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Working Paper

Aid, debt relief and new sources of finance for meeting the millennium development goals

WIDER Research Paper, No. 2005/09

Provided in Cooperation with:

United Nations University (UNU), World Institute for Development Economics Research (WIDER)

Suggested Citation: Addison, Tony; Mavrotas, George; McGillivray, Mark (2005) : Aid, debt relief and new sources of finance for meeting the millennium development goals, WIDER Research Paper, No. 2005/09, ISBN 9291906867, The United Nations University World Institute for Development Economics Research (UNU-WIDER), Helsinki

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Research Paper No. 2005/09

Aid, Debt Relief and New Sources of Finance for Meeting the Millennium Development Goals

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and Mark McGillivray²

March 2005

Abstract

The Millennium Development Goals (MDGs) have lofty expectations regarding the impact of official development aid. Are these expectations valid? This paper surveys the literature on aid and growth. It finds that practically all aid studies since the late 1990s conclude that aid increases economic growth. By implication, therefore, it can be inferred that poverty would be higher in the absence of aid. As such the above-mentioned expectations are, to a certain extent, valid. The paper then reviews volumes of and trends in official development assistance since 1960, highlighting flows to Sub-Saharan Africa. A downturn in volumes in the 1990s is demonstrated. It asserts that poverty is higher and the MDGs are hard to achieve because of this downturn. It also asserts that while aid will be important, other sources of external finance are required to achieve the MDGs. The paper concludes by examining recent proposals regarding new sources of such finance.

Keywords: official development assistance, debt relief, growth, poverty, Millennium Development Goals, Sub-Saharan Africa, innovative sources of finance

JEL classification: F35, O55

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The paper has been prepared within the UNU-WIDER project 'Development Aid: A Fresh Look' directed by George Mavrotas and Mark McGillivray.

UNU-WIDER gratefully acknowledges the financial contributions to its research programme by the governments of Denmark (Royal Ministry of Foreign Affairs), Finland (Ministry for Foreign Affairs), Norway (Royal Ministry of Foreign Affairs), Sweden (Swedish International Development Cooperation Agency—Sida) and the United Kingdom (Department for International Development).

ISSN 1810-2611 ISBN 92-9190-686-7 (internet version)

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Camera-ready typescript prepared by Liisa Roponen at UNU-WIDER

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1 Introduction

The Millennium Development Goals (MDGs) now provide a clear set of objectives for mobilizing the international development community, notably in the area of development finance. The recent Millennium Project Report recommends that high-income countries should increase official development assistance from 0.25 per cent of donor GNP in 2003 to 0.44 per cent in 2006 and 0.54 per cent in 2015 (UN 2005). This would amount to doubling official world aid from its current level, to approximately US\$120 billion per year. The call for increased aid as well as more debt relief and the creation of new sources of development finance has increased since the UN Financing for Development Summit in Monterrey and the subsequent report of the panel chaired by President Ernesto Zedillo of Mexico on development finance. The February 2005 meeting of G7 finance ministers pledged more aid and more debt relief, and similar statements can be expected from world leaders in the run-up to the UN Millennium summit in September 2005. If action were measured in words rather than dollars, then the problems of development finance would have been solved long ago.

The urgency of mobilizing increased external resources cannot be overemphasized. The current projections for the MDGs are stark: the principal MDG target—reducing the proportion of people living in extreme poverty to half the 1990 level by 2015—will not, on current trends, be achieved in Sub-Saharan Africa (SSA). Even seemingly optimistic forecasts suggest the MDG income poverty target will not be achieved in SSA until 2147—some 132 years late. SSA of course faces deep development problems, but the picture is only somewhat better elsewhere. Primary education enrolment rates remain low in South Asia, and HIV/AIDS is rapidly spreading in the Asia-Pacific region, for instance. Poor-country governments cannot mobilize enough domestic resources to meet these challenges alone; generous external assistance is imperative.

Yet despite the evidence that aid broadly works, our review of trends in aid shows that aid has fallen for much of the recent period, with serious consequences for growth and poverty reduction in the developing world. We highlight aid flows to SSA given the plight of that region, and its importance to the overall achievement of the MDGs. And we examine recent proposals to mobilize additional finance for development, focusing on those that have emerged from a recent study by UNU-WIDER for the United Nations General Assembly.

2 The effectiveness of aid and debt relief

Aid's contribution to meeting the MDGs is premised on two fundamental assumptions, namely that aid raises economic growth (thereby reducing poverty when the growth process is pro-poor) and that aid relaxes the budgetary constraints impeding development spending (including pro-poor services and infrastructure).¹ These assumptions also underpin arguments that aid can promote human security; growth fosters peaceful livelihoods and increased development spending may redress grievances, reducing the need to resort to violence as a livelihood or to express frustration with the status quo.

¹ On pro-poor growth the reader is referred to Shorrocks and van der Hoeven (2005).

However, aid's role in development is constantly questioned, no more so than in the present debate on aid effectiveness, and it would be fair to say that criticism is especially strong in the United States where some highly influential people have concluded that aid is a complete failure in achieving development, and indeed downright harmful. Typical of such a stance is a recent editorial in *The Wall Street Journal* which states that: 'For the record, we don't put much faith in foreign aid as a development tool. There is no evidence that the two are connected' (2005: A20). By extension, critics also dismiss debt relief as well as proposals to create new sources of development finance.

It is certainly the case that one can find aid projects and programmes that were ill-conceived or which had unexpected and adverse development (and poverty) effects (aid for large infrastructure-projects such as dams is especially controversial). But this is also true of projects in the commercial world. And in failing to meet their objectives, some aid projects may nevertheless yield extremely valuable lessons, just as some of the best commercial projects incorporate the lessons of previous failures (as do some of the best philanthropic initiatives). Thus the true test of aid effectiveness is not the existence of bad projects or programmes, but whether aid does or does not contribute to *overall* economic growth and human development. This is also the true test of other forms of external development finance, including foreign direct investment (FDI) for example.

However, uncovering the macroeconomic and development impact of any external financial flow—be it aid, debt relief or FDI—is far from a straightforward task (but then neither is investigating the impact of any other economic variable or policy). Nevertheless, research in this area, most of which involves the econometric analysis of panel data sets, has shown considerable progress, especially over the last decade. This reflects advances in methodologies and greater availability of data, giving us some confidence in the resulting findings and as least as much as in other areas of economics.

So what does the evidence show? When we review the literature we find that the overwhelming majority of recent empirical studies do conclude that aid increases economic growth, and below we cite more than 30 studies that find that growth would be lower in the absence of aid.² There is also evidence that aid increases public expenditure, including expenditures that are pro-poor in orientation (for example primary education and basic health care). One can reasonably infer that on the basis of these findings, poverty would be higher in the absence of aid. Thus much of the criticism of aid is not supported by research, and we submit that it is research that should guide aid policy not anecdotal evidence. This is not to say that aid delivery cannot be improved upon nor, as we indicated before, that there are no bad aid projects. Fungibility, insufficient alignment between donor and recipient government policies, commercial tying, proliferation of donor activities within recipient countries and insufficient policy coherence within and among donor activities are among these

² In addition to the 30 published, peer reviewed or widely empirical circulated studies cited below, the authors are aware of a further 15 empirical papers that conclude that aid are positively associated. Note that these studies report results from different (in some cases revised or updated) empirical exercises, using different data or estimation techniques. The only exception are the Collier and Dollar studies (2001, 2004) which report (identical) results obtained from a single empirical investigation. There are a handful of studies that either struggle to find evidence of a link between aid and growth or conclude that the link is negative. These studies are though very much in the minority. For further details, see Clemens, Radelet and Bhavnani (2004) and McGillivray (2005).

criticisms. But in their proper context they are not reasons why aid has failed. Instead they are reasons why aid has not worked better and areas in which improvements need to be made.

Why aid now appears to work at the macro level, after decades of little or no clarity over its effectiveness, is a matter of speculation. A widespread view as to why this is so is that donors, following the demise of the Cold War, are paying more attention to developmental criteria in the design and application of aid activities (Burnside and Dollar 1997; Collier and Dollar 2004; McGillivray 2003).³ Another plausible reason why aid is now thought to have a positive impact is that recent studies employ better empirical methods and have access to better data, making it possible to observe such an impact. This of course implies that aid might always have been effective, and that earlier studies were simply not able to observe such an impact (McGillivray 2003).

There is evidence that aid's impact on growth is contingent on the policies of recipient countries, so that while aid works in all countries it works better in countries with better policy regimes (Burnside and Dollar 1997, 2000, 2004; Collier and Dollar 2001, 2002; Collier and Dehn 2001; Collier and Hoeffler 2002). But there is more evidence to suggest that aid works in countries irrespective of the policy regime (Amavilah 1998; Durberry, Gemmell and Greenaway 1998; Hansen and Tarp 2000, 2001; Lensink and Morrissey 2000; Lensink and White 2001; Dalgaard and Hansen 2001; Guillaumont and Chauvet 2001; Hudson and Mosley 2001; Lloyd, Morrissey and Osei 2001; Lu and Ram 2001; Chauvet and Guillaumont 2002; Dalgaard, Hansen and Tarp 2004; Grounder 2001, 2002; Gomane, Girma and Morrissey 2003; Ram 2003, 2004; Clemens, Radelet and Bhavnani 2004; Economides, Kalyvitis and Philippopoulos 2004; Feeny 2005; Ouattara and Strobl 2004).⁴ Irrespective of whether policy is important for aid effectiveness, it must be emphasized that both groups of studies agree that aid works, in one way or another. They agree that in the absence of aid flows growth would have been lower and, to the extent that growth and poverty are positively associated, poverty would have been higher. The debate is over whether aid impact is contingent upon recipient policy regimes. More precisely, debate is not over the importance of policy but whether one can validly observe a robust aid-policy-growth relationship from an econometric analysis of panel data. One would in principle expect that better policies would in all probability result in more effective aid. Possibly reflecting this, there is some acceptance among researchers that better policies, however defined, should in all probability result in more effective aid.⁵ Yet one would also expect that with the

³ See Cassen (1994) for an excellent discussion of the results of earlier studies.

⁴ Some of these studies explicitly test for the relevance of policy, finding that aid's impact on growth is not contingent on the recipient policy regime. Others do not take this issue into account, but still find that aid and growth are positively associated. Note that Ouattara and Strobl (2004) concludes that project aid worked but programme aid did not and Ram (2004) concludes that bilateral but not multilateral aid worked. Almost all the studies cited above looked specifically at the impact of aid on per capita GDP growth. For surveys of the aid-growth literature, see Beynon (2001, 2002); McGillivray (2003); and Morrissey (2001). Easterly, Levine and Roodman (2003) and Roodman (2003) provide alternative views on aid effectiveness, highlighting the fragility of the results obtained by a number of the studies cited above, although not challenging the fundamental result, that aid is effective. For a discussion of a range of related issues, see Lensink and White (2000), and Collier and Dollar (2004).

⁵ See Robinson and Tarp (2000); Benyon (2001, 2002); Morrissey (2001); and McGillivray (2003).

exception of extreme cases, aid provided to countries with bad policies (however defined) can still have positive impacts.

Importantly, the studies referred to above utilize diverse samples of countries. There is diversity in terms of whether or not a country is structurally vulnerable, in a post-conflict scenario, undergoing trade shocks, democratic, highly populated and so on.⁶ Importantly, the samples include countries located in all regions in which developing countries are situated geographically and some of the above studies provide results that are region-specific.⁷ Each of these studies concludes that growth in the countries under consideration would have been lower in the absence of aid. It necessarily follows that disappointing growth records in SSA cannot be attributed to aid ineffectiveness. To this extent, aid has not failed SSA.

Aid can of course contribute to poverty reduction or, more generally, well-being enhancement more directly, via channels other than growth. This is important, as growth is not the only way of reducing poverty, nor is it necessarily the most efficient way. Gomanee *et al.* (2002). look at aid and pro-poor expenditures, finding that aid is associated with increases in these expenditures and in turn improvements in well-being. Kosack (2003) found that, contingent on the extent of democracy in recipient countries, aid was positively associated with the level of well-being among countries as measured by the human development index. A related literature looks at the impact of aid on various categories of public expenditure and revenue.⁸ Included in expenditure categories are those that support the provision of health and education services important to MDG achievement. It is in general concluded that aid results in increased public expenditure, although it can also result in decreases in tax revenue and increases in public sector debt.⁹

However, we can have too much of a good thing. A number of studies show that aid can be subject to diminishing returns; aid is positively related to growth up to a certain level of aid relative to recipient GDP and negatively related thereafter (studies find the turning point to be between 15-45 per cent of GDP).¹⁰ Beyond a certain point an increase in the amount of aid may push up the real exchange rate, thereby creating a disincentive to the production of tradable goods (the so-called 'Dutch Disease' effect) and constraining export-led growth. Governments may also be limited in the amounts of

⁶ This can make empirical work more difficult and cause one to doubt the robustness of the results obtained. In the case of the literature cited above reasonable steps were taken to handle this diversity.

⁷ Lensink and Morrissey (2000) and Gomanee, Girma and Morrissey (2003), for example, report findings that are specific to SSA. Others provide results that are country-specific. Gounder (2001, 2002) and Feeny (2005) look at the cases of Fiji, Solomon Islands and Papua New Guinea, respectively.

⁸ Recent studies include Feyzioglu, Swaroop and Zhu (1998); Franco-Rodriguez, McGillivray and Morrissey (1998); McGillivray and Ahmed (1999); Swaroop, Jha and Rajkumar (2000); McGillivray and Morrissey (2001b); McGillivray (2000); Mavrotas (2002, 2003); Mavrotas and Ouattara (2006), and McGillivray and Ouattara (2005).

⁹ The relevant literature is surveyed in McGillivray and Morrissey (2001a).

¹⁰ Among the studies reporting diminishing returns are Collier and Dollar (2002); Collier and Hoeffler (2002); Hansen and Tarp (2000, 2001); Dalgaard and Hansen (2001); Hudson and Mosley (2001), Lensink and White (2001) and Dalgaard, Hansen and Tarp (2004).

aid they can use effectively (Clemens and Radelet 2003).¹¹ Donors therefore need to be conscious of absorptive capacities and to work with recipient countries to remove bottlenecks to aid effectiveness. This is an important matter if aid flows are to be increased substantially to help achieve the MDGs.

This is especially an issue for the group now labelled ‘fragile’ or ‘stressed’ by the donor community; the UK’s Department for International Development (DFID) has assembled a list of 46 fragile states, while the World Bank lists 30 ‘low-income countries under stress’ (LICUS) (DFID 2005). These are countries which are often marked by violent conflict (including those in ‘post-conflict’ recovery), have quite limited state capacities, and in which the government’s ability (or willingness) to help the poor has been low. Donors will need to invest heavily in building up central and local state institutions to make aid effective in these countries.

The Heavily Indebted Poor Countries (HIPC) Initiative launched in 1996 (and ‘enhanced’ in 1999) aims to reduce debt-servicing to sustainable levels in eligible countries. Unfortunately, rich countries remain divided over how, or indeed whether, to be more generous. The communiqué issued by the February 2005 meeting of G7 finance ministers is ambiguous; it promises ‘as much as’ 100 per cent debt relief for highly indebted poor countries. And rich countries are divided as to how this will be financed, if at all.

Critics of aid are also critics of debt relief, arguing that the HIPC Initiative will do little for development. But what does research show? Debt relief can raise growth by reducing the so-called debt-overhang effect which is a disincentive to private investment and by making available more resources for growth enhancing (and poverty reducing) public investments where those resources would otherwise go to servicing debt. This negative effect of high debt on growth is borne out by empirical research, with the first effect (debt overhang) being the most evident.¹² This indicates that debt relief can raise growth and, by implication, reduce poverty (the scale of poverty reduction being very much dependent on the character of the growth process). However, if debt relief does not add to the total level of concessional finance—if for example donors substitute debt relief for aid—then growth is unlikely to rise; the literature stresses the importance of the *additionality* of debt relief resources (Hansen 2004). Debt relief must therefore go hand-in-hand with more aid.

3 Despite aid’s effectiveness, aid flows have fallen

Despite the research finding that aid is broadly effective, aid flows have declined substantially from the 1990s onwards (see Figure 1).¹³ Total official development

¹¹ Heller and Gupta (2002) provide a useful discussion of this issue, along with the related problem of Dutch Disease. Note though that Gomanee, Girma and Morrissey (2003), using a general technique specifically designed to detect threshold effects, struggle to find evidence of such returns and therefore question the inferences drawn by previous studies.

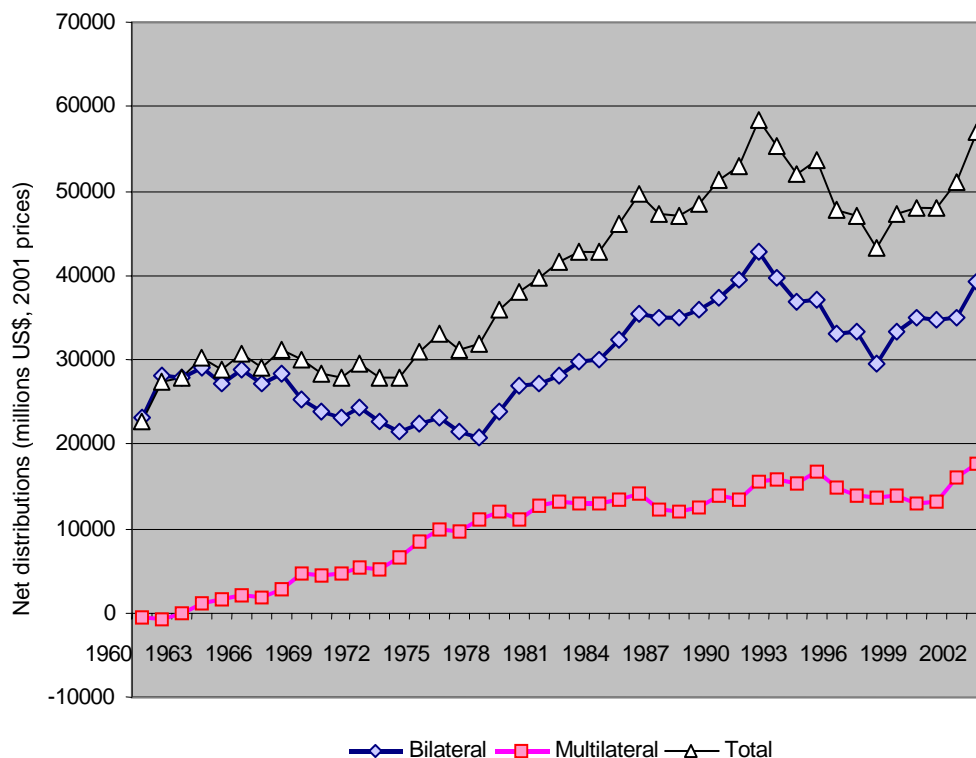
¹² See Pattillo, Poirson and Ricci (2004).

¹³ All data shown in this section are taken from OECD’s *International Development Statistics On-line* (2004) and relate to aid flows emanating from countries belonging to the OECD Development

assistance peaked at US\$58.3 billion in 1991 and then dropped sharply to US\$43.2 billion by 1997, before a partial recovery in the latter 1990s so that by the end of 2002 ODA was at a level lower than 11 years earlier. The overall trend in total official development assistance was largely driven by the pull-back in bilateral aid, while multilateral official development assistance has been more stable, rising modestly between 1960 and 2002. For SSA, the region most in need of aid, ODA fell from US\$17.3 billion in 1990 to US\$1.6 billion in 1999, and only reached its 1990 level again in 2002 (see Figure 2). Indeed, donors actually allocated aid away from SSA in the 1990s, as is evident from the decline in the region's share of world aid for much of the decade (Figure 3).

Developing countries attract, of course, development-oriented foreign financial transfers in addition of official development assistance. They attract from OECD countries official flows that do not qualify as official development assistance and private flows. The OECD reports data on both flows, labelling the former as other official financing

Figure 1
Total bilateral and multilateral ODA, 1960-2002



Assistance Committee (DAC). All dollar amounts are in constant 2001 prices. As mentioned, the measure of aid used is ODA, which is defined by the DAC as grants or loans to developing countries which are: (i) undertaken by the official sector; (ii) with the promotion of economic development and welfare as the main objective; (iii) at concessional financial terms (a loan must have a grant element of at least 25 per cent). In addition to financial flows, technical cooperation is included in ODA. Grants, loans and credits for military purposes are excluded. The flows shown in Figures 1 to 3 are net ODA disbursements, which are the actual international transfer of resources from donor to recipient, less any repayments on ODA loans from previous periods. Total net ODA is simply the sum of bilateral and multilateral ODA. See OECD (2003) for further details. The latest available comparable international aid data are for 2002.

Figure 2
Aid flows to Sub-Saharan Africa, 1960-2002

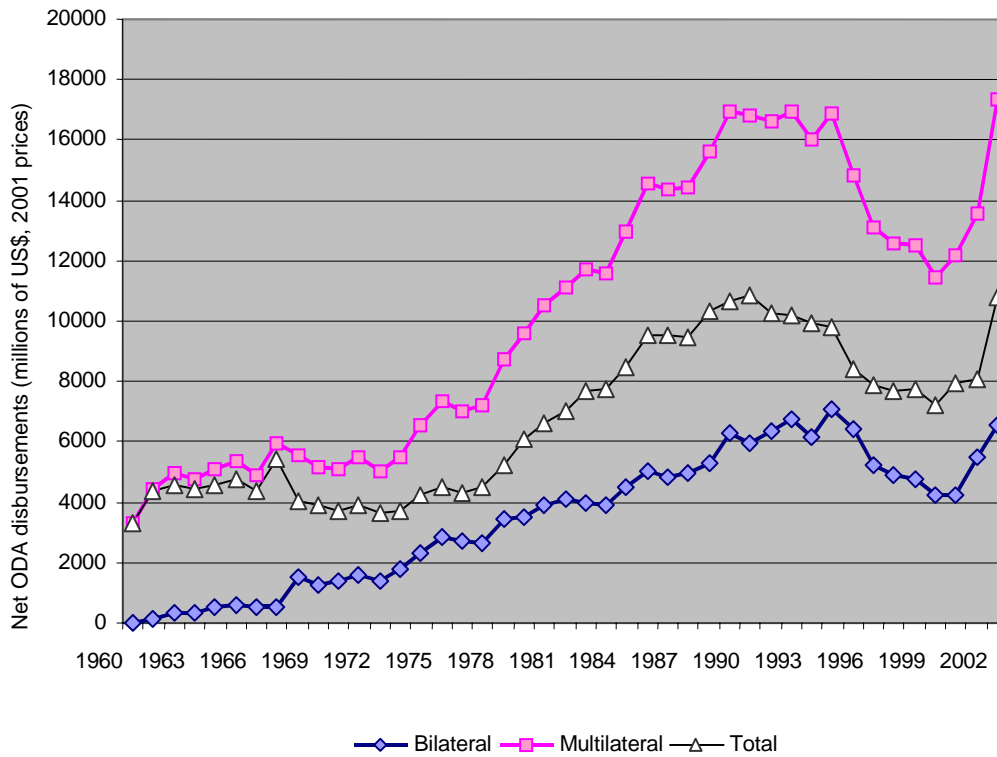
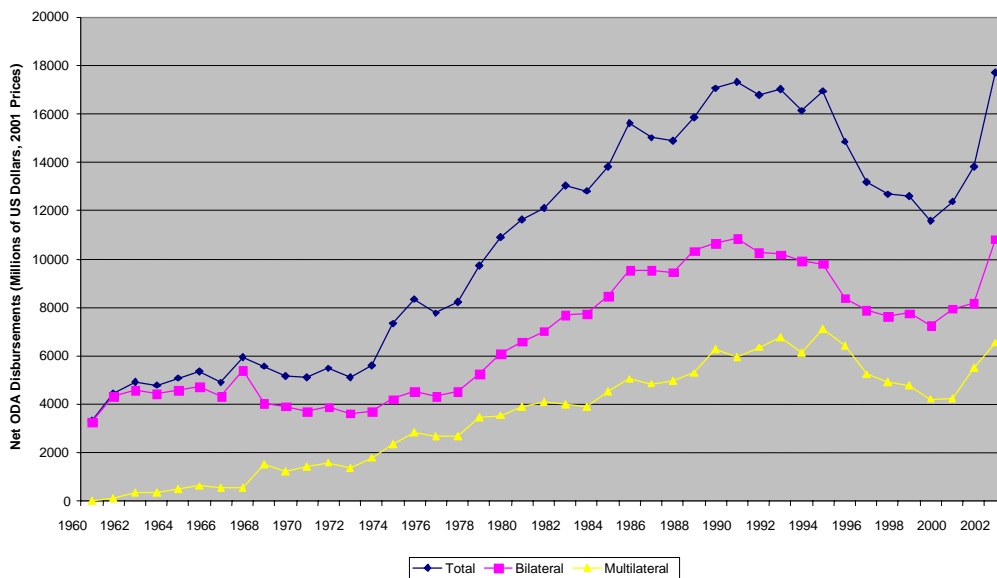


Figure 3
World aid shares to Sub-Saharan Africa, 1960-2002



(OOF) and the latter simply as private flows, which consist mainly of foreign direct investment. A reduction in ODA might be mitigated by increases in these flows, although there is less clarity over the impact of OOF and (to a lesser extent) private flows on growth and poverty reduction. Such mitigation has not occurred. As Figure 4 shows, OOF flows to SSA have trended downward since the late 1980s, and were

negative in each of the years 1996 to 2001. OOF increased sharply in 2001, but its level that year was much less than that which prevailed in the mid- to late-1980s. Private flows have been much more volatile. They fell dramatically in 1984, recovered in 1989, but then trended downward thereafter.

Figure 4
Non-ODA flows to Sub-Saharan Africa, 1960-2002

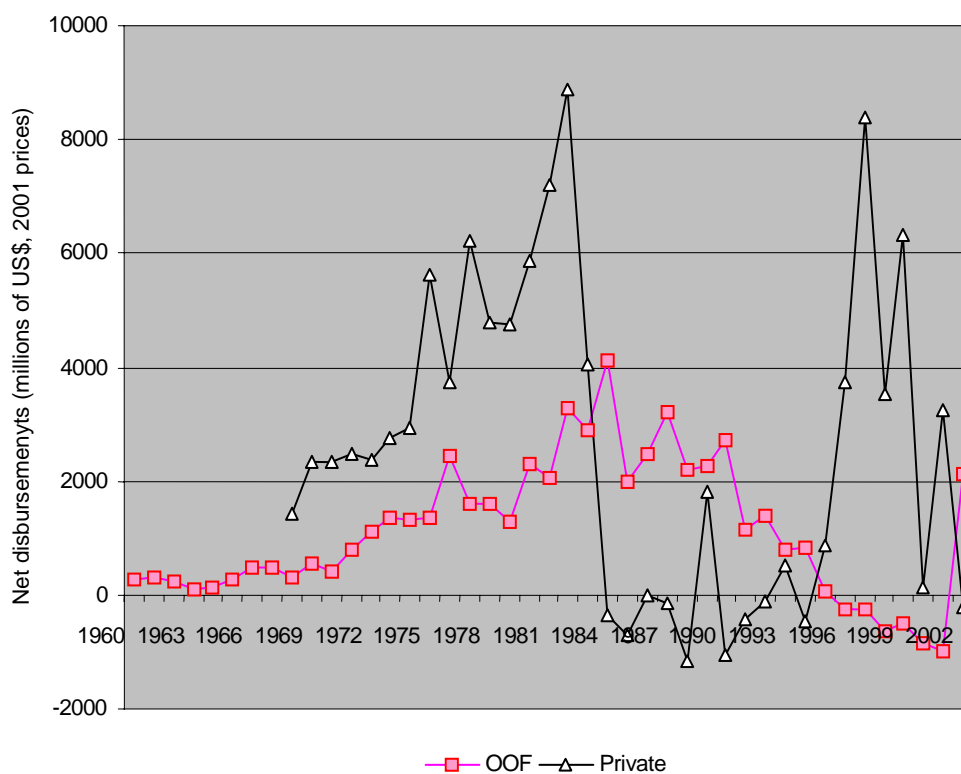


Table 1
Total net disbursements of total official and private flows, by type, 1971-2002 (%)

	1971-78	1981-90	1991-2002
All developing countries			
Official development assistance (ODA)	36.7	50.8	43.6
Bilateral	29.0	38.3	30.9
Multilateral	7.7	12.5	12.7
Other official flows (OOF)	8.7	6.6	4.3
Private flows	50.7	38.2	47.7
Grants from NGOs	3.9	4.4	4.8
Total	100.0	100.0	100.00
Sub-Saharan Africa			
Official development assistance (ODA)	59.5	77.8	88.3
Bilateral	42.0	52.9	54.2
Multilateral	17.5	24.9	34.1
Other official flows (OOF)	11.2	14.4	0.2
Private flows	29.3	7.9	11.5
Grants from NGOs	na	na	na
Total	100.0	100.0	100.0

Source: OECD (2004).

While declines in official development assistance might potentially be mitigated by increases in other inflows, it should be recognized that this potential is somewhat limited in the case of SSA. This is made clear by Table 1, which shows percentage breakdowns of foreign inflows reported by the OECD. Official development assistance accounted for almost 90 per cent of total flows to SSA during 1991 to 2002, indicating that many of the countries in this region find it very difficult to attract private capital. Not only is this share more than twice that for all developing countries for the same period, but it is substantially higher than for the 1970s and 1980s overall. Official development assistance dependency is a reality in SSA. Thus even if OOF and private flows were to continue to increase to SSA, such increases would have to be dramatic and sustained over many years for them to reduce the region's dependence on ODA.

What can we infer from trends in aid and other foreign inflows to developing countries in light of the findings of the literature on the macro level impacts of official aid? There would appear to be one inescapable conclusion from the above data. Given that the vast majority of the literature finds that aid is effective in promoting growth, and by implication in reducing poverty, that this result holds on average for all countries, and that reductions in aid have not been offset by increases in other development-oriented inflows, poverty is clearly higher in SSA as a result of the declines in aid to this region during the 1990s. This in turn means that the MDGs will be harder to achieve in that region than would otherwise have been the case. While recent increases in aid to this region are to be welcomed, there remain many significant challenges for governments in SSA and the international donor community.

4 Finding new sources of development finance

The 'traditional' mechanisms of aid and debt relief can only take us so far, and there has recently been much discussion of 'new' or 'additional' sources of development finance; in late 2004 the General Assembly discussed these at its Second Committee (Economic and Finance) meeting, the governments of Brazil, France, Chile, and Spain organized a heads of state meeting on 'Action against Hunger and Poverty' at the UN which focused on finance, and President Chirac of France subsequently made a presentation on the theme at the 2005 Davos conference. Potential new sources include international taxes such as the currency transactions tax (otherwise known as the 'Tobin Tax') as well as taxes on environmental pollutants and international travel (the French proposal to tax airline fuel), novel measures to leverage funds for aid programme from the international capital markets (the UK's International Finance Facility), and measures to stimulate additional or new private flows, including migrant remittances and philanthropy as well as schemes such as the global lottery and the global premium ('prize') bond. This is obviously a very mixed bag and the proposals involve quite different mixes of private and public initiative. Some require major and comprehensive international agreement, others can be put in place by individual countries or groups of countries, and still others are purely dependent upon private action. Although some of the proposals have been on the table for quite a long time (notably the Tobin Tax), they remain 'new' in the sense that they have yet to be enacted and may offer potential for the future either as a modest supplement to conventional aid and debt relief or as major sources of development funding in their own right.

Debate on new sources of finance at the 2004 UN General Assembly was focused around a new analysis by UNU-WIDER undertaken in cooperation with UN-DESA following an earlier call for a rigorous study by the General Assembly after the 2002 UN Financing for Development conference in Monterrey. The UNU-WIDER study was led by Anthony B. Atkinson of Oxford University, and we summarize the main findings here.¹⁴

The UNU-WIDER study first looked at global taxation, and specifically the currency transactions tax (CTT) which would apply to transactions in the foreign-exchange markets (spot, forward, future, swaps and other derivatives) and the study also examined one global environmental tax (a tax on the use of hydrocarbon fuels according to their carbon content).¹⁵ These taxes have ‘double dividends’ in that they meet some other goal than simply raising taxation for development purposes; in the case of the CTT it is reducing exchange-rate volatility while the carbon tax will contribute to reducing global warming. However, the UNU-WIDER study concentrated on the financing objective, and its main finding is that these taxes can raise quite substantial sums at modest tax rates (below the rates proposed by those whose main concern is with exchange-rate volatility and global warming). Thus the CTT could generate US\$15-28 billion per year, while a carbon tax could raise US\$50 billion; both these taxes alone would therefore provide enough revenue to more than double existing levels of aid (although governments would no doubt also wish to spend some of the revenues on increasing the provision of global public goods as well).¹⁶ But although such global taxes are promising from a revenue-raising perspective (as is the French proposal for an airline fuel tax), they need a large amount of political agreement internationally; the present US administration is firmly opposed, and the French government has yet to win consensus on the issue within the European Union.

There are alternatives to global taxation, and the UK’s proposal for the International Finance Facility (IFF) is one of these, as is the idea of creating Special Drawing Rights (SDRs) for development purposes. The IFF’s fundamental aim is to provide predictable and stable flows within an agreed disbursement mechanism thereby effectively guaranteeing funding for the poorest countries, and overcoming the volatility in aid that bedevils current donor practices.¹⁷ Long-term pledges of a flow of annual payments to the IFF would leverage additional money from the international capital markets through a securitization process (IFF bonds). The IFF could achieve a flow of US\$50 billion during the crucial years 2010-15 (i.e. up to the target date for the MDGs) building up from 2006 and falling to zero by 2020. A major advantage of the IFF over global taxes is that it requires a smaller sub-set of countries to get the measure off the ground and indeed the IFF does not require the participation of all high-income countries (it appears that Canada and the United States are unlikely to sign-up, in part because of doubts as to whether the IFF is consistent with their budgetary procedures). EU countries are politically the most likely to press ahead if the UK can persuade them (France, Germany and Italy appear to be supportive), but one as yet unresolved problem is whether the IFF is consistent with the EU’s stability and growth pact which aims to contain the fiscal

¹⁴ See Atkinson (2004) for details.

¹⁵ See Sandmo (2004) for a detailed discussion.

¹⁶ Nissanke (2004) provides further discussion.

¹⁷ For further discussion, see Mavrotas (2004).

deficits and debt levels of member states. The UK intention is to have the IFF bonds accounted for at arms length on the books of a new IFF agency but if the bonds are counted as being on the balance sheet of participating governments then they will add to the problem that these countries already have in meeting the so-called 'Maastricht criteria'. Other issues to be resolved are what happens after 2020, and what form the new IFF organization will take.

Still, despite these difficulties, the IFF remains one of the most promising of the new financial proposals and, in the minds of many commentators, more likely to be created than global taxes which require much more international political unanimity. The IFF is also much more likely to be implemented than the separate proposal to create SDRs for development purposes, with donor countries making their SDR allocation available to fund development.¹⁸ The UNU-WIDER study estimates that an SDR allocation of US\$25-30 billion could make a significant contribution to the overall financing needs of poor countries (as well as a potentially positive impact on the global macroeconomy through generating growth in the South). But any expansion in SDRs for this purpose requires the proposal to be ratified by 100 IMF members (85 per cent of the voting power of the Fund). This is much more difficult to achieve than assembling what the UK's development minister, Hilary Benn, refers to as a 'coalition of the willing' for the IFF.

There is much less disagreement between governments over expanding private flows of finance to developing countries, in part because such flows—in particular remittances and philanthropic donations—are already sizeable and growing (a more cynical view is that initiatives in this area do not require governments to commit much, if any, public money). Proposals on remittances are 'new' in the sense that they aim to reduce the transfer costs involved in remitting money back to home countries (as well as complementary measures to remove the irregular residency status of migrants which can make them reluctant to use lower-cost channels for remitting). Given that remittances are running at US\$80 billion annually (much more than annual aid flows), a reduction in transfer costs could have significant benefits and may directly contribute to meeting the MDGs when remittances flow to poorer households and communities. However, all of these efforts also have to be squared with recent national legislation in the areas of money laundering and counter-terrorism legislation.¹⁹

Philanthropy can raise substantial sums as well; in the United States accounting for more than 1.5 per cent of income. However, much charitable giving is directed to domestic causes, rather than to development (Germany has the largest fraction going to overseas development).²⁰ Charitable donations for development by individuals and firms can certainly be increased by tax incentives, global funds, and corporate giving (and measures to encourage payroll giving). But we must also recognize that while responses such as that to the recent tsunami disaster in Asia have been outstanding, and need further encouragement, charitable giving in one area can expand at the expense of another. Moreover, as desirable as they may be, direct donations to communities and NGOs cannot substitute for aid to fund government budgets, particularly spending on

¹⁸ See Aryeetey (2004).

¹⁹ See Solimano (2004) for a detailed discussion.

²⁰ See Micklewright and Wright (2004).

building up comprehensive nationwide education and health systems (nor can charitable donations fund large-scale infrastructure projects, such as rural electrification, that can transform livelihoods).

Finally, the UNU-WIDER study examines the proposal for a global lottery, an idea given impetus by the Crisis Management Initiative (a Finnish NGO led by the former Finnish President Martti Ahtisaari).²¹ A global lottery could be organized to fund development either by means of national-run versions sold parallel to existing state and local lotteries or through a single global lottery sold worldwide through the Internet. Its revenue potential is obviously hard to estimate but the UNU-WIDER study comes out with a rough figure of US\$6 billion a year (which is feasible given that the world market for lottery products is at least US\$120 billion per year and gambling, in all its forms, is a US\$1 trillion per year business). Although some people will buy a global lottery for philanthropic reasons (and this may take money away from direct charitable donations), this may be less important to revenue-generation than its ability to compete with other lottery and gambling products. No doubt some people will question the ethics of financing development in this way, but in defence it must be said that lotteries are now a very common means for national and regional governments to fund themselves across the world—and the MDGs are a cause that is at least as worthy as many existing uses of lottery revenues. An alternative proposal in the UNU-WIDER study is to create a global premium bond for development modelled on the very successful UK premium bond (which provides funding for the British government); bonds are entered into a monthly prize draw, and the prizes provide an income stream (which depends on the bondholder's luck) with no loss of the initial investment (in contrast to the purchase of an unlucky lottery ticket). This may be more ethically acceptable than a lottery product. Governments may oppose both ideas if either threatens their own funding (lotteries and casinos have grown increasingly important to the finances of local governments in both Australia and the United States, for example) and commercial gambling operators often have powerful political friends. However, not all governments have to sign up to put these products into the marketplace and since their purchase is voluntary they do not face the political difficulties inherent in increasing aid from general tax revenues or from introducing new global taxes.

In summary, a range of possibilities now exist that can provide more development finance (and we have only discussed a subset in this paper). A key point is that these opportunities should not crowd-out existing official flows, rather they must be additional to them. For example, in pressing the case for global taxes governments should not allow these to substitute for increasing their bilateral and multilateral aid flows. As with debt relief, additionality is crucial.

5 Conclusions

This paper has examined the macroeconomic impact of official aid, paying special attention to its contributions to growth and poverty reduction. It shows that the empirical literature, published over the last seven or eight years, concludes overwhelmingly that growth in developing countries would have been lower in the absence of official aid. As such, it is reasonable to conclude by extension that poverty

²¹ See Addison and Chowdhury (2004) for details.

would have been higher in the absence of these flows. The paper then highlighted a substantial downturn in world aid flows in the 1990s. It also highlighted downturns in aid to SSA, where the MDGs will be hardest to achieve, and in non-aid, development oriented flows. Given that the vast majority of the literature finds that aid is effective in promoting growth, and by implication in reducing poverty, that this result holds on average for all countries, and that reductions in aid have not been offset by increases in other development-oriented inflows, the paper argued that poverty is clearly higher in SSA as a result of the declines in aid to this region during the 1990s. This in turn means that the MDGs will be harder to achieve in this region than would otherwise have been the case. While recent increases in aid to this region are to be welcomed, there remain many significant challenges for governments in SSA and the international donor community.

The obvious challenge is to sustain recent increases in official aid to SSA. Another appropriate response is to look to other, innovative sources of external finance to assist in the achievement of the MDGs. A number of possible sources have been recently been proposed. These include the Tobin Tax, the International Finance Facility, a global lottery, a global premium bond, development-focused special drawing rights and global environment taxes (Atkinson 2004). These sources should be seen as an augmentation of official aid, building on the positive impact of these flows, but at the same time building on factors that increase the poverty-reducing impact of this category of inflow. Ultimately, it is a case of not throwing the baby out with the bath water.

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