the construction of the clinic and nurses' quarters, there has been no record of maternal death because expectant mothers can now receive ante-natal care. The number of infants covered by immunisation has increased. Medical statistics have improved and epidemics can easily be traced and responded to on time.

Source: Ghana Poverty Reduction Project/Social Investment Fund (GPRP/SIF) (2004) *Report on Impact of Ghana Poverty Reduction Project/Social Investment Fund (GPRP/SIF)*, Accra.

Many African countries do not have enough information with which to assess trends in income/consumption poverty since the mid-1990s. Poverty is manifest in different dimensions in addition to low levels of income and consumption expenditure. Low net primary enrolment rates, high infant and child mortality, stunting amongst children, and low access to safe drinking water and sanitation are all manifestations of poverty, as is social exclusion and lack of voice. Fortunately, trend data is available in several countries for many of the non-income measures of poverty.

The Human Poverty Index (HPI) of the UNDP is an attempt to capture the multidimensionality of poverty; it focuses on non-income measures. It is a composite of non-income measures of poverty (probability at birth of not surviving to age 40, adult illiteracy rate, percentage of population without sustainable access to an

Table 4.1: The Incidence of Poverty in Selected African Country National Surveys

	Year	%		Year	%
Algeria	1998	12	Kenya	1997	52
Benin	1999	29	Madagascar	1997	73
Burkina Faso	1998	45		1999	71
	2003	46	Malawi	1999	65
Cameroon	1996	53	Mali	1999	64
	2001	40	Morocco	1999	19
Chad	1996	64	Mozambique	1997	69
Egypt Arab Republic	1996	23[a]	Rwanda	2000	60
Equatorial Guinea	2000	17	Tanzania	2001	36
Ethiopia	1996	46	Tunisia	2000	2
	2000	44	Uganda	2000	34
Gambia	1998	58		2003	38
Ghana	1991	51.9	Zambia	1996	69
	1998	39.5		1998	73

Source: World Bank, *World Development Indicators*.

improved water source, and percentage of underweight children). The HPI improved by 5 or more percentage points for 12 out of 41 African countries between 1997 and 2003 and deteriorated by 5 or more percentage points for another 12 countries (Table 4.2). The remaining 17 countries did not register significant changes in the index.

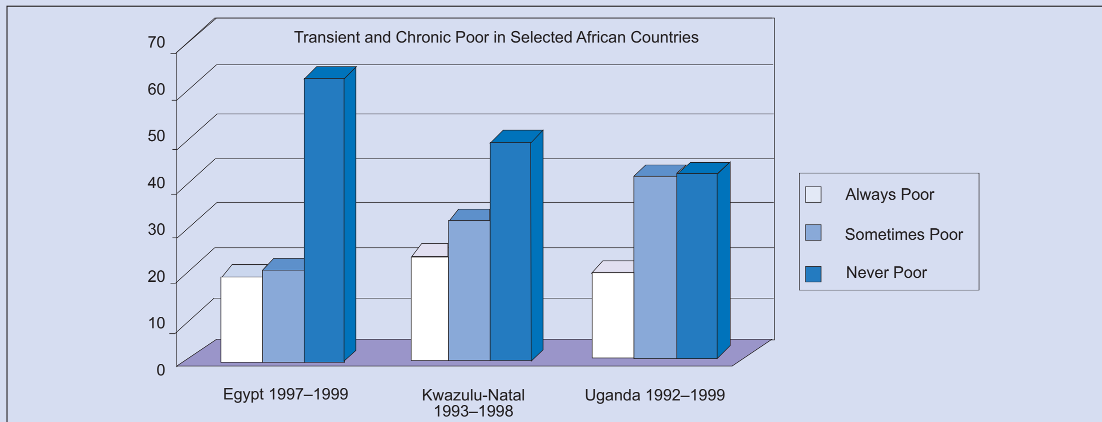
Progress made by African countries towards the Millennium Development Goals is mixed. Between 1990 and the 1997–2002 period, 31 out of 51 countries reduced maternal mortality rates significantly (Figure 4.2). Countries such as Benin, Guinea, and Senegal made significant progress in reducing maternal mortality. Although several countries have made substantial progress, maternal mortality rates remain above 100 deaths per 100,000 live births in several African countries. Cape Verde, Libya, Mauritius, Sao Tome and Principe, and Tunisia stand out with maternal mortality rates lower than this level. Maternal mortality rates worsened significantly in 7 African countries over the period.

Child mortality rates fell significantly (by 10 or more points) in more than half of the countries between 1992 and 2003, but worsened significantly in 5 of the countries. Despite the improvements in several countries, child mortality rates remain high: in 40 African countries, the rates exceed 100 deaths per 1000 live births.

Between 1997 and 2002, the mean daily calorie intake increased in 38 African countries, but declined in 10 of them.

Box 4.6: Poverty Dynamics in Africa

There is a considerable movement of persons and households above and below the poverty line over time. The transient poor constitute a significant proportion of the poor at any particular point in time. In Uganda, for example, more than half of the poor in 1991/1992 and in 1999/2000 were poor in one of the two years. The recent poverty reduction strategy paper for Burkina Faso observes that "overall the increase in poverty… between 1998 and 2003 is due to the number of transitory…. poor. This number has increased much more than the number of long-term poor which is in relative decline. This worrisome situation signifies an increase in vulnerability."



Source: Odura and Jebuni (2006)

However, the daily calorie intake in 36 countries remained below 2500 calories in 2002. The slow growth in calorie intake is attributable to the lacklustre performance of food production in several countries. Indeed, food production per capita declined in 31 countries between 1997 and 2002.

Progress in increasing the proportion of the population with access to safe water has been slow. Out of 40 countries for which data is available, only 18 of them improved access to safe water by more than 10 percentage points between 1990 and 2002. There was no significant change in access (Figure 4.2) among the remaining countries.

Six African countries attained universal primary education with net primary enrolment rates of 100 percent (Seychelles) or above 95 percent (Libya, Mauritius, Tunisia, Algeria, and Cape Verde). In 2002–2003, net enrolment rates in 6 African countries were below 50 percent. During the period 1990–1991 — 2002–2003, net enrolment rates increased by more than 10 percentage points in 17 African countries; no significant improvements or deterioration were recorded in 18 of them (Figure 4.2).

Questions have been raised about whether the Millennium Development Goals are attainable within the set time

Table 4.2: Human Poverty Index (% value), 1997 and 2003

	1997	2003		1997	2003
Algeria	28.2	21.3	Lesotho	23.0	47.6
Angola	–	41.5	Libya	16.4	15.3
Benin	50.9	48.4	Malawi	42.2	43.4
Botswana	27.5	48.4	Mali	52.8	60.3
Burkina Faso	59.3	64.2	Mauritania	47.5	40.5
Burundi	46.1	40.9	Mauritius	12.1	11.4
Cameroon	38.1	36.2	Morocco	39.2	34.5
Cape Verde	24.7	18.7	Mozambique	49.5	49.1
Central African Republic	53.6	47.8	Namibia	25.0	33.0
Comoros	34.6	31.2	Niger	65.5	64.4
Congo	32.3	30.1	Nigeria	38.2	38.8
Congo, Dem. Rep.	–	41.4	Rwanda	–	37.7
Cote d'Ivoire	46.8	41.9	Senegal	49.6	44.2
Chad	52.1	58.8	Sierra Leone	57.7	54.9
Djibouti	40.8	29.5	South Africa	19.1	30.9
Egypt	33.0	30.9	Sudan	36.8	32.4
Eritrea	–	38.7	Swaziland	27.6	52.9
Ethiopia	55.8	55.3	Tanzania	29.8	35.8
Equatorial Guinea	–	38.1	Togo	38.4	39.5
Gambia	49.9	44.7	Tunisia	23.1	18.3
Ghana	36.2	35.1	Uganda	40.6	36.0
Guinea-Bissau	51.8	48.2	Zambia	38.4	46.4
Kenya	28.2	35.4	Zimbabwe	29.2	45.9

Source: UNDP *Human Development Reports*

frame. The provision of primary school buildings can be expanded within a year, but this may not be sufficient to ensure an increase in net primary enrolment rates. This is because net primary enrolment rates are determined by other factors such as the education of parents, the proximity of secondary schools, the quality of education in primary schools, and the opportunity costs of education. Some of these variables cannot be changed in the short- or medium-term. The Millennium Development Goals should therefore be considered more as targets that countries are desirous of achieving. Thus, the assessment criteria should be progress made towards achieving these targets. Initial conditions among African countries differ considerably and are important in determining when the targets will be reached. Several African countries have made progress in the right direction towards achieving some

of the Millennium Development Goals. The current levels of most indicators suggest that several African countries may not attain all the goals by the year 2015. The effectiveness of aid should not be assessed based only on whether the targets have been attained, but also on progress made towards achieving the targets.

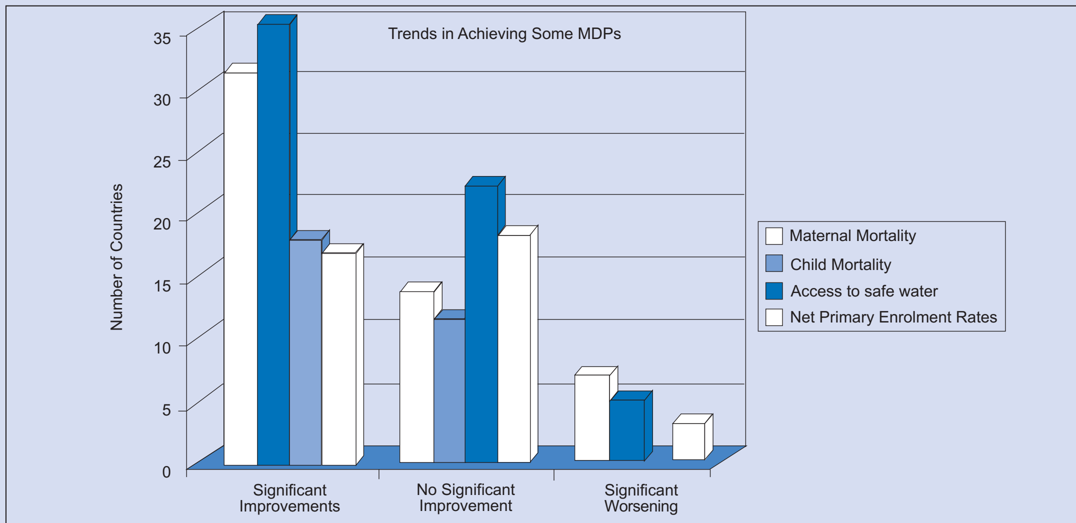
Ensuring Poverty Reduction

The link between aid, debt relief, and poverty reduction is a tenuous one and depends on several caveats. The reduction in poverty envisaged in poverty reduction strategy papers and in the Millennium Development Goals requires a concerted effort on the part of recipients and donors. Recipient countries must develop clearly articulated pro-poor growth strategies and carefully manage the macroeconomic impact of aid. Greater effort should be made to harmonise aid in full cognisance of the challenges that moving towards greater harmonization entail.

Developing Pro-Poor Growth Strategies

Aid and debt relief will reduce poverty if the inflows bring about pro-poor growth. One school of thought believes that even though growth is essential for sustained poverty reduction, what is required is pro-poor growth — growth that is accompanied by a decline in poverty. Another school of thought considers that

Figure 4.2: Trends in Some Selected Millennium Development Goals in Africa



Source: Estimated using data from the African Development Bank *Selected Statistics on African Countries Vol. XXIV.*

little additional value would be achieved in terms of poverty reduction by differentiating between pro-poor growth, in particular, and growth in general. The sectoral composition of growth is important to the extent that different sectors may have different factor intensities. If growth occurs mainly in sectors that require skills and capital that the poor do not have, then, although the economy may grow, it may have no appreciable impact on poverty reduction. The income, spatial, and gender inequalities that exist in most of Africa leave no one in doubt that a trickle-down growth strategy that does not take into consideration income distribution issues will not bring about the desired sustained reduction in poverty. The Commission for Africa's nine-pronged strategy includes policies aimed directly at ensuring that no one is excluded from the development process and that the growth strategy includes the poor.

Recent research findings suggest that policy reforms should focus on identifying and addressing binding short-run constraints that, if removed, would generate significant growth and/or poverty reduction. In the past, countries were expected to undertake reforms on a wide range of measures. Some reforms were partially implemented or not at all. Concurrent action on several fronts strained implementation capacities. Researchers have found it difficult to identify variables that can explain acceleration in growth rates, that is, the drivers of growth (Hausmann et al., 2006). Furthermore, the efficacy of policy is not consistent across countries. The UN Millennium Project proposes a list of seven areas for public investments and policies, recommending that "each country will need to decide on policy and investment priorities for early implementation, depending on local circumstances. These might be based on where the needs are greatest or where interventions can have the greatest impact."[16]

The principles underlying the preparation process and content of poverty reduction strategy papers create the potential for the design of a pro-poor growth strategy based on the particular circumstances of individual countries. However, the experience suggests that this potential has not been exploited. The various components of the strategies are poorly integrated and do not always fit into the macroeconomic framework. There are weaknesses in some papers in the analysis of the key constraints to growth and poverty reduction, the analysis of sources of growth and poverty and social impact analysis (IEO, 2004). A more comprehensive analysis is needed to inform the design of a poverty reduction strategy that considers growth policies and the non-social sectors. These weaknesses can be attributed to inadequate data and weak technical capacity.

A pro-poor growth strategy should have the following objectives: ensure that markets work efficiently, create sustainable employment opportunities for the poor and increase their capacity to take advantage of the opportunities so created. In addition, policy should be concerned with enabling

[16] UN Millennium Project (2005:98).

the poor to build up their physical, financial, social and human capital base, and encouraging institutional reform and governance that will provide opportunities for voice and inclusion of all groups. Even though the immediate policy focus will be relaxation of short-term constraints, forward-looking assessments must be undertaken to identify emerging constraints as the short-run constraints are addressed. In pursuing pro-poor growth strategies, the exact menu of policies that a country chooses should be geared towards increasing the incomes of the poor by improving the returns to their assets.

The Share and Composition of Social Sector Spending

Current poverty reduction strategies are characterized by a heavy emphasis on social sector spending. Public sector spending decisions will have to consider three issues. The first is the appropriate share of social sector spending in the total. An increase in social sector spending may improve the non-income measures of poverty, but it is unlikely to cause the desired spurt in growth in the short run. The appropriate mix between social sector spending and infrastructure spending, for example, will vary by country and should be determined by the identified short-run bottlenecks that must be addressed.

The second issue is the composition of social sector spending. A quick way to achieve the second Millennium Development Goal of universal primary education may be to build more schools. The distance of primary schools from communities can delay entry into the first year and can discourage the enrolment of girls. A school-building programme may increase enrolments immediately but will not be sustained if there are not enough teachers. This is because children and parents will soon realise that not much is being learnt in school because of overcrowded classes and overworked teachers. An alternative approach to increasing net primary enrolment rates would be to invest in the training of teachers. This may delay the takeoff of enrolment rates, but the rate is likely to improve with the increase in the proportion of children that complete primary school.

Social sector spending in many African countries consists largely of spending on education and health. The prevalence of transitory poverty in most African countries calls for a more nuanced approach to poverty reduction. The additional resources made available through aid flows and debt relief will create room for the introduction and implementation of social protection programmes. Humanitarian aid and emergency relief provide resources in times of crises. There is, however, a need for social protection programmes that contain safety net programmes to assist invalids, orphans, and the elderly, for example, who cannot take advantage of growth opportunities and social insurance schemes that reduce vulnerability to poverty-increasing risks. From a poverty reduction perspective, and contrary to the prescription of the UN Millennium Development Group, some of the aid flows and debt relief should be allocated for consumption purposes through carefully designed social protection programmes (See Box 4.7).

Box 4.7: The Case for Social Protection Strategies in Africa

Social protection can be defined as "all public and private initiatives that provide income or consumption transfers to the poor, protect the vulnerable against livelihood risks, and enhance the social status and rights of the marginalised, with the overall objective of reducing the economic and social vulnerability of poor, vulnerable and marginalised groups." (Devereux and Sabates-Wheeler, 2004: 9).

African households are exposed to a wide range of risks, for example, variability in the weather, illness, death, economic instability, and crime. Almost half of Ethiopian households in a rural sample covering the period 1999–2004 reported loss of assets, income or consumption due to drought (Dercon: 2005). Another 43 percent of the households were adversely hit by the death of the household head or spouse. A character of the risk African households face is its frequency. The modal number of shocks reported by households in Builsa, a rural district in Ghana, was five or more over a period of two years (UNDP, 2005). Risk can cause poverty. In the absence of adequate coping mechanisms such as a market for insurance and public safety nets, negative shocks can move a household into poverty. In a high-risk environment with imperfect credit and insurance markets, low-income households may choose low risk investments that have low returns.

Provision of social programs can be poverty reducing and growth promoting. The availability of safety nets can change the investment decisions of low-income households and therefore have a positive impact on growth. Safety nets can prevent consumption from falling below a level that can adversely affect the health of children with its attendant long run effects and discourage physical and therefore economic activity of adults. Resources that are set aside for precautionary purposes can be re-directed for investment purposes.

Social protection programs will not only reduce vulnerability to risks, but can also provide the basis for individuals to disentangle themselves from relationships that protect them from falling into deprivation when crisis hits, but which might at the same time be exploitative.

The third issue that should be in the forefront of pro-poor spending decisions is ensuring that the spending reaches the intended beneficiaries. User fees, the direct cost of travel to access the service, and the opportunity cost of the time it takes to access the service are some of the factors that determine whether the poor will benefit from an increase in spending on primary education or on primary health care, for example. In Uganda, the removal of user fees has increased the use of health services among the poor (Deininger and Mpuga, 2005). In Mozambique, physical distance is a constraint on usage of curative health services. The further away the health facility, the less likely it is that a sick person will visit the facility (Lindelow, 2005).

Strengthening Monitoring and Evaluation Systems

Monitoring and evaluation can play an important role in poverty reduction strategies. Policy makers must be regularly informed on progress towards achieving targets and goals. Policy implementation must be assessed and reviewed to identify bottlenecks and constraints and to ascertain

the relevance and effectiveness of policy actions. Targets may have to be revised and new policy actions introduced in the context of changing economic conditions.

Clearly defined objectives and strategies must guide the implementation of monitoring and evaluation. Thus, the strength of the monitoring and evaluation system will be determined by how clearly the strategy outlines the objectives, targets, and processes that should be pursued and implemented for these purposes. The monitoring and evaluation process should feed into the decision making process, in particular, the budgetary process. As part of the enhanced HIPC Initiative, countries that have prepared poverty reduction strategy papers must conduct annual progress reviews. The contribution of the annual progress report as a monitoring and evaluation tool and input into the policy making process has been mixed. In countries such as Burkina Faso, Ghana, Tanzania, and Uganda the reviews have had an impact on the budget. In Ghana, specific actions have been taken to improve the link between the budget and the poverty reduction strategy paper. These actions include organising workshops to improve the understanding of the ministries, departments and agencies of the MTEF process as well as linking the poverty reduction strategy paper to the annual progress review process and to the budget. The ministries, departments and agencies are required to show progress made in achieving targets laid out in the poverty reduction strategy paper and are required to incorporate poverty reduction strategy policies in their strategic plans.

Many countries suffer from a dearth of good quality macroeconomic and socio-economic data. When available, data is hardly ever disaggregated by locality or gender. Effective monitoring and evaluation requires an information system that provides the needed information. The identification of binding constraints requires in-depth knowledge and understanding of country circumstances. Moving towards targeted interventions will not be possible without the required data and information. Indeed, without the requisite data, it will be impossible to assess progress made in moving towards poverty reduction targets. Annual progress reports should endeavour to strike a balance in presenting evidence on input, process, output, and outcome indicators (Box 4.8). Although some output and outcome effects will not be achieved in the short-run, it is important to provide data on these indicators at regular intervals. In several African countries, as the evidence in Table 4.1 shows, the most recent estimate of the incidence of income/consumption poverty in the public domain is about 7 years old. Countries must develop information systems for the collection, storage, and analysis of data.

Rationalising Strategies

Many countries are implementing several initiatives concurrently. Poverty reduction strategies are being implemented under the aegis of the International Financial Institutions (IFIs) and the Millennium Development Goals have been adopted as the framework for poverty reduction. In addition to other initiatives, countries have

Box 4.8: The Critical Importance of Data in the Implementation of a Poverty Reduction Strategy

"Experience during the preparation of the last two progress reports and this one reveals that the reporting quality of progress on both outcomes and impact indicators requires improvement. This includes all PRS sector and thematic areas. Further, reporting on progress towards poverty reduction in terms of incidence and correlates can only be made if new data sets are generated. Government will strengthen the reporting capacities of sectors and thematic areas during the PRS review and the new PRS cycle."

Source: United Republic of Tanzania (2004) *Poverty Reduction Strategy. The Third Progress Report 2002/03*, p.1.

"Many of the challenges to data collection identified in the 2003 APR still persist. These include: inconsistencies in data between the regions and districts, challenges to addressing the different M&E needs of different stakeholders, inadequate resources for M&E at all levels. Given scarce resources and weaknesses in data collections systems, a 'minimalist approach' is recommended for GPRS M&E. It is more effective to collect data on a small set of core indicators and targets which reliably reflect annual progress as compared to collecting a lot of unreliable data."

Source: Government of Ghana (2005) I*mplementation of the Ghana Poverty Reduction Strategy. 2004 Annual Progress Report*. p.2.

their own national development strategies. More effort is required to ensure consistency among the objectives, goals, and targets of the different initiatives. The multiplicity of strategies and targets with possible inconsistencies amongst them can confound the process of effectively addressing binding constraints and waste both financial and scarce technical skills. As a matter of urgency, the development strategy, focus, and direction of each country must be synthesised under a single framework that all stakeholders agree on. Annual budgets must be designed within the context of this agreed upon framework strategy. This will ensure policy consistency and contribute to credibility. These are needed if clear signals are to be sent to private agents to encourage the allocation and utilisation of resources in ways that will enhance growth and reduce poverty. The focus on binding short-run constraints may result in different emphasis being put on various aspects of the Millennium Development Goals. Countries cannot and should not be expected to make equal progress towards each of the goals. The relaxation of the most binding constraints can also generate positive spill-overs that will hasten the speed of attaining other goals.

Managing the Macroeconomic Impact of Aid and Debt Relief

The possible negative effects of aid must be adequately managed to prevent them from cancelling out the potential positive effects of aid. The findings of a non-linear relationship between aid and growth suggest that conscious measures should be implemented to increase the absorptive

capacity of aid. The real exchange rate is more likely to appreciate if aid and debt relief are spent on non-traded goods and if there is no excess usable supply to meet the increased demand for non-traded goods. However, the expected real appreciation of the exchange rate can be dampened or averted if aid inflows are spent on improving the productivity of the non-traded goods sector or if there is a rapid response of the exports sector to productivity-enhancing support.

Formulating a single development and poverty reduction framework is the first step in addressing the issue of absorptive capacity. Rationalization will probably translate into savings in terms of time of skilled technical and managerial staff. In contrast, identifying binding constraints and conducting forward assessments to anticipate constraints that emerge as the binding constraints are relaxed will require capacities and skills that are lacking. The experience acquired during preparation of the poverty reduction strategy papers will be useful in identifying the existing gaps in analytical capacity.

Re-defining Donor-Recipient Relationships

The architecture of the donor-recipient relationship adds to the absorptive capacity constraints that countries face. Currently, African countries receive aid from a myriad of donors; there is a plethora of project implementation units whose presence creates a parallel civil service which risks undermining the official one. The various donors have different reporting procedures, fiscal years, strategies, targets, objectives, and goals. These goals and targets are not always consistent with one another or with the goals and targets of the recipient country. The different aid conditionalities of various donors can undermine the effectiveness of aid (see Chapter 3).

In addition to the multiplicity of donors and the attendant problems, aid flows are more volatile than tax revenues and volatility of aid flows has increased in recent years (Bulir and Hamann: 2006). Using data from the World Bank's Global Development Finance database, Bulir and Hamann (2006) found that in the period 2000–2003, disbursements of long-term loans were lower than commitments by one third. Low-income countries are more likely to have high commitment to disbursement ratios, compared with other countries.

Evidence from a study of 8 African countries also reveals that aid flows are unpredictable (Celasun and Walliser, 2005). The Special Programme for Africa Support Alignment Survey found that aid flows were disbursed late or not at all. This was largely due to administrative problems experienced by donors or recipient countries and the difficulty of recipient governments in meeting conditions. Governments adjust to budget aid shortfalls by cutting domestically financed investment spending or by borrowing from banks. During periods when aid flows exceed predicted flows, the excess flows are not used to shore up spending on investment. Finally, aid flows tend to be pro-cyclical. Aid shortfalls coincide with periods of tax revenue shortfalls and aid flows do not always increase when there are GDP shocks. Thus, current aid

disbursement patterns can, in some instances, exacerbate the macroeconomic instability experienced by African countries.

The down side of low donor coordination is that it imposes transaction costs on the recipient countries. However, low coordination creates room for greater policy autonomy on the part of the recipient country. The risk of greater donor coordination is that donors may "gang up" against the recipient country and coerce it to accept and implement policy measures that may be contrary to the country's goals and targets. In contrast, effective donor harmonisation could result in greater predictability in aid flows as the experience of Tanzania shows (Box 4.9).

Greater aid harmonisation has been proposed as a means to address some of the weaknesses of the donor-recipient relationship. The advantages of harmoniza-

Box 4.9: Aid Harmonisation in Tanzania

Aid harmonisation in Tanzania is implemented through the Tanzania Assistance Strategy (TAS) that was launched in 2002. The TAS is a national medium-term framework for effective resource management. It includes an action plan for harmonisation and a donor-government secretariat. Almost three quarters of development partners participate in donor coordination.

A number of achievements have been realised :

- Progress has been made in aligning the timing and output of all processes with the Poverty Reduction Strategy and the budget cycle.
- Quiet times have been identified with the aim of providing the Government of Tanzania with adequate time to concentrate on preparing the budget and participating in the Parliament budget sessions.
- Eleven bilateral agencies, the African Development Bank, the European Union, and the World Bank have allocated a substantial proportion of their development assistance in the form of budget support to the Poverty Reduction Strategy. The group has adopted a common framework—the Performance Assistance Framework. Early completion of reviews under this Framework prior to the start of the fiscal year has enhanced the predictability of resource flows.
- Aid commitments are made on a multi-annual basis by about three quarters of the development partners.

Challenges remain. Some of these include the following:

- Some donors carry out practices that are not consistent with the Tanzania Assistance Strategy. They continue to approach the Government behind closed doors at various levels. Limited progress has been made towards conducting joint missions.
- Conditionality is not streamlined.
- Reporting and accountability systems are not harmonised. Some donors insist on maintaining their own systems. Others indicate a willingness to use national systems but mention the lack of a consistent system on the part of Government.

Source: Independent Monitoring Group (2005) *Enhancing Aid Relationships in Tanzania. Final Report of the Independent Monitoring Group*. Economic and Social Research Foundation.
OECD (2005) *Survey on Progress in Harmonisation and Alignment*

tion are not automatic and may take time to be realised. Transaction costs are unlikely to decrease immediately with the shift to greater harmonization as the experience of Tanzania and Uganda seems to suggest (Driscoll et al., 2005). The shift to new aid modalities may require the acquisition of new skills and this learning process may add to transaction costs in the interim (Independent Monitoring Group, 2005). Adverse trends in predictability of aid flows over time have occurred during periods of increased moves towards harmonisation. The Paris Declaration on Aid Effectiveness sets out the responsibilities of recipient and donor countries implied by improving upon aid effectiveness.

Thus, efforts towards greater donor coordination and harmonization will involve strengthening the recipient countries' negotiating and organisation skills. Recipient countries must develop clearly articulated development and poverty reduction strategies and operational frameworks with realistic targets that are acceptable to all stakeholders. Public financial management systems will need to be strengthened and streamlined across all levels (horizontal and vertical) of government to ensure consistency in reporting and in accounting procedures and processes. Country circumstances should determine whether aid is delivered through projects, programmes, or general budget support. The aid delivery mechanism chosen should be one that does not undermine ownership, partnership, and efficiency in the use of aid resources.

Conclusion

Aid has made some inroads in reducing poverty in Africa. How much poverty reduction can aid and debt relief deliver? The additional resources that African countries are likely to receive from increased aid and debt relief will only be effective if both African countries and their development partners make changes. A clear commitment must be made to growth and poverty reduction through the creation of a consistent realistic development and poverty reduction framework that is articulated in annual budgets and in all aspects of public sector activity.

The quest to identify short-run bottlenecks requires intensive and extensive knowledge of the country, its economy and social and political architecture. This will require an increase in reliable, regular data that is disaggregated by locality and, where required, by gender. This calls for capacities in analytical, implementation, and management skills. Monitoring and evaluation systems will have to be developed where they are absent and strengthened where they are weak to provide necessary inputs for policy making as well as irrefutable evidence of the utilisation of resources. Development partners can also contribute to this effort by developing an aid architecture that reduces transaction costs, increases the predictability of aid flows and creates room for ownership and partnership while facilitating the effective use of aid and debt relief.

CHAPTER 5

Financing Alternatives to Aid and Debt Relief

Introduction

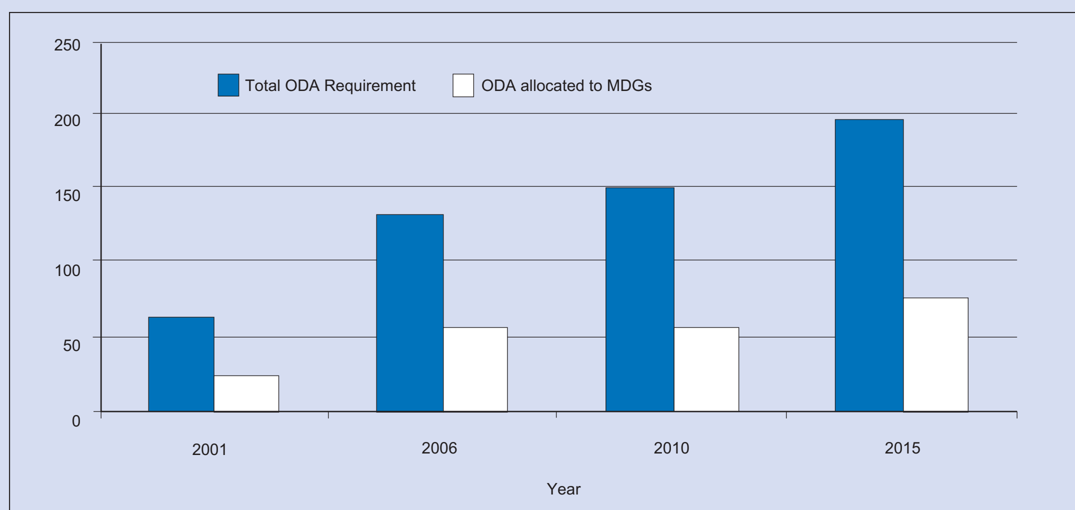
Financing has been a major constraint on the achievement of the Millennium Development Goals (MDGs) for most African countries. In these countries the levels of incomes and savings are extremely low, limiting the possibilities for increased domestic resource mobilization that would make a meaningful contribution to poverty alleviation. At the same time, international aid efforts continue to face political and fiscal constraints in donor countries, making it increasingly difficult to substantially raise official development assistance (ODA) to meet the incremental resources required for Africa to achieve the MDGs. The situation is quite worrisome in view of the declining trend in foreign direct investment (FDI) flows to the continent in recent years.

Nonetheless, recognizing the critical need to accelerate progress towards the MDGs, the international community has pledged to increase ODA. The G8 commitment in 2005 to increase aid is expected to double annual aid flows to Africa from US$25 billion to US$50 billion by 2010 and to raise total ODA to US$129 billion by the same year.

While the fulfilment of these pledges may accelerate progress towards the MDGs, it is unlikely, even with additional funding, that many of the MDGs will be achieved in Africa. As Figure 5.1 shows, required ODA in 2010 is projected at about US$150 billion, significantly higher than the amount promised by the G8. Even the level of ODA needed in 2006 is higher than the amount committed for 2010. Furthermore, in 2001, less than half of ODA was spent on the MDGs (Figure 5.1). In the midst of these financial difficulties, FDI flows to Africa declined from US$18.8 billion in 2001 to US$14.4 billion in 2003 (Addison and Mavrotas, 2004). These trends indicate that MDG-dedicated ODA could be less than what is required for the attainment of the goals.

Against this background, the international community is now focused on finding alternative financing mechanisms to scale up resource flows to developing countries. These financing mechanisms are crucial, given that Africa remains the continent with the most financial difficulties and has made the least progress towards the MDGs. The past few years have witnessed an increase in the number of funding development proposals. While these proposals generally recognise that traditional ODA will remain a vital source of finance for a long time, they tend to be based on the premise that scaling up such ODA might be difficult for several donor countries for political reasons. A number of institutions, including those in the UN system, continue to examine alternatives

Figure 5.1: ODA Requirement to meet MDGs (US$ billions)



Source: United Nations (2005), *Investing in Development: A practical Plan to Achieve the MDGs*, New York, UN

such as remittances, a global lottery, an international finance facility, and a global environmental tax as ways to augment aid and debt relief. This chapter summarises a number of recent arguments made in support of several alternatives, with emphasis on those initiated by the UNU-WIDER in 2004.

Recent Assessments of New Sources of Development Finance in Africa

Global Taxation

Global taxation is one of the major alternatives advocated as a viable mechanism for increasing resources to developing countries. It is one of the development financing proposals that has received widespread public support, particularly among civil society groups. This is partly because it seeks to finance a global public "good" (development) by imposing a tax on a global "bad" such as environmental pollution, speculative international finance, or the arms trade.

Global taxation has several advantages: it does not require any new institutional arrangement or international organization; the international taxes can be created only for a limited period of time; the taxes can initially aim at financing only core programs that need stable and predictable resources; even small amounts, at the start, would make a difference by increasing the return on other aid flows and creating an

environment that will increase their overall efficiency.

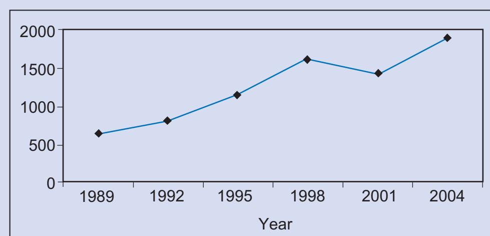
Notwithstanding the above advantages, global taxation may present a number of problems. International taxation can only result from a decision by states to cooperate, since they have the power to impose taxes. This means that this power, a basic attribute of sovereignty, would be subordinated to an international common objective. This can only be achieved if there is a high degree of convergence between objectives. International taxation may therefore prove difficult to negotiate and agree upon.

Several forms of global taxation have been advocated, including charging for the use of global commons (such as positioning satellites) — this is attractive in principle, but has modest revenue potential; and taxing arms dealing — this appears to have minimal revenue potential. It has been observed, for example, that a 5 percent tax on the legal and documented trade in arms (worth around US$50 billion per year) would yield at most US$2.5 billion annually. One principal drawback, which makes this proposal less appealing, is the fact that higher taxation on arms dealing could stimulate more illicit arms dealing. The two main types of global taxation that have attracted major attention in the literature at numerous fora are the currency transaction tax, or the "Tobin tax", and environmental taxation.

Currency Transaction Tax

The currency transaction tax (CCT), or Tobin tax, has attracted considerable attention in the recent debate on alternative sources of development finance. It is a marginal levy on global currency transactions and was first proposed by Tobin with the objective of enhancing international monetary system operations by reducing short-term speculative currency flows. Tobin's proposal did not receive the needed consideration from policy makers and researchers in the 1970s and 1980s on the grounds of its impracticability on the technical and political fronts as well as its potential distortion effect in the market.

Figure 5.2: Daily Foreign Exchange Market Turnover (billions of US dollars)



Source: Bank for International Settlements (2005), *Triennial Central Bank Survey of Foreign Exchange and Derivative Market Activities (2004)*.

The appeal of the Tobin tax over the past decade has been motivated by the observed trends in the global foreign exchange market (Figure 5.2) and by developments in international payments and settlement systems. It also stems from the urgent need to create a new international financial architecture that governs capital flows across borders in the

face of financial crisis[1]. Specifically, from the early 1990s, there was a surge in interest in the tax largely because of its potential for generating substantial tax revenues that could more than offset the declines in official aid inflows. It has been widely argued that the revenue from the CTT can serve as an important source of finance for global public goods. A number of recent studies have assessed the potential of the CTT as an important tax instrument for generating revenue for global development in addition to its effect on addressing exchange rate volatility and averting financial crises[2].

The size of the global foreign exchange market continued to grow steadily from 1989 until 2001 when the reported daily turnover dropped below US$1,500 billion (Figure 5.2). The decline in turnover was largely attributable to the introduction of the euro, which significantly reduced the number of traded currencies. Nissanke (2003) links the decline in global foreign exchange market turnover in 2001 to the general slowdown of the global economy and world trade as well as to the increased economic and political uncertainty of recent years. However, the market picked up quickly after 2001 and by 2004 the average daily turnover had reached about US$1,880 billion, broadly equivalent to the annual GDP of the United Kingdom.

Available estimates suggest that the Tobin tax could yield large returns with the imposition of a very small tax rate on a large tax base. This largely explains the appeal of the tax to many governments and NGOs. For instance, an extrapolation of revenue income from the world's most traded currencies reveals that about US$40 billion revenue could be generated from a currency transaction tax rate of 0.005 percent. A number of studies have predicted tax revenues of considerable size with tax rates of 0.05 percent to 0.25 percent. For example, Frankel (1996) applied a 0.1 percent tax rate to the 1995 global foreign exchange and predicted an estimated annual tax revenue of $176 billion — taking into account that the 0.1 percent tax would cause a reduction in trade volumes by 45 percent and allowing 20 percent deduction for exempted official trading and tax evasion. Tobin (1996) applied a 0.1 percent one-way tax on an estimated 30 percent of gross volume transactions and predicted a maximum of US$94 billion in revenue. This, according to him, could fall below US$50 billion if tax-induced reductions are taken into account. Felix and Sau (1996) estimated that applying 0.1 percent to the 1995 global foreign exchange could generate US$148 billion and US$180 billion with pre-tax transaction costs of 0.5 percent and 0.1 percent, respectively. This estimated revenue drops to $90 billion and US$97 billion with a tax rate of 0.05 percent. Nissanke (2003) estimated a possible revenue generation of US$17 billion to US$19 billion for a tax rate of 0.01 percent and US$31 billion to-US$33 billion for a rate

[1] This includes the self-fulfilling currency crises among a number of European countries in the exchange rate mechanism and emerging market economies such as China.

[2] See Frankel (1996), Felix and Sau (1996) and Kenen (1996).

Table 5.1: Potential Income for Development from a Transaction Levy on the World's most Traded Currencies

Country/Zone	FX spot ($ billion)	FX Derivatives ($ billion)	Total ($ billion)
USA	10.84	6.82	17.66
Euro zone	4.55	2.65	7.20
Japan	2.48	1.60	4.08
UK	2.07	1.15	3.21
Australia	0.67	0.51	1.18
Switzerland	0.75	0.32	1.06
Canada	0.51	0.39	0.90
Hong Kong	0.23	0.38	0.61
Sweden	0.28	0.25	0.53
Norway	0.17	0.15	0.33
Denmark	0.11	0.16	0.27
Singapore	0.12	0.12	0.24
New Zealand	0.12	0.06	0.18
Total	24.37	15.27	39.64

A Sterling Solution (2005) A report for stamping out poverty of Intelligence Capital Limited

of 0.02 percent after taking into account the decline in the tax base with the introduction of the euro.

All the studies reviewed confirm the revenue potential of the Tobin tax at considerably reduced rates. The disadvantages of the tax include the risk of a shrinking and very mobile tax base, and difficulty in uniform application across jurisdictions. Other challenges include tax avoidance through migration of foreign exchange markets to tax-free jurisdictions and substitution of tax-free for taxable transactions. There is also debate about whether the Tobin tax would reduce or increase currency volatility. Spahn (2002) suggests a dual tax rate; the usual tax rate of 0.01 percent, which, in his estimation would yield about EUR 17 billion if the tax were restricted to the European time zone; and a very high tax rate of 50 percent to 100 percent during heavy currency market turbulence to combat currency fluctuations during extremely short periods.

The different estimates of the revenue potential of the Tobin tax, coupled with its inherent challenges have led to calls for prudence in its implementation. Nissanke (2003) argues that in light of recent structural changes in the foreign exchange market as well as consideration of market efficiency, liquidity, and technical and political feasibility, the Tobin tax should be implemented in a cautious manner, starting with a lower rate. To what extent can Africa benefit from the Tobin tax given the less developed foreign exchange markets of countries in the region? Further studies may help provide the answer to this question.

Global Environmental Taxation

Another proposal for global taxation is "green" or environmental taxes. The economic case for environmental taxes, which seek primarily to control the climate externalities that are of increasing concern to the public, is very strong (Sandmo, 2003). A morale case can also be made for generating revenue for global development from environmental taxes since these taxes are seen as charges for use of global commons. Global environmental taxes include taxes on goods that generate negative environmental externalities, with specific reference to a tax on the use of

hydrocarbon fuels based on their carbon content. The strong advocacy for a global pollution tax system is propelled by the potential of the tax to produce "triple dividends": It will generate resources for development; it can create a better global environment; and its application does not result in efficiency[3] or employment loss. This tax could provide a better way to finance development, compared with traditional aid, on account of possible spin-off benefits like a cleaner environment.

The revenue potential of global environmental taxes is estimated to be quite substantial. Green taxes currently yield on average 2.5 percent of GDP in OECD countries, while taxes on high-income countries alone raised US$50 billion in revenue (Sandmo, 2003). Based on estimates of global emissions of carbon dioxide at 22,754 million metric tons, Clunies-Ross (2003) calculated that a uniform tax of about 4.8 cents per US gallon (or 0.01 EUR per litre) on all countries would correspond to a tax of approximately US$21 per metric ton of carbon, yielding annual revenues of US$130 billion per year. Even though the amount drops to about US$61 billion annually when it is levied only on "high income" countries, it is still within the US$30 billion to US$70 billion range required annually to reach the MDGs by 2015. Cooper (1998) cites an OECD study that estimates the revenue from a carbon tax at a lower tax base (5.2 million metric tons) at US$750 billion annually.

[3] The revenue can be seen as a pure transfer between private and public sector.

However, a global environmental tax seems too distant a prospect to help fund the MDGs in time. Rich countries have not shown much eagerness to utilize the proceeds from their new carbon-related tax for aid purposes. The green tax could also focus on areas such as taxes on aviation fuel or maritime pollution. Aviation fuel enjoys a low or zero tax rate in EU member states and was identified in early 2005 by France and Germany as one means of raising money to fund immunization and anti-AIDS treatment in Africa.

A lot of pessimism has been expressed about the political acceptability of introducing global environmental taxes. Some national governments are concerned about possible loss of revenue if they join global taxation. Another challenge to the implementation of global environmental taxes is the possible reduction, over time, in the amount of ODA earmarked for development. As noted by Sandmo (2003), the adoption of the global carbon tax would imply a large increase in the outflow of resources for development purposes, and the political system could well react to this by cutting back the amount of ODA over time or increasing it by less than they would have done had the global carbon tax not been in place. Evidence from the Kyoto process has also shown how difficult it would be to implement such a tax worldwide.

These challenges notwithstanding, global environmental taxes instituted to generate revenue for development purposes may enhance its political acceptability. It is essential that the implementation of this tax include institutional arrangements for

collecting and disbursing the tax. For example, a new international agency could be established to collect and disburse revenues. Alternatively, national authorities could be charged with collecting the taxes in individual countries and paying them to an international agency that would be in responsible for allocating the revenue for development purposes.

Selective Taxation: International Solidarity Levy on Airline Tickets

International solidarity levies have been proposed as an innovative approach to generating more stable and more predictable revenue in order to meet the needs of developing countries. International solidarity levies offer a way of safeguarding the poverty-reduction system from shifts in policy and international cooperation. The solidarity levies would finance the recurrent costs of poor countries' human development programmes, which must be continued over the long term; for example, training of doctors, wages of teachers, purchase of medical drugs. A tax on airline tickets has been proposed as a major international solidarity levy. Air transport is one of the industries that benefits the most from globalisation, and it grows at an average annual rate of about 5 percent. This makes it legitimate for the air transport sector to contribute to solidarity efforts being made for those left behind by globalisation, whose benefits are not equally distributed.

Actions taken so far have increased international solidarity towards raising revenue for development. Following consultations with the governments of Algeria, Brazil, Chile, Germany, and Spain, France passed a law in 2005 to implement the proposal for a Solidarity Levy on Airline Tickets. The resources mobilized from the levy on airline tickets are expected to complement the commitment of France to increase ODA from 0.47 percent of GDP in 2006 to 0.7 percent by 2012. The increased resources will mostly benefit development cooperation in Africa. Airline ticket taxes will become effective in France from 1 July 2006, for all domestic, intra-European, and international flights. Chile will impose a tax of US$ 2 per passenger on all international flights. The United Kingdom has indicated that it will allocate revenue collected from existing air passenger taxes to contribute to proposed health development.

The advocacy for airline ticket taxes appears to enjoy some notable advantages. The air-ticket levy will not trigger any distortion in competition between airline companies because it will be based on territorial aspects rather than on nationality. All airline companies, regardless of nationality, will have to charge the solidarity levy when one of their airplanes departs from an airport located in a participating country. In addition, even with a limited number of participating countries, the air-ticket levy will not result in any rerouting of traffic. Exempting passengers on connecting flights will ensure that airports located in participating countries are not penalized. Finally, at the international level, the air ticket levy can be implemented by countries in both the North and the South, with rates differentiated according to the level of development of the participating country. Thus,

there is a high probability that the application of this financing mechanism will be broadened in most countries as, based on studies undertaken to date, this international tax will have no impact on competition or on the tourism industry and will not distort country economies.

Migrant Remittances

Remittances have recently emerged as an important source of development finance for developing countries, including those in sub-Saharan Africa. Remittances have been growing in volume and relative to other sources of finance, such as aid and FDI. Remittances are currently the second largest component of external resource flows to developing countries after FDI (Solimano, 2005). The strength of remittances over other forms of external finance lies in the fact that, unlike foreign aid, remittances do not impose any burden on taxpayers in rich countries. They only occur to the extent that emigrants from poor countries can work in rich countries. Essentially, remittances provide significant support for economic growth in recipient countries by complementing national savings, providing a source of finance for capital formation, as well as improving foreign exchange availability. For instance, remittances from migrants in Cote d'Ivoire accounted for a quarter of the GDP of Burkina Faso, and a civil war in the former rapidly reverberated to the latter (Kapur, 2004). For sometime now, remittances have been one of the most stable sources of external finance and provide social insurance for many low-income countries. The transfer of money by emigrants to their family members in their home country serves as social protection for the families.

The growth effect of remittances on recipient countries can occur through savings and investments. Ratha (2003) shows instances where in sub-Saharan Africa, and in other developing countries, remittances have funded the building of schools, clinics, and other infrastructure. In other instances, migrants return home with fresh capital to finance investment projects and acquire rental properties. The growth effect of remittances in receiving economies can also act through short-run effects on aggregate demand and output through consumption. A considerable chunk of remittances are spent on food, housing rent, medicine, and other basic commodities. The combined effects of remittances on investment and consumption can promote economic growth.

The indirect effect of remittances on growth depends on the type of emigrants leaving home, the state of the labour market, and the productivity of the emigrants. If the emigrant is an unskilled worker, with low productivity, or an unemployed worker, reflecting slack and excess supply in the labour market, then the effect of emigration on output in the home country is bound to be small. In contrast, if the emigrant is a highly skilled worker, an information technology expert, or an entrepreneur with a high direct and indirect contribution to output, the adverse growth effect of high-skilled emigration is bound to be high (Solimano, 2001, 2002).

The poverty-reducing and income distribution effects of remittances are explained by the fact that the recipients of

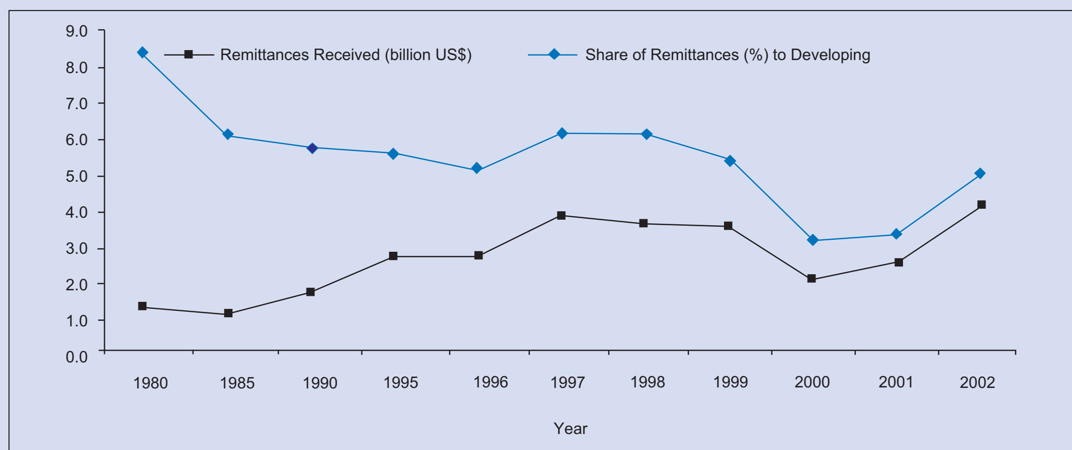
remittances are often low-income families whose offspring have left the country to work abroad. In a way, emigration is an attempt by emigrants to escape poverty at home and to improve their income-earning capacity by attempting to enter a foreign labour market in a richer country. At the same time, remittances alleviate the poverty of migrants' families in the home country by supplementing their incomes through transfers. People from poor countries migrate and send home money that helps their families and their countries as well. This implies that instead of governments, immigrants become the biggest provider of "foreign aid" and as "private" foreign aid, it is likely to benefit people who really need it. Thus, remittances seem to be good for equity and for poverty reduction, without imposing budgetary costs.

It is important, however, that developing countries weigh the benefits of receiving remittances against the potential costs of emigration in terms of the loss of scarce human skills (brain drain). The loss of professionals to rich countries may be deemed costly if the losing country finds it difficult to replace these professionals. The continuing migration of African professionals in medicine, engineering, science, and education appears to have greatly impaired African development since remittances from these migrants do not compensate for the loss. On the contrary, if excess supply of labour compels people to migrate, then the country stands to gain from the resulting remittances.

During the last two decades, the flow of remittances into developing countries has been growing on account of expanding opportunities in developed economies, compared with developing economies. Remittances to developing countries increased from US$15.5 billion in 1980 to US$80 billion in 2002, representing an annual average increase of about 8 percent (Solimano, 2005). Interestingly, the bulk of international remittances do not accrue to the poorest countries. As noted by Kapur (2004), nearly half of all remittances received by developing nations flow to lower middle-income countries, while the remaining half flows about equally to upper-middle and low-income countries. The main sources of remittances are the United States, Saudi Arabia, Germany, Kuwait, Israel, and Oman; while India, the Philippines, and Mexico are the main recipient countries.

The regional distribution of remittances over the past decades has been skewed in favour of Latin America and the Caribbean, South Asia, the Middle East, and North Africa, with sub-Saharan Africa languishing at the bottom of the list of beneficiary regions. Although capital flows in the form of remittances to sub-Saharan Africa improved by about 5 percent over the same period, the region received the lowest amount of remittances, compared with other developing regions. Specifically, the Africa region accounted for only 3.3 percent of remittances to developing countries in 2001, compared with at least 12 percent for other regions (Solimano, 2005). As shown in Figure 3 below, remittances to sub-Saharan Africa increased from US1.3 billion to US$4.0 billion between 1980 and 2002; however, this was not enough to prevent the region's share of

Figure 5.3: Remittances Received by Sub-Saharan Africa, 1980–2002



Source: Extracted from Table 9.1 in Solimano (2005)

remittances to developing countries from dropping from 8.4 percent to 5.0 percent over the same period. Remittances received by sub-Saharan African counties accounted for about 1.2 percent of GDP and 45.1 percent of FDI inflows over 1996–2002[4]. In Solimano (2005), no sub-Saharan African country figured among the top twenty developing-country recipients of workers' remittances in 2001.

The fact that sub-Saharan Africa received the lowest amount of remittances, compared with other regions, and the slow growth in remittances to the region over the past decade seem to suggest that Africa cannot seriously rely on remittances as the solution to its external financing problems. Kapur (2004) attributes limited inflows of remittances to Africa to geographical factors that hinder the movement of African migrants into rich countries in Europe, the United States, and Japan. He recognises the large migrations from African countries but argues that civil strife in these countries sends migrants across borders to other African countries instead of to rich countries. For instance, South Africa remains the main destination of most migrants from Zimbabwe, Mozambique, Botswana, Lesotho, and many other southern African countries, while, until recently, Cote d'Ivoire and Nigeria were destinations for many West African migrants. The proximity of Mexico and Latin America and the Caribbean to the United States, as well as of South Asia and North Africa to Europe and the Middle East provide opportunities for migrants from

[4] Computed from Table 9.3 of Solimano (2005).

these less-developed regions to work in these rich regions.

Nonetheless, there are a considerable number of African migrants living in the United Kingdom, the Netherlands, France, Italy, Spain and the United States. However, earnings of African migrants are observed to be low, which may account for the low levels of remittances to Africa. Invariably, the majority of African migrants are unskilled workers with low productivity who may be escaping economic hardship or political upheaval. The type of work they engage in, given their skills level, and the fact that their legal status is often not regularised, contribute to their low earnings, thereby adversely affecting effort in sending money home.

Many analysts have identified the high costs of remittances, for emigrants, as a major constraint to the flow of remittances to developing countries, including to African nations. Remittances are generally channelled through financial entities such as money transfer organisations (MTOs), post offices, couriers, travel agencies, individual travellers, and other informal financial institutions, and, to some extent, commercial banks. Empirical evidence suggests that the costs of remittances are higher than the marginal costs of electronically transferring funds, given that electronic transfers are possible (Solimano, 2005). The high costs of transfers to emigrants have been attributed to the lack of competition and to the highly segmented nature of the international market for remittances. Although the cost of sending remittances through commercial banks is lower than the fee charged by MTOs and other agencies, many African emigrants are unable to deal with banks since their legal status is seldom regularised. Other reasons for the high transfer costs include the often small nature of transactions, which may require high fees to compensate for the transaction, possible exchange risks facing the market, and regulations in the sending country, such as licensing costs.

Moving Forward with Remittances

What can be done to improve the flow of remittances by African migrants to their home countries? It is important to recognise that the level of remittances will remain low if they originate from the recent migration of people who are escaping political and economic hardship but have no employable skills, and have an irregular legal status in the country they migrate to. On the contrary, if migrants acquire employable skills before embarking on their journey and, above all, form associations and “institutionalise” their commitment to their home countries, remittances may grow and become useful to the migrants’ home country. Besides the skills of migrants, Elleman (2003) and Solimano (2002) reveal that the sustainability of remittances over time depends on various factors such as anticipated flow of migration and whether the migrants come alone or with their family, and how this changes over time.

Not surprisingly, recent proposals on remittances have targeted efforts at reducing the transfer costs of remitting money to home countries. Since remittances are the second most important source of external finance for developing

countries, after foreign direct investment (Solimano, 2005), reducing transfer costs could have significant benefits and may directly help meet the poverty reduction goals of recipient countries when the remittances flow to poorer households and communities. The institution of measures by sending countries to remove the irregular residency status of migrants will facilitate greater access by migrants to a variety of bank services, including remittance services.

From the host country perspective, competition among money transfer agencies could be encouraged to reduce the cost of remittances if immigrants are well integrated into the financial system of the country. This could be done through efforts to speed up the process of regularising the legal status of immigrants — one of the basic requirements to access bank services. Promoting the use of ATM cards in making transfers rather than the current more costly means used could be an effective method of reducing the cost of remittances (Solimano, 2005). Furthermore, licensing costs for new operators and other regulations on banks and non-bank intermediaries wishing to provide services for migrants should be minimal to avoid the creation of entry barriers into this market. Care must however be taken not to compromise the effort of countries to prevent money laundering or the financing of terrorism.

Africa stands to reap enormous benefits from remittances if significant attention is paid to making the financial sector more flexible by introducing financial instruments that can be patronised by emigrants. African countries can put in place measures such as issuing remittance bonds, opening foreign currency accounts for migrant workers in the home country, and creating facilities for voluntary donations to projects to leverage remittances for African development. Greater international efforts to establish effective international money transfer systems in African countries emerging from war could encourage the nationals of these countries to help their nations through remittances. Efforts by the international community to help design a financial system that reduces the transaction costs of intermediations and increases transparency could facilitate the flow of remittances into Africa.

The promotion of democratic principles and freedom in African nations could encourage the return of African emigrants with new ideas, fresh capital and networks. In addition, governments could facilitate the creation — in their home countries — of education and housing accounts for migrants, to enhance the efficient use of proceeds from remittances for the benefit of their communities and nations. Another important measure that can enhance the flow of remittances to Africa is the transformation of the role of post offices, the largest global distribution channel. This is against the backdrop of the less-developed nature of ICTs in Africa, which limits the connectivity of many financial intermediaries on the continent. Above all, African countries will need to have information about their nationals living abroad by region and by country to allow financial intermediaries to better target these communities. It would also help governments to forecast

the flow of remittances into their economies and facilitate the preparation of their annual budgets.

Another suggestion for an innovative financing mechanism for development, which is closely related to migration, is "brain drain" tax. This is a form of tax imposed mainly on rich countries for using the services of professionals from developing nations. It is estimated that a substantial number of African professionals live in Europe, the United States, Canada, and Japan, and other countries, where they provide various kinds of services in medicine, education, construction, finance, and so on. It has been argued that the annual benefits by rich countries for the use of African expertise may be equivalent to the annual ODA flows to the region. Since most of these professionals benefited from the education systems in their home countries, with some of them even enjoying free education, it is appropriate that, in addition to the remittances that may flow from these migrants to their families and communities, a formal mechanism be put in place to allow Africa to officially benefit from the expertise of its overseas citizens. However, the implementation of such an initiative may require a lot of consultation and consensus, particularly among the professionals, the home country, and the overseas country. This proposal could be put to further debate to establish a feasible mechanism for its adoption or abandonment.

Global Lottery

This is one of the innovative financing mechanisms that have been suggested as a means of meeting global development finance needs. It was first proposed by Crisis Management Initiative (CMI), and it focuses on a global lottery operated through national state-operated and state-licensed lotteries, with proceeds shared between national participants and an independent foundation established in conjunction with the United Nations. The CMI advocates the introduction of instant ticket lotteries followed by lotto games at a later stage.

The revenue potential of a global lottery can only be assessed on a speculative basis. As pointed out by Addison and Mavrotas (2004), the revenue potential of the global lottery is difficult to estimate but could reach US$6 billion a year. Indeed, the revenue-generating potential could be estimated by looking at trends in global lottery profits. In 2001, the gambling industry recorded US$200 billion from a gross turnover of US$950 billion; global lotteries accounted for the largest share of this amount, with US$62 billion, representing 31 percent of the total; gaming machines recorded the second largest amount, US$58 billion; and Casinos, US$50 billion (Global Betting and Gaming Consultants, 2002). Gambling markets in the United States and Japan accounted for about 55 percent of the global gambling industry profit, while profits in markets in the United Kingdom, Spain, Australia, Germany, India, Canada, Italy, and France ranged from 5 percent to 2 percent.

Based on the profit performance of the gambling industry, a global lottery could generate an annual gross profit of about US$9 billion, assuming that it generates

15 percent of the 2001 global lottery gross profit. This is equivalent to about 36 percent of total ODA allocated to MDGs in 2001. The global lottery would be patronized by "players" who may abandon other forms of gambling, such as national lotteries, in favour of the global lottery or be motivated to raise their total gambling expenditure in response to the introduction of the new lottery–the global lottery. In addition, out of global altruism, new participants may be motivated to buy the global lottery, especially when they are convinced of its intended purpose–to finance a global development agenda.

Africa's participation in and contribution to the global lottery revenue could be minimal largely because of the small size of the gambling market on the continent. For instance, in 2001, Africa accounted for just 0.49 percent of world lottery sales[5]. Undoubtedly, global lottery funds will be generated largely from developed countries given that the largest global gambling profits are derived from developed countries such as the United States, Japan, and a number of European countries.

Essentially, the ability of the global lottery to raise enough funds to augment other sources of development finance would depend on how the proposals for its establishment address a number of challenges. It is expected that the global lottery may take a substantial market share from existing national lotteries. This may trigger opposition from the beneficiaries of existing lotteries, who include governments and national charities. In the United Kingdom, for instance, charities lobbied hard against the introduction of a national lottery in 1994, expressing fears of its effect on their own charity-lottery and overall charitable donations (UK Parliament, 2001). This may cause undue delay in the implementation of the lottery or even prevent its takeoff. The potential loss of the market share of private gambling operators to the global lottery may also trigger opposition from these private operators, especially if they provide substantial revenue to the government. Strong opposition could also arise when the global lottery takes the form of national versions and the method of distributing the lottery funds are perceived to be at variance with national interests.

Thanks to revolutionary advances in global ICTs, it is now easier to operate the global lottery from a single source, with significantly lower administrative costs. However, the transformation of the gambling industry through the ICT revolution poses a greater challenge to the survival of the global lottery in the form of competition from the fast-growing Internet gambling sector, particularly in developed countries. This could negatively affect the revenue-generating potential of the global lottery. Although the global lottery may face less competition in Africa, due to the low level of ICTs, it may raise much revenue due to the small size of the market.

The introduction of the global lottery could also generate ethical concerns from religious groups that disapprove of their members engaging in gambling. Even

[5] Computed from Table 8.1 in Addison and Chowdhury (2005).

though this practice varies widely across religious faiths, the role of religious organizations in the debate for the establishment of the global lottery for development is quite relevant. Tolerance for lotteries varies across Muslim countries, such that, whereas no active national lotteries exist in Saudi Arabia, Malaysia and Pakistan run active state lotteries. The degree of tolerance also differs across Christian faiths. The Catholic religion does not expressly disapprove of lottery or gambling provided the gambler is not forced into it[6]. On the contrary, some protestant and charismatic or spiritual churches totally forbid gambling or lotteries.

A major concern about the global lottery is how its proceeds will be shared. To minimize opposition to the introduction of the global lottery, the method of sharing the global lottery funds and the use of the funds must address global and national concerns such as global security, health, education and the environment. However, compared with other forms of lotteries, the global lottery has some strong advantages. Because of its global coverage, the proceeds will not be adversely affected by business cycle fluctuations, which national lotteries cannot escape. To make the global lottery more appealing to attract considerable patronage, its development-financing goal must be well advertised. The attractiveness of the global lottery relative to other gambling products will also determine the level of patronage of the lottery. The debate for the introduction of a global lottery could be sustained with the involvement of major stakeholders around the globe, including governments, civil society, religious groups, and private operators in the gambling industry to develop consensus before its takeoff.

[6] See the Catholic Encyclopedia at www.newadvent.org

International Finance Facility

The International Financial Facility (IFF), a UK Government proposal, has the potential to provide substantial additional funds to help meet the MDGs. Its founding principle is long-term, but conditional funding guaranteed to the poorest countries, including those in sub-Saharan Africa, by the donor community. The key concept of the IFF is built on donor pledges for a flow of annual payments to the IFF. Based on these pledges (its assets), the IFF would issue bonds in its own name (its liabilities). Long-term pledges of flows of annual payments to the facility would leverage additional financial resources from the international capital markets through a securitisation process in the magnitude of US$50 billion over the period 2010–2015, building up from 2006 and falling to zero by 2020 (Mavrotas, 2003). The IFF is based on four fundamental components:

- Government backing — the driving force behind the IFF is donor pledges of additional future aid. Donors would make legally binding pledges of future increases in aid commitments without making immediate appropriations or fiscal commitments.
- Bond issuance — a treasury platform would use the donor pledges as backing to issue AAA-rated bonds.

This platform, the IFF itself, would rely on donor pledges (not cash) to back the bonds. The excess of pledged amounts over the amount of IFF borrowings would provide the financial enhancement needed to support the AAA rating on IFF bonds.

- Bond repayments — the IFF would pay off the bonds, drawing down donor pledges. The strength of the IFF mechanism is that it provides flexibility to mediate between what is needed in terms of disbursements and when donors pay for it, so it can be adapted to support a desired ODA time profile.
- IFF governance — Bond proceeds would be channelled through existing multilateral and bilateral aid programs. Allocations would be made in accordance with an aid allocation framework agreed under the IFF's governance structure.

This proposed facility has attracted comments from all quarters. The facility derives its strength from its revenue potential. If initiated as suggested, the Facility could boost aid to as much as US$100 billion per year during the crucial 2010–2015 period (Mavrotas, 2005). In addition, since donor coordination would take place through existing aid delivery channels, poor countries would not have to face a myriad of donors and regulations. By proposing to ensure predictable and stable aid flows, the IFF could help minimize the negative effects associated with the unpredictable and volatile nature of traditional aid, which tends to constrain future public expenditure planning in recipient countries and undermines the achievement of sound macroeconomic management. By resolving the uncertainties of aid flows associated with traditional aid, the IFF will be able to finance and upload future flows to smooth out aid consumption over time (Lin and Mavrotas, 2004).

In addition, as noted by Mavrotas (2005), unlike other donor facilities such as the Millennium Challenge Account (MCA), the IFF does not deal with recipient countries on a bilateral basis only and would therefore not undermine the significant progress made in improving donor coordination. More importantly, the proposed facility has been deemed robust on the basis that the securitisation principle for raising financing through the IFF is a tried and tested method for raising financing in international capital markets.

However, as with any borrowing mechanism, the final burden would be shouldered by future generations, with no guarantees on the return on expenditures that would be financed in this way. The fundamental question then concerns what happens after 2015, when a significant part of ODA spending in developed countries will be devoted to IFF repayments rather than to transfers to developing countries. Some concerns have also been expressed about the capacity of recipient countries to cope with high levels of aid flows and possible diminishing marginal rates of return to increased aid when the IFF comes into operation. Other potential drawbacks of the IFF include the famous Dutch-disease, which may have adverse effects on

the terms of trade of aid-recipient countries. The commitment of donor countries to the IFF scheme may constrain the future flow of traditional aid from these sources to developing countries.

The key challenge to the success of the IFF concerns donor coordination and commitment issues. Essentially, the success of the proposed facility will depend on the number of donors who participate in the facility, their perceived strength in international capital markets, as well as their long-term commitment to the facility. The withdrawal of major players in future may jeopardise the existence of the facility. In addition, the assumption of donor commitment throughout the life of the facility is too optimistic. The heavy reliance on political coordination among the donor countries that will finally participate in the facility could be a major challenge to the smooth operation of the facility. Another possible challenge that may diminish the development impact on recipient countries is the effect of resources from the facility on the public sector in recipient countries in terms of laxity in domestic revenue mobilisation efforts. There is also the question of countries, especially those in sub-Saharan Africa, which will still need aid. For these countries, frontloading aid entails some risk, especially if other sources of finance have not been created in the meantime.

Millennium Challenge Account

In March 2002, President Bush of the United States of America proposed the establishment of a Millennium Challenge Account (MCA) that would provide substantial new financial resources in the form of foreign assistance to low-income countries that adopt political and economic reforms. The economic and political reform required for these countries to qualify for access to the MCA include enactment of market-oriented measures designed to open their economies to competition, fight corruption, and encourage transparent business dealings. In addition, the governments of these countries are required to invest in education and health care. In effect, poor countries that are committed to promoting good governance, investing in their people, and encouraging economic freedom are the key target and will benefit from this account. The MCA qualification criteria suggest that a nation's resources are used more effectively when the nation respects its citizens, open its markets, and invests in better health care and education. By focusing assistance on countries that are committed to policies considered conducive to economic growth and development, the MCA suggests that developing countries cannot just be recipients of aid; they must undertake reform to make aid more development focused.

The MCA, which began in fiscal year 2004, sought to bring about financial change in US foreign assistance policy. It is administered and supervised by the Millennium Challenge Corporation, a different entity from the U.S. Agency for International Development (USAID). Through this new initiative, the United States will increase its core development assistance by 50 percent over a three-year period, resulting in an annual increase of

US$5 billion by the end of fiscal year 2006. The MCA funds will be devoted to projects in nations that govern justly, invest in their people, and encourage economic freedom on the grounds that sound policies are essential conditions for development. By aiming to encourage democratic governance, rule of law, and free market economies, the MCA seeks to prevent the diversion of foreign aid into individual hands, a situation that has prevented citizens of many countries from reaping the benefits of foreign aid.

Apart from its size, the MCA is considered different from other existing programmes for the critical reason that it has narrower and more clearly defined objectives, aimed principally at supporting economic growth and development rather than other foreign policy goals. In addition, it provides assistance to only a select group of low-income countries that are implementing sound development policies, making the aid funds sent to those countries more effective. More importantly, the administration of the account appears to give recipient countries a greater say in the design, implementation, and evaluation of the programme the fund is intended for, thus improving efficiency and effectiveness.

The MCA is premised on the grounds that aid can be more effective if it is focused on nations that are committed to good governance, transparency, and accountability and the establishment of policies and institutions conducive to economic growth and poverty reduction. The World Bank (2001), as well as other statistical researchers, have observed a positive growth effect of aid in countries that pursue good macroeconomic and trade policies, strong investments in health and education, good governance and less corruption; and little or no positive growth effect in countries that pursue weak policies with high corruption. In countries like Botswana, where the government places a high priority on growth and development and is committed to reducing corruption, aid has yielded great results. The challenge for donors is to identify countries where aid is most likely to be effective and those where it is less likely to be effective.

The MCA grants are awarded on the basis of how a country performs on 16 different indicators grouped under three broad categories: govern justly, investing in people, and promoting economic freedom. Each country's score in each category must be higher than the median of all countries evaluated. Based on these criteria, and with minimal political consideration and no regional quotas, 17 countries were selected to benefit from the program in 2004, of which, 8 were from sub-Saharan Africa and the rest from Latin America, Asia, and Eastern Europe. The African countries selected were Benin, Ghana, Mali, Senegal, Lesotho, Mozambique, Madagascar, and Cape Verde. In addition, 6 of the 13 countries selected as MCA threshold countries were from sub-Saharan Africa. These countries are Burkina Faso, Zambia, Kenya, Malawi, Tanzania, and Uganda.

As of mid-October 2005, two countries from Africa, Madagascar and Cape Verde, had signed compacts with the MCA to the tune of US$110 million. In addition,

Burkina Faso, as the first threshold country, was awarded US$12.9 million to improve girls' primary education in 2005. The MCA relationship with sub-Saharan Africa looks good compared with other continents. This might be linked to the objectives of the programme, which emphasize eradication of poverty — a common feature of sub-Saharan Africa. Nonetheless, the criteria for selecting beneficiary countries have eliminated many countries that need such assistance, particularly countries such as Liberia and Sierra Leone that have just emerged from protracted civil war. Countries also tend to "over-liberalise" in an effort to satisfy open market criteria, thus exposing fragile domestic enterprises to "unfair" competition. This may be counter-productive to the poverty reduction initiatives advocated under the MCA.

The implementation of the MCA faces a number of challenges such as the fact that as one of several programs being implemented, there is a greater possibility of duplication and overlap of programmes — this may undermine the effectiveness of foreign aid from the United States. Also, establishing a different institution to administer the fund — other than the USAID, which has experience dealing with development and humanitarian programmes — may cause duplication and overlap between the two agencies. It is also unclear how the two agencies would coordinate US assistance programmes.

Country selection is another major concern that may decrease support for foreign aid programmes for countries that do not meet MCA access criteria. Thus, the fact that only a select number of countries will benefit from the MCA fund may, in turn, reduce support for foreign assistance programmes in "excluded" countries, particularly the very poor African countries which are in critical need of foreign assistance. The resulting disparity in access to resources could widen the income gap among African nations and further destabilise populations/countries struggling with severe poverty.

The implementation of the MCA must ensure that the programme remains focused on its stated objective of reducing poverty and maintaining transparency and accountability in decision making. Developing proposals with selected countries and determining the implementation of their programmes as well as ensuring effective management of the funds allocated to them should be effectively monitored. It is therefore important to establish a foreign aid delivery coordination mechanism with other donors to prevent duplication and possible programme overlaps. The success of the MCA, compared with other types of foreign aid from the United States is yet to be determined.

The main strength of the MCA is that its selection process commits qualifying countries to fully adhere to the principles of good governance devoid of high corruption incidences and to demonstrate a strong commitment to fighting poverty. This new foreign aid initiative also appears to give qualifying countries greater ownership over programme design and implementation — which has not always been the case in the past. It seeks to encourage these countries to adopt a

participatory approach, involving civil society and development partners, in designing a national poverty reduction strategy. Under this new approach to aid that emphasizes country ownership, Cape Verde sought to channel the resources from the MCA to address four impediments to economic growth: severe water scarcity, lack of adequate infrastructure, weak institutional support for the private sector, and an insufficiently trained work force. Madagascar also requested support to address its inefficient financial system, which does not serve the rural poor; and its weak land-titling system, which impedes investment in poor rural areas and access to credit. Ghana also wants to use MCA funds to enhance its position as an exporter of high-value fruit and vegetables by improving the investment climate, roads, irrigation, training, and access to finance.

The real benefit of the MCA for sub-Saharan African countries is that it supports and encourages policy change among countries competing for MCA grants. Progress toward economic freedom and the rule of law will ultimately determine the economic fate of sub-Saharan Africa and represents the true potential of the MCA to help bolster economic growth and development. This will help promote the rule of law on the continent as countries struggle to meet the requirements and also make countries more committed to ensuring economic freedom for their people. Nonetheless, the positive impact of the MCA lies in the measures put in place to effectively monitor the use of the resources by qualifying countries.

Special Drawing Rights

The creation of special drawing rights (SDR) by the IMF to finance development has been on the development agenda for many years. The search for financing options to help achieve the MDGs has rekindled the SDR debate in recent years. In addition, the shrinking of capital flows to developing countries since the Asian crisis has also led to the growing call for multilateral finance institutions to find innovative ways of increasing financing options (such as enhancing the role of SDRs) for these countries.

The SDR is an international reserve asset. Created by the IMF to supplement the existing official reserves of member countries, it is allocated to member countries in proportion to their IMF quota. Basically, it is a form of promissory note issued by the IMF to member countries participating in the SDR department, based on a quota that is related to their relative strength in the world economy. The SDR was created to increase the world stock of monetary reserves from time to time without making countries run surpluses or deficits. With the allocation of SDRs, the costs associated with earnings or borrowing reserves when countries experience large external imbalances are contained. Less-developed countries may use SDRs to repay the IMF, to reimburse debt owed to the Paris Club, to resolve foreign exchange crises, and to provide hard currency reserves for import cover and foreign private debt service. The growing pressures on the international financial system to respond to the

development finance needs of poor countries has extended the use of the SDR beyond its traditional role. In terms of the revenue-raising potential of the SDR, Aryeetey (2004) estimates that an allocation of US$25 billion to US$30 billion could make a significant contribution, but cautions that it depends on frequency.

Assessment of a Development-Oriented SDR

The campaign for using SDRs to support development is being pushed along two complementary lines. The first advocates the resumption of the regular SDR to deal with frequent shortages of liquidity in developing countries (Stiglitz, 2003); the second considers occasional injections of SDR that mainly target developing countries (Soros, 2002). The IMF, for its part, considers that SDR proposals are meant to supplement Fund resources and to finance development.

The underlying reasons for advocating development-oriented SDRs are to provide developing countries with an opportunity to devote resources — which would have been used to increase reserves — to services that facilitate development. The campaign for development SDRs also reflects the need to speed up development of global public goods (Soros, 2002 and Stiglitz, 2003) because effective delivery of global public goods enhances the achievement of the development goals of poor nations. According to Clunies-Ross (2002), the attractiveness of SDRs as a source of globally available funds lies in the fact that it is created by an international institution and therefore belongs to the world as a whole, thus making it useful for the maintenance of global public goods for global stability and the full employment of resources. In addition, he estimates that the resulting world income and output may either equal or exceed the value of the funds assigned for the purpose. It is expected that development SDR allocations to poor nations would significantly raise the consumption level of these nations, leading to an increasing demand for goods from industrial economies (Wade 2002). By implication, industrial economies do not necessarily lose by consenting to the creation of development SDRs.

However, a number of concerns have been raised about the proposal to issue development SDRs. The key concern stems from anxiety about the fact that measures put in place to restrain the IMF from excessively injecting new liquidity into the financial markets may compel cash-strapped poor nations to go on a spending spree. This largely accounts for the refusal of the US Congress to ratify the 1997 proposal for a development SDR. Others argue that it is not clear what advantages poor developing nations will derive from the issuance of SDRs that they do not get from traditional aid packages. Furthermore, the impact of a stable world economy is unclear and the institutional adjustments required to create special SDRs — which affect country quotas — are probably not politically appealing to industrial economies and hence not likely to happen.

Essentially, the issue of new SDRs for development purposes may require some level of consensus among developed

countries. With the introduction of various development financing mechanisms, including the IFF, the MCA, and global taxation, it may be easy to gain the support of powerful countries like the United States for its adoption, bearing in mind that US approval is required to put any amendment into effect.

Improving Domestic Revenue Sources

While focusing on external sources of financing for the MDGs, it is important for African countries to look within their national boundaries for funds to supplement the international effort. The national budgets of developing countries have potential for savings and redistribution. Governments can make additional resources available for sustainable development by reforming their tax systems and eliminating unproductive expenses. More often, the alleged transfer of state funds by some leaders (or dictators) to secret bank accounts, and the transfer by wealthy citizens of their savings overseas, have the potential to drain domestic financial resources and undermine the development agenda.

In many developing countries ODA finances a substantial proportion of spending. In many countries in sub-Saharan Africa, public investment is almost entirely funded by donors. Revenue generated from domestic sources is often low due to low incomes and to the failure to make use of available opportunities to improve domestic revenue mobilization. To effectively meet the MDG targets, the governments of developing countries need to step up their efforts to mobilize more domestic revenue; even in the poorest countries, there are opportunities to do this (Addison and Mavrotas, 2004).

In this regard, governments should undertake institutional investments to improve tax administration and reform the tax system. A number of countries have witnessed a fairly smooth implementation of the value-added tax (VAT) and its impact on domestic revenue mobilisation has been quite successful. However, it seems the excise tax has been overshadowed by the VAT in the tax reform agenda of many countries, even though it is seen to be distributional-friendly besides its revenue raising potential. The two forms of indirect taxes can raise substantial revenue for development, particularly when the optimal tax rate is applied to prevent high evasion and corruption.

A lot of suggestions have also been made on broadening the tax base. However, moves in this direction should be made with a considerable degree of caution to avoid burdening the poor. For instance, broadening the VAT base to raise more revenue cannot be achieved without increasing the tax burden on the poor. Consequently, the policy of broadening the tax base should be implemented in a manner that will make the net fiscal incidence quite favourable to the poor. Domestic revenue can also be raised by reinforcing tax and customs administration, reducing tax exemptions and combating corruption and fraud. Essentially, the revenue-generating impact of these initiatives would depend largely on the institutional capacity of the revenue

agencies. The commitment of countries to upgrade the human resource capacity of revenue agencies, motivate personnel, and institute measures to block leakages in tax administration could raise the domestic revenue of many developing countries.

Conclusion

The gap between current ODA and the amounts required to meet the MDGs is the prime reason for seeking alternative sources of development funding. Most of these financing sources are discussed quite extensively in the literature. Essentially, the renewed debate over the search for a new financing mechanism for development is critical to Africa, considering that the continent is highly deprived in the midst of extreme financial constraints to development. Africa undoubtedly stands to benefit if some of these financing mechanisms are adopted to raise the needed funding towards the realisation of the MDGs.

However, the key challenge is that while some of the financing mechanisms depend on the level of altruism of individuals (in the case of remittances and private donations), others require ratification of new agreements or amendments of existing ones, which need the acceptance and commitment of economically powerful countries. For instance, the difficulty in persuading countries like the United States, considered a major contributor to global carbon emissions, to accept the proposal on global environmental taxation has prevented its adoption. Some other financing mechanisms such as the global lottery may face stiff opposition from national governments and private commercial operators due to the competition that its introduction will bring into the gambling market. In this regard, it is important that global consensus building be seen as a key ingredient in the design of proposals for development financing mechanisms.

CHAPTER 6

Toward Enhanced Use of Aid and Debt Relief for Development

Introduction

Many African countries are among the most aided nations in the world, and it is likely that foreign aid will continue to play an important role in the growth and development process of these countries. Nonetheless, controversies abound on issues relating to the effectiveness of foreign aid in promoting growth and development in Africa. These range from the quantum and quality of foreign aid to its allocation and absorption across countries. Donorship and ownership issues, which deal with the limited effectiveness of conditionality and how it can be replaced by accountability and ownership on the part of the recipient, are also at the centre of these controversies. Similarly, the role of aid in the emergence of the underlying institutional and political foundations needed for sustainable development also feature prominently in the aid debate. Other issues include transaction costs and debt overhang as well as the role of debt relief in the restructuring of aid; the impact of aid on the "development trap"; and the danger that high aid levels will lead to extended periods of aid dependence in Africa.

This chapter provides an overview of these and other related issues and presents an agenda for refocusing Africa's aid relationships on promoting sustainable economic growth and development.

The Changing Nature of Foreign Aid to Africa

Last year's edition of the African Development Report (ADR 2005), *Public Sector Management in Africa*, shows how recurrent shifts in economic development theories have altered development policy and practice in Africa. Foreign aid, which has played an important role in Africa's development efforts, also reflects the changes that have taken place in the theoretical arena. Thus, in the 1960s, the emphasis was on project aid that served as a catalyst for interventions aimed at complementing domestic African efforts. Although the idea was that capital and expertise would make a difference, the perspective on aid was that it would not be needed except for an interim — albeit unspecified — period.

In the 1970s, donors realized that foreign aid was there to stay and that it had to be planned and managed at a high level. Projects were too scattered and lacked the necessary forward-backward linkages necessary to make the wheels of the whole economy move. By planning concerted efforts at sectoral levels, donors assumed that they could reduce poverty, in collaboration with African governments. Greater emphasis was therefore laid on the administration of rather complex programs such as integrated rural development initiatives.

During the first two decades of project and program assistance, donor countries dispatched their own experts to work side by side with Africans in various advisory — occasionally executive — capacities. These experts were all busy on what was perceived as the frontline of development, gaining valuable field and country experience that they could eventually use in planning development assistance projects and programs in the headquarters of their agency. They had a personal perception of what it meant to work in these countries and of the difficulties that African realities often posed to success. Although there were a few exceptions, the interesting aspect about this generation of aid workers is that despite hardship and difficulties they retained a great measure of moral and political enthusiasm about their role. It is this generation, now gradually disappearing from the scene, which has been largely responsible for administering development assistance in the past two decades.

The second generation of aid workers is more generalist in orientation. The economics profession has taken the lead, but has been supplemented by others, for example, lawyers and political scientists, with skills in analysing and evaluating policy interventions aimed at liberalizing the economy and enhancing the institutional capacity of governments. These people may have had the occasional field experience but it is not a requisite for their job. They are at least one step removed from African realities and typically work with models or policy designs that are meant to apply to any country. They "get their kick" not from solving practical problems in a "hands-on" fashion in an African country, but rather from "hard" statistical evidence that their model or policy produces for measurable results at the macroeconomic level.

The donor relationship with African governments has clearly changed. The latter used to be referred to as: recipients", but they are now called "partners". Development aid focused on policy and governance issues does not lend itself to a dictatorial mode, although it has taken donors time to learn this. The rather rigid conditionalities that characterized foreign aid in the 1990s have gradually been softened and been replaced by the notion of dialogue. The latter is a more suitable notion in a partnership than conditioning terms set by only one party.

An accompanying change is the move from project and program aid to what is called funding of sector-wide approaches (SWAPs) or outright budget support. This means that the bulk of the aid goes to the partner government in the form of general support. It is paid to the ministry of finance's general account for use in accordance with priorities agreed upon in annual consultations between representatives of the partner governments. In some respects, this marks a return to the practice in the 1970s, especially among some donors, of giving aid with no questions asked. It would be too simplistic, however, to suggest that the situation in 2006 is the same as it was before. The dialogue raises issues about implementation and use of funds. Much stricter rules of financial accountability have now been built into SWAPs or budget support.

The jury is still out with respect to how helpful the new approach actually is. Donors like it because it simplifies their administrative burden. African governments like it, too, because it allows them to exercise greater control on how external funds are being used. It does assume, however, that these governments are committed to the same principles of good governance as their Western donors and that they really have the financial and operational capacity to keep track of what happens with the funds. Attempts at expenditure tracking by consultants hired by the donors suggest that there are still serious shortcomings in most countries. This may not be because of sheer corruption, but inadequate accounting is enough to cause suspicion in donor circles that their partner is not playing by the rules.

The changes in the definition of aid and in the role that donors should play are still evolving but they are turning bilateral aid agencies that used to be the operational arm of their respective governments in developing countries into think tanks of their particular foreign affairs ministry. Because these agencies do less on the ground in African countries, specialized staff in operational and advisory capacities are no longer needed there to the same extent. The result is that bilateral aid agencies have become more focused on being up-to-date on reading relevant literature and attending interesting workshops or seminars. In short, they have become more interested in becoming true "learning organizations".

Problems of Aid Management in Africa

Aid management problems in Africa can be viewed from both ends of the aid spectrum: recipient countries and aid agencies. It is true that many of the aid-recipient countries in Africa have weak capacity to manage aid effectively. But it is equally true that some of the aid agencies also often lack the capacity to manage the types of complex situations found in African countries. Much of the discussion on aid management in Africa has centred on two areas: aid delivery mechanisms and debt overhang.

Problems Relating to Aid Delivery Mechanisms

It has been pointed out that delivery mechanisms influence the quality of aid through their impact on the underlying institutional environment. A high percentage of tied aid reduces the options of aid-receiving countries and their capacity to own and develop their development strategies, as well as to respond flexibly to emerging contingencies. In addition, the heavy use of expatriate technical assistance to implement donor projects has probably weakened local capacities in aid-receiving countries, with perverse institutional consequences. Local officials often find it easier to leave management to the donors and technical assistance is written into projects without much review. This is because the key public sector civil servants of recipients countries are few and many expatriates are brought in to service donor

financial management and reporting requirements (World Bank, 2000b: Elbadawi and Gelb, 2003).

Problems Relating to Debt Overhang

Debt overhang is likely to have a directly adverse effect on growth and investment. High debt creates expectations of future taxes and policy reversals, which reduce the incentives for current investments. High fixed-debt service obligations increase leverage and raise uncertainty, especially if donor funding is decided on a short-term basis. In such circumstances, investors will exercise their option to wait until returns are great enough to compensate for risk. High ratios of debt service to government revenue also imply a potential internal transfer problem. In addition, high indebtedness can also weaken the effectiveness of aid in enhancing growth through increasing the weight of externally driven project-based financing relative to budget resources to support the core functions of the state (Elbadawi and Gelb, 2003).

Impacts and Implications of Foreign Aid

The effectiveness of foreign aid is a vexed issue, with critics on opposite ends of the ideological spectrum. These critics' assessment of the impact of aid is generally negative: In relation to results, it costs too much; or, in relation to growth or poverty alleviation objectives, it achieves too little. There is some truth to these criticisms, but they ignore the achievements that have been made in such sectors as health, education, and physical infrastructure. The problems encountered in relation to foreign aid in Africa stem from a range of different sources: unrealistic expectations; a strong disbursement imperative; low levels of sustainability; spiralling recurrent costs; constant aid dependency; declining public accountability; problematic co-ordination.

Unrealistic Expectations

The problem with much foreign aid, whether in the form of project or budget support, is that it sets highly unrealistic timelines for the achievement of particular developmental objectives. The MDGs are only one recent example of this inclination. This means that from the outset, foreign-funded activities are doomed to be assessed negatively. With more realistic timelines, such problems would not have arisen to the same extent. People would have viewed aid with more pragmatic eyes. In the current context, foreign-funded activities are the constant subject of the critical lenses of consultants whose evaluation reports often become the final statement on the fate of a particular activity. Far too many foreign-funded activities, therefore, are written off prematurely by critical evaluators.

The Disbursement Imperative

There is often more money available for funding development activities in Africa than there is demand or capacity to use it. Donor agencies operate within annual budget cycles and there is bureaucratic pressure to demonstrate that money that has been allocated is committed and disbursed within the annual cycle. This

means that even money that can be moved forward to the next year's budget is viewed as a weakness if it cannot be dispatched on time. This is why the call for raising foreign aid in all donor countries to the level of 0.7 percent of GDP is controversial. If existing funds cannot be effectively used because of lack of demand or capacity, critics ask, what is the point of raising the spending level? There is certainly some validity in the questioning. Far too often, donor "solutions" are in search of African "problems" rather than *vice versa*. Money is often being committed and disbursed even if few of the questions about feasibility and costs/ benefits have been answered.

Low Sustainability

Foreign-funded activities are typically pursued on premises that have more to do with the operational and organizational imperatives of the donor agency itself than with those existing on the ground in the African country. Again, whether it is project or budget support, the premises on which assistance is being extended are those with which the foreign staff members are comfortable. This leads to the implantation of values and principles that can be maintained as long as these foreigners are there or at least keep an eye on what is happening. A review of 366 World Bank projects in Africa with institution-building objectives between 1970 and 1989 found that "substantial results" were achieved in less than one quarter of the cases (UNDP, 1993). Other donor-sponsored evaluations have issued broadly similar assessments (Van de Walle and Johnson, 1996). The result is that once a donor-funded activity has come to its official end, it rarely survives on its own. There is not enough commitment or capacity among local staff members to continue.

Spiralling Recurrent Costs

Donors have had an understandable preference for funding something new rather than financing an ongoing activity or institution. A principal reason for this is that donors have maintained the assumption that their aid is an investment or "development" cost that is going to be run with matching contributions from local sources. The distinction between "development" and "recurrent" expenditures was strictly maintained during the 1960s and 1970s, but since the contraction of state budget outlays, it has become increasingly difficult for many poor African countries to come up with matching funds. In countries like Mozambique and Zambia, one-third of all maintenance costs, including wages, comes from external donor sources. This incompatibility is another reason why more funding for development is not without its costs. There is not enough local revenue to meet additional recurrent expenditures. On economic policy grounds, governments in these countries are being told not to increase this type of expenditure. If the foreign funding continues, it increases aid dependency, on both the development and the recurrent sides of the national budget.

Aid Dependency

Reducing aid dependency in Africa remains an objective in the international development community. However, under the auspices of the Millennium Development

Goals (MDGs), Africa is presented with a funding package that will actually make this phenomenon more, rather than less, constant. Countries are being encouraged to receive more money in the hope that they will be able to swing their way out of poverty. Given past experience — and taking into consideration improvements in public sector management in recent years — the question must be asked whether such huge increases in funding, as proposed in the United Nations Report (*Global Plan to Achieve the Millennium Development Goals*, 2004), are really desirable. A more acceptable vision is suggested by the example of infrastructure development in Tanzania, where the government has demonstrated that by collecting road revenue and establishing a national road fund, it has been able to fund physical infrastructural improvements from the country's own resources. It has also been able to hire contractors competitively at a price below the costs incurred when such projects are subject to international tendering using foreign funds. The best part of the story is that the roads have also been built and completed without evidence of bribery and at a level of standard that surpasses previous road projects in the country.

Declining Public Accountability

Because funds from external sources tend to be relatively easy to come by, there is a tendency for government officials to ignore the importance of local revenue collection. Taxing citizens is generally considered to be part of building a sense of civic consciousness—in return for paying tax, the citizens can demand greater civil and political rights. Taxation provides citizens with a justification for knowing how government handles their money. It encourages transparency and public accountability — two cornerstone principles of good governance. More foreign aid, therefore, has its political costs. It may, in the long run, not be compatible with building sustainable public institutions (Moore, 1997; Kjaer, 2004). It also tends to make government officials more attentive to negotiations with external actors than concerned with how the principles of good governance can be most effectively implemented — whatever promises they may have given donors about adhering to the global good governance agenda.

Problematic Coordination

Partly because donor funding comes in the form of revenue collected from local taxpayers in the donor country, there is an understandable tendency for these agencies to operate with their own domestic constituency in mind. This is particularly true of the US Agency for International Development (USAID), which has always been very much restricted in its operations by rules imposed on it by the Congress. It is reflected in the way that other agencies operate too, albeit it to a less explicit degree. This means that coordination among donor agencies is difficult. To the extent that it takes place, it does so in the context of specific institutions like the OECD's Development Assistance Committee (DAC). This coordination, however, is problematic from an African perspective, because it overlooks the point of view of

the recipient government. Coordination among donors tends to reduce the space for negotiation that recipients have. Some progress has been made toward localizing coordination to recipient country level by providing budget support and having donor representatives participate in joint annual consultations of government priorities. This is a step in the right direction, but it still leaves coordination in the hands of government officials with little, if any, input from other societal actors, be it private sector or civil society.

Restructuring Africa's Aid Relationship

Notwithstanding the problems associated with aid effectiveness and their implications for development in Africa, there are indications that the increase of aid and its redirection toward developmental ends are still critical to Africa's future. In other words, consensus has emerged that aid must change and that it must focus on reducing poverty. With effective regional cooperation and donor support in a "coordinated, long-term partnership, … Africa could solve its human development crisis in one generation" (World Bank, 2000b: p.3). In this regard, the new approach to aid should be underpinned by four key principles:

- Being more selective in choosing aid recipients;
- Designing aid activities with the participation of potential beneficiaries and implementing them in partnership with other development organizations;
- Strengthening the capacity of recipients — whether central or local governments, private enterprises, or non-governmental organizations (NGOs) — charged with implementing programs; and
- Restructuring aid delivery mechanisms to make recipients responsible for development — while recognizing the interest of donors that resources be used effectively (World Bank, 2000b: p.247).

There are four noteworthy movements in this direction, which are meant to restructure the process of Africa's aid relationship. These are (a) the Millennium Development Goals of the 21st Century; (b) the enhanced Initiative for Heavily Indebted Poor Countries (HIPC); (c) the Poverty Reduction Strategy Paper (PRSP) process; and (d) the New Partnership for Africa's Development (NEPAD).

The International Development Goals of the 21st Century, adopted by the global development community and developing countries, sets targets for "poverty reduction, education, health, gender equality, and environmental sustainability by 2015". The endorsement of the Millennium Development Goals meant that aid would be targeted to poverty reduction. Consequently, the international financial institutions found common ground in poverty reduction. For instance, the Comprehensive Development Framework (CDF) of the World Bank calls for country ownership of a comprehensive, results-oriented development agenda integrating macroeconomic, structural, and social

policies developed with the broad participation of civil society. In the same vein, the IMF changed the name of its Enhanced Structural Adjustment Facility to the Poverty Reduction and Growth Facility (World Bank, 2000b).

Another major development relates to the Heavily Indebted Poor Countries' (HIPC) Initiative, introduced in 1996 and enhanced in 1999, which is expected to provide deeper and faster relief and to help fight poverty. Because the enhanced HIPC Initiative aims to expedite poverty reduction, recipient countries are expected to adjust macroeconomic policies to accommodate the resources freed by debt relief. As discussed in Chapter 1, the implementation of the HIPC Initiative has led to fiscal resources freed up from debt service to be used to increase essential poverty reducing expenditures, including basic health, education, and rural infrastructure. In addition, it is estimated that about 80 percent of the relief received by African countries is allocated to poverty-related spending (Elbadawi and Gelb, 2003).

Related to the HIPC initiative is the PRSP process, which was introduced in 1999 provide the basis for all concessional lending and for debt relief under the enhanced HIPC Initiative. The process incorporates and builds on the ideas previously developed around the country-level Comprehensive Development Framework (CDF). It is being used to assist African countries to put in place the necessary conditions for a dynamic private sector, sound institutions, a predictable legal and economic environment, and a level playing field. The development and implementation of the PRSP process in African countries have yielded enormous benefit to the realization of the poverty outcomes. It has also resulted in the broadening and mainstreaming of poverty reduction, in particular its integration with macro policy and the budget. In addition, it has led to the upgrading of the dialogue on poverty, moving away from a focus only on the social sectors and with stronger links to budgetary processes and the medium-term allocation of resources (Booth, 2001; Elbadawi and Gelb, 2003).

Yet another important initiative in the development process is the NEPAD, launched in October 2001 as a blueprint for Africa's regeneration. The salient features of the NEPAD initiative are presented in Box 6.1.

NEPAD is innovative for two reasons. First, it uses an African peer review mechanism (APRM) to encourage collective action to promote standards, whether of governance, accountability, or sound economic management. Participating countries enter into a series of commitments to create or consolidate basic governance processes and practices, while a forum operating at the level of heads of state serves as a mechanism through which the leadership will monitor and assess progress. Second, it lays emphasis on facilitating at the political level, regional and sub-regional approaches toward the provision of essential regional public goods as well as the promotion of intra-African trade and investments. African countries are small and interdependent, and collective action is needed to address

Box 6.1: Key elements of the NEPAD Initiative

- Good governance: proper adherence to good corporate, economic, and political governance. Growth and development cannot be achieved in the absence of good governance. Any effort to reduce poverty must start with and build upon good governance;
- Entrenchment of democracy, peace and security: Peace, democracy, and security are a necessary precondition for attracting investment, garnering growth and development, and reducing poverty;
- Sound economic policy-making and implementation: This entails the restoration and maintenance of macroeconomic stability, especially by developing appropriate standards and targets for fiscal and monetary policies, and introducing appropriate institutional frameworks to achieve these standards. In addition, African countries should reduce their dependence on foreign aid and seize the historic opportunity that has presented itself to end the scourge of underdevelopment that afflicts the continent, given that resources (including capital, technology, and human skills), that are required to launch a war on poverty and underdevelopment, exist in abundance;
- Productive partnerships: This entails the development of a more productive partnership between Africa and its bilateral and multilateral partners. The overall objective is to improve effectiveness in development cooperation primarily through better practice in the aid relationship, delivery, and reporting systems. This new and better practice would set out mutually agreed performance targets and standards for both donor and recipient countries;
- Domestic ownership and leadership: No initiative for Africa's development, however well crafted and internationally accepted, can and will be successful if it is not owned by Africans themselves. Ownership matters because it directly affects program acceptance and implementation at the national and local levels. Domestic ownership generates political support and "buy-ins" by relevant stakeholders who are much more likely to view the initiative as a worthy indigenous one rather than immediately dismissing it as a foreign imposition (Hope, 2002; Elbadawi and Gelb, 2003).

impediments to full economic cooperation (Elbadawi and Gelb, 2003).

What Can and Should Be Done?

The problems associated with aid flows to Africa are complex and multidimensional, and solutions to these problems should be grounded in a multi-faceted approach, which takes into account key ingredients that should underpin efforts at developing Africa in the future (see Box 6.2).

There is a need, therefore, to go beyond the current conventional wisdom without doing away with the best of what has been accomplished in the last twenty years. This includes:

- acknowledging the market as a necessary foundation for accelerated development;
- continuing to reform public institutions to become more efficient and effective;

Box 6.2: Ten key Elements that Should Underpin Africa's Development Efforts

The ten ingredients that should underpin Africa's future development efforts can be broadly captured in the need for:

- maintaining a longer term perspective on the issues than what is typically offered (including the MDGs);
- avoiding the trap that more extensive external funding is the best means to solve problems;
- adopting more operational flexibility than the current "blueprints" provide;
- greater respect for country variation in endowment and culture;
- making partnership between donors and recipients more operational;
- accepting that the state in most countries is still in a formative, not a consolidating, mode;
- relaxing the premises on which most institutional models and policies are based;
- encouraging local learning rather than assuming that best practices already exist "on the shelf";
- accepting that development objectives are conflicting as often as they are complementary;
- acknowledging that politics, when practised as clientelism, is problematic for development.

Source: Hyden (2005)

- searching for solutions to tricky national/sub-national relationships;
- finding ways of strengthening domestic revenue collection;
- providing greater scope for professional input into policy-making.

This means that this stocktaking builds on past achievements but also calls for a return to the drawing-board on the premise that these accomplishments have also been accompanied by failures and less than satisfactory performance. Despite an impressive turnaround in many African countries during the past twenty-five years, there are outstanding issues that need to be addressed. It is always tempting, when returning to the drawing board, to produce yet another "blueprint". For this reason, it is important to emphasize here that what is being recommended below is not a complete package that suits every country in Africa. It does, however, contain components that should be considered — in part or in total — as relevant for making the best of the ongoing economic and political reform efforts at this point in time. It is offered here, therefore, merely as an agenda.

To place the agenda in perspective, it is worth repeating what African countries and the international donor community have committed themselves to, namely:

- Achieving a significant measurable reduction in poverty and hunger;
- Accelerating human development through education and better public health measures;
- Strengthening respect for human rights and principles of good governance;
- Enhancing the global partnership for development.

These commitments may be interpreted as a summary of the MDGs, but they are more permanent than the MDG process

itself. They are stand-alone universal goals. Because they are wide in scope, it is difficult to address each one of them in detail here. The commitments leave out the important issues of debt relief and global trade issues. The question then is, what are the implications of these goals for how donors and African governments institutionally deal with the development challenges in individual African countries?

The Biggest Challenge

One of the biggest development challenges facing many African countries today is the prevalence of informal practices such as clientelism (or neo-patrimonialism, as it is sometimes called), which render formal institutional arrangements less effective. These informal measures are rational from an individual perspective — that of both the patron and the client — but they undermine objectives at the macro level. They also contradict reform efforts and often serve as the basis for resisting them. The question is whether these informal practices can be transcended and turned into something positive. Are there other ways than external conditionalities or mere persuasive appeals to turn the relationship between formal and informal institutions in African countries into a win-win equation?

A "Policy" Government

Policy analysts in donor agencies and multilateral development institutions emphasize the role of policy in the development process. However, many governments in the developing world are far from what one would call "policy" governments; they are rather "patronage" governments. This is certainly true in many African countries, where rewarding loyal followers becomes so prevalent that it overshadows the effort to achieve public policy goals. To the extent that patronage governments operate according to patronage, they look backwards rather than forward toward achieving a set of development goals. Needless to say, this undermines the role of government as an institutional mechanism that can make a developmental difference. This problem is increasingly being recognized, but little progress has been made toward tackling it because the institutional solutions proposed in the past have failed to gather political traction.

A "policy" government is committed to providing and implementing goals that have been duly approved by institutions with legitimate authority to do so. There is a clear separation between "official" and "personal" and the distinction between "public" and "private" matters. In the best-case scenarios, there is, on top of that, a professional pride in work and in what one achieves. This idea of a "policy" government is still in the making in African countries. It needs to be further strengthened if these countries are going to become more efficient and effective in achieving development goals on their own.

Autonomous Development Funds

Patronage politics has the tendency to encourage discretionary control of resources that can be used to reward followers. Individuals in key positions of authority would wish to have personal control over funds at the disposal of their

organization. This inclination is at the root of the prevalence of informal institutions in Africa and, in many instances, the prevalence of corruption. This problem will not be solved by simply trying to "fix" formal institutions using the New Institutional Economics model, for example. This is a political governance issue that must be tackled as such.

The objective must be to insulate public funds from control by powerful individuals who overstep their authority. In the social and economic development fields, this may amount to the creation of autonomous development funds that are legally public institutions but so constituted and governed that they are also accountable outside the government system. Some years ago, an expert consultation, brought together under the auspices of African Association for Public Administration and Management (AAPAM) and made up of representatives of African governments, non-governmental organizations, and the donor community, including the World Bank provided a recommendation for what was called "autonomous development funds" (Dag Hammarskjold Foundation 1995). See Box 6.3.

Box 6.3: Objectives of Autonomous Development Funds

The principal objectives of Autonomous Development Funds would be to

- provide funding on a competitive basis to organizations in and outside of government;
- serve as catalytic mechanisms for mobilizing and allocating funds within sectors identified as priority areas in government policy;
- ensure resource allocation based on professional criteria;
- encourage a demand-driven development process;
- stimulate local capacity-building;
- promote donor coordination within African countries based on local institutional priorities.

The assumption with these funds would be that they are institutions with a public mandate, established to cater for demands for development within a given sector or in relation to a specific theme, for example, "women and development". Each fund would be open to proposals submitted from 'executive agencies' (or development ministries, if such agencies have not been established), local government authorities, non-governmental and community-based organizations, and where applicable, private sector organizations. An important feature is the competition that such a fund can create among different types of organizations. This is vital for institutional growth and has the potential of formalizing organizations in an organic manner, that is, without causing the kind of conflict that has prevailed so far between informal practice, on the one hand, and formalization efforts, on the other.

Donors have already abandoned project funding, in line with their preference for disbursing their funds in large grants. For instance, without having to abandon the preference for budget support, it would be possible for donor agencies to negotiate with their African counterparts to set aside a certain amount

for deposit into such autonomous development funds. With the establishment of such funds, it would also be possible for donors to place money in a common pool that is subject to local national accounting and audit practices.

Autonomous development funds are not new to the international community (see Box 6.4). In African countries, donors once invested their money in rural development funds controlled by the office of the president or the ministry of planning and development. Following the introduction of Structural Adjustment Programmes in the 1980s, the World Bank supported a number of Social Action Funds aimed at financing social development activities. The problem with these earlier efforts is that little or no attention was paid to how these funds were controlled and governed, and they sometimes become "slush" funds for powerful political figures. In other instances, when supported by a single donor, control by the donor was too rigid,imposing upon recipients accounting regulations that were time-consuming to comply with. In short, more time was spent on reporting requirements than on effective spending of the money. Other shortcomings abound in the literature. For these reasons, the "fund" idea has a negative connotation in the minds of many analysts and practitioners.

There is no reason, however, to "throw the baby out with the bathwater". The autonomous development fund is a good idea provided it is publicly accountable and governed in ways that reduce, if not wholly eliminate, the shortcomings associated with cases in the past. Thus, some of the key principles that would have to be considered before establishing an autonomous development fund would be:

- shared governance between government, civil society, and foreign donors;
- board members serving in an individual capacity;

Box 6.4: A Success Story of an Autonomous Development Fund

The idea of an autonomous development fund is not just an academic one. It has been put into practice on an experimental basis in several countries. One example that is particularly instructive is the Cultural Development Trust Fund in Tanzania (*Mfuko wa Utamaduni Tanzania*). This fund started six years ago as an autonomous fund for cultural development in the country. It has been able to attract support from three donors and the government. Its board comprises nine members: one representing donors, one representing the government, and seven others representing different constituencies within the cultural sector, for example, performing artists, librarians, writers, and so on. This means that the cultural sector itself is more extensively represented, but it was an arrangement that government and donor representatives agreed to in an initial meeting. It is worth mentioning here that each constituency nominates both a male and female member to ensure gender equity.

The Cultural Development Trust Fund has helped mobilize funds for the sector. It has responsibly allocated grants not only to activities and artists based in the main city of Dar es Salaam, but also to the twenty other regions in the country. Thus, it has had a catalytic effect while also serving as a model for how money can be used in ways that enhance the principles of good governance.

- funds that have a national, but sector-specific mandate;
- funds, as public institutions, are accountable to the national legislature.

The idea of a shared tripartite governance arrangement is meant to reduce the risks of mismanagement of the money. In a game theoretic situation where there are three, as opposed to just two, actors — which is the standard model in donor-recipient relations — the possibility of poor use of resources diminishes. There is always the possibility of one of the three parties being ready to "blow the whistle". Furthermore, with three, compared with just two actors involved, the "power game" is less likely to end up in zero-sum outcomes. In short, the sharing of fund governance on an equal basis between representatives of government, civil society, and the external donors creates a positive atmosphere.

To ensure that narrow personal or organizational interests do not threaten such an atmosphere, it is important that people are not appointed to the board on an ex-officio basis. A senior civil servant should not be on the board merely because of his position; nor should an ambassador representing a donor country or a director of an NGO. Government, civil society, and donors should be three separate constituencies that are governed by their own rules and meet to nominate and elect representatives to the board of such a fund. The representatives should be trusted persons who are recognized and respected within the constituency and, preferably also, within the public.

The donors or resource providers do not necessarily have to be external donors only. Once the demand for resources from these funds has become institutionalised, governments may wish to contribute their own share in order to increase the total resources available for allocation among applicant organizations. This would also enhance the image of these funds as public institutions.

There is no guarantee that corruption and other possible malpractices will completely disappear with the creation of these autonomous development funds, but they do stand a much greater chance of reducing them than those institutional arrangements that have prevailed in the past. By virtue of being legally incorporated public bodies in an African country, the autonomous development funds are more sustainable than other institutional arrangements that are more directly dependent on external funding. At the same time, donors who have placed money in any one of these funds do of course have the right to withdraw their support if malpractices occur that cannot be immediately corrected. This gives them a right to sanction. In the long run, this may be a corrective mechanism that turns the fund in the right direction.

Conclusion

The problems associated with aid flows to Africa are complex and multidimensional, and solutions to these problems should be grounded in a multi-faceted approach, which takes into account key ingredients that should underpin efforts at developing Africa in the future. Notwithstanding the

problems associated with aid effectiveness and their implications for development in Africa, the chapter argues that increased development aid and its redirection toward productive activities will be critical to Africa's future growth and development. New approaches to aid in Africa should be underpinned by four key principles: being more selective in choosing aid recipients; designing aid activities with the participation of potential beneficiaries and implementing them in partnership with other development organizations; strengthening the capacity of recipients; and restructuring aid delivery mechanisms to make recipients responsible for development.

CHAPTER 7

The Role of the African Development Bank in Aid and Debt Relief in Africa

Introduction

The African Development Bank (ADB) is an African multilateral development institution whose mandate is to provide as well as mobilize financial assistance for its regional member countries (RMCs) in order to promote sustainable economic growth and reduce poverty in these countries. The Bank strives to achieve its objective of tackling the development challenges facing the different groups of African countries by financing a broad range of development projects and programs through concessionary and non-concessionary loans and grants to its RMCs[1]. It also provides loans to the private sector and technical assistance for institutional support and capacity building activities. The number of Bank operations has fluctuated over the years, but since its establishment in 1964, the Bank Group has approved over 3000 loans, grants, and debt relief operations for its regional member countries, totalling over US$ 55 billion. With respect to debt relief situations, the African Development Bank, along with the World Bank and the IMF introduced the HIPC Initiative in 1996 and its enhanced variant in and is currently implementing the MDRI. The implementation of the MDRI, which provides a 100 percent cancellation of debt of post-completion point HIPC countries, will further deepen the HIPC debt relief process by creating fiscal space which would enable these countries make real progress towards achieving the MDGs. This chapters examines the role of the African Development Bank in the provision of aid, debt relief and other development assistance to its regional member countries.

Nature and Extent of the Bank Group Operations

During its four decades of existence, the Bank Group has sought to respond to the development needs of its RMCs by financing development programs and projects and by providing technical assistance. The types of programs and projects that it has financed have changed over the years from an initial narrow concentration in a few sectors to a broader, more diversified portfolio. Similarly, the priority areas of engagement have evolved over the years, with poverty reduction and the promotion of sustainable economic

[1] The Bank Group comprises the African Development Bank (ADB), the African Development Fund (ADF), and the Nigerian Trust Fund (NTF). Henceforth, the use of "The Bank" in the rest of this chapter will be synonymous with The Bank Group. The ADB window provides loans to middle-income countries on non-concessionary basis while the ADF and the NTF make available concessionary loans and grants to low-income RMCs.

growth becoming key strategic objectives, particularly for concessional resource financing in Low-income countries. For the middle-income countries that have access to its 'hard' ADB window, however, the Bank's vision is to assist these countries improve the competitiveness of their economies by helping them implement key reform programs, upgrade their infrastructure, and strengthen their private sectors.

Table 7.1 summarizes Bank Group operations in regional member countries. The number of operations has fluctuated over the years, but since its establishment in 1964, the Bank Group has approved 3,111 loans, grants, and debt relief operations for its regional member countries, totalling approximately US$ 55.2 billion. This was made possible by resources mobilized from capital markets, through its ADB window, and from donors through the ADF and NTF windows. Distribution of the Bank's cumulative financial operations shows that the ADB accounts for 57.1 percent of total operations (equivalent to US$ 31.5 billion), while the ADF and NTF windows account for 42.1 percent (or US$ 23.3 billion) and 0.8 percent (US$ 407 million), respectively. The disproportionate shares of the three windows reflect the varying periods of operations. While the cumulative figures for the ADB relate to the period 1967-2005, those for the ADF and the NTF go back to 1974 and 1976, respectively.

In line with its new strategic orientations and priorities, and with its operational principles, the Bank has continued to focus on a number of priority areas of intervention at the country and regional levels to achieve its twin objectives of stimulating economic growth and reducing poverty in RMCs. At the country level, it focused on agriculture and rural development; infrastructure, comprising transport, power supply, communications, water supply and sanitation; education; health; private sector development; and good governance. At the regional level, the priority was on economic cooperation and integration through continued support for the NEPAD, the APRM, and water initiatives. Crosscutting issues such as sustainable environmental management and gender equity have received increased attention in recent years.

The sectoral distribution of the Bank Group's cumulative loan and grant approvals, shown in Table 7.2, suggests that the bulk of the Bank operations is heavily weighted in favor of trade-related activities, led by transportation (16.45 percent), finance (12.50 percent), social services (11.70 percent) and power supply (9.45 percent).

The Bank also continued to provide support for structural reforms and for debt relief in RMCs through the enhanced HIPC Initiative and the Multilateral Debt Relief Initiative (MDRI) launched by the G8 countries in July 2005. Its multi-dimensional response to the persistent and widespread poverty in Africa includes implementing its new Poverty Reduction Policy; continuing to support RMCs in their Poverty Reduction Strategy Paper (PRSP) processes; strengthening Bank staff capacity in poverty analysis; and providing technical assistance, advisory services, and

Table 7.1: Summary of Bank Group Operations, 1996–2005 (millions of US dollars)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Cumulative Total
Bank Group Approvals b/											
Number	33	112	133	93	144	134	118	145	124	102	3,111
Amount	822.95	1,880.05	1,751.01	1,770.87	2,585.00	2,981.31	2,771.99	2,624.69	4,327.78	3,278.23	55,162.45
Of which HIPC	–	–	30.60	125.92	844.46	768.14	613.85	2.74	1,567.20	727.04	4,679.95
Disbursements	1,641.57	1,578.16	1,249.58	1,215.83	896.68	1,079.39	1,424.97	1,519.83	2,043.05	1,843.48	33,338.21
ADB Approvals b/											
Number	11	21	18	23	38	26	31	28	23	34	991
Amount	508.18	798.50	940.52	1,088.94	1,098.67	1,239.97	1,452.05	1,108.30	2,359.86	1,241.65	31,519.18
Of which HIPC	–	–	30.60	28.48	226.59	219.85	255.56	–	1,099.17	108.61	1,968.86
Disbursements	1,007.94	927.23	618.96	700.62	535.42	609.20	679.45	969.27	978.76	850.92	20,185.84
ADF Approvals b/											
Number	21	91	115	70	103	107	84	112	99	65	2,045
Amount	306.14	1,081.55	810.49	681.93	1,472.42	1,734.92	1,306.14	1,482.93	1,953.55	2,032.02	23,236.52
Of which HIPC	–	–	–	97.45	617.87	548.29	358.02	2.74	468.03	613.86	2,706.26
Disbursements	626.45	646.07	623.88	504.94	352.99	466.43	740.97	546.94	1,056.82	987.72	12,892.32
NTF Approvals											
Number	1	–	–	–	3	1	3	5	2	3	7
Amount	8.63	–	–	–	13.92	6.41	13.79	33.45	14.37	4.56	406.76
Of which HIPC	–	–	–	–	–	–	0.26	–	–	4.56	4.83
Disbursements	7.18	4.86	6.73	10.27	8.28	3.76	4.56	3.63	7.47	4.85	260.05

Sources: ADB *Annual Report 2005*.
a/ The cumulative figures go back to the initial operations of the three institutions (1967 for the ADB, 1974 for the ADF, and 1976 for the NTF)
b/ Approvals include loans and grants, private and public equity investments, emergency operations, HIPC debt relief, loan reallocations and guarantee, post-conflict country facility.

Table 7.2: Cumulative Bank Group Loan and Grant Approvals by Sector, 1967–2005

Sectors	Value (million units of Account)	Share (%)
Agriculture and Rural Development	6,787.3	18.50
Social (Education, Health and Others)	4,292.9	11.70
Water Supply and Sanitation	2,819.2	7.68
Power Supply	3,466.2	9.45
Communication	911.3	2.48
Transportation	6,036.2	16.45
Finance	4,585.1	12.50
Multisector	5,576.3	15.20
Industry, Mining and Quarrying	2,121.7	5.78
Urban Development	1.9	–
Environment	93.1	0.25
Total	36,691.2	99.99

Source: ADB (2006), *Annual Report 2005*

Economic and Sector Work (ESW) to RMCs. This response is particularly important in light of the global consensus to harmonize poverty reduction policies, programs, and procedures, and of the need to accelerate efforts to achieve the MDGs.

The Bank's Policies on Financial Assistance

Bank Group operations in RMCs are currently guided by ADF-X Financing Policy Guidelines, which are grounded in the following cardinal principles: country ownership; selectivity; development effectiveness; harmonization, alignment and managing for results; sector wide approaches and development budget support; donor coordination and partnerships; allocation of resources based on country performance; debt sustainability; post-conflict situation; and transparency and accountability (see Box 7.1).

Enhancing Country Ownership

In past ADF replenishment cycles, the Bank had attempted to promote country ownership in the design and implementation of its programs. Such approaches are currently being adopted under the ADF-X cycle. Indeed, country ownership will be greatly facilitated by the Bank's decentralization strategy, which will result in the opening of field offices, bringing to 25 the total number of country and regional offices by the end of 2006. This will undoubtedly bring the Bank closer to its RMCs, thereby enhancing dialogue between the Bank and its RMCs and facilitating greater stakeholder participation.

Greater Aid Selectivity

As the Bank cannot address all the problems of its regional member countries, it focuses its attention on areas in which it has a comparative advantage in order to increase the effectiveness of its operations. In particular, the Bank has continued to enhance its coordination and collaboration with other multilateral and bilateral development partners. Selectivity will continue to be exercised at two levels: at

Box 7.1: ADF-X Financing Policy Guidelines

In June 2005, the ADF Board approved the ADF-X Financing Policy Guidelines, designed to supplement and implement the ADF's general operational guidelines during 2005–2007 (ADF-X period). The objectives of ADF operations under the ADF-X funding cycle are to reduce poverty, improve living standards, and promote sustainable pro-poor economic growth to achieve the MDGs. These objectives will govern all project/program loans and grants, policy-based lending operations, technical assistance operations, new resources, and other ADF activities during 2005–2007.

Under previous ADF funding cycles, the Bank made considerable progress in creating a coherent and comprehensive policy framework as well as in improving its internal procedures and processes. Notably, management introduced new and revised policies and guidelines and the Strategic Plan for 2003–2007 to guide Bank Group operations in priority areas. As affirmed in the ADF Independent Evaluation, the Fund is now in a position to assume a greater role as a strong regional institution that is capable of providing more effective development assistance to its regional member countries and to providing leadership on key development issues. The following key principles will guide ADF-X operations in view of this goal: enhancing country ownership; greater selectivity; enhancing development effectiveness; harmonization, alignment and managing for results; progressive involvement in sector wide approaches and development budget support; improved donor coordination and partnerships; allocation of resources based on country performance; debt sustainability; support to post-conflict countries; and transparency and accountability.

During the past ADF cycles, the Bank had endeavoured to promote country ownership, particularly through the Country Strategy Paper (CSP) processes. This approach is likely to be boosted by the Bank's decentralization strategy, which aims to enhance the process of delegation of authorities in the areas of policy dialogue between the Bank and RMCs, procurement and disbursement of resources. In terms of aid selectivity, the Bank will continue to use this approach at two levels: at the ADF-wide level among client RMCs, and at the national level, among sectors. In both cases, management will be guided by the assessment of the comparative advantages of the Bank relative to other development assistance partners operating in the RMC. The Bank's strategy in enhancing the development effectiveness of its operations will be centred on activities that expedite the Bank's transition to results-based management (RBM) processes. Efforts are being made to raise staff awareness on aid effectiveness, upgrade the ICT infrastructure and data processing capacity, strengthen change management activities, and train staff. In the RMCs, a number of measures are being taken, including the preparation of CSPs and Regional Assistance Strategies (RAS), the development of results-oriented tools, and strengthening the quality of Bank operations at entry as well as during implementation.

With regard to harmonization and alignment issues, the Bank will continue to coordinate its activities with other donors and with RMCs within the framework of the "good practice principles" developed by the OECD and the MDBs. In the past, allocation of Bank resources to client RMCs was based on country performance, using a performance-based resource allocation system grounded in Country Performance Assessment (CPA). This approach ensures that the bulk of ADF's resources are allocated to countries with most conducive policy and institutional environments. More recently, however, an enhanced allocation system was introduced to give governance and post-conflict status significant weights in the CPA formula.

Source: ADB (2005), *ADF-X Financing Policy Guidelines, ADF/BD/WP/2005/55*; ADB (2006), *Annual Report 2005* (Tunis TRA: Operations Policies and Review Department, ADB Group).

the ADF-wide level, among client RMCs, and at the national level, among sectors. Among eligible RMCs, selectivity is exercised in terms of performance-based allocation of ADF resources to countries. At the level of individual RMCs, selectivity takes the form of prioritisation of strategic areas of focus or pillars of intervention, within the framework provided by the Result-Based Country Strategy Papers (RBCSPs). The choice of pillars will be optimised by taking into account (i) development challenges facing the country; (ii) lessons learned from the implementation of past Bank operations; (iii) dialogue with other donors; and (iv) the analysis of the country's PRSP. In particular, in selecting the pillars for the Bank's intervention, management will be guided by the assessment of the comparative advantages of the Bank relative to other development assistance partners operating in the RMC.

Enhancing Development Effectiveness

The Bank's strategy in enhancing the development effectiveness of its operations is centred on activities that expedite the Bank's transition to results-based management (RBM) processes. These include raising staff awareness, upgrading information technology and data processing capacity, strengthening change management activities, and staff training. With regard to Bank operations, a number of measures that are being taken during the ADF-X funding cycle include preparing Country Strategy Papers (CSPs) and Regional Assistance Strategies (RAS) utilizing a results-based format; developing results-oriented tools, such as enhanced logical frameworks; strengthening the quality of Bank operations at entry as well as during implementation. The Bank continues to improve the quality at entry of its interventions through increased investment in Economic and Sector Work (ESW), greater selectivity in the operational focus of its result-based CSPs, anchored to client countries' PRSPs, and the shift, where necessary, toward sector-wide programs, development budget support lending, and larger loans/grants. With regard to ESW, the Bank strives to boost the scope, quality, and relevance of its analytical studies and diagnostic reviews. As a result, the Bank aims to strengthen its in-house capacity in ESW by improving the skills mix of its staff, increasing allocation of resources, and applying a more rigorous quality assurance process for reviews, studies, and diagnostic products. However, the Bank tends to avoid unnecessary duplication of ESW produced by its development partners if it is of good quality and is relevant to Bank operations. The Bank continues to engage actively in collaborative activities with other partner institutions and with RMCs. The Bank also continues to assure the quality, at implementation, of its operations through a more effective quality and compliance review process.

Harmonization, Alignment, and Managing for Results

As a partner in the implementation of the Rome Agenda, the Bank will continue to coordinate its harmonization activities with other donors and with RMCs within the framework of the "good practice

principles" developed by the OECD and the MDBs. The Bank's actions within this agenda will be guided by the four core principles: (i) country ownership, (ii) harmonization of all aspects of development assistance by countries and donors, (iii) alignment of donors' support with country objectives, priorities, and policies; and (iv) managing for results. Within this framework, the Bank, during the ADF-X cycle, will be working under three closely linked undertakings: first, to achieve closer alignment of its assistance operations with the development priorities and poverty reduction strategies, systems, and timeframes of its RMCs. Second, to harmonize its operational policies, practices and even operational and financing modalities with other multilateral and bilateral development assistance providers and coordinate its interventions with them with a view to minimizing transaction costs on client countries. Third, to manage effectively towards the attainment of desired development results (see Box 7.2).

Improved Donor Coordination and Partnerships

During recent ADF cycles, the Bank enhanced its collaboration with other IFIs, particularly the World Bank, and also with bilateral and multilateral development agencies in such areas as managing for results and promoting harmonization. The Bank will continue with such efforts under the ADF-X program in order to strengthen its strategic partnerships and in-country coordination with other development partners—both multilateral and bilateral—through joint field missions and country analytic work. The Bank will enhance its cooperation and partnership with the Bretton Woods Institutions, the United Nations agencies, and bilateral development organizations engaged in work in the particular sectors/areas where the Bank is expected to intervene.

Allocation of Resources Based on Country Performance

Under the last two ADF cycles, the Bank introduced a performance-based resource allocation system based on Country Performance Assessments (CPA). This has resulted in the bulk of ADF resources being provided to countries that have the most conducive policy and institutional environment for promoting sustainable, broad-based growth. The introduction of the CPA also enabled the ADF to stress, during policy and program dialogue with countries, the importance of poverty reduction and other critical issues such as governance, regional integration and public expenditure management. Adjustments recently made to the CPA formula have led to an enhanced allocation system, whereby governance as well as the post-conflict status of countries has been given significant weight, thus allowing countries with better governance systems or those emerging from conflict to have access to increased allocations. The allocation of resources to countries will continue to be based on performance, as measured by the Bank's enhanced CPA system, which is linked to actual implementation of reforms.

Box 7.2: Harmonization, Alignment, and Managing for Results

The African Development Bank Group participated actively in the Rome High Level Forum on Harmonization and Alignment for Aid Effectiveness (February 2003), the Marrakech Second Roundtable on Managing for Development Results (February 2004), and the Paris High-Level Forum on Harmonization, Alignment and Managing for Results (March 2005), and is fully committed to implementing the core principles and frameworks of actions agreed upon at those meetings. The Bank, therefore, will strive to align its operational activities with the development priorities and poverty reduction strategies of its RMCs. It will also harmonize its operational policies and practices and coordinate its interventions with those of key multilateral and bilateral development assistance providers and RMCs within the framework of the "good practice principles" developed by the OECD and the MDBs.

To this end, Management presented to the CODE for approval, in April 2005, the Bank Group's Action Plan on Harmonization, Alignment, and Managing for Results (HAMfR). Under the HAMfR Action Plan the Bank will strengthen the alignment of its assistance with countries' priorities, systems, and procedures, while increasing its harmonization and coordination with other donor agencies in order to rationalize activities and avoid unnecessary duplication. Efforts will be made to use, as much as possible, joint systems through sector wide approaches or budget support. In order to achieve stronger alignment, the Bank will provide support to its member countries to strengthen national capacities in the preparation and implementation of development and poverty reduction strategies and operational frameworks, including the planning, budgeting, procurement management, and performance evaluation functions.

The Bank will also define, in collaboration with other donors, acceptable performance indicators and their monitoring, in public financial management and procurement as well as promote their quick and widespread application. The Bank will effectively address RMCs' low institutional capacities that prevent them from developing and implementing results-based national development strategies. In implementing its operations, the Bank will avoid promoting the establishment of parallel structures. In addition, countries will be provided with up-to-date information on their Fund resource allocations and disbursements. Management and the RMC authorities will collaborate in rooting out corruption and misapplication involving development finance resources. With a view to more fully implementing its HAMfR commitments, the Bank will further expand the scope of the delegation of authority to its field offices, as a tool for more effective development partnership in the RMCs.

Source: ADB (2005), *ADF-X Financing Policy Guidelines, ADF/BD/WP/2005/55.*

Debt Sustainability

Under the ADF-X program, the new IMF/World Bank Debt Sustainability Framework (DSF) will guide the Fund in setting financing terms for ADF resources. The new DSF has two pillars: (i) a set of thresholds of external debt-burden indicators that take into account countries' policies and institutions and their vulnerability to external shocks; and (ii) actual and projected behaviour of debt-burden indicators and other key macroeconomic variables as indicated in Debt Sustainability Analyses (DSAs), both

under a baseline and possible shock scenarios. The appropriate loan and grant mix for each country will then be determined according to its debt-distress risk category. During the transition to a system that fully takes into account the key aspects of the second pillar, insights from available DSAs will be used to inform the decision on how to classify countries. Grants will be limited to ADF-only countries to reduce the risk related to the 'free-rider' problem.

Support to Post-Conflict Countries

In 2004, the Boards of Directors approved the creation of a Post-Conflict Country Facility (PCCF) to provide, in close collaboration with the World Bank and the IMF, support for clearing the arrears of countries emerging from conflict, enabling them to re-engage with the donor community. The facility is currently operational with a modest resource base of around UA 100–150 million to finance the clearing of arrears of post-conflict countries. The Bank will continue to use the resources of the facility, on a case-by-case basis, to assist post-conflict countries that meet the criteria established under the PCCF.

Transparency and Accountability

The Bank continues to promote accountability and transparency using a two-pronged approach. At the operational level, the Bank aims to increase support to RMCs in their efforts towards promotion of good governance. At the corporate level, the Bank Group intends to take appropriate steps to attain a high ranking on institutional transparency among peer international financial institutions.

Shifting Emphasis Towards Sector-Wide Approaches (SWAPs)

Management has recognized the growing importance of Sector-Wide Approaches (SWAPs), also referred to as sector investment programs (SIPs), which have become important instruments for operationalizing country-led development frameworks. SWAPs and budget support operations tend to enhance donor coordination and harmonization of procedures, and to deliver effective support to country-owned poverty reduction strategies. In particular, SWAPs are likely to address the shortcomings of the project approach, such as the high transaction costs of individual projects, multiplicity of donor-sponsored project implementation units (PIUs), variations in donor conditionality and procedures, and donor-driven accountability systems.

During the ADF-IX cycle (2002–2004), the Bank introduced SWAPs and Development Budget Support Loans (DBSLs) on a case-by-case basis. It has now developed appropriate guidelines for SWAPs (see Box 7.3) and prepared program budget support through which the its resources will be pooled with country and other donor resources to support programs outlined in PRSPs. The Boards of Directors have already approved both the SWAP operational guidelines and development budget support lending. The Bank will continue to increase its participation in such investment frameworks, in line with these guidelines, using a case-by-case approach.

Box 7.3: Guidelines for Bank Group Operations Using SWAPs

SWAPs emerged in the 1990s out of a growing dissatisfaction with the traditional project approach that has often been viewed as "fragmented, donor-driven" and entailing high transaction costs for aid-recipient countries. SWAPs emphasize greater reliance on government institutions, common implementation procedures, and stronger and closer country partnerships with development partners. The defining imperatives for an effective SWAP process include the existence of a government-led and coordinated comprehensive sector development programme; the existence of a conducive policy environment or policy reform agenda leading to it; and, the commitment and availability of donor resources in the form of sector investment loans and grants for institutional capacity building and studies to underpin sector development issues. SWAPs also require the existence of a strong and coordinated donor approach to the relevant sector's problems as well as the presence of an effective consultation mechanism between the aid-recipient member country and its development partners. The approach generally envisages the pooling of donor financial resources in support of the government's budget, the use of a common government-led implementation and coordination mechanism and streamlined/ harmonized and procurement procedures.

In view of the SWAPs in the development process, the Bank has developed guidelines to familiarize its staff with the key features and characteristics of SWAPs and to guide them in the preparation of and participation in SWAP operations. The guidelines also set out the conditions under which the Bank can undertake or participate in a SWAP operation. Indeed, SWAPs are consistent with the Bank's operational policies and, in particular, with the 2002–2007 Medium Term Assistance Strategy which emphasizes client focus and selectivity of interventions leading to the creation of comparative advantages and niches for the Bank and enhanced development impact for its operations. The SWAP guidelines are not only consistent with the Bank's strategic orientations or approach;, they are also central to the comprehensive development strategies of regional member countries as outlined in their PRSPs.

It is anticipated that the Bank's participation in SWAPs will improve the efficiency of the relevant portfolio, enhance the contribution of the Bank to the member country's efforts to reduce poverty, and facilitate the attainment of the MDGs. Another principal rationale for SWAPs derives from the framework's features, which seek to overcome the shortcomings of the traditional project approach to development. Some of the shortcomings of the project approach include the high transactions costs of individual projects, multiplicity of donor project implementation units (PIUs), variations in donor conditionalities and procedures, and donor-driven accountability systems. Underlying the growing importance of SWAPs is the realization that sectoral goals are best pursued through country-led sector-wide approaches in the context of nationally defined policies, strategies, and coordinated budgetary frameworks rather than through a series of discrete donor projects.

The prerequisites for Bank Group funding of SWAP operations derive from the key characteristics of the SWAP process discussed above. However, for the Bank to participate effectively in the process, a number of supportive structures and institutional frameworks must be in place. These include sector policy frameworks, collaborative processes, expenditure frameworks, institutional capacity analyses, performance monitoring indicators and data monitoring systems, joint reviews, identification of the appropriate instruments for Bank intervention, and staffing. Other desirable requirements include pooling of donor funds and harmonization of donor procedures for financial management and procurement.

Source: ADB, *Revised Guidelines for Bank Group Operations Using Sector-Wide Approaches (SWAPs)* (Tunis ATR: Operations Policies and Review Department, ADB Group, April 2004).

Prerequisites for the Bank's participation in SWAPs

A critical set of conditions has to exist for a sector-wide program to be initiated and effectively implemented. These include economic and political stability; government commitment; effective country-led donor coordination mechanisms; and a minimum threshold of institutional capacity. Economic stability, reflected in low inflation, manageable budget deficits, stable exchange rates, and sustainable current account balances, is necessary for sector programs to attract adequate and stable financing. Similarly, political stability is also important for SWAPs due to the significance of ownership and institutional capacity or capability. Thus, the application of SWAPs is unlikely to be sustained in countries that are prone to volatile political regimes or in countries engaged in conflicts.

Similarly, engagement in SWAP operations requires an explicit government commitment (for example, to avoid policy reversals or to adopt a participatory approach in decision making) to adopt an integrated approach to develop a collaborative process. Governments should also put in place a mechanism for consultations with key stakeholders to ensure smooth implementation of SWAP programs. A country must also have the required level of institutional capacity to undertake the preparation and implementation of a sector-wide program. Although SWAP programs can enhance the institutional capacity of aid-recipient countries, the country must first have a

Box 7.4: Challenges Facing the Bank in its SWAP Operations

The following factors have been identified as key constraints to the Bank's effective participation in SWAP operations:

Limited involvement in SWAP preparations: Although the government embarking on a SWAP operation has the ultimate responsibility for preparing the programme, donors do provide timely assistance by providing consulting services or undertaking economic and sector work. In its previous operations, the Bank was rarely active in this preparatory stage. The recent institutional reform at the Bank, which saw the creation of an operations complex for economic and sector work, will likely address this problem.

Limited Bank Group field presence and intermittent participation in annual reviews: The limited presence of the Bank or the absence of sector and procurement experts in the field has often been a constraint to effective implementation of SWAPs. Also, the Bank has often faced difficulties in attending joint supervision and program review meetings and consultations, which serve as useful forums for all stakeholders to assess implementation progress and develop remedial measures for identified bottlenecks. It is anticipated that as more regional and country offices are established with the appropriate skills mix, these problems can be overcome.

Centralized procurement decision-making: Until 2000, when the selection of contracts for procurement post-review was introduced, the procurement process within the Bank Group was centralized, causing delays in the approval of bids. The Bank needs to adopt more flexible procedures like those of other multilateral development banks, where approval of procurement documentation is determined by threshold, and task managers have some authority to approve bids up to a certain amount.

Rigidity in the use of special accounts: In most cases, the Bank Group replenishes special accounts only when the borrower is able to justify use of at least 50% of the initial disbursement. In other MDBs, especially the World Bank, replenishment of the special account is made regularly (several times a month), depending on the amounts that the borrower is able to justify on the basis of statements of expenditure.

General Budget Support: Within the context of the PRSP, many donors currently provide development assistance using the general budget support approach. The Bank has conditionally embraced the approach in principle, noting the importance of transparent fiduciary systems. As fiduciary systems in RMCs improve, the Bank is likely to use this instrument in its policy-based lending and SWAP operations.

Source: ADB, *Revised Guidelines for Bank Group Operations Using Sector-Wide Approaches (SWAPs)*, Operation Policies and Review Department, April 2004.

threshold level of implementation capacity. In the absence of such minimum levels of institutional capacity, the Bank, either on its own or in collaboration with other donors, will assist the country to develop the required capacity before SWAP operations can begin. Such support is often provided in the form of technical assistance or grants under the Bank's capacity building initiative.

The Bank's Experience with SWAPs

Table 7.3: Status of Enhanced HIPC Debt Relief Implementation as at end-December 2005 (millions of US dollars)

Country	IMF/WB APPROVAL DATE		CUT-OFF DATE	DEBT RELIEF COMMITTED		LAST DATEOF DEBT	RELIEF DELIVERED		RELIEF DELIVERED /TOTAL COMMITTED		40 PERCENT CEILING INTERIM LIMIT DATE
	DEC. POINT	COMPL. POINT		COST NPV TERMS	COST NOM. TERMS	RELIEF	NPV TERMS	NOM. TERMS	NPV TERMS (%)	NOM. TERMS (%)	
Completion point cases											
Benin	Jul-00	Mar-03	Dec-98	37.57	46.50	Apr-09	24.61	28.15	65.5	60.5	Irrevocable
Burkina Faso	Jun-00	Apr-02	Dec-99	86.70	125.74	Oct-20	24.90	37.32	28.7	29.7	Irrevocable
Ethiopia	Nov-01	Apr-04	Jun-01	339.46	461.39	Sep-21	112.27	123.45	33.1	26.8	Irrevocable
Ghana	Fev-02	Jul-04	Dec-00	130.93	160.15	Jan-13	73.70	80.39	56.3	50.2	Irrevocable
Madagascar	Dec-00	Oct-04	Dec-99	60.06	80.40	Mar-13	28.92	31.83	48.1	39.6	Irrevocable
Mali	Sep-00	Mar-03	Dec-98	69.72	86.42	Jul-10	40.55	45.65	58.2	52.8	Irrevocable
Mauritania	Fev-00	Jun-02	Dec-98	72.80	90.69	Apr-11	45.63	51.55	62.7	56.8	Irrevocable
Mozambique	Apr-00	Sep-01	Dec-98	22.25	29.27	Sep-10	12.17	14.07	54.7	48.1	Irrevocable
Niger	Dec-00	Apr-04	Dec-99	50.01	86.26	Jul-24	10.80	12.30	21.6	14.3	Irrevocable
Senegal	Jun-00	Apr-04	Dec-98	56.80	65.42	May-06	51.91	57.01	91.4	87.2	Irrevocable

Rwanda	Dec-00	Apr-05	Dec-99	116.10	222.29	Oct-31	23.41	26.82	20.2	12.1	Irrevocable
Tanzania	Apr-00	Nov-01	Jun-99	124.90	190.75	Jul-17	47.79	55.44	38.3	29.1	Irrevocable
Uganda	Feb-00	May-00	Jun-99	59.30	78.65	Mar-12	31.53	36.53	53.2	46.5	Irrevocable
Zambia	Nov-00	Apr-05	Dec-99	146.10	214.50	Jul-25	73.34	78.93	50.2	36.8	Irrevocable
Subtotal				**1,372.7**	**1,938.4**	**…**	**601.5**	**679.5**			
Interim period cases*											
Burundi*	Aug-05	2007-S1	Dec-04	124.22	226.01	Feb-43	…	…	…	…	Apr-08
Cameroon1	Oct-00	2006-S2	Jun-99	78.60	90.11	Mar-06	31.44	33.34	40.0	37.0	Sep-03
Chad	May-01	2006-S2	Dec-00	36.90	49.38	Apr-12	14.63	16.48	39.7	33.4	Mar-06
DRC2	Jul-03	2007-S1	Dec-02	905.09	1,804.87	Sep-24	229.59	241.67	26.7	13.4	Jul-07
Gambia1	Dec-00	2007-S1	Dec-99	15.80	19.57	Jan-09	6.31	6.77	40.0	34.6	Jul03
Guinea1	Dec-00	2007-S1	Dec-99	75.30	89.07	Apr-07	30.12	32.27	40.0	36.2	Oct-03
Guinea Bissau2	Dec-00	2008-S1	Dec-99	50.84	84.98	Jan-24	18.00	20.38	35.4	24.0	Jan-07
Malawi1	Dec-00	2006-S2	Dec-99	70.90	98.22	Jan-14	26.45	29.09	37.3	29.6	Dec-04
Sao Tome& Pr.	Dec-00	2006-S2	Dec-99	34.20	78.93	Oct-38	6.60	7.57	19.3	9.6	Oct-06
Sierra Leone	Mar-02	2006-S2	Dec-00	42.81	98.62	Jan-36	9.34	10.61	21.8	10.8	Jan-07
Subtotal	**…**	**…**	**…**	**1,434.66**	**2,639.77**	**…**	**372.50**	**398.19**	**…**	**…**	**…**

Source: ADB Annual Report (2005).
* Dates for completion points are tentative.
1. These countries have experienced delays in reaching their completion points, as a result, they are expected to fully pay their debt service obligations falling due completion point cases
2. Post-conflict countries pre-decision point cases

The application of SWAPs is a recent phenomenon, but the number of sector-wide programs financed by the Bank has risen since the 1990s. Most of these programs have been largely concentrated in the social and agricultural sectors (ADB 2004). The experience gained from these operations has enabled the Bank to appreciate the characteristic features of SWAPs and the advantages and challenges of SWAPs relative to the project approach. Based on this experience, the Bank is also in a better position to address the following constraints identified while participating in SWAPs: limited involvement in SWAP preparations; limited Bank field presence; intermittent participation in annual reviews; centralized procurement decision-making; rigidity in the use of special accounts; and general budget support (see Box 7.4).

The ADB and the Heavily Indebted Poor Countries' (HIPC) Initiative

As stated earlier, international financial institutions, including the African Development Bank, introduced the HIPC Initiative and its enhanced variant in 1996 and 1999, respectively. Since then, progress has been made in the implementation of the HIPC Initiative. As at June 2006, a total of 40 countries around the globe (33 in Africa) were classified as HIPC. Of the 33 African HIPC countries, 24 of them were receiving debt relief from the Bank's enhanced HIPC Initiative. Furthermore, 14 of these countries have reached the HIPC *completion point* while 10 are classified as interim period countries (between *decision point* and *completion point)*. (See Table 7.3). The debt relief cost of the 14 completion point countries stands at $1.37 billion in net present value (NPV) term (equivalent to $1.94 billion in nominal value). The HIPC debt relief cost of the 10 remaining interim period countries is estimated at $1.43 billion in NPV terms ($2.64 billion in nominal terms).

It should be noted that most HIPCs that have reached the decision point under the Initiative are likely to have substantially lower debt and debt-service ratios. Indeed, upon reaching their respective completion points, the NPVs of the debt stock of HIPCs is projected to decline by about two-thirds, whilst their debt service-to-exports ratio is projected to have declined from an average of 16 per cent in 1998–1999 to 7 percent in 2005 (Global Monitoring Report, 2006). Of the 33 HIPC regional member countries, only three (Cameroon, Mozambique and Senegal) have a present value debt-to-exports ratio of less than 75 percent (Vencatachellum, 2006). All three countries have reached their completion points. Mozambique was the second African country (after Uganda) to reach its completion point in September 2001. Interestingly, Uganda had a debt-to-exports ratio (in present value terms) of 172 percent in 2004, which is above the 150 percent ceiling of the HIPC Initiative. Indeed, the debt-to-exports ratio for 10 of the African HIPCs exceeded 200 percent in 2004.

The Multilateral Debt Relief Initiative (MDRI)

At their summit in Gleneagles in July 2005,

Box 7.5: MDRI Implementation Modalities

At the ADF Deputies' meeting in Washington, D.C. in December 2005, Deputies concluded negotiations on implementation modalities for the MDRI. For the ADF and IDA, debt stock cancellation will be a three-phase process: (i) post-completion-point HIPCs will be relieved of their repayment obligations and their gross assistance flows adjusted downward by the same amount; (ii) donors will make new contributions to ADF and IDA to match, "dollar-for-dollar", foregone principal and service charge payments based on an agreed burden sharing; (iii) additional funds will be allocated to all ADF-only and IDA-only recipients on the basis of existing performance-based allocation (mechanisms.

Additional funds to cover the full cost of obligations due during the ADF-X and IDA-14 period will be made available immediately. Similarly, donors will be committed to making additional contributions to the subsequent regular ADF and IDA replenishments to cover the full cost of obligations until all obligations under the cancelled loans have been met. During the meeting, the Deputies underscored that providing firm and unqualified commitments over a rolling 10-year period would allow ADF to commit pledged resources in advance over the regular disbursement horizon of each ADF Replenishment. To this end, donors pledged to fully finance the costs to ADF over the 50-year time span of the Initiative. They agreed that the level of ADF-X donor contributions, measured in real terms, would serve as the baseline on which new donor financing for the Initiative would be assessed over time.

Regarding the scope of the Initiative, Deputies supported the following proposals from management: an implementation date of January 1, 2006; a definition of credit coverage as debt outstanding and disbursed; December 2004 as the cut-off date; the eligibility of 33 RMCs for debt cancellation; and the use of ADF-X normalized burden shares as the basis for the increase in resources for the Initiative.

Based on debt outstanding and disbursed at December 31, 2004, as the cut-off date, and January 1, 2006, as the implementation date, the cost of cancelling the ADF debt of the 33 potential beneficiaries, after HIPC relief, is estimated at UA 5.84 billion (US$9.06 billion) in nominal terms. This is disaggregated into UA 3.91 (US$6.07 billion) as debt relief to the 14 post-completion point HIPCs; UA 1.28 billion (US$1.99 billion) for the 10 interim period HIPCs; UA 0.60 billion (US$0.93 billion) for the 8 pre-decision point HIPCs; and UA0.046 billion (US$0.071 billion) for sunset clause possible HIPC countries.

The ADF Deputies unanimously supported the following criteria for confirming immediate eligibility for the 14 post-completion point HIPCs under the Initiative: (i) satisfactory macroeconomic performance; (ii) satisfactory PRSP implementation; and (iii) satisfactory governance and public expenditure management systems. They endorsed the proposal to prepare a common list of countries eligible for debt relief based on a one-time assessment that will be prepared jointly with the IDA and the IMF. The ADF will participate in these assessments. The Deputies also agreed that, for other HIPCs, reaching completion point would be sufficient to establish eligibility for the debt relief initiative. Under the indicative timetable for the implementation of the adopted MDRI, revised country allocations of ADF resources for 2006 would be finalized in the third quarter of 2006, with retroactive adjustments to January 1, 2006, as the effective starting date for beneficiary countries.

Source: ADB (2006), *Annual Report 2005* (Tunis TRA: African Development Bank).

G8 leaders proposed to cancel 100 percent of the debt stock that HIPCs owe to the ADF, the World Bank's IDA, and the IMF. The G8 proposal, widely known as the Multilateral Debt Relief Initiative (MDRI), applies only to countries that reach their completion point under the enhanced HIPC Initiative. The aim of the MDRI is to deepen the HIPC debt relief process by providing more resources to help 39 countries worldwide, including 33 countries in Africa, to make progress towards the MDGs. The MDRI process also safeguards the long-term financing capacity of the ADF and the IDA, as both institutions would receive full compensation for the costs of their MDRI debt relief. It is noteworthy that although the MDRI applies to the ADF, the IDA and the IMF only, these institutions' approaches to the MDRI differ in terms of coverage and implementation modalities (see Box 7.5).

The cut-off and the implementation dates of the MDRI matter for foregone credit reflows for the ADF and IDA. For the ADF, the cut-off date of the debt cancellation initiative was 31 December 2004, whilst the implement date was 1 January 2006. Since the main objective of the MDRI is to assist eligible member countries to achieve the MDGs, applying the cut-off date of December 2004 permits a larger coverage of the debt overhang that must be cancelled (ADB 2005, Concept Note for the African Ministers of Finance Meeting, Tunis, November 2005).

The cost of cancelling the ADF debt of the 33 potential beneficiaries in Africa, after HIPC relief, is estimated at over $9 billion in nominal terms. This is disaggregated into $6 billion debt relief to the 14 post-completion point HIPCs; $2 billion for the 10 HIPCs that are in the interim between the decision point and completion point; $1 billion for the 8 pre-decision point HIPCs; and around $71 million) for sunset clause possible HIPC countries (see Box 7.5).

Eligibility for the ADF debt cancellation initiative is grounded in the following criteria: satisfactory macroeconomic performance; satisfactory PRSP implementation; and satisfactory governance and public expenditure management systems. These criteria have been endorsed by the ADF Deputies. Under the indicative timetable for the implementation of the adopted MDRI, revised country allocations of ADF resources for 2006 would be finalized in the third quarter of 2006, with retroactive adjustment to January 1, 2006, as the effective commencement date for beneficiary countries.

The MDRI will significantly reduce the debt burdens of HIPCs. As for the 14 African countries that have reached the HIPC completion point, about 80 percent

[2] The ADF-X and IDA14 agreements base their grant allocations on the DSF 'traffic light' system by comparing a debtor country's past debt ratios with policy-dependent debt burden thresholds. Countries assessed as 'red', with high risk of debt distress, receive their ADF allocations in 100 percent grants; those assessed as 'green', with low risk of debt distress, receive their allocations in 100 percent loans; and those assessed as 'yellow', with moderate risk of debt distress, receive their allocations in 50/50 percent loan/grant combinations.

of their outstanding debt stocks is owed to the ADF, the IDA and the IMF. The debt cancellation will see average NPV debt-to-exports ratio fall from over 140 percent, after HIPC relief, to less than 60 percent after implementation of the MDRI (Global Monitoring Report, 2006). Thus the new debt sustainability framework is expected to signal a low risk of debt distress for all the eligible post-completion point RMCs[2]. This will create room for RMCs receiving grants only to begin to borrow from both concessional and non-concessional sources. This is likely to create 'free-rider' or 'moral hazard' concerns. To overcome the free rider problem, it is generally agreed that the MDRI will affect gross assistance flows from ADF and IDA via a two-step process. First, 100 percent stock cancellation will be delivered by relieving eligible countries of repayment obligations and by adjusting their gross assistance flows by an equivalent amount. Second, the dollar-for-dollar compensation to the ADF and IDA for the forgone debt service from the country will be reallocated to ADF-only countries and IDA-only countries through the existing performance-based allocation systems of the two institutions. This procedure will help strengthen the link between resource transfers and country performance levels (Global Monitoring Report, 2006).

Conclusion

The African Development Bank Group has, over the last four decades, played a significant role in aiding its RMCs. In addition to the resources that it has made available, it has engaged in extensive policy dialogue and has provided technical assistance. And more recently in the context of ADF-IX operations, a grant financing mechanism has been introduced to support the broader operational objectives critical to RMC's attainment of MDGs. In 2005, grant financing accounted for approximately 29 percent of approvals from the ADF window and close to 18 percent of total Bank Group approvals for the year. In addition to its own resources, the Bank has also mobilized funding through its co-financing operations in RMCs. At year-end 2005, the Bank had cumulatively mobilized over UA 45.59 billion from external sources to complement the loans and grants it had provided to its borrowing RMCs. Thus, along with the other multilateral and bilateral donors, the Bank has contributed to the significant improvements in macroeconomic management, competitiveness and poverty reduction efforts in its RMCs.

The Bank has recently undertaken institutional reforms to position itself to play an expanded role in the development

of the African continent. The driving forces behind the ongoing institutional reforms in the Bank are the need to: (i) consolidate the Bank's achievements and reposition the institution for greater effectiveness and efficiency; (ii) increasingly meet the evolving development challenges of RMCs; and (iii) provide leadership in particular in areas where it has or can develop comparative advantage as well as areas mandated to it by RMCs, NEPAD and the international community. In this regard, the Bank created a new position of Vice Presidency for Infrastructure, Private Sector and Regional Integration to help its RMCs overcome their supply-side constraints and infrastructure bottlenecks, which often militate against effective regional integration and international competitiveness.

The key guiding principles for the operational activities of the ADB stress the three pillars of ownership, partnership and selectivity. Thus, in designing its programs, the Bank Group strives to ensure that they are demand-driven and owned by the countries being assisted, i.e., they are based on the countries' needs as expressed in their development strategies and programs. The Bank Group also takes account of the interventions of other development partners in a given country through the Country Strategy Paper (CSP) process. This ensures that the guiding principle of partnership is observed in the Bank Group's operational activities. Finally, selectivity of sectors of intervention is also embedded in the Bank Group's Country Strategy Papers, and the current portfolio places considerable emphasis on support to both the public and private sectors.

BIBLIOGRAPHICAL NOTES

Introduction

The background papers prepared specifically for the Report are listed below, along with the selected bibliography used in the Report. These papers synthesize relevant theoretical and empirical literature. The Report has drawn on a wide range of African Development Bank reports, including ongoing research and internal Bank documents. It has also drawn on outside sources, including published works of institutions such as the IMF, the World Bank, IFC, OECD, and the United Nations and its agencies such as the ECA, UNU-WIDER, UNCTAD, UNIDO, and UNDP.

Background papers

(i) Ernest Aryeetey (2006), "An Overview of Aid and Debt Relief in Africa".

(ii) Melvin Ayogu (2006), "Can Africa Absorb More Aid?"

(iii) Oludele Akinboade (2006), "Aid Effectiveness in Africa — selevtivity versus conditionalities".

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