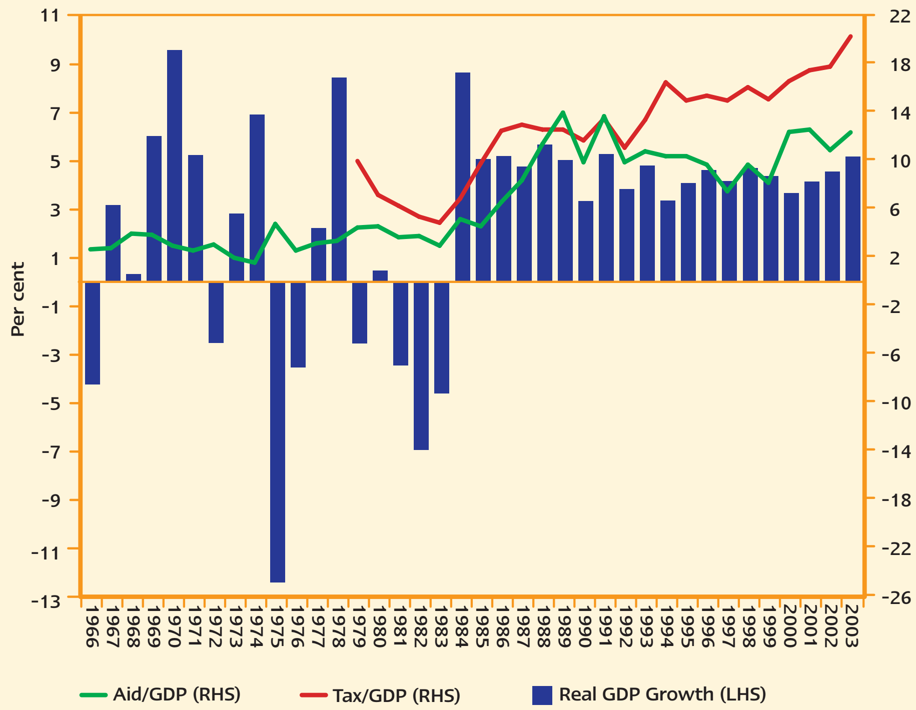
Annex 1: Scaling Up Aid to Ghana

Recent performance and needs

1 Economic performance in Ghana since the early 1980s has been reasonably strong and stable. Figure A9.1.1 shows that average real GDP growth between 1966 and 1983 was less than one per cent, whereas between 1984 and 2003 it was 4.7 per cent, and much more stable[1]. It seems aid has played a crucial role in helping the Government of Ghana to bring about this turnaround.

Figure A9.1.1 **Aid, Revenue and Growth in Ghana**



Source: World Bank African Development Indicators, 2004

2 The results of research by Lloyd et al (2001) indicate that policy reforms implemented after 1983 served to enhance the effectiveness of aid and other public investments, and helped to increase exports[2]. They emphasise the important role played by aid in helping to bring about this change. Other research, using different estimation techniques find similar results: 'Aid has financed higher imports, investments and government spending and has thus made a positive contribution to growth'[3]. An authoritative study by the World Bank also stresses the beneficial interaction between improvements in governance and higher aid flows[4]. Overall, poverty rates have fallen from 51.7 per cent in 1991/92 to 39.5 per cent in 1998/99. Other social indicators have also improved. For example, the proportion of rural population with access to safe water rose from 40.0 per cent in 2000 to 46.6 per cent in 2003[5].

3 At the end of the 1990s, due to pressures created by the election, and adverse shocks, a fresh round of macro-stabilisation became necessary. Since then, however, progress has been good.

4 The Millennium Project needs assessment study has estimated that to reach the MDGs, US$52 per capita in external finance would be needed by 2006, rising to US$70 by 2015[6]. In terms of aid spending on MDG-related activities, this would mean more than a doubling of assistance from levels in 2002.

Table A9.1.1: **Aid, Growth and Poverty in Ghana**

	Real GDP growth (%)	Aid (billions 2003 US$)	Aid/GDP (%)	Govt Revenue/ GDP (%)	Govt Expenditure/ GDP (%)	Govt Expenditure per capita (US$)	Real Aid per capita (US$)	People below poverty line (%)
1999	4.4	500	7.9	16.4	24.3	79.9	26.0	39.6
2000	3.7	791	12.1	17.7	29.8	99.7	40.4	37.5
2001	4.2	840	12.3	18.1	30.4	104.2	42.2	35.3
2002	4.6	757	10.6	18.0	28.6	100.8	37.4	33.1
2003	5.2	907	12.1	18.1	30.2	109.5	43.8	30.8
2004	5.0	979	12.4	18.2	30.6	114.2	46.3	28.6
2005	5.0	1,057	12.8	18.3	31.0	119.1	49.0	26.6
2006	5.0	1,196	13.7	18.3	32.1	126.7	54.3	24.8
2007	5.0	1,353	14.8	18.4	33.2	135.0	60.1	23.1
2008	5.0	1,530	15.9	18.5	34.5	144.0	66.6	21.5
2009	5.0	1,731	17.2	18.6	35.8	153.7	73.8	20.0
2010	5.0	1,958	18.5	18.7	37.2	164.3	81.8	18.6
2015	5.0	1,784	13.2	19.1	32.3	164.3	67.2	13.0
2020	5.0	1,472	8.5	19.6	28.1	164.3	50.0	9.1
2025	5.0	970	4.4	20.0	24.4	164.3	29.7	6.3

Assumptions: GDP growth of 5 per cent (PRGF target), doubling aid from 2004 levels between 2006 and 2010, afterwards spending per capita remains constant. Population growth set at 2.1 per cent and elasticity of poverty with respect to GDP at -1. Aid+Government Revenue is assumed equal to Government Expenditure.

Source: World Bank African Development Indicators, 2004 and Commission's estimates

5 Table A9.1.1 shows a gradual doubling of aid to Ghana from 2004 levels, between 2006 and 2010, and constant public spending per capita thereafter. From the table it should be clear that as aid declines (measured as a ratio to GDP), financing from higher domestic revenues takes over, while spending per capita remains constant.

Feasibility of scaling up

6 Between 1993 and 2002, economic growth in Ghana averaged 4.3 per cent, and increased real GDP per capita moderately. Ghana has been subjected to significant terms-of-trade shocks during the last decade. Cocoa prices, for example, hit a 27-year low in 2000, while oil prices rose[7]. From 2001 onwards, the new Government has embarked on an ambitious new reform programme, and key macro-economic variables have improved significantly over the last three years[8].

7 As part of the Government of Ghana (GoG) self assessment policy, a sovereign rating was conducted by Standard and Poor's. The result, published in September 2003, rated Ghana as a B+, which compared favourably with Senegal's B+ and Morocco's B rating, although it did less well against Botswana's score. In December 2004, a rating by Fitch confirmed the country's long-term sovereign ratings. This came with the following comment: "an impressive degree of macroeconomic stability has been achieved ahead of next month's elections." On current forecasts, the fiscal deficit for 2004 is expected to be 2.3 per cent of GDP, relative to the budgeted value of 1.6 per cent. Compared with previous election years, this level of deficit, both in size and variance, would seem to be much smaller[9].

8 Although aid volumes between 1984 and 2002 have been higher than between 1966 and 1983, flows of aid have been more volatile[10]. For the years between 1999 and 2003, total aid disbursements ranged from a high share, at around 15 per cent GDP, to a low share of five per cent. For these years, project support seems to have been more volatile than budget support. Since the creation in 2003 of the Multi Donor Budget Support (MDBS) process, which groups together all budget support donors, budget support has become more predictable and less volatile – although the assessing period is arguably too short to make conclusive observations.

9 Nevertheless, a mutually reinforcing virtuous relationship seems to be emerging from a set of linked processes: improved macroeconomic and public financial management; Ghana's poverty reduction strategy; HIPC debt relief; the IMF's Poverty Reduction Growth Facility (PRGF); and the multi-donor budget support programme. It appears that the MDBS has:

(a) led to more stable budget support flows, which has helped the GoG to improve macro-economic management, and has allowed a sharp reduction to be made in domestic borrowing – declining from five per cent of GDP in 2002 to roughly zero in the past two years. In the past, the GoG increased domestic borrowing to offset shortfalls in budget support (or terms of trade shocks) to maintain expenditure levels;

(b) allowed authorities to increase the share of the budget devoted to poverty-reducing expenditure;

(c) allowed more timely releases of funds to be made to the District Assembly Common Fund, the main form of transfer from the centre to districts for financing small-scale development projects;

(d) strengthened the role of the Ministry of Finance in establishing financial and accounting controls in administering substantial HIPC and budget support funds;

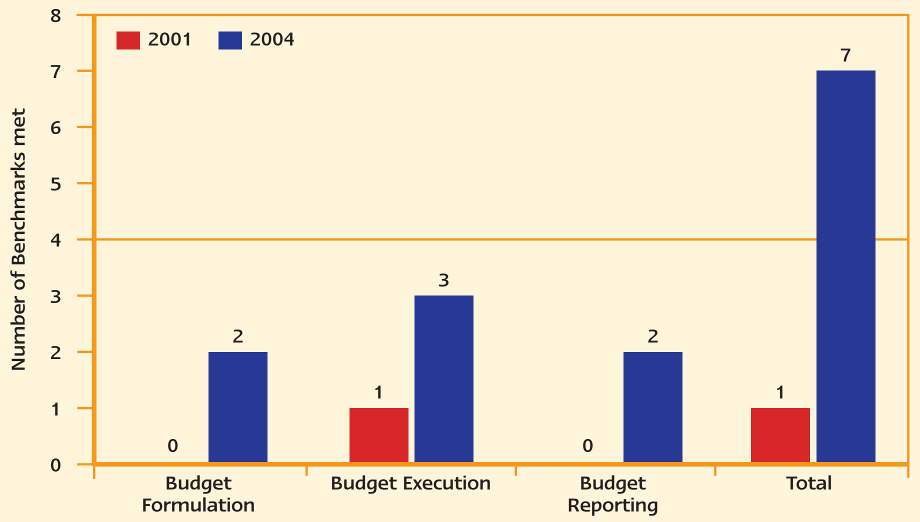
(e) encouraged more joint missions and reduced reporting burdens on government;

(f) allowed Ghana to maintain a sustainable level of external debt having reached completion point in 2004[11].

10 Ghana has made great strides in improving its Public Financial Management (PFM) System. In part, this has been the result of the GoG giving greater priority to financial management reforms, but HIPC debt relief and the MDBS processes have also been influential. The 2004 HIPC Expenditure Tracking Assessment showed that Ghana scored 7

out of 16 benchmarks, which the World Bank and IMF consider to be important for ensuring good public expenditure management (see Figure A9.1.2). Given that in a previous assessment in 2001 Ghana succeeded in scoring only one out of 15 benchmarks, the improvement achieved within a short period of time is significant[12]. The IMF in its 2004 Report on the Observance of Standards and Codes (ROSC) – Fiscal Transparency Module, also noted that "in recent years, Ghana has been making substantial efforts to improve fiscal transparency", and furthermore, "Ghana already meets the standards of the fiscal transparency code in several areas[13]."

Figure A9.1.2 **HIPC Assessment and Action Plan (AAP) in Ghana**



Source: World Bank, IMF and Government of Ghana, 2004

11 Over the last 10 years, the aid-to-GDP ratio in Ghana averaged 10 per cent. Whilst reliance on external assistance is relatively high, it is not extraordinarily so compared with other sub-Saharan African countries. Figure A9.1.1 shows that while the tax effort in Ghana was low in the pre-1983 period, subsequent inflows of high levels of aid have not been detrimental to this. Indeed, tax revenues have risen dramatically from 4.6 per cent of GDP in 1983 to 20.8 per cent in 2003, and this was achieved despite a lowering of tax rates that occurred during the first decade of reforms. The installation of the Ghana Revenue Authority has also been critical in bringing about this evolution[14].

12 High aid inflows to low-income countries could have an appreciating impact on the real exchange rate, and which might affect export competitiveness negatively. In Ghana's case, however, according to Sackey (2001), aid inflows seem to have had a depreciating effect. This has largely been possible because of the beneficial growth-enhancing impact of aid associated with improvements in the policy and general investment climate[15].

Conclusion

13 Given favourable developments in Ghana, doubling aid to Ghana over the next three to five years would help to accelerate development, and would allow more rapid progress to be made in reaching the MDGs. The key ingredients for success appear to be: sound macro-economic and public financial management; a strong commitment to growth and poverty reduction; and better quality aid.

Annex 2: Scaling Up Aid to Ethiopia

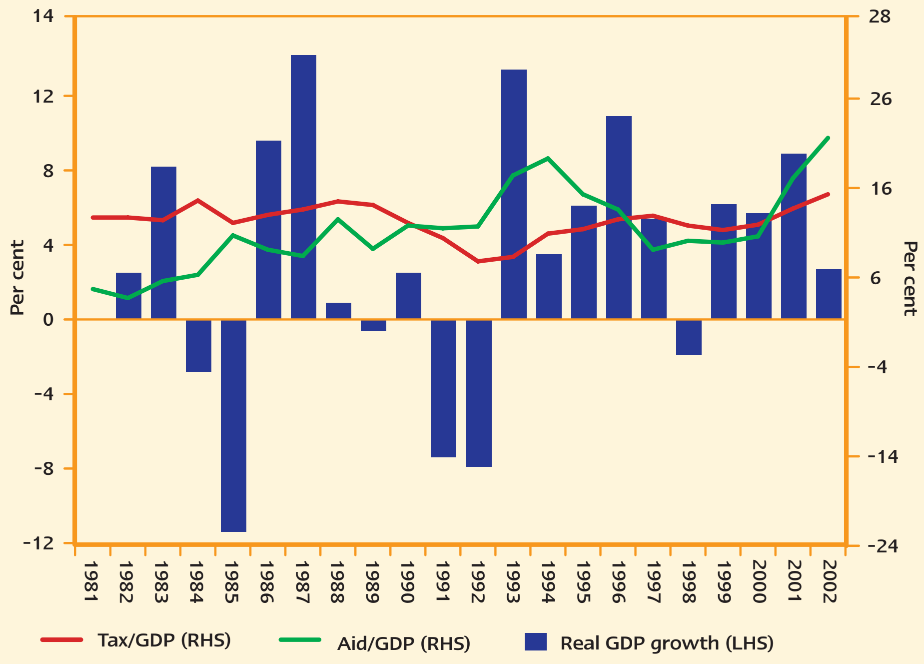
Recent performance and needs

1 Ethiopia is one of the poorest countries in Africa and the developing world. Its population has doubled in three decades – to 67 million – and it is continuing to grow fast. Despite very good economic growth achieved in the 1990s (see Figure A9.2.1), real per capita income is barely above what it was in the 1970s; it is currently about $110 per annum[16].

2 The country is heavily reliant on primary commodity production and is vulnerable to extreme fluctuations in weather, terms of trade, and conflict. In 2002/03 for example, precarious food-supply conditions were made worse by the severe drought. This resulted in GDP declining by 3.8 per cent. However, growth rebounded strongly thereafter and reached 11.6 per cent in 2003/04, thus benefiting from recoveries in the agricultural sector[17].

3 While there is potential for dynamic economic growth to be achieved, which would allow a gradual diversification away from agriculture, this potential has yet to be realised. More than 85 per cent of the population is still reliant on agriculture for a livelihood. Agricultural production also accounts for more than 40 per cent of total GDP.

Figure A9.2.1 **Aid, Revenue and Growth in Ethiopia**



Source: World Bank African Development Indicators, 2004

4 Nevertheless, over the last couple of years, progress has been encouraging. Between 1993 and 2002 economic growth was six per cent compared to 0.5 per cent in the previous decade, although it was fairly volatile during the 1990s. The aid-to-GDP ratio went up from 10 per cent in the 1980s to 12.9 per cent in the 1990s. Prospects for a significant scaling up in aid seem highly promising. It should be possible for Ethiopia to absorb a doubling in aid over the coming three to five years. The basis for this suggestion is outlined below.

5 Social progress in Ethiopia has been good. Between 1995 and 2000, estimates of poverty reduction range from one per cent to five per cent per year[18]. Enrolment of pupils in primary education increased by 14 per cent per annum between 1997/98 and 2000/01. The first Health Service Development Programme (1997/98 - 2001/02) doubled immunisation coverage and reduced the threat and loss of life from major infectious diseases. Finally, the first Road Sector Development Programme expanded the road network by 30 per cent[19].

6 More recently, in 2002/03 real expenditure on road improvements increased by nearly 40 per cent, while public expenditure in agriculture rose by around 33 per cent. Since the end of the war with Eritrea, defence spending fell by 2.7 per cent between 2002 and 2003.

7 On current trends, it seems Ethiopia will not succeed in meeting the MDGs. Table A9.2.1 shows World Bank estimates on what it would cost to meet the MDGs[20]. The resource gap to reach all the MDGs would require increasing oda to 30.7 per cent of GDP[21].

Table A9.2.1: **Ethiopia's External Resource Requirement to Meet 2015 MDG Targets (per cent of GDP)**

	SDPRP Budget 2002	SDPRP Required 2005	Required to meeting MDGs 2015*
Poverty focused expenditure	19.4	27	38.5
Non-poverty expenditure	15.2	12.2	12.2
Total expenditure	34.6	39.2	50.7
of which Capital	*13.0*	*16.0*	*22.9*
Domestic tax and non-tax revenue	23.0	23.0	23.0
Food security (non-MDG related)			3.0
External resource requirement	11.2	16.2	30.7

Source: Table 6 in World Bank, 2004

8 Net aid per capita in Ethiopia was US$19 in 2002. This is smaller than the average for sub-Saharan Africa (estimated to be US$28), and much less than amounts received by other countries such as Tanzania (US$35), Rwanda (US$44), or Mozambique (US$112)[22].

9 The IMF in its latest Article IV and PRGF review included a scenario in which aid might be doubled to reach the MDGs. The estimated increase in assistance is expected to be in grants in order to maintain external debt sustainability. Increased aid would reach US$6 billion by 2015[23]. The additional assistance would allow poverty spending per capita to rise from US$19.5 in 2003/04 to US$78.4 in 2015/2016.

Feasibility of scaling up

10 Over the last decade or so, Ethiopia's macro-economy has been stable, and its management has been good[24]. Aid flows have increased steadily. Such increases do not appear to have had adverse effects on export competitiveness arising from a real appreciation in the exchange rate[25]. If increases in aid can be utilised to ease supply-side bottlenecks, and to increase productivity, it should be possible in the medium to long term to counter any adverse effects on export competitiveness that may arise from aid-induced appreciations in the real exchange rate.

11 As for Public Expenditure Management (PEM), the latest HIPC expenditure tracking assessment survey noted that Ethiopia achieved eight benchmarks in 2004 compared to six in 2001[26]. A recent fiduciary risk assessment undertaken for DFID observed that: "overall, the public financial management systems of Ethiopia do not present significant or material fiduciary risk"[27]. Donor support for upgrading public financial management systems in Ethiopia is fairly well streamlined. Ethiopia is also scheduled to be one of the first countries to be assessed using a new co-ordinated assessment procedure that has been developed recently for a donor consortium by the Public Expenditure and Financial Accountability (PEFA) Secretariat based at the World Bank.

12 Considering the size of Ethiopia's population, and aggregate poverty levels, institutional capacity at the central government level is remarkably high. However, capacity at the sub-national level is limited (Foster, 2003). The country's poverty reduction strategy (SDPRP) emphasises the importance of decentralisation both for building capacity and for satisfactory implementation of poverty plans. The Government of Ethiopia has placed great emphasis on the need to build adequate capacity, and has established a National Capacity Building Program.

13 Ethiopia's total external debt was US$5.9 billion at the end of 2002, of which 51 per cent was owed to multilaterals and 46 per cent to bilateral creditors. Ethiopia has reached HIPC completion point, and received significant additional ('topping up') relief in 2004[28]. Nonetheless, debt burdens remain significant, which is made more serious by the economy's continued vulnerability to external shocks[29]. To help Ethiopia manage its external debt position better, the International Financial Institutions have called on donors to support Ethiopia's reform efforts primarily in the form of grants[30].

14 As Figure A9.2.1 shows, the share of taxes in GDP in Ethiopia is not low and the domestic revenue effort rose during the 1990s. Sustained flows of aid have not affected the domestic revenue effort negatively.

15 Although the quality of aid to Ethiopia, relative to other countries, is now much better, more could be done to support the government programmatically in implementing its poverty reduction strategy. The presence of a common framework for providing general budget support, and the pooling of donor funds at the sector level, raise the prospects for increasing the effectiveness of aid even further.

Conclusion

16 The case of Ethiopia demonstrates that in an environment where peace prevails, and where authorities have worked hard in producing a robust poverty reduction strategy, it has been possible for donors to provide rising levels of good quality aid. With continued progress, prospects for a significant ramping up in aid levels seem possible, and indeed would be desirable if a serious effort is to be made at reaching the MDGs. Foster (2003) suggests that it would be realistic to double aid to Ethiopia over the next five years[31]. In 2002, Ethiopia received US$1.3 billion in foreign aid. Re-allocating aid to Ethiopia using IDA's current performance-based criteria would imply an increase of roughly US$ one billion.

Annex 3: Scaling Up Aid to Mali

Recent performance and needs

GDP averaged 5.5 per cent in 1996–2002

1 Mali is a landlocked country that is democratically governed. It is heavily dependent on producing and exporting primary products, and is the largest producer of cotton in sub-Sahara Africa. The economy is vulnerable to exogenous shocks. Nonetheless, economic progress has been good: average real GDP growth was 5.5 per cent per annum between 1996 and 2002 and GDP per capita rose by 2.7 per cent each year (Figure A9.3.1). Growth accelerated to 6.1 per cent in 2003 which benefited from bumper harvests of cotton and cereals (including rice)[32]. Given the political crisis in Côte d'Ivoire, Mali's main economic and regional trading partner, the strong economic performance in Mali is indeed noteworthy.

2 Mali's mining sector has also developed over the past five years. Gold production more than doubled in 2001, and gold exports are now the largest source of foreign exchange earnings. Mining and investment codes have been revised and the country has attracted significant foreign interest since gaining preferential access to US markets under the African Growth and Opportunity Act (AGOA). Mali's production capacity in textiles is expected to double by 2005 due to higher foreign and domestic investment. Oil companies were granted exploration permits in 2004.

Some MDGs – especially education – could be reached by 2015

3 Despite solid economic growth, social indicators reveal a range of problems: in 2002, 64 per cent of the population was estimated to be living below the poverty line; life expectancy at birth was 52 years; infant mortality was 113 per 1,000 live births; and the adult illiteracy rate was 55 per cent. With existing policies, Mali could reach at least one target in each of the MDG categories (poverty, education, health and environment). But with better policies, all poverty and education targets could be met by 2015[33].

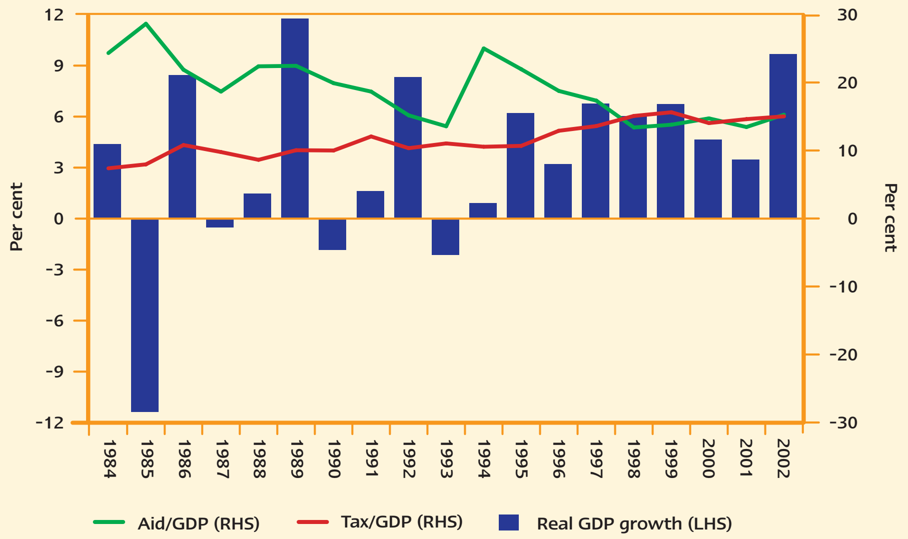
4 Mali's poverty reduction strategy paper (PRSP), which was completed in May 2002, highlights resource requirements to 2005 and sets out priorities under three pillars:

- institutional development and improvement in governance and participation;
- sustainable human development and improved access to basic social services;
- development of basic infrastructure and support to productive sectors.

5 The PRSP annual progress report, released in July 2004, indicated some improvements in the education and health sectors. Health coverage rose from 41 per cent in 2001 to 44 per cent in 2004, and the overall gross enrolment rate in primary schools rose from 58.1 per cent in 2000 to 64.3 per cent in 2004. The share of recurrent expenditures in health and education in the central government's budget also increased between 2001 and 2003, from 27.0 per cent to 30.3 per cent for education, and from 10.0 per cent to 10.8 per cent for health.

6 As illustrated in Table A9.3.1, projections for financing PRSP-related objectives over the 2002-05 period are based on assuming increases in internal financing from mobilising domestic resources (by 10 per cent a year). External financing is set to contribute an average of 38.5 per cent of the total financing needs, estimated at CFAfr2.7 billion (US$5.3 billion)[34].

Figure A9.3.1 **Aid Revenue and Growth in Mali**



Source: World Bank African Development Indicators, 2002

Table A9.3.1: **External and Internal Financing of Mali's PRSP (US$ million)**

	2002	2003	2004	2005	2002-05
Programmed external financing	349	392	401	410	1,552
Additional external financing	88	126	131	145	490
Total external financing	**437**	**519**	**532**	**555**	**2,043**
Tax revenue	648	718	804	898	3,068
Non-tax revenue	47	47	47	47	189
Total internal financing	**695**	**765**	**851**	**946**	**3,257**
Total financing	**1,133**	**1,284**	**1,383**	**1,500**	**5,300**
Total external financing (%)	39%	40%	39%	37%	39%
Total domestic financing (%)	61%	60%	62%	63%	62%

**Note: exchange rate used is CFA fr 510 = US$1*

Source: Government of Mali, 2002

Donors have pledged US$2.4bn for the 2004-07 period

7 Aid resources are crucial for Mali. Net ODA inflows in 2002 were US$472m, representing 15.3 per cent of the country's GDP. In March 2004, a donor roundtable meeting of donors – the first since 1998 – renewed commitments in support of the PRSP. A total of US$2.4 billion was pledged for the 2005-2008 period.

8 Good progress has been made in implementing donor programmes, especially in road building. Mali has received significant assistance for the construction of the Bamako-Senegal road axis, which is one of NEPAD's short-term infrastructure projects. Several sections of this road-building exercise have been completed.

9 Mali reached completion point under the enhanced HIPC initiative in February 2003. This provided a debt relief package totalling US$675 million. As a result, approximately CFAfr30-40 billion of domestic resources have been freed up annually for spending in priority poverty-related sectors.

Feasibility of scaling up

Public sector performance has improved

10 Under a UNDP initiative, Mali received its first credit rating in 2004. Standard & Poor's assigned Mali a B rating. Budgetary discipline has been maintained, and macro-economic management has been considered sound by the IMF[35]. The budget deficit declined from 3.7 per cent of GDP in 2002 to 0.7 per cent of GDP in 2003. Total revenue receipts increased by 17 per cent to reach 21.4 per cent of GDP in 2003 as a result of more effective revenue collection. Grants also increased significantly to CFAfr112.4 billion, representing 21 per cent of total receipts. On the expenditure side, capital outlays were lower than expected, valued at CFAfr201.6 billion, while recurrent expenditure increased moderately by 2.5 per cent, reflecting a government commitment to control non-essential expenditures.

11 Mali's membership of the CFA franc zone has also helped to maintain fiscal discipline. Direct government borrowing is restricted to less than 20 per cent of the previous year's receipts (direct advance by the regional central bank have now been substituted for treasury bills) and the UEMOA has also set up a number of performance convergence criteria, which member countries are required to adhere to. These include: moving towards a balanced budget; controlling the build-up of domestic and/or external arrears; reducing total public debt to less than 70 per cent of GDP; keeping the wage bill at less than 35 per cent of revenue; funding at least 20 per cent of the government's share of public investments from fiscal receipts; and increasing fiscal receipts to at least 17 per cent of GDP.

12 Mali reached all but one of the UEMOA targets in 2003. Ongoing fiscal reforms have continued to focus on boosting domestic tax efforts (VAT was introduced in April 1999) and improving customs administration. Total tax revenue as a percentage of GDP has increased significantly over the last decade, from 10.6 per cent of GDP in 1994 to 15.0 per cent in 2002. The government is also committed to increasing the allocation of expenditures towards priority sectors.

13 Fighting corruption has also remained one of the main priorities of the Malian Government. In its 2003 report, the anti-corruption watchdog Transparency International (TI) reviewed the perceived level of corruption in Mali for the first time. Mali scored 3.0 out of 10 (in a range of scores where zero represents 'completely corrupt' and 10 'uncorrupt'), and it was ranked 78th out of the 133 countries surveyed (neighbouring Côte d'Ivoire ranked 118th).

Implementation capacity is increasing

14 The Government of Mali has also made significant progress in implementing measures to improve its capacity for supporting development and poverty reduction efforts more effectively[36].

15 In planning, the Government of Mali introduced a new budget classification in April 2003, in line with UEMOA requirements. This allows for more transparency in the government's medium-term spending plans. A Medium-Term Expenditures Framework for the education and health sectors has also been adopted.

16   Mali's decentralisation programme has made great progress since being launched in the late 1990s. Local elections were held in 2004, and legislation was adopted for transferring decision-making responsibility in health, education and water to local governments. Regional offices of central government ministries have been reinforced to assist local authorities in taking over new responsibilities, and 46 support centres have been set up to assist local authorities in technical and financial matters.

17   Whilst progress in implementing the PRSP has been good, some weaknesses have been highlighted. These include delays in implementing a monitoring and evaluation mechanism; weak links between the government's budget programmes and PRSP objectives; and a lack of co-ordination between central and local government sectoral programmes.

Donor co-ordination has increased

18   Mali is a pilot country of an OECD-DAC exercise to improve aid effectiveness. In 1998, the government established a joint commission to steer the implementation of the aid reform process[37]. Its first review, released in 1999, indicated a lack of aid co-ordination and lack of aid effectiveness. Progress has been evident since then, and largely due to the adoption of the PRSP approach[38].

19   As part of the PRSP process, the government holds regular meetings with major donors under the auspices of the Mali-Partners Joint Committee. Bilateral and multilateral donors also co-ordinate activities on a monthly basis. Noteworthy improvements are evident in education and health. For example, in the education sector a mechanism for pooling finance has been set up with the World Bank as lead donor. Although the bulk of donors' assistance is project-based, several donors have started to provide budget support as part of the aid-reform process. In 2004, five bilateral and multilateral donors contributed CFAfr33.4 billion to the Government's budget (EU CFAfr14,5 billion; Holland 5.4; Sweden 3.6; France 2.3; Netherlands 7.6).

Conclusion

20   The pattern of foreign aid to Mali has not changed much since the mid-1990s. On average it has been US$421 million per year – equivalent to 16 per cent of GDP. Given improvements in policies and institutions, a strong government commitment to reduce poverty and to meet the MDGs, and a shift towards better aid practices recently, Mali is now better poised for a significant increase in assistance. Good progress in implementing the PRSP are further grounds for expecting that increases in aid will be productively utilised. The growing confidence in Mali is reflected in renewed pledges made by donors at the Geneva roundtable meeting in May 2004, which is expected to generate annual ODA inflows of US$800 million per annum, i.e. roughly double the amount that Mali currently receives.

Annex 4: Allocating Development Assistance for Poverty Reduction

1 Donors should allocate development assistance to support countries' longer-term poverty reduction strategies and – based on an annual assessment of performance and development potential – allocate resources selectively using varied instruments of support. Although a useful measure of a country's policy and institutional environment, the World Bank's Country Policy and Institutional Assessment (CPIA) needs to ensure its criteria are objective, and that its methodology for scoring countries is clear, fair, and transparent.

2 To ensure that a wider range of African countries receive international assistance, and of the right kind, the AU/NEPAD, and UN agencies should play a bigger role in guiding aid allocation decisions and in recommending better criteria for selecting countries. A mechanism is required for ensuring a broader range of countries receive appropriate levels of aid and the right kind of assistance. This should allow African countries to play a bigger role in shaping aid allocation decisions and in recommending appropriate criteria.

3 In Chapter 9 we recommend creating an annual dialogue between the Development Ministers of the OECD countries and African Finance Ministers, along with representatives of civil society and international organisations to consider aid allocation criteria and to make suggestions for a better distribution. This could provide a regional forum for discussing a range of supporting actions that the international community should take, including the volume and the form of finance. (An extension of the ECA's 'Big Table' meetings could provide a possible model for achieving this).

Supporting argument and evidence

4 Multilateral and bilateral donors allocate development assistance to low income countries using a variety of criteria: country policy and institutional performance (e.g. World Bank and some bilateral donors); historic links (most bilaterals); prevalence of poverty in country (IDA and bilateral donors); political influence (some bilaterals); and commercial interest (some bilaterals)[39]. In recent years, donors have been shifting the allocation of aid to countries where it can be used more effectively (better policies and institutions) and where poverty can be reduced the most[40]. Multilateral aid agencies have been more successful in making this shift. The US – through its Millennium Challenge Account – has gone the furthest in setting out a transparent set of criteria for qualifying countries.

5 The World Bank's CPIA process, whilst having many merits – in that various performance and institutional criteria are considered in assessing how much World Bank assistance developing countries should receive – has been criticised by developing countries and NGOs for not being inclusive, for its non-transparent process, and for its bias against measuring outputs and outcomes[41].

6 While welcome for being less arbitrary, the emphasis on strong institutions and good policies in the allocation of aid, has in practice tended to under-provide assistance to countries that have weaker and less stable institutions (including post-conflict), of which the bulk are in Africa[42]. Compared to the average range of developing countries, countries with weaker and less stable institutions also face bigger development challenges, notably in health, sanitation, child immunisation, malaria, and access to drinking water.

7 Analysis undertaken for the OECD/DAC shows that countries with weaker and less stable institutions are: (a) recipients of comparatively less aid; (b) more neglected than

others, even within the same group; and (c) recipients of relatively more volatile aid flows. The current aid architecture seems to favour some countries – the donor 'darlings' – and to neglect others, the donor 'orphans'. Given that countries with weak capacity require external assistance for a longer period of time (owing to longer maturation times for producing results and for generating net-positive income streams), the relative under-financing of donor 'orphans' requires urgent correction.

8 Assistance to countries should not only take account of past performance in strengthening policies and institutions, but also consider development prospects. This call came strongly from the meeting of African Finance Ministers in Abuja in November 2004[43]. As discussed elsewhere in our report, there are many interventions that can be implemented in the short-term (and through various providers), which would help to improve the lives of poor people across a range of situations in Africa.

9 In order to ensure a fair and better-informed process for allocating assistance in Africa, key representatives of African countries should have a bigger role in the aid allocation process. As Chapter 10 shows, the present aid architecture allows very little space for African countries to shape aid allocation patterns and to influence the activities of the IFIs in Africa. A forum, in which senior representatives of the AU/NEPAD, African governments, civil society, international organisations and OECD/DAC donors participate, should go a long way towards correcting the current bias. This process might build on the 'Big Table' meetings initiated by the ECA.

10 Country selectivity should be influenced by clear transparent criteria and be endorsed broadly by international donors, the UN, and receiving countries. Financing priorities for countries should vary: for some, it will mean more emphasis on ensuring enduring peace and security; for others it will mean trying to achieve a quick turnaround in prospects and preparing better the conditions for receiving more longer-term development finance; and for others still, it will mean providing harmonised finance that is better aligned to budgets and in support of strong poverty reduction strategies.

Annex 5: Detailed Breakdown of the Commission's Recommendations

1 Table A9.5.1 shows what it would cost to implement all of the Commission's recommendations. This is a more detailed version of Table 9.2a in Chapter 9, and provides a breakdown of costs by sub-sector.

2 It should be noted that these estimates of costs are calculated for the year 2010, the last year of our proposed stage one. Whereas new priorities will undoubtedly emerge by then, we also anticipate some savings. For example, the Polio Eradication programme has an expected funding gap of US$0.6 billion over the next four years. If this is filled, and a programme is subsequently implemented, then the chances are that polio could be eradicated by 2008. In this case, the required amount of finance for this programme in 2010 will be nil (hence, in the table below, we show a US$0 billion entry against polio eradication).

3 Most estimates are drawn from publications, and/or discussions held with individuals from specialist institutions, and which have undertaken comprehensive assessments of specific costs; for example, by the AU/NEPAD, the World Bank, UNICEF, the ILO, WHO, UNAIDS, etc.

4 We should emphasise that the recommendations, and the detailed sectoral breakdown of costs shown in the table below, should be regarded as an indication of what might be implemented. They are not firm estimates of sectoral plans for Africa. Actual programmes and projects will be generated from country and regional strategies and initiatives. However, there is a logic to our recommendations; for if implemented as an integrated whole, the package should deliver progress on an accelerated basis, which would not be possible if implementation was piecemeal. From this perspective, Table A9.5.1 allows an overall estimate of expenditure to be formed.

Table A9.5.1: **Costings of the Commission's Recommendations – Taking No Account of Constraints of Absorptive Capacity***

	Resource Estimates for 2010 (US$ billion)
Governance (Chapter 4)	**2.6**
- APRM trust fund	0.01
- AU Institutional Transformation Program	0.02
- Programme costs for AU (excl. Peace & Security)	0.02
- Improve statistical systems	0.06
- Higher education	0.50
- Science & technology (Centres of Excellence)	2.00
Peace and Security (Chapter 5)**	**1.7**
- Arms control	0.04
- UN peacebuilding fund	0.25
- Expand World Bank Post-Conflict Reconstruction Trust Fund	0.06
- Clearing arrears for post-conflict countries	1.00
- AU Peace Fund	0.30
HIV and AIDS (Chapter 6)	**10.0**
Education (Chapter 6)	**7.5**
- Primary education (incl. through FTI)	3.75
- Secondary education	3.75
- Extra for curriculum development	0.04
Health (Chapter 6)	**19.6**
- WHO/NEPAD health systems strengthening	1.50
- Human resources	5.00
- GAVI	0.50
- Polio eradication	0.00
- Malaria and HIV and AIDS vaccine development	1.00
- Sexual and reproductive health services	0.29
- Programmes against parasitic and infectious debilitating and blinding diseases and micronutrients	0.30
- 'Tuberculosis and HIV and AIDS linkages' program	0.25
- Commission for Macroeconomics and Health basic health package	10.58
- Protection against vitamin and mineral deficiency	0.14
Social Inclusion (Chapter 6)	**4.0**
Growth (Chapter 7)	**20.1**
- Infrastructure (incl. irrigation, water, sanitation, slum upgrading, transport, power)	20.00
- Investment Climate Facility	0.08
- MIGA	0.02
- Africa Enterprise Challenge Fund	0.01
- Youth Employment Network	0.01
- Growing Sustainable Business Initiative	0.004
Environment (Chapter 7)	**0.01**
Trade (Chapter 8)	**0.1**
- Meeting sanitary and phytosanitary standards	0.07
- Improve productive capacity	0.02
- Trade facilitation (inc. customs reform)	0.004
Mitigation of Shocks (Chapter 9)	**3.8**
Contingency Funding	**5.6**
TOTAL	**75.0**

** It should be noted that certain sectoral external financing exercises already make some assumptions on domestic resources.*
*** Peace & Security estimates are examples of possible activities and are NOT based on a 'full sector needs assessment'*

Source: Commission's estimates

Annex 6: The Productive Absorption of Additional Aid to Africa

The definition and determinants of aid absorption and effectiveness

1 Despite glaring needs across Africa, there is a limit to the number of roads, dams, schools, and clinics that can be built and serviced effectively in any one year. For example, the required number of technical experts and managers to plan and budget extra finance may not be available to make productive use of the resources.

2 The extent to which resources can be productively absorbed into economies is circumscribed by macro-economic, institutional, physical, human, social, cultural and political factors. As shown in Table A9.6.1, their interaction at different levels of the country context could either constrain resource absorption, or lift it, depending on policy and the behaviour of key actors, notably recipient-country governments and external donors[44]. Thus at any one moment, increases in aid will yield diminishing returns as the limits of capacity constraints make their effects felt.

Table A9.6.1: **Constraints to Absorption of Additional External Resources**

	Macro	Institutional	Physical and human	Social/cultural/ political
Macro/National government	Fiscal and debt sustainability, competitiveness, Dutch disease.	Monetary and fiscal policy instruments. Exchange rate management.	Administrative, management, and planning skills, trained technicians, sector specialists.	Stable national political institutions, power-sharing mechanisms, social stability.
Allocative instruments and mechanisms	Inter-governmental fiscal relations.	Public expenditure management (PEM) (budget preparation/ execution, accounting, treasury, audit, etc.). Administrative capacity. Legal framework.	Sector management skills. Connectivity and communications networks.	Power sharing mechanisms and institutions.
Service delivery/ Local government		Local government institutions, private sector capacity.	Road accessibility, water control, geography. Local government skills and capacity.	Cultural norms, ethnic, caste, class, and household demand. Local power structures.

Source: reproduced from World Bank, 2004:25

3 The term 'absorptive capacity' is generally used as short-hand to capture this issue, which – all other things being equal – is especially acute in very poor countries. Depending on the policy and institutional environment, recent literature shows aid can be effective in contributing to growth and poverty reduction, and in helping countries to address evident capacity constraints[45].

4 The efficiency and effectiveness of aid to poor countries depends on three key factors: how much is provided; how well it is delivered by donors, and in what form; and how productively it is used in the recipient country in pursuit of human development, economic growth and poverty reduction. There is evidence showing that the effectiveness of aid has increased in recent years. This is because, unlike 15-20 years ago, policies and governance in African countries have improved. An increasing proportion of aid has also been going to countries where poverty is relatively high and where prospects for economic development are better (based on assessing the quality of the policy and institutional environment). The switch in assistance to areas where it is more effective is more pronounced within IDA than it is among bilateral donors[46]. There have also been improvements in the quality of aid.

5 Evidence suggests that there is a virtuous circle of mutually reinforcing actions which donors and governments can take in making aid more efficient and effective. This requires donors to provide better quality aid, which in practice means adjusting donor procedures and processes to suit recipient-country circumstances better. It also requires aid-receiving governments to create a more conducive governance and institutional environment for attracting more resources for public and private investment.

6 Based on current knowledge (see below) it seems that aid works best if:

(a) it is targeted to suit circumstance, reduce poverty and meet specific needs, thus:

- i. promoting peace and security, and delivering essential services to communities emerging from conflict and/or years of neglect;
- ii. supporting countries with more and better quality assistance, where governance and public accountability demonstrably show signs of improvement;

(b) its quality is improved in ways that:

- i. reduce recipient countries' burdens in managing aid relationships;
- ii. advance alignment with national priorities and support the upgrading of existing systems;
- iii. improve predictability and flexibility to resource-constrained governments and enable them to push ahead with key reforms and raise public expenditure;

(c) it is provided to support change:

- i. enabling recipient-governments to implement reforms that improve governance and accountability systems (e.g. better budgeting, public sector management and procurement, service delivery, monitoring and reporting); and
- ii. encouraging investment and reducing business risks, promoting human development and increasing poverty-reducing public expenditure.

Evidence suggests that with improving country conditions aid absorption can be much higher

7 Recent work shows that aid is effective in a range of situations. Absorption of larger quantities of aid is more likely where policy environments are better and/or improving. In such situations, an extra one percentage point's worth of aid (relative to GDP) would on average increase the rate of economic growth in one year by 0.6 percentage points. In policy environments that are neither exceptionally good nor bad, a marginal increase in aid can generate 0.4 per cent of extra economic growth; and in worse policy environments, the same effect is possible, although its impact is less strong as it generates an additional 0.2 per cent of growth[47].

8 While research shows that aid is effective in all policy environments, it seems there are diminishing marginal returns to aid. This implies that the productive absorption of aid is not boundless. Beyond a certain proportion of GDP, depending on context, diminishing returns will set in as aid flows are increased, and will eventually generate negative returns[48].

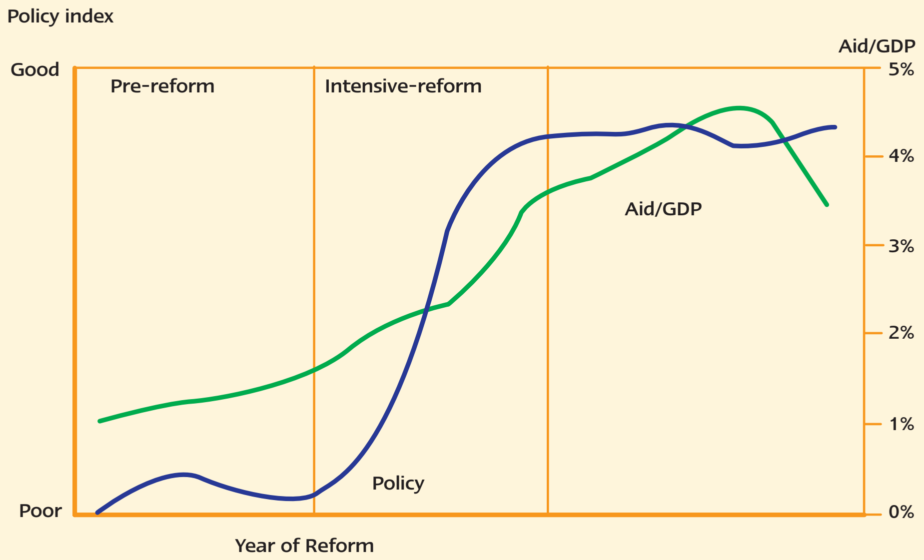
9 Recent work by Clemens, Radelet and Bhavnani (henceforth CRB) of the Centre for Global Development, distinguishes the effects of different types of aid on economic growth[49]. The growth-enhancing effects of some types of assistance (which CRB term 'short-impact aid' because its effects on growth materialise over four to five years), is found to be much higher than is observed with other forms of aid (e.g. long-term Technical Assistance). 'Short-impact aid' (SIA) includes: balance of payments and budget support, and aid investments in public utilities, roads, transport, finance, energy, agriculture and industry. These and other forms of aid benefit human development directly by allowing governments to improve the level and quality of public services – in education, health, and social protection.

10 Within the range of CRB's estimation there is a positive but declining effect on the growth rate. The strong effect on growth is evident throughout the range of observations. As CRB indicate, however, the quality of policies and institutions affect the strength of the link between short-impact aid and growth, although the relationship is less sensitive than what other studies have found.

11 Beyond considerations of economic growth, aid to resource-constrained governments is provided to improve health, education and social outcomes, and for alleviating poverty directly. As Table A9.6.1 indicates, while the absorption of aid for improving human development outcomes can be constrained by many factors, in the short term, institutional and technical factors are more likely to inhibit rapid increases. With improvements in governance and the investment climate, a sustained and significant scaling up in aid across African countries should be possible.

12 The relationship between the policy and institutional environment and aid is complex, as shown in Figure A9.6.1, which maps the link between the amount of aid provided in three countries that have implemented reforms successfully: Vietnam, Ghana, and Uganda[50]. The figure shows when country conditions were weaker, donors provided relatively small amounts of assistance. Once reforms got under way, the amount of external assistance increased in support of these, which also served to demonstrate to citizens the benefits of implementing reforms.

Figure A9.6.1 **Relationship Between Policy and Institutional Environment and Aid**



Source: Collier and Dollar, 2004[50]

13 In many African countries, sharply scaled up programmatic assistance has followed moments when relatively small amounts of aid were provided by donors in the form of technical assistance and policy advice. A rapid rise in assistance to a range of countries, and in the form of sector and general programme aid and budget support, only became possible once governments committed themselves to implementing a sweeping programme of reforms. In countries where governance and public accountability is weak, where there might be differences in policy perspectives, and where conditions are less propitious for receiving large amounts of programmatic aid, recent work shows donors can ramp up assistance and provide it in ways which promote sustainable development (see below).

Evidence suggests that with improved donor actions the absorption and effectiveness of aid can increase

14 The terms and conditions by which donors provide aid makes a big difference to how well aid is absorbed and used. Better quality aid is aid that is: (a) aligned to country policies and strategies for reducing poverty; (b) making use of and supporting national systems; (c) co-ordinated and harmonised with other donors; (d) provided predictably over the longer term, and (e) not disruptive of annual budgeting practices.

15 Research shows that the better the quality of aid provided, the more likely it is that it will go towards supporting effective policy-making and promote better governance and accountability to domestic citizens. In turn, resulting shifts in the institutional environment will make it more possible for additional aid to be absorbed. Better quality aid allows virtuous circles to develop in countries: initially more (and better) aid is supplied; this is then absorbed productively; and eventually, reliance on aid declines as sustained growth kicks in and internally-generated revenues displace external assistance (e.g. as is demonstrated by Botswana's successful management of its natural-resource advantage).

16 Without aid practices improving significantly from what they currently are, it would not be advisable to increase aid flows substantially. Relative to other regions of the world, sub-Saharan Africa receives much lower quality aid, and has done so for almost thirty years. According to Elbadawi and Gelb (2003:53), if the quality of aid to sub-Saharan Africa were to improve to levels common in other developing regions (a step improvement of 24 per cent), per capita GDP growth in sub-Saharan Africa would rise by about 1.8 per cent per annum. Enhanced absorption of aid would be possible if better quality aid reduced the burden of transactions costs on governments, if it reduced significantly levels of public debt and provided flexible on-budget programme resources, and if it substituted for Technical Assistance which – relative to other developing country regions – is supplied in higher proportions to sub-Saharan Africa[51].

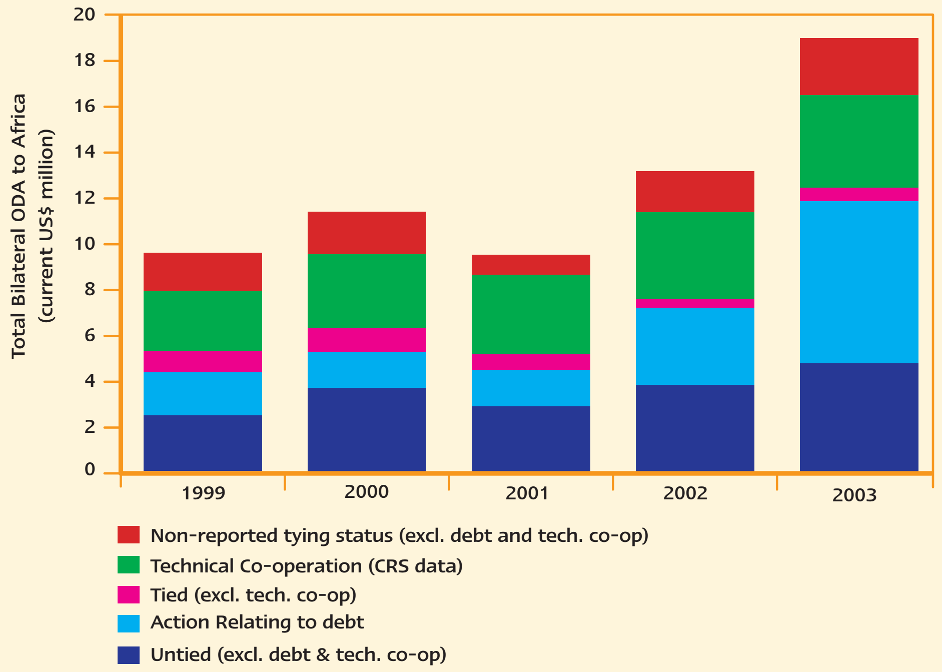
17 Studies show that aid is especially effective when it backs national priorities and endeavours, and in ways that: (a) enhance the use of local knowledge; (b) strengthen existing systems (such as budgeting, monitoring and accounting, procurement, auditing); (c) enable authorities to make better policy decisions, and; (d) promote accountability to citizens[52]. Good practice guidelines on aid effectiveness produced by the OECD therefore recommend that donors should: (a) reduce the burden of transactions they place on already stretched governments; (b) channel assistance in ways that do not undermine public decision-making; (c) strengthen local systems, and; (d) conduct business so that government accountability to citizens is promoted.

18 When aid is 'tied', it comes with the instruction to recipient countries that the assistance provided is used for purchasing goods and services from the donating country. Since the 1960s, the OECD/DAC has declared aid tying to be ineffective and inefficient, because it constrains recipient governments to following priorities that are set by donors and requires them to purchase goods and services from donor countries supplying the assistance at prices that are often above those prevailing in world markets. Tied aid undermines national ownership. As Chapter 4 suggests, tied aid weakens decision-making, by-passes local governance and accountability systems and delays public-sector reforms. Thus, the extent to which aid is tied is commonly regarded as a key indicator of aid effectiveness. Developing countries have consistently opposed the tying of aid, and have recently renewed their call for untying[53].

19 Recent estimates show the tying of aid raises average costs to recipients by 15 - 30 per cent, and more than 40 per cent in the case of food aid. Assuming average costs of aid tying are in the range of 20-30 per cent, the OECD estimate that in 2002, tied aid reduced the actual value of bilateral oda to Africa by US$0.7 to US$1.3 billion. This is a conservative approximation, as the indirect costs of aid tying are not considered, i.e. those arising from higher transactions costs through parallel procurement and monitoring and evaluation procedures stipulated by donors. The benefits of untying aid are not just limited to issues of capacity development and performance improvements in the public sector. Studies show aid untying stimulates the private sector by enhancing competition. It also allows more technical choices to be made that are more suitable to the countries' resource endowments and levels of technological development.

20 Although the benefits of untying are known, progress by donors in reforming practice is still slow. As Figure A9.6.2 shows, while untied aid to Africa increased between 1999 and 2003, both in value and as a share of total aid, the change towards untying is more apparent because of the inclusion of debt relief, which is not tied. Moreover, the tying status of between 30-50 per cent of aid to Africa is not known because of unclear and inconsistent reporting by donors[54].

Figure A9.6.2 **Untied Aid Trends in Africa**



Source: ECA and OECD/DAC, 2005

21 Evidence commissioned by the OECD/DAC shows that in countries where states are perceived as being fragile, of which many are in sub-Saharan Africa, donors provided as much as 43 per cent less aid between 1992 and 2002 than the level that these countries' performance ratings (CPIA) suggested might have been possible to absorb[55]. In this sense, these countries have been significantly under-aided, which could be corrected if donors adopted more innovative approaches in supporting reforms in such environments (including better co-ordination). Analysis also shows that aid receipts by fragile states are twice as volatile as those to other low-income countries. The relative neglect of these countries by the international community is costly, not least because it is estimated that countries neighbouring fragile states bear annual losses in the order of 1.6 per cent of GDP[56]. Countries with weaker and less stable institutions, for example those emerging from conflict, also face bigger development challenges, notably in health and sanitation, child immunisation, malaria, and access to drinking water.

22 Sweeping and substantial changes in donor practices would enable more aid to be absorbed, and more effectively. For poor countries the benefits of better aid are considerable. Improvements could lead to:

(a) stronger country ownership of development policies and programmes and backed by donors;

(b) a rise in per capita GDP growth, by about 1.8 per cent if Africa were to receive the same quality of aid as that supplied to other developing regions;

(c) reduced donor fragmentation leading to less transactions costs to recipients by eliminating bad practices (e.g. of numerous parallel donor procedures and practices, multiple and unco-ordinated missions, unpredictable disbursements);

(d) increases in the value of aid to recipients by 20-30 per cent on average from untying aid (which in 2002 would have amounted to roughly US$0.7-1.3 billion as extra oda to Africa);

(e) changing the emphasis in accountability towards citizens in aid-receiving countries, rather than primarily to donors; and

(f) a better global allocation of aid so that currently 'under-aided' countries can receive the assistance required to turn fortunes around strongly and to make better economic and social progress, and thus reduce spill-over costs on neighbouring countries.

Practices in Africa are improving but progress could be accelerated

23 Recent experience shows that partner countries and donors can work together better towards increasing aid levels, improving the effectiveness of donor assistance, and implementing poverty reduction strategies more effectively. In many countries aid practices are changing. Recent examples include: Burkina Faso, Mali, Uganda, Mozambique, Ghana, Tanzania and Ethiopia. In these countries donors are working together to come more firmly behind national efforts. Donors are also responding by increasing aid levels. For example, between 1997-2002, total net oda to Ethiopia grew by 138 per cent in real terms, to Mozambique by 126 per cent, to Ghana by 40 per cent and to Tanzania by 39 per cent[57]. In all instances, and as the examples of Ghana and Ethiopia show (see Annex 1 and Annex 2), more and better aid has gone hand-in-hand.

24 The enhanced HIPC initiative has made it possible for donors to begin a shift away from bad aid delivery practices. There is a greater readiness now in providing programmatic assistance in support of national poverty reduction strategies[58]. Annual HIPC progress reports (presented to the Boards of the World Bank and IMF), and recent work by the OECD/DAC and the Strategic Partnership with Africa (SPA), shows that programmatic support by the international community to PRSPs is helping to improve the quality of aid, although progress is not as rapid as it might be[59]. Recent studies show more donors are co-ordinating efforts in helping countries to improve their public financial management systems. Increasing attention is being given to improving the predictability of aid, and in many instances, this is being done through the activities and actions of a number of multi-donor budget support arrangements which have formed across Africa, e.g. in Ghana, Tanzania, Ethiopia, Mozambique, Burkina Faso, Benin and Rwanda. Donors made more use of local systems when channelling aid. And, there is a gradual, albeit slow, shift towards accounting for aid through results. Compared with the past, these changes imply improvements in the productivity of aid, as is being confirmed by recent reviews of studies examining the impact of aid[60]. There is considerable scope for raising productivity further by making more determined changes in donor behaviour, as the recent comprehensive paper produced by the OECD/DAC makes clear[61].

25 While higher aid flows would undoubtedly bring many benefits to aid-recipient countries, the assistance could be misused if authorities do not manage the impact of the inflows very well. A common problem arising from higher aid inflows is the appreciation of the real exchange rate. Recent evidence indicates that the economic effects of an aid-induced appreciation in the real exchange rate can be managed well. To ensure that the use of the aid does not cause macro-economic problems, governments should ensure that the aid is invested to expand productive capacity. Monetary authorities should intervene to help stabilise the volatility stemming from short-term exchange rate and interest rate fluctuations[62]. As Chapter 9 shows, the more aid is used for purchasing imports, and/or for boosting foreign reserves (as and when necessary), the less will be its impact in appreciating the real exchange rate. (For if fewer units of foreign currency are

sold and converted into domestic currency, it will dampen the demand created for goods and services produced locally. In turn, given tight domestic supplies in the short run, this will put less pressure on prices to rise.) As investments in better infrastructure increase, it should be possible for firms' production and distribution costs to be lowered, which will improve export competitiveness and facilitate further rounds of economic growth.

26 With more resources now, it should be possible to make interventions at various levels of the government and the economy. It is important to recognise that by investing in the MDGs today (and intensifying efforts to combat the incidence of HIV and AIDS and the impact of tropical diseases) sub-Saharan Africa's future capacity to accelerate development will expand. Africa will have more skilled people to design and build the necessary infrastructure, to deliver services, and to provide the managerial know-how for planning, organising, and implementing activities. To increase absorptive capacity, sub-Saharan African countries should use the aid provided so as to improve the efficiency of the public sector, ensuring that appropriate investments are made towards training managers, building technical expertise, and expanding the quantity and quality of infrastructure.

27 For more effectiveness, it is crucial that the predictability of future aid flows improves, as this will allow donors and recipients to plan and manage financial flows much better. Given that external concessionary resources account for a large part of the budgetary income of African countries, it will not be possible for governments to scale up social sector expenditure for, say, health and education without having regular, and assured, disbursements from donors. The likelihood of the next generation of PRSPs incorporating scenarios for reaching the MDGs should also help to identify critical institutional bottlenecks for realising more ambitious plans. Donors should urgently implement measures that provide aid-recipient countries with predictable finance over the longer term.

28 What about increasing levels of aid to countries where states and governments are fragile, because of conflict, the lack of peace, poor public-sector management, corruption, and where the absorption of increased aid presents special challenges?

29 Although it is more complex, donors can ramp up aid levels to such countries and help to reduce poverty. Donors are giving increasing attention to these issues in recognition of the fact that without greater attention to such countries, poverty reduction and collective security goals will not be achieved. A recent High Level Forum meeting of OECD/DAC Ministers in London (14-15 January 2005), concluded that the risk of inaction was far greater than donors not taking any action at all. At this meeting, Draft Principles of Good International Engagement were adopted – see Annex 7 for details. Where conditions are less robust, for example in countries where states are fragile, and where donors and governments disagree on policy priorities, it should still be possible for donors to provide adequate and effective aid in ways that do not undermine national systems, and/or long-term sustainability[63]. These include:

(a) ensuring transparent information on aid flows to countries regarded as having fragile states and/or governments;

(b) making aid more effective at reducing conflict, improving the understanding and analysis of risk factors, and being willing to provide better responses to risk, for example by addressing issues of inequality and human security (see Chapter 5);

(c) sustaining a commitment to reducing poverty in difficult environments and developing more innovative ways of being effective;

(d) engaging in countries over the longer term, and providing less volatile and more predictable funding, even when threatened by temporary setbacks;

(e) increasing funding by about 40 per cent, which should be possible without damaging the norms of efficient aid allocation, as suggested by Collier and Dollar (2004); and

(f) investing in those interventions that recent research suggests can help countries with weaker and less stable institutions to experience rapid turnaround. The benefits of these interventions can be as high US$80 billion[64].

Conclusion: Africa can effectively absorb double the current amount of aid

30 After reviewing the capacity of sub-Saharan African countries to absorb more aid, by considering the varied policy, economic and institutional environments, the Commission's analysis suggests a strong and determined increase in aid levels is possible. Our assessment indicates that over the next three to five years aid levels could be doubled and used productively. Higher absorption of aid should be possible with: (a) continuing policy and governance improvements within Africa; (b) better allocation so that a broader range of countries can receive assistance, and through appropriate channels; (c) better quality assistance.[65]

Annex 7: *Draft* Principles for Good International Engagement in Fragile States[66]

1 The long-term vision for international engagement in fragile states is to build legitimate, effective and resilient state institutions. States are fragile when governments and state structures lack capacity – and in some cases, the political leadership – to deliver public safety and security, good governance and poverty reduction to their citizens. Civil society structures are also important for long-term governance and may play a critical transitional role in providing services, but the long-term focus of international support must be to work to ensure that the core functions of the state operate in an effective and legitimate manner.

2 Fragile states share a common vulnerability but face very different combinations of problems. With concentrated and co-ordinated attention it is possible to create the basis for positive change. International engagement and analysis must be calibrated to particular country circumstances, recognizing different constraints of capacity, political will, and conflict, and the different needs of countries undergoing an early transition from conflict or political crisis in comparison to those facing declining governance environments.

3 The interdependence of political, security, economic and social activities should be recognized, and international actors should move to support unified planning frameworks for political, security, humanitarian, economic and development activities at a country level. PRS principles of national ownership and participation apply in fragile states but need to be adapted to environments of weak capacity, immediate pressures to improve delivery and, in many cases, the central importance of political and security issues. The use of simple integrated planning tools in fragile states, such as the transitional results matrix, can help set and monitor realistic priorities and improve the coherence of international support across the political, security, economic, development and humanitarian arenas.

4 The interconnected nature of issues and responses also requires policy coherence within the administration of each international actor. What is necessary is a whole of government approach, involving those responsible for security, political and economic affairs, as well as those responsible for development aid and humanitarian assistance, while respecting the mandates of each.

5 Harmonisation is a strategic priority for all international actors working in fragile states, and can occur even in the absence of strong government leadership. The principles and practice of harmonization apply in fragile states, although we may need to work through tools and approaches that are tailored to the circumstances of these states. In these fragile contexts, it is important to emphasize the need for upstream harmonization on analysis; joint assessments; joint strategies; co-ordination of political engagement; and practical initiatives such as the establishment of joint donor offices.

6 Where traditional alignment behind government-led strategies is not possible due to particularly weak governance, donors should nevertheless seek to align differently: broaden the range of national actors involved in setting priorities and seek opportunities for partial alignment and harmonization at the sectoral or regional level. Another approach is to use 'shadow alignment', so that donor programs comply as far as possible with government procedures and systems even if operating in territories beyond the government's effective jurisdiction.

7 International actors should especially seek to avoid activities which undermine national institution-building, such as bypassing national budget processes or setting high salaries for local staff which undermine recruitment and retention in national institutions.

8 Fragile states require a mix of aid instruments, including, in particular for countries in promising but high-risk transitions, instruments to support recurrent financing. Instruments to provide long-term support to health, education and other basic services are needed in countries facing stalled or deteriorating governance. Close attention to the sequencing and mix of instruments is particularly important in fragile states.

9 International engagement in fragile states needs to address the problems of 'aid orphans' and aid volatility. Since volatility of engagement (including aid volumes, as well as diplomatic engagement and field presence) is potentially destabilizing for fragile states, donors should agree to regular analysis of aid flows to fragile states as well as commit to developing a system of mutual consultation and co-ordination prior to a significant reduction in programming.

10 Given low capacity and the extent of the challenges facing fragile states, investments in aid, diplomatic and security engagement may need to be of longer-duration than in other low-income countries. Assistance to fragile states should therefore be based on long-term partnerships, but capable of flexibility at short notice to take advantage of windows of opportunity and respond to changing conditions on the ground.

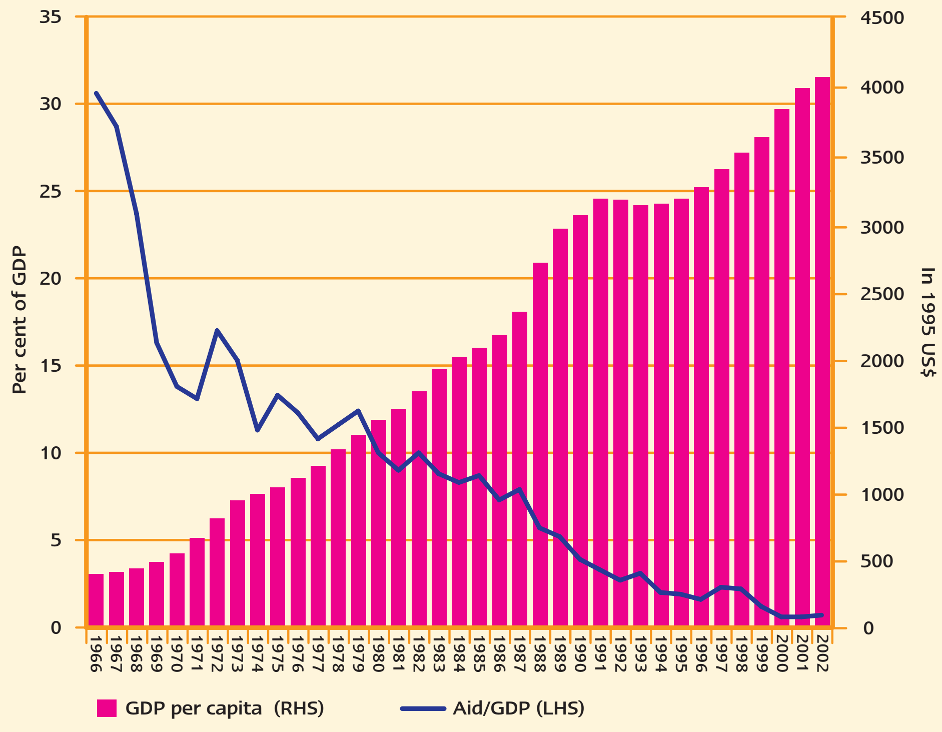
Annex 8: Botswana Graduating From Aid

1. "Botswana is a unique case study of aid dependence in Africa. It has gone from being one of the poorest, most aid dependent countries to a middle-income country no longer in need of significant amounts of external assistance and where aid donors have begun to phase out that assistance"[67].

2 Botswana for almost 30 years has been one of the fastest growing developing countries. Its story is one in which aid and high economic growth have gone hand-in-hand (Figure A9.8.1).

3 Botswana has managed to use aid inflows exceptionally well. Through determined effort by the government, aid has been integrated into national strategies. If development assistance was not seen to fit with national policies and priorities, government has been willing to reject it. In the immediate years after independence, as only few students had completed secondary school, external assistance played a key role in building capacity. Much needed Technical Assistance helped to fund the geological exploration which eventually led to the identification of potentially rich mineral resources[68].

Figure A9.8.1 **Aid and GDP Per Capita in Botswana**



Sources: World Bank World Development Indicators, 2004 and OECD/DAC International Development Statistics Online

4 The government of Botswana managed the economy extremely well after independence. The large revenue inflows which accrued to government from extracting minerals were carefully accounted for and expenditure was managed sensibly. A positive investment climate for private sector development was established.

5 The government has consistently left most development to the private sector, which has been nurtured by a number of measures:

(a) maintaining macroeconomic stability;

(b) sustaining a constant real exchange rate against the country's main trading partners;

(c) managing labour relations;

(d) retaining membership of the Southern African Customs Union (SACU) and agreeing free trade agreements with the EU and the USA;

(e) investing in institutions promoting private sector interests;

(f) avoiding extending government ownership other than to the main utilities (resulting in few parastatals);

(g) channelling most credit to the private sector;

(h) having few import controls and eliminating exchange controls gradually; and

(i) sustaining the lowest level of corruption in Africa (as recorded by Transparency International).

6 Investors approaching the investment promotion agency do not consider tax incentives and government subsidies as being critical deciding factors. Rather, Botswana is chosen as a destination for investment because of the generally favourable investment climate that is maintained.

7 Over time, Botswana's policies have proved successful. The ratio of imports to GDP has halved, and non-traditional exports have grown rapidly, despite firms facing fierce competition from South Africa. In turn, employment has grown and poverty has been reduced.

8 As the diamond industry only employs about two per cent of formal sector employees in Botswana, the main channel by which proceeds from the diamond industry benefit the economy is the public sector. A combination of fast economic growth, expansion of formal sector employment, and efficient government targeting, reduced the population living in poverty from 49 per cent in 1986 to 38 per cent in 1994. What's more, it was the population living in extreme poverty that was reduced the most.

9 Even though Botswana's mineral wealth has undoubtedly contributed, it is the quality of political leadership and stress on maintaining good governance that makes it a real success story[69].

Annex 9: Possible Actions for Further Debt Relief

Action 1: 100 per cent Debt Service Cancellation through to 2015

1 100 per cent cancellation of all debt service for all HIPCs and other severely indebted low-income countries through to the year 2015. For HIPCs, this would include:

(a) 100 per cent cancellation of debt service falling due before decision point. The service paid would be put 'into trust' for each country to receive back on reaching decision point, in order to kick-start MDG-related spending;

(b) cancellation of 100 per cent debt service falling due between decision and completion point; and

(c) cancellation of 100 per cent service falling due from completion point to 2015.

2 For non-HIPCs, funds could be put into trust until such time as they establish a track record of design and implementation of interim Poverty Reduction Strategies equivalent to that of HIPCs. Moral hazard of countries falling off track while receiving relief would be avoided by the fact that the countries would have aid and IMF programmes suspended.

3 The option to cancel 100 per cent debt service is preferable to 100 per cent up-front stock cancellation for two main reasons:

(a) because African governments see the liquidity burden of their debt as a more critical barrier to development than that of the debt overhang; and

(b) because it is the most cost-effective use of funds in the context of limited resources, making the maximum contribution to financing the MDGs. Even if sufficient money were available to cancel 100 per cent of debt up front, it would not be the most desirable option for Africa, as it would mean diverting funds away from funding the MDGs in other countries, in order to cancel 100 per cent debt service which does not fall due for more than 10 years.

Action 2: Relief on all Dangerous Debt

4 It is important to address the 'precarious' component of HIPCs' debt which is causing African governments to pay out large sums up-front and reducing funds for the MDGs. This is debt owed to non-OECD bilateral and commercial creditors which are not participating in the HIPC Initiative. It is increasingly becoming a target for lawsuits by the original creditors, and disreputable speculators. Two urgent measures are required:

(a) establishing a trust fund to help finance relief on debts owed by HIPCs to other debt-distressed developing countries. As discussed above, this could use a sliding scale of discount based on their degree of debt distress; and

(b) establishing a rapid response legal technical assistance facility, independent of the BWIs, to help African countries pre-empt and avoid lawsuits, and change national debt relief laws.

5 These measures would not be very costly, but would leverage large debt relief, and might ideally also be extended to other African (and non-African) low-income debt distressed countries which apply for debt relief.