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Report of the Luxembourg High-level Symposium

"Working together to increase the development impact of aid"

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I. Introduction

1. The 2005 World Summit mandated the United Nations Economic and Social Council (ECOSOC) to convene a biennial high-level Development Cooperation Forum (DCF) to "review trends and progress in international development cooperation, including strategies, policies and financing; promote greater coherence among the development activities of different development partners and strengthen the normative and operational link in the work of the United Nations". [1]

2. The forum aims to promote and improve international development cooperation to attain the Internationally Agreed Development Goals (IADGs), including the Millennium Development Goals (MDGs). It provides a platform to enhance dialogue among all stakeholders to find effective ways to support this process. [2]

3. The next DCF will be held on 5 and 6 July 2012 in New York. To facilitate dialogue among development cooperation actors and UN members States, the UN Department of Economic and Social Affairs have supported the organization of high-level symposia in 2011 and 2012. The Luxembourg Symposium was the second of three preparatory events for the 2012 DCF. The first Symposium was held in Mali in May 2011 on how aid can achieve development results in the long run. The third Symposium will be held in Brisbane, Australia on 14 and 15 May 2012 on the nexus of development cooperation and sustainable development.

II. Objectives of the Luxembourg High-level Symposium

4. The Symposium was held against the backdrop of the continuing economic and financial crisis. It was a time when concerns about the risk of a double dip recession in developed countries were high, and when there was a perceived need for more effective action in major economies to put the world on a path to economic recovery. It was also a time when expectations about future trends in official development assistance were grim.

5. The Symposium aimed to better understand how best to maximize the impact of aid. It focused on how to use aid to leverage other sources of development finance that are most conducive to poverty eradication and the realization of the internationally agreed development goals. The various sessions and breakout groups enabled participants to exchange lessons learned. This led to lively discussions on how to use aid to broaden access to inclusive financial services, promote domestic revenue mobilization and attract foreign direct investment.

6. The Symposium also debated experiences of developing countries in promoting more coherent management and use of both aid and other development finance notably domestic and foreign resources. It also reflected on how to include all relevant actors in national and sectoral reviews of aid policies and commitments – with a view to enhancing the impact of aid.

7. A common theme running through the discussion was the need to maintain the volume of aid at a level commensurate with challenges faced by developing countries and consistent with promises made.

[1] More information on the 2008 DCF and its preparations are available online: http://www.un.org/ecosoc/newfunct/2008dcf.shtml and http://www.un.org/ecosoc/newfunct/preparations.shtml

[2] The Doha Outcome document recognized the important contribution of the DCF in efforts to improve the quality of ODA and to increase its development impact. It also mandated the Forum to review more systematic and universal ways to follow quantity, quality and effectiveness of aid, giving due regard to existing mechanisms (A/Conf.212/L.1/REV1*).

8. The Symposium was attended by approximately 150 participants representing the wide spectrum of development actors, from Governments to parliamentarians and from non governmental organizations to the private sector, and local authorities. The discussions were frank and lively. They were held under Chatham House Rules. Key messages from the discussions are highlighted below.

9. The recommendations of the Luxembourg Symposium will serve as a basis for discussions at the 2012 DCF. The discussions on the catalytic role of aid also contributed to the preparations for the Fourth High-level Forum on Aid Effectiveness (HLF-4), in Busan, Republic of Korea in November/December 2011.

III. Key messages from the Symposium

The following key messages emanated from the Symposium:

(a) Aid may be used to mobilize other development finance conducive to development:

- The discussion of how to maximise the development impact of aid should not take place in a vacuum. There is a need to more aggressively take into consideration the political economy dimension.
- Whenever public money is used to leverage private funding, it is critical to ensure that it leads to concrete and measurable development outcomes.
- If a project appears sustainable in the long term, guarantees, soft loans and equities should be used to finance those projects rather than precious and scarce aid money. At the same time, the current debt sustainability frameworks should be reviewed so that countries are not pushed into debt distress.
- Some felt that Multilateral Development Banks should put a greater emphasis on domestic resource mobilization rather than focussing on Foreign Direct Investments.
- Better harnessing the potential of innovative sources of finance is one way to afford developing countries the necessary policy space to conduct countercyclical policies.

(b) Many lessons have been learned on how to support inclusive financial sectors:

- Financial inclusion should not be seen as an end in itself, but as one element among many others that may contribute to the achievement of MDGs.
- Inadequate access to microfinance has implications for the real economy. It leads to a sub-optimal amount of investment and job creation.
- At the national level, public policy interventions on the supply side and on the demand side, as well as measures targeted at the financial sector as a whole, are necessary to ensure access, usage and impact, three key elements of financial inclusion.
- Important measures are called for to address market failures; and there is a need to further develop supporting structures for the financial sector, as well as capacity building frameworks for financial service providers.
- Public funds can leverage large amounts of private (capital market) funds for the support of inclusive financial sectors; and public and private interests can be successfully brought together in innovative partnerships.

- At the global level, key principles have been established for building inclusive financial sectors.
- The 2006 "Blue Book on Building Inclusive Financial Sectors for Development" paved the ground for many present and future global initiatives.
- The evidence about the development impact of microfinance supported by aid is currently mixed. There is a need for more analysis to demonstrate that financial services are really supporting MDG achievement.

(c) Domestic resource mobilization is at the centre of resilience

- Domestic revenue mobilization should be an integral part of discussions on effective development cooperation at global level.
- Tax reform is a main source of domestic finance and a powerful tool to reduce aid dependency. It needs to be visibly supported and developed by senior government officials.
- More long-term external support is needed for strengthening national tax systems to raise nominal tax revenues. Such support should be demand-driven, aligned to national priorities and well coordinated with all relevant actors. It should go hand in hand with broad-based political dialogue on tax issues and the functioning of tax systems.
- To demonstrate the positive impact of paying taxes, government services for the most vulnerable populations must improve. It is vital that revenues mobilized through taxation clearly contribute to the achievement of international and national development goals.
- National governments should also put the spotlight on tax evasion.
- There is great scope for increasing coherence between policies related to Foreign Direct Investment and those related to domestic resource mobilization. Governments need to strike a balance between taxing large taxpayers and multinational corporations and other segments of tax-paying populations.

(d) Using aid to catalyze Foreign Direct Investment entails both opportunities and risks:

- Private investment is critical to expand the revenue base of developing countries and promote their financial independence. Developing countries, however, face considerable challenges in attracting sufficient private flows and ensuring that they contribute to national development objectives such as job creation, sustainable growth and poverty eradication;
- Mobilizing private investment/Foreign Direct Investment (FDI) to promote development entails opportunities but also risks.
- A range of lessons have been learned in the last 30 years on how best to use aid to attract private investment, including Foreign Direct Investment, that contributes to poverty reduction and inclusive growth.
- Aid should be used to mitigate the risks/costs for private investors and to improve the overall investment climate to attract all kinds of investment. It should however not turn into a form of subsidy for FDI at the expense of the host country nor in another form of tied aid.
- At the same time, strategies to use aid to attract FDI need to link private investment incentives on the one hand and the national economy and national development goals of developing countries, on the other.

- The use of aid as catalyst for FDI should be accompanied by a proper regulatory framework and regular country level reviews of the impact of FDI on the host country's economy as compared to more broad-based forms of investment.
- Domestic private investment is more effective and sustainable than Foreign Direct Investment in promoting national development

(e) Capacity building is needed to promote more coherent management and use of financing at country level:

- Managing various financial flows to maximize their development impact involves understanding the diverse incentives, modalities, and timeframes governing such flows.
- Priority should be given to improving the capacity and public finance systems of recipient countries in managing various financial flows.
- National development strategies, including partnership policies and frameworks, are important tools to ensure coherent management of all kind of financial flows. They should ensure that all actors work together and use national systems. An exit strategy is also essential. Stakeholders must work together to ensure that these strategies and policies achieve results
- Both donors and recipients should "do their job well". Donors should accelerate division of labour and prioritize budget support. Recipients should align their policies with development objectives.

(f) Mutual accountability is increasingly seen as critical to maximizing aid results

- Mutual accountability between programme countries and their development providers is gaining traction in the political debate on the results and impact of aid. It should become an integral part of results-oriented development planning at country level. Yet, progress in developing effective mutual accountability mechanisms remains disappointingly low.
- Aid policies and performance assessment frameworks can be a major incentive for progress in honouring commitments. This is particularly true if they include individual targets for providers and programme countries and build on national development strategies.
- High-level inclusive multi-stakeholder platforms and accessible databases on aid are equally critical.
- An injection of resources is needed to scale up information systems, monitoring and evaluation capacity, and country leadership with regard to analysis, consultation and negotiation.
- At the same time, accountability and reporting structures need to be simplified for programme countries. The number of indicators against which recipients are being assessed needs to be reduced.
- "Beyond aid" issues affecting development should also be better addressed in mutual accountability mechanisms.
- Peer learning at country and regional levels will be critical in the coming years. So far, structured South-South exchanges of lessons learned among developing countries have been effective in improving mutual accountability processes.
- At global level, the DCF should further strengthen its position as the global apex body for mutual accountability. Dialogue structures need to be truly inclusive.

IV. Detailed summary of panel discussions at the Symposium

a) Aid may be used to mobilize other financial flows conducive to development:

This panel discussed how to (a) effectively use aid to leverage other sources of development finance; and how to (b) ensure continued focus of development cooperation on poverty reduction and MDG achievement. Initial presentations were made by Zambia, the United States, and EURODAD.

Background

Closing the "MDG financing gap" is essential to achieve the MDGs by 2015. So is maximizing the development impact of aid. One factor limiting the development impact of aid is that, at the moment, aid is not sufficiently allocated based on needs and structural vulnerabilities. Nonetheless, given its focus on the MDGs and the social sector, aid has been targeted at the poorest, which is not always the case of other sources of development finance.

While there has been a sharp increase in the absolute quantity of aid, aid dependency – namely the proportion of government spending that comes from aid – has fallen considerably in the poorest countries. Reduced aid dependency can help countries increase their fiscal and policy space and empowers them to design their own country-owned and country led development strategy by shielding them from the volatility of aid flows. Where used effectively, aid itself has played an important role in reducing aid dependency. It has helped to mobilize additional resources by encouraging higher taxation, savings and investment, including by the poorest, and helped to accelerate growth.

In many developing countries, aid is also now dwarfed by other financial resources such as remittances, foreign investment, bank loans or bonds and from domestic sources such as tax revenue and domestic savings investment and loans. Innovative sources of finance are also playing an increasingly important role. Foreign capital can make an important contribution to development. Where Foreign Direct Investment (FDI) forges linkages with the wider local economy, a positive impact on development and MDG achievement can be observed. South-South foreign direct investment can be particularly effective in forging such linkages.

Key challenges and success factors

The question of how to maximise the development impact of aid should not be discussed in a vacuum. There is a need to more actively take into consideration the political economy dimension. It is important to acknowledge the potential conflict between a developing country focus on country ownership and a donor country focus on development results assessed against global targets.

The focus should be on country ownership, as established in the High Level Forums (Paris, Accra and Busan) on aid effectiveness. This implies supporting countries in realizing their chosen development path. To secure continued funding, donors frequently pursue highly targeted aid programmes with clearly defined global goals and targets. These tend to lack country ownership and may be poorly integrated into countries' national strategies.

Aid predictions for the coming years are sobering. Despite the fact that development aid reached an all time high in 2010, only a handful of countries have met or even exceeded the 0.7 percent UN ODA target. In addition, there is an increasing bilateralisation of aid.

There is an urgent need to address the issue of aid orphans. The proposal of the European Commission to give priority to countries with the greatest needs and vulnerabilities is welcome. It was pointed out that, to make real headway, a political economy analysis would be needed.

Development assistance often comes with policy advice attached. Conditionalities remain prevalent, in particular in the area of technical assistance. Regulations and standards should be adopted for ensuring a minimum standard for public private partnerships.

Current funding modalities should not push countries into debt distress. There is a trend to use blended funding and leverage aid in order to stretch out ever scarcer aid monies. To ensure that countries are not being pushed into debt distress, there was a call to review the current World Bank/ IMF debt sustainability framework to ensure that countries servicing their debt will, at the same time, be able to make the necessary investment to achieve the MDGs.

Private investment needs to be sustainable over time. On the increased use of public money to leverage private funds, it was pointed out that blending aid and loans might be suitable for private sector lending. If long term sustainability of a project appears ensured, guarantees, soft loans and equities rather than precious aid should be used to finance it.

A more rigorous assessment of the development impact of mobilizing private investment is needed. A World Bank report which assessed all projects of the International Finance Corporation, found that more than half could not prove that they are delivering development outcomes. There is a need for developing tools to ensure that the development impact is not only higher but also clearly measurable.

Developing countries should be supported in their efforts to strengthen their capacity to negotiate fair investment contracts. Developed countries should adopt investment rules which promote responsible investment.

Multilateral Development Banks should put a greater emphasis on domestic resource mobilization rather than focussing on Foreign Direct Investment. Recent experience has shown the risks associated with unregulated financial markets. There was a call for a greater allocation of funds to support domestic investment, which today is an orphan in the portfolio of several development banks.

The importance of promoting effective tax system as a key element in domestic revenue generation was highlighted. There is an urgent need to curb the USD 1.3 trillion illicit capital outflows from developing countries each year. The provisions of the OECD convention against foreign public officials and the UN convention against corruption should be effectively enforced..

Countries need to be aware of all of the funds available to them for development - both on budget and off budget. This would help to ensure that development is country-owned and country-led. It is also important to include parliaments and donors in aid management strategies. Rwanda was cited as a successful example.

Better harnessing the potential of innovative sources of finance is one way to afford countries the necessary policy space to conduct countercyclical policies. In its new communication, the European Commission proposed to allocate a higher share of aid to innovative mechanisms of financing with significant revenue generation potential, including through blending and other risk sharing mechanisms.

In terms of aid allocation, one participant suggested that a distinction should be made between the countries which have put in place the necessary policies, systems and frameworks and might hence achieve the MDGs in the future and those which did not undertake what is necessary and might hence never achieve the MDGs.

b) Many lessons have been learned on using aid to broaden access to inclusive financial sectors:

This panel discussed ways to maximize the impact of aid on promoting pro-poor inclusive financial systems and sectors, with particular impact on microcredit, micro-savings, and micro-insurance.

Presentations were made by representatives of Burkina Faso, Luxembourg and the United Nations' Capital Development Funds (UNCDF) as well as by an independent expert. Panellists and participants then shared policies and practices, identified challenges and suggested solutions.

Background

Today, more than 2.5 billion people worldwide lack access to regular and affordable financial services. This deprives them from opportunities to invest, raise or stabilize their incomes and diversify their assets, preventing them in turn from reducing and mitigating their vulnerability.

The Monterrey Consensus on Financing for Development recognizes the importance of inclusive financial sectors. It states that "microfinance and credit for micro-, small and medium sized enterprises […] as well as national savings schemes are important for enhancing the social and economic impact of the financial sector". Insurance and remittances, as well as many other innovative financial services, might be added to this list, today.

The past years have seen an exponential increase in the amount of aid devoted to financial inclusion. A study from the Consultative Group to Assist the Poor (CGAP) shows that, in 2010, more than US$ 13 billion were committed for this purpose by international donors and investors with an increase of US$ 1 billion per year.

With this trend, it has become all the more important to provide evidence about the development impact of aid-supported microfinance. Today, that evidence is mixed. There is indication that microfinance may have benefited people with entrepreneurial skills and those around the poverty line or above, rather than the poorest.

The example of Burkina Faso, which included microfinance as a key tool in its poverty reduction strategy, illustrates the potential of microfinance. Burkina Faso's membership in the West African Economic and Monetary Union has helped the country to create an enabling environment. Since 1995, the microfinance sector has experienced a remarkable growth, accompanied by a special effort to reach out to the most vulnerable and poor people. Despite this impressive progress major challenges remain. Better supporting structures for the financial sectors and more capacity building frameworks for financial service providers are needed.

Luxembourg's experience shows that public funds can leverage huge amounts of private funds for microfinance and for other initiatives. Public-private partnerships have been at the heart of this success. Luxembourg has continuously established links between different national ministries, NGOs, and private actors in order to foster collaborations in the domain of inclusive finance, and microfinance more specifically. One example is the Luxembourg Microfinance and Development Fund (LMDF), a commercial microfinance investment vehicle which leverages funds from foreign investors to finance specialized lower-tier microfinance institutions in Africa, Asia and Latin America. Another example is the Alliance for a Green Revolution in Africa (AGRA), an initiative which leverages funds from local investors, and especially local banks, for the financing of innovative agricultural projects in Africa. Today, one third of all commercial microfinance investment vehicles are registered in Luxembourg with assets under management of over 3 billion USD.

The following key messages emerged from the debate:

Key challenges and success factors

Financial inclusion should not be seen as an end in itself, but as one element among many others that may contribute to the achievement of the MDGs. Financial inclusion and microfinance seem to have the potential of helping people in developing countries to better manage their cash flows and risks, to reduce their poverty, and to cope with their vulnerability.

Encouraging individual success stories exist, and microfinance seems to have important implications for the real economy of developing countries, as it affects the overall level of investment and job creation. However, sustainability and outreach of inclusive financial service providers remain important challenges, and incidences of over-indebtedness of clients have become more common. So, the evidence of the true development impact of microfinance remains mixed, and there clearly is a need for more analysis to prove that financial inclusion supports the MDGs.

At a national level, public policy interventions on the supply side and on the demand side, as well as measures targeted at the financial sector as a whole are needed to ensure access, usage and impact, the key elements of financial inclusion. Financial inclusion means the opportunity to access financial services, which requires a bank branch, an automated teller machine (ATM) or some other physical point of sale. Furthermore, no matter how dense and well-designed the financial infrastructure of a developing country, in order to ensure financial inclusion, people also need the capacity and thus the education to fully understand the terms and conditions, and the risks and costs of financial services. And even if proper usage of credit, savings, insurance and other financial services is given, for financial inclusion to be fully realized, there still need to be positive effects, i.e. an impact on the wellbeing of individuals or of the society as a whole. Financial inclusion thus requires national public policy interventions on the supply side, mainly affecting access, and on the demand side, mainly affecting usage, as well as measures targeted at the sector as a whole, mainly influencing the impact of inclusive financial services.

At the global level, key principles have been developed for building inclusive financial sectors.
The fact that the UN has a specific convening power for supporting and strengthening inclusive financial sectors became especially clear, when, in 2005, the International Year of Microcredit, the United Nations Capital Development Fund (UNCDF) and the Financing for Development Office (FfDO) of the UN Department of Economic and Social Affairs (UNDESA) launched a consultative process on financial inclusion, coordinated by a group composed of the World Bank, the IMF, the ILO and the IFAD, and supported by many other financial sector experts. As a major part of this process, a series of multi-stakeholder consultations were organized in Africa, Asia and Latin America, culminating in a Global Meeting on Building Inclusive Financial Sectors and in the publication of the so-called "Blue Book", containing key principles for financial inclusion.

Policy solutions and suggestions

Important measures are called for to address market failures; and there is a need to further develop supporting structures for the financial sector, as well as capacity building frameworks for financial service providers. Supply side interventions to improve access to inclusive financial services can consist in more direct actions, such as the creation of government banks, development finance institutions (DFIs) and apex funds; but they can also consist in more indirect actions, such as the establishment of an enabling environment for the development of inclusive financial systems and for the provision of inclusive financial services. In this latter context, well-functioning infrastructures, adjustments in the regulation and supervision of the financial system, the elimination of barriers to market entry, or smart subsidies, as well as fiscal sanctions and incentives for inclusive financial services providers can play an important role. Demand side interventions to improve the usage of inclusive financial services focus more on financial education and consumer protection, and include awareness raising campaigns, financial literacy trainings and the like.

And finally, measures improving the impact of inclusive financial services, especially concern the development of supporting structures for the financial sector, as well as of capacity building frameworks for inclusive financial services providers. Actions that increase transparency within the sector and that allow for a better exchange of data and other information between inclusive financial service providers also play an important role here.

Public funds can leverage large amounts of private (capital market) funds for the support of inclusive financial sectors; and public and private interests can be successfully brought together in innovative partnerships. Successful collaborations in the domain of inclusive finance generally, and in the domain of microfinance more specifically, can be realized by continuously establishing and reinforcing links between national ministries, civil society organizations, and private actors. Particularly, where commercial interests are related to development outcomes, innovative public-private partnerships (PPPs) can be a promising path. The different providers of inclusive financial services should, however, carefully assess the comparative advantages and disadvantages of the different supporting and funding opportunities available to them.

The 2006 UN "Blue Book on Building Inclusive Financial Sectors for Development" paved the ground for many global initiatives. The 2006 UN "Blue Book on Building Inclusive Financial Sectors for Development", published in the framework of the UN's global consultative process on financial inclusion, established key principles for supporting and funding inclusive financial sectors worldwide. Furthermore, it paved the ground for many later initiatives such as the "Global Partnership for Financial Inclusions" by the G-20, the Alliance for Financial Inclusion (AFI), the Consultative Group to Assist the Poor (CGAP), or the International Finance Corporation (IFC). The need for continuing multi-stakeholder exchanges and joint, well-coordinated efforts for building inclusive financial sectors, however, remains unquestioned.

c) Domestic resource mobilization is at the centre of resilience

Tax reform is a main source of domestic finance and a powerful tool to reduce aid dependency. It is therefore an increasingly attractive area for developing countries and donors alike. Improving tax policy and administration is also important for governments to improve their delivery of services and their accountability to their citizens. It is receiving mounting interest at a time when fiscal austerity is increasing in donor countries and when ever growing importance is attached to sound public finances.

Germany, Uganda and ActionAid made short presentations. This was followed by an interactive debate moderated by the former President of the North South Institute. At the end of the panel, a consultant from Nathans Associates identified key findings from the discussion.

Background

Mobilizing domestic resources gained traction through the Financing for Development process. It is also being addressed by the OECD and the European Commission, including through their efforts to eliminate tax havens. The fundamental purpose of taxation is to raise revenue effectively, efficiently and fairly in order to finance public goods and services to accelerate progress towards the MDGs. Today, challenges are well understood. They show a lot of commonalities across countries, despite the fact that specific country contexts have determinant impact on tax reform.

Countries with a strong track record in reducing their aid dependency often have efficient tax collection systems. These are a centre-piece of their development strategy. Champions in tax mobilization are also among the best performers on development effectiveness. The value of their monthly tax collections exceeds initial investment by far.

Despite the potential of strengthened tax policies and administrations, only a few donors provide long-term support in this area. They usually focus on very specific areas of interest or broader reform of Public Financial Management (PFM). Donors report mixed results of their engagement in terms of raising nominal tax revenues.

Key challenges and success factors

Reforming tax systems is closely related to the political economy. Many tax systems in developing countries are regressive, not progressive. Underlying questions of ideology and equity define the multiple challenges related to tax reform. They differ from country to country. Tax reform depends on the political will of government elites. Revenue mobilization plays a critical role in governance and increases the demands for government accountability.

Tax reform is a multi-dimensional endeavour. Good tax policy reform requires a system that relies primarily on broad-based taxes at moderate rates, self-assessment, tax simplification, low levels of exemptions and preferences, and a streamlined tax regime for small businesses. A good tax administration requires an integrated management structure, strong strategic planning, modernized information and technology systems and business processes. Good human resource development, a culture of customer service and strong internal audit capabilities and institutional integrity are also essential.

The tax base is often extremely limited. Many developing economies are characterized by large informal sectors, weak administrative systems and organizational capacities. Every year, tax evasion exceeds annual ODA world-wide several times. Capital flight, including to European countries, is common. A culture of exemptions of taxation is prevalent in many countries. Trade liberalization can erode tariffs which are a major source of revenue in many development countries.

Donor support remains fragmented. Activities of different donors lack harmonization and do not adequately align to the unique requirements in individual programme countries. They concentrate on technical work (e.g. automation of systems, integration of tax departments and capacity building) and rarely encourage political dialogue and advocacy. Programme countries sometimes have little control over the aid provided for tax reform or they need to coordinate with a large number of donors.

Aiding tax reform should not lead to reducing aid. Programme countries welcome the focus on using aid as a catalyst for taxation, provided such support is secured in the long-term and responds to country demands. Programme countries also voiced concerns that investing in tax systems may come at the expense of reduced ODA in the longer run. It was also mentioned that aid should not be tied to tax reform.

Aid modalities differ. There are no magic fixes or one-size-fits-all solutions on how aid should be invested to support tax reform. Support needs to be well coordinated among donors. It should be under the leadership of relevant national authorities, including tax authorities, Ministries of Finance and Planning.

Attracting investment can be very costly. Developing countries provide considerable tax incentives to international companies to ensure that they invest in their infrastructure, and promote economic growth. This is understandable given the dire need to strengthen the economic base in many developing countries. Yet, there is great scope for increasing coherence between policies related to Foreign Direct Investment and domestic resource mobilization. Donors should take greater responsibility for this. Trade mispricing and re-invoicing of international companies are also common practice.

Taxing aid money Aid is a major source of income for many developing countries. It was argued that it could be taxed to increase investment in areas where donors already provide budget support. On the other hand, it was noted that taxation should only apply to economic activities of individuals and enterprises. Aid would be taxed twice, once in developing countries and once in donor countries.

Policy solutions and suggestions

Encourage long-term investment that aligns with priorities of programme country. More long-term and demand-driven aid is needed to ensure visible improvements of national tax policies and administrations. There are many opportunities to support good practices to scale up efforts. Any donor initiative needs to address the complexity of challenges. It should steer clear of supply-driven support to avoid fragmented results. Aid for taxation should not come at the expense of ODA commitments. Tax reform should ensure that tax systems become more pro-poor. To eventually increase the taxable economic surplus, donors and the national government need to place greater emphasis on creating employment, investing in productive capacity and promoting favourable and rights-based social and labour policies.

Spend tax revenue on development. It is vital that revenues mobilized through taxation clearly contribute to the achievement of international and national development goals. To demonstrate the positive impact of paying taxes, government services for the poor must improve. This would serve an incentive in the long term. Also critical is to empower the poor and ensure that they are better represented in public policy-making and efforts to enhance good governance. If donors are seen as a more robust investor than the government, the incentive for paying taxes may be minimized. A focus should be placed on building social protection floors. But it is also essential to spend tax revenues in the country, including through strengthened local procurement. It would be useful to develop a common understanding of how taxation best contributes to development and of a common strategy to make it happen.

Strike a balance on whom to tax. It is of course important to attempt to bring all economic activities into the formal economy. But cooperatives and other bodies providing for low-income populations should not be the primary target of taxation systems. This reduces the purchasing power of the poor. Rather, tax revenue authorities should apply a flexible approach to different segments of tax-paying populations. It was mentioned that large taxpayers, multinational companies that benefit from tax exemptions and entrepreneurs with personal relationships to tax authorities should be specific targets.

Put the spotlight on tax evasion. In some countries, it has been useful to demonstrate how companies and other potential large taxpayers manage to avoid tax payments, even within legal parameters. Greater capacities to monitor local tax payers through country-by-country reporting systems are much needed. Regional collaboration in this regard was also encouraged.

Strengthen tax systems, even with low level of economic activity. Even for countries with a limited tax base and resources, there is scope for improving tax systems and administrations. These need to be perceived as fair, predictable and steady. Greater efforts are needed to address capital flight, tax evasion and corruption. This will also make the case for increased aid packages from provider countries.

Ensure country leadership of support to taxation. It is vital that central government takes leadership and encourages donors to align and harmonize their efforts to support taxation. It was agreed that policy dialogue should focus on how strengthened revenue mobilization can be used to enhance support for the achievement of national and international development goals.

Use ICT, but invest more in human resources. Investment in online tax collection systems have helped to increase the revenue base, reduce corruption and promote a sense of duty towards tax. To be effective, these efforts must place greater emphasis on human resource capacity and management and on training of personnel. This is also important when processes within tax administrations are becoming increasingly IT-based. Without robust human resources in this area, development results will not materialize.

Invest in research in developing countries. Research departments in tax revenue authorities act as early warning systems on the status of the national and global economy. They are also important for strategic planning on how national resources will be generated in future. Without strong research capacities, it is difficult for countries and regions to overcome shocks.

Bolster political will and strengthen legal basis. It is vital to ensure that senior government officials support tax reform. More needs to be done to reform the legislative basis for tax reform. For example automated tax collection systems can go hand in hand with e-commerce and electronic signature laws.

Improve coordination with donors. Some country experiences show that coordination can be ensured among multiple donors through basket funds or by appointing a lead donor to coordinate with the government. The donor community should further support tax reform, including through specific support, much wider Public Financial Management programmes and mainstreaming tax-related recommendations throughout programmes and projects. Yet, donors should try to "do no harm" so that domestic accountability relationships are not undermined.

Promote communication within developing countries... Communication within different departments of revenue authorities is crucial to avoid a silo mentality in mainstreaming tax reform. Greater support should be provided to these institutions' outreach and advocacy functions towards their multiple clients. Also important is to encourage ministries or departments responsible for aid management and coordination to engage with national tax authorities to discuss trade-offs, e.g. between trade liberalization and promoting FDI, as well as their fiscal implications. More evidence-based assessments of taxation policy need to be encouraged. Equally critical is a dialogue on capacity constraints, needs and the political economy in which tax reform takes place. This must be organized under central government leadership and with participation of all relevant national stakeholders, including parliamentarians, civil society, and the private sector.

Double taxation agreements between developing countries. The growing number of double taxation agreements between developing countries is one of many encouraging developments in regional collaboration. Knowledge sharing and horizontal partnerships among Southern actors have also been instrumental in tackling global tax challenges that go beyond national borders. Initiatives to encourage cross-border collaboration should get considerable attention by donors to help avoid illegal financial flows and tax evasion. More support would be needed to promote regional collaboration, for example in the area of taxation of multinational corporations. Regional and global initiatives to reduce illicit capital flights should also be further strengthened.

Bring taxation and domestic revenue mobilization into the development cooperation dialogue. At regional and global levels, existing initiatives – from African Tax Administration Forum (ATAF) to the International Tax Compact (ITC) – produce valuable policy recommendations for country-level programming. It should be ensured that such initiatives do not duplicate efforts. They should be built upon to promote a shift from a focus on the expenditure side to a focus on the revenue side in development cooperation. They should become an integral part of discussions on effective development cooperation.

Develop indicators for measuring progress in Domestic Resource Mobilization. Indicators for effective Domestic Resource Mobilization should be developed jointly by governments. They should go beyond mere performance criteria, such as the Tax-to-GDP ratio, since tax authorities have limited influence on this kind of benchmark. Taxation should become an integral component of PFM support from donors and of expenditure planning processes at country level. The DCF was viewed as a strategic place to further explore this and facilitate a debate in future.

d) Using aid to catalyze Foreign Direct Investment entails both opportunities and risks:

This session discussed how aid could be used most effectively to mobilize the kind of private investment, especially foreign direct investment (FDI), which contributes to poverty reduction and inclusive growth.

Panellists from Afghanistan, Turkish International Cooperation and Development Agency, and CONCORD made short presentations, followed by interactive discussions.

Background

Development financing is becoming increasingly diverse and complex forcing to rethink the role of aid vis-à-vis other sources of development finance. There is a growing consensus that public expenditures funded by aid alone cannot be sustainable. Private investment, both external and domestic, is critical to expand the revenue base of developing countries. This is essential to assure their financial independence and policy space. Developing countries, however, face considerable challenges in attracting sufficient private investment. Ensuring that private investment flows contributes to achieving national development objectives, e.g. job creation, sustainable growth and poverty eradication, is even more difficult. These challenges can be more effectively addressed if aid is provided and used effectively to attract foreign direct investment (FDI) and other private investment that promote development in developing countries.

Key challenges and lessons learned

The discussions reiterated the risks and opportunities associated with the use of FDI to promote development as learned from the experience of the last 30-40 years. Participants shared views on how to use aid as a tool to channel FDI towards the achievement of national development objectives.

Private investment is guided by the logic of profit, which might not be conducive to achieve national development objectives. The risks associated with private investment for development are well known. FDI have often crowdedout the domestic private sector in host countries, with a negative impact on economic growth and development opportunities. Aid strategies need to include incentives to attract private investment in developing countries while remaining consistent with the objective to strengthen the national economy and national development goals for job creation, poverty eradication and inclusive growth. This is especially important in the LDCs, who are highly dependent on FDI for economic growth, given the low productivity of their private sector.

Attracting FDI to developing countries requires reducing/mitigating risks and costs for private investors. Aid can be used to mitigate risks and help reduce costs for private investors. This can be done by sharing the costs of investing in developing countries and helping to support access to skilled labour, infrastructure, improved business environment and trade facilitation. There is however a need to ensure that using ODA as a catalyst for FDI does not become a way to subsidize FDI at the expenses of the host country’s development sector. There are indeed other ways to reduce investor risks in developing countries. Multi-lateral development banks (MDBs), for example, can help fill the gap left by commercial banks in supporting investment in Small and Medium Enterprises (SMEs). This, however, might require additional capital and guarantees from stakeholders as well as other forms of risk mitigation. Those may include various forms of support to improve the business environment and trade facilitation in the context of aid for trade. Such measures are important to enable MDBs to absorb greater risks and play this role.

Private-public partnerships aimed at promoting FDI in programme countries might be another form of tied aid. There is some evidence indicating that donor countries financing private-public programmes in developing countries also tend to involve their own private firms in the implementation of these programmes. Using aid as catalyst for FDI might thus become another way to tie aid to the use of specific firms from the donor countries. Supporting national private investment as opposed to FDI might be more effective in promoting national development and more sustainable in the long run.

There is a need to promote private investment as a whole, not only FDI. FDI is only one component of private investment. Although it has increased over the years, foreign investors are still wary to invest in developing countries, particularly in the LDCs. The public sector thus needs to step in to facilitate private investment as a whole, both external and domestic, in developing countries and ensure that it leads to greater job opportunities and improved livelihood. The role of aid, in particular, should be to leverage other types of financial flows that could have a greater impact on these objectives. This could be done by supporting a stronger overall investment climate in programme countries that can attract all kinds of investment.

Expanding the role of private sector is not a guarantee of inclusive economic growth and poverty eradication. 30% of current ODA continues to be directed to private sector and infrastructure development. It was however said that the past 30 years have shown that private sector development does not necessarily lead to poverty eradication. This is demonstrated by the fact that 75% of the poor lives in Middle Income Countries. Directing ODA to private sector development away from the health and education sectors can be justified only if it contributes to sustainable and inclusive growth, job creation, and poverty eradication.

Aid as a catalyst of FDI: proposals

Promote the emergence of local entrepreneurship. Aid would have a greater impact by investing in people, particularly women and girls. This is a dimension that is generally missing in the discussion on public finance. Private sector development and social dimensions should be pursued at the same time as they are interconnected dimensions of people's productive life.

Provide specific incentives for private investors to invest in local and national productive activities in developing countries – Aid should contribute to improve the business climate of programme countries by promoting market access, availability of skilled labour and land. In the current climate, this is particularly urgent as the role of the private sector in development cooperation is bound to increase.

Facilitate knowledge and technology transfer. A proper regulatory framework for FDI would need to be developed to enable transfer of knowledge and technology. Aid should be used to develop national capacity to formulate such a framework. For example, ODA could support the formulation of appropriate tax levels and rates as well as environmental, labour and social standards. It could also support national capacity to define and negotiate countries' own conditions for regulating FDI and thus maximize their impact in the economy.

Promote development-oriented trade policies. Developing countries' access and acquisition of technology is constrained by international and bilateral trade rules. Donor countries' trade policies should ensure that FDI facilitates technology transfer. There is also a need for international regimes (trade and property rights regimes) to allow LDCs to establish their own conditions for the emergence and evolution of a domestic private sector.

Encourage sustainability of private investment. Grant-related investments should have an exit strategy in case investment is profitable.

Foster accountability and transparency. There should be regular country level reviews of the total net impact of FDI on the economy of partner countries so to be able to compare with other, more broad-based form of investment. Such reviews should include all relevant stakeholders, including civil society and parliaments. Ensuring greater information and transparency on how FDI will be managed is also important. Such conditions should be met before aid is used to promote FDI.

e) Capacity building is needed to promote more coherent management and use of financing at country level:

This session discussed ways to manage various financial flows so that they jointly contribute to development results. In general, coordinating aid and non-aid flows was seen as particularly challenging, given the lack of capacity in recipient countries, shortage in coordination in both giving and receiving countries as well as the diverse incentives governing such flows.

Panelists from Uganda, IMF and Belgium made short presentations, followed by interaction discussions.

Background

Developing countries receive financing from multiple sources. These flows are of different nature. Financing modalities are increasingly diverse. Ensuring that all external and domestic resources work together in contributing to national development objectives remains a persistent challenge for all developing countries.

Different sources of finance do not necessarily share common motives, interests, objectives and priorities. Aid is often driven by foreign policy objectives. Priorities of investors range widely. Developing countries are ill-positioned to negotiate with donors or investors. In practice, there have not been much experience sharing and discussion in this area.

Key challenges

Flows from various sources are governed differently. Bilateral, multilateral and new state actors, non-state actors as well as vertical funds all have their own institutional setups, authority arrangements, relationship between Headquarters and the field, and different sets of strengths and weaknesses.

Objectives and purposes of actors are diverse. Funding directed at specific sectors focuses on one area and may not be necessarily aligned with national priorities. Private funding is profit oriented, which requires regulatory frameworks and clear tax schedules.

Modalities of development financing are becoming increasingly diverse. Combining general budget support, SWAPs, debt, innovative financing and non-financial flows (for example technical assistance) in one framework is a complex task.

Time frames are not necessarily in sync. Different funding sources follow different timeframes. Development funding works with budget cycles. This is not necessarily the case for non-development funding.

Governance structures in donor and recipient countries are not conducive to coherent management of flows. In the area of aid, good mutual accountability mechanisms at country level can facilitate participation of development partners. But, when it comes to coordinating flows beyond aid, other authorities need to be engaged. However, there is lack of dialogue in donor countries and development cooperation ministries and there are rarely any discussions beyond aid flows with other authorities. The same applies to recipient countries.

Progress in aid coordination is modest at best. Aid dynamics have changed as actors in and outside the aid effectiveness agenda have entered the development cooperation landscape. Aid is not well coordinated nor aligned with national priorities. In country, actors are not informed of each other's activities in the same sector. There is tendency for each to pursue its own agenda. Uncoordinated country missions are an example of lack of coordination. Division of labour among donors has not made sufficient progress. In certain cases, it has led donors to withdraw from certain sectors.

A real time 'snapshot' of donor activities is lacking. What donors do and plan to do usually remain obscure to recipient countries, which makes coordination impossible. When these become known, the politics may have already changed and priorities shifted.

There is shortage of funding for coordination. Setting up coordination frameworks, mechanisms and plans entail costs. But, there are cases where the commitment to fulfilling these requirements is not matched by financial support.

Lessons learned and solutions

Establish partnership policies/frameworks/country compact. Coherence needs broad frameworks. Development priorities need to be defined by the framework, against competing demands. Uganda's partnership policy has set an example. In 2009, Uganda set up a policy coordination framework, which is used to assess the performance of all partners. The framework includes indicators such as budget support, policy coordination, untying of aid, joint mission, transparency as well as indicators for programme country government in line with the principles of value for money and transparency. The framework stresses the importance of beyond aid strategy, combining subsidy, trade, market access and technology. Stakeholders work together to ensure that the framework achieves results. The benefits that the partnership policy can bring include, among others, greater benefits from financial flows and reduction of transaction cost.

Make national development strategies multifaceted. National development strategies must look at how the country can manage different flows, and where the gaps are. This has to be based on an understanding of what is available and of the associated terms/conditions, timeframes, predictability, level of alignment with strategic objectives. This can lead to offsetting of institutions and mutual accountability and performance mechanisms. Ultimately, the strategy has to ensure that all actors work together around it and use national system but without much management. An exit strategy is also essential. Co-ordination around the strategy must open a space for NGOs and the private sector. Both may not be brought to the table on the same terms.

Let recipient countries set the rules of the game. When the framework is in place, all actors should be engaged. If certain actors prefer business as usual, recipient countries should be empowered to say no. Real dialogue usually takes place in sector groups where the leadership of the government is more easily exercised. On the other hand, both donors and programme countries should do their jobs right. Programme countries should make sure their policies are not contrary to their development objectives.

Strengthen the capacity of recipient country governments. Setting up and managing policy frameworks requires dedicated institutions/agencies and upgrading the skills of personnel, which in some cases recipient countries alone cannot do due to lack of capacity. Resources are also needed to manage, collect, process and communicate information. Sound public financial system is also critical. The limitations in capacity have been underestimated in the past and should be readdressed as a priority.

Accelerate the division of labour. The EU has encouraged its members to focus on three sectors. For example, Luxembourg decided to exit from certain sectors in some countries and focus on fewer areas. Such experiences should be widely shared.

Prioritize budget support. Donors should work towards a single contract with the government. If budget support is not applicable, using national systems is the minimum requirement. Vertical funds should be used with caution, as they can distort budgets. Loans should be managed more carefully to minimize impact on future budgets.

Use aid to leverage private resources. A majority of the poor now live in Middle Income Countries and this trend will continue. Aid itself cannot meet such significant demands unless it leverages other flows. There is clear change in ODA priorities. It was said that ODA should be used to create an enabling environment and inclusive growth conditions. This strengthened link will make possible coherent management of flows.

f) Mutual accountability is increasingly seen as critical to maximizing aid results

This session identified recent trends in mutual accountability. It explored ways to include relevant actors in national and sector-level reviews of aid policies and the definition and review of targets on aid quality. The ultimate objective of such change was seen to be two-fold: enhance the impact of aid and hold them to account for their aid commitments.

The United Republic of Tanzania, Togo, the European Commission and the IBON Foundation/BetterAid presented their views and this was followed by an interactive debate.

Background

Mutual accountability between developing countries and providers is gaining momentum. It is a means to oversee the effectiveness of development cooperation on the ground. It should be rolled out universally, while being specific to country priorities. It should build on countries' democratic systems and respect parliamentary oversight and civil society engagement. Mutual accountability should apply to development results. Those should be defined based on national priorities. They should be assessed against national priorities and internationally agreed principles, as agreed among all stakeholders.

In recent years, few countries have made progress in developing effective mutual accountability mechanisms that involve all relevant actors. It is well recognized that an integral part of these mechanisms are aid policies and performance assessment frameworks with individual targets, high-level multi-stakeholder platforms, and accessible databases on aid. 55 surveyed developing countries have no aid policy document at present.

Accountability mechanisms are more efficient if they focus on priority sectors chosen by the programme countries. Existing performance assessment frameworks should be used to review progress on a limited number of agreed, locally adapted targets on development effectiveness. Particularly useful are targets defined for individual providers. Performance assessment frameworks should be tailored to country contexts. They should be based on multi-stakeholder consultations with governments in the lead. Political momentum on the ground should be strengthened. All actors should be effectively involved under country leadership.

At the global level, it was felt that a light structure should monitor progress independently. As a universal platform fostering multi-stakeholder consultations, the DCF is an important global apex body for mutual accountability.

Key challenges to make mutual accountability work:

Alignment with key country priorities. Aid policies need to build on national development strategies. This way, they will be embedded in a framework that responds to domestic, national and international commitments and standards. This will also ensure greater country ownership and avoid interference when multiple actors engage in mutual accountability.

Capacity challenges. At the same time, governments often quote the lack of national capacity as a key hindrance to further engagement in mutual accountability. This applies especially to countries in transition or relief from conflict. A major injection of resources is needed to (i) scale-up national information systems and databases in order to provide timely aid information relevant for national planning purposes; (ii) invest in monitoring and evaluation capacity in order to root mutual accountability in a meaningful evidence-base; and (iii) strengthen country-leadership to analyze policy documents and negotiate change. Ensuring that aid documents and review processes are owned by all stakeholders is time-consuming and requires costly consultations and training.

Creating accountability relationships in programme countries. In some cases, the lack of domestic accountability from governments to their own citizens is a major limitation in establishing a culture of accountability. Parliamentarians and civil society organizations are usually not adequately involved in overseeing aid management, coordination and delivery. Greater authority should be granted to them. Also important is closer engagement with local governments and the supreme audit institutions as well as with media. These are vital to create an enabling environment based on good governance. The accountability of civil society organizations as providers of development cooperation is of particular concern to governments, despite existing standards and codes of conduct at regional and global level.

Coordination of providers on the ground. Limited coordination and coherence of providers at country level is a concern. Mutual accountability mechanisms can help to promote donor coordination, which in turn can make aid relationships more balanced. It was noted that donors sometimes do not agree on targets against which developing countries should report. Without increased coherence of donors' approaches at country level, developing countries will not be able to hold donors to account and simplify their accountability and reporting to donors.

Overly complex and unfocused reporting. The number of indicators used to assess programme countries' development policy as part of mutual accountability mechanisms for aid is excessive and needs to be reduced. They should be tailored to focus more on relevant development outcomes, rather than inputs and outputs.

Broadening the tent. A special challenge is to ensure that mutual accountability deliberations include development partners beyond those that provide general budget support (GBS). At national level, those – including non-DAC donors and the private sector – should be encouraged to voluntarily engage in mutual accountability and report on their specific development cooperation activities. This may include signing agreements with the central government and other donors. The dual characteristics of middle income countries as providers and recipients of development cooperation would need to be reflected in these agreements. At sectoral level, Sector Wide Approaches should involve all relevant government entities, bi- and multi-lateral development partners, civil society organizations and the private sector.

Addressing other financing for development. Aid covers an increasingly limited portion of development finance. Donors are not held accountable on issues beyond aid, notably on those that affect development, such as trade, investment or debt relief policies.

Policy solutions and suggestions from the debate:

Holistic and country-specific reforms are needed to enhance mutual accountability. Mutual accountability should not be only a technical dialogue. Instead, it should be part of a broader discussion of the delivery of results and the impact of aid. Reform should aim to put practitioners in the lead. Also important is to focus on a manageable set of indicators for all actors. Such indicators should build on guidance from global processes. Global policy-dialogue should also be energized to refine the roles of different actors in holding providers and governments to account on promises made.

They should be driven by a strategic and inclusive vision. It was said that a global representative coalition of actors should work together post-Busan to draw up a strategic plan. The purpose would be to ensure that mutual accountability mechanisms become an integral part of results-oriented development planning at country level. This should entail suggestions to promote mutual accountability and identify ways to disclose relevant aid information. Donors need to support this process.

Challenges should be identified based on evidence. A more thorough analysis of the political economy of individual countries and their status in mutual accountability may be useful to evaluate why progress is minimal in some contexts. It would also help to identify which countries could be prioritized.

Do not reinvent the wheel. It should be avoided to create new mutual accountability mechanisms, in countries where elements of mutual accountability (policies, dialogue structures etc.) already exist. The national development strategy should be at the centre of reform to improve existing policies and meetings/governance structures. This is important to frame government-led dialogue with providers. Reform should also help establish a strong link between domestic accountability to citizens and mutual accountability between government and providers. It is critical to ensure that lessons learned and challenges are regularly reviewed at global level. Global review mechanisms and independent reports are critical in this regard.

Lessons can be learned from specific sectors. In some countries, mutual accountability mechanisms at sector, sub-sector and programme level have had considerable impact on development results. They adopt a 'business-like' approach and are more evidence-driven. They thus provide incentives for governments to take the lead. At this level, it is meaningful to involve informed practitioners from providers, local governments, parliamentarians and civil society organizations. Some of these actors are only answerable at this level. Fundamental accountability relationships should be nurtured at local level. For example local public hearings also have a strong impact on domestic accountability. Such assessments are most efficient when they ask what works and what does not work to promote accountability. They would however need to feed into higher levels of coordination. This will help ensure that they have a long-term impact on development planning and the overall policy framework of the central government.

Political buy in must be bolstered. Mutual accountability is inherently political. A two-pronged approach in pursuing mutual accountability reviews has been effective in yielding meaningful results. It should consist of (i) an inclusive high-level political debate on progress and effectiveness of development efforts and (ii) informed policy dialogue among practitioners to identify solutions to remaining challenges.

A link should be established with supranational structures to strengthen behavioural change. At regional and global levels, dialogue structures need to be truly inclusive as well. They should not duplicate each other (*see also extensive recommendations from the Expert Group Meeting on International Mutual Accountability on this issue*). Lessons can be learned from the format of the Cotonou agreement and the African Union.

Good practices should be shared. There are a number of good practices in building capacity in the area of statistics, promoting open civil society engagement and strengthening budget and programme monitoring and policy evaluation by parliaments. An exchange of experiences can help replicate and expand them, where feasible. Parliamentary networks should be better used to promote exchange on accountability for results. Active local governments should act as champions and encourage other local authorities to engage in mutual accountability.

Beyond aid issues should be addressed. Country level mutual accountability systems should review incoming financing flows beyond aid. It would be useful to negotiate indicators that focus on the contribution aid can make towards more effective development cooperation. National monitoring and evaluation (M&E) systems need to be scaled up and strengthened as they can generate evidence for meaningful mutual accountability. Also, donor representatives should have greater capacity and authority to discuss beyond aid issues and policy coherence. National fora should increasingly discuss the role of aid as a catalyst for other development financing.

Lessons can be learned from South-South exchanges. Peer learning at country and regional level will be critical in the coming years. So far, structured South-South exchanges of lessons learned among developing countries have been effective in improving mutual accountability processes. They help to strengthen national ownership of the mutual accountability agenda and to build capacities at country level in a cost-effective and results-oriented way.