

**FOR
AGENDA**

SM/05/102

March 14, 2005

To: Members of the Executive Board

From: The Secretary

Subject: **Global Monitoring Report 2005—MDGs: From Consensus to Momentum**

Attached for consideration by the Executive Directors is a draft report entitled “Global Monitoring Report 2005—MDGs: From Consensus to Momentum,” prepared by the staffs of the Fund and the World Bank, which is tentatively scheduled for discussion on **Friday, April 1, 2005**. The report is also to be discussed by World Bank Executive Directors at a meeting of the World Bank’s Committee of the Whole scheduled for March 24, 2005.

Following the discussion, the report will be revised as necessary. The overview (Chapter 1) will be turned into an issues paper and distributed to the Development Committee, with the full report also issued to the Committee as a background document. These papers will be posted on the Development Committee’s website prior to the Development Committee meeting. The full report will also be published as a product of the staffs of the World Bank and the International Monetary Fund.

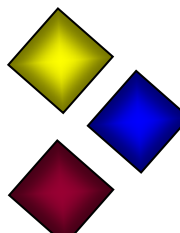
Questions may be referred to Mr. Berg (ext. 38843), Mr. Fallon (ext. 35993), and Mr. C. Leite (ext. 34295) in PDR.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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GLOBAL MONITORING REPORT



2005



Draft

March 10, 2005

Global Monitoring Report 2005

MDGs: From Consensus to Momentum

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Abbreviations and Acronyms

ACP	African-Caribbean-Pacific	ECA	Europe and Central Asia
AfDB	African Development Bank	ECLAC	Economic Commission for Latin America
AfDF	African Development Fund	EFA-FTI	Education for All Fast Track Initiative
AGOA	African Growth Opportunity Act	EIA	Environmental Impact Assessment
APRM	African Peer Review Mechanism	EPZs	Export Processing Zone
ARVT	Antiretroviral Therapy	ESAF	Enhanced Structural Adjustment Facility
AsDB	Asian Development Bank	ESW	Economic and sector work
AsDF	Asian Development Fund	ETC	Early Transition Countries
ASEAN	Association of South East Asian Nations	EU	European Union
ATC	Agreement on Textiles and Clothing	FDI	Foreign Direct Investment
BEEPS	Business Environment and Enterprise Performance Surveys	FSAP	Financial Sector Assessment Program
BWI	Bretton Wood Institutions	FSO	Fund for Special Operations
CAC	Collective action clauses	FTI	Fast Track Initiative
CAE	Country Assistance Evaluation	GAO	General Accounting Office
CAP	Common Agricultural Policy	GATS	General Agreement on Trade and Services
CAS	Country Assistance Strategy	GAVI	Global Alliance for Vaccines and Immunization
CFAA	Country Financial Accountability Assessment	GDP	Gross Domestic Product
CGIAR	Consultative Group on International Agricultural Research	GEF	Global Environment Facility
CPA	Country Performance Assessment	GEP	Global Economic Prospects
CPAR	Country Procurement Assessment Report	GFATM	Global Fund to Fight HIV/AIDS, Tuberculosis, and Malaria
CPIA	Country Policy and Institutional Assessment	GMR	Global Monitoring Report
CSP	Country Strategy Paper	GNI	Gross National Income
DAC	Development Assistance Committee	GPG	Global Public Goods
DC	Development Committee	GSP	Generalized System of Preferences
DEC	World Bank Development Economics Group	HD	Human Development
DFID	Department for International Development	HIPC	Heavily Indebted Poor Country
DOTS	Directly Observed Treatment, Short-course	HLF	Harmonization, Alignment and Results
DPCs	Difficult Partnership Countries	HNP	Health, Nutrition and Population
DSF	Debt Sustainability Framework	HR	Human Resources
EAP	East Asia and Pacific	HS	Harmonized System
EBA	Everything but Arms Initiative	IBRD	International Bank for Reconstruction and Development
EBRD	European Bank for Reconstruction and Development	ICA	Investment Climate Assessment
		ICB/NCB	International Competitive Bidding/National Competitive Bidding

IDA	International Development Association	PAHO	Pan American Health Organization
IDB	Inter-American Development Bank	PCR	Project Completion Report
IEO	Independent Evaluation Office	PEFA	Public Expenditure and Financial Accountability Program
IF	Integrated Framework	PER	Public Expenditure Review
IFC	International Finance Corporation	PPP	Purchasing Power Parity
IFF	International Finance Facility	PRGF	Poverty Reduction and Growth Facility
IFFIm	International Finance Facility (IFF) for Immunization	PRS	Poverty Reduction Strategy
IFI	International Financial Institution	PRSC	Poverty Reduction Support Credit
IMF	International Monetary Fund	PRSP	Poverty Reduction Strategy Paper
JSA	Joint Staff Assessment	PTA	Preferential Trade Arrangements
JSAN	Joint Staff Advisory Note	QAG	World Bank Quality Assurance Group
LAC	Latin America and Caribbean	RB-CAS	Result-based CAS
LDC	Least Developed Countries	RB-CSP	Result-based CSP
LICs	Low-Income Countries	ROSCs	Reports on Observance of Standards and Codes
LICUS	Low-Income Countries Under Stress	SME	Small and medium enterprises
M&E	Monitoring and Evaluation	SPA	Strategic Partnership with Africa
MAMS	Maquette for MDG Simulation	SPS	Sanitary and phytosanitary
MCA	Millennium Challenge Account	SSA	Sub-Saharan Africa
MDBs	Multilateral Development Banks	SWAps	Sector-Wide Approaches
MDGs	Millennium Development Goals	TA	Technical assistance
MENA	Middle East and North Africa	TB	Tuberculosis
MFN	Most-Favored Nation	TIM	Trade Integration Mechanism
MICs	Middle-Income Countries	UN	United Nations
MIGA	Multilateral Investment Guarantee Agency	UNAIDS	Joint United Nations Programme on HIV/AIDS
MNA	Middle East and North Africa	UNCTAD	UN Conference for Trade and Development
MTEF	Medium-Term Expenditure Framework	UNDP	UN Development Programme
NAFTA	North American Free Trade Agreement	UNECA	UN Economic Commission for Africa
NCA	New Capital Accord or Basel II	UNICEF	UN Children's Fund
NEPAD	New Partnership for Africa's Development	UNMP	UN Millennium Project
NGO	Nongovernmental organization	VAT	Value-added tax
NTBs	Non-Tariff Barrier	WAEMU	West African Economic and Monetary Union
NTMs	Non-tariff measures	WB	The World Bank
ODA	Official Development Assistance	WBI	World Bank Institute
ODI	Overseas Development Institute	WDI	World Development Indicators
OECD	Organisation for Economic Co-operation and Development	WDR	World Development Report
OED	World Bank Operations Evaluation Department	WEO	World Economic Outlook
OTRI	Overall Trade Restrictiveness Index	WHO	World Health Organization
		WP—EFF	Working Party on Aid Effectiveness and Donor Practices
		WSS	Water supply and sanitation
		WTO	World Trade Organization

Overview¹

Building Momentum toward the MDGs

1. The Millennium Development Goals (MDGs) and the Monterrey Consensus have created a powerful global compact for development.² But the continued credibility of this compact hinges on fostering momentum in its implementation. With the five-year stocktaking of the implementation of the Millennium Declaration focusing increased global attention on development, 2005 is a crucial year to build momentum.

2. Without tangible action to accelerate progress, the MDGs would be seriously jeopardized. At stake are prospects not only for hundreds of millions of people to escape poverty, disease, and illiteracy, but also prospects for long-term global security and peace—objectives that are intimately linked to development. Behind the cold data on the MDGs are real people, and lack of progress on the goals has immediate and tragic consequences. Every week in the developing world, 200,000 children under five die of disease and 10,000 women die giving birth. In Sub-Saharan Africa alone two million people will die of AIDS this year. Moreover, 115 million children in developing countries are not in school. The need to scale up and speed up action is thus urgent, and the opportunities presented by the year 2005 must be seized.

3. The MDGs set clear targets for eradicating poverty and related human deprivations and for promoting sustainable development. The Monterrey Consensus created a framework of mutual accountability between developing and developed countries in the quest for these goals, calling on developing countries to improve their policies and governance and developed countries to open their markets and provide more and better aid. With consensus on the goals and the responsibilities for action, the focus was put squarely on implementation. As reviewed in this report, both groups of countries have made progress on needed policies and actions, including in the past year. But progress has been uneven and slower than envisaged. The pace must pick up if the vision of the Millennium Declaration is to be realized—hence the title of this report.

I. MDGs: Daunting Challenges—and Grounds for Hope

4. Globally, prospects are promising for the achievement of the income poverty MDG. China and India, two countries with the highest absolute number of poor people, have achieved sustained strong growth and made major and rapid progress in reducing poverty. Due largely to their efforts, East Asia has already achieved the poverty goal, and South Asia is on target. Most other developing regions are making steady progress and are expected to achieve the goal or come close—though some countries in all of these regions will fall short while some others will continue to have large pockets of poverty even when meeting the goal at the national level. In Sub-Saharan Africa, the momentum has been much slower, and most countries in the region are at risk of falling far short. Indeed, between 1990 and 2001 the incidence of poverty rose in Sub-Saharan Africa. Almost half of the region's population lives on less than a dollar a day.

5. Across regions, the risks of falling short are far greater for the human development goals. The prospects are gravest in health. On current trends, most regions will fall short—some seriously—

¹ As last year, in the light of discussion by the Executive Directors, the Overview of the report will be converted into a short paper, including an executive summary, which will serve as the document for discussion by Ministers at the Development Committee meeting. The full report will serve as a background document.

² The MDGs flowed from the Millennium Declaration that was adopted by 189 countries at the United Nations Millennium Summit, held in New York in 2000. The Monterrey Consensus emerged from the United Nations Conference on Financing for Development, held in Monterrey, Mexico, in 2002.

of the health and related goals, including reduced child and maternal mortality and expanded access to sanitation. The number of people with HIV/AIDS continues to grow. Prospects are brighter in education, but in three of the six developing regions the pace of progress is too slow to attain the universal primary completion goal. Significant progress has been made in all regions in reducing gender disparities in education, but again in half of the regions the target of achieving gender equality in primary and secondary education by 2005 will not be met. Prospects for achieving gender equality in tertiary education by 2015 are even less encouraging. One region is off track on all of these goals—Sub-Saharan Africa.

6. Against this backdrop, and with just a decade to go until 2015, achieving several of the MDGs seems daunting. Indeed, it is a huge challenge. But rapid progress is possible. The success of the better-performing regions and countries provides grounds for hope for others. A particularly striking example is Vietnam, a low-income country that reduced poverty from 51 percent in 1990 to 14 percent in 2002. And even in many lagging countries, including in Sub-Saharan Africa, progress is being made and the ground is being laid for better performance. This progress needs to be furthered and quickened, within the framework of the enhanced global development partnership envisaged at Monterrey.

II. Building Momentum: A Five-Point Agenda

7. How to generate momentum and broaden progress? Developing countries must themselves take the lead in articulating and implementing strategies that aim higher, to rise above current trends and substantially accelerate progress. That will require improvements in policies and governance to achieve stronger economic growth and scale up the delivery of human development and related key services. Developed countries must also raise their game, and live up to the commitments they made at Monterrey. Providing more, and better, aid is an important part of such efforts. But it is not all. A “big push” in aid is not the sole answer. International development policy needs to move beyond the aid silo, and aim for a set of actions that cohere into a big push—including, importantly, trade policy reform but also other policies that affect development, such as those involving private capital flows, knowledge and technology transfer, security, and the environment.

8. Based on its analysis, the report proposes a five-point agenda to accelerate progress toward the development goals (Box 1.1). Within its global coverage, this year’s Global Monitoring Report³ has a special focus on Sub-Saharan Africa—the region that is farthest from the development goals and faces the toughest challenges in accelerating progress. But much of the analysis of Sub-Saharan countries is relevant to similar countries in other regions. For example, Sub-Saharan Africa contains the largest number of least developed countries (LDCs) and low-income countries under stress (LICUS). But other regions also contain countries in these groups, with similar characteristics and challenges. For example, East Asia, better known for its major emerging market economies, contains 6 of the 25 countries currently classified as LICUS.

³ The first Global Monitoring Report (GMR), prepared for the Spring 2004 Development Committee meeting and published in June of that year, provided a comprehensive assessment of the policy agenda for achieving the MDGs and related development outcomes, spanning the responsibilities, as reflected in the Monterrey Consensus, of all the key actors—developing countries, developed countries, international financial institutions. Building on that report, the 2005 GMR has a more selective focus on key areas of the policy agenda but aims to provide a more in-depth assessment in those areas.

Box 1.1 Accelerating Progress toward the MDGs: A Five-Point Agenda

Anchor actions to achieve the MDGs in country-led development strategies

- Operationalize the MDGs in country-owned and -led poverty reduction strategies, linked to medium-term fiscal frameworks. Donors should use these strategies as the basis for aligning and harmonizing assistance.

Improve environment for stronger, private sector led economic growth

- Strengthen fiscal management, with a focus on the structure of public spending.
- Improve the enabling climate for private activity, by removing regulatory and institutional constraints and strengthening economic infrastructure.
- Improve governance—by upgrading public sector management and combating corruption.

Scale up delivery of human development services

- Rapidly increase the supply of skilled service providers (health workers, teachers).
- Provide increased, flexible, and predictable financing for these recurrent cost-intensive services.
- Manage the service delivery chain to ensure that money produces results.

Dismantle barriers to trade

- Achieve an ambitious outcome to the Doha Round that fully realizes its development promise, including in particular a major reform of agricultural trade policies in high-income countries, completing the Round no later than 2006.
- Augment assistance to poor countries to address behind-the-border constraints to their trade capacity, through investments in critical trade-related infrastructure.

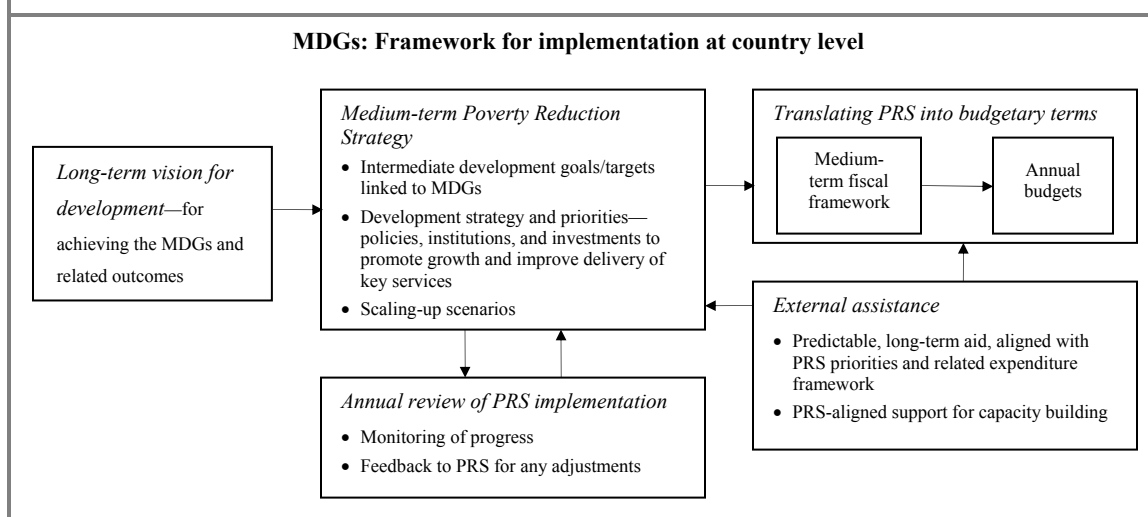
Substantially increase the level and effectiveness of official development assistance

- Double ODA in the next five years to support the MDGs, particularly in low-income countries and Sub-Saharan Africa, aligning the pace of the increase with recipients' absorptive capacity.
- Improve the quality of aid, with faster progress on alignment and harmonization, and delivery modalities that increase aid flexibility and predictability.
- Reach closure during 2005 on current proposals for additional debt relief. Any additional debt relief should not cut into the provision of needed new financing.

Anchoring MDG Efforts in Country-Led Development Strategies

9. An overarching theme of this report is the centrality of country-based development strategies in the implementation of the MDG agenda. Country-owned and -led poverty reduction strategies (PRSs) should be the framework for operationalizing the MDGs at the country level in low-income countries (equivalent national development strategies should perform this role in middle-income countries). Framed against a long-term development vision, PRSs should define medium-term targets, tailored to country circumstances, for progress toward the MDGs and related development outcomes. And they should articulate a clear national agenda and priorities for achieving those targets, spanning policy reforms, institutional strengthening, and investments. The development program set out in a PRS should be linked to a medium-term fiscal framework and annual budgets to align budget allocations with program priorities. Donors should then use this framework of nationally articulated priorities—and their budget implications—to align and harmonize their assistance. In this way, the PRS process can bring coherence both to the setting and implementation of national priorities for achieving the MDGs and to donor support to the country. It can also, through the annual review of PRS implementation, provide a mechanism for monitoring progress on the development agenda in an integrated manner and for making adjustments to the agenda as needed (Figure 1.1).

Figure 1.1 Country focus and leadership are key to coherent and effective implementation of the MDG agenda



10. To perform this central strategic and operational role effectively, PRSs need strengthening in many countries. Overall, there has been good progress in extending and deepening the PRS process in developing countries. At present, 47 countries are implementing PRSs, and another 12 have prepared interim PRSs. Of these, 33 are Sub-Saharan countries. Countries are increasingly reflecting the MDGs more centrally in their PRSs. The PRS process is being deepened along various dimensions, including the transparency and inclusiveness of the process, articulation of the growth agenda in the PRS, attention to institutional capacity building issues (such as public expenditure management), and incorporation of poverty and social impact analysis. Progress on these dimensions, however, varies across countries.

11. Going forward, an area requiring particular attention is strengthening the links between PRSs and fiscal frameworks, which in most countries will require further development of medium-term expenditure frameworks. This is key both for enhancing the operational effectiveness of PRSs for national authorities in setting and implementing development priorities and for donors in better aligning their support with country priorities. In most low-income countries, achieving the MDGs will require a major scaling up of development efforts. Countries should use the PRS framework to assess alternative scenarios that can help them map out how to scale up, drawing implications for intensified domestic policy reform, mobilization of additional external assistance, and enhancement of absorptive capacity.

Spurring and Sustaining Economic Growth

12. PRSs and other national strategy documents must define clear agendas for promoting stronger and sustained economic growth and governments must firmly commit to those agendas. Growth is central to achieving the MDGs and related development outcomes. It reduces poverty directly and expands resources and capacities for achieving the non-income MDGs. In recent years, developing countries have achieved a very encouraging pick-up in economic growth, thanks to continuing progress in improving policies and governance. In 2004, GDP growth in developing countries averaged 6.5 percent, the highest level in more than a decade.

13. Sub-Saharan Africa also appears to be turning the corner. Twelve countries in the region—including Ghana, Mali, Mozambique, Tanzania, and Uganda—are currently experiencing growth accelerations of the type more commonly associated with other regions. They have achieved average GDP growth since the mid-1990s of more than 5.5 percent. Despite particular handicaps

that a number of African countries face, such as unfavorable geography and the incidence of disease, policies and institutions matter in delivering higher growth. Differences in policies and institutions largely explain the differences in growth and poverty reduction between other regions and Sub-Saharan Africa and between countries in Sub-Saharan Africa.

14. Still, this recent strengthening of growth is only the beginning of what Sub-Saharan Africa needs to achieve and sustain necessary improvements in income levels. Historically, it has been far more difficult to sustain growth than to initiate it. To achieve the income poverty goal, Sub-Saharan Africa would have to achieve average annual GDP growth of around 7 percent over the next decade—almost double the region's current growth rate. Though this is a big challenge, past achievements of countries in other regions and of some countries in Sub-Saharan Africa itself show that rapid progress is possible if there is sufficient commitment to reform and support from development partners.

15. Specific priorities and sequencing of actions to promote growth necessarily vary by country. There is considerable diversity among countries in their economic circumstances. Sub-Saharan Africa alone contains a rich variety: middle-income countries as well as least developed countries, large countries as well as small island economies, resource-rich countries (including oil exporters) as well as resource-poor countries, coastal countries as well as landlocked countries, and countries experiencing conflict and other forms of severe stress. The specifics of the policy agenda for growth at the country level must therefore be defined as part of individual country development strategies. Looking across countries, the report's analysis suggests three broad areas requiring particular attention:

16. ***Deepening progress on macroeconomic management.*** Macroeconomic management has improved in all regions, yet progress has been uneven and remains fragile in many Sub-Saharan countries. The main area requiring attention is fiscal management, particularly the structure and quality of public spending. Better public expenditure management would allow allocations to growth-promoting and poverty-reducing spending to rise in a way consistent with sustainable fiscal and debt positions. The scope for such improvement in spending remains sizable in many countries. Sound fiscal management and macroeconomic stability also are important underpinnings of an environment conducive to growth in private investment.

17. ***Improving the enabling climate for private sector activity.*** A vigorous private sector drives economic growth, but government plays a vital role in creating a climate where entrepreneurship can flourish. An improved business environment not only delivers higher and more productive private investment, it also expands the private sector by establishing a level playing field—encouraging small businesses (often the most dynamic business segment), inducing a shift from the informal to the formal economy, and better engaging the energies of women. A better business environment is also essential to attracting more foreign investment. Action is needed on two fronts:

- *Improving the regulatory and institutional environment for private activity*, with a focus on simplifying regulations for starting a business, securing property rights, and strengthening contract enforcement and the rule of law. Access to finance also needs to be improved, but fundamentally depends on the same regulatory and institutional underpinnings. Sub-Saharan Africa considerably lags other regions on these dimensions. Countries should use the improved diagnostics and metrics of the private business environment now available (such as the Doing Business Indicators and Country Investment Climate Surveys) to guide action and monitor progress. Further reductions in trade barriers (discussed below) also are necessary to improve the climate for private investment and growth.
- *Substantially increasing investment in physical infrastructure*, promoting private participation and reversing the decline in public investment that persisted for much of the past decade—recognizing that the bulk of the increase in infrastructure investment, especially in Sub-

Saharan Africa, will have to come from the public sector. Gaps in infrastructure are especially severe in Sub-Saharan Africa, reflecting a lack of past investment as well as the large needs implied by the region's challenging geography—as with transportation to link distant rural areas to markets (key to boosting agriculture, which accounts for the bulk of employment in most countries) and regional infrastructure to link landlocked countries to international trade. Infrastructure spending (investment plus operation and maintenance) will need to rise in all regions to support stronger growth and service delivery consistent with the MDG targets. But such spending will need to double in Sub-Saharan Africa, from about 4.7 percent of GDP in recent years to 9.2 percent over the next decade—implying annual infrastructure spending of about \$20 billion and a need for about \$10 billion a year in additional external financing. The increase in spending will need to be managed well to ensure effectiveness and quality, with the pace of the increase depending on institutional capacity and macroeconomic conditions in the countries concerned.

18. ***Strengthening public sector governance.*** Improving the quality of governance—upgrading public sector management, controlling corruption—overarches this agenda, because it is crucial to both the private sector's business environment and the public sector's development interventions. Although governance is getting better in most countries, in many reforms need to be accelerated. Sub-Saharan Africa has seen encouraging progress in political representation, reflecting a trend toward broader participatory processes that enable citizens to influence policymaking and hold leaders accountable. There has been less progress in public sector management and institutional effectiveness. But the improvements in political institutions could create the momentum needed to strengthen the institutions of economic governance. The African Peer Review Mechanism, recently introduced by the African Union's New Partnership for Africa's Development (NEPAD), focuses on improving governance and could provide impetus. Informed by the peer reviews, countries should develop capacity building strategies, with NEPAD providing a forum to share best practice, reinforce peer pressure, and advocate for external support. External partners should support the strengthening of this promising African-led reform framework. Developed countries can also help curb corruption by demanding high standards from their companies active in developing countries, including by giving high-level political endorsement to the Extractive Industries Transparency Initiative.

19. The context for economic growth in Sub-Saharan Africa also appears to be improving in terms of the region's peace and security outlook, with some decline in the incidence of conflicts. Still, preventing, managing, and helping countries recover from conflicts remain major challenges in the region.

Scaling Up Service Delivery

20. The human development goals require a major scaling up of education and health services—primary education, basic health care and control of diseases such as HIV/AIDS, women's access to education and health care—and of water and sanitation infrastructure that is closely linked to health outcomes. The shortfalls are most serious in Sub-Saharan Africa and the need to scale up most urgent.

21. As with the growth agenda, specific priorities for action in scaling up human development services must be determined in the context of country-owned development strategies. The appropriateness of individual interventions, be they “quick wins” or longer-term efforts, needs to be evaluated in such country-specific frameworks. Analysis undertaken for this report finds that most countries face three critical challenges in scaling up service delivery.

22. *Increasing the supply of skilled service providers.* Expansion of education and health service delivery on the scale needed to achieve the MDGs will require major increases in the supply of

teachers, doctors, nurses and community health workers, especially in Sub-Saharan Africa. The region will need to triple its health workforce by adding one million workers by 2015. The impact of AIDS on the workforce is exacerbating the capacity problem in countries such as Malawi, Tanzania, and Zambia. Human resource shortages are likely to be a binding constraint on service expansion, especially in health, unless countries adapt policies and increase provider productivity. Strategies that are proving effective include:

- pragmatic adjustments to recruitment standards, to increase production of community teachers and health workers;
- careful deployment and management of providers, to avoid underutilization;
- maximum use of non-salary incentives to make public sector positions, especially in rural areas, attractive;
- selective salary adjustments for the highest skilled workers (e.g., doctors) in the public sector, to restrain migration; and
- cost-effective investments in medical, nursing and teacher training capacity, to complement the shorter-term strategies noted above.

Donors have an important role to play in addressing the health worker crisis. Developed countries that benefit from African-trained medical personnel can help finance expanded training facilities in home countries and assist them in recouping medical students' loans.

23. *Mobilizing flexible and predictable financing.* Developing countries have increased budgetary allocations to education and health but many of them need to go further to achieve the MDGs. For education, 20 percent of the recurrent budget is the benchmark under the Education for All—Fast Track Initiative (FTI), while Sub-Saharan African countries, for example, currently average 15 percent. For health, African governments themselves, meeting in Abuja in February 2000, set a target of 15 percent of the recurrent budget, well above their current average of 8 percent.

24. Allocating more from countries' own fiscal resources, however, will not be enough. A substantial increase in external financing is required. The need for incremental external financing to achieve the primary education MDG in low-income countries is estimated at \$3 billion annually at a minimum. Much more is estimated to be needed to meet the health goals—at least \$25 billion annually. Equally important are deep changes in the nature of donor support. A significant share of bilateral assistance falls completely outside the national planning and budgeting process. Transactions costs severely strain countries' limited administrative capacity. Aid flows are often volatile. And there often exists a disconnect between the types of expenditures countries need to finance in order to scale up service delivery in education and health—recurrent, local, largely personnel costs—and what bilateral donors are actually providing—tied and largely technical assistance financing. As much as 70 percent of all aid to education consists of technical assistance.

25. Flexibility and predictability of financing is especially important for these recurrent cost-intensive services. Priorities in improving the delivery of financing to these services include:

- *Making aid flexible.* All aid should support priorities identified in the PRS and endorsed sector plans. In countries meeting public expenditure management thresholds, more aid should be provided in the form of budget support.
- *Creating a stable funding framework for FTI.* To strengthen the FTI, bilateral partners should make a monitorable, public, long-term commitment to annual increases in funding for primary education. The target should be a significant annual increase from each partner's 2005 base, which the FTI Secretariat should monitor. Each partner's annual funding

commitment should help fill agreed financing gaps for endorsed countries where they have a bilateral presence or interest; any residual should be allocated to the FTI's Education Program Development Fund (EPDF) or the FTI Catalytic Fund.

- *Aligning global health initiatives with national policies and priorities.* Additional external resources are needed to prevent and treat childhood diseases, reduce maternal mortality, sustain HIV/AIDS treatment, and make progress against malaria and TB. Increased donor funding must be longer-term and aligned with country priorities. The international health community urgently needs to look at all options for ensuring that global programs organized around specific health priorities do not undermine the coherence of countries' health sector strategies, balanced allocation of resources, and the strengthening of health systems. While preserving the mandates these programs currently have for resource mobilization, awareness raising, results monitoring, and financing of global public goods with respect to individual diseases, these functions must be better coordinated at the global level and better aligned at the country level with government-led sector plans, with harmonized procurement, disbursement, and reporting procedures. The High Level Forum for the Health MDGs established in 2003 offers a platform for this collaborative "rethink" of the current global architecture in health and the development of common principles and standards of good practice for the engagement of global health partnerships at the country level.

26. *Improving management of the service delivery chain.* Sound expenditure management and a focus on development results are crucial to effective service delivery. The realization of increased aid, especially in the form of flexible budget support, also depends on them. The first requires systems for budget formulation, allocation, and reporting that meet threshold standards of integrity and efficiency. In a number of countries in greatest need of external recurrent cost support, these systems are too weak to give donors confidence that resources can be tracked and well-used. Donors are giving high priority to capacity building in this area, but progress depends crucially on strong domestic commitment to reform.

27. The second requires the capacity for real time data on MDG progress. Countries need to be able to track the primary completion rate, and use regular household surveys and sentinel monitoring to generate data on child and maternal mortality and major communicable diseases. Since these indicators improve relatively slowly, intermediate indicators of progress are also important, as are measures of system efficiency, such as those for education developed by the FTI. A similar framework is currently under development by a donor consortium in health (Health Metrics Network). Progress also requires a better evidence base for policy, built on rigorous impact evaluation of key programs.

28. Ultimately, strengthening service delivery requires action to improve the core accountability relationships identified in the 2004 World Development Report: the responsiveness of governments to citizen demands through the political process; the responsiveness of service providers to clients; and the effectiveness of government agencies in turning resources into results. Weaknesses in these accountability relationships can be the deepest threat to effective service delivery. But countries are making progress. Sector management can be helped by clear funding norms, competency-based recruitment, results focus, attention to cost-effective standards, and strategies to make effective use of the private sector. And above all, governments can strengthen the voice of clients at the point of service delivery—through the power of information, direct involvement in school and health facility monitoring or management, and the use of conditional cash transfers.

Realizing the Development Promise of Trade

29. *The Doha Development Agenda.* Improving market access for developing countries would provide a major boost to economic growth and progress toward the MDGs. Multilateral,

reciprocal, non-discriminatory trade liberalization offers the best means to realizing the development promise of trade. A timely and pro-development outcome to the Doha Round therefore is crucial. Based on developments to date, there is a significant risk that a limited, “business as usual” outcome may emerge. Not only would such an outcome greatly reduce the potential of trade to help achieve the MDGs, it could imply a further hollowing out and erosion of the multilateral trading system. The Doha Ministerial Declaration put development at the center of the trade reform agenda. The international community must raise the level of its ambition with respect to the Doha Round and aim for an outcome that is equal to that vision. High-income countries must lead by example. The ambition should center on a major reduction in market access barriers, and in particular a transformation of agricultural trade policy in high-income countries. Taking into account both tariff and nontariff measures, trade policy in high-income countries is more than seven times as restrictive in agriculture as in manufacturing. Ambitious reference points would be helpful in guiding the negotiations, including:

- *Agriculture*: reduction of all agricultural tariffs to no more than 10 percent, elimination of all agricultural export subsidies, and complete decoupling of domestic agricultural subsidies and rural support from production.
- *Manufacturing*: elimination of all tariffs on manufactured products.
- *Services*: commitments to ensure free cross-border trade in services delivered over telecommunications networks, complemented by actions to liberalize the temporary movement of service providers.

For these actions to assist in attaining the MDGs, they should be completed by 2015, with major progress achieved by 2010.

30. Significant trade policy commitments by developing countries themselves are an essential, and equally urgent, part of the agenda to realize the potential of trade for development, including tapping the considerable scope that exists for expanded trade among them. Trade restrictions are in general much higher in developing than developed countries, and are highest on average in Sub-Saharan Africa, South Asia, and Middle East and North Africa.

31. An ambitious Doha Round would yield large gains for the world as a whole and for developing countries. Most estimates of the gains from such an outcome are upwards of \$250 billion per year by 2015, with about 33-40 percent of the global gain accruing to developing countries, higher than their one-fifth share in world GDP. This would imply a boost to the GDP of low-income countries of about 2 percent and that of Sub-Saharan Africa of 1.3 percent; corresponding estimates for a low-ambition, business-as-usual Doha outcome are 0.3 and 0.1 percent, respectively. As much as two-thirds of the estimated global gains are related to reform of agricultural trade. These estimates include gains from merchandise trade reform only. Significant liberalization of services could increase the gains considerably—by a multiple on some estimates.

32. ***Aid for trade.*** Complementing an ambitious Doha outcome, “aid for trade” should be scaled up substantially. For many low-income countries, fully capturing the opportunities arising from improved market access, as well as their own trade reforms, requires addressing the “behind-the-border” constraints on their trade capacity. This applies particularly to the LDCs, most of which are in Africa, for whom lack of trade capacity and competitiveness is the binding constraint. The agenda includes trade logistics and facilitation, strengthening of critical trade-related infrastructure such as transport, and further reform of policies that create anti-export bias.

33. A host of diagnostic trade integration studies undertaken for LDCs under the Integrated Framework for Trade-Related Technical Assistance (IF) have identified areas where aid can be used effectively to build trade capacity. The IF, a collaborative joint venture between multilateral agencies, bilateral donors and LDC governments, offers a mechanism to identify priorities and allocate additional assistance toward trade-related investments and support for policy reforms.

Resources provided to the IF to date have been able to support only small-scale technical assistance efforts. But the IF offers a ready-made vehicle to boost aid for trade, supported by increased integration of the trade capacity building agenda by countries in their PRSs.

34. *Tariff preferences.* Recent policy in OECD countries has emphasized tariff preferences for small, poor countries—LDCs, Sub-Saharan African economies. While actions to make existing tariff preference programs more effective—for example, through adoption of common, liberal rules of origin—would be beneficial in the short run, for the longer term the focus should shift toward alternative forms of trade assistance that generate greater benefits for recipients and at the same time are less trade-distorting. Tariff preferences have been of limited value to many African countries and have negative effects on the functioning of the global trading system. Alternative measures include stepped-up financial assistance to strengthen trade capacity, and to help countries deal with the adjustment costs of trade policy reform—preference erosion, loss of revenue. They also include action by major importers to minimize the incidence of nontariff measures (quotas, licensing requirements, health and safety related product standards) on exports from poor countries. Regardless of their intent, regulatory product standards applied at the border have a major restrictive impact on trade and impact poor countries disproportionately. Reducing their incidence on these countries, including by assisting in building their capacity to meet the regulatory requirements, would have a high payoff.

35. *Regional integration.* Regional trade agreements can also contribute to leveraging trade for development provided they do not detract from the pursuit of an ambitious Doha outcome. The full realization of the development contribution of both North-South and South-South regional integration arrangements requires that developing country members of these arrangements implement significant liberalization on a nondiscriminatory basis in addition to granting preferential access to partner countries. As a number of Sub-Saharan African countries still rely on import duties for a significant portion of total government receipts, revenue concerns and the ability to put in place alternative revenue sources are a factor in determining the appropriate speed of liberalization. Agreements that the EU and the US are negotiating with developing countries can do much good if designed in a way that puts development considerations at the center.

Increasing the Level and Effectiveness of Aid

36. *Scaling up ODA.* Developing countries must exert stronger efforts to mobilize more domestic resources to support accelerated progress toward the development goals—moving more vigorously on the agenda to spur economic growth, strengthening revenue administration, and improving the efficiency of spending. They also must build on progress in reforms that enhance their ability to attract private non-debt capital inflows, especially foreign direct investment. Moreover, in a number of countries, workers' remittances are becoming an increasingly important source of private external finance. Still, for most low-income countries, official development assistance (ODA) remains a major source of external finance. For poor and least developed countries, it remains the predominant source. In Sub-Saharan Africa, home to a majority of these countries, official flows account for about two-thirds of all capital inflows. Even with stronger efforts to mobilize more domestic resources and to attract more private capital inflows, these countries will need a substantial increase in ODA to improve their prospects for progress toward the MDGs. In middle-income countries, aid plays a much smaller but still important role, by catalyzing reforms, reinforcing domestic efforts to tackle large concentrations of poverty, and helping to counter negative shocks.

37. Donors are beginning to respond to the need to increase aid, following up on their Monterrey commitments. Aid volumes are recovering since 2001, following a decade of almost continuous decline. Net ODA increased in real terms by 12 percent during 2002-03. This is encouraging, but

aid remains well short of what the poor countries need and can use effectively. At least a doubling of ODA will be needed within the next five years to support adequate progress toward the MDGs. Further increases will likely be needed beyond that period up to 2015. The need for an increase in ODA is especially acute in Sub-Saharan Africa and evidence suggests that, given recent and prospective progress on policy and institutional reforms in many countries, the region as a whole can effectively use a doubling of aid over a five-year time frame.

38. To signal that needed resources will be forthcoming, 2005 is an opportune time for donors to raise their initial post-Monterrey commitments and extend them over a longer time horizon—2010 or beyond. To date only about half of DAC donors have announced aid commitments beyond 2006. Others should do so in 2005.

39. While aid volumes are rising, it is important to ensure that development aid to poor countries to support their efforts to achieve the MDGs is not crowded out by donors' strategic and security objectives. Large amounts of aid have recently been committed to geo-politically important countries. A better balance in aid will be needed, focusing more on poverty reduction. Reducing poverty and hopelessness that comes with human deprivation is perhaps the most effective means to promoting long-term peace and security. And it also costs less. A doubling of ODA will amount to less than one tenth of what high-income countries devote to military spending. And it is also eminently affordable, representing only about 0.2 percent of high-income countries' GNI.

40. ***Aligning aid with absorptive capacity.*** Both how aid is allocated across countries and how increases are sequenced within countries must be aligned with the recipients' absorptive capacity. The readiness of countries to utilize significant increases in external assistance varies considerably. Which countries should be "fast tracked" depends on the robustness and strength of ownership of development programs articulated in their PRSs and progress in governance and institutional capacities to implement it, and necessarily should be approached on a country-by-country basis through the normal dialogue between recipients and donors.

41. A number of low-income countries, including several in Sub-Saharan Africa, have demonstrated the capacity to manage effectively a scaling up of the development effort supported by external assistance. To cite a few examples: Tanzania's scaling up of primary education; Indonesia's rapid development of rural infrastructure in its *kecamatans*; Uganda's accelerated expansion of poor people's access to primary health care and of programs to combat HIV/AIDS; Mozambique's transformation of its growth performance by harnessing significant aid flows effectively in support of stepped-up domestic reform and investment; and Vietnam's rapid reduction of poverty and the incidence of scourges such as malaria. Detailed work on absorptive capacity in Ethiopia recently carried out by the World Bank, in cooperation with the government, shows the feasibility of substantial increases in aid in support of the MDGs being utilized effectively but also underscores the importance of appropriate sequencing of aid to minimize costs and ensure delivery of desired development results. There are also many countries where absorptive capacity is weak at present and increases in aid need to be more measured. Absorptive capacity is neither static nor exogenous to aid; aid can be instrumental in expediting the build-up of capacity.

42. ***Tailoring aid to the needs of LICUS.*** Support to capacity-building is particularly important for low-income countries under stress (LICUS). Appropriately timed and directed aid can be effective in these situations. Key elements of effective support are appropriate sequencing of aid within a longer-term engagement (rather than a stop-go or quick-in, quick-out approach), and the use of a mix of instruments and delivery mechanisms responsive to specific local conditions while supporting the longer-term build-up of national institutional capacity. Well-timed aid can also be quite productive following adverse exogenous shocks, helping to limit the diversion of development resources into short-run relief efforts.

43. ***Raising aid quality.*** Increasing the quality of aid is just as important as increasing its quantity. As noted above in relation to the financing of human development services, aid is often fragmented and volatile, aligned more with donor agendas and preferences than country priorities, and entails high transaction costs. Fortunately, these issues are now receiving increased attention and progress is being made, but it is slow and uneven. The outcome and follow-up to the Second High Level Forum on Aid Effectiveness, held in Paris in early March, must lead to a significant step-up in progress. Key areas for attention are achieving closer strategic and operational alignment with country-owned and -led strategies (PRSs or other national development strategies), improving the predictability of aid (including making longer-term commitments where recipient performance warrants it), and strengthening the focus on development results. A notable outcome of the Paris Forum is the adoption of a set of indicators of aid quality that should help with closer monitoring of progress and reinforcement of accountabilities.

44. ***Debt relief.*** For heavily indebted poor countries, debt relief is important to increase the fiscal space for much-needed increases in spending to promote growth and reduce poverty and to relieve the debt overhang. Continued and effective implementation of the HIPC Initiative remains key. With respect to current proposals for additional debt relief, efforts should be made to reach closure in 2005. Any additional debt relief should not cut into the provision of needed new financing, which for these countries should be primarily in the form of grants. Recent steps to increase the share of grant financing in IDA and other MDB concessional funds and to link grant/credit mix to recipients' debt sustainability represent notable improvements in the framework for assisting poor countries.

45. ***Innovative financing modalities.*** The year 2005 should also see progress on ongoing work on the merits and feasibility of innovative modalities for mobilizing resources to fund the needed increases in aid and ensure their timely availability, including the proposed International Finance Facility and global taxes related to important international externalities, such as carbon emissions. Blending arrangements, that combine flows with different financial terms and characteristics to increase concessionality or gain leverage, also offer possibilities to augment resources for the MDGs agenda, in both low-income countries and middle-income countries with large pockets of poverty. Finally, the impressive scale of private contributions in response to the Asian tsunami, and major private contributions already made to causes such as combating HIV/AIDS, point to the importance of exploring mechanisms to enhance the role and effectiveness of voluntary contributions in supporting development.

III. Strengthening and Sharpening IFI Support

46. How are the IFIs contributing to the implementation of the above agenda—by supporting country development; drawing on sectoral, regional, and global programs and research; working through partnerships; and managing for development results. The report finds that there has been progress in each of these areas, but there is need to do more and pick up the pace.

47. ***Low-income countries.*** Recent replenishment negotiations for the AfDF, AsDF, and IDA endorsed a common framework for the use of PRSs that reflect the MDGs, grants, debt sustainability, and disclosure of country policy and institutional assessment scores. They also supported the piloting of results-based country strategies, the adoption of results measurement systems, and special programs for low-income countries under stress. As these replenishments cover some 95 percent of all multilateral development bank (MDB) programs in low-income countries, they have established a concrete platform for accelerating the implementation of these initiatives and their harmonization across MDBs. Reflecting independent evaluations, the World Bank and the IMF need to support stronger country leadership of the PRS process, while deepening the dialogue with the countries on the policy agenda. Clearer ownership of the PRS by

the country, with the Bank and the Fund reflecting their own views in JSANs and related process, would also help to make clearer the accountabilities of Bank and Fund staff.

48. ***Middle-income countries.*** For middle-income countries, there also has been a trend toward harmonization across the MDBs, albeit slower, reflecting the evolving and differentiated needs of these countries themselves. Middle-income countries have been vocal in calling for reductions in the costs of doing business with the banks, especially when those costs arise in the context of replenishment exercises for concessional funds that they cannot access. Competitive pressures among the banks have led to the transmission of innovations in one—such as the liberalization of expenditure eligibility categories for investment lending or the reliance on country systems—to the others in fairly rapid succession.

49. ***Knowledge and capacity building.*** IFI research has helped to articulate the global development agenda, making notable contributions on trade and aid, among other areas. The IFIs have also contributed much on trade capacity building and enhancing countries' fiduciary and fiscal systems for the absorption of aid. But they need to do more—including systematically keeping track of where the capacity gaps are, as a basis for guiding donor actions—if developing countries are to fully utilize the opportunities emerging from the dismantling of trade barriers and increasing the scale and effectiveness of aid proposed above.

50. ***Partnerships.*** The MDBs are partnering more effectively with clients, with each other, and with other donors. In large part, this progress is due to the developments cited above with respect to the replenishments of MDB concessional windows and the greater reliance on country systems for the processing of MDB funding. Vis-à-vis civil society, a major issue remains disclosure, where despite improvements many critics feel that the IFIs have not met a standard of accountability commensurate with their power and influence in a number of areas. Meanwhile, Bank-Fund relations have continued to mature, based on comparative advantage and a mandate-driven division of labor highlighted by ongoing collaboration on PRSs, debt sustainability analysis and its application to concessional and grant financing, and the further streamlining of structural conditionality.

51. ***Managing for development results.*** The past year has seen important milestones in building results-based systems in the MDBs. These include: the completion of the first cycle of the IDA-13 Results Measurement System; the adoption of the IDA-14 and AfDF-X Results Measurement Systems; the completion of Results-Based Country Strategy pilots by AsDB and the World Bank, and their commitment (along with AfDB's) to carry out further pilots in 2005; IDB's adoption of a Medium-Term Action Plan for Development Effectiveness; the new independence of AsDB's evaluation department; the launch of the (draft) Results Sourcebook; and the major PRSP evaluations carried out in cooperation by OED and IEO. The IMF is considering how to conceptualize and operationalize the results agenda within its institutional framework, drawing on specific recommendations from various reports of the Independent Evaluation Office.

52. ***Priorities in the Agenda.*** How can IFIs strengthen and sharpen their support going forward? The assessment suggests five priorities for action and monitoring progress:

- Support the deepening of the PRS framework in low-income countries, and the operationalization of the MDGs and alignment of IFI assistance within that framework. For LICUS, support to building institutional capacities is a critical priority.
- Continue to adapt approaches and instruments to better respond to the evolving and differentiated needs of middle-income countries, including further streamlining conditionality and investment lending.
- Ensure that the implications of the dismantling of trade barriers and increasing the scale and effectiveness of aid are adequately reflected in support for country capacity building, so that

emerging opportunities can be fully utilized. Ensure that IFI support for global and regional public goods adds value.

- Strengthen partnerships and harmonize further by improving transparency, reducing red tape and enhancing the flexibility of assistance (through simplification and use of sectorwide approaches), and promoting the development and use of countries' own systems—for procurement, financial management, and environmental assessment.
- Strengthen focus on results and accountability by supporting country efforts to manage for development results (strengthening public sector management and development statistics) and furthering progress within IFIs in enhancing the results-orientation of their country strategies and programs and quality assurance processes. Adopt common framework for self-evaluation of MDB performance and results measurement, and adapt to IMF operations as much as possible.

IV. Issues for Discussion

53. The following issues are proposed for Ministerial consideration at the Development Committee meeting on April 17, 2005:

- Do Ministers broadly agree with the five-point agenda for accelerating progress toward the MDGs summarized above and the related accountabilities of developing and developed countries? What in their view are the key outcomes to achieve in this important year in order to move the agenda forward?
- Do they broadly agree with the indicated priorities for IFIs to strengthen and sharpen their support to this development agenda? Are there particular areas or actions that they would wish to emphasize?
- What guidance would Ministers offer on how the global monitoring exercise should evolve in facilitating the Development Committee's strategic oversight of progress on the global development agenda, a key issue being how to strike the right balance between comprehensiveness and selectivity in future GMRs?

2. Spurring and Sustaining Economic Growth

1. Economic growth is central to reducing poverty and meeting the MDGs. Globally, prospects are promising for the achievement of the income poverty goal by 2015. The two countries which in 1990 were home to the highest number of poor people, China and India, have accelerated economic growth for a sustained period and made significant inroads into reducing the incidence of poverty. Due partly to their efforts, East Asia has already achieved the poverty goal, and South Asia is on target. Most of the other regions are making steady progress and are expected to either achieve the goal or come close, even as some pockets of poverty remain at both the national and subnational level. In Sub-Saharan Africa, however, the momentum has been slower, and the bulk of countries in the region are at severe risk of falling short.

2. To meet the challenge of accelerating progress toward the poverty goal, Sub-Saharan Africa will need to accelerate economic growth substantially. Increases in overall income tend to lift the income of the poor proportionately, and there seems little doubt that differences in policies and institutions have played a major role in explaining the divergent poverty trends seen, for example, in East Asia and Sub-Saharan Africa. The growth process in Africa, although subject to some initial disadvantages such as geography and the incidence of disease, responds to the key policy drivers in a fundamentally similar manner to economies elsewhere. Thus, the promotion of higher rates of growth through policy and institutional reforms is critical for poverty reduction (Box 2.1), and outlining the domestic agenda for spurring and sustaining growth in Sub-Saharan Africa is the focus of this chapter.

3. More recently, there is evidence that Sub-Saharan Africa has begun to turn the corner. Twelve countries are currently experiencing a growth acceleration of the type more commonly associated with other regions. More generally, improvements in both economic policy and political institutions have supported recent increases in growth rates across the region. However, these achievements in spurring growth are only the beginning of what is needed to sustain the necessary improvements in income and standards of living. Historically, it has been considerably more difficult to sustain growth than merely to initiate it.

4. Higher aid alone is insufficient to spur and sustain higher growth in Sub-Saharan Africa. The relatively poor economic performance over the past four decades in Sub-Saharan Africa, and the difficult prospects for reaching the MDGs, have led some analyses to conclude that many African countries are caught in a 'poverty trap'. The suggestion in these analyses is that large amounts of upfront aid are thus necessary to jumpstart the growth process across the region. However, the provision of more aid, by itself, does not constitute a growth strategy. While certain forms of aid do appear to raise the growth rate, the impacts can be relatively small and subject to diminishing returns. There is also no systematic evidence supporting the empirical relevance of poverty traps.

5. The policy agenda discussed in this chapter is daunting in its breadth, complexity, and ambition. It would be very useful to describe the minimum set of reforms necessary to spur growth, or the larger set that is sufficient to sustain growth. Unfortunately, neither is possible: the relationship between growth and policies, shocks, external environment, aid, and other factors is complex. The policy recommendations contained in this chapter reflect a wealth of cross-country, time-series, and case-study experience. However, it is also true that growth often happens in cases in which several of the components are not in place. Similarly, countries may undertake substantial reforms and observe a disappointing growth pay-off. With respect to growth accelerations, for example, occurrences are both fairly common and hard to explain although there is evidence that both policy and institutional improvements help to extend the length of these episodes.

6. What, then, are the priorities? First, the broad priorities emphasized in this chapter are macroeconomic stability, and institutions and policies that promote private sector growth. For countries that have achieved broad macroeconomic stability, better expenditure management is critical to sustaining stability and creating fiscal space for investments aimed at growth promotion and poverty reduction, including those that complement private-sector activity. To invigorate the private sector and encourage a wider range of profitable opportunities to be taken up, it is essential to remove excessive regulatory and institutional constraints, and to improve weak infrastructure. To underpin these efforts, it is critical that recent progress on political governance begin to translate more clearly into progress on economic governance. The latter is important in terms of improving the private sector environment and increasing the effectiveness of the public sector. Transparency in its various dimensions is a theme underlying many of the key interventions here. Trade liberalization is also a critical domestic policy priority in many cases, and is covered in Chapter 4.

7. Even this discussion of priorities is broad. This is inevitable, however, because in the end the best path will be country-specific. While there are many similarities, different countries face different problems to different degrees. Equally importantly, the relationship between different aspects of reform will vary across countries. It is clear that progress must take place on a number of fronts, and equally clear that the key areas will vary from country to country. In many cases, trade liberalization may open up possibilities for reform in other areas. In others, some improvement in the regulatory environment may have an important impact. In still others, improvements in the regulatory environment or even macroeconomic stability may depend on improvements in public sector governance. In the end, countries must adapt the recommendations, both in terms of form and sequence, to their own circumstances, in the context of country-owned poverty reduction strategies. However, the priorities and indicators of progress described in this chapter should help determine the direction of reform and should help in assessing progress.

8. In Sub-Saharan Africa, home to the majority of low-income countries under stress (LICUS), the road ahead is not easy but there is a need for bold action. Within the agenda outlined above, there is substantial room for enabling virtuous circles. For example, as credible evidence of a change in the macroeconomic policy regime takes hold, the uncertainty attached to fixed investments begins to decrease, and as more investors consider taking up profitable opportunities, the demand for an improved investment climate also increases. Because there will remain vested interests intent on maintaining the status quo, political commitment is key to initiating reforms and staying the course.

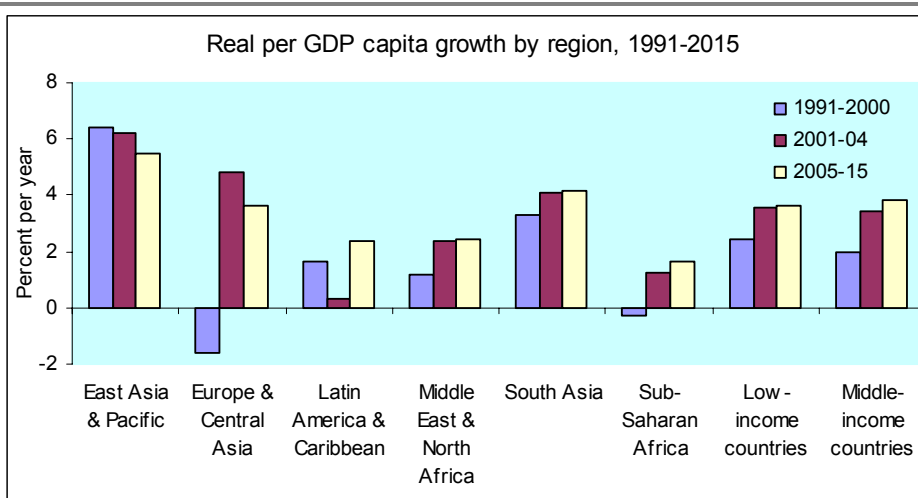
9. The scale of the challenge in Sub-Saharan Africa means that domestic efforts will nonetheless require external support. Large increases in aid will be necessary, particularly to accelerate progress towards the non-income MDGs, as discussed in chapter 3. Improved access to the markets of developed countries will be necessary to promote and diversify exports, and this is discussed in chapter 4, and ensuring that external debt loads are sustainable will be necessary to ease the burden on fiscal policy, and this is discussed in chapter 5.

10. Section I provides the context for the discussion of the growth agenda by (i) reviewing growth projections and the outlook for poverty rates over the medium term; (ii) analyzing the record on economic performance in Sub-Saharan Africa; and (iii) identifying conditions which have historically accompanied the onset of, and tended to sustain, episodes of growth acceleration. The subsequent sections—II to IV—then focus on the three key elements of the growth agenda: the macroeconomic environment, the private investment climate, and public sector governance.

I. Growth and Implications for Poverty

11. Overall, the outlook for growth over the next decade remains promising, and prospects have recently brightened in Sub-Saharan Africa (Figure 2.1).¹ Strong growth should continue in East Asia even as China's spectacular growth rates ease over the medium-term, and in Europe and Central Asia as the benefits of accession to the European Union continue to flow to several countries in the region. Elsewhere, ongoing reforms should ensure an improved investment climate and a stable macroeconomic environment, particularly in South Asia, where the average increase in per capita income is expected to exceed 4 percent per year over 2005-15.² After a difficult period, including the effects of contagion from the lengthy crisis in Argentina, per capita growth in Latin America is expected to average close to 2.5 percent per year. In Sub-Saharan Africa, performance has improved since the mid-1990s (see discussion below), but the region continues to lag in terms of economic growth.

Figure 2.1 Growth prospects are promising, but wide regional disparities remain



Source: Staff calculations.

12. This forecast scenario would allow global achievement of the income poverty MDG. Worldwide, the poverty headcount index would fall from 27.9 in 1990 to 10.2 percent in 2015, and the number of poor people (on the equivalent of a \$1-a-day basis) would fall below 625 million from about 1.22 billion in 1990 (Table 2.1). To a large extent, these achievements reflect the success in India and China, which had most of the world's poor in 1990 but where growth in income has since accelerated and remained high for some time. In Europe and Central Asia, where the rate of poverty is relatively low, the deterioration in poverty rates that

¹ The scenario presented is based on current trends and primarily useful as a reference point.

² The tsunami disaster that hit Indian Ocean countries on December 26, 2004 left behind a human tragedy of epic proportions. The quick humanitarian and financial response of the rest of the world assisted the affected countries to quickly launch the recovery and reconstruction process and also helped to limit the economic and financial costs of the tragedy. Based on initial assessments, the macroeconomic impact is expected to be modest for Indonesia, India, Thailand and Sri Lanka. Although the impact on growth and inflation will also be modest in the Seychelles, the economy was not as robust as the other countries prior to the disaster, and there may be increased pressure on the fiscal position and the balance of payments in 2005. In the Maldives, where the physical destruction was also significant, the macroeconomic impact may be more pronounced, with initial estimates suggesting that output in 2005 may be lower than forecast by some 5 percentage points of GDP. Somalia was also affected by the disaster, but the relative lack of information and the absence of an internationally recognized government operating in the country have slowed the pace of assessments, which are currently underway.

accompanied the sharp drop in incomes in the early period of the 1990s has been reversed, as it has in Latin America.

Table 2.1 Growth rates and decline in poverty by region, through 2015

Region	Annual average growth rates (2005-15)		Population living under \$1 per day					
	Scenario		Headcount (percent)			Number of persons (millions)		
	Per capita GDP	GDP	1990	2001	2015	1990	2001	2015
East Asia and Pacific	5.5	6.3	29.6	14.9	0.9	472	271	19
China	6.0	6.7	33.0	16.6	1.2	375	212	16
Europe and Central Asia	3.6	3.7	0.5	3.6	0.4	2	17	2
Latin America and the Caribbean	2.4	3.6	11.3	9.5	6.9	49	50	43
Middle East and North Africa	2.4	4.2	2.3	2.4	0.9	6	7	4
South Asia	4.2	5.6	41.3	31.3	12.8	462	431	216
Sub Saharan Africa	1.7	3.6	44.6	46.4	38.4	227	313	340
Total	3.6	4.8	27.9	21.1	10.2	1,219	1,089	622
Excluding China	2.8	4.2	26.1	22.5	12.9	844	877	606

Source: Staff calculations.

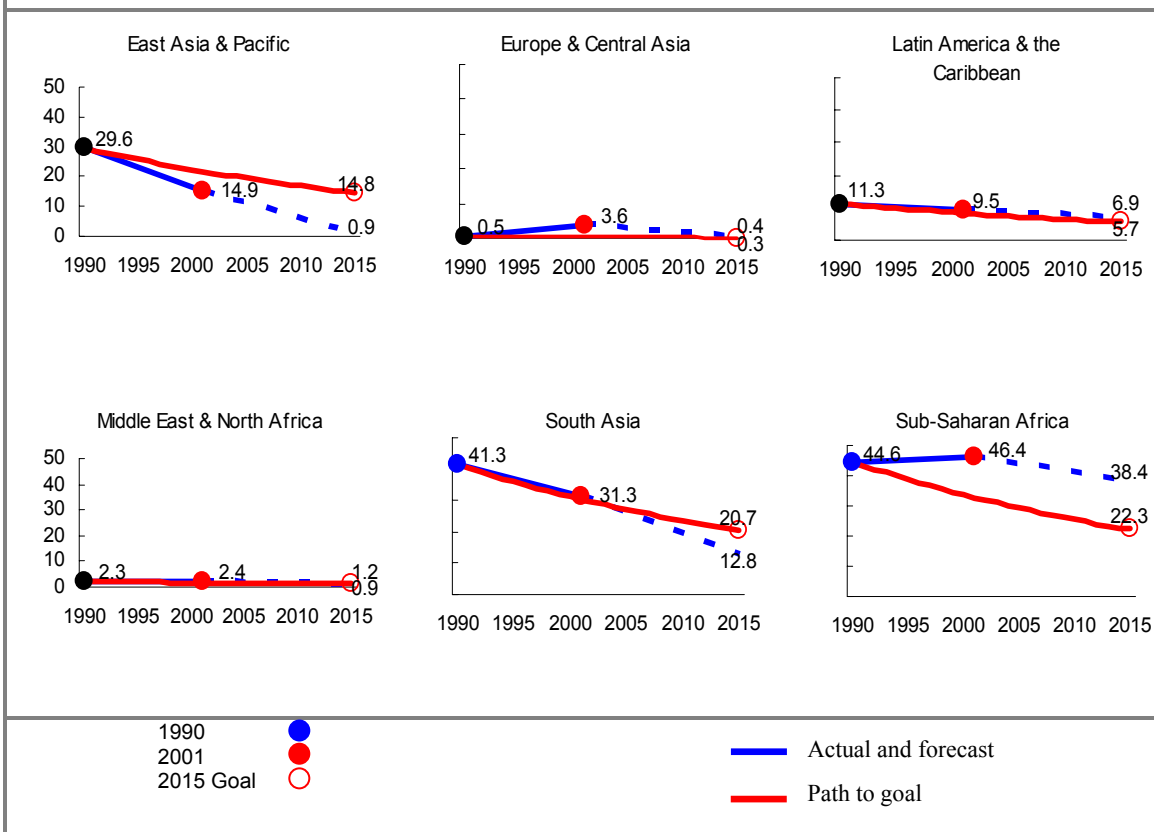
13. Still, many individual countries are not on track to achieve the poverty goal, including the majority of countries in Sub-Saharan Africa. Even in regions with overall strong performance and prospects for achieving the poverty MDG, some countries may need to substantially accelerate progress, such as Papua-New Guinea and Cambodia in East Asia. In some large middle-income countries, while the national poverty rate may be low, some subnational regions continue to have large concentrations of poverty, such as inland western provinces in China, some southern states in Mexico, and the northeast region of Brazil.³

14. In Sub-Saharan Africa, reaching the poverty goal will require a substantial acceleration in income growth or a significant increase in the poverty elasticity of growth. While the recent pickup in growth has improved prospects, the economic stagnation of the early 1990s caused poverty rates, already the highest in the world in 1990, to increase even further by 2001 (Figure 2.2). On the basis of household surveys, which are available for 28 countries (covering 78 percent of the region's population and 87 percent of the region's GDP), the weighted average growth rate in income per capita required for achievement of the poverty goal is estimated at approximately 5 percent (Table 2.2). Of these 28 countries, Cameroon, Ethiopia, Senegal, South Africa and Swaziland have a required per capita growth rate lower than 3 percent per annum, leaving them well positioned to meet the poverty goal. Also close are Mauritania and Mozambique, where the required per capita growth rate is lower than 3.5 percent per annum. Together, this group of 7 countries represents under 1/4 of the population of Sub-Saharan Africa.

³ Additionally, for some regions, the \$1-a-day poverty line may underestimate the extent of poverty. Using a \$2-a-day definition of poverty, the headcount measure for East Asia and Pacific would be 69.9 percent for 1990 and 11.3 for the 2015 forecast; for Europe and Central Asia, it would be 4.9 percent for 1990 and 5.2 for the 2015 forecast; and for Latin America and the Caribbean, it would be 28.4 percent for 1990 and 19.6 for the 2015 forecast.

Figure 2.2 Most regions will reach the poverty goal by 2015, but Sub-Saharan Africa is seriously off track

Actual and projected decline in the number of people living on less than \$1 a day, 1990-2015



Source: Staff estimates.

Table 2.2 Required growth for achievement of the poverty MDG in Sub-Saharan Africa, 2005-2015

Required growth of GDP per capita rate (2005-2015)	Number of countries	Population, 2000 (millions)	Population share (percent)	2000 GDP share (percent)
< 2	1	9.5	1	2
2 - 3	4	124.5	19	52
3 - 4	2	20.2	3	1
4 - 6	4	44.4	7	5
> 6	17	315.4	48	27
Total	28	514.0	78	87

Note: For the sample of 28 countries, the weighted average required growth rate in GDP per capita is 5.2 percent.

Source: Staff estimates.

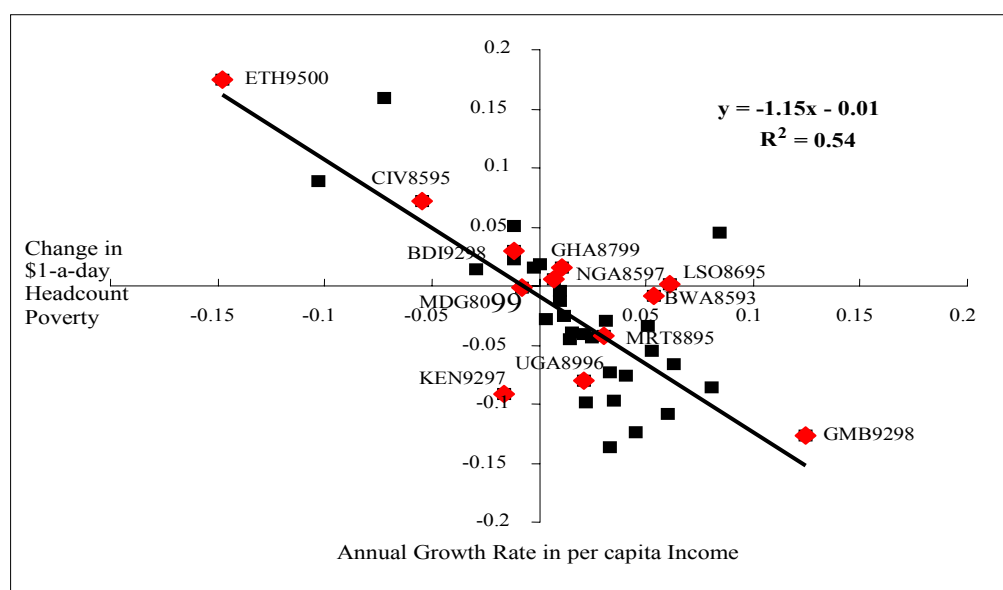
15. Ensuring that Sub-Saharan Africa makes significant progress towards the poverty goal will require substantial efforts from the countries in the region and all development partners. In terms of a successful example, the region might look to South Asia, where similar initial disadvantages, including a high incidence of conflict, and similar levels of income have not prevented faster progress towards the MDGs. In this region, an improving investment climate and stronger policies have sustained a period of rapid economic growth and allowed significant inroads on the incidence of poverty. Important developments in service delivery such as NGO and private provision of basic services have also contributed to the MDGs in some countries. Nevertheless, sustaining and accelerating economic growth, pushing for greater effectiveness of public expenditures, making services work for the people, and dealing with lagging regions and countries remain vast challenges in South Asia (Box 2.2).

Box 2.1 Growth is central to sustained poverty reduction

The strong relationship between income growth and poverty reduction has been documented in a large empirical literature and can be seen from the figure below, for a large sample of developing countries.* Here, the change in poverty is estimated by the \$1-a-day headcount measure. Also evident from the figure is the wide variation around this average relationship. What are the implications of these differences for poverty reduction?

Consistent with other developing regions, the majority of countries in Sub-Saharan Africa are clustered in the top-left quadrant (with negative growth and rising poverty) or in the bottom-right quadrant (with positive growth and declining poverty). Sub-Saharan African countries have a median per capita growth rate, at 0.8 percent per year, substantially lower than the overall median, at 2.1 percent per year, and most of them fall above the regression line, indicating a poverty reduction performance lower than expected for a typical developing country with similar growth performance.

The figure also indicates that there are important differences across countries in the rate at which poverty declines for a given rate of growth. Within Sub-Saharan Africa, Uganda, Mauritius, and Ghana, for example, had similar rates of growth (in the 1 to 3 percent range), but the rates of change in poverty ranged from about -8 percent to +2 percent per year. Mechanically, there are two reasons for these differences in country performance at a given rate of growth: (i) cross-country differences in the sensitivity of poverty to growth, holding constant the distribution of income; and (ii) cross-country differences in how the distribution of income changes over time.



Further analysis reveals that Sub-Saharan African countries tend to have a relatively low sensitivity of poverty to growth, and that the contribution of changes in inequality to changes in poverty in

Sub-Saharan Africa is very similar to that in the developing world as a whole. Together, these results suggest that poverty reduction in Sub-Saharan Africa over the past two decades has been disappointing for two major reasons: (i) growth itself has lagged that in the rest of the developing world, and (ii) the sensitivity of poverty to growth (holding constant the distribution of income) has also been relatively low. This low sensitivity of poverty to growth can, in turn, be traced back to Sub-Saharan Africa's very low income levels and unusually high inequality.**

What are the implications for policy? At a basic level, growth remains central for poverty reduction in Africa, and all the more so given that Africa's low income levels imply a relatively low sensitivity of poverty to growth. Moreover, the dominance of growth as the driver for changes in poverty seems to be even clearer over longer time periods, suggesting that for sustained reductions in poverty, growth is particularly critical. Finally, evidence does not suggest that the policy and institutional reforms aimed at promoting growth lead to higher inequality, which would temper the poverty impacts of growth.***

Recent case studies on the factors driving pro-poor growth in 14 developing countries confirm that macroeconomic policy reforms were followed by substantially higher growth without any increase, over the short-run, in the Gini coefficient.**** In Burkina-Faso and Uganda, for example, per capita growth increased significantly during the first five-year period of economic reforms: by, respectively, 2.0 and 4.5 percentage points annually. At the same time, the Gini coefficient fell from about 0.47 to 0.45 in Burkina-Faso, and although lack of pre-reform data pre-empts a similar comparison for Uganda, a relatively low post-reform Gini coefficient of 0.36 does not raise serious concerns about rising inequality.

* Sub-Saharan African countries are labeled in the figure with the World Bank country acronym and the years over which the change in poverty is calculated. For details on the data and decomposition methodology used in this box, please refer to Kraay (2005).

** World Bank (2004) confirms that Sub-Saharan Africa and Latin America are the most unequal regions in the world.

*** See, for example, Dollar and Kraay (2002) and Ghura, Leite and Tsangarides (2002).

**** See Lopez, Humberto (2004).

Box 2.2 Stronger growth and more effective service delivery are key to accelerating progress toward the MDGs: the case of South Asia

With income per capita in the order of \$460, the eight countries* of South Asia are home to nearly 40 percent of the world's poor living on less than a dollar a day. Since 1990, the region has experienced rapid GDP growth, averaging close to 5.5 percent a year. This has helped to reduce the consumption poverty rate: India, the largest country in the region with a population of more than one billion has, for example, reduced the poverty rate by 7-10 percentage points since 1990. Most other countries in the region registered a similarly significant reduction in poverty over the period. Two notable exceptions are Pakistan, where poverty has stagnated at around one third of the population, and Afghanistan, which is emerging from decades of conflict.

In addition, improving the delivery of human development and related key services has been instrumental in boosting MDG-related outcomes and prospects. Three places in the South Asia region stand out as having good MDG indicators for their income levels. Sri Lanka and the Indian state of Kerala have an established pattern of good performance (more consistent with high-income countries) that reflect the priority successive post-independence governments (and even pre-independence governments) have given to investments in human development. Bangladesh has shown remarkable progress with many of the MDGs, despite its low income level and high incidence of poverty (second only to Afghanistan in the region), adverse initial conditions, high population density, contentious politics, and vulnerability to natural disasters. Bangladesh's success has owed much to an effective scaling up of basic services built in large part on a combination of effective partnerships between the public sector and NGOs and the resulting high degree of community involvement, local innovation and experimentation.

Although reducing poverty remains a huge challenge for South Asia, the poverty MDG is within reach with continued high economic growth raising incomes, widening economic opportunities and creating jobs for the poor. Sustaining rapid economic growth will require continued improvements throughout the region in the investment climate, basic infrastructure, and effective delivery of basic services within a framework of macroeconomic (especially fiscal) stability.

A number of other goals are also within the region's reach if access to services for poor people and effective delivery to them improve, as already demonstrated by the region's own success stories. Despite substantial public expenditures, some countries and states continue with services in health, education, and water and sanitation that fail for poor people. In many instances, this is due to the fragile accountability between users, providers, politicians and policymakers caused by ineffective public institutions, poor focus on outcomes and incentives, political clientelism and patronage, and the difficulty of monitoring and supervision. However, with democracy firmly rooted across the region, the devolution of political power to lower levels of governments is proceeding. While progress varies, decentralizing resources and responsibilities to local service providers and communities holds the prospect of improved service delivery. Against this backdrop, the universal primary education, gender equality, child mortality and major disease MDGs would appear within reach of most of the countries in the region, with only Pakistan, Afghanistan, and the poorer states in India remaining off track unless progress quickens substantially.

* Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.

Africa's Growth in Retrospect ⁴

16. Although performance has recently improved, the economic record over the past four decades for Sub-Saharan Africa presents a somber picture. Not only did growth in per-capita real GDP lag other developing regions, but growth rates were also more volatile (Figure 2.3).⁵ Of the 45 Sub-Saharan African countries, only 5 consistently recorded annual per-capita real growth rates exceeding 2 percent: Botswana, Cape Verde, Mauritius, Seychelles and Swaziland.⁶ Economic disruptions have also been widespread, with close to $\frac{3}{4}$ of the countries recording at least one year with a per capita growth rate lower than -10 percent. Consequently, Africa's real income per capita has steadily declined relative to other regions, and in terms of level, it now stands roughly unchanged from the early 1980s (Figure 2.4).

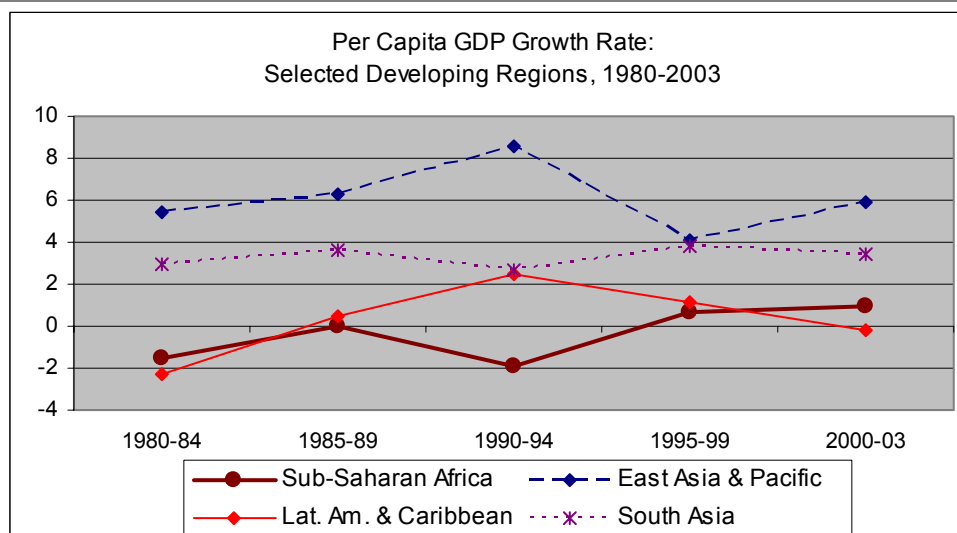
17. At the same time, income distributions may have become more unequal. Empirical estimates indicate that overall inequality in Africa has increased since 1970, with the income of the poorest deteriorating but the income of the richest remaining stable. These findings have potentially important political-economic consequences: with the elite buffered from the poor economic performance, they are less likely to introduce the reforms necessary to improve Africa's outlook.⁷ This argument is perhaps more evident in those economies where the elite has a more autonomous source of income, such as oil-sector rents.

⁴ This section draws on IMF (2005b).

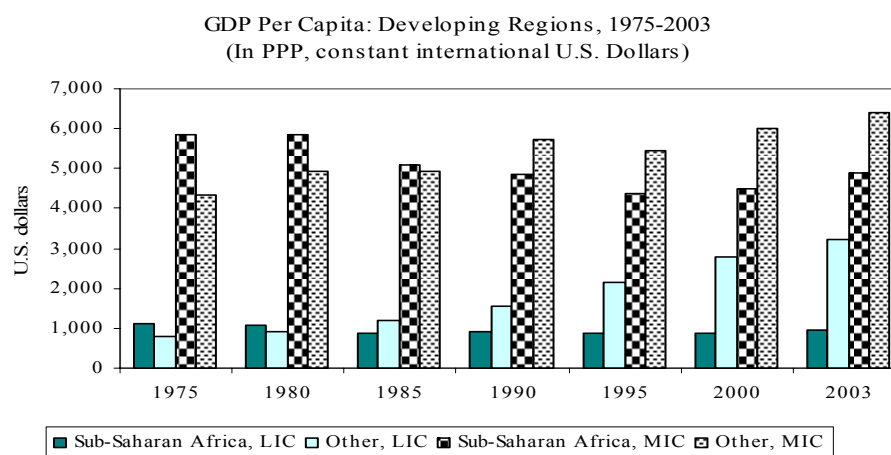
⁵ The Figure excludes Europe and Central Asia, for which membership has varied considerably across the period covered, and Middle East and North Africa, where heavy reliance on oil complicates regional comparisons. In either case, the relevant conclusions are robust to their inclusion.

⁶ Equatorial Guinea should also be included in this group, but its period average growth rate has been heavily influenced by spectacular oil-led growth since the mid-1990s.

⁷ The estimates of inequality and the argument on the political economic consequences of observed patterns across Africa are both due to Artadi and Sala-i-Martin (2003). The same study points out that most of the inequality within Africa can be accounted for by inequality within countries rather than across countries.

Figure 2.3 Sub-Saharan Africa has lagged behind other regions

Source: Staff calculations.

Figure 2.4 And the gap in income levels is widening

Note: In this figure, income classification groups follow the earliest available World Bank analytical classification (1987), in order to minimize the effects of selectivity bias. The conclusion on a widening gap is robust to the use of classifications for different years.

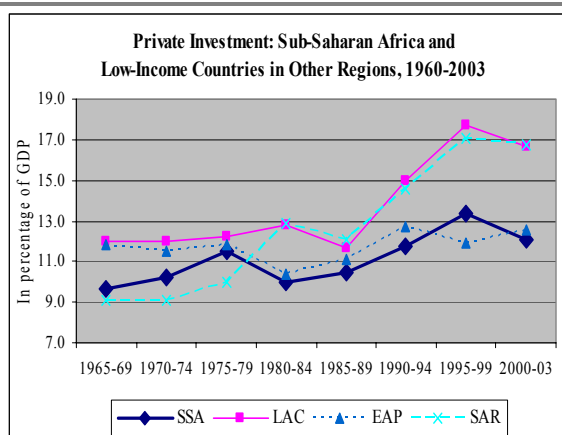
Source: World Development Indicators; and staff calculations.

18. While factor accumulation rates were lower than other regions, the primary source for the slower growth in Sub-Saharan Africa was the negligible improvement in productivity. The rate of private investment was consistently lower in Sub-Saharan Africa, even when the comparison is restricted to low-income countries in other developing regions (Figure 2.5), with a relatively

small number of major oil producers receiving the bulk of the increase in private investment in the 1990s.⁸ Similarly, modest increases in education implied a smaller contribution from increased human capital than for most other developing regions.⁹ But the key source for the economic underperformance was that total factor productivity growth was nil between 1960 and 2002, unlike in other developing regions where such efficiency improvements played an important role in supporting growth.¹⁰

19. On a more positive note, economic growth from the mid-1990s has improved to levels last recorded in the region in the early 1970s. Since 1995, more than 15 Sub-Saharan African countries have persistently recorded annual per capita real growth rates in excess of 2 percent, compared to only 5 in 1960-1994. This improvement has benefited a range of countries, including low- and middle-income countries and even those that have suffered conflict. On the whole, however, oil-based economies have enjoyed the best performance with real per capita growth of close to 4 percent per year since the mid-1990s.

Figure 2.5 Lower investment rates in Sub-Saharan Africa have been a source of low growth



Source: World Economic Outlook and World Development Indicators databases; and staff calculations.

20. What explains the poor economic record and the incipient recovery? Sub-Saharan Africa has suffered, and continues to suffer, from a number of major disadvantages relative to other regions. In particular, it has a disproportionately large number of landlocked countries which, given weak inter-continental infrastructure, are unduly dependent on trade with their immediate neighbors. Many of its countries are heavily dependent on low-value agriculture and therefore vulnerable to climatic fluctuations, including to severe periodic droughts. Its population endures high rates of malaria, HIV/AIDS and other communicable diseases.¹¹ Since 1970, one quarter of

⁸ The major oil producers are Angola, Cameroon, Chad, Equatorial Guinea, Gabon, Nigeria and Republic of Congo.

⁹ Bosworth and Collins (2003, p. 8).

¹⁰ See Bosworth and Collins (2003) and Tahari et al (2004). Growth in “total factor productivity” reflects not just changes in economic efficiency *per se*, but also the influence of growth determinants not otherwise included in the measured changes in either physical or human capital, including political instability and conflicts, droughts and other exogenous shocks, and changes in government policies and institutions.

¹¹ While HIV prevalence rates differ widely across countries, ranging from 1 to almost 40 percent, average life expectancy across the region has fallen over the last 15 years, largely owing to HIV/AIDS. The primary effect of HIV/AIDS is an increase in mortality and a deterioration in health, primarily among young adults. In turn, HIV/AIDS affects most of the common indicators of living standards, such as income, health standards, and access to education, and success in combating HIV/AIDS, along with other communicable diseases, is one of the MDGs. However, the

its countries have experienced the ravages of civil conflict. In common with other developing regions, Sub-Saharan Africa has also been handicapped by lack of access for its exports to markets of developed countries.

21. There is a general view, however, that the fundamental drivers of growth operate in Africa in much the same manner as elsewhere.¹² Critically, on the main dimensions of macroeconomic and structural policies as well as on the effectiveness of institutions, there is a tendency for Sub-Saharan Africa to under-perform relative to other developing regions. The World Bank's Country Policy and Institutional Assessment (CPIA) ratings confirm that Sub-Saharan Africa achieves, on average, a lower score than other developing countries on each of the main subcategories assessed: economic management, structural policies, social inclusion and equity policies, and public sector management and institutions. Additionally, macroeconomic instability, as measured, for example, by the standard deviation of consumer price inflation or the parallel market exchange rate, has tended to be higher in Sub-Saharan Africa than most developing regions.¹³ Even when comparisons are restricted to low-income countries, the quality of macroeconomic policies is still somewhat lower in Sub-Saharan Africa (Table 2.3).

22. Empirical studies confirm that weak macroeconomic policies and governance have had a negative impact on growth in Sub-Saharan Africa. These studies indicate that Sub-Saharan Africa's growth could have been significantly raised by improved fiscal policies (including lower government consumption and smaller fiscal deficits), policies that promote human capital formation and private investment, and stronger institutions. Estimates of the additional growth that Sub-Saharan Africa would have enjoyed with the adoption of policies, institutions and rates of factor accumulation similar to other regions are in the range of 2 to 8 percent per year.¹⁴

23. One explanation for which there is no systematic empirical evidence is the view that poverty traps explain Sub-Saharan Africa's poor economic record. Proponents of such explanations argue that low productivity or savings rates make it difficult for poor countries to rise past a threshold level of income. The logic is plausible, given the persistence of poverty. In general, however, neither macroeconomic nor microeconomic evidence tends to be supportive of the existence of such traps. Additionally, the type of behavior in productivity and savings that are necessary at low levels of income to generate the poverty trap are not in evidence (Box 2.3).

channels through which the disease affects economic growth are not well understood. Studies focused on disruptions to the production process and additional health expenditures tend to find modest effects. On the other hand, studies that have attempted to capture some of the microeconomic impacts associated with the disease, find a larger effect on economic growth owing, for example, to disruptions in the process of accumulating human capital (Haacker, 2004).

¹² The earlier spotlight on unique drivers of African growth has given way to a more complex explanation as the empirical relevance of the "African dummy" has been eliminated and a more policy-relevant dialogue has focused on the underlying determinants of economic outcomes. See, for example, Hoeffler (2002).

¹³ Satyanath and Subramanian (2004) attributes the causes of long-run macroeconomic instability to the incidence of conflict, lack of openness to trade and ineffective political institutions. This raises the general question of the extent to which macroeconomic policy is itself a function of deeper determinants and thus not an independent driver of growth. It is clearly the case that macroeconomic performance is indeed partly driven by deeper political, economic and structural factors. However, a variety of evidence, including case studies and experience, suggests that there is a important role for macroeconomic policy itself. In any case, both macroeconomic policy and underlying institutional policies must be addressed simultaneously.

¹⁴ Artadi and Sala-i-Martin (2003) and Tsangarides (2005).

Table 2.3 Quality of Macroeconomic Policies in Low-Income Countries (in percent of countries)

	Fiscal Policy	Composition of Public Expenditures	Monetary Policy	Consistency of Policy Mix	Governance in the Public Sector	Governance and Transparency in Monetary and Financial Institutions	Trade Regime
Africa							
Unsatisfactory	42	68	17	30	46	30	14
Good	22	3	72	46	14	52	73
Other LICs							
Unsatisfactory	19	57	7	14	26	7	5
Good	48	10	74	55	14	63	86

Source: IMF staff assessments.

Note: policies are assessed as good, satisfactory or unsatisfactory. Percentages do not add to 100 as the intermediate category—satisfactory—is not shown.

24. Empirical evidence also offers some words of caution on the commonly proposed solution for poverty traps, namely large external resource transfers. Certainly, large increases in foreign assistance are needed in many Sub-Saharan African countries, including to allow a significant increase in key public services, as discussed in Chapter 5. Moreover, aid increases complement improvements in policy, institutions, and the international environment. However, the apparently limited growth impact of aid transfers, in combination with evidence on diminishing returns, implies that aid, by itself, does not constitute a growth strategy.¹⁵

25. The experience of oil windfalls in Sub-Saharan Africa in the late 1970s illustrates clearly that foreign-inflow-led public investment increases are not likely in themselves to lead to sustained growth. Because of large increases in both oil production and prices, countries such as the Republic of Congo enjoyed large windfalls during a period of close to ten years starting in the late 1970s, but the medium-run impact on standards of living was, at best, negligible (Box 2.4). What makes this example particularly relevant is that oil rents share many of the characteristics of and have similar macroeconomic impacts as foreign assistance flows.

Box 2.3 Can Poverty Traps Account for Africa's Underdevelopment?

A popular and plausible view of the reason for Africa's persistent underdevelopment is that much of the continent is caught in a trap: poverty leads to low savings, low productivity of investment, poor health, and other features that in turn cause poverty to persist.* There is, however, relatively little empirical work testing for poverty traps, and much of this tends not to be very supportive of the hypothesis.

The persistence of poverty across countries is consistent with the hypothesis. A number of papers have documented that the distribution of per capita incomes across countries is gradually becoming bimodal over the past 50 years, with a group of countries clustering around a quite low income level.** Other evidence comes from looking at the dynamics of individual incomes. Many models of poverty traps

¹⁵ The impact of foreign aid on the recipient country has been a controversial question in the academic literature, with earlier results often found not to be robust to changes in sample or specification. Recently, Clemens et al (2005) found that economic aid did raise growth in Sub-Saharan Africa, but they also found evidence of diminishing returns to aid. By their estimates, raising aid to Sub-Saharan Africa from current levels to the point at which marginal returns diminish to zero, at close to 17 percent of GDP, would raise growth in the region by 0.4 percent per year.

suggest that individuals receiving large negative income shocks may take a very long time to recover, and if incomes fall below a certain threshold, they may never recover. However, Lokshin and Ravallion (2004) carefully examine household data from Hungary and Russia, and conclude that there is no evidence of the kind of “threshold effects” associated with models of poverty traps.

Reduced-form evidence such as this can demonstrate persistence of poverty but not the nature of the underlying mechanism that may be creating a trap. Without this information it is difficult to distinguish a poverty trap from persistence in the determinants of poverty, or to formulate an appropriate policy response. Several recent studies have looked for evidence of particular mechanisms generating poverty traps. One such mechanism has to do with financial market imperfections. If the up-front cost of starting a small business is large, and poor individuals cannot borrow to finance this investment, then they will be unable to reap the benefits of self-employment. McKenzie and Woodruff (2004) use detailed data on microenterprises in Mexico and document that the costs of starting such a small business are surprisingly small, averaging just two weeks’ income of a typical low-wage Mexican worker. This casts doubt on the idea that fixed costs combined with financial frictions are responsible for poverty traps.

Another possible mechanism is that productivity is low at low levels of development. This may be because it is difficult to reach minimum efficient scales of production, or because complementary investments in public goods such as infrastructure are inadequate in poor countries. Once these thresholds are crossed it is possible that productivity increases sharply, allowing countries to reach much higher income levels. Kraay and Raddatz (2004) embed this mechanism in a standard growth model and show that for this mechanism to generate a poverty trap, it must be the case that productivity increases implausibly sharply with the level of development. In particular they show that if this mechanism is at work, we should expect to see increasing returns to scale that are substantially larger than is ever seen in the large empirical literature on estimating production functions. And somewhat more directly, McKenzie and Woodruff (2004) find in their Mexican data that returns to investment are very high even for very small enterprises.

Poverty traps might also arise because saving rates are low in poor countries. If many households live at the margins of subsistence, they will be unable to save very much. Public saving might also be low at low income levels because governments of very poor countries have difficulty with tax collection. These low saving rates may translate into sufficiently low investment rates that countries are unable to accumulate very large stocks of productive assets per capita. And if saving rates only begin to increase at much higher levels of development, then countries that start out poor may be stuck in a poverty trap.

Kraay and Raddatz (2004) confirm that savings rates do indeed tend to increase with income but not in a way that would explain the existence of a poverty trap for most countries in Africa. They also calibrate a growth model with subsistence consumption and find that the impact on saving and growth is substantial only for countries that start out very close to subsistence levels. However, the observed dispersion in per capita incomes, which is significant even within a poor region such as Sub-Saharan Africa, implies that the role of subsistence consumption can only explain low saving and growth in just a few of the very poorest countries in the region.

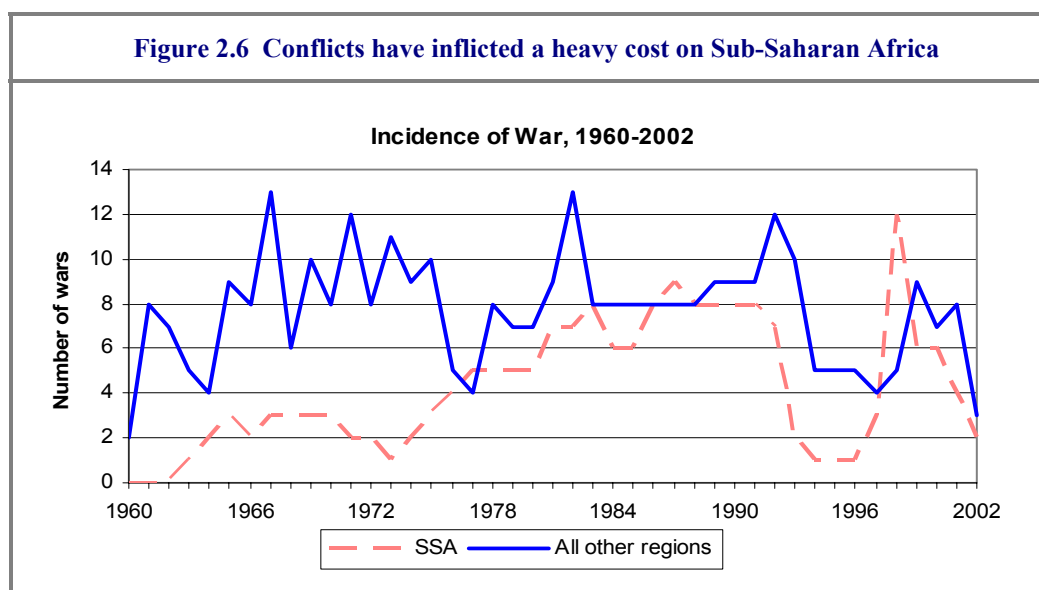
There are also potential poverty traps based on self-reinforcing dynamics in the area of governance. There is, for example, evidence that civil wars are both a consequence and a cause of low income, creating the possibility of a conflict trap (Collier et. al. 2003). There are also reasons to believe that high levels of corruption create self-perpetuating expectations of future corruption. The role of such mechanisms in generating stable poverty traps in growth models is not yet fully studied. In these cases, however, large increases in financial assistance might actually be counterproductive, increasing incentives and opportunities for corruption and conflict. As argued in Collier (2004) tackling these underlying dysfunctions directly must be done in parallel with any large increases in aid.

* The poverty trap view of Africa’s underdevelopment has also been made forcefully in Sachs et. al. (2004) and Collier (2004).

** See Azariadis and Stachurski (2004) for links between models of poverty traps and this kind of empirical evidence, and Quah (1993a, 1993b, 1996, and 1997) for the evidence, and Kremer, Stock and Onatski (2001) for a critique. Bloom, Canning, and Sevilla (2003) also provide closely-related cross-country evidence.

26. Along with economic stagnation, Africa has generally experienced a higher incidence of conflict and endured the associated heavy costs (Figure 2.6). In low-income Sub-Saharan Africa, the typical civil war has lasted around seven years and has led to a decline in GDP (relative to counterfactual) of just over 2 percent per year. It has typically taken around 14 years after the end of a conflict for a conflict-affected economy to recover to its pre-war growth path. Substantial spillover costs are also imposed on neighboring countries, whose economies also underperform. In the typical low-income African country, with a purchasing-power-parity value of GDP of around US\$20 billion, the present value of the cost of conflict is currently around US\$50 billion. Most costs arise in the form of externalities, accruing either to people in the future or to neighbors.¹⁶ Crucially, the risk of conflict tends to be strongly affected by low economic performance (Box 2.5).

27. The recent recovery in Sub-Saharan Africa has been supported by improvements in key macroeconomic indicators, particularly in the fastest growing economies, with some strengthening of political institutions. Across the continent, macroeconomic indicators have improved since the mid-1990s: price inflation is down to near historic lows; distortions in exchange rates have been mostly eliminated; fiscal deficits are lower; and export volumes have increased. School enrolments are also increasing along with budgetary allocations to both health and education, the percentage of countries holding competitive elections has increased, and the incidence of conflict has fallen.



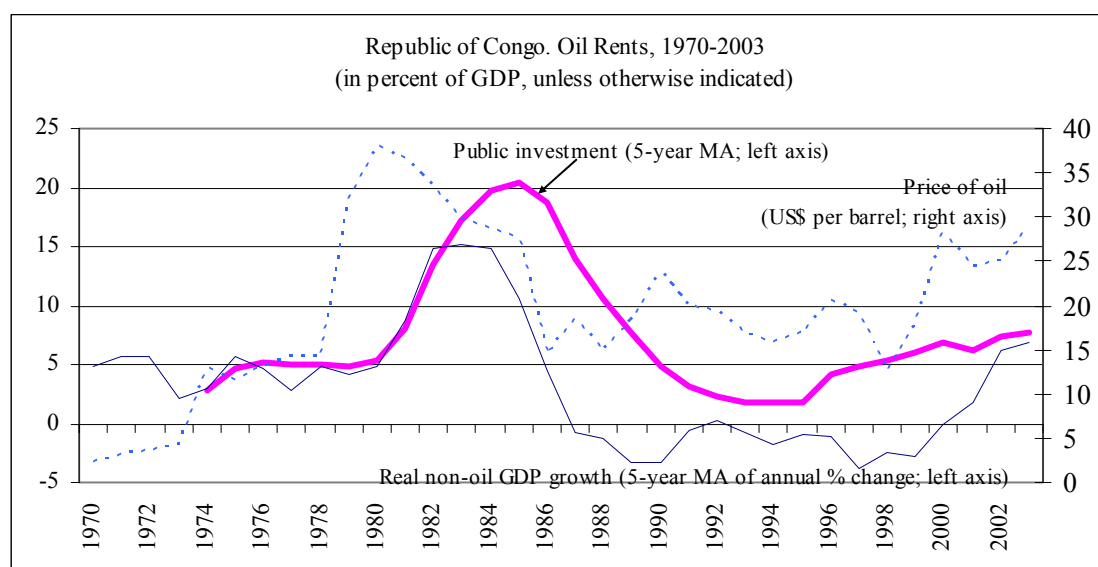
28. The improvement in policies since the mid-1990s has been particularly striking among the fastest growing countries. Among these countries, and in comparison with slower growers, the average inflation rate was significantly lower, fiscal deficits were smaller (despite similar levels of expenditure), and trade openness (measured by the share of exports and imports in GDP) was significantly higher. Moreover, the measured growth in productivity was a robust 2.4 percent (excluding Equatorial Guinea) for the fastest growers, compared to close to zero for the others.

¹⁶ See Collier, Hoeffler and Soderbom (2004) on duration, Collier and Hoeffler, (2004a) on the costs, and Staines et al. (2005) on the macroeconomics of recovery from conflict.

Box 2.4 A gush of oil rents and a surge in public investment do not ensure sustained growth

Starting in the early 1970s, the Congo benefited from a large rise in oil rents as international oil prices surged and national oil production increased. In 1979-86, oil prices averaged in excess of US\$30 per barrel (from US\$14 in 1978 and US\$2 in 1970) and national production reached 120,000 barrels per day (from 65,000 barrels per day in 1980). Suddenly, the Congo was much richer, and the state treasury, as the main local beneficiary of the suddenly wealthy enclave oil sector, experienced a surge in revenues. Between 1980 and 1986, the growth in government oil revenues (taking 1979 as the base year) averaged in excess of 50 percent of 1979 nominal GDP. A temporary growth acceleration then ensued (Hausmann et al (2004), and Figure (--)).

The failure to sustain the growth spurt of the early 1980s was apparently not due to the appropriation of the rents for consumption. As shown below, the Congo significantly boosted the level of public investments, initially to about 5 percent of GDP and then substantially more aggressively after 1980.* In fact, the increase in public capital expenditures between 1980 and 1986 (again taking 1979 as the base year) was equivalent to approximately 93 percent of the additional government oil revenues. The impact on social indicators was positive, including a surge in electric power consumption and school enrollments. Ultimately, however, weak policies and institutions (including a highly overvalued real exchange rate and low ratings on governance) did not sustain the growth spurt, real income per capita,** which had risen to close to US\$1,000 by the mid-1980s, tumbled to less than US\$900 by the year 2000, and the improvement in social indicators proved temporary. Aid flows increased throughout the oil boom until reaching a peak, at just over \$70 per capita, in the mid-1990s, after the first round of civil conflict.



Source: IMF staff calculations.

* The use of the 5-year moving average is intended to capture the effects of: (i) faster financial than physical execution, and (ii) the usual lags in bringing projects fully online.

** Measured in PPP terms and constant US\$ (source: WDI).

Box 2.5 Political commitment is central to breaking the conflict cycle

The onset of conflict tends to have multiple causes. Typically, an incipient rebel group gets a charismatic leader, the government mishandles counter-insurgency, and a neighboring government sees an opportunity for mischief. However, the susceptibility to such events is strongly affected by economic circumstances, namely low income, low growth, dependence on natural resource exports and vulnerability to adverse shocks (Miguel et al, 2004, and Collier and Hoeffler, 2004). Middle-income countries with rapid growth and diversified economies can probably withstand the sort of political events that tip low-income Sub-Saharan Africa into war. The role of aid and economic policy is limited to their impact on the growth rate (Collier and Hoeffler, 2002b). Another factor that makes a country more prone to civil war is the legacy of previous conflict, possibly because the only organizations that flourish are those that profit from violence. If Cote d'Ivoire conforms to the global pattern, its prospects are for prolonged and intermittent violent conflict.

Post-conflict experience is highly diverse: some economies recover rapidly, while others continue to decline. Recent analysis finds that choices of policy, institutions and governance are radically more important for the growth process during the post-conflict decade than at other times: the same improvement (as measured by the CPIA) generates much more growth during the post-conflict decade. Aid also appears effective in raising the growth rate during the post-conflict decade. However, the peak effect of aid is in the middle of the decade. In the first few years, although needs are great, the capacity to absorb project aid is probably rather limited. Hence, an early priority is to rebuild the institutions that manage the spending process.

Because the risk of repeat conflict is high, policy needs to be directed to managing these risks. The typical approach taken by post-conflict governments is to maintain very high levels of military spending – almost at conflict levels. Thus, very little peace dividend is taken. This can be a major policy error, as high government military spending in post-conflict situations can increase the risk of further conflict. Two good models are Mozambique, where the government radically cut its military spending, and Sierra Leone, where peace has been guaranteed not by domestic military spending but by robust and substantial external peace-keeping. In addition, a high degree of political commitment to economic development and social inclusion is fundamental.

Growth Accelerations

29. To achieve the MDGs, the central challenge facing Africa is the generation of a period of at least 10 years of sharply accelerated growth. Such growth accelerations, while not uncommon (Table 2.4), have proven to be somewhat more elusive in Sub-Saharan Africa.¹⁷ Since 1960, across developing countries as a whole, the probability of a growth acceleration starting in a country in any year has been 3.3 percent on average, while approximately 37 percent of observed country years occurred in an acceleration episode. However, in Sub-Saharan Africa, the annual probability of such an episode starting was only 2.4 percent and only 20 percent of country years occurred in such an episode.¹⁸

¹⁷ Growth accelerations are defined in Box 2.6.

¹⁸ The lower incidence of growth accelerations in Sub-Saharan Africa does not seem to be attributable to the region's higher proportion of low-income countries. Measured by the percentage of country years spent in acceleration episodes, the incidence of growth accelerations has been unrelated to either the initial level of income per capita or the initial savings rate—a result that holds for both the overall sample of countries and for those in Sub-Saharan Africa.

Table 2.4 Incidence of Growth Acceleration Episodes in Developing Countries, 1960-2003

	Probability of Starting			Proportion of Country-Years		
	Growth Episode			In an Episode		
	Sub-Saharan Africa	Europe and Central Asia	Other	Sub-Saharan Africa	Europe and Central Asia	Other
1960s	5.5	6.7	8.1	18.8	42.1	42.6
1970s	1.8	0.0	2.7	25.7	14.3	50.2
1980s	0.9	2.7	2.5	11.8	13.4	30.5
1990s	3.3	8.2	3.2	20.2	30.2	32.2
2000s	28.4	60.2	9.7
All periods	2.4	2.5	3.3	20.0	32.5	36.7

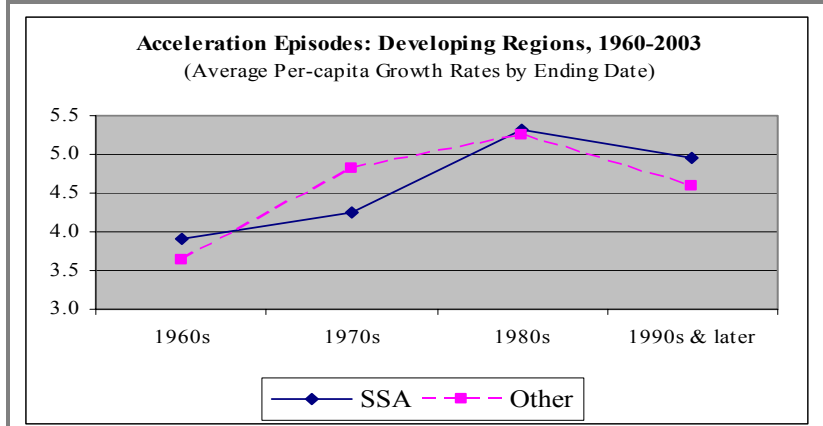
Source: Penn-World Tables and WEO; staff calculations.

30. Not only has it been more difficult to initiate sustained growth in Sub-Saharan Africa, but safeguarding those advances has also been more problematic in post-acceleration periods. Growth acceleration episodes in Sub-Saharan Africa have been more likely to be followed by a period of negative per-capita growth: of the 23 accelerations that ended before 1998, only 7 were followed by a period of positive growth.¹⁹ This observation is in sharp contrast to the post-acceleration experience in other regions, as for example, in the Latin American and Caribbean region, where 20 of 33 acceleration periods were followed by positive per-capita growth.

31. On a more positive note, it is reassuring that in the midst of the general slump of the 1990s, when the average per capita growth rate was negative for the region as a whole, some successes began to emerge in Africa. Over the last decade or so, the frequency of growth episodes, and the proportion of country years spent in such episodes, in Sub-Saharan Africa have increased relative to other regions, with the exception of Europe and Central Asia. The average growth performance within these recent African episodes is similar to those of other regions, as in earlier decades. In terms of episodes ending in the 1990s or ongoing at end-2003, the annual average per capita growth rate was approximately 5 percent per capita in Sub-Saharan Africa (Figure 2.7).

¹⁹ The cutoff at 1998 is imposed to allow calculation of the post-episode 5-year average.

Figure 2.7 Annual growth rates during accelerations improving in Sub-Saharan Africa



32. The experience on the duration of growth acceleration episodes raises a note of caution with respect to episodes currently underway in Sub-Saharan Africa. Historically, 75 (44) percent of episodes in low-income (middle-income) Sub-Saharan African countries end before their 10th anniversary. At end-2003, the average length of the episodes currently underway stood at 8.5 years for low-income countries, and close to 20 years for middle-income countries; with two relatively long episodes underway in Botswana and Mauritius among the latter group.

33. Initial analyses of the determinants of growth accelerations have found that these episodes are not easily amenable to explanation or prediction.²⁰ Still, it is possible to identify some policy and institutional measures that are significant correlates with their inception (Box 2.6). On the whole, the analysis suggests that lower levels of inflation, a higher allocation of fiscal expenditures to investment (within a given spending envelope), higher levels of private investment, and better governance tend to be associated with the beginning of growth accelerations, particularly those that last longer.

²⁰ Hausmann et al. (2004) find that statistical models tend to have modest explanatory power but that political regime changes, macroeconomic stabilizations, and positive terms of trade shocks tend to be statistically significant predictors of accelerations, and that sustained booms tend to be associated with economic reform rather than external shocks.

Box 2.6 Improved macroeconomic policies and stronger institutions are associated with longer growth accelerations

While statistical models of growth accelerations have modest explanatory power, there is some evidence that improvements in key policies and institutions tend to accompany the onset of growth accelerations, particularly in the case of longer episodes. Comparing the behavior of key policy and institutional variables at the onset of growth accelerations with the preceding 5-year period indicates that rapid increases in growth tend to be accompanied by a lower level of inflation, a less distorted exchange rate, and an improved perception of 'law and order'.^{*} On the other hand, there is no evidence of major changes in investment, exports, terms of trade, foreign aid, or savings.

Over the lifetime of growth accelerations, there is improvement in a broader set of indicators. While this result would generally be expected for macroeconomic variables, including private investment and the fiscal balance, it is perhaps surprising in the case of institutions, which are generally thought to be relatively stable. During the lifetime of a typical 10-12 year acceleration, the indicators on political regime, 'bureaucratic quality' and 'law and order' improve by a statistically significant amount, raising the possibility of a virtuous circle whereby higher rates of growth facilitate institutional reform.

Just as critical as spurring growth accelerations is sustaining them. The improvements observed during accelerations are consistent with the idea that ongoing reforms are necessary to sustain them but it is also possible that it is the jump in the growth rate which enables policy improvements. Comparing the degree of upfront improvement in indicators across longer episodes (those lasting at least nine years) and shorter episodes (those lasting less than eight years) sheds some light on what tends to make accelerations durable.

As shown in the table below, the upfront improvement in macroeconomic indicators is more generalized for longer episodes than shorter episodes. First, the improvements in inflation and the exchange rate that tend to accompany the onset of accelerations are stronger for longer accelerations. Second, longer episodes tend to be more private-sector-led, with lower government consumption and higher private investment. Third, there is an upfront improvement in the perception of corruption in the episodes that turn out to be longer (but not in those that turn out to be shorter). These results are generally robust across different sub-groups of countries, including the sub-samples of Sub-Saharan African and low-income countries, and similar conclusions emerge when the assessment is made three years into episodes of growth accelerations.

Changes in Values of Key Indicators at the Onset of an Acceleration Episode:

Onset of long vs. short episodes (in percentage except where noted below)

Inflation rate	-10.6
Gov. consumption (to GDP)	-4.1
Non-interest expenditure (to GDP)	-4.2
Black market premium	-39.2
Law and order (index) ²	0.1
Corruption (index) ²	0.6
Private investment (to GDP)	2.5

Notes:

¹ Numbers in bold indicate statistical significance at the 10 percent level.

² 'Corruption' and 'law and order' are measured on a scale of 1 to 6, where a higher score indicates less corruption and stronger application of law and order.

contd/

These results offer hope that recent improvements in these indicators in a number of Sub-Saharan African countries may mean that ongoing African accelerations will prove more sustained than in the past.

Source: Staff calculations.

* For purposes of this analysis, a growth acceleration is deemed to last at least 5 years (the average duration exceeds 8 years) and to be defined by: 1) an increase in annual average per-capita GDP growth of at least 2 percent (accelerating growth); and 2) annual average per-capita growth of at least 3.5 percent (rapid growth). Accelerations are deemed to end when annual per-capita GDP growth dips below 2 percent on average for the subsequent 5-year period, and below 3 percent in the year immediately following the period of acceleration. This is an extension of the definition proposed by Hausmann, Pritchett and Rodrik (2004).

II. Macroeconomic Policy: Stability, Sustainability, and Space

34. Recent progress towards macroeconomic stability across Sub-Saharan Africa has begun to remove some of the obstacles for vigorous economic growth and growth has picked up in some countries. On the whole, however, the region continues to experience comparatively lower rates of growth. In these circumstances, key issues include the sustainability of the current fiscal stance and, in light of the pressing development needs faced by the majority of Sub-Saharan African countries, the availability of fiscal space for additional investments in crucial areas such as physical infrastructure and human capital.

35. Underlying the discussion is the central notion that a stable policy framework is a key determinant of an enabling macroeconomic environment. As emphasized in World Bank (2005a), the relationship between policy, macroeconomic stability and economic growth is intermediated by the institutional setting. Ultimately, higher growth is the result of profitable investment opportunities, whose feasibility depends not just on macroeconomic predictability but also on the state of the micro economy and the (enabling) role of institutions. Macroeconomic stability is thus a necessary but not sufficient condition for sustained growth.

36. Over the medium term, it is crucial that fiscal policy be perceived as sustainable. The fiscal stance is sustainable when wrenching policy adjustments will not likely be required to maintain stability and avoid crisis. Such a policy configuration will increase the predictability of the domestic macroeconomic environment and ensure the longer-term viability of a noninflationary growth path for the economy. Policy stability itself contributes to overall macroeconomic stability by (i) removing the effect of destabilizing policies themselves, and (ii) enabling a stabilizing response to exogenous shocks.

37. In low-income countries, fiscal sustainability has two distinct dimensions. Overall fiscal sustainability is related to the size of the deficit after grants relative to expected growth rates and the cost of financing. In heavily-indebted countries, debt sustainability is closely linked to the attainment of the completion point under the Enhanced HIPC Initiative. The high degree of concessionality of external finance implies that, as long as the productivity of investment is reasonable and the country is not subject to large adverse shocks, further external finance should not threaten sustainability.²¹

38. Equally critical is the second dimension of fiscal sustainability: limiting recourse to domestic financing. With relatively underdeveloped financial sectors, most governments in Sub-Saharan Africa do not have the option of raising substantial sums from domestic capital markets,

²¹ In addition, successful implementation of the new Bank-Fund forward-looking debt sustainability framework for low-income countries will be critical. This in turn will require an adequate supply of grant financing. These issues are discussed in Chapter 5.

and the growth of domestic credit (and therefore money supply and prices) tends to be closely linked to the government's financing requirements.²²

39. On the expenditure side, the effect of government spending on growth depends on the macroeconomic context and the composition of expenditures. If macroeconomic stability is lacking, even government spending that is productive can, on net, have an adverse effect on growth, owing to negative macroeconomic consequences. On the other hand, a structure of spending which is financed in a sustainable manner and which favors growth-sensitive sectors can be expected to increase factor productivity and crowd in private investment, including by reducing private sector costs.

40. Targeting fiscal sustainability while paying attention to the structure and quality of fiscal spending is fully consistent with the goal of promoting productive public investment. For Sub-Saharan Africa, further progress towards fiscal sustainability will be necessary to secure recent gains, and that the current structure of spending could be made more commensurate with the growth imperative. Institutionalizing improvements in macroeconomic policy may be a quick way to change perceptions.

Policy and Macroeconomic Stability: Recent Developments

41. A climate of macroeconomic stability will deliver higher rates of economic growth, provided that profitable opportunities exist and can be taken up. Across low-income countries as a whole, macroeconomic policies have improved over the past decade. Inflation has slowed appreciably, and other indicators, such as fiscal and external current account deficits, also improved, although more modestly (Table 2.5). Similar patterns have materialized in Sub-Saharan Africa. On this basis, to what extent can stabilization in Sub-Saharan Africa, as the region most in need of a growth payoff, be considered a success?

42. Achieving macroeconomic stability relies heavily on performance on the inflation and fiscal fronts, although some definitions of stability also include criteria on positive rates of growth as an additional measure of internal macroeconomic balance, and on the level of international reserves as a measure of robustness to external shocks.²³ The rationale on the inclusion of a fiscal criterion derives from the close link between the fiscal stance and inflation, particularly in an environment where fiscal policy holds sway over monetary policy or where the scope for noninflationary domestic financing is limited.

²² The fragility of fiscal sustainability with respect to domestic financing is illustrated by the cases of several African countries that saw sharp increases in domestic real interest rates as domestic debt levels rose from very low levels to amounts that would not typically be considered excessive in more developed economies. The examples of Malawi, Zambia and Ghana show how even what look like relatively small increases in domestic debt can sharply increase real interest rates.

²³ There is no universal definition of a successful stabilization (i.e., a post-stabilization) country. Adam and Bevan (2004) suggest that inflation rates lower than 15 percent for at least 2 years is sufficient for qualification as a successful stabilization. World Bank (2001) advocate a primary surplus of at least 3 percent of GDP. Gupta et al (2002) propose a combination: fiscal deficits under 2 percent of GDP and inflation rates under 10 percent. As mentioned previously, a forthcoming IMF study advances a more comprehensive measure: (i) some degree of internal macroeconomic balance, proxied by positive per capita growth rate and low inflation; (ii) a fiscal stance which is sustainable over the medium term, proxied by restricted domestic financing of the budget deficit; and (iii) robustness to external shocks, proxied by the level of international reserves.

Table 2.5 Macroeconomic Indicators for Low-Income Countries, by Region, 1984-2009						
(annual averages)						
	1984-88	1989-93	1994-98	1999-03	2004 (estimate)	2005-09 (projected)
Inflation (median annual %)						
East Asia and Pacific	7.1	9.5	8.7	6.1	5.8	3.6
Europe and Central Asia	1.2	417.7	233.8	10.2	5.6	4.2
Latin America and the Caribbean	4.4	12.6	6.7	3.3	3.9	3.1
Middle East and North Africa	14.2	23.1	21.0	6.3	8.6	7.1
South Asia	7.7	10.5	8.4	3.7	4.6	4.1
Sub-Saharan Africa	9.9	10.6	12.7	5.6	6.5	3.6
All low-income	6.8	10.8	11.9	4.7	5.0	3.8
Current account balance (including grants; % of GDP)						
East Asia and Pacific	-1.9	-4.4	-1.5	-1.3	-1.1	-3.1
Europe and Central Asia	-1.0	-6.4	-11.7	-7.1	-7.7	-2.5
Latin America and the Caribbean	-10.8	-14.3	-14.1	-12.1	-11.7	-11.3
Middle East and North Africa	-6.5	-5.4	-1.4	0.3	-3.6	-9.8
South Asia	-7.2	-5.7	-2.4	-1.3	-2.0	-2.3
Sub-Saharan Africa	-7.2	-8.5	-9.1	-8.8	-7.7	-6.8
All low-income	-6.1	-8.0	-8.0	-6.9	-6.5	-5.9
External debt (% of GDP)						
East Asia and Pacific	63.1	69.4	58.5	60.1	56.5	52.3
Europe and Central Asia	0.0	14.2	49.8	63.8	49.8	43.6
Latin America and the Caribbean	105.8	178.2	92.5	68.0	60.6	58.8
Middle East and North Africa	53.4	57.1	68.6	59.9	53.3	48.4
South Asia	45.5	50.8	45.1	45.6	46.0	40.1
Sub-Saharan Africa	85.9	108.1	136.7	120.5	97.4	84.0
All low-income	70.6	93.5	99.2	89.6	75.1	66.2
Fiscal balance (including grants; % of GDP)						
East Asia and Pacific	-8.9	-5.7	-4.0	-5.0	-3.8	-3.5
Europe and Central Asia	-1.2	-11.1	-7.7	-3.6	-2.0	-0.2
Latin America and the Caribbean	-7.7	-5.1	-2.4	-5.0	-3.9	-2.8
Middle East and North Africa	-16.7	-11.2	-6.0	-0.5	-1.8	-8.2
South Asia	-5.5	-5.0	-4.8	-5.9	-4.9	-4.7
Sub-Saharan Africa	-6.2	-6.9	-5.5	-5.4	-3.2	-1.3
All low-income	-6.5	-6.9	-5.1	-5.0	-3.3	-2.2
Memo item: Real GDP per capita growth (%)						
All low-income	1.3	-1.3	1.5	1.5	2.8	3.3
Note: Averages are calculated as unweighted means of country values. Median inflation is calculated from annual medians and then averaged over five-year periods.						
Source: IMF World Economic Outlook database; staff calculations.						

43. Given the focus on Sub-Saharan Africa and the region's degree of reliance on concessional external financing, it seems appropriate to assess the fiscal contribution to stabilization by monitoring the extent of domestic financing of the budget deficit, instead of the deficit itself. Not

only does external financing tend to have less of an impact on inflation than domestic financing, but most of this borrowing tends to come with a sizeable grant element, further diluting the applicability of the fiscal balance measure. In this context, a forthcoming IMF study, in defining successful stabilizations in developing countries, measures fiscal sustainability by limited recourse to domestic financing, proxied by a target of less than 1 percent of GDP.

44. With the recent progress toward price stability, most countries in Sub-Saharan Africa would meet the criterion on low inflation but the picture is more mixed on the fiscal front. During the period 2000-03, the median rate of inflation was 5 percent, and only a half-dozen countries (Angola, Eritrea, Liberia, Nigeria, Zambia and Zimbabwe) recorded annual price increases persistently above 10 percent. On the other hand, progress on the fiscal front has been somewhat less consistent.²⁴ Although domestic financing in Sub-Saharan Africa averaged close to 1 percent of GDP during the period 2001-03, approximately one-third of countries in the region exceeded this level. Of the latter, twelve recorded domestic financing rates persistently higher than 3 percent of GDP. In these countries, further progress on fiscal consolidation would appear particularly prudent in order to safeguard the recent improvements on the inflation front.²⁵

45. Within this general assessment, there is considerable variation across the region. As a group, the middle income Sub-Saharan Africa countries²⁶ have, in fact, registered substantial progress on macroeconomic stability since the beginning of the 1990s. Over that time, these countries have averaged growth rates of close to 4.5 percent per capita, and their fiscal position appears sound. At end-2003, their recourse to domestic budgetary financing stood at close to 1 percent of GDP while their stock of international reserves reached 5 months of imports, levels which would allow flexibility in the advent of unanticipated fiscal challenges.

46. For the low-income Sub-Saharan Africa countries, tangible progress towards stabilization started to materialize only in the second half of the 1990s, but by 2000-03, the picture had brightened noticeably. Within this group, the natural resource-dependent economies have benefited most from recent movements in international prices. As a result, their fiscal position has strengthened, with the fiscal primary budget in balance and supplemented by external grants of close to 4 percent of GDP. Of potential concern, however, these countries remain exposed to international price corrections, and domestically, recent appreciations in the real exchange rate may weaken the competitive position of the non-resource sectors, on which the majority of people depend. In addition, fiscal policy in these countries has tended to be procyclical, partly a reflection of some unique challenges imposed on public policy by the nature of oil operations (Box 2.7).

²⁴ Using the alternative indicators on the fiscal balance to assess progress in Sub-Saharan Africa would tend to reduce the number the countries considered as a successful stabilizers.

²⁵ Despite the caveats mentioned in the text on the applicability of overall fiscal deficits to assess the sustainability of fiscal positions in Sub-Saharan Africa, it is worthwhile noting that empirical estimates of the deficit/growth nexus yield a substantively similar conclusion in suggesting that some African countries could boost growth with a reduction in fiscal deficits. Recent studies indicate that post-stabilization countries with low deficits may not benefit from further fiscal consolidation. However, most countries in Sub-Saharan Africa have a fiscal deficit higher than the threshold of between 1½ and 2½ percent of GDP (Adam and Bevan, 2005). At end-2003, there were 25 countries in Sub-Saharan Africa with a fiscal deficit, including grants, higher than -2½ percent of GDP, with 13 countries exceeding -5 percent. Among the latter group, the growth rate per capita was 0.9 percent in 2003 compared to the regional average of 1.2 percent.

²⁶ As of April 2004, this group includes: Botswana, Cape Verde, Equatorial Guinea, Gabon, Mauritius, Namibia, Seychelles, Swaziland, and South Africa.

Box 2.7 The special challenges facing fiscal policy in oil-producing developing countries

As elsewhere, the oil producing countries of Sub-Saharan Africa face some sharp and unique challenges. At a technical level, the main challenges stem from: (1) the high volatility and unpredictability of oil prices, and (2) the non-renewable nature of oil reserves. At an institutional level, the nature of oil operations raises the social benefit of good governance.

At a technical level, the first challenge is that uncertainty about oil prices translates into uncertainty about fiscal revenues. As a result, the fiscal balance tends to be volatile and unrelated to domestic demand developments. One of the principal concerns of policymakers should be insulating the local economy from this volatility. In this context, two standard policy prescriptions are that fiscal policy should be guided by: (i) the non-oil primary balance as a fiscal target, and (ii) precaution as a motive for building up financial reserves. Contrary to these prescriptions, the oil economies in Sub Saharan Africa have tended to carry out fiscal policies that are procyclical relative to oil price movements, leading to: (i) variability in the real exchange rate, which tends to be damaging to the non-oil sector and capital formation; and (ii) increased fiscal costs, including through a negative impact on the quality of expenditures induced by boom-bust cycles in the levels of spending. It is also desirable for such countries to build up financial reserves against unanticipated falls in revenue, but such prudence in fiscal policies has not always emerged. One example of good practice is Botswana, which in 2001-02 relatively smoothly absorbed the negative impacts of a confluence of negative shocks by relying on income from accumulated financial assets.

The second challenge stems from the non-renewable nature of oil revenues and the attendant rise in the importance of long-run fiscal sustainability, mainly on account of concerns for intergenerational equity. In countries with significant short-term development needs and an insufficient stock of physical and human capital, intergenerational equity could conceivably be secured through sufficient accumulation of financial and non-financial assets. In this context, it is essential that projects be compatible with broader development strategies, and projected returns be effectively secured by strong oversight. As discussed for the case of the Republic of Congo, returns have not always matched expectations.

At an institutional level, high levels of governance are of primary importance in the context of: (i) an enclave oil-sector, which benefits the country mainly through its tax payments, and (ii) the nature of oil revenues, which tend to be both high and easily appropriable. With the government being the channel of most of the possible benefits of an enclave oil sector, the judicious use of government revenues is even more critical than usual. Otherwise, the rest of the economy only sees its competitiveness eroded (the typical Dutch disease effect).

In an environment with weak oversight institutions, the size of oil revenues may mean that the public sector is asked to manage more resources than it can prudently administer and that the governing elite acquires substantial financial independence. In practice, the oil-producing countries of Sub Saharan Africa tend to underperform on key dimensions of economic governance. Yet, given the extreme need to ensure judicious administration of public resources, these are precisely the countries where poor governance has the highest social opportunity cost. With their income derived mostly from the oil sector, including possibly in illicit ways, the governing elite are less motivated to strengthen oversight institutions, and the overall investment climate suffers.

The nature of oil sector contracts also tends to bring further obfuscation to public sector management and to hamper revenue transparency; the typical results are fiscal policies that are beholden, not to the population, but to entrenched elites. Under the typical oil contract in Sub-Saharan Africa, the bulk of the fiscal regime in most oil-dependent countries is subject to confidentiality clauses and unknown to the public. In such circumstances, the system draws resources, including human capital, into activities geared to appropriating rents rather than encouraging more directly productive activities. Here, the elites tend to favor excessive and imprudent investment, especially large projects which are particularly prone to graft, and other inefficient means of rent distribution, such as sustained protection for favored firms. In light of the resulting difficulties of implementing prudent fiscal policy and promoting sound economic governance in oil-producing countries, the creation of oil savings funds is often proposed as a solution. In terms of implementation, it is crucial to integrate these funds into the overall design of fiscal policy and the budget process, and in practice, they have tended to work well in an environment of strong institutions, as for example in Norway, U.S.A. (Alaska) and Canada (Alberta). However, savings funds have tended not to work where underlying institutions were weak and political commitment was lacking, as in the case of the Venezuelan Investment Fund and the oil-stabilization fund in Mexico.

47. For the majority of these countries, the challenge is not just to strengthen the fiscal outlook (and stabilize prices) for an interim phase but for a sustained period of time and in a credible manner. For a significant impact on growth, “actual gains in macroeconomic stability need to be viewed by the private sector as indicative of a *permanent* change in the macroeconomic policy regime.”²⁷

Fiscal institutions: Key to Fiscal Sustainability and Macroeconomic Predictability

48. At a fundamental level, strong fiscal institutional structures will contribute to enhanced fiscal discipline and provide clear evidence on the direction of policy. A growing literature has indicated that institutional weaknesses, such as budgetary institutions that allow narrow interests to prevail, play an important role in influencing fiscal outcomes. Some developing countries have been shown to lack institutions that can promote sound fiscal policies, such as: (i) transparency, including wide dissemination of key economic data and controls on public enterprise budgets; (ii) “hierarchical” budget procedures that give relatively more power to the executive than to congress; (iii) judicial systems that control tax evasion; and (iv) spending constraints that mitigate tendencies toward procyclical spending policies.

49. On the expenditure side, the structure of public spending in some Sub-Saharan African countries could also be made more commensurate with the growth imperative. Fiscal adjustment and sustainability should be viewed not just in terms of quantity but also quality. To the extent that basic investments in both physical and human capital raise growth, it is crucial to orient public expenditures towards productive projects in these areas.

50. Recent increases in social sector allocations in low-income countries implementing Poverty Reduction Strategies have begun to make a difference, but there is scope for further improvement. In the most recent period, 2000-03, increases in the spending envelope (non-interest expenditures in percent of GDP) have not resulted in additional allocations to public investment. Moreover, given the consensus on the need to (rapidly) raise the level of human capital across the region, further progress on raising the share of non-interest expenditures allocated to education and health would appear necessary. This is particularly true in the case of health expenditures, for which Sub-Saharan Africa as a region, appears at the bottom of the ranking of developing regions (Figure 2.8).²⁸

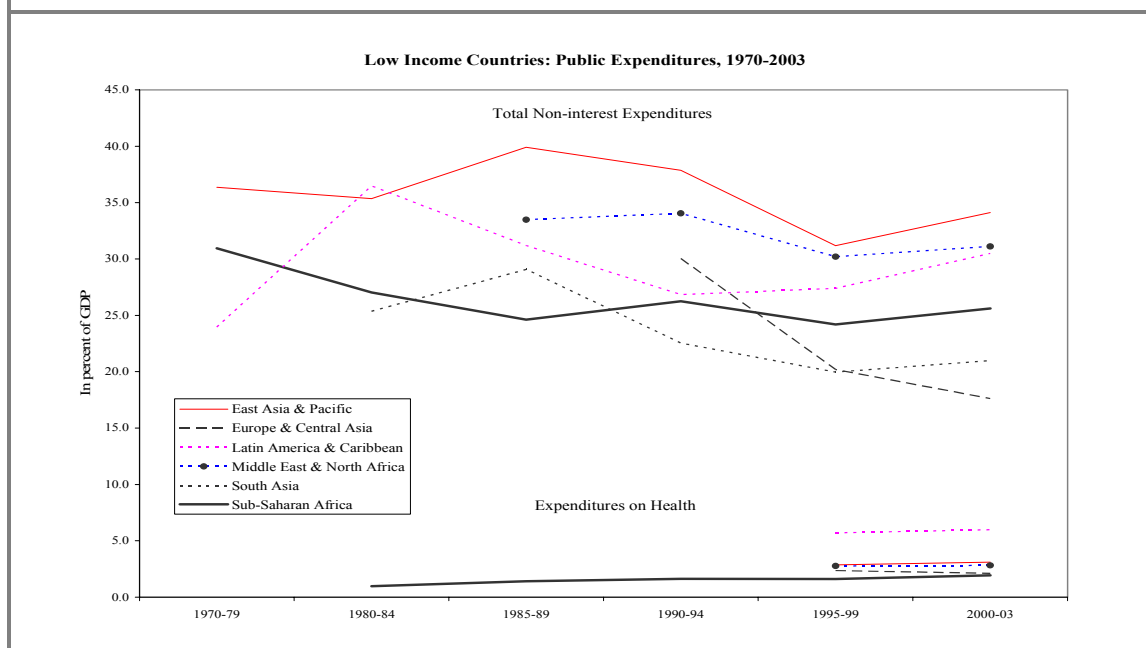
51. Looking ahead, it will be essential that Sub-Saharan African countries underpin attempts to strengthen the fiscal outlook with enhanced transparency and stronger fiscal institutions. Budget transparency has been associated with enhanced fiscal discipline, particularly in the aftermath of the Asian crisis in the late 1990s, and enhanced accountability of governments. The more transparent government operations are, the easier it is to identify fiscal policy weaknesses and address them. Fiscal transparency improves the business environment, because investors (domestic and foreign) gain more confidence in government policies, and evidence suggests that transparency can improve sovereign credit rating – a very tangible benefit for cash-strapped governments. Consequently, the IMF published the Fiscal Transparency Code in 1999, the Manual on Fiscal Transparency in 2001, and a draft Guide on Resource Revenue Transparency is currently available for public comments and will be published in the near future. The earlier publications serve as a framework for the fiscal Report on the Observance of Standards and Codes (ROSC), a voluntary diagnostic tool which assesses the availability and quality of fiscal

²⁷ World Bank (2005a, Chapter 3, p.16)

²⁸ Within Sub-Saharan Africa, the pattern of relative under-allocation towards capital expenditures and the social sectors is particularly striking in the oil economies, which tend to under-invest relative to other countries in the region.

data. In Sub-Saharan Africa, 11 countries have agreed to publish their fiscal ROSC, and the assessments, while recording some progress and some examples of good practice, highlight the general need for improvement in budget formulation and reporting, and also in broadening data coverage (Box 2.8).

Figure 2.8 There is scope for allocating more to priority sectors such as health



52. One country in Sub-Saharan Africa which has recently made significant strides toward fiscal transparency is the Republic of Congo, where the publication of fiscal data, reports on external verification of government revenue, oil-sector contracts and data and audit reports on oil sector activities has been influential in convincing development partners that a significant change in the policy regime is underway.²⁹ Nevertheless, as discussed below, broader gains in the governance area are necessary for Sub-Saharan Africa to reach the level recently attained by other developing regions.

53. More broadly, stronger fiscal institutions can improve fiscal management by clarifying the lines of responsibility and constraining the nature of the political bargaining that typically affects fiscal outcomes. One approach has been to create autonomous revenue agencies and grant central banks independence in the pursuit of price stability. Another approach has been to strengthen the rules governing budgetary procedures and reporting, often in the context of medium term expenditure frameworks (MTEF). In Sub-Saharan Africa, neither of these approaches has been widely embraced. Institutional independence is more likely to be effective in a climate with multiple checks and balances, and an MTEF is only effective when fully integrated into the budget process and related documents, which has only happened in five countries in Sub-Saharan Africa.³⁰ Yet another approach is to adopt a type of Fiscal Responsibility Act, under which a broad discussion of the policies underlying the budget documents precedes the formal presentation of the budget document. The debate takes place both within and outside parliament,

²⁹ The data, contracts and audit reports are available at <http://www.mefb-cg.org>.

³⁰ Le Houerou and Taliario (2002), p.35.

improving transparency and binding government over the medium-term, as in the case of Brazil, where a fiscal responsibility law was adopted in 2000.³¹

Box 2.8 Fiscal Transparency has improved in Africa, but much remains to be done.

Country-specific fiscal transparency assessments (called fiscal Reports on the Observance of Standards and Codes, ROSC) have been published on the IMF's website for over 70 countries, including a number of countries in Sub-Saharan Africa (Benin, Burkina Faso, Cameroon, Ghana, Malawi, Mali, Mauritania, Mozambique, Rwanda, Tanzania, and Uganda). Several more reports are under preparation for other Sub-Saharan African countries.

The assessments record some progress in improving fiscal transparency in a number of areas, including for example the quality of budget formulation and investment in improved fiscal reporting systems. South Africa, while it has not published a fiscal transparency ROSC, provides a range of examples of good transparency practices, including clear policy statements and publication of a "Budget in Brief"—a summary of the annual government budget written for the layman. However, the fiscal transparency reports have also found that much still remains to be done in Africa. For example, in many Sub-Saharan African countries, central government budget data remain weak and unreliable, and there is insufficient reporting on local government fiscal operations. Fiscal risks related to off-budget activities (e.g., quasi-fiscal activities related to state-owned enterprises or banks, contingent liabilities, tax expenditures) are often non-transparent. External audit is generally weak, impairing the ability of parliaments and the general public to monitor government operations and hold the executive accountable for its actions. There appears to be a strong need to maintain continuing assessment of fiscal transparency practices in Sub-Saharan Africa and to encourage publication and dissemination of good practices that are in place.

More recently, the need for better fiscal transparency in resource-rich countries has gained some prominence. Several Sub-Saharan African countries, including Nigeria and Ghana, have begun to participate in the Extractive Industries Transparency Initiative (EITI). This initiative, which is supported by the IMF, emphasizes the need for oil and other extractive industry companies to publish what they pay to governments and to reconcile these payments with what government reports show that they have received from companies. The IMF has prepared a *Draft Guide on Resource Revenue Transparency*, which supplements the *Manual on Fiscal Transparency* and can be used to assess fiscal transparency in resource-rich countries. The *Draft Guide* has been published for public comments (<http://www.imf.org/external/np/sec/pr/2004/pr04274.htm>). A number of pilot country assessments are currently being undertaken in resource-rich countries, including in Equatorial Guinea which recently hosted a seminar for parliamentarians from the six countries of the Economic and Monetary Community of Central African States (CEMAC) that focused on fiscal transparency and accountability (see IMF Survey, February 7, 2005).

Note: The IMF has promoted fiscal transparency over the past several years as part of its Standards and Codes initiative. The *Fiscal Transparency Code* and the *Manual on Fiscal Transparency* are both available on the IMF's website (<http://www.imf.org/>).

Fiscal Space: Safeguarding Development Spending

54. The identification of significant infrastructure gaps, particularly in Latin America, has recently given rise to calls for the creation of 'fiscal space' by means of a revision in accounting rules and a change in the approach to fiscal analysis. In this context, it has been suggested that data on fiscal expenditures should not cover the operations of public enterprises, and that fiscal programming should target the current, instead of the overall, fiscal deficit. Subsequently, these

³¹ IMF (2005).

arguments have also been marshaled as a way to substantially increase government spending tied to the MDGs.

55. Ultimately, a change in accounting rules cannot make the resource envelope larger or ensure that additional spending is justified. For Sub-Saharan Africa, the proposed change in fiscal data coverage would not have much of an impact, given that standard practice across the region already limits coverage to general government (and only records direct transfers to public enterprises as fiscal expenditures). Moreover, targeting the current deficit (as a way of treating investment spending differently from recurrent expenditures) would not obviate the need to assess sustainability of debt loads, the impact of higher domestic financing on inflation and private investment, and the productivity of expenditure.

56. Effectively raising fiscal space would require, first, the generation of additional resources, and second, ensuring that projects are appropriately selected and implemented. Domestic sources of additional resources include the mobilization of additional fiscal revenue and domestic borrowing. Scope for the latter is typically very limited, however, in part because domestic financial markets in Sub-Saharan Africa are thin and in part because of a need to preserve domestic savings for private sector investment. External sources include a sustained and predictable flow of external grants (and, to a lesser extent, other concessional borrowing). Ensuring the overall adequacy of projects may entail: (i) reprioritization of expenditure towards more productive sectors and projects (as discussed earlier), and (ii) lifting limits on absorption capacity, including by improving expenditure monitoring systems.

57. In Sub-Saharan Africa, the bulk of the additional financing for achieving the MDGs will have to come from sources other than revenue generation. Certainly, revenue ratios in low-income Sub-Saharan African countries are on the low side. However, raising revenue ratios will require improvements in tax administration and the resolution of important issues of tax design, including greater reliance on indirect taxation schemes, such as the VAT.³² Experience has shown that the associated political and administrative challenges are not easily overcome in a short time frame.³³

58. External grants unambiguously enhance fiscal space, in contrast to borrowing where such space is constrained by debt sustainability considerations, even when loans are on concessional terms. Still, a sustained and predictable flow of external grants is necessary to secure a sustained scaling up of expenditures. Historically, aid flows have been relatively more volatile and less predictable than other sources of revenue.³⁴ These tendencies have been more pronounced for those countries least capable of absorbing external shocks: those with a higher proportion of aid-financed budgets and those with fewer domestic financial instruments to smooth the fiscal impact. These effects tend to undermine some of the positive impact of foreign assistance.

59. In Sub-Saharan Africa, recent drops in the share of public investment underscore the importance of improving the capacity to implement productive projects. Over the last two decades, the share of public investment across Sub-Saharan Africa has fallen by roughly 3 percentage points of GDP. Although part of the drop has been offset by a rising share of private investment, there is evidence that budgetary execution in Sub-Saharan African low-income

³² Tax reform could also contribute to policy stability by helping to moderate the relatively large variance of revenue ratios in African countries. This tendency for greater variability effectively reduces the level of sustainable debt, *ceteris paribus*.

³³ As discussed earlier, sustainable policy configurations themselves, by promoting private investment and higher rates of economic growth, can be an effective source of fiscal space.

³⁴ Bulir and Lane (2002) document that aid has been up to seven times more volatile than domestic fiscal revenue, and that aid disbursements have not been well predicted by aid commitments.

countries regularly results in lower-than-programmed capital expenditures in combination with overruns on current expenditures. These shortfalls in capital spending cannot be entirely attributed to lower-than-expected foreign financing, underscoring the importance of ensuring that project selection and implementation is improved.

60. Improving the quality of public expenditure management is critical in addressing concerns on the relationship between additional spending, public service delivery, and improved outcomes. There have been attempts to address public expenditure management issues in the context of efforts to raise allocations to pro-poor expenditures under the aegis of the Enhanced HIPC Initiative (Box 2.9). The reported increase in poverty-reducing spending will have to be supplemented by improvements in efficiency and targeting to raise social outcomes. For this, countries must also develop the means to assess the effectiveness and social impact of poverty-reducing expenditures.

61. More generally, identifying and addressing absorptive capacity constraints requires formulation of country-specific strategies. At the macroeconomic level, aid flows may distort domestic markets by raising the relative price of domestic goods or services, and impair economic performance by threatening fiscal sustainability (particularly with volatile and unpredictable aid flows). Managing these additional policy challenges is facilitated by the use of a medium-term fiscal framework and flexibility in adjusting expenditure and revenues, and possibly by the absorption of shortfalls in aid flows with the use of international reserves or non-monetary financing instruments. For some sectors, for example health and education, human and physical infrastructure constraints may also be relevant. Addressing these concerns is likely to require more resources and time.

62. In summary, sustained effort is necessary to ensure that recent progress toward a stable macroeconomic environment marks a permanent shift in the policy regime. In the short-term, with fiscal deficits relatively high and with only a limited ability to raise revenues, increases in the domestic contribution to the development needs of the region will come mostly from higher rates of economic growth and a shift in the structure of spending towards high-quality projects in growth-sensitive sectors.

63. Finally, macroeconomic stability cannot bear the entire burden of boosting economic growth. As the experience over the last two decades has confirmed, the institutional environment in Sub-Saharan Africa has not always ensured that policy gains translated into permanent improvements. In the fiscal area, an appropriate institutional setting should ensure transparency, effective expenditure monitoring and sustainability. Institutionalizing nascent improvements in macroeconomic policy may be a quick way to change perceptions.

Box 2.9 Strengthening Expenditure Monitoring under the Enhanced HIPC Initiative

With the recognition that public expenditure management (PEM) plays a key role in supporting poverty reduction efforts, the Fund and the Bank have been working closely with countries benefiting from the Enhanced HIPC Initiative to strengthen the link between HIPC assistance and poverty reduction.* As part of this effort, an action plan was agreed with the authorities of each HIPC country, and two rounds of assessments on implementation of those plans have now been completed.** Under the assessment framework (as described in SM/02/30), progress was initially tracked on the basis of 15 key indicators, 7 of which relate to budget preparation and 4 each to execution and reporting. For the 2004 assessments, a new indicator on procurement was added.

Following an initial 2001 assessment that confirmed the generally weak state of PEM systems, HIPCs have begun to implement detailed action plans aimed at strengthening expenditure management and monitoring. By 2004, the majority of countries were able to report poverty-reducing spending as defined in their respective PRSPs, and the average number of benchmarks met increased from 6 to 6.5.*** On average, pro-poor spending has been increasing at an average of approximately 2 percent of GDP per year. In order to reduce poverty, however, higher spending must be accompanied by improvements in efficiency and targeting to improve social outcomes. Revised action plans are being incorporated into Fund-supported programs and Bank adjustment operations, and to increase ownership, should also be incorporated into PRSPs.

Upgrading needed, and number of benchmarks met (2001, 2004)				
Upgrading required	2004			
	Substantial		Some	Little
Substantial (7 or fewer benchmarks met)	Bolivia (5,4) Cameroon (4,7) Ethiopia (6,7) Gambia (5,3) Ghana (1,7) Guinea (5,5) Madagascar (7,4) Malawi (7,5)	Mozambique (5,4) Niger (3,5) Sao Tome (4,4) Senegal (4,7) Zambia (3,3)		
Some (8 to 10 benchmarks met)	Honduras (8,7) Chad (8,7)		Benin (8,8) Burkina Faso (8,9) Guyana (8,10) Rwanda (8,8) Uganda (9,8)	Mali (8,11) Tanzania (8,11)
Little (11+ met)				
Not assessed in 2001	Guinea-Bissau (0) Sierra Leone (7) Democratic Republic of Congo (4)			

* More generally, a key feature of the Fund's PRGF, the Bank's PRSC, and the PRSP approach that the budgets of low-income countries should become more pro-poor, which makes tracking poverty-reducing expenditures relevant to all PRSP countries.

** The underlying action plans take into account the technical assistance available to HIPC countries from all development partners.

*** Assessments were carried out for 25 HIPC countries, of which 22 are in Sub-Saharan Africa and 3 in LAC.

III. Enabling Climate for Private Sector Activity

64. Our earlier analysis of growth accelerations underscores the role of a rise in private investment in supporting sustained increases in economic growth. In slow growing economies, in Sub-Saharan Africa and elsewhere, typically investment is low.³⁵ The rate of return on investment also tends to be low, on account of both low productivity and high costs of doing business.³⁶ Faster growth requires a business climate that enables the private sector to take up profitable investment opportunities, raising both the level and productivity of investment. In many developing countries, however, excessive business regulation and other institutional constraints impose a heavy burden on entrepreneurial activity. A number of countries are implementing regulatory reforms, but recent improvements need to be deepened and underpinned by stronger institutions, particularly those related to property rights and the rule of law. Alongside reform of the regulatory and institutional framework, access to finance and availability of key infrastructure need to be improved. Limited access to credit and poor infrastructure act as a brake on private activity in many countries, limiting growth in industry and agriculture alike. The region where the need for improvement in these determinants of the private business environment is greatest is Sub-Saharan Africa.

Assessing the Business Environment

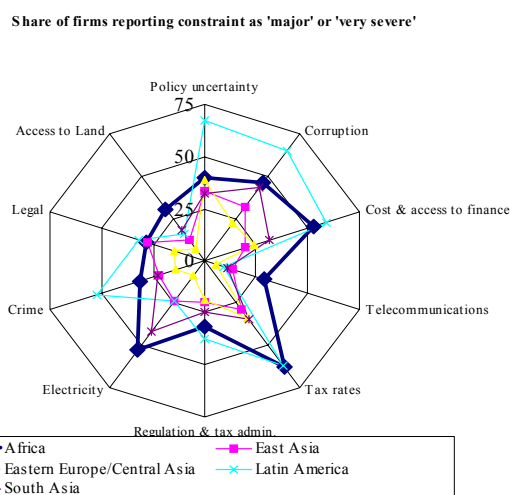
65. Recent enterprise surveys and business regulation assessments provide the necessary metrics for a careful evaluation of the investment climate in developing countries.³⁷ The enterprise surveys benchmark investment climate indicators and firm performance, allowing conclusions to be drawn on constraints facing entrepreneurs. The business regulation assessments benchmark regulatory and property protection systems, providing specific policy guidance on areas for improvement. Across the developing world, entrepreneurs consistently report regulatory impediments, corruption, and lack of access to finance and key infrastructure such as electricity as major factors constraining their activity.

66. In Sub-Saharan Africa, firms report high taxes and poor access to finance as among their most significant constraints (Figure 2.9). With a smaller tax base, firms can bear a disproportionate share of the tax burden, particularly small and medium sized firms. With the informal sector representing more than 70 percent of non-agricultural employment in Sub-Saharan Africa, many firms do not pay any taxes—or only report a fraction of sales to authorities. Concurrently, many firms, particularly small ones, do not see many benefits from becoming formal. The majority of firms do not have confidence that courts will uphold their property rights and most have little access to finance due to lack of depth of the financial system and difficulty of obtaining collateral.

³⁵ See, for example, Levine and Renelt (1992) on the robustness of investment in cross-country regressions, and Collier and Gunning (1997) on the conclusion that investment in Africa is low.

³⁶ For example, Devarajan, Easterly and Pack (2001), and more recently, Eifert, Gelb and Ramachandran (2005). Arguably, the reported high level of capital flight from Sub-Saharan Africa could be seen as a rational response to the lack of profitable investment opportunities at home (Collier et al, 1999).

³⁷ The Investment Climate Surveys and the assessment of business regulations in the *Doing Business Report 2005* were conducted by the World Bank in collaboration with local partners. To date, there have been eight surveys completed by countries in Sub-Saharan Africa, in a total of 53 across all developing regions, and eight more are planned over the next year. The goal of the exercises is to assess the impact of the investment climate on firm performance, and to measure business regulations across the world and benchmark best practices. The *Doing Business Report 2005* covers 145 countries, including 32 in Sub-Saharan Africa.

Figure 2.9 Firms view taxes, finance, electricity, and corruption as particularly constraining

Source: World Bank Investment Climate Surveys.

67. Corruption and policy uncertainty are other significant constraints. In particular, the discretion that many officials enjoy in implementing complex regulations opens opportunities for bribes and uneven application of requirements. Over 95 percent of firms report that corruption and policy uncertainty present a problem, with the majority of firms reporting that it is a major or severe constraint on their ability to operate and expand their business.

68. Unreliable electricity supply is reported as a constraint by over 52 percent of firms in the region, compared to 42 percent in South Asia, 24 percent in East Asia and Latin America, and less than 10 percent in Eastern Europe and Central Asia. Furthermore, a significantly larger share of African firms report frequent power outages and serious production losses stemming from such interruptions in production.

Table 2.6 Selected indicators of the investment climate

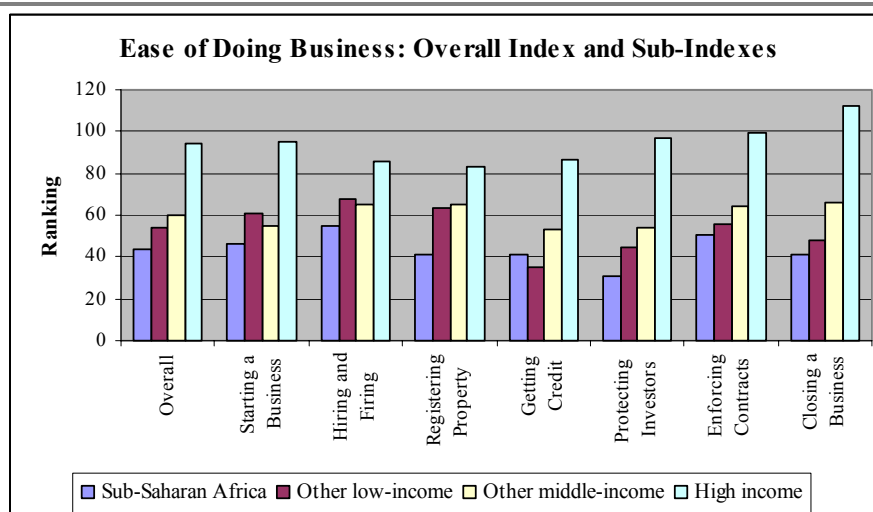
	Unpredictable interpretation of regulations	Lack confidence courts uphold property rights	Mgt. time dealing with officials	Avg. days to clear customs	Finance as Major constraint	Infrastructure as major constraint	Skills as major constraint
	%	%	% mgt time	Days	%	%	%
Kenya	45.5	51.3	13.8	8.9	58.3	48.1	27.6
Mozambique			11.3	11.9	78.0	64.0	33.5
Senegal	42.5	40.5	13.8	6.5	60.0	30.7	18.5
Tanzania	58.6	55.1	16.2	17.5	53.0	58.9	25.0
Uganda	40.0	30.1	5.0		52.8	44.5	30.8
Zambia	70.1	36.0	14.1	4.8	67.7	39.6	35.7
China	33.7	17.5	19.0	7.9	22.3	29.7	30.7

Source: World Development Report 2005 and World Bank Investment Climate Surveys.

69. There is considerable intra-regional variation in the ranking of constraints reported by Sub-Saharan African firms. (Table 2.6). For example, policy uncertainty is reported as a major or severe constraint by 27 percent of firms in Uganda but by 57 percent in Zambia. Similarly, unpredictable interpretation of regulations is a problem reported by 40 percent of firms in Uganda but by 70 percent in Zambia. In Kenya, more than 75 percent of firms report that bribes are paid, averaging over 5 percent of sales. Losses from power interruptions average 6-7 percent of sales in Ethiopia and Zambia, and 10 percent or more of sales in Eritrea, Kenya, and Senegal.

70. The above picture derived from country Investment Climate Surveys is corroborated by Doing Business indicators. Regulatory burden on business is heaviest in Sub-Saharan Africa (Figure 2.10).³⁸ Among the group of twenty countries with the most regulatory obstacles to doing business, sixteen are in Sub-Saharan Africa, with Angola, Burkina-Faso, Chad, and the Democratic Republic of Congo ranking among the lowest five worldwide. In these countries, the costs faced by entrepreneurs are staggering across the spectrum of areas assessed: starting a business, enforcing contracts, registering property, hiring and firing labor, getting credit, closing a business, and protecting investors.

Figure 2.10 Sub-Saharan Africa lags other regions in the quality of the business environment



Source: *Doing Business in 2005* database.

71. Two areas where African entrepreneurs face the highest costs are starting a business and registering property. On average, starting a company in an African country costs the equivalent of 224 percent of national per capita income, compared with 45 percent in South Asia and only 7 percent in high-income countries. Similarly, a simple, formal property transfer costs 14 percent of the value of the property and takes more than 100 days to complete in the average African country, compared to 48 days in East Asia and Pacific and 36 days in high-income countries.

72. Nigeria has among the most cumbersome regulations in the world for registering property, currently requiring 21 procedures, 27 percent of the property value in fees, and a registration period of 274 days. Other countries in the region present similar obstacles to registering property: completing the transfer process takes over one year in Ghana and 354 days in Rwanda, and it

³⁸ The ease of doing business index is the simple average of country rankings (from 1 to 135) in each of the seven measures included in *Doing Business in 2005*, with higher values indicating more efficient regulation and stronger protection of property rights.

costs 34 percent of the property value in Senegal and 23 percent in the Republic of Congo. Moreover, in Africa, property registries tend to be poorly organized and provide little effective security of ownership.

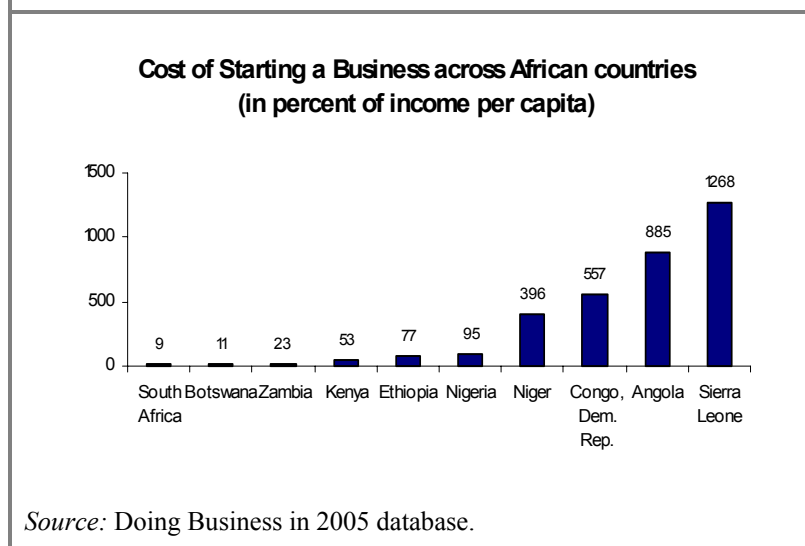
73. Sub-Saharan Africa is also the region where it is most difficult to enforce a simple commercial contract through the courts. On average, creditors must go through 35 steps, wait 15 months, and pay 43 percent of their countries' per capita income before receiving their due payment. The result is less access to justice and weaker protection of property rights, leading to fewer (formal) business transactions.

74. Hiring and firing workers in the formal sector in Africa also is not easy. The region has the highest rigidity in labor regulations³⁹ and among the highest firing costs. In Burkina Faso, for example, employers cannot write fixed-term contracts unless the job is seasonal; the mandated minimum wage is \$54 a month, which at 82 percent of value added per worker ranks as the third highest in the world; night and weekend work are prohibited; and women are not permitted to work more than 8 hours a day. If a business needs to downsize, it must notify the Ministry of Labor of its intention to retrench workers, and the law mandates that the redundant worker must be trained and placed in other jobs prior to dismissal. If an employer follows these procedures, a redundancy would cost 18 months' wages in severance pay and penalties. Little wonder that many businesses operate in the informal economy, which currently accounts for approximately 40 percent of the country's output. With high firing costs, employers are less likely to hire.

75. Without clearly defined property rights or efficient contract enforcement, lenders are less likely to extend credit to entrepreneurs. Although African countries perform relatively better on indicators of legal rights for borrowers and lenders than some other regions, with higher scores than South Asia, Latin America and the Middle East, institutions that support credit markets are weak. For example, only 4 African countries—Botswana, Ghana, Namibia and South Africa—have a private credit bureau to provide lenders with information on a borrower's creditworthiness.

76. Within this overall difficult business environment in the region, however, performance varies appreciably and there are several examples of good practice. For example, the cost of starting a business in Africa varies across countries by more than 100-fold, from one-tenth of income per capita to more than 10 times income per capita (Figure 2.11). Botswana and South Africa achieve low cost in official fees in line with the average in high-income countries whereas Angola and Sierra Leone have cost levels that are among the highest in the world. There

Figure 2.11 The cost of starting a business varies widely



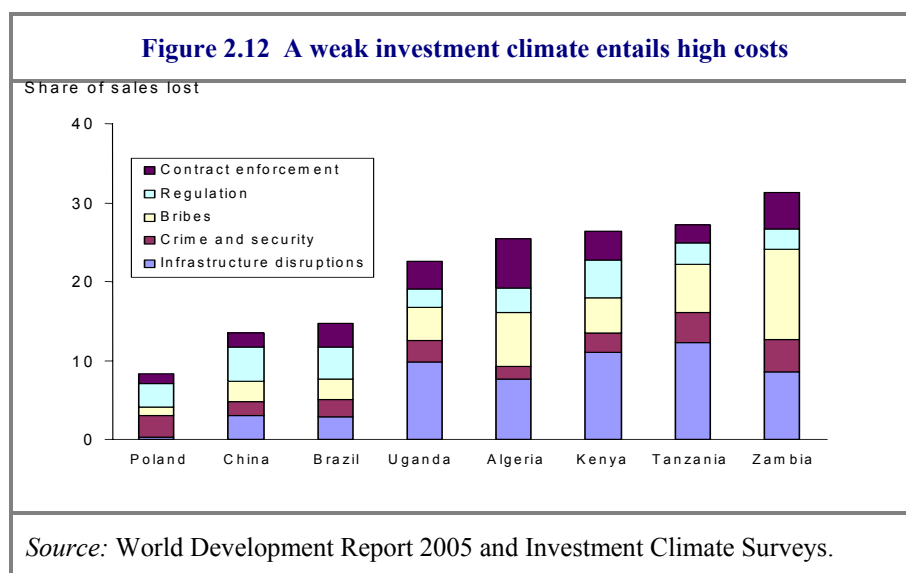
³⁹ Labor regulation rigidity is average of difficulty of hiring index, rigidity of hours index, and difficulty of firing index. It varies from 0 to 100 with higher values indicating more rigid regulation.

are also other examples of good practice. Tanzania and Uganda have commercial or small claims courts; in Tanzania, bankruptcy procedures are carried out by a specialized court; in Botswana and Tanzania, there is no minimum capital requirement for starting a business; in Madagascar and Namibia, a moderate severance pay for redundancy has been introduced; and in South Africa, investors have access to ownership and financial data before they invest in a company.

77. There are also broader patterns across the region. Middle-income countries have more efficient regulation than low-income countries, as in other regions. For instance, it takes 234 days, on average, to enforce a debt contract in a middle-income country, while it takes close to double that time in a low-income country. On the other hand, oil-dependent economies (Box 2.10), and countries that recently endured civil conflict, tend to have the most onerous business regimes

Improving the Business Environment

78. The costs of a weak investment climate are substantial and the impacts are widespread. At the enterprise level, estimated costs, measured in terms of the share of sales lost, range from less than 10 percent in Poland to more than 30 percent in Zambia. The composition of the costs also varies dramatically across countries. In Kenya and Tanzania, weak infrastructure services are particularly burdensome, while in Zambia bribes are especially costly (Figure 2.12). Priorities for reform thus vary by country.



79. Evidence confirms that payoffs to reform are large. In Ethiopia, business registrations increased by 48 percent when the process was simplified in 2003. In Namibia, the cost to expand output fell by 15 percent as a result of more flexible working hours introduced in 2003. In Mozambique, commercial banks report that reforms to the public credit registry have assisted them in providing credit to a wider set of entrepreneurs. Empirical analysis indicates that Africa could grow by an additional 1.6 percent per year if the average country were to improve its business regulation system to the level of the average OECD country.⁴⁰ Countries with a better business environment tend to benefit from higher rates of private investment—among Sub-Saharan Africa countries which scored 50 or higher on the ease of doing business index in 2005, the correlation between that score and the rate of private investment during the period 1990-2003

⁴⁰ Djankov, McLiesh and Ramalho, "Growth and the Ease of Doing Business", *World Bank Working Paper*, August 2004.

was 70 percent. Improvements in private business environment in Uganda contributed significantly to a strengthening of economic performance in the past decade (Box 2.11).

Box 2.10 Comparing business regulations in two resource-dependent economies: Angola and Botswana

One of the manifestations of the “resource curse” is the lack of economic diversification in resource-dependent economies. Among the most acute cases have been the oil-dependent economies in Sub-Saharan Africa, such as Angola, where large flows of private investment have flowed to the oil-sector (with its enclave fiscal, regulatory and legal regime) but, for the most part, not into other sectors. Other countries, including Botswana, have been able to harness the power of natural resources by implementing sound macroeconomic and structural policies and providing adequate incentives for entrepreneurs to take up profitable opportunities across all sectors. The table below compares the regulatory burden imposed on entrepreneurs in Angola and Botswana.

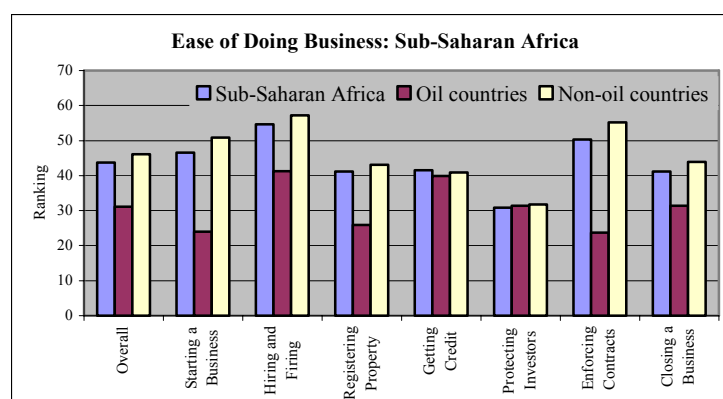
	Starting a Business		Enforcing Contracts		Registering Property		Hiring and Firing		Getting Credit		Closing a Business	Protecting Investors
	Days	Cost	Days	Cost	Days	Cost	Labor Rigidity	Firing costs	Legal Rights	Credit Information	Recovery Rate	Disclosure Index
Angola	146	885	1011	9	335	11	75	116	3	4	1	2
Botswana	108	11	154	25	69	5	20	19	9	5	51	5

Notes:

1. Cost of starting a business is measured in percent of GNI per capita; cost of enforcing contracts is measured in percent of debt value; cost of registering property is measured in percent of property value; firing costs are measured in number of salary weeks due as severance payment; recovery rate is measured in cents on the dollar.
2. Labor rigidity is an index between 0 and 100, with higher values indicating more rigid regulation.
3. Legal rights measures the degree to which collateral and bankruptcy laws facilitate lending, and the index ranges from 0 to 10, with higher scores indicating easier access to credit.
4. Credit information measures access to information through either public or private bureaus, and the index ranges from 0 to 6, with higher scores indicating more availability of information.
5. Disclosure measures the extent of disclosure of corporate information, and the index ranges from 0 to 7, with higher scores indicating more disclosure.

Worldwide, Angola is among the 20 countries with the least business-friendly regulations, while Botswana is among the top twenty. On most indicators measured by the *Doing Business* project, Botswana substantially outperforms Angola. For example, registering property, essential for obtaining credit in many countries, takes almost 7 times longer in Angola than Botswana. Hiring and firing workers is considerably less flexible and more costly in Angola. Closing a business, which helps entrepreneurs start and grow their business, is significantly more complex in Angola.* Not surprisingly, Botswana has a more diversified economy and has grown roughly twice as fast as Angola over the past ten years.

Contd/



Across Sub-Saharan Africa, Angola is typical of oil countries, which tend to have a more cumbersome system of business regulations and weaker protection of property rights than non-oil economies. In these countries, reforms in these areas could make a significant contribution to enhancing the attractiveness of non-oil private investment.

Empirical analysis, discussed in *Doing Business in 2005*, shows that a higher recovery rate in insolvency is associated with higher rates of private credit, and that economies with a higher rate of exiting firms tend to also have a higher rate of entering firms (as a percentage of total firms).

Box 2.11 High returns to investment climate improvements in Uganda

The success of China and India are well known, with China growing at 10 per cent a year and India having doubled its growth rate since the 1970s, following major reforms over the last two decades. But the benefits of investment climate reforms are not limited to large countries. Uganda's experience shows the importance of persistence, rather than perfection, in translating investment climate reforms into increased growth and poverty reduction. Uganda launched its program of investment climate improvements in the early 1990s, after a period of civil conflict and macroeconomic instability.

Reforms covered many areas affecting the investment climate: macroeconomic stability was achieved; expropriations by a previous government were reversed; trade barriers were reduced; and tax and court systems were strengthened. The persistence of the government's reform efforts enhanced its credibility, giving firms the confidence to invest. Indeed, private investment as a share of GDP more than doubled, from just over 6 percent in 1990 to 15 percent in 2002. These improvements contributed to stronger per capita income growth, which averaged 4 percent per year during 1993-2002 (or eight times the average in Sub-Saharan Africa), and a reduction in the share of Uganda's population living below the poverty line from 56 percent in 1992 to 35 percent in 2000.

Source: Adapted from WDR 2005

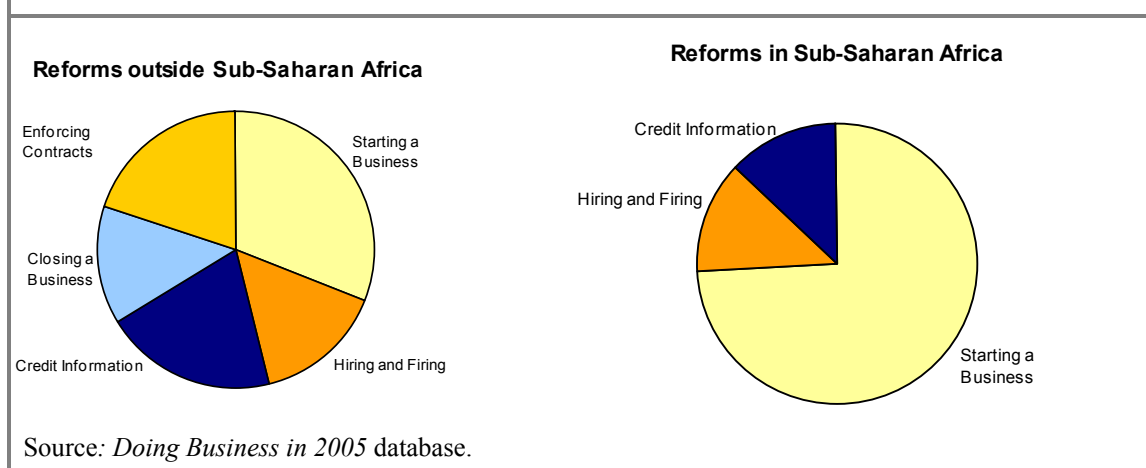
80. While some countries in Sub-Saharan Africa are taking notable steps to improve the private business environment, the pace of reform needs to be quickened and reforms extended to other countries. Despite the heavier burden of business regulation and weaker protection of property rights, African countries lagged those in other regions in the scope and pace of reform achieved in the past year, as assessed by the annual *Doing Business* review.⁴¹ Of the 58 countries in the *Doing Business* sample that reformed regulation or strengthened property rights in the last year, only

⁴¹ *Doing Business in 2005*.

eight were in Africa. Most reforms in Africa were in the relatively straightforward area of starting a business, while outside Africa there were reforms in every area measured (Figure 2.13).

81. Among the African nations enacting reforms, Ethiopia improved the process for starting a business by cutting the number of required procedures and reducing the associated cost and time. Madagascar slashed the time required to start a business by establishing a new one-stop shop for entrepreneurs—GUIDE (*Guichet Unique*). Benin, Cote d'Ivoire, Democratic Republic of Congo, and Kenya also reformed entry regulation. In Mozambique, a public credit registry went online and strengthened the quality of data. In contrast, developments in some countries worsened their investment climate: actions in Malawi, Mauritania, Rwanda, and Zimbabwe had the effect of raising the cost of business start-up.

Figure 2.13 Reform of the business environment needs to be scaled up in Sub-Saharan Africa

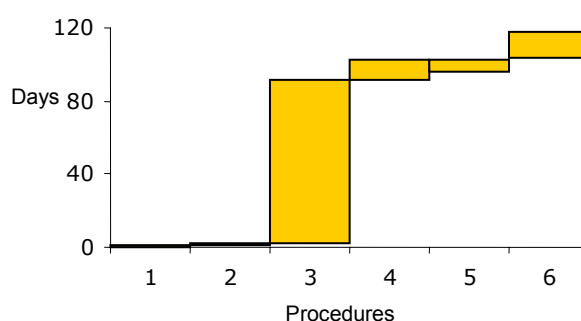


82. Looking ahead, how to improve the business environment in Sub-Saharan Africa? The evidence points to a broad agenda of reform, specific priorities within which, and sequencing of actions, vary from country to country. The assessment of the business environment in the region suggests the following as key areas for attention with respect to improvement of the regulatory and institutional framework in many countries:

- *Streamlining entry regulations and cutting fees.* In Africa the official fees for starting a business are prohibitive for most would-be entrepreneurs. Cutting these fees would help encourage more businesses to operate in the formal sector. To reduce the number of procedures and time for business registration (which can also lead to a significant reduction in cost), governments could also create single access points for business, such as the GUIDE in Madagascar; introduce temporary business licenses; impose “a silence is consent rule” in business registration; and standardize paperwork.
- *Cutting fees and unnecessary procedures for property registration.* A large bottleneck in several African countries is the requirement for government consent before property is transferred. This causes delays, usually requires an exorbitant fee, and can be a major source of corruption. Lesotho, Malawi, Nigeria, Rwanda, Senegal, and Zambia all have government consent requirements. The impact of such requirements can be considerable. For example, if Malawi eliminated the requirement of obtaining consent from ministry of land (procedure 3), registering property would take 28 days, instead of 118 (Figure 2.14). Other reforms that strengthen property rights and encourage investment include simplifying and consolidating different procedures at the property registry, cutting fees, linking the cadastre and property registry, and providing easier access to information in the registry.

- *Encouraging the establishment of credit bureaus.* Access to credit would be made easier by assurances to lenders that borrowers are creditworthy (and that it is possible to recover debt, in case of default). By encouraging the development of credit bureaus, African governments can help furnish creditors with information to sort the good from bad borrowers, price loans correctly, and reduce the costs of screening.
- *Making labor regulations more flexible and reducing the cost of firing.* To accomplish this, African countries can increase the length and scope of term contract; introduce apprentice wages, following the example of Madagascar; allow flexible working hours, as in Namibia; and remove administrative approvals for dismissal.
- *Cutting unnecessary procedures and reducing overall time in enforcing contracts.* Key examples include the introduction of case management, as in Uganda; the reduction in the abuse of appeal procedures, as in Botswana; the improvement of enforcement (in Uganda, the creditor's attorney is responsible for enforcement, with the help of the police); and the creation of specialized courts or sections of commercial courts, as in Tanzania and Ghana.

Figure 2.14 Registering property is unduly time-consuming in Malawi



Source: Doing Business in 2005 database.

83. Some reforms, such as improvements to entry regulations, credit reporting systems, and property registries, can be achieved relatively quickly through administrative reforms. Others, such as labor regulation and court reform, require longer-term efforts and legislative action. Investment climate reform is a process, not an event. Not everything needs to be fixed at once, or perfectly at one go. Significant progress can be achieved by addressing the more important constraints facing businesses in a way that gives them confidence to invest, and by sustaining a process of ongoing improvements.⁴²

84. The foregoing agenda focused on regulatory and institutional reform. The evidence presented above also points to the lack of financial and physical infrastructure as major constraints in many countries. The following two sections focus on these aspects of the agenda.

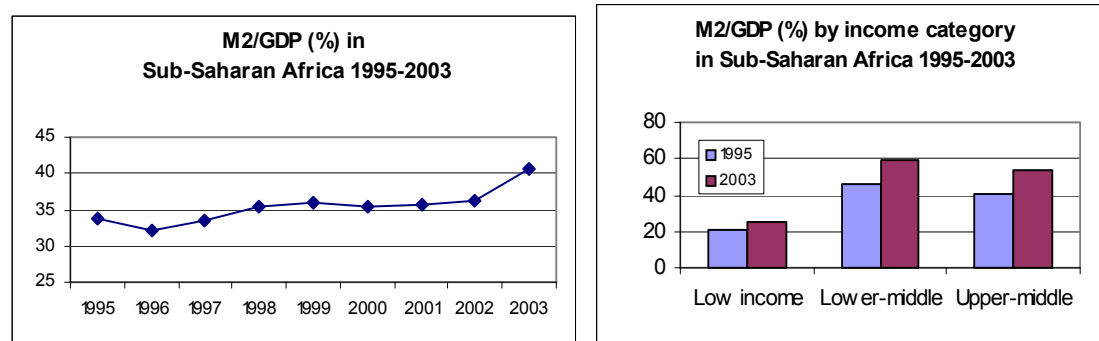
⁴² This is a key message of *World Development Report 2005*.

Financial Sector

85. In Sub-Saharan Africa, the financial sector has gone through major changes over the past decade, and has been largely transformed into an open system that includes a variety of institutions owned by domestic and foreign private entities. With the proliferation of financial institutions, the average bank size has shrunk by about twenty-five percent. These changes revealed underlying weaknesses in regulatory capacity and limitations in risk assessment within the financial institutions, and many African countries have had to cope with significant bank failures. The resolution of these failed banks through restructuring and privatizing has been the main focus of policymakers in the past fifteen years.

86. Additionally, considerable efforts have been made to improve legal and regulatory frameworks as well as to build capacity in the regulatory bodies to prevent further failures. African laws and regulations are now largely comparable to international standards, although the enforcement of regulatory standards is weak, as in many other developing countries. These banking system reforms have achieved substantial results, and financial system stability has improved considerably.

Figure 2.15 Financial depth is lowest among low-income countries in Sub-Saharan Africa



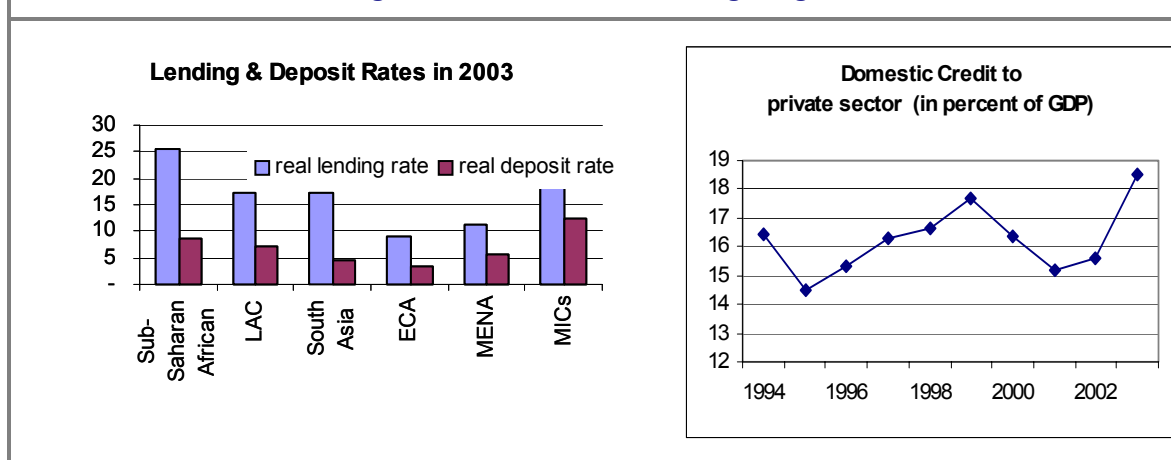
87. Despite this legal and regulatory progress, financial systems in Sub-Saharan Africa remain relatively underdeveloped. Outside South Africa and Mauritius, lending to the private sector is still limited and costly. Over the past decade, there has been only limited progress on financial sector deepening (Figure 2.15). Excluding South Africa, the volume of private sector credit relative to GDP has grown only about two percentage points over the last ten years, with most of the growth occurring recently. A number of explanations have recently been advanced, including increased holdings of government paper by banks due to bank restructuring, crowding out, and more conservative lending in face of high credit risk.⁴³ In practice, the cost of borrowing in Sub-Saharan Africa is higher than other regions (Figure 2.16).

88. In this context, improving access to financial services poses a significant challenge. Investment climate surveys in Sub-Saharan Africa consistently reveal that inadequate access to finance is a major constraint facing entrepreneurs. The same surveys also indicate that access is hampered for two reasons. First, high real interest rates and banking fees make it too costly to utilize financial services, so affordability is a major concern. Second, mainstream financial institutions fail to serve the needs of important population segments, including small-scale

⁴³ Source: Hanson and Ramachandran, *Lessons from Financial Liberalization*, 2004.

entrepreneurs. Virtually all surveys indicate that financial institutions are hesitant to lend because of difficulties in securing collateral and seizing assets in case of loan defaults. The availability of financial services is also crucially related to financial system infrastructure, such as information infrastructure, property rights, regulatory environments and overall governance and institutional development levels.

Figure 2.16 The cost of borrowing is higher



89. There have been notable efforts to put in place credit information systems and better regulations to facilitate access to finance.⁴⁴ The World Bank has documented the incipient development of credit reporting systems in thirty countries in Africa, including some operated by private firms (in Botswana, Cape Verde, Equatorial Guinea, Eritrea, and Namibia). A number of countries have improved regulatory systems to facilitate access to finance, notably the system of legal rights to creditors in Kenya, Nigeria and Zimbabwe, and the registration of movable collateral in Botswana and South Africa. Additionally, Kenya, Uganda, Tanzania, Ghana, and Mauritius have introduced regulatory frameworks to facilitate the integration of micro-finance institutions in the mainstream financial system. These are all promising efforts as development of the financial infrastructure can secure access to credit for a wider segment of the population.

90. Most African countries receive bilateral and multilateral donor-funded facilities for trade and investment finance purposes. When these facilities are implemented effectively, they enhance domestic private sector credit in a substantial way (e.g. Zambia). But the experience to date on donor-funded financing vehicles have shown the need for terms and conditions that are more consistent with long term financial sector development goals. In this respect, donor funded facilities that are: a) priced below market rates; b) targeted to specific sectors and borrowers; and c) channeled through a select few intermediaries, do not provide an adequate framework for the promotion of efficient resource allocation. Coordination among providers of these facilities and harmonization of terms and conditions remains one of the most important challenges among donor-funded facilities to improve financial intermediation.

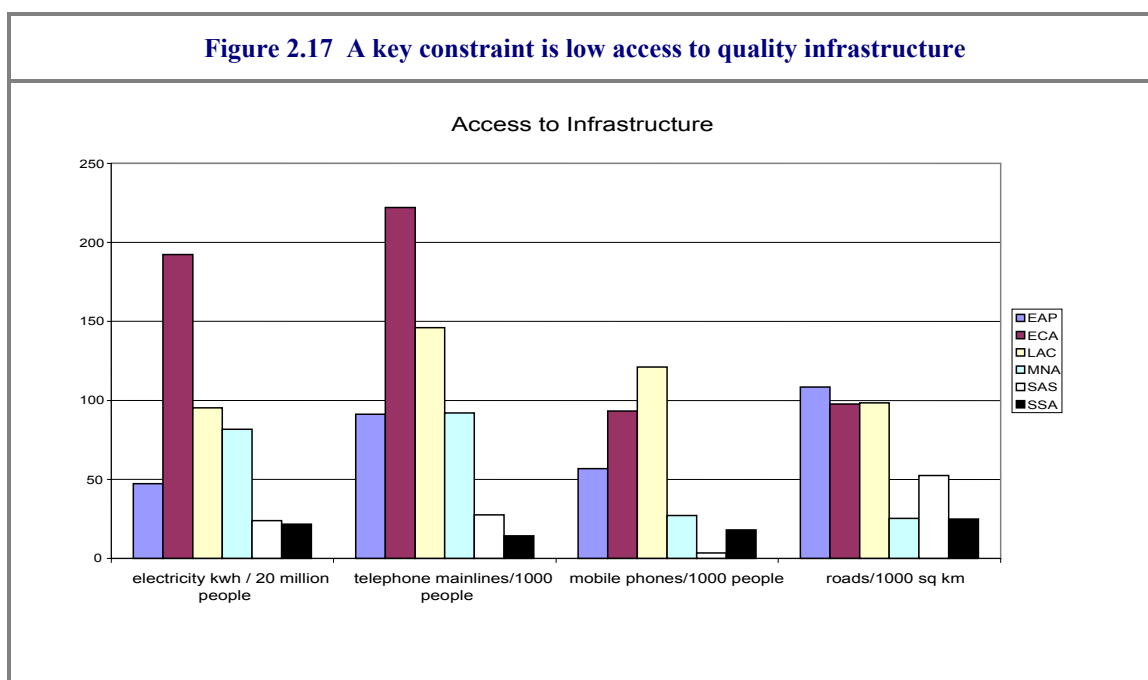
Physical Infrastructure

91. Inadequacies in the level and quality of infrastructure – including of electricity, transport and communications – can adversely affect private sector productivity and investment rates. While macro evidence on the growth impacts of infrastructure remains inconclusive, businesses

⁴⁴ Source: Doing Business data base.

in developing countries often list the quality of infrastructure among their top constraints, particularly in Sub-Saharan Africa and South Asia. For example, entrepreneurs in Sub-Saharan Africa list the lack of reliable electricity supply among the highest constraint overall. Transport infrastructure also is key in that region, given the geographic distances and the existence of a number of landlocked countries. However, the wide variation in survey responses across developing countries suggests that the severity of the constraints imposed on the private sector by inadequate infrastructure varies considerably.⁴⁵ In particular, in some countries, lack of sufficient maintenance, rather than a lack of infrastructure *per se* is the more pressing issue.

92. Available data show that Sub-Saharan Africa and South Asia have the lowest access to basic infrastructure such as water, electricity, communications, and roads (Figure 2.17). Even when services are available, their quality tends to be quite low. Moreover, there is some evidence that the quality of electricity and roads declined during the 1990s.⁴⁶ Across developing countries as a whole, infrastructure deficits deteriorated in the 1990s in the face of falling public investment and a lower-than-expected rise in private investment

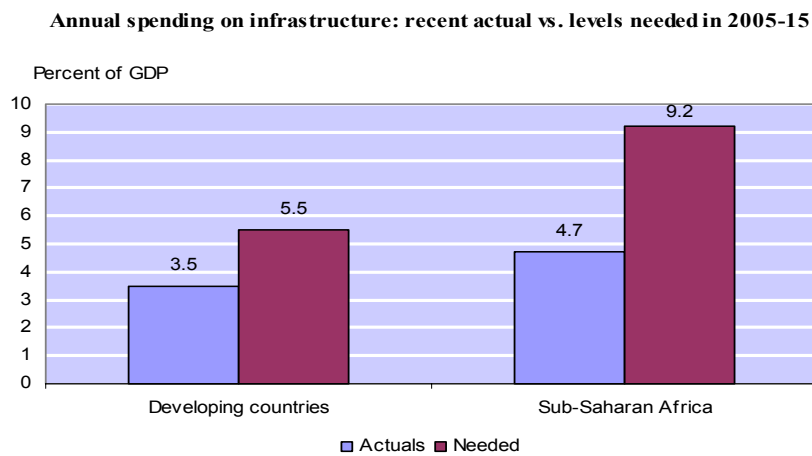


93. Estimates of the infrastructure gap for the developing world indicate sizeable investment needs, and consequently large financing gaps. These gaps increased in many developing countries in the 1990s as public investment in infrastructure fell and private investment failed to rise sufficiently to take up the slack. Based on forecasts of future demand, recent estimates indicate that Sub-Saharan Africa faces investment needs in the order of US\$17-22 billion per year, including both capital and maintenance expenditures.⁴⁷ With estimates on public infrastructure investment of approximately US\$6 billion per year (roughly half of which is donor-financed), and private sector commitments of around US\$4 billion per year, the infrastructure financing gap is calculated to be in the order of US\$7-12 billion per year for the period 2005-15, or close to 4.5 percent of GDP (Figure 2.18).

⁴⁵ There are, of course, other good reasons to prioritize investments in infrastructure, such as enhancing service delivery and accessibility in line with the non-poverty goals of the MDGs; these are discussed in the next chapter.

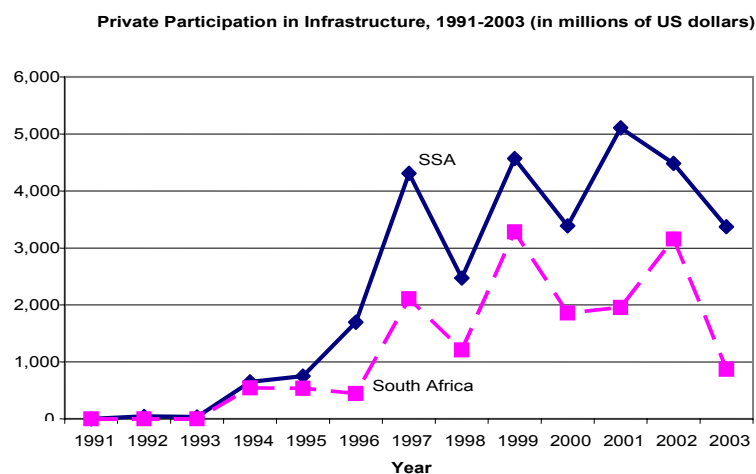
⁴⁶ Estache and Goicoechea (2004).

⁴⁷ Estache and Yepes (2004)

Figure 2.18 Substantial infrastructure gaps, particularly in Sub-Saharan Africa

Source: Estache and Yepes (2004).

94. Under current conditions, it is unlikely that private sector participation in infrastructure (PPI) projects in Sub-Saharan Africa would fill a significant portion of the identified financing gap. With a relatively low level of private sector involvement, Sub-Saharan Africa escaped the retrenchment of PPI observed throughout the developing world in the late 1990s (Figure 2.19). Nevertheless, the initial round of experience with PPI in Sub-Saharan Africa was unsatisfactory in two key respects: first, the level of private participation was below government expectations, and second, a number of contracts were subsequently renegotiated or cancelled. In general, private investors perceived a high level of both operational and political risk, particularly because of the lack of reliable information on the operational and financial outlook, and the bulk of projects were implemented in South Africa.

Figure 2.19 Private participation in infrastructure in most countries remains low and has declined overall

Source: PPI database.

95. The key to long-term success will be in ensuring an enabling regulatory environment for both private and public projects. In this respect, three challenges appear crucial. First, it is important to maintain an adequate balance in the government budget between capital and recurrent expenditures. Politicians tend to find more satisfaction in opening new facilities, but throughout the developing world, the maintenance deficit tends to significantly shorten the lifespan of expensive equipment. Second, it is essential to ensure the financial viability of infrastructure projects with a focus on full cost recovery. It is notable that South Africa, which has made enormous progress in expanding access to water and sanitation services, has a policy of full cost recovery. Third, it is also essential to ensure that returns will not be confiscated by the government. A major risk for private-public partnerships is that governments will renege on commitments to cost-recovering tariffs once fixed investments are sunk. Addressing these questions requires careful design of the contract under which the utility operates and the regulatory environment in which it occurs.

IV. Public Sector Governance: The Role of Institutions

96. Public sector governance has a significant impact on economic outcomes, such as income level and poverty reduction, and on the achievement of non-income MDGs, and in many ways, improving governance is the major challenge facing developing countries. Building on the earlier discussion on the need for sound public financial management and an enabling environment for private sector activity, this section assesses progress in strengthening a broader set of institutions, economic and political, that impinge on economic outcomes.

Economic Governance

97. The standard perception that economic governance remains weaker in Africa than other regions is broadly supported by the available indicators. For example, the Worldwide Governance Indicators, a comprehensive set of measures compiled by the World Bank and based on information for a wide set of sources, show a relatively weak performance in Africa for the four critical governance issues (control of corruption, rule of law, voice and accountability, and government effectiveness) throughout the period covered, 1998-2004. The only exception is voice and accountability, where Sub-Saharan Africa countries slightly outperform two regions: Middle East and North Africa, and South Asia. The Country Policy and Institutional Assessments (CPIA), based on World Bank staff assessments, present a similar picture, with African countries rated lower than all other developing regions on: property rights and rule-based governance, quality of budgetary and financial management, efficiency of revenue mobilization and quality of public administration.

98. Crucially for investment flows, the perception presented by these indicators is confirmed by risk assessment services commonly used by private investors. For example, the composite risk index from ICRG rates Sub-Saharan Africa as the highest-risk region in the world during the period 2000-03 (and consistently since the inception of their assessments in the 1980s).⁴⁸ This overall rating is consistent with the results of the previous section as well as low scores on the key

⁴⁸ The International Country Risk Group (ICRG) measures are published by the PRS Group. The economic risk index is a weighted average of measures on political, economic and financial risk components, with the values ranging from 0 to 100, where a *higher* score indicates *lower* risk. During 2000-03, the median rating for Sub-Saharan Africa is 59, followed by South Asia at 62; Latin America and Caribbean at 67; East Asia and Pacific, Europe and Central Asia, and Middle East and North Africa at 70; and high-income countries (OECD and others) at 82.

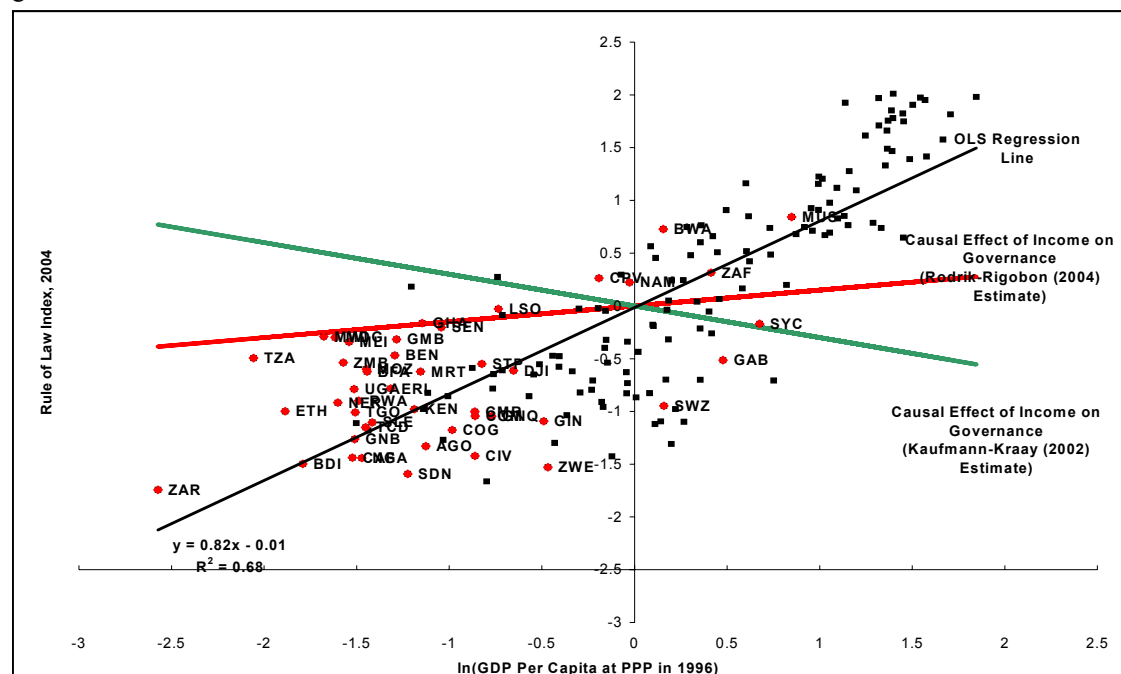
economic governance dimensions, such as 'bureaucratic quality', 'corruption' and 'law and order'.

99. Moreover, while there has been some improvement in recent years on a few indicators in some African countries, econometric evidence confirms that African countries tend to underperform on governance, relative to their income level. Recent claims to the contrary suggest that the perception of weaker governance in Africa is due entirely to low levels of income assume that higher income leads to improved governance; these claims ignore the effect of potential causality from governance to income levels. However, empirical evidence clearly suggests that: (i) the stronger causality effect is from governance to income, and (ii) more importantly in the current context, the majority of African countries have a governance score lower than would be expected on the basis of their level of income (Box 2.12).

Box 2.12 Governance and per capita incomes in Africa

A recent academic paper has argued that weak governance is not a major factor in Africa's poor growth performance (Sachs et. al., 2004). The argument is that, once we allow for the (low) level of income, countries in sub-Saharan Africa do not have particularly poor governance indicators. This point is illustrated in the figure below, which plots the 'rule of law' measure from the Worldwide Governance Indicators (on the vertical axis) against the logarithm of real per capita GDP in the mid-1990s (on the horizontal axis). Countries in Sub-Saharan Africa are highlighted in red. A striking observation from this graph is that over half (27 out of 46) of the countries in the region actually fall above the (ordinary least squares; OLS) regression line, shown in black. The conclusion drawn by Sachs et al (2004) is that, with over half the countries in the region performing better on governance than would be predicted by their level of income, the perception of weak governance in Africa is simply a reflection of a low level of income.

However, simple correlation as portrayed by the OLS regression line does not imply causality. The above argument relies on an assumption that higher income leads to (or causes) better governance. Intuitively, however, causality could run in the opposite direction, with better governance leading to higher income, or more likely, in both directions. In either of these cases, OLS results do not isolate the different directions of causality, and do not support any conclusion on the causal relationship between governance and income.



On the other hand, the red and green lines below are drawn from two attempts to effectively identify the direction of causality. The upward-sloping red line is from Rigobon and Rodrik (2004) and the downward-sloping green line is from Kaufmann and Kraay (2002). Although the two estimates employ different approaches to identification, the conclusions are similar: very few countries (7 and 6, respectively) fall above the regression line. Therefore, the evidence suggests that governance in the region is not as good as one might expect given the level of per capita income.

Source: Daniel Kaufmann, Aart Kraay, and Massimo Mastruzzi (2005).

100. Within this general assessment, disaggregation of the previous indexes by income level reveals important differences across African countries. While low-income countries in Sub-Saharan Africa are assessed as having a weaker performance than their counterparts elsewhere, the 8 middle-income Sub-Saharan Africa countries outperform other middle-income countries. This result holds for the Worldwide Governance Indicators and the CPIA scores, as well as the ICRG risk assessments.⁴⁹

Political Governance and Accountability

101. On political governance, Sub-Saharan Africa's performance is stronger, with indicators generally ranking Sub-Saharan Africa ahead of some of the other developing regions. For example, on Freedom House's 2005 rankings of political rights and civil liberties, Sub-Saharan Africa is rated as 'more free' than both Middle East and North Africa, and South Asia. More impressively, the Database on Political Institutions maintained by the World Bank shows that, by 2002, Sub-Saharan Africa attained a higher percentage of countries with chief executives selected via competitive multi-party elections than the average for other developing regions (see figure below). Finally, the African Governance Indicators, compiled for UNECA's 2005 African Governance Report,⁵⁰ confirm the (relatively) higher scores on the political dimension and lower scores on economic governance (see Box 2.13).

102. On press freedom, a key indicator of political accountability, the picture is similar. A well-informed citizenry has been cited as the "ultimate constraint on a democratic government"⁵¹ and recent evidence points to the role of the mass media in promoting good governance and holding governments responsive and accountable.⁵² For 2004, the Freedom House indicator of press freedom ranks Sub-Saharan Africa (with 50 percent of countries ranked as 'Not Free') ahead of both MENA and South Asia (with, respectively, 100 and 75 percent of countries ranked as 'Not Free').

Is Governance Improving?

103. On economic governance, there is little evidence of region-wide improvement. The Worldwide Governance Indicators do not provide any evidence of a relative improvement over

⁴⁹ On the ICRG economic risk index, low-income countries in Sub-Saharan Africa have a risk assessment of 31, compared with 33.5 for other low-income countries (where a lower score implies a higher risk). On the other hand, the same index rates middle-income countries in Sub-Saharan Africa at 36.5, compared to 35.5 for other middle-income countries.

⁵⁰ United Nations Economic Commission for Africa: *Striving for Good Governance in Africa. Synopsis of the 2005 African Governance Report* (Prepared for the African Development Forum IV, Addis Ababa, October 2004; <http://www.uneca.org/agr/>).

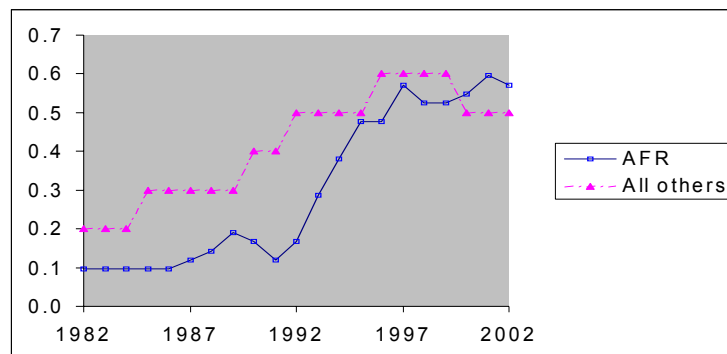
⁵¹ McMillan and Zoido (2003), p. 87.

⁵² Besley and Burgess (2002) and Djankov et al (2003).

the period covered, 1998 to 2004.⁵³ Similarly, the most commonly used ICRG indicators (bureaucratic quality, corruption, and law and order) show no improvement over time, while the CPIA assessments show only marginal improvement.⁵⁴ The same pattern of stagnation holds for both low-income and middle-income Sub-Saharan Africa countries.

104. On the other hand, the past decade has brought substantial improvement in political institutions across Sub-Saharan Africa. [Since 1990], the Freedom House indexes on political rights and civil liberties in Africa have outpaced the general trend towards more inclusive and open political systems; similar indications are provided by the Polity index on democracy. Equally positive has been the progress suggested by the Database on Political Institutions, according to which Sub-Saharan Africa has made impressive strides since the mid-1990s (Figure 2.20).

Figure 2.20 Participatory processes are improving everywhere, but most rapidly in Africa



Source: Database on Political Institutions, World Bank.

1/ Non-competitive elections are deemed to be those in which the winner receives more than 75 percent of the vote.

Can Policy Spur Institutional Reform?⁵⁵

105. Institutions tend to persist but they are not predetermined. Economic institutions have certainly improved considerably in Chile and the fast growing countries of East Asia, and there is some evidence of recent improvements in political institutions across Sub-Saharan Africa. At times, crises or changes in leadership have led to institutional change but these are not amenable to policy guidance. More applicable is the possible role of policy in promoting improvements in economic or political institutions.

106. In general, policies that open up economic opportunities to a circle wider than the initially entrenched elite tend to be conducive to institutional improvement. An improved investment climate tends to spur demands for wider institutional reforms because as “investors, whether domestic or foreign, come forward, they tend to demand more effective institutions, greater security, and constant improvements in the provision of public goods, which further enhances the

⁵³ These indicators are not, strictly speaking, designed to show progress over time but they do indicate whether a region is making progress relative to others, over time.

⁵⁴ The improvement in the CPIA assessments during 1999-2003 is marginal in two senses: (i) relative to the average improvement in other regions, and (ii) statistically, compared to the standard deviation.

⁵⁵ This discussion draws on IMF (2003).

quality of the investment climate”.⁵⁶ Along the same lines, a number of studies have found that strengthening competition, including through trade openness, can be conducive to institutional improvement.⁵⁷ Opening up new markets may reduce the rents derived from the prevailing economic and institutional arrangements and thus weaken vested interests.

107. There is also evidence that the wide availability of independent sources of information tends to encourage accountability. Where ownership of press outlets is monopolized by the government, political and economic freedom tends to be lower and corruption higher, and when there is more information available on policy choices and outcomes, governments tend to be more responsive.⁵⁸ In a prominent case, Amartya Sen drew a link between the impact of transparency on the relative incidence of poverty and famine in India and China.⁵⁹ The combination of higher transparency of public decisions and press freedom to stoke the public debate tends to constrain the options available to policymakers and reduce the scope for institutional failure.

108. In some cases, external anchors may also contribute to institutional change. In combination with domestic commitment to reform, external incentives, constraints and agreements may assist in breaking through entrenched interests and other domestic impediments to reform. This has been true in the case of accession to the European Union for new members in Central and Eastern Europe, NAFTA for Mexico, and WTO in the case of China. In Africa, NEPAD aims to use collective commitments and peer pressure to promote institutional reform (see discussion below). Concessional loans and technical assistance from international financial institutions are also geared to improving the policy and institutional framework in borrowing countries.

Priorities for Building Capable and Accountable States in Africa

109. Across Sub-Saharan Africa, there is increased recognition of the critical role of good governance and a renewed resolve to improve performance on the ground. Under the aegis of the New Partnership for Africa’s Development (NEPAD), African states agreed to improve their economic and political governance. Concurrently, the work of regional development agencies is focusing more on governance, and UNECA’s 2005 African Governance Report represents a major contribution towards the build-up of a critical mass of country-specific data and analysis on governance achievements and challenges. On the ground, NEPAD continues to advance with its innovative approach to improving governance, the African Peer Review Mechanism (APRM).

110. On the ground, 23 countries, comprising approximately ¾ of the population of Sub-Saharan Africa, have already acceded to the APRM, a key objective of NEPAD since its inception in 2001. Under the APRM, African governments sign up their countries voluntarily to ‘open their books’ on political governance, economic governance, corporate governance, and socio-economic development. The underlying objective is to foster the adoption of policies, standards and practices that lead to political stability, high economic growth, sustainable development and accelerated sub-regional and continental economic integration through sharing of experiences and reinforcement of successful and best practice.

111. In 2004, NEPAD Heads of State approved Ghana, Kenya, Mauritius and Rwanda as the first countries to be exposed to the APRM reviews. The second group of countries to be reviewed will

⁵⁶ Stern, A Strategy for Development, ABCDE Keynote Address, May 2001, Washington, DC.

⁵⁷ See, for example, Ades and Di Tella (1999), Berg and Krueger (2003), Djankov et al (2001), Wei (2000) and the World Development Report 2002.

⁵⁸ See, for example, Djankov (2001), Adserà et al (2003) and Brunetti and Weder (2003) on the relationship between the press and governance, and Besley and Burgess (2000) on the relationship between government responsiveness and newspaper circulation.

⁵⁹ Sen (1995).

include Algeria, Mali, Mozambique, Nigeria, Senegal and South Africa. The four countries that have started the review process have established focal points (at ministerial level or higher) for the APRM as well as national coordinating mechanisms to secure widespread consultations through all APRM stages. The extended design of the APRM process emphasizes learning and seeks to build more inclusive processes than what are typically found in, for example, PRSP formulation and implementation.

112. Recent changes in approach have lengthened considerably the process, and the focus has changed from the regional to the country-specific level. With the limited capacity of the APRM Secretariat to prepare background analyses of countries and to promote substantive, political discussions on governance problems in the individual countries as well as in the APR Panel and Forum, the APRM faces the challenge of moving beyond formal consultations and extended processes. These are critical challenges for the APRM as the most innovative and potentially influential component of NEPAD.

113. In the period ahead, it will be essential to translate the recent improvements in political institutions to similar enhancements in economic institutions, particularly in rule-based governance and protection of property rights. Extending reforms to these critical dimensions of governance would begin to set in motion a virtuous circle consisting of renewed incentives for better policies, a more favorable environment for private investment, and rising standards of living. Improved policies can play a role in spurring institutional development, including by helping to overcome the resistance to change from entrenched interests. In practice, political commitment will be key in ensuring that reforms extend beyond mere changes of formal laws to more fundamental transformations of daily practice, including the informal rules of behavior and the impact of vested interests.

Box 2.13 UNECA's 2005 African Governance Report: Indicators and Agenda

The African Governance Indicators, compiled as part of UNECA's 2005 African Governance Report, offer interesting insights on the relative strengths and weaknesses of different governance dimensions in Africa. Based on surveys in 25 countries in Sub-Saharan Africa, the figure below shows that, on average, the highest scores are given for indicators of political representation: the credibility of the electoral process; the freedom of political parties; and the distribution of political power. Average scores were lower for the effectiveness of institutions in all three branches of government (executive, judiciary, legislature). Scores were lower still for the efficiency of government services, the control of corruption, and the transparency and accountability of the civil service. Scores were lowest for the decentralization of government structures and corruption in the tax system. Generally, these assessments are consistent with the thrust of the earlier discussion on economic and political governance.*

The Report identifies ten priority areas in building capable and accountable states:

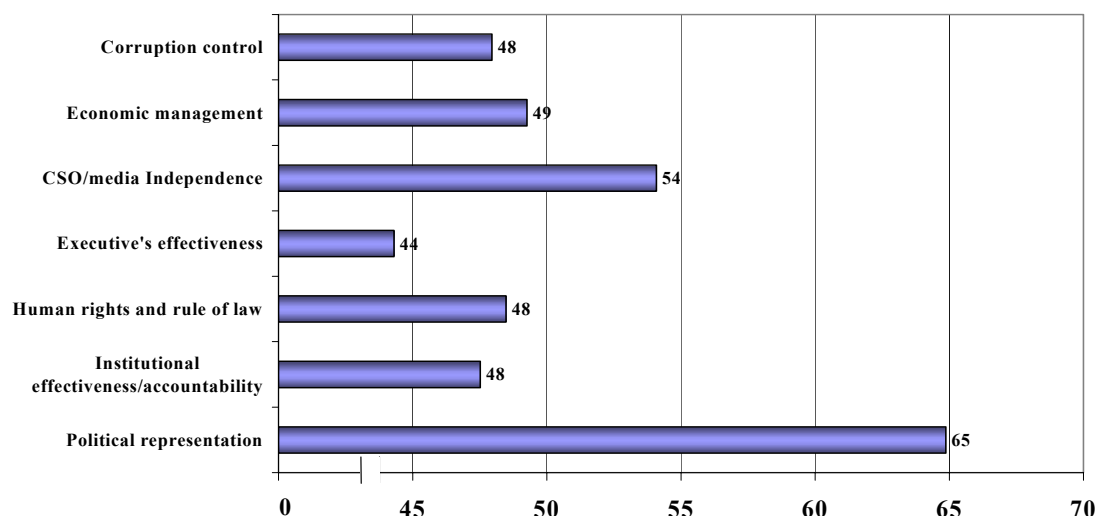
1. Strengthening the *capacity of parliaments* to perform their core functions, including providing checks and balances on the executive. Parliamentarians and their support staff need training and access to libraries and databases.
2. Deepening *legal & judicial reforms*, including through protection and enforcement of the autonomy of the judiciary and modernization of the judicial process. The judiciary needs independent funding. Reforms must cover also the police force and public prosecutors.
3. Improving *public sector management* through long-term sustained efforts, tailored to each country's needs; for example, reducing red tape, accelerating improvements in pay and other incentives, and using in-country, regional and international knowledge hubs.
4. Improving the *delivery of public services*, through effective channels of accountability between public service providers and their clients. Options include decentralization and encouraging greater choice and competition.
5. Removing *bottlenecks to private enterprise*, to improve national and regional investment climates. This requires macroeconomic stability, consistent policies and regulations of business

- entry, protection of property rights and enforcement of contracts.
6. Tapping the potential of *information and communication technologies* for promoting transparency, openness and knowledge exchange also in the affairs of government. Due to high costs, a strategic approach to e-governance is needed.
 7. Fostering *credible and responsible media* that report accurate information and stimulate debate in an environment of freedom. Training is needed to support professionalism and effective self-regulation by the media.
 8. Maximizing the contribution of *traditional modes of governance*. Traditional authorities must be enabled to complement the resources of government in providing public goods and services, including for conflict prevention and resolution.
 9. Confronting the *governance dimension of HIV/AIDS*, which requires strong national leadership to reduce the effects of the pandemic on institutional structures and to manage the resources and mechanisms needed for society-wide responses.
 10. Getting *partners to live up to their commitments* for more and better aid through harmonized procedures, budget support and predictable disbursements. Policies on aid, trade and debt must be consistent with African efforts to achieve the MDGs.

This is an ambitious reform agenda that will require considerable contributions in the area of political commitment and supporting actions from donors, including assistance for capacity development. On every dimension, the international financial institutions, in concert with bilateral donors, have launched initiatives to assist steadfast reformers push ahead.

**Stronger performance on political representation;
weaker performance on public sector management and institutional effectiveness**

Perception of Key Dimensions of Governance (average for 23 African countries)



Note: The scale is from 0 to 100, where scores close to 100 reflect good governance as perceived by the survey respondents.

Source: Survey of national expert/opinion leader panels conducted for the 2005 African Governance Report, published by the United Nations Economic Commission for Africa.

* The qualitative conclusion on the relative ranking of political and economic institutions is not affected by taking into account the confidence intervals of these survey estimates.

3. Scaling Up Service Delivery

1. The chance for every child to go to primary school. A place to go for medicine and basic health care. Clean water flowing from the tap. Sanitation. Electricity at the turn of a switch. These basic services are taken for granted by citizens of industrial countries. Yet in much of the developing world—even for relatively wealthy groups—these services are either unavailable or only available at low quality or high private cost.

2. The human development outcomes at the core of the Millennium Development Goals (MDGs)—primary education, literacy, gender equality, good health—depend on access to these basic services. Human development outcomes are also influenced by many other factors, such as individuals' traits and family background, community features (including roads and communications), and country characteristics (including income, demography, geography, and history). But striking differences in these outcomes across countries can be explained to an important degree by the policy choices governments make to shape the financing and delivery of the basic education, health, water, and sanitation services that directly affect human development.

3. This chapter assesses the progress that countries and regions are making toward the human development MDGs, focusing on the three most difficult implementation challenges for most countries:

- Scaling up skilled providers—the doctors, nurses, and teachers needed to rapidly expand health and education services.
- Ensuring the sustained financing required to expand these recurrent cost intensive services.
- Making sure that resources translate into effective service delivery, by improving governance and accountability.

4. This selective focus means that the chapter gives less attention to many other issues—including social protection, population trends, pharmaceuticals, school construction—that are also important for MDG progress. The goal is to complement other analyses, including *Global Monitoring Report 2004* and the recent Millennium Project and task force reports, which are more comprehensive. The chapter also contains a detailed assessment of MDG-related global programs launched since 2000 and of the role donors need to play in accelerating MDG progress. It concludes with an action agenda for countries and their development partners, derived from this stocktaking, one-third of the way to 2015.

I. The Pace of MDG Progress, 2000–05

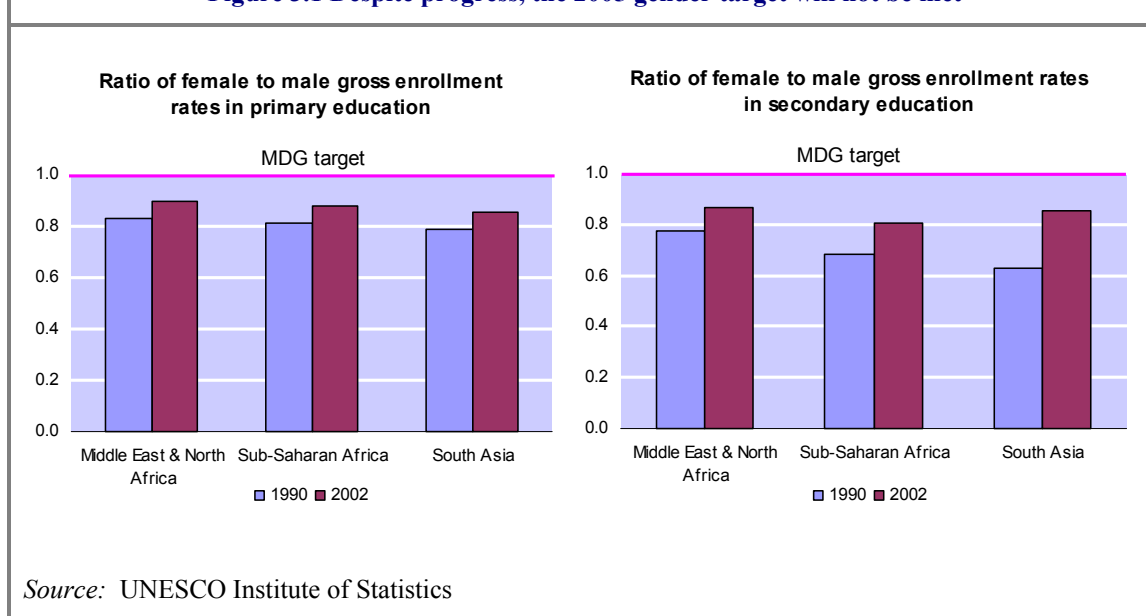
5. Five years after the global commitment to the MDGs, progress has been inadequate to assure their attainment. Sub-Saharan Africa is not on track to achieve a single MDG. In addition to the goals discussed in the sections that follow, it is off track on the hunger goal—and is the only region where child malnutrition is not declining. South Asia is off track on six goals: gender equality, universal primary completion, child mortality, maternal mortality, communicable diseases, and sanitation. And while malnutrition in the region is dropping sufficiently to achieve the MDG target reduction, it still remains at very high absolute levels: almost one child in two under age five is underweight. The Middle East and North Africa is also off track on six goals: gender equality, universal primary completion, child mortality, communicable diseases, water, and sanitation. Europe and Central Asia is off track on child mortality, maternal mortality, communicable diseases, and sanitation. And both Latin America and East Asia and the Pacific are off track on child mortality, maternal mortality, and communicable diseases.

6. This slow progress is all the more troubling because the MDGs are only first-stage development goals; no 21st century country can afford to focus on these alone. No matter how far they are from universal primary completion, countries must invest simultaneously in secondary and tertiary education – both to produce the skilled workers that health, education and other sectors need, and because increasing rates of primary completion generate social demand for more schooling. No matter how high child mortality is, countries also face increased chronic diseases among adult populations. In a world of competing priorities and devastating natural disasters, the challenge facing developing countries is not only to achieve the MDGs; it is to achieve them at minimum global cost while simultaneously advancing other important goals. The next sections look at where progress is being made, where it is not, and why.

Gender Equality

7. The world will not meet the first MDG target, set for 2005: the achievement of gender equality in primary and secondary education. Despite strong progress in every region, girls' enrollments at the primary level are still less than 90 percent of boys' in Sub-Saharan Africa, South Asia, and the Middle East and North Africa (figure 3.1). At the secondary level, only Europe and Central Asia has achieved enrollment parity. Primary completion rates show the same pattern—great progress in narrowing the gap, but as of 2003 the completion rate for girls was still more than 15 percent below that of boys in Sub-Saharan Africa and South Asia. Forecasts for the 2015 goal of gender equality in tertiary education are even less encouraging, as less than twenty percent of developing countries are on track to achieve this target.

Figure 3.1 Despite progress, the 2005 gender target will not be met



8. Although gender parity in primary education will not be reached globally in 2005, an impressive number of countries will reach it—even in the three regions with the deepest education inequality. In Sub-Saharan Africa these countries include Botswana, Gabon, Kenya, Lesotho, Mauritius, Namibia, Rwanda, Seychelles, Tanzania, and Zimbabwe; in South Asia, Bangladesh, Maldives, and Sri Lanka; and in the Middle East and North Africa, Jordan, Libya, Oman, and Saudi Arabia. Jordan and Oman have also achieved gender parity in secondary education.

9. While some of these countries had relatively equitable gender outcomes in education in 1990 (the year against which progress toward the MDGs is measured), in others, policy actions and incentives have transformed the playing field for girls. In Guinea girls' enrollments in primary education rose from barely 40 percent of boys' in 1990 to a projected 88 percent in 2005. Similar progress has been made in Benin, The Gambia, and Mauritania, as well as Bangladesh, Morocco, Nepal, Papua New Guinea, and Yemen. How did they do it? Box 3.1 profiles different strategies.

10. But achieving gender equality and empowering women, which is the third MDG, involve more than parity in education enrollments. Other objectives include increasing the share of women in nonagricultural employment, gender parity in literacy, and the share of women in national parliaments. Paid employment is crucial to women's empowerment and important to families' welfare, because women are more likely than men to invest their income in health care, education, and food.¹ But progress has been slow. Between 1990 and 2003 women's share of nonagricultural employment in developing countries increased only 2 percentage points, from 35 percent to 37 percent.

11. Progress has been made in reducing female illiteracy. But it has not been sufficient to close the gender gap in Sub-Saharan Africa, South Asia, and the Middle East and North Africa. In these regions, literacy rates among women aged 15-24 are still 10–20 percentage points lower than among men.

12. More encouraging is the progress in political representation. The share of countries where women hold at least one-fifth of the seats in national parliaments grew from 13 percent in 1990 to 24 percent in 2004. This is a significant change. However, a report prepared for the recent "Beijing plus 10" conference rightly noted that the real mark of progress is women's greater prominence in political life translating into leadership positions and more influence over the decision-making process. In many cases, the report concluded, this has yet to happen.² The conference concluded that there is still much to implement from the Beijing plan of action, including faster progress in the MDG targets for gender equality.

13. The world's failure to meet the 2005 target for gender parity in primary and secondary education should not be rewarded with a reprieve to 2015. Most regions are on track to achieve parity sooner—particularly at the primary level, where girls' enrollments have been growing faster than boys' in every region. The UN should review the latest available data and set a new year for this target, such as 2007 or 2008, to encourage the fastest possible progress.

¹ Haddad, Hoddinott, and Alderman

² "Gender Equality: Striving for Justice in an Unequal World", UN Research Institute for Social Development, 2005

3. Scaling Up Service Delivery

Box 3.1 Fast progress in closing the gender gap is possible

Ten Sub-Saharan countries will meet the 2005 target of gender parity in primary education, and at least three others will come close. In every case, some combination of the following policies lies behind the progress:

- *Making schools affordable.* Eliminating school fees increases both girls' and boys' enrollments, but as demonstrated in Tanzania and Uganda, these policies have a larger effect on girls. Countries such as Bangladesh and The Gambia have gone further, providing scholarships and financial aid for girls in the poorest communities. Cash and food transfers conditional on girls' school attendance have also helped. World Food Program "take-home rations" in Eritrea, Ethiopia, Ghana, Guinea, and many other African countries have been associated with significant increases in girls' school attendance and completion.
- *Adding water and sanitation to schools* - In Kenya,³ Bangladesh,⁴ Nigeria,⁵ India⁶ and other countries, the introduction of clean and private sanitation and washing facilities in schools has raised girls' attendance rates by as much as 11 per cent.⁷ UNICEF surveys in Africa and Asia show that as few as 10 per cent of schools in some countries have adequate and separate sanitation facilities, and student/latrine ratios can be as high as 150:1.⁸ Standpipes at schools also relieve the burden girls face in fetching household water from distant sources.
- *Providing bilingual instruction.* Instructing children in their first language during the early years of schooling lowers repetition and raises attendance, classroom participation, exam scores, and promotion rates—especially for girls. In Mali, teaching in the mother tongue in grade 1 and gradually replacing it with French afterward has led girls to volunteer more during class, read more comfortably, and stay in school. In Mauritania a switch to Arabic language instruction has increased girls' enrollments.
- *Increasing the number of female teachers.* In Botswana a consistently positive relationship was found between the higher proportion of female teachers in a school and girls' achievement levels. The Gambia also reviewed curricula to ensure that they were gender-sensitive, and offered career counseling for girls.
- *Involving the community.* Involving communities in the development of national and local action plans has helped identify and address factors that deter girls from attending school. In 1993 The Gambia became the first country to apply Participatory Learning and Action (PLA) to girls' education. Ideas that emerged included flexible fee payment schedules, separate latrines for girls and boys, and enforcement of sexual harassment policies in schools—and resulted in sharp increases in girls' enrollments at both the primary and secondary levels. In Guinea, Kenya, Senegal, and Uganda this approach has led to changes in school calendars and fee policies, single-sex schools, and community-supervised protection for girls.
- *Raising public awareness.* In Niger the rise in girls' primary enrollments is due in part to campaigns on the importance of girls' education, particularly in rural areas. The Gambia has used women's theater groups to raise community awareness of the importance of girls' education.
- *Reducing the distance to school.* Girls' enrollments often expand faster than boys' with the construction of new schools because they relieve concerns about girls' safety in walking long distances to school.
- *Making schools girl-friendly.* Allowing married and pregnant adolescents to attend school and offering flexible school schedules has promoted girls' secondary school attendance in Botswana, Guinea, Kenya, Malawi, and Zambia.

³ IRC, 2004

⁴ Sen, 2000

⁵ UNICEF Nigeria, 2003;

⁶ UNICEF India, 2003; and other UNICEF India sources

⁷ Sen, 2000

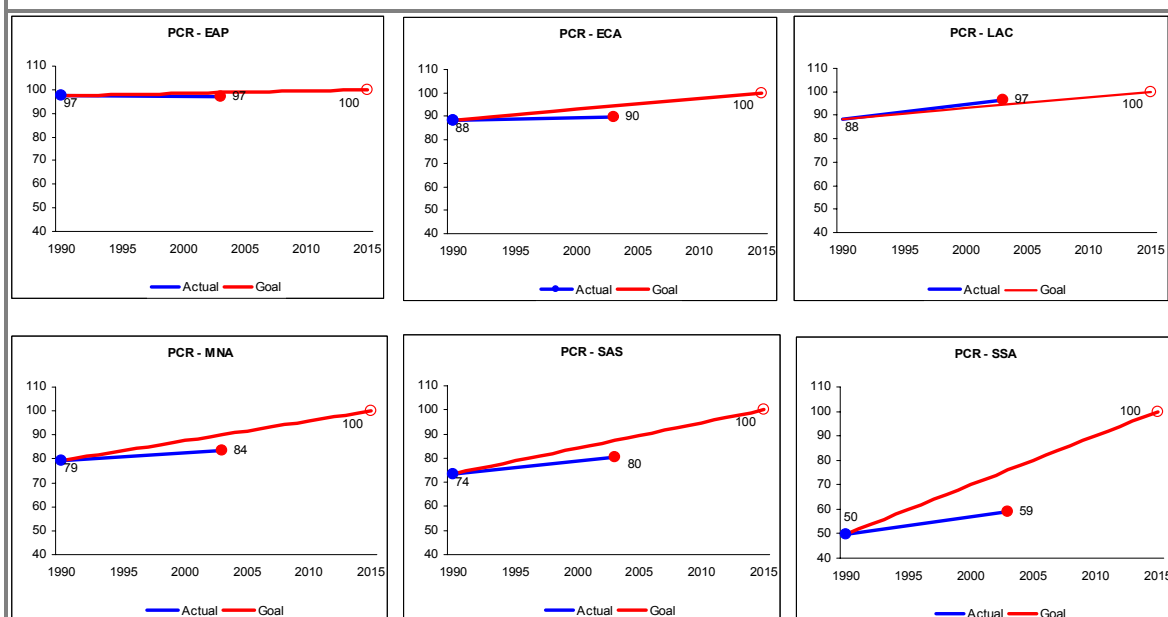
⁸ e.g.: UNICEF Somalia 1999 KAP survey, recent Sudan survey

Universal Primary Education

14. Primary education completion rates are increasing in all developing regions. But as with gender equality, in the Middle East and North Africa, South Asia, and especially Sub-Saharan Africa the pace of progress is too slow to ensure attainment of the second MDG: universal primary completion by 2015 (figure 3.2). Latin America and the Caribbean has made strong progress and, on a population-weighted basis, both it and East Asia and the Pacific are close to achieving the goal. In both regions, though, some smaller countries are not on track. Although Europe and Central Asia needs to accelerate progress, the goal is within reach.

15. In Sub-Saharan Africa the prospects are dim. In 2003 only 59 percent of children completed primary school, and on current trends the region will not achieve universal primary completion until 2061. In five African countries less than one child in three completes primary school.

Figure 3.2 Several regions are off-track to universal primary completion by 2015



Population-weighted.

Source: UNESCO Institute for Statistics and World Bank joint database.

16. Yet enormous education progress is being made in Sub-Saharan Africa. The annual increases in primary completion being registered in the best-performing low-income countries far exceed anything achieved by today's industrial countries at a similar stage in their development.⁹ Since 1990, seven of the developing world's top ten performers have been in Africa, including Mali, Eritrea, Guinea, Sao Tome and Principe, Benin, Ethiopia and Togo. In all of these countries, completion rates have increased by more than 4 percent per year, well above the region's average of 1.3 percent per year. Core elements of the policy progress in these and other countries have been: political commitment to universalizing education; pragmatic actions to lower the costs of schooling coverage through more efficient construction, teacher training and hiring; attention to crucial quality inputs such as books and materials; and "demand-side" actions to make schools more accessible—by adapting the language of instruction, changing the school calendar and other actions.

⁹ Clemens, 2003

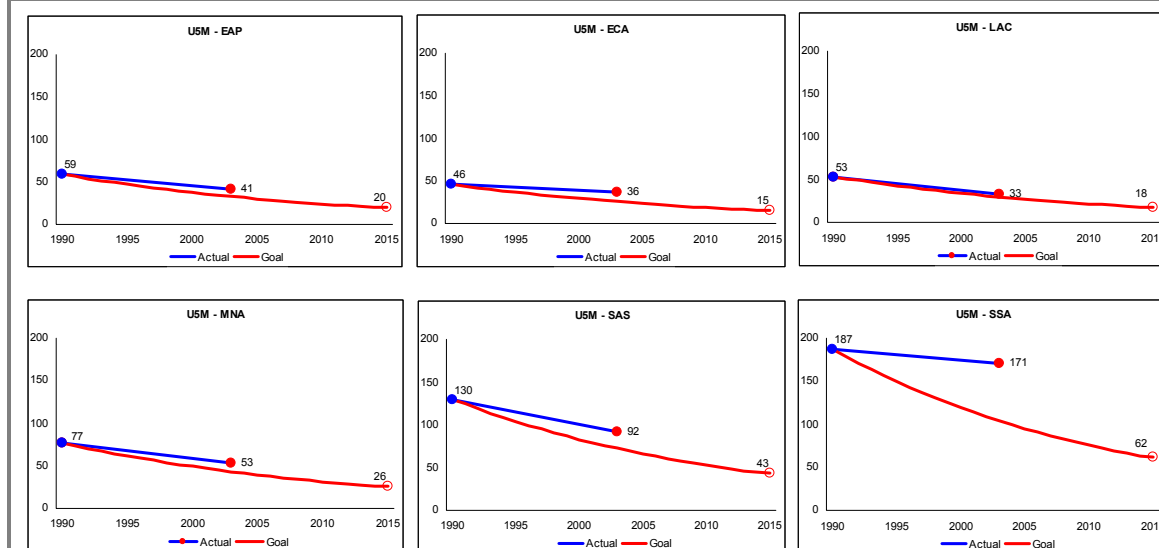
17. The issue for MDG attainment is the very low base from which many African countries have started. For any country with a completion rate below 62 percent in 2003, even the highest recorded rates of improvement (on a percentage point basis) would not be enough to assure attainment of the MDG. Across five regions, 26 countries fall below this threshold—and 22 are in Sub-Saharan Africa.

18. In another set of countries, though, slow progress is the issue. The primary completion rate was virtually stagnant from 1990 to 2000 in Ghana, Kenya, Nigeria, and Tanzania, and has only recently begun to increase. These countries can attain universal primary completion, but only if progress improves substantially and is sustained. That is also true for a significant number of countries in other regions, most notably India. There is clear scope for diffusion of knowledge and expanded financing to help lagging countries, including through global programs such as the Education for All Fast Track Initiative. But global attainment of universal primary education by 2015 is far from assured.

Child Mortality

19. Every week in the developing world, 200,000 children under five die of disease—the equivalent in deaths of the recent South Asian tsunami, just among children, every week. The fourth MDG aims to reduce infant and under-five mortality by two-thirds between 1990 and 2015, implying an average reduction of 4.3 percent a year. Although no region achieved such a population-weighted reduction in the 1990s, Latin America and the Caribbean, the Middle East and North Africa, and East Asia and the Pacific are not far off track (figure 3.3).

Figure 3.3 Despite progress on child mortality, all regions are off track



Source: U.N.; World Bank staff estimates.

20. As with the primary completion rate, there is substantial variance in trends at the country level. Even in Sub-Saharan Africa, where little progress has been made overall, countries such as Mozambique, Malawi, Namibia, Uganda and Ethiopia have improved child survival despite challenging circumstances, such as widespread HIV/AIDS (box 3.2). But other Sub-Saharan countries saw child mortality increase in the 1990s, erasing earlier progress.

21. About 70 percent of child mortality occurs within the first year of life, and almost 40 percent is in the first month of life. Most of these deaths are due to five highly preventable and treatable conditions: acute respiratory infections, diarrhea, malaria, measles, and malnutrition. Basic postnatal care, breastfeeding, and access to simple, low-cost treatments for diarrheal diseases can have major impact on infant mortality. Water supply and sanitation also have a large impact: approximately 90% of diarrheal deaths among children are attributed to lack of safe water and sanitation.¹⁰ Finally, low-cost immunizations against measles, diphtheria, polio, and other diseases can prevent childhood morbidity and deaths. Encouragingly, three developing regions have achieved 90 percent coverage against measles: Europe and Central Asia, Middle East and North Africa, and Latin America and the Caribbean. But coverage has fallen in East Asia and the Pacific, and in Sub-Saharan Africa it has stagnated at less than 60 percent.

Box 3.2 Reducing child mortality in Mozambique

Despite low economic development and high poverty—GNI per capita was \$200 in 2002, and 54 percent of the population lives below the poverty line—Mozambique has made impressive progress in lowering under-five mortality, from 226 per 1,000 live births in 1990 to 170 in 2003. While this level is still very high, the decline is encouraging given the country's unfavorable disease environment, with HIV/AIDS affecting an estimated 15 percent of adults and a high prevalence of malaria and other infectious childhood diseases.

What accounts for Mozambique's success? One important factor has been the country's efforts to provide basic preventive health services in remote areas, delivered by both community health facilities and mobile teams, resulting in high coverage for key interventions. About 85 percent of women receive antenatal care, while 77 percent of children are immunized against measles and 63 percent are fully immunized. Community-based services also promote healthy behaviors such as breastfeeding and oral rehydration therapy. Mozambique has demonstrated that mobile teams can be effective, in an environment with too few health facilities and a dire shortage of qualified health staff, reaching households that otherwise lack access to health care.

Source: Mozambique Health Country Status Report, World Bank (2004)

Maternal Mortality

22. Every week 10,000 women in the developing world die giving birth. A woman's risk of dying during delivery is 250 times higher in low-income countries than in industrial countries. The fifth MDG calls for a three-quarters reduction in the maternal mortality ratio between 1990 and 2015, an average annual reduction of 5.4 percent. Due to very scarce data, maternal mortality is tracked largely through modeling projections from demographic data rather than direct reporting, and trend estimates are quite tentative. The World Bank's estimates are that only one developing region is on track to reach the target (Middle East and North Africa), though two others (East Asia and the Pacific, Europe and Central Asia) are close. (Wagstaff and Claeson, 2004). In Latin America and the Caribbean the maternal mortality ratio (190 per 100,000 births) is lower than in other regions, but it is proving more difficult to achieve incremental improvements.

23. Because measuring maternal mortality rates directly is so difficult, the percentage of deliveries attended by medically skilled personnel is also used to track progress. Although this indicator increased in all regions between 1990 and 2000, it is still below 50 percent in South Asia and Sub-Saharan Africa.

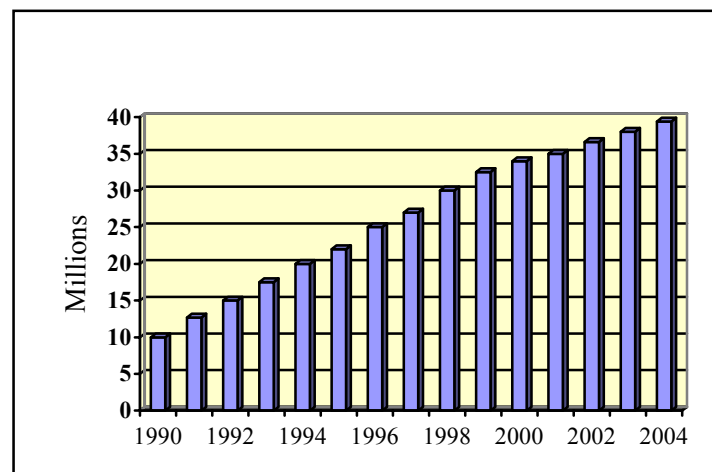
¹⁰ Black, 2003.

HIV/AIDS, Malaria, and Other Diseases

24. The sixth MDG is to halt and begin reversing the spread of HIV/AIDS, malaria, and other major communicable diseases by 2015.

25. *HIV/AIDS.* Despite 20 years of efforts to control it, HIV/AIDS continues to spread. In 2004, 39 million people were living with HIV/AIDS (figure 3.4), and 3.1 million died—more than from any other infectious disease. That same year an estimated 4.9 million people became infected with HIV, 2 million children were living with it, and 15 million children had been orphaned.

Figure 3.4 The number of people living with HIV/AIDS has quadrupled since 1990



Source: UNAIDS

26. Sub-Saharan Africa remains by far the worst-affected region, with nearly two-thirds of all people with HIV/AIDS. The average HIV prevalence rate in the region is 7.4 percent, or 1 in every 14 people—and in Southern Africa it is 1 in 3. Life expectancy in nine African countries has dropped below 40 because of the disease, and 11 million children have been orphaned by it.

27. But there is no room for complacency in any region. Since 2002, the number of people with HIV/AIDS rose by 50 percent in East Asia, reflecting China's rapidly growing epidemic, and by 40 percent in Europe and Central Asia, where key factors were rapid spread in the Russian Federation and Ukraine.

28. Two decades of battling HIV/AIDS have taught the world two main lessons. First, countries have a crucial window of opportunity early in the epidemic, when prevalence is largely confined to high-risk populations such as sex workers and intravenous drug users. Brazil, Cambodia, Senegal, and Thailand are among the countries that acted decisively to introduce strong prevention programs when prevalence was low and have achieved declining levels of new infections. Early action in Thailand averted an estimated 5 million infections during the 1990s.

29. Second, even in countries where HIV/AIDS has spread into the general population and the main mode of transmission is heterosexual, some are doing a better job than others in curbing the spread. Among African countries, in Uganda HIV prevalence among pregnant women has dropped from 13 percent in the early 1990s to 4.7 percent in 2002, and in Ethiopia, Kenya, and Botswana, the prevalence in urban populations appears to have stabilized. (UNAIDS,

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Epidemiological Fact Sheets, 2004 update) The key has been forthright national leadership, widespread public awareness campaigns, and intensive prevention efforts.

30. Yet these lessons appear unheeded in many countries, including large countries such as China, India, and the Russian Federation. Unless more aggressive actions are taken in these and other countries, HIV prevalence is projected to rise further. Work continues on vaccine development, and UNAIDS estimates that the number of people with access to antiretroviral treatment increased from 300,000 in 2002 to 700,000 in 2004. But given that the impact of expanded treatment on HIV transmission is not clear, it is crucial to redouble education and prevention efforts at the same time.

31. Financing, research, and global advocacy for HIV/AIDS have increased significantly since the MDGs were adopted. Disbursements for HIV/AIDS prevention and treatment programs jumped from less than \$400 million in the late 1990s to \$6 billion in 2004—equal to two-thirds of total donor funding for health. Now concerns have shifted from financing to implementation, reflecting multiple donor procedures for accessing support, as well as weaknesses in health delivery systems. Faster progress is needed in harmonizing donor aid at the country level, implementing the “three ones” principles agreed in mid-2004: that all donors will work through one national AIDS coordinating agency in each country, one national HIV/AIDS strategic plan, and one system for monitoring and evaluating progress.

32. **Malaria.** Malaria takes a large toll on health and economic productivity in areas where it is endemic, and it is highly concentrated in the countries that can least afford this: sixty nine of the 80 lowest-income countries in the world have endemic malaria. Data are poor because many cases go unreported but the annual incidence of malaria is estimated as 300–500 million cases and 1.2 million deaths, mainly among children. At least 85% of deaths from malaria occur in Africa, 8% in Southeast Asia, 5% in the Eastern Mediterranean region, 1% in the Western Pacific, and 0.1 % in the Americas. In most African countries, it is the leading cause of death.

33. Yet malaria is eminently preventable, curable, and controllable with modern technologies—at a cost of a few dollars per person. Brazil’s malaria control program is credited with averting an estimated 2 million cases and 231,000 deaths. Other countries that have made impressive progress include Eritrea (which has reduced malaria incidence over four consecutive years through the use of insecticide-treated bednets), India (which since 2002 has reduced malaria incidence by 58–98 percent across different states), and Vietnam.

34. Effective strategies generally involve a combination of vector control, insecticide-treated bednets and curtains, indoor residual (house) spraying with insecticides where the pattern of transmission warrants it, intermittent preventive treatment during pregnancy, and prompt treatment of infections with effective drugs. Global funding for malaria has almost quintupled over the past several years, from \$120 million to \$570 million, thanks largely to the Global Fund for AIDS, Tuberculosis, and Malaria. Yet most experts estimate that as much as \$1 billion more a year is needed. Bednet use remains low in many malarious countries, vector control is inadequate, and increased resistance to traditional drugs is requiring newer, more expensive treatments. But experience shows that rapid gains can be made against malaria, even in countries with weak health systems. The Roll Back Malaria effort provides a global framework for intensified progress.

Water and Sanitation

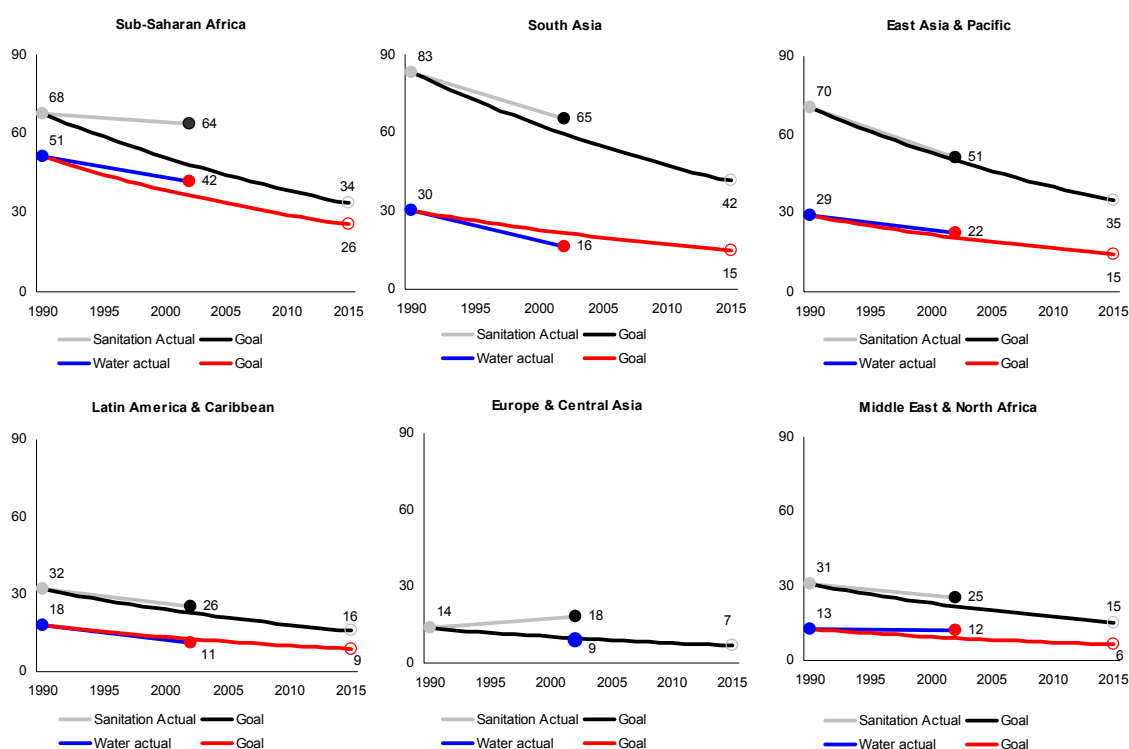
35. Expanding water and sanitation services is one of the most cost-effective strategies for improving health outcomes. Water and sanitation coverage also contribute powerfully to several other MDGs, including gender equality, reduced malnutrition, and poverty reduction. The

seventh MDG seeks to halve by 2015 both the proportion of people without sustainable access to safe water and the proportion of people without adequate sanitation. Reaching both targets would give safe water to another 1.5 billion people and sanitation to another 2.0 billion people. Unsafe water and poor sanitation and hygiene cause 90 percent of diarrheal diseases and an estimated 4–8 percent of the total disease burden in developing countries.¹¹

36. The most recent estimates by the World Health Organization and United Nations Children's Fund are that most developing regions are on track to achieve the safe water target (figure 3.5). The exception is Sub-Saharan Africa, where only slightly more than half of the population has access to safe water. To achieve the water target in Sub-Saharan Africa, for each of the next 10 years the number of additional people served would have to double for urban water and triple for rural water. Only a handful of countries in any region have achieved such progress, particularly in rural areas. But Ghana, Senegal, South Africa, and Uganda have shown that it can be done.

Figure 3.5 Progress is being made in water supply, especially in South Asia.... But sanitation progress is slower

(percent of population without access to piped water and improved sanitation, and needed trends)



Source: WHO and UNICEF joint monitoring program.

37. The sanitation target is more problematic, with only two regions on-track—East Asia and the Pacific and Latin America and the Caribbean. At current trends, by 2015 half a billion people will remain without access to sanitation services. But even within lagging regions some countries have made significant progress: Between 1990 and 2002 Bangladesh, India, and Nepal more than doubled sanitation coverage, with some notable success stories in slum sanitation. (Box 3.3) In Africa, Cameroon, South Africa, and Uganda stand out as making strong progress. And within

¹¹ WHO 2002 World Health Report.

countries there are local success stories, as in Burkina Faso and Senegal. The keys are sustainable institutions financed through effective cost recovery of sanitation surcharges linked to water bills, greater use of demand-based onsite sanitation technologies, and increased reliance on small-scale local contractors and artisans as sanitation service providers. A shift in focus to onsite sanitation, which is much cheaper than piped sewerage, is helping increasing numbers of low-income countries speed MDG progress.

Box 3.3 Slum Sanitation Improvement in India

Mumbai's crowded slums are home to seven million people. An innovative slum sanitation program financed by the World Bank has built 320 toilet centers that now serve half a million adults and children. The community-managed toilet centers provide sanitary excreta disposal with continuous water supply for hygiene, and health education, and are gradually replacing the municipally managed latrines that were rapidly falling into disuse. The toilet centers were financed by grants, but the users pay monthly family subscriptions that cover the running costs, including the wages of an attendant. So far all of the toilet centers are operational and well-maintained, and are the pride of the communities that own them. The success of similar community-run programs in other cities in India has led to the adoption of a national slum sanitation program where the same principles will apply.

Is MDG progress reaching the poor?

38. The MDGs clearly aim to improve human welfare. But it is important to realize that some of the goals—especially in health—can be achieved without progress reaching poor people. In two-thirds of the countries that have reduced child mortality since 1990, outcomes for families in the lowest income quintile have improved less than those for richer groups. (figure 3.7) In some of these countries, outcomes have actually worsened for the poor while improving for other segments of the population.

39. It is crucial to learn from exceptions. Mali, Turkey, Egypt, Peru and Cameroon over the late 1990s all achieved faster reductions in child mortality for the poorest quintile than for the population as a whole. Improvements in health outcomes for the poorest groups will not automatically result from the pursuit of MDG health goals. Policymakers must focus on targeted strategies for reaching poor households in order to achieve equitable MDG progress. In many settings, effective targeting needs to take account of other characteristics of disadvantaged groups as well, such as rural residence or ethnicity. In South Asia and the Middle East and North Africa, for example, the gender gap in school participation in rural areas is dramatically higher than in urban areas. Effective strategies for reaching target groups include prioritizing the expansion of services in poor or rural regions, expanding those services (such as basic water and sanitation, primary health care and primary education) that most benefit poor people, and eliminating user fees in primary education and for essential health services for poor families, since such fees can impede their access to services.

40. In education, progress toward universal primary completion generally enhances equity. In 21 of 31 developing countries for which comparable survey data are available between 1990 and 2002, primary enrollments for children in the bottom income quintile increased faster (in two cases, declined less) than enrollments for the population as a whole (figure 3.6) This finding is confirmed by more detailed studies in countries such as India, showing that expansion of basic education has been progressive in impact—that is, it has benefitted lower-income groups more than other groups.¹² Still, in about 30 percent of countries primary enrollments for children from In education, health, water, and sanitation many of the interventions needed for better outcomes

¹² Lanjouw and Ravallion 1999.

3. Scaling Up Service Delivery

in developing countries are well understood. The International Water Supply and Sanitation Decade of the 1980s showed that scaling up investment is not difficult—but ensuring the sustainability of systems, which is crucial for safe and continuous services to consumers, is. In education and health, building schools and clinics is far less complex than organizing the large workforce of skilled providers that must engage in face-to-face interactions with individual clients across a highly decentralized network. The two main implementation challenges to the health and education MDGs for most countries are scaling up skilled providers to achieve universal access to services and ensuring that providers perform effectively. The rest of the chapter focuses on these two issues, and on a third with important links to both: the role of donor financing in supporting system expansion and leveraging better performance.

Figure 3.6 While MDG progress in education generally benefits the poor....

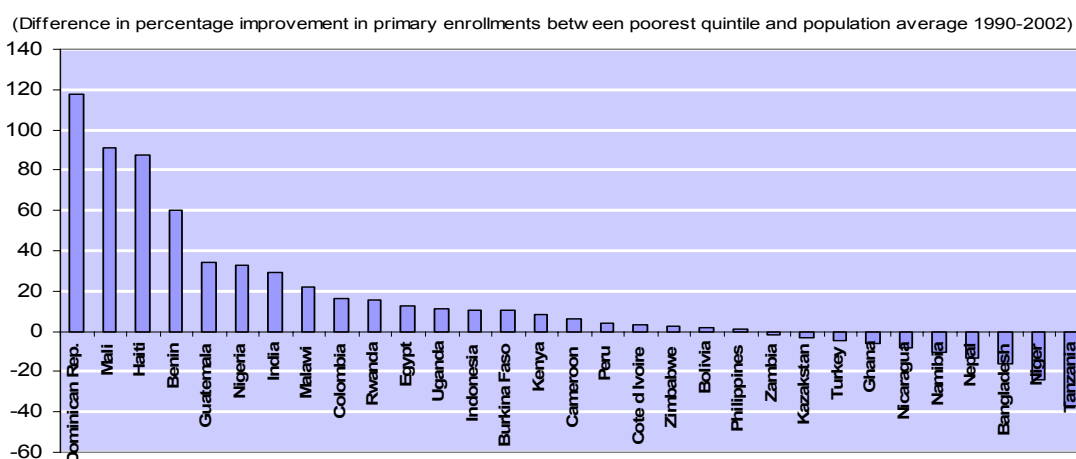
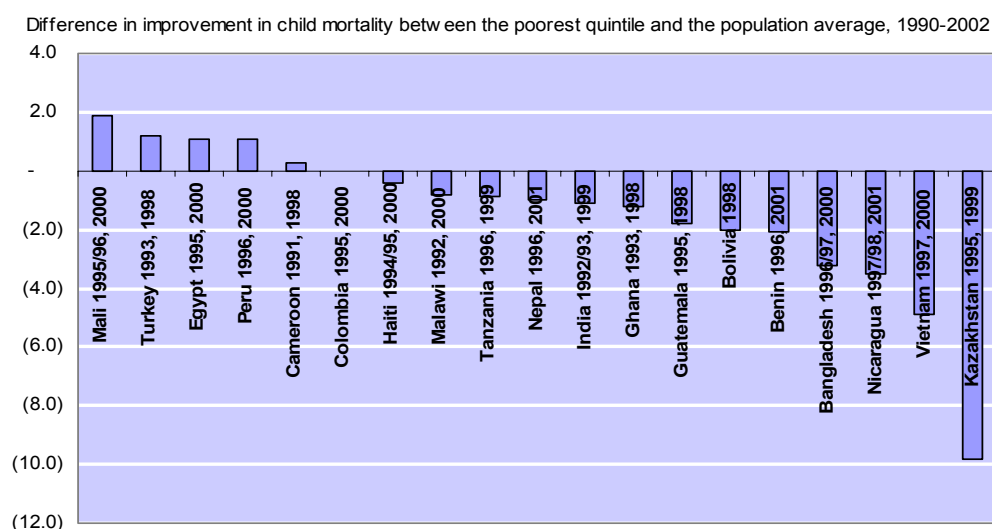


Figure 3.7 ...this is not true in health

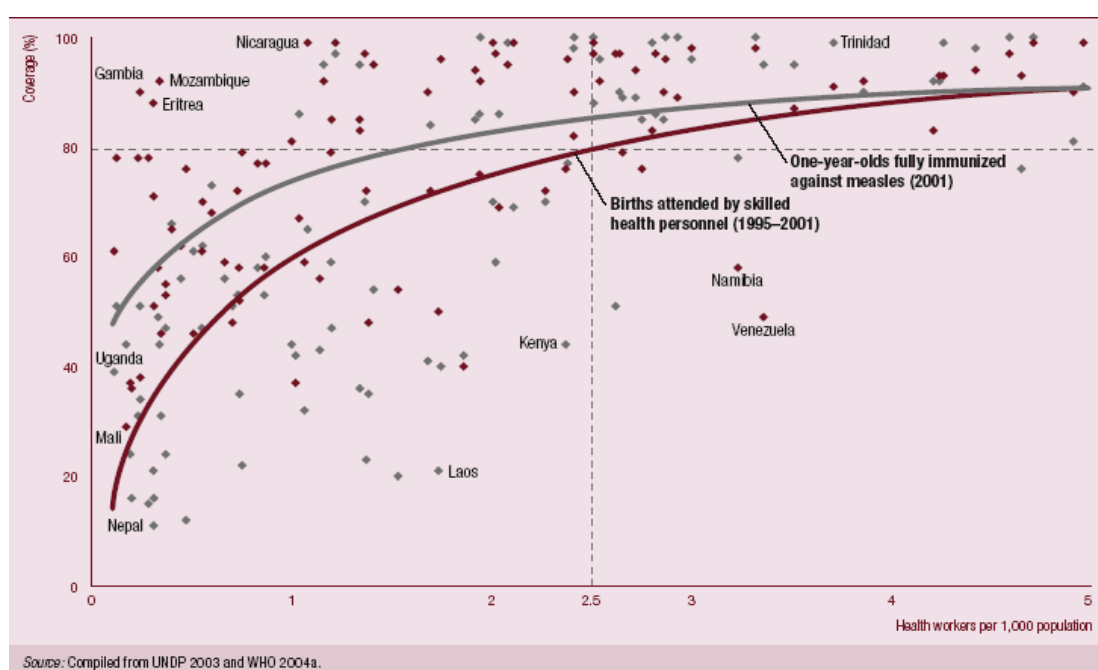


Source: DHS data and World Bank estimates.

II. Scaling Up Skilled Providers

41. Student learning and patient health result from multiple complementary inputs, including school and clinic infrastructure, availability of books, drugs, and clean water, and family investments of time and energy, to study for exams or follow treatment instructions. But skilled providers—teachers, doctors, nurses—are the biggest expense in any social sector budget, as well as the most essential input for effective service delivery. Teacher costs average 75 percent of total education costs in developing countries, and health care salaries typically account for 60–75 percent of government health spending.¹³ Policies governing the recruitment, training, salaries, deployment, and management of skilled education and health workers are core drivers of system costs, unit costs, resources available for complementary inputs, and outcomes.

Figure 3.8 Health service coverage increases with provider numbers



42. While there is a good deal of variability across countries, provider numbers in health are correlated with health service coverage. Studies show that countries with less than 1.5 health workers per 1,000 people are highly unlikely to have a measles immunization rate of 80 percent, whereas this rate is almost assured in countries with a density of more than 2.5 health workers (figure 3.8).¹⁴ Countries with less than 2.5 health workers per 1,000 people are also less likely to have 80 percent or more of births attended by skilled personnel. In education the process of classroom instruction creates even tighter limits on the number of children that can receive “education services” for a given number of teachers. No country with less than 1 teacher per 70 school-age children has achieved universal primary enrollment.

¹³ Joint Learning Initiative 2004.

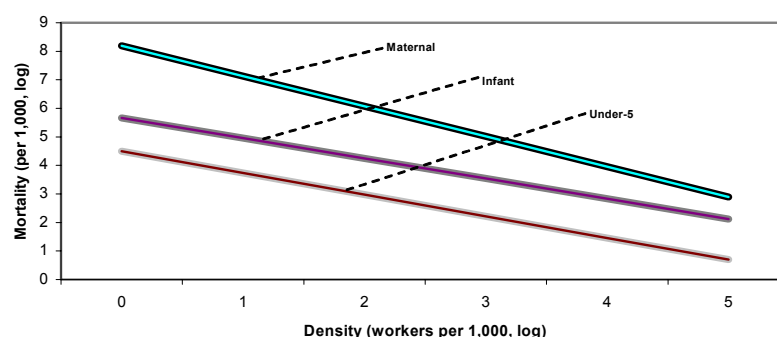
¹⁴ Joint Learning Initiative 2004.

43. Research also shows the importance of skilled providers for health outcomes. A recent study of 83 countries found that a 10 percent increase in the number of trained health workers (doctors, nurses, midwives) per population unit is associated with a 2–5 percent decline in mortality, controlling for per capita income, poverty, and female literacy (figure 3.9)¹⁵

Maternal mortality outcomes are the most sensitive to provider density, because skilled health workers can address a larger share of the conditions that lead to maternal mortality than the conditions that lead to infant or child mortality.

Figure 3.9 Provider presence is also associated with improved health outcomes

Skilled Health Worker Density and Mortality



Source: Calculations based on Anand and Barnighausen, 2004

44. Although worker numbers are important, skill levels are key. In a rigorous study of primary education in the United States that controlled for students' innate ability and socioeconomic status, the teacher a child was assigned could affect his or her learning levels that school year by up to a full grade—a huge difference that dwarfs any other factor correlated with learning, such as books, facilities, class size, or teacher salaries.¹⁶ And, important for policymakers, these large differences in teacher effectiveness were not well correlated with the formal measures usually believed to determine teacher quality, such as their level of education or years of experience. What counted was what teachers know and can do.

45. A recent large-scale learning assessment in Vietnam provides some evidence to confirm this. The strongest predictor of students' performance on the fifth grade tests of reading comprehension and mathematics administered in 2000 was their teachers' performance on the same tests. Not salaries, not level of training, not teaching conditions, but teachers' mastery of the subjects being taught. A sobering finding was that the bottom 30 percent of fifth grade teachers actually scored lower on reading comprehension than the top 12 percent of students.¹⁷ Few developing countries have braved political pressures to measure teachers' subject knowledge directly, but those which have – including Brazil and Peru – have all found teacher's mastery of content to be a critical variable for education quality.

46. Research also demonstrates the importance of provider quality in health. In 1992 Indonesian health centers were forced to cut incentive payments for rural doctors as part of a government effort to reduce the fiscal deficit. As result, over the next several years there was a 30 percent decline in the average number of physicians per rural health center (from 1.8 to 1.2). Although patient visits were not affected, the quality of care was—and there was a 39 percent increase in child stunting in the affected regions.¹⁸ Such severe malnutrition is likely to have long-term

¹⁵ Anand and Barnighausen 2004.

¹⁶ Rivkin, Hanushek, and Kain 2002.

¹⁷ Vietnam: Reading and Mathematics Assessment Study, World Bank, August 2004

¹⁸ Barber and Gertler 2004.

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cognitive and productivity effects on the children involved, and may generate cumulative economic costs that outweigh the short-term fiscal savings from the reforms.

47. Interestingly, the researchers in Indonesia evaluated providers not with formal measures such as level of education, but by observing how closely they followed best practices in diagnosing and treating patient conditions. The conclusion: as in the education research, what providers know and can do are crucial to quality services. Whether scaling up systems through new hiring or attempting to improve existing education and health services, the most effective governments focus on screening and rewarding candidates for competency, and avoid recruitment and advancement driven by clientelism, formal qualifications, or years of service alone.

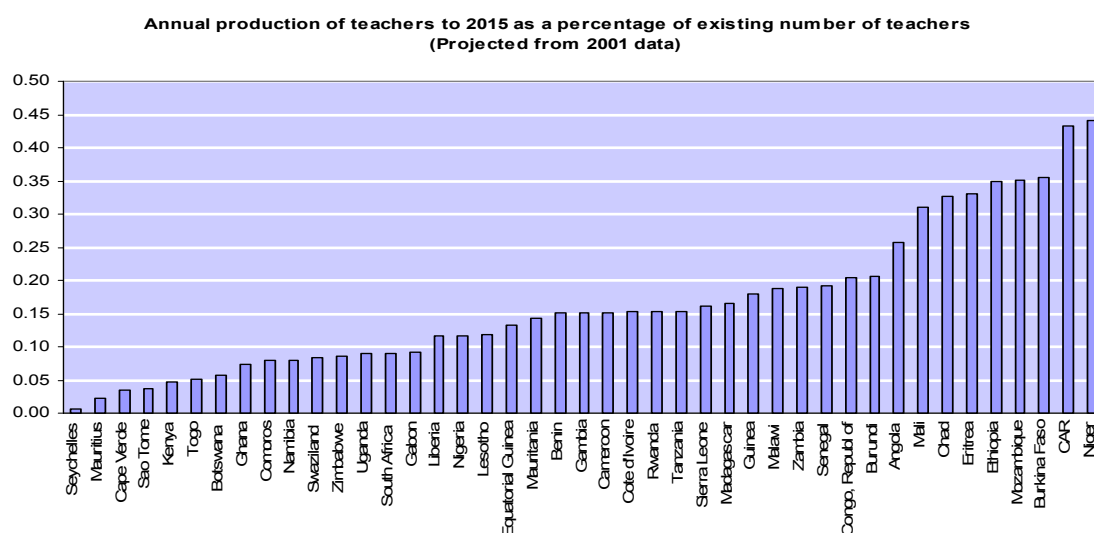
Are Human Resources a Binding Constraint?

48. The low-income countries furthest from the MDGs, many of which are in Sub-Saharan Africa, face major challenges in producing the number of skilled providers required to deliver the health and education services needed for MDG attainment—even under optimistic assumptions about the impact of service delivery on outcomes. The Joint Learning Initiative, supported by the Rockefeller Foundation, the World Health Organization and other health donors, estimates that for Sub-Saharan Africa to increase from the current ratio of 1 health worker per 1,000 population to a target level of 2.5, the region will need to add the equivalent of 1 million health workers between now and 2015.¹⁹ Ethiopia will require an additional 150,000 workers, while the Democratic Republic of Congo and Nigeria will each need 90,000. Globally, about 4 million additional health workers will be needed, including 285,000 in Bangladesh.

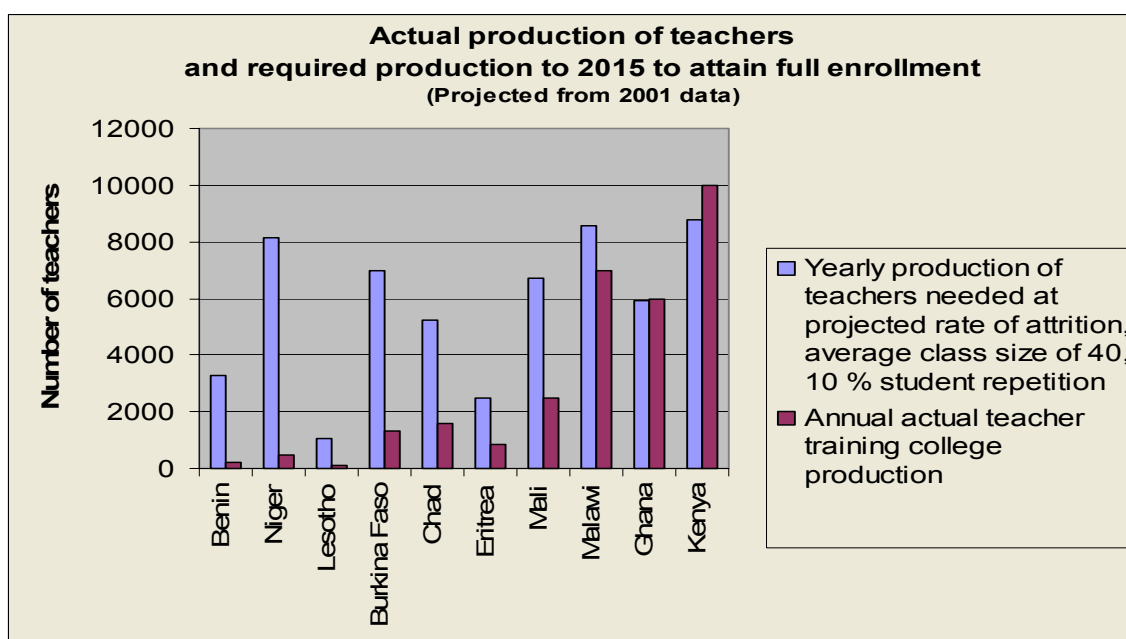
49. Estimates of teacher requirements are also daunting, especially for Sub-Saharan Africa. To meet the needs for primary education alone, eight Sub-Saharan countries must produce at least 30 percent of their current stock of teachers each year until 2015 (figure 3.10). Two countries need to annually produce more than 40 percent of their current stock. In several countries annual requirements are more than 10 times current output from teacher training schools (figure 3.11).

50. Clearly, in much of Sub-Saharan Africa the MDGs will not be attained with “business as usual” approaches to the production of skilled health workers and teachers. But in a growing number of countries, pragmatic changes in human resource policies have permitted dramatic increases in the number of skilled providers. Although not all cases have been equally successful in terms of provider and service quality, they demonstrate a range of strategies for rapidly shifting the production curve for skilled providers. In several cases sector efficiency has also improved, because new recruitment strategies have lowered costs per beneficiary served. And a few cases show that rapid expansion of quantity can be managed with attention to quality.

¹⁹ Joint Learning Initiative, Harvard University, 2004

Figure 3.10 Projected primary teacher needs are large in Sub-Saharan Africa

Source: Calculated from Edstats data

Figure 3.11 Projected primary teacher needs exceed teacher training capacity in many places

Source: Calculated from Edstats data

Core Strategies for Scaling Up Providers

51. Three basic strategies can be used to rapidly increase a country's production of education and health workers:

- Expand training capacity and/or adapt recruitment standards or the training process to permit faster production.
- Manage international migration, either by importing skilled workers or curbing outflows of nationally trained workers.
- Increase retention by drawing retired or unemployed workers back into the workforce or by improving the health of sick workers, such as with antiretroviral treatment for employees with HIV/AIDS.

52. The first of these strategies has generated the most dramatic progress: in a wide range of countries, adapted standards and re-engineered training processes for teachers and health workers have set the stage for rapid expansion of service delivery. The second strategy applies much more to health than to education, given the international market for health workers. The third strategy, while important, offers limited quantitative prospects in most contexts.

53. **Adapting recruitment standards and training requirements.** The time lag and costs involved in expanding traditional medical, nursing, and teacher training schools have led a number of developing countries to seek alternative ways of scaling up basic health and education personnel. In education the most common approach is to set new standards for teaching that do not require graduation from a pedagogical institute—even though in some cases more years of general education may be required. In health waiving or shortening medical schooling for doctors is generally unacceptable, so the main strategy is to leverage available doctors and nurses better with paraprofessionals. These paraprofessionals—often called community health workers—are trained for periods ranging from three months to two years, and can provide many primary and preventive health care services. In countries with severe shortages of higher-skilled professionals they may even perform duties normally performed by physicians, as China’s “barefoot doctors” did in the 1960s.²⁰ An important advantage of community health workers—and of alternative or community teachers—is that they are willing to work in rural areas, where it can be difficult to attract highly trained personnel. Community health workers are also less likely to migrate out of the country.²¹

54. Bangladesh, China, Cuba, The Gambia, Ghana, India, Madagascar, and South Africa are among the many countries that have trained community health workers to scale up delivery for a wide range of services, including malaria prevention, immunizations, family planning, tuberculosis treatment, and home visits to provide neonatal care. In many cases these efforts have substantially increased coverage, generated measurable improvements in outcomes, and dramatically lowered unit costs. In rural Maharashtra, India, infant mortality was cut in half—from 76 to 39 per 1,000 live births—between 1995 and 1998 by a program that trained village health workers to visit new mothers and monitor infants’ weight and health for the first month of life. In control villages infant mortality declined only from 77 to 75 per 1,000 live births.²²

55. Since 1991 South African tuberculosis patients treated by community health workers have actually achieved better health outcomes than those treated by higher-skilled personnel; 88 percent of patients seen by community health workers completed the full course of treatment, compared with 79 percent of patients seen by fully trained doctors and nurses. The study concluded that the directly observed treatment strategy (DOTS) for TB implemented by community health workers was as effective as hospitalization or sanatorium care—at less than half the cost.²³

²⁰ Dugger 2004.

²¹ Dovlo 2004.

²² Bang and others 1999 cited in *Attaining the Millenium Development Goals in India*, World Bank, 2004. .

²³ Lehmann and others 2004.

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56. The Planned Parenthood Association of Ghana has trained community members to provide health education and family planning support to women in their communities. In villages covered by the program, family planning use reached 25–44 percent, far higher than the rural average. Immunization rates were 74–87 percent, compared with 30 percent in control villages. Moreover, village women who have received support have begun promoting maternal and child health and family planning in neighboring villages. The results point to a low-cost strategy for improving maternal and child health.²⁴

57. Drawing on these experiences and the evidence on cost-effectiveness, several African countries are rapidly scaling up training of paraprofessional health cadres. Over the next five years, for example, Ethiopia plans to train 20,000 health extension workers to staff rural health posts throughout the country.²⁵ However, not all country efforts to realign the skills mix in health have been evaluated carefully, and clearly not all skills can be substituted. A significant number of programs—particularly where paraprofessionals are unpaid and not supported with basic equipment, drugs, and backup—have been unsuccessful.²⁶ But with adequate supervision, reasonable remuneration, and simple support systems, there is potential for community health workers to help expand service delivery at basic levels of quality.²⁷ Six countries in Sub-Saharan Africa lack a medical school, and 21 countries have only one.²⁸ For countries such as these, at least over the short-to-medium term while production of doctors and nurses expands, there appears little alternative but to leverage the skills of fully trained professionals with judicious use of community health workers.

58. In education the potential for alternative teachers to help accelerate expansion of primary schooling has been demonstrated in a number of countries. Even countries where the annual production of teacher training institutes is small often have large pools of unemployed university graduates who can be recruited into teaching. In West Africa this strategy has led not only to a large increase in primary enrollments over the past decade, but also to rising average levels of teacher education. Guinea—which over the past decade has achieved one of the world’s most impressive increases in primary school completion—is a good example.

59. In 1998, under a project supported by the World Bank, Guinea experimented with two alternative changes in recruitment standards for primary teachers. Under one variant pre-service teacher training was shortened from two years to a staggered program involving three months of initial training, eight to nine months of on-the-job training, and a final three months of formal training. The second variant involved eight months of formal training followed by eight to nine months on the job. For both alternatives the pre-training education requirement was increased from grade 10 to grade 13 (grade 12 for women).

60. The two new programs enabled Guinea to increase annual teacher production from 200 to 2,000 a year—a 10-fold increase that has had a similar impact on enrollment growth. Moreover, the benefits were not all quantitative: controlling for socioeconomic and school factors, students of the new teachers performed better than those of traditional teachers on a recent study of learning achievement in francophone countries.²⁹ Guinea’s experience suggests that adjusting teacher recruitment standards to emphasize content mastery (through a higher level of general education), and complementing this with relatively short-term training focused on practical classroom techniques, can be more efficient than expanding traditional teacher training institutes.

²⁴ Lehmann and others 2004.

²⁵ Federal Ministry of Health 2004.

²⁶ Stekelenburg and others 2003.

²⁷ WHO, World Health Report, 2004.

²⁸ Improving Health, Nutrition, and Population Outcomes in Sub-Saharan Africa, World Bank, 2005

²⁹ Mingat 2004.

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61. A similarly pragmatic strategy enabled Madhya Pradesh, India, to eliminate its backlog of children out of school in just 18 months, at one-third the usual cost.³⁰ The state reduced the education level required to teach in schools in rural areas and gave villages funding to hire local secondary school graduates directly. This relaxed the constraint on teacher supply and permitted rapid expansion of access; in 1997, the state opened 40 new primary schools per day. A key similarity with the Guinean program is the emphasis placed on supporting these new teachers in service, with materials and regular supervision, as a cost-effective alternative to formal pre-service training.

62. These two examples—and similar earlier reforms in countries ranging from the Republic of Korea in the 1950s to Indonesia in the 1970s and Zimbabwe in the 1980s—demonstrate that with pragmatic strategies to adapt recruitment standards and restructure training, teacher production can be scaled up 10-fold or more in just one or two years. In recent years virtually all countries with very low primary completion rates have begun pursuing such policies, and in none has the supply of potential teachers been a constraint. On the contrary, even when offering average salaries as low as half the civil service teacher wage, countries have found more qualified applicants for contract teaching positions than they can afford to hire. In Benin, where the national training institute produces only 100 teachers a year, 6,500 university graduates recently applied for 1,000 new contract positions. In Senegal, which in 1998 became the first West African country to introduce contract teachers, there were 35,000 applicants for the first 6,000 positions. In Niger teacher production has quadrupled since 2001, when teacher training was shortened from two years to one and contract teachers were introduced. The experience has been the same in Ethiopia, Mali, Togo, and elsewhere.

63. Do the adapted standards affect quality? While more research is needed, the best answer at present is that the results have been mixed. In many countries the adoption of new standards has been driven as much by fiscal constraints on hiring teachers at prevailing civil service standards and wage scales than by an absolute shortage of skilled (or skillable) personnel. Alternative teachers are often hired under new contracting arrangements that provide less job security and, in many cases, a direct role for communities in creating contracts and monitoring performance. These multiple variables can make it difficult to disentangle whether changes in teacher behavior and student learning outcomes reflect differences in teacher skills or differences in motivation. In contrast to the results from Guinea, a study of fifth graders in Togo showed slightly lower learning by students of contract teachers, controlling for other factors.³¹ But it is important to remember that in most cases—and especially for poor children in rural areas—the alternative to contract teachers is not a formally trained civil service teacher, but no schooling at all.

64. Changes in teacher contracting and the training of paraprofessional health workers have met resistance from labor unions. Even more difficult than launching such reforms may be the political economy of maintaining two-tier salary systems over time. African teachers' unions have been vocal critics of the use of contract teachers and are attempting to organize these workers to demand higher salaries.

65. But the magnitude of human resource shortfalls relative to MDG targets in these sectors leave governments committed to universalizing education and basic health coverage little choice but to make these pragmatic adjustments, evaluate them carefully, and upgrade provider quality over time. It is encouraging that the long-term evidence in education suggests that, controlling for country income, countries that achieve universal coverage sooner -- even by adapting teacher standards -- achieve higher average levels of student learning.³² The keys to success are likely to be countries' ability to screen new candidates carefully, train them effectively, equip them

³⁰ Jalan and Glinskaya 2003.

³¹ Vegas and De Laat 2004.

³² Crouch and Fasih 2004; UNESCO EFA Monitoring Report 2005.

adequately with well-designed teaching manuals and treatment protocols, provide ongoing, cost-effective, in-service support and supervision, monitor and reward performance effectively, and gradually raise standards over time. In education that has been exactly the approach taken over a 40-year span by countries, such as the Republic of Korea and Singapore, that have made the transition from low-income status and low average education levels to sustained economic growth and high-performing education systems.

66. **Managing migration.** A confounding issue for developing countries trying to scale up health services is the globalization of the health care workforce, as migration flows increase throughout the world. While the national specificity of the curriculum makes teacher migration relatively rare, the past decade has seen an explosion in the migration of physicians and nurses from developing to industrial countries.³³ Outflows of health care workers have reached troubling levels in several developing countries, when compared with the size of the health workforce and the output of local training institutions. There are allegedly more Nigerian doctors in the New York area than in Nigeria; more Malawian doctors in Manchester than in Malawi. Documented facts are that of over 600 physicians trained in Zambia since its independence, only 50 remain in the nation's health system. Of the 489 students graduated from the Ghana Medical School between 1986 and 1995, 61 percent have left Ghana – with more than half of these going to the United Kingdom, and just over a third to the United States.³⁴ One third of Ethiopia's physicians left the country between 1988 and 2001. In just 2003, seven percent of Zimbabwe's public sector nursing force migrated to the United Kingdom alone.

67. While migration brings significant benefits in terms of remittances, networks, and transfer of technology, for most Sub-Saharan countries it also creates a loss of skills that the region can ill afford. There are relatively few countries in the region where the labor market cannot fully absorb graduates of medical training programs. A more common pattern is that of Malawi, where vacancy rates for funded positions in the public health system are 25 percent for nurses and as high as 80 percent for specialists, and Zambia, where 40 percent of funded public sector positions are vacant. Yet in both countries skilled providers are leaving the public system. The key constraint on the use of available funding appears to be the public sector's inability to selectively increase wages in health to more competitive levels without creating broader civil service wage pressures.

68. The pull from industrial countries is expected to grow. In the United States an estimated 126,000 nursing positions are unfilled, and the shortage is projected to hit 500,000 by 2015. The United Kingdom will require an additional 35,000 nurses by 2008.³⁵ Given the enormous compensation differences between developing and industrial countries, what can developing countries do to manage migration?

69. Policies currently being tried include bonding, mandatory community service, diaspora exchange programs, and ethical recruitment guidelines, such as the Commonwealth Code of Practice adopted in 1999 in the United Kingdom. While the general consensus is that these efforts have had little impact,³⁶ Thailand, however, has had some success in attracting back medical professionals. The Thai government's "reverse brain drain" strategy has involved relaxing licensing requirements and offering generous research funding and monetary incentives.³⁷ A few other countries, most notably Ghana, are trying reverse migration strategies; in the early 1990s they began recruiting Cuban doctors and senior allied health professionals. The number of Cuban

³³ Dovlo and Martineau 2004; Joint Learning Initiative 2004; Vujicic and others 2004; Buchan and others 2003.

³⁴ Dovlo and Martineau 2004.

³⁵ Dovlo and Martineau 2004.

³⁶ Joint Learning Initiative 2004; Stilwell and others 2003.

³⁷ Wibulpolprasert and Pengpaibon 2003.

doctors recruited to Ghana has increased from about 60 a year in the early 1990s to more than 200 a year in 2003. The doctors provide services, mainly in rural areas, for two years.³⁸

70. There is no simple solution, and actions are needed by both industrial and developing countries. Donor countries can help by trying to attract more of their own citizens into nursing, for example, by raising wages; the British government recently did this. Donors can also help finance the expansion of medical training in developing countries, recognizing that some share of graduates will inevitably migrate. Developing countries need to keep salaries in public health systems as competitive as possible. Donor countries can help finance salary increases through development assistance. Finally, developing countries can make medical and nursing students finance their studies with loans and, if a student migrates before the loan is repaid, work with the receiving country to recoup the balance through that country's tax system.

71. **Increasing retention.** To boost human resources, several countries have explored recruiting retired, inactive, or unemployed workers back into the labor force and in some cases allowing flexible, part-time employment. Since 1994 public hospitals in Thailand have recruited retired physicians to work part time.³⁹ Ghana is also experimenting with such policies. Up to two-thirds of retiring doctors and nurses apply to the Ghana Health Service to be reengaged after retirement. The first contract period lasts two years, and is renewable for two more years and an additional year until the age of 65.⁴⁰

72. *Managing the impact of AIDS.* Countries facing human resource shortages must actively protect the health of existing providers, particularly those with HIV/AIDS. In low-income countries disability and death typically account for less than 10 percent of attrition among health care providers. But in Southern African countries such as Malawi, where HIV/AIDS prevalence has reached 15 percent among 15–49 year olds, death accounted for 58 percent of the attrition of Ministry of Health personnel between 1990 and 2000—with a substantial proportion due to AIDS.⁴¹ Data are scarce, but in the highest prevalence countries the annual death rate from AIDS is now estimated at 4–5 percent among education workers and 2–3 percent of health workers.⁴² Surveys of supervisors indicate that absenteeism linked to AIDS, both from sickness and attending funerals, is also a serious issue. Most employers estimate that the costs of absenteeism are even higher than the costs of training and recruitment to replace staff lost to AIDS.⁴³

73. The key operational implication is that human resource management and planning—even in relatively low-prevalence settings—must address the impacts of HIV/AIDS. HIV/AIDS tends to exacerbate existing weaknesses in HR management and planning, and few countries have put in place systems to respond effectively to the additional stresses that the epidemic places on the supply of services. Less than 5 out of 30 Ministries of Education in Sub-Saharan Africa have built HIV/AIDS indicators into their management information systems or included AIDS impact projections in their models of future HR needs. Many countries also lack workplace policies that ensure access to prevention, antiretroviral therapy, and other support and treatment, to mitigate the impacts on infected staff, and clear backup arrangements for staff absences. Most crucial of all is to protect health workers from on-the-job exposure to infection, through appropriate training, enforceable safety policies, and adequate supplies and protective gear – and to give these workers first call on antiretroviral therapy.

³⁸ Vujcic and Sagoe 2004.

³⁹ Wibulpolprasert and Pengpaibon 2003.

⁴⁰ Vujcic and Sagoe 2004.

⁴¹ UNAIDS 2003; UNDP 2002b cited in *Improving HNP Outcomes in Sub-Saharan Africa*, World Bank 2005 p. 98.

⁴² Bennell 2005; Grant, Gorgens, and Kinghorn 2005.

⁴³ Grant, Gorgens, and Kinghorn 2005; Grassly and others 2003.

Deploying Providers to Underserved Areas—A Separate Issue

74. In both the developed and developing world, even when overall numbers of education and health personnel balance needs, there can be wide variations in the quantity and quality of service delivery across regions. Almost always, these variations result from difficulties in deploying and retaining workers in rural areas. While 66 percent of Ghana's population lives in rural areas, for example, only 15 percent of its physicians work there.⁴⁴

75. Several countries have analyzed the factors influencing the willingness of service providers to locate in remote areas. While salary compensation is one factor, other factors are just as important. But virtually all the relevant factors imply higher costs for governments. Nonfinancial concerns include the intellectual and social isolation that highly qualified staff can feel in remote rural communities, lack of amenities such as electricity and telephones, primitive accommodations, limited transportation availability and difficulties in maintaining contact with family and colleagues, an absence of professional support and development, lack of quality education options for children, and a mismatch between an individual's professional training and the skills required on the job.⁴⁵

76. Countries that have succeeded in implementing multipronged strategies to provide rural services include Indonesia, which posted tens of thousands of primary school teachers to rural areas in the 1970s and thousands of skilled doctors to remote provincial clinics in the 1980s, and Thailand (box 3.4).

77. In education, Guinea, Mauritania, and Niger provide allowances for teachers in deprived areas, and Niger has also introduced allowances for teachers in nomadic schools. The premium over the average salary varies, but in these cases is in the range of 20-40 percent. Experiences from these and other countries permit several cautious conclusions about the keys to success:

- Rural and other hardship allowances should be linked to the position, not the person. If a teacher leaves a rural post, he or she should not continue receiving the premium. In countries such as Bolivia the failure to enforce this has led to a large share of rural hardship allowances going to teachers in urban schools.
- Allowances should be calibrated to regional conditions, but the differentials should be transparent and based on observable characteristics.
- The criteria for and levels of allowances must be reevaluated periodically.

Box 3.4 Attracting doctors to rural areas in Thailand

Over the past 30 years Thailand has achieved universal coverage of basic health services and sustained improvement in health outcomes. At the heart of this success are three decades of policy efforts and incentives aimed at expanding health services and attracting doctors to rural areas. Thailand's experience illustrates the need for a multipronged approach and confirms evidence from other countries that financial incentives are not always the most important component of such efforts.

In the early 1970s Thailand began implementing a bonding system that offers medical students heavily subsidized tuition if they promise to work in the public sector for three years upon graduation. Students who decline the program have to pay full tuition, which is quite high. Doctors who breach the contract must pay a large fine. During that period the government also began putting priority on rural health infrastructure, as part of a national rural development effort. Expansion of urban hospitals was halted, while rural hospitals and health centers grew significantly. So did the availability of paramedics,

⁴⁴ Joint Learning Initiative, 2004

⁴⁵ Zambia Ministry of Health 2004; Vujicic and Sagoe 2004; Joint Learning Initiative 2004.

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drugs, equipment, supplies, housing, and other amenities in rural areas.

A further reform aimed at strengthening rural service delivery began in 1994, when medical schools began increasing recruitment of students from rural areas. By 2001, 32 percent of medical students were from rural areas, up from 23 percent in 1994. Medical training was also changed, to increase exposure to rural practice, and rural doctors were given priority in continuing education programs. Experience in rural public service is now a prerequisite for residency training programs, and doctors with more than five years of rural experience can apply for a Thai board certificate—the equivalent of a doctorate.

Rural doctors receive hardship allowances, with the largest allowances going to the most remote districts. In addition, each year a rural hardship award is presented to the best doctor from a remote area, as is a rural doctor of the year award.

Over this thirty year period, the difference in density between doctors in rural areas and Bangkok has been cut in half, from 1/20th to 1/10th—a dramatic improvement equaled by very few countries. In addition, the proportion of outpatient visits to public health facilities occurring in rural areas has increased from 54 percent to 82 percent. After their compulsory three-year contract expires, two-thirds of doctors in rural areas remain there. During the late 1990s an economic boom led many doctors to breach their public contracts (paying a large fine) to work in the private sector. But doctors with rural training were least likely to do so.

Source: Wibulpolprasert and Pengpaibon 2003.

78. As a general strategy, recruiting individuals from rural areas into service or training programs is a more effective way to increase retention and improve service delivery than trying to rotate individuals trained in urban areas to rural settings.⁴⁶ Recent research in western Kenya shows interesting results in this respect. Since 2004 a pilot program there has enabled schools to hire additional teachers for grade 1, to cope with increased enrollment after Kenya's introduction of free primary education. Teachers are hired locally, at about one-fifth the cost of civil service teachers. Once a month an NGO team visits schools unannounced and records attendance of grade 1 teachers and pupils. In the first year of the program, in schools that received the funding, attendance averaged 90 percent for locally hired teachers and 73 percent for civil service teachers. Locally hired teachers were also more likely to be in class when the researchers arrived—71 percent compared with 46 percent for regular teachers. Finally, the program seems to have had generally beneficial effects on school accountability and performance: average teacher attendance in the program schools is 78 percent, compared with 71 percent in nonprogram schools.⁴⁷

79. In sum, in many developing countries the magnitude of doctor, nurse, and teacher shortfalls relative to ambitious MDG targets calls for pragmatic strategies for scaling up providers that represent a sharp change from traditional training systems. Such strategies include changes in recruitment standards to permit faster production of providers, maximum use of complementary, less skilled workers to leverage scarce skills, attention to international migration pressures, and incentives or rural recruitment strategies to ensure service delivery in rural areas. These strategies have enabled some countries to achieve impressive scale-up of human development services. In some cases it appears that the supply of trained or trainable human resources could support even faster production or hiring. The next section examines financing issues that affect the scaling up of human development services

⁴⁶ Wagstaff and Claeson 2004.

⁴⁷ Duflo, Kremer, Dupas 2005.

III. Ensuring Sustained and Predictable Financing

80. As argued earlier, the challenge is not just to achieve the MDGs but to achieve them at minimum global cost. That implies four distinct lines of action, aimed at both minimizing costs and maximizing the efficiency of financing:

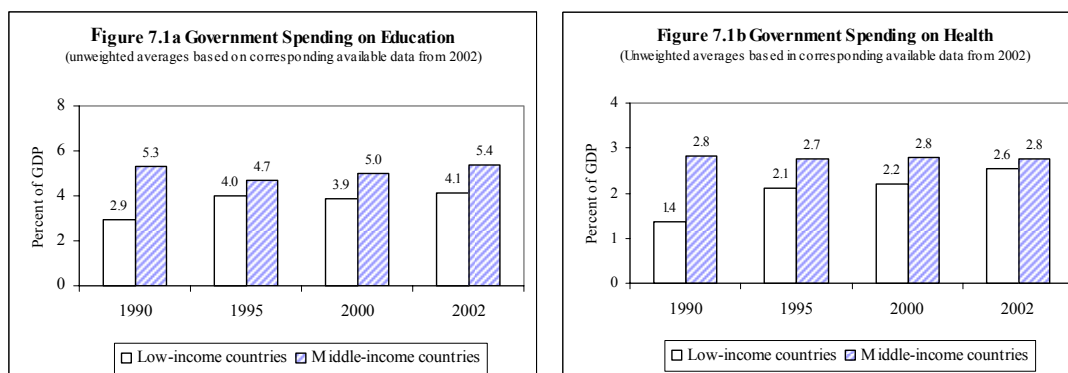
- Lowering the marginal costs of expanded service delivery as much as possible, especially through human resource strategies such as those discussed above, to leverage scarce skills and expand provider cadres at sustainable unit costs.
- Increasing the efficiency of service delivery, the focus of the next section.
- Increasing domestic financing for education, health, water, and sanitation in countries where fiscal allocations for these sectors are low.
- Mobilizing efficient donor support to fill remaining financing gaps.

Trends in Developing Countries' Spending

81. Between 1990 and 2002 low-income countries significantly increased their spending on education and health. In both sectors spending as a share of GDP started from a low base—2.9 percent of GDP for education and 1.4 percent for health—but it has grown by 40 percent in education and nearly doubled in health (figure 3.12). There is little question that delivery of human development services has become a higher priority in many poor countries.

82. By contrast, spending shares in middle-income countries have remained flat. These countries started the 1990s with much higher levels of GDP devoted to education and health than low-income countries, but the gap in health has nearly closed and in education it has narrowed considerably.

Figure 3.12 Low-income countries are spending more on health and education

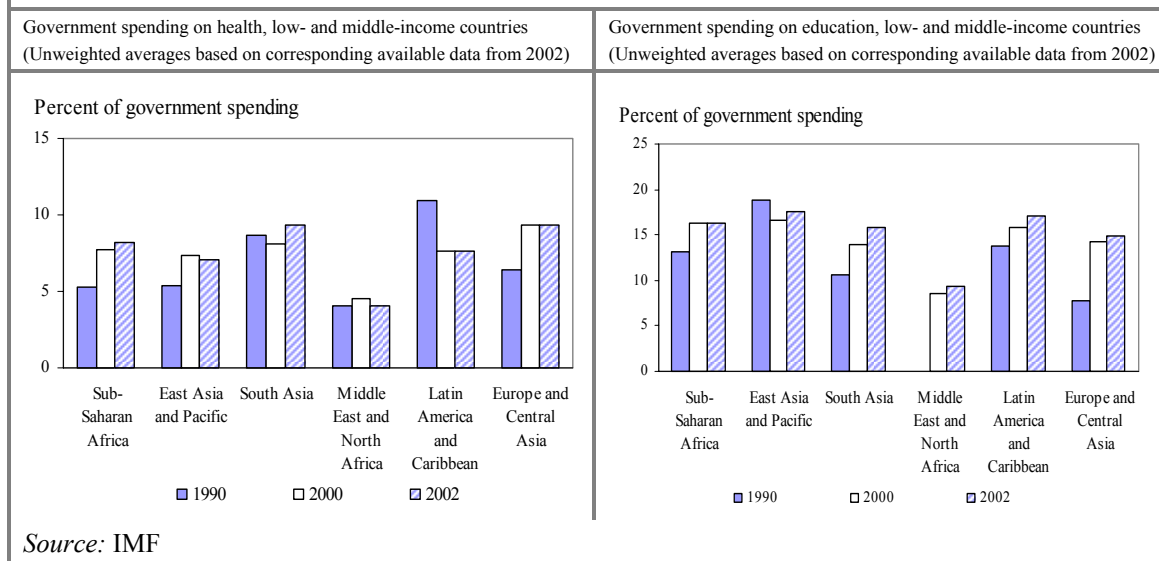


Source: IMF

83. Education and health spending also accounts for a growing share of government budgets in low-income countries. Between 1990 and 2002 education rose from an average of 12 percent to 14 percent of government spending, and health increased from 5 percent to 7 percent. The upward trend has been most pronounced in Sub-Saharan Africa, South Asia, and Europe and Central Asia, and more consistent in education than health, but overall it reflects increasing fiscal shares for the two sectors (figure 3.13). In Sub-Saharan Africa these trends show the benefits of debt relief. A recent study of African heavily indebted poor countries found that between 1998 and

2002 their spending on education and health increased by 1.9 percentage points of GDP, while debt payments as a share of GDP fell by 1.4 percentage points.⁴⁸

Figures 3.13a and 3.13b. Budget shares for education and health are increasing in many regions



84. At the country level, however, there is wide variation in fiscal efforts for human development. In Sub-Saharan Africa alone, while education spending for the region as a whole averaged 4.9 percent of GDP in 2002, it ranged from less than 2 percent of GDP in Burkina Faso and Guinea to about 5 percent in Eritrea, Ethiopia, and Mozambique—and more than 10 percent in Botswana, Lesotho, and Zimbabwe. In health, the regional average was 2.7 percent of GDP in 2002, but Burundi and Madagascar spent less than 1 percent, while Lesotho, Eritrea and São Tomé and Príncipe spent over 5 percent of GDP. In numerous countries human development spending appears to be below what they could afford.

85. In health, though, public spending is only a small part of the story. In low-income countries as much as 70 percent of health spending is private, out-of-pocket payments to private providers. In general, as country incomes increase, both the private share of health spending and the share of private spending that is out-of-pocket—rather than for health insurance—tend to decrease. The mix of these sources has important implications for health system access, equity, and financial sustainability.

86. Broadly speaking, these financing trends are encouraging. Still, spending falls well short of needs. Progress on MDG outcomes needs to be accelerated for some goals in every region—and in Sub-Saharan Africa, for every goal. Even with significant increases in fiscal effort for health, in recent years slow GDP growth and rapid population increases have translated into declines in per capita public spending in several regions, most dramatically in Sub-Saharan Africa (table 3.1). If South Africa is excluded, rather than \$12 per capita in 2001, the region's public health spending drops to \$6 per capita.

87. Many low-income countries require substantially increased domestic financing and external aid if they are to achieve the MDGs. For middle-income countries, although not all are on track to all the goals, the incremental costs of achieving the MDGs are much lower and the case for incremental aid is less compelling—given these countries' higher fiscal capacity, closer proximity to MDG targets, and more developed health, education, and water supply and sanitation systems.

⁴⁸ Hinchliffe 2004.

Table 3.1 Public health spending per capita has fallen in some regions

US current \$, weighted by population					
Region	1997	1998	1999	2000	2001
East Asia and Pacific	15	15	16	17	19
Europe and Central Asia	100	90	77	84	89
Latin America and Caribbean	131	132	120	125	122
Middle East and North Africa	59	61	61	66	69
South Asia	4	5	5	5	5
Sub-Saharan Africa	17	15	13	13	12
High income	1,596	1,609	1,694	1,714	1,763
World	274	274	284	285	294
<i>Source: WHO 2004.</i>					

External Financing Requirements

88. Numerous studies have estimated the incremental costs and external financing needed to reach the MDGs. These estimates have varied widely because of the sensitivity of cost estimates to assumptions about spending efficiency, the difficulty of factoring in the impacts of synergies from progress on other MDGs, and the sensitivity of global aid requirements to assumptions about countries' own fiscal efforts in pursuit of the goals. Estimates of external financing needs are also sensitive to assumptions about the efficiency of aid in filling estimated funding gaps, an issue that has received less attention.

89. Table 3.2 summarizes the best available estimates of incremental spending requirements for the health and primary education MDGs. While the range is large, even the most conservative estimates of the external financing gap call for at least a doubling- to- tripling of current levels of ODA for health and primary education.

90. In addition, it is estimated that the MDG targets for water supply and sanitation – which are essential for the achievement of health and education outcomes -- cannot be met without more than doubling annual investments in these sectors. The overall incremental financing needs for infrastructure investments related to the MDGs (including water and sanitation) are discussed in Chapter 2. But it is estimated that to achieve the MDG target for expansion of water supply, an increase in annual investment from \$9 billion to \$12 billion is required, and for sanitation coverage, an even larger increase -- from \$4 billion to \$18 billion in annual investment -- is needed. Roughly one third of this investment is needed in East Asia and the Pacific, close to one-third in South Asia, and about 17 percent in Sub-Saharan Africa. Even if progress in mobilizing increased private participation continues, it is estimated that the bulk of this financing will need to come from the public sector and ODA. Over the past decade, 43 percent of funding for water supply and sanitation has come from government budgets, communities and households, and about 28 percent from development assistance. Internal cash generation from utilities provided 7 percent, and international private investment financed 5 percent.

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Table 3.2 Estimated additional annual financing required to achieve the health and education MDGs

Countries covered	Total incremental financing needed annually	Incremental external financing needed annually	Study
Health goals			
83 low-income countries	\$57 billion (2007) – \$94 billion (2015)	\$22 billion (2007) – \$31 billion (2015)	CMH, Lilani and others
135 developing countries	\$25-70 billion	Not estimated	Preker and others
155 developing countries	\$30 billion (2006) – \$50 billion (2015) ⁴⁹	\$18 billion (2006)– \$33 billion (2015)	UN MP, 2005
151 developing countries	\$20-25 billion	\$15-25 billion	Devarajan, Miller and Swanson (World Bank 2002)
Universal primary completion			
79 low-income countries	\$9.7 billion	\$3.7 billion ⁵⁰	Bruns and others (World Bank 2003)
79 low-income countries	Not presented	\$5.7 billion ⁵¹	UNESCO 2002 EFA Monitoring Report
155 developing countries	\$33–38 billion	\$5–7 billion	Bruns and others (World Bank 2003)
151 developing countries	\$10-30 billion	Not presented	Devarajan, Miller and Swanson (World Bank, 2002)
155 developing countries	\$9.1 billion	Not presented	Delamonica and others (UNICEF 2001)
155 developing countries	\$9 billion	Not presented	Naschold, ODI 2002
155 developing countries	\$5–6 billion	Not presented	Colclough and Lewin 1993

91. There is no question that, in all of these sectors, there is significant scope for lowering unit costs and increasing domestic financing for the MDGs in many countries. But a few costing studies have examined this potential carefully and concluded that even with major increases in spending efficiency, a significant financing gap will remain.⁵² The estimates of investment needs in water and sanitation presented above, for example, explicitly factored in the assumption that investment and operating efficiency will be higher than in the past, due to reforms of sector management being implemented in many regions. The Bruns, Mingat, and Rakotomalala study of the costs of universal primary completion goes even further. Not only does it model improvements in unit costs and spending efficiency to best practice levels for all low-income countries, it also models increases in all countries' fiscal efforts to a best practice norm (about 20 percent of the recurrent budget and 4 percent of GDP devoted to education, with half for primary). But even under these best case assumptions, the study estimates a financing shortfall of nearly \$4 billion a year for low-income countries to reach the 2015 goal, and a gap of \$5-7 billion per year for all developing countries to achieve it.

⁴⁹ The MP report does not present a disaggregated estimate of global financing requirements for health. The amounts here are estimated from the MP's five country case studies, which do show the health sector share of total estimated MDG costs in these sample countries. The estimate of average external financing required for health in this row is similarly based on a rough pro-rata estimation of the health share, based on the country studies.

⁵⁰ Total external financing requirement, not incremental. The report estimated the baseline level of external funding for primary education to IDA-eligible countries as \$1 billion per year.

⁵¹ Total external financing requirement, not incremental. No baseline estimate presented for external funding for primary education in middle-income countries.

⁵² Bruns, Mingat, and Rakotomalala, 2003; Colclough and Lewin (1993), Wagstaff, and Claeson (2004).

3. Scaling Up Service Delivery

92. As part of the Abuja Declaration in 2000, African governments agreed that funding for health should increase to 15 percent of their budgets, up from the current average of 8 percent. World Bank simulations for a sample set of five African countries indicate that even if this spending target were achieved from 2005 on, countries would still not be able to finance the increased recurrent salary and other costs associated with scaled-up service delivery (to a target level of 2.5 providers per 1,000 population) by 2015 out of domestic resources alone. Indeed, for a few of the countries, projected external financing needs would not decline significantly until after 2020.

93. In sum, the incremental aid requirements estimated in even the most conservative studies are large. But for the social sectors in particular, as important as increasing the quantity of aid is the need for profound changes in its quality. The additional public spending needed to scale up human development service delivery is largely for recurrent costs, especially personnel. This spending will need to be sustained and increased over time—in many countries for a 10–20 year horizon. There is a near-complete disconnect between this core need and the nature of donor assistance to these sectors today in three major respects: aid flexibility, aid predictability, and transactions costs.

94. **Aid flexibility.** The financing gaps in health and education are for core budget expenses—largely local costs, largely recurrent, and largely for personnel. But a high share of aid to these sectors is tied to other purposes, especially technical assistance. About 70 percent of official development assistance (ODA) for education is in the form of technical assistance—much higher than the 30 percent share for ODA in general. From 2001–2003, 10 bilateral donor countries devoted more than 80 percent of their ODA for education to technical assistance (figure 3.14).

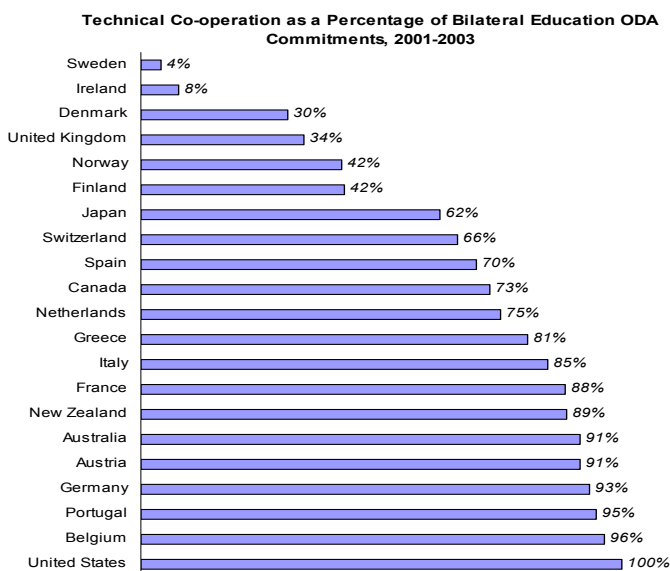
95. This picture may be improving somewhat, with the U.S. Millennium Challenge Account expected to start disbursing in 2005. Still, the bulk of aid for education cannot be used to pay the public sector workers that are the number one requirement for scaled-up education services. No matter how important or even crucial the training, scholarships, technical advisors, and studies supported by current education aid flows may be, they do not offset the estimated financing gaps. Virtually all of education MDG costing exercises have focused on the inputs that are most straightforward to cost, such as teachers, classrooms, books, student stipends, and other direct system operating costs. From the standpoint of filling those gaps and producing MDG results, the current pattern of education assistance represents a very inefficient transfer

96. Although multilateral lenders such as the International Development Association (IDA) report lower shares of funding for technical assistance, their funding traditionally has not been available for personnel costs either. World Bank policy has treated financing of recurrent costs as exceptional, and allowed it only on a declining basis. Between fiscal 2001 and 2004 the share of Bank investment lending used to finance recurrent costs averaged only 4–6 percent. Recognizing the constraint this policy could impose on achieving the MDGs, in 2004 the Bank's Executive Directors approved a new policy on eligibility of expenditures in investment lending, including recurrent cost financing. Under the new policy, financing of recurrent costs need not be considered exceptional nor occur on a declining basis. But decisions on the use of such financing must take into account its impact on the borrowing country's fiscal and debt sustainability, the country's commitment and ability to provide continued financing after Bank financing ends, and sustainability issues at the sector and project levels. The new policy is in its first year of implementation, so it is early to judge its impact. But it is expected to have a positive effect on the flexibility of IDA support for MDG-related projects.

97. Aid is also poorly targeted to the regions and countries that are furthest from the MDGs. Aid for water supply and sanitation, for example, is highly concentrated, with the ten largest recipients receiving close to half of total ODA for period 1997–2001. Only 12% of total aid to the water sector in 2000–2001 went to countries where less than 60% of population has access to improved water source, which includes most low income countries.

98. **Aid predictability.** A second issue is the volatility of aid flows. Bilateral aid commitments—which account for 70 percent of education ODA and 50 percent of health ODA—are relatively short-term (one to two year) commitments, and disbursements can lag or diverge substantially from commitment amounts. Ministries of finance have raised understandable concerns about taking politically irreversible personnel actions that have long-term fiscal costs, such as hiring additional personnel or adopting wage increases to retain personnel, if it is not clear that financing will be sustained. As can be seen from the pattern of donor funding commitments for health in seven different African countries, commitments can vary tremendously from year to year (figure 3.15).

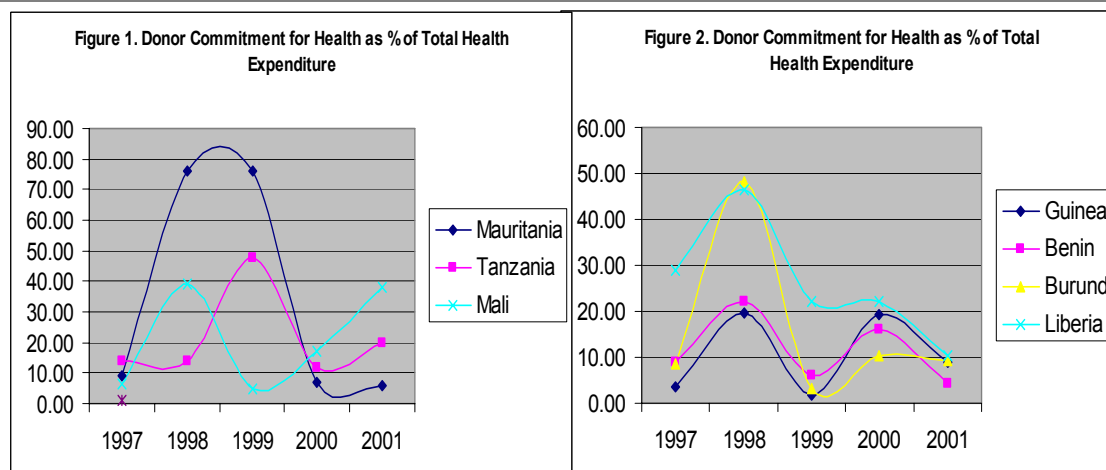
Figure 3.14 Seventy percent of bilateral education aid is tied to technical assistance



Source: OECD DAC database - Table 5

Source: FTI Secretariat from OECD DAC data

Figure 3.15 Donor commitments can oscillate substantially



Source: WDI and OECD DAC donor funding database. Staff estimates

99. Although low-income countries eventually need to be able to sustain their education, health, and water and sanitation systems with domestic resources, that can only be achieved gradually in most countries, with economic growth and deepening of fiscal capacity over time. In the short to medium term, countries face significant risks in expanding health or education systems in an environment where the level and continuity of donor support are largely unpredictable.

100. These issues are particularly acute in the lowest-income countries, which have a high degree of aid dependency and would grow even more aid-dependent in the period to 2015 under most scenarios for attaining the MDGs.⁵³ In health more than 30 percent of spending is already externally financed in 13 low-income African countries. In these countries (some of which appear in figure 3.15) aid volatility has pushed sector spending into inefficient stop-and-start patterns, constrained expansion, and disrupted service delivery.⁵⁴

101. **Transactions costs.** A third issue is the high transactions costs that countries bear in accessing foreign aid. Even small volumes of aid for small countries flow through hundreds of parallel bilateral, multilateral, and global program channels, each with its own negotiation, reporting, and administrative requirements. In 2000 the typical bilateral donor provided ODA to about 115 nations. Mozambique has more than 100 development partners in its health sector alone. It is sobering to recognize that, from the standpoint of a health minister, the volatile lines in figure 3.15 showing total external financing for health are actually composites of many different financing sources and disbursement patterns, each with its own volatility and administrative requirements.

102. Donors often require assistance to be kept in parallel budgets outside the ministry of finance, to facilitate their accounting of the direct impact of their aid. But aid is fungible, and the cumulative demands on recipients are heavy. Low-income countries are forced to allocate limited human resources away from managing service delivery to managing donors.

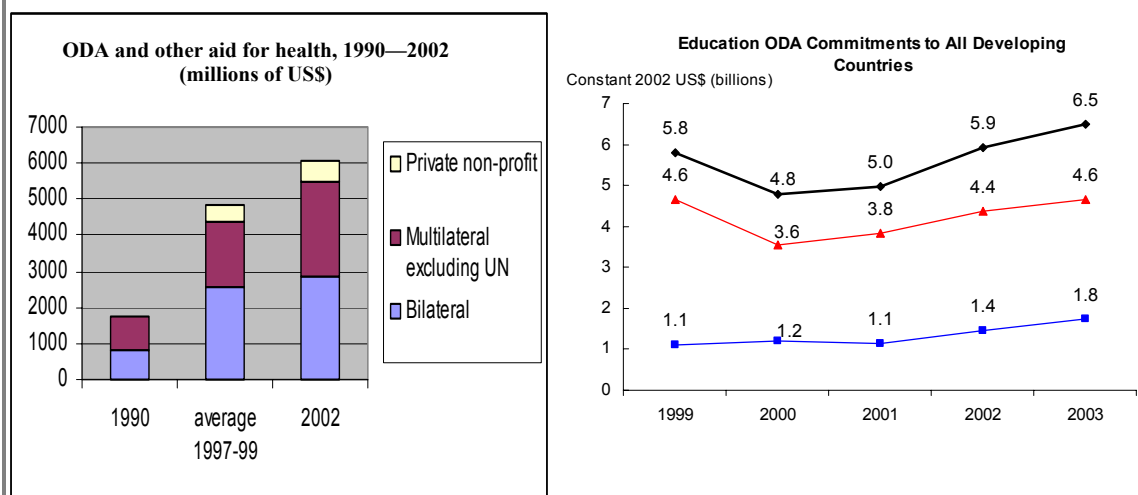
103. There is a growing view that because aid is fungible, donors should dispense with the notion that they can identify what their money buys and focus on the entire public expenditure program and sector-wide results. In education this has been a major thrust of the Education for All Fast Track Initiative (see the next section), and it is increasingly being discussed in health. Harmonization is also being advanced more generally through the Rome, Marrakech, and recent Paris meetings and ongoing work by OECD's Development Assistance Committee to implement country partnership and harmonization agreements.

Are Global Programs Advancing the MDGs?

104. Development assistance for health has risen steadily since 1990 and significantly since the MDGs were adopted in 2000 (figure 3.16). In contrast, support for education declined between 1990 and 2000, but increased by 35 percent in real terms between 2000 and 2003. Multilateral sources contributed a large share of the increase.

⁵³ Bulir and Hamann 2003; Bruns, Mingat and Rakotomalal (2003)

⁵⁴ Gottret (forthcoming)

Figure 3.16 Total ODA for health and education is increasing

Source: World Bank estimates from DAC database

105. **Health.** In health, much of the post-2000 increase in ODA and private philanthropic funding (notably the Gates Foundation) can be credited to a new set of global programs aimed at mobilizing global awareness and funding for the eradication of major diseases. Major global programs in health include the Global Fund to Fight AIDS, Tuberculosis, and Malaria (GFATM), the Global Alliance for Vaccination and Immunization (GAVI), the World Bank's Multi-country AIDS Program (MAP), the US President's Emergency Fund for AIDS Relief (PEPFAR), and some 70 other separate global health initiatives. The impact on HIV/AIDS funding has been particularly large: by 2003, almost 80 percent of public spending on HIV/AIDS in low-income countries was financed with external grants.⁵⁵

106. The new global initiatives have transformed the landscape in the health sector. In just three to five years these programs have had three major achievements:

- *Raising global awareness of key diseases.* The global health initiatives have been very effective in drawing donors' attention to communicable diseases such as malaria, tuberculosis, and HIV/AIDS that are major killers in the developing world, as well as to less-known tropical diseases that disproportionately affect low-income countries—such as river blindness, Chagas disease, and dengue fever. This advocacy has had a major impact on funding for malaria, tuberculosis, and HIV/AIDS, all of which are key for MDG progress. Some of the resulting partnerships, notably for river blindness, have also been catalysts for the cross-border collaboration needed to produce results. The global programs have played an equally important role at the country level, in encouraging developing country governments to revitalize programs for these sometimes neglected diseases. Finally, they have helped improve the delivery of interventions, often by contributing drugs.
- *Stimulating new drug and vaccine research.* The global health initiatives have used innovative approaches and market power to stimulate research on the drugs and vaccines needed by developing countries; they have also stimulated production and helped lower prices. In noncompetitive markets, such as those for vaccines against childhood illnesses, guarantees of future purchases and sharing of risks with producers have been used by the Global Alliance for Vaccination and Immunization, for example. In competitive markets,

⁵⁵ Haacker 2004, p. 63 in The Macroeconomic of HIV/AIDS, IMF 2004

3. Scaling Up Service Delivery

programs such as the Tuberculosis Global Drug Facility have been effective in expanding access to high-quality drugs at reduced prices through pooled financing and commodity purchases. The Malaria Medicines Supply Service is proposing to use globally pooled procurement to increase purchaser leverage and reduce prices, while at the same time creating demand for artemisinin combination treatment (ACT) and expanding markets.

- *Making aid for health pro-poor.* The resources of global health initiatives are more focused on low-income countries than are donor commitments overall, and a high proportion of their resources are dedicated to communicable diseases, which disproportionately affect the poorest people in low-income countries. Support from the initiatives is directly pro-poor, and they have been very effective at leveraging additional funds from foundations. Finally, they promote cost-effective interventions.

107. Against these achievements, however, there is a growing realization that the “verticalization” of health sector support through diverse, specialized global initiatives is having adverse effects. All the new global programs have put substantial effort into establishing lean and technically proficient administrations, careful accounting of funding and results, and innovative approaches to program delivery—including, for example, channeling funds directly to nongovernmental organization (NGO) providers. But their cumulative impact is to undermine the capacity of ministries of health for coherent planning, financing, personnel deployment, and administration.

108. A recent study of 14 low-income countries found that the multiplicity of global programs, on top of existing multilateral and bilateral channels, is exacerbating transactions costs and distorting sector priorities.⁵⁶ There have been numerous instances of different teams of technical experts with identical terms of reference visiting a single country, and different donors promoting conflicting approaches and priorities. Citing recent proposals in Guyana and Tanzania for HIV/AIDS treatment programs that equal half of existing health budgets, the report argues that such programs—driven by global financing availability rather than national Poverty Reduction Strategy priorities—may draw disproportionately on health sector staffing and other resources.⁵⁷ Of equal concern are reports of agency turf fights and other coordination difficulties at the country level. An International Monetary Fund (IMF) mission recently concluded that bureaucracy and infighting linked to different specialized programs were the main reason one African country was unable to disburse more than 20 percent of available aid for health in 2004.⁵⁸

109. If ODA for health in support of the MDGs is to produce the desired results, a new framework is needed. Given the predominantly recurrent and local nature of financing needs, there is a strong case for providing the bulk of funding as general or sectoral budget support. Equally important is that all donor support be organized around a country-led health strategy that encompasses HIV/AIDS, malaria, and all other disease priorities in a balanced and coherent way. The sector strategy should be fully aligned with the country’s Poverty Reduction Strategy and consistent with its Medium-Term Expenditure Framework. No donor assistance should be “off plan” or off budget, and the first priority for donors should be to fill financing gaps in implementing the Poverty Reduction Strategy.

110. But for donors to accept flexible transfer of their funding through national budgets, there must be a quid pro quo: country public expenditure management and sector monitoring must meet performance standards that assure citizens of donor countries their money is resulting in efficient service delivery—and that those services, over time, are producing MDG results.

⁵⁶ Foster 2004.

⁵⁷ Foster 2004.

⁵⁸ IMF Africa desk.

111. **Education.** Such a “compact” between countries and donors figures prominently in the Education for All Fast Track Initiative. Consistent with the Monterrey consensus, the FTI aims to assure developing countries committed to universalizing primary completion the technical and financial support they need, in exchange for increased accountability for results. In contrast to health, there is a single global partnership to support MDG progress in education, which all education donors have formally agreed to. Also in contrast to the global health programs, the core objectives of the Fast Track Initiative are to support countries’ development of a coherent education strategy and promote coordinated—and more efficient—donor support. To make technical assistance more efficient, the donors have agreed to a pooled Education Program Development Fund at the global level to help countries develop credible education strategies and costed programs—and reduce the welter of uncoordinated, overlapping studies and capacity building initiatives. At the country level, all education donors participate in ministry of education–led coordination groups, with a rotating donor “lead” agency. While such groups had arisen in some countries previously, they were not a systematic practice.

112. Country-level donor groups have three key responsibilities: review and collectively endorse the sector plan, align their financing with the country’s priorities, and monitor progress in improving education spending efficiency, through a set of agreed performance indicators. Indicators include key outcomes, such as the primary completion rate and the gender ratio in education, and key intermediate indicators, such as the repetition rate, the pupil-teacher ratio, the share of education in public spending, and the share of education spending on books, materials, and other crucial quality-enhancing inputs.

113. Making each dollar of education spending go further is a joint priority under the initiative’s “compact.” Donors have also agreed that their progress in increasing aid efficiency should be monitored annually and reported transparently. At the Paris Higher Level Forum on Harmonization and Alignment in March 2005, donor agencies committed to a specific set of harmonization indicators. (See Chapter 5) Progress on these indicators would be monitored by OECD/DAC. The EFA Fast Track Initiative, which involves both country level coordination groups and regular global meetings to monitor progress offers a ready made channel for disseminating the indicators and working with education sector donors on these agreed areas of harmonization and alignment. The FTI Secretariat, for example, is helping to turn principles into good practice by developing sample Memoranda of Understanding and common guidelines for assessing the quality of education sector plans.

114. The Fast Track Initiative was launched in June 2002. What has it accomplished? There is general consensus around two conclusions:

- The initiative is having positive impact on donor coordination at both the country and global levels. Honduras’s minister of education called this the FTI’s greatest benefit, and countries such as Nicaragua,, Vietnam, and Yemen have credited the FTI with bringing the donor communities in their countries together—and creating discipline around a country-led, coherent process of education planning and priority setting linked to their Poverty Reduction Strategies. At the global level the Fast Track Initiative has promoted ongoing dialogue and information sharing among donors, through semiannual meetings and working groups focused on priority issues such as tracking of aid flows and harmonization.
- A continuing challenge for FTI is countering skepticism about its ability to mobilize substantially increased funding for the education MDG. Although a first set of endorsed countries has received significant additional support, the number of countries is small and the commitments are fairly short term. Moreover, many more countries are now poised to enter the initiative. As part of the global stocktaking of MDG progress in 2005, donors need to develop options for a more stable funding framework for FTI.

115. In contrast to the global programs in health, the Fast Track Initiative started with little upfront funding. Instead, donors pledged to commit additional resources to specific countries once their sector plans had been endorsed and financing needs established. The rationale was that channeling incremental funding through existing bilateral and multilateral mechanisms would speed disbursements and avoid the increased bureaucracy and transactions costs of setting up new global funds. With initial support from the Netherlands (subsequently joined by Belgium, Italy, Norway, and the United Kingdom), however, a \$235 million trust fund was established in 2003, called the Catalytic Fund. Given its size, the fund was not designed to be the primary financing channel for primary education support. Rather, it provides transitional (two to three year) financing to endorsed countries with only a small number of active donors (“donor orphans”) until larger and more sustained volumes of aid can be attracted from new bilateral or multilateral channels.

116. While this approach has kept administrative and transactions costs lower than in the health sector, it is difficult to argue that it has worked well from the perspective of mobilizing the incremental aid volumes needed to achieve the education MDG. The financing gaps for the first seven countries endorsed by the initiative have been closed, but it took almost two years to do so, and transitional support from the Catalytic Fund has played a large role. The additional commitments for these seven countries represent a 30-40 percent increase in their ODA for primary education, but the new commitments only extend to the end of 2006. The gap-filling has not been timely, and the assurance of sustained and predictable financing is largely absent.

117. Another five countries, endorsed in 2002–03, still have financing gaps totaling \$260 million (over three years). And in 2005 as many as 25 additional countries could meet the Fast Track Initiative endorsement requirements (having a Poverty Reduction Strategy and an agreed education plan), raising global financing needs for the program to an estimated \$1.7 billion in 2005 and more than \$3 billion a year from 2006.⁵⁹ From a developing country standpoint, however, there has been no credible indication from the initiative’s donors that these amounts are being programmed.

118. The Fast Track Initiative’s country-driven model, its alignment with Poverty Reduction Strategy and Medium Term Expenditure Framework planning and budgeting, its focus on monitoring results and spending efficiency, and its active promotion of donor harmonization are all important achievements. Its donors now need to develop a fundraising model that ensures a substantially increased volume of sustained, predictable funding for countries with credible education plans and good implementation performance.

Box 3.5 IMF programs and MDG progress

The IMF has a clearly stated policy of ensuring appropriate flexibility in fiscal targets, including by seeking and accommodating higher aid flows in PRGF-supported countries. How is this policy being implemented? What impact is it having on government spending and MDG progress in low-income countries? Why do critics continue to assert that Fund programs constrain countries’ ability to scale up health and education service delivery? We look at the facts in three African countries.

Zambia. Some 16 percent of the adult population is HIV positive in Zambia, and the Government, has set the target of reaching 100,000 Zambians with anti-retroviral treatment by the end of 2005. In the fight against HIV/AIDS, Zambia is receiving support from the World Bank’s Multi-country AIDS program (MAP), the Global Fund and the US government’s PEPFAR. Resources from the MAP and the Global Fund are mainly channeled through the National AIDS Council, while PEPFAR operates largely outside the government budget. Efforts are now underway to compile a comprehensive database that tracks these inflows to improve coordination.

Contd/

⁵⁹ FTI Secretariat, Status Report, February 2005

Box 3.5 IMF programs and MDG progress

Funding to combat HIV/AIDS is rising sharply and there now appears to be a problem of absorptive capacity. This is not a result of any direct or indirect limit on spending of hiring under the IMF-supported program. No limit has been placed on external funding of HIV/AIDS programs or hiring of health workers in the program. The budget for 2005 makes special efforts to ensure the employment and retention of available health workers. However, external sources of funding to HIV/AIDS typically do not cover personnel.

Uganda. Uganda has achieved considerable success in reducing HIV prevalence rates through aggressive public sector efforts at prevention and, now, treatment. Since 1997/98, the health budget has increased from 1.8 to 2.6 percent of GDP between 1998 and 2005. Additional annual health resources of potentially up to 2 percent of GDP are available to Uganda from the Global Fund and PEPFAR. At present close to 40,000 people are on anti retroviral therapy in the country. The authorities hope that by end-2005, 60,000 people will benefit from the therapy (out of 120,000 who need it).

The IMF PRGF arrangement with Uganda includes a “ring-fence” to protect health care and other poverty-related spending from within-year budget cuts, and promotes a progressive shift in resources to social programs, for example, by seeking to limit growth of non-priority spending such as on public administration. At the same time, adequate budget resources are not the only issue. Improvements are needed in the management of Global Fund and other health resources to accelerate the utilization of approved funding (currently less than 20 percent of funding has been used). Capacity will also need to be enhanced in the health sector, notably through training additional nurses and doctors.

Kenya. Kenya’s HIV infection rate is estimated at 14 percent of the adult population. The fiscal framework underpinning the PRGF-supported program reflects the PRS priorities, including the fight against HIV/AIDS—including actions to increase the number of AIDS patients on ARVT.

The Global Fund (GFATM), the MAP, and PEPFAR are expected to annually disburse US\$32 million (over the 2005-2006) to support the Kenyan Government’s AIDS program--about 0.2 percent of GDP. The Government estimates that the AIDS treatment targets will require the hiring of 4,000 more nurses on top of an estimated 2,000 additional nurses needed for the overall health system. The Global Fund has agreed to provide financing for 725 nurses on two-year contracts, under prevailing pay scales. While the current IMF program places limits on the size of the core civil service establishment, teaching, health, and security services are excluded. It has been agreed that these services may hire additional personnel to fill the 3,000 positions lost by the core civil service through natural attrition.

Source: IMF Africa Region staff

IV. Making the Money Work

119. Achieving the MDGs will depend above all on developing countries’ ability to achieve stronger public sector performance in delivering services. The challenge is essentially political. The evidence that aid works best where policies and governance are good is influencing aid flows, and this trend will intensify. While some donors suggest that a viable strategy in weak states is to bypass the public sector altogether, no OECD country has ever achieved universal health or basic education coverage with mainly private systems—in fact, most are heavily public. Both for-profit and nonprofit private actors will likely play more important roles in the development of these sectors in low-income countries, especially low-income countries under stress (box 3.6), and especially in water and sanitation. But even where services are privately provided, effective state capacity is required to perform the core functions of mobilizing revenues, planning, costing and prioritizing sector investments, setting standards and policies, contracting with providers, and monitoring outcomes.

Box 3.6 Scaling up service delivery in low-income countries under stress (LICUS)

Low-income countries under stress are defined by their weak policies and institutions. Many have recently emerged from or been affected by conflict. Achieving effective service delivery in these circumstances is a challenge. Nevertheless, successful approaches are emerging, including some that feature the use of local institutions or that work with nonstate actors in ways designed for eventual transfer to state delivery.

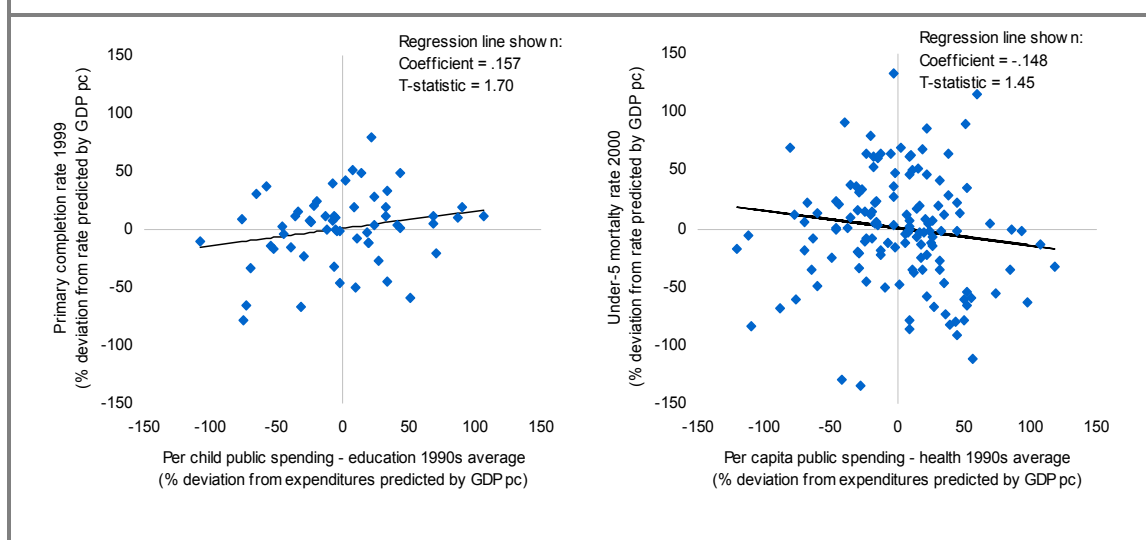
In countries where national institutions are weak, it may seem counterintuitive to look to the subnational levels of government to provide services. But in a number of low-income countries under stress, it is at the local level that formal and informal institutions often demonstrate the most capacity to manage and allocate resources. Community-driven development and social fund approaches have been widely used and proven well suited to these country contexts.

The Northern Uganda Social Fund, for instance, supports construction and rehabilitation of social and economic infrastructure that is identified, managed, and implemented by local communities in conflict-affected areas. In Afghanistan community forums helped ensure vital services and income generation opportunities in local areas during a period of state collapse. Supported by small grants to cover initial costs, the forums relied mostly on community mobilization and cost recovery to organize and finance services. They gradually developed relationships with local governments and donors to become key development actors at the local level. Their highly flexible approach allowed them to respond to community initiatives and local conditions, and to later become the basis for a social fund after the fall of the Taliban. Until recently their model of representative governance was unique in Afghanistan, and contributed to the local reduction of ethnic tensions at a time when ethnicity became heavily politicized and a driver of conflict. The project laid the basis for the new National Solidarity Program, which operates at scale and has been instrumental in bringing both participatory processes and a positive state presence to many remote areas.

Particularly in post conflict low-income countries under stress, experience shows that it is important to give early attention to building the capacity of government actors to take responsibility for service delivery, as well as to restoring basic services quickly. In Timor Leste health indicators improved significantly in the four years following the country's crisis, through a strategy that balanced these two goals. The program worked simultaneously on short-term needs such as reconstruction of health facilities, through government contracts with nongovernmental organizations (NGOs), and medium- to long-term goals such as developing a national health policy, pharmaceutical logistics systems, human resources for health, and gradual handover of NGO contracts to government.

120. The World Bank's *World Development Report 2004* documents the many ways in which the public sector in developing countries fails in service delivery, particularly for poor people. Even where spending on education and health absorbs a high share of GDP, key outcomes can be weak (figure 3.17). Studies consistently confirm the weak relationship between social spending and outcomes – especially in health -- and the two main causes. Health spending on hospitals and costly tertiary care services, for example, will not have as much impact on child mortality rates and malaria incidence as will spending focused on immunization programs and malaria control.

Figure 3.17a & 3.17b: Higher spending on education and health do not always mean better outcomes.



121. The second issue is that even where resources are allocated to the basic education and primary health care services most closely linked to MDG outcomes, the chain of people and transactions through which resources flow down to frontline providers is long, geographically dispersed, dependent on the discretionary behavior of many individuals, and open to leakage at many points. The core services that frontline teachers and doctors provide are complex and individualized, making them difficult to monitor and manage. Difficult working conditions, uncompetitive salaries, and higher status relative to illiterate and unempowered families can undercut providers' accountability to clients and foster absenteeism and low quality. Inefficiency in the use of available resources, arising from all these sources, can be large.

122. The case for additional aid, especially in the form of flexible budget support, will depend on countries' ability to show that funds are well managed and producing MDG results. And as the World Development Report 2004 emphasizes, reforms to improve service delivery must address not only its proximate causes—no drugs in clinics, teacher absenteeism, no water connections in poor urban areas—but also the underlying power and accountability relationships linking citizens, politicians, and service providers that are the cause of persistent inequity and inefficiency in the use of public resources. Progress in many settings will require actions on all three dimensions of the “accountability triangle” linking citizens, politicians, and service providers. It will require broad reforms to improve governance and increase the responsiveness of elected officials to citizens, strategic actions to improve the management of resources and performance along the service delivery chain, and strengthening of “client power,” or citizens' ability to demand better basic services directly from frontline providers.

Improving Governance

123. The broad structures at the foundation of good government—the rule of law, control of corruption, sound economic management, representative governance, and independent media—are crucial for macroeconomic growth and foreign direct investment. They also have direct repercussions on the equity and efficiency of public services.

124. Jump-starting progress toward the MDGs can require decisive actions to prioritize universal coverage of basic services over the interests of politically influential stakeholders. It has involved

such politically difficult actions as shifting to contract teachers to make the costs of expanding schooling more sustainable, at the price of opposition from teacher unions; eliminating fees for basic health services for the poor while retaining them for upper-income groups; shifting to low-cost construction of schools and clinics by communities rather than more expensive national or international contractors; and resisting pressures from teachers and parents for smaller classes until universal coverage is achieved.

125. All these actions to lower the unit costs of basic services or recover costs from those who can afford them promote faster achievement of universal coverage. Countries that have made the fastest MDG progress have given priority to coverage for all, adopted cheaper but “good enough” service delivery models initially, and focused on improving quality over time. These political choices are unlikely in contexts where the voices of the groups likely to benefit from universal access are weak and the influence of institutional stakeholders, such as medical or teacher unions, is strong. A recent study of Georgia concluded that slow progress on the health MDGs and underfunding of MDG-related health services were much more a “failure of citizens to exercise their voice power and the ability of politicians to remain largely unresponsive to the poorly expressed demands than of resource limitations per se.”⁶⁰

126. But progress is being made. In most developing regions, two decades ago democracy was the exception; now it is the rule. Political representation, transparency, corruption, and the quality of public administration are being openly evaluated with a number of international indexes, and most are steadily improving. Since 1999 the average ratings for Sub-Saharan African countries on the World Bank’s policy and institutional assessment index (CPIA) have been stable or increasing in all five areas (quality of budgetary and financial management, efficiency of revenue mobilization, quality of public administration, property rights, rule-based governance). The New Partnership for Africa’s Development has developed a peer review mechanism that uses transparent national assessments by teams from neighboring countries to highlight governance weaknesses in African countries and encourage improvements. (see Chapter 2 for more on NEPAD and the African Peer Review Mechanism).

127. One of the most critical areas for progress is public expenditure management. Achieving the health and education MDGs will require greatly increased volumes of flexible aid channeled through national budgets. But in many of the low-income countries in greatest need of external recurrent cost support, budget systems are too weak to give donors confidence that resources can be tracked and well used. Systems for budget formulation, execution, and reporting must be able to meet threshold standards of integrity and efficiency.

128. Under the Heavily Indebted Poor Countries initiative the IMF and World Bank have worked with countries on benchmarks for measuring capacity to manage priority public spending. Although a first assessment of 24 countries in 2002 found no country with a fully adequate system and most in need of substantial upgrading, many countries showed progress when they were reassessed in 2004 (See Chapter 2 for more) Mali and Tanzania advanced to the category of “little upgrading needed,” and Ghana and Senegal showed substantial progress. For the group as a whole the average number of benchmarks met increased from 6.0 to 6.6 out of a possible 15. Much more is needed, obviously, but trends are in the right direction. But countries’ performance against these indicators can be expected to play a major role in their access to expanded aid in the form of budget support.

⁶⁰ Operationalizing MDGs: How Effective is the Long Route? A Case Study of Georgia, World Bank, ECA Region, 2005

Managing the Service Delivery Chain

129. Broad improvements in political responsiveness to citizens and in public expenditure management should increase the resources available for MDG-related services. But it is the service delivery chain—institutional performance and policies in the education, health, water, and sanitation sectors—that transforms financing into coverage and coverage into outcomes. Substantial country evidence shows that both links can be problematic. But country experience also points to four important strategies for strengthening provider accountability and system efficiency.

130. **Measure results, performance, and impact.** Fundamental for progress is measurement of performance and results. At present, countries are far from real-time tracking of MDG progress for virtually all the goals and indicators. To focus health and education systems on key results, countries need better and more timely administrative data. Capacity building in this area should be a priority, but it must be carried out in new ways that avoid the wastefulness of incompatible management information systems financed by different donors and technical assistance that fails to build true local capacity. Countries also need household surveys at regular intervals – such surveys are essential for tracking MDG outcomes by income quintile, gender, ethnicity or region.

131. The World Bank and the United Nations Educational, Scientific, and Cultural Organization's Institute of Statistics should put coordinated emphasis on building countries' capacity for consistent annual reporting of primary school completion and build up the Primary Completion Database they have jointly launched. The targets for MDG 2 should also be expanded to include some measurement of student learning. Universal primary completion is a meaningful goal only if it signals that children have learned, and in an economically integrated world this threshold level of skills and knowledge should be a globally relevant one. Donors should support work by a consortium of international testing agencies on a culturally neutral global "core curriculum" that can be embedded in the various regional learning assessments in use today. Countries not participating in regional assessments should be encouraged to do so. And strengthening national assessment systems should be a priority area of support. Equally important is making results known to parents and communities. Albania, Romania, and Turkey, among other countries, have recently made important strides in broad public diffusion of student learning results.

132. Most MDG outcomes improve relatively slowly, so intermediate indicators of progress are also important—above all, measures of system efficiency. The Fast Track Initiative "indicative framework" for monitoring education sector performance is transparent and permits direct comparisons of countries' progress; a similar framework is being developed by a donor consortium in health (Health Metrics Network). These new approaches will work to the advantage of countries committed to better performance.

133. Finally, rigorous evaluation of the impact of development programs builds the knowledge base for better policies. Considerable resources are devoted to evaluation studies today, but the failure to establish clear baseline data or appropriate controls often compromises the quality and policy value of the results. Several recent examples, including the Progres/Oportunidades conditional cash transfer program in Mexico and school health interventions in Kenya, attest to the role that well-designed evaluations can play in persuading policymakers to expand or sustain programs, even across changes of government.

134. One of the most crucial questions for policymakers is how a program or policy's design will play out in different country circumstances. This kind of knowledge, which can only be derived from comparable evaluations across countries, is a global public good—and the costs of generating it need to be broadly shared by the international development community. The World

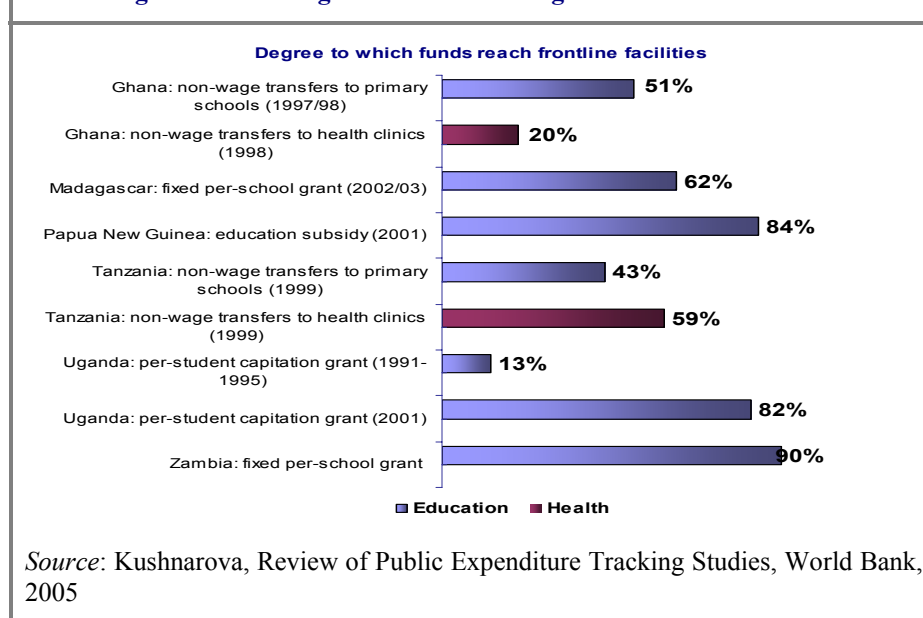
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Bank is especially well-positioned to identify programs with similar objectives and design features being implemented in different parts of the world, and to support systematic and rigorous evaluations of their impact. Through the Bankwide Development Impact Evaluation (DIME) initiative and efforts by the Bank's Human Development Network to organize impact evaluations of key types of education, health, youth employment, and early child development programs, there has been a sharp increase in attention to this area over the past year. It should be strengthened further, with expanded support from donors to build capacity in low-income countries for data collection and analysis and to broadly diffuse evaluation results. Developing country policymakers and their donor partners should also provide a "demand side" stimulus to impact evaluation, by systematically asking for the evidence base when considering new programs or policy proposals.

135. Use transparent allocation rules and the power of information. A core issue in education and health service delivery is getting funds to the frontlines, where services are delivered. Setting simple, clear norms for the allocation of funding has been a boon to more efficient and equitable service provision in both industrial and developing countries. In education, "funding follows the student" reforms have had dramatic effects in countries ranging from Brazil to Australia. In Brazil a 1997 reform that set a minimum floor on education spending in all regions sharply increased resources for the poorest (Northeast) region, and nationally caused primary enrollments of children from the lowest income quintile to rise from 55 percent to 85 percent—in the space of six years.

136. Norms for the allocation of personnel or other inputs (such as medicines or books) can also be established, and clearly communicated to each facility. In addition, fees for health services and drugs should be posted transparently, to ensure that patients are charged fairly and collected funds are not diverted. In Georgia prominent posting of the fee schedule in the children's hospital in Tbilisi has curbed excessive payments and significantly increased hospital revenues.⁶¹ The positive impact of clear funding rules on leakage is shown by public expenditure tracking studies, which document wide variations in the degree to which funds intended for frontline facilities actually get there (figure 3.18). Leakage estimates are not comparable across countries and sometimes only reflect a failure to record transfers properly, not a failure of resources to arrive. But the studies show that even in the same country, results can vary substantially under programs of different design. Leakage is not an inevitable feature of low-income settings.

⁶¹ Ibid, p. 38.

Figure 3.18 Leakage of funds can be high but is not inevitable...

137. Clear allocation rules have the greatest impact if they are widely known. Uganda raised the share of per student capitation grants that made it to schools from 22 percent in 1991–95 to 80 percent in 2001 by publishing monthly data on the transfers in newspapers, broadcasting it on the radio, and having primary schools post notices of their entitlements and the amounts actually received. For the first time, parents had the information they needed to understand and monitor the grant program.

138. Subsequent research has documented that throughput to the school level is most efficient in areas where newspaper penetration is highest—pointing to the power of information.⁶² And a new study shows that, controlling for other factors, schools with higher transfers show more improvement in student learning.⁶³ Uganda’s story points to three key messages for MDG progress:

- Clear, equitable norms for managing key inputs—be it personnel allocations or funding for books or drugs—are important.
- Broad use of the media and transparent reporting at the facility level can unleash “client power” and pressures for improvement.
- It is important to go the extra step to analyze not just progress in reducing leakage, but also its impact on outcomes, such as student learning or community health indicators.

139. Few countries have done all these things, but the growing number of countries using Public Expenditure Tracking Surveys (PETS) and Service Delivery Surveys to measure frontline funding and service quality is encouraging.

140. **Focus on provider quality, deployment, and incentives.** Skilled providers are the most expensive element of health and education systems; recruiting, deploying, equipping, and supervising them carefully are key to maximizing the productivity of spending. Yet very few countries recruit teachers on the basis of tests measuring their subject mastery and what they can

⁶² Reinikka and Svenson, 2003

⁶³ Bjorkman 2005.

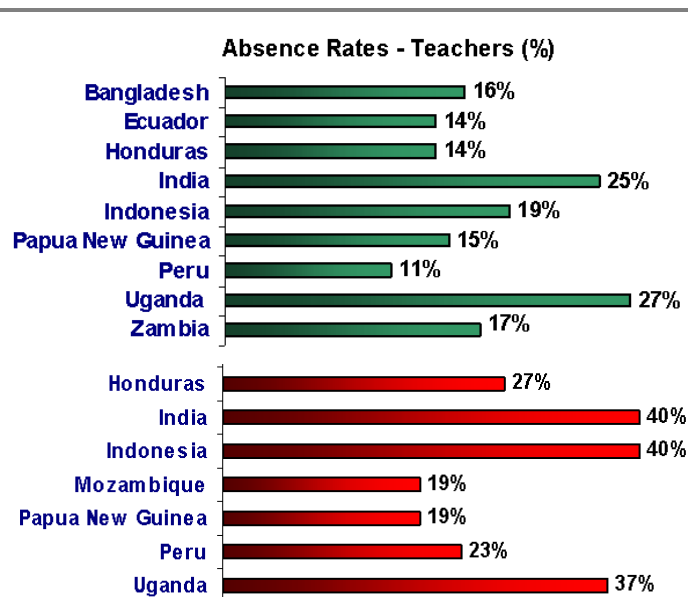
do in the classroom. Far more common are the practices of Colombia, where teachers and headmasters are routinely hired based on party affiliation regardless of their experience, training, or knowledge,⁶⁴ or Cameroon, where headmaster posts are sold.⁶⁵

141. Deployment is also poorly managed in many settings. In Ethiopia each health worker in the Afar region handles 1,200 outpatient visits a year, in Addis Ababa 680, and in Gambella just 82.⁶⁶ The implication? If health care workers were posted more efficiently across the system, achieving Afar's degree of productivity everywhere, the Ethiopian health care system could dramatically increase service delivery with the current number of workers.

142. Similarly, studies in Sub-Saharan Africa find some countries doing a far better job of allocating teachers equitably across schools. Whereas in Benin 39 percent of teacher postings deviate from the official norm of 40 students per teacher, in São Tomé and Príncipe only 3 percent do. Deviations from official norms almost always reflect an oversupply of teachers in more appealing urban areas and low service provision in rural zones.⁶⁷ Countries seeking better MDG outcomes can start by examining factors like these.

143. Even when providers are deployed relatively efficiently, poor incentives, weak management, widespread illness, and other factors can cause high rates of provider absence. Surveys of service delivery that make unannounced visits to a sample of facilities show consistently high absence rates among teachers and health workers (figure 3.19). The problem is especially acute among doctors, who have a ready private market for their services. In Bangladesh absentee rates for physicians average 74 percent at small rural posts.⁶⁸ Provider absence seriously disrupts service delivery and undermines MDG outcomes. In Nigeria a recent study found that almost half the annual school hours in Kano, Nasarawa, and Lagos in 2003 were lost because of teacher and pupil absences.⁶⁹

Figure 3.19 Absence Rates



Source: Chaudhury and others., 2004; Reinikka and Svensson, 2000; The PNG PESD, 2004; the Mozambique PETS, the Cameroon PETS.

144. Studies that have examined this issue in detail have found that it is not simply a question of salary incentives. In Bangladesh the highest-paid teachers were most likely to be absent.⁷⁰ And in India, as well as Bangladesh, a large share of teacher absences were excused absences for training and other administrative processes. Many providers posted to remote rural areas, for example,

⁶⁴ TF education report 2005, p. 49.

⁶⁵ Bennett 2001.

⁶⁶ WHO 2004.

⁶⁷ Mingat and Tan 2004.

⁶⁸ Chaudhury and Hammer 2004.

⁶⁹ RTI 2004.

⁷⁰ Chaudhury and others 2005.

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must travel long distances to pick up their pay—and must do so on business days. Countries concerned about MDG outcomes need to address these managerial issues.

145. Average salaries for skilled providers may need adjustment in many contexts, to counter providers' incentives to migrate internationally in health or to extract informal payments. But there is abundant evidence that effective incentives are not just a question of average salaries, or even salary dispersion, although—if tied to performance evaluation systems perceived as fair—this can help. Nonsalary inducements (such as housing, research and training opportunities, and public recognition) are important, as are accountability pressures through, for example, effective supervision. In Karnataka, India, the Learning Guaranty Program is an innovative attempt to strengthen incentives for public education providers to focus on outcomes that really matter—how well they serve all children in the community, and how much children learn (box 3.7).

Box 3.7 Rewarding schools for MDG outcomes

The Learning Guaranty Program, launched in 2002 by the government of Karnataka, India, in collaboration with the Azim Premji Foundation, aims to strengthen incentives for schools to enroll all children and ensure that they learn. All of the approximately 10,000 public primary schools in the poor, northeastern districts of the state are eligible to participate in the program, which is essentially a competition. Using a novel approach, the program rewards schools on the basis of learning outcomes for all children in their catchment area, whether or not they are enrolled. If 60 percent of children can demonstrate on assessment tests that they have acquired 90 percent of prescribed competencies in mathematics and language, the school receives 5,000 rupees. If 70 percent of children do well, the reward is 10,000 rupees. And with 80 percent, the reward is 20,000 rupees. Over a three-year period a school can win a maximum of 60,000 rupees.

In the program's first year, about 10 percent of schools competed, but the number has since risen dramatically. The program provides direct financial incentives for government schools to deliver better education services to their communities. It is expected that the program will enable parents and communities to put pressure on their children's schools to become a certified Learning Guaranty School. It is also expected that such schools will develop more creative ways of encouraging children to enroll and stay in school. The Learning Guaranty Program is an interesting attempt to more closely align schools' incentives and MDG outcomes.

Source: Azim Premji Foundation (2002) cited in *Attaining the Millenium Development Goals in India*, World Bank, 2004

146. **Make good use of the private sector.** Comparisons of service delivery norms and outputs in public and private facilities often reveal large differences in efficiency. Although the Christian Health Association of Ghana employs only 17 percent of health sector staff, it handles 41 percent of hospital patient visits (outpatient and inpatient) and 27 percent of health clinic visits.⁷¹ Evaluations of Jesuit-run Fe y Alegria schools in nine Latin American countries have found that the schools systematically outperform public schools, with lower repetition and dropout rates and higher graduation rates—despite the fact that resources per student are the same or lower in Fe y Alegria schools and the schools cater to disadvantaged students.⁷²

147. The higher efficiency of private providers can have major benefits for poor people's access to services and for MDG progress. After Argentina privatized local water companies in about 30 percent of its municipalities in the early 1990s, child mortality fell by 5–7 percent in those areas. The largest gains occurred in the poorest municipalities, where child mortality fell by 24 percent. Researchers estimate that privatization of water services has prevented 375 child deaths a year.⁷³ Data from Bolivia and Chile confirm this pattern: private companies' capacity to generate income from efficiently operated services and promote faster system expansion led to pro-poor expansion

⁷¹ Vujicic and Sagoe 2004.

⁷² LAC region report 2004.

⁷³ Galiani, Gertler, and Schargrodsky 2002.

of water supply, with 25–30 percent of network expansion targeted to the poorest fifth of the income distribution.

148. Countries can capitalize on what private providers do best by allowing high-quality for-profit providers to serve the top segments of the income distribution and making strategic use of contracting with for-profit and NGO providers to serve other income groups. NGO providers are often associated with local innovation and community involvement in service delivery, which increase quality, targeting, and cost-effectiveness. El Salvador, Guatemala, Honduras, and Panama are increasingly contracting with NGOs to provide health services to remote (often indigenous) populations on the basis of fixed annual capitation payments. In most cases the NGOs use networks of itinerant teams, complemented by community-based paramedics. In Guatemala, where the experience is longest, about 90 NGOs serve more than 3 million people—30 percent of the national population. Impact evaluations have shown more cost-effective health outcomes under this approach than under traditional public sector delivery.⁷⁴

149. That Bangladesh has made faster progress on MDG outcomes than other South Asian countries, despite its lower per capita income, is attributed by many observers to its widespread use of partnerships between the government and innovative NGOs. In health the country's largest NGO, BRAC, developed a system for teaching mothers how to use oral rehydration therapy for children with diarrhea, under which more than half of outreach workers' compensation is paid as bonuses. Bonuses are based on sample surveys of mothers, and the greater the number of women in a village who can explain how to make and use the rehydration solution, the higher the payment. Within the first two years of the program, two-thirds of mothers sampled could use the therapy—a much higher success rate than outreach and communication efforts usually achieve. Researchers also observed a wide range of practical and effective teaching techniques developed by the outreach workers in response to what worked best for clients.⁷⁵

150. But private service delivery does not automatically lead to better accountability. Also in Bangladesh, researchers have found higher rates of teacher absence in privately run, government-subsidized secondary schools than in schools run by the government directly. Even though continued public funding is supposed to be tied to school performance, government supervisors rarely visit schools, and there are few institutional mechanisms to ensure accountability.⁷⁶ The issue is not public or private; it is the degree to which the institutional framework creates incentives for good performance and the capacity to hold providers accountable.

Strengthening “Client Power”

151. In many settings slow progress toward the MDGs mainly reflects the failure of services to reach or meet the needs of poor people. Poor regions are the last to receive access to social services. And even when they do, deep social inequalities and rampant illiteracy can produce such imbalances in client-provider relationships that abusive or alcoholic teachers, nurses hitting mothers during childbirth, and doctors refusing to treat patients of a lower caste constitute “service delivery” for hundreds of millions of poor people. Even more widespread is the failure to listen to low-income clients' needs in order to make services work better.

152. Countries are experimenting with ways to strengthen client power in frontline relationships, and the results are encouraging. While increasing client choice among providers is a core strategy, it is most feasible in relatively developed settings—urban areas in middle-income countries—where provider density is relatively high. Approaches that increase voice appear to

⁷⁴ La Forgia and others 2004.

⁷⁵ South Asia region note.

⁷⁶ Chaudhury and others 2005.

hold more promise for expanding MDG-related services in low-income countries, at least for the near future.

153. Involve communities in monitoring and management. Experiences with community-run schools, health clinics, and rural water systems in a diverse group of countries suggest that direct client involvement in the management of services can yield positive results. The experience is most extensive in education. Evaluations in numerous Latin American countries and states in India have found that parental and community involvement in schools is correlated with lower teacher absenteeism, higher student test scores, and in some cases lower dropout and repetition rates. Three Central American countries—El Salvador, Honduras, Nicaragua—have more than a decade of experience with relatively strong devolution of autonomy to primary schools and substantive engagement of parents in school management—including the ability to hire and fire principals and teachers. Such reforms have resulted in less teacher absenteeism, more teacher work hours, more homework assignments, and closer parent-teacher relationships. These are promising changes, especially in contexts of low education quality where teacher absenteeism is high and schools are often not functioning.⁷⁷

154. But evaluations in these countries have also shown that the degree of effective control varies across schools. While El Salvador's EDUCO schools have shown that illiterate parents can manage school budgets and key personnel decisions, researchers in Nicaragua observed many schools where de jure involvement of parents in school councils was not matched by de facto voice. Communities often need capacity building and support in taking on these new functions. Finally, evaluations of student learning outcomes provide a reminder that improving teacher attendance and work hours are only first steps toward improving education quality. The impact of school-based management on learning outcomes is mixed, with Honduras showing the most improvement, El Salvador some improvement, and Nicaragua declines. For better outcomes, teachers also need to be knowledgeable in the subjects they are teaching and to use effective teaching methods. School-based management has not affected these areas.

155. Let citizens evaluate providers. A second tool for promoting voice is citizen report cards or other surveys to gain client feedback on the performance of public services. Report cards enable clients to signal needed reforms and can increase accountability pressures through media coverage and civil society advocacy. Report cards on public services were first tried in Bangalore, India in 1993. The feedback—revealing poor quality, petty corruption, lack of access for slum dwellers, and the large hidden private coping costs of deceptively cheap public services—were widely publicized by an active press. The report cards empowered citizens to directly evaluate the civil service, and pushed managers of public agencies to act.⁷⁸ By 1999, a report card rated some Bangalore services substantially higher. Citizen report cards have since been used in Peru (where they are built into the national household survey), Bogota, Colombia (where a program called *Como Vamos* is supported by major media groups that disseminate results), the Philippines, Vietnam and most recently in Albania. They are also being developed in Ukraine, Argentina, Bolivia, Ecuador, Honduras, and Mexico. A similar tool is community scorecards, which focus on service performance at the facility or community level. Rwanda is developing community scorecards for health and education facilities. In Parana, Brazil, a school report card allows parents to rate their children's schools, teachers, and overall performance.

156. These approaches have the potential to alter accountability relationships between clients and providers, but in many settings it will take time for client power to develop. In Parana state officials observed that parents were often unsure about what to assess and found it difficult—particularly in face to face meetings—to criticize the school establishment. Still, as a signal from

⁷⁷ Vegas 2004.

⁷⁸ Citizens, Politicians, and Providers: the Latin American Experience with Service Delivery Reform, LAC region, World Bank, 2004.

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the public sector that citizens' views are considered important for improving the quality of service delivery and the accountability of providers, these approaches are an important step in the right direction. Their effectiveness will be enhanced if communities have regular access to basic information on school, clinic, district, and national performance on key MDG and other indicators.

157. Strengthen demand with conditional cash transfers. Conditional cash transfers provide cash grants directly to poor families, conditional on their children's regular school attendance and health clinic visits for immunizations, nutrition support, and growth monitoring. They have been adopted in a number of Latin American countries over the past 10 years and are spreading to other regions.

158. Such transfers have a number of selling points. First, rigorous impact evaluations have shown that they work—they are effective both in raising the immediate incomes of poor families and developing their longer-term human capital.⁷⁹ Second, conditional cash transfers have political advantages: they allow central governments to have a direct relationship with a target population and to provide a visible and popular form of assistance. The programs can operate with small technical teams, focused on designing and maintaining the targeting system and ensuring timely payments by post or local bank accounts to large number of families. Compared with the alternative of channeling incremental public funds through inefficient public agencies or decentralized levels of government, the political attraction for national politicians is clear.

159. But from the standpoint of MDG progress, conditional cash transfers third asset is by far the most important. They can protect the health and brain development of children during the period when these investments are most crucial—the first three years of life. Losses in brain development from undernutrition, micronutrient deficiencies, illness, and lack of cognitive stimulation in this period are irreversible. Investments supported by conditional cash transfers in early child development are the most highly leveraged investments countries can make toward MDG progress.⁸⁰ They affect nutrition, infant and child mortality, and subsequent performance in primary school.

160. The evidence from Latin America is robust that conditional cash transfer programs increase clients' use of education and health services. Some researchers also point to empowerment effects on poor clients, who gain a sense of legitimacy in approaching public services because the transfers rest on an explicit expectation that they should use such services. A major question in adapting such transfers to other countries is how efficient they are in settings where service quality is poor. Conditional transfers cannot fix the supply side of service delivery. But where supply is adequate, they are an effective tool for stimulating demand among target vulnerable groups.

Quick Wins Are Not Enough

161. Many developing countries must promote MDG progress as rapidly and cost-effectively as they can over the coming years. There is understandable interest in interventions that produce results quickly—such as insecticide-treated bednets and the elimination of school fees. But there are some important cautions. First, even “quick” interventions require system capacity to deliver, and it is crucial that capacity be built in efficient and sustainable ways. In pursuit of faster progress, donors have too often succumbed to the temptation to “parachute” in capacity or develop parallel delivery channels that may not be sustainable over the long term. Even the quickest of wins needs to be part of a long-term process of capacity building.

⁷⁹ Rawlings and Rubio 2003.

⁸⁰ Carneiro and Heckman 2003.

162. Deworming pills, for example, work very quickly, but it has taken four years—after funding became available—to get deworming mainstreamed across primary schools in Guinea and Senegal. Water and sanitation access for clinics and schools can bring vital gains in effectiveness, but while the physical access may be relatively easy to achieve, the capacity to operate and maintain the hardware is not: witness the large number of non-functioning school toilets in developing countries. “Quick wins” are not necessarily quick or easy to implement at scale. And even harder and longer-term is building the capacity and systems to sustain them.

163. Second, some powerful and cost-effective interventions may have longer-term impacts, such as conditional cash transfers that stimulate early child nutrition and health care, or the building of a new medical school. The key for any country is to prioritize investments that will have the highest overall returns in its context. This needs to emerge from a careful diagnosis of the national context, through the Poverty Reduction Strategy process, supported by sound sector planning, costing, and identification of binding constraints.

164. Still, the “quick wins” recommended by the Millennium Project offer a useful menu for countries to consider. Most of the recommended interventions are backed by robust micro-level research. Some will be relevant in a number of different country contexts.

165. But they will not be enough. Quick wins are no substitute for context-specific identification of priorities. Nor do they constitute the full range of high-return investments in a given context, some of which are inherently longer term. Finally, even where they are adopted as relevant strategies, they do not solve the biggest challenge: building capacity for effective, large-scale implementation.

V. Priorities for Global Action

166. For many countries, especially in Sub-Saharan Africa, the MDGs will not be met without unprecedented expansion of health and education service delivery. The private sector will play an important role, particularly in health, but most incremental funding will be channeled through the public sector—and in many countries deep changes in public sector functioning are needed for funding to produce results. The challenge is great, but pragmatic strategies are being shown to work.

167. As discussed elsewhere in this report, the priorities for public action in education, health, water supply, and sanitation must be determined in the context of a country-owned Poverty Reduction Strategy that is at the center of national planning and budgeting processes. If the MDGs are to be reached, Poverty Reduction Strategies must include well-costed, coherent sector strategies aimed at these goals—which has not always been the case. Individual interventions—such as “quick wins”—need to be evaluated in this country-specific framework. To cope with uncertainties in aid levels, countries can draw on sector plans to prepare two or three alternative “stretch” scenarios that can be implemented if additional funding is available.

168. Special actions are needed in the three critical areas analyzed in this chapter: scaling up skilled providers in health and education, ensuring the sustained financing required to expand these recurrent, cost-intensive services, and making sure that money produces effective service delivery and results.

Scaling up skilled providers

169. Expanding education and health services on the scale needed to achieve the MDGs will require major increases in teachers, doctors, nurses, and community health workers, especially in

Sub-Saharan Africa. Human resource shortages are likely to be a binding constraint on system expansion, especially in health, unless countries adapt policies and increase provider productivity. Strategies that are proving effective include:

- Pragmatic adjustments to recruitment standards, to increase production of alternative teachers and community health workers.
- Careful deployment and management of providers, to avoid underutilization.
- Maximum use of non-salary incentives to make public sector positions attractive, especially in rural areas.
- Selective salary adjustments for the highest-skilled workers (such as doctors) in the public sector, to diminish migration.
- Cost-effective investments in medical, nursing and teacher training capacity, to complement the shorter-term strategies above.

170. Donors have an important role to play in addressing the crisis in human resources for health in many developing countries. Health sector wage adjustments in OECD countries could attract more of their own nationals into service. Industrial countries that benefit from African-trained medical personnel could help finance expanded training facilities in those countries and assist them in recouping medical students' loans. A donor working group has begun to develop proposals in this area, which should get priority attention.

Mobilizing sustained recurrent cost financing

171. To achieve the MDGs, many developing countries will need to allocate more of their own fiscal resources to education and health. For education, 20 percent of the recurrent budget is the benchmark under the Fast Track Initiative, while Sub-Saharan African countries, for example, currently average 15 percent. For health, African governments have set a target of 15 percent of the recurrent budget, well above their current average of 8 percent.

172. But every MDG analysis has concluded that countries' own efforts will not be enough, and a large increase in external financing is required. Equally or more important for the human development MDGs are deep changes in the nature of donor support. A significant share of bilateral assistance falls outside national planning and budgeting processes. Transactions costs severely strain recipient countries' limited administrative capacity. And there is a near-complete disconnect between the types of expenditures countries need to finance to scale up service delivery in education and health—recurrent, local, largely personnel costs—and what bilateral donors are actually providing—tied, short-term, and largely technical assistance financing.

173. Most MDG cost estimates have focused on countries' core financing requirements, but most aid today—bilateral and multilateral—cannot be flexibly used for these. Support for capacity building is important, but it must be costed over and above the core requirements. Technical assistance should also be carried out in new ways, to eliminate the all too common pattern of uncoordinated and overlapping studies, training, and technical advisers being provided to the same country by different donors.

174. The MDGs will not be achieved unless all development partners rethink the way they do business. Specific priority actions include:

- *Untying aid.* All aid should support priorities identified in the Poverty Reduction Strategy and endorsed sector plans—nothing should be “off plan.” In countries meeting public expenditure management standards, all aid should flow through national budget and procurement systems.

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- *Limiting the number of recipient countries.* A twofold strategy of narrowing the number of countries of bilateral interest and channeling future increases in ODA largely through multilateral channels and coordinated global efforts would contribute to MDG progress.
- *Harmonizing assistance.* At the recent Paris Forum, donors committed to specific harmonization indicators. Progress on these indicators will be monitored by OECD/DAC. But the EFA Fast Track Initiative, which involves both country level coordination groups and regular global meetings to monitor progress, and the High Level Forum and country level coordination groups in health offer ready made channels for disseminating the indicators and working within the respective sectors towards improved harmonization and alignment.
- *Creating a stable funding framework for the Fast Track Initiative.* To strengthen the FTI, its partners should make a monitorable, public, commitment to sustained funding for primary education. The target should be a significant annual increase from each partner's 2005 base, which the FTI Secretariat should monitor. This kind of predictable funding framework is essential to signal to actual and potential recipient countries that the FTI has sustained financial backing. Each partner's annual funding commitment should help fill agreed financing gaps for endorsed countries where they have a bilateral presence or interest; any residual should be allocated to the FTI's new Education Program Development Fund or the FTI Catalytic Fund. Donors should also show that expanded support for primary education is not coming at the expense of funding for other levels of education, especially secondary education.
- *Supporting increased funding for health.* Additional external resources are needed to prevent and treat childhood diseases and maternal conditions, sustain HIV/AIDS treatment, and make progress against malaria and tuberculosis. Increased donor funding must be longer-term and more predictable, aligned with country priorities, and increasingly made available through budget support.
- *Aligning global health initiatives with national policies and priorities.* The global health community urgently needs to examine all options for ensuring that global programs organized around specific health priorities do not undermine the coherence of countries' health strategies, the balanced allocation of resources, and the strengthening of health systems. Scenarios should preserve the mandates these programs currently have for resource mobilization, awareness raising, results monitoring, and financing of global public goods with respect to individual disease priorities. But these functions must be much better coordinated at the global level, to achieve greater convergence of policies and strategies, and especially at the country level, with harmonized procurement, disbursement, and reporting.

Each country should have a country-led health sector working group involving all development partners—including the national HIV/AIDS coordinator and a representative from the education sector, to coordinate school health and prevention programs. This group should agree on the overall sector strategy and medium-term investment plan for health, and on key outcome and intermediate indicators to be monitored annually. The most efficient strategy is to create a single pooled fund to provide budget support linked to implementation of the agreed sector program. Within such a framework, global programs could pursue the same objectives—but without the high transactions costs of separate programming missions and procurement and reporting requirements.

The High Level Forum for the Health MDGs, established in 2003, offers a platform for this collaborative “rethink” of the current global architecture in health and for the development of common principles and standards of good practice for the engagement of global health partnerships at the country level.

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- *Aiding countries to absorb more aid effectively.* Finally, the IMF should continue to take a public, proactive stance in assisting governments to increase absorption of external grants linked to the MDGs. Fund policy is that program ceilings should be flexible in accommodating such additional spending when grant financing is available. The Fund should assist country authorities to work with development partners and civil society groups to clarify how fiscal and wage bill ceilings are derived, and to provide reassurance that program ceilings are in fact flexibly accommodating spending supported by grants. Staff reports should also explicitly discuss how Fund-supported programs have addressed key macroeconomic issues that affect MDG progress.

Translating resources into service delivery and results

175. Achievement of the MDGs is in the hands of developing countries. Increased aid—especially in the form of flexible budget support—is unlikely to materialize unless countries demonstrate both sound public expenditure management and MDG results. The first requires systems for budget formulation, allocation, and reporting that meet threshold standards of integrity and efficiency. In many of the countries in greatest need of external recurrent cost support, these systems are too weak to give donors confidence that resources can be tracked and used well. Donors are giving high priority to capacity building in this area, but the deepest constraints to country progress are political.

176. The second requires the capacity for real time data on MDG progress. Countries need to be able to track the primary completion rate and use regular household surveys and sentinel monitoring to generate data on child and maternal mortality and major communicable diseases. Data must be disaggregated by gender, region and income, to make sure that MDG progress is reaching vulnerable groups. Because outcome indicators improve relatively slowly, intermediate indicators of progress are also important—above all, measures of system efficiency, such as those for education developed by the Fast Track Initiative. A similar framework is being developed by a donor consortium in health (Health Metrics Network). These new approaches will work to the advantage of countries demonstrating improved performance.

177. Progress will also require a better evidence base for policy, built on rigorous impact evaluation of key programs. Programs should be rolled out in ways that permit the use of control groups. Countries should develop local capacity for carrying out quality evaluations and using results. But knowledge on how interventions play out under different country circumstances is a global public good—and the costs of generating it need to be broadly shared by the international development community. The World Bank has an important role to play, through the Development Impact Evaluation initiative, in organizing more—and more systematic—evaluation of innovative programs across countries, supporting metastudies in key areas, ensuring broad diffusion and use of results, and supporting country-level capacity building.

178. Ultimately, strengthening service delivery requires action to improve core accountability relationships: the responsiveness of governments to citizen demands through the political process, the responsiveness of service providers to clients, and the effectiveness of government agencies in turning resources into results. These weaknesses are the deepest threat to MDG progress. There are no panaceas. But countries are making progress in improving governance. Sector management can be helped by clear funding norms, competency-based recruitment, results focus, attention to cost-effective standards, and strategies to make effective use of the private sector. Above all, governments can strengthen the voice of clients at the point of service delivery—through the power of information, direct involvement in school and health facility monitoring and management, and the use of conditional cash transfers.

4. Realizing the Development Promise of Trade

1. Removing barriers to trade that discriminate against developing countries is potentially a powerful tool to help achieve the Millennium Development Goals (MDGs). Multilateral, reciprocal, nondiscriminatory trade liberalization offers the best approach for supporting development. Rapid conclusion of an ambitious Doha Round is therefore of great importance. As noted in *Global Monitoring Report 2004*, the round should spawn a major reduction in trade-distorting policies. Ambitious reference points could be helpful in guiding the negotiations, such as capping the agricultural tariffs of industrial countries at 10 percent, eliminating their agricultural export subsidies and manufacturing tariffs, fully decoupling domestic agricultural and rural support policies from production, and pursuing meaningful liberalization of trade and investment in services, including through temporary movement of service providers. Equally important, developing countries need to set ambitious targets to further reduce the average level and dispersion of protection and substantially expand their World Trade Organization (WTO) commitments. To assist in attaining the MDGs, such actions should be fully implemented by 2015, with significant progress before 2010.

2. A surge in ambition is needed to realize the promise of the Doha Development Agenda. The ambition must focus on transforming agricultural trade policies in OECD countries, devoting greater attention to reducing the trade-restricting effects of nontariff measures, and safeguarding and expanding the scope for developing countries to contest services markets. Given that trade restrictions are much higher in developing than industrial countries, significant further liberalization by developing countries will also be required to realize the full potential of trade for development. Indeed, two-thirds of the potential developing country gains from trade reform will come from reforms by developing economies.

3. An ambitious Doha Round will benefit the world as a whole and developing countries as a group. But it is not a panacea, and it is not costless. Trade is a key driver of growth, but needs to be complemented by many other policies. In many developing countries “behind-the-border” policies and the investment climate are binding constraints on the ability to realize the benefits from greater trade opportunities. All countries will incur adjustment costs from deep trade reforms, and some developing countries will confront erosion of current tariff preferences. Such changes should be considered within the broader context of development and poverty reduction strategies, with special attention to the concerns of poor households. The standard argument for trade liberalization is that total gains exceed total losses—especially over time—and that gainers can compensate losers while still improving their welfare. But in practice such compensation does not occur. An ambitious Doha Round will generate substantial gains, providing a basis for transferring additional resources to low-income countries to enhance trade capacity. Given that lack of competitiveness due to high operating costs and weak investment climates are the primary factor limiting trade potential in many poor countries, actions to lower such costs are urgently needed, especially in Africa. The agenda includes supporting trade logistics and facilitation, strengthening transport infrastructure, and further reforming policies that create antiexport bias—including import tariffs.

4. A “package deal” that involves an ambitious Doha outcome—significant liberalization commitments by both industrial and developing countries—complemented by a credible commitment to transfer some of the resulting gains to the poorest countries would send a strong signal that political will exists to leverage trade to achieve the MDGs. Such a deal would help countries that have the capacity to export but are now constrained (such as middle-income agricultural exporters) as well as countries that have much less capacity and are unlikely to benefit much from the standard reciprocal exchange of market access commitments in the WTO.

5. Recent policy in OECD countries has emphasized tariff preferences for small, poor countries, especially the least developed countries (LDCs) and Sub-Saharan African countries. While actions to make tariff preferences more effective in the short run could be beneficial—for example, through adoption of common, liberal rules of origin—consideration should be given to alternative forms of trade assistance that generate greater benefits for recipients and are less trade-distorting. Tariff preferences have been of limited value to many African countries and have negative effects on the functioning of the global trading system. Alternative measures include sharp reductions in most favored nation (MFN) tariffs and other barriers by industrial and middle-income countries on goods and services of export interest to developing countries, financial assistance, and actions to minimize the incidence of nontariff measures on exports from poor countries.

6. “Aid for trade”—assistance to bolster trade capacity and reduce trade costs—can have high returns in terms of increasing growth, reducing poverty, and facilitating the realization of ambitious global trade reforms. The share of aid for trade in total aid commitments increased from 3.6 percent in 2002 to 4.2 percent in 2003 (WTO and OECD 2004). A concerted effort to further expand such assistance could do much to improve developing countries’ capacity to benefit from both global and domestic reforms. Numerous trade integration studies undertaken for LDCs under the Integrated Framework for Trade-Related Technical Assistance, as well as similar analyses done in other developing countries, have identified areas where such aid can be used effectively. The Integrated Framework, a collaborative venture between six multilateral agencies, bilateral donors, and governments of LDCs, offers a mechanism to identify priorities and allocate additional assistance to trade-related investments and policy reforms. To date, dedicated resources to support implementation of the framework have been limited to small-scale technical assistance. Funding for trade priorities is considered in the context of the resource allocation and prioritization process related to country development strategies (PRS or equivalent national development strategies), with donor assistance complemented by loans and other support from international financial institutions. While this should continue to be the case, the Integrated Framework could be used more extensively to both bolster trade capacity of poor countries and help address the adjustment costs from an ambitious Doha Round.

7. Regional cooperation is another potentially powerful instrument to leverage trade for development—as long as it does not detract from the pursuit of an ambitious Doha Round and focuses policy attention on domestic (intra-regional) policy-related trade constraints. In Africa, there is a strong regional dimension to growth, absorptive capacity, and the widening of economies of scale needed to lower infrastructure costs and facilitate trade. To fully realize the development promise of both North-South and South-South regional integration arrangements, developing country members of trade agreements should implement significant liberalization on a nondiscriminatory basis in addition to granting preferential access to partner countries. Many Sub-Saharan countries still rely on import duties for a significant portion of government receipts, so revenue concerns and the ability to put in place alternative revenue sources are factors that need to be taken into account in determining the speed of liberalization.

I. Trade Performance of Low-Income and Least Developed Countries

8. The past two decades saw a boom in world trade. Growth in non-oil exports from developing countries outpaced those from industrial countries (table 4.1), and their market share rose from 21 percent in 1980 to 37 percent in 2003 (table 4.2). This increase reflects the growing openness of developing countries to trade and the competitiveness of their exports in global markets. Openness ratios (the sum of exports and imports as a share of GDP) have increased for most developing regions, and range from a low of 25 percent in South Asia to 64 percent in Europe and Central Asia.

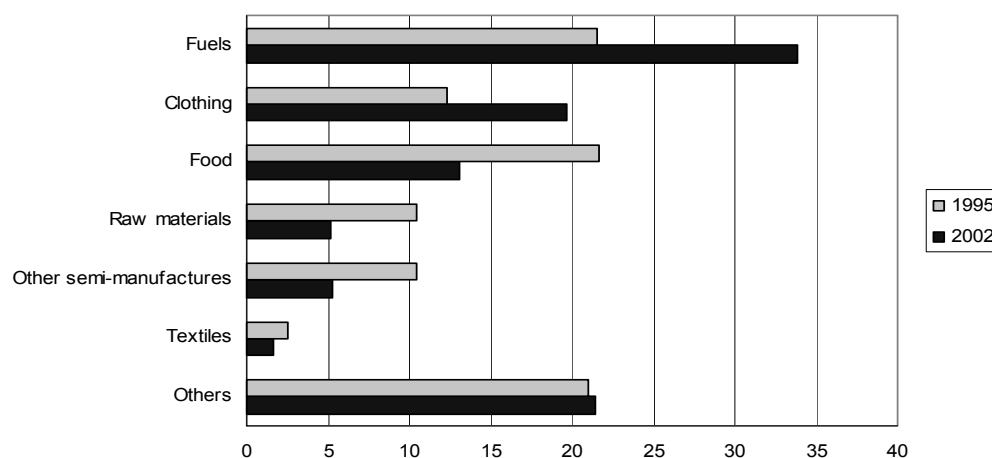
Table 4.1 Trade has grown rapidly in recent years, especially in developing countries (average annual growth rate; percent)			
Country group	1991–95	1996–2000	2001–03
Exports			
World	8.7	4.8	5.8
Developing countries	12.2	7.7	7.4
Least developed countries	3.8	10.1	8.4
African least developed countries	0.1	7.3	10.2
Low-income countries	8.7	9.6	8.1
African low-income countries	2.8	12.6	4.2
Imports			
World	8.1	5.2	6.0
Developing countries	13.3	5.3	8.1
Least developed countries	5.8	3.3	12.0
African least developed countries	3.1	1.9	13.3
Low-income countries	9.2	4.4	12.8
African low-income countries	5.2	0.9	16.1
<i>Source: IMF, Direction of Trade Statistics.</i>			

Table 4.2 Developing countries account for a growing share of nonoil exports (percentage of total)						
Country group	1975	1980	1990	1995	2000	2003
Industrial countries	80.3	78.9	76.5	70.6	65.1	62.6
Developing countries	19.7	21.1	23.5	29.4	34.9	37.4
Least developed countries	0.8	0.6	0.6	0.4	0.5	0.6
African least developed countries	0.6	0.4	0.4	0.2	0.3	0.3
Low-income countries	3.1	1.7	2.0	1.9	2.3	2.5
African low-income countries	2.1	0.8	1.0	0.7	0.9	0.9
<i>Source: IMF, Direction of Trade Statistics.</i>						

9. Foreign exchange earnings of the poorest countries depend importantly on agricultural commodities and labor-intensive manufactures. Average annual export growth in Sub-Saharan Africa increased since the second half of the 1990s, but Sub-Saharan Africa's share of world trade remains far below what prevailed in the 1970s (Table 4.2). Reasons include the region's high dependence on agriculture, limited trade opportunities caused by highly distorting policies in OECD countries, and downward global price trends for some commodities (such as coffee) due to expanding supplies. Problems on the supply side of the market also help explain the below-average trade and foreign direct investment performance of many low-income countries. Civil conflicts undermined economic performance in a score of African countries, and in others poor macroeconomic policies often led to price disadvantages as a result of overvalued currencies (World Bank 2001). Moreover, governance problems, corruption, and institutional weaknesses worsened the local investment climate and inhibited local entrepreneurs from taking advantage of market opportunities. Those same factors also induced instability in commodity prices and had adverse effects on the demand for commodity exports.

Figure 4.1 LDC Exports: Less food and raw materials, more energy and apparel

(Share in total exports, %)

*Source:* WTO (2004).

10. Since the mid-1990s average growth rates of exports from low-income countries and LDCs have outpaced those for the world and for developing countries (see table 4.1). This largely reflects an increase in commodity prices and more recently the decline in the U.S. dollar, as well as an increase in exports of manufactures (textiles). These developments contributed to a minor recovery in these countries' world market shares, though these remain below those of the 1970s (see table 4.2). Global export shares for low-income African countries and for LDCs as a group exceed their shares in world GDP.¹ Average import growth rates have also picked up recently, outpacing growth in imports for the world and for developing countries during 2001–03.

11. Exports from the poorest countries remain concentrated in primary commodities. The concentration index of Sub-Saharan Africa's exports was 0.47 in 2001—similar to that of the Middle East and North Africa, a region heavily dependent on oil exports. This is almost twice the figure for East and South Asia, and 50 percent higher than in Latin America.² Agricultural products account for at least a quarter of exports from Sub-Saharan Africa and Latin America. As a result countries in both regions are subject to greater commodity price (terms of trade) volatility. The decline in nonfuel commodity prices and the increase in energy prices since 1995 have contributed to a decline in the shares of food and raw materials and an increase in the share of fuels in exports from LDCs (figure 4.1). Expanding apparel exports from Africa are a noteworthy development of recent years. While reliable data on the composition of exports for 2003 are not yet available, the sharp increase in fuel prices during 2003–04 will likely further increase the share of fuels in LDC exports.

¹ Shares in global GDP for all LDCs, African LDCs, all low-income countries, and all African low-income countries in 2003 were 0.6, 0.3, 2.5, and 0.9 percent, respectively.

² The measure of concentration reported here is the Herfindahl-Hirschmann index (the sum of squared shares).

II. Recent Developments in Trade Policy

12. Global trade policy developments in 2004 provide a mixed picture. After a disappointing outcome at the WTO ministerial conference in Cancun, Mexico, in September 2003, there was considerable gloom about the prospects of the multilateral trading system. But in 2004 WTO negotiations came back on track, with a package of agreements reached in August. The WTO agreed on a framework for negotiations on agriculture and industrial products, a set of recommendations on services, and modalities for negotiating improved customs procedures. Other positive developments included proposals for reforming EU sugar and banana regimes, and an end—after some 40 years—to the regime of managed trade in textiles and clothing.

13. The proliferation of reciprocal preferential trade arrangements continued in 2004, with activity spread across all regions and countries. Since 1990 the number of preferential trade arrangements in force and notified to the WTO has risen from 50 to nearly 230 (World Bank 2004), and another 60 are being negotiated. But there is growing concern that such arrangements create trade diversion and substantial administrative costs due to complicated rules of origin. Although many of the countries most active on this front are strong proponents of the Doha Round and consider the agreements a form of “competitive liberalization” that reinforces WTO-based liberalization efforts, preferential trade may create interests opposed to multilateral extension of market access opening and divert scarce negotiating resources. Moreover, while the agreements can help developing countries by reinforcing internal reforms and lowering trade costs, such benefits do not require preferential access to markets. As discussed later in this chapter, minimizing discrimination and focusing attention on cooperation to lower regulatory trade is an important challenge from a development perspective.

14. The recent accession of 10 new members to the European Union consolidated the extensive network of intra-European trade agreements and expanded the EU internal market. The European Union is also pursuing association agreements with Common Market for the South (MERCOSUR) and Mediterranean countries, and is negotiating reciprocal economic partnership agreements with regional subsets of African, Caribbean, and Pacific (ACP) countries.

15. Over the past year the United States has also been active in concluding preferential trade agreements, including with Australia, Bahrain, Central America, the Dominican Republic, and Morocco. Several more are under negotiation. In Latin America, MERCOSUR signed an agreement with Andean countries and is negotiating with India, Mexico, and South Africa (in addition to the European Union). Mexico is negotiating trade agreements with Japan and Singapore. Similarly, a South Asia free trade area is being negotiated between seven countries, and in Africa the customs union of the East African Community has been launched. The Association of South-East Asian Nations (ASEAN) has agreed to negotiate preferential agreements with China, India, and Japan, among others. Japan, the Republic of Korea, Singapore, South Africa, and Thailand have also been negotiating bilateral accords.³ The rising regional activity in East Asia is particularly noteworthy given these countries’ historical noninvolvement in preferential trade and reliance on the multilateral trading system. An increasing number of developing countries are seeking membership in regional agreements. The spread of preferential trade agreements has potential negative repercussions for the robustness and relevance of the multilateral trading system if not accompanied by nondiscriminatory liberalization.

16. Developments also occurred for nonreciprocal preferences. The European Commission introduced a new Generalized System of Preferences scheme offering duty-free access to the EU market for 80 percent of dutiable tariff lines to countries that adhere to a number of international conventions on human rights, labor, the environment, and governance. The new scheme enters into force in April 2005 and provides for better product coverage, more relaxed rules of origin,

³ World Bank (2004a) provides a comprehensive discussion of the ongoing proliferation of regional trade agreements.

and greater certainty and predictability in the granting of preferences. In the United States, passage of the African Growth and Opportunity Acceleration (AGOA III) Act extends the general timeframe for AGOA preferences until 2015. It also extends the third-country fabric manufacturing provision for least developed AGOA beneficiary countries until 2007—an important provision since few AGOA beneficiary countries have adequate capacity to manufacture fabric. The legislation provides temporary respite to textile and clothing sectors in several Sub-Saharan countries (including Lesotho, Madagascar, and Swaziland) as competitive pressures intensify following the elimination of all quantitative export restraints in January 2005.

Tariffs, Nontariff Measures, and Contingent Protection

17. In recent years there has been a decline in tariff barriers worldwide, reflecting autonomous reform, regional agreements, and WTO accession (including by Cambodia, China, Egypt, India, Iran, Pakistan, Tunisia, and Zimbabwe). Globally, average tariffs fell by 2 percentage points between 1997 and 2000 and by 1 percentage point between 2000 and 2003. As measured by most favored nation tariffs, South Asia is the most restrictive region, followed by Sub-Saharan Africa (table 4.3).

18. By contrast, there has been no decline in nontariff measures affecting trade, such as licensing requirements and antidumping investigations. (Licensing requirements are often associated with health- and safety-related regulatory requirements that apply in principle to both imports and domestic products; see below.) Nontariff measures apply to a large share of trade, with the highest ratios in developing countries (table 4.4). But as discussed below, when converted to ad valorem equivalents, nontariff measures are more important in rich countries.

Table 4.3 Applied most favored nation tariffs are highest in South Asia and Sub-Saharan Africa
(simple average, percent)

Region/income group	Late 1980s	2004 (preliminary)
East Asia and Pacific	18.8	9.6
Europe and Central Asia	10.2	7.3
Latin America and Caribbean	22.4	10.4
Middle East and North Africa	17.3	12.4
South Asia	68.9	17.7
Sub-Saharan Africa	25.1	15.3
High-income OECD	7.0	4.1
High-income non-OECD	9.0	6.6
Developing countries	25.4	11.7
Least developed countries	28.4	15.1
Low-income countries	31.7	12.9
Middle-income countries	21.8	10.5

Note: Classification of regions and income groups based on World Bank 2004b.

Source: UNCTAD *TRAINS* database; World Bank, *World Development Indicators*; IMF Trade Policy Information Database; WTO Trade Policy Reviews.

Table 4.4 Nontariff measures are highest in Middle East and North Africa, 2002

(percent)

Region/income group	Frequency ratio (share of tariff lines)	Coverage ratio (share of imports)
East Asia and Pacific	44.0	32.8
Europe and Central Asia	14.6	23.9
Latin America and Caribbean	26.9	44.4
Middle East and North Africa	49.5	51.6
South Asia	12.1	28.6
Sub-Saharan Africa	24.4	28.8
High-income OECD	22.0	24.1
High-income non-OECD	45.1	46.9
Developing countries	27.2	34.3
Least developed countries	20.0	36.7
Low-income countries	25.5	36.4
Middle-income countries	28.3	34.0

Note: Classification of regions and income groups based on World Bank 2004b. Nontariff measures include price controls, quantity restrictions, state trading monopolies, and technical product regulations as classified in the UNCTAD TRAINS database.

Source: UNCTAD TRAINS database; WTO Trade Policy Reviews; EU Product Standards Database; Groupe d'Economie Mondiale, Institut d'Etudes Politiques.

19. The use of instruments of contingent protection (antidumping and safeguard actions) against imports by WTO members has grown steadily, with more than 2,400 antidumping investigations launched since 1995 (table 4.5). This instrument is increasingly being used by developing countries against other developing countries. Indeed, developing countries have overtaken industrial countries in the number of cases launched: between 2002 and June 2004 industrial countries initiated 190 cases, compared with 441 by developing countries. India has passed the United States as the top initiator, and Argentina and South Africa have an even higher incidence of antidumping use relative to the value of their imports (table 4.6).

20. Another important nontariff measure affecting exports and imports are health- and safety-related product standards. In contrast to antidumping efforts, which by definition are intended to protect domestic import-competing industries, health and safety regulations (mandatory product standards) are often applied equally to domestic and foreign (imported) products—so in principle they are not (or should not be) intended to protect domestic industries. Indeed, WTO rules prohibit the protectionist use of technical product regulations. As discussed below, such norms affect trade by increasing the costs of entering a market, with the incidence of the associated costs differing across countries depending on the composition of their exports and the ease of satisfying (documenting compliance with) a specific norm.

Table 4.5 Developing countries initiate more antidumping investigations, 1995-2003

Initiating region	Target region			
	Industrial countries	Developing countries	Transition economies	Total
Industrial countries	226	574 (129)	132	932
Developing countries	453	827 (225)	173	1,453
Transition economies	4	7 (2)	20	31
Total	683	1,408 (356)	325	2,416
Share of total (percent)				
Industrial countries	24.2	61.6 (13.8)	14.2	100.0
Developing countries	31.2	56.9 (15.5)	11.9	100.0
Transition economies	12.9	22.6 (6.5)	64.5	100.0
Total/average	28.3	58.3 (14.7)	13.5	100.0

Note: Numbers in parentheses are actions against China. Industrial countries are Australia, Canada, EU15, Iceland, Japan, New Zealand, Norway, Switzerland, and United States. Transition economies are Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Poland, Romania, Russian Federation, Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan, and Yugoslavia.

Source: WTO Antidumping Committee data.

Table 4.6 A few large developing countries have launched the most antidumping investigations, 1995–2003

Initiating country/region	Number of cases	Share of total (percent)	Index of initiations per US\$ of imports (United States = 100)
India	379	15.7	2,416
United States	329	13.6	100
European Union (15)	274	11.3	101
Argentina	180	7.5	2,577
South Africa	166	6.9	2,634
Australia	163	6.7	719
Canada	122	5.0	170
Brazil	109	4.5	590
Mexico	73	3.0	155
China	72	3.0	109

Source: WTO Antidumping Committee data; IMF, *Direction of Trade Statistics*.

Textiles and Clothing, Bananas, and Sugar

21. A major trade policy change in 2004 was the phase-out of bilateral quotas on exports of textiles and clothing at the end of the year, as required by the Uruguay Round Agreement on

Textiles and Clothing. Because the quotas were bilateral and not based on competitive considerations, their removal is likely to lead to export declines and balance of payments swings for several countries. China and India are expected to gain from this liberalization, as they are considered the most competitive producers. But the actual effects will depend on market sourcing decisions by retailers and buyers, as well as the extent to which safeguard measures are invoked and US quotas are maintained under the provisions of China's WTO membership. In January 2005 China imposed a low most favored nation tax—ranging from 2–4 percent—on its textiles and clothing exports, to remain in place through the end of 2007.⁴ Although this will attenuate the expected shift in sourcing to Chinese producers, the elimination of the quotas will still force significant adjustments in less efficient countries (box 4.1).

Box 4.1 Impacts of the Agreement on Textiles and Clothing

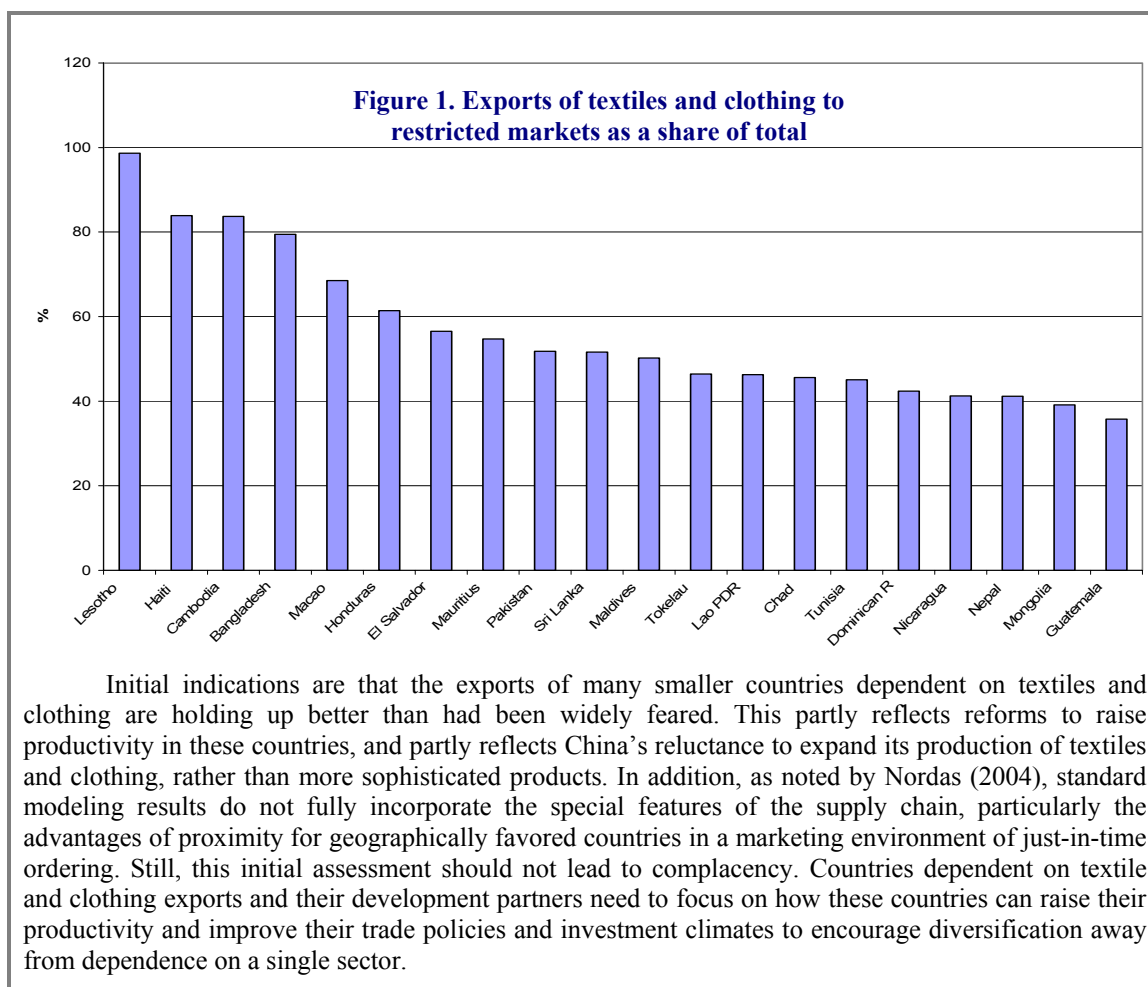
The Agreement on Textiles and Clothing, agreed to as part of the Uruguay Round, was designed to progressively phase out quotas that limited developing countries' opportunities to export textiles and clothing. Quotas were to be gradually abolished, and the growth rates of export volumes subject to quotas steadily increased, over a 10-year period ending on 1 January 2005. Importing countries were allowed to choose which products to make quota free at three intermediate stages set out in the agreement (1995, 1998, and 2002). They chose products in which developing countries did not have a comparative advantage—or even face quotas. The acceleration of quota growth did succeed in making quotas nonbinding for some exporters, but for some dynamic exporters—particularly China—the quota growth rates of around 3 percent a year were much lower than their supply capacity. As a result quotas became more restrictive.

Quota abolition will lower prices for consumers in markets that had restricted textile and clothing imports. Prices in unrestricted markets can be expected to rise, absent the incentive for efficient exporters to divert products shut out of U.S. and EU markets into these markets. In addition, less competitive suppliers—including small, poor countries that became exporters of textiles and clothing in part because dynamic exporters were fettered by quotas—may be confronted with lower prices for their products. The impacts on individual exporters will depend on the destination of their exports. One way to identify countries that might lose from this change is to examine what percentage of their exports comes from exports of textiles and clothing to restricted markets. The 18 most vulnerable countries are those for whom exports of textiles and clothing to Canada, the European Union, and the United States exceeded 35 percent of total exports in 2003 (see figure). Most of these are small economies.

Francois and Spinanger (2004) estimate that for China the quotas had the same effect as a tax of about 25 percent on clothing exports to the European Union and United States. Most other exporters faced much lower barriers. The adverse effect on the prices received by vulnerable exporters would be much smaller than 25 percent, partly because textiles and clothing are differentiated products (exports from different countries are very different; see Martin, Manole, and van der Mensbrugghe 2004) and partly because prices in unrestricted markets can be expected to rise following abolition of the quotas. To take an extreme possibility, if the price impact on exports to restricted markets was –10 percent, the Agreement on Textiles and Clothing would have a significant negative impact on countries dependent on such markets for a substantial share of their exports in this sector.

Continuation of quotas against China is a possibility because of the safeguard provisions included when China acceded to the WTO in 2001 (Bhattasali, Li, and Martin 2004). But these apply only against China: if invoked, they would allow other efficient exporters to fill the gap. A safeguard system—or an equivalent export tax on China's exports—would create global costs of around \$13 billion, while transferring some \$3 billion to competing exporters (Manole 2004). Most of this benefit would go to countries that are not heavily dependent on exports of textiles and clothing to restricted markets.

⁴ These are reportedly specific taxes, not ad valorem, and thus will imply an incentive upgrade quality (produce higher value products). These taxes may seem low but because they apply to all exports (not just exports to restricted markets), they are significant.



22. In July 2004 the European Union announced that it will substantially reduce its sugar production and exports over a four-year period.⁵ The cut in output is to be accompanied by a reduction in domestic support prices of about one-third, implemented over a three-year period. Import quotas from African, Caribbean, and Pacific countries and India will be maintained at present levels. Farm support payments will be decoupled from production and linked to environmental and food safety standards. While this reform will benefit EU consumers and competitive developing country suppliers, it will reduce benefits from sugar production for several African, Caribbean, and Pacific countries as the value of their quotas declines. The European Union has made provisions for adjustment assistance for such countries.

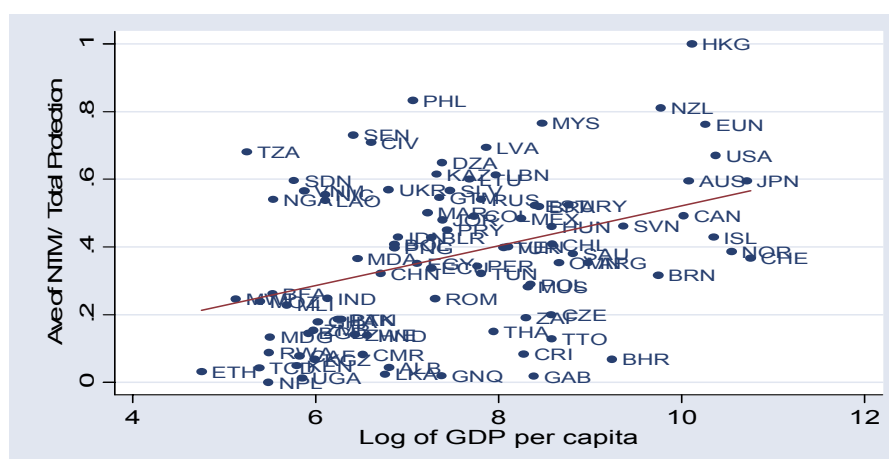
23. In October 2004 the European Union announced a proposal to change its import regime for bananas. Under a WTO-backed agreement with Ecuador and the United States, the Union is required to move away from its quota-based system of controlling imports to a tariff-only system by January 2006. Under the proposal the Union would levy a tariff of 230 euros a ton on banana imports from non-African, Caribbean, and Pacific countries, which it argues is equivalent to the level of protection now in place. This move has disappointed producers in several Latin American countries, who are concerned that such a high tariff will make them unable to compete in the EU market, as well as producers in African, Caribbean, and Pacific countries, who fear that the proposed tariff is not high enough to maintain their existing market shares.

⁵ In a case brought by Australia, Brazil and Thailand against the EU sugar regime, a WTO dispute settlement panel ruled that a number of aspects of the EU policy violated WTO rules, including on export subsidies. African, Caribbean, and Pacific countries opposed the case on the basis that reforms in the EU regime would erode existing preferential access arrangements.

III. Restrictiveness and Incidence of Trade Policies

24. As noted in *Global Monitoring Report 2004*, the trade policy measures reviewed above cannot be readily compared across countries. Such comparison is possible only on the basis of an index that measures the overall trade restrictiveness implied by trade policy. The measure used is the overall trade restrictiveness index (OTRI), which represents the uniform tariff equivalent of the different policy instruments observed for a country that would generate the prevailing level of trade. When the focus is on measuring the trade effects of policies on an importing economy, the trade restrictiveness index can be defined as the equivalent uniform tariff that would keep imports constant. When the focus is on an exporting country's perspective (market access), the index is the equivalent uniform tariff implied by the set of policies maintained by one country (or all importers) on that economy's export bundle. The OTRI is calculated as the weighted sum of

Figure 4.2 Non-tariff measures are more important in rich countries



Source: Kee, Nicita, and Olarreaga 2005a.

nominal tariffs and the ad valorem equivalent of nontariff measures at the tariff line level.⁶

⁶ The OTRI belongs to the family of trade restrictiveness indices developed by James Anderson (Boston College) and Peter Neary (University College, Dublin) for the World Bank in the early 1990s. A welfare-based measure was originally developed in Anderson and Neary (1994, 1996); an import volume-based measure was first defined in Anderson and Neary (2003). The index is a theoretically well-grounded measure of protection. The OTRI does not suffer from the well-known drawbacks of simple or import-weighted tariff averages, and allows the impact of both tariffs and nontariff measures to be estimated. The methodology used for the measure comprises four steps. First, import demand elasticities by country and by product are estimated at the 6-digit level of the Harmonized System of commodity classification (HS) (some 4,200 product categories). Second, an estimate is made of the impact on imports, again at the 6-digit HS level, of core nontariff barriers (quotas, nonautomatic licensing, minimum prices, and similar policies), measures of a regulatory nature (particularly technical, product-specific regulations, and sanitary and phytosanitary measures), and domestic support granted to agriculture. Third, using these demand elasticity and impact estimates, the product-level ad valorem equivalent of the nontariff measures and agricultural subsidies is calculated for each country in the sample. Finally, tariffs and ad valorem equivalents of nontariff policies at the product level are aggregated to produce an overall measure of trade restrictiveness. The index is calculated bilaterally for every country and its partners. The OTRI calculations use the most recent measures of applied preferential tariffs—both reciprocal and nonreciprocal—as well as ad valorem equivalents of specific tariffs. In both instances the source of these data is CEPII (France). It is assumed that tariff preferences are fully utilized by eligible countries and that any associated rents

25. The contribution of nontariff measures to the overall level of trade restrictiveness increases with GDP per capita (figure 4.2; Kee, Nicita, and Olarreaga 2005a). One reason is that average tariffs in rich countries tend to be lower and are bound in the WTO and through regional trade agreements. As a result protectionist pressures, if successful, will by necessity be reflected in other instruments—antidumping being a major example. Most developing countries have tariff bindings (commitments) in the WTO that are well above their applied tariffs, and may not have bound tariffs at all, allowing for the use of tariffs when desired.

Trade Restrictiveness, Income, and Poverty

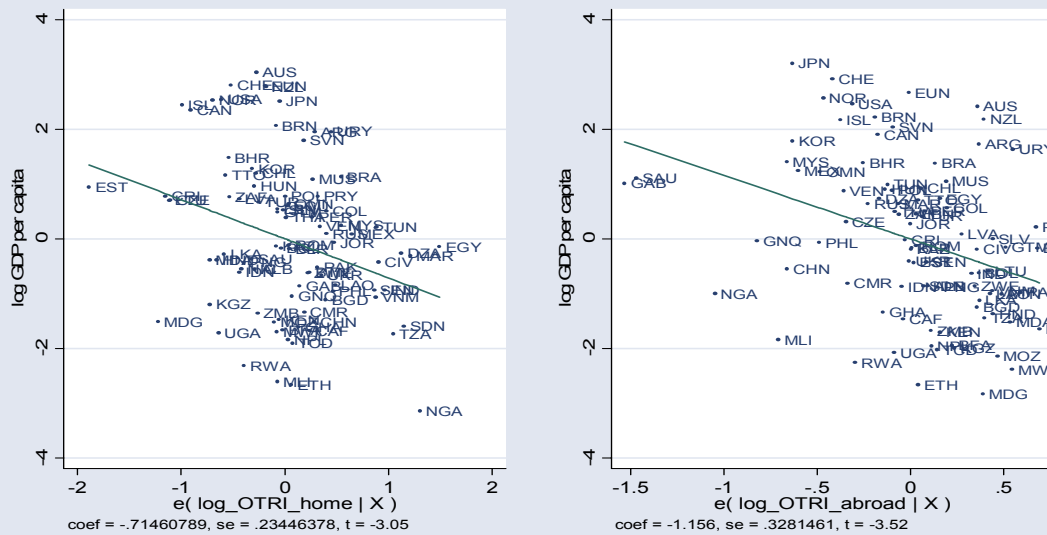
26. OTRIs are negatively correlated with GDP per capita—the higher is a country's GDP per capita, the lower is its trade restrictiveness as measured by the OTRI (figure 4.3). Similarly, the higher is a country's GDP per capita, the lower are the trade barriers imposed by the rest of the world on its exports. Thus there is a negative association between GDP per capita and the trade restrictiveness that countries impose on their imports and that imposed by the rest of the world on their exports.

27. For developing countries for which poverty headcount data are available, OTRIs are positively correlated with poverty headcounts: the higher is a country's trade restrictiveness, the poorer it tends to be (figure 4.4). Higher trade restrictiveness on exports is also positively correlated with poverty headcounts—that is, the higher is the OTRI confronting a country's exports, the more poor households that country is likely to have.⁷ The implication is that reductions in protection at home and abroad are likely to be pro-poor. Although such correlations of average trade restrictiveness and the total number of poor people in a country suffer from aggregation bias and do not imply there is a causal relationship, more detailed microeconomic studies of trade reforms in developing countries find that liberalization has tended to benefit poor people.⁸

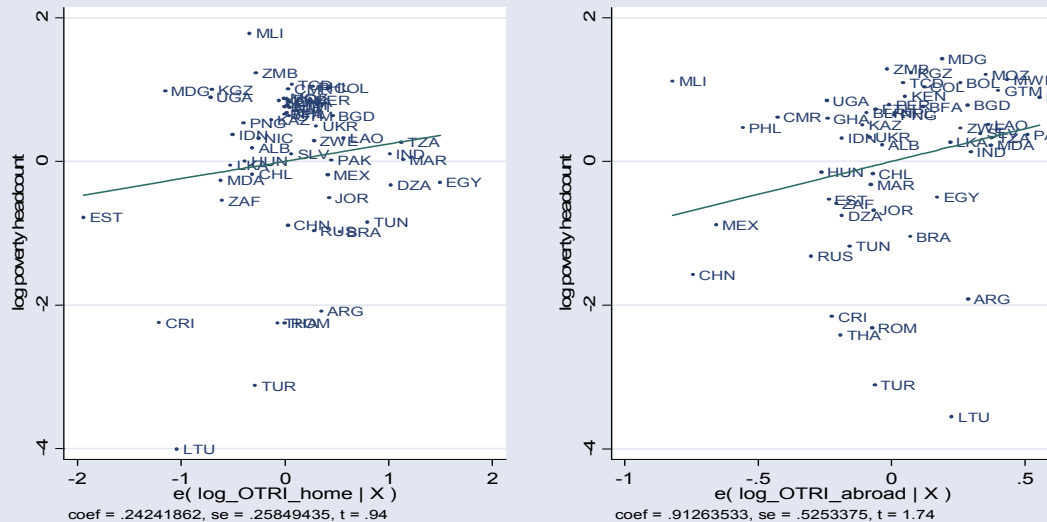
accrue to the exporting countries. As discussed below, there is evidence that in practice a share of any rents accrue to importers in the countries providing preferential access.

⁷ The statistical robustness of these relationships is not strong, especially for own trade restrictiveness imposed on imports. Removing just a small number of (outlier) countries results in the relationship either disappearing or becoming a negative association—that is, more protection is associated with less poverty. The relationship between OTRIs on exports and poverty is stronger (both the coefficient and its statistical significance).

⁸ See Nicita (2004c) on Mexico and Porto (2003) on Argentina, as well as the Africa-specific work summarized below. Hertel and Winters (2005) contains a review of recent evidence.

Figure 4.3 Trade restrictiveness at home and abroad falls as countries become richer

Note: Partial correlation plots obtained regressing log GDP per capita on constant, log OTRI at home and log OTRI abroad

Figure 4.4 Trade restrictiveness at home and abroad rises with poverty headcount

Note: Partial correlation plots obtained regressing log poverty headcount on constant, log OTRI at home and log OTRI abroad

The Incidence of OECD Trade Policies

28. Estimated OTRIs for high-income OECD countries average 12 percent for all trade. They are much higher for agricultural trade than other merchandise—44 percent compared with 6 percent (figure 4.5). This disparity reflects high levels of producer support: the OECD Producer Support Estimate rose to 32 percent in 2003, up from 31 percent in 2002 (OECD 2004).⁹ A similar sectoral pattern applies to OTRIs for imports from developing countries, although the absolute level of trade restrictiveness is substantially lower for trade with Sub-Saharan Africa as a result of bilateral tariff preference programs (but still high in agriculture).

29. Nontariff measures account for a large share of these OTRIs.¹⁰ Thus, taking the effects of such measures into consideration is important in accurately assessing the extent to which policies affect trade, both imports and exports. It is important to bear in mind that not all nontariff measures have explicit protectionist objectives. Particularly in the case of health- and safety-related product standards, the intention generally is not (and should not be) to protect domestic producers. To varying degrees, all countries maintain such regulations. WTO rules on such policies require that they be justified by scientific evidence and a process of risk assessment, and based on international norms if any exist. Such standards should also apply to domestic goods, although WTO case law and numerous bilateral disputes over many years regarding their enforcement illustrate that in practice these standards may be used to shield domestic producers from import competition.¹¹ However, it is not possible to discern intent in the data—the OTRI simply shows that these types of policies have a major effect on trade, especially in agricultural products.¹² No presumptions exist or are implied regarding the intent or scientific basis of any of the nontariff measures captured in the OTRI.¹³

⁹ That is, 32 percent of the gross receipts of farmers were generated by transfers from consumers and taxpayers.

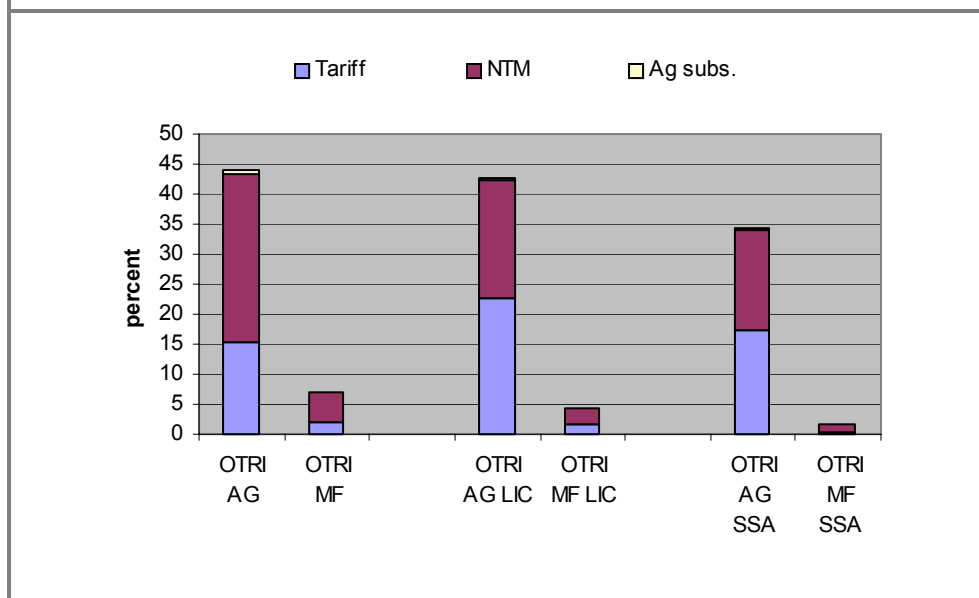
¹⁰ Relative to the *Global Monitoring Report 2004*, the OTRIs reported here are higher on average due to the inclusion of information on mandatory product standards. These were not included in last year's report due to an absence of national data for EU member states in the TRAINS database. Such data were collected in preparation for this year's report.

¹¹ See Sykes (1995).

¹² Whether the intent of these measures is protectionism or based on sound scientific evidence is an important question, but one that is difficult to address. Does the ban on hormone beef imports or restrictions on genetically modified food products in Europe have a protectionist element? Is the ban on Iberico ham "pata negra" or on some types of French epoisse cheese in the United States protectionist? Are they legally and scientifically defensible on health grounds? The answers to these questions will clearly vary depending on which side of the Atlantic they are asked, influenced by risk perceptions and attitudes of those who answer, regulatory requirements, and so on. The OTRI simply measures the impact that these policies have on imported quantities and prices.

¹³ It is not possible to make clear-cut distinctions in the data between discriminatory and regulatory measures. Even so-called core nontariff barriers identified in the UNCTAD database—such as nonautomatic licensing—may be used as a measure to enforce regulatory requirements.

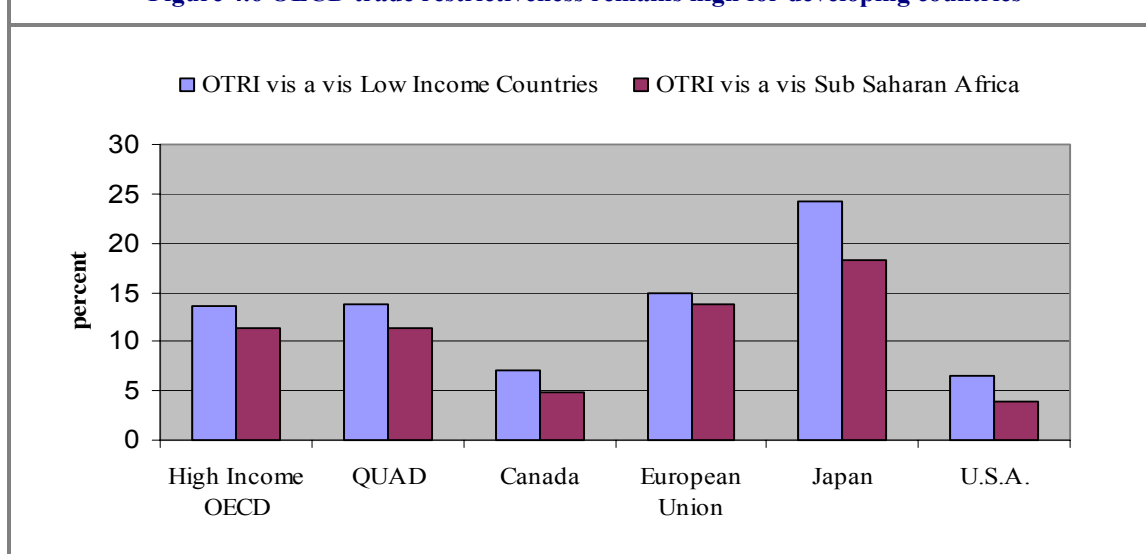
Figure 4.5 Agricultural protection is high in OECD countries, and border barriers account for most of it



30. Because the OTRI does not include services trade and policies, it likely underestimates countries' actual trade restrictiveness. Trade in services has been growing rapidly for the past two decades and now accounts for some 40 percent of world trade if sales of foreign affiliates are included.¹⁴ But statistical agencies do not compile the type of detailed data on bilateral trade in services that exist for merchandise. Nor is there a comprehensive global database on services-related trade policies.

31. The trade policies of high-income OECD countries imply higher restrictions on imports from low-income countries than from other sources (table 4.7). In part this simply reflects the sectoral structure of protection—most intra-OECD trade is in manufactures that confront low barriers. Barriers are highest for agricultural imports from middle-income countries, which do not benefit from the preferences accorded to poorer countries (table 4.8). Still, even after taking into account the fact that developing countries benefit from tariff preferences under the Generalized System of Preferences and that Sub-Saharan Africa and the LDCs have highly preferred—often duty- and quota-free—access to many OECD markets as a result of programs such as the EU Everything But Arms initiative and the U.S. African Growth and Opportunity Acceleration Act, OTRIs for low-income countries average 14 percent (figure 4.6).

¹⁴ This comprises trade as defined by the WTO General Agreement on Trade in Services (GATS).

Figure 4.6 OECD trade restrictiveness remains high for developing countries

32. A reason for this is that the incidence of nontariff measures in a number of OECD countries tends to be disproportionately high on products that developing countries export—especially agricultural products. Thus the higher OTRI against low-income countries primarily reflects the product composition of imports—developing countries happen to be exporters of the goods most affected by nontariff measures—and the fact that not all low-income countries benefit equally from the preferential access regimes offered by the OECD members concerned.¹⁵ An implication is nontariff measures matter, in that they tend to reduce the effective value of the preferential access granted through tariff exemptions. Insofar as the incidence of nontariff measures is higher on developing countries, there is a case for additional assistance to be directed at these countries to help them address the underlying regulatory requirements. The need for this increases the more ambitious the outcome of the Doha Round will be, as deep multilateral liberalization will reduce the value of existing tariff preferences.

Table 4.7 OECD trade restrictiveness is highest toward low-income countries, 2002

(percent)						
Importing income group/country	OTRI for all countries	OTRI for low-income countries	OTRI for least developed countries	OTRI for Sub-Saharan Africa	Share of low-income country exports	Share of low-income countries in total imports from developing countries
High-income OECD	12	14	12	11	68	11
Canada	6	7	6	5	1	8
European Union	13	15	13	14	27	11
Japan	14	24	21	18	10	13
United States	8	6	5	4	23	10

Note: OTRI stands for overall trade restrictiveness index.
Source: Kee, Nicita, and Olarreaga 2005b.

¹⁵ These preference regimes generally target the LDC group, which is a subset of the broader low-income group. Note also that many African countries are not LDCs.

Table 4.8 Globally, trade restrictiveness is highest for agriculture, 2002

(overall trade restrictiveness index; percent)

Total trade	Importing region/income group						
<i>Exporting region/income group</i>	Quad	High-income OECD	Middle-income	Low-income	Least developed	Sub-Saharan Africa	World
Quad	8	8	19	23	21	23	14
High-income OECD	8	9	19	23	21	23	14
Middle-income	9	9	22	25	22	25	15
Low-income	14	14	25	26	22	26	20
Least developed	12	12	24	25	22	26	18
Sub-Saharan Africa	11	11	23	24	21	24	17
World	12	12	20	22	21	23	18
Agriculture							
<i>Exporting region/income group</i>							
Quad	30	31	46	37	29	34	37
High-income OECD	35	36	45	36	28	34	39
Middle-income	49	49	42	36	28	33	43
Low-income	43	43	40	34	27	31	39
Least developed	38	38	39	32	26	30	37
Sub-Saharan Africa	35	34	38	33	26	30	35
World	43	44	36	30	26	32	35
Manufacturing							
<i>Exporting region/income group</i>							
Quad	6	6	15	21	20	21	11
High-income OECD	5	5	15	21	19	21	10
Middle-income	4	4	19	23	21	24	11
Low-income	4	4	20	22	21	24	13
Least developed	3	3	20	22	21	24	12
Sub-Saharan Africa	2	2	16	19	18	21	9
World	6	6	17	20	20	22	12

Source: Kee, Nicita and Olarreaga, 2005b.

33. Another striking feature of the OECD OTRI estimates is that agricultural subsidies play only a small role in determining the magnitude of OTRIs for most countries that employ them (see figure 4.5). That is because from a market access perspective, subsidies are often redundant—because border barriers such as tariffs and tariff rate quotas are the instruments that determine the (world) price impacts. If border barriers were to be reduced significantly, agricultural subsidies would become much more important determinants of trade restrictiveness; thus they are not innocuous. But the implication is that policies (and negotiations) should focus

on removing border protection. Lowering agricultural subsidies without lowering border protection will not have much effect.¹⁶

34. Although market access dominates in terms of affecting world prices and distorting domestic markets, subsidies are very important for some developing countries.¹⁷ Cotton is an example where global trade barriers are low, but subsidies in several OECD countries are large—with well-documented detrimental effects on West African and other developing country producers. Cotton accounts for about 30 percent of exports from the four West African nations that proposed a cotton initiative in the WTO, and for a significant share of income for millions of poor farming households in the region.¹⁸ Recent U.S. cotton subsidies have ranged from \$1.5 billion to almost \$4.0 billion, depending on market conditions.¹⁹ Eliminating U.S. cotton programs, while leaving in place other farm programs, would reduce U.S. production by 25–30 percent, reduce U.S. exports by about 40 percent, and raise world prices by about 10 percent. The annual losses for LDC cotton producers resulting from U.S. and EU support policies are in the range of \$120–240 million.²⁰

The Incidence of Developing Country Trade Policies

35. Developing countries have higher average OTRIs than do high-income OECD countries. Countries in the Middle East and North Africa have the highest OTRIs, followed by Sub-Saharan Africa, South Asia, and East Asia. The average OTRI for all developing countries is 20 percent (table 4.9). As with high-income OECD countries, manufacturing protection tends to be lower than restrictions applied to agricultural trade, though the differences are smaller than in the OECD countries (see table 4.8). On average the world has an OTRI in agriculture that is three times that in manufacturing—35 percent compared with 12 percent—with high- and middle-income countries being more restrictive than low-income countries. The LDCs have the lowest agricultural OTRIs of all income-based country groups. Conversely, developing countries have much higher manufacturing OTRIs, with the highest average levels observed in Sub-Saharan Africa. Generally this reflects either a desire to protect local industries or fiscal objectives—tariff account for a substantial share of government revenues in many Sub-Saharan countries.

36. In terms of the incidence of OTRIs, a pattern similar to that for OECD countries is observed for developing countries—OTRIs are higher for exports from other developing countries (see table 4.8). LDCs confront slightly lower average OTRIs than do other low-income countries. The highest OTRIs are imposed by Middle Eastern and North African countries, the lowest by Eastern European and Central Asian countries (many of which acceded to the European Union in 2004). Thus, in addition to facing high barriers in OECD countries, developing countries impose high barriers on trade with one another, and the incidence of these intra-developing country trade restrictions is higher for poorer countries—just as the incidence of OECD trade restrictions is higher for poorer countries.

¹⁶ As discussed below, this conclusion regarding the relative impact of subsidies on global prices is supported by both partial and general equilibrium analysis. See Hoekman, Ng, and Olarreaga (2004); Anderson, Martin, and van der Mensbrugghe (2005); and Hertel and Keeney (2005).

¹⁷ Argentina is an example of a country that is very significantly affected by OECD agricultural subsidies—they account for about half of the OTRI it confronts in the EU market.

¹⁸ Minot and Daniels (2001).

¹⁹ Baffes (2004).

²⁰ Sumner (2005).

Table 4.9 Developing countries impose high restrictions on trade with one another, 2002

(overall trade restrictiveness index; percent)

Importing region/income group	OTRI for all countries	OTRI for low-income countries	OTRI for least developed countries	OTRI for Sub-Saharan Africa
East Asia and Pacific	21	26	26	26
Europe and Central Asia	12	16	15	16
Latin America and Caribbean	18	21	20	20
Middle East and North Africa	31	48	47	40
South Asia	23	29	27	28
Sub-Saharan Africa	23	26	26	24
Developing countries	20	25	25	23
Least developed countries	21	22	22	21
Low-income countries	22	26	25	24
Middle-income countries	20	25	24	23
<i>Source:</i> Kee, Nicita and Olarreaga, 2005b.				

37. These estimates show that the protectionist trade policies of high-income OECD countries are not the only external problem undermining the ability of developing countries to use trade for development and poverty reduction. Indeed, middle-income countries maintain much higher levels of protection. Reducing such protection would be in their own interest and that of poorer countries—which often confront higher barriers in global markets than do rich countries, implying that the structure of trade policies in middle-income countries is antipoor. Thus reform of trade policies in developing countries should be a central part of the trade reform agenda. This conclusion also emerges from the research summarized below assessing the potential gains from the Doha Round—which are potentially large only if the round encompasses significant further liberalization of trade by developing countries.

IV. The Doha Challenge

38. The WTO is the primary multilateral instrument through which countries can reduce the trade protection summarized above. In August 2004 the WTO General Council reached several agreements to guide future negotiations under the Doha Round. The agreements were a welcome step forward after the setback at Cancun, but they leave key questions unanswered and extend the timeframe of the round. The agreements include a framework for negotiations on agriculture and industrial products, recommendations on services, and modalities for negotiating improved customs procedures (trade facilitation; table 4.10).

Table 4.10 Key elements of the August 2004 WTO framework agreement

Agriculture subsidies	All forms of agricultural export subsidies to be eliminated. Overall bound level of trade-distorting domestic support to be reduced over time, with a 20 percent reduction in the first year. Members with higher levels of support to commit to larger reductions, with product-specific caps on the most trade-distorting forms of agricultural support.
Market access in agriculture	Nonlinear formula to ensure deeper cuts in higher tariffs. A category of “sensitive” products to be subject to greater flexibility. Possibility of trading off more modest tariff reductions against larger tariff rate quotas.
Cotton	To be dealt with “ambitiously and expeditiously” within the agriculture negotiations, by a special subcommittee.
Non-agriculture market access	No a priori exclusions. Recognition that credit should be given for autonomous liberalization. Nonlinear formula to tackle tariff peaks, high tariffs, and tariff escalation, to be applied on a line-by-line basis.
Services	Revised offers to be tabled by May 2005, and developing countries to be given technical assistance to help them participate in the negotiations.
Trade facilitation	Negotiations to be part of the Doha Round, with a focus on expediting the movement, release, and clearance of goods, with implementation by developing countries linked to provision of technical assistance.

Why Ambition Matters: Likely Impacts of Different Doha Outcomes

39. The extent to which reform commitments under the Doha Round will have economic repercussions depends on whether they affect applied policies. WTO negotiators focus not on applied tariffs and subsidies but on the levels of import tariffs, export subsidies, and domestic support for agriculture that countries commit not to exceed. These so-called bindings are often much higher than applied levels of protection, especially in developing countries. Thus, if cuts to bound tariffs or subsidy rates are not very large, or the gap between bound and applied rates is large, the reforms required by a Doha deal may be minimal. So, much depends on the extent to which changes in bindings translate into real reductions in applied protection levels. Much also depends on the magnitude of exceptions and exemptions for specific instruments or products.

40. Deep trade reform could generate large global gains. Freeing all merchandise trade and abolishing all trade-distorting agriculture subsidies would boost global welfare by \$80–280 billion a year by 2015, depending on whether exogenous population and labor supply growth, savings-driven capital accumulation, and labor-augmenting technological progress are taken into account.²¹ These estimates ignore possible dynamic productivity gains, exploitation of economies of scale, effects of increased competition on markups and X-inefficiency in production, and liberalization of trade in services—including through greater temporary international mobility of service suppliers. They also assume that beneficiary countries make full use of preferences and that any resulting rents accrue to exporters. Taking such factors into account greatly increases the potential aggregate gains and affects the distribution of net effects across countries.²²

²¹ Anderson, Martin, and van der Mensbrugghe (2005); Hertel and Keeney (2005).

²² For example, work by Walmsley and Winters (2003) concludes that allowing inflows of service suppliers (natural persons) equivalent to 3 percent of the labor force would generate global (static) gains of more than \$300 billion. Estimates of global gains from deep liberalization that include induced productivity effects and services liberalization exceed \$1 trillion (Anderson 2004a; Anderson, Martin, and van der Mensbrugghe 2005) and range to up to \$2.1 trillion (Brown, Deardorff, and Stern 2003). The extent to which such gains can be realized in practice depends importantly on complementary actions being taken to improve the investment climate and business environment so as to allow factors

41. Recent research suggests that developing countries would obtain about one-third of the global gain from freeing all merchandise trade, well above their one-fifth share of global GDP. Recent analyses using global general equilibrium models and the latest databases on trade protection and preferences suggest that developing countries would receive a 1.2 percent static gain over initial welfare (real income) levels, compared with just 0.6 percent for industrial countries (assuming an overall global gain of \$280 billion). The larger gain for developing countries is partly because of their relatively high tariffs—meaning, they would reap substantial efficiency gains from reforming their protection—and partly because their exporters face much higher farm and textile tariffs in industrial country markets than do exporters from other industrial countries (notwithstanding nonreciprocal tariff preferences for many developing countries; Anderson, Martin, and van der Mensbrugghe 2005).

42. Agriculture is the most important sector in realizing these potential gains, reflecting the extensive assistance it receives relative to other sectors. Food and agriculture policies are responsible for almost two-thirds of the global gain forgone by merchandise trade distortions (table 4.11)—despite the fact that agriculture and food processing account for less than 10 percent of world trade and less than 4 percent of global GDP. Agriculture is as important for the welfare of developing countries as it is for the world as a whole: their gains from global agricultural liberalization account for almost two-thirds of their total potential gains, compared with one-quarter for textiles and clothing and one-eighth for other merchandise liberalization (see table 4.11).

43. Stronger subsidy disciplines are important, but increased market access in agriculture is crucial. High applied tariffs on agricultural relative to nonfarm products are the main reason food and agriculture policies account for 62 percent of the welfare cost of merchandise trade distortions. Aggregating across all products, subsidies to farm production and exports are only minor contributors: 3 and 1 percentage points, respectively, compared with 58 points due to agricultural tariffs.²³ Tariffs are more important in developing than in industrial countries, because subsidies are much less prevalent. Given that bound tariff rates are high in agriculture, large cuts are needed to make a difference. The average bound tariff rate in industrial countries is almost twice the average applied rate; in developing countries the difference is even greater. To lower the average global actual agricultural tariff by one-third, bound rates would have to be reduced for industrial countries by at least 45 percent, and the highest tariffs by up to 75 percent.²⁴

44. Even large cuts in bound tariffs will do little if exemptions for “sensitive” products are allowed. If WTO members limit tariff cuts for “sensitive” farm products such as rice, sugar, milk, beef, fruits, vegetables, and rice, most of the prospective gains from Doha could evaporate. Classifying 2 percent of six-digit Harmonized System agricultural tariff lines in industrial countries as sensitive (and 4 percent in developing countries, to reflect demands for differential treatment) and subjecting them to just a 15 percent tariff cut would shrink by three-quarters the welfare gains from global agricultural reform.²⁵ These findings illustrate the importance of the call made in *Global Monitoring Report 2004* for ambitious targets with respect to lowering agricultural tariffs, for example, to no more than 10 percent.

of production to be allocated to their most productive uses, markets to clear, and so on. This “behind the border” complementary agenda will require investment and is an area where development assistance can play an important role in allowing countries to capture the potential dynamic gains from trade.

²³ Hoekman, Ng, and Olarreaga (2004); Hertel and Keeney (2005), table 2.7.

²⁴ Anderson, Martin, and van der Mensbrugghe (2005).

²⁵ The potential loss can be reduced by requiring any product with a bound tariff in excess of 200 percent to be reduced to the cap rate. See Anderson, Martin and van der Mensbrugghe (2005).

Table 4.11 Most economic welfare benefits of full merchandise trade liberalization would come from agriculture, 2015

(percent)

Global welfare benefits

<i>Source of benefits</i>	<i>Sector liberalized</i>			
	<i>Agriculture and food</i>	<i>Textiles and clothing</i>	<i>Other manufactures</i>	<i>All goods</i>
Industrial country policies	42	6	20	68
Developing countries' policies	20	8	4	32
Total	62	14	24	100

Developing countries' welfare benefits

<i>Source of benefits</i>	<i>Sector liberalized</i>			
	<i>Agriculture and food</i>	<i>Textiles and clothing</i>	<i>Other manufactures</i>	<i>All goods</i>
Industrial country policies	34	16	7	57
Developing countries' policies	28	9	6	43
Total	62	25	13	100

Note: These data are shares based on a simulated global gain of \$280 billion that takes into account exogenous population and labor supply growth, savings-driven capital accumulation, and labor-augmenting technological progress between 2001 (base year) and 2015. Industrial countries include the transition economies of Eastern Europe and the former Soviet Union.

Source: Anderson, Martin, and van der Mensbrugghe 2005, table 12.4.

45. While agricultural market access liberalization is by far the most critical merchandise trade issue on the negotiating table from a developing country perspective, disciplining domestic production subsidies and phasing out export subsidies is also important. In part these steps are needed to prevent “re-instrumentation” of assistance from tariffs to domestic subsidies. Moreover, some OECD subsidies are very important for developing countries. Removing cotton subsidies (which would raise producer prices by more than 50 percent in the United States and even more in the European Union) would raise the price of cotton in international markets and benefit developing country exporters. For Sub-Saharan Africa, recent research suggests that the increase in export prices relative to manufactures overall would be small. But cotton exports from Sub-Saharan Africa would increase 75 percent. The share of all developing countries in global cotton exports would expand to 85 percent, instead of the 56 percent projected for 2015.²⁶

46. The foregoing analyses of possible outcomes of negotiations consider policy instruments such as tariffs, preferences, subsidies, and tariff rate quotas in agriculture. But they do not consider the effects of nontariff measures, and mostly ignore the implications of removing barriers to trade and investment in services. Given that nontariff measures play an important role in determining the overall trade restrictiveness of countries, reducing the incidence of such policies could generate additional gains for developing countries and the world as a whole. Using a partial equilibrium framework that allows much greater disaggregation across products and countries than is possible in global computable general equilibrium models, Hoekman, Nicita, and Olarreaga (2005) compare the likely effects of an unambitious Doha Round and an ambitious

²⁶ Sumner (2005); Baffes (2004).

one that addresses nontariff measures. The low-ambition round is defined as causing a 40 percent cut in bound tariffs, a reduction in tariff peaks to a maximum of 50 percent, a 40 percent reduction in domestic agriculture subsidies, elimination of export subsidies, and an improvement in trade facilitation that increases world trade by an average of 2 percent.²⁷ Conversely, an ambitious Doha Round would result in free trade (elimination of all applied tariffs), a 50 percent cut in the restrictiveness of nontariff measures, elimination of trade-distorting agriculture production and export subsidies, and the same improvement in trade facilitation.

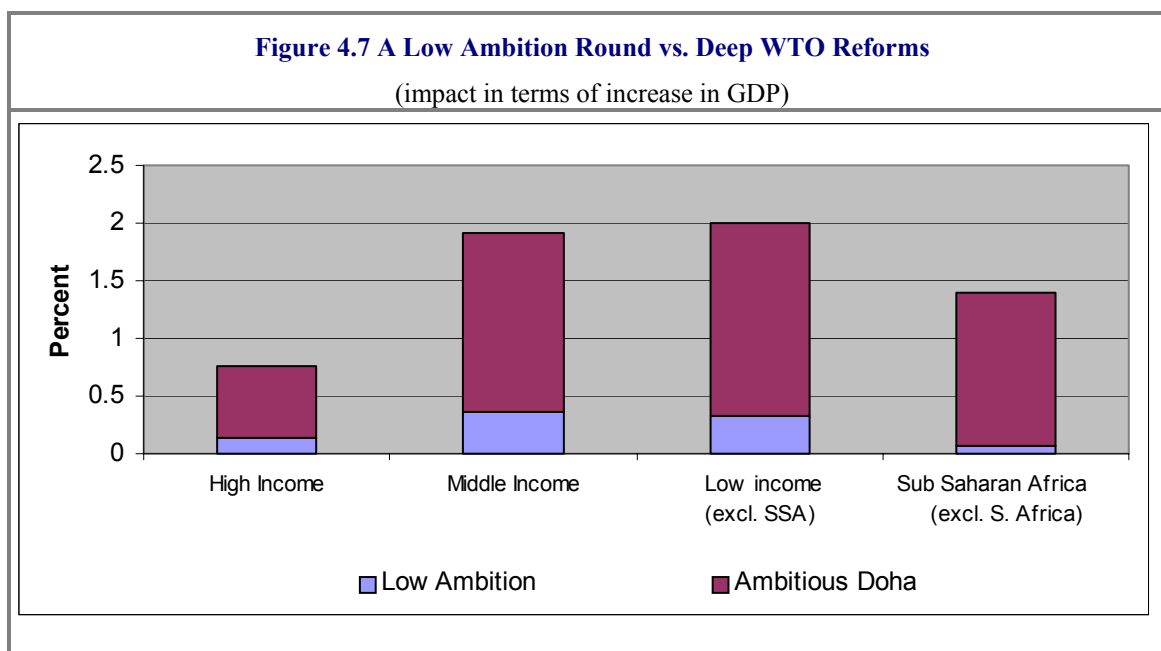
47. An unambitious Doha Round would not do much to improve developing country welfare or help achieve the MDGs. Static global welfare gains would be about \$59 billion. In contrast, an ambitious Doha agenda could nearly quintuple these gains, to \$269 billion. Full tariff and subsidy reform without any changes in nontariff measures would generate “only” \$111 billion.²⁸ Sub-Saharan Africa would see its welfare increase by an estimated \$2.8 billion under the ambitious scenario, compared with only \$140 million under the type of agreement that current trends suggest is likely to emerge. The low-ambition scenario would raise Sub-Saharan GDP by 0.1 percent. In contrast, an ambitious Doha Round outcome could boost GDP by 1.3 percent. Around 40 percent of the gains from the round would accrue to developing countries under both scenarios, with the greatest absolute amount going to middle-income nations. Low-income countries would obtain 14 percent of the developing world welfare gains. Under both scenarios welfare gains relative to GDP are largest for low- and middle-income countries (figure 4.7).

48. This analysis suggests that efforts to reduce the incidence of nontariff measures are important. But as noted, not all these measures are discriminatory. In the case of regulatory product requirements—which account for a large share of nontariff measures in many high-income countries—attenuating the effects of enforcement is unlikely to be costless. Thus the additional \$150 billion that could be attained by halving the ad valorem equivalent of nontariff measures is an upper bound estimate of potential net gains. Determining how to attenuate the impacts of nontariff measures at the lowest cost requires both country-specific analysis and a concerted effort to improve the global information base on applied nontariff policies. But it is probable that much of the appropriate response revolves around “aid for trade” to improve quality, testing, conformity assessment capacity, and so on.

49. Prospects for realizing the potential of trade to support development are also conditional on further liberalization by developing countries. As revealed by the OTRIs, developing countries maintain much higher trade barriers against nonagricultural products than do OECD countries, and impose high trade barriers on each other. Combined with the fact that many (especially middle-income) developing countries have been growing more rapidly, prospects for greater trade flows are greatest between developing countries. Moreover, most of the benefits of trade reform derive from what countries do themselves—as discussed in *Global Monitoring Report 2004* and numerous recent reports, including the United Nations MDG taskforce report on trade, maintaining high barriers to trade imposes costs on an economy.

²⁷ Based on estimates reported in Francois, van Meijl, and van Tongeren (2005).

²⁸ This is larger than the \$80 billion found by Hertel and Keeney (2005) using a static CGE model and the latest GTAP database (which also includes preferences) because of the greater disaggregation of products.



50. If developing countries as a group were not to participate in liberalizing trade under the Doha Round, not only would global gains fall significantly—by half to two-thirds, depending on assumptions—but potential gains to developing countries would fall by up to 80 percent.²⁹ Sub-Saharan Africa and LDCs could even end up losing from the Doha Round if they do not pursue reforms. The reason is that the efficiency gains from own liberalization are needed to help offset terms of trade losses that may arise because food prices rise (in the case of net food importers), tariff preferences are eroded, or market share is lost to other developing countries that pursue reforms (or have already done so).

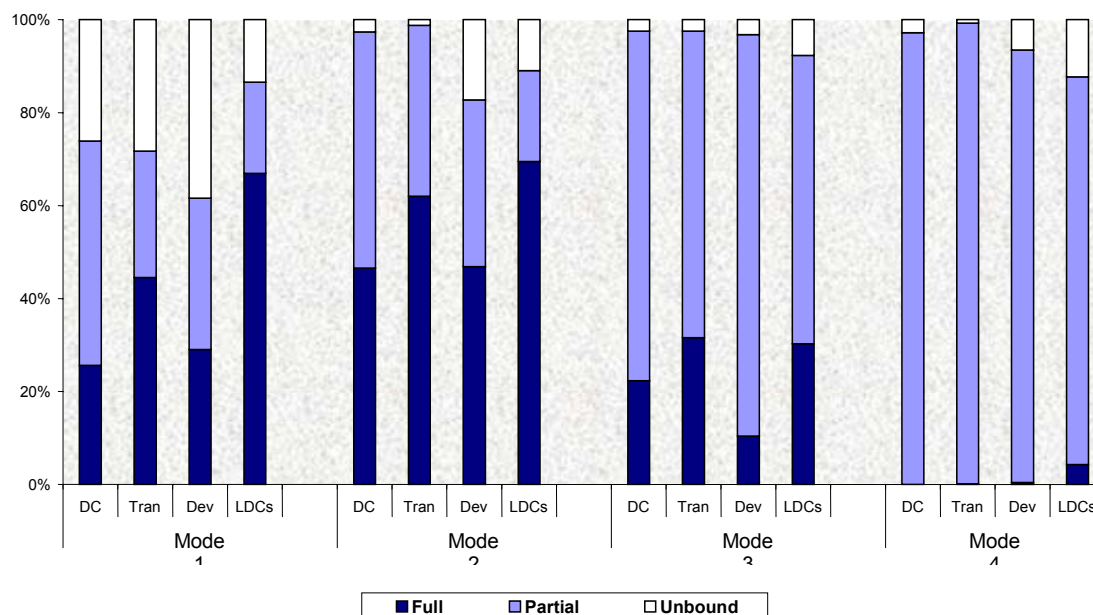
Services

51. The foregoing discussion largely ignores domestic reform and liberalization of service sector policies, an area where research suggests there is great potential for gains, in terms of both efficiency and equity. Countries such as Brazil and India have seen exports of business process services such as call centers, software development, and back-office services expand rapidly. African exports of commercial services grew by more than 20 percent in 2003, in line with merchandise export growth, and account for 18 percent of total exports—the largest share of all developing regions (WTO 2004).

²⁹ Anderson, Martin, and van der Mensbrugghe (2005).

Figure 4.8 WTO Market access commitments for services by mode of supply

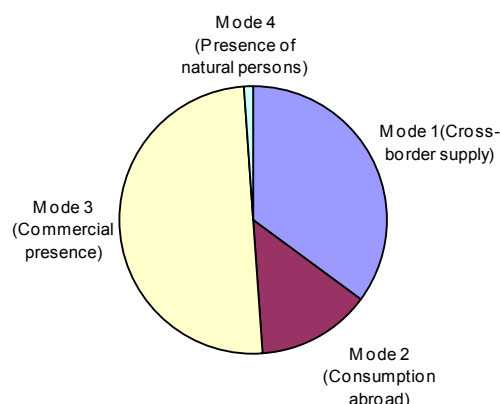
August 2004, Percentage of bindings (a)



Note: (a) Based on a sample of 37 representative sectors. DC (Developed Countries); Tran (Transition Economies); Dev (Developing Countries). Full implies a binding commitment to market access and national treatment; unbound implies no commitments were made, and partial implies specific policies limiting access or involving discrimination were bound.

Source: Marchetti (2004), updating WTO document S/C/W/99.

52. Developing countries have called for specific commitments on improving access to OECD markets for service suppliers, especially through temporary migration (mode 4 in the General Agreement on Trade in Services, or GATS). This is the main area where virtually no commitments have been made (figure 4.8). As noted in *Global Monitoring Report 2004*, it is also the area with the greatest potential for increased exports from developing countries (figure 4.9).

Figure 4.9 FDI and cross-border exchange account for most trade in services

Source: Maurer (2004)

Table 4.12 Developing countries have made fewer market access and national treatment commitments for services

Country group	Average number of sub-sectors committed per country	Range (lowest/highest number of committed sub-sectors)
Developing countries	54	1–154
Least developed countries	20	1–110
Transition economies ^a	106	58–154
Industrial countries	108	87–117
Accessions to WTO since 1995	106	37–154

Note: Data as of August 2004. The total number of subsectors in which commitments can be made is 160. These commitments may be full or partial bindings; see note to figure 4.8.

a. Includes only European and Central Asian transition economies.

Source: Marchetti 2004.

53. To date, little progress has been made on services negotiations. Although numerous requests have been put on the table, only 47 first-round offers have been put forward by WTO members.³⁰ Most of these are of limited value as they do not go beyond status quo policies. The LDCs have made the fewest commitments on services in the WTO, in contrast to recently acceded countries that have been asked to make far more commitments than most existing WTO members (table 4.12). There is great scope for more advanced countries to lock in liberal trade and investment policies in areas that matter to developing countries—especially on cross-border trade (mode 1)—and increase the extent to which service markets can be contested through temporary movement of service providers. Conversely, developing countries can do much more to use the WTO as an instrument to commit to greater liberalization of their services. While

³⁰ These are mostly confidential; only some countries have derestricted them.

considerations of “balance” create incentives not to do so until greater clarity has emerged on what is likely to be feasible in other areas (such as agriculture), services commitments are an area where a quid pro quo can be offered that is likely to benefit the country. Much of the agenda here revolves around making commitments that are targeted at attracting greater foreign direct investment (FDI) in services (mode 3 of the GATS). Encouraging FDI in both goods and services production is a direct way to improve the investment climate.

54. FDI can do much to enhance the productivity of the economy as foreign services suppliers offer new technologies, new products and more differentiated and higher quality services. Greater competition associated with open access to service markets will also put pressure on prices as well as performance of incumbent firms, thus reducing the input costs for firms that buy the services. The importance of an efficient service sector goes beyond the contribution of the services sector itself to the balance of payments, because the efficiency of many service sectors is a key determinant of the competitiveness of firms. Key sectors that influence the ability of firms to participate in world trade are telecommunications, transportation, financial services and other business services such as accounting and legal services. In many LDCs inefficient business services are an important barrier to effective integration in world markets. High cost trade-support services acts as a tax on exporters and ultimately on growth and poverty reduction. For a small economy confronting given world prices of traded goods, higher service costs reduce export prices and increase prices of delivered imports. Hence, exporting industries must pay lower wages or accept lower returns on capital. For example, freight rates for Sub-Saharan African countries often are considerably higher than on similar goods originating in other countries and thus have contributed to the region’s poor trade performance and poverty over the last decades. High transportation costs are due in part to weak infrastructure, geography and economic size of markets, but may also reflect policies that restrict competition, such as cargo reservation schemes or entry barriers into air and maritime transport.

Doha, Low-Income Countries, and Sub-Saharan Africa

55. Market access is a necessary but insufficient condition for harnessing trade for development. As noted in *Global Monitoring Report 2004*, domestic supply constraints are the main reason for the lack of trade growth and diversification in many developing countries. Without action to improve supply capacity and reduce transactions costs, trade opportunities cannot be fully exploited and the potential gains discussed previously will not be realized. The agenda spans many areas, many of them “behind the border.” Dealing with these issues will require action in developing countries and assistance from industrial countries, including both finance and efforts to reduce the costs of nontariff measures.

56. Recent country studies that analyze the potential impacts of global reforms on African poverty, using information from household surveys, show that trade policy actions will have limited effects—positive or negative. Complementary reforms and investments are needed to stimulate the desired supply response to changed incentives. In Ethiopia, one of the world’s poorest countries (with more than two-thirds of the population living on less than \$2 a day), the Doha Round alone will not have any significant effect on poverty.³¹ That is because any impact on the prices and quantities of Ethiopia’s main exports—coffee, qat (a mild stimulant exported mostly to neighboring countries), and livestock—will not be large. Moreover, exports represent a small part of GDP: annual exports are about \$600 million, or \$10 per capita, equal to 15 percent of GDP—one of the lowest shares in Sub-Saharan Africa. Thus even a hypothetical doubling of international demand for Ethiopian products would not have much impact on poverty. Domestic markets are poorly connected, limiting the price and quantity effects of any trade policy changes in rural areas, where most poor people live. If price signals fail to reach households, supply

³¹ Nicita (2005).

responses to international shocks will be low. In addition, low agricultural productivity implies that supply responses will be associated with higher production costs, reducing net benefits. Finally, Ethiopian households, especially the poorest, are insulated from market shocks (and thus effects of trade policies) because they are widely engaged in subsistence activity. More than half the budget of poor households is from subsistence.

57. This does not mean that an ambitious Doha Round would not bring opportunities to Ethiopia. It would increase international demand for Ethiopian products. But for that to translate into quantifiable benefits, the increased demand would have to be accompanied by improved productivity (rather than a simple increase in production), to also spur nonexported agricultural production (especially staple crops). And given that most poor Ethiopians live in remote areas, increased productivity alone may not have a large effect on poverty in the absence of complementary policies. Better infrastructure and access to credit are two preconditions for integrating the rural poor with domestic markets and reducing subsistence.

58. A similar conclusion arises from a recent study on Zambia.³² In 1998 more than 70 percent of the country's population lived in poverty. Using an approach similar to the analysis of Ethiopia, in terms of projecting the likely effects of a Doha Round on world prices, the authors investigate the impact of trade reforms on household welfare through effects on consumption and income. They conclude that only small impacts can be expected from a Doha Round set of trade reforms. This reflects the fact that the round will likely generate only a small change in prices, so gains and losses for producers and consumers will be small too. Moreover, Zambian households spend a large fraction of total expenditure on, and derive a large fraction of income from, home-produced goods—which are unlikely to be affected by trade liberalization. Larger effects are predicted on the income side, particularly in terms of higher wages, employment opportunities, and a move from subsistence to market-oriented agricultural activities. Again, a key finding is that trade is not enough. Complementary policies are important in allowing households to take full advantage of trade liberalization and global market opportunities. This result is illustrated by two case studies in Balat et al (2004): one on the role of extension services in boosting productivity among poor Zambian farmers, and another on the role of job programs in providing employment for heads of households.

59. An analysis for Madagascar similarly concludes that global trade reforms will have limited impact.³³ Many of the country's exports do not confront high protection (vanilla, cloves, crustaceans, semiprecious stones), most poor people live in rural areas not connected to markets (preventing the pass-through effects of border price changes on supply), and productivity is low. Moreover, limited competition in domestic markets is likely to concentrate gains from trade in the hands of traders and exporters, as opposed to poor farmers.³⁴ Global liberalization would increase international demand for Madagascar's exports, but to take full advantage of this it would be necessary to raise productivity and reduce the transportation costs of getting products to urban areas and export hubs. Past unilateral reforms and improved access to export markets show that trade can reduce poverty—although given their low initial base, the impact of greater exports can only be limited in the short to medium run (box 4.2).³⁵

³² Balat, Brambilla, and Porto (2004).

³³ Nicita (2004b).

³⁴ Regarding cereal and particularly rice, which are largely consumed and produced in Madagascar, predicted price increases following an ambitious Doha Round will have mostly neutral effects from a poverty perspective as the poorest households are both consumers and producers of rice. An increase in the price of rice will likely produce a redistribution of income between geographic areas, with rural areas benefiting at the expense of urban areas. Given that Madagascar is a net importer of rice (although only 7 percent of total consumption is imported), the increase of the price of rice will have a small negative effect on overall welfare.

³⁵ Similar conclusions emerge from other LDC country case studies that were undertaken as background research for the MDG taskforce report on trade (Soloaga 2004), as well as a number of recent country cases collected in Hertel and Winters (2005).

Box 4.2 Apparel exports and poverty in Madagascar

Fueled by low labor costs, relocation of textile and apparel firms from neighboring Mauritius, preferences granted by the U.S. African Growth and Opportunity Act, and the creation of export processing zones, Madagascar's textile sector experienced dramatic growth in the late 1990s. Textile and apparel exports increased from \$100 million in 1995 to almost \$500 million in 2001. In the same period employment in the sector grew from 30,000 to 200,000 individuals. Expansion of the textile and apparel industry has enabled many individuals and households to increase income and in some cases escape poverty. But the welfare effects of this expansion have been geographically confined: most of the employment has been created in a few urban areas with relatively low poverty.

Most of the gains, in both absolute and relative terms, have accrued to nonpoor households. As a result this export-led growth has increased inequality between poor and nonpoor people, between urban and rural areas, and between skilled and unskilled workers. Skilled workers have experienced rapidly increasing wages, while rural areas have largely been cut off from the effects of the growing textile and apparel sector. Unskilled workers have benefited only marginally, because a large pool of unemployed and underemployed workers has kept their wages from rising. But poor households located in the capital, where most of the employment was created, have benefited. It is estimated that five years of expansion of the textile sector reduced poverty by almost 1 percentage point, or about 150,000 individuals.

These results suggest that two factors are required if export-led economic growth is to reduce poverty. First, growth and job creation must not be restricted to a few geographic areas. Dispersion could be achieved by creating geographically diverse export processing zones, to generate job opportunities for a wider range of the population. Second, to facilitate their absorption into the formal labor force, poor people must be assisted in obtaining the skills sought by expanding industries. This can be achieved by providing government-sponsored training or incentives for firms to provide training.

Source: Nicita 2005.

60. In sum, country-based analysis of the poverty impacts of global trade reforms in very poor countries suggests that the first order (or static) effects are small. Price effects, whatever the magnitude, will be passed through incompletely, little will be done to attenuate the effects of nontariff measures, and many LDCs have concentrated export bundles involving products that often are not heavily protected in world markets (such as vanilla in Madagascar and coffee in Ethiopia). Second order effects—allowing for adjustments on the supply side through movements from subsistence into market participation, changes in crops, and moves out of unemployment—can be larger. But for any positive effects to be significant, global trade reforms must be accompanied by complementary actions targeted at increasing the supply response. Such actions could center on reducing transportation costs from remote areas, increasing farm productivity through extension services, and so on.

61. This conclusion is supported by the many Diagnostic Trade Integration Studies conducted under Integrated Framework auspices for LDCs, as well as similar assessments for other developing countries. These find that trade cannot play much of a positive role if the macroeconomic climate is unstable and the business environment is hostile, and that for many countries the key challenges are to reduce constraints on competitiveness and supply responses—especially lack of transport, energy, and water infrastructure, lack of access to finance, and weak worker skills. Improving trade policies and taking action to facilitate trade by strengthening and streamlining customs can have a significant payoff, but a major impact on poverty requires reducing domestic supply constraints.

62. Thus trade often has limited potential to alleviate poverty in the short to medium run. And though its potential is substantial, especially in the long run, trade is just part of the solution.³⁶

³⁶ Previous reports, including the *Global Monitoring Report 2004*, have argued that trade has significant potential to help achieve poverty reduction and support higher growth rates. As noted in those reports, however, trade offers an opportunity, not a guarantee. Realization of significant reductions in poverty rates is dependent on functioning markets,

Even in Kenya and Lesotho, African countries with dynamic export sectors (cut flowers and apparel, respectively), booming exports have not had major benefits for employment, and development of supply industries (backward linkages) has been slow (OECD 2005).

V. Trade and Development—Toward a Concerted Response

63. The traditional international policy response to the challenge of expanding trade in developing countries has been a mix of preferential access and development assistance. In recent years preferential access has been deepened and made more meaningful through the EU Everything But Arms initiative and the U.S. African Growth and Opportunity Acceleration Act. Efforts have also been strengthened to provide more aid for trade.

64. All these programs have been beneficial. But preferences are an eroding asset: they have become less valuable as importing countries have liberalized their trade—both on a nondiscriminatory (most favored nation) basis and as a result of regional trade agreements. The value of preferences will be further eroded the more the Doha Round results in significant further liberalization. The answer is not to stop global liberalization to maintain the value of preferences. Instead, action is required on complementary instruments to help countries address competitiveness challenges and exploit market access opportunities. This includes measures to reduce the incidence of nontariff measures.

Market Access: Beyond Tariff Preferences

65. To some extent tariff preferences offset the explicit discrimination against developing country trade reflected in higher tariffs on key exports and the higher incidence of nontariff measures revealed by the OTRIs discussed previously. Given that developing countries generally do not give significant tariff preferences to other poor countries, preferences only significantly affect the incidence of industrial country trade policies. A seemingly logical implication of this is that advanced developing countries should also offer preferential access to their markets to the poorest countries. At the 2004 meeting of the United Nations Conference on Trade and Development in Brazil, it was agreed that countries would seek to do so in the framework of the Global System of Trade Preferences.³⁷

66. Much of the literature on this subject concludes that preferences have not resulted in the desired export expansion and diversification in many countries. There have been several notable exceptions, but these are associated with quantitative restrictions being imposed on competitive suppliers. Reasons why benefits have often proven limited include restrictive rules of origin—reducing utilization below 100 percent, especially for key manufactures such as clothing,³⁸ and excluding “sensitive” products from the coverage of arrangements. Recent preference schemes for the poorest countries—such as the EU Everything But Arms initiative for LDCs, the U.S. African Growth and Opportunity Acceleration Act for eligible Sub-Saharan countries, and

linking farmers to markets, and so forth. Dealing with the complementary “behind the border” and investment climate agenda is critical.

³⁷ The Global System of Trade Preferences (GSTP) was established in 1988 as a framework for negotiations aimed at the exchange of trade preferences. It is based on (differentiated) reciprocity—that is, is not unilateral.

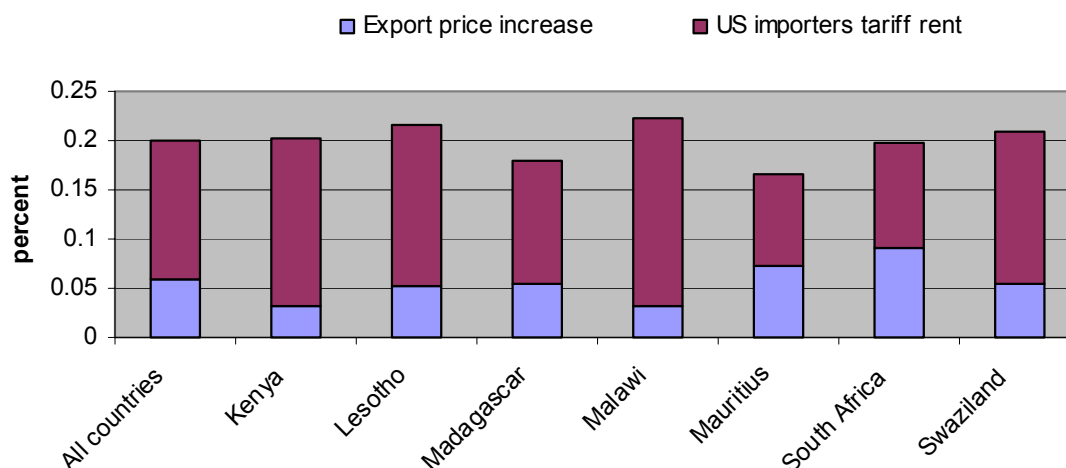
³⁸ Recent research suggests that rules of origin generate costs on the order of 3–5 percent of the value of the goods (Brenton 2003; Anson and others 2003). Given that many most favored nation tariffs in OECD countries are less than these levels, this has obvious implications for the effective value of tariff preferences. Candau, Fontagne and Jean (2004) find that underutilization is highest in textiles and garments (for EU imports under both the Global System of Preferences and Everything But Arms programs). In the case of the Everything But Arms initiative, exporters in principle benefit from 100 percent duty-free access, but are found to pay up to 6.5 percent average tariffs. They also find that the utilization of preferences is lower when the preferential margin is small, suggesting that compliance costs (rules of origin) are a factor.

Canada's duty- and quota-free access program for LDCs—provide more comprehensive coverage than do traditional General System of Preferences-type programs. In the case of the African Growth and Opportunity Acceleration Act, they also apply more liberal rules of origin and have allowed exports of textiles to expand rapidly from eligible countries.

Box 4.3 A large share of the rents created by preferences accrues to importers

For exporters, the benefits from preferences depend on the size of the rents associated with being able to sell into a protected market and on whether they can capture the associated rents. Recent research has found that importers may be able to capture some, if not most, of the associated rents. For example, one study found that the average export price increase for products benefiting from preferences under the African Growth and Opportunity Act was about 6 percent, whereas the average most favored nation tariff for these products was some 20 percent (Olarreaga and Ozden 2004). Thus, on average exporters received around one-third of the tariff rent. Moreover, poorer and smaller countries tend to obtain lower shares. The estimates range from a low of 13 percent in Malawi to a high of 53 percent in Mauritius (see figure). Reasons why importers and retailers capture a large share of the rents include the monopsony power of buyers and limited bargaining power of African exporters—perhaps reflecting limited or asymmetric information.

AGOA apparel exporters' share of tariff rents



67. While preferential access may generate rents and stimulate export-oriented production in countries that are granted liberal origin rules, any rents are shared with importers (box 4.3).³⁹ More important, such rents are highest where there are also quantitative restrictions on competitive suppliers (as under the Agreement on Tariffs and Clothing and the EU sugar regime). These regimes are being (or have been) dismantled, implying erosion of rents even before the conclusion of the Doha Round. One response is to deepen and extend preferences to additional countries. The experience under the Africa Growth and Opportunity Act suggests that existing tariff preference programs could be made more effective by adopting common, liberal rules of origin. Several OECD countries have also proposed that middle-income countries apply access schemes like those under the act.

68. While a decision to adopt common, liberal rules of origin would be desirable if put in place rapidly, and preferential access to large middle-income markets would be of value, it must be recognized that such “affirmative action” is not a panacea for poor countries to expand and diversify their trade. One reason is the earlier observation that preferences that have generated

³⁹ See Olarreaga and Ozden (2004) on the Africa Growth and Opportunity Act; Ozden and Sharma (2004) on the U.S. Caribbean Basin preference program, and Tangermann (2002) on agricultural preferences in general.

rents have largely been accompanied with quotas. With the implementation of the Agreement on Textiles and Clothing, these have now largely been removed. A second reason is that many countries have not been able to benefit from existing deep preferences, so extending these may not have much effect. Third, there is a global negative externality associated with preference programs—they create incentives not to pursue global liberalization, especially in sectors where the distortions are the highest. Preferences for some countries by definition imply greater discrimination against other, less preferred developing countries, and thus trade diversion—because the set of goods that beneficiary developing countries produce overlaps with those of other developing countries that are not beneficiaries. This trade diversion and discrimination has created significant tension between developing countries and has recently given rise to several formal WTO disputes (the sugar case noted earlier is an example). Finally, in terms of numbers, most of the world's poor people do not live in the poorest countries, and preferences for some come at the cost of equally poor households in other, less preferred developing countries.

69. Given the systemic downsides, limited benefits, and historical inability of many poor countries in Africa and elsewhere to use preferences, a decision to shift away from preferential “trade as aid” toward more efficient and effective instruments to support poor countries could both improve development outcomes and help strengthen the multilateral trading system. More effective integration of the poorest countries with the trading system requires instruments aimed at improving the productivity and competitiveness of firms and farmers in these countries. Supply constraints are the primary factors that have constrained the ability of many African countries to benefit from preferences.⁴⁰ This suggests that the main need is to improve trade capacity and facilitate diversification. In part this can be pursued through a shift to more (and more effective) development assistance that targets domestic supply constraints as well as measures to reduce the costs of entering foreign markets. Such aid for trade is particularly urgent for countries that confront preference erosion as the result of multilateral reforms. This is a significant economic issue for a small number of small countries dependent on sugar, bananas, and to a lesser extent garment exports—products where protection and thus preference margins are high. Importantly, most of these are not the poorest countries, but middle-income economies.⁴¹

Aid for Trade

70. Bolstering trade capacity by linking farmers to markets and improving their productivity, lowering transactions costs by identifying and removing red tape and improving customs clearance, or putting in place the regulatory preconditions for benefiting from and managing liberalization—especially in the area of services—are all institution-intensive. The needs are not just for trade infrastructure facilitation, but also involve complementary actions to put in place safety nets, enhance access to credit, improve health and education services, and pursue effective regulation to attain efficiency and equity objectives. This agenda extends well beyond trade integration. It is largely “additive” in that actions on these fronts can be pursued in parallel.⁴² On all these fronts development assistance can play an important role in enhancing the overall gains

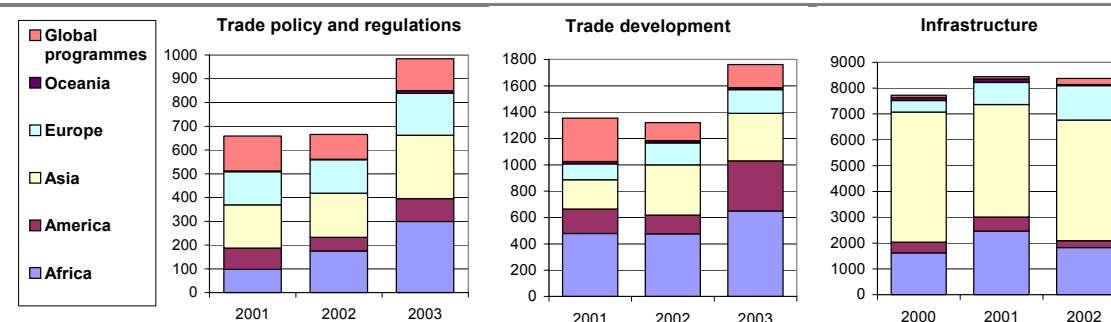
⁴⁰ Stevens and Kennan (2004).

⁴¹ IMF (2003) concludes that the potential loss from preference erosion resulting from a 40 percent cut in protection in the Quad at 1.7 percent of total LDC exports. However, individual LDCs may suffer a more significant loss due the concentration of their exports in products that enjoy deep preferences. Of these, Cape Verde, Haiti, Malawi, Mauritania, and São Tomé and Príncipe are found to be the most vulnerable to preference erosion. The total (aggregate) value of export revenue that would be lost by LDCs as a whole is estimated at some \$530 million—similar to the \$600 million figure found by Limão and Olarreaga (2005). This assumes full utilization of preferences and that developing countries get all of the associated rents, so this is an upper bound. Alexandraki and Lankes (2004), focusing on middle-income countries, conclude that potential erosion impacts are less than 2 percent of total exports for countries that are most “preference dependent”. Six countries—Belize, Fiji, Guyana, Mauritius, St. Kitts and Nevis, St. Lucia—would be significantly affected, with predicted export declines ranging from a high of 11.5 percent for Mauritius to 7.8 percent for Fiji.

⁴² Winters (2004).

from trade and managing costs and downside risks. A specific example where assistance may have high payoffs is in reducing the costs of satisfying nontariff regulatory policies in export markets.

Figure 4.10 Distribution of ODA for trade-related activities and infrastructure by region and main category – US\$ million

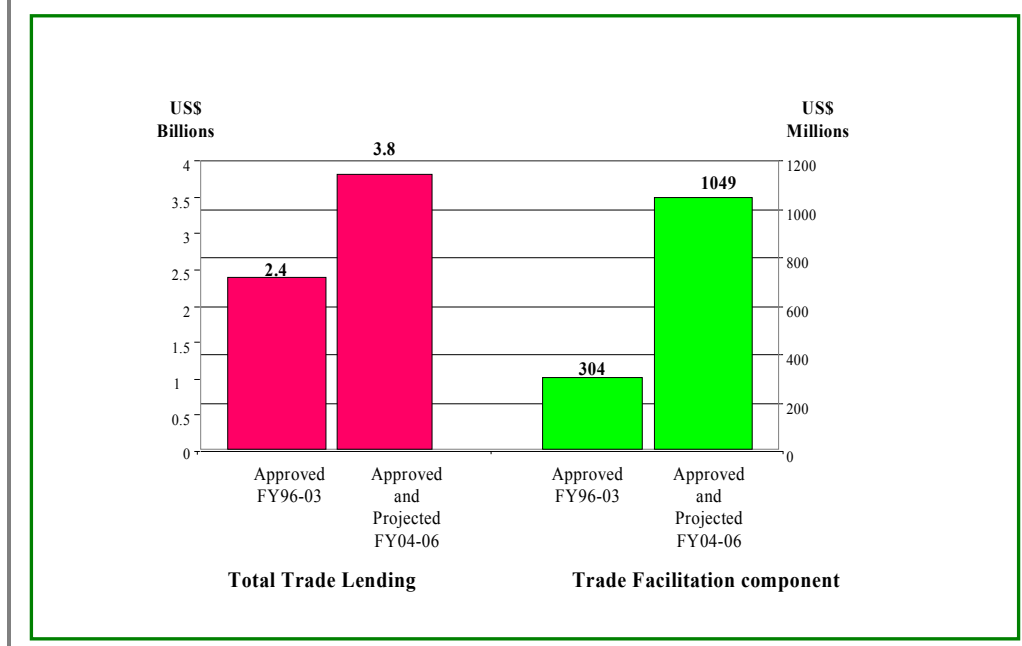


Source: WTO and OECD, 2004.

71. In recent years progress has been made in expanding trade-related technical assistance and capacity building. The share of such activities in total aid commitments rose from 3.6 percent in 2002 to 4.2 percent in 2003 (WTO and OECD 2004). About one-third of this support went to LDCs. The WTO and OECD database that tracks such assistance distinguishes between trade policy and regulations (technical assistance for product standards, integration of trade with development plans, trade facilitation), trade development (trade promotion, market development activities, and so on), and infrastructure. Infrastructure is the largest category and is not limited to trade-related projects. Aid has been expanding most rapidly for trade policy and regulations (figure 4.10), reaching almost \$1 billion in 2003, with the amount allocated to Africa tripling between 2001 and 2003. Commitments for trade development activities, which amounted to some \$1.35 billion a year in 2001 and 2002, reached \$1.8 billion in 2003.⁴³ Assistance to build infrastructure was stable at around \$8 billion a year between 2000 and 2002, with Asia by far the largest recipient region. In 2002 Africa's share in infrastructure diminished, reflecting an emphasis on social sectors.

72. The World Bank has continued to expand its activities and support for trade, focusing on trade integration broadly defined to encompass trade policy, infrastructure, and customs and trade facilitation. Trade diagnostic work is being carried out in more than 35 countries, and is complemented by regional studies that examine issues for several countries at a time. There is a growing lending program for trade-related activities (figure 4.11). Projected commitments for new trade operations between fiscal 2004 and 2006 are significantly larger than in previous years, with trade facilitation lending being a major growth area.

⁴³ Examples mentioned in WTO and OECD (2004) include a regional trade facilitation program of the United Kingdom that aims to increase trading opportunities for small-scale farmers and traders through the development of common standards across goods and services and the streamlining of customs procedures in Southern Africa. Another example is France's regional program that aims to develop "fair trade" in Africa. Increases in trade development activities have centered on regional programs such as an International Development Association (IDA) credit to assist the development of power exports between Southern African countries and an EU multisector small and medium-size enterprise development project in Latin America.

Figure 4.11 World Bank Trade-Related Lending

73. Trade policy has been a frequent component of programs supported by the International Monetary Fund (IMF). In April 2004 concerns about the balance of payments impacts of trade policy changes motivated the introduction of the Trade Integration Mechanism. Although the core of the IMF's mandate involves support for orderly external adjustment in the face of shocks, the mechanism provides added assurances and represents the first explicit attempt to help members adjust to shocks that emanate from multilateral trade liberalization. The Trade Integration Mechanism was designed to help mitigate the stated concerns (by many developing countries) that implementation of WTO agreements might give rise to temporary balance of payments shortfalls—through the erosion of tariff preferences, adverse changes in the terms of trade of net food importers, or expiration of quotas following full implementation of the WTO Agreement on Textiles and Clothing. In July 2004 Bangladesh became the first member to obtain support from the Trade Integration Mechanism, followed in January 2005 by the Dominican Republic.

74. These activities reflect the growing recognition that trade-related reforms and infrastructure—both hard and soft—can have high rates of return in increasing economic growth rates. Realizing an ambitious Doha Round and addressing trade capacity priorities in poor countries calls for more to be done. Not only will the associated trade and related reforms give rise to adjustment costs, but to enhance the benefits for poor households in poor countries, as argued previously, investments are needed to facilitate trade, lower transport costs, link farmers and producers to markets, and improve productivity. Strengthening “aid for trade” mechanisms to pursue this agenda would help improve the development relevance of both the WTO and regional integration agreements. An expanded allocation of aid for trade would also help build support for the gradual elimination of discriminatory tariff preferences. Indeed, such support is likely to be a precondition for attaining an ambitious Doha outcome that benefits all developing countries.

75. In considering options for expanding financial support for trade adjustment and integration, two issues are particularly pertinent: the “additionality” of aid resources and the operational framework through which additional funds are made available. Additionality may be achieved by recognizing that a Doha Round, especially an ambitious one, will generate substantial gains for the world as a whole, and that much of these gains will accrue to industrial countries. The potential gains create an opportunity for donor countries to consider transferring an increment of

4. Realizing the Development Promise of Trade

the total net gain from trade liberalization to help address adjustment costs and improve trade capacity in developing countries. Various options could be considered in this connection, in addition to more official development assistance and stronger public-private partnerships: a commitment to transfer a proportion of the tariff revenue currently collected on imports from developing countries, capturing an increment of the consumer gain resulting from lower agricultural support for specific products, or a partial reallocation of current subsidies and income support to development assistance.⁴⁴ In all such cases explicit earmarking of additional funding for trade is not desirable—instead the goal is to establish a framework to commit to redistributing some of the gains from global trade reforms.

76. The operational framework for allocating aid for trade must ensure harmonization of donor efforts (bilateral and multilateral) and place assistance for trade reform, adjustment, and competitiveness within the broad context of a country's development program. The attention given to the trade and investment agenda in a country's national development strategy depends on many factors. Whether trade capacity and trade policy reforms should be given greater priority is a decision for governments. To determine this requires that trade be considered when designing national development and Poverty Reduction Strategies. Progress has been made in this direction and continues to be pursued, but much more can be done to integrate trade considerations into this process. Equally important, demands for funding to address trade and supply capacity constraints need to be met by the donor community in instances where trade is considered a priority and requests for assistance have been put on the table.

77. The institutional mechanism to identify priorities and allocate additional aid for trade could build on the Integrated Framework for Trade Related Technical Assistance. This mechanism has already been established, piloted, and subjected to external evaluation, and has broadly based donor and recipient support. The framework is a unique collaborative joint venture between six multilateral agencies—the IMF, International Trade Centre, United Nations Conference on Trade and Development, United Nations Development Programme, WTO, and World Bank—17 bilateral donors, and LDC governments. The primary objective is to integrate assistance in alignment with national development strategies and priorities (including Poverty Reduction Strategies), based on diagnostic country studies and national consultations. Demand for the framework's trade assessments is high—14 LDCs have completed the assessments and another 14 are under way or planned.

78. Progress in subsuming the Integrated Framework's recommendations into country growth strategies has been slower than anticipated. Without additional assistance, over time, legitimate questions can be raised about the efficacy of the program in providing a more effective enabling process of integration with the global trading system. The dedicated resources associated with the Integrated Framework have been limited to small-scale technical assistance. Funding for trade priorities is considered in the context of the Poverty Reduction Strategy resource allocation and prioritization process, with donor assistance (grants) complemented by loans and other support from international financial institutions and regional development banks. While this should continue to be the case, the Integrated Framework could be used more extensively to both bolster trade capacity of poor countries and help address the adjustment costs from an ambitious Doha Round. To so, consideration should be given to expanding the framework's reach beyond LDCs to include other low-income countries and consider regional trade cooperation priorities (in Africa, for example, members of regional integration initiatives span both LDCs and non-LDCs). Given the strong case for additional funding to meet trade adjustment and integration costs, building on the Integrated Framework could improve aid effectiveness in the trade area and ensure that identified trade priority projects are implemented.

⁴⁴ Hoekman (2005a); Prowse (2005).

Leveraging Regional Integration as a Tool for Development

79. Regional agreements among neighboring developing countries can help lower trade transactions costs and remove policy barriers to intraregional trade. Achieving this is particularly important for landlocked economies that must transport goods through neighboring countries. The agenda extends beyond tariffs and nontariff barriers imposed at borders—it includes regulatory cooperation and joint provision of infrastructure to facilitate trade. South-South integration can also play a beneficial role in helping to create the preconditions for agglomeration, clustering, and the linkages that are critical in diversifying productive activities and sustaining growth. In Africa in particular, there is a strong regional dimension to growth, absorptive capacity, and the widening of “economic space” needed in order to lower costs of infrastructure and facilitate trade. This goes well beyond the trade agenda narrowly defined and includes natural resource management and increasing supply and reliability of energy. With regard to absorptive capacity, regional integration provides a means to increasing aid flows in order to open markets and enhance growth prospects developing countries. Some poor countries in Africa are too small to raise savings for investment on their own, to improve growth with the limited national market size, or to effectively absorb large aid flows for infrastructure. A regional strategy such as that foreseen by NEPAD, revolving around improving policies and governance and the development of regional programs for groups of countries to cooperate on infrastructure (power, roads and transportation), can do much to expand the capacity of the countries concerned to absorb and use greater aid flows effectively.

80. As has been discussed in a number of recent studies,⁴⁵ the potential for narrow trade agreements between developing countries to foster economic growth is limited, as the preferential liberalization of trade policies offers substantial scope for costly trade diversion to occur. A necessary condition for regional integration to be beneficial is that external barriers be low.

81. North-South agreements can help provide both a focal point for behind the border trade reforms in developing countries and mechanisms through which to engage stakeholders and policymakers in the design and implementation of reforms. Because they require trade liberalization by the developing country members, such agreements can also help reduce trade diversion created by South-South agreements the countries concerned are members of. They also create more opportunities for economic benefits to be realized given larger Northern markets and higher income levels.

82. Preferential trade agreements revolve around trade discrimination: this is an explicit objective. Because global development prospects are best served by nondiscrimination,⁴⁶ from a development perspective the best outcome would be if regional agreements promoted the principle of nondiscrimination. Achieving this is a major challenge given that the driving force of trade agreements is in part mercantilist—improving (preferential) access to markets. This specific challenge is an illustration of a more general one: to change the modus operandi of designing and implementing trade agreements to place development (economic efficiency and equity) considerations more at the center of deliberations.

83. Agreements that the European Union and United States are negotiating with developing countries can do much good if they are designed in a way that puts development first. The ongoing Economic Partnership Agreement (EPA) negotiations are the most important in terms of scale and country coverage, but Japan, the United States, and other large traders are also negotiating agreements with other developing countries.⁴⁷ Taking development seriously in such negotiations has a number of implications, including identification of the most appropriate form

⁴⁵ Schiff and Winters (2003); World Bank (2004a).

⁴⁶ World Bank (2004).

⁴⁷ World Bank (2004).

of, and membership in, counterpart regional arrangements, addressing trade barriers with neighboring countries, and identifying actions to reduce trade costs—something of great importance for landlocked countries.⁴⁸ Perhaps most important in the context of EPAs and Africa is to avoid trade diversion costs and attenuate tariff revenue losses associated with a move to reciprocal free trade with the European Union.⁴⁹ If African, Caribbean, and Pacific partner countries maintain current levels of protection against the rest of the world, the effect of moving to free trade with the European Union will be to transfer part of what is now collected in revenue on imports to EU producers in the form of higher prices. This points to the importance of complementing reciprocal liberalization with reductions in external barriers to trade, as well as effective assistance to facilitate trade and improve services and related behind the border regulation. Pursuit of nondiscriminatory tariff liberalization by developing countries where such barriers are still significant would be better than full preferential liberalization relative to the developed partner only. Many Sub-Saharan African countries still rely on import duties for a significant portion of government receipts, so revenue concerns and the ability to put in place alternative revenue sources should influence the speed of liberalization.

84. The policy agenda confronting developing countries at the regional level is similar to that at the multilateral level: in both cases much of the challenge is to use these instruments to help address specific national and foreign trade constraints. A major difference is that in the case of regional agreements, reducing external barriers is important to reduce trade diversion. Another difference is that in the case of North-South agreements there may be significant development assistance commitments associated with the implementation of agreements. Allocating and channeling such aid for trade through a multilateral mechanism—such as the Integrated Framework—would ensure explicit recognition that the trade agenda is (and should be) largely a national, country-specific one, and that technical and financial assistance should be directed toward trade-related areas identified as priorities by countries.

⁴⁸ These issues are discussed at greater length in Hinkle and Newfarmer (2005) in the specific case of the EPAs. For example, the form of African, Caribbean, and Pacific agreements is an issue because a customs union—the preference of the European Union—may be difficult to implement given overlapping regional agreements in Africa and the need to develop revenue sharing mechanisms.

⁴⁹ Hinkle and Schiff (2004).

5. Increasing Aid and Its Effectiveness

1. Developed countries can support developing countries in achieving the MDGs by providing more and better aid. Development assistance can ease the overall resource constraint that poor countries face in the near and medium term, allowing these countries to make much needed investment in infrastructure and social services. In many low-income economies, especially in Africa, aid dominates all sources of external development flows. These economies are particularly dependent on higher levels of assistance in achieving the MDGs, and they are also more vulnerable to aid shortfalls. The issue that arises is whether aid can be scaled up in these countries. Low-income countries that implement sound economic policies, strengthen institutions, and adopt good governance practices can absorb additional amounts of aid rapidly and effectively. The way aid is allocated and delivered is as important to achieving the MDGs as aid volumes. Aid is more effective in fostering growth and improving service delivery in countries with better policies and institutional environment. It is also more effective when it is aligned with recipients' priorities, when it reduces transaction costs through harmonized processes and donor coordination, when it is more predictable, and when there is clearer focus on results.

2. At Monterrey in March 2002, donors committed to providing higher levels of aid and in more effective ways. What has been the recent progress in boosting aid volumes and effectiveness? The recovery in official development assistance that started in 2001 is continuing, but recent levels of development assistance and near-term projections of these volumes fall far short of estimates of what is needed to meet the MDGs. ODA as a share of DAC donors' income remains low in comparison to donors' efforts of the 1990s and before. Moreover, a substantial amount of the recent increase in ODA reflects donors' increasing attention to regional and global security. Donors' attention to geo-politically significant countries appears to be crowding out assistance to countries that need the most help in achieving the MDGs. A better balance is needed between poverty reduction and other donor objectives. Aid policy should reflect the increasing recognition that perhaps the most effective means to promote long-term peace and security is to invest in reducing poverty and human deprivation.

3. The proportion of aid going to Sub-Saharan Africa is rising slowly, but much more could be done. The size of ODA relative to recipients' GDP is 6.2 percent on average in Sub-Saharan Africa. While this is high compared to other regions, it is below the levels of the early 1990s. Most of the \$8.5 billion increase in bilateral ODA during 2001-03 was in the form of debt relief; the increment in program and project assistance was a modest \$0.6 billion. While debt relief helps to relieve problems associated with a high debt burden and to create more fiscal space, it alone is not enough. Substantial increases are needed in program and project assistance to meet the incremental financing requirements of developing countries as they scale up their development efforts to achieve the MDGs. Sub-Saharan African countries have seen a decline in ODA flows to rural/agricultural development and infrastructure. Investment in social sectors in these countries also has been inadequate, as reviewed in Chapter 3. Large shortfalls in financing to these sectors, that are key to spurring growth and scaling up the delivery of MDG-related services, point to the need for much higher amounts of ODA.

4. Discussions continue on proposals to augment higher aid flows with innovative financing mechanisms, such as the International Financing Facility, global taxes, and voluntary mechanisms. To date most progress has been made on the IFF, which is designed to frontload aid flows in the short term to help reach the MDGs. Technical aspects of the IFF are being worked through in a "pilot" IFF for Immunization. A wide range of proposals have been made on ways to raise additional resources through new tax instruments. If the technical and political difficulties of

5. Increasing Aid and Its Effectiveness

using these tax instruments could be resolved, global taxes could complement the IFF, generating additional aid funds in the medium to long term when flows under the IFF would diminish.

5. The policy and institutional environment in developing countries is continuing to improve, promoting a better enabling environment for scaling up aid. Low-income countries as a group can effectively absorb much more aid, although the amount that can be absorbed varies by country. A number of countries are well placed to manage a doubling of assistance in the short to medium term. Capacity constraints are likely to be a significant obstacle in countries with weak policies and institutions. In all cases, a country-specific approach anchored in a PRS framework is required for assessing external financing needs, identifying and addressing capacity constraints, and appropriately sequencing incremental financing. Absorptive capacity is a dynamic concept, so even though capacity may be limited today, it can be built over time, and aid can play an important role in that as well.

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

7. Progress on harmonization and alignment has been mixed so far, and that on managing for results is just beginning. The Rome High-Level Forum of early 2003 and the meeting in Marrakech in February 2004 strengthened the focus on aligning donor assistance with recipients' national strategies and priorities as articulated in PRSs or equivalent national strategy documents, harmonizing donors' processes and procedures with those of partner countries, and managing donor aid programs for development results. Participants at the just concluded Paris High-Level Forum on Aid Effectiveness reaffirmed their commitment to the global agenda on harmonization, alignment, and results. Yet, implementing good practice in these areas has been slow and uneven. Progress is most evident in countries where governments have worked the longest and hardest to take ownership of the aid process. Some early progress on managing for results is also evident, as the development community moves to implementing the results agenda.

8. The potentially large financing needs associated with the MDGs pose a challenge to low-income countries to maintain sustainable debt positions. The enhanced HIPC Initiative has lowered the debt burden for participating countries—27 countries have reached the decision point (15 have reached the completion point, but progress towards reaching the completion point has been slower than earlier envisaged) and are receiving debt relief. Nevertheless, continued measures are needed by HIPCs and their creditors to ensure that financing the MDGs will not lead to an excessive buildup of new debt. This issue of debt sustainability is not limited to HIPCs of course, and extends to other low-income countries with existing or prospective debt pressures. The Bank and Fund are jointly developing a forward-looking debt sustainability framework for low-income countries that incorporates a systematic analysis of the time path of key debt-burden indicators under baseline assumptions and in the event of plausible shocks and that establishes indicative thresholds for these indicators, based on the quality of policies and institutions in a country. A number of proposals for further debt relief to low-income and highly indebted countries beyond the HIPC Initiative also have recently been put forward by members of the G7.

5. Increasing Aid and Its Effectiveness

9. Looking ahead, priority areas for action are:

- Donors need to implement their post-Monterrey commitments and pledge to substantially raise and extend their commitments beyond 2006, say to 2010. While several countries have committed to expanding aid efforts beyond 2006, fully half of Development Assistance Committee (DAC) members have not, including some of the largest donors. They should do so in 2005.
- The PRS should provide the framework for scaling up aid—assessing financing needs, identifying and addressing capacity constraints, and appropriately sequencing incremental financing. Where absorptive capacity is an obstacle to scaling up, aid can still be effective by focusing on building capacity and providing service delivery through innovative mechanisms.
- Donors need to sharpen further their focus on providing aid to better performing poor countries. On their part, recipient countries should speed up implementation of their own actions to enhance their capacity to make effective use of incremental aid flows.
- Donors need to address more effectively the special needs of difficult partnership countries (including LICUS), exerting greater efforts to better coordinate and sequence aid.
- Progress on implementing the harmonization, alignment, and managing for results agenda should be accelerated. Participants at the Paris High-Level Forum agreed to set quantitative targets for 12 key indicators of progress, which will facilitate monitoring on this agenda. Nevertheless, continued focus at the highest level in donor and partner countries will be required to accelerate the pace of change. Developing countries need to take more ownership of the aid alignment and harmonization process.
- On debt relief, continued and effective implementation of the HIPC Initiative remains key. On proposals for additional debt relief for poor countries with heavy debt burdens that are pursuing credible reforms, efforts should be made to reach closure in 2005. Additional debt relief should not cut into the provision of needed new financing, which for these countries should be primarily in the form of grants.

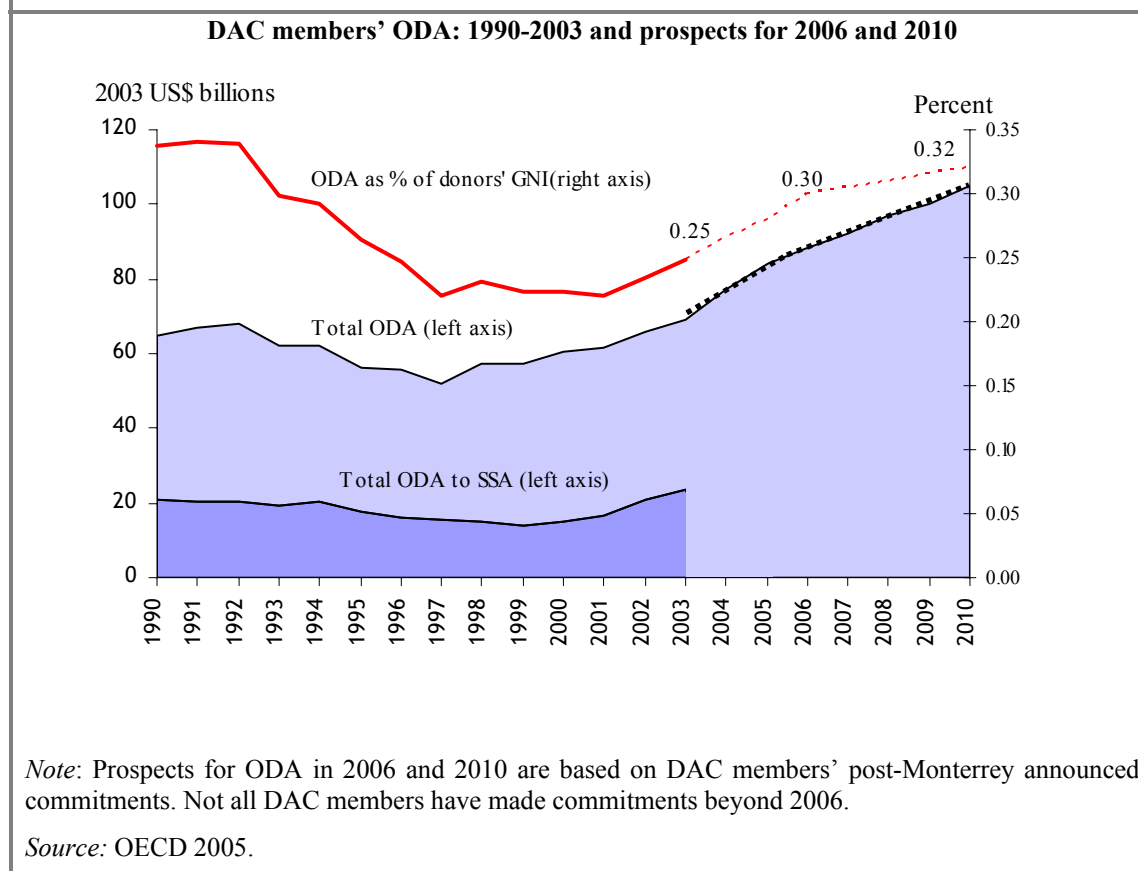
I. Post-Monterrey Trends in Aid

Aid is rising but is insufficient to meet MDG needs

10. *Aid volumes.* The recovery in official development assistance that started in 2001 is holding as donors deliver on post-Monterrey aid commitments. Aid volumes increased by 5 percent in real terms in 2003, a slower pace of expansion than the 7 percent growth recorded in the previous year. Combined with exchange rate movements and inflation, which accounted for \$7.9 billion of the increase in aid volumes in 2003, nominal ODA rose by \$10.7 billion to \$69 billion. If announced aid commitments are delivered, ODA volumes are expected to grow by nearly 30 percent in real terms during 2003-2006 and could rise to over \$100 billion by 2010 (figure 5.1).¹ Several countries have committed to higher aid effort beyond 2006, the target date for the commitments made at Monterrey, but some of the largest donors have not done so.

¹ OECD (2005a). The Paris Club's recent decision to forgive up to 80 percent of its debt claims on Iraq will add \$12-\$17 billion to ODA flows in 2005-06. For many donors these flows will be additional to their Monterrey commitments.

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

11. Despite the progress in expanding ODA volumes since Monterrey, donors' aid efforts lag behind those of the early 1990s and before.² At 0.25 percent, ODA as a share of donor GNI in 2003 was three-quarters of the aid effort achieved in the 1970s, 1980s and the early 1990s and only about half of the aid effort of the 1960s.³ Five countries—Denmark, Luxembourg, Netherlands, Norway, and Sweden—have achieved ODA/GNI ratios of 0.7 percent or more, and six countries—Belgium, Finland, France, Ireland, Spain, and the United Kingdom—have announced a timetable for achieving this level. Implementation of pledges will be vital to raising aid flows to poor countries (figure 5.2); the target of \$5 billion in annual assistance by fiscal 2006 under the U.S.'s Millennium Challenge Account is now likely to be reached in fiscal 2007 (box 5.1). Even on announced pledges, DAC donors' aid effort is expected to reach only 0.3 percent by 2006 and 0.32 percent by 2010, below the level of the early 1990s. Among the actions being considered by the European Commission is the setting of new—and higher—interim targets for ODA relative to members' GNI for the period beyond 2006, with the view of reaching the ODA

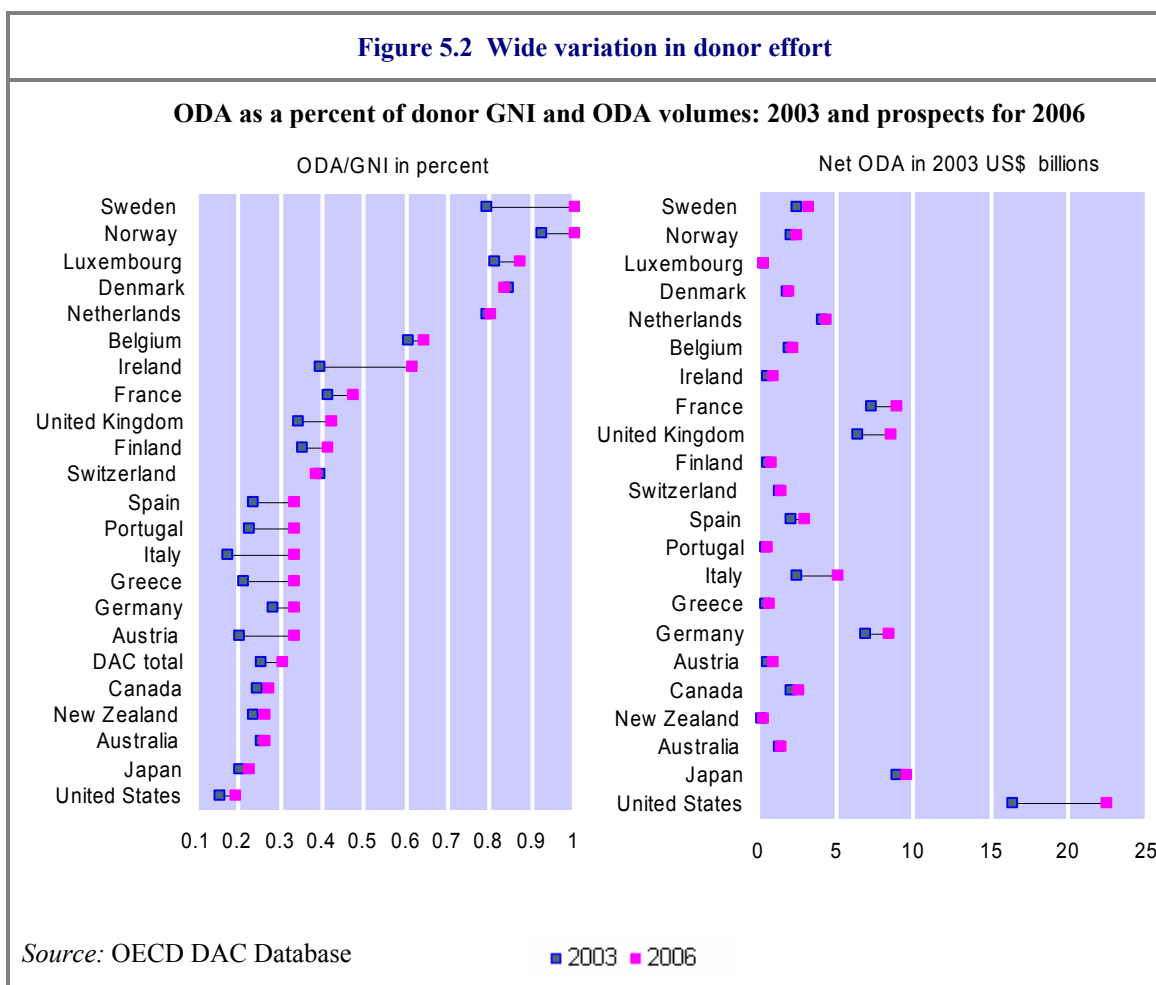
² Military expenditures have risen sharply in recent years - 18 percent in real terms during 2002 and 2003 (Stockholm International Peace Research Institute) – and they dwarf aid flows. For example, U.S. military expenditure in 2002 was \$1,217 per capita and ODA was \$46 per capita. At \$358 per capita, military spending in EU countries was also much larger than ODA of \$61 per capita (Economists Allied for Arms Reduction, 2004).

³ Oxfam (2005).

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to GNI target of 0.7 percent as soon as possible.⁴ Donors need to commit to expanding aid efforts beyond 2006, to 2010 or beyond.⁵

Figure 5.2 Wide variation in donor effort



12. The increase in bilateral development assistance is mostly in the form of non-cash assistance and debt relief.⁶ Debt relief and technical cooperation account for fully two-thirds of the increase in DAC members' ODA between 2001 and 2003: \$6 billion of the \$16.7 billion nominal increase in DAC members' net ODA was allocated to debt relief and \$4.8 billion to technical cooperation (figure 5.3). At about 17 percent, emergency disaster relief and food aid also represented a significant portion of the increase. The increase in these categories of ODA cuts into the share of assistance available in cash and more flexible forms to meet countries' incremental financing requirements for meeting the MDGs—program and project assistance; the increase in bilateral ODA allocated to the latter category during this period was a modest \$0.6 billion. The share of this category in total bilateral ODA was only a quarter in 2003, down from a third in 2001 and well below the roughly 60 percent average of the 1980s. Debt relief levels will

⁴ European Commission (2004). Under the Barcelona Commitments adopted by the European Council in 2002, the average intermediate target for ODA to GNI is 0.39 percent by 2006.

⁵ Donors have recently agreed to a more than 25 percent increase in contributions to IDA-14. The overall grant share of total IDA support in the coming three years—July 1, 2005 to June 30, 2008—is expected to be about 30 percent.

⁶ Grants such as technical cooperation, emergency and distress relief, and developmental food aid typically represent non-cash assistance. Debt relief grants represent a net transfer of cash if debt is being serviced (i.e. not in arrears), but they amount to an accounting exercise when debt is not being serviced.

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remain high (and rise) in the near term as more countries reach their completion point under the enhanced HIPC initiative, and because of the recent decision by the donors to forgive up to 80 percent of Iraq's debt to the Paris Club. Possible additional debt relief to poor countries beyond the enhanced HIPC initiative would also affect the size of this category. While debt relief is crucial to relieving problems associated with a high debt burden and to expanding fiscal space, there are concerns that it might come at the expense of needed increases in new financing for development.⁷ Donors will need to ensure that additional debt relief does not crowd out the provision of needed new financing.

Box 5.1 Millennium Challenge Account: poised to deliver?

The Millennium Challenge Account (MCA) is a new bilateral aid mechanism established by the United States in fiscal 2004 (announced in March 2002). The MCA uses performance-based allocation criteria to direct new U.S. aid flows to poor countries. Countries are selected based on their relative strong performance on three categories of policies: governing justly, investing in people, and promoting economic freedom. To date, 17 countries have been determined to be eligible to apply for MCA assistance. A "threshold" program (no funding available under this program) provides additional incentive for policy reform by offering assistance to 13 countries to improve in areas where they fell short of qualifying for the MCA.

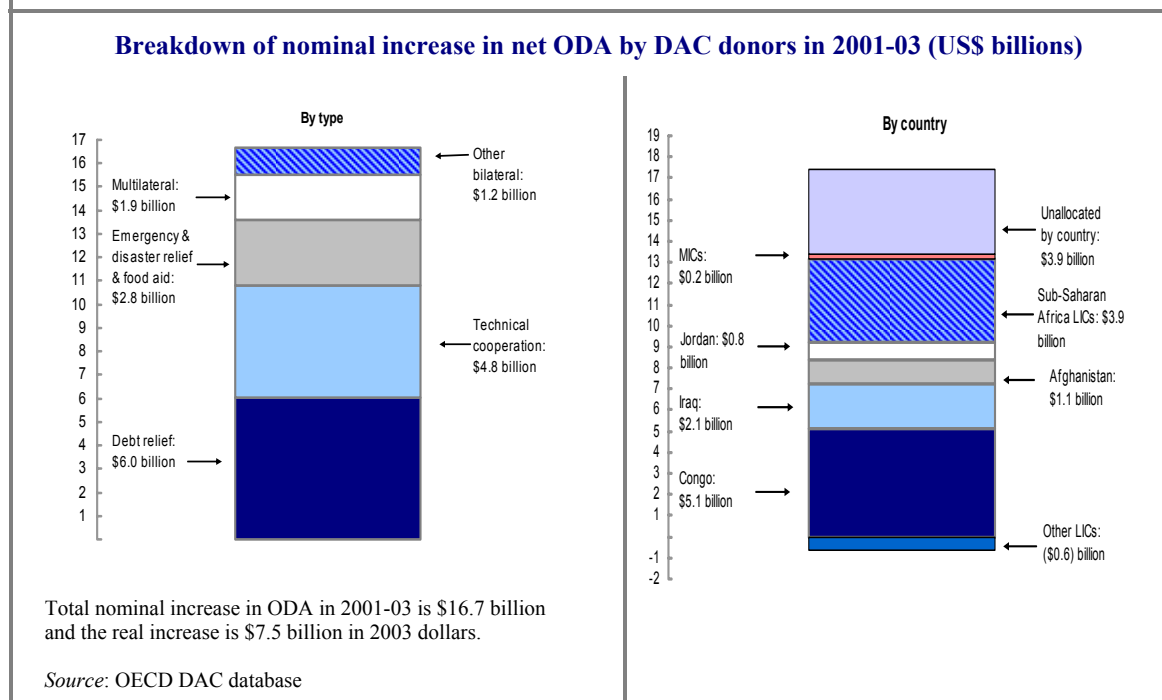
MCA eligible countries identify their own priorities and develop their own MCA proposal, based on their assessment of the greatest barriers to their development and in consultation with civil society and the private sector. MCA proposals are evaluated based on their contribution to reducing poverty through sustainable economic growth and are not restricted to any particular sector or area. MCA countries join with the MCC, which administers the MCA, in a multi-year public Compact for achieving shared development objectives, which is funded up-front. The Compact identifies the responsibilities of each partner and contains clear objectives, benchmarks to measure progress, procedures to ensure fiscal accountability for the use of MCA assistance, and a plan for effective monitoring and objective evaluation of results. Programs are designed to enable progress to be sustained after the funding under the MCA Compact has ended.

Initially, a target of \$5 billion in annual assistance under the MCA by fiscal 2006 was envisioned. The U.S. Administration's fiscal 2006 budget request of \$3 billion doubles the 2005 appropriated level and allows for an effective expansion of MCA assistance to \$5 billion in 2007. No disbursements have yet been made from the MCA, but it is expected that disbursements will begin in spring 2005.

13. Global and regional security concerns have pulled up aid flows as well. Aid to Iraq was sharply higher in 2003, rising to \$2.3 billion from \$0.1 billion in both 2001 and 2002. Likewise, aid to Afghanistan has risen nearly fourfold during 2001-2003 to \$1.5 billion and Jordan has seen an approximately threefold increase in development assistance flows. Pakistan has received large amounts of net aid (about \$2 billion) in 2001 and 2002, but loan repayments (on previously rescheduled debt) lowered net flows in 2003.

⁷ See Section IV: Debt Relief of this chapter for a further discussion of the issue.

5. Increasing Aid and Its Effectiveness

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

14. Non-OECD countries are contributing significant amounts of assistance to less developed countries. Non-DAC ODA flows continued to grow in 2003. These flows reached \$3.4 billion or 4.9 percent of DAC ODA (more than twice the level in 2001).⁸ Saudi Arabia continued to be the largest provider of development assistance in this group. Its ODA contributions have grown from under \$500 million in 2001 to \$2.4 billion in 2003. Other non-DAC countries have also seen a rapid increase in their ODA. For example, the Czech Republic more than tripled its development assistance in the past two years, providing \$91 million in 2003. Important contributions to the development effort in poor countries also are being made through South-South cooperation, particularly in the form of sharing of experience and know-how. Comprehensive data on South-South development assistance are not available, but countries such as Brazil, China, and India have been particularly active in providing technical assistance to low-income countries.⁹ The potential for South-South assistance is expected to grow as these larger economies continue to record impressive economic and technological advances. The favorable trend in grants from NGOs (using their own resources) is continuing. These grants totaled \$10.1 billion in 2003 (compared to \$8.8 billion in 2002) and are expected to be sharply higher in the aftermath of the East Asia tsunami.

15. Rising developing country income means that higher aid volumes have translated into only a modest rise in the share of ODA in recipients' GNI. Indeed, this share is only slightly above the low of 1997 and it is expected to remain in a narrow range going out to 2006. The share of Sub-Saharan Africa in total net ODA (disbursements) has continued to grow in recent years, climbing to 33 percent in 2003. The weight of aid in recipients' economies is largest in Sub-Saharan Africa

⁸ Data are for the 14 non-DAC donor countries (not in the OECD) for which the OECD collects data on development assistance.

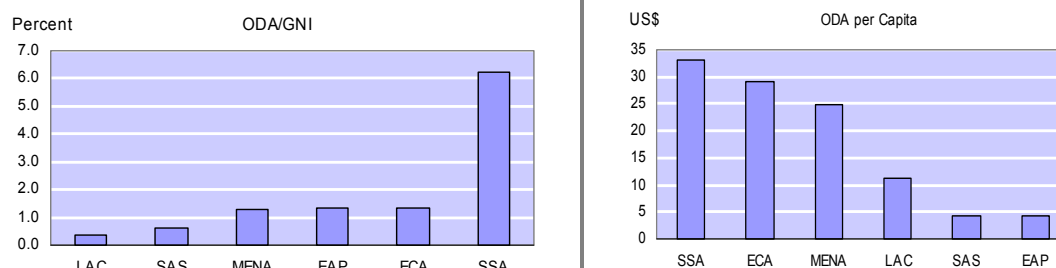
⁹ The Forum on Partnerships for More Effective Development Co-operation, which was held on Feb 1-2, 2005, brought together DAC members and a number of non-OECD countries involved in furthering development in developing countries. The aim was to improve coordination and cooperation among the entire donor community particularly through better information and knowledge sharing.

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at roughly 6.2 percent in 2003, at least four times that in other regions, signaling the importance of aid for this region (figure 5.4). Per capita ODA has edged up as well and averaged around \$14 in 2003, below the level of the early 1990s. Again there is wide regional variation; Sub-Saharan Africa is the region receiving the largest amount of ODA on a per capita basis.

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

Size of ODA in recipients' economies (2003)



Note: Data for ECA is only for countries receiving ODA and does not include OA (official assistance).

Source: OECD DAC database.

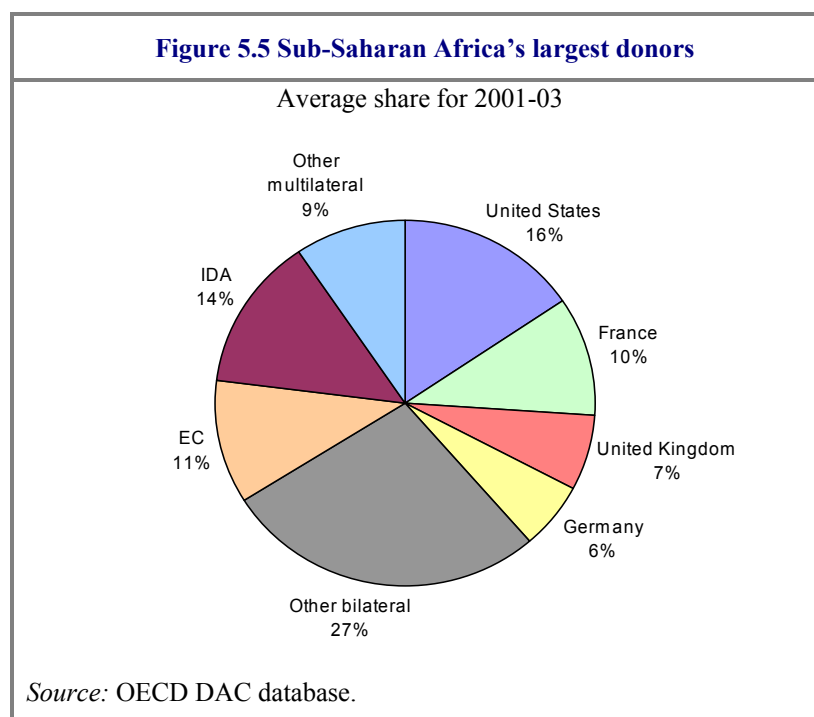
Improving trend in development assistance to Sub-Saharan Africa

16. *Trends in aid to Sub-Saharan Africa.* Mirroring the recovery in overall ODA, development assistance to Sub-Saharan Africa has begun to rise from the substantial slide of the 1990s. Aid volumes in real terms have now surpassed the levels of the early 1990s. As well, the region is now receiving a somewhat larger share of net ODA (disbursements) than historically: at \$23.7 billion, Sub-Saharan Africa's share in total ODA was 33 percent in 2003 compared to 27 percent in 2000. Aid is mostly in the form of grants; bilaterals provide nearly all their assistance in grants and multilateral net ODA consists of highly concessional loans (60 percent) and grants (40 percent). The United States and France were the largest donors to Sub-Saharan Africa in 2001-03¹⁰ followed by IDA and the EC (figure 5.5). Bilateral donors such as Belgium, France, Italy, and Ireland allocate over 50 percent of their net bilateral ODA to Sub-Saharan Africa.

17. While the positive trend in development assistance to Sub-Saharan Africa is encouraging, increase in aid provided in cash and more flexible forms—program and project assistance—has been rather modest. Most of the \$8.5 billion increase in net bilateral ODA to the region during 2002 and 2003 was in the form of debt relief (\$5.6 billion) and emergency and disaster relief and food aid (\$1.5 billion). The increment in program and project assistance (in cash) was only around \$0.6 billion. The increase in overall ODA to the region was also concentrated in a handful of countries: Congo (DR) received an additional \$5.1 billion most of it for debt relief operations, Cameroon \$480 million, Sudan \$436 million, Tanzania \$398 million and Ethiopia \$389 million. The remaining countries in the region received around \$2.5 billion. Although the amount of aid allocated to social services has grown, that to rural/agricultural development and infrastructure has steadily declined.

¹⁰ The share of the United States more than doubled in 2003 to 22 percent.

5. Increasing Aid and Its Effectiveness



18. Although aid to Sub-Saharan Africa is rising, much more will be needed to support the effort to achieve the MDGs. The size of ODA relative to recipients' GDP is 6.2 percent. While this is high compared to other regions, it is well below the levels of the early 1990s, and the estimated needs to meet the MDGs. There is also large variation in the size of aid flows across Sub-Saharan African countries. A handful of countries such as Mozambique and Sierra Leone have very high aid to GDP ratios. Overall, one sixth of the countries in this region have bilateral ODA/GDP levels over 10 percent and an almost equal number have bilateral ODA/GDP levels under 1 percent.¹¹ The corresponding distribution in 1990 was nearly 40 percent and 2 percent, respectively.

19. *Sources of foreign finance.* Aid flows represent the largest source of foreign finance to Sub-Saharan Africa. Indeed, the importance of aid flows has actually increased in total resource flows. Figure 5.6 shows that aid is a particularly important source for Sub-Saharan Africa: aid now accounts for nearly 60 percent of external flows to the region, up from the levels of the late 1990s.¹² Foreign direct investment provides a small, yet significant source of external finance to the region. The size of FDI flows relative to GNI in 2003 was 2.5 percent for Sub-Saharan African countries, larger than the share for low-income countries (1.5) and just slightly higher than the average for all developing countries (2.3 percent).¹³ FDI in Sub-Saharan Africa is concentrated in a handful of relatively large, resource-rich economies: three countries—Angola, Nigeria, South Africa—account for over 50 percent of FDI to the region during 2001-03. The size of remittance flows to the region relative to GNI in 2003 was small at 1.5 percent.¹⁴ Like FDI, remittance flows are also concentrated in a few countries: Kenya, Nigeria, and Sudan accounted for almost 55 percent of these flows to the region during 2001-03.

¹¹ Out of a sample of 42 countries.

¹² All official flows – ODA and non-ODA – account for a slightly smaller share of resource flows, i.e. 55 percent, because flows on non-ODA official flows are a small negative.

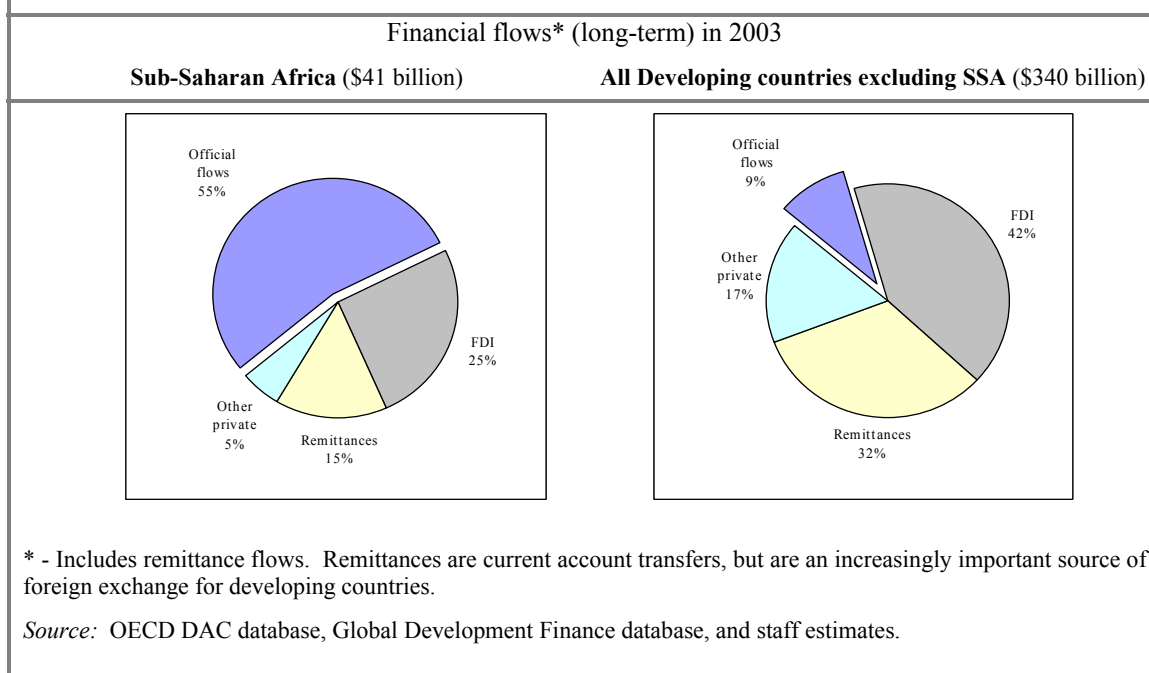
¹³ FDI to SSA in 2004 rose in tandem with overall FDI to developing countries.

¹⁴ Official data underestimate the actual size of remittance flows, and unrecorded remittances may be larger than recorded remittances.

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20. For most Sub-Saharan countries, the prospects of attracting FDI are constrained. While many African countries have gone through tough processes of reform to liberalize their economies, create macroeconomic stability, and rationalize taxes and tariffs, much remains to be done. FDI is strongly influenced by a country's investment climate. African countries have the most regulatory obstacles to doing business relative to other regions.¹⁵ African countries perform especially poorly on the cost of starting a business, enforcing, labor regulation flexibility and the cost of registering property. The costs of a weak investment climate can be substantial. Data from the Investment Climate Survey shows that: costs as a share of lost sales (across five policy areas) are between two to three larger in Kenya, Tanzania and Zambia than in China and Brazil. The composition of the costs also varies dramatically across countries: in Tanzania and Kenya weak infrastructure services are particularly burdensome; in Zambia bribes are especially costly. The priority area for reform thus varies by country. Small size and geographic location (land-locked) are added constraints to attracting FDI. Sub-Saharan countries need to accelerate the pace of reforms to enhance investment climate and they also need to scale up investment in basic infrastructure. Through improving their investment climate, Sub-Saharan Africa can over time attract more FDI. In the near to medium term, however, increases in ODA will remain critically important for the region.

Figure 5.6 ODA is the main source of external finance for Sub-Saharan Africa, twice as large as FDI and nearly four times as large as remittances



21. Given the relative importance of official flows in Sub-Saharan economies and in fiscal budgets, variation in these flows can be a problem. In many countries aid tends to be more volatile than fiscal revenues.^{16,17} Volatile and less reliable aid flows can undermine budget management in recipient countries and efforts in these countries to develop medium-term expenditure frameworks. Aid shortfalls in poor countries are typically offset by cutbacks in

¹⁵ See World Bank (2004b) and Chapter 2 for a detailed discussion of private investment climate and its links to growth.

¹⁶ Bulir and Hamann (2003) and Bulir and Lane (2002).

¹⁷ World Bank (2005) and Pallage and Robe (2001) find that aid to poor countries is more volatile than GDP.

5. Increasing Aid and Its Effectiveness

spending, and sometimes by tax increases.¹⁸ Improved predictability of aid flows is important to effective scaling up of assistance.

Innovative financing mechanisms to augment traditional ODA

22. In the absence of sufficient traditional ODA, innovative financing mechanisms may be required to increase aid flows. Several proposals are currently under discussion.¹⁹

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

24. Technical aspects of the IFF proposal are being worked through in a “pilot” IFF for Immunization. The “IFFIm” would seek to raise frontloaded, reliable funding over a number of years to expand the global immunization effort to help achieve the child health MDG.²⁰ The programmatic proposal for the IFFIm proposal focuses on two funding streams for the use of frontloaded funds: (1) accelerating increased production of new and existing vaccines, to stimulate private sector investment and competition, and to reduce vaccine costs more rapidly than if there were no scale-up; and (2) strengthening the capacity to deliver vaccines, to save children’s lives immediately, to reduce the risk of disease over the longer term, and to support other health interventions by improving the public health infrastructure.

25. The financial structure is intended to be a small IFF, using off-budget donor pledges of future aid increases as backing for AAA bond issuance. The IFFIm would rely largely on the existing governance structure and country programs of the Global Alliance for Vaccines and Immunization (GAVI) and the Vaccine Fund. If successful, the IFFIm would demonstrate the feasibility of several aspects of the proposed IFF: the capacity to garner donor support for such a mechanism; resolution of issues on the fiscal treatment of contingent IFFIm donor pledges, and acceptance of IFF-generated AAA bonds by the rating agencies and capital markets.

26. Global Taxes: A wide range of proposals has been made of ways to raise additional revenue through new tax instruments, but many have technical obstacles, all face varying degrees of political opposition, and all would take time to implement. For example, a common carbon tax, while technically attractive in that it could generate substantial revenue and mitigate climate change, would be very difficult to achieve politically. Also, as with all innovative mechanisms, additionality is a critical consideration. Increasing international attention on how to move forward on specific mechanisms may lead to more focused work on promising alternatives. One possibility recently put forward in the EU would be an international airline fuel tax, which would address two externalities: the environmental damage caused by air transportation and the failure of international tax coordination in that airline fuel, unlike any other fuel, is generally untaxed. If technical and political difficulties can be resolved, global taxes could complement the IFF,

¹⁸ Gemmell and McGillivray (1998).

¹⁹ “Moving Forward: Financing Modalities Toward the MDGs” forthcoming will analyze the various proposed innovative mechanisms that are under discussion. Also see Development Committee (2004) and Reisen (2004).

²⁰ The IFFIm would be established as a UK charitable entity, essentially as a special purpose vehicle for the Vaccine Fund. Negotiations are underway to establish a core group of donors interested in funding the IFFIm.

5. Increasing Aid and Its Effectiveness

generating additional aid funds in the medium to long term as IFF flows, designed to increase development funds in the short term, diminish while its bonds are being repaid.²¹

27. **Voluntary Contributions:** Private contributions to fund development are increasing. They are made in a range of ways that could be expanded, encouraged and made more effective. Some mechanisms, such as the establishment of “affinity” credit cards that provide funding for development through voluntary surcharges, could be undertaken by interested banks or companies. Others, such as the creation of a special purpose global lottery or premium bond, would require regulatory action by participating countries, either unilaterally or acting in concert. As with global tax mechanisms, it is important, and not easy, to ensure that the establishment or encouragement of voluntary contributions results in truly additional flows that are used effectively and do not distort development flows by overemphasizing some needs at the expense of others.

28. **Blending Arrangements:** Multilateral aid is delivered as an aggregate of assistance and funds from different sources. The terms and levels of available aid are not consistent across recipient countries, whether due to uneven efforts to ground aid in country performance levels, capacity and income level, or because aid reflects strategic or other priorities of donors. Blending arrangements—that is, combining flows with different financial terms and characteristics to increase concessionality or gain leverage—are a possible way to augment resources for the MDG agenda, fund global public goods projects, and to address individual country circumstances, such as creditworthiness constraints affecting gap countries.²²

II. The Case for More Aid

MDG financing needs call for a major scaling up of aid

29. *Estimates of MDG financing needs.* Current levels of development assistance and near-term projections of these volumes are likely to fall far short of what is needed to meet the MDGs. Although recent estimates of additional resources needed to achieve the MDGs vary widely, they all point to a significant financing gap (box 5.2). At the conservative end of these estimates, an increase in ODA of at least \$50 billion is needed, with the increases phased so as to align with rise in recipients’ absorptive capacity. The UN Millennium Report (2005) projects the additional external assistance needed for directly supporting the MDGs in low-income countries at \$73 billion in 2006, rising to \$135 billion by 2015. The financing of MDGs and other needs would imply a nearly threefold increase in total net ODA. Since costing of MDGs is hard, there is currently much debate about the amounts needed to achieve the MDGs.²³ Despite the debate on the precise amounts, there is broad agreement that current levels of development assistance are insufficient and substantially more aid is needed.

²¹ Taxes that correct inefficiencies ultimately imply an increase in a country’s real resources, and the possibility of increased development financing. See Development Committee (2004) for a detailed discussion of the additionality of various innovative instruments.

²² Gap countries are countries that are ineligible for IDA financing (since GNI per capita is above the IDA cutoff), other than on an exceptional basis, and that are constrained from normal MDB borrowing because of difficult debt or performance problems.

²³ IMF-World Bank (2004a).

5. Increasing Aid and Its Effectiveness

Box 5.2: Estimates of MDG financing needs vary widely, but all point to the need for a substantial increase

The Millennium Project Report (2005) conducted a detailed MDG-based needs assessment for five countries – Bangladesh, Cambodia, Ghana, Tanzania, and Uganda. The per capita needs assessments range from \$70 to \$80 in 2006, and they rise to \$120 to \$160 by 2015. The bulk of this will require external finance: \$40 to \$52 per capita in 2006 and \$70 to \$95 in 2015 (domestic resource mobilization rises by about 4 percentage points of GDP). The study projects the MDG financing gap in low-income countries to be \$73 billion in 2006, rising to \$135 billion in 2015. That in middle income countries is projected to be \$10 billion. The overall net ODA needs to meet the MDGs in low and middle-income countries and to meet other needs will imply additional ODA over 2003 levels of \$66 billion in 2006 and \$126 billion in 2015; a nearly threefold increase in total net ODA by 2015. This implies ODA/donors' GNI of 0.44 percent in 2006, rising to 0.46 percent in 2010, and reaching 0.54 percent by 2015.

Several other costing exercises have attempted to place a figure on the global cost of meeting the MDGs. These were discussed in detail in last year's *Global Monitoring Report*, and the results of these studies are only presented in summary form here. The range of estimates varies widely, but most point to the need to increase ODA in support of MDGs by at least \$50 billion.

Estimates of additional ODA requirements vary widely

	Estimates of additional annual ODA requirements for meeting the MDGs
Millennium Project Report (2005)	Increase over 2003 levels of: \$66 billion by 2006 \$83 billion by 2010 \$126 billion by 2015
Various Development Committee Papers (2003-2004)	Initial increment of at least \$30 billion (for MDG investment needs), rising into the \$50 billion plus range
Report of the High-Level Panel on Financing for Development (Zedillo Report, 2001)	Approx. an additional \$50 billion a year over current levels (for directly supporting the MDGs)
Commission for Africa (2005, preliminary)	For SSA: An additional \$25 billion a year (i.e. doubling over current levels) within 3-5 years, followed by an additional \$25 billion a year by 2015.

30. Human development services. As discussed in Chapter 3, most poor countries will fall far short of achieving the service delivery goals on current trends. The financing needs for meeting these goals are large relative to available domestic resources, and significantly higher amounts of aid will be needed to fill the financing gap. Adequate progress by developing countries on the health goals, where the shortfalls on current trends are greatest, will require at least \$25 billion a year in additional aid. Additional aid requirements for meeting the primary education goal in low-income countries are estimated to be at least \$3 billion annually.²⁴

²⁴ See Chapter 3 for details.

5. Increasing Aid and Its Effectiveness

31. **Infrastructure.** Along with the need to scale up health and education services, poor countries need to address serious gaps in infrastructure.²⁵ Annual spending on infrastructure—electricity, transport, telecommunications, water and sanitation—is about 3.5 percent of GDP in developing countries, against estimated needs of about 5.5 percent of GDP to reach the MDGs. The shortfall in infrastructure financing is worse in poor countries: for example, SSA needs to double annual infrastructure spending from 4.7 percent of GDP to 9.2 percent of GDP.²⁶ Ethiopia's example illustrates just how large the gap in infrastructure is. Ethiopia's road density in 2001 is estimated at 0.029 km/sq km of land, about a quarter of the low-income average. The cost to scale up road networks in Ethiopia by 2015, so as to increase road density by a factor of three as part of a strategy to accelerate progress toward the MDGs, is estimated at \$7.2 billion over 2005-15. This amount is more than three times larger than what the investment would be if current trends continued. Clearly, many low-income countries do not have the domestic resources or large enough access to global financial markets to finance this scale of investment.²⁷ More aid will be critical to accelerating provision of infrastructure.

32. Recent evidence suggests that aid can boost growth if it is invested well, say, in infrastructure.²⁸ A cross-country study by Clemens, Radelet, and Bhavani (2004) finds that the components of aid that directly support investment exert a positive influence on growth. Thus, budget support, balance of payments support, and investment in infrastructure and productive sectors like agriculture appear to have a significant impact on growth in the short term. Aid to social sectors also contributes to growth, but their impact is longer term. Importantly, the case for more aid to education and health, apart from the “narrow” contribution to economic growth, derives from its impact on the non-income dimensions of poverty.

Absorptive capacity constraints to scaling up

33. Scaling up of development assistance will only be effective if poor countries have adequate capacity to absorb higher aid amounts. Constraints to developing countries' capacity to effectively absorb resources can manifest themselves at a number of levels—national policy, public budget management, local delivery—and in various ways—macroeconomic management, institutional capacity, infrastructure, human capital, social and cultural factors. But not all constraints are equally binding; some constraints can be relaxed in the near term while others may require a longer period to overcome.²⁹ Thus, constraints relating to the labor market (supply of skilled health and education service providers) and to the quality of governance (corruption) might take longer to overcome, while constraints in the form of inadequate public expenditure management systems could be overcome more readily.³⁰ Moreover, change in one area can be a catalyst for improvement in other areas, i.e. change can be mutually reinforcing. All these aspects

²⁵ Some have argued that poor countries often lack a minimum amount of capital—in terms of infrastructure, human capital, and public administration—to support modern production activity, so capital above a minimum threshold is needed to boost economic activity. According to that argument, the key to breaking out of such ‘poverty traps’ is a large infusion of investment in physical and human capital, which must be funded predominantly from external sources given limited domestic capacity to save. See Sachs et al (2004) for a poverty trap perspective on Sub-Saharan Africa. See Chapter 2 and Kraay and Raddatz (2005) for empirical evidence on poverty traps.

²⁶ See Chapter 2 for details.

²⁷ The Millennium Project Report (2005) estimates that the annual cost of infrastructure investment in roads to meet the MDGs in Ghana is 2.9 percent of GDP, almost 4 times greater than can be domestically financed by the government, and that in Uganda is 5.4 percent of GDP, double what can be domestically financed.

²⁸ There is considerable debate in the recent economic literature on the impact of aid on growth. One set of cross-country macro studies finds an unambiguously positive relationship between aid and growth. Another set of studies shows more conditional results, with the effect of aid on growth dependent on quality of policies and institutions or other country characteristics. A third set of studies finds no effect, or even a negative effect, of aid on growth.

²⁹ Development Committee (2004) and Renzio (2004).

³⁰ Levy (2004).

5. Increasing Aid and Its Effectiveness

of capacity constraints imply that sequencing is central to capacity building; prioritizing and sequencing interventions across the range of constraints is necessary for an effective strategy for capacity building, as is alignment of public investment with those priorities.

34. The complex and dynamic nature of capacity building points to the need for a country-specific approach to identifying, analyzing, and addressing capacity constraints. Box 5.3 provides a preliminary assessment of Ethiopia's ability to achieve the MDGs, and the impact of labor, macroeconomic, and infrastructure constraints to resource absorption. The modeling framework helps capture country and sector-specific constraints (such as skilled labor shortages), the cross-effects from investing in related MDGs, and the role of sequencing investment. The simulation results show that it is possible to achieve the MDG targets by scaling up aid (grant financing)—roughly a doubling of aid (as a share of GDP) by 2015. They also help illustrate key absorptive capacity constraints, the limits to frontloading of disbursements, and the importance of care in sequencing the increase in aid and associated investment.

An improving environment for aid absorption

35. The policy and institutional environment in developing countries has steadily improved in recent years, creating a better environment for scaling up aid. Along with pursuing sound macroeconomic policies and better public sector management, developing countries have strengthened institutional quality, improved public sector governance, pursued wide-ranging structural reforms, and adopted policies of social inclusion and equity. The overall improvement in policy frameworks and institutional performance has contributed to faster growth in these countries. The average quality of policies and institutions has risen as measured by the CPIA over the past five years; improvements in some areas such as institutions and public sector management have lagged those in others, but the overall upward trend is widespread. In tandem, output growth has more than doubled over the average rate of the 1990s; low-income regions such as South Asia and Sub-Saharan Africa are seeing much stronger growth.³¹

36. A Development Committee report (2003) assessed the capacity of 18 better performing, low-income countries to effectively use more aid to achieve the MDGs.³² The report found that the five large Asian countries in the sample (Bangladesh, India, Indonesia, Pakistan, and Vietnam) could effectively absorb an immediate doubling or more of aid. Some Sub-Saharan African countries such as Ethiopia and Madagascar could, with substantial policy reform, absorb a doubling of aid as well. Overall, all the Sub-Saharan countries in the sample were found to have the capacity to use additional aid productively if they continued and strengthened their reforms. Of course, there was considerable variation in absorptive capacity across countries.

37. As the relevance of the Poverty Reduction Strategy approach continues to grow, the enabling environment for growth and poverty reduction is expected to improve further. In low-income countries the Poverty Reduction Strategy Paper provides the strategic and operational framework for programs and policy reforms to promote growth and reduce poverty. It is also now broadly viewed as the key operational vehicle for achieving the MDGs. As of end-February, 2005, 47 countries had prepared full PRSPs and another 12 had prepared I-PRSPs.³³ Of these, 33 are Sub-Saharan countries. Solid progress has been achieved in many aspects of the PRSP approach, but a key challenge going forward is to deepen implementation on the ground.³⁴

³¹ World Bank (2004a).

³² Development Committee (2003).

³³ Of the 47 full-PRSP countries, 22 had produced at least one annual progress report as of the same date.

³⁴ For more on the PRSP process and related agenda see Chapter 1.

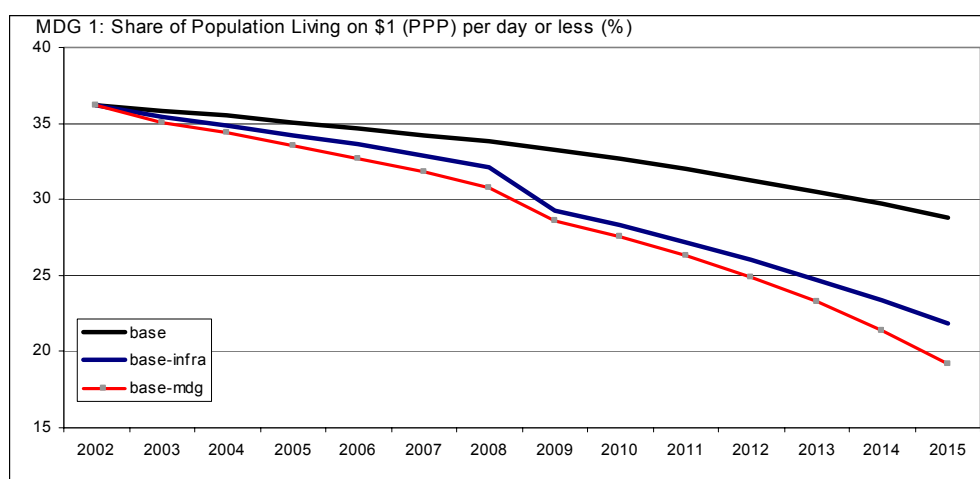
5. Increasing Aid and Its Effectiveness

Box 5.3. Addressing absorptive capacity: the case of Ethiopia

Government policies and the flow of foreign aid required to target the MDGs have strong economy-wide effects, which, through markets for labor, goods, services, and foreign exchange, feed back on the MDG targets. Measuring and projecting MDG costs and achievements must therefore be based on an economy-wide approach that can complement in-depth sector-specific studies. To examine these macro-micro linkages for Ethiopia—a very poor country for which the MDGs pose enormous challenges—a model has been calibrated to Ethiopian data to capture select macro and sector-specific constraints.³⁵ Simulations of progress towards the MDGs are possible that reflect, in particular, labor market, infrastructure, and macroeconomic constraints.

Figure 1 shows the projected level of income poverty incidence through 2015 under three scenarios.³⁶ Scenario 1 is a continuation of present trends. Growth follows the past decadal trend rate (3.6 percent), external aid levels increase marginally (1.5 percent per annum) above the current level [\$16 per capita], and there is modest investment in physical infrastructure. Under this scenario Ethiopia will fall *significantly short* on all of the MDGs. Under this ‘base case’ the poverty rate falls from its current level of around 35 percent to a level of 29 percent over the decade. Progress towards the other MDGs also shows a significant shortfall.³⁷

Figure 1. Projected income poverty incidence (MDG1) 2003-2015 (Headcount index)



The second scenario adds public investment in basic infrastructure which is considered critical to growth. Without this investment—in roads and transport, energy, and irrigation serve to connect markets and support growth—Ethiopia cannot reach MDG1, to halve income poverty. The network effects from improved infrastructure enable returns to private sector activities—marketing, worker productivity, agricultural yields, etc.—to rise over time.³⁸ This requires about a 15 percent increase in foreign grants relative to the base case. After 2009, productivity gains help to boost growth to nearly 5 percent, and poverty reduction is accelerated, falling to 22 percent.

In the third scenario the core investment in public services is included at levels required to reach each of the core human development targets—100 percent primary education completion, halving of under-five mortality, reducing maternal mortality by 75 percent, and halving the population share without access

³⁵ The results of the Ethiopia MAquette for MDG Simulation (MAMS) simulations are described in detail in Bourguignon et al (2004), and technical details of the model are available in Lofgren et al 2004.

³⁶ Projections employ the Ethiopia MAMS model, parameterized using data from the Ethiopian poverty assessment ‘Well Being and Poverty in Ethiopia: The Role of Agriculture and Agency, World Bank, 2005.

³⁷ The simulation exercise considers five MDGs: halving poverty and hunger; achieving universal primary education; reducing by two-thirds the under-5 child mortality rate; reducing by three-fourths the maternal mortality rate; and improving access to safe water and basic sanitation.

³⁸ Infrastructure investment is frontloaded, growing initially by 10% until 2009, and 5% thereafter reflecting network effect (see *Ethiopia: A Strategy to Balance and Stimulate Growth*, World Bank, January 2005).

5. Increasing Aid and Its Effectiveness

to improved water and sanitation services. This ‘MDG scenario’ requires a gradual but substantial increase in foreign grants, rising to around \$60 per capita, or 40% of GDP by 2015, or roughly *twice* the current level of aid as a share of GDP.

These scenarios illustrate some key points. It is possible to achieve the MDG targets *provided there is adequate external grant financing, and expansion of MDG services are accompanied by investment in basic infrastructure to raise growth*. Additional aid is essential. Financing this domestically would reduce income growth, lower household consumption, and deepen poverty, even as some of the human-development MDGs may be achieved. Investment in basic infrastructure is also key to supporting economic expansion. Without improving growth performance income-poverty goals will not be achieved. In the short run this requires improving physical infrastructure, whereas investing in human development has a longer-term impact growth.

This framework helps illustrate the important role of absorptive capacity and the lags inherent in expanding capacity. Consider investing to achieve MDG2—100 percent primary education completion by 2015. Ethiopia at present has an estimated 75,000 teachers and a student teacher ratio of around 75:1. In order to meet the MDG2 target, sector studies indicate that more than 52,000 additional teachers will need to be trained and deployed by 2015 with an unchanged student-teacher ratio, whereas as much as 160,000 more teachers would be required for a much needed reduction in the student-teacher ratio to 40:1. Recruiting teachers to meet this demand requires either increasing supply of skilled labor to overcome this constraint—a gradual process with a lagged response—or raising real wages to hire skilled labor away from alternative uses. But raising wages to bid away skilled labor has adverse consequences. It reduces skilled labor from the private sector, effectively crowding out private growth. It also raises public sector labor costs, pushing up the unit costs of public services.

Constraints to absorptive capacity are also evident in the *macroeconomic impact* of higher aid flows. Aid flows permit a larger trade deficit and increases the demand for domestic goods and services. This puts upward pressure on the exchange rate and reduces competitiveness of both exports and import competing goods. Over time this can shift the economy away from production for trade, and make it more dependent on aid flows. This ‘Dutch disease’ impact can impose a cost in terms of future growth and the ability of the economy to generate exports. In the third scenario above, which requires roughly a doubling of aid to GDP by 2015, the real exchange rate appreciates and harms export growth, leading to shrinkage of the export sector. This underscores the importance of other policy measures to offset these costs, in particular improvements in the business environment and trade reforms to improve market access and reduce behind-the-border barriers to export productivity.

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

Finally, there are also important implications for the pace of investing in the MDGs and the impact of frontloading disbursements to accelerate improvement. Frontloading infrastructure investment helps accelerate productivity gains, and poses less of a macroeconomic constraint because it is more import-intensive, and thereby has less impact on the exchange rate. However, frontloading aid to accelerate provision of social and other MDG services runs into absorptive capacity constraints relatively quickly. Real wages rise, appreciation of the exchange rate is evident, and growth is compromised. A series of simulations suggests that the cost-minimizing share of spending on MDG services over the first five years for Ethiopia is around one-fifth of total expenditures by 2015 (in present-value terms) to meet goals related to these services (excluding basic infrastructure).³⁹

Source: Bourguignon et al (2005), “Building Absorptive Capacity to Meet the MDGs.”

³⁹ Note however, that although this is cost-minimizing, it may not be welfare maximizing since this has not compared differences in the service delivery path.

5. Increasing Aid and Its Effectiveness

38. Countries are giving increasing attention to improving public expenditure management capacity (PEM), which is key for effective aid utilization. By strengthening PEM systems, available public resources can be aligned better with announced development priorities, and the budget process can be made more transparent. In many cases significant changes to PEM have been adopted or are planned, and country strategies increasingly include measures to enhance PEM.⁴⁰ Sustained government commitment and strong, well-coordinated donor assistance can boost progress on strengthening PEM capacity.

39. *PRSP and budget linkages: progress in aid delivery in Sub-Saharan Africa.* Several recent studies have reviewed budgets in highly aid-dependent countries to assess how PRSPs have helped in improving aid delivery. The country-level empirical evidence shows that the PRSP process has fostered improvements, although there is much room for improvement.⁴¹

40. *Uganda.* The country has seen a sharp increase in foreign aid of nearly 5 percentage points of GDP between 1997/98 and 2001/02. The increase has been in budget support, with 60 percent of it in grants and the remaining in concessional loans. Uganda's experience with untied budget support—PRSCs from the World Bank, which are a series of annual credits supporting a three year rolling program of reforms, and grants from other donors—in support of it.⁴² Poverty Reduction Action Plan demonstrates that it has helped to make the overall budget envelope more predictable and helped to boost service delivery, especially to the poor.⁴³ The ratio of actual disbursements to amounts initially programmed has risen steadily from under 40 percent in 1998/99 to over 85 percent in 2002/03. During this period, the deviations in overall budget outturn and allocations narrowed with the discrepancy index falling from nearly 10 percent to 5.5 percent.⁴⁴ Along with improved predictability of resources, the amount of budget allocated to the Poverty Action Fund has more than doubled from 17 percent in 1997/98 to 37 percent in 2002/03.

41. *Tanzania.* Foreign assistance has more than doubled during 1999-2003, and donors are financing about 90 percent of Tanzania's development budget.⁴⁵ Increases in donor financing are associated with increases in priority sector spending.⁴⁶ With PRSP implementation, government spending on priority sectors has continuously increased and by FY02, spending for priority sectors was above aid amounts (figure 5.7). But donor funds still exceed core priority area expenditure, implying that there is scope for sharpening donor focus on core priority areas. As donors align with national priorities, there is also scope to better integrate donor support into the budget.⁴⁷ Aid continues to be highly variable, and though the variability of aid has declined in

⁴⁰ See IDA-IMF (2005) and box 2.11 in Chapter 2 for results from the just concluded joint IMF-WB poverty-reducing public spending tracking exercise for HIPC countries.

⁴¹ See Alonso, Judge and Klugman (2004) for a comparative analysis of PRSP and budget linkages in four countries.

⁴² The PRSC has also facilitated donor coordination and shifted greater amounts of aid in direct budget support. Bilateral donors providing budget support include Belgium, Ireland, Netherlands, Sweden, United Kingdom, and United States.

⁴³ Miovic (2004). Input-level data show that much larger amount of resources have been channeled to basic health, education, and water and sanitation.

⁴⁴ While the overall performance was stable, there were within-year budget fluctuations in some sectors of the budget.

⁴⁵ Alonso and Utz (2004).

⁴⁶ Per capita expenditure allocated to priority sectors increased by 53 percent between FY99 to FY02, and the core priority areas saw a rising trend in expenditure as well, with expenditure increasing by 77 percent between 1999-2002. The much larger increase in the core priority areas was because of the donor-funded Primary Education Development Program.

⁴⁷ Tanzania has a large number – approximately 650 – of donor projects being implemented by sector ministries and local governments. One of the four priorities of the Tanzanian Assistance Strategy *Implementation Action Plan* agreed in 2003 by government and development partners is to integrate donor funds – including projects – into the government budget. To this end, the government has created a special mechanism – that links information to government accounts – for donors to use in channeling funds to projects, NGOs and the private sector. It has also provided relevant training to interested donor agencies. As of August 2004, however, only four of Tanzania's development partners had indicated their readiness to use this facility. See Peretz and Wangwe (2004).

5. Increasing Aid and Its Effectiveness

recent years it exceeds that of domestic revenues. Within year variability of aid flows is substantial as well.

42. Burkina Faso. With foreign assistance comprising a substantial part of the budget (40 percent), donor alignment with national priorities is paramount to successful implementation of the PRSP in Burkina Faso. Aid is increasingly aligned with priority sectors as evidenced by the narrowing gap between foreign assistance and spending on priority sectors and core priority areas.^{48, 49} Nevertheless, the gap between development assistance and the amount of spending on core priority areas remains high at about 4 percentage points of GDP. This implies that foreign assistance is being spent on non-core priority areas (figure 5.7). Since the PRSP, donors also are shifting the composition of aid towards budget support. Thus, program loans and grants have increased from 2.6 percent of GDP to 4 percent of GDP over 1998-2002 and project loans and grants have declined from 8.5 percent of GDP to 6.6 percent. The in-year variability of aid is large, however. During 1996-2000, about 60 percent of aid disbursements were in the last quarter of the year. This bunching of assistance, which is usually not synchronized with the budget cycle, makes it difficult for the recipient country to finance its budget in an effective way. Receiving funds at the beginning of the fiscal year would contribute to better public expenditure management. Gaps between PRS projections and actual expenditures can be both large and variable. The gaps in primary education expenditure are apparently due to the shortfall in foreign financing, i.e. gap between projected and actual foreign financing. When foreign financing has been late in coming or postponed, this is reflected in a gap between PRS projections and actual expenditures. When foreign financing has been delivered as projected, then this gap is relatively low.

43. *Country-level studies on scaling up*. Scaling up of development efforts is occurring at national, state, and community levels. The Shanghai conference (May 2004) showcased a number of country examples of successful efforts to reduce poverty and expand access to health, education, water and other key services (box 5.4). The country experiences demonstrate a broad range of interventions that can scale up poverty reduction and that countries have been able to implement successfully. They reinforce some of the factors that are shown by other evidence as common to successful scaling up: institutional and policy change; innovation, learning, and adaptation; political leadership and sustained commitment; partnership with all stakeholders (which is key for service delivery); and supportive external environment

44. Country-level evidence, recent research, a better understanding of how to address absorptive capacity constraints, prospects of a continuing favorable trend in policies and institutions, and a stronger focus on governance all show that countries have increased, and continue to increase, their capacity to absorb aid productively. Prospects vary by country, however. Many low-income countries are well positioned to effectively absorb a scaling up of aid. In some countries, especially difficult partnership countries (DPCs), absorptive capacity can be a significant obstacle to scaling up and innovative ways of channeling aid are needed. In all cases, a country-specific approach anchored in the poverty reduction strategy (or joint needs assessment, such as the UN/WB Post-Conflict Needs Assessment, and results based frameworks, such as Transitional Results Matrix, for DPCs) is required for assessing financing needs, identifying and addressing capacity constraints, and appropriately sequencing incremental financing and investment.

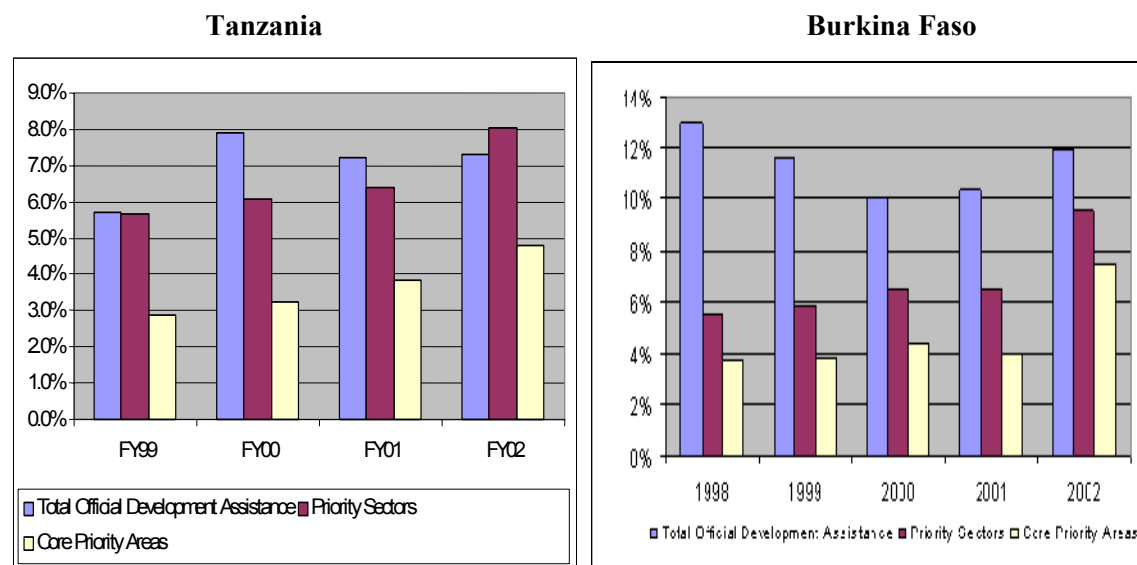
⁴⁸ Alonso (2004).

⁴⁹ Although priority sectors are seeing higher spending their share in the total budget is largely unchanged, even with HIPC funds earmarked for priority sectors. Real expenditure devoted to the priority sectors has increased between the start of the PRSP in 1999 and 2002. The improvement is also in real per capita terms. Moreover, core priority expenditure has increased in tandem (core priority expenditure has doubled in real per capita terms). Real per capita expenditure in priority sectors and core priority areas has doubled during 1998-2002. The increase in the allocation of expenditure between the core priority areas has been quite uneven, however.

5. Increasing Aid and Its Effectiveness

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

Development assistance and spending on priority sectors and core priority areas (as a percentage of GDP)



Source: Alonso and Utz 2004; Alonso 2004.

Box 5.4 Scaling up development efforts

The Shanghai conference presented a number of country cases of successful efforts and interventions to reduce poverty and scale up key service delivery. Below are two examples of successful scaling initiatives.

El Salvador's education reform attains universal primary school enrollment. Years of conflict had weakened the country's education system, and by the end of the 1980s over a fourth of the population was illiterate and 20 percent of primary-school-age children were not in the system. Beginning in the early 1990s, the country started reforming the education system. The reforms transferred resources and decision-making to stakeholders such as schools, local communities, and parents. Public spending on education rose from 1.9 percent of GDP to 3.3 percent over 1992-2002. The share of the government's education budget devoted to basic education rose to 75 percent from 71 percent over 1996-2001. The program especially targeted low-income and rural area. The education reforms, which were supported by World Bank sector loans, were successful in helping the country to achieve a primary enrollment rate of 112 and a secondary enrollment rate of 56 percent (more than double that of 10 years ago). El Salvador's successful education program has spurred similar innovations in Guatemala and Honduras.

Indonesia's rural community-based program for small-scale infrastructure. Indonesia's Kecamatan Development Program (KDP) is a community-based operation to alleviate rural poverty. It began as a small program in 1997 in 25 villages and by 2003 it had been scaled up to 28,000 villages. KDP provides rural communities with block grants to build small-scale productive infrastructure. The communities receive the transfers at the beginning of the planning cycle, providing certainty of funding. Planning and decision-making activities are directly with the local communities, i.e. decentralized execution. In a relatively short period of 7 years, the program has reached 35 million people. Other Social funds which have involved communities in the planning and decision-making process such as in Yemen, Malawi, and Zambia have likewise had national scope and impact.

Source: Shanghai Conference and World Bank 2003.

III. Making Aid More Effective

45. The way aid is allocated and delivered is as important an issue as aid volume in achieving the MDGs. The broad consensus that has emerged is that development assistance is particularly effective in poor countries with sound policy and institutional environment.⁵⁰ Even as donors are allocating more aid to better performers, increasing attention is being focused on the special needs of difficult partnership countries and on seeing how to make aid effective in these economies. A critical dimension of aid effectiveness is the way it is delivered. Donors need to provide assistance in ways that are aligned with country-based and -led development priorities as articulated in the PRSP or other equivalent national development strategy. As well, they should disburse aid in effective ways—reducing the burden of processes, procedures, and requirements and making aid more predictable. Along with improving the delivery mechanism of aid, a stronger focus is needed on the results agenda. This calls for a move from “accounting by inputs” to practical ways for “accounting for outputs.” Equally important to improving aid effectiveness is the need for more coherence in donor policies.

Aid selectivity

46. Donors are becoming more performance focused. Aid allocations reflect a sharper focus on both policy performance and poverty. The policy selectivity index, which measures the elasticity of aid with respect to the quality of policies and institutions (CPIA), shows a generally improving trend for overall aid in 1999-2003 (table 5.1).⁵¹ This positive trend has to a large extent been fueled by the sharpening policy focus of multilateral assistance. The relationship between overall aid and policy selectivity is much stronger for multilateral aid than for bilateral aid. However, bilateral aid does exhibit a significantly positive relationship with the quality of recipients’ policies and institutions: for more than 80 percent of bilateral donors this relationship is positive, and for more than half of them the relationship is statistically significant. Although mirroring the overall improving trend in policy selectivity of assistance, some of the largest bilateral donors are less selective. Donors’ poverty focus has strengthened as well, as reflected in the rise in the poverty elasticity index (elasticity of aid with respect to recipients’ per capita income level). Thus, more aid is being allocated to poorer countries by both bilateral and multilateral donors.

47. Since the various components of aid are far from homogenous, it is not surprising to see substantial variation in the policy and poverty sensitivity of the different types of aid. The results for disaggregated aid indicate that flexible ODA is more sensitive to policy performance than technical cooperation.⁵² A 100 percent increase in the quality of recipients’ policies and institutions is on average associated with a more than 250 percent increase in flexible ODA. Technical cooperation by contrast is not sensitive to quality of policies and institutions. This category of aid is also the least selective with respect to poverty, reflecting the fact that technical

⁵⁰ As noted earlier, there is considerable debate in the recent economic literature on the impact of aid on growth. A recent study by Dollar and Levin (2005) adds micro evidence to the macro results in the literature. The study finds a strong link between institutional quality and aid-financed project outcomes. The results support the findings of cross-country studies that find aid to be effective in good institutional environments. In various specifications of the regressions the most robust results are for rule of law. Also, geography does matter as countries in SSA have lower successful outcomes of projects (although tropical location does not significantly affect outcomes). The study also finds that different institutions have different effects on project success. The quality of democratic political institutions contributes to the success of policy-based loans: thus, better democratic political institutions result in better outcomes for policy-based loans. Whereas the success rate for project loans are facilitated by better property rights/rule of law. This is consistent with the growth literature that finds a favorable link between property rights and economic growth.

⁵¹ Based on Dollar and Levin (2004)

⁵² Flexible ODA is defined here as total ODA less special-purpose grants—such as technical cooperation, debt relief, emergency and disaster relief, and food aid.

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cooperation is provided to a broad range of countries—special need and conflict countries, which have extremely weak institutional capacity, to middle-income countries with institutional capacity gaps in narrowly defined areas. The results suggest that the scope for improving the allocation of aid through altering its composition is potentially large.

Table 5.1 Selectivity in aid allocation: donors' policy and poverty focus is improving, but bilateral donors could do more

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

* Significant at the 10 percent level or higher.

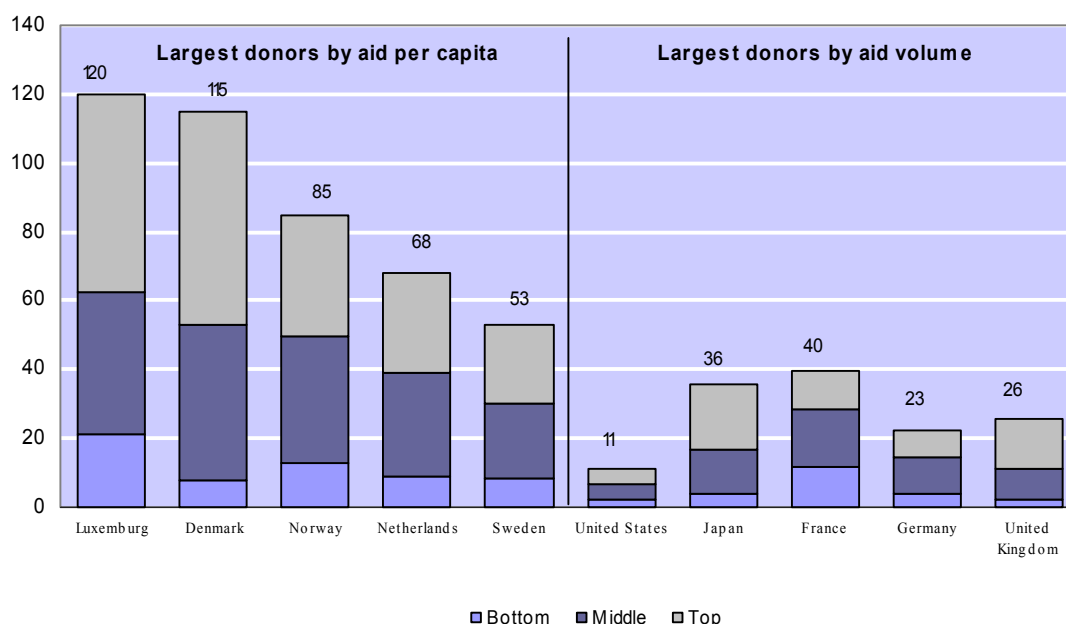
Source: Levin 2005.

48. Donor focus on performance is stronger in low-income countries. Thus, some donors that are not very selective in overall aid allocations, nevertheless tend to favor better performers among poor countries. The allocation of aid to the top third of recipients as measured by the CPIA averages 40 percent (figure 5.8). Likewise, the bottom third of recipients as measured by the CPIA receive roughly 17 percent on average. There is wide variation in donor effort directed at low-income countries (i.e. IDA-eligible countries). Among countries that have consistently (1999-2003) been the top providers of assistance per donor country citizen to low-income countries are Denmark (with an annual average of \$62 per Danish citizen out of a total of \$115 directed to the top third of policy performers in low-income countries), Luxembourg (\$57 out of \$120), Norway (\$35 out of \$85), Netherlands (\$29 out of \$68), and Sweden (\$23 out of \$53). Comparable amounts for some of the largest donors are \$4 out of \$11 for the United States and \$11 out of \$40 for France. The more generous donors in terms of per capita aid effort are also in general more selective.

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

Distribution of aid per bilateral donor country's capita by quality of policies and institutions in IDA-eligible countries (average for 1999–2003 in \$ per capita)



Note: IDA-eligible countries are divided into three groups—Bottom, Middle, and Top—using the 33.3 and 66.7 percentiles of quality of policies and institutions as measured by the CPIA.

Source: Based on Levin 2005.

Aid effectiveness in difficult partnership countries

49. As bilateral donors move towards more policy and poverty selectivity in aid allocation, there is concern that difficult partnership countries (DPCs) may be “under funded.”⁵³ Empirical evidence shows that DPCs are receiving disproportionately lower aid volumes than predicted by their policy and institutional environment.⁵⁴ DPCs receive roughly 40 percent less assistance than predicted by their policy and institutional rating (figure 5.9). There is wide variation among DPCs, with the so-called “aid orphans” receiving relatively much less aid and the “aid darlings” receiving much larger amounts of aid than can be explained by policy and poverty criteria. While not all difficult partnership countries should receive higher aid, the results suggest that some increase in overall aid to the DPCs as a group would not compromise the performance basis of aid.^{55, 56}

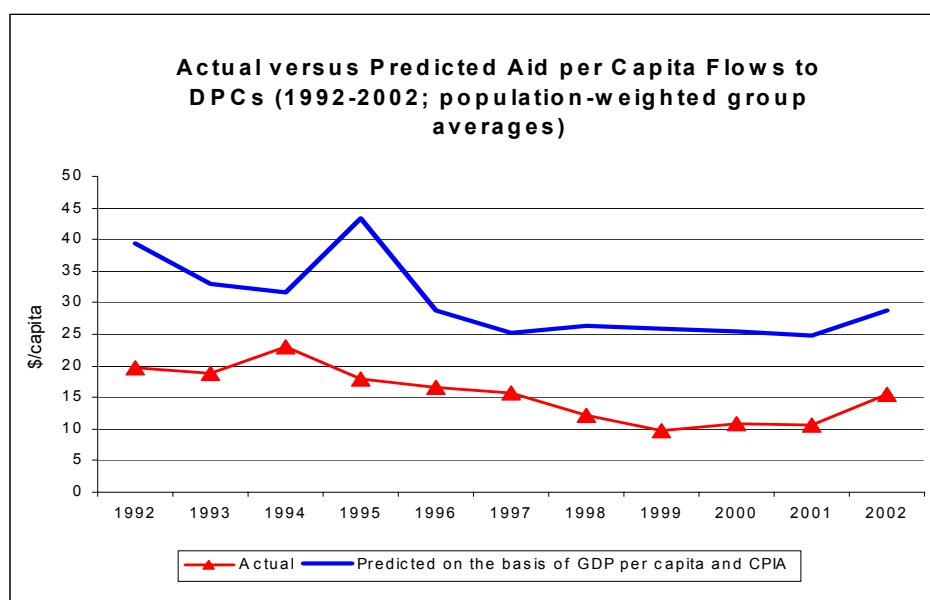
⁵³ Difficult partnership countries (which include LICUS) are low-income countries with weak institutions, i.e. with CPIA scores in the bottom 2 quintiles.

⁵⁴ Levin and Dollar (2005).

⁵⁵ Current models of aid allocation need to be extended to better reflect the costs of conflict and the benefits of conflict prevention on growth and poverty reduction.

⁵⁶ Also see Chalmers (2004) and Chauvet and Collier (2004) for evidence on the potentially large effects of aid in DPCs. Aid reduces the risk of conflict by raising economic growth.

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Figure 5.9 DPCs receive less aid than predicted by their policy/institutional quality and poverty levels

Source: Levin and Dollar (2005).

50. Recent empirical studies find that post-conflict countries are able to absorb higher amounts of aid than other low-income countries with similar levels of poverty and institutions. Aid allocation patterns in post-conflict periods show an increase in aid in the first few years after the end of a conflict, followed by a drop off. Kang and Meernik (2004) find that, compared to conflict levels per capita aid is generally higher by \$2 in the second post-conflict year, rising and peaking at around \$9 per capita in the fourth post-conflict year.⁵⁷ Collier et al (2003) find that the increase is higher in the first 2 years before falling off. But post-conflict countries can effectively absorb higher levels of aid in later periods when their capacity to absorb aid has increased, so higher aid sustained over a longer period is more desirable for ensuring a turnaround in these countries.⁵⁸ Thus, donors need to provide assistance for a longer period (an example is Sierra Leone's 10-year development plan) so as to rebuild weak capacity and obtain desired results of restarting growth and reducing poverty.⁵⁹

51. Because these countries have weak capacity and risky environment, the challenge of delivering effective aid is considerable.⁶⁰ Aid should be focused on building capacity and providing key services through innovative mechanisms. Some successful approaches are emerging, including those which feature the use of local level institutions for service delivery, and those that work with non-state actors in ways designed for eventual transfer to state delivery.⁶¹ The appropriate aid modality is likely to vary by country situation. But to be effective, aid needs to be better coordinated to minimize the problem of aid darlings and orphans and also better sequenced and sustained.

⁵⁷ Kang and Meernik. 2002. "Determinants of Post-Conflict Economic Assistance." *Journal of Peace Research*.

⁵⁸ By contrast, aid has typically been inadequate and mistimed, phasing out just when it should be phasing in.

⁵⁹ See OECD (2005d) for how donors are moving forward on improving the effectiveness of their aid to fragile states.

⁶⁰ DPCs, especially countries emerging from conflicts and post-conflict countries, often need to rebuild basic institutions of state, civil society, and private sector.

⁶¹ See Chapter 3 for more on service delivery in countries under stress

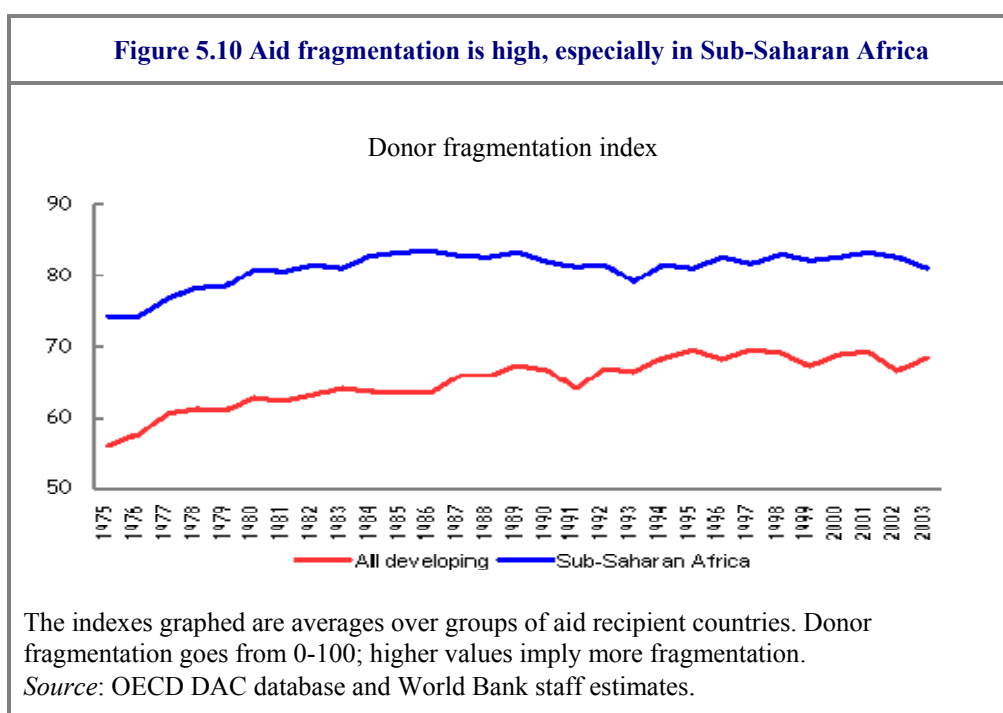
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Aid fragmentation

52. Donor fragmentation remains high in developing countries. A donor fragmentation index, constructed from shares of individual bilateral donors in annual bilateral aid flows to a country, shows that the degree of fragmentation in 2003 was largely unchanged at 68—the level in the previous year was 67 (figure 5.10). High fragmentation can have negative implications for aid quality for several reasons: high transaction costs for recipients because more time is taken up meeting donor requirements; too many small projects, with consequent limited opportunities to reap scale economies; and smaller or narrower donor stake in the overall country outcome.⁶² A large number of donors also compounds the challenge of donor coordination. A number of DAC members are looking at measures to limit the number of countries on which they focus.

53. Donor fragmentation is even more severe in Sub-Saharan Africa. The donor fragmentation index for 2003 is 81. The high degree of donor fragmentation is especially surprising given that aid tends to be concentrated in a relatively few countries: 60 percent of bilateral aid to the region is concentrated in 10 countries. The empirical evidence shows that although donors have their favorite countries, they like to be present in many countries in the region. On average, a recipient country in Sub-Saharan Africa received aid from 25 different donors per year in the past two decades. The number of donors varies, ranging from 16 for Gabon to 37 for Ethiopia in 2003.

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

**Untying aid**

54. Untying of aid is a significant way to increase its effectiveness, yet large amounts of bilateral ODA continue to be tied. The DAC recommends untying of all aid, excluding technical cooperation and food aid, to the least developed countries.⁶³ Almost all DAC countries have largely implemented these provisions, but four donors, including the largest donor (United States), do not report on the tying status of their bilateral ODA. Also, technical cooperation,

⁶² Knack and Rehman (2004).

⁶³ A DAC High Level Meeting in April 2001 adopted recommendations to untie ODA to the least developed countries.

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which accounts for over a third of bilateral ODA and is largely spent on source-country expertise, is essentially a form of tied aid. Although substantially smaller, food aid (excluding humanitarian assistance) is mostly tied as well. Tying of aid is costly for recipients, however. A recent OECD study finds that untying food aid allows access to up to 50 percent more beneficiaries than tied aid.⁶⁴ Other studies also have found that untying aid (project aid) yields sizable savings.⁶⁵ More progress on untying categories of aid that are currently tied and/or broadening coverage to other developing countries would improve the effectiveness of aid. DAC members are considering several options to broaden the scope of recommendations on the untying of aid. At the recently concluded Paris High-Level Forum, DAC donors agreed to continue to make progress on untying aid and to monitor this progress through an indicator that measures the share of bilateral aid that is untied.⁶⁶

Progress on harmonization, alignment, and results

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

Implementing harmonization and alignment

56. The Rome High-Level Forum (February 2003) provided an impetus to implementing alignment and harmonization, and this global agenda was the focus at the recent Paris High-Level Forum on Aid Effectiveness at which Ministers and senior officials from over 90 developed and developing countries and the 25 Heads of multilateral and bilateral reaffirmed their commitment to the Rome Declaration. Evidence from the OECD DAC Working Party on Aid Effectiveness⁶⁷ (WP-EFF) survey, the Strategic Partnership for Africa (SPA) surveys, and ECA-OECD DAC Mutual Review of Development Effectiveness in the Context of NEPAD show that partner countries and donors are working together and taking some actions to improve coordination and aid effectiveness (box 5.5). In African countries, the SPA surveys and the ECA-OECD DAC report find that while progress is being made, that progress has been uneven and has largely been concentrated in those countries which have worked the longest and hardest to take ownership over the aid process (box 5.6). By the end of 2004 more than 60 partner countries (worldwide) and 40 bilateral and multilateral agencies were engaged in some harmonization and alignment activities. The challenge remains to ensure that the broad range of activities which are taking place, and the energy and creativity driving it, contribute to achieving greater aid effectiveness.

57. *Progress on aid management and alignment.* The WP-EFF has begun to quantify progress toward the harmonization and alignment commitments which were adopted in the Rome Declaration in February 2003. Following the Rome meeting a set of country-level indicators were developed, and the WP-EFF undertook surveys of harmonization and alignment in fourteen

⁶⁴ OECD (2004a).

⁶⁵ Aryeetey et al (2003) find the savings to be in the range of 11-25 percent and Jepma (1991) 15-30 percent.

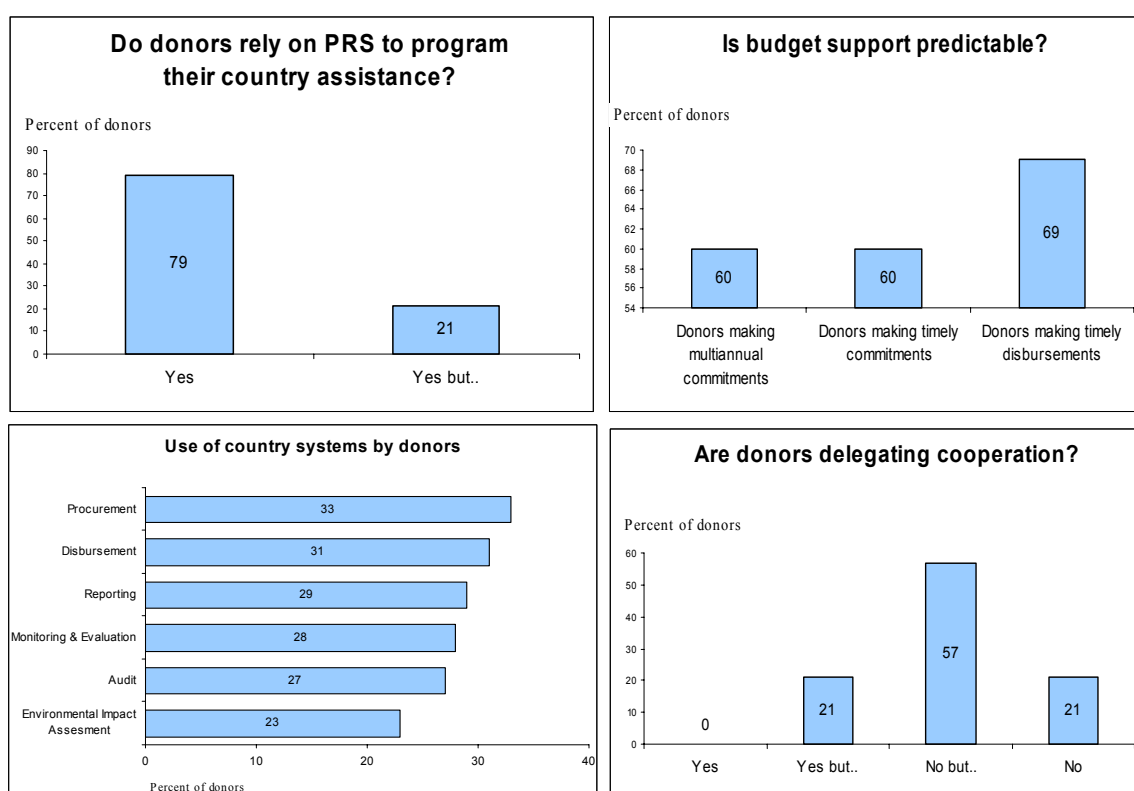
⁶⁶ Also see table 5.3 and OECD (2005e).

⁶⁷ OECD (2004a). WP-EFF is a grouping of bilateral and multilateral donors which formed after Rome to monitor and assist progress toward harmonization and alignment globally.

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partner countries self-identified at the Rome High-Level Forum as being interested in pursuing harmonization efforts.⁶⁸ The Working Party's survey found that donors have internalized the principle of aligning their programming to the needs and priorities identified in the PRSs. Over three-quarters of all the donors consulted indicated they were relying exclusively on the PRS to program their country assistance and only 21 percent chose to express reservations (figure 5.11).⁶⁹ However, the WP-EFF and SPA surveys found that the number of examples of collaborative approaches to harmonizing assistance strategies among donors around agreed country priorities is small, and they found little evidence that, overall, donors have adapted their ongoing programs in support of national growth/poverty strategy priorities. Furthermore, in a number of countries the growth/poverty strategies are still typically broad and while donors may be aligned with broad categories—i.e. priority sectors—this may not imply alignment with core priority areas.

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



Source: WP-EFF Survey

58. *Flexibility and predictability of aid.* There has been some progress in improving the flexibility and predictability of aid. Budget support is often viewed by partner governments as a motion of confidence in support of the country's development policies and processes. Multi-annual funding commitments and timely disbursements allow partners to plan their medium term

⁶⁸ The 14 partner countries surveyed were Bangladesh, Bolivia, Cambodia, Ethiopia, Fiji, Kyrgyz Republic, Morocco, Mozambique, Nicaragua, Niger, Senegal, Tanzania, Vietnam, and Zambia. These countries, along with Mali, are associated with the work of the Task Team on H&A, a sub-group of the Working Party. In addition, South Africa participates in the Joint Venture on Public Financial Management, another group under the WP-EFF.

⁶⁹ This is like the case, for example, when donors disagree with specific items of partner country policies (e.g. government's resettlement policies).

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macro-economic and fiscal projections. Of course, an important pre-requisite for efficient use of budget support is effective public expenditure management systems. Countries are making progress on strengthening PEM systems and public financial management (see section 2). For countries that receive budget support, figure 5.12 shows that 60 percent of donors provide multi-annual commitments and timely commitments, and 69 percent of donors disburse budget support on schedule. Notwithstanding these numbers, further progress is hampered by insufficient clarity about policy and investment priorities and the absence of a robust medium-term framework that links these priorities to the country's budget and spending decisions and timetables. There is considerable variation in donor behavior across countries. Thus, while 93 percent of donors make multiannual commitments on budget support in Tanzania and 79 percent in Mozambique, only 40 percent do so in Bangladesh and a mere 20 percent in the case of Zambia.

59. The SPA survey finds that for Africa as a whole, budget support did increase, from about \$1.5 billion in 2002 to about \$2.5 billion in 2003.⁷⁰ For five countries this support amounted to between 5 and 7 percent of GDP, while for another five, it amounted to between 3 and 5 percent of GDP. Four donors (the World Bank, UK, EC and the Netherlands) provided over 25 percent of their support to the survey countries in the form of budget support. The OECD DAC-UNECA report finds that despite an increase in budget and sector support among good performers, there is little change in the overall aid landscape in Africa. Projects are still the dominant aid delivery mode, particularly as concerns bilateral development assistance, often administered outside partner oversight and control. Also, capacity development efforts continue to fall outside mainstream aid coordination and effectiveness efforts: they are still invariably piecemeal, atomistic, and supply driven. However, coordinated multi-donor budget support efforts are emerging in several, particularly where aid relationships are characterized by mutual trust and accountability.

60. *Limited use of country systems.* Donors continue to make limited use of country systems. One of the cornerstones of the Rome agenda was the provision of development assistance in ways that build partners' sustainable capacity to develop policies, implement them, and account for these activities to their people and legislature. This means increased reliance on partners' own systems and procedures to manage aid. At the present time, few donors reported using country systems (for financial reporting, disbursement, procurement, audit, monitoring and evaluation) and there are very significant disparities between the 14 countries in this area.⁷¹ On average, donors reported that only about 29 percent of their portfolio of projects is managed according to national procedures. Results from the Working Party Survey ranged from 23 percent of donors who said they rely on country systems for environmental impact assessments to 33 percent who use country procurement systems. Additional technical work has been done since Rome and Marrakech to develop criteria for assessing and strengthening country systems and for harmonising donor requirements around them. In several country programs, these criteria are guiding efforts among groups of donors to simplify and harmonise fiduciary, monitoring, and reporting arrangements.

61. *Sectorwide approaches.* Sectorwide approaches (SWAs) are used to support a country-led program for a sector in a comprehensive and coordinated manner. In 2003-04, multilateral institutions' middle- and low-income borrowers have shown increased interest in SWAs as a means for aligning around sectoral priorities. A growing number of SWAs are using countries; existing frameworks for channelling and accounting for funds, becoming an integral component of the harmonization and alignment agenda. In Brazil (health), India (education), Mexico (rural infrastructure), and Poland (roads), SWAs use country systems for procurement and financial management.

⁷⁰ SPA Budget Support Working Group (2004).

⁷¹ Country systems need to meet certain criteria for donors to rely on them.

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62. The SPA survey demonstrates that sector support operations are an important aid delivery mechanism for promoting and consolidating harmonization and alignment. The survey concluded that sector programs with strong elements of harmonization included joint consultations with stakeholders, analytic work, partner review and government reporting, and monitoring and evaluation. Alternatively, sector programs on procurement arrangements, disbursement mechanisms, financial management, and technical assistance and capacity building had very low elements of harmonization.

63. *Delegated cooperation.* Donors are also pursuing some delegated cooperation in some areas. The Rome Declaration encouraged donors to intensify their efforts to work through delegated co-operation at the country level as a means of reducing transaction costs through greater use of the comparative advantages of individual donors. For instance, in a delegated cooperation agreement being prepared for Ethiopia, Sweden will delegate its role in the health sector program to Norway, while Norway will delegate its role in the education sector program to Sweden. The level and form of delegation varies considerably, and the Working Party Survey revealed that there are actually very few examples of delegated cooperation. Only 21 percent of donors across 14 countries reported that they were delegating cooperation. In terms of joint missions and diagnostic reviews, on average, less than 8 percent of donor missions were carried out jointly.⁷²

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

Cambodia. Developing country ownership is a process that takes time, patience, perseverance, and resources. To address the problems of poor aid management, the government and donors launched various initiatives since the formation of a new coalition government in the late 1990s. The multi-donor three-year Technical Cooperation Action Plan was approved in May 2001 to assist the government strengthen its overall capacity to formulate and implement sound macroeconomic policies and to manage public finances more effectively. Cambodia has over the last few years started to connect to the global debate and is now a signatory to the Rome and Paris Declarations on harmonization. A number of positive developments, many occurring over 2004-05, have significantly improved the prospects for moving towards a more productive use of resources. For example, the Government has committed to merge three separate donor-funded strategies, the Second-Socio-Economic Development Plan 2001-05 (supported by the AsDB), Cambodia's Millennium Development Goals (supported by the UNDP), and the National Poverty Reduction Strategy (supported by the World Bank and the IMF) into one poverty-focused national development plan for 2006-10. Donors have responded with common country strategy development processes, joint analytic work, joint support in public financial management reform measures, sectorwide approaches (SWAs), and other types of collaboration. In November 2004, and together with the local donor community, the government developed a National Action Plan for Harmonization and Alignment which guides the implementation of the government's commitment to the Rome and Paris Declarations on ownership/leadership, capacity building, and harmonization and alignment. More recently, government-donor collaboration was further strengthened in public financial management reform areas under a sector-wide approach launched in late 2004.

Ethiopia. In many countries where the national systems are inadequate for donors to rely on, the donor community has bolstered collective action to help the country strengthen their national systems by stepping up capacity development efforts. Recognizing that public sector capacity-building efforts were largely supported by fragmented donor projects and ad hoc financing, the Government launched a consolidated five-year program to rapidly scale up capacity building and institutional transformation efforts in six crucial areas: a "woreda" (regional) decentralization program that rapidly transferred delivery responsibilities with substantial fiscal and administrative authority to rural jurisdictions; municipal reform efforts designed to restructure and empower urban centers; reformulated civil service reforms focused increasingly on strengthening public sector fiduciary framework and service delivery results on the ground; initiatives to enhance connectivity and develop e-government applications such as

⁷² WP-EFF 14-country survey

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the “woreda” —and school-net projects; efforts to reform of the justice system including the courts, law making and law enforcement institutions, and the legislative process; and an ongoing tax reform that strengthens tax policy and administration at the federal and regional level. In May 2003, the scale up process resulted in a SWAp—seven donors incorporated their financial support under the program by pooling funds under the approach and aligned their procedures with the Government’s planning, budgeting, and disbursement procedures.

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

Middle-Income Countries. Many middle-income countries have not elaborated an approach formally labeled “harmonization and alignment,” but have simply pursued relevant aspects of the agenda. In Brazil, India, Mexico, and Morocco, assistance often involves sectorwide approaches (SWAps) and increasingly relies on the use of country systems for financial management, disbursements, and procurement. Brazil’s Bolsa Familia SWAp, for example, integrates several pro-poor federal programs into one comprehensive program covering health, education, and nutrition, with program implementation streamlined into a single administrative and management mechanism. The Poland Road Maintenance and Rehabilitation project supports the country’s road rehabilitation and maintenance effort and is fully aligned with the Government’s program and budget cycle. Implementation of the program relies heavily on country systems for financial management, accounting, environmental safeguards.

Box 5.6 Mutual accountability in Mozambique: the donor “Performance Assessment Framework”⁷³

In all African multi-donor budget support arrangements, a framework for periodically assessing partner country performance is defined and agreed. In an innovative twist, government and donors in Mozambique have agreed to establish a performance assessment framework for the donor community as well. The objective is to monitor donor behavior regarding commitments, expose non-compliance and weaknesses to peer pressure, and strengthen donor accountability to government. Key features of this arrangement include:

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

64. *How recipients view donor efforts.* The SPA survey asked African governments to describe the level of satisfaction they had with donor behaviors across a number of dimensions. The results in presented in table 5.2 indicate that donors have made some progress between 2002 and 2003. There seems to be a higher degree of coordination (if not harmonization). Moreover, for the most part, satisfaction rose in countries with more experience and higher levels of budget support (Mozambique, Tanzania and Uganda) and fell in countries with less experience and lower levels (Rwanda, Benin and Niger).

⁷³ Gerster and Harding (2004).

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Table 5.2 Overall satisfaction with donor behavior (5=highest)

	2002/03	2003/04
Coordinate conditionality	3.0	3.4
Joint missions or reviews	3.2	3.4
Reporting requirements minimized and coordinated	3.2	3.1
Coordinated support on public finance reforms	3.1	3.3
Coordinated support to strengthen statistical systems	2.7	3.1
Conditionalities are seen as useful	3.1	3.6
Minimize the number of conditions		2.1
<i>Source:</i> SPA Budget Support Surveys.		

65. Partner countries also viewed donors positively (i.e. above a score of 2.5) on average in areas such as “providing information on planned disbursements in time” (3.76), “aligning disbursements with national budget cycle” (3.56), “disbursing at the intended time” (3.48), and “using government reports with minimal demands for other information” (3.47).

Managing for development results

66. The development community has moved from conceptualizing to implementing the global results agenda. Some early progress in managing for development results is evident at the country level, agency level, and across aid agencies. Partner countries are beginning to focus on results. They are integrating results in the development strategy process. For example, strong strategies in education and health in Ethiopia have helped to set a well prioritized and costed PRS program for the country. Budget processes and public expenditure management have a stronger results orientation. In all countries there is some move to apply the principles of managing for results at either a line ministry, in programs or in cross-cutting themes. Stronger links are observed in Brazil, Philippines, South Africa, Thailand, Vietnam, and Uganda. A number of countries have also developed strategies to improve their monitoring and evaluation systems. Recognizing the importance of quality statistical systems to support monitoring and evaluation, a few countries—Burkina Faso and Ukraine—have started programs for statistical capacity development and strategic plans of statistical systems are being finalized in other countries—Albania, China, India, Kenya, Nigeria, and Yemen.

67. Aid agencies are strengthening the focus on results in their country programs, financial instruments, incentives, and reporting systems. Many aid agencies are deriving country programming from the partner country’s PRS and linking country support to partner’s medium-term expenditure framework. Emerging practices are being shared and analyzed in the OECD-DAC Joint Venture on Managing for Development Results. All aid agencies have strengthened monitoring and evaluations to better ascertain the quality and impact of their operations. They are also working to enhance staff ownership of the results agenda through guidance, training, and information technology systems. Both bilateral and multilateral agencies have strengthened their development effectiveness work and corporate reporting.

68. At the global level, aid agencies are working more systematically in identifying actions that produce results, scaling up support for that work, and ensuring the availability of appropriate data. Work is underway on presenting existing experience in a *Sourcebook on Emerging Good Practice in Managing for Development Results*. Aid agencies are seeking to harmonize results reporting requirements around national monitoring and evaluation systems that help countries to

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manage for results. Progress is expected in four pilot countries in Africa in 2005. Work by aid agencies on jointly assessing the monitoring and evaluation setting in a country and aligning capacity building support to a national strategy on M&E is in its early stages, and will be pursued by supporting communities of practice in managing for development results.

Challenges Ahead

69. Progress on harmonization and alignment has been mixed so far, and that on managing for results is just beginning. The pace of progress needs to be accelerated. It will not be easy because achieving harmonization, alignment, and managing for results requires intensive work among participants—from the donor communities and partner countries—to remove remaining obstacles. Continued commitment at the highest level to the harmonization, alignment, and results agenda will be needed for its successful implementation. At the Paris High-Level Forum, participants acknowledged that enhancing the effectiveness of aid is feasible and necessary across all aid modalities, and they committed themselves to taking concrete and effective actions to address the remaining challenges that impede progress.

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

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

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

73. While the overall picture on progress is mixed, it is also promising, with upside potential and immediate opportunities. It is also risky, with significant remaining obstacles in donor and partner institutions, and longer-term consequences for public confidence in development cooperation. Through the Paris Declaration, and in the spirit of mutual accountability, the international development community agreed to measure progress on aid effectiveness against

5. Increasing Aid and Its Effectiveness

twelve specific indicators (see table 5.3).⁷⁴ In order to track and encourage progress at the global level among the countries and agencies, participants to the Paris Forum also agreed to set targets for the year 2010 for the twelve indicators. Five preliminary targets were agreed during the Forum and these as well as the remaining targets will be finalized and adopted before the UNGA Summit in September 2005. Commitment at the highest level will be needed to accelerate progress.

IV. Debt Relief

74. *Progress on the HIPC Initiative.* For heavily indebted poor countries, debt relief is crucial to create the fiscal space for much-needed increases in spending to promote growth and reduce poverty. Overall, substantial progress has been made in the implementation of the enhanced HIPC Initiative. As of November 2004, 27 HIPCs—or more than two-thirds of the 38 countries that potentially qualify for assistance under the initiative and which also account for about two-thirds of the total expected debt relief in net present value terms—have reached the decision point and are receiving debt relief. Fifteen HIPCs have also reached the completion point—when creditors provide the full amount of debt relief committed at the decision point on an irrevocable basis.

75. Progress towards reaching the completion point has increased in the last year although it has generally taken longer than earlier envisaged. For the 12 countries that are in the interim period between their decision point and completion points, most are on track with respect to their macroeconomic programs; others that experienced difficulties in program implementation are pursuing the necessary policy measures to bring their economic programs back on track.⁷⁵ Most of the countries in the interim period have finalized their PRSPs and are making good progress in their implementation. The completion of the PRSPs followed by implementation in the subsequent year should not impede progress in reaching the completion point, provided that performance under IMF and IDA supported programs remains satisfactory.

76. Challenges remain for the 11 countries that have not yet reached the decision point. Nearly all these countries have been affected by domestic conflict and several have protracted arrears to various creditors. These problems have complicated the design and implementation of reform programs. Notwithstanding these difficulties some are making good progress in establishing a track record of macroeconomic performance.

77. The sunset clause of the HIPC Initiative has been extended by a further two years to end-2006. All IDA only/PRGF-eligible countries that have not yet benefited from HIPC debt relief and whose external indebtedness based on end-2004 debt data is in excess of the enhanced HIPC Initiative thresholds after the full application of traditional debt relief, will be potentially eligible for the Initiative. Staffs of the Bank and the Fund are preparing a list of countries meeting this criterion for consideration of the Boards in 2005. In all cases, countries would (as now) receive debt relief based on the level of debt at the time of reaching the decision point.

⁷⁴ OECD (2005e).

⁷⁵ IMF-World Bank (2004b).

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Table 5.3 Alignment, Harmonization, and Results: Indicators of Progress To be measured nationally and monitored internationally		
OWNERSHIP		TARGETS FOR 2010
1	<i>Partners have operational development strategies</i> — Number of countries with national development strategies (including PRSs) that have clear strategic priorities linked to a medium-term expenditure framework and reflected in annual budgets.	At least 75%* of partner countries
ALIGNMENT		TARGETS FOR 2010
2	<i>Reliable country systems</i> — Number of partner countries that have procurement and public financial management systems that either (a) adhere to broadly accepted good practices or (b) have a reform programme in place to achieve these.	Target for improvement to be set by September 2005
3	<i>Aid flows are aligned on national priorities</i> — Percent of aid flows to the government sector that is reported on partners' national budgets.	85%* of aid flows reported on budgets
4	<i>Strengthen capacity by co-ordinated support</i> — Percent of donor capacity development support provided through co-ordinated programmes consistent with partners' national development strategies.	Target for improvement to be set by September 2005
5	<i>Use of country systems</i> — Percent of donors and of aid flows that use partner country procurement and/or public financial management systems in partner countries, which either (a) adhere to broadly accepted good practices or (b) have a reform programme in place to achieve these.	Target for improvement to be set by September 2005
6	<i>Strengthen capacity by avoiding parallel implementation structures</i> — Number of parallel project implementation units (PIUs) per country.	Target for improvement to be set by September 2005
7	<i>Aid is more predictable</i> — Percent of aid disbursements released according to agreed schedules in annual or multi-year frameworks.	At least 75%* of such aid released on schedule
8	<i>Aid is untied</i> — Percent of bilateral aid that is untied.	Continued progress
HARMONIZATION		TARGETS FOR 2010
9	<i>Use of common arrangements or procedures</i> — Percent of aid provided as programme-based approaches.**	At least 25%*
10	<i>Encourage shared analysis</i> — Percent of (a) field missions and/or (b) country analytic work, including diagnostic reviews that are joint.	Target for improvement to be set by September 2005
MANAGING FOR RESULTS		TARGET FOR 2010
11	<i>Results-oriented frameworks</i> — Number of countries with transparent and monitorable performance assessment frameworks to assess progress against (a) the national development strategies and (b) sector programmes.	75%* of partner countries
MUTUAL ACCOUNTABILITY		TARGET FOR 2010
12	<i>Mutual accountability</i> — Number of partner countries that undertake mutual assessments of progress in implementing agreed commitments on aid effectiveness including those in this Declaration.	Target for improvement to be set by September 2005
* These figures will be confirmed or amended by September 2005.** See OECD (2005e) Appendix A: Methodological Notes on Indicators. Source: OECD (2005e).		

5. Increasing Aid and Its Effectiveness

78. HIPC relief is projected to substantially lower debt stocks and debt service ratios for most HIPCs that have reached the decision point. NPV debt stocks in the 27 HIPCs that reached the decision point by July 2003 are projected to decline by about two-thirds once they reach their respective completion points. HIPCs in the interim period have benefited from Paris Club debt relief as well as relief from several multilateral creditors under the HIPC Initiative. Compared with the 1998-99 averages, the ratio of debt service to exports and fiscal revenues for the 27 countries that have reached their decision-points or completion points is estimated to have declined from an average of about 16 percent and 24 per cent to 10 and 15 per cent in 2003 respectively. These ratios are projected to decline further to less than half of the 1998-99 average by 2006 (table 5.4).

79. Debt relief under the HIPC Initiative has helped countries to increase poverty-reducing expenditures which on average have risen in the countries that have reached the decision point. For these 27 countries, poverty-reducing expenditures on average have risen from 6.4 percent of GDP in 1999 to 7.9 percent of GDP in 2003, a level about three times that spent on debt service.⁷⁶ In absolute terms poverty-reducing spending is estimated to have increased from about \$6 billion in 1999 to \$7.4 billion in 2002, and is projected to increase to \$11.9 billion in 2006 (table 5.4).⁷⁷

80. Although creditor participation has improved under the Initiative, some non-Paris Club bilateral and commercial creditors have not yet committed to provide HIPC relief. Most of the costs attributable to bilateral creditors continue to be borne by members of the Paris Club. Commercial creditors represent less than five percent of the NPV cost of relief, in part because of measures by the Debt Reduction Facility for IDA-only countries which has reduced the stock of commercial debt stock in HIPCs. Moral suasion however remains the principal measure for encouraging participation and discouraging litigation by remaining commercial creditors. With respect to multilateral debt, 23 of the 30 multilateral creditors have indicated their intent to participate in the initiative, representing more than 99 per cent of the total debt relief required.

81. A key premise of the HIPC Initiative is that debt relief should be additional to other forms of external financing assistance. An important issue is whether countries receiving debt relief are also receiving additional resources or whether debt relief crowds out other aid flows. Merely observing the size of flows does not provide conclusive evidence of additionality, as we do not know how much aid these countries would have received without the HIPC initiative. There are also substantial difficulties in measurement as different donors account for debt relief in different ways—debt relief is sometimes explicit, such as through grants for debt relief, or implicit, such as through debt service reductions.

82. The August 2004 HIPC Status of Implementation Report based on updates of the debt stock and debt service indicators in post-completion point HIPC countries found that the NPV of debt ratios had climbed since the completion point. Most of the increase was due to interest and exchange rate changes while high exports had lowered the debt ratio significantly. Debt service ratios for these countries had also increased but remained close to 10 percent on average. While the low level was due to HIPC debt relief and the high concessionality of new debt, the average change masked important differences between countries. Medium term projections generally pointed to a stable or declining trend in the debt and debt-service ratios. The review indicated that notwithstanding HIPCs high vulnerability to shocks, sound economic policies and close monitoring using the framework of the debt sustainability for low-income countries would help prevent the re-emergence of unsustainable debt.

⁷⁶ The definition of poverty-reducing expenditures varies across countries. Commonly included are primary education, basic health, and rural development.

⁷⁷ Country authorities are putting in place public expenditure management systems that would ensure the efficiency of poverty-reducing expenditures. See IMF-World Bank (2005).

5. Increasing Aid and Its Effectiveness

**Table 5.4 Debt service and poverty-reducing expenditure by the 27 HIPC
that have reached the decision point**

(in US\$ millions, unless otherwise indicated)								
	1999	2000	2001	2002	2003	2004	2005	2006
	Actual				Estimate			
					Projected			
Debt service	3,179	3,224	2,562	2,555	2,843			
Debt service due after enhanced HIPC Initiative relief						2,734	2,272	2,564
Debt service/exports (%) ^a	14.5	14.3	10.8	10.6	10.0	8.2	6.5	6.8
Debt service/government revenue (%) ^a	21.8	22.5	17.3	15.9	15.2	12.6	9.6	10.0
Debt service/GDP (%) ^a	3.4	3.5	2.7	2.5	2.5	2.1	1.7	1.7
Poverty-reducing expenditure	5940	5914	6439	7458	9079	10700	11,060	11,870
Poverty-reducing expenditure/government revenue (%) ^a	40.9	41.3	43.5	46.4	48.5	49.3	46.6	46.4
Poverty-reducing expenditure/GDP (%) ^a	6.4	6.3	6.7	7.4	7.9	8.3	8.0	8.0
<i>Note:</i> Debt service figures for 1999 reflect debt relief already provided to Bolivia, Guyana, Mozambique and Uganda under the original framework. Data on poverty-reducing expenditures are not available for all countries, particularly for 2003–05. In aggregate, the last available period was used for future years, thus understating the likely level of poverty-reducing spending. a. Weighted averages.								
<i>Source:</i> HIPC country documents and IMF staff estimates.								

83. *Debt sustainability.* Continued measures are needed by HIPC countries and by creditors to ensure that debt sustainability is maintained after the completion point, just as similar measures are needed for other low-income countries. The Executive Boards of the IMF and the World Bank have endorsed the key elements of a proposed debt sustainability framework for low-income countries aimed at supporting low-income countries in their efforts to achieve the Millennium Development Goals without creating future debt problems, and to keep countries that have received debt relief under the HIPC Initiative on a sustainable track. In guiding future financing decisions, the framework rests on three pillars: (i) an assessment of debt sustainability guided by indicative country-specific debt-burden thresholds related to the quality of policies and institutions; (ii) a standardized forward-looking analysis of the debt and debt-service dynamics under a baseline scenario and in the face of plausible shocks; and (iii) an appropriate borrowing (and lending) strategy that contains the risk of debt distress. Building on initial Board discussions of the proposed framework in February/March 2004, and further considerations in September 2004, the staffs of the two institutions are preparing a follow up paper that attempts to resolve outstanding issues on the indicative debt-burden thresholds; the interaction of the framework with the HIPC Initiative; and the modalities for Bank-Fund collaboration in deriving a common assessment of sustainability. It needs to be stressed, however, that debt sustainability is not only a resource flow issue. It also depends on increasing growth, diversifying exports, increasing access to global markets, and adequately mitigating the effects of exogenous shocks.

84. IDA's financial support to poor countries will now take systematic account of vulnerability to debt. Debt sustainability will be the primary determinant of the grant/credit mix in IDA14, and the joint debt sustainability framework for low-income countries will form the analytical basis to link debt sustainability and grant eligibility.⁷⁸ The countries facing the toughest debt problems—most of them in Sub-Saharan Africa—will get all their support in the form of grants, while less

⁷⁸ IDA (2004).

5. Increasing Aid and Its Effectiveness

debt-burdened countries will receive IDA's highly concessional long-term loans, or in a few cases a mixture of grants and credits. The resulting overall grant share of total IDA support in the coming three years is expected to be about 30 percent.

85. *Proposals for additional debt relief.* A number of proposals for additional debt relief have been put forward by members of the G7 that differ in a number of important respects (box 5.7). Debt relief has the advantage that it may yield additional development financing beyond what could be forthcoming in the form of additional gross flows, given the broad-based political constituency for debt relief. It could also eliminate problems associated with debt overhang and the defensive lending required to refinance large debt repayments by poor countries, thereby enabling a more effective policy dialogue between donors and debtor countries. Debt relief also has the advantage that, to the extent that it is committed irrevocably up front, it could provide aid in a predictable and easy-to-deliver form.

86. However, there is a danger that debt relief might instead result in a diversion of resources that would have gone to increase direct aid flows. Furthermore, compared to the alternative of higher new aid flows, debt relief could have a number of potential disadvantages. First, it would allocate resources according to existing debt stocks rather than need or policy performance, and therefore may prove inconsistent with the principle of allocating assistance to countries where it would be most effective. Second, it may reduce the scope for linking assistance to the maintenance of good policies to the extent that an irrevocable commitment to debt relief is made up-front. Third, it may create expectations of further relief in the future, thus increasing the moral hazard associated with any subsequent lending, and hinder the development of a credit culture.

87. It is important to emphasize that any debt relief initiative would still leave an unfinished agenda. Further debt relief is inevitably only a part of a wider picture that involves stronger policies in developing countries, more development assistance, and a supportive international environment for growth.

Box 5.7 Proposals for additional debt relief beyond HIPC

A number of proposals for further debt relief beyond HIPC have recently been put forward by members of the G7. It is clear that there are differing motivations underlying these proposals. Some proposals reflect a desire to provide additional resources to help low-income countries achieve the MDGs, others see further debt reduction as a way of increasing the scope for new lending under the low-income country debt-sustainability framework to countries with relatively strong policies, while yet others aim at eliminating the need for “defensive lending” and future debt relief for HIPCs.

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

- Whether eligibility for relief should be restricted to HIPCs or be available to all low-income countries;
- Which institutions' debt should be relieved;
- What percentage of eligible debt should be relieved;
- Whether relief should take the form of debt stock reduction or relief on the flow of debt service payments;
- The strictness of conditionality; and
- How the debt relief of the IFIs will be financed; e.g., with contributions from bilateral donors or by the institutions themselves, such as, for example, by the sale of IMF gold.

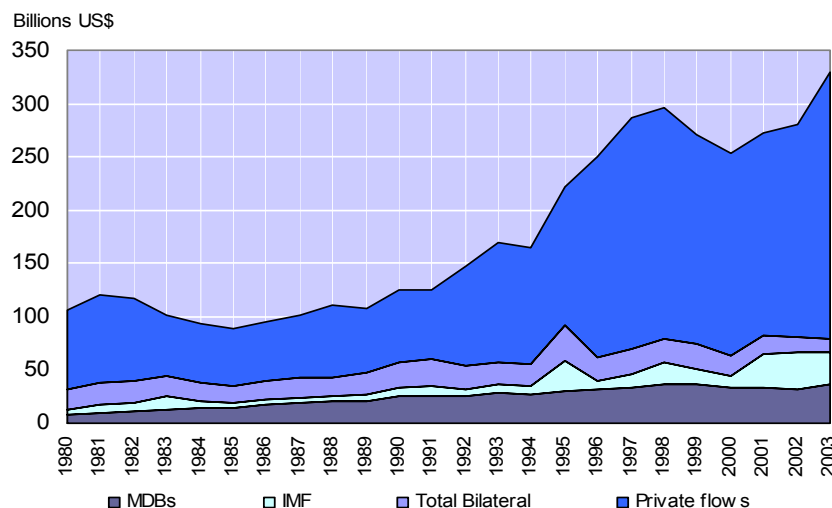
6. Strengthening and Sharpening IFI Support

1. This chapter analyzes the support provided by international financial institutions (IFIs) to help developing countries achieve the Millennium Development Goals (MDGs) and related development objectives, and offers priorities for strengthening and sharpening that support. The focus is on the five largest multilateral development banks (MDBs)—the African Development Bank (AfDB), Asian Development Bank (AsDB), European Bank for Reconstruction and Development (EBRD), Inter-American Development Bank (IDB), and World Bank (WB)—and the International Monetary Fund (IMF). The discussion is structured around the four-pillared organizational framework developed in *Global Monitoring Report 2004*: country focus, global and sectoral programs, partnerships, and results.

2. **IFI Business Models.** In applying the framework, the chapter reflects the similarities across the IFIs and the common directions of change, but also the differences – especially in the ways the MDBs and the IMF influence the achievement of the MDGs. Operating in some ways like the aid agencies considered in Chapter 5, the banks work through a large variety of instruments and sectors tailored to country circumstances through decentralized processes; to a large extent the key to understanding their contribution lies in understanding how and how well those processes are working. The IMF product line is simpler, with the issue of program design focused on substantive policy issues at a higher level of execution.

3. **IFI Financial Roles.** To provide historical context for the chapter, Figure 6.1 overviews the development finance picture for the past 25 years. It shows a secularly rising trend of private sector flows, albeit with considerable fluctuations, mostly related to international financial crises. The contribution of the MDBs grew gradually but steadily through the late 1990s while shrinking relative to private finance, thereby increasing its strategic and catalytic role in supporting policy development and institution building. The figure shows that the IMF contribution was sometimes countercyclical vis-à-vis private sector flows, and sometimes pro-cyclical, while bilateral flows shrank somewhat over the period.

Figure 6.1. Development Finance: Role of Big 5 MDBs, IMF, and Others



Source: World Bank, Debt Reporting System.

Box 6.1. Profile of the “Big 5” MDBs

Together the five biggest multilateral development banks—the AfDB, AsDB, EBRD, IDB, and WB—commit and disburse about \$35 billion a year. These banks share many characteristics. But they also have differences—in country coverage, mandate, voice and ownership, and location of work—that influence how they respond to the challenge of helping countries achieve the MDGs and other development goals.

Country Coverage. Most developing countries are borrowing members of two MDBs – the WB and their respective regional MDB. Exceptions include six countries that are members only of the WB among the Big 5, and six countries that are members of three banks – the AsDB, the EBRD, and the WB.¹

- Drilling down on the MDBs’ individual country lists reveals important differences in the mix of their developing members. As Figure 6.2 shows, these translate into very different client bases. At one end of the spectrum, AfDB and AsDB have the largest share of low income countries (LICs). EBRD and IDB have the highest share of middle income countries (MICs). The WB is in the middle. These differences also translate into very different average income levels for bank clients – as shown in Figure 6.3
- Also of relevance is the relative importance of different funding sources to the different categories of clients – for investment-grade and other emerging market economies, private financing provides some 85-95 percent of inflows. For the others, the private share is in the 50-60 percent range. These differences translate into differences across countries in the relative importance of the MDBs’ financing role vis-a-vis their policy and catalytic role.
- A third consideration is the size of borrowers – particularly as between large states (over 100 million people) – and small states (under 1.5 million people). The former include nine countries, with one in AfDB (Nigeria), five in AsDB (Bangladesh, China, India, Indonesia, Pakistan), one in EBRD (Russia) and two in IDB (Brazil and Mexico). The small states cut across the entire spectrum of classifications, with Barbados being investment grade and Solomon Islands being fragile, with most falling in between – whether core MIC, blend, or core LIC – and more aid-dependent than larger states. They also cut across the

Figure 6.2. Differences in Big 5 Client Base

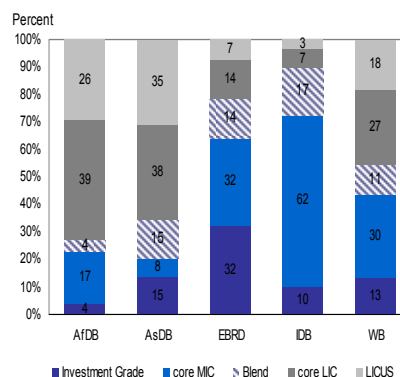


Figure 6.3. Average Incomes of MDB Clients

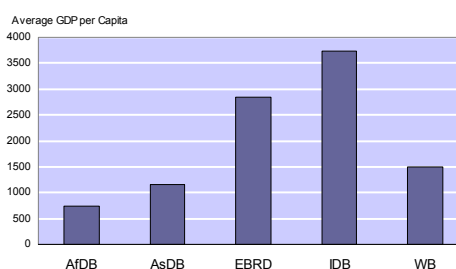
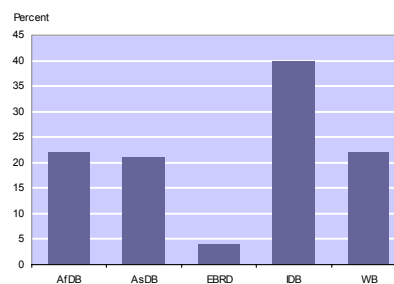


Figure 6.4. Small States in Big 5 (% of Client Countries)



6. Strengthening and Sharpening IFI Support

MDBs, as shown in Figure 6.4, where small states comprise over 20 percent of country clients in the AfDB, AsDB, and WB, about 40 percent of IDB clients, and less than 5 percent of EBRD country clients.

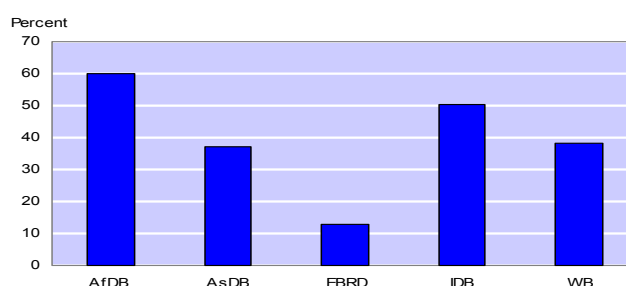
Mandate. The mandates of the AfDB, AsDB, IDB, and WB are similar with respect to promoting growth, development, and poverty reduction. For the EBRD, however, the mandate is to promote transition and private sector development. The mandates of the AfDB, AsDB, EBRD, and IDB include an important regional dimension – to focus on regional and sub-regional projects and programs and to promote intra-regional trade.

Voice. As shown in Figure 6.5, the Big 5 differ in the relative shares of borrowers in bank ownership, ranging from a low in EBRD to high in AfDB. But the influence of non-borrowers is also affected by the role played by the banks' concessional windows, which are heavily supported by non-borrowing donors.

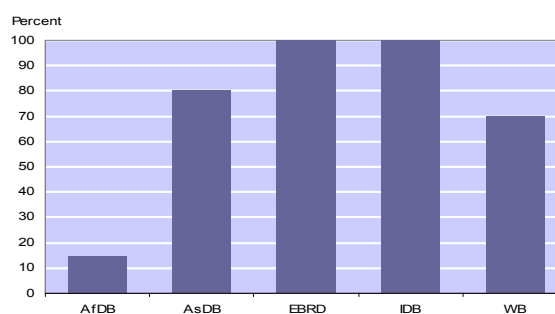
In AfDB, the share of concessional lending to total lending averages 44 percent; for AsDB it averages 27 percent; and for WB it averages 40 percent of total lending; IDB has a concessional Fund for Special Operations, which amounts to 7 percent of total lending. Also relevant is the process for selecting the President: with the AsDB, EBRD, and WB selected from developed countries and the AfDB and IDB from developing countries.

Location. A final issue is the respective locations of the banks and their work. Headquarters of the EBRD, IDB, and WB are in G-7 countries; while AfDB and AsDB are located in borrower countries. Equally important is the location of work and staff. Two parameters are key – coverage of field offices and roles and responsibilities. As shown in Figure 6.6, most of the Big 5 have full or fairly full field presence in its developing member countries. The exception is the AfDB, which had closed its previous field offices because of problems. It now is in the process of establishing new ones, in 25 countries, following the example of the other Big 5 and the lessons learned from the recently established offices in Egypt, Ethiopia, Gabon, Mozambique, Nigeria, Senegal, Tanzania, Tunisia, and Uganda. Also apparent from the table, all of the Big 5 consider project administration as a key task of their country offices. But the AsDB, EBRD, and WB also see a critical role for their country offices in strategy formulation and program design, with most WB country directors located outside Washington.

Figure 6.5. Borrower Shares in Big 5 MDB Ownership



**Figure 6.6. Big 5 MDB Decentralization:
(% of Developing Countries with MDB Office)**



	AfDB	AsDB	EBRD	IDB	WB
Project Admin	✓	✓	✓	✓	✓
Country Strategy	no	✓	✓	no	✓

MULTILATERAL DEVELOPMENT BANKS

4. In line with the model set out in earlier chapters, the key avenue for MDB support for the MDGs is effective support for country policies, institutions, and investments and global and regional public goods. In this context, this section addresses what and how well the MDBs contribute to this agenda. The comparative profile set out in Box 6.1 provides a perspective for interpreting the observations on the individual MDBs, especially with respect to the banks' mix of low- and middle-income borrowers.

I. Supporting Country Development

5. In exploring the different ways that the MDBs are tackling the challenge of helping their developing member countries achieve the MDGs, this section looks at how the banks approach country ownership, strategies, financial support, and analytical and capacity building support. It reflects the view that the MDBs' contribution to achieving the MDGs lies in the relevance of their country support programs – especially the links between PRSPs (or other national strategy documents) and the banks' country strategies – and the implementation quality of those programs. It draws on the findings of the banks' independent evaluation departments, and notes plans for further evaluation studies that can inform future Global Monitoring Reports.

A. Country Vision and Ownership

6. All the MDBs recognize the importance of country ownership, with an emerging consensus that country demand, balanced with staff analysis, should form the basis for the policy dialogue.

Low-Income Countries

7. The 75 low-income countries that are members of MDBs are home to 2.5 billion people. Their populations range from 150,000 people in Sao Tome and Principe to 1 billion people in India. They are islands, landlocked, peninsulas, and continents, with tremendous diversity across and within countries. Each faces unique development challenges, sharing a common statistic of annual per capita income of \$735 or less. They contain 70 percent of the world's people living on less than \$1 per day and 60 percent of those living on less than \$2 per day. They are eligible for concessional financing from the MDBs – from the WB's International Development Association (IDA) and, in their respective regions, from the African Development Fund (AfDF), the Asian Development Fund (AsDF), and the IDB's Fund for Special Operations (FSO). Low-income members of the EBRD are supported by the Early Transition Countries (ETC) Initiative, under which the EBRD accepts higher risks in the projects it finances.

8. **Poverty Reduction Strategies.** In each of these facilities, the PRSP/NPRS is explicitly recognized as the vehicle for the banks to work with low-income countries (LICs) on their MDG priorities.² On this basis, all MDBs are committed to using the PRS process in the dialogue, and as the starting point of their country strategies. Recent reviews of the PRS approach carried out in tandem by the WB and IMF independent evaluation departments (respectively, OED and IEO) have highlighted strengths and weaknesses of the PRS process – as well as priorities for change. (See Box 6.2 for the findings of the OED review; the IEO review is discussed in Box 6.10.) Going forward, steps are being taken to strike a better balance between country ownership and external involvement—including by IFIs—and to help countries broaden domestic participation, develop and monitor their strategies, strengthen analysis of the sources of growth and poverty reduction, link ambitious objectives with existing resources and capacity constraints, and set out the operational path to sustained implementation.

Box 6.2. Independent Evaluation of WB Role in Poverty Reduction Strategies

OED's review found that the Poverty Reduction Strategy (PRS) Initiative is relevant to the development challenges in low-income countries and warrants continued WB support.³ But, according to OED, the Initiative has not yet fulfilled its full potential to enhance poverty reduction efforts in low-income countries. OED found that countries have focused more on completing documents, which give them access to resources, than on improving domestic policies and practices. Other identified weaknesses include the absence of an effective mechanism for adapting the Initiative to differing country conditions, especially in the context of the weak public sector capacity found in most low-income countries. Most PRSPs also focus largely on public expenditures, and pay more attention to social sector spending than to infrastructure, rural development, and other areas with growth and poverty reduction potential. External partners have supported PRSP formulation, and changes in donor *processes* are evident but they have not defined specifically whether and how they should change the *content* of programs to reflect PRSPs.

The review also assessed the WB's role in the PRS Initiative. Most problematic, in OED's view, the WB's process for presenting PRSPs to the Board undermines country ownership. The Joint Staff Assessment was designed to provide the WB and IMF Boards with an assessment of the soundness of the PRSP as a basis for support; it was also designed to provide feedback on how a country's PRS could be improved over time. But OED finds that these assessments are of mixed analytical quality and coverage, with limited awareness of their findings and recommendations among stakeholders. On the positive side, OED found: (i) the WB has effectively supported national stakeholders in PRSP formulation; (ii) WB lending since the launch of the Initiative has increased for countries with PRSPs completed through 2003; and (iii) economic and sector work has added value to country planning, with Poverty Assessments and Public Expenditure Reviews useful for PRSP formulation. OED also found that the WB has promoted the PRSP as a coordinating framework for donor activities, although apparently with little success, in light of the evidence.

Going forward, OED recommends that the WB should:

- *PRSP content.* Help countries address key analytical gaps about the poverty impact of policies and programs.
- *PRSP process.* Emphasize ways of improving country processes for planning, implementing, and monitoring public actions geared toward poverty reduction; place less emphasis on completion of documents; and develop a review procedure that is more supportive of ownership and more effectively linked to decisions about the WB's program.
- *Partnership and alignment.* Assist countries in using the PRSP as a partnership framework by encouraging government-led aid management and selectivity; and better integrate its own assistance with the efforts of other partners.

Low-Income Countries under Stress

9. Among the LICs, LICUS are the most fragile – frequently conflict-affected – with the weakest governance, policies, and institutions. This translates into severely limited progress on and prospects for poverty reduction and the other MDGs. The 500 million poor people living there share bleak socio-economic indicators, with per capita income levels half, and child mortality rates double, those of people living in other LICs. Six LICUS are also small states – Comoros, The Gambia, Guinea-Bissau, Sao Tome and Principe, Solomon Islands, and Timor-Leste – making them particularly vulnerable to economic shocks and volatility; they also face unique challenges in sustaining support from donors. Clearly, LICUS face the most difficult circumstances for meeting the MDGs and other development goals. Hence the importance of focused attention on their special needs, a central topic of the recent Senior-Level Forum on Development Effectiveness in Fragile States – hosted by DFID and co-sponsored by the European Commission, OECD-DAC, UNDP, and the WB. The Forum discussions led to support by the OECD-DAC High Level Meeting in March of a new set of Principles for International

Engagement in Fragile States, and agreement to pilot these principles in donor programs in seven countries.

10. ***MDB Support for LICUS.*** Of the 25 core LICUS in FY2005, the WB is working with 12 focus countries to apply LICUS principles. Of the eight where the WB had previously completely disengaged, there have been in-country missions to all, along with analytic work to regain basic knowledge. These early re-engagement activities have proved critical in positioning the WB to move quickly when necessary, as has happened recently in Haiti, Liberia, and Sudan. Of the \$25 million in the LICUS implementation trust fund approved by the Board in March 2004 to support governance and social service delivery in countries in arrears to the WB, grant packages totaling \$20 million have been approved for Central African Republic, Comoros, Haiti, Liberia, and Somalia, and Sudan. Of the 25 core LICUS members of the WB, 14 are also members of the AfDB and nine of the AsDB. Responding to the urging of the AfDB Deputies in the context of the recent replenishment process, the AfDB is currently preparing a Board document that will present a comprehensive framework and strategy for institutional engagement, with implementation of the strategy to begin later this year. In the meantime, the AfDB is continuing to implement its Post-Conflict Country Facility, which was approved by its Board in July 2004.⁴ The AsDB is now developing an approach for working with fragile states in the context of the AsDB IX replenishment. The approach will emphasize the use of highly focused interventions at points where assistance can be effectively used and with an increased emphasis on strategic partnerships. Other issues under consideration include (i) the importance of an initial assessment of absorptive capacity; (ii) use of stakeholder and partner analysis to refine interventions; (iii) instruments that allow flexibility in situations where existing institutions are essentially non-functional; and (iv) the potential role of subregional cooperation.

Middle-Income Countries

11. Some 2.7 billion people live in middle-income countries, which range in size from the very small, such as Dominica (with fewer than 100,000 people), to the very large, such as China (with almost 1.3 billion people). Relative to low-income countries, middle-income countries have greater public- and private-sector capacity, more resources, and better prospects, although there are clearly large variations across MICs. Though they have less than the LICs, MICs still have too much poverty – about 30 percent of all people living on less than \$1 per day and 40 percent of those living on less than \$2 per day.

12. ***Country-Specific Approaches.*** Few MICs are bound by the PRS process, as they are generally not eligible for concessional funding. But they have long been in the development driver's seat, and are articulate in expressing their views. Most set out clear strategies for growth and poverty reduction in the context of their annual budget and planning documents, which in turn provide the starting point for the dialogue with the MDBs (and donors). The MDBs help middle-income countries through a combination of knowledge, lending, and financial services tailored to each country's specific needs and circumstances. They strive to ensure that their country strategies respond to MICs' diverse needs, as covered by the Banks' mandates. By supporting policy and institutional reforms, the MDBs also play a catalytic role in attracting private sector investment as well as support from other development partners. The access to international capital markets of many MICs reinforces the MDBs' shared premise that their job is to add value that private markets cannot – or will not – a factor to be considered in reviewing trends in lending and net transfers.

B. MDB Country Strategies

13. The country strategy process forms the basis for MDB support for country development – and in turn for the MDGs. In each case, the process begins with the country's own priorities – as expressed in PRSPs/NPRs in LICs (and ETCs in the EBRD) and country-specific plans in

MICs. It takes account of participatory approaches and performance under earlier strategies, and reflects the diagnostic analysis of the country, the bank, and partners. Options for future support are set out, reflecting the likelihood of success in contributing to sustained growth, the MDGs, and other development goals. The point here is that MDB financial, analytic, and capacity-building support is customized to individual country needs through this process, aimed at ensuring the best package in light of the priorities articulated by the country. In all MDBs, the evaluation departments assess their strategies upon program completion, thus affording opportunities to test and validate results – including with respect to MDB contributions to the achievement of the MDGs. (See Table 6.1.) In a recent study, OED has concluded that roughly two-thirds of the 70 WB country assistance programs it reviewed had had satisfactory outcomes, with tailoring to country context, strong knowledge bases, and realism on policy outlook, critical success factors. Conversely, the absence of these factors was an important ingredient in the other third of country assistance programs – that is, those that were judged unsatisfactory.

Table 6.1. MDB Country Strategies

	AfDB	AsDB	EBRD	IDB	WB
Terminology	Country Strategy Paper (CSP)	Country Strategy Paper (CSP)	Country Strategy (CS)	Country Strategy (CS)	Country Assistance Strategy(CAS)
Grounded in Country Vision and Objectives	PRSP for LICs; national development plans for MICs	PRSP/NPRS for LICs; country documents for MICs	PRSP/NPRSP for ETCs; country documents for MICs	PRSP for LICs; country documents for MICs	PRSP for LICs; country documents for MICs
Frequency of Bank Strategy	Every 3 years	Every 3-5 years	Every 2 years	New government	Every four years
Progress Report	Annual CSP Update	Annual CSP Update	Annual Country Strategy Update	Annual Country Strategy Update	Every 2 years
Results-based Country Strategy	Being launched in 2005	Pilot completed for Nepal; underway for Vietnam, Philippines	no	no	7 pilots completed; assessment underway
Country Strategy Completion Report	To be launched with RB CSP	Under consideration, as part of RB-CSP	No; but lessons learned reflected in new CS	No; but lessons learned reflected in new CS	7 completed; discussed with Board
Independent Evaluations	5 CAEs completed; 4 underway	8 CAPEs completed; underway for Bhutan, Indonesia, Uzbekistan	2 Country Strategy Evaluations competed	CSE: for every Country Strategy ⁵ ; 17 completed	CAE: once every 8-10 years; 70 completed
Country Strategy Retrospective	Underway	Under consideration	Transition Impact Retro every 5 years	no	CAS Retro: every 3-4 years

14. **Results-based Country Strategies.** Looking to improve their effectiveness, the banks are increasingly focused on results, with the AfDB, AsDB, and WB piloting “results-based” strategies. The value added of such a results focus is (i) to improve the relevance of the support program by sharply focusing the selection of interventions on those that will maximize expected MDB impacts; and (ii) to identify indicators and baselines that can be used during implementation and on completion to assess progress. In the EBRD, country strategies do not have results indicators as such; however, they do contain transition indicators, which also are included in unit business plans. IDB’s independent evaluation department OVE has consistently

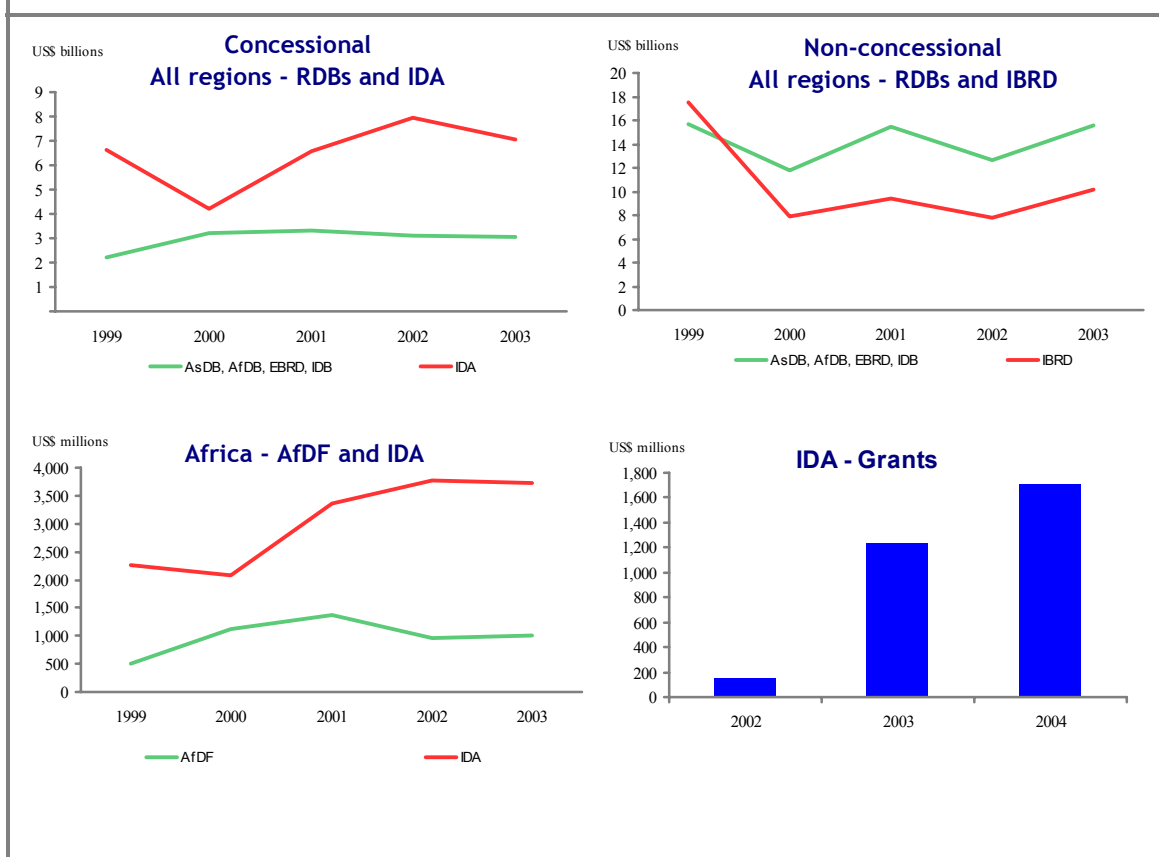
identified the need for better “evaluability” of IDB country strategies and projects, including better results frameworks in country strategies and indicators for measuring progress.

C. Financial Support

15. The MDBs provide financial support through lending and grants and for debt relief under the HIPC Initiative.

16. **Lending.** MDB lending serves two developmental purposes – (i) financial and (ii) policy and institutional development. Recent trends in MDB commitments are pictured in Figure 6.7. As shown there, the increase in concessional lending over the past few years has been driven primarily by IDA lending to Sub-Saharan Africa, which increased sharply over the period, with grants entering the picture in a major way in 2003. For non-concessional lending, commitment levels have been fluctuating, following a spike in policy-based lending in 1999 – especially in the IDB and WB reflecting the turbulent financial conditions in global financial markets for many emerging market economies during that period. More recently, the MDB totals have been affected by strong commitment activity in European countries by both EBRD and IBRD.

Figure 6.7. Trends in MDB Lending, Credit, and Grant Commitments



17. **Lending Instruments.** For many years, there was a proliferation of lending instruments in the MDBs, responding to specific requests of shareholders and clients. More recently, attention has focused on the two major kinds of instruments in the MDB toolkit – investment lending and policy-based lending – with the others recognized simply variations on these two instruments.⁶ Investment lending – or project lending as it is often called – is offered by all the banks. Policy-based lending is not offered by the EBRD, which does however, have a substantial program in equities, equity funds, and guarantees. Though there are many specific differences between project-based and policy-based lending, the two instruments are fundamentally distinguished by

the rules governing the use of the funds they provide, with disbursements of investment lending funds historically tied to complex requirements for procurement, financial management, and environmental assessment, and policy-based lending disbursed in a more untied manner, albeit associated with policy conditionality.⁷ Reforms of recent years have focused on both, in a way that has narrowed the differences between them. Table 6.2 summarizes the status quo in each of the banks, illustrating the trend towards greater flexibility for both investment and policy-based lending:

- On investment lending, the reforms are moving the banks in the direction of sector-wide approaches (SWAs) and related approaches, allowing greater reliance on country systems, where the latter meet agreed standards, and in turn encouraging the banks to do more to help countries meet those standards.
- For policy-based lending, the reforms are moving the banks toward the streamlining of conditionality, relying more on country ownership and selectivity to align the flow of financial resources with the policies needed to ensure their wise and prudent use and in turn encouraging the banks to help countries to own and implement the requisite reforms.

18. **Grants.** The MDBs have long provided grant facilities, whether funded out of net income or donor funds. Traditionally, these have taken the form of small grants to countries, public agencies, and private entities to carry out specific tasks – and such funding continues at all the banks, including on a large scale through the IDB's Multilateral Investment Fund, which together with its partners has directed over \$1.6 billion in technical assistance and investment projects for private sector development. Grant funding to public agencies took a giant step under IDA 13, allowing for some 18-21 percent of the resource envelope to be used for special purposes, with AfDF and AsDF taking similar approaches. Under the recently completed IDA-14 replenishment, concerns about debt sustainability led to the expansion of grants and mainstreaming of their use for eligible countries, based on the WB-IMF debt sustainability framework. (Box 6.3.) Grants under AfDF X are to follow the same approach as IDA14, with the AfDF using its own performance assessment ratings for eligible member countries. The AsDF IX grants program – which has as its objectives: (i) reducing the debt burden of development finance in the poorest countries of the region; (ii) assisting poor countries in accelerating their transition from post-conflict situations to peace and stability; (iii) combating HIV/AIDS and other infectious diseases; and (iv) undertaking priority technical assistance – will be reviewed at the AsDF Mid-Term Review.

19. **HIPC and Debt Sustainability.** The Regional MDBs have participated in the HIPC Initiative, along with the WB and the IMF. The estimated cost to the AfDB and the IDB broadly equal the cost to the IMF and are half the size of the cost to the WB. AsDB is committed to providing HIPC relief; however, no AsDB member has so far requested it. Going forward, MDB cooperation on debt relief and sustainability issues has taken on a new dimension with AfDF, AsDF, and IDA starting to allocate grants and credits based on debt sustainability considerations, and with the announcements by G7 and others of interest in further debt relief. In this context, plans are underway for Regional MDB collaboration on LIC debt sustainability analysis – using the new debt sustainability framework – to provide a common platform for judgments on the mix of financial assistance provided to low-income countries. This also moves in the direction previously recommended by OED, which had found that the WB and its partners did not always calibrate the size and financing of their assistance to recipients' debt carrying capacity.

Table 6.2. MDB Lending Instruments

	AfDB	AsDB	EBRD	IDB	WB	
Investment Lending						
Availability	✓	✓	✓	✓	✓	
Share of commitments in FY03/04	77	81	81	71	IDA	IBRD
			Remainder is equities, fund, and guarantees		80	60
Recent Reforms	SWAps	SWAps	--	SWAps; liberalization of expenditure eligibility	SWAps; liberalization of expenditure eligibility	
		Scope for use identified				
Forward Agenda	simplification	developing similar proposals on liberalization of expenditure eligibility	--	Elimination of minimum disbursement periods ⁸ and “matrix” for forex financing. ⁹ Increasing use of country systems.	Increasing use of country systems in procurement; pilot for use of country systems for environmental and social safeguards; review of conditionality	
Policy-Based Lending						
Availability	✓	✓	no	✓	✓	
% Share of commitments in FY03/04	23	19	--	29	IDA	IBRD
					22	39
Statutory limits on \$ and/or %	25	20	--	If New Lending Framework (NLF) approved: Ordinary Capital (OC): \$9.8b 2005-8; FSO: \$100 million p.a.	No; but shares monitored regularly	
Recent Reforms	Development budget support loan policy	Scope for use identified of program-based approaches identified	--	no	From adjustment lending to development policy lending	
Single-tranche operations permitted	✓	✓	--	Yes for OC, if NLF approved	✓	
				no for FSO		
Stance on conditionality	Streamlined: fewer and simpler	Country ownership essential	--	None explicit	Minimize legally binding conditions	
Forward Agenda	Further streamlining of conditionality	Review of program-based approaches underway	--	NLF, if approved, eliminates limits on disbursement periods	Review of conditionality underway	

Box 6.3. Grant Financing in the AfDF, AsDF, and IDA

Recent empirical research has emphasized the need to fully consider the specific factors that affect debt sustainability in low-income countries (LICs)¹⁰. It calls for country-specific external debt thresholds that take into account the importance of policies and exogenous shocks. In particular, the risk of debt distress in LICs is inversely correlated with the quality of policies and institutions in these countries; and positively correlated with the severity of shocks that may affect them. This research has also formed the basis for a new joint WB-IMF debt sustainability framework¹¹ (DSF) for LICs.

AfDF. During the recently concluded AfDF X Replenishment discussions, donors recommended that the terms of financing should be based on an analysis of country prospects for debt sustainability¹², and it was agreed that eligibility for AfDF X grants would be based on the WB-IMF DSF. This means that eligibility will be guided by the same policy-dependent external debt thresholds used for IDA14, although AfDF will continue using its own CPIA ratings to evaluate performance of its member countries. Meanwhile, the share of grants has been more than doubled under this replenishment – from 21 percent under AfDF IX to about 44.5 percent under AfDF X. Under AfDF IX, as under IDA13, the overall grant share was limited to 18 to 21 percent of total resources and covered multiple objectives, including grants for countries with GNI per capita below \$360 per annum and a minimum of 7.5 percent of each AfDF country's allocation as grant-financed technical assistance funds.

AsDF. AsDF IX negotiations were concluded before the IDA14 and AfDF X negotiations were finalized.¹³ The AsDF IX grants program is similar to the IDA13 and AfDF IX programs, incorporating a 21 percent upper limit on the overall grant share and a broad coverage, that includes grants for debt-vulnerable poorest countries, post-conflict countries, HIV/AIDS operations, and priority technical assistance. AsDF donors recommended that the AsDF IX grants program be reviewed by Mid-Term Review and that the AsDF coordinate closely with the WB and the IMF on debt sustainability issues.

IDA. Participants in the IDA14 Replenishment discussions in December 2004 recommended that debt sustainability should be the primary determinant of the grant/credit mix in IDA14. They also agreed that IDA should adopt the joint DSF for LICs as the analytic basis to link debt sustainability and grant eligibility¹⁴ in IDA14. Therefore, unlike in IDA13, grants in IDA14 will no longer be allocated according to multiple, special-purpose eligibility criteria. In fact, in IDA13, the overall grant share was expected to fall between 18 and 21 percent of the total IDA13 envelope, covering post-conflict countries, countries with per capita GNI below \$360 per annum, debt-vulnerable poorest countries, and HIV/AIDS and natural disaster relief projects. Instead, under the new grant allocation system, the share of grants in total IDA financing will emerge from a country-by-country analysis of the risk of debt distress. The resulting overall grant share is estimated to be around 30 percent.

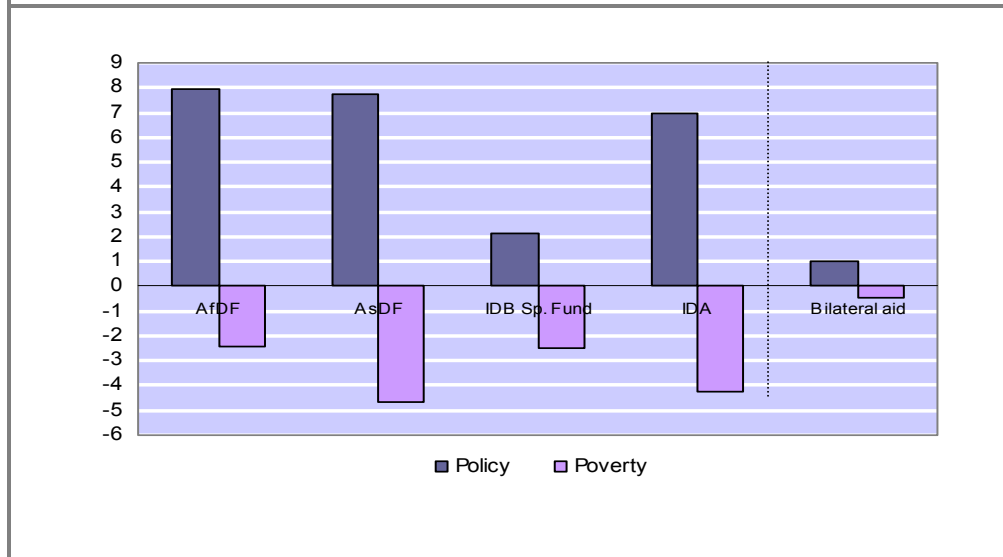
Cross-country Determinants of MDB Financial Support

20. While *within-country* lending and other resource allocation decisions are determined via country strategy and programming processes; cross-country allocations are determined differently.

21. **LICs.** To allocate their scarce concessional funds, the four banks with concessional windows (AfDB, AsDB, IDB, and the WB) follow broadly similar performance-based allocation processes. Country Policy and Institutional Assessments (CPIAs) are carried out by staff, as part of a formula taking into account population, degree of poverty, and track record for effective use of MDB funds. As discussed elsewhere in this report, the criteria used by the banks are converging, as are the scores for countries rated by two banks. Recent research has examined the selectivity of the concessional assistance provided by the MDBs and other agencies. As summarized in Figure 6.8, the findings suggest that selectivity in aid allocations by the MDBs, as measured by the policy and poverty elasticities of their aid, is in general high – both absolutely and relative to bilateral donors—and has held up well in recent years, showing a modest trend toward further improvement.¹⁵ According to the research findings, AsDF's allocations are the

most targeted to the poor countries within its region, followed by IDA. On policy selectivity, in 4 out of 5 years, AfDF is found to be the most selective for countries with good policies and institutions within its region, followed by AsDF and IDA, which the research suggests are also well aligned with policy performance. Meanwhile, the performance-based allocations of MDB concessional financial resources precludes substantial financial allocations to LICUS, where the banks continue to engage through focused capacity building to help restore essential functions of the state and through social service delivery to the most vulnerable groups, in some cases relying on trust fund support.

Figure 6.8. Policy and Poverty Selectivity of MDB Aid, 2003¹⁶



22. **MICs.** For the MICs, the level of support provided by the MDBs is determined by institutional financial constraints and country creditworthiness considerations, and country demand factors. The latter has received much attention in recent years in the MDBs, with “cost-of-doing-business” concerns cited by developing country members as a factor discouraging them from borrowing from the banks for infrastructure and related investments, along with other constraints such as limited fiscal space. The MDBs are implementing broadly similar reforms to respond to these concerns – which also are being applied as relevant to LIC borrowers. Being developed under different names – the New Partnership Framework in AfDB, the New Lending Framework in IDB, and the MIC Action Plan in the WB – these initiatives have involved a healthy rethinking of many bank processes, leading them towards more risk-adjusted approaches that are also likely to enhance the efficiency of operations and (over the medium term) contribute to country capacity building through enhanced attention to country systems.

D. Analytic and Capacity-Building Support

23. The MDBs also contribute to country development through their analytic and capacity-building support—both in terms of their inputs into the selection, design, and implementation of MDB-supported lending operations and in terms of the more fundamental challenge of helping countries to manage their development, regardless of financing source. While MDB analytic work is important for all developing member countries, it is relatively more important for the countries at the opposite ends of the performance spectrum – MICs and LICUS, given the relatively smaller financial role played by the MDBs with those member countries – with targeted analytic support important for MICs and more basic capacity building important for LICUS. Going forward, future GMRs could usefully quantify the respective contributions of the MDBs in

these areas. But this will require further work, including on reaching a consensus among the MDBs on appropriate metrics and monitoring tools.

24. *Analytic Work.* Economic, technical, and sector work underpins the MDBs' policy dialogue with member countries – on policies, strategies, lending, and capacity building support. In the aforementioned review of 70 WB country programs, OED (WB) found that economic and sector work was critical for good outcomes, and that successful country programs were associated with timely analytic work. It also concluded that the absence of analytic work leads to unsatisfactory project outcomes, and that analytic work can be an effective vehicle for engaging Governments in policy dialogue and informing civil society. Though the focus of that review was WB programs, the broad conclusions about the importance of analytic work are relevant to the other banks as well:

- Scaled to the availability of resources, AfDB's analytic work is frequently carried out in partnership with partners, including the WB. Working to enhance its Africa-specific comparative advantage, AfDB has introduced the Country Governance Profile (CGP) as a diagnostic tool for systematically identifying governance-related structural and institutional weaknesses and informing participatory dialogue; CGPs were prepared for Chad, Cameroon, Malawi, Benin, Senegal, and Swaziland in 2004. AfDB is also developing Private Sector Country Profiles, setting out its private sector strategy in the country, building on Investment Climate Assessments and other diagnostic work.
- Analytic work is the basis of all AsDB policy discussions, strategy formulation, and preparation of lending and non-lending programs. Pre-CSP analysis such as macroeconomic and poverty analyses, assessments on gender, governance, private sector development and environment provide the necessary background to formulate the CSP, while detailed roadmaps steer operations in individual sectors. AsDB, together with the WB, has carried out investment climate surveys in selected Asian countries.
- EBRD's analytic work is mostly carried out as part of project due diligence (for example, market studies, least cost analyses). To support its policy dialogue on the investment climate, EBRD (together with the WB) has undertaken periodic surveys on the business environment and enterprise performance (BEEPS). The next round of the BEEPS is planned for 2005, covering all 26 EBRD borrowers – and, as noted below, the BEEPS survey is to be extended to all developing countries under a joint initiative of the MDBs. A parallel EBRD-only exercise will focus on the Early Transition Countries. EBRD's knowledge-transfer activities focus on market-economy skills for the private and public sectors and on results-based demonstration projects.
- IDB country strategies benefit from analytic work carried out in partnership with governments and other development partners. Sector policy notes and increasingly, debt sustainability assessments (in both HIPC and non-HIPC countries), are becoming an integral part of the country strategy preparation process, albeit within a highly constrained administrative resource envelope. OVE (IDB) has emphasized the importance of underpinning IDB's technical work with local knowledge to improve its usefulness and fit.
- The WB has adopted a partnership approach to economic and sector work (ESW). Carrying out its analysis with borrowers helps to promote capacity building while grounding the analysis in country conditions. Sharing the work with bilateral and multilateral partners helps to contain costs – both out of pocket and in terms of scarce country capacity – by reducing duplication and promoting harmonization. Much of the WB's diagnostic work on country fiduciary systems is carried out with partners, a trend also increasing in the preparation of Poverty and Social Impact Assessments and Investment Climate Assessments. The growth in the WB's ESW has begun to level off from the very rapid rates recorded in the early years of its ESW reform program, with sector work on human and social development and social

protection, the rural sector and agriculture, and other discretionary topics gaining ground relative to fiduciary diagnostic studies, as gaps in the latter have increasingly been filled. Tracking the status of country fiduciary systems, assessments, and knowledge gaps is an area that will continue to require a close watch – especially in view of the capacity building role played by the MDBs in helping countries to put in place the needed financial accountability systems for absorbing higher aid levels.

25. Capacity Building. Capacity building constitutes the quintessential challenge of development assistance, and support for it is embedded in almost all MDB activities. It is at the core of AfDB and WB efforts for supporting country development in Sub-Saharan Africa (Box 6.4). As discussed later in this chapter, support for capacity building in managing for results and statistics is central to the MDB results agenda. Of equal and complementary relevance to this report – in view of the recommendations of earlier chapters – is MDB support for (i) enhancing countries' absorptive capacity for managing and accounting for aid (and other resource) flows, in view of the evident need for increased volumes if the MDGs are to be met; (ii) improving the capacity for private sector-led growth; and (iii) trade capacity building, particularly for trade facilitation, financial services, and transport infrastructure.

- **Aid Management.** Increasing aid absorptive capacity requires credible country systems for accounting for and managing the money – including importantly fighting corruption. This involves arms-length financial audits, competitive procurement, and accountable public expenditure management. All the MDBs are working in these areas, with lessons learned shared through the MDB Working Group on Governance, Anti-Corruption, and Capacity Building. Meanwhile, as part of the ongoing shift from enclave projects to SWAps, budget support operations, and broader lending support vehicles, the MDBs (and others, such as DFID, the European Commission, and the IMF) have been helping to strengthen country systems for managing public funds from all sources, utilizing diagnostic instruments such as Country Financial Accountability and Procurement Assessments and Public Expenditure Reviews and the HIPC Public Expenditure Management Assessment and Action Plans. These efforts all focus on the supply-side of aid management, and have generally received high marks in evaluation reviews. In its recent review of anti-corruption activities, OED (WB) also stresses the importance of underpinning such efforts with demand-side initiatives – geared to fostering public support among a wide spectrum of stakeholders.
- **Investment Climate.** The MDBs' approach to private sector development has evolved through time, from support for credit institutions to a greater focus on macroeconomic policies, and now to a greater focus on the quality of a country's investment climate. Institutions – including the “rules of the game” – and associated capacity building efforts are now seen as key, and the MDBs all have major programs of support and analysis including extensive programs on Investment Climate Surveys. The MDBs have recently announced their intention to extend the BEEPS survey currently in use by the EBRD and WB in Europe to all developing countries, thus opening a new window into the conditions faced by the private sector in different country circumstances. Such country-specific information is especially valuable in view of MDB evaluation findings on investment climate assessments, highlighting the need for greater knowledge of country-specific constraints and opportunities.
- **Trade Facilitation.** The MDBs are active in this area, but more needs to be done especially to coordinate better – avoiding duplication and gaps in country coverage and to promote synergies. The AsDB has been supporting customs harmonization and streamlining and anti-money laundering and other measures, focusing on the Greater Mekong Subregion and Central Asia, while the EBRD, using donor funds in conjunction with its Trade Facilitation Programme, has been providing training and advisory services to help banks in Russia, Azerbaijan, Armenia, Georgia, and Central Asia to improve the delivery of international trade finance services to their clients. The IDB's Multilateral Investment Fund supports the

modernization of customs facilities and border crossings in the Latin American and Caribbean Region. Focusing on diagnostic work, last year the WB carried out Trade and Transport Facilitation Audits in Benin, Chad, Guinea, Malawi, Mozambique, Rwanda, Tanzania, and Zambia – as part of an intensive program of support for Sub-Saharan Africa – as well as in Bangladesh, the Dominican Republic, and Tajikistan. It also approved 16 new projects with trade facilitation components, with commitment levels more than doubling compared with the previous year. Noting the marked shift on WB support from adjustment to trade facilitation during the 1990s, OED has launched an evaluation of WB assistance on trade, whose findings should be available for inclusion in next year's GMR.

Box 6.4. IDA's Strategy in Sub-Saharan Africa

(To be updated)

Strategic Context and Vision

The current international focus on the “Year of Africa” offers unique opportunities – and challenges – for IDA to support African development. Africa's improved performance needs to be matched by follow-through on the international community's promises of increased resources – not just by IDA14 but by all partners – and by a meaningful outcome in the Doha development round.

In this context, IDA's outlook for Africa is one of hopeful realism:

- Hopeful because: (i) African leadership is getting stronger (the New Partnership for Africa's Development (NEPAD), the African Union, and within countries – South Africa, Nigeria, Ghana, Senegal, and others); (ii) macroeconomic management is improving and CPIAs are rising; (iii) growth is widening (15 countries now have growth rates > 5% for several years); (iv) sub-regional integration efforts are growing; (v) HIV/AIDS prevention is beginning to show promise; and (vi) the Extractive Industries Transparency Initiative is taking root.
- Realism because: (i) 7% growth is needed to achieve the poverty reduction MDG; (ii) conflict remains a threat to stability, investment and growth; (iii) HIV/AIDs and Malaria are exacting a great cost in terms of lives, public services, productivity and growth; and (iv) insufficient aid is flowing in (too little quantity, and the quality in terms of harmonization and alignment remains weak).

Strategic Directions

The new emphasis in the IDA strategy is to accelerate and deepen shared growth in order to achieve significant poverty reduction and make faster progress towards the other MDGs; and to satisfy the need to invest in the assets of the poor (human, physical, financial) in order to enable them to participate in, and benefit from growth. Africans will not benefit from higher growth unless it is also sustained and broadly shared. An Action Plan is currently being developed to scale up WB activities in the context of IDA14. The elements of focus to underpin shared growth will include among others:

- **Trade and effective regional integration** – will be integrated fully into WB approach in Africa—into analytical work, national poverty reduction strategies, and CASs.
- **Agriculture and rural development** – multi-sectoral approach will be developed, explicitly linked to IDA's private sector development and infrastructure programs.
- **Alignment and partnership** – WB support will be consistently aligned with government-led programs and processes.
- **Governance, capacity building, and conflict** – will cover several dimensions: On governance – clearer benchmarks for measuring performance in difficult environments, drawing on the work of the UN Economic Commission for Africa; on capacity building, Task Force to complete its work in June; and on conflict, WB experience and lessons point to the value of explicit attention to conflict prevention and, in post-conflict cases, the need to be engaged early and deeply.

II. Sectoral, Regional, Global, and Research Programs

26. The MDBs' country focus is supported by four pillars, considered in turn below. First are the banks' sectoral and thematic strategies. Second are their regional programs – for addressing both regional issues and regional public goods. Third, are their global programs – for addressing both global issues and global public goods. Fourth is MDB research, itself an international public good.

A. Sector and Thematic Strategies and Programs

27. As the MDBs have become increasingly country focused, they have relied on sectoral and thematic strategies to guide country strategy formulation, program and project design, and implementation, building on the lessons of operational experience and research. These strategies set out the banks' sectoral and thematic modalities for helping developing member countries achieve their objectives. Of course, to fully understand the MDBs' different sectoral and thematic orientations, the evidentiary picture needs to go beyond statements of strategy and intentions. It also must include an analysis of actual MDB interventions, tracing through how the underlying sectoral and thematic strategies have been reflected in country strategies and programs, and MDB sectoral and thematic "results", once the MDB interventions have worked their way through country systems. However, neither of these other dimensions is easy to address at the MDB-wide level with currently available data. Hence, what is sketched below is the very beginning of an analysis that could in due course be linked more directly to the results measurement initiatives being developed by the MDBs in other contexts. To take it further in future GMRs will require more in-depth work – including a possible investment by the banks in the harmonization of their sectoral/thematic classifications for lending and analytic work.

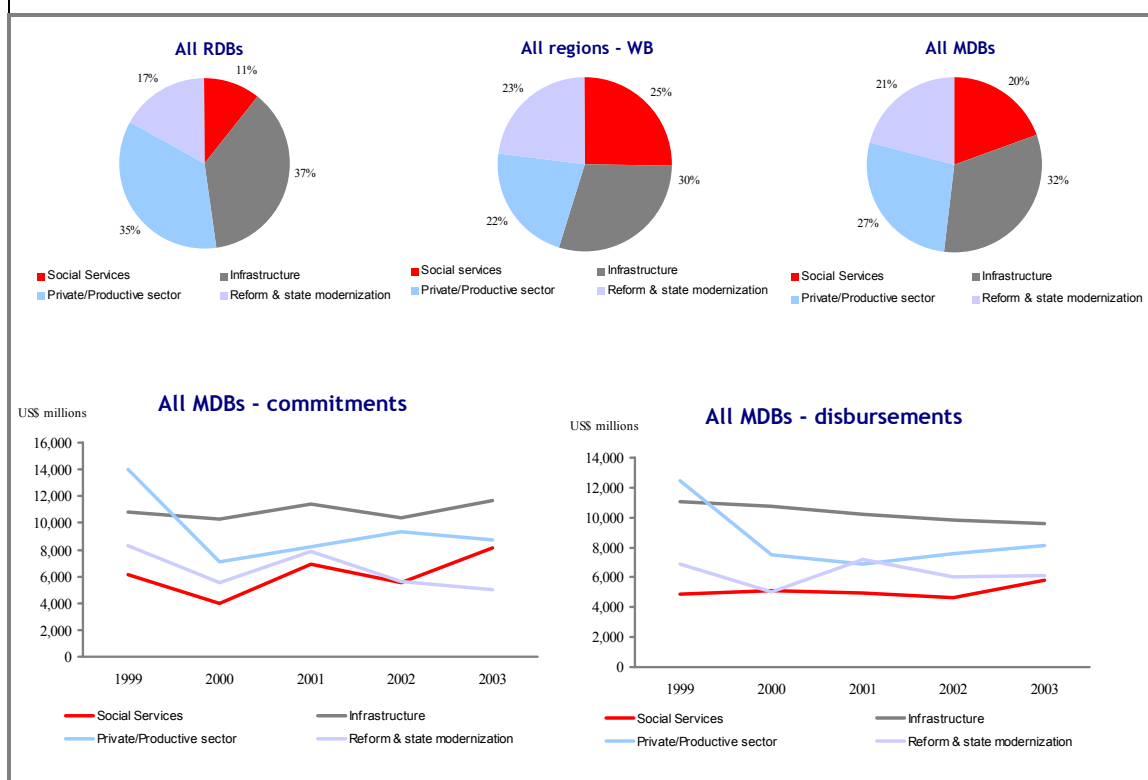
28. ***Sectoral and Thematic Strategies.*** In line with the themes of this report, the MDBs' strategies all stress the importance of private-sector-led growth, infrastructure, governance, and – with the exception of EBRD – the delivery of social services. Specifics include:

- Tailored to the needs of Africa, the AfDB has developed policy and sectoral strategy papers over the years, including on agriculture and rural development, social sector (especially education and health), fighting HIV/AIDS, integrated water resources management, water and sanitation, infrastructure, private sector development, gender and environment, governance, finance, and regional economic cooperation and integration
- Over the past decade, the AsDB prepared a number of sectoral and thematic policy and strategy papers, setting out institutional priorities, directions, and guidance to staff. It updated many of these last year – including those covering safeguards and gender. It also reviewed its overarching Poverty Reduction Strategy – assessing progress, evaluating the conceptual framework, and addressing implementation challenges – and updated it by enhancing country focus through alignment with national PRSs, introducing capacity development as a new thematic priority, and integrating timebound indicators in all operations.
- EBRD's sector strategies cover its main activity areas – agribusiness, energy, financial sector, microfinance and SMEs, municipal infrastructure, property and tourism, transport, and telecommunications – setting out the approaches that must be followed in operations.
- The IDB's the "2+4+1" program has focused on seven sector strategies¹⁷ developed in 2002-2003 in the priority areas of the Bank's Institutional Strategy. These include: sustainable economic growth; poverty reduction and promotion of social equity; modernization of the state; competitiveness; social development; regional integration; and the environment. Each includes lines of action designed to help focus Bank actions and enhance its development impact.

- Of particular relevance for this report are the WB's focus on (i) private-sector led growth in manufacturing, agriculture, and services, for which the Bank Group – drawing on the synergies across the Bank, IFC, and MIGA – can provide full-service support from upstream work with the Bank on the regulatory and policy framework to downstream work with IFC and MIGA on actual deals; (ii) infrastructure, through the Bank Group Infrastructure Action Plan, which seeks to revitalize this critical sector by internalizing recent innovations involving pragmatic approaches, output-based aid, public-private partnerships, and so on; (iii) governance, where the focus is on institutional development via sustained reform, effective public financial management, transparent processes, and anti-corruption; and (iii) the delivery of social services, especially for primary education and health care.

29. ***Sectoral and Thematic Shares and Trends.*** Sectoral lending trends across the MDBs are summarized in Figure 6.9. The individual pie charts suggest that for MDB lending volumes, measured by disbursements, infrastructure is the largest MDB sector. It also is the largest sector for the AsDB and IDB individually, and for the WB in Asia and Europe and in the aggregate. For African and Latin American and Caribbean borrowers from the WB, social sector lending is the largest. These charts point to differences between MDB support across regions that warrant further analysis – especially as between Asia (where AsDB and WB sectoral shares are similar) and Latin America and the Caribbean (where IDB and WB sectoral share are different). Such an analysis could be undertaken for the next GMR, including an analysis of MDB trends in analytic work across sectors and countries. Meanwhile, Figure 6.9's trend lines reflect the steep drop off from 1999's spike in MIC borrowing levels shown in a different context in Figure 6.7. They also show the continuing decline of infrastructure disbursements, reflecting developments in the 1990s when MDB infrastructure lending had fallen because of heightened concerns about environmental risks, fiscal space constraints, and crowding out of the private sector, which was expected to play a larger role than in fact actually materialized. With infrastructure commitments on a recovery path, disbursements also will recover, albeit with a lag.

30. ***Sectoral Results and Evaluations.*** The methodological challenges of going beyond lending tallies to assess the MDBs' sectoral contributions and results are not insignificant – involving complex methodological issues on causation. Adopting a pragmatic approach, the MDBs are beginning to measure their sectoral *outputs* more systematically, for example in the context of the IDA-14 Results Measurement System (discussed later in this chapter). But it is still early days in this process and much work still needs to be done to see how to move credibly from measuring bank-supported sectoral outputs to outcomes. Whatever solution ultimately emerges, it is likely to rely heavily on the findings of the banks' independent evaluation departments, which have carried out a number of relevant reviews. These generally paint a mixed picture, in which the MDBs are found to have made contributions in infrastructure, private sector development, governance, and the social sectors, but where performance could have been better, especially at it has affected country, program, and project outcomes, institutional development, and sustainability. While the individual findings vary, three themes run through many of the MDBs' sectoral and thematic evaluations – (i) the need for clearer evaluability at the design stage, with the intended results and measurement platform clearly set out; (ii) the importance of providing country typologies for guiding localization, so that the strategies can be more easily customized to country conditions; and (iii) the importance of integrating the political economy of reform – and the incentives of key players in sector reform – to allow the strategies to take those factors into account and be truly strategic.

Figure 6.9. Big 5 MDBs: Sectoral Distribution of Lending

B. Regional Public Goods and Programs

31. The MDBs support a number of regional and sub-regional programs and initiatives in collaboration with other partners, as highlighted below. Especially important for the Regional MDBs, given their regional mandates, these programs are a mix of regional public goods programs, including for regional infrastructure projects, and multi-country programs.

- Regional cooperation and integration are key areas for the AfDB, including ‘trans-boundary’ water rights and river basin development. Support has been provided for capacity building for regional economic communities, the development of regional infrastructure, the creation of an enabling regional environment for the private sector, and promotion of sustainable development at the regional level, and the fight against the spread of HIV/AIDS. AfDB supports the NEPAD Secretariat, the African Union, and the Global Environment Facility (especially on the development of the Environmental Action Plan for Africa), and the Africa Regional Coordination Unit for the UN Convention to Combat Desertification.
- In Asia, the Greater Mekong Subregion Program has long been a prominent area of AsDB support. Other regional programs cover the Pacific Islands, Central Asian Regional Economic Cooperation, South Asia Subregional Economic Cooperation, the Indonesia, Malaysia, Thailand Growth Triangle, and the Brunei, Indonesia, Malaysia, Philippines East ASEAN Growth Area. AsDB also implements technical assistance projects and loans supporting regional cooperation. Areas of support range from infrastructure (transport, energy, trade facilitation), to health (combating infectious diseases), environment, urban development, financial and capital markets development, capacity building in public sector management, including managing for development results. Particularly noteworthy is the collaboration between the AsDB and IDB on regional public goods – including their joint sponsorship of the recent Tokyo Forum on the Operational Dimensions of Supplying

Regional Public Goods through Regional Development Assistance – and AsDB leadership on tsunami-related work, both the March 18 High-Level Conference being organized by the AsDB and its pledged support for an interim tsunami warning system.

- EBRD administers a number of regional programs supporting private sector development, including for trade facilitation and SME development. These programs include a series of country-specific sub-projects, which are monitored and processed as country-level operations. In addition, a growing number of projects cover more than one country (for example, regional equity funds, projects in which sponsors from one country invest in another, and energy trade).
- IDB's approach to regional issues has long focused on facilitating cross-fertilization on policy issues. Its Regional Policy Dialogue provides a forum for regional policy-makers to discuss issues of common concern in its seven network areas (education; natural disasters; environment; central banks and finance ministries; poverty and social protection; and public policy management and transparency), with 15 regional and subregional meetings taking place in 2004. Its Regional Technical Cooperation Program has focused on promoting modernization of the state, supporting the private sector through competitiveness strengthening, and addressing social issues of development. Responding to the growing demand for regional public goods over the past decade to support country reform efforts, the IDB Initiative for the Promotion of Regional Public Goods is now operational. Since its approval in March 2004, the Bank has received 35 proposals for an amount close to \$64 million. The Initiative will provide up to \$10 million annually to help finance the selected projects.
- The WB supports a large number of regional programs and initiatives, in cooperation with the other MDBs and relevant partners. Examples of direct relevance to the priorities set out in earlier chapters include: (i) the Trade and Transport Facilitation in Southeast Europe Program, which promotes more efficient and less costly trade flows across the countries of Southeast Europe and provides customs standards compatible with the European Union; (ii) the Latin American regional initiative on infrastructure, in cooperation with the IDB; and (iii) the Strategic Framework for IDA's Assistance to Africa.

C. Global Public Goods and Programs

32. Like their regional programs, MDB global programs are a mix of global public goods programs and multi-country programs. As implementing agencies geared to supporting country development, all the MDBs are involved in helping their clients meet their commitments under international agreements governing the provision of GPGs – from peace and security, to disease control and support for the global commons to financial stability and anti-money laundering, open trade, and knowledge sharing – and they are implementing agencies for the Global Environment Facility and participate in the Global Fund to Fight AIDS, TB, and Malaria, GAVI, and so on. As the single global institution among the MDBs, WB support for global programs has grown rapidly in recent years, with 70 different programs funded by the Bank's core budget, the Development Grant Facility, and donor-supported trust funds.

33. **Independent Evaluation.** The WB's support for global programs has been the subject of an extensive evaluation by OED. GMR 2004 reported on the findings of OED's Phase 1 report. As noted there, OED concluded that the Bank had played a useful role in these programs by providing a platform for learning, advocacy, and collaborative action to address key global challenges. But, with notable exceptions including large and high-profile programs such as the GEF and CGIAR, for the most part OED found the programs to be undermanaged, especially relative to country programs, with too little attention to formal appraisal and evaluation criteria, too little policy content, and unclear accountabilities. Based on a review of 26 of the Bank's

global programs, the Phase 2 report finds that the WB's current global programs are a mix of high priority global public goods programs and smaller multi-country programs that support national public goods. The multi-country programs are often impeded by: (i) lack of results orientation; (ii) focus on advocacy without the necessary resources for TA or investments; (iii) unclear poverty impacts; and (iv) weak knowledge management components. OED's recommendations stress the need for a global strategy, based on a consultative process involving key partners, and better day-to-day management of the existing global portfolio, designed to enhance returns to Bank country operations and helps set international standards for quality. Reflecting these findings, the WB has established a small central Global Programs and Partnerships Secretariat to better manage and monitor these activities and is currently fleshing out its strategy.

D. Research

34. MDB research has helped to articulate the global and regional development agenda, with notable contributions on aid, private-sector led growth, and trade, as reflected in earlier chapters of this report. It also has provided a basis for the application of emerging lessons at the country level, albeit somewhat less successfully according to MDB evaluation reviews, which have generally pointed to the need for greater specificity based on country conditions. OED (WB), for example, has argued that the WB's research on the investment climate provides insufficient guidance to client governments and staff. Meanwhile, consistent with the partnership theme of this chapter, there is another area for improvement, which is on the cross-fertilization across the MDBs. At present, MDB researchers meet in a variety of contexts, but more systematic approaches also would be fruitful, especially given the Banks' different vantage points – with the regional MDBs often intermediating between the global development agenda and regional considerations. AfDB and AsDB currently have reviews underway of the role and contribution of their research capacities; it would be useful to broaden out these initiatives to the other Banks, and more generally to increase the interactions across the Banks in this area.

- Until recently, the AfDB, due to budgetary and personnel constraints, has had limited opportunities to take full advantage of its position as a regional bank to undertake research at the desired scale. Efforts are now being launched to upgrade the Bank's capacity, focusing on: poverty analysis, growth, and debt sustainability; macroeconomics and forecasting; public policy and public sector management; agriculture and food security; financial sector development; science, technology and industrial development, human capital and social development; and international trade and regional integration.
- AsDB undertakes research including innovative, experimental or theoretical work to acquire new knowledge, normally directed towards a specific purpose such as developing a new policy or evaluating a program. AsDB's intellectual work includes advocacy, capacity building, and research, with each of these roles contributing in different ways to development thinking and knowledge. In 2004, AsDB adopted a knowledge management framework to enhance knowledge sharing among its clients and to become a better learning organization. AsDB is presently carrying out a detailed review of its research function, including analysis of cost, user demand, and quality, with a view to enhancing the quality and impact of its research.
- Flagship EBRD research publications are the Transition Report (autumn) and Transition Report Update (spring), which includes indicators on progress in transition at the country-level, as well topical analyses. Areas of particular research interest include transition economics, social transition, the business environment, energy, infrastructure, and the financial sector. The Office of the Chief Economist, which oversees the Bank's research, provides the transition impact ratings for projects, which are a key input for assessing operational performance.

- Mainstays of IDB research are a focus on macroeconomics, private sector, and growth; trade and integration; and sector strategies and policies. The Bank has also been actively supporting regional research networks promoting academic research and policy dialogue and strengthening the research capacity of regional institutes.
- Research is central to the WB's knowledge-bank mission, with its agenda evolving continually in response to operational and policy needs. Its main focus is strategic – directed at informing the overall agenda for development policy and development assistance, through flagship vehicles such as this year's World Development Report on the investment climate and analysis and data critical to international trade negotiations – as at Cancun last year – and the ongoing international dialogue on growth, poverty reduction, trade, and aid effectiveness, especially with respect to the mutual contributions of developing and developed countries, as discussed in earlier chapters.

III. Partnerships and Harmonization

35. Virtually everything discussed in this report involves partnerships – at the regional and global level, at the country level, and at the institutional level – all touching the issue of harmonization in one way or another. Also relevant are the issues of transparency and disclosure, which bear on the inclusiveness or exclusiveness of the partnerships under consideration.

A. Global Partnerships

36. The MDBs actively participated in the recent Paris High-Level Forum on Harmonization, Alignment, and Results (HLF), with the MDB Heads endorsing the Paris Declaration on Aid Effectiveness¹⁸ setting out specific commitments for further alignment, harmonization, and results. All have been engaged in the new Working Party on Aid Effectiveness and Donor Practices—a broad partnership of bilateral and multilateral donors/agencies, with representatives of more than 16 developing countries, supported by the OECD/DAC—put in place after the Rome High-level Forum on Harmonization in 2003 to facilitate, support, and monitor progress on harmonization, alignment, and managing for development results. AsDB is represented on the overall Steering Committee for the Working Party, and MDB staff chair/co-chair four of the five subgroups, and contribute substantively to the work of all.¹⁹ The WB chaired the steering committee for the Forum and has seconded a full-time staff member to the OECD/DAC Secretariat to assist the Working Party. All the MDBs were involved in regional workshops organized to ensure the inclusion of country and regional perspectives on the challenge of harmonization and managing for results in the HLF.

37. ***Global Partnership on Managing for Development Results.*** Central to the above is the MDBs' work in fostering a Global Partnership on Managing for Development Results. To this end, they have established an active MDB Working Group on Managing for Results, and along with bilateral donors and UNDP have formed the Joint Venture on Managing for Development Results, under the DAC Working Party on Aid Effectiveness and Donor Practices, to join efforts in this area. Through these efforts, they strive to harmonize country results reporting around national systems and better coordinate donor support to countries to strengthen their capacity to manage for results. The main outcome of the global partnership to date is the convergence of the MDBs around agreed core principles and results agendas that share common elements and approaches – reflected in the recently issued (draft) Results Sourcebook²⁰.

B. Country-level Partnerships

38. The true test of global partnerships is operational work at the local level: without follow-through there, the various global meetings remain talk shops with little impact. At this level, the MDBs have entered into a variety of arrangements with their developing member countries and other partners – ranging from the preparation of joint analytic work and strategies to joint operations and common environmental impact assessment procedures. These processes have been facilitated by the common direction in which the banks have been moving on their strategies and lending, as summarized earlier in Tables 6.1 and 6.2. Nevertheless, individual personalities and behavior continue to affect the speed and depth of progress on institutional commitments to partnership. Hence while there are many examples of good practice; there remain instances of bad practice, which are long remembered by those affected. Despite the sense among many that WB culture has changed, its staff continues to be considered arrogant by some, including by staff in other MDBs, and as reflected more broadly in the WB Global Poll.²¹

39. **Country Strategies and Portfolio Reviews.** As examples of good practice, the MDBs are increasingly coordinating their country strategies and portfolio reviews with each other and with other partners. Coordinated strategies are planned, under preparation, or recently completed for Bangladesh, Cambodia (Box 6.5), Honduras, Nigeria, Tanzania, and Uganda; these exercises involve working with the authorities to ease administrative burdens and with other partners to coordinate schedules, share diagnostics, and ensure consistency and balance while avoiding contradiction and duplication. In LICUS countries, such as Afghanistan, Guinea Bissau, and Haiti, Liberia, Sudan, and Timor Leste, MDB teams are collaborating closely with other donors to provide support on strategy development (including in some case transitional results matrices and pooled funding mechanisms). Meanwhile, the AfDB, AsDB, and WB have undertaken joint portfolio reviews in a number of countries, including Kenya, Kyrgyz Republic, Mozambique, Rwanda, the Philippines, Uganda, and Vietnam.

Box 6. 5. Cambodia Country Strategy: AsDB, DFID, and WB

The Cambodia country strategies for the AsDB, DFID, and the WB were prepared together, all drawing on the Cambodia PRSP. By working together, the partners aimed to increase coordination and coherence in the policy dialogue and reduce Government transaction costs in dealing with them. Meanwhile, the Government has signaled a greater commitment to country ownership and leadership of the development and donor coordination process, giving greater attention to project implementation and on the enhancement of the level of resource transfers from development partners.

In support of the above, the AsDB, DFID, and the WB have agreed on a “lead-agency” approach to implementing their partnership. Under this approach, the lead agency in a sector (or sectors) provides primary support for the Government’s strategy development and implementation, while providing back-up support in other sectors. For example, AsDB takes the lead in: (i) agriculture and water resources; (ii) education; (iii) finance; and (iv) transport, while supporting the dialogue in sectors where DFID or the WB has the lead role.

AsDB, DFID, and the WB also have developed a set of “Partnership Principles” guiding their relationships with each other and with the Government, other international development partners, the private sector, and civil society. Other partnership initiatives include the restructuring of the existing Government-donor Technical Working Groups at the sector and thematic level, greater reliance on SWAp, and better harmonization of donor procedures in project implementation.

Recognizing Cambodia’s weak capacity – and LICUS status – the harmonization action plan agreed with the Government and donor partners places the burden on donors for initial efforts to reduce transactions costs and improve information and reporting, rather than waiting for Government’s capacity to improve *before* improving donor behavior.

40. **Operational Support.** The innovations in MDB lending instruments discussed earlier in this chapter have opened the door to much greater partnerships at the country level, especially the introduction of SWAp by the AfDB, AsDB, IDB, and the WB.²² (See Box 6.6 for an example of a SWAp in the support of AIDS prevention and treatment.) The Poverty Reduction Strategy Credit (PRSC) is also proving useful for coordinating donor support for LICs' Poverty Reduction Strategies, with half of the PRSCs currently under implementation involving coordination of support and conditionality with other donors.

41. **Joint Analytic Work.** Carrying out joint analytic and diagnostic work is a win-win approach to reducing costs to donors and countries alike. The MDBs have increasingly conducted analytic work jointly with other partners, especially for the core diagnostic and fiduciary reviews that underpin lending. To facilitate sharing and promote collaboration on analytic work, the WB hosts the Country Analytic Work website at www.countryanalyticwork.net, which carries major reports of more than 25 multilateral and bilateral donor agencies; over 1410 reports²³ were added to this website in 2004. Going forward, it will be important to build on this important initiative to use the data base for the joint programming of analytic and capacity-building work, based on the identification of gaps and needs in key areas.

Box 6.6. Malawi Multi-Sectoral HIV/AIDS SWAp

Partly because of work on the PRSP, donor coordination in Malawi is improving. Major donors and sectoral donor working groups in economic management, poverty reduction, water, and agriculture meet regularly. In addition, donors have been collaborating on sector-wide approaches (SWAp) for development assistance, as evidenced in the Multi-Sectoral HIV/AIDS Project, which aims to support Malawi's efforts to reduce the transmission of HIV, improve the quality of life of those infected and affected by AIDS, and mitigate the impact of HIV/AIDS – all central PRSP objectives.

Key project components include a focus on (i) advocacy aimed at behavioral change – and the prevention of HIV transmission – especially among targeted populations, to mitigate the spread of the epidemic, which includes the promotion of safe sex, such as the use of condoms, and, incorporate as well life-skills education, and HIV/AIDS information into educational curricula; and (ii) impact mitigation targeting communities, orphans, widows/widowers affected by the epidemic. Further components focus on capacity building, and partnerships to implement, and coordinate responsiveness to the epidemic; research, and monitoring and evaluation, to enable the National AIDS Commission interventions, in the prevention, and care of the epidemic; and, leadership and coordination to support policy related issues, and, program management to support procurement, financial management, and institutional development.

The project is structured as a SWAp, supported by a number of donors, including AfDB and IDA, as well as CIDA, DFID, the Global Fund to Fight AIDS, Tuberculosis, and Malaria, NORAD, UNDP, and USAID. It involves coordinated joint implementation reviews, pooled funding arrangements, a single framework for financial reporting and M&E including one set of quarterly financial tables and progress reports for all eight donors, and harmonized procurement.

C. IFI Partnerships

42. As noted in the introduction to this chapter, IFI business models differ as between the MDBs on the one hand and the IMF on the other. These differences translate into differently shaped partnerships across the IFIs. Among the MDBs, given their many parallel concerns and challenges, there is a premium on cross-fertilization and networking in the pursuit of best practice. Between the banks (and especially the WB) and the IMF, given their more complementary roles and contributions, the focus is more on joint products and the appropriate division of labor in producing them.

43. **MDB Networks.** Consistent with the above, the MDBs are increasingly functioning as a federation of networks, operating at almost as many different levels that the banks themselves

operate. The recent announcement that the MDBs will extend the EBRD/WB BEEPS survey to countries in other regions is but the latest development in an ever expanding series of such efforts. Meanwhile, existing working groups on financial management, procurement, environment, results, and capacity building have continued to progress, with new groups such as the MDB Working Group on Managing for Development Results energizing the partnership across a broad front. In January, the AsDB hosted a meeting to discuss common challenges in managing the performance-based allocation systems of the MDBs' concessional windows – an exercise that is likely to segue into an ongoing working group, especially as the MDBs move forward towards CPIA disclosure in early 2006. To date, these groups have proven to be productive fora for sharing experiences, challenges, and best practices across the institutions. Going forward, they should be encouraged to think more boldly and strategically, moving beyond the harmonization agenda to seeing how their professional groups might function as fully-fledged networks across the MDBs and how they might advise MDB Management on future directions for strategic selectivity.

44. **Bank-Fund Collaboration.** In line with the earlier discussion and as highlighted below in the IMF section on partnerships, three issues continue to be of central importance to the WB partnership with the IMF – and of continuing interest to the other banks as well – debt sustainability, the PRSP process, and the streamlining of structural conditionality. In addition, two other themes warrant highlighting in line with the themes of this report – the collaboration between OED and the IEO, and issues surrounding public investment in infrastructure. On the partnership between OED and IEO, the collaborative review of the PRSP process set an important precedent and example for future reviews also by other institutions. On infrastructure investment, the Bank and the Fund are currently working on steps that could be taken to safeguard productive public investment and improve the quality of public investment planning and oversight, while maintaining a focus on fiscal and macroeconomic sustainability. Following up on earlier work by the Fund's Fiscal Affairs Department²⁴ – carried out in close cooperation with the Bank and the other MDBs, in particular the IDB – eight case studies have been prepared, the preliminary findings of which point to little impact on growth of the public investment compression under investigation. (See also Box 6.11, which discusses this topic in the context of the role and work of the IMF.)

D. Partnership with Civil Society

45. All the above are about partnerships among “insiders”, those with particular institutional affiliations that give them access to information. But to many IFI critics, the more relevant issue is about openness to “outsiders”, those without official affiliation and credentials, for whom access to information and transparency of MDB activities are key. Over the past 15 years, the MDBs have adopted formal policies for partnering with civil society and for providing access to information and documents, with a number of further changes recently approved (in the case of the WB) and pending or under consideration (in the case of the AfDB and AsDB). (See Table 6.3.) Nevertheless, there remain concerns among IFI critics that the MDBs have not met a standard of transparency and accountability commensurate with their power and influence in a number of areas, such as on project implementation and Board deliberations.

Table 6.3. MDB Transparency					
	AfDB	AsDB	EBRD	IDB	WB
Country Strategy Documents					
Early Draft	✓	Not routinely Proposed in new policy	✓	no	✓
Final Draft (pre-Board)	under consideration	no	no	no	no
Final (after Board)	✓	✓	✓	✓	✓
Analytic and Project Work					
ESW	✓	not routinely proposed in new policy	Partially	✓	✓
CPIA: Starting with 2005 scores	under consideration	✓	✓ Transition Scores in the Transition Report	no	✓
Appraisal Reports Except privileged info	✓	public yes private no yes for both proposed in new policy	Partially (e.g., EIAs)	✓	✓
Project Supervision Reports	no	no updated PPRs and PIDs disclosed under proposed new policy	no	no	no
Project Completion Except privileged info	✓	public yes private no yes for both proposed in new policy	no	✓	✓
Policy Papers					
Final Draft (pre-Board)	under consideration	no	no	no	no
Evaluation Documents					
Bankwide	✓	✓	✓	✓	✓
Country Strategy	✓	✓	no (country strategy evaluation is still in pilot stage)	✓	✓
Sector Review	✓	✓	✓	✓	✓
Project Audits	✓	✓	Partially (through summary documents)	✓	✓
Board Procedures					
Agenda	✓	Not now proposed in new policy	no	✓	✓
Minutes	no	Not now proposed in new policy	no	✓	✓

IV. Managing for and Measuring Results

46. This section covers two points. First, what are the MDBs doing to manage better for results? Second, what are they (and others) doing to measure results?

A. Managing for Results

47. The MDB conceptual framework defines results as sustained improvements in development outcomes at the country level. It posits that they can be improved through critical actions along the results chain that leads from inputs to outputs and in turn to outcomes. For the MDBs, this translates into a focus on: (i) country capacity and “demand” for results; and (ii) MDB strategies and quality.

48. Table 6.4 summarizes the key points of this shared approach. As shown there, all the MDBs have approached the results agenda in a similar manner. The exception is EBRD, which does not have a program supporting statistical capacity building.

Country Pillar

49. All the MDBs recognize that the most important element of the results agenda is the support it provides for country-based systems. The key elements of the external pillar are support for public sector management and statistical capacity building. This support has two objectives. First, it is aimed at increasing the efficiency of resource allocation and use – whether at the national, state, provincial or local levels, and/or in the context of a given sector. Second, and more narrowly, it is aimed at improving the implementation of Bank-financed operations, through a greater reliance on country systems for managing for results.

50. **Public Sector Management.** Helping countries to manage for results goes to the heart of the banks’ public sector management agenda. That said, it calls for an upgrade of attention to certain aspects, such as evaluation capacity and other vehicles for increasing institutional accountabilities in government agencies and departments. (See, for example, Box 6.7.) This process is occurring at all the banks, who are using existing facilities to focus more on the critical need of managing for results, whether in the context of training for staff from project executing agencies (in AfDB and IDB), or using technical assistance grants to build evaluation capacity in borrowing countries (AsDB), or building evaluation-related institutional capacity in project agencies on a project-by-project basis (EBRD), or through the strengthening of country budget and evaluation systems in the context of policy-based lending (WB). The WB, with its PEFA partners, has developed a standardized set of performance indicators for use in monitoring country progress in public financial management, and is widely consulting with development partners through the OECD DAC, and with client countries. The indicators are part of a strengthened approach to public finance reform that emphasizes country leadership in reform strategy, donor coordination behind the government strategy, and performance indicators for monitoring progress over time.

51. **Statistical Capacity Building.** Supporting and complementing these efforts is a major agenda to help countries build and strengthen their statistical capacity. Improved statistics and

Table 6.4. Managing for Development Results in MDBs

	AfDB	AsDB	EBRD	IDB	WB
Country					
PSM	✓	✓	✓	✓	✓
Statistics	✓	✓	no	✓	✓
Institutional					
Strategies	✓	✓	✓	✓	✓
Projects	✓	✓	✓	✓	✓

analysis are essential for improved measuring, monitoring and managing for development results. Without good statistics, governments cannot deliver efficient administration, good management, and evidence-based policy making. Nor can citizens effectively monitor government performance and make informed decisions about their own lives. An effective and efficient national statistical system, providing the data needed to support better policies and to monitor progress, is thus a crucial component of good governance and accountability. Support for capacity building in this area thus complements MDB support for public sector management in other areas, such as budget management and auditing, and is being provided by all the MDBs except EBRD. Programs include technical assistance grants for statistical capacity development such as those provided by the AsDB. In addition, a number of joint initiatives, many working closely with the PARIS21 initiative, are under way, including the joint IDB, UN/ECLAC, and WB Program for the Improvement of Surveys and the Measurement of Living Conditions (MECOVI) initiative, which provides technical and financial assistance to improve household surveys of social conditions; the AfDB's work with the International Comparison Programme in helping countries collect economic statistics; and the WB's Statcap program, which provides support for the long-term development of the national statistical system and may involve a series of separate grants or loans as appropriate.

Box 6.7. MDB Support for Colombia's Culture of Evaluation

In 2000, with the support of the IDB and the WB, the Government of Colombia implemented three emergency social programs to help poor Colombians cope with the effects of the economic crisis – *Familias en Accion*, *Empleo en Accion*, and *Jovenes en Accion* – collectively known as the RAS (*Red de Apoyo Social*). *Familias* is a cash transfer program conditional on school and health center attendance by children, *Empleo* is an employment program for low-skilled adults, and *Jovenes* is a job-training program and subsidy for youth from poor neighborhoods. US\$5 million of the combined US\$400 million loans was programmed to be spent on external evaluations for the programs.

Highly credible because of their very high quality, the impact evaluations clearly showed that the RAS programs are effective tools for crisis management at the household level. For example, the results of the evaluation of *Familias en Accion* showed that: (i) food consumption was 14-24 percent higher among recipients, with no effect on household tobacco and alcohol consumption; (ii) school attendance rates were 4-8 percentage points higher among program participants age 12-17; and (iii) program participants age 0-6 were taller (0.75 centimeter) and heavier (0.25-0.5 kilos) than non-program participants – partly due to less illness among these children, particularly in rural areas.

The impact evaluations also played an important strategic role. Critics of the *Familias* program had argued that it was costly and that the grant money would be poorly spent by beneficiary families, thus making it a candidate for budget cuts. When the evaluation results were presented to the President, the Government's strategy reversed: the program was not only maintained, but pilots and evaluations were undertaken to explore the possibility of expansion.

The RAS evaluations also helped institutionalize impact evaluation and results-based management in the Colombian social sectors. While the Government had established an evaluation department – SINERGIA²⁵ in the early 1990s – the RAS program evaluations gave it a concrete objective. The two banks worked with SINERGIA to develop its capacity to be a good “consumer” of impact evaluations, and to undertake evaluation studies. Over the past four years, technical assistance, grants, policy-based loans, and investment operations have been used to support SINERGIA's efforts to build a culture of evaluation. Specific activities included new evaluations of social programs, a law requiring periodic impact evaluations of social programs, creation of a multi-Ministerial group on impact evaluation, regular production and dissemination of reports monitoring the government's progress in the implementation of its policies, and a high-profile international conference on the importance of impact evaluations to government policy.

Institutional Pillar

52. The approach to MDB performance and results focuses on country strategies and lending operations – including support for measures to help countries develop their own capacity to manage for results, as described above – with self- and independent-evaluation playing a key role.

53. **Strategies.** As noted earlier, and summarized in Table 6.1, the AfDB, AsDB, and the WB are piloting results-based approaches. EBRD and IDB are incorporating many features of the results-based approach in their strategies – including the reflection of lessons learned from past strategies in new strategies – with EBRD focusing on Transition Impact as its key measure of results and IDB increasing the evaluability of its country strategies, by improving the indicators in its strategy monitoring matrices for measuring the specific outcomes of its interventions. The critical feature is to use the process to move to a more strategic approach to country programming, focused on where the MDB can have the biggest impact and to overcome supply-driven tendencies that may otherwise linger among sectoral staff. Based on its ongoing review of experience with the Results-Based CASs to date, the WB plans to introduce ratings into the CAS Completion Report process, thereby taking a step towards more systematic self assessment of the achievement of the intended CAS outcomes.

54. **Lending Operations.** Emerging best-practice relies on self-assessment by teams, arms-length assessment by quality assurance groups, and independent assessment on completion to validate. Table 6.5 shows where MDBs are on putting in place this best practice system. The WB has taken a number of steps, building on the longstanding efforts of its Quality Assurance Group (QAG) and Management commitment to act on QAG (and OED) recommendations. But the IDB also has made major strides in the past few years on this component, piloting quality-at-entry reviews for both investment lending and policy-based lending, and proposing in its Medium-Term Action Plan for Improving Development Effectiveness (MTAP) the launch of a quality-of-supervision exercise as well.²⁶ AfDB has committed in the context of AfDF X for the full complement of reviews designed to reinforce the positive trends emerging there.²⁷ The key in all cases will be effective follow-through.

B. Measuring Results

55. Several approaches to measuring MDB results have emerged in recent years. First, is the practice being developed in the context of the replenishments of the MDB concessional windows. On a parallel track, albeit more focused on MDB performance rather than results, some MDB shareholders are developing comparative frameworks for assessing MDB (and other multilateral) performance, generally with a view to finetuning the distribution of their own financial support to multilateral agencies. Third, civil society organizations are monitoring MDB performance, in an increasingly systematic manner. Finally, reflecting the lessons learned from these and other efforts, the MDB results teams are developing a comparative performance assessment framework that also can be used to underpin future GMRs.

Table 6.5. MDB Monitoring, Evaluation, and Reporting over the Project Cycle

	AfDB	AsDB	EBRD	IDB	WB
Upstream: Arms Length Review of Quality at Entry	To be launched in 2005; AfDF X Agreement	Under discussion	Ratings assigned by Chief Economist's Office and VP Risk Management	Piloted for investment loans and policy- based lending	QAG reviews since 1998
Midstream: Arms Length Review of Quality of Supervision	To be launched in 2005 under AfDF X agreement	Case by case reviews by OED	PED reviews; also, since 2003, transition impact monitoring system managed by Chief Economist's Office and VP Risk Management	Recommended under MTAP; timing not yet agreed	QAG reviews since 1999
Completion: % share of Project Completion Reports validated by Evaluation Department	50%	50% in depth; 50% normal	40%	100% starting 2004;	100% since 1980
				0% before 2004	

Concessional MDB Windows

56. These efforts began with the adoption of the IDA-13 Results Measurement System, which had its genesis in discussions with donors in 2001. At that time, the MDBs' work on results was just beginning to heat up, with the first Roundtable on Results in 2002. Much debate, technical analysis, and dialogue with donors and IDA eligible countries went into the construction of the initial approach, which has subsequently been refined for IDA-14 and in turn is being analyzed in the context of the AfDF and AsDF systems.

57. **IDA 13.** Box 6.8 shows the results of the IDA 13 measurement system, which were validated by an independent external audit. As shown there, the focus was on several country outcome indicators (chosen because of data availability and relevance) and the delivery of agreed inputs of analytic work by the WB.

58. **IDA 14.** As the WB's results agenda took shape during 2002-2004, the IDA Results Measurement System was aligned to it, focused on a broader set of country indicators – more closely aligned with the MDGs but also reflecting a broader set of objectives including growth, governance, and infrastructure – and the emerging institutional strategy described above focused on results-based country strategies and the quality and outcomes of lending operations. The indicators for the new system for IDA 14, agreed in December 2004, are also shown in Box 6.8.

59. **AfDF.** In line with the instructions from its Deputies,²⁸ the AfDF Results Measurement System is similar in methodology to that of a prototype of the IDA-14 Results Measurement System. Scheduled for revision in 2005, AfDB performance will be assessed at the project, institutional (country strategy) and country level, through the use of operations quality indices, evaluation findings, and changes in country-level indicators, based mostly on internationally available statistics.

Box 6.8. Results Measurement: IDA-13 and IDA-14**IDA-13 Results Measurement System – Results vs. Targets***

Education Outcomes		ORIGINAL PROCEDURE	TREND METHODOLOGY
Increase PCR from baseline	Target (%)	69	69
	Result (%)	70	73
Increase number of countries with positive PCR growth rate	Target (# Countries)	38	38
	Result (# Countries)	45	43

Health Outcomes	TARGETS (%)	2001 Result	2002 Result
Increase in Population-Weighted Coverage Rate of Measles	60	61	65
Number of Countries with 80% Coverage	29	27	29

Private Sector Development Outcomes	TARGET (%)	RESULTS
Reduce Time Required for Business Start-up	7	12
Reduce Formal Cost of Business Start-up	7	19

Inputs: Analytic Work	COMPLETED FY01 TO SPRING 2004	TARGET FOR SPRING 2004
CFAAs	51	40
o/w Africa	21	20
CPARs⁵	42	38
o/w Africa	19	19
PERs	42	40
o/w Africa	20	20
ICAs⁶	16	14

*As of April 1, 2004.

IDA-14 Results Measurement System**IDA 14 – Outcome Indicators**

- ✓ Proportion of population below \$1/day poverty line
- ✓ Under-5 child mortality
- ✓ HIV prevalence rate of pregnant women aged 15-24
- ✓ Proportion of births attended by skilled health personnel
- ✓ Ratio of girls to boys in primary/secondary education
- ✓ Primary school completion rate
- ✓ Proportion of population with sustainable access to an improved water source
- ✓ Fixed lines and mobile telephone per 1,000
- ✓ Formal cost required for business start up (percent of GNI per capita)
- ✓ Time required for business start up (days)
- ✓ Public financial management (# of benchmarks met)
- ✓ GDP per capita (Annual growth rate)
- ✓ Access to rural population to an all-season road (percent of rural population)
- ✓ Household electrification rate (percent of households)

Indicators of IDA Performance, FY05-07**Project Level**

- ✓ % IDA projects with satisfactory outcome ratings
- ✓ % IDA projects with satisfactory rating quality at entry
- ✓ % first IDA Project Supervision Reports with satisfactory baseline data on expected outcomes for projects initiated after July 03
- ✓ % IDA Implementation Completion Reports with satisfactory data on project outcomes

Country level

- ✓ # Results-based CASs prepared during IDA14

Outputs²⁹

- ✓ Health
- ✓ Education
- ✓ Water Supply
- ✓ Transportation

60. **AsDF.** Currently, the AsDB is developing a Bankwide Monitoring and Results Reporting System, which is also relevant to the AsDF. It is reviewing the IDA 14 approach, especially against the backdrop of AsDB's particular mandate as a regional MDB, and plans to introduce a systematic approach to results measurement during the course of this year.

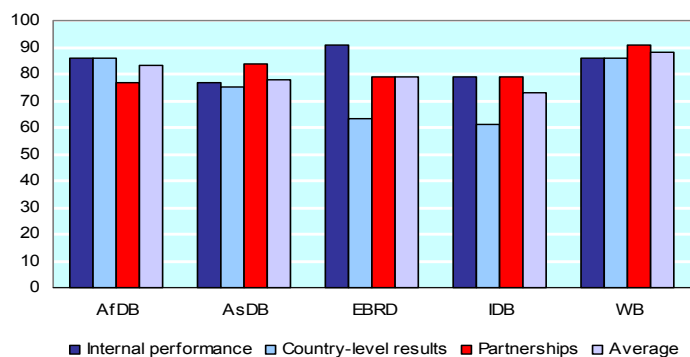
Donor/shareholder Initiatives

61. In parallel with these efforts, bilateral donors and shareholders have initiated a number of programs to measure institutional performance of multilateral agencies. As discussed below, several efforts are just getting underway, while others are quite advanced – including provisions for allowing assessed units to review and comment on the factual accuracy and other elements of the assessment. To date, none of the efforts include vehicles for rating/comparing the performance of MDBs by borrowers or by shareholders of borrowing countries.

62. **Danida.** Danida relies on ratings structured around a set format for assessing the performance of each multilateral organization it supports – which include AfDB, AsDB, and the WB – including an assessment of the contribution to each of the organizations. The reporting forms part of Danida's results-measurement system set up to assess the effectiveness of Danish Multilateral Assistance. The results are reflected in Danida's annual high-level consultations with each organization.

63. **DFID.** Figure 6.10 shows the DFID scorecard for the MDBs. As noted there, the scorecard rates agencies on three dimensions – internal performance, country-level results, and partnerships. The ratings for each area are based on DFID assessments of: corporate governance, corporate strategy, resource management, operational management, quality assurance, staff quality, monitoring and evaluation, and reporting of results. The ratings for internal performance include DFID's judgments on the agencies' project performance, evaluation system, implementation of strategic directions, and transparency. Here, the high scorer is EBRD. The ratings for country-level results reflect DFID's assessment of the agencies' PRSP and MDG orientation, inter alia, where AfDB and WB had the top scores. For partnership, which includes DFID assessments of performance on harmonization and related behavioral issues, the WB was rated the highest. The WB also had the highest overall score.

Figure 6.10. DFID Scorecard for MDBs



64. **MOPAN.** In a parallel effort organized by an informal network of like-minded donors – Canada, Denmark, Germany, the Netherlands, Norway, Sweden, Switzerland, and the U.K. – the Multilateral Organizations Performance Assessment Network was launched in 2002, with an initial focus on four of the Big 5 MDBs plus WHO and UNICEF. The methodology relied on questionnaires of agency staff and of knowledgeable stakeholders. The findings of the initial pilot, which focused on the health sector, gave the highest ratings to PAHO, the next to WHO, UNICEF, and the WB, and the next to the Regional MDBs. However, in providing these scores,

the report stresses the limitations of the methodology especially the fact that many raters lacked familiarity with the RDBs.³⁰

65. **GAO.** The U.S. General Accounting Office conducts periodic reviews of IFI performance on individual topics. Last year, the GAO assessed the sustainability for the HIPC Initiative³¹, and in two other studies completed in 2002 and 2003, it looked at the control framework for the Big 5 MDBs.³² The HIPC review highlighted the likely financial shortfalls facing the AfDB, IDA, and IDB, which GAO concluded are likely to be far higher than projected because country export earnings are likely to be less than projected by the WB and IMF, which assume higher-than-historical export growth rates.³³ On the control framework, GAO found that all MDBs had consistently received “clean audits” and had clear internal and external control frameworks. Nevertheless, in view of what it characterized as the difficult and challenging environment in which the MDBs operate, the GAO concluded that all the banks and their members could benefit from an additional annual examination and reporting by external auditors (through the MDBs’ annual financial statement audit processes) in the area of internal control over lending operations and compliance with key policies.

Civil Society

66. A number of civil society organizations and websites are devoted to monitoring specific aspects of individual MDB programs. These organizations and websites provide important feedback – typically quite critical – on Bank activities. One such organization – the Bank Information Center (BIC) – is focused on the Big 5 MDBs jointly and severally, providing important monitoring and other watchdog services especially on compliance with MDB operational policies. BIC has recently launched the IFI Transparency Resource³⁴ – an in-depth data base cataloguing and comparing MDB disclosure policies – concluding that a “leveling up” to the highest disclosure standards of each MDB was needed.

MDB Self-Assessment Platform

67. The above initiatives for assessing MDB performance and contribution are important. They are indicative of the rising “demand” for systematic comparative assessments. And, by actually experimenting with specific measures, they provide useful lessons in assessing and measuring performance. Going forward, the MDBs need to make progress on their own self-assessment framework, taking into account the available self- and independent-evaluation data; feedback from shareholders, borrowers, beneficiaries, researchers, and critics; and lessons learned from approaches developed by others. Such a framework also could underpin future Global Monitoring Reports, building on the analysis set out in this report – especially with respect to the comparative Tables 6.1-6.5, but also bringing in quantitative information on lending, grants, and analytic work (such as poverty and social impact assessments, investment climate assessments, and the various fiduciary assessments) – providing metrics, baselines, and indicators for tracking progress over time.

INTERNATIONAL MONETARY FUND

68. This section describes the activities of the IMF in support of the MDGs within the framework of the four-pillar approach set out in the 2004 Global Monitoring Report and used above to analyze the MDBs—country programs, global programs, partnerships, and quality and results. As for the MDBs, the IMF's contribution is largely indirect. What follows is focused on the areas of the IMF's competence and comparative advantage.

I. Country Programs

69. The policy advice and financial support provided to countries contributes to the achievement and maintenance of macroeconomic stability and growth, prerequisites for poverty reduction; and assists them in recovering from crises and exogenous shocks. The IMF also provides technical assistance, either to resolve specific problems of policy implementation or to address larger capacity constraints. In many developing countries, this includes trade-related technical assistance, primarily in customs administration and tariff policy, aimed at securing an effective liberalization of trade while safeguarding public revenues, or in the context of the Integrated Framework for Trade-Related Technical Assistance, which helps developing countries prepare to benefit from trade liberalization, and is expected to help mainstream trade issues in PRSPs.

70. As of end-2004, there were 49 IMF arrangements in place, of which 33 were under the PRGF, and 17 further arrangements were under consideration. A total of 61 members (33 percent of the membership) thus had arrangements in place or under consideration. Thirteen of these arrangements were first approved over the last 12 months, for total commitments of SDR 1.8 billion, compared with 21 new arrangements in 2003. Of these, 7 were new PRGF arrangements, for total commitments of SDR 534 million in PRSP-related programs considered by the Board.

A. Low-Income Country Programs

71. IMF support for low-income countries' efforts to achieve the MDGs is provided within the framework of the country-driven Poverty Reduction Strategy (PRS) approach. The support is predicated on full ownership by the country of the priorities and programs set out in its Poverty Reduction Strategy Paper (PRSP), reflecting the recognition that successful implementation of policies cannot be sustainably imposed from outside. Much of the IMF's work in low-income countries involves countries in Sub-Saharan Africa (Box 6.9).

72. The suitability of the goals of IMF-supported programs in low-income countries in the context of the MDGs is perhaps best assessed in relation to the situation of the particular country. One can distinguish between *mature stabilizers*, *early stabilizers*, and *fragile states*, with corresponding differences in how IMF-supported programs should be designed.³⁵

73. Mature stabilizers typically have had several years of relative macroeconomic stability, face less binding fiscal and external financing constraints; and have more firmly established and internalized PRS processes and better defined and prioritized PRSs. PRGF-supported programs in such countries should thus be expected to: focus more on consolidating past gains; accelerating and sustaining growth; set macroeconomic targets would that allow greater scope for pro-poor policies and improving the investment climate; provide for less IMF financing to close balance of payments gaps, as financing constraints recede; and have streamlined conditionality more closely aligned with PRSP priorities, given the greater degree of country ownership.

Box 6.9. The IMF's Relations with Sub-Saharan Africa

As of end-December 2004, the IMF had financial programs in place in 18 sub-Saharan African countries, with a total commitment of SDR 1.9 billion, of which roughly SDR 850 million remained to be drawn. This represented a small decline over the previous year, when there were 21 programs in place. All of these are PRGF arrangements. In terms of the HIPC Initiative, 10 of 14 countries reaching the completion point, and 12 of 13 at the decision point are in sub-Saharan Africa. For the first group, nominal debt relief delivered was \$20.3 billion³⁶, and for the second group, \$23.4 billion. Over 80 percent of HIPC debt relief provided by the IMF was to this group of countries.

Policy Advice

The IMF's policy advice to sub-Saharan African countries encompasses all areas of the IMF's areas of competence and mandate—fiscal and monetary policy, exchange rate issues, trade, financial sector issues, including banking regulation and supervision, and macroeconomic and financial statistics—frequently supported by technical assistance. Given the number of PRGF arrangements in place, much of this policy advice aims to facilitate the policy and structural reforms necessary to achieve and maintain macroeconomic stability and reduce imbalances.

Sub-Saharan Africa has seen an overall improvement in fiscal and external balances from the early 1990s, accompanied by a more prudent financing mix. Inflation has reached historical lows since 2000, and while growth has slowed slightly, current account deficits have stabilized at moderate levels, and fiscal deficits have shown further improvement, allowing countries to reduce the recourse to domestic financing. There has however, been an upward trend in spending on health and education, in particular, and IMF fiscal policy advice to countries implementing PRGs has aimed at accommodating increases in poverty-reducing expenditures while maintaining a sustainable overall fiscal stance. Particular emphasis has been placed on strengthening domestic resource mobilization to augment the resources available to fund development and poverty reduction, and on analyzing fiscal and debt sustainability over the medium term.

Together with the WB, IMF staff have placed increasing emphasis in the policy dialogue on financial sector development and trade as sources of additional growth. Areas of particular importance are enhancing the access of small and medium enterprises to financial services, deepening financial intermediation, and strengthening banking supervision and regulation. In trade, the focus has been on improving the effectiveness of the many regional trade arrangements, and preparing countries to participate more actively in multilateral trade liberalization. The IMF has also stepped up its efforts to assess the impact of exogenous shocks on sub-Saharan African countries and help them deal with them, particularly as regards the impact of declining world cotton prices, and in preparing for the removal of textile quotas.

Technical Assistance

Sub-Saharan Africa receives a roughly a quarter of all technical assistance delivered by the IMF, consistently more than any other region. The principal areas of focus are: banking supervision and monetary operations; public expenditure policy and budgetary management; customs and tax administration and policy; public debt management; and macroeconomic and financial statistics. One third of the assistance supports countries' poverty reduction efforts, and regional issues, such as trade and monetary policy. But a large portion is dedicated to post-conflict and isolation cases. Almost two-thirds of the assistance supports capacity building and policy reforms in IMF core areas. The IMF has opened two regional technical assistance centers, one in Tanzania covering 6 East African countries in October 2002, and the other covering ten West African countries in May 2003. An increasingly important share of the technical assistance and capacity building support to East and West African countries is delivered through regular short-term visits, seminars and training provided by experts at regional centers. A recently completed independent mid-term evaluation of the centers found that they had made a positive contribution to the efficiency of TA delivery; were responsive to the needs and requests of the countries; and were better able to provide customized assistance owing to their proximity. If the centers' operations prove to be successful, three additional centers will be opened to cover all of sub-Saharan Africa.

74. Early stabilizers, by contrast, usually can not yet sustain macroeconomic stability, often due to slippages in policy implementation; they still need to consolidate the public finances and implement key structural reforms, and to bring domestic and external debt under control; and still face major balance of payments gaps. They are also often at relatively early stages of the PRS process, possibly with less well articulated poverty reduction strategies. PRGF-supported programs in these cases would focus on macroeconomic stabilization, essential structural reforms, building basic administrative capacity, and often, recovering from external shocks. The extent of the required adjustment effort and continuing imbalances limit the scope for direct poverty-reducing expenditures. IMF financing would typically play a greater role in closing external financing gaps. And finally, conditionality is unlikely to be very clearly linked to the PRSP, which often is not very well defined.

75. Fragile states, often recently emerged from conflict situations, generally lack the political and economic institutions to implement full-fledged macroeconomic programs, or to elaborate a comprehensive poverty reduction strategy. They also often face pressing needs for humanitarian and balance of payments financing. IMF assistance will thus typically focus on providing technical assistance to help rebuild critical institutions of macroeconomic management, with limited financial support provided through the emergency and post-conflict assistance program.

76. In broad terms, as expected there is evidence of a change in the orientation of IMF program design in mature stabilizers. However, even in these cases, the link between the goals of IMF-supported programs and national strategies is often not clearly specified, a particular shortcoming where the PRGF-supported program is intended to support the implementation of the PRS. Macroeconomic outcomes in low-income countries have improved markedly in recent years. Reflecting improvements in policy implementation, higher official financial support, and a relatively conducive international environment. At the forefront of this improvement in macroeconomic outcomes is a small group of countries where (relatively) high growth rates have been sustained for some time and macroeconomic imbalances have receded furthest.

77. As part of the ongoing review of PRGF program design, staff examined the stylized facts of some aspects of program design in 15 of these post-stabilization countries with PRGF-supported programs.³⁷ The analysis found that :

- In the main, growth is projected to be some 5½ percent, and outcomes have been marginally higher. Programs initially target a 4-6 percent range of inflation, but inflation targets have in fact tended to be gradually revised upwards over the course of the program.
- On the fiscal front, programs have generally targeted modest increases in capital spending and (offsetting) increases in tax revenues, thus aiming at broadly unchanged fiscal deficits of around 4½ percent of GDP. Fiscal outturns have been less expansionary than envisaged, with capital spending increasing more modestly than programmed, but with a significant increase in poverty-reducing spending.
- Programs are largely centered around avoiding nonconcessional financing from both domestic and foreign sources. Thus, to a large extent, the level of the budget deficit seems to be largely determined by the level of external concessional financing, as increased domestic financing is usually not targeted.
- The growth of reserve and broad money has tended to exceed the program targets, accommodating unforeseen declines in velocity. It is unclear whether the limits on domestic financing of the budget in PRGF-supported programs allowed higher credit growth to the private sector.

B. Independent Views of the IMF's Role in PRGF/PRSP Countries

78. The 2004 Evaluation of the PRSPs and the PRGF by the IMF's Independent Evaluation Office found only limited progress in embedding the PRGF into the overall national strategy for growth and poverty reduction, despite evidence of a greater "pro-poor, pro-growth" orientation in PRGF-supported programs. These shortcomings are explained by the IEO as reflecting in part a lack of clarity about what the IMF should be delivering in some areas, and insufficient recognition of the qualitative changes implied by the PRS approach for the IMF's "way of doing business". The IMF's role in the PRSP process, and by implication, also the PRGF, are thus seen to fall short of the ambitious expectations set out in the original policy documents (see Box 6.10).³⁸

79. Other critics echo these points—in particular, IMF-supported programs are seen as constraining budgets to the envelope of available external financing, rather than considering the policies needed to achieve the MDGs and then identifying and helping to mobilize the necessary resources. Critics have also seized upon the apparent lack of willingness to open up the debate on macroeconomic policy issues. The apparent lack of consistency between the PRSPs and the PRGFs makes it difficult to discern the links between the two, and has cast doubts on the extent to which the PRS approach has generated a greater poverty focus in IMF-supported programs.³⁹

80. Some of these problems may reflect shortcomings of the PRSPs themselves, which seldom contain a detailed discussion of the macroeconomic framework and necessary structural reforms, the sources of growth, or the role of the private sector in generating that growth.⁴⁰ It is also unclear in many cases how the priorities of the PRSP are reflected in budget allocation decisions.

81. However, the IEO report also points to persisting ambiguities concerning the IMF's contribution to the PRS process and achieving the MDGs, as well as overambitious expectations of the PRS process itself. Many of these questions can be answered through a clear definition of the IMF's role in the PRS approach, and in low-income countries more generally. This process is already underway. Recent staff papers have set out key elements of a conceptual framework for the IMF's role in low-income countries articulated around a set of guiding principles, and work is underway to define specific aspects of this role (see Box 6.11).

II. Global Programs

82. As noted in the last GMR, the IMF has a key role in promoting and helping maintain a stable and open global economic and financial environment, and preventing and resolving crises. It meets this responsibility through its program work; bilateral, regional and multilateral surveillance activities; its ongoing assessments of members' economic and financial vulnerabilities, and its work on standards and codes.

83. Of note in the area of surveillance in 2004 was the further extension of the IMF's regional work, reflecting the increasing importance of regional organizations in economic and monetary policy. This encompasses a broad range of activities (the production of regular notes on regional outlooks and other issues; the maintenance of a dialogue with various regional fora; and research on regional issues) that feed into bilateral and multilateral surveillance. Better integration of these activities, and better assessment of potential global and regional spillovers, have been explicitly recognized as two priority areas of work over the next two years.

Box 6.10. Evaluations by the IEO in 2004

Over the past two years, the IMF's Independent Evaluation Office (IEO) has conducted several major reviews. This box summarizes the key recommendations of the evaluations conducted in 2004. A more complete picture of IEO activities can be found in the IEO's 2004 Annual Report.⁴¹

Poverty Reduction Strategy Papers and the Poverty Reduction and Growth Facility

The IEO found participation in the formulation of PRSPs to be generally more broad than in previous approaches, though not necessarily drawing on existing domestic institutions. Ownership results were mixed, with the least change in macroeconomic policy areas. PRSPs provided greater focus on poverty and some results orientation, but by and large fell short of providing a strategic roadmap for policy formulation, addressing difficult tradeoffs, or setting out clear priorities; or addressing capacity constraints, particularly in the budgetary and expenditure management area.

The IEO found some progress with respect to the key features of PRGF-supported programs set out in the original policy documents, particularly in the mature stabilizers—a marked increase in poverty-reducing expenditures; greater fiscal flexibility; some streamlining of program conditionality; and a greater willingness to consider alternative country-driven policies. However, progress was found to be relatively limited in other areas—little broad discussion of policy alternatives; the need to strengthen country-specific growth analysis underpinning programs; and an absence of clear links in program documentation between growth, poverty, and macroeconomic policies.

Recommendations included: increasing the flexibility of PRS implementation to better fit the specific needs of countries; shifting the emphasis from the production of documents to the development of sound domestic policy formulation and implementation processes; clarifying the purpose of the JSA and redefining it; clarifying the implications of the PRS approach for the IMF's own operations and strengthening its implementation of that role; strengthening the prioritization and accountability on what the IMF itself is supposed to deliver within the PRS framework; and encouraging a strengthening of the framework for establishing the external resource envelope as part of the PRS approach.

The Role of the IMF in Argentina, 1991-2001

The IEO found weaknesses in the Fund's pre-crisis surveillance of Argentina's economic policies, with little in-depth discussion of exchange rate policy until early 1999. Fiscal policy discussions paid inadequate attention to the provincial finances, and overestimated the sustainable level of public debt. There was little progress in fiscal structural reforms in the later years, and a lack of strong structural conditionality in Fund-supported programs. The critical shortcoming of the crisis management period (2000-01) was the failure to have in place an exit strategy including a contingency plan, given the known risks.

Lessons drawn included that the IMF should have a contingency strategy from the outset of a crisis with "stop-loss rules" to determine when a change in approach is needed, and with a clearly defined role when confronting a solvency problem. The assessment of medium-term debt and exchange rate sustainability should be intensified and expanded to cover vulnerabilities that could surface over the medium term. The IMF should not enter a program relationship with a country if there is no immediate balance of payment need or serious political obstacles to the necessary adjustments and reforms. Finally, the Board should exercise effective oversight of management decisions, based on full access to the necessary information and open exchange with management on all topics.

Technical Assistance Provided by the Fund

The IEO evaluation of IMF technical assistance emphasized the need for a medium-term framework for defining TA priorities; better filters for translating these priorities into resource allocation; greater involvement by the country authorities in the definition of TA priorities and a deeper commitment to implementing TA recommendations; and the need for greater effort to measure the impact of TA. The evaluation also advocated a clearer distinction between technical assistance provided in support of policy advice or program implementation, and that aimed at longer-term capacity building; and shifting the emphasis from TA delivery through missions and short-term assignments back to greater use of long-term resident experts.

Box 6.11. Key Elements of the IMF's Role in Low-Income Countries

A conceptual framework for the IMF's role in low-income countries was presented to the Board in August 2004.⁴² While a final decision has not yet been made, key elements include:

- *improving PRGF program design* through better analysis of growth and greater use of alternative scenarios and stress tests in dealing with exogenous shocks; systematic integration of fiscal and debt sustainability analyses; analysis of the macroeconomic impact of higher aid flows; and helping country authorities define the linkages between realistic baseline macro frameworks and more ambitious frameworks for scaling up efforts to reach MDGs.
- *better coordination* of IMF support for PRS implementation with the efforts with other partners, including providing timely assessment of the macroeconomic situation;
- *demonstrating the linkage between the PRGF arrangement and the PRSP*, through clear descriptions of the alignment of PRGF objectives and conditionality with PRSP priorities in PRGF documentation.

In September 2004, partly in response to the findings of the IEO/OED evaluations of the PRS process, the Executive Boards of the IMF and the WB approved several changes in the PRS architecture. These amendments, particularly the elimination of the requirement of Board endorsement of the PRSP as the basis for BWI concessional lending, aim at strengthening country ownership of the PRS process and its underpinning in domestic processes, and reducing the perception of "Washington sign-off" on PRSPs.

In 2005, the IMF's Executive Board will consider policy papers that pertain to several aspects of the IMF's activities in low-income countries:

- signaling and donor coordination in low-income countries;
- the role of IMF staff in the PRS process;
- the triennial in-depth review of the PRS process, jointly with the WB
- options and instruments for helping countries deal with exogenous shocks (e.g. in January 2005, the Board approved the subsidization of the IMF's emergency assistance for natural disasters).

Fund staff is also elaborating issues related to fiscal policy and public investment, based on an analytical framework recently tested through eight pilot country case studies. Many of the pilot countries were found to have sizeable infrastructure needs. However, they also face important trade-offs and complementarities between infrastructure spending and other investment spending (including for human capital) and current expenditure items (e.g., in health and education). Infrastructure spending per se is unlikely to be growth-enhancing, and the various trade-offs will have to be addressed on a case-by-case basis. In general, countries with an already high public debt burden have limited scope for increasing public investment. Also, additional room for infrastructure spending cannot result from changes in fiscal accounting. Therefore, desired increases in public investment for infrastructure would need to be achieved first and foremost through increases in public savings. The pilot country case studies also confirm that, in general, there is significant scope for improving the quality of government infrastructure spending through better project evaluation, prioritization, and management. In many countries, this will need to go hand-in-hand with improving the coverage of the fiscal accounts. The IMF and the WB are working together on steps to safeguard productive public investment and improve its planning and oversight within a stable fiscal and macroeconomic framework. The full findings from the pilot country case studies are expected to be available in April 2005.

Finally, as part of its ongoing research program on low-income countries, in February 2005, the IMF co-hosted with the WB an international research conference on macroeconomic issues in low-income countries.

Box 6.12. Major Surveillance Activities in 2004 and Outlook for 2005

In addition to the regular Article IV consultations with individual member countries and regional organizations, in 2004 the IMF Executive Board completed the *Biennial Review of IMF Surveillance*.⁴³ The review found the IMF's surveillance to be generally well focused, but suggested some improvements: better integration of bilateral, regional and multilateral surveillance; fuller treatment in Article IV consultations with the largest IMF members of the global impact of their economic conditions and policies; a clear and candid treatment of exchange rate issues; wider coverage of financial sector issues; and refinements of the vulnerability and sustainability assessments. The Review also noted the scope for Article IV reports to draw more on analysis of relevant issues done by third parties, including other donors. Looking ahead, specific monitorable objectives have been proposed for assessing the effectiveness of surveillance at the next review. It was also decided to extend the formal procedures for IMF surveillance of the euro area to the three other existing currency unions—a policy paper on Surveillance in Currency Unions is planned for 2005.

In the context of the joint work with the WB on the *standards and codes initiative*, by end-2004 reviews of the observance of standards and codes (ROSCs) and financial sector assessment programs (FSAPs) were completed in 119 and 18 countries, respectively. At end-2004, 82 countries had participated in the IMF's General Data Dissemination Standards (GDDS) and 58 countries had subscribed to the Special Data Dissemination Standards

Finally, in the area of *crisis prevention and resolution*, the IMF continued its monthly vulnerability assessments as part of an early warning system that allows emerging problems to be identified and addressed before they develop into crises. The IMF has also been actively supported the introduction of collective action clauses and the code of conduct in sovereign bond issues. Another area of recent work concerns the development and refinement of financial soundness indicators, and policies on contingency financing arrangements. Increased publication of policy papers and country reports has also facilitated better risk assessment by the private sector and helped mobilize support for policy actions.

In 2005, the IMF will complete a review of its trade policy advice; and is stepping up its work on remittances, which represent a potentially major source of development finance (for example, the forthcoming Spring *World Economic Outlook* will contain a section on remittances); and its participation in various initiatives related to the efficient management of natural resources, including the Extractive Industry Transparency Initiative (EITI). The IMF is also intensifying its analysis of the impact of the HIV/AIDS pandemic on country economic performance, and addressing the operational issues confronting HIV/AIDS donors in working with IMG staff.⁴⁴

84. The IMF has also been increasingly active in promoting the overall coherence of developed country policies, as called for in the Monterrey Consensus. In addition to calls for donors to increase their official development assistance consistent with their commitments at Monterrey, the primary focus of the effort has been on trade-related issues.

85. The IMF has stepped up its surveillance of trade-related issues. Since the start of the Doha Round there has been a significant focus, in Article IV consultations, management's public communications, and other fora, on trade policies in the larger industrial economies, especially with regard to policy spillovers, trade-related macroeconomic vulnerabilities, and regional trade initiatives.⁴⁵ IMF staff has also undertaken a significant amount of trade-related research.⁴⁶

86. The trade focus in IMF-supported programs has shifted from trade policy measures towards trade administration. In 2004, the IMF further increased its focus on trade vulnerabilities in its program work with the introduction of the Trade Integration Mechanism, through which the IMF will support members in designing appropriate adjustment policies to trade-related shocks, and also provide financial assistance to help address any related balance of payments problems.⁴⁷

87. In other areas, the IMF continues to play a major role in the implementation of the HIPC Initiative and other debt relief proposals. The IMF participated in two of the Task Forces which

contributed to the final report of the Millennium Project, which IMF management has endorsed, and the IMF continues to collaborate closely with the UN system in the implementation of the PRS approach on the country level and in the follow-up to the implementation of the Financing for Development Conference.

III. Partnerships

88. As noted in last year's report, in supporting the PRS approach and in all its activities related to the MDGs, the IMF's principal partner is the WB. It has also deepened its partnerships with other agencies and institutions, including the UN system, and intensified the dialogue with parliaments, trade unions, and nongovernmental organizations and civil society organizations.

89. Three areas of cooperation with the WB have received increased attention over the last year. First, the framework for debt sustainability analysis initially developed for middle-income countries has been jointly adapted and extended to low-income countries to strengthen their overall debt management. This is particularly important in the context of pledges of substantial increases in aid inflows, as well as concerns over rising debt levels in post-HIPC completion point countries. Secondly, the IMF and the WB continue their close collaboration in further streamlining their structural conditionality.⁴⁸ Thirdly, IMF and WB country teams collaborate closely to identify the needs for analysis of the poverty and social impact of planned reforms in PRSPs. While the Bank naturally has the lead in many areas, the IMF has created a special PSIA unit to conduct some of this analysis in the IMF's areas of competence, identify relevant PSIA work done elsewhere, and support country teams in the integration of the results of PSIA into PRSPs and IMF program design. The IMF and the WB also continue their close collaboration on policies governing the enhanced HIPC Initiative (on topping up and sunset clause arrangements); and the IMF worked closely with the Bank in the preparation of its report to the Development Committee on aid effectiveness and financing modalities.⁴⁹

90. The importance of IMF collaboration with other donors in its country work has risen with the emphasis in the Monterrey Consensus on building effective partnerships for achieving the MDGs. Donor coordination in supporting PRS implementation, and in aligning their programs with the country priorities, is a critical element of the PRS approach, and also contributes to enhancing aid effectiveness through the simplification and harmonization of donor procedures. The IMF has been an active participant in work in the OECD-DAC, the SPA, and other fora to advance the donor harmonization and alignment agenda, leading up to the recent Second High-Level Forum on Aid Effectiveness in Paris in early March 2005.⁵⁰ For the IMF, a key aspect of this collaboration is its role in providing signals to donors.

91. The IMF's partnership with the WTO is of increasing importance in the context of the mutual interest in advancing the Doha Round and further developing the multilateral trading system. Management and staff of both institutions enjoy excellent working relationships, and collaborate closely on a wide range of issues.⁵¹

92. Another major area of IMF collaboration with donors is technical assistance. The 2004 IEO review of IMF TA and the independent mid-term assessment of the African Regional Technical Assistance Centers (AFRITACS) underscored the rising importance of this collaboration. About one third of TA provided by the IMF is funded by other donors. However, both reviews noted the absence of an effective medium-term framework for prioritizing and coordinating the TA provided by different partners, and considered that a country's PRSP should provide such a framework.

93. Finally, the IMF will strengthen its collaboration with the UN system, particularly the UNDP, in helping countries adapt the MDGs to their specific circumstances, and reflect them in their PRSPs. Increasing emphasis will be placed on enhancing countries' systems for monitoring

and evaluating performance, consistent with the managing for development results agenda set out at Marrakech in 2004.

IV. Quality and Results

94. The IMF has several means of ensuring quality control. First, there are regular reviews of IMF facilities and policies, as well as progress reports on, and periodic updates and revisions of the operational guidance notes provided to staff for, their implementation. This process ensures that IMF policies and facilities are appropriately adapted to the requirements of the membership and the changing economic environment, and that their implementation by the staff takes account of changing circumstances and emerging best practices. Reviews and progress reports of policies and facilities have been conducted in 2004 in virtually all areas of the IMF's activities: surveillance; standards and codes and transparency; lending facilities; IMF program design; crisis prevention and resolution; collaboration with the WB; the HIPC Initiative; and the PRS approach. Major reviews planned for 2005 will assess PRGF program design; the 2002 conditionality guidelines; the Standards and Codes Initiative; experience in post-conflict countries; the IMF's work on trade; access policy; and the triennial in-depth review of the PRS approach. Policy work is also informed by the ongoing research activities of the IMF, as well as in-depth analytical studies of specific country experiences in working papers and occasional papers, as well as the selected issues papers that accompany Article IV consultation reports.

95. Targeted reviews by the IMF's Independent Evaluation Office are a major element of efforts to enhance the quality and effectiveness of the IMF's activities. In 2004, the IEO conducted the major evaluations of the IMF's technical assistance program; of the PRSP and the PRGF discussed above; as well as of the IMF's involvement in Argentina (see Box 6.10). Ongoing projects include evaluations of the IMF's approach to capital account liberalization; of the financial sector assessment program; and of IMF assistance to Jordan. The IEO's work program for 2005 may include assessments of bilateral surveillance in large industrial countries and of policy advice on exchange rates in the context of surveillance; the data dissemination standards; and IMF experience in a low-income transition economy.

Measuring Success

96. It is difficult to measure the impact of the IMF's activities, as the intended "outcomes"—improved economic stability and performance of members, stability of the international economic and financial system, and more favorable conditions for global growth and prosperity—depend not only on the IMF's inputs. In most cases, results are affected by a variety of factors, including policy implementation and exogenous influences. Moreover, the causality between a specific policy action and a given result is often difficult to establish or to measure in the short term. Comparing the targets and outcomes of IMF-supported programs would thus be a complex and difficult exercise, and may not generate conclusive results that would guide future action.

97. From the perspective of measuring the effectiveness of the IMF's contribution to the MDGs, it would be useful to rely on other parameters measuring the extent to which the IMF's PRGF is linked to the country's PRSP and has the features set out in the original policy documents. First and most important is the linkage between the macroeconomic framework of an IMF-supported program, the country's budget, and the poverty reduction effort. A key issue here would be how the program contributes to overcoming the constraints to growth. An assessment of the quality and scope of the policy dialogue can give a sense of the extent of country ownership. This includes the nature and extent of IMF staff participation in the PRS process; how program targets and objectives are set; and how they are adjusted to accommodate higher aid inflows, or to reflect the PSIA of critical reforms. The links between program conditionality and PRSP

priorities, and the timing of PRGF missions and reviews, would give a sense of the alignment of the content and processes of the PRGF with the PRSP.

98. Performance could be assessed by monitoring the extent to which IMF program documentation frames the PRGF-supported program in terms of the country's objectives and plans for reaching the MDGs, and addresses these specific aspects. Combined with the regular internal reviews, progress reports, and updates of guidance notes, the independent evaluations by the IEO, and the follow-up to the conclusions of these and other external reviews, it should be possible to measure progress over time in progressively adapting the IMF's policies and operations to help countries meet the challenges of the MDGs.

CONCLUSIONS

99. Earlier chapters of this report analyzed progress on, and prospects for, meeting the MDGs, identifying the priority actions for developing and developed countries alike. Against this background, this chapter has considered how the IFIs are contributing to the international effort to achieve the MDGs and related development outcomes and how they can strengthen and sharpen their support. This section summarizes the conclusions of the chapter for the IFIs and ends with some implications going beyond the IFIs.

100. The main findings of the chapter and priorities for action by the IFIs are set out below.

101. **Low-Income Countries.** Clearly the priority in low-income countries is to support the deepening of the PRS framework and to align IFI assistance with that framework. For LICUS, support for building institutional capacities is of particular importance. The good news is that recent replenishment agreements for the AfDF, AsDF, and IDA have endorsed a common approach to the reliance on PRSPs/NPRSPs, including for the operationalization of the MDGs, grants, debt sustainability, CPIA disclosure, results-based country strategies, results measurement systems, and special programs for LICUS. As these replenishments cover some 95 percent of all MDB programs in low-income countries, they have established a concrete platform for accelerating the implementation of these initiatives and their harmonization across the MDBs. Reflecting independent evaluations by OED and IEO, the WB and the IMF need to support stronger country leadership of the PRS process, while deepening the dialogue with the client on the policy agenda. Clearer country ownership of the PRSP, with the Bank and the Fund reflecting their own views in JSA documents and process, will also help to clarify and distinguish the accountabilities of Bank and Fund staff vis-a-vis the authorities.

102. **Middle-Income Countries.** For middle-income countries, the priority for the IFIs is to continue to adapt approaches and instruments to respond to these countries' evolving and differentiated needs, including through the streamlining of conditionality and the simplification of processing requirements for investment lending, also important for low-income countries. For the MICs, there has been a trend toward harmonization across the MDBs, albeit slower than across the LICs, reflecting the evolving and differentiated needs of the MICs themselves. The latter have been vocal in calling for reductions in the costs of doing business with the banks, especially when those costs arise in the context of replenishment exercises for concessional funds that they cannot access. Healthy competition across the banks has led to the transmission of innovations—such as the liberalization of expenditure eligibility categories for investment lending or the reliance on country systems—from one bank to another. Going forward, the MDBs' increasing collaboration, including their participation in joint workshops with bilateral agencies on MIC concerns, should provide a vehicle for more regular cross-fertilization on these issues and help to hasten the speed of innovation and its transmission.

103. **Knowledge and Capacity Building.** To ensure that the opportunities emerging from the recommendations for dismantling trade barriers and increasing the scale and effectiveness of aid set out in earlier chapters can be taken advantage of, the IFIs need to upgrade their support for and monitoring of country capacity building for trade, private sector-led growth, and public financial management and accountability. IFI research has helped to articulate the global development agenda, making notable contributions on the investment climate for private-sector led growth, trade, and aid, as reflected in earlier chapters of this report; the IFIs have also contributed much on (i) trade capacity building, particularly for trade facilitation, financial services, and transport infrastructure, and (ii) enhancing countries' fiduciary and fiscal systems for the absorption of aid. But they need to do more—including systematically tracking key capacity gaps, as a basis for informing the composition of their own and other partners' programs and investing more in country-level knowledge as basis for informing the design of their own and other partners' programs. In this context, the recent announcement by the MDB Heads of their support for the extension of the BEEPS survey to all developing countries is a very welcome development.

104. **Partnership.** The MDBs are partnering more effectively with clients, with each other, and with other donors. In part, this progress is due to the developments cited above with respect to the replenishments of MDB concessional windows and the greater reliance on country systems for the processing of MDB funding. Vis-à-vis civil society, a major issue remains disclosure, where despite improvements many critics feel that the IFIs do not yet meet a standard of accountability commensurate with their power and influence in key areas; however, very recent and pending changes in AsDB, AfDB, and WB disclosure policy do constitute further progress. Meanwhile, Bank-Fund relations have continued to mature, based on comparative advantage and a mandate-driven division of labor highlighted by ongoing collaboration on the PRSPs; debt sustainability analysis and its application to concessional and grant financing; and the further streamlining of structural conditionality. Going forward, in line with the Paris Declaration on Aid Effectiveness, the MDBs need to continue their efforts to strengthen partnerships and harmonize further by enhancing the flexibility of their assistance (through continued simplification and use of sectorwide approaches), and promoting the development and use of countries' own systems—for procurement, financial management, and environmental assessment.

105. **Results.** The past year has seen important milestones in building results-based systems in the MDBs. These include: the completion of the first cycle of the IDA-13 Results Measurement System; the adoption of the IDA 14 and the AfDF X Results Measurement Systems; the completion of Results-Based Country Strategy pilots by AsDB and the World Bank and their commitment (along with AfDB's) to carry out further pilots in 2005; IDB's adoption of the Medium-Term Action Plan for Development Effectiveness; the new independence of the AsDB's evaluation department; the recent launch of the (draft) Results Sourcebook; and the landmark PRSP evaluations carried out in cooperation by OED and IEO – in addition to continuing progress on statistical capacity building, results-based public sector management, the quality agenda, and the Global Partnership on Managing for Development Results. Meanwhile, the IMF is considering how to conceptualize and operationalize the results agenda within its institutional framework, drawing on specific recommendations from various reports of the Independent Evaluation Office. Clearly, the IFI focus on results and accountability must continue, by supporting country efforts to manage for development results (strengthening public sector management and development statistics) and furthering progress within IFIs in enhancing the results-orientation of their country strategies and programs and quality assurance processes. Priorities for immediate action include the adoption of a common framework for self-evaluation of MDB performance and results measurement, with adaptations that will also allow for consideration of IMF operations as much as possible, and follow-through on the Paris HLF commitment to support regional communities of practice in managing for development results, including through a focused “fast-track learning process” in selected developing countries.

B. Beyond the IFIs

106. The following priorities relate the IFIs' contributions to the broader international institutional context.

107. **Harmonization, Alignment, and Results.** The Paris High-Level Forum on Harmonization, Alignment, and Results brought together developing countries, bilateral donors, global funds, UN agencies, civil society, and the IFIs to assess progress since Rome and Marrakech and to chart the way forward, including through the monitoring of the agreed indicators of progress. Key components of the agreement involve the alignment of international support around national development strategies and the use of strengthened country systems (for public financial management, accounting, auditing, procurement, results frameworks, and monitoring) for providing assurances that aid will be used for agreed purposes. This agreement places a premium on credible analysis of the adequacy of country systems for the amount and modalities of donor support. It also places a premium on the integration of the economic and sector work prepared by the IFIs and others, especially in terms of assessments of the underlying country financial accountability systems and the priorities needed to improve them, within the country-led framework for capacity development.

108. **Monitoring and Evaluation.** Credible monitoring and evaluation are at the core of an effective multilateral system. The IFIs have made progress on this front, and it will be important to bring the PRSP approach to bear also on the evaluation end of the country programming cycle, bringing together the MDBs' country assistance evaluations, the OECD-DAC's joint donor peer reviews, and the UNDP's country program evaluations in a way that focuses on agency contributions to the achievement of country outcomes. But the lessons of a well-functioning M&E system go beyond the work on countries, and are relevant also for the management of global public goods. The ongoing work of the Secretariat of the International Task Force on Global Public Goods has focused on GPG "anchor" institutions – such as the IMF for international financial stability, the WTO for trade, the WHO for disease control, and the UN Security Council for peace and security – as critical pillars of the international architecture.⁵² The Secretariat has called for more systematic monitoring by the anchors, citing the IMF's work with its Article IVs, ROSCs, and WEO and other reports as a good-practice example. It also calls for a periodic apex monitoring report on GPGs, along the lines of the GMR. Clearly if the recommended GPG Monitoring Report is launched, close coordination with the GMR process will be needed to ensure coherence and avoid duplication.

109. **Voice and Participation.** Early on, in profiling the MDBs, this chapter highlighted the differences in developing country ownership shares across the institutions. But in the end, what has emerged as the key drivers of MDB differentiation are their respective client bases and mandates, with the banks moving in very similar directions, notwithstanding large differences in ownership shares. The IMF is also moving in similar directions on transparency and conditionality, although its unique mandate continues to set it apart – despite the ownership and voice structure it largely shares with the WB. The IFIs have acted progressively on transparency, and the reform process is still ongoing. But the voice issue (voting shares/quotas, distribution of Board seats) continues to undermine the perceived legitimacy and effectiveness of the Bretton Woods Institutions, and is prejudicial to their effectiveness as partners in the international development system. The 2002 Monterrey Consensus encouraged the Bank and the Fund to find pragmatic ways to continue to enhance the participation of developing and transition countries in their decision-making, and "thereby to strengthen the international dialogue and the work of those institutions as they address the development needs and concerns of those countries."⁵³ This issue needs to be resolved as a matter of urgency.

End Notes

¹ These include, respectively: Islamic Republic of Iran, Jordan, Lebanon, Republic of Yemen, the Syrian Arab Republic, and Turkey; and Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

² See AfDF replenishment and AsDF replenishment documents on www.afdb.org and www.adb.org.

³ OED, *The Poverty Reduction Strategy Initiative: An Independent Evaluation of the World Bank's Support Through 2003*, Washington D.C.: World Bank, 2004.

⁴ The 7 Post-Conflict Countries (PCCs) to benefit from the AfDB PCCF include: Côte d'Ivoire, Central African Republic, Burundi, Congo, Sudan, Liberia and Somalia. The other 2 PCCs not yet beneficiaries are: Comoros and Togo. The facility is designed to help clear the arrears of eligible PCCs, so that they can qualify for debt relief at decision points under the enhanced HIPC Initiative and otherwise re-engage with the African Bank Group and other IFIs. Burundi PCCF proposal was approved in October 2004, and Congo Republic in December 2004.

⁵ Seventeen country program evaluations are available on the OVE website, including recent studies of Brazil, Argentina, Ecuador, Belize, Paraguay and Bolivia. See www.iadb.org.

⁶ Strictly speaking this covers only the majority of instruments. Clearly, guarantees and deferred drawdown operations, inter alia, are sui generis.

⁷ See *Special Evaluation Study on Program Lending*, Operation Evaluation Department, AsDB, 2001.

⁸ Pending approval by IDB Board of Directors and Board of Governors.

⁹ Pending approval by IDB Board of Governors.

¹⁰ See e.g., Aart Kraay and Vikram Nehru (2004). "When is External Debt Sustainable?", *World Bank Policy Research Working Paper* 3200.

¹¹ See IMF and World Bank (2004). *Debt Sustainability in Low-Income Countries – Proposal for an Operational Framework and Policy Implications*, Washington, D.C., February, and subsequent papers.

¹² See AfDF (2004). *A Partnership for Poverty Reduction and Economic Growth in Africa. Report on the Consultative Meetings on the Tenth General Replenishment of the African Development Fund*, December.

¹³ See AsDF (2004). *ADF IX Donors' Report: Development Effectiveness for Poverty Reduction*. June.

¹⁴ See IDA (2004). *Debt Sustainability and Financing Terms in IDA14: Further Considerations on Issues and Options*, IDA/SecM2004-0779, December.

¹⁵ See chapter 5 for more details on calculation of these elasticities.

¹⁶ See David Dollar and Victoria Levin: *The Increasing Selectivity of Foreign Aid, 1984-2002*.

¹⁷ IDB strategies include Sustainable Economic Growth, Poverty Reduction and Promotion of Social Equity, Social Development, Modernization of the State, Competitiveness, Regional Integration, and Environment. In addition, there is an implementation plan for the sector strategies, which sets a series of output indicators, principally for the IDB Sustainable Development Department and the Regions.

¹⁸ <http://www1.worldbank.org/harmonization/Paris/FINALPARISDECLARATION.pdf>

¹⁹ The WB also continues its leadership of and participation in the MDB and MFI working groups on financial management, procurement, environment, results, legal issues, and a new working group beginning collaborative efforts on capacity building.

²⁰ See <http://www.mfdr.org/sourcebook.html>.

²¹ See *The World Bank's Global Poll 2002-2003: Follow-up and Related Activities*. OM2003-0056, October 29, 2003.

²² Since 2002, when new fiduciary processes were introduced to allow the WB to participate in pooled financing arrangements, the WB's lending using SWAs has risen: in FY03, four projects (or 1.8 percent of total Bank commitments) used sectorwide approaches, and in FY04, already 13 SWAs received approval by the Executive Directors representing 9.3 percent of total lending.

²³ Statistics include delivered, ongoing, and planned documents.

²⁴ See *Public Investment and Fiscal Policy*, IMF, March 2004.

²⁵ National System for Evaluation of Results and Public Management (Sistema Nacional de Evaluación de Resultados de la Gestión Pública).

²⁶ See IDB, *MTAP*, September 2004. See also *Annual Report on Portfolio Management, Performance and Results (ARPRE)*, July 2, 2004.

²⁷ See *Stepping up to the Future: An Independent Evaluation of ADF-VII, VIII and IX*, AfDB, Operations Evaluation Department (OPEV), August 2004.

²⁸ See ADF-IX Results measurement Framework Paper, ADF/BD/IF/2003/121/Rev, December 2003.

²⁹ Output indicators will be recorded for all projects, drawn from Implementation Completion Reports, but definitions of outputs can not be standardized across all projects within a sector without undermining country ownership and fit to particular institutional environments and sectoral policies.

³⁰ See *MOPAN: Report from the 2003 Pilot Exercise*, December 2003, Christian Michelsen Institute.

³¹ See GAO, *Achieving Poor Countries' Economic Growth and Debt Relief Targets Faces Significant Financing Challenges*, April 2004.

³² See GAO, *Regional Multilateral Development Banks: External Audit reporting Could Be Expanded*, December 2001; and GAO, *World Bank Group: Important Steps Taken on Internal Control but Additional Assessments Should Be Made*, June 2003.

³³ The U.S. Treasury, IMF, and World Bank all provided critical comments on the methodology employed; however, these comments were not taken into account by GAO.

³⁴ See <http://www.ifitransparencyresource.org/en/Index.aspx>.

³⁵ See *The Role of the Fund in Low-Income Member Countries over the Medium Term—Issues Paper for Discussion*, July 21, 2003, <http://www.imf.org/external/np/pdr/sustain/2003/072103.htm>.

³⁶ In terms of NPV in the year of the decision point.

³⁷ The countries are: Albania, Azerbaijan, Bangladesh, Benin, Ethiopia, Guyana, Honduras, Kyrgyz Republic, Madagascar, Mongolia, Mozambique, Rwanda, Senegal, Tanzania, and Uganda.

³⁸ See *Key Features of IMF Poverty Reduction and Growth Facility (PRGF)-Supported Programs*, August 16, 2000, <http://www.imf.org/external/np/prgf/2000/eng/key.htm>.

³⁹ For example, see Graham Bird (2004), *The IMF and Poor Countries: Towards a More Fulfilling Relationship*, Surrey Centre for International Economic Studies, University of Surrey, UK. A paper presented to FONDAD conference in The Hague on 11- 12 November 2004; Trócaire (2004), *The Other Side of the Coin – an Alternative Perspective on the Role of the IMF in LICs*, Maynooth, Ireland; EURODAD (2004), *Open letter from 26 civil society organizations on what role the IMF should play in LICs*, Brussels, Belgium. <http://www.eurodad.org/articles/default.aspx?id=548>.

⁴⁰ See, for example, *The Treatment of the Private Sector in African PRSPs and APRs*, Report to the Bureau for Africa of USAID by James W. Fox, Washington D.C., November 2004.

⁴¹ Including an overview of the recommendations, the response of the Executive Board and the reactions of staff to the conclusions, and follow-up to date on the recommendations from previous evaluations (of the prolonged use of Fund resources, fiscal adjustment in IMF-supported programs, and the role of the IMF in recent capital account crises). See <http://www.imf.org/External/NP/ieo/2004/ar/index.htm>.

⁴² See *Role of the Fund in Low-Income Member Countries*, August 13, 2004, <http://www.imf.org/external/np/pdr/lic/2004/eng/081304.htm>.

⁴³ See *Biennial Review of the Implementation of the Fund's Surveillance and of the 1997 Surveillance Decision—Overview; Modalities of Surveillance; and Content of Surveillance*, August 24, 2004, <http://www.imf.org/external/np/pdr/surv/2004/082404.pdf>.

⁴⁴ See *The Macroeconomics of HIV/AIDS*, edited by Markus Haacker, IMF, 2004.

⁴⁵ Trade policies formed an important part of the recently published Sub-Saharan Africa Regional Economic Outlook, <http://www.imf.org/external/pubs/ft/afr/reo/2004/eng/02/pdf/reo1004.pdr>.

⁴⁶ Regional integration was the most prominent of trade-related research topics. Other recent studies include an analysis of the impact of exchange rate volatility on trade (<http://www.imf.org/external/np/res/exrate/2004/eng/051904.htm>); and a study of preference margins and the possible impact of preference erosion on developing country export revenues (<http://www.imf.org/external/pubs/ft/wp/2004/wp04169.pfr>).

⁴⁷ See *Fund Support for Trade-Related Balance of Payments Adjustments*, 2/27/04, <http://www.imf.org/external/np/pdr/tim/2004/eng/022704.htm>. In July, Bangladesh became the first country to obtain funding under this mechanism.

⁴⁸ A recent staff study and the IEO evaluation both confirmed a clear reduction in structural conditionality in recent PRGF arrangements, and both institutions are currently assessing whether overall conditionality has in fact decreased, consistent with the rising country ownership of programs, particularly under the PRS approach, and the continuing improvement in policy formulation and implementation in developing countries. See *Strengthening IMF-World Bank Collaboration on Country Programs and Conditionality – Progress Report*, 2/24/04, <http://www.imf.org/external/np/pdr/cond/eng/022404.htm>.

⁴⁹ See DC-2004-0012, September 28, 2004.

⁵⁰ As IMF-supported programs are often aligned with the member's budget cycle, at least initially, the alignment of the PRGF with the PRSP would be greatly facilitated by the internal alignment of the PRS cycle with the budget cycle. The principle of aligning the PRGF with the PRS cycle was discussed by the Executive Board in April 2003, see *Aligning the Poverty Reduction and Growth Facility (PRGF) and the Poverty Reduction Strategy Paper (PRSP) Approach—Issues and Options*, April 25, 2003, <http://www.imf.org/external/np/prsp/2003/eng/042503.htm>.

⁵¹ For example, the August 2004 framework agreements call for consultation with the IMF and other agencies to direct resources toward developing economies where cotton is vitally important.

⁵² See www.GPGTaskForce.org.

⁵³ See *Voice and Participation of Developing and Transition Countries: Progress Reports*, DC2004-0014, September 29, 2004.

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