The International Aid System 2005-2010: Forces For and Against Change

Draft: January 2004.

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2004-2005 constitutes a major window for change in the international aid architecture. The United Nations Special Assembly to assess progress on the Millennium Development Goals will take place in 2005. This agenda could, and many think should, also be centre-stage for the UK's 2005 chairing of the G7 and the EU. Commissions on global governance, for example the Helsinki Process and the International Taskforce on Global Public Goods, will deliver verdicts. Elections will occur in several key countries. The mandates of the leaders of other key institutions – the EC, the IMF and the World Bank – are also up for renewal in 2004 or early 2005. Major multi-annual funding frameworks will need to be renegotiated during this period.

Meanwhile, aid is still adapting to recent attempts at structural change. The launch of new instruments (for example, the Global Fund to Fight AIDS, TB and Malaria (GFATM) and the US Millennium Challenge Account (MCA) or the broaching of others (the International Financing Facility) has had serious implications for the system as a whole. Attitudes to multilateralism and aid in post-conflict environments have shifted profoundly in the wake of 9/11. Implementation of ambitious rhetoric on the volume and quality of aid, and its anchoring in good governance and sovereign choice, has not yet occurred.

It is by no means certain that the international aid system, or even a refreshed version of it, will survive this decade unscathed, despite fifty years of broad global presence. This paper traces some of the changes that might take place, forces that might shape such changes, and directions they may take.

The paper accompanies a seminar series in January and February 2004. It is intended for informal consultation and comments.

Contents

Abbreviations **3**

Abstract **5**

Major Timelines for Decision Makers **6**

Section 1 Introduction **7**
Section 2 The Aid System and its Peculiar Structure **8**
a) Aid is not a market, but… 8
b) Finance matters 9
c) Non-governmental aid agencies and voluntary giving 9
d) Foreign direct investment (FDI) and other private capital flows 11
e) The demand side: low-income client countries 12
f) Global public goods 13
Section 3 Four Major Factors Shaping the Aid System: Towards a Theoretical Framework **14**
Section 4 The 'Leading' Paradigm of Effective Aid, and Some of its Limitations **15**
a) The compact 15
b) the Millennium Development Goals (MDGs) 16
c) Partnership approaches and the Poverty Reduction Strategy process 17
d) The failure of conditionality and the new 'streamlining' 18
e) Performance-based aid allocations 18
f) Conclusion 19
Section 5 Unfinished Business and Open Questions **19**
a) Aid volume and absorption 19
b) The new bilateralism and tied aid 20
c) Selectivity and balance 21
d) Aid terms: grants versus loans 22
Section 6 The Emergence of Radically New Institutional Arrangements **23**
a) The US Millennium Challenge Account (MCA) 23
b) The Global Fund to Fight AIDS, TB and Malaria (GFATM) 25
c) the International Financing Facility proposal 26
Section 7 Towards Simplified Scenarios for the Future of Aid **27**

Appendix Changing Roles of the Major Multilateral Institutions **29**
a) International Financial Institutions 29
b) the UN aid sub-system 30
c) the European Union and European Commission 31

Appendix 2 Official Development Aid System **33**

References **35**

Abbreviations

ACP	African, Caribbean and Pacific countries linked to EU
DAC	Development Assistance Committee
DFID	Department for International Development
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECOSOC	UN Economic and Social Council
EDF	European Development Fund
EIB	European Investment Bank
EPA	Economic Partnership Agreement
EU	European Union
FAO	Food and Agriculture Organization
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GDP	Gross Domestic Product
GFATM	Global Fund to Fight AIDS, TB and Malaria
GNI	Gross National Income
GSP	Generalised System of Preferences
HIPC	Heavily Indebted Poor Countries
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IFF	International Finance Facility
IFI	International Finance Institutions
IFIAC	International Financial Advisory Commission
ILO	International Labor Organization
ILO WCSDG	ILO World Commission on Social Dimension of Globalization
IMF	International Monetary Fund
JBIC	Japan Bank for International Co-operation
LICUS	Low Income Countries Under Stress
MCA	Millennium Challenge Account
MDB	Multilateral Development Bank
MDG	Millennium Development Goal
MEDA	Euro-Mediterranean Partnership
NAFTA	North American Free Trade Agreement
NGO	Non-governmental Organisation
ODA	Official Development Assistance
OECD	Organisation for Economic Development and Co-operation
OECF	Overseas Economic Cooperation Fund (Japan)
PGRF	Poverty Reduction and Growth Facility
PRS	Poverty Reduction Strategy
SARS	Severe Acute Respiratory Syndrome
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNFPA	United Nations Population Fund

UNICEF	United Nations Children's Fund
UNIDO	United Nations Industrial Development Organisation
USAID	US Agency for International Development
WB	World Bank
WEF	World Economic Forum
WHO	World Health Organization
WTO	World Trade Organization

Abstract

Today's international aid 'market' has too many providers to operate as an effective cartel, yet suffers from a lack of client information and voice, weak ownership, and other restrictions on competitive discipline. Despite persistent criticism from different points in the ideological spectrum, these imperfections help to explain why no major aid institution has been closed in 50 years, whereas many have been created, even as aid's share of world income has shrunk.

So what is driving current governmental and intergovernmental aid? Four underlying factors are identified, some ongoing, and some new:

- *multiple foreign and security policy objectives*, loosely bundled with anti-poverty goals, with no common weighting system;
- the continued existence of *institutional barriers* insulating aid programmes to different extents from hard budget constraints;
- *reduced willingness, or ability, to use aid in its current form* at both ends of the client spectrum: more advanced countries reject foreign intrusion; weaker countries badly need aid but cannot demonstrate the ability to use it;
- new *cosy relationships with private and voluntary organisations*, funded by official aid, and competing with them for taxpayer and commercial support.

With these shaping forces in mind we will summarise the main elements of the stylised 2003 'consensus' model of aid effectiveness (the Monterrey Aid Compact, the Millennium Development Goals, the Poverty Reduction Strategy process, 'streamlined' conditionality, and performance-based aid allocations). We will then examine in this context four main elements of unfinished business: aid volume and absorption; new tied aid; selectivity and balance; and grants versus loans, highlighting implications for the aid system in each area.

We will then review from a systemic perspective three recent institutional innovations enacted or proposed: the US Millennium Challenge Account, the GFATM and the International Financing Facility. If these are to succeed, existing aid institutions will have to accept much more change on their own part than they appear ready to accommodate today.

Finally, we will sketch four of the many possible future scenarios for the aid system. The first two see with the current focus on aid as a catalyst for pro-poor growth reinforced, both in the context of more competition among actors in the system, and in the context where there is, conversely, less competition. The other two look at scenarios where the emphasis on poverty becomes much weaker, again in different contexts of competition among actors in the system The Appendix looks at how the different scenarios could affect the changing roles of the major multilateral agencies.

The next phase of this work will, we hope, build and discuss scenarios for the system as a whole beyond 2010, outlining implications in each scenario for the major categories of institutions, including UN agencies, multilateral banks, the EC and prominent bilaterals.

Major Timelines for Decision Makers

Year	International Events	Elections /Appointments	Financial Horizons/Replenishments	Publications/Results of committees
2004	April: Commission on Sustainable Development June: US chairing of G8 31 December expiry of the EU Generalised System of Preferences	June: European Parliament elections November: installation of new EU-25 Commission. November: US presidential elections	November: formal negotiations on new financial perspectives (including possible budgetisation of EDF) Mid-term review of the EDF allocations (with additional €1 billion for ACP states)	January: WEF Global Governance Initiative
2005	September: Helsinki Conference WTO Ministerial September: UN special Assembly on MDGs 20th Anniversary of Live Aid UK chairing of G8	March: next term of new IMF Managing Director April-June: possible UK elections May: next term of new World Bank President July: UK half-year presidency of the EU Council September: New WTO Director General.	June: IDA 14 Replenishment Start of the negotiations on the 10th EDF (transition period to budgetisation until 2008-2011) (Likely conclusion of EU perspectives)	January: WEF Global Governance Initiative July: Publication of Helsinki Process findings December: International Task Force on Global Public Goods
2006	Russia chairing of G8	By June (latest): UK elections	Implementation of Monterrey pledges: aid increases of US$16 billion a year Spain's commitment to increase aid to 0.33%	January: WEF Global Governance Initiative
2007	Germany chairing of G8 WTO Ministerial		EU Agreement on Financial Perspectives post 2006-5 or 7 years Expiry of current EDF (9) April: UK biennial Spending Round Ireland's commitment to increase aid to 0.7%	
2008	Japan chairing of G8	November: US Presidential elections	June: IDA 15 Replenishment Scheduled conclusion of Economic Partnership Agreements (EPAs) under the Cotonou Agreement	
2009	Italy chairing of G8			
2010	Canada chairing of G8		Doubling of Canada's aid assistance Belgium's legal commitment to aid to reach 0.7% Finland's commitment to increase aid to 0.7%	
2011	France chairing of G8			

Section 1 Introduction

The aid 'system' has developed incrementally, without evident systematic intent, over several decades. This paper will look at how this system will attempt to help recipient countries achieve the UN development goals, while delivering on promised inputs, such as radical increases in aid volume together with improved aid quality. These objectives exist within a new foreign policy environment where failing states, until now considered unable to absorb much aid, could be catapulted into top priority status.

The aid 'system' here mainly includes the organisations, their political owners and civil servant managers, as well as their sources and uses of funds. It managed to adapt to the various events, theories and fashions shaping development practice during and after the Cold War. It is important to ask whether the next few years will see the system just muddling through, or whether its stakeholders will demand and achieve major reform, and, if so, in which direction?

To explore this question, we set against these mixed political objectives some institutional arrangements, old and new, that may be more or less conducive to systemic change. Longstanding arrangements include financial set-ups that insulate aid programmes from hard budget constraints, to various extents. For this reason alone, some institutions will fare worse than others in an unfavourable climate; this may have little to do with aid 'effectiveness' in the sense of the institutions' relative contribution to poverty reduction, or other measures of development. Similarly, in a major upsurge of aid funding, will all agencies benefit, or are some better placed to expand than others?

There are also new institutional forms for aid, enacted or proposed, that could reshape the 'system' considerably. Some are built on radically different premises of what constitutes effective aid delivery in the 21st century, and are arguably incompatible with the aid system that preceded them. This is the case for the US Millennium Challenge Account and the Global Fund to fight AIDS, Tuberculosis and Malaria. The more impact they have and the more support they attract, the more existing aid institutions will need to adapt or yield ground to this reality. The International Financing Facility proposes a massive front-loading of aid flows, potentially reaching an outright doubling over the next few years. These flows would be allocated from a single central point; this is of crucial importance for how the aid system adjusts to what could be a whole new 'market' in its own right.

A final set of institutional arrangements which will shape the aid system response is the relationship, itself in flux, between official aid and voluntary flows and, to a lesser extent, private flows to developing countries. Voluntary flows have grown and diversified, and complement official aid at the same time as competing with it. We infer in particular that the more the 'old' aid agencies adopt state-to-state budget support as their preferred mode of operation, the more the voluntary sector, and perhaps also the new global funds, will seek to provide clear-cut alternative solutions.

To limit the scope of this paper, we will focus on official aid, financed directly or indirectly through taxation, with less emphasis on private and voluntary sources of finance, except where they have a major impact on official aid. The paper will also consider: aid to low-income and low middle-income countries, but noting the rising power of more advanced developing countries in shaping the system; and international aid, as against the entire spectrum of policies affecting global stability and progress: trade; investment; debt; migration; environment; and security, to name just a few.

Section 2 looks at the structure of the aid 'system' and some of its imperfections. It suggests a framework of four underlying factors that contribute to its current form. Section 3 puts forward a theoretical appraisal of the aid system. Section 4 looks at the main elements and limits of today's apparent consensus model on international aid and its limits. Section 5 looks at some questions hanging over the present aid system, unanswered by the consensus model. Section 6 looks from a systemic perspective at three proposed innovations: the Millennium Challenge Account, the GFATM and the International Financing Facility. Section 7 concludes, suggesting four possible scenarios for the future of the aid system. The Appendix looks at specific cases of major multilateral agencies, and the forces and perceptions shaping their roles.

Section 2 The Aid System and its Peculiar Structure

a) Aid is not a market, but…

Market metaphors and supply-demand concepts should be applied with caution to a system where all the major actors are nation-states or their collective agents (Raffer and Singer, 1996). Indeed, neither competitive forces nor a grand cartel of owners drives the shape of the aid system today. It is riddled with imperfections, inertia and bureaucratic 'intrapreneurship', and has developed a distinct, sheltered bureaucratic culture outside the mainstream of donor (and sometimes recipient) government administrations.[1] These factors also tend to neutralise sporadic top-down reform initiatives, which have mostly been limited in scope and time.[2]

In 50 years of aid no major institution has exited the market through closure or merger,[3] with considerably more in existence today (over 40 bilateral agencies of which 23 DAC members, 15 UN system agencies, and 20 global and regional financial institutions: Besanzon, 2003) than when the share of aid in GDP was a third larger. They overlap in many ways under a rhetoric of 'harmonisation', (prevalent since Monterrey in 2002) and which is, doubtless coincidentally, self-preserving. The creation of some institutions (see Section 5 for examples) was deliberate, as a result of perceived deficiencies in existing ones. The latter were nonetheless allowed to continue, and even grow in parallel. Yet others are often seen as having little impact but struggle on in a diminished form through patronage ties, inertia, non-transparent funding formulas, and by eschewing any controversy that could tip political opinion towards outright closure.

Major governmental shareholders generally behave as if the aid system of cross-holdings as a whole is beyond their collective, let alone individual, grasp. Few have tried to develop comprehensive strategies or to compare the value-for-money of their investments across the whole architecture.[4] There are

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1 For an institutional perspective on development and development co-operation see Ostrom (2002). This study provides a method and tools for an institutional analysis and evaluates the relationship between aid incentives and sustainability.

2 Major recent attempts to reform the Multilateral Development Banks (MDB) include: the Meltzer Commission (see footnote 29); the World Bank Strategic Compact (1997); debt relief and the Heavily Indebted Poor Country Initiative (1997–98); the InterAmerican Development Bank doubling of its capital base, and its entering into new areas, such as technical assistance and soft lending; and the African Development Bank's major reorganisation in the second half of the 1990s. See Bezanson (2003).

3 Although there has been some consolidation among Japanese loan-based agencies (leading to the current JBIC), and some closures of Cold War era co-operation agencies in Eastern Europe, as well as of smaller OPEC-based institutions.

4 There have been a few exceptions: Nordic countries, for example, have raised questions regarding the structure of the aid architecture and proposed reforms. Sweden has recently issued high profile work on the MDBs and the financing of the UN system. In addition, the US has challenged the current architecture by advocating new approaches, such as the MCA (see Section 6), by urging the MDBs to issue

clearly factors at work here other than market forces and the strong will of well coordinated joint owners. We turn to some of them below.

b) Finance matters

As a general proposition, the *financing formula* used for an aid institution and, in particular, the way budget constraints do or do not bite make the institution either relatively vulnerable, or impervious to pressure from any quarter, including its owners. Those that have a substantial *endowment* are the least exposed, and that now includes at least one window of most international financial institutions.[5] In a nutshell, the war chest of equity and retained earnings that such institutions have accumulated partially insulates them from financing pressures. Indeed, hypothetically, if some of them were to stop lending activities altogether, they would be able to continue to out pay hundreds of millions of dollars a year in running costs and/or as grants to third parties, for years if not decades.[6]

At the other end of the scale there are institutions, especially in the UN system, which are entirely dependent on their membership for periodic *replenishment* of their core funding and their programmes. At the extreme these are annual and entirely voluntary contributions, but usually they are multi-annual, and build in some element of proportionality among donors, for example where shares are pegged in fixed proportion to those of the largest contributors. Even if only one or two large sponsors, archetypically the US, become unwilling or unable to provide support, these formulas can ratchet down overall funding, hence the agency's core capacities, very sharply.

In parallel with this chronic vulnerability and periodic funding crises there has been a build-up of non-core or programme-specific funding, especially among UN agencies.[7] Ironically, although erosion of core funding support can be deeply damaging, a number of barriers prevent actual closure or forced merger. These include ties of patronage (especially with the host country of the organisation), voting structures that allow blocking minorities, and inertia. There are also few incentives to encourage activist members to take upon themselves the considerable transaction costs of 'killing off dinosaurs', even when these are widely seen to contribute nothing of value.

c) Non-governmental aid agencies and voluntary giving[8]

As the cost of accessing reliable information on the poorest countries has fallen, owing to improved technology and some indirect help from aid budgets, the scope for non-governmental intermediation in

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grants, and through Congressional activity, such as the Meltzer Commission (see footnote 29). For a discussion of donor behaviour regarding resource allocation across the aid system, see Dyer *et al.* (2003) and Bezanson (2003).

5 The IMF's Poverty Reduction and Growth Facility (PRGF), for example, is largely financed from reinvested earmarked proceeds of gold sales, kept in a semi-permanent trust. To unwind it would amount to a massive redistribution from low-income to richer members, as a group, which would presumably have to be compensated in other ways.

6 Contrary to public belief, the MDBs as a group and the World Bank in particular do not make most of their income from loans but instead from earnings on their accumulated capital base, on which they do not pay dividends. This has led some (e.g. Klein, 1998) to envisage a scenario in which the institution ceases all lending activity and lives off this endowment, as a high-powered development 'foundation'.

7 For example, across three major UN agencies non-core funding has increased: from 1996 to 1999 core funding for UNDP decreased by 20%, whereas non-core funding increased by 42%; for UNICEF core funding decreased by 4% whereas non-core funding increased by 30%; and for UNFPA core funding decreased by 19% whereas non-core funding increased by 79%. (Unpublished DFID working paper.)

8 For a broader discussion of new sources of financing for development, see Atkinson (2003). He emphasises that their relevance hinges on whether they are intended as complements to, or substitutes for, ODA – which is true also for leveraging private giving through official support, as discussed here.

development has risen. Non-governmental agencies tap into the public's suspicion of bureaucracy as well as its desire for concrete results, and implicitly compete with government agencies for taxpayer resources. However, they remain partially dependent on public aid for funding, guarantees, tax relief and other support that mitigates their risks, so competitive pressure is muted. They can still take strong advocacy positions against a government's policy (e.g. on Iraq) whilst accepting its funding support at the same time. At present, though, they do not portray themselves overtly to the public as a direct alternative to ODA.[9] This could change over time if state-to-state aid is perceived (initially by insiders) as failing to deliver. As will be discussed later, general budget support is particularly unappealing to the voluntary sector, as it largely bypasses them. On the other hand, global funds, discussed below, are a natural rallying point as they distribute large-scale official aid via voluntary channels.

The simple atomised model of private citizens making small donations to charities, which then send staff to execute projects in the remotest areas, is no longer an accurate picture. Estimates of total Northern NGO annual disbursements from their own resources to low-income countries are already at more than US$7 billion,[10] but this does not show the scale and scope of civil society involvement. Government funding to NGOs is financially complex, in issues from the subcontracting of official aid projects to tax relief on charitable donations. In several countries, for example the Netherlands, a minimum share of the aid budget must, by regulation, be channelled through development NGOs. This automatic escalator therefore benefits the NGOs in terms of both rising GDP and rising aid shares.

NGOs and private foundations also tap into (tax-supported) corporate donation, and the skills and in-kind resources of private partners overseas. Northern NGOs increasingly underwrite local partners, to whom they provide management support responsible for project execution. They are thus becoming financial intermediaries in their own right. Local NGOs and co-operatives, including microfinance institutions, are also increasingly able to access funds from foreign aid, corporate donations and foundations in their own name, often in competition with Northern NGOs.

This trend towards financial intermediation may well accelerate, because development spending can increasingly be benchmarked, packaged and standardised in ways that pass international scrutiny, without expensive on-site diligence. There may be willingness for ethical funds, for example, to take on more exposure in local infrastructure, providing that projects can be adequately 'bundled' in large enough units and that they obtain acceptable quality certification. There could be a valuable role for official development-agency staff expertise in developing this certification, rating and bundling capacity. This would encourage such competitive, non-governmental flows, and move progressively away from direct project finance.

As non-governmental bodies develop considerable expertise in their fields and improve their 'knowledge management' and marketing skills, and as they deploy this expertise flexibly, they also come into competition with UN specialised agencies, or at least those constituted primarily as

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9 NGOs appeals often imply, at least indirectly, that other assistance, including ODA, cannot reach a given target group in time, but that they can. Citizens who donate generously thus have two reasons to resist an increased tax spend on ODA: (i) it does not work, and (ii) they have paid someone else to do it.

10 DAC statistics on NGOs are limited to flows for developmental or humanitarian relief purposes, and gather data on three types of flow: contributions made by NGOs from their own resources; contributions by governments to NGOs' own programmes; and government aid programmes administered on their behalf by NGOs. For the first item, DAC member countries have reported about US$7–9 billion annually in recent years. About half of this is attributable to NGOs in the United States. Contributions by governments to NGOs' own programmes are reported as at around US$1 billion annually, although this may underestimate the flows because some donors do not report. The third item, funds channelled through NGOs, is only reported by about half the donors and is significantly underestimated by the annual figure of about US$1 billion. It is therefore likely that the total amount of bilateral aid channelled through non-government organisations is about US$4 billion annually. Total flows for development and relief handled by non-government organisations are at approximately US$12–14 billion annually. (See Table 14 from the statistical annex of the Development Co-operation Report 2004.)

repositories of talent and advice rather than financial intermediation or regulatory competence. The relative bureaucratic rigidity of these more formal bodies and their difficulty in attracting the best talent (for monetary or other incentive reasons) puts them at a disadvantage in a situation where funding for advisory functions is increasingly subjected to fully competitive processes.

d) Foreign direct investment (FDI) and other private capital flows

Before the Asian crisis the share of aid in overall flows fell steadily, and some predicted the terminal decline of public aid, eclipsed as it was then by private capital flows already six times as large as ODA. The latter's importance has changed since the Asian crisis: 2002 net private flows did not reach levels achieved in 1993 and afterwards.[11] However, such flows are both more *volatile* (with the partial exception of FDI) and much more geographically *selectiv*e (save for oil and mining FDI) than was hoped in the early 1990s. FDI flows still almost totally bypass the poorest countries, whereas in some 'emerging' markets the sudden reversal of capital flows and ensuing crises have entailed disproportionate costs to people living in poverty. The role of aid in low-income countries has not shrunk. Indeed, official agencies have also had to try to offset the near total withdrawal of private foreign lenders, as a result of increased concern over debt sustainability there.

When bond financing for emerging-market infrastructure investments temporarily collapsed, there was a reassessment of the future role of aid in 'crowding-in' private investors. Previous assessments of this role, helping to improve the local regulatory environment and providing political risk cover and other government support, had been optimistic. These areas remain significant areas of donor activity, though, and could become more prominent soon, in line with underlying private sector demand, at least in market-worthy and nearly market-worthy countries.

At the same time, the premature retreat of aid-financed infrastructure funding in low-income countries, where private appetite was probably overestimated from the outset, has yet to be reversed. Of the major aid players, only the European Development Fund and JBIC, formerly OECF and Eximbank, of Japan, have retained a significant focus on infrastructure finance in low-income countries throughout the 1990s. Some mistakenly attribute the sustained sharp drop in infrastructure funding elsewhere to the fact that the Millennium Development Goals must mean refocusing public spending on social service provision, especially through recurrent cost financing (see Section 3). Public aid for infrastructure may prove the best way of crowding-in investors in low-income environments, provided that there are also improvements to the regulatory and political climate. In middle-income countries, publicly owned investment banks like IFC and EBRD have tried counter-cyclical approaches, which may have helped to shore up otherwise bearish investor sentiment. They have absorbed significant short-term losses in doing so.

As always, it is hard to prove whether such indirect state involvement in private markets is genuinely catalytic, or whether it merely reduces the exposure of private investment, which could have been sunk into the same country anyway. The very fact that 'public investment banks' have survived as a genre into this millennium – though some, like EBRD, are clearly intent on working themselves out of a job

11 Private net flows were US$198 billion in 1993, but only US$143 billion in 2002. However, developing countries as a group are still heavily reliant on private capital inflows. Although private capital flows decreased from a record US$285 billion in 1997 to US$143 in 2002, they were still significantly higher than net official flows, which were US$36 billion and US$49 billion respectively. (See Global Development Finance 2003, CD-ROM.) The larger point is that almost all of these flows bypassed the low-income developing countries, with the exception of some investments in oil, gas and mining. FDI flows as a percentage of GDP, mainly on extractive industries, can nonetheless be larger for African countries than for developing countries on average (te Velde, 2001).

very soon – illustrates a strong political desire to keep open all avenues for public intervention in support of privately led growth. It helps when these constructs are largely off-budget options.

e) The demand side: low-income client countries

Governments of low-income countries generally do not have sufficient information, mobility or power to make choices among aid providers. Competing lobbies inside recipient governments favour spurious differentiation among donors. By endorsing different circles of patronage for grant-based aid (foreign affairs/co-operation) and loan-based aid (finance) in many recipient countries, the aid system has put up artificial barriers to integration. Trade-offs cannot then be made below full Cabinet level, if at all.

There is a large and growing subset of low-income countries, which are labelled 'difficult partners' or 'countries under stress'. Donors believe that these countries, despite substantial increases in aid flows, are unable to put aid to good use, owing to their weak institutional and policy performance base and their chronic vulnerability to unrest, conflict and state failure.[12] These characteristics, combined with the new orthodoxy of performance-based aid allocations (see Section 3), have until recently isolated them from much of the aid system. Humanitarian relief flows are an exception, and may, by default, begin to take on part of the role of longer-term structural aid in some country settings.

Recent research (Shepherd, 2004) finds that this view of poor-performance is not supported by evidence. Apart from failed and collapsed states, which can be recognised *relatively* easily, but for which data on development outcomes and processes is often a huge problem, it is very difficult to identify a group of countries performing poorly on both of two key indicators (growth and infant mortality reduction) over both the 1980s and 1990s. The institutional inability of donors to engage with such countries, linked mainly to defects in the sovereignty of the recipients, may be more important in making these classifications than the rest of the policy and institutional context. Either way, the effect of 'performance' problems, real or perceived, on reducing effective demand for aid at this end of the market is very much in evidence, and shows no signs of abating.

At the other end of the income scale, the leverage of countries on donors (as opposed to the more traditional leverage of donors on countries), especially on the international financial institutions, increases as the ratio of aid to market funding declines. Several large countries could already move away from aid entirely but choose instead to maintain some links, mostly for insurance and for knowledge-transfer purposes. Meanwhile, they try to lower the political and fiduciary costs of this aid, which has lost its financial edge for them.[13]

Somewhere between the two extremes there is a category of not-quite-creditworthy countries, whose access to grants and concessional loans is rationed by virtue of their relatively high income, but which otherwise have relatively few solid backers, private or public. They are considered to be of, at most, only very limited creditworthiness, in particular for the 'hard' windows of the multilateral banks. Many of these cases are ex-Soviet Republics. They would be able to pay a (modestly) higher rate for wider

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12 For an in-depth discussion on how to define, strengthen and improve aid allocation to 'Low Income Countries Under Stress', see World Bank (2002) and (2003). For a discussion on how 'difficult partnerships' fit into the partnership model see DAC (2001) [DCD/DAC(2001)26/REV1].

13 The most overt example of this was Thailand's decision to cease to accept aid, but instead to become a modest sub-regional donor. India's recent dismissal of all but the largest donor programmes, though from a lower income level, also illustrates the trade-off between political costs and financial benefits. The share of China in the World Bank's lending, to take another example, is larger than the World Bank's relative contribution to China's funding needs.

access to resources, and as a group could make more effective use of such an increment than their poorer cousins, but this is not currently possible in the one-size-fits–all packaging of concessional lending. Greater flexibility would seem to be necessary between full IDA terms and full IBRD terms, or their equivalents from regional banks.

These three groups affect the 'demand' for aid. Some of this gap in effective demand could be addressed if donors were able to make their instruments more flexible, adapt them to the widely differing situations, and modulate both the financial and non-financial costs of dealing with them accordingly. If donors are not able to make this shift, then they will be faced with a client base with a 'shrinking middle', which is being encroached on from both ends by seemingly difficult or impossible clients.

f) Global public goods

Recent concern over South-North contagion effects, arising in particular from pollution and disease, financial instability, and terrorism havens, is increasing the supply of aid to these 'hotspot' areas and, temporarily at least, of aid overall. However, it can shift internal aid distribution away from where it may have the largest poverty impact. Aid spending priorities in the North shift every time a credible new threat to its security, either natural or manmade and unrelated to basic poverty, emerges from a Southern quadrant. So far attention has repeatedly been focused on terrorism and on the Middle East, but other scenarios are possible. It is the misfortune of some of the poorest regions of the world that their suffering is *not* yet considered to be contagious, at least not over very long distances. This could change.

Spending on conflict prevention, peace-building, policing and the general nexus of security sector interventions is now only eligible as ODA to a very limited extent. This may seem an anomaly in a world where building greater local security and development can go hand in hand. However, although there are already strong advocates for expanding the scope of ODA in this direction, any attempt to reclassify a larger share of such interventions as aid could easily lead to abuse. First, it could divert scarce ODA towards military purposes with a much more debateable development impact. Secondly, it could question the integrity of the MDG funding base and of ODA-based measures of the various effort donors are making towards them. These could lose all credibility if this important 'goalpost' is moved.

More generally, some (te Velde *et al.*, 2002) see a serious threat to aid from an ever-expanding mandate to finance public goods away from development aid budgets. Global public goods imply a whole series of priorities conferring major benefits on the donor countries themselves. The prospects for the aid system as a whole are thus bound up to some extent with the discussion of new mechanisms for global problem solving[14] and, linked to these, mechanisms for international resource mobilisation. These may or may not realistically include some form of global redistribution through taxation.

Finally, there are early signs (Kaul, 2004, forthcoming) that some other forms of international co-operation, such as cross-border assistance to the judiciary, or carbon trading, are starting to escape the purview of aid agencies and ministries of foreign affairs. If these trends continue and increase, the aid

14 For example, the International Task Force on Global Public Goods was created in April 2003. Its mandate is to assess and prioritise international public goods, global and regional, and make recommendations to policymakers and other stakeholders on how to improve and expand their provision. The Helsinki Process mandate is even broader – to explore innovative and empowering solutions to the problems of global governance.

system will have serious (official) domestic rivals not only for its own budget – which is not in itself a new phenomenon – but also for the attention of its client countries.

Section 3 Four Major Factors Shaping the Aid System: Towards a Theoretical Framework

The following sections will use a four-part framework of the factors likely to shape the aid system over time:

- *multiple foreign and security policy objectives*, loosely bundled with anti-poverty goals, with no common weighting system;
- the continued existence of *institutional barriers* insulating aid programmes to different extents from hard budget constraints.
- *reduced willingness, or ability, to use aid in its current form* at both ends of the client spectrum: more advanced countries reject foreign intrusion; much weaker countries badly need aid but cannot demonstrate ability to use it.
- new *cosy relationships with private and voluntary organisation*, funded by official aid, and competing with it for taxpayer and commercial support.

Section 2 has described this framework, but with reference mainly to the multilateral and global contexts. In Section 5 we will look more closely at how national foreign, commercial and security policy objectives – the new bilateralism – influence aid, and how institutional barriers also operate to shield bilateral programmes from trade-offs with other spending options.

There is probably no single 'grand theory' that would adequately explain the evolution of the aid system, as it is a large and complex set of relationships and institutions which has developed over long periods. We recognise that the four factors above are just casual approximations for now, implying several underlying theoretical approaches that could be applied to the aid system. Among the more relevant could be: Collective-Action Theory, as applied to donor behaviour; Principal-Agent problems, in the relationships between: taxpayers and their (state and voluntary) development agencies, between governments and international institutions they jointly own, and between donors and recipients, when donors have distinct objectives of their own; and the lessons of domestic Monopoly and Antitrust Regulation, including market entry and exit, for example for public utilities, as they might be extended to the aid system.

Some of these themes will be discussed in the next phases of this work programme.

Section 4 The 'Leading' Paradigm of Effective Aid, and Some of its Limitations

Several current elements make up a stylised 'consensus' view, or rather, the views of a substantial sub-group of aid donors on what makes for an effective aid system (we call this the Monterrey view after the 2002 UN Conference on Financing for Development there[15]). Not everybody subscribes equally to all of these elements and, as we shall see, not all who do subscribe then act on them consistently. Few, however, reject any of them explicitly and categorically. At present, they are already embedded in formal policy guidelines used by the UN system, the World Bank and IMF, the EU, and a large number of European bilateral aid agencies.

The key elements are

- a *compact* linking sovereign responsibility in developing countries for good governance and development choices with better aid quality and sharply increased aid volume in developed countries;
- the *Millennium Development Goals* (MDGs) as guidance for country development priorities;
- *partnership approaches* including the Poverty Reduction Strategy process, discussed below;
- *streamlined conditionality*, recognising the failure of traditional conditionality;
- *performance-based aid allocations*.

a) The compact

In the Monterrey global compact, aid recipients recognise their prime responsibilities to be good governance and the establishment of development priorities (ownership); donors agree to increase both aid volume and aid quality in support of these choices (alignment), as well as to deliver on major policy changes, notably trade openness on their part, which can unlock larger wealth-generating opportunities. The UN Millennium Development Goals for 2015, adapted to country circumstances, are supposed to benchmark this collective action. The Poverty Reduction Strategy (PRS) cycle is the most visible mechanism in low-income countries for expression of country goals and focusing of donor support. The aid volume pledges at Monterrey, amounting to an increase of US$16 billion, or around 30%, by 2006, and prospects for reaching them, are discussed in Section 5.

Since 2002 there has been considerable effort invested by donors in 'harmonising' their aid processes in an effort to lower costs of transaction to recipient countries.[16] In seeking to improve the quality and flexibility of aid, several donors now deliver aid as *budget support* rather than project or sector investment finance. Others criticise this emphasis as unwise, or at least premature. Because project funding is mostly fungible with domestic resources, the government can redeploy it to offset much of the narrower concentration the donors intended, the difference between the two modes of support is

15 Our informal compilation of the views from Monterrey on aid should not however be confused with the full final document emerging from Monterrey, formally called the Monterrey Consensus (see UN Finance for Development http://www.undp.org/ffd/) though they are very similar in content on aid matters. Monterrey also covered policy intentions in other areas, notably trade, which are vital to increasing resource flows to developing countries.

16 The Monterrey Conference highlighted the importance of harmonising donor practices to reduce transaction costs, see OECD DAC (2003c). These directly support the broad agreement of the international development community on this issue as reflected in the Monterrey Consensus. DAC established a task force on donor practices to examine how transaction costs could be reduced to make aid delivery more effective for donors and recipients, see OECD DAC (2003a).

easily overstated. However, explicit budget support draws much more political attention to the overall quality of public spending and of its governance/accountability. Some commentators[17] also question whether budget support processes save rather than add to transaction costs when viewed systemically. At the very least, in the transition towards more frequent and intense programmatic discussions, combined with still large, though falling, numbers of stand-alone projects, it is likely that overall aid costs and complexity for recipient countries will rise for some time yet before they eventually fall.

As well as ownership, transparency, flexibility, and simplification, the leading paradigm of aid calls for more sustained and predictable patterns of assistance, in line with the steady cumulative results needed over two decades to achieve the MDGs. At present very few donor instruments (an exception is debt reduction) allow for predictability in commitments over a period of many years. This includes most forms of budget support, which typically have a very short time limit and are not closely tied to ultimate development outcomes. Aid flows overall are still more volatile than recipient country growth patterns, when they should be less.

b) the Millennium Development Goals (MDGs)

The second main element of the 'consensus' is the global goal to halve the incidence of absolute (monetary) poverty by 2015 and tackle other dimensions of deprivation, such as child and maternal mortality and inadequate schooling.[18] Individual countries are free to place more emphasis on some MDGs than others and to set their own pace for attaining them. Nonetheless, many in the donor community believe that the MDGs provide clear cross-country benchmarks and associated pressure for positive emulation, as well as monitorable progress indicators and cost estimates that serve to increase donor accountability for results (see Section 5).

This said, the current MDG focus has been questioned from at least two angles. First, there is some evidence that donors and governments often interpret the centrality of human-development outcomes in the MDGs too narrowly and simplistically, as a mandate to boost spending primarily on health and education (Black and White, 2003). This can mean neglect of the broader growth context, which enables increased social services spending to become sustainable in the longer term. This may not be so much a criticism of the MDGs, as of a 'social welfare school' of aid allocation that may have taken them too literally. The government of Uganda, as well as some aid agencies, is challenging this school.

Secondly, the MDGs naturally have a shelf life. As 2015 grows closer, the probable statistical outcome of these individual endeavours will become clearer. Only five to six new cohorts of children can both enter and finish primary school by 2015, for example, and radical transformations of complex public institutions are unlikely in such a timeframe. It is almost certain that some large countries (in particular, China and India) will achieve most MDGs, to the extent that they alone will determine the global outcome. At the opposite end of the spectrum, many low-income countries already have no realistic chance of meeting some, if not most, MDGs, virtually regardless of their efforts, or of the size and quality of outside support in the intervening period.

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17 See Killick (2004).

18 The Millennium Development Goals are: eradicate extreme poverty and hunger; achieve universal primary education; promote gender equality and empower women; reduce child mortality; improve maternal health; combat HIV/AIDS, malaria and other diseases; ensure environmental sustainability; develop a global partnership for development. For a further discussion, see http://www.un.org/millenniumgoals/

The intermediate group, where greater efforts now could yet tip the balance, will shrink quickly – well before 2010 and probably much earlier. During our period of 2005-2010, therefore, and perhaps already by 2005–6, the MDGs will probably cease to be an effective reference point both for very successful and very unsuccessful countries, and may also lose their potency for most of the undecided category.

A new motivating set of benchmarks will therefore be needed. Establishing another set of proportional targets, such as reducing the by-then-unattained residual by a further third or half, starting from a new reference year (such as 2010) is technically possible, but might strain credulity around the world. How might a new MDG-type global consensus on this emerge? Who would develop it and when? How would successful MDG-2015 countries such as China be kept actively engaged? Presumably these considerations will be centre-stage at the UN and by mid-2005.

c) Partnership approaches and the Poverty Reduction Strategy process

The third strand in the Consensus is a new approach to partnership, built around longer-term development visions, established in a democratic, consultative way by recipient countries, and with the support but not the direction of major donors. The literature on development partnerships has a long history, centred on Sweden and UNDP, as well as the DAC and the EU's partnership agreements; this originated long before the Bretton Woods institutions espoused such approaches.

In recent years this strand has become more central. The *Comprehensive Development Framework* (Wolfensohn, 1999) emphasised the multisector, multidisciplinary, long-term development vision approach, as well as country leadership in designing the 'architecture' of local donor co-operation. This was piloted as a purely voluntary approach in several countries, with promising results that have yet to be fully evaluated (partly because attribution of outcomes to individual actors is so hard in this area).

The trigger for its wider use came when the boards of the World Bank and IMF decided in 2001 to adopt a very similar conceptual framework, the Poverty Reduction Strategy (PRS) cycle. This was the basic springboard for all low-income country access to expanded debt relief, and then to the concessional funding windows of the two institutions. A number of donors, among them the European Commission and the UK, threw their full support behind the PRS approach and placed their own grants to low-income countries under the same discipline.

There is an inherent tension between on the one hand a *voluntary*, country-owned statement of priorities (the PRSP) and on the other hand a *mandatory*, externally driven judgement as to its quality and feasibility. Whilst the two components are notionally separate – the government 'owns' its strategy and the donors 'own' their independent assessments of the strategy and resulting aid allocations – in practice, different power relationships and local chemistry will determine how much one component actually influences the other. In aid-dependent countries, the requirements of donors will inevitably start to 'pollute' the home-grown vision, if the government is, quite rationally attempting to get the widest possible support for it.

Opinions differ as to the future of this important focal point for the aid system in low-income countries. At one extreme, the whole process could remain quite invasive and disrespectful of national ownership, despite rhetoric to the contrary. In this case it would probably degenerate and collapse over time. At the other extreme, donors could pool all their efforts under a single country approach essentially given to them by the recipient government as a non-negotiable platform. This would involve cartel-like internal

discipline and sanctions against free riders within the donor community. An intermediate outcome, discussed below, would be where due attention and respect are given to the poverty reduction strategy itself, but where additional conditions perhaps only loosely related to it are subsequently developed and enforced.[19]

d) The failure of conditionality and the new 'streamlining'

Belated donor recognition that 'conditionality does not work' also underpins the Monterrey Consensus (Killick, 2004; Collier *at al*., 1997). Countries with a sound pro-poor policy framework and adequate institutions in place can convert aid into more growth and poverty reduction. If this homegrown framework is absent, neither offering nor withholding aid works to change policies, which thereby limits the prospects for progress. There is ample empirical evidence to support this finding. Large resource flows to poorly performing environments will not bring progress; they may even postpone needed change.

However, conditionality cannot be disposed of entirely, as Northern taxpayers require their agencies to demonstrate use of their funds (beyond certifying alignment of aid to the recipient's choices). In other words, donors must rate recipient-country performance, and then do something concrete with these ratings. In a technocratic world the ratings would be unconditional, at arms-length from donors, and non-negotiable; support tomorrow would depend only on objectively observed performance of today. In practice, donors, and especially the World Bank and IMF, still negotiate many specific additional conditions for support, partly as a 'lock-in' and reference mechanism for programme commitments freely entered, and partly as a method to improve performance through conditionality (a now discredited idea). This negotiating process is typically invasive, discretionary and non-transparent, quite the opposite of the partnership paradigm described above. There has been some progress towards simplifying conditionality and publishing ratings recently, although the evidence is mixed. The number of conditions in IMF and, especially, World Bank programmes is still very high and most of the reduction has been in the 'softer' conditionality which does not directly trigger disbursement (Killick, 2004; IMF, 2001).

To sidestep this intrusiveness, alternative approaches like the MCA (see Section 5) are being tested. They involve setting upfront, published, highly selective ratings thresholds, which will qualify a country for aid in exchange for waiver of further major conditionalities for the few who pass the first test.

e) Performance-based aid allocations

This 'performance-based' aid allocation model also has uncomfortable political implications for the aid recipient selection process. Millions more can be sprung from poverty if aid is focused on countries with high levels of poverty and *existing* (i.e., not promised) adequate pro-poor policies and institutions. Moreover, aid should filter in gradually with improving performance, and filter out only slowly for the best performers. Unfortunately, actual patterns of aid diverge substantially from this ideal, with many bilateral donors and the EC at the wrong end of the spectrum and nobody near perfection. A major unresolved issue is how best to support poor countries below minimum performance thresholds,

19 For a discussion of PRSPs and how they have not reduced the number of uncoordinated demands on recipient governments, see Booth (2003).

especially failing states (see Section 2, above). We discuss the selectivity issue further in Section 5: the fact that so many aid donors are, at least statistically, making 'bad' allocations (on purely pro-poor measurements) indicates that they have other objectives than poverty reduction in mind. Unfortunately these objectives are rarely made explicit, much less quantified.

f) Conclusion

The above 'package deal' encapsulates most of the current conventional wisdom, at least in Northern European bilateral and most multilateral aid agencies, on where public aid should be heading, and the leading, if not yet universal, practices of its champions. There are some who consider this the high point of the Monterrey model, from which there will inevitably and increasingly be retreats. Others believe that, behind the rhetoric, aid incentives have not yet shifted fundamentally but may yet do so if political attention does not wander. In any case, new emphases are bound to emerge before 2010, even as the potency of the MDGs as a rallying point starts to wane.

Section 5 Unfinished Business and Open Questions

a) Aid volume and absorption

Recent detailed costing exercises (Devarajan *et al*. 2002) agree on the need to raise global aid spending immediately by at least 100% and perhaps as much as 200%. In order to achieve the MDGs, this increase must then be sustained over a decade or more (assuming, of course, the recipient countries continue to improve their own governance environments as promised).

There is evidence of public opinion support in some leading OECD countries, including the UK, for continued steady, occasionally double-digit percentage increases in ODA of the kind experienced recently (including for the UK a doubling over seven years in absolute terms, though still only about halfway to the 0.7% of GNI target). Moreover, in the short term, continued improvements in just a few lagging aid budgets, with the more generous countries merely holding their current line, could mathematically deliver the more modest Monterrey promise of a one-third increase by 2006 or soon after.[20]

But there are real doubts – in official as well as academic circles – as to whether the dramatic public spending increases, on the much larger, instant-doubling scale called for by the MDG costing exercises can be safely managed and absorbed, even if there is widespread acceptance of the need. There is also

20 The Monterrey aid volume commitment has two main independent components, the EU and the US pledges. The EU-15 countries as a group are committed to reach 0.39% of GNI by raising all individual contributions at least to the current group average (0.35%) and not decreasing any contributions already above this threshold. The major onus here falls on Italy (0.20%) and Greece (0.21%), who will have roughly to double aid (0.15% at Monterrey and 0.20% at the end of 2002) in just three years to make the cut, and also on Germany (0.27%), Austria (0.26%), Portugal (0.27%) and Spain (0.26%). From 2001 to 2002 in real terms the volume of aid of Austria, Germany and Spain decreased, whereas, Portugal, Greece and Italy increased aid allocations (See DAC http://www.oecd.org/dataoecd/3/2/22460411.pdf). Any slowdown in this group could be offset by faster voluntary progress in countries near or above 0.33% such as France (up to 0.38% in 2002 from 0.32% in 2001) and the UK (at 0.31% but with firm spending commitments well above the rate of GNI growth). The US pledged a US$5 billion a year increase by 2006, amounting to a 50% increase in pre-Monterrey levels and bringing its share to 0.16% of GNI. Its original vehicle for doing this was the MCA (see Section 6) whose rollout is proving slower than planned, but there have also been other large commitments for increases made since Monterrey, especially to HIV/AIDS programmes, that have offset this.

some evidence of sharply diminishing returns for aid over this larger range,[21] where aid may peak at over 20% of GDP (Foster and Keith, 2003), for example from Dutch-disease[22] effects such as exchange-rate appreciation.

In any case, public opinion support for budget assistance is arguably weaker than for aid as a whole for a variety of reasons: it is not as tangible as project aid; it appears more vulnerable to poor governance than project support; and, crucially, it does not integrate non-government agencies, who therefore do not lobby for it and may in fact lobby against it. Some OECD countries may as a result enjoy popular backing only for activities that are *not* easily scaled up in the Monterrey sense, even in the best-performing countries. An exception could be the strong latent support for further debt reduction after the Jubilee 2000 campaign, despite the fact that the Cologne-terms debt deal was quintessentially a government-to-government, not people-to-people, transaction. It was, however, never marketed in these unpopular terms.

There is also the risk that aid that is not structural, especially in humanitarian and post-conflict activities, will continue to grow faster than mainstream aid, as it is doing today.[23] This would slow the rate of increase in the kind of core resource transfers that the model envisaged. Extension of successful crisis-appeal modes of fundraising to, for example, the fight against HIV/AIDS (see Section 6, Global Fund) could also weaken the case for accelerating 'conventional' aid at the margin and introduce further distortions.

b) The new bilateralism and tied aid

Bilateral aid now exceeds multilateral aid, roughly 70 to 30. This shows a return to long-term trends after a brief surge in multilateral shares in the 1980s. The ratio could rise even further. The post-9/11 foreign-policy environment with its emphasis on early and major support to previously failed or failing states, could further encourage bilateral aid spending for purposes only vaguely linked to poverty outcomes. Some even see a potential new Cold War in the aid environment. This could lead to a further loss of aid effectiveness in the performance-based aid sense discussed above. UN system agencies are most threatened by collateral damage, especially if they do not reverse their increasing dependence on programme-specific as opposed to core, bilateral funding, and if their mandate prevents them from full participation in some of these new ventures.

Meanwhile, the interest groups protecting the less effective bilateral programmes face little pressure, partly because aid is rarely the subject of partisan domestic debate in OECD countries, and partly because it is still hard for the public to come by independently audited information. Even where an explicit trade-off between EC and bilateral aid allocations is called for, for example, only a minority[24] of the 15 present EU members has the two spending heads within the same departmental budget. There

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21 For a discussion of the problems of aid absorption see Atkinson (2003); Ter-Minassian (2003); Foster and Keith (2003).

22 Dutch disease refers to a situation whereby high aid transfers can have a negative effect on the competitiveness of the economy and hence on growth prospects. For a discussion on the causes see Foster and Keith (2003).

23 Humanitarian aid now represents 10% of all ODA. This includes spending on refugees and asylum seekers in DAC countries. However, this figure still under-represents the amount of ODA spent in response to disasters, as spending by the World Bank on post-disaster/conflict is excluded. In addition, post-conflict peace-building and voluntary humanitarian assistance from the public, among other forms of aid, is not included. See Global Initiatives (2003).

24 Subject to confirmation, these are the UK, the Netherlands, Finland and Luxembourg. Interestingly, the first two have been the most overtly critical of the quality of European Commission aid.

are no independent comparative evaluations of the effectiveness of different channels available to taxpayers.[25]

A corollary cause of the new bilateralism is that tied aid is alive and well, despite the hard-won DAC guidelines against it (mandatory so far only for the Least Developed countries). Procurement of antiretroviral drugs at domestic branded prices, as opposed to the trend towards cheaper generics, is an example of where the costs of such aid tying can be truly massive, as is the well-known case of technical assistance tied to national providers.

Proposed arrangements for pooling post-conflict reconstruction trust funds are throwing up similar underlying tensions. This was seen recently in the Iraq case, where non-coalition members were initially excluded from bidding for the largest, US-funded, component, but were nonetheless expected to make parallel, mostly untied, contributions of their own. This could turn out to be a one-off exception, of course, or could set the trend for further restrictions of this kind. The preferred purchasing channel could in future even pre-empt the multilateral/bilateral funding option, as multilateral management is unlikely to deliver the same commercial outcomes as bilateral management. EU aid, usually the champion of competition regulation at home, remains partly tied (in favour of its members and development partners as a group). It can make exceptions when co-operating in broader donor alliances but the Iraq experience may make it think again on that score.[26]

Extending this *Realpolitik* line even further, the increased recourse to aid as a deliberate trade tool is not implausible. If rapid trade reform, especially the dismantling of agricultural subsidies, is not on the cards, there is still the possibility of substantial volumes of aid being proposed as a 'sweetener' or transitioning device, offsetting some of the costs of adjustment in the South but also in the North. Trade policy itself could become more bilateral, of course, if multilateral trade negotiations stalled and bilateral free trade agreements (FTAs) became the order of the day. EU aid, for example, has a long history of being an adjunct to a regional FTA, rather than an end in itself. Sometimes this trade-to-aid perspective has indirect effects. For example, the stated goal of the EU's Mediterranean aid programme is to smooth the transition for the 12 partner countries to increased competition from the EU under an FTA. 'Industrial modernisation' therefore features high in the list of co-operation priorities, prioritising more vocational and technical, but not general, education. For several of the recipient countries, and in an MDG perspective, general education could address more urgent needs and prove to have greater spread effects.

c) Selectivity and balance

The paradigm of aid targeting based primarily on the measurable policy of recipients, and their institutional readiness to use aid for growth and poverty reduction, faces other political obstacles in real life. This is exemplified by EC aid, whose poor overall effectiveness score measured in terms of pro-poor allocations (Beynon, 2003) is largely explained by a low share of aid to India, plus a high share to moderately wealthy low-performers in the EU's 'near abroad' to the South and East. Massive aid redirection towards South Asia would therefore sharply increase both EC and global aid 'effectiveness'

25 There is no agreed published rating system cutting across the public aid spectrum that could form the basis for allocation decisions across agencies. Qualitative ratings or 'peer reviews' of DAC members are valuable in their own right and help push for good practice, but no decision-maker in the world has the realistic option of shifting funds between *bilateral* programmes, and multilateral ones are not covered by these reviews. Voluntary agencies are not compared by any independent assessment mechanism, and many do not publish internal impact evaluations either.

26 See Commissioner Patten's comments in the Guardian, 13 December 2003.

(and, arguably, equity, on a per capita basis).[27] But this does not easily square with notions of geographical 'balance'. Even IDA, for example, is required to spend at least half its resources on Africa, regardless of need (by statistical measures, there are more poor in India, let alone in South Asia, than in the whole of sub-Saharan Africa) or effectiveness. This is inconsistent, strictly speaking, with the institution's poverty-reduction mandate.

Some (Patten, 2003) advocate a balanced country allocation system, which could try to move 'anti-poverty' and 'foreign-policy' objectives into separate budgets for agencies facing such pressures, with distinct results indicators to match. The cost of shifting resources between the two categories could at least become more transparent. Similar considerations apply to the apparent good-cop, bad-cop relationship between MCA and USAID in the US. MCA will shift average, as against marginal, US effectiveness only slightly, and possibly not at all, unless USAID criteria are similarly realigned in a pro-poor direction.

More generally, when chronically weak countries show fresh signs of hope (restoration of democracy, for example), aid optimism tends to run ahead of reality. Similarly, it is easy to oversell the sustainability of early success in more stable countries, and it is from these recipients that aid must periodically be released to fund new priorities. Added to this mix are the entrenched distortions of aid flows resulting from historic and colonial/cultural ties. The resulting messy aid landscape produces donor-favourites and donor-orphans, with only transitory links to sustained development performance.

Some have suggested[28] that the multilaterals should deliberately perform the role of donor-of-last-resort, leaning against such imbalances. But this would mean abandoning their (imperfect) policy of performance-based allocations and instead acting as a semi-passive residual, despite supposedly being freer from political interference and better placed to enforce higher standards.

Finally, aid selectivity and aid absorption concerns can be mutually reinforcing. The idea of diminishing returns to aid at levels of ODA to GDP of 20, 30, or 40% could seem quite far-fetched if aid continues to be relatively widely distributed at far lower levels. However, these thresholds are much more likely to be passed if aid is increased considerably *and* only a few countries pass the qualifying criteria which are rigorously applied and generously rewarded, as is the intention of the Millennium Challenge Account (Section 6 below).

d) Aid terms: grants versus loans

A lasting legacy of the Jubilee 2000 debt campaign, taken up by the Meltzer Commission and the Bush Administration in the US,[29] is the call to convert all remaining concessional loan windows into grant terms. IDA, the soft-loan window of the World Bank and now the largest remaining creditor of heavily

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27 For a discussion on the main arguments and evidence generated by Burnside/Collier/Dollar regarding aid effectiveness and its implications for aid allocations, see Beynon (2003). This analysis also subjects the Collier/Dollar models to a wider range of sensitivity tests to assess the robustness of their results. In addition, it analyses the relative efficiency of aid allocations over time and between donors. For a survey of evidence in favour of widening aid selectivity criteria of Collier and Dollar to include , for example, specific criteria on conflict, structural vulnerability, and government expenditure, see McGillivray (2003)

28 Unpublished DFID working paper.

29 On November 1998, Congress established the International Financial Advisory Commission (IFIAC), an 11-member panel headed by Professor Allan Meltzer. The Meltzer Commission found that the IMF and WB were failing in their mission to address world poverty and economic stability – they needed major reform. The Commission recommended restricting the IMF to short-term crisis assistance and that the Bank and its regional equivalents move away from assisting middle-income countries altogether and operate on grant terms in low-income countries. The Meltzer Commission full report is at http://www.house.gov/jec/imf/meltzer.htm

indebted poor countries, found itself first in the firing line in 2001–2. The ensuing transatlantic debate was settled in the short term when about 20% of IDA became grant-based. In the discussion there were sharply different views on the merits of the World Bank, now with a substantially larger grant pool, encroaching even further upon traditional UN agency roles. Some saw the 'credit culture', which allegedly focuses borrower countries' attention more on results from loans than from grants, as having a major development benefit in its own right. Others, also as a result of the Jubilee debt cancellation campaign, completely disagreed.

A financial matter further complicated this debate, namely, the extent to which the increased recourse to grants should dissipate the IDA 'endowment' built up from repayments of loans. The more this happens, the more dependent this window becomes in the future on taxpayer financing, and, thus, more subject to political volatility and the vagaries of burden-sharing replenishments (as described in Section 2). The IMF, whose 'endowment' financing of its concessional window is now nearly self-sustaining, has been spared such close attention, although its continued role in low-income countries probably faces stronger opposition, internally and externally.

The broader issue is whether it would be possible for low-income countries to mobilise and absorb funding on a larger scale if financial terms of aid were made much more flexible and responsive to individual debt handling capacities. At present the rules give an all-or-nothing proposition, with most countries getting only one very specific set of soft-loan terms, among many possible alternatives, and a few also getting grants. In a modified scenario, countries that have no ability to absorb even the softest loans would get 100% grant allocations outright. A group in the middle would benefit from the kind of terms now on offer: a combination of roughly two parts grant and one part hard loan.[30] The more advanced group (referred to in Section 2) would get more loans than today, but would also pay a higher price for them, perhaps 3%. The groups could effectively cross-subsidise each other, leaving the burden on the taxpayer unchanged, or at least expanding more slowly than overall ODA from this source.

Section 6 The Emergence of Radically New Institutional Arrangements

a) The US Millennium Challenge Account (MCA)

On its unveiling shortly after Monterrey in 2002, the MCA was heralded as a completely new way of delivering aid. It was funded by the increment in US aid, pledged to rise by an annual US$5 billion by 2006. The MCA is a challenge funding mechanism, for which developing countries can become eligible only if they meet a battery of indicators of good governance and development readiness. These are taken mostly from published indices on good governance and benchmarks for national human development attainment and effort, from both US and international (mainly World Bank) sources. The requirements are stringent: [31] countries that meet all of them have access to large amounts of funding which they can apply flexibly and which have few additional requirements. The MCA executive would

30 Soft-loan windows such as IDA typically require only a token interest charge (less than 1%), and offer 10 years of grace and 30 years for repayment. Depending on the discount rates used, this is equivalent to giving away outright roughly two-thirds of the face value of the loan and lending the rest at market terms. Put another way, the true cost of such loans can be instantly offset by anyone willing to invest the one-third portion, i.e., the 'net present value'. Hence the appeal of increasing ODA through concessional loan windows: contributor money gets multiplied into much larger disbursements of soft loans.
31 Some have calculated that as few as three Sub-Saharan African countries have qualified under MCA in 2003. (See Radelet, 2003a)

be set up as a lean ‘corporation’ to assess eligibility and make awards, with no field presence and no role in preparing or supervising development programmes on the ground.[32]

As of the beginning of 2004, the MCA has yet to make its first country awards, largely because of delays in the Congressional authorisation and appropriations process. It is expected to begin operations later in 2004, initially on a smaller scale, with an appropriation of about US$1 billion. Its potential importance as an alternative business model should not be underestimated, despite the current practical start-up difficulties. It offers the possibility of cutting through the dilemma of conditionality (see Section 2) by accepting as eligible only a smaller sub-group of US partner countries that meet a transparent, non-negotiable set of standards. It would then give support to these chosen few, so long as they stay above the requisite thresholds.

Others could emulate this basic approach, starting with USAID, which makes up the remainder of US aid. Applying any single set of absolute performance thresholds across all such cases will be difficult but the establishment of a hybrid with transitional arrangements, moving slowly towards MCA-like rigour, is not beyond possibility.

The details of the indicators used for MCA eligibility, which are still a work in progress, deserve further scrutiny, and will doubtless improve in future years. Such concerns should not obscure the major MCA innovation of putting eligibility decisions firmly into the public domain and thereby severely limiting the scope for supply-side bureaucratic initiative. At the very least, this increases the pressure on other agencies to publish the basis of their own ratings. The ratings function and the emulation effects in non-recipient countries which are seeking to attain such standards could even turn out to be a more important long-term role for aid institutions than the transfer of funds itself.

Two other features of MCA should be highlighted. First, if the envelope allocated to the Account as a whole varies, independently of the actual stream of country cases, there may be an extreme outcome where a few small qualifiers temporarily share, like jackpot winners, resources out of all proportion to their absorption possibilities. The reverse is also true, but MCA would not be the first aid window to ration disbursements in response to unexpected funding cuts.

Secondly, MCA is set up to be a ‘lean’, corporate, foundation-like structure, with no representation in developing countries and no role in upstream programme formulation or downstream fiduciary management (the latter of which it is expected to subcontract to USAID, which might well make the sum total less ‘lean’ than intended). Interestingly, it shares this ostensibly hands-off, demand-led approach with both the Global Fund (GFATM) and, to some extent, the IFF, as discussed below. In the case of MCA and GFATM, this desire for leanness reflects not just the drive for efficiency, but also the value judgments of its founders that ‘conventional’ aid structures are totally unable to respect the knowledge and choices of recipients. This is a revolutionary, as opposed to evolutionary, intent, fudged for the time being by letting the two systems coexist side-by-side.

32 For a fuller discussion of the MCA mechanism, and in particular its implications for country absorptive capacity, see for example Clemens and Radelet (2003a) and Radelet (2003b).

b) The Global Fund to Fight AIDS, TB and Malaria (GFATM)

The creation of the thematic global funds, the largest of which is GFATM, was also a response to the perceived failures of ‘big aid’, including that of the World Bank and the WHO, to mobilise fast and far enough against exponentially expanding global threats (in this case the three major pandemics).

It was not insufficient implementation or project-formulation capacity that was responsible for the creation of GFATM. Instead, the emphasis was on matching committed groups, with implementable ideas, to adequate external resources that could be speedily mobilised. Proposals would come from diverse coalitions involving civil society, and people living with the diseases in particular, as well as governments and philanthropic interests. (These were coalitions mirrored on the Global Fund’s board, unlike conventional aid institutions.) Staff would not be able to second-guess proposals. Instead, independent panels of experts would subject them to rigorous peer-review scrutiny, in a similar approach to academic research-funding processes in many OECD countries. Once the experts had approved them, the Global Fund would administer grant awards lightly from a distance, relying on outsourced local monitoring agents, mostly accounting firms.

At heart, this approach is quite different from traditional donor health programmes under the PRS, paradigm and it has proven difficult to retrofit the former to the latter. Indeed, the Global Fund’s central guiding principle of *additionality* (the Global Fund must not displace existing programmes, but instead add new activities or coverage) is inherently inconsistent with that of *complementarity* with existing activities. However, by finding ways in which these activities, and the donors that stand behind them, are leaving significant untapped absorption possibilities, including civil society mechanisms, the Global Fund can make programmes go faster and further. Therefore, some of the tension between the Global Fund and in-country donors is down to a difference of perspective regarding what capacity means and how delivery systems can be improved, i.e., regarding innovation and its limits.

More broadly, there is some debate as to whether such new instruments are in fact mobilising additional funding, or just rearranging delivery of the same amount of ODA through multiple channels. The Global Fund is heavily dependent on pledges from OECD governments; private, especially pharmaceutical-industry, donations are very far behind. In turn, most public funds come from ODA budgets. However, some major contributions (including the initial US one) come from health budgets, which has set an important precedent. This may be a way to enable deployment of non-ODA money for other global public goods.

The Global Fund, a brand-new multilateral agency, disproves the idea that new institutions cannot be created quickly in response to urgent political signals. It also illustrates, as did Jubilee 2000, the shock effect on the aid system that agile lobbies of activists can have when they work, at least initially, directly with G7 presidents and treasuries, and less through their aid agencies. The kind of shortcut GFATM offers has great energising appeal for the general public and lobby groups, and hence for senior politicians. Encouraging the usual suspects in aid to greater efforts does not. This can, of course, lead to good or to bad results on the ground. The early signs from GFATM are hopeful, but there is no comprehensive evaluation yet available.

The Global Fund has already built a strong cumulative financial momentum, especially, but not only, from funding life-supporting medicines that simply cannot be withdrawn after just one or two funding cycles. Its commitment levels, subject to firm funding of course, will probably pass US$3 billion a year by about 2005. That puts it not so far behind IDA in terms of global aid institutions, and on course to overtake it before 2010 (always assuming IDA itself is not substantially increased in the meantime).

This is no small achievement for a two-year-old establishment. Over time, as funding pressures mount, the issue of how other aid agencies should adapt to the Fund, and vice versa, may come more and more to the forefront of debate.

c) the International Financing Facility proposal

The IFF idea is all about accelerating the availability of funding for development by securitising future aid expenditure through bond markets. In this way, the increased aid that Monterrey pledged for 2006 onwards (around US$16 billion per year), and perhaps other increases later, can be 'leveraged' into much faster increases in funds received by recipients in the years before 2015. This borrowing by the Facility is to be repaid with interest, of course, for a decade and a half afterwards. The Facility would have the backing of commitments by OECD governments. The Facility would not, however, tie these commitments to spending streams so closely that they would count against public sector borrowing limits.[33]

Most attention is on the financial engineering of the scheme; careful review is necessary of issues like the possible liquidity impact of a large new entrant into the international bond market. However, in development terms the core issue is elsewhere entirely. Do we believe that the returns from such additional aid expenditure are considerably higher than the IFF's cost of borrowing? Yes, absolutely. There is no doubt that underlying expenditures in the MDG process can generate much higher returns, otherwise the whole development endeavour would be absurd. Of course, this result depends heavily on the aid system's ability to deliver a huge increase in spending, to perhaps as much as double in two to three years (see Section 3) without a sharp fall in the return on this anti-poverty investment. The IFF itself, by design, is neutral as to the ultimate uses of aid at country level. It thus has no way of guaranteeing this outcome. The debate on the IFF is therefore inseparable from that on public confidence in the aid system in general, and in bulk aid, in particular general budget support, specifically.

Another frequently voiced question asks why regular ODA increases (which still lag far behind the 0.7% goal – even for the UK) cannot finance this. One opinion is that the IFF's sleight-of-hand lets the laggards off too lightly, forcing more generous countries to repay a disproportionate share of the costs. Gauging the likely incentive effect of the IFF on the behaviour of donors (those who choose to pledge additional commitments to it and those who do not) is not straightforward. For some bilaterals, for example Italy, there is a case for 'locking in' Monterrey increases. Otherwise these bilaterals may not be confident that they can spend the money directly through their own channels; far from crowding out aid increases, this might crowd them in. However, the IFF could also be used to re-interpret the 0.7% target more loosely. This could lead to perverse effects on the mobilisation of more underlying ODA.[34]

The last and greatest potential effect of the IFF – which is still some way from implementation – would be on the governance of the aid system itself. This is still the least talked about aspect in the public debate on the Facility. Once the IFF existed it would instantly become a huge 'synthetic donor',

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33 Raising the financial backing for concessional loan window through gifts and, if necessary, through borrowings could conceivably achieve similar effects to the International Financing Facility in terms of accelerating aid availability, but without creating new institutions. Much debate may be expected on this subject in the coming weeks. The Development Committee in April 2004 will consider a report by the World Bank and the IMF on the issue. See also d) on grants versus loan terms in Section 4.

34 A technical clarification here: ODA is measured at the point of origin, not destination. So disbursements by donors to fulfil commitments to the IFF would count as ODA, but not the outflows by the facility in favour of aid programmes, which will be much larger than donor commitments in the early years of the scheme. (See German and Randel, 2003)

potentially the largest single source of development finance in the world. The whole point of the IFF, in public finance accounting terms, is that it breaks the absolute link between government budgets which pledge commitment streams to the Facility (which it then uses to back its bonds), and the use of the proceeds of sale from these bonds. In breaking that link, it has to come up with alternative rules for spending the money it raises, other than simply giving it back to each sponsor proportionately to their pledge. In particular, it must decide which aid channels it will support and why. There are a number of formulas it could use to do this. Most likely, it would need to rely on some transparent independent assessment on standardised criteria, including for example, whether the policy framework of any candidate agency has a clear poverty focus, or a good fiduciary system.

The next choice for the IFF is how to divide up funds among eligible agencies. The implausible extremes here are: (i) a free-for-all, with bilaterals from several countries along with other agencies, all competing hard against each other, even for the amounts they themselves generated originally; (ii) a rigid division in proportion to the underlying commitment streams, i.e., no competition at all – which would presumably be impossible in public finance terms. Intermediate solutions are possible, indeed more likely. For example, some sponsors could seek veto rights on awards to institutions that are ineligible under their national regulations, but otherwise defer to the Facility's governance process.

Even a modest element of 'steered' competition, existing under the most sensible and bland standards, will inevitably rearrange the overall pattern of aid allocation, both by type of delivery channel and by country. Recipient countries obviously have a big stake in these outcomes, as has civil society. This is why it is surprising that neither group has yet taken a clear stand on the Facility and its future governance. Thus far the latter appears to be mainly reserved for representatives/nominees of donor governments. Doubtless this will change as and when the IFF, or some variant, gets wider endorsement.

The IFF, like the MCA and the Global Fund, is another idea with a potentially powerful systemic impact, but which is also dependent on considerable adjustment of behaviour in the aid system that pre-existed it.

Section 7 Towards Simplified Scenarios for the Future of Aid

At this point, we can only sketch out a few of the many sets of possibilities for the evolution of the aid system to 2010 and beyond. We hope to be able to build some full scenarios in the next months.

If we broadly accept what this paper sees as some of the forces shaping the system, there are, arguably, two general axes along which it could evolve, each with its extreme. On one axis, there is a more fragmented, foreign-policy-driven focus, versus a greater deliberate poverty focus. The second axis scales an aid system more subject to competition, versus less subject to competition. It should be kept in mind that the following is, at present, no more than a caricature, and in no way presents preferred or most-likely outcomes.

Fragmented versus poverty-focused: At the poverty-focused end we see the UN-MDG-Monterrey model dominating. Aid volume is up, and by a great amount, as is the share going to aid which is allocated for poverty-reduction purposes. Not only is more and more aid directed according to country-based, poverty-focused performance-based principles, but also the UN plays the decisive co-ordinating role. Its legitimacy has been re-established, including vis-à-vis the Bretton Woods agencies, which

have lost ground to the UN in both public opinion and member support and funding, and have come to accept a measure of control by UN supervisory bodies. Small bilaterals increasingly depend on multilaterals, including the IFIs, the UN and the EC, and several bilateral programmes effectively close down.

The opposite extreme of this axis, conversely, sees less and less serious effort to make allocation trade-offs in anti-poverty terms, and a resurgence and dominance of multiple, unweighted foreign-policy objectives for aid agencies, especially in weak states, perhaps taking on some of the institutional forms of the Cold War. Aid volume may be up a little but its allocation is less and less poverty-efficient. The MDGs are at best token rhetoric, and may have faded away altogether. Tied aid and single-purpose agencies are stronger. The Bretton Woods institutions, to cope with these conflicting demands, make increasing alliances with big bilaterals and ignore the UN. New partnerships for global public goods are promoted with vigour, but without overall leadership or consistency. ODA budgets are increasingly used for wider peacekeeping operations. Every one of the (by then) EU-30, including Turkey, maintains its own aid programme and demands that the EU, as a collective, stays out of national development policy.

Competitive versus 'collusive': the competitive outcome in this second axis sees the opening up of the traditional project-finance market to multiple voluntary and private intermediaries, and the shrinkage of medium and small official agencies. Several such agencies concentrate on benchmarking and packaging programmes for others to fund and/or execute. Thematic funds, which are booming, also stimulate this development. Among those able to deliver bulk support, an IFF-like funding system provides challenge funding on a huge scale, which few agencies, and especially few UN agencies, are initially able to exploit. Small bilaterals close, or find niche alliances. USAID shrinks as the MCA succeeds, but eventually adopts MCA-like guidelines.

The collusive/cartelised end of this axis sees centralised government-to-government negotiations driving the actions of multilaterals in a synchronised way, and a solid cartel of aid donors pooling solutions to present to aid recipients. These groups also effectively limit the country access of outsiders, including in thematic funds, and restrain entrepreneurial ventures by the IFIs and the UN into new areas, like global public goods. Harmonisation is the watchword, and multilateral aid deliberately compensates for absent bilaterals, under close instructions from them.

Obviously, elements of each continuum can be combined, producing any one of four mini-scenarios:

1. competition up, with a greater poverty focus ('pluralist');
2. competition muted, but with a greater poverty focus ('statist');
3. competition up, with a bilateralised foreign-policy focus ('fragmented');
4. competition muted, with a bilateralised foreign-policy focus (*Realpolitik*).

Armed with some basic analysis from earlier sections on how different institutions in the system might respond to different types of pressures and events, readers are invited to place themselves and their concern – possibly either their institution or country – into each of these very stylised worlds, and try them for size. (Annex 1 provides more contextual information on the issues facing different categories of multilateral institutions.)

We hope to return to some of these outcomes, and others, more systematically in the next phase of this work.

Appendix Changing Roles of the Major Multilateral Institutions

a) International Financial Institutions

These institutions, beginning with the IMF and the World Bank, face two strategic quandaries over our 2005-2010 period, namely, (i) the robustness of their funding base; and (ii) how far their ownership and governance structure needs to evolve to retain international legitimacy and political support.

The funding-base issue for the IMF does not really relate to its operations in low-income countries (these are assured, as discussed in Section 2). Rather, it deals with the Fund's role as lender of last resort in much larger and more market-sensitive middle-income crisis situations, a full discussion of which is beyond the scope of this paper.[35]

The streamlining in recent years of respective roles of the IMF and the World Bank in low-income countries has meant that they are no longer nearly as contentious as they were before the PRS era, as discussed. Practical implementation problems remain, for example, concerning the capacity of the World Bank to undertake enough social impact assessments in the timescale required by its sister institution. A greater systemic threat could perhaps arise from the possible disengagement over time of IMF staff from low-income countries, so as to concentrate on its larger surveillance mandate (IMF, 2003). This, though, is this is not seen by many as an immediate risk.

The core funding issue for the World Bank and, to a lesser extent, its sister regional development banks, is the risk of continued erosion of middle-income clientele, as described above. If net flows of funding to middle-income developing countries should remain negative for several years[36] (i.e., the institution presides over major South-North capital flows and not the reverse), solidarity among the membership could come under serious strain. This would also reduce the ability to cross-subsidise the non-concessional window, IDA, and make it more dependent on rich-country budget transfers.

The second threat for the IFIs, and in particular the Bretton Woods twins, is growing criticism from the general public and their larger borrowing constituents, about their skewed voting structure and weak democratic credentials.[37] Their defenders counter that decisions are usually made by consensus, after debates where powerful borrower voices are increasingly in evidence. In this argument, even weaker countries are able to defend their interests effectively, providing they have the human capacity to do so (which they lack more than formal voting share). Critics retort, however, that even the much diluted board-level representation of low-income countries overstates their real voice, because it is donor representatives who generate policy for concessional windows in closed replenishment sessions, and who present it for ratification by the full boards of the institutions at the last moment.

It is difficult to predict whether the clamour for the reform of IFI governance structures will prompt credible action by their current majority owners or if, instead, the fundamentals of control will remain unchanged, eroding public support for these institutions. This would validate the popular belief that they are effectively a tool of US-driven foreign policy.

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35 Without considerable change in the institutional arrangements on sovereign bankruptcy, the moral hazard and credibility problems of intervening with finite resources in order to lean against huge and highly mobile private flows are daunting. This has long been recognised inside and outside the institution but this awareness does not guarantee that effective remedies will be put in place soon.
36 As they were in 2002 for the World Bank (IBRD window) for the first time in thirty years, see Global Development Finance (2003).
37 For a detailed discussion of IFI voting structures and representation see Buira (2003).

The heads of both the IMF and the World Bank come to the end of their current mandates in early 2005; decisions on their successors will have to be made months before that. The inclusiveness (or otherwise) of the next round of leadership appointments will do a lot to allow or refute this negative branding. From our perspective, this rather parochial window of governance activity matters a great deal in terms of what it signals. A shift towards 'bilateralisation' or polarisation of the IFIs, whether by design or default, would greatly affect the whole aid system, especially if erosion of donor support for the UN system also continued (see below).

The regional banks play an ambiguous role in the aid system today. Some of them follow the overarching goals, operating principles, and practices of the World Bank to such an extent that their systemic value-added is debateable.[38] Financially, they are more than the World Bank's equal (as a group) in terms of total and, especially, net transfers, and are still growing. Despite being close to their regional membership and its concerns, which is reflected also in the formal voting structures, this closeness is somewhat reduced in practice by the dominant role in replenishment discussions of non-regional contributors. Ironically, though with some exceptions, they also have a lower field presence than the World Bank, especially in their smaller member countries – which arguably need them most. They could also develop more aggressively than hitherto a specialised role in support of cross-border activities in their regions, such as infrastructure.

Some less visible financial institutions have chosen to avoid the limelight of policy debate, focusing only on financing investment transactions. An example of these is the European Investment Bank, in financial terms the world's largest public development bank: its operations outside the EU have grown massively and now cover several developing regions. These large, mostly public, investments can be perfectly sound on their own merits, yet might have low overall development impact, precisely because they are not set in a clear policy context. Country allocations are likewise ostensibly the aggregate result of a project pipeline and of exposure considerations, rather than an explicit assessment of development-policy performance. Conversely, they 'give the client what they want' in the sense that they do not attempt to second-guess broad expenditure priorities, as do some of the agencies working in the PRS context. The external side of the EIB is still not a 'multilateral development bank' in terms of its legal form or overriding objectives, but it has several attributes of an MDB and may grow into one more explicitly over time.

b) the UN aid sub-system

UN reform is a vast topic in its own right. This paper looks primarily at a smaller cluster of institutional issues around the 'UN Development Group' of agencies (listed at Annex 2) and their 'fit' with the IFIs. Among the many other strands of the global-governance discussion, there is the recurring proposition that the IFIs need to be brought under the UN umbrella of political legitimacy, for example by becoming more accountable to the UN Economic and Social Council (ECOSOC). So far, the recent introduction of annual discussions among ECOSOC and the Boards of the World Bank and IMF are the most tangible step in this direction. It is hard to imagine that countries that already resist dilution of their direct control of the IFIs would allow this process to go very far down the road to full external governance, i.e., indirect dilution of control.

[38] This is most true for the African Development Bank and least true for the EBRD, with its unique mandate, and arguably the InterAmerican Development Bank.

In the narrower context of the multilateral aid architecture, the most uncertain division of labour is probably that between the UN Development Programme (UNDP) and the World Bank. Though long in conflict, there is now a tacit agreement that the two institutions should set aside tensions born of different cultures, advocacy positions and staff incentives, and work together pragmatically in the field. In a few years' time this may be seen as an 'ask no questions, tell no lies' solution which nobody wishes to challenge, but which nobody fully trusts either. By 2010, and after two or more further changes in the leadership (and funding replenishments) of the institutions, it is possible that this issue of closer organic ties between the two institutions, even the pros and cons of an outright merger, will resurface in earnest, despite vested interests against it.

Further away from New York and Washington, the role and value-added of some specialised UN agencies could come up against further challenges in the next five or six years, which their funding structures may not be well placed to continue to resist. These agencies include UNIDO (United Nations Industrial Development Organisation), UNCTAD (UN Conference on Trade and Development) and perhaps UNESCO (Education Science and Culture), and FAO (Food and Agriculture Organization). The WHO's development role, partly overtaken by global funds now, could face increased pressure, though it also has a broader global mandate, e.g. the surveillance of new epidemics.

On the positive side of this argument, the world clearly needs diversity in the kind of development advocacy institutions and centres of intellectual debate (in particular, so far, UNDP and UNICEF) that can challenge the ideological orthodoxies of big countries and the big institutions they are seen to control, such as the IMF and the World Bank. It also needs places to pool expertise in specialised domains, such as education, and where up-to-date knowledge can be harnessed and deployed effectively for the benefit of weaker countries that lack such capacities.

Quota-type arrangements for contracting within the UN system still give the specialised agencies a certain amount of shelter. This shelter, though, is a double-edged sword: the agencies have probably not had reason to develop marketable skills to the same degree as other players. At the same time, other development agencies, with the benefit of 'endowments' from their other activities, have been able to cross-subsidise knowledge products of their own and enter increasingly into territory previously claimed by the specialised agencies. For example, the World Bank has taken on more of an explicit policy leadership role for education development globally, partly to fill a vacuum left in the same area by UNESCO. Even some bilaterals, in particular the UK's DFID, have invested heavily in policy research and dissemination capacities with a global reach.

c) the European Union and European Commission

The last and probably most problematic area of role overlap is that between the European Commission (EC), entrusted with a huge aid budget for the EU as well as management of the European Development Fund, and the development programmes of its own member states.[39] This in turn raises the issue of the value-added of the EU's multilateral aid activities as compared to global institutions, be they IFIs or UN agencies.

The conventional response to both issues is that the EU/EC has the unique ability to deploy a number of policies other than aid: trade, in particular, but also foreign and security policy instruments. It can thus leverage its aid efforts in a 'coherent' way that multiplies their impact. None of its members acting

39 For a full discussion on the dilemmas facing EU development aid, see Maxwell and Engel (2003).

alone can do this. Indeed, trade, along with agriculture and other matters, is an area of constitutional EU competence; only the Commission can negotiate with authority for the membership in this domain. Finally, the EU has concluded landmark partnership agreements with groups of low-income countries that place the aid relationship within a much larger framework of mutual obligation, thus is in the vanguard on development issues.

This general response begs at least two further questions. The first is empirical. Does the EU actually deploy its non-aid policy instruments, especially trade, in such a way that they are more likely to support than to undermine its aid goals, from a poverty-reduction perspective? In other words, does it behave coherently, on the whole? This matter has not yet, to our knowledge, been put to a rigorous test. It could conceivably be argued, for example, that EU aid programmes are more responsive to EU trade goals than vice versa.

The second question is more institutional. Supposing the value-added of a common development programme is clear, why are EU members now running 15 parallel aid programmes alongside it, and soon will run many more? Is there not a strong case for pouring at least many of the smaller programmes into the bigger multilateral pot, not least for the sake of coherence and lower transaction costs? Obviously, this will depend on the specific strengths of each programme relative to the Commission, but there will be some which are unlikely ever to be large enough to benefit from returns to scale, for example of the EC's near-universal network of delegations. Here some of the sheltering and imperfections of bilateral programmes described above, including the narrowly commercial interest, are in evidence, and there is no obvious sign of a coming together – or a trade-off of one type of expenditure for another.

Within the overall EU budget, several other effects are in play. First, a cap on overall EU spending (at present 1.24% of EU GNI) makes it mechanically difficult to integrate new spending heads, even if these are just internal transfers between the members and the central funds which leaves the sum of the two unchanged. Secondly, burden-sharing arrangements (the UK budget rebate, for example) and colonial histories stand in the way. What may seem right from a poverty-reduction point of view may seem inequitable given other distributional factors that have to be balanced. And thirdly, the inside-out way the EU looks at the world makes it very unlikely that any major savings from internal policies will be redeployed transparently into its aid budget. Were this not the case, a concerted effort to earmark for development aid any reduction in the EU's agricultural subsidies, for example, could create generate additional benefits for which a broad development coalition, along with environmental and consumer advocates, could lobby.

At present, there are some voices in favour of renationalising the EU's aid to its members. Others are arguing, conversely, for denationalising its bilateral aid budgets, and recentralising them in the EU. This standoff is not likely to change very soon and neither outcome looks probable. Enlargement (aid in the new member states being a tiny fraction of that in the existing ones) will certainly increase noise levels and transaction costs, but may not add much clarity, at least in a poverty-reduction sense.

Appendix 2 Official Development Aid System

Bilateral Agencies [a]

Australia*
Austria*
Belgium*
Canada*
Czech Republic Development Co-operation
Denmark*
Estonia Development Co-operation
Finland*
France*
Germany*
Greece*
Hungarian (MFA) International Development Co-operation Department[b]
International Development Co-operation of Slovenia
Ireland*
Italy*
Japan*[c]
Kuwait Fund for Arab Economic Development (KFAED)
Luxembourg*
Netherlands*
New Zealand*
Norway*
Polish Ministry of Foreign Affairs Development Co-operation
Portugal*
Saudi Fund for Development (SFD)
Slovak (MFA) Official Development Assistance
Spain*
Sweden*
Switzerland*
United Kingdom*
US Agency for International Development (USAID)
  Millennium Challenge Corporation
  Office of the US Global AIDS Coordinator

International Financial Institutions and European Programmes

African Development Bank (AfDB)
Andean Development Corporation (CAF)
Arab Authority for Agricultural Investment and Development (AAAID)
Arab Bank for Economic Development in Africa (BADEA)
Arab Fund for Economic and Social Development (AFESD)
Arab Gulf Programme for United Nations Development Organization (AGFUND)
Arab Monetary Fund (AMF)

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a *=DAC member. For simplicity's sake only DAC countries have been listed. For an exhaustive list of DAC member bilateral aid agencies see http://www1.oecd.org/dac/pdf/CRSann3.pdf

b Hungarian Development Co-operation began programme implementation in January 2003

c JBIC was established on 1 October 1999 by the merger of the Export-Import Bank of Japan (JEXIM) and Overseas Economic Co-operation Fund (OECF).

Arab Trade Financing Program (ATFP)
Asian Development Bank (AsDB)
Bank for International Settlements (BIS)
Caribbean Development Bank (CBD)
Central American Bank for Economic Integration (CABEI)
Commonwealth Fund for Technical Cooperation
East African Development Bank (EADB)
European Bank for Reconstruction and Development (EBRD)
European Commission (EC)
European Development Fund (EDF)
European Investment Bank (EIB)
Inter-American Development Bank (IADB)
International Bank for Reconstruction and Development (IBRD)
International Development Association (IDA)
International Finance Corporation (IFC)
International Fund for Agricultural Development (IFAD)[d]
Islamic Development Bank (IDB)
Islamic Research and Training Institute (IRTI)
Multilateral Investment Guarantee Agency (MIGA)
North American Development Bank (NADB)
The Global Fund to Fight Aids, TB and Malaria
The Gulf Investment Corporation (GIC)
The International Monetary Fund (IMF)
The Nordic Development Fund (NDF)
The Nordic Investment Bank (NIB)
The OPEC Fund for International Development (OPEC Fund)
West African Development Bank (BOAD)

UN/Multilateral Development Institutions
Food and Agriculture Organization of the United Nations (FAO)
International Labour Organization (ILO)
Joint United Nations Programme on HIV/AIDS (UNAIDS)
United Nations Capital Development Fund (UNCDF)
United Nations Children's Fund (UNICEF)
United Nations Conference on Trade and Development (UNCTAD)
United Nations Development Fund for Women (UNIFEM),
United Nations Development Programme (UNDP)
United Nations Environment Programme (UNEP)
United Nations Educational, Scientific and Cultural Organization (UNESCO)
United Nations High Commissioner for Refugees (UNHCR)
United Nations Human Settlements Programme (UN Habitat)
United Nations Industrial Development Organization (UNIDO)
United Nations Office for Project Service (UNOPS)
United Nations Population Fund (UNFPA)
World Health Organization (WHO)
World Trade Organization (WTO)
World Food Programme (WFP)

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d IFAD and World Bank are also members of the UN Development Group.

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