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## **AID EFFECTIVENESS AND FINANCING MODALITIES**

### Background paper

Attached for the October 2 Development Committee meeting is a background paper issued as an addendum to the report prepared by the staff of the World Bank and the IMF, entitled "Aid Effectiveness and Financing Modalities."

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## Abbreviations and Acronyms

AFD	Agence Française de Développement (French Agency for Development)
CDF	Comprehensive Development Framework
CPIA	Country Policy and Institutional Assessment
DAC/OECD	Development Assistance Committee of the OECD
DC	Development Committee
DFID	Department for International Development (UK)
EU	European Union
GAVI	Global Alliance for Vaccines and Immunization
GDP	Gross Domestic Product
GFSM	Government Financial Statistics Manual
GMR	Global Monitoring Report
GNI	Gross National Income
HIPC	Heavily Indebted Poor Countries
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immune Deficiency Syndrome
HLF-2	Second High Level Forum
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFF	International Finance Facility
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
LIBOR	London Inter Bank Offer Rate
LICUS	Low-Income Countries Under Stress
MAMS	Maquette for MDGs Simulation
MDBs	Multilateral Development Banks
MDGs	Millennium Development Goals
MICs	Middle-Income Countries
NGOs	Non-Governmental Organizations
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
OED	Operations Evaluation Department (World Bank)

PEM	Public Expenditure Management
PRS	Poverty Reduction Strategies
PRSC	Poverty Reduction Support Credits
PRSP	Poverty Reduction Strategy Paper
SDRs	Special Drawing Rights
SWAps	Sector-wide Approaches
UN	United Nations
USD	United States Dollar
UK	United Kingdom

## EXECUTIVE SUMMARY

i. The starting premise of this paper is that larger, more predictable and more effective aid flows are critical in accelerating the implementation of the international development agenda. Most developing countries are seriously off track in reaching the MDGs by 2015, with gaps being the worst in the poorest countries. Many middle-income and blend countries also face major challenges in reaching the MDGs.

ii. Addressing the international development agenda requires concerted movement on several fronts. More aid is only one element for success. As the Global Monitoring Report noted, reforming international trade and improving the way aid is delivered are essential, as are policy reforms in developing countries.

iii. There is compelling evidence that additional aid flows can be highly effective. Indeed, aid can play a catalytic role in helping to secure domestic reform and to crowd in other sources of financing. The converse is also true: increased aid in and of itself can distort incentives, and alone is not sufficient for rapid reforms.

iv. A new aid framework is taking shape that takes account of these factors and thereby makes aid more effective. Continued effort and discipline are essential on all fronts; developing countries are improving their economic policies and their management of public resources; both developing countries and donors have more effective strategies to reduce poverty; aid is better targeted to poor countries and good performers, supported by the PRSP process; and programmatic budget support for good performers has made it easier to align development assistance with country priorities. All this is enhanced by donor efforts to coordinate their actions and better link budget support to the PRS review process and to country budget cycles.

v. In recent years, aid management and implementation practices have shifted toward a greater focus on results, supported by a community of practice on managing for development results. There has also been some progress in aligning aid with country strategies. However, on all these fronts progress has been slow and much more aggressive implementation is required. The 2<sup>nd</sup> High Level Forum planned for March 2005 is the next milestone for accelerating implementation.

vi. Scaling up the use of aid requires that work proceed now, along with improving the framework for aid to strengthen the capacity of countries to absorb it. Many countries already have the capacity to scale up productively their use of aid flows (discussed in the 2003 Annual Meetings DC report). However, other countries face constraints across several dimensions: macroeconomic, institutional, physical, human, and social.

vii. These constraints should not be an excuse for inaction: efforts to increase aid need to move in tandem with work to improve its effectiveness by strengthening policy frameworks, building institutional capacity, mobilizing the private sector and

identifying innovative avenues for service delivery. Country-specific strategies are required to address capacity constraints, along with assistance specifically targeted to help in tackling bottlenecks. Much more emphasis on improving monitoring and evaluation to learn from international experience is also needed.

viii. Some increases in aid flows have already been pledged, and it is important that these be delivered. However, the best estimates suggest that substantially more aid than as yet pledged will be needed both in the short and medium terms. The best option is for more donor countries to move faster towards the ODA goal of 0.7 percent of GNI. Donors are now negotiating the replenishment of IDA14 (FY06-08), which is of particular significance for achieving the MDGs by 2015, as most development programs and investment projects take several years to implement and become fully productive.

ix. Some of the proposals for additional aid, such as those on global taxes, appear technically feasible and should be pursued—but they will take time to implement and are likely to face political opposition. The feasibility of these options needs to be explored further to develop a complementary set of mechanisms. Proposals to frontload aid are worth pursuing if there is confidence that aid flows in the medium and longer terms will cover both future needs and the repayments of frontloading. The most advanced proposal to frontload aid is the International Finance Facility (IFF). The Spring Paper of the Development Committee concluded that the IFF proposal appears technically feasible, subject to accounting, legislative, and other circumstances of individual donors.

x. Further work on the practical aspects confirms that the IFF could be a feasible option for some donors. Others would not be able to make the long-term legally binding commitments or treat them as off-budget and off-balance sheet liabilities—key features of the IFF. There may be scope for different kinds of support from donors with varying fiscal positions and legal structures—support that could help to improve the efficiency or advance rate of donor commitments to such a financing facility.

xi. To the extent possible, an IFF should rely on existing institutional mechanisms to avoid a proliferation of funds and facilities with separate and demanding decision making structures. This paper concludes that there might be benefits in an IFF being associated with, but not part of, the World Bank and other MDBs. Further work is needed on several detailed elements: fiscal transparency, legal restrictions, governance, and the design of links with existing borrowing platforms and existing delivery mechanisms, including those of the multilateral institutions.

xii. In addition to aid flows, extra non-concessional MDB lending can help some middle-income countries to increase investments and spending on MDG-related activities, including infrastructure development. Blending aid flows with other forms of financing can augment resources for targeted MDG spending in both low- and middle-income countries where governments do not have the revenue or borrowing power to finance such investments themselves.

xiii. Donors and developing countries stand at a critical juncture in advancing the international development agenda. Donors need to marshal strong political commitment to provide more aid and more predictable aid—and to make it more effective. Developing countries, often with support from donors, need to consolidate their policy reforms and ease the capacity constraints to applying more resources more productively. Essential to the goal of greater aid effectiveness are reforming international trade and progressing faster with harmonization and managing for development results. Concerted efforts are needed to pursue all options and implement feasible ones for mobilizing additional aid.



## AID EFFECTIVENESS AND FINANCING MODALITIES

### I. INTRODUCTION

1. In the lead up to and since Monterrey, a renewed focus on aid and aid effectiveness, and in particular on the role it can play in accelerating progress towards the Millennium Development Goals (MDGs), has been at the forefront of the global development agenda.

2. At the 2003 Annual Meetings, the Development Committee discussed the requirements of aid on the basis of a paper—*Supporting Sound Policies with Adequate and Appropriate Financing*—that took a country-based approach on how external development financing could be productively used to accelerate progress towards the MDGs. Based on a review of the aid agenda, the Development Committee (DC) and the International Monetary and Financial Committee (IMFC) asked that the Bank, in cooperation with the Fund, undertake a comprehensive review of aid effectiveness, absorptive capacity, and results-based measurement mechanisms, and examine the merits of various policy options, such as an international financing facility, to mobilize the substantial additional resources that are needed over the medium term, that can be effectively used to achieve development results and scale up progress towards the MDGs.

3. At the 2004 Spring Meetings, the first *Global Monitoring Report* (GMR) provided an assessment of policies and actions for achieving the MDGs and related development outcomes, and reviewed the implementation of the Monterrey Consensus: what progress had been made; what the constraints to implementation were; and how all parties were delivering on their commitments. A progress report on *Financing Modalities Towards the Millennium Development Goals* reported on work in progress exploring ways to mobilize financing towards achieving the MDGs. It should be noted that this paper does not portray new work on the role of aid and aid effectiveness but provides a synthesis of works previously undertaken.

4. Over the past year, there has also been other work and discussions that have a bearing on the aid agenda:

- ❖ a broad-based work program on aid effectiveness in the OECD/DAC, including the work of the DAC Working Party on Aid Effectiveness and the Task Team on Harmonization and Alignment;
- ❖ the Second International Roundtable on Better Monitoring, Measuring and Managing for Results held at Marrakech in February 2004, and recommendations adopted by IDA deputies in July 2004 for a strengthened Results Measurement System for IDA14 to monitor progress on aggregate country outcomes and IDA's contribution to country outcomes;

- ❖ the recent *World Development Report 2004: Making Services Work for Poor People*, and work on the agenda and financing needs for infrastructure development;
- ❖ the Task Forces set up by the UN Millennium Project to review strategies to achieve the various MDGs, prioritize reforms and global interventions, and evaluate financing mechanisms and options;
- ❖ the aid conference in Paris in April 2004 on Financing for Development to assess the challenge of scaling up financing for development in terms of additional resources and accelerated commitments, quality, sustainability and predictability, and to consider innovative financing mechanisms that may, in an effective way, meet high volume needs and enhance prospects for multiyear commitments; and
- ❖ the Shanghai conference in May 2004 on scaling up poverty reduction, a culmination of a series of case studies, multi-country interactive videoconferences, online dialogues, and field visits leading up to a working Conference that allowed key development actors to share their experiences and policy lessons learned from poverty reduction initiatives around the world.

5. As part of the consultations for this paper, a high-level workshop *Delivering on the Aid Agenda to Meet the MDGs* was held on July 30, 2004 with senior representatives from developing countries, bilateral donor agencies, and multilateral institutions, including the IMF, OECD/DAC, the UN and the EU, among others. The workshop discussions focused on an effective architecture to reach the MDGs, scaling up and strengthening absorptive capacity and innovative financing mechanisms for mobilizing the resources needed to reach the MDGs.

6. Building on this body of work and discussions, this paper reports on four key aspects of the aid agenda.

- ❖ First, it briefly reviews the role of aid in helping to accelerate the pace of development, and in particular on the progress towards meeting the MDGs. The paper reaffirms that substantially larger amounts of aid resources and more effective use of such resources will be needed to scale up efforts to meet the MDGs.
- ❖ Second, the paper presents a detailed discussion of aid effectiveness, reviewing and assessing the main components of the new aid architecture that is taking shape. From the recipient countries' perspective, the paper discusses the improvement of country policy performance and institutions and how the Poverty Reduction Strategy (PRS) framework has helped to enhance the development of country-owned and credible long-term strategies for poverty reduction and growth. From the donors' perspective, it assesses progress in more effective aid modalities, including a stronger

focus on managing for results, performance-based selectivity, and efforts to reduce cost in the delivery of aid through harmonization and alignment.

- ❖ Third, the paper unbundles absorptive capacity by considering three different levels of aid delivery and allocation, as well as several channels through which absorption may be constrained. The unbundling makes it possible to address absorptive capacity as a multi-dimensional and dynamic process—and the relevance of the various components to different groups of countries.
- ❖ Fourth, and as a major focus, the paper assesses the options for mobilizing the substantially larger amounts of resources that will be needed. The paper reviews the recent trends in aid flows and stresses the importance of delivering on the commitments already made. In addition it examines other possible mechanisms for mobilizing and increasing the leverage of aid including global tax mechanisms and voluntary contributions, frontloading increases in aid commitments through mechanisms such as an international finance facility, and leveraging other resources for MDG purposes through blending arrangements.

## II. SOURCES OF FINANCE AND THE ROLE OF AID

7. Three key conclusions emerge on the role of aid from recent analytical work and country evidence. First, as highlighted in the GMR, the challenge of achieving the MDGs remains a daunting one, despite progress made in recent years. The world will most likely meet the first goal of halving income poverty by 2015 at the aggregate level; however, most of Sub-Saharan Africa and low-income countries under stress in other regions are at risk of falling far short. Prospects for progress on the human development goals are at even greater risk; the target for gender equality in education to be achieved in 2005 will not be met, and on current trends, a third of all developing countries appear unlikely to achieve it even by 2015. But the prospects are gravest in health, where the goals on maternal and infant mortality will not be attained in most regions. The health goals are rendered more difficult by the large gaps in access to safe water and basic sanitation. Achieving the goal of halving the population without access to safe drinking water and basic sanitation means providing an additional 1.5 billion people with water and 2 billion people with basic sanitation, and at current rates of progress, most regions will fall well short. It is important to note that progress on MDGs at the country level is based on averages that hide significant differences across income groups and regions. This dimension is important with regard to the targeting of aid using localized MDG targets.

8. There are considerable differences across regions and countries—but all developing countries face important gaps. As shown in Figure 1, low-income countries, especially IDA-only countries and LICUS, are at greatest risk of falling short across the spectrum of MDGs. Middle-income countries are better placed to meet the income poverty and hunger targets but remain home to 300 million people living on less than \$1 a day i.e., around 27 percent of the world's poor (Table 1). All blend and many middle-income countries face difficult challenges in meeting the MDGs on health, environment, and water and sanitation.

9. Second, as also stressed in the GMR, developing countries need to continue improving their policy frameworks. Although their policies have generally improved, thus enhancing their capacity to make effective use of resources, there is considerable variation across countries. As outlined in a separate paper prepared for the 2004 Fall Meetings of the Development Committee—*Elements of Growth*—developing countries need to pursue vigorously reforms that enhance the investment climate for growth, strengthen capacity in the public sector, scale up investment in infrastructure and enhance the effectiveness of service delivery. Country leadership and ownership of these reforms are important elements for their success. Strengthening governance at all levels is a necessary pillar to support growth and service delivery.

**Table 1: Developing Country Grouping and Poverty Incidence**

Country Group	Population (in billion)	GDP per capita per day (in current USD)*	Proportion of world's poor (<\$1 a day, in %)*
	2001	2001	1990s
High-Income	0.9	72.0	--
Middle-Income Countries	2.7	5.3	27
Blend Countries**	1.4	1.3	42
Low-Income Countries (excluding blends and LICUS)	0.6	0.9	20
LICUS	0.4	1.0	11

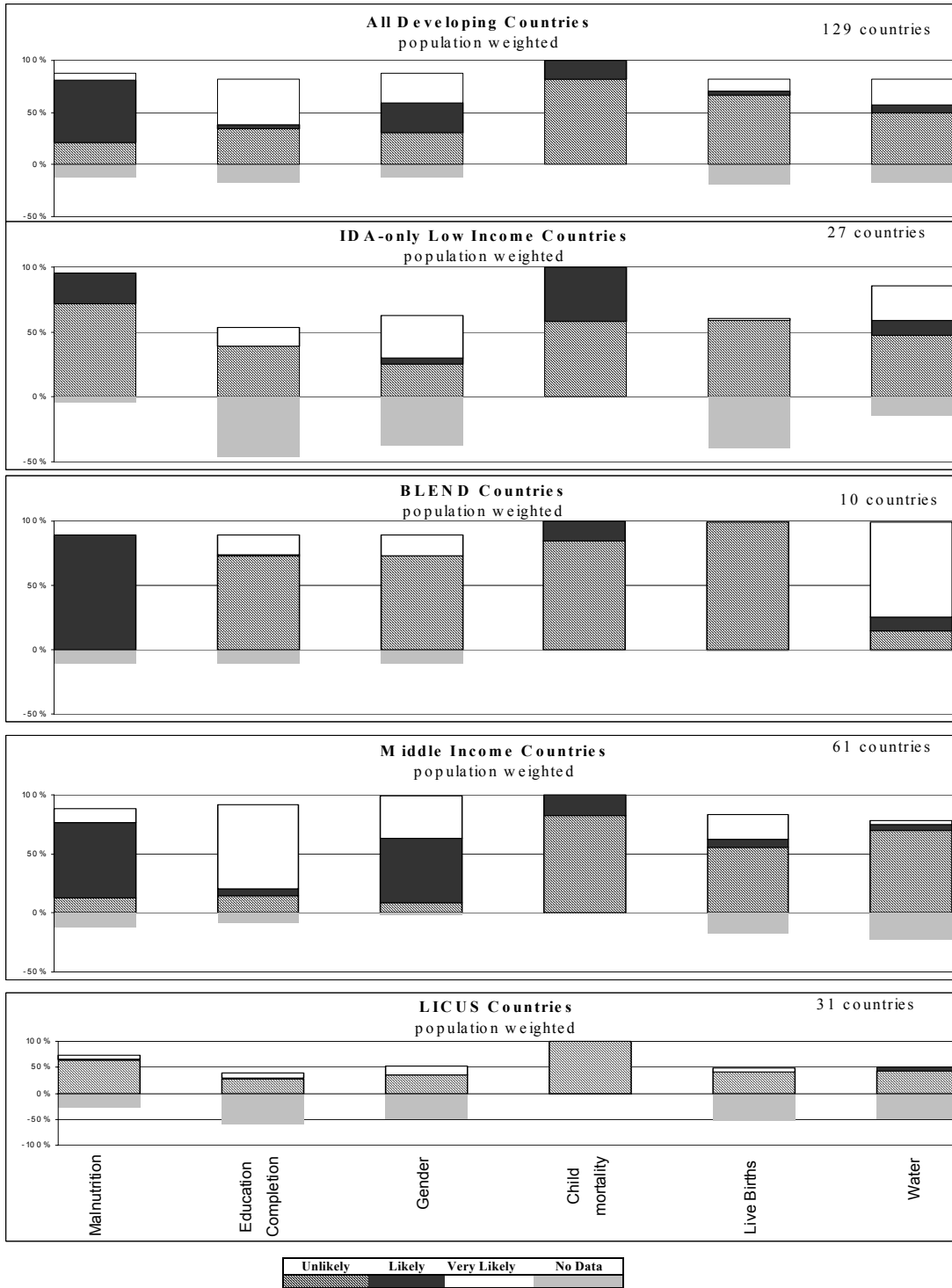
*Note:* \* GDP per capita per day is measured in current US dollar at 2001 exchange rates while the proportion of poor is measured on purchasing power parity (PPP) basis. \*\* Blend countries have GNIs that are below the IDA operational cutoff of US\$895 (Atlas methodology) but enjoy creditworthiness for IBRD lending.

10. Third, successful scaling up will also require an enhanced global development partnership providing more and better aid,<sup>1</sup> and decisive actions by the developed countries to expand access to their markets. This mutual commitment to development results was the essence of Monterrey, but progress to date has been relatively slow. In addition to the need for sound policies and governance to improve the effectiveness of aid, an adequate amount of financing is also vital to achieving the wide-ranging goals in the development agenda. Even with the right policies, many low-income countries simply do not have adequate resources to undertake the infrastructure investment and social spending necessary to achieve sustained growth and poverty reduction. The levels of investment and spending in critical sectors are far below what is needed, and without substantial increases in aid the prospects of meeting the MDGs will be remote. While the trend in aid flows in recent years has been encouraging, a large part of the increase was accounted for by debt relief and emergency relief and not directed to financing the incremental costs of meeting the MDGs. The time frame of the MDGs—to 2015—adds another element of urgency.

11. Increased volumes of aid will be critical to achieving the goal of reaching the MDGs by 2015; so will its effectiveness. It will be necessary to continue to monitor and evaluate the role and effectiveness of aid over time from an MDG perspective and to assure stakeholders that aid effectiveness continues to make significant and realistic strides.

<sup>1</sup> For a more systematic treatment of the need for larger foreign assistance, see World Bank (2002).

**Figure 1: Likelihood of Reaching MDGs on Present Trends**



Note: Progress towards each goal is assessed by comparing actual annual progress if past trends were to prevail. The reference path is calculated assuming a constant, annual or geometric rate of change. See Swanson and Heyman (forthcoming).

12. As shown in Table 2, aid is a modest source of development finance except in IDA-only low-income countries and in LICUS. Domestic resource mobilization, private capital flows—especially foreign direct investment—and debt relief together constitute the primary means for financing development and the MDGs. Also, the new round of trade liberalization could potentially bring large gains to developing countries, helping to promote growth and, indirectly, domestic revenue mobilization. It is estimated that gains from a successful Doha Round could lift 140 million people out of poverty and add \$300 billion to developing country incomes by 2015.<sup>2</sup> As shown in Table 2, other external sources of financing flows are greater than ODA for most country groupings. But aid can play an important complementary role in bridging the financing gap and in scaling up development efforts. In particular, aid can play a critical role in supporting MDG-related spending (including social spending and infrastructure) where governments do not have the revenues or borrowing power needed to finance such investments themselves. Remittances are becoming an increasingly important source of external finance for many developing countries. It is important to underline that remittances are quite distinct from aid flows. They cannot meet the same needs as aid in achieving the MDGs and are private transfers rather than donor country assistance. The text below makes clear the role of aid.

**Table 2: Investment, Savings and External Financial Flows**  
(as a share of GDP in percent, averages for 2000-02)

Country Groups	Domestic Investment	Domestic Savings	FDI	Other Private Flows	ODA	Remittances
Middle-Income	25.4	27.1	3.2	0.2	0.2	0.7
Blend	20.4	20.9	0.3	- 0.3	1.0	1.6
Low-Income Countries (excluding Blends and LICUS)	23.2	14.7	2.2	- 0.3	7.2	3.0
LICUS	17.9	19.7	3.7*	- 0.6	4.8	0.4

*Note:* \*The relatively high level of FDI for LICUS reflects large investments in the oil sector. Excluding Nigeria and Angola, which received most of the foreign investments, the share of FDI in overall GDP is significantly lower at 2.9 percent.

*Source:* *Global Development Finance and World Bank staff estimates.*

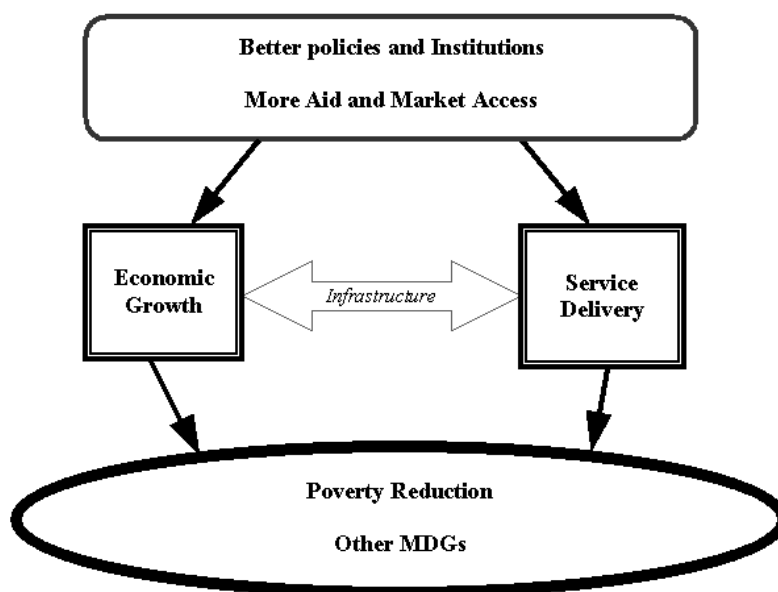
13. Cross-country evidence shows that aid is effective in good policy environments.<sup>3</sup> Cross-country statistical analysis shows that aid has accelerated growth

<sup>2</sup> World Bank (2004g).

<sup>3</sup> This conclusion is based on a range of works including Burnside and Dollar (2000). The issue whether foreign aid will boost growth in countries with good policies remains, however, relatively controversial and warrants additional research. A recent research paper by Clemens et al. (2004) finds a strong positive causal relationship between aid that plausibly could stimulate growth within a four-year period and economic growth. Also, as shown in Figure 5 below, better-governed countries in Sub-Saharan

when allocated correctly, and this allocation is improving. Country case studies show that aid has supported, cemented and helped shape reform efforts that have delivered poverty reduction in recent years. Program and project analysis have shown high returns to development assistance on indicators of human development. And global programs such as investment in agricultural research and programs to halt communicable diseases have been an important complement to country-specific efforts. Aid can thus play a catalytic role in helping to shape change and secure domestic reform and in crowding in other sources of financing (Box 1 in page 11). Most recent OED studies (CDF, HIPC, and PRSP evaluations) have affirmed the need for increased aid to meet development needs and goals; however, they have also shown that increased aid in and of itself can distort incentives, and alone is not sufficient for rapid reforms.

**Figure 2: A Framework for Accelerating Progress Towards the MDGs**



14. The combination of good policies, institutional strengthening, and greater aid flows can accelerate progress toward the MDGs (Figure 2). This proceeds through two channels: through strengthening *economic growth* and improving *service delivery*. Aid can support better policies and institutions, and augment resources for scaling up investments, including in infrastructure, which is vital for growth, service delivery, and expansion of social spending. There is evidence to support this. The report discussed by the Development Committee at the 2003 Annual Meetings—that surveyed 18 well-performing low-income countries which represent about half the world’s poor people and receives a third of global aid flows—showed that with policy reforms in place and more external resources, a major expansion of public services, infrastructure, and

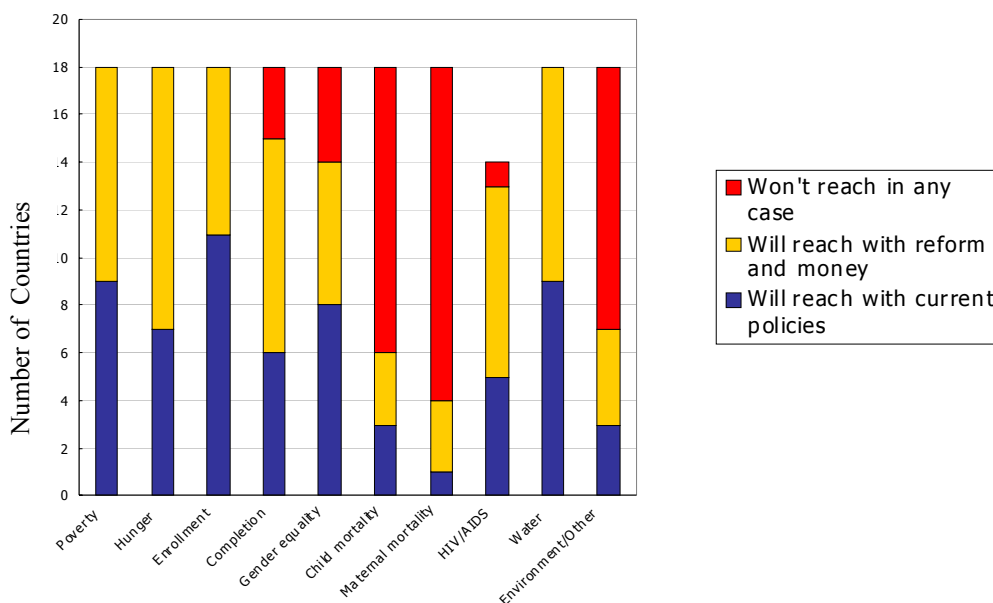
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Africa, as measured by an above average CPIA ratings, which also received higher per capita foreign aid, have registered significantly higher growth rates compared to poor performers.



institution building would permit many more countries to achieve the MDGs by 2015 (Figure 3). With current projected resource flows and policy environment, roughly half of the 18 countries covered in the report are expected to meet the MDGs for reducing income poverty, hunger, availability of potable water, and reaching full primary school enrollment rates. But with better policies and scaled up aid flows—an average doubling of current flows for the large Asian countries and an average 60 percent increase for the 10 Sub-Saharan countries—all 18 countries would be expected to meet the above four MDGs. More countries could achieve the MDGs for primary schooling completion, gender equality, and reducing HIV/AIDS. But less progress can be made toward the remaining three MDGs—child and maternal mortality rates, and environmental strengthening—for which the challenges are far greater.

**Figure 3: Sound Policy Reforms and Additional Aid Financing Can Accelerate Progress Towards the MDGs**



15. Continuing analytical work and country evidence reaffirm the conclusions of the Development Committee paper of last fall that substantial increases in aid, well beyond existing commitments, are needed and can be productively used in support of better policies and institutions to enhance the prospects of meeting the MDGs. The Bank's 2003 Development Committee report concluded that, as a conservative estimate, an initial increment of at least \$30 billion annually could be used effectively by recipient countries. The paper did not estimate the costs of meeting all the MDGs in all countries and did not capture fully the likely costs of infrastructure investments or global public goods. As countries improve their policies and governance over time and upgrade their capacities, the amount of aid that can be used effectively in the medium term could rise to \$50 billion or more per year. Most other estimates of the aggregate

amount of aid needed to meet the MDGs are also in the range of \$50 to \$70 billion of incremental aid per year.<sup>4</sup>

16. In addition to the above country-specific agendas, there are global development challenges such as the spread of infectious disease, loss of biodiversity, deforestation, and climate change that cannot be handled solely by individual countries and therefore require multilateral actions and additional resources. Financing is also needed to help cushion low-income countries from the impact of exogenous shocks.

17. Despite clear recognition of the critical role of infrastructure in enabling growth and reducing poverty, current financing for infrastructure in developing countries remains far below the levels needed. The latest estimates show that developing countries need to spend about 6-7 percent of their GDP<sup>5</sup> over the next few years to address their infrastructure needs; roughly half this expenditure is needed for new infrastructure investments, and half for operations and maintenance. But actual spending on infrastructure in recent years has only been about 3-4 percent of GDP on average. This suggests that, in order to meet infrastructure needs, expenditures in developing countries would need to double from their current levels. Part of the reason why the financing challenge is so large is that investment in infrastructure has declined significantly since the late 1990s, linked to declines in both public and private financing.

18. The Millennium Project, commissioned by the UN Secretary-General and supported by the UN Development Group, has undertaken a comprehensive needs assessment of what it would take to meet all the MDGs by 2015 based on detailed country case studies of five countries and on the work of 10 thematic task forces. In early July, a High Level Consultation on the Millennium Project at the DAC/OECD came to agreement on some key points: (i) link Poverty Reduction Strategy Papers (PRSPs) to a longer and more ambitious view of policies and aid; (ii) recognize the importance of country policies and governance as determinants of how much additional aid can be used productively; (iii) take urgent action now to attain many of these goals, particularly those on health and water and sanitation, especially in the poorest countries; (iv) provide significantly more aid, much of it in grants, in ways that countries can use more easily to finance their progress towards the MDGs; and (v) complement more and better aid with steps to improve the access of developing countries to industrial country markets.

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<sup>4</sup> While the target date for reaching the MDGs is 2015, it should be noted that aid will continue to be needed beyond this period to ensure that the progress made is sustainable. Hence it is important that aid be both increased and sustained.

<sup>5</sup> The Global Monitoring Report (2004) estimated total resources needed, for both investment and maintenance at roughly 6.9 percent of GDP in low-income countries and 5.1 percent in lower middle-income countries. Recent World Bank staff estimates came up with slightly higher figures.

### Box 1: The Catalytic Role of Aid

Domestic revenues and proceeds from international trade are the main sources of development finance, with FDI and debt relief providing additional funding. But these sources are not sufficient to help most countries reach the MDG targets, and foreign aid remains critical to financing development needs. Moreover, there is limited scope for meeting these needs through non-ODA flows because reaching the MDGs requires a significant amount of publicly financed goods and services.

Well-designed aid can also act as a catalyst to support reforms needed to benefit from these financial flows. Prospects of future aid flows can encourage developing countries to make more rapid reform. Leaders may also be more likely to undertake multi-year reforms if they can depend upon resources on a predictable basis. Several important points need to be noted:

- Aid can support policies to raise public savings: first, by helping countries adopt policies to raise domestic revenue mobilization; and second, by stemming capital outflows by improving the domestic business environment and governance.
- Aid can help unlock the benefits of trade liberalization. Well-targeted “aid for trade” can help countries take advantage of new market openings and provide assistance for countries to implement trade reforms. Aid can also help provide technical assistance for trade policy analysis and support of domestic reforms and provide assistance to improve services, such as transport, finance, and communications that can better link the poor to the global marketplace through programs such as the Integrated Framework for Technical Assistance to Least Developed Countries.
- More predictable aid commitments can facilitate private capital. However, in countries where resources are not predictable, private companies are more reluctant to make investments or provide services. The donor community needs to become more attuned to the use of ODA to improve the environment for business and to “crowd in” private sector resources.
- Grant-based aid helps countries emerging from the HIPC process to secure financing for development on terms that enable them to preserve a sustainable level of debt in the face of the severe shocks, both external and domestic. Debt sustainability will require better debt management to limit borrowing to highly concessional resources, and to increase the share of grants in financing. Grants were introduced by IDA for the first time in IDA13, and their level and use is a major element of the negotiations for IDA14.

19. The approach taken by the Millennium Project, which is based on unit costs and focuses on the financing needs of reaching the MDGs by 2015, is somewhat different from the approaches of the Bank and Fund. The latter also take into account absorptive capacity constraints and fiscal and macroeconomic issues in the aid recipient countries. The exchange of views between the Millennium Project and the Bank and Fund on analytical foundations and country contexts have proven useful in clarifying the issues,

adding value and narrowing differences both on the issues of financing needs and on efforts to address physical and human capacity constraints.

20. In conclusion, aid plays an important but diverse role in helping developing countries meet the MDGs. Low-income countries need aid the most, need the most aid, and they are likely to need it beyond 2015. Most of these countries are in Sub-Saharan Africa. They are far from achieving the MDGs, they face debt sustainability risks, and they are vulnerable to shocks. In the LICUS and post conflict countries, the challenges go well beyond the social agenda: large amounts of aid are likely to be ineffective, but non-governmental channels can be used to target aid towards basic human needs while building up capacity to absorb larger flows efficiently. The middle-income countries have large pockets of poor and large needs on the social agenda, including social infrastructure. They have relatively good policy frameworks and track records of success to build on. However, many face tight fiscal constraints and still have relatively low per capita income levels. Well-targeted aid in these countries can be a powerful catalyst in accelerating progress on the MDGs.

### III. A STRONGER FRAMEWORK FOR AID EFFECTIVENESS

21. A better and more effective international aid framework is taking shape. Many developing countries have improved their policy frameworks and institutions—and achieved faster growth, and have created the conditions for financial assistance to be more productive. Poverty reduction strategies, which provide better development frameworks over previous strategies with a longer perspective and a results orientation, have opened space for greater development ambitions and country leadership. Together with stronger country ownership, there is a greater focus on accountability between development partners. Also, aid allocation has become more selective and more performance-based. There is more choice of instruments for delivering aid, such as budget support and sector-wide approaches for good performers. Donors are also beginning to organize among themselves to better align their assistance to PRSs and to enhance the efficiency of their assistance through new delivery mechanisms including budget and sector wide support, closer collaboration and harmonization of procedures and practices to reduce burdens on recipient countries, and managing for results.

#### A. Better Country Performance

22. Developing countries, on average, are getting better at maintaining good economic policies and at managing public resources. This is creating a more promising environment for accelerated development, and for aid to be more effective.

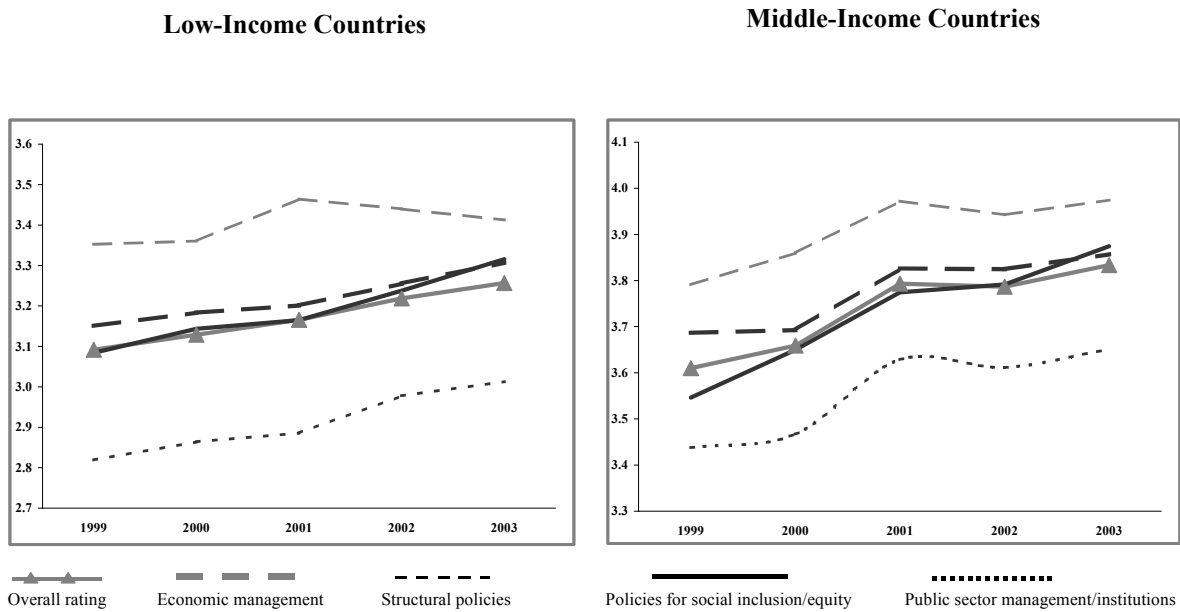
- ❖ *Sound macroeconomic environments.* Since the 1990s, GDP growth has accelerated for many countries. Average annual inflation rates have declined by half, to around 5 percent. Fiscal and current account balances have improved and average debt to GDP ratios are declining. For a sample of average to well performing countries in Sub-Saharan Africa, domestic revenue, expressed as a share of GDP, increased by approximately 1.5 to 2 percentage points since the second half of the 1990s. These trends appear likely to continue (World Bank 2004e).
- ❖ *Country policy and institutional indicators.* In tandem with the improving macroeconomic environment there has been a strengthening of country policies and institutional performance (Figure 4), as measured by the World Bank's Country Policy and Institutional Assessment (CPIA). The four clusters of indicators —economic management, structural policies, policies for social inclusion and equity, and public sector management and institutions—all show upward trends over the past five years.<sup>6</sup> The index of public sector management and institutions, an important indicator of potential aid effectiveness, registers the lowest average performance rating

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<sup>6</sup> The World Bank's CPIA index results are robust when compared to similar indices of economic and institutional performance such as the Heritage/Wall Street Journal Index of Economic Freedom, International Country Risk Guide, and the Economist Intelligence Unit Country Risk Service with broadly similar outcomes and high rank correlations (Annex B, World Bank 2004a).

suggesting that public sector management remains an area in need for concerted action. There is considerable variation across countries, and evidence points to the greatest challenges in low-income Sub-Saharan countries, many of which have also experienced improved policy frameworks and stronger institutions. In Africa, for example, in the period 1996–2002, high-rated CPIA countries typically grew faster than other countries by 3–4 percentage points a year (Figure 5).

**Figure 4: Average CPIA Trends in Low and Middle-Income Countries**



Note: CPIA ratings range from 1-6, with an increase denoting improvement.  
 Source: World Bank CPIA database.

- ❖ *Public expenditure management.* Improvements in the management of public resources, an area critical both to government capacity to implement development programs as well as to meet fiduciary requirements of external agencies, can be seen from the PEM tracking exercise initiated for HIPC countries in 2001/02 (Box 2). Progress in implementation or initiation of measures towards strengthening PEM systems in HIPCs was reported in last year's papers to the Boards of the Bank and the Fund.<sup>7</sup> Preliminary results from the second survey undertaken in 2003/04 appear to show further improvement. Progress was most evident in improving budget composition, budget classification, and the timeliness of account closure. This is particularly important in light of the more serious deficiencies in developing

<sup>7</sup> IMF and World Bank (2003).

country macroeconomic management pertaining to structural aspects of fiscal policy and budget composition, as identified by the Fund.<sup>8</sup>

**Box 2: Tracking Public Expenditure Management in the HIPCs**

In 2001/02 the World Bank Public Sector Group and the IMF Fiscal Affairs Department jointly designed an assessment tool and carried out an evaluation of public expenditure management (PEM) performance and ability to track poverty reduction expenditures for HIPC countries. The tool assesses performance against a set of 15 indicators on comprehensiveness, classification, and projection in budget formulation; internal control and reconciliation of budget execution; reporting and auditing of budget evaluation systems; and of procurement practices. The purpose of these assessments is to identify key weaknesses in country PEM systems, and design action plans to meet their short-term expenditure tracking needs, and strengthen their long-term expenditure management capacity.

The first assessment was done in 2001-02 covering 24 HIPCs and found that 9 of the 24 countries required “some upgrading” of their PEM systems (8-10 benchmarks of the 15 were met) to be able to track poverty-reducing spending satisfactorily. The remaining 15 required “substantial upgrading” (fewer than 7 benchmarks met). The main weaknesses included inadequate coverage of government transactions, program classification, in-year budget reporting, and poorly integrated information systems. The second assessment was recently completed and preliminary results appear to confirm the trend towards improvement of public resource management.

This tracking tool has proven effective in tracking performance of PEM systems in the HIPCs, identifying priority areas of concern, laying down agreed-upon short- and medium-term action plans for improving expenditure management systems, and in identifying program resources for technical assistance. Both the US Treasury Office of Technical Assistance and the UK’s DFID are using it, and work to improve and streamline the tracking tool continues.

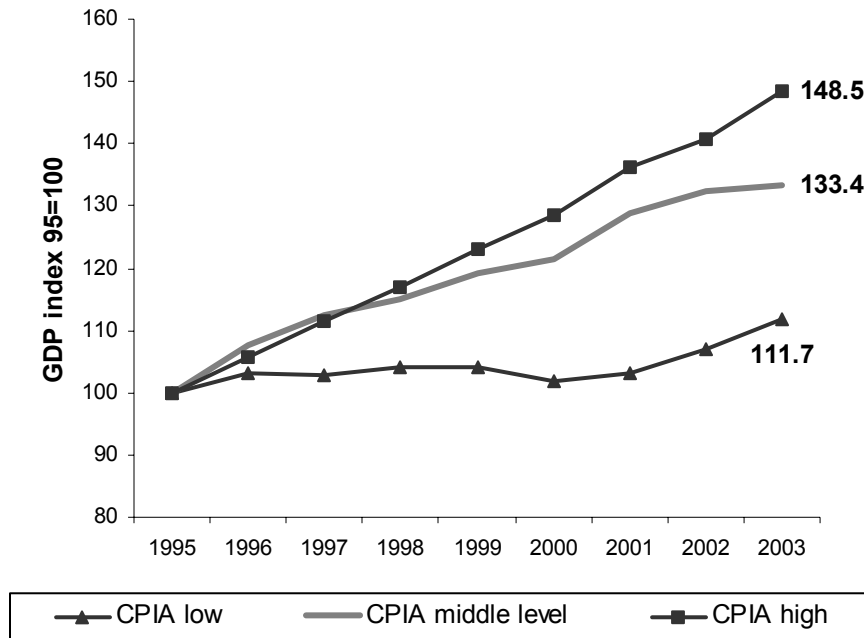
23. The evidence shows that better policies and institutions backed with stronger and better-directed development assistance lead to faster growth. The per capita incomes of IDA countries increased at an annual rate of 1.9% a year in 1995–2002, a remarkable improvement over 1981–1994, when per capita income was almost stagnant. The improvement can be traced to changes in some key factors that correlate positively with growth rates: greater political stability; more space for market mechanisms and lower barriers to international trade; sustained efforts to strengthen governance, increased transparency, and addressing corruption issues; improved attention to expenditure management and key social and infrastructure investments; with better and more comprehensive development strategies backed by increased and better directed external assistance.<sup>9</sup>

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<sup>8</sup> See World Bank 2004b (GMR, p. 59) for further discussion.

<sup>9</sup> World Bank (2004i).

**Figure 5: Better Governed Countries Are Growing Faster**



## B. Stronger Poverty Reduction Strategies

24. Since the late 1990s, there has been stronger and more effective progress by both developing countries and the international community on development strategies clearly aimed at poverty reduction. This movement is nowhere near complete, but it has markedly changed the framework for aid and sharpened the focus of governments and their external partners on the things that really matter for the MDGs. Noteworthy progress has been achieved in some of the technical aspects of the PRSP approach. All PRS countries have sharpened their focus on poverty-related expenditures, particularly in the key social sectors, and more budgetary resources have been reallocated toward these outlays.

25. However, all countries face greater challenges in other aspects of the approach. PRSPs underscore the importance of growth for poverty reduction, but for the most part, the analysis of the sources of growth is fairly weak, making the prospects for accelerated, pro-poor growth more difficult to assess. Similarly, the approach to private sector development is for the most part gradually being refined in the second and third years of implementation. There is evidence that, in more recent PRSPs, countries have begun to address more squarely the need for investment in economic and productive infrastructure—together with continued emphasis on the social sectors. Ensuring sustainable growth is of paramount importance not only to poverty reduction, but also to aid effectiveness.



26. Evidence from the CDF and PRSP evaluations by the Bank and the Fund indicate that in many low-income countries, progress has been modest in making strategic prioritization of development needs and establishing effective monitoring systems and measuring results. Furthermore, many poverty reduction strategies fail to provide strategic prioritization, showing that the hard choices in prioritizing actions over the short to medium term remain an important challenge.

### **C. Greater Selectivity in Aid**

27. Aid is becoming better focused on poor countries and good performers. About three-quarters of the 40 or so donors (aid agencies) surveyed have a positive relationship between their aid allocations and the soundness of recipients' policies and institutions.<sup>10</sup> And donors today are in general more selective than they were a decade ago. More aid is being allocated to poorer countries, given the quality of policies. This very promising result shows that donors can target countries with high levels of poverty as well as the ones with relatively good governance at the same time.

28. Donors vary widely in their approach to selectivity, however. On average, multilateral assistance is much more selective than bilateral assistance, with a much stronger relationship between allocations and the quality of policies and institutions. The largest bilateral donors covered in the survey (in terms of the absolute amount of aid provided) are less selective—while the Nordic countries, the Netherlands, and the United Kingdom are more selective. The selectivity of aid flows is a key feature of the new Millennium Challenge Account initiative of the United States; its overarching aim is to improve aid effectiveness by selecting recipients with better policies.

29. With the PRSP process, programmatic budget support has become a more popular instrument for good performers, making it easier to align development assistance with country priorities and medium-term development programs. For good performers there is also a concerted effort among donors to coordinate their actions through joint budget support groups, linking budget support to the PRS review process and to the country's budget cycle. There is also a growing recognition of the need make stronger medium-term commitments to facilitate medium-term planning by recipients and reduce vulnerability to fluctuations in annual access to budget support. But reaching agreement on indicators for monitoring progress has remained contentious and time consuming.

30. Generally in IDA countries, country assistance strategies for low-income countries and more particularly those in Sub-Saharan Africa explicitly seek to match client absorptive and management capacity to desirable engagement levels and instruments and provide incentives for clients to move upward along the continuum. This is supported by IDA's performance-based allocation (PBA) system.<sup>11</sup>

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<sup>10</sup> Dollar and Levin (2004).

<sup>11</sup> World Bank (2004 I).

31. Countries at the low end of the performance spectrum usually receive modest technical assistance and capacity-building projects to increase country knowledge and build a foundation for improved management and greater IDA engagement in the future. As countries progress, this engagement can be supplemented by projects in social sectors and basic infrastructure, health, and education, with the idea of building capacity to move further along the continuum. For stronger performers, assistance is geared toward building greater capacity in economic management to increase absorptive capacity and lay the foundation for growth. More assistance is given in the form of general program and policy based support, for example through IDA's poverty reduction support credits (PRSCs). In the social sectors especially, engagement shifts from stand-alone projects to sector-wide approaches. Traditional projects continue in some areas, notably for large-scale infrastructure and rural projects and also in financial sector reform and private sector development.

32. Donor assistance to LICUS<sup>12</sup> poses bigger challenges. LICUS are characterized by weak policies, institutions and governance; a lack of capacity or inclination to use finance effectively to reduce poverty; and, often, restrictions on forms of public participation. Assisting these countries is a complex task, and all external partners have to grapple with a fundamental dilemma in LICUS, which have deep development needs but poor results prospects if a purely financing approach is used. Recent Bank work has focused on finding better ways to support them, including through economic and sector work and policy dialogue. The major challenge in LICUS is to identify channels of support that can simultaneously strengthen engagement towards a reform process while building capacity for greater aid effectiveness.

#### **D. Managing for Results**

33. In recent years, there has been a shift in aid management and implementation practices toward a greater focus on results. The need to better manage for results—to use information to improve decision making and steer country-led development processes toward clearly defined goals—has become a key element of the global development agenda in the post-Monterrey period. It is part of the overall compact on scaling up the level and impact of development assistance.

34. Partner countries and development agencies are converging around core principles and results agendas that share common elements and approaches. Since Monterrey, a community of practice on managing for development results has emerged. In the period leading up to the Marrakech International Roundtable on Results in February 2004, this community defined the conceptual framework and the principles of managing for results (see Box 3).

35. Over the past year, development agencies have moved beyond the conceptualization phase of the results agenda, which recognizes the need to focus on results *throughout the development cycle*: early on, for *strategic planning*; during

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<sup>12</sup> Subgroup classifications include: core, non-core, conflict, non-conflict, and borderline.

implementation, for *day-to-day management*; and toward the end for *evaluation and feedback*. Actions to increase the focus on results take place across three pillars:

- ❖ *Strengthening Country Demand and Capacity to Manage for Results.* Managing for results has received more impetus by: strengthening the results focus of poverty reduction and other development strategies; building demand within civil society for accountability for results; adopting results-based approaches to public sector management; strengthening capacity for monitoring and evaluation and statistics; and identifying and sharing knowledge about what gets results.

### **Box 3: Promoting a Harmonized Approach: Principles on Managing for Results**

At the Second International Roundtable on Managing for Development Results in Marrakech, representatives from developing countries and bilateral and multilateral development agencies shared experiences on the challenges of managing for development results at the country level, and the ways in which countries and development agencies are addressing these issues on the ground. The Joint Marrakech Memorandum outlined a set of principles for a harmonized approach to managing for results and a plan of action for taking that agenda forward.

These principles provide a foundation for a broad consensus among development agencies and developing countries on how best to manage for results, and ultimately get better results for sustainable improvements in the lives of the poor. Specifically, the principles call for: (1) focusing the dialogue on results at all phases—from strategic planning through implementation to completion and beyond; (2) aligning actual programming, monitoring and evaluation activities with the agreed expected results; (3) keeping the results reporting system simple, cost-effective and user-friendly; (4) managing for, not by, results; and (5) using results information for management learning and decision-making, as well as for reporting and accountability.

The principles also emphasize that agencies should rely on and support partner countries' own priorities, objectives and results, coordinate with other development agencies and strengthen partner countries' own institutions, systems and capabilities to plan and implement projects and programs, report on results, and evaluate their development processes and outcomes, avoiding parallel donor-driven mechanisms. A strong partnership between the bilateral and multilateral community will be key in taking forward the results agenda.

- ❖ *Enhancing Development Agencies' Contribution to Country Outcomes.* Central elements are: linking assistance strategies to country priorities and outcomes, focus on outcomes and outcome-oriented management; and reporting systems that capture and use information on results, such as the IDA Results Measurement System.
- ❖ *Fostering a Global Partnership on Managing for Development Results.* Inter-agency mechanisms have been established, such as the MDB Working Group and the OECD/DAC Joint Venture on Managing for Development Results. The Second International Roundtable on Managing for Development Results aimed at raising awareness and developing a global framework and plan of action.

36. A complex and demanding implementation agenda lies ahead requiring medium-term institutional development at the country level, systems development and a realignment of incentives within the development agencies, and an easing of constraints to harmonized action among agencies. Actions are needed across all three pillars discussed above.

#### **E. Harmonization and Alignment**

37. In the last two to three years there has been some progress toward making aid more disciplined and better aligned with development priorities and country strategies. There is a broad-based global effort underway, involving cooperation between the MDBs and donors working together in the DAC and its Working Party on Aid Effectiveness and the Task Team on Harmonization and Alignment. At the first High-Level Forum on Harmonization in Rome in February 2003, the international donor community committed to align assistance around country strategies and priorities and to harmonize donor policies, procedures and practices, around strengthened partner country systems. At this point, almost 60 partner countries and at least 40 bilateral aid agencies and multilateral institutions are engaged in harmonization and alignment efforts.

38. Harmonization can be reflected in many types of actions including joint analytic work, preparation of common country assistance strategies and results frameworks, and joint reviews of implementation. Joint actions help build trust and confidence among development partners by providing a common base for strengthening dialogue, harmonizing procedures, aligning support around country priorities outlined in the PRSP or equivalent document, and facilitating government leadership. Experience on the ground shows that it is possible to make progress on this agenda.

39. For example, the government of Mozambique's leadership of the poverty reduction strategy, along with strong buy-in from donors, led to conditionality that was harmonized around a limited and prioritized set of actions and indicators. It also provided budget support in line with country budget cycles. In Uganda, shared views among government and donors of the broad priorities for budgetary allocation, sector dialogue and sector monitoring and evaluation is leading to improved resource predictability and reduction of the duplication and transactions costs associated with the more traditional project approach. In Vietnam, the government is pursuing a comprehensive aid effectiveness program that includes years of technical work (on procurement, financial reporting, auditing, environmental and social safeguards) and consensus building on alignment around the government's poverty reduction strategy. This is complemented by a comprehensive multi-donor capacity building exercise. Efforts are now being made to apply some of the results of this work, for example, through selected aspects of pilot projects and sector wide approaches in areas such as roads.

40. From the donors' perspectives, experience with budget support, sector-wide approaches based on agreed sector strategies, pooled funding, and common fiduciary

and disbursement arrangements is driving donors to align aid to country priorities and building capacities. Recent actions by several donors include:

- ❖ Earlier this year, the European Commission proposed the development of a common legal framework among EU members for aid implementation procedures, more coordinated multi-annual programming and analytic work, and taking concrete steps to establish a local EU Action Plan for coordination and harmonization in any partner country where two or more EU donors provide assistance.
- ❖ Following the Rome meeting in February 2003, the Nordic+ group<sup>13</sup> formulated a Joint Action Plan for more harmonized aid delivery across all the countries where these donors work, and focused substantial attention on implementation of harmonization actions in Zambia. In April 2004, an expanded memorandum of understanding on achieving greater aid effectiveness through harmonization was signed by the group along with Germany, the UN, and the World Bank. In December 2003, Sweden's parliament passed into law an integrated global development policy that takes the MDGs and the Monterrey Consensus as its starting point, with harmonization as one of its guiding principles.
- ❖ In June 2004, the UN put in place a harmonized programming process among its agencies. A key objective is to deliver more effective and efficient assistance aligned with national planning processes and priorities as reflected in country poverty reduction strategies and to support sector-wide approaches.

41. Despite progress, much remains to be done. Progress is seen most often in countries where the initial conditions are most favorable, where government leadership is strong, and where some degree of donor coordination is already taking place. However, in many countries these conditions are not present and active planning has not yet begun. Making progress in these countries will require attention to disconnects between commitments at the highest levels of aid agencies and actions on the ground; effective mechanisms in developing countries for holding governments and donors accountable for aid effectiveness, including related behaviors, policies and procedures; and a determination to stay the course to undo decades of practices that have made alignment and harmonization necessary.

42. Evaluations of the CDF and PRSP frameworks by the Bank's Operations Evaluation Department provide evidence on the slow progress donors have made in improving their aid practices (e.g., in areas of harmonization, collaboration). Both of these evaluations point to the gap that continues to exist between donor pronouncements on ways to improve the delivery of aid and the actions by donors to make those improvements. The Rome meeting in 2003 recognized these

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<sup>13</sup> The Nordic+ group comprises donor agencies in Denmark, Finland, Ireland, the Netherlands, Norway, Sweden and the United Kingdom.

implementation challenges. The 2<sup>nd</sup> High Level Forum (HLF-2), planned for early March 2005 in Paris, presents an opportunity to accelerate, scale up implementation, sustain and enhance political support for doing so, and more firmly push for better aid practices by demonstrating what could be accomplished in the near term. The HLF-2 meeting is also an opportunity to learn from and publicize examples of successful and not-so-successful implementation of the Rome commitments, linking to other events in 2005 that can spur momentum on this agenda.<sup>14</sup>

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<sup>14</sup> Other such events include the 2005 High-level Dialogue on Financing for Development, the United Nations MDG meeting in Autumn 2005 (Millennium Summit + 5), ongoing work on Difficult Partnerships, in-country donor coordination meetings (UN Roundtables, Consultative Group Meetings, etc.), and continued reporting to the Development Committee and the OECD-DAC's Senior-Level Meeting.

## IV. ABSORPTIVE CAPACITY

43. The key elements of a new aid architecture are thus being put in place and are already enhancing the effectiveness of additional aid. This section examines the scope for developing countries to use additional external resources to scale up their development efforts and to accelerate progress toward reaching the MDGs. To do this, they must have the absorptive capacity to put such extra resources to effective use.

44. Recent research and analysis is beginning to shed more light on countries' absorptive capacities, with a number of in-depth country studies throwing more light on the issue. In general terms we know that country policies and institutions have improved in ways likely to make additional assistance more effective, as discussed in section 2. Analysis has also shown that constraints on absorptive capacity can operate at a number of levels—national policy, budget management and local delivery, and in a variety of ways—macro-policy, institutional, physical and human, as well as social, political and cultural. It is clear that the degree of constraint varies greatly across countries and sectors, that improving absorptive capacity is a dynamic process integral to development itself, and that steps can often be taken to greatly increase absorptive capacity. This section reviews recent work on each of these issues and concludes that the balance of evidence suggests there is considerable scope for increasing aid volumes without hitting absorptive capacity constraints, and that where there are constraints they can often be tackled relatively quickly and simply.

### **A. The Improving Environment for Aid Absorption and Effectiveness**

45. As is clear from earlier sections, cross-country and in-depth country studies confirm that the policy environment for productive aid is improving in a substantial and growing number of countries; that many countries are well placed to handle significant increases in aid; and indeed that such increases are clearly needed if they are to make progress towards the MDGs. Paragraphs 14-15 above summarize the detailed country work carried out in the Bank which demonstrated the ability of many low-income countries to absorb significant increases in aid flows, and the potential progress towards the MDGs if additional aid financing materializes and sound policy reforms are kept on track. Paragraphs 22-23 above summarize the evidence: macroeconomic indicators show significant improvement since the mid-1990s; country policy indicators capture a persistent strengthening of the institutional environment for both low and middle-income countries; public expenditure management is seen to be more robust in many HIPC countries; and better governed countries are clearly growing faster. Moreover, paragraphs 37-42 identified significant trends towards improving aid harmonization and alignment to fit with development priorities. Taken together, these elements strongly suggest an improving international environment for aid absorption and effectiveness.

## B. Factors Constraining Absorptive Capacity

46. Absorptive capacity is a complex, multi-dimensional and dynamic concept.<sup>15</sup> Some things, such as the importance of country-specific approaches, are well understood. But there is still much to learn. In taking the analysis further, it is useful to look separately at the points where constraints can occur, the factors that can limit absorptive capacity, and the opportunities presented for enhancing both national and sectoral capacities. It should also be kept in mind that aid itself can help to tackle capacity constraints successfully and to prepare the way for a rising profile of effective aid disbursements. The complementary role of knowledge transfers in aid, through design and shared experience in implementing policy reforms, can help make aid more effective and build capacity.

47. *Country specificity.* The main constraints facing countries affect one of three principal points in the delivery chain from external funding at the macro level to service delivery at the local level (Table 3). At any point along the resource transfer chain there are potential factors that limit the effective use of aid: macro, institutional, physical infrastructure, human, or social and cultural constraints.

- ❖ The first delivery point is at the national and macro level where countries have to manage monetary and fiscal policies. Macro policy challenges face governments regardless of external aid flows. But external aid can both influence macro policy outcomes, and in turn be affected by the macro policy context.
- ❖ The second level is through allocative mechanisms that direct resources to where they will be used by agencies and end-users. The quality of public expenditure management is critical to addressing these fiduciary concerns.
- ❖ Third, at the local level are public and other agencies responsible for service delivery—health centers, schools, local utilities, and local government. Effective demand by households may also constrain the actual uptake of services and absorptive capacity.

48. *Macroeconomic constraints to absorptive capacity.* Macro constraints refer to national-level conditions under which aid flows may distort domestic markets and impair economic performance. The thinness of domestic markets, public indebtedness, and relative share of aid in the national economy are major determinants of this risk. There are three main macro constraints confronting developing countries in expanding absorptive capacity. The first two are closely related—ensuring fiscal and external debt sustainability. Fiscal sustainability can be put in jeopardy when aid flows are volatile and unpredictable, or when they take the form of debt and incur unsustainable servicing costs. Maintaining macro stability in the face of volatile aid flows requires either a

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<sup>15</sup> The term “absorptive capacity” refers to decreasing returns to aid as higher flows reduce the marginal contribution from additional units of aid. Limits to absorptive capacity are reached when marginal returns fall below some minimum acceptable level.



flexible fiscal framework to quickly adjust expenditures and revenues, a smoothing of aid flows through allowing international reserve levels to fluctuate, or using domestic non-monetary (bond) financing to fill gaps in aid flows. Each option poses different policy challenges that are best minimized through collaboration with aid agencies to minimize the underlying volatility of external support.

**Table 3: Major Constraints to Absorbing More External Resources**

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

49. Managing both the fiscal burden of debt servicing and ensuring external debt sustainability require planning for the recurrent cost implications of debt financing and effective debt management capacity. Borrowing externally towards reaching the MDGs may not be advisable even on highly concessional terms, depending on the level of the country's debt distress. Managing additional aid thus requires a medium-term fiscal framework. For highly indebted countries with particularly large financing requirements, aid requires higher concessionality, including a higher proportion of grants.<sup>16</sup>

50. The third macroeconomic constraint is the potential of higher aid flows to erode external economic competitiveness, leading to what is commonly referred to as the 'Dutch disease' (used originally with regard to natural resource earnings). Higher

<sup>16</sup> Although the HIPC initiative relaxes debt burden to allow greater fiscal space for development needs, these countries still face severe external financing constraints. The Bank and the Fund are now working on a joint paper that will propose modalities for supporting country efforts to maintain debt sustainability.

spending from aid often falls on domestic goods and services, raising their relative prices. Large aid inflows can thus lead to appreciation of the real exchange rate in the short run, and disadvantage exports and import-competing sectors. This can be a serious concern.<sup>17</sup> However, when domestic resource utilization is low to begin with, or where aid flows are well targeted and improve productivity, aid-induced changes in relative prices are likely to be low and/or offset. This assumes as well that relatively strong governance and low levels of corruption prevail. Mozambique, Ghana and Ethiopia are examples of countries that have managed large aid inflows with little evidence of serious macro constraints surfacing. The Fund and Bank provide advice to countries on how to address these challenges, establish and maintain sound macroeconomic policies and external viability, and support structural measures essential to fostering durable growth and reducing poverty.

51. *Institutional constraints.* Weak institutions and regulatory policies, elevated corruption, and poor governance can lead to sharply diminishing returns to aid. The quality of governance and institutions is most critical in using aid to accelerate progress toward the MDGs. In many areas, building institutional and regulatory capacity requires time, and needs to reflect the local environment and practices. Reducing corruption and establishing mechanisms for greater institutional and political accountability are essential elements that also require time and persistent effort. However, in other areas real progress can be made rapidly, such as strengthening public resource management. As noted in Box 2 above, within a two-year timeframe most HIPC countries in the tracking exercise made significant improvements in their PEM capacity, providing evidence that institutional strengthening can be fairly rapid when policy dialogue, technical assistance, and political attention coincide.

52. Where governance is poor and public capacity is lacking, both the private sector and NGOs can in many instances be used to strengthen service delivery towards reaching the MDGs. Scaling up is often possible through tapping non-governmental capacity, such as expansion of girls basic education programs and micro-finance institutions in Bangladesh, private distribution of family planning services in India's poorest state of Bihar, or health care provision a HIV/AIDS prevention in Zambia and Uganda.<sup>18</sup> The complementarity of policies towards strengthening the investment climate, easing institutional constraints to private investment, and enhancing aid effectiveness has been emphasized in recent discussions of successful development strategies.<sup>19</sup>

53. Developing local government and community capacities is also important in improving national absorptive capacity. Many developing countries are turning to the decentralization of service delivery and greater community empowerment for strengthening service delivery and developing accountability mechanisms for service

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<sup>17</sup> Adverse effects of exchange rate appreciation need to be addressed through expenditure switching (towards imports or areas of excess capacity), fiscal tightening, and in some instances limited sterilization of aid inflows.

<sup>18</sup> See case studies for the May 2004 Shanghai Conference (Bangladesh) and World Bank (2004c).

<sup>19</sup> See for example Stern (2002) and World Bank (*forthcoming*).

providers.<sup>20</sup> Decentralization efforts in several low-income countries have become core elements of national development strategy, which raise additional challenges for effective aid absorption. Decentralization also aims to reduce the urban bias in many national development strategies (typically managed by urban elite). Appropriately targeted international aid for local technical assistance and training is one element that helps enhance capacity and reduce the risk in these cases (see Box 4). In addition, better information on local inputs and outcomes can both help improve performance of local officials and empower beneficiaries to demand higher-quality services, as has been shown for aid effectiveness in sanitation, reproductive health, and primary education.

#### **Box 4: Using Decentralization to Overcome Central Capacity Constraints**

Case studies on the Malawi Social Action Fund and Zambia Social Investment Fund illustrate how decentralization can help overcome weaknesses in public delivery systems. Both funds were semi-autonomous and were placed outside the civil service structure, which helped reduce the degree of political interference in the allocation of goods. They have also demonstrated the ability of communities with limited literacy and numeracy, and exposure to formal systems, to deliver certain kinds of infrastructure and services more effectively than top-down centralized systems.

##### **Malawi Social Fund**

Between 1995-2002, the Malawi Social Action Fund gave small grants to communities to fund their own-defined priorities to improve infrastructure in education, health, water supply and sanitation, postal services, markets, community halls, roads, bridges, and soil conservation. An estimated 5.8 million people (54% of the population in 2002) benefited from increased access to social services as a result of these investments. However, infrastructure alone was not enough to overcome service delivery constraints. In designing the social action fund, the World Bank and Government of Malawi have made efforts to move beyond the construction of physical infrastructure to provide inputs that will visibly improve services and thereby contribute to progress towards the MDG targets.

##### **Zambia Social Investment Fund**

The Zambia Social Investment Fund aims to empower local communities through the financing of sub-projects identified, implemented, managed and maintained by communities. The focus of the social fund has been on the construction and rehabilitation of medical wards and maternity wards. The project includes a Community Investment Fund that finances community managed projects and a District Investment Fund aimed at strengthening the planning, management, and implementation capacity of local authorities and community members. An evaluation of the fund found that as a result of improved quality of education and health facilities in participation communities demand for primary education and select health services increased significantly.

54. *Human and physical infrastructure constraints.* Human and physical infrastructure constraints can undermine capacity and render interventions ineffective.

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<sup>20</sup> Such approaches should be managed carefully and tailored to local institutions and social systems so as not to undermine existing institutions or create parallel structures.

In the better performing low-income countries where national level institutions are relatively strong and governance constraints less severe, scarcity of skilled labor and weak national infrastructure are often the more binding constraints faced in efforts to accelerate development. Most of the better performing PRSP countries in Sub-Saharan Africa—Ethiopia, Mozambique, Uganda, Burkina Faso, and many more—face such shortages, which are exacerbated by both the deep scourge of deaths from HIV/AIDS and the major problem of skilled labor migration—particularly health workers to rich countries. Efforts to increase the number of doctors in health clinics, for example, run up against the long time requirements for training doctors, and often compete for the same thin labor pool with the private sector, other government services, or foreign markets. Addressing the problem of skilled labor migration will require more resources to help retain professionals through improved incentives and facilities, and may require consideration of internationally coordinated responses.<sup>21</sup>

55. The gap in human capital covers the full range of skills, from doctors and educators to accountants and administrators. Infrastructure requirements are also very large in communications, transport, and core utilities—important inputs to delivering quality social services. Extra resources can help build schools, but without teachers they cannot be productively used. Innovative approaches need to be considered. In some instances there is scope for building private-public or NGO-public partnerships, or even for importing skills to temporarily fill gaps. Ethiopia is drawing on trainers in education from India for example to help fill a gap in skilled teachers as they have rapidly expanded primary school capacity, and agricultural extension workers.

56. Differences in physical and human endowments of sub-national units often lead to major differences across regions which pose special challenges to service delivery for national authorities. Southern Mexico, the Indian States of Uttar Pradesh and Bihar States, and Northeast Thailand are examples of such lagging regions with concentrated poverty and lagging social indicators. This can influence national growth, aid absorption, and progress towards the MDGs. Persistent performance gaps in lagging sub-national regions may require special assistance strategies to enhance resource absorption, including regionally targeted interventions such as public investment in infrastructure to offset regional disadvantages and improve integration with national markets. Institutional structures governing inter-governmental relations and administrative capacity also need attention in developing regional strategies.

57. *Social and cultural constraints.* Often overlooked are the cultural and social aspects of aid delivery. Ignoring these constraints can undermine aid effectiveness, particularly where there is a need for reliance on community channels for information flows, beneficiary identification, and service delivery.<sup>22</sup> Recent research on cultural

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<sup>21</sup> Emigration is identified as the second most critical factor affecting undersupply of health professionals following inadequate health training programs and facilities. In Ghana, for example, by 1999, 70 percent of medical professionals who graduated in 1995 had migrated abroad. In Zambia, only 50 of 600 physicians trained in country since independence remain in the Zambian health system. (World Bank (2004i).

<sup>22</sup> Attention to social development themes in projects is a clear factor improving project outcomes. A recent OED report found that projects which addressed at least one social development theme—

constraints to development highlight social and cultural context in program design, such as in the highly successful program to reduce HIV/AIDS among sex workers in Calcutta through peer recruitment and extension services sensitive to characteristics of the particular subculture.<sup>23</sup> Demand side constraints to service uptake at the household level often reflect social or cultural considerations in addition to economic concerns. Increased recruitment of female teachers and construction of separate girls' toilet facilities are strengthening demand for female primary education in Pakistan's Northwest. These examples underscore the difficulty of implementing programs based simply on "best practice" drawn from different countries without reference to context.

58. *Sectoral variations.* Within and across countries, there are also differences in absorptive capacity between sectors. For example, infrastructure investment often provides good opportunities for the use of incremental aid, and the high import content of some infrastructure investments, such as the power sector, makes them less susceptible to Dutch disease concerns. Many infrastructure investments—in power, irrigation, and road networks—are also not very divisible, and failing to attain sufficient scale can under certain circumstances be inefficient and costly. Many developing countries face a major shortfall in infrastructure financing as funding over the past decade has fallen far short of needs, with expectations of private financing failing to materialize. Moreover, infrastructure investments are important for reaching other MDGs. Roads and transport networks can stimulate market growth, contribute to poverty reduction, and help reduce unit costs of service delivery in remote areas. Water and sanitation can provide critical inputs reducing child mortality rates. Capturing these benefits up front can boost efforts related to achieving development objectives.

59. In contrast, capacity constraints can pose more of a problem in reaching health and, to a lesser extent, education targets. Skilled labor and service norms (number of students per teacher or doctors per 1000 people) can make human capital constraints a limiting factor in accelerating service delivery in low capacity countries. In these cases, more gradual increases in resource flows may be needed as capacity expands. However, as Box 5 shows, under the right circumstances, countries with serious skilled labor constraints may nevertheless achieve social sector MDGs. Temporary recourse to external skilled labor, predictable external financing, and flexibility to allocate aid between changing recurrent and capital expenditure needs over time appear key to Ethiopia's future success. Hence, sector-wide approaches (SWAs) and direct budget support are important for scaling up, particularly for social sector programs.

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community-driven development, conflict, culture, gender, indigenous peoples, resettlement, etc. —were rated 3 to 4 percent higher on outcome, sustainability, and institutional development impact (World Bank (2004a).

<sup>23</sup> This example, and an excellent discussion of the role of culture in development effectiveness, is found in Rao and Walton (2002).

### **Box 5: Modeling the MDGs and Absorptive Capacity - Ethiopia 2015**

To examine the potential of scaling up aid to achieve the MDGs, the World Bank is developing dynamic general equilibrium models that explicitly take into account different aspects of absorptive capacity and targeting of the MDGs. The MAMS models (Maquette for MDGs Simulation) describe availability of skilled labor, efficiency of service delivery and Dutch-disease mechanisms; all potential obstacles to effective use of additional aid as well as initial conditions and key social indicators.

The models also illustrate how development programs can reinforce each other. For example, accession to clean water makes health care provisions more effective and resources used to reduce maternal mortality may reduce at the same time child mortality. Taking advantage of these synergies can create additional capacity. The models show expected achievements over time and can highlight the importance of baseline growth and the nature and timing of additional policy reforms.

In a pilot study, the model has been specifically calibrated to the Ethiopian economy, one of the poorest countries in the world. The model focuses on primary school completion and mortality rates. In the Ethiopian case a crucial constraint is the availability of skilled labor.

Preliminary results of the education analysis show that under current growth forecasts Ethiopia is expected to achieve an increase in primary school completion from around 30 percent now to 40 percent in 2015, still far below the MDG of 100 percent. With predictable foreign grant financing, rising gradually and averaging an additional 6.5% of GDP annually, as well as flexibility over time to allocate funds between recurrent and capital financing requirements, Ethiopia could achieve the full primary school completion MDG by 2015. The skilled teacher shortage would be addressed both by training additional teachers domestically and using some foreign educators in the near term to reduce skill shortages in other sectors. Erosion of competitiveness through real exchange rate appreciation is present (Dutch disease) but quite modest. The net benefits from higher aid flows to support primary school completion are clearly positive under this scenario.

### **C. Conclusion**

60. As is clear from the preceding discussion, the nature of absorptive capacity constraints varies greatly from country to country and from sector to sector, and country specific strategies for strengthening capacity are necessary. The Bank has begun development of a country-based modeling framework to look at the costs and feasibility of accelerating progress to meet the MDGs. But more rigorous micro and macro analysis on a country-by-country basis is needed to improve our understanding of where constraints are most binding, what the key determinants for accelerating capacity building are, and how aid programs can best serve this objective. The role of aid in strengthening the business environment and leveraging greater resources through private sector and NGO channels is also an important element of this work. The Bank and several other agencies are already engaged in deepening the research agenda towards this end. Some general messages are already clear.

61. There is significant potential even in the short term for using increased aid productively, by substantial amounts. This is true in many countries with higher capacity and in sectors, such as infrastructure investment, which is more amenable to rapidly absorbing large aid flows. Absorptive capacity constraints do exist. But they can often be addressed relatively quickly when there is the incentive and policy framework to do so. The assurance of predictable and increasing aid flows can itself be important in giving the needed incentive to address constraints. This could mobilize private sector contributions that can play a significant role in helping remove these constraints. In the medium term it will often be possible to use initial assistance to help tackle capacity constraints, opening the way to a rising disbursement profile as absorptive capacity expands. Finally, constraints to aid absorption should not be an excuse for inaction: resource mobilization needs to move in tandem with efforts to address aid effectiveness through strengthening the policy framework, building institutional capacity, identifying innovative avenues for service delivery, and improved monitoring and evaluation to strengthen successful learning-by-doing and learning from international experience.

## V. FINANCING NEEDS AND MECHANISMS

62. The previous sections made the case that all groups of developing countries will need to step up additional resources to scale up investments and delivery of social services—not all of which can be financed from domestic sources or private flows. Substantial improvements in developing country policies have made aid more effective and a new aid architecture is taking shape that could further strengthen aid effectiveness through better harmonization, donor alignment and a sharper focus on results. This paper has also shown that many developing countries can absorb more aid effectively now; and others are building the capacity to absorb much larger amounts effectively in the future. Larger, more predictable increases in aid can help catalyze a virtuous cycle of actions to meet the MDGs. Therefore, all options to mobilize the needed aid resources need to be explored simultaneously. This section reviews the delivery of ODA commitments and explores in greater depth the three main categories of financing approaches that were described in the Progress Note on Financing Modalities Toward the MDGs for the Spring Meetings: global tax mechanisms, the international finance facility, and financing and blending mechanisms that tailor concessionality according to country circumstance.

63. Taken together, the financing approaches discussed in this paper provide elements of a menu to address important aid financing objectives: increasing aid volumes in the short run; enhancing the efficiency of aid; and finding ways of increasing the predictability and financial sustainability of aid flows over the long term. Further work will be needed on the feasibility and design of specific elements.

### A. Delivering on Aid Commitments

64. At Monterrey, donors agreed to make concrete efforts toward reaching ODA levels of 0.7 percent of gross national income (GNI). Since Monterrey, ODA has indeed increased, beginning to move back up toward the level of ODA in the early 1990s.<sup>24</sup> (See Figure 6) From 2001 to 2003, ODA rose in nominal terms by \$16.1 billion from \$52.3 billion in 2001 to \$68.4 billion in 2003. As a percentage of GNI, this was an increase to 0.25 percent in 2003.<sup>25</sup>

65. But care must be taken in interpreting disseminated aid figures. The very large exchange-rate changes and to a smaller extent, inflation in the donor countries account for 57 percent of this increase in the reported dollar-denominated value, mainly due to a weakening of the dollar. In 2002, over half of the nominal increase was due to debt relief, a fifth was increased aid to just two countries (Afghanistan and Pakistan), and

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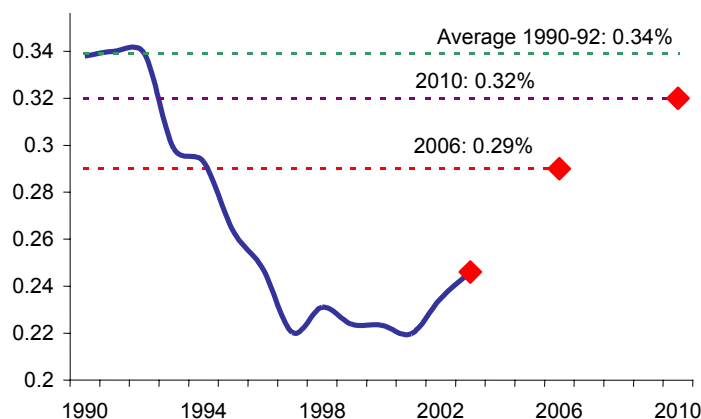
<sup>24</sup> The Global Monitoring Report will be the instrument for monitoring the delivery of those aid commitments, and progress on the effectiveness with which they are delivered, drawing on data and work of the DAC/OECD, the World Bank and other agencies. The DAC/OECD is considering how to improve indicators and data on aid effectiveness. Finally, the Bank is in the process of setting up a system to monitor and record channels through which aid flows move.

<sup>25</sup> It should also be noted that non-DAC ODA has shown an increase in recent years. In 2003, non-DAC ODA flows were \$3.2 billion, the highest level in 10 years (World Bank 2004h).



most of the remainder was technical cooperation. In 2003, strategic factors continued to play an important role, with reconstruction aid to Iraq accounting for an estimated 87 percent of the increase. Out of the real increase of \$6.9 billion (or around 13 percent) since 2001, only low levels of net cash inflows are going to countries in need, due to the predominance of strategic factors, debt relief and larger technical cooperation grants. The increment flowing to MDG “deficit” countries has been small.

**Figure 6: ODA to GNI pledges**



66. Looking forward, five countries have laid down a clear timetable for achieving the 0.7 percent target (Belgium, Finland, France, Ireland, and the United Kingdom). If all DAC countries were to meet their expressed commitments, the ODA to GNI ratio would increase to 0.30 percent by 2006, and 0.32 percent by 2010 (from 0.22 in 2001), with just under three quarters of the increase coming from the European Union. This is a good start, but more needs to be done.

67. The simplest approach to ensuring that more aid flows where it is needed would be for donor countries to increase their aid budgets. As noted above, many are doing so, but rapid and substantial increases in aid are politically and fiscally difficult for many countries. While the push to increase aid is critical—and the most effective route may be to encourage popular support for aid in donor countries—it is worth exploring whether aid flows can be supplemented through other mechanisms.

## **B. Global Tax Mechanisms and Voluntary Contributions**

68. In the absence of sufficient traditional ODA, one way to increase aid flows over time would be the use of global taxes or voluntary giving mechanisms. Many proposals have been made of ways to raise additional revenue for financing global development through new tax instruments or measures to encourage voluntary giving by

individuals.<sup>26</sup> Most could be made to work without creating a global tax administration, and many without participation by all developed countries. But all would take time to implement, and all would face varying degrees of political opposition. Some would have adverse economic effects. These difficulties suggest that revenue from these innovative sources in the near future is likely to be, at best, no more than a complement to finance that could be achieved from other proposed mechanisms, such as frontloading. As with all innovative mechanisms, additionality is a fundamental concern, as countries might well reconsider the level of their other contributions if they established a tax that generated very substantial annual revenues.

69. Innovative instruments are naturally judged by the standard principles of good taxation, with some additional considerations arising from their international nature. All else being equal, an instrument is better:

- ❖ The greater, more stable and less volatile its revenue yield;
- ❖ The more it improves efficiency in the allocation of national and global resources, correcting international externalities—arising either from border-crossing environmental problems or inadequate cooperation in setting national tax policies. Such a tax would be desirable almost irrespective of the use made of the revenues it raised. Taxes on the economic rents associated with the exploitation of global common property resources are also attractive on these grounds, since taxes on rents cause little distortion. Conversely, tax instruments that cause efficiency losses are unattractive (a category that, as a basic principle of public finance, would include any tax on intermediate transactions unless it corrects some specific environmental or other harm);
- ❖ The greater its additionality, in not being partially or wholly offset by reductions in contributions to development finance from other sources. There is an important link between this and the efficiency criterion above: instruments that increase efficiency ultimately expand the resources available for, among other things, development assistance;
- ❖ The more equitable its impact, both within and across countries;
- ❖ The easier it is to comply with and to collect. Distinctive considerations arise in the need for cross-border administrative cooperation not only as a technical matter of ensuring compliance but—perhaps even more important—because participating countries will want assurance that others are implementing the tax properly (rather than, for instance, seeking to advantage their own firms in world markets by lax enforcement of a cost-increasing tax). In addition, ensuring that national administrations have

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<sup>26</sup> See annex for a review. Surveys of the issues and proposals are provided by Annan (2001), Atkinson (2003), Jha (2002), the draft report of a working party appointed by President Chirac of France henceforth the Landau report (2004), Reisen (2004), and United Nations (2001).

some incentive to devote the resources needed to collect a tax whose proceeds are passed on to another agency will likely mean allowing nations to retain some part of the proceeds (perhaps 5-10 percent) to cover their administration costs;

- ❖ The greater its political acceptability; and
- ❖ The smaller and more supportive the set of countries needed to make the tax viable.

70. There are important trade-offs between these criteria. For instance, surcharges on pre-existing national taxes are easy to administer and comply with since they rest on existing machinery. But since their impact is to intensify existing distortions associated with the tax, they may offer little if any efficiency gain or, hence, additionality. Similarly global taxes may entail tradeoffs in their distributional impact and social incidence between and within countries. And the more that countries gain from the non-cooperative behavior in tax setting—and hence the larger the gains from addressing the associated global inefficiencies—the harder it will be to build political support.

71. No proposed tax instrument is free of serious weaknesses by the foregoing criteria. A common carbon tax—whether levied by all countries or only by developed ones—is technically the most attractive candidate, as it could generate substantial revenue and correct significant international externalities, notably by mitigating global warming. But the Kyoto process has shown that a carbon tax, or equivalent tradable permit schemes, is politically very difficult to achieve, even when nations retain the revenues. Given such opposition, it may be better to focus on more modest initiatives aimed at addressing narrower environmental or ‘public bad’ concerns such as taxes on aviation fuel or maritime pollution. Charges for the use of the global commons—such as positioning satellites—are attractive in principle, but have modest revenue potential for the foreseeable future. Taxes whose impact on economic efficiency is questionable—such as those on currency or wider financial transactions, on world trade, or surcharges on national taxes—should be viewed with caution. Not only can they cause harm, but by further distorting economic activity and impeding the overall operation of the tax system, funds raised from such taxes are most likely to be offset by reductions, or slower growth, in traditional development support.

72. Measures to enhance voluntary contributions by individuals—such as global lotteries, premium bond schemes (the latter combining a fixed nominal return with a lottery element), or providing the opportunity to donate in annual tax returns—may also offer a way ahead. Voluntary giving is, by definition, equitable, though some see lotteries as a regressive tax. Difficulties could arise, however, from the potential crowding out of other activities supported through private donations. Moreover, it cannot be taken for granted that increased voluntary giving will be additional, as it may erode the political support for tax-financed development support.

73. Though there would be significant practical and political problems to be overcome, some of the more modest proposals—by increasing the efficiency of global

tax system—may over the longer term have a useful role in freeing additional resources to support development.

### **C. Frontloading Aid: The International Finance Facility**

74. Another approach to increasing aid flows would be to bring forward some of the aid increases announced by donors for the future. Again, the simplest way to do that would be for donors to increase their current aid budgets and reduce future commitments correspondingly. Some donors, however, are not able to increase budget outlays immediately, but are prepared to make firm commitments to increase aid within a definite timeframe. In such circumstances, frontloading of aid could be considered.

75. Frontloading has two aspects. First, frontloading aid disbursements, as discussed above, responds to immediate needs for funds, in cash, for critical development investments. The use of frontloaded aid funds needs to be managed at the country level, taking into account absorptive capacity, along with ways to improve it, on a country-by-country basis. Frontloaded aid should also flow in support of sectors, programs and projects in which increased aid flows can be absorbed rapidly.

76. Second, frontloading aid commitments, by contrast, responds to the long-term need for assured, predictable funding, so that developing countries can invest in building human, institutional, and physical capital with reasonable confidence about their financing over the sustained period necessary to make them successful. Arguably the most important aspect here is to provide predictability about future flows at the country level, an issue now being discussed, for example, in the context of donors making firmer multi-year commitments when they provide budget support. It can also be helpful to supplement such commitments with global forward commitments. Donors do already find ways to make forward commitments on aid flows, including setting out their long-term expenditure plans (e.g., the United Kingdom and France) and establishing peer group monitoring (as in the European Union). In some global mechanisms, for example via the replenishment of multilateral concessional windows (IDA, Asian Development Fund, African Development Fund, the Global Environment Facility), donors are able to make multi-year commitments. But more needs to be done to increase certainty about future aid flows particularly at the recipient country level, and there is an additional attraction to global financing mechanisms that would both signal and support the commitment to provide long-term aid flows.

77. The International Finance Facility (IFF), which would support both aspects of frontloading, is the most advanced proposal to frontload aid. It would enable aid disbursements to be frontloaded to help reach the MDGs, since it would have the flexibility to raise funds in the capital markets as and when they are needed. It would also allow aid commitments to be frontloaded, as it is specifically designed to provide a platform for pledged increases in future ODA commitments to be used in the near term to support development financing. It could be a complementary mechanism, with global tax mechanisms, as it is designed to increase development funds in the short term while global taxes would generate funds in the medium to long term. As an intermediary

financing mechanism, it is intended to provide a way to better match future flows with what is needed now.<sup>27</sup>

78. ***IFF Structure.*** The IFF is based on four fundamental components:

- a) *Government backing.* The driving force behind the IFF is donor pledges of future aid—donors would make legally binding pledges of future increases in aid commitments without having to make immediate appropriations or fiscal commitments.
- b) *Bond issuance.* A treasury platform would use the donor pledges as backing to issue AAA-rated bonds. This platform, the IFF itself, would rely on donor pledges (not cash) to back the bonds, avoiding a liquidity buildup and associated negative cost of carry. The excess of pledged amounts over the amount of IFF borrowings would provide the financial enhancement needed to support the AAA rating on IFF bonds.
- c) *IFF governance.* Bond proceeds would then be channeled through existing multilateral and bilateral aid programs. Allocations would be made in accordance with an aid allocation framework agreed under the IFF’s governance structure.
- d) *Bond repayments.* The IFF would pay off the bonds, drawing down donor pledges.

79. The Spring paper for the Development Committee concluded that the IFF proposal, although subject to the accounting, legislative and other circumstances of individual donors, appears to be feasible.<sup>28</sup> That is, the IFF structure would support the issuance of AAA-rated bonds to provide development funding. Since then, work has focused on some of the practical issues raised by the IFF, including ways to adapt the IFF to different donor needs, and ways it could be structured.

80. Each component of the IFF structure has details that need to be fleshed out and issues that need to be resolved. For the first component, there are issues relating to the feasibility of using future donor support as a basis for raising finance now—notably how to ensure that donor pledges to the IFF are both off-budget and legally binding, and accepted as such by the capital markets. For the second component—establishing the IFF as a treasury platform and bond issuance vehicle—the questions revolve around how efficiently the IFF would be able to issue AAA-rated bonds. Third, on the IFF’s governance structure, the challenge is to create a broadly supported IFF without

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<sup>27</sup> Of course, donors can simply borrow (or use taxes) on their own and disburse either through their own bilateral programs or in the form of contributions to multilateral agencies rather than go through a pooled mechanism. But as discussed below, one key consideration is that donor contributions would not count as immediate budget outlays under the IFF. Details of the IFF structure and analysis of options are found in Annex 2.

<sup>28</sup> World Bank (2004e).

contributing to a proliferation of international aid funds and facilities with separate and demanding decision-making. The IFF's potential contribution to overall aid effectiveness will hinge on how effectively and efficiently IFF funds are allocated, an outcome of its governance arrangements. Fourth, bond repayments will need to be handled with a careful eye on the levels of overall ODA flows over time. These issues are considered in turn.

81. ***Government backing for an IFF.*** The key to the successful implementation of the IFF proposal will be the level and breadth of donor participation, and its use of legally binding but off-budget pledges of future aid flows. The IFF would not require universal participation, but to satisfy the requirements that it be independent of donors and robust enough to satisfy capital market scrutiny, the participation of several donors would be required, ideally five or more. The breadth and quality of donor participation, and the nature of the contingent commitments to the IFF which they undertake, will be critical to the viability and financial efficiency of such a vehicle, especially in establishing the ratio of AAA-rated bond financing which can be realized relative to the underlying donor pledges.<sup>29</sup>

82. Pledges to the IFF would most likely be bilateral financial agreements entered into by and between the IFF and each donor country. Requirements for an aid pledge to be off-budget vary country by country, and interest in such a mechanism also varies country by country. The fiscal treatment of these contingent liabilities will need careful examination to ensure consistency with broadly accepted principles of fiscal transparency. In addition to the issue of fiscal treatment, countries would also need to have the ability to make legally binding pledges of a long-term nature.

83. A key aspect of the off-budget nature of IFF pledges is that they would be contingent on some sort of high-level financing condition so that donors would not be obligated to make certain payments to the IFF if the condition were to be triggered. As the high-level financing condition, the UK proposed that beneficiary countries not be in arrears for six months or more to the Fund, because it is an independently verifiable condition, and would be expected to occur only with respect to high-risk countries for which payment might be politically undesirable on performance grounds.

84. If the condition is not met—that is, if a country that received IFF funds went into protracted arrears with the Fund—donors would not be obligated to make payments to the IFF for assistance volumes related to that specific country for the period it remained in arrears. Since there is real, though low, developing country risk

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<sup>29</sup> The efficiency of the IFF structure, and its inherent risks, are reflected in the advance rate, which is the proportion of the amounts pledged that could be borrowed and become available for development financing. Assuming that a defaulting recipient country would exit IMF arrears after 4 years (or 7 years), in order to maintain a AAA rating on IFF bonds, about 76 percent (or 66 percent) of donor pledges could be translated into bond issuance. Assisted by Goldman Sachs and Standard & Poor's, the UK Treasury has estimated the advance rate using Monte Carlo simulations based on IDA-eligible countries as IFF recipients and assuming donor funding from G7 countries. Measures that improve the advance rate would improve the efficiency of the structure, by supporting higher disbursement levels for a given amount of pledges.

inherent in this condition, financial enhancement would be needed to maintain the required AAA bond rating that will ensure low IFF borrowing costs.

85. In these circumstances, there may be scope for different kinds of support from donors in different fiscal positions and with different legal structures. Thus, an important area of exploration would be other possible ways for governments to provide backing to an IFF. Possibilities, summarized in Box 6, could include the use of executory contracts; government guarantees; partial or secondary guarantees; and government purchase of supporting-tranche IFF bonds.

#### **Box 6: Possible Forms of IFF Donor Support**

Ways that donors could support the IFF, in addition to off-budget, legally binding pledges of future aid flows, include:

*Executory contracts*, under which a donor government would enter into a contract with the IFF as bond issuer stating the terms of its support, which in this case would be a defined payment stream to the IFF if specified conditions are met.

*Government guarantees*, committing a donor now to paying the IFF later in support of the IFF's bond obligations.

*Partial or secondary guarantees*, not as direct IFF funding but to back up other pledges. A donor could guarantee that it would make payments to the IFF in the event of default by another donor, and/or if the high-level financing condition was triggered and other donors were no longer obligated to pay a portion of their pledges. Such guarantees could help improve the efficiency or advance rate from donor commitments.

*Purchase of "second-tranche" IFF bonds*, with the second tranche having an equity element supporting the AAA rating of the first tranche by bearing the risk of contingent non-payment by IFF donors.

86. Given the quite different situations faced by donors in relation to ODA generally and the IFF specifically, these options might provide different ways for donors to consider supporting an IFF. The original IFF proposal was based on a simple EU-specific model, but further investigations have yielded a variety of complementary approaches that might be acceptable in jurisdictions with different budgetary regimes. Moving forward, one area of work could be to examine the technical details of these possible alternative forms of donor support.

87. *Institutional Efficiency*. A second set of issues revolves around the broad understanding that the IFF should not be established as a new, international organization with its own staff. It should instead, to the extent possible, rely on existing institutions to avoid complicating the already overlapping international aid architecture. This has implications for both the executive functions of the IFF and for its governance arrangements.

88. *Bond Issuance/Treasury Platform.* As an institution, the IFF would consist primarily of a treasury platform that would be responsible for a range of functions: managing donor pledges and drawdowns; issuing and servicing bonds and dealing with rating agencies, regulatory and qualification agencies, underwriters, and fiscal agents to maintain the AAA rating on IFF bonds; managing the flow of the IFF's borrowing and repayment streams; disbursing to implementing agencies; tracking expected disbursement levels; and coordinating the IFF's financial reporting across implementing agencies. Taken together, these are significant and sophisticated financial management functions.

89. As these tasks are familiar for the World Bank and other MDBs, several shareholders asked whether it would be possible to place an IFF fully within the existing international financial institutions. This prompted an examination of different ways one could structure an IFF platform. The basic financial criteria for choosing an appropriate structure for the IFF include issuance vehicle setup and management costs; expected borrowing rates; and treasury management and cash flow administration capabilities. Costs would also vary depending on the expected level of funding and bond issuance—a certain minimum volume would seem necessary to support the setup and cover transaction costs. From the IBRD's perspective, if an IFF were to become an integral part of its financial and legal structure it would be difficult to insulate shareholders, notably its borrowing members, against negative impacts in terms of increased funding costs given the possibility of market confusion and name dilution with respect to IBRD bonds.

90. These cost factors suggest that it would not be appropriate to establish the IFF as part of the World Bank, but there would be clear benefits of a close association with the World Bank and/or MDBs, since the greater the reliance on an existing institution or platform, the lower setup costs are likely to be. Similarly, borrowing rates—within the range of AAA securities—are likely to be lower the more closely associated the IFF is to a well-established AAA-rated bond issuer that enjoys extensive market recognition. Financial management services should be available from commercial banks, but commercial rates for these services would normally be more expensive than if they were undertaken by the World Bank or other MDBs, which would by presumption provide such services on a cost-recovery basis. These factors point to possible benefits of having one or more international financial institutions establish the IFF platform as a subsidiary or affiliate that is legally and financially separate, but that would draw on the institutions' skilled staff and the capital market and financial management experience. Any proposed structure should also ensure that the IFF is protected by appropriate privileges and immunities with consideration given to whether they should be accorded by the international community or by a single sponsoring country.

91. *Governance Arrangements and Aid Delivery.* The desirability of avoiding further institutional proliferation in aid decision-making criteria and delivery gives rise to a related set of issues on how best to design governance arrangements for an IFF. There are competing considerations when it comes to the best institutional structure for the IFF. There is a broad reluctance to fashion anything new—and to avoid, to the



extent possible, elaborate institutional structures, separate decision-making bodies, and a separate staff. But IFF participants will make core decisions (such as funding levels, allocations, and fundamental policies and operating principles) of great interest to recipients and international civil society. These interests will need to be balanced.

92. The IFF's core allocation decisions will be a key aspect of its contribution to aid effectiveness. It is meant to facilitate commitment of additional aid, and thus its impact on overall ODA flows must be carefully managed. It is intended to support aid predictability, and so must be backed by long-term funding commitments. It is intended to help achieve the MDGs, and so its funds must flow where they can be absorbed and where they will enhance harmonization and alignment. And as its funds flow in combination with existing flows, it must support country ownership, macroeconomic stability and performance without adding to recipient burden.

93. The IFF will not disburse resources directly but through existing delivery channels. These channels already have in place specific terms and conditions that apply to the provision of financial assistance. Thus, any conditions imposed by the IFF in making resources available would need to be consistent with those that already apply under these existing channels to avoid conflicts.

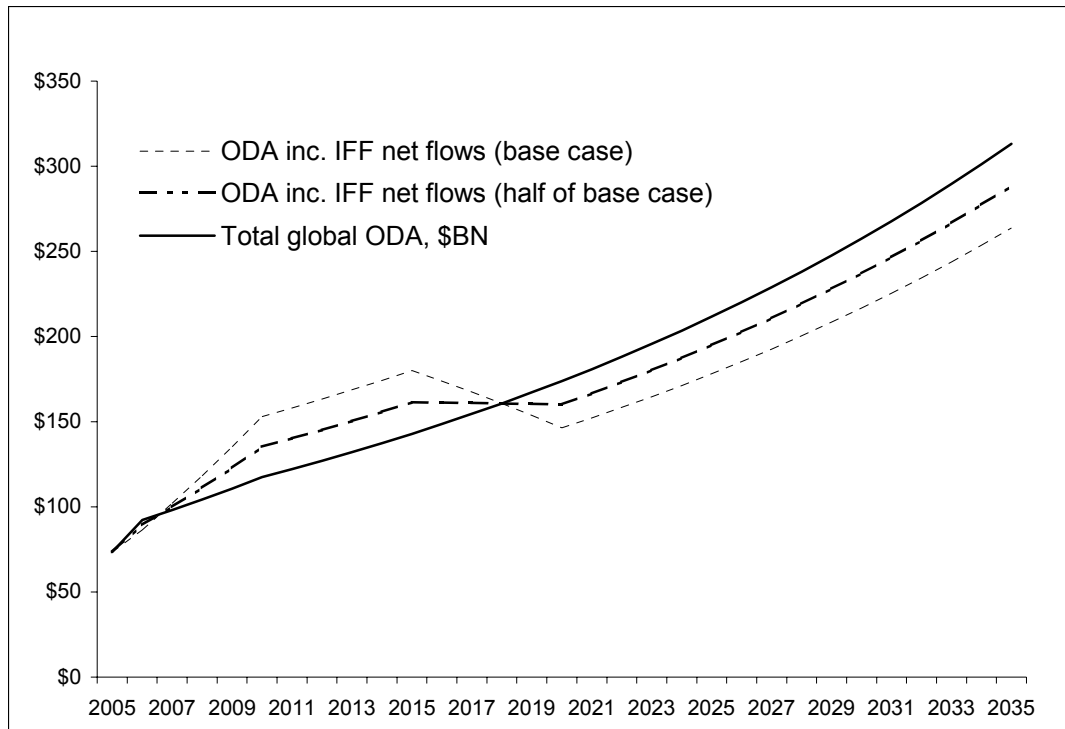
94. ***Bond Repayments and Impact on Aid Flows.*** A frequent concern expressed about the IFF is the risk that using the IFF to frontload aid flows, even incremental aid flows, could result in a drop-off in flows after 2015. Because of the added cost, compared to current aid flows, of establishing and running the IFF, of its market transactions, and interest paid on its bonds, flows diverted from aid budgets to pay IFF bonds could be substantial. Ultimately, the effectiveness of an IFF will depend not only on the impact on the ground of IFF funds but also on what happens as future government aid flows are used to repay IFF bonds.

95. Absorptive capacity considerations mean that scaling up aid will need to be managed carefully and investments targeted at mitigating capacity constraints. Once flows increase, they will need to be maintained in the medium term. As discussed in the preceding section, increasing aid flows can itself be an important investment in giving the needed incentive to address absorptive capacity constraints. Thus, the original UK proposal, which called for a significant short-term increase in aid and then a drop in aid flows post-2015, should be modified to ensure that the frontloading of future aid flows through an IFF results in a short-term increase and then a steady flow of funds beyond 2015.

96. One of the strengths of the IFF proposal is precisely that it provides the flexibility to mediate between what is needed, in terms of disbursements, and when donors pay for it, so it can be adapted to support a desired ODA profile. An example of such a profile is given in Figure 7, which assumes a continuing 4 percent increase in ODA flows. In the base case (consistent with the original UK proposal), that increase would be fully frontloaded into an IFF, and aid flows would drop for several years after 2015 before rising again as increasing ODA more than covers payments to the IFF. The mid-line case assumes that only half of ODA increases would be channeled through the

IFF, and that IFF flows would be managed so that they would plateau, starting in 2015, before rising again.

**Figure 7: Scenario of 4 Percent ODA Growth**



97. **Conclusion.** If the international community wishes to move forward with the IFF, the next step would be to work through the details of implementation. Possible ways to support an IFF, as suggested here, should be fleshed out in detail for interested donors. Further work can be done on the feasibility of creating an IFI subsidiary to determine if expected efficiencies will materialize. Further work can also be done aimed at determining the most efficient structure for establishing the IFF. Specific proposals on governance must be examined to find an appropriate balance between its aid purposes and simplicity; between efficiency and wide participation in governance decisions.

#### **D. Getting More from Aid**

98. Finally, it will be important to address the third category of “innovative financing” options discussed in the April 2004 Development Committee paper. Can new financing and blending mechanisms help produce a bigger impact for a given level of ODA flows? Multilateral aid is delivered as an aggregate of assistance and funds from different sources. Flows from each source are subject to the priorities and practices of individual donors or multilateral institutions. The terms and levels of available aid are not consistent across countries—whether due to an uneven effort to enhance aid effectiveness by grounding it in country performance levels, or to the extent that aid reflects strategic or other priorities of donors. There is little evidence that

the overall aid effort is currently producing the maximum possible impact in terms of poverty reduction and achieving the MDGs, and much evidence that it is not.

99. Efforts discussed in Section II to target aid better to countries where it will be most productive and harmonize and align aid at the country level are critical to aid effectiveness. Also critical may be efforts to match the terms of aid—its degree of concessionality—better to individual country and project circumstances, and to actions needed to achieve the MDGs. In this task, there appears to be considerable scope for the international community as a whole to be much more systematic in how it brings different available financing sources to bear on different countries and projects. This would not be a simple endeavor – aid flows have a depth and breadth of political and historic drivers that are often difficult to change. But there could be a substantial pay-off. Better pooling of different sources of funds and matching concessionality to recipient needs can increase the total volume of development finance and preserve the most concessional finance for where it is most needed.

100. In principle, the multilateral aid system is based on a spectrum of concessionality across countries based on poverty levels. As GNI per capita levels go down, the spectrum runs from middle-income countries eligible for MDB lending, through blend countries with access to both MDB and concessional loans and “IDA-only” countries eligible for concessional lending and grants, to LICUS and post-conflict countries with access to limited, highly concessional financing and grants. In practice, only a part of global aid flows is targeted on this basis, with some 40% of total flows of grant and concessional ODA going to MICs. Many bilateral donors, and some multilaterals such as the European Commission, provide high levels of aid on grant terms to MICs.

101. Moreover, levels of average country per capita incomes may not in themselves be a sufficient guide to required levels of concessionality. Countries face a range of complicating circumstances as they strive to reduce poverty, including their relative institutional capacity, fiscal constraints, progress toward development goals and the MDGs, and access to external finance. Even in MICs there may be some projects—for example those directly linked to MDGs or to global or regional public goods—where more concessional finance may be appropriate; and even in the poorest countries there may be some projects—for example those with a significant commercial return—where less concessionality is appropriate. Some donors are already taking steps to match concessionality more to needs. Agence Française de Développement (AFD) has different degrees of concessionality of assistance for different projects in the same country, and even different components of the same project. DFID is taking steps to ensure that no more than 10 percent of their ODA goes to middle-income countries, and to ensure that aid to MICs so far as possible is directed to poverty reduction and the MDGs. The following paragraphs discuss a variety of ways in which aid flows could be better targeted, with varying degrees of concessionality, in different groups of countries.

102. The challenges in *LICUS countries* are daunting. With the exception of the subgroup of conflict-affected LICUS countries that have made strong efforts to consolidate

peace and resume normal development efforts, these fragile states cannot use high aid volumes as effectively as stronger-performing countries due to their weaker policies and institutions.<sup>30</sup> Further advances made in the design of aid interventions, particularly the genre of ring-fenced programs used in Timor and Afghanistan, may offer additional potential to scale up aid programs for critical social services even in environments of weak government institutions.

103. For *IDA-only countries*, aid terms should be examined carefully in relation to their debt-carrying capacity, as suggested by the ongoing Bank-Fund work. In the IDA14 replenishment negotiations, it has been proposed to continue to base country allocations in IDA's performance-based allocation system, and to adjust financing terms in the light of debt sustainability assessments. The IDA14 framework assesses countries on the basis of risk of debt distress, and grant eligibility is determined accordingly. For example, countries with a high risk of debt distress could receive 100% grant financing, while countries with a medium risk of debt distress receive 50% grants and 50% credits, and credits would be extended to countries with a low risk of debt distress.

104. *Blend countries* already are eligible to receive a blend of concessional IDA and regular IBRD lending. Additional non-concessional financing could be a useful measure to encourage MDG investments, and for countries at the lending limit, country-specific partial guarantees from donors might be a low-cost way for donors to spur additional flows. In other cases, blending concessional bilateral finance with extra non-concessional MDB finance could be a way to gain extra leverage in helping these countries make progress toward the MDGs, or tackle a particular pocket of poverty.

105. For the low-income countries as a whole, more needs to be done to ensure that aid is available rapidly and flexibly when countries encounter exogenous shocks, with appropriate degrees of concessionality in each case, particularly when progress on the MDGs is endangered.

106. *Gap countries*—whose GNI per capita is too high for IDA eligibility, and creditworthiness is too poor for access to IBRD funds—raise a different set of issues. These countries are considered as having exceptional access to IDA, and are subject to hardened, but still highly concessional IDA terms. MDBs and bilateral donors acting together could work toward a more systematic approach to address the varying needs of this varied group of countries.

107. A different set of issues applies to the *MICs*. As noted, they receive significant aid flows, and large numbers of the world's poor live in MICs, but most aid flows are not at present directed toward MDG purposes. These funds, especially concessional and grant funds, could be better targeted toward meeting the MDGs where their possible leverage could be substantial. Following the recent review of its strategy for middle-income countries the Bank has begun to explore with other donors ways in which

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<sup>30</sup> Dollar and Levin (2004) suggest that current aid flows to LICUS as a group are lower than their policy and institutional ratings indicate that they could absorb implying that even with no change in aid delivery mechanisms, a sub-group of LICUS could effectively absorb an increase in aid flows.

collaboration in supporting MICs could be strengthened. A potentially powerful way to move the MDG agenda forward in MICs would be to look systematically for opportunities to blend donor grant finance with IBRD and similar lending to address MDG related spending needs. Grants can be used strategically in this and other ways to leverage much larger flows of domestic and external resources, both for individual projects and over time. One existing example is the blending of DFID grants with IBRD loans in the health and education sectors in China. It should, however, be noted that for this mechanism to work, the bilateral grant needs to be fully untied and the country assistance strategies of the two agencies need to be closely aligned. Another example would be encouraging the creation of micro-credit institutions, where often grants can help with pilot operations before financing moves to more conventional, and more sustainable, market-based funding. Careful use of such blending in MICs could be a powerful way of accelerating progress towards the MDGs, given the numbers of the world's poor who live in MICs.

108. **Conclusion.** Given the range of resources and types of concessionality provided for development by the international community, there appears to be significant scope for the international community, working together, to match degrees of concessionality better to needs across and within countries in these different groupings. Given the different motivations and contexts of different donors this would not be an easy enterprise—but the potential gains in terms of better use of aid resources are considerable.

## Annex 1: Global Tax and Similar Mechanisms

1. This annex reviews proposals for tax and similar innovative instruments, gauged against the criteria set out in the text. For analytical purposes, it is useful to make a broad distinction between four types of proposals: taxes that correct inter-jurisdictional inefficiencies, taxes on common property resources, other taxes, and measures to enhance voluntary giving by individuals.

### *Taxes that Correct Inter-jurisdictional Inefficiencies*

2. Taxes that correct inefficiencies would be desirable—at least in the sense of increasing efficiency—even if the revenue were retained by the nations that paid them. But the argument for using such taxes to finance development is stronger than has been widely recognized, as they make it less costly to raise revenue and are therefore more likely to generate additionality. This effect may not be very strong, since the use of a more efficient tax instrument is akin to an increase in real income, so that the magnitude of additional spending on development would depend on the income responsiveness of the supply of aid. Nonetheless, the total amount of revenue raised is likely to increase, and with it the prospects for increased development financing.<sup>31</sup> The most recurrent candidates under this heading are taxes on hydrocarbon fuels, currency transactions, air travel, arms sales, and multinational corporations.

3. The technical case for a uniform global carbon tax—a tax related to emissions from the use of hydrocarbon fuels—is strong. Such a tax is addressed to a clear and potentially important externality, since countries acting in isolation do not have proper incentives to impose additional costs on their producers in order to address border-crossing global warming. Administration of such a tax should be relatively straightforward, since the tax could be collected through the current excise tax mechanisms (although, given the potential impact on production costs, each participating country is likely to require strong assurance that the tax is properly implemented by the others). Moreover, the tax could raise very substantial revenue.<sup>32</sup> A uniform global tax of USD 21 per metric ton of carbon (about five cents per gallon of gasoline)—far below some estimates of the level needed to internalize the costs of global warming—would raise about USD 130 billion—enough to finance the MDGs several times over.<sup>33</sup> As stressed by Landau (2004), it is likely that much of the revenue would need to be returned as compensation to the countries levying it (20 percent of this revenue would arise in the US alone). Nevertheless, given the potential improvement in efficiency, the prospects for worthwhile additionality are in principle relatively high.

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<sup>31</sup> Keen (2004).

<sup>32</sup> Before proceeding with such a tax, it will be necessary to understand how it would affect different countries, including oil-producers.

<sup>33</sup> Landau (2004) is much more cautious, estimating that a tax of USD 10 per metric ton would raise USD 10-20 billion. However, this case depends on the time frame selected and the level of control required.

4. Significant equity issues also arise with a uniform carbon tax. Rich countries would contribute most of the total revenues collected, but poor countries would also be affected as they use more energy per unit of production. While the interests of efficiency call for a uniform tax across countries since emissions cause the same global damage wherever they arise, concerns about the impact on poor countries have led to suggestions that the tax be limited to developed countries. The revenue would still be substantial, as a USD 21 tax per ton would raise about USD 60 billion<sup>34</sup> in additional revenue, but the efficiency gain would be lower including through the tax-induced relocation of polluting firms to low-income countries. Imposition of a uniform carbon tax would also raise concerns about distributional issues within countries, as energy use constitutes a significant part of the expenditure of needy and vulnerable groups, such as the aged.

5. The Kyoto process has made clear the political obstacles to a carbon tax. There is likely to be a supportive “green” constituency in favor of a carbon tax in many rich countries but also strong popular opposition, especially when fuel prices are high—notably, but not only, in the United States. There can be a potential conflict between environmental goals and the use of the revenue a carbon tax would raise.

6. A ‘Tobin tax’ on short-term currency transactions<sup>35</sup> has been proposed as a means of addressing perceived inefficiency arising from excessive exchange rate volatility. The revenue raised by such a tax could be substantial, as a tax of two basis points might raise in the order of USD 30 billion.<sup>36</sup> The tax is however, also likely to create distortions, including possibly increasing volatility: impeding trade and risk-management arrangements, encouraging avoidance by financial engineering (for example, using options to replicate spot transactions), and other methods of avoidance—all consequently reducing the base of the tax. The prospects for additionality are limited, not only because of distortions induced by a currency transactions tax, but also because compensation is likely to be required by the countries in which most revenue arises.

7. The inter-country distributional impact is likely to be progressive, since the least developed countries, whose currencies are not traded internationally, will be largely shielded from the tax. But there may also be interest rate effects (operating through interest parity) that could alter the distributional impact. The intra-country distributional impact would be modestly progressive to the extent that wealthier individuals are more involved in foreign currency transactions, but the final incidence is difficult to determine since the tax to some degree cascades by affecting transactions throughout the production chain, with non-transparent effects on final prices. Administratively, the mobility of the tax base requires that the major financial centers participate, but even

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<sup>34</sup> Sandmo (2003).

<sup>35</sup> The tax rate needed to deter speculation in crisis periods would have to be much higher than the desired tax rate for revenue raising purposes. This has led to a proposal for a dual rate structure, with a higher rate applying once the exchange rate has moved outside some bounds. See Spahn (1996).

<sup>36</sup> Niskanen (2003).

then, measures are likely to be needed to prevent exchange business migrating to non-participating countries.

8. Politically, such a tax has some vocal popular support, and has been endorsed by some governments (conditional on its adoption by others). However, opposition from the financial sector and the business community is strong.

9. A wider tax on financial transactions raises many of the same difficulties. These have been widely used in Latin America, essentially as crisis measures. The experience is that the revenue raised can be substantial—though it tends to decrease over time as ways are found of avoiding the tax—but welfare losses arising from disintermediation are significant.<sup>37</sup> Considerable revenue could certainly be raised by a tax levied at such a low rate that these problems might seem to be minimal. But since the tax cascades throughout the production chain, being levied on multiple transactions, the effective tax rate can be much higher and vary across commodities in haphazard and non-transparent ways. Moreover, a country that has invested in the apparatus needed for its administration may rationally set a higher rate in order to raise further revenue for itself.

10. A tax on international aviation fuel would address two externalities: the considerable environmental harm caused by air transportation and the failure of international tax coordination, which has meant that aviation fuel, unlike any other fuel, is almost everywhere untaxed as it is difficult for a country to levy such a tax unilaterally, since planes may simply refuel elsewhere. In practice, it might be more convenient administratively to proxy the theoretically-preferable tax on aviation fuel by a tax on air tickets collected (as in some countries at present) by airlines or on the use of air corridors. The revenue from such a tax would be significant: perhaps in the order of USD 10–15 billion.<sup>38</sup> The tax also has relatively attractive distributional effects, falling mainly on richer people in richer countries. There would, however, be political resistance, both from currently troubled airlines and from countries heavily reliant on tourism. The tax would also need to be coordinated with domestic taxation of these fuels, as most international carriers use the same aircraft and facilities in international and domestic flights. Taxes on maritime bunker fuels and spill pollution have many of the same attractions as aviation taxes, though with less revenue potential.<sup>39</sup>

11. The argument for a tax on arms sales has been couched largely in moral terms, but can also be described as addressing the offensive inefficiencies associated with the pricing of weapons at below their true marginal social cost. The revenue impact is

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<sup>37</sup> See Ebrill, Coelho and Summers (2001) and Kirilenko and Summers (2003).

<sup>38</sup> IPCC (2001) estimate that a 25 percent aviation fuel tax would raise about USD 12.5 billion. As something of an upper bound, Clunies-Ross (2003) estimates (allowing for some demand response) that a tax on passenger fares and freight at the (probably impracticably high) rate of 10 percent would raise about USD 20 billion.

<sup>39</sup> Landau (2004) estimates the yield of a 10 percent tax on bunker fuel at about USD 1 billion; Jha (2002) puts the revenue from a reasonable tonnage- and power-based tax somewhat lower.



likely to be modest—a five percent tax would raise about USD 2.5 billion<sup>40</sup>—but, to the extent efficiency improves,<sup>41</sup> additionality could be relatively high. The incidence and hence equity impact of the tax is unclear. To the extent that the impact is borne by arms producers, this would presumably be welcome, but to the extent that it is passed on to purchasers, as there would be no net tax paid on official purchases by arms-producing countries even if the tax were not restricted to exports, it could be seen as a tax on weaker countries. While the registry of official arms trade maintained by the UN provides a basis for administering such a tax, a key concern is the possibility of driving arms transactions still further into unofficial channels.

12. Surtax on the profits of multinationals has been proposed to deal with the inefficiencies that arise from the absence of a proper incentive for each country to help other countries enforce their residence-based tax systems, and as a response to downward pressure on rates arising from international tax competition. The revenue raised could be sizeable, but also relatively volatile given the strong cyclicity of corporate profits. Additionality would also be relatively high to the extent that inefficiencies are mitigated. However, such a tax seems impracticable for the foreseeable future, as it would need to be levied on a common base in order to avoid countries undermining it by instead granting base-reducing incentives, but tax bases vary widely across countries. This problem has led to proposals to base such a tax on accounting profits, but accounting rules are still far from being applied uniformly across countries. Even leaving these difficulties aside, the proposal faces a difficulty common to all surcharges that they tend to raise efficiency costs. In this context, countries might offset such a surcharge by reducing their own tax rates, but to address any revenue loss they consequently suffer they would need recourse to other and less preferred measures. In any event, experience with the OECD Harmful Tax Practices project and the debate on corporation tax coordination in the EU suggest that there will be strong political resistance, including from countries that see international tax competition as providing a healthy discipline on spendthrift governments.

### ***Taxes on Common Property Resources***

13. Taxes on assets of which the value cannot legally be appropriated by any individual nation score well in terms of both efficiency and potential additionality. Insofar as they are less distorting than existing national taxes (which they are likely to be, to the extent that they bear on the economic rents associated with resources in short supply and so are relatively non-distorting), they can be expected not to fully displace pre-existing sources of development finance. A disadvantage of such taxes is that, being based on supra-national property rights, they are likely to require the creation of a new tax authority.

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<sup>40</sup> Reisen (2004).

<sup>41</sup> Clunies-Ross (2003) puts the revenue potential even lower: even assuming an unchanged base, a 25 percent tax would raise only USD 5 billion.

14. The main possibilities for such instruments appear to be:

- ❖ Charges on mining of the seabed or Antarctica, whether through the auctioning of permits, royalties, profit-based charges, production sharing agreements or other of the many charges found in the mining sector. Potential revenue is limited for the near future, as there is no seabed mining at present, and mining in Antarctica is banned, but is likely to increase given technology advances in facilitating mining activities in deep sea areas. Consideration would need to be given to vesting administration in an international organization administering mining rights for extra-territorial areas (such as the International Seabed Authority). Politically, resistance is likely to be relatively minor since the tax does not remove any rights exercised at present, and as the UN Law of the Sea already provides a framework for taxing mining in international waters.
- ❖ Charges on positioning of satellites are also likely to yield only relatively modest revenue for the foreseeable future, though such revenue could increase over time.
- ❖ Any increase in communication costs is likely to be marginal, and the inter-country distributional impact to be positive. The charges might be collected by a UN agency (such as the UN Office for Outer Space Affairs, which maintains a register of space objects).
- ❖ Charges on fishing rights in international waters are also attractive in principle, but experience suggests that they may be hard to enforce. New enforcement mechanisms are likely to be needed, since no country will have a proper incentive to collect the tax.

### ***Other Taxes***

15. Another proposal<sup>42</sup>—with elements of taxation in the form of seignorage from the issuance of national currency—is to create and voluntarily redistribute additional Special Drawing Rights (SDRs) to developing countries or to a fund operated on their behalf. If developed countries were to lend these SDRs to developing countries, this would effectively provide the latter with access to hard currency in the form of termless, low-interest loans, while if they were to donate them, the effect would be akin to a grant. However, in either case the scheme would operate as a non-transparent tax on developed countries. There is also political resistance to the issue of new SDRs, and this would require approval by 85 percent of the votes of the Fund membership, and a finding that there was a long-term global need for additional international liquidity.

16. Surcharges on personal income tax have the merit of transparency, and as add-ons to existing taxes incur relatively little additional administration or compliance costs. But, as noted above in relation to a multinational surcharge, the additionality of such surcharges may be weak, as adding to an existing tax increases its distortionary impact

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<sup>42</sup> See for instance Soros (2002).

and makes revenue more costly to raise at the margin. Moreover, as with a multinational surcharge and indeed to an even greater extent, problems arise from cross-country differences in the tax base. It may be noted that essentially the same difficulties apply to any tax levied as a surcharge (e.g. excises on cigarettes).

17. It is difficult to see economic merit in proposals for a world trade surcharge—an additional duty imposed on all imports and possibly exports—which would run directly counter to the objective of supporting development by orderly trade liberalization and would likely increase the extent of illicit trade. The idea of a bit tax on electronic transmissions runs counter to the principle of not taxing intermediate transactions without good reason and to existing explicit policy commitments in some countries.

### ***Enhancing Voluntary Contributions***

18. In terms of the criteria set out in the text, voluntariness has the attraction that equity problems do not arise, as people will not contribute unless they perceive themselves to be better off by doing so. There may thus appear to be no losers from voluntariness—a considerable political attraction. But this appearance may be deceptive, for two reasons. First, enhancing voluntary contributions may crowd out other activities supported by private giving. This indeed is likely to be the most important source of political resistance to such proposals. Second, and perhaps more troubling, voluntary contributions may squeeze out tax-financed development support. Indeed it is in principle possible that allowing individuals to give directly could lead to such a reduction in tax-based provision that total support for development would fall, as the political support for tax-based finance may be eroded by the knowledge that it will be replaced to some degree by voluntary giving. Additionality is thus likely to be lower than often supposed. All of the measures discussed in this section are subject to these reservations.

19. One set of suggestions is to subsidize private giving for development purposes, either by allowing special tax deductions or by matching public gifts. However, experience with tax deductions suggests that they can all too easily become vehicles for tax avoidance. In this context, it is not hard to envisage (but would be harder to control) the establishment of charities in developing countries that served the interest of voluntary givers more than those of development.

20. It is already possible for individuals to make voluntary gifts to support development, and some suggestions simply amount to ways of making giving easier. One idea, for instance, is for voluntary personal income tax payments, either as “tick-the-box” additional contributions on tax forms or as an option to earmark part of the tax payment to development assistance. The latter approach has the disadvantage of setting a precedent for similar voluntariness in allocating taxes paid to the finance of particular activities, thus threatening the integrity of the wider tax system. Other suggestions for facilitating giving are though voluntary surcharges on utility bills and/or credit cards.

There is nothing at the present time to prevent such surcharges being used, and experience thus far has not been entirely encouraging.<sup>43</sup>

21. There is also emerging interest in the use of lotteries (run at either national or global level) and premium bonds (combining a low-interest, safe investment with a lottery).<sup>44</sup> Both of these rely on voluntariness and the propensity of individuals to overestimate the odds of winning, although the evidence as to whether the prospect of contributing to a good cause will encourage participation is not clear-cut. National lotteries have proved their ability to raise considerable sums, and potential revenue from new lotteries is significant. If new lotteries succeeded in capturing twenty percent of worldwide lottery profits, they would raise about USD 12 billion annually. Viewed as a tax, lotteries have the disadvantage of being regressive, although there is a counterargument that they are not a tax, and that viewing them as such is inappropriately paternalistic.

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<sup>43</sup> Landau (2004).

<sup>44</sup> Addison and Chowdury (2003).

## Annex 2: The International Finance Facility

1. The International Finance Facility (IFF) is the most advanced proposal to frontload aid. Under the proposal put forward by the UK Government, donor countries would make legally binding pledges to make future payments to the IFF, subject to a specified condition. On the basis of these pledges, the IFF would issue AAA-rated bonds in the international capital markets. The excess of pledged amounts over the amount of IFF borrowings would provide the financial enhancement needed to support the AAA rating on IFF bonds. The proceeds of the bonds would then be disbursed through existing multilateral and bilateral aid programs to developing countries.

2. The IFF would allow aid to be frontloaded. It is designed to be able to raise funds in the capital markets so that they can be disbursed as and when they are needed to help achieve the MDGs. It would provide a platform for pledged increases in future ODA commitments to be used in the near term to support development financing. Thus, as an intermediary financing mechanism, it is intended to provide a way to better match future flows with what is needed now.

3. In analyzing the IFF, it is useful to consider it in terms of its four fundamental components:

(a) *Government backing.* The driving force behind the IFF is donor pledges of future aid—donors would make legally binding pledges of future increases in aid commitments without having to make immediate appropriations or fiscal commitments.

(b) *Treasury platform.* A treasury platform uses the donor pledges as backing to issue AAA-rated bonds. This platform, the IFF itself, would rely on donor pledges (not cash) to back the bonds, avoiding a liquidity buildup and associated negative cost of carry. The excess of pledged amounts over the amount of IFF borrowings would provide the financial enhancement needed to support the AAA rating on IFF bonds.

(c) *IFF governance.* Aid funds are delivered as bond proceeds are channeled through existing multilateral and bilateral aid programs. Allocations would be made in accordance with an aid allocation framework agreed under the IFF's governance structure, which must be independent, not within the control of any single donor government.

(d) *Bond repayments.* The IFF pays off the bonds, drawing down donor pledges.

4. Each component of the IFF structure has details that need to be fleshed out and issues that need to be resolved. For the first component, there are issues relating to the feasibility of using future donor support as a basis for raising finance now – notably how to ensure that donor pledges to the IFF are both off-budget and legally binding, and accepted as such by the capital markets. For the second component – establishing

the IFF as a treasury platform and bond issuance vehicle – questions revolve around how efficiently the IFF would be able to issue AAA-rated bonds. Third, on the IFF’s governance structure, the challenge is to create the IFF with broad support and without complicating the international aid architecture—that is, without contributing to a proliferation of international aid funds and facilities with separate and demanding decision-making. The IFF’s contribution to overall aid effectiveness will hinge on how IFF funds are allocated, an outcome of its governance arrangements. Fourth, bond repayments will need to be handled with an eye on overall ODA flows over time. These issues are considered in turn.

### ***First component: Government Backing***

5. The IFF proposal contemplates that donors will make off-budget pledges of future aid flows.<sup>45</sup> Pledges are off-budget to capture incremental aid commitments made after Monterrey that donors are unable to appropriate in the near term. They are based on the situation where a donor has made specific public commitments to increase ODA toward the 0.7 percent of GNI target but is able to increase its ODA spending only slowly.

6. The key to the successful implementation of the IFF proposal will be the level and breadth of donor participation. The IFF would not require universal participation, but to satisfy the requirements that it be independent of donors and robust enough to satisfy capital markets requirements, the participation of several donors would be required, ideally five or more.

7. The efficiency of the IFF structure, and its inherent risks, are reflected in the advance rate, which is the proportion of the amounts pledged that could be borrowed and become available for development financing.<sup>46</sup> Measures that improve the advance rate would improve the efficiency of the structure, by supporting higher disbursement levels for a given amount of pledges.

8. *Legally binding commitments.* Pledges to the IFF would most likely be bilateral financial agreements entered into by and between the IFF and each donor country. Requirements for an aid pledge to be off-budget vary country by country. The fiscal treatment of these contingent liabilities will need careful examination to ensure consistency with the principles of fiscal transparency.<sup>47</sup> Several donors have indicated

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<sup>45</sup> The IFF proposal is based on Eurostat requirements.

<sup>46</sup> Assuming that a defaulting recipient country would exit IMF arrears after 4 years (or 7 years), in order to maintain a AAA rating on IFF bonds, about 76 percent (or 66 percent) of donor pledges could be translated into bond issuance. Assisted by Goldman Sachs and Standard & Poor’s, the UK Treasury has estimated the advance rate using Monte Carlo simulations based on IDA-eligible countries as IFF recipients and assuming donor funding from G7 countries.

<sup>47</sup> The Statistics Department of the IMF analyzed how the IFF proposals would impact the fiscal accounts of donor countries. Based on the *Government Financial Statistics Manual 2001*, an internationally accepted standard for fiscal statistics, they concluded that donor pledges are initially a contingent liability. They believe that, at the time the IFF issues bonds in the capital markets, the pledges should no longer be treated as contingent and a liability equivalent to the amount of bonds issued would need to be recognized immediately in the accounting records of donor countries to ensure consistency with the principles of fiscal transparency in the *GFSM 2001*. The amount of the pledges in excess of the

that their laws are not compatible with the structure on which the IFF proposal is based, and that they would not be able to participate.<sup>48</sup> Under their domestic legal and accounting systems, they lack the legal authority to make such long-term legally binding commitments or to treat them as off-budget and off-balance sheet liabilities.

9. *High-level financing condition.* A key aspect of the off-budget nature of IFF pledges is that they would be contingent on some sort of high-level financing condition so that donors would not be obligated to make payment on some part of IFF bond obligations if the condition were to be triggered. The nature of the high-level financing condition has been the subject of some debate. The condition must be clearly defined, and whether or not it has been triggered needs to be easily and objectively ascertainable by IFF bondholders. The high-level financing condition should also be somewhat predictable so that it can be reasonably estimated by IFF bondholders based on historical or other factors. Donors may have political requirements as well, so that if and when the condition is triggered there is a clear rationale for governments to stop payment.

10. As the high-level financing condition, the UK proposed that beneficiary countries not be in arrears for six months or more with the Fund. This condition meets the baseline criteria, as it is independently verifiable, and would be expected to occur only with respect to high-risk countries. If the condition is not met – that is, if a country that received IFF funds went into protracted arrears with the Fund – donors would not be obligated to make payments to the IFF for assistance volumes related to that specific country for the period it remained in arrears. In this context, undisbursed but committed funds would not be disbursed to the recipient country in arrears to the Fund, while if disbursements were completed at the time the condition was triggered, there would be no impact on the recipient country. Since there is real, though low developing country risk inherent in this condition, financial enhancement would be needed to maintain the required AAA bond rating that will ensure low IFF borrowing costs.

11. The proposed high-level condition could possibly affect the way the Fund and its members conduct their discussions on clearing arrears to the Fund, as it may create incentives for donors and recipient countries to put pressure on the Fund to approach the clearing of arrears based on the effects that such clearance will have on the high level condition. However, such incentive effects are considered to be unlikely.

12. Some donors have suggested that the high-level condition should be tied to positive rather than negative development outcomes. For example, donor payments could be stopped if recipient countries attained a specified GNI per capita level (such as the IBRD graduation level). In that case, a country with a GNI per capita above the cutoff for more than a certain time period, such as two or three consecutive years, could

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amount of the bonds issued would remain a contingent liability. There are differing views on this point, and varying agreement on the principle that some amounts pledged by donors may need to be recognized in donor fiscal accounts prior to appropriation.

<sup>48</sup> It should be noted that several countries with ODA levels above 0.7% of GDP have indicated that, while they do not object to the IFF, the proposal by its nature – frontloading incremental Monterrey pledges of countries increasing ODA toward the 0.7% goal – does not fit their circumstances.

assume the repayment obligations on the portion of bond repayments relating to IFF funds disbursed to it (or some part of those amounts, as other donors could also support the IFF by guaranteeing or partially guaranteeing such payments, as detailed below).

13. *Possibility of donor default.* The IFF's ability to support the issuance of AAA-rated bonds is based, among other things, on the premise that markets would consider a donor default on its obligations to the IFF as a sovereign default. But because donor commitments to the IFF and their fiscal treatment are not identical to normal sovereign debt issuance by governments, legal agreements between donors and IFF as well as bond terms would need to be specified carefully to ensure that IFF pledges are legally binding obligations under the laws of each donor.

14. In these circumstances, it may be worth exploring other possible ways for governments in different fiscal positions and with different legal structures to provide backing to an IFF, including:

- ❖ Executory contracts, under which a donor government would enter into a contract with the IFF as bond issuer stating the terms of its support, which in this case would be a defined payment stream to the IFF if specified conditions are met. Executory contracts have been used as the conditional government “pledge” for a limited number of existing capital markets transactions where government support has been securitized to support the issuance of bonds. This approach is being explored in the context of the immunization facility based on IFF principles that is being explored by GAVI/Vaccine Fund, UNICEF and WHO.
- ❖ Government guarantees could also be used to back IFF bond issuance. These are usually treated as an on-budget item (which may be helpful or unhelpful depending on donor circumstances). Like a “regular” IFF pledge, a guarantee would effectively frontload ODA commitments by committing a donor now to payment later and enabling the IFF to use donor guarantees of its bond obligations (in addition to, as originally envisioned, off-budget pledges).
- ❖ Partial or secondary guarantees could also be used, not as direct IFF funding but to back up other pledges. The IFF proposal contemplates that donors would be severally (individually), not jointly, liable for their payments to the IFF, and so would not have responsibility for making payments on which another donor had defaulted. This, combined with the risk of non-payment if the high-level financing condition is triggered, would normally be managed by issuing a lower amount of bonds than the total pledges backing the IFF. These risks could be handled – and the level of bond issuance increased – if donors were to provide a secondary or partial guarantee that would serve as a backup pledge. A donor could guarantee that it would make payments to the IFF in the event of default by another donor, and/or if the high-level financing condition was triggered and other donors were no longer obligated to pay a portion of their pledges. This possible way to increase the IFF's



efficiency was suggested as an avenue of IFF support for interested donors that cannot for legal or budgetary reasons participate in the core IFF.

- ❖ Similarly, the IFF could issue two tranches of bonds, with the second tranche having an equity element supporting the AAA rating of the first. Governments wishing to support the IFF without making long-term future pledges could purchase second-tranche bonds that would bear the risk of contingent non-payment by IFF donors. This approach is similar to a partial guarantee. Rather than committing to make payment if defined events took place, governments would hold the second-tranche bonds as an asset issued by the IFF for which the IFF's payment to them would be conditional. The same triggers could be used, such as the high-level financing condition being triggered. As with the use of partial or secondary guarantees, this is a form of support that would increase the proportion of the amounts the IFF is able to borrow at AAA rates as against the amounts pledged by donors, improving the efficiency of the structure, by supporting higher disbursement levels for a given amount of pledges.
- ❖ Finally, direct pledges or payments of cash provide IFF liquidity as well as backing for bonds. Here, the issue is whether it would be more efficient and more desirable for such flows to go directly to IDA or other existing aid channels.

15. The original IFF proposal was based on an EU-specific model, but as detailed above, further investigations have yielded a variety of complementary approaches that might be acceptable in jurisdictions with different budgetary regimes. Given the quite different situations faced by donors in relation to ODA generally and the IFF specifically, one area of work moving forward could be to examine the technical details of these possible alternative forms of donor support.

### ***Second Component: Bond Issuance/Treasury Platform***

16. As an institution, the IFF would consist primarily of a treasury platform that would use donor pledges as backing to issue AAA-rated bonds. As an executive body, it would be responsible for a range of functions:

- ❖ The IFF would manage interactions with donors with respect to their pledges and pledge drawdowns.
- ❖ As bond issuer, the IFF would deal with rating agencies, regulatory and qualification agencies, underwriters, fiscal agents and so on, to maintain the AAA rating, minimize borrowing costs, and issue and service bonds.
- ❖ The IFF would manage the flow of its borrowing and repayment streams. To ensure low interest rates on IFF's AAA-rated bonds, the payment structure on its bonds will require some payments to bondholders from the time of

issuance. Donors may have to agree to either diverse (across donors) or to flexible payment arrangements, or both.

- ❖ The IFF would manage disbursements to implementing agencies, tracking expected disbursement levels, responding to specific requests, and coordinating the IFF's financial reporting.
- ❖ Although a high-level governance group would likely set IFF policies and allocations, the IFF would still need some sort of secretariat to manage implementation of that framework.

17. Taken together, the IFF would have significant and sophisticated financial management functions, as it managed pledged commitments to support bond issuance, issued bonds to support disbursements, and tracked liquidity to manage repayments and to keep liquidity low. These tasks are familiar functions for the World Bank and other MDBs.

18. Several shareholders have asked whether it would be possible to place an IFF within the existing international financial institutions, prompting exploration of different ways one could structure an IFF platform. Possibilities include:

- ❖ New international entity. A new international entity is normally agreed through an international treaty and, adopted by participating countries. Donor countries, in adhering to an IFF treaty, would become members of the organization and commit resources over time that would be used to repay IFF bonds. The legal obligation to pay amounts pledged to the IFF could be either an obligation of membership set out in the multilateral treaty or detailed in agreements concluded between each donor country and the IFF. However, there would be widespread objection to establishing a new international organization with a temporary mandate independent from the existing IFIs/MDBs and with its own staff, which could complicate the international aid architecture, entail substantial setup costs, and take a considerable amount of time.
- ❖ New commercial entity. A stand-alone issuance vehicle could be established (possible locations include Ireland, Luxembourg, England). Banks or other commercial sources could be drawn on to provide the treasury and cash management services that would be needed (although some of the functions, in particular managing donor transactions, are not normally offered commercially). Such a vehicle would go through the same regulatory and qualifying procedures as any new issuer (such as rating agency assessments, risk-weighted capital treatment assessment, and listing requirements). The IBRD and/or other MDBs could provide core treasury and financial management services to such an entity, drawing on their skilled staff as well as capital market and financial management experience.

- ❖ Existing International Organization: IBRD or IDA. It might be possible to incorporate an IFF directly into an existing international organization, so that it would borrow for the IFF in its own name and carry the financial transactions of the IFF on its balance sheet. However, the complications outweigh the possible benefits. From IBRD's perspective, it would be difficult to insulate shareholders, particularly its borrowers, against the negative impacts from the inclusion of the IFF. These impacts would potentially be seen in terms of increased funding costs, reduced bondholder confidence due to the financial reporting impacts, and higher portfolio credit risk arising from the high-level condition.<sup>49</sup> In addition, various existing policy limitations on the Bank arising from the application of the Articles of Agreement would appear potentially inconsistent with the objectives of the IFF. IDA, on the other hand, would not run into market risks since it does not issue bonds. But commingling IFF funds with regular IDA funds (not to mention HIPC funds) could pose risks to IDA's funding base, and thus to the predictability and additionality of IDA funding. Moreover, in either case, the rating agencies would likely require virtually the same type of credit review of the pledges that they would require for a stand-alone IFF, removing one of the apparent advantages of using an existing international organization.
- ❖ International Trust Fund. Under this approach, the IFF would be established as an international trust fund under international law and administered by an MDB. Such a trust could be established by treaty entered into by donor countries and the administrator, which would offer significant visibility but, like the establishment of a new international organization, would require significant time to achieve. In the alternative, such a trust fund could be established by an MDB, such as by resolution of its Board of Executive Directors. This would make establishment of an IFF simple, but it is not clear whether the bonds issued by an international trust fund would be able to achieve the eligibility qualifications normally associated with AAA-rated bonds, or whether such an innovative approach would be accepted in the capital markets.
- ❖ IBRD/MDB-owned subsidiary. The IBRD, perhaps with other MDBs, could consider establishing a subsidiary in the jurisdiction of one of its members.<sup>50</sup> This approach would involve approval by the sponsoring host government. In terms of internal institutional procedures, it would be similar to the establishment of multi-donor trust funds administered by the Bank,

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<sup>49</sup> For example, if IFF volumes were substantial, the current low borrowing cost of relatively limited volumes of deep sub-LIBOR structured borrowings would likely increase. Similarly, large changes in the Bank's structure and balance sheet could ultimately give rise to bondholder concerns about the stability of the Bank's structure and the protections they currently enjoy. As currently specified, the high-level financing condition, would also likely be correlated with IBRD's credit risk and therefore have capital implications.

<sup>50</sup> Preliminary indications are that some MDBs would be interested in cooperating on such a possibility, while others could not legally do so.

requiring approval by the Executive Directors or the Board of Governors. Such an entity would generally be in the same position as a new commercial entity for regulatory and qualifying requirements. Depending on its structure, however, it might benefit from being an international organization. IBRD/MDB ownership, administration, and treasury expertise might be politically appropriate, help in efficiently providing relatively low-cost expertise, and assist in market recognition and in obtaining appropriate immunities and exemptions. Precedents for such an approach include the European Investment Fund, a subsidiary of the European Investment Bank.

19. The basic financial criteria for choosing an appropriate structure for the IFF include issuance vehicle setup and management costs; expected borrowing rates; and treasury management and cash flow administration capabilities. Costs would also vary depending on the expected level of funding and bond issuance – a certain minimum volume would seem necessary to support the setup and transaction costs. These cost factors would point to establishing an IFF in close association with the World Bank and/or MDBs. In starting up an IFF, the more one relies on an existing institution or platform, the lower setup costs are likely to be. Similarly, borrowing rates—within the range of AAA securities—are likely to be lower the more closely associated the IFF is to a AAA-rated bond issuer that enjoys extensive market recognition. Lower interest rates would reduce the cost of repayments on IFF bonds, releasing more funds for development uses. Effective financial management services should be available from commercial banks, but it is likely that commercial rates for these services would be more expensive than if they were undertaken by the World Bank (or other MDBs), which would by presumption provide bond issuance and treasury management services on a cost-recovery basis. These factors point to possible benefits of having one or more international financial institutions establish the IFF platform as a subsidiary or affiliate that is legally and financially separate, but that would draw on the institutions' skilled staff and the capital market and financial management experience. Any proposed structure should also ensure that the IFF is protected by appropriate privileges and immunities with consideration given to whether they should be accorded by the international community or by a single sponsoring country.

#### ***IFF Governance: Aid Delivery Framework***

20. The IFF's contribution to overall aid effectiveness will hinge on how IFF funds are allocated, an outcome of its governance arrangements. Thus, its governance structure will have to be carefully engineered to ensure efficiency, inclusion, and accountability. Basic issues include what its institutional structure should be, and how its functions should be divided ranging from the establishment of general principles of the allocation and delivery of IFF funds to core implementation. More fundamentally, the IFF's principles of operation and of allocation need to verify its *raison d'être*, using IFF funds to increase aid predictability and effectiveness.

21. *High-level governance framework.* There are competing considerations when it comes to the best institutional structure for the IFF. There is a broad reluctance to fashion anything new—and to avoid, to the extent possible, elaborate institutional

structures, separate decision-making bodies, and a separate staff. But the IFF participants will make core decisions (such as funding levels, allocations, and fundamental policies and operating principles) of great interest to recipients and international civil society. These interests will need to be balanced.

22. It clearly would be desirable to keep the IFF's governance structure as lean and simple as possible. The IFF is meant to be a financing mechanism, not an aid disbursement agency. It should not complicate the international aid architecture nor should it create an additional burden or transaction costs for aid recipients. To that end, its disbursements are expected to be made through existing aid channels, and any conditions imposed by the IFF would need to be consistent with those of the existing delivery channels.

23. This need for simple governance arrangements nonetheless raises questions. How would donors decide on allocations, and at what level of detail? How would recipients be involved in the process? What about civil society?

24. The IFF's core allocation decisions will be a key aspect of its contribution to aid effectiveness. It is meant to facilitate commitment of additional aid, and thus its impact on overall ODA flows must be carefully managed. It is intended to support aid predictability, and so must be backed by long-term funding commitments. It is intended to help achieve the MDGs, and so its funds must flow where they can be absorbed and where they will enhance harmonization and alignment. And as IFF funds flow in combination with existing flows, it must support country ownership, macroeconomic stability and performance without adding to recipient burden.

25. *Executive Body/Secretariat.* As detailed earlier, some sort of secretariat would be needed to implement this larger framework, and to discharge the day-to-day work of the IFF as it manages donor backing, periodic bond issuance, disbursements, repayments, and reporting. The secretariat would also support the process of calling for new commitments to the IFF.

26. *Rules of the road.* Between high-level decisions and implementation functions, however, there is a gray area of issues that could be set in greater or less detail by a high-level group or could be left to the discretion of the secretariat. A number of issues will need to be considered. For example, although it is expected that disbursements would be made in accordance with existing procedures and policies of intermediate aid agencies, they could and probably should be subject to minimum standards such as untied procurement. To maintain the required independence of the IFF, and to satisfy the needs for aid harmonization as well as market efficiency, it would be best for IFF funds to be pooled rather than allocated specifically to individual donor uses. In the end, IFF flows will need to be managed with an awareness of how they fit into the overall ODA picture for each IFF recipient country, not an insignificant task.

27. At a high level, it could be decided to focus IFF funds on specific uses where the value of frontloading is particularly high—or on uses where the sure availability of long-term funding is essential. And the question of terms of financing would arise. IFF

financing does not have to be in the form of grants – concessional loans might be more appropriate in certain circumstances, and would reduce repayment obligations as IFF loan repayments were used toward bond repayments. A framework establishing the terms of IFF financing to recipients (grants, concessional loans, or some combination) could be established, but inevitable innovations and differences in approach among implementing agencies would arise.

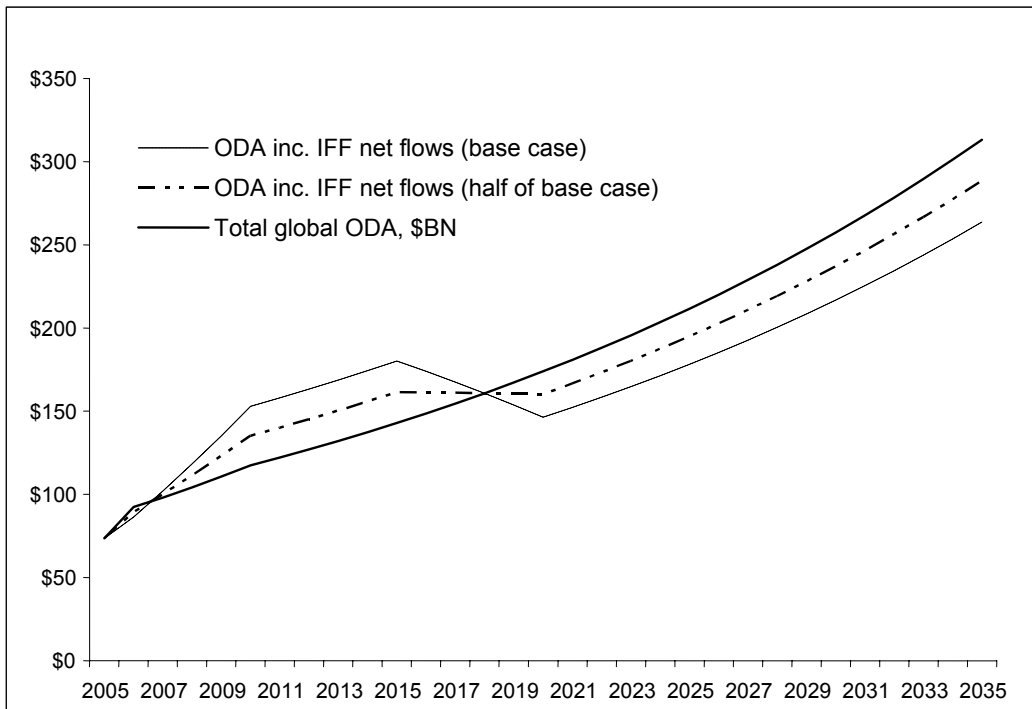
### ***Bond Repayments and Impact on Aid Flows***

28. It is important that using the IFF to frontload aid flows, even incremental aid flows, should not result in a drop-off in flows after 2015 (or whenever the frontloading period was actually over). Because of the added cost, compared to current aid flows, of establishing and running the IFF, of its market transactions, and interest paid on its bonds, flows diverted from aid budgets to pay IFF bonds could be substantial.

29. The buildup of absorptive capacity suggests that scaling up aid will need to be managed carefully – and once flows increase, they will need to be maintained in the medium term to ensure that results are sustained. Thus, the original UK proposal, which called for a significant short-term increase in aid and then a drop in aid flows post-2015, should be modified to ensure that the frontloading of future aid flows through an IFF results in a short-term increase and then a steady flow of funds.

30. One of the strengths of the IFF proposal is precisely that it provides the flexibility to mediate between what is needed, in terms of disbursements, and when donors pay for it, so it can be adapted to support a desired ODA profile. An example of such a profile is given in Figure 8, which assumes a continuing 4 percent increase in ODA flows. In the base case (consistent with the original UK proposal), that increase would be fully frontloaded into an IFF, and aid flows would drop for several years after 2015 before rising again as increasing ODA more than covers payments to the IFF. The mid-line case assumes that only half of ODA increases would be channeled through the IFF, and that IFF flows would be managed so that they would plateau, starting in 2015, before rising again.

Figure 8. : Scenario of 4 Percent ODA Growth



31. In any case, repayments on IFF bonds would be made smoothly, starting before 2015; otherwise the market would likely assess an interest-rate penalty if the IFF, an innovative and untested structure, were to issue bonds with a substantially delayed or bullet repayment structure.

32. Ultimately, the effectiveness of an IFF will depend not only on the impact on the ground of IFF funds but also on what happens as government aid flows are diverted to repay IFF bonds. IFF flows should therefore be managed carefully to ensure that they contribute to sustainable results, and with an eye on overall aid flows and specific developing country needs.

33. **Conclusion.** If the international community wishes to move forward with the IFF, the next step would be to work through the details of implementation. Possible ways to support an IFF, as suggested here, should be fleshed out in detail for interested donors. Further work can be done on the feasibility of creating an IFI subsidiary to determine if expected efficiencies will materialize. Further work can be also done aimed at determining the most efficient structure for establishing the IFF. Specific proposals on governance must be examined to find an appropriate balance between its aid purposes and simplicity; between efficiency and wide participation in governance decisions.

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