Chapter III
Towards a new aid architecture

Summary

- While the international community has agreed to focus its assistance efforts on poverty eradication, the global aid system has become highly fragmented and its components highly dispersed.
- The mushrooming of aid agencies with diverse objectives, as well as inconsistencies between donors and aid recipients in terms of goals and actions, has contributed to aid volatility and loss of ownership, thereby weakening efforts to reduce poverty and promote development.
- Aid effectiveness is achievable by transitioning to a needs-based aid architecture built on new forms of partnerships among donors and recipients that are aligned with national sustainable development strategies. Resource mobilization for the new architecture would increasingly rely on approaches pioneered in the search for innovative sources of development financing, including internationally coordinated levies.

Introduction

International aid approaches changed when shifts occurred in the dominant development ideas

There have been substantial shifts in the system of official development assistance (ODA) over the past 60 years. Shifts in the dominant development ideas and in the relative economic power among countries have induced changes in the mechanisms and modalities of aid. The emergence of significant global economic players from the ranks of developing countries as well as the international philanthropy community is expected to initiate a new realignment which is already putting its stamp on the international aid system. The increased participation of new players, the ongoing deep rethinking of decades-old beliefs held on correct economic management approaches, the challenges facing donors in raising the aid resources required, and emerging development challenges, such as climate change, present both dilemmas and opportunities to those engaged in reshaping the global aid system.

The aid "architecture" has become increasingly fragmented

The present chapter examines these challenges with a view to understanding the strengths and weaknesses of the international aid system. It assesses the effect that aid and its delivery mechanisms have had on the support for economic development and the building of partnerships for development cooperation. The fact that, over time, the aid "architecture" has become increasingly fragmented and its components increasingly dispersed has substantially affected the effectiveness of development assistance. If, moving forward, the aid architecture is to become more effective and live up to the challenges of today, the ways in which resources for development assistance are mobilized and the modalities for providing that assistance will need to be fundamentally reformed.

Changing views about development assistance

Overlapping donor motivations have been subject to changes over time

The motivations behind donor provision of development assistance may be divided into three categories: developmental, geopolitical and humanitarian. These motivations, which often overlap, have been subject to changes over time. While it is difficult to make across-the-board generalizations about donors, one can argue that the approach to development aid has been strongly influenced by changing views regarding the development process itself.

The scarcity of capital was considered to be the key development bottleneck

During the 1950s and 1960s, the scarcity of capital had been considered to be the key development bottleneck. ODA could play an important role in overcoming this bottleneck, especially in cases where foreign-exchange constraints formed the main obstacle to increasing investment levels. Development assistance focused on providing finance and technical assistance for infrastructure projects, including roads, bridges, ports and energy systems, which by their very nature required investments that were long-term, hence lumpy. Since this was also the era of State leadership in economic development, there was a notable effort by assisting countries to establish economic planning offices through technical cooperation and capacity-building, based on the presumption that Governments in poor countries aspired to be developmental States. It was believed that the role of ODA would be catalytic and temporary in the early stages of development until growth enhanced domestic resource mobilization and eased access to private sources of external finance.

As discussed in chapter I, dissatisfaction with the results of the modern growth strategies of the 1950s and 1960s, whose success had depended on government performance, sparked a paradigm shift in development thinking. Aid flows were perceived to have been poorly managed, and wasted through the "rent-seeking" activities of government functionaries and their favoured allies. Capacity-building often did not take root. Meanwhile, bank lending, in particular, became an attractive external financing option for Governments in many developing countries, especially middle-income countries, compared with aid flows or multilateral bank lending often subject to restrictive policy conditions. As private capital flows proved strongly pro-cyclical and as borrowing conditions abruptly changed at the end of the 1970s, many developing countries ended up saddled with unserviceable debts. The debt crisis that emerged came to be perceived as another failure in the development effort, reflecting unsound fiscal management and failure to create dynamic export sectors which could have kept debt service-to-export ratios within sustainable boundaries. These events also spurred reconsideration of international development cooperation. The multilateral financial institutions introduced structural adjustment programmes which conditioned new development financing to policy adjustments which were to eliminate many of the perceived market distortions introduced by Governments and ensure macroeconomic stability along the lines of the Washington Consensus (see chap. I). Bilateral aid donors often aligned support behind the existence of an International Monetary Fund (IMF) agreement, hence subjecting it to similar policy conditions

The social costs of adjustment under the new paradigm proved to be highly significant

The implied social costs of adjustment under the new paradigm proved to be highly significant. This, together with the influence of earlier concerns raised in the 1970s that growth might not be a sufficient condition for poverty reduction (see chap. II), led to a shift in the focus of aid to more direct support of poverty reduction and social programmes. The lending policies of the multilateral banks underwent the same shift in focus. Support for infrastructure and economic diversification was de-emphasized. In all, aid, in its move away from supporting broader transformative development processes, became much more narrowly focused on poverty and the social sectors. Through the implementation of the agendas of the Millennium Development Goals and the Poverty Reduction Strategy Papers (PRSPs), this constriction was overcome only partially.

The proportion of ODA support for economic infrastructure and production sector development declined

The above-mentioned shift has been visible in the sectoral allocation of aid of the major donor countries united in the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD).[1] As shown in table III.1, the share of ODA allocated to social infrastructure and services increased from an average of 21 per cent during 1970-1979 to 34 per cent in 2000-2008. The shares of debt relief and humanitarian aid also increased. This was at the cost of general programme support as well as support for economic infrastructure and production sector development[2] (including support for agriculture). The combined share of these previously predominant destinations of aid resources fell from 50-60 per cent in the 1970s and the 1980s to about 30 per cent in the 2000s.

Table III.1:
Sectoral allocation of net disbursements of ODA by DAC members, as a proportion of total ODA[a]

Percentage

Sector	*1970-1979*	*1980-1989*	*1990-1999*	*2000-2008*
Social infrastructure and services	21.27	25.22	26.94	33.96
Economic infrastructure and services	12.31	19.05	19.79	13.03
Production sectors (including multisector)	20.18	23.95	16.28	13.31
Commodity support/ general programme assistance	19.52	15.86	9.96	4.59
Debt relief	4.22	2.58	10.31	16.08
Humanitarian aid	0.93	1.72	4.72	6.28
Administrative costs of donors	..	2.32	4.48	5.14
Support to non-governmental organizations	..	1.41	1.31	2.85
Refugees in donor countries	..	..	0.91	2.32
Unallocated/unspecified	21.57	7.88	5.27	2.44

Source: Organization for Economic Cooperation and Development/Development Assistance Committee (OECD/DAC) database.

a Period averages.

1 The Development Assistance Committee is the principal OECD body dealing with issues related to cooperation with developing countries. The DAC donor countries are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, the Republic of Korea (a member since 1 January 2010), Spain, Sweden, Switzerland, the United Kingdom of Great Britain and Northern Ireland, the United States of America and the Commission of the European Union. Non-DAC donors reporting aid to DAC are Taiwan Province of China, the Czech Republic, Estonia, Hungary, Iceland, Israel, Kuwait, Latvia, Liechtenstein, Lithuania, Poland, the Republic of Korea (prior to 2010), Saudi Arabia, Slovakia, Slovenia, Thailand, Turkey and the United Arab Emirates.

2 For the impact on public investment allocations in the Lao People's Democratic Republic, see Memis, Montes and Weeratunge (2006).

A complex and fragmented aid architecture

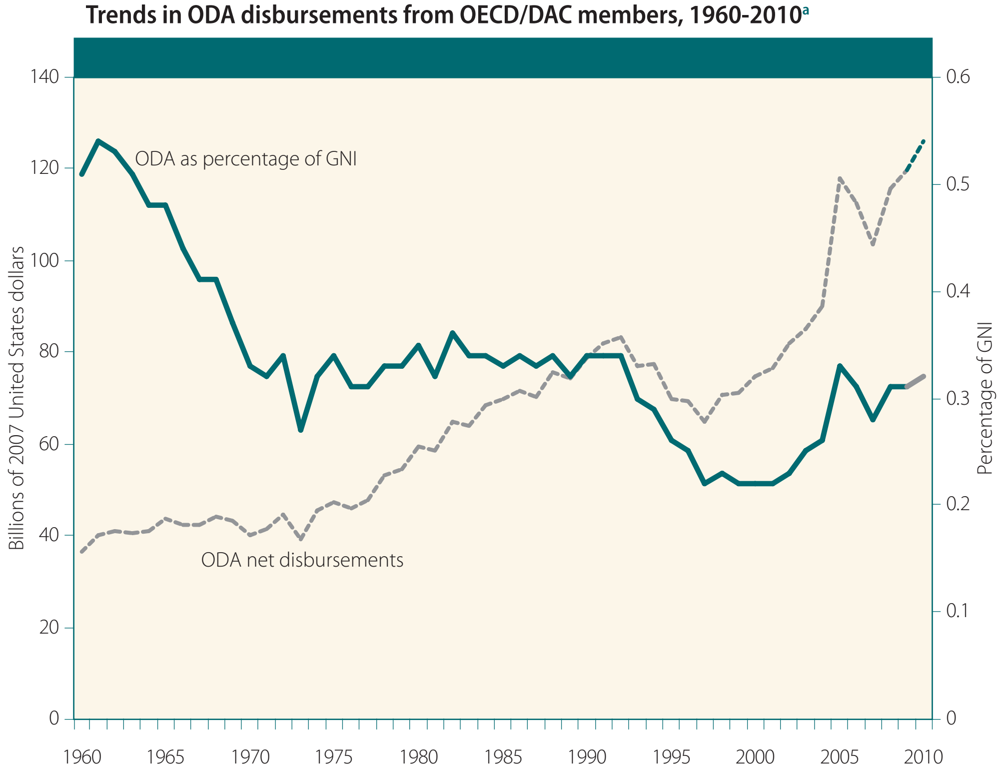
Shifting aid objectives and mechanisms have created an increasingly fragmented and highly dispersed aid architecture, which, while it has been responsible for the clear and tangible benefits enjoyed by recipient countries in specific areas, does not appear to be supporting an effective system overall. Aid effectiveness has been found wanting on several counts: while abundant in some contexts, resource flows have fallen short of needs in others; aid delivery has become highly fragmented thereby increasing transaction costs; for many recipient countries, resource flows tend to be volatile, thereby complicating budget processes and development project implementation; and policy conditionality has undermined country ownership and effective use of resources.

Is aid sufficient?

Most donors have not met the long-standing target of 0.7 of gross national income (GNI) for ODA

A proliferation of donors does not necessarily mean more aid. The average size of aid programmes has become smaller (see below). DAC donors, the major providers of ODA, have gradually increased disbursements in absolute terms over the past 50 years. There had been a drop during the 1990s after the fall of the Soviet Union, reflecting the significance of geopolitical influences on aid giving, and a revival during the 2000s. As a proportion of donors' gross national income (GNI), however, aid flows have been on a declining trend since the 1960s, falling from a high of 0.54 per cent in 1961 to a low of 0.22 per cent in the late 1990s (see figure III.1). Over the past 10 years, ODA recovered as a share of donor country GNI and that share is estimated to reach 0.35 per cent in 2010. However, the recovery in aid flows is, to a large extent, attributable to debt relief (Addison, Arndt and

Figure III.1
Trends in ODA disbursements from OECD/DAC members, 1960-2010[a]



Source: OECD/DAC database.
a Data for 2010 based on OECD/DAC projections.

Tarp, 2010), reflecting a disregard for the principle agreed in the Monterrey Consensus of the International Conference on Financing for Development (United Nations, 2002) that debt relief should be additional to traditional aid (para.51). The recent increases in total aid flows from DAC members have proved far from sufficient to meet the long-standing United Nations target of 0.7 per cent of GNI.

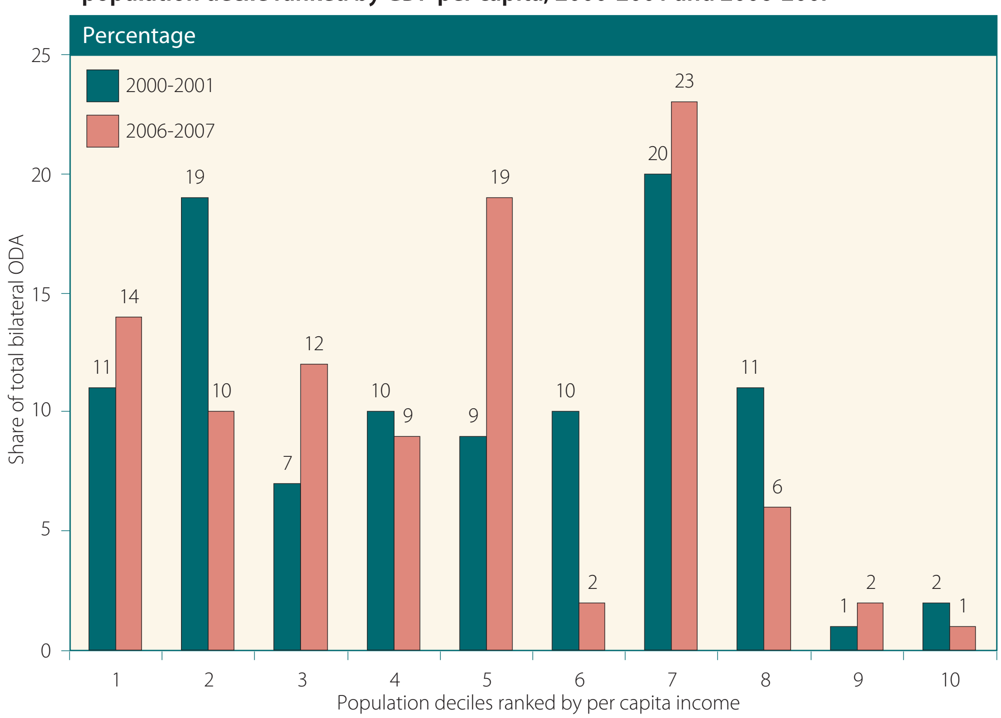
Delivery gaps are largest in aid commitments for Africa

The delivery gap in respect of fulfilling the commitments to support the Millennium Development Goals development agenda has been made all the more glaring by the poignant calls for additional assistance to the poorest countries to enable them to address food security problems and climate change. That delivery gaps are largest in aid commitments for Africa reflects the continued unevenness in the distribution of aid flows, which does not strongly favour populations in low-income countries. Figure III.2 indicates that, excluding India and China, the 10 per cent of the developing world's population that lived in the poorest countries received 14 per cent of bilateral ODA in 2006-2007, slightly up from their share in 2000-2001. Overall, bilateral aid from DAC countries is not strongly concentrated among the poorest countries. In contrast, multilateral aid, which accounts for about one fifth of ODA flows generated by DAC members, shows a stronger bias towards the poorest countries (United Nations, 2009c).

There has been an acceleration of non-DAC aid flows

DAC members contribute about 90 per cent of the total volume of ODA flows. Recently, a number of non-DAC countries, including emerging developing countries like China, Brazil and India, have increased their role as donors. This is not a new phenomenon. Recently, China has expanded its foreign assistance to low-income countries, in particular to Africa, but previously—during the 1960s and 1970s at the height of the cold war—it also provided substantial foreign assistance, including for the financing of infrastructure projects in parts of Africa. Several oil-exporting countries have substantially increased

Figure III.2
Distribution of DAC bilateral ODA for developing countries, by population decile ranked by GDP per capita, 2000-2001 and 2006-2007



Source: United Nations (2009c, p. 15).

their ODA over the past decade in the wake of higher world oil prices, as they did during the 1970s and 1980s. Figure III.3 shows the recent acceleration of non-DAC aid flows during the 2000s but it also shows that, in real terms, these flows have been well below the amounts of South-South development assistance provided during the 1970s.

China, India, Saudi Arabia and Venezuela (Bolivarian Republic of) are among the most active non-DAC donor countries, but the contributions of Brazil, the Republic of Korea, Thailand and Turkey have also been on the rise. In 2008, the Republic of Korea increased its ODA budget by 31.5 per cent, which in absolute terms thereby surpassed the aid budgets of DAC members Greece, New Zealand and Portugal (United Nations, 2010).[3]

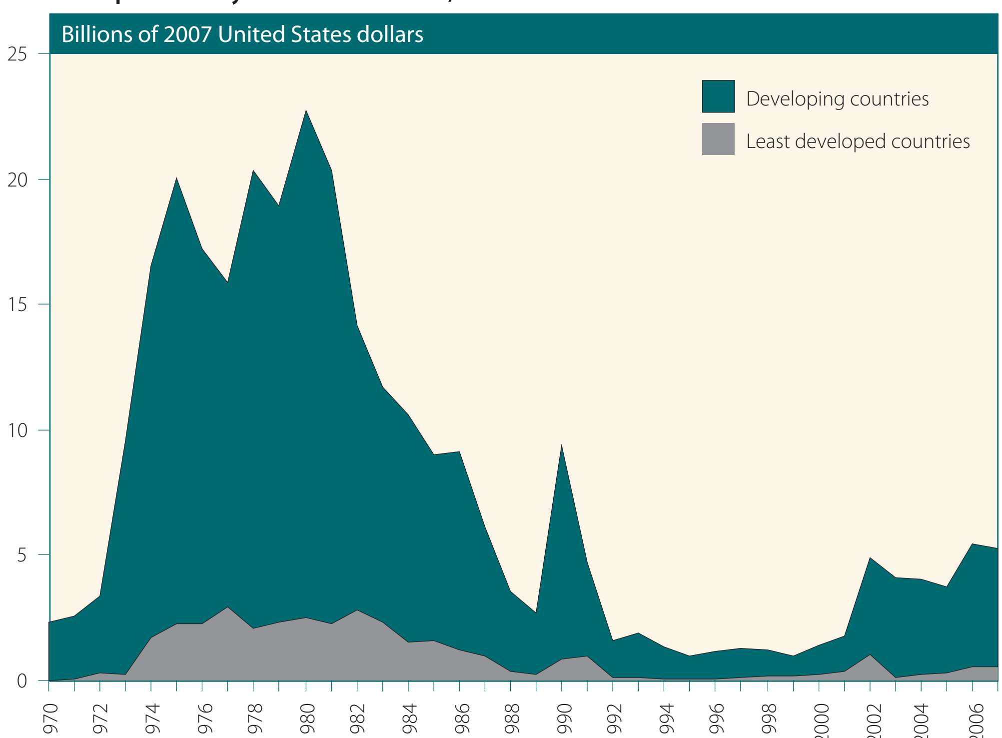
Non-DAC ODA is not necessarily more focused on low-income countries

Countries in Asia and Africa are the main recipients of non-DAC South-South aid flows. Africa's share declined significantly, however, during 2000-2007 as compared with previous decades. The amount of non-DAC ODA directed at low-income countries is no greater than that provided by DAC members (Organization for Economic Coooperation and Development, Development Co-operation Directorate (DCD-DAC), 2010).

Private foundations and international non-governmental organizations have also become prominent development actors

While there is even greater uncertainty regarding private foundations and international non-governmental organizations in respect of their quantitative contribution to development, they have become quite prominent in the area of development assistance, particularly within specific fields such as health services. The 2009 Index of Global Philanthropy and Remittances (Hudson Institute, Center for Global Prosperity, 2009)

Figure III.3
ODA provided by non-DAC countries, 1970-2007



Source: OECD/DAC database.

3 It should be noted that there is some uncertainty about the exact levels of ODA coming from non-DAC members. OECD estimates non-DAC contributions of $5.7 billion for 2006. For the same year, a United Nations-sponsored study estimated that Southern contributors disbursed between $9.5 billion and $12.1 billion, representing 8-10 per cent of total aid flows (United Nations, Economic and Social Council, 2008). The OECD estimates do not include the contributions of China, India and Venezuela (Bolivarian Republic of).

estimates that foreign assistance to developing countries financed from private foundations, non-governmental programmes and individual donations in OECD countries amounted to $49 billion in 2007.

Targeting aid commitments as a percentage of GNI was originally suggested by the World Council of Churches

Even after adding flows from DAC, non-DAC and private sources, total aid would remain far from reaching the OECD target of 0.7 per cent of GNI. Hence, is the level of aid inadequate? When measured against the political commitment, clearly it is. The origins of this target date back more than half a century, however. It was first promoted by the World Council of Churches in 1958 which had argued that only with substantial aid from the advanced countries, could the poorer nations carry out their development plans and "avert the human disasters that follow from their failure".[4] The Council estimated that at least 1 per cent of the national income of the rich countries should be allocated for this purpose, but as it expected that 0.3 per cent of GNI could come from private sources, 0.7 per cent would need to be provided in the form of official grants and concessional loans. The target was subsequently sanctioned by influential economists, including Paul Rosenstein-Rodan and Hollis Chenery, who independently estimated that the foreign exchange needed (calculated as the difference between capital requirements and domestic savings) to reach a target rate of growth of about 5 per cent per year in developing countries would be in the order of $10 billion. This happened to have been equal to 1 per cent of the combined GNI of the advanced countries in 1961.[5] Although it is based on a rather simple estimation made more than 50 years ago and although the nature of global development challenges has changed radically, the target of 0.7 of donor GNI for aid has remained accepted internationally to this day. Such acceptance is probably due to the fact that the target has never been met and the needs of the poorest countries remain so large.

Is a global aid target still relevant today?

However, there are more than enough reasons to rethink the target. First, it does not appear to make much sense to calculate the financing requirements of one set of countries as a fixed share of a largely unrelated aggregate of a different set of countries. Second, the original estimate of the required level of ODA was based on the assumption that all of the aid would support investment and all of the investment would lead to commensurate increases in income growth. The related evidence is not very strong (see below). Moreover, as discussed, the motivations behind disbursing aid have changed over time and the focus is far from exclusively on promoting economic growth. Third, it is likely that needs vary over time and will be context-specific. In a fairly recent United Nations Development Programme (UNDP)-sponsored study (United Nations Millennium Project, 2005), the attempt to estimate the aid flows required to meet the Millennium Development Goals based on recipients' needs resulted in a figure of 0.54 per cent of rich-country GNI. However, these estimates were based on a few country-level needs assessments only and it is doubtful whether, given the diversity in contexts, total aid requirements can be derived by "scaling up" financing needs of a few individual countries. Further, we need to ask the question how to incorporate other recipient needs that, to be addressed, may require additional support through ODA, such as those relating to food security, climate change and natural disaster relief.

In sum, owing to the lack of adequate needs assessments and to the fact that the existing target has in actuality been defined independently of recipients' needs in the current context, it is difficult to assess whether present levels of ODA are sufficient. Hence,

4 World Council of Churches (1958), "Minutes and reports of the eleventh meeting of the Central Committee of the World Council of Churches: Nyborg Strand, Denmark, August 21-29, 1958" (Geneva), appendix XIV, pp. 124-125.

5 See, for instance, Clemens and Moss (2005) for a recounting of the origins of the 0.7 per cent target.

although the ratio of ODA to GNI may still be a relevant indicator of the budget priorities of donor countries and of how much they are capable of contributing to international development, it still does not make clear the absolute size of required aid flows.

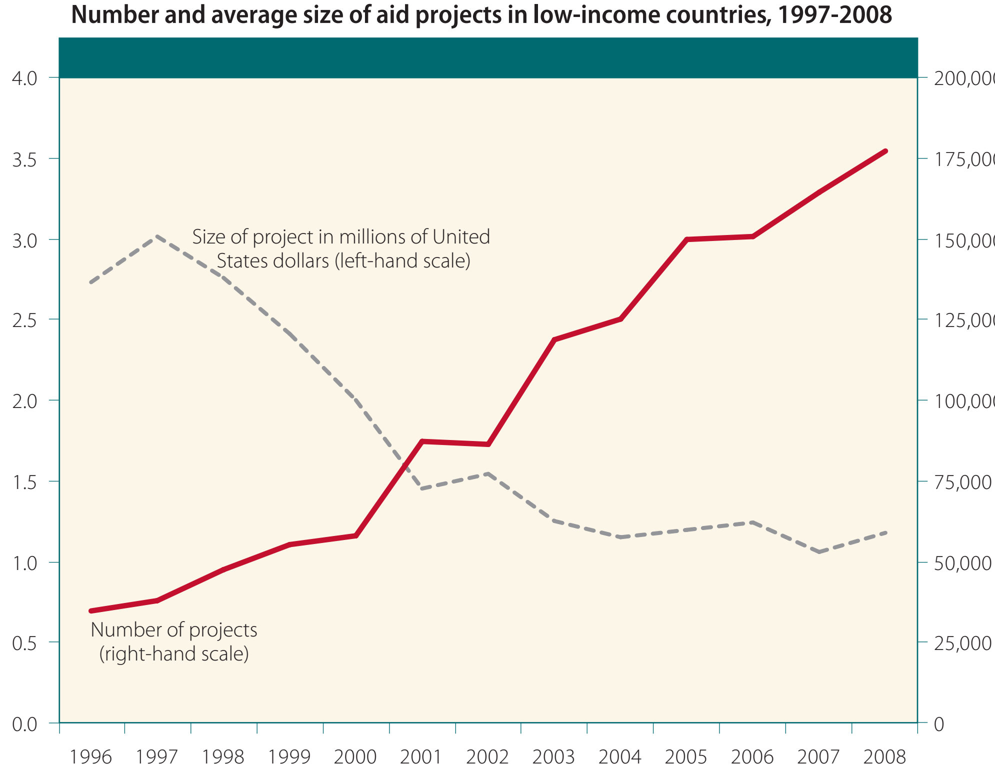
Aid fragmentation

As the number of projects has gone up, the average size of aid projects has gone down

The trends in ODA flows just described have caused the aid architecture to become more fragmented, with a largely uncoordinated proliferation of destinations, donors and modalities. This has made the sufficiency of aid even more difficult to determine. The number of donors has risen exponentially while the average size of aid projects has declined considerably. The World Bank (2007) has estimated that, in 2006, donor support for development encompassed over 60,000 ongoing projects, with some partner countries engaging in over 1,000 donor-funded activities, hosting over 1,000 missions each year, and preparing as many as 2,400 progress reports annually. Figure III.4 demonstrates that, in low-income countries, as the number of projects has gone up, the average size of projects have gone down. In this regard, the United Republic of Tanzania manages over 700 externally funded development projects and in 2005 received over 540 donor missions. The average number of official donors—bilateral and multilateral—per country has increased threefold since the 1960s; the number of countries with over 40 active bilateral and multilateral donors has ballooned from zero to over 30 since 1990 (ibid.).

Resurging Southern providers and non-governmental organizations and private foundations have added to this proliferation. Southern bilateral development assistance is virtually all in the form of project loans and grants, each with its own modalities and procedures (see box III.1). Through international philanthropy, historic contributions

Figure III.4
Number and average size of aid projects in low-income countries, 1997-2008



Source: World Bank (2007).

Box III.1

South-South development cooperation

Main trends

South-South cooperation encompasses financial flows, such as loans and grants for social and infrastructure investment projects and programmes, as well as the sharing of experiences, technology and skills transfers, preferential market access and trade-oriented support and investments.

Virtually all Southern bilateral development assistance is in the form of project loans and grants. More specifically, about 90 per cent of South-South development cooperation comes in the form of project finance and technical assistance, with about 10 per cent in balance-of-payments or budget support, although some contributors are planning to move to more programme-based approaches in the future. Many Southern contributors and multilateral creditors have provided debt relief for heavily indebted poor countries (HIPCs), although not all on strictly comparable HIPC terms, with some countries having written off significant sums owed by HIPCs.

Intensified regional cooperation and integration constitute a major catalyst for South-South development cooperation. The bulk of South-South cooperation is undertaken intraregionally to support regional integration initiatives. The African Union, the New Partnership for Africa's Development,[a] Association of Southeast Asian Nations Plus Three cooperation and the Caribbean Community (CARICOM), among others, are important platforms for facilitating South-South exchanges through regional and interregional partnerships while consolidating economic integration. Southern countries can help each other not only financially, but also in many vital areas encompassing, for example, design of development strategies and sharing for mutual benefits of development experiences that have been undergone over the past decades.

Many contributors to South-South development cooperation have programmes that are co-financed by triangular cooperation, whereby Development Assistance Committee (DAC) donors finance projects executed by institutions of the South. As developing countries offering South-South development cooperation programmes are seen as having expertise relevant to meeting developing-country needs, the focus of triangular development cooperation is primarily technical.

Coordination at the country level

Harmonization among contributors on procedures related to the provision of South-South cooperation has not been formalized. An exception is the coordination achieved by Arab institutions (the Abu Dhabi Fund for Development (ADFD), the Arab Bank for Economic Development in Africa (BADEA), the Islamic Development Bank (IsDB), the Kuwait Fund for Arab Economic Development (KFAED), the OPEC Fund for International Development, and the Saudi Fund for Development (SFD)) through the Arab Coordination Group and project co-financing arrangements. The Arab contributors, for example, have adopted common procurement procedures.

There is a certain degree of coordination, on a regional basis, among some Southern providers with Northern donors. For example, Malaysia, Singapore and Thailand coordinate with the Islamic Development Bank, United Nations organizations and Japan through regional initiatives in Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam, some of which are related to triangular cooperation arrangements. OECD/DAC is liaising with bilateral Southern contributors with the aim of reaching the stage of agreement on and/or endorsement of good development practices, as formulated by the Development Assistance Committee, which includes soliciting stronger participation of those contributors in the policy formulation process as well as in co-shaping the outcomes. However, in general, few Southern providers engage directly in macroeconomic or social policy dialogue with programme country Governments and rarely participate in national donor coordination meetings, which are usually organized in conjunction with DAC donors.

Challenges of aid effectiveness

There have been repeated calls for Southern providers to bear some of the commitments of donor countries as outlined in the 2005 Paris Declaration on Aid Effectiveness and the 2008 Accra Agenda for Action,[b] the most significant international agreements on aid effectiveness. As of today, 111 non-DAC countries have subscribed to these agreements. However, in spite of the large number of partner country signatories, the Paris Declaration and the Accra Agenda for Action are still perceived as

a Document A/57/304, annex.

b Document A/63/539, annex.

Box III.1 (cont'd)

reflecting an agenda set by Northern donor countries. There is a widespread view that South-South development cooperation took root in a special historical context, with distinct features vis-à-vis official development assistance (ODA). South-South cooperation is recognized as a common endeavour of peoples and countries of the South, born out of shared experiences and sympathies, based on their common objectives and solidarity, and guided by the principles of respect for national sovereignty and ownership, free from any conditionalities. Moving towards the Paris Declaration targets may mean that some of the benefits of Southern development assistance to programme countries will decline; and a move towards more programme-based assistance may mean that there is less direct project funding available for infrastructure projects. Untying development assistance could potentially lead to slower project implementation if the competitive bidding process turns out to be time-consuming.

Yet, some policy orientations of the aid effectiveness agenda are governed by universal values regarding international cooperation for development. These values include respect for national ownership and leadership as well as mutual accountability, whereby providers of cooperation and their partners are accountable to one another for development results. This was recognized collectively by Southern countries during the High-level Conference on South-South cooperation held in Nairobi in December 2009, which stressed the need to enhance the development effectiveness of South-South development cooperation by continuing to increase its mutual accountability and transparency, as well as coordinating its initiatives with other development projects and programmes on the ground, in accordance with national development plans and priorities. Although the indicators of the Paris Declaration cannot be applied in their entirety, some could provide important reference points for South-South development cooperation. In this respect, there is a need for a platform of Southern countries able to take the lead in developing such criteria, taking into account the aid effectiveness agenda.

Support for multilateralism and development

South-South development cooperation funding represents an important complement to ODA flows. Against the backdrop of global economic turbulences, there are clear indications that global development cooperation in the coming years will operate under increasingly stringent aid budgets. At the same time, South-South development cooperation is expected to continue growing. For example, the United Nations system, as an important channel for South-South development cooperation, has witnessed significant growth in contributions from non-DAC countries in recent years. Non-DAC countries contributed $708 million to the United Nations development system in 2007, representing a 220 per cent increase over 2004 and a 57 per cent over 2005. This momentum, if maintained, will contribute to support for the efforts of developing countries to realize the internationally agreed development goals, including the Millennium Development Goals.

In addition to providing additional flows, South-South development cooperation opens up to developing countries an effective avenue for capacity development. Developing-country skills and technological solutions have evolved in an environment of similar factor endowments, such as labour abundance, capital scarcity and poor infrastructure, while expertise of developing countries is likely to be at levels more appropriate to the size of markets in other developing countries. With these comparative advantages, Southern contributors are regarded as competitive providers of more appropriate and cost-effective responses to the needs of their fellow developing countries.

The best practices in South-South development cooperation could inform the aid effectiveness agenda and help to reshape the framework for international development cooperation, for South-South development cooperation has been perceived by programme countries as a modality that is more flexible and predictable as well as more responsive to country priorities. Another hallmark of this modality is its cost-effectiveness and efficient implementation. These merits could provide important lessons for donors involved in redefining the aid effectiveness agenda.

Yet, identification of good practices and learning in South-South cooperation needs to be improved. While some of this work is being done in the context of OECD/DAC, the new Development Cooperation Forum, held by the Economic and Social Council, could play a critical role in engaging developing countries in identifying such good practices and, notably, engage countries offering South-South cooperation programmes on a major scale.

Source: UN/DESA.

have been made to achieving malaria eradication and the goals of other global health programmes and in the area of the discovery and dissemination of high-yielding agricultural crops, among others. At the same time, non-governmental aid mechanisms have contributed to further aid fragmentation, as their operations and disbursements are more difficult to align with national priorities.

Aid fragmentation complicates the pursuit of coherent long-term development policies

Aid fragmentation can be costly: donors undertake identification missions, negotiate the terms of projects to be funded, maintain their own accounting methods, tend to set their own conditions, and prefer to do their own monitoring and evaluation. A European Union (EU) report estimates the costs of delivering EU aid programmes at €2 billion-€3 billion; if all EU aid had been delivered in the form of budget support, transaction costs might have been less than €0.9 billion (European Commission, 2009). Indirect costs may be even much higher, thereby affecting the institutional capacity of developing countries and complicating the pursuit of coherent long-term development policies by Governments, especially when they are highly dependent on aid and are dealing with multiple donors every day.

Earmarking of aid and proliferation of vertical funds

The last two decades have seen the proliferation of special-purpose funds for specific aid objectives. Among the major funding pools are the Global Environment Facility which provides support for a set of multilateral environmental agreements, and the Global Fund to Fight AIDS, Tuberculosis and Malaria. Aid for Trade is a donor facility launched during the Doha Round of the World Trade Organization to help developing countries exploit the market access that they have obtained through trade negotiations.

Special-purpose aid vehicles imposes many dilemmas on the demand side of aid

While the establishment of special-purpose aid vehicles facilitates coherence in particular areas on the supply side of aid, it gives rise to many dilemmas on the demand side because of well-known inflexibilities of earmarked funding. For example, the delivery of health services in response to AIDS is often hampered by inadequate health systems. To achieve the goal of "fighting AIDS", it may be necessary to rebuild the whole health system, but special-purpose funds by their very nature cannot be re-channelled in this way. The administrative demands associated with accessing different special vehicles on the recipient side are high; and the costs of earmarking are just as relevant at the international as at the domestic level. Here lies one argument for providing assistance to countries through the overall budget channel and allowing recipients to use these resources according to their own priorities.

Aid effectiveness

The stable flow of resources is key for aid effectiveness

Aid effectiveness evaluations since the 1970s have generally been undertaken in regard to aid's contribution to overall economic growth, even as its purposes and role in development have been shifting. Addison, Arndt and Tarp (2010) and de Haan (2009) argue that aid has a positive impact on economic growth, albeit with decreasing returns. In general, for each 10 per cent increase in the proportion of ODA to gross national income (GNI), the impact would be an increase of 1 per cent in economic growth (Tarp, 2010). Successful post-war European reconstruction (see the discussion below on the Marshall Plan approach) and other "economic miracles" in the second part of the twentieth century demonstrate that carefully designed development objectives, appropriate institutional settings, and a stable flow of resources are key for aid effectiveness. Easterly (2006), in contrast, argues that while aid has been successful in a number of specific programme cases, failure has been the norm, owing mainly to both donor fragmentation and the diversion by recipients of fungible aid resources towards unproductive uses. Bhagwati (2010) also underlines absorptive capacity and fungibility problems as key factors undermining aid's effectiveness. From different analytical perspectives, other studies have stressed the risks of becoming aid-dependent and experiencing few incentives for economic development (Reinert, 2005).

Greater coherence among aid objectives is critical

Donors have been trying to mend the situation. The 2005 Paris Declaration and the 2008 Accra Agenda for Action have called for greater coherence among aid objectives and for the acceleration of the implementation of the agreed principles therein. The Paris Declaration provides new codes of conduct for donors which aim to reduce fragmentation, including through target-setting for greater harmonization in aid provisioning, alignment behind recipient country development programmes, coordination of donor missions and diminishing the use of project implementation units. The quality of aid is to be enhanced by more predictable aid flows programmed at the country level. Strengthening mutual accountability of donors and recipients, an additional aim set out in the Paris Declaration, should help reduce transactions costs and strengthen State capacity. An example is the joint Economic Commission for Africa (ECA)-OECD project discussed in box III.2.

Box III.2

The Mutual Review of Development Effectiveness (MRDE) in Africa

Pursuant to the Millennium Summit, held in 2000, at which the Millennium Development Goals were agreed, both African Governments and their development partners entered into a series of mutual commitments designed to promote the achievement of the Goals in Africa. These commitments were embodied in the New Partnership for Africa's Development (NEPAD)[a] launched by African leaders in 2001, and in subsequent declarations by the African Union Commission, and in the responses from development partners that followed.

Coordinated review of commitments

The New Partnership for Africa's Development proposed the establishment of a system enabling African countries and their development partners to discuss development effectiveness and aid management issues. At their meeting on 3 November 2002, the NEPAD Heads of State and Government Implementation Committee (HSGIC) underscored the need for mutual review of development partners in terms of their commitments to Africa. To this end, the Economic Commission for Africa (ECA) and the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) developed a framework within which "Joint reviews of development effectiveness", could be carried out for African countries and their development partners.

The joint mutual reviews involve objective evaluations of performance by African countries and external development partners based on an agreed set of commitments and indicators that are monitored through the review process. In this sense, the 2005[b] and 2009[c] reports reviewed the commitments made, actions taken to deliver on those commitments, results, and priority actions. Building on the first report, the 2009 report covers four main topics: sustainable economic growth, investment in people, good governance and development finance. It treats capacity development and policy coherence as key cross-cutting issues together with regional integration and international systemic issues.

a Document A/57/304, annex.

b ECA and OECD, "Development effectiveness in Africa: promise and performance—applying mutual accountability" (October 2005).

c ECA and OECD, "The mutual review of development effectiveness in Africa, 2009: promise and performance" (April 2010).

Box III.2 (cont'd)

Progress on economic growth and climate change commitments

Africa has made good progress with respect to its commitments on promoting growth, investing in the health and education of its people, improving governance and mobilizing resources. Development partners have scaled up their financial and technical assistance.

Positive results that have been achieved in Africa include strong and sustained economic growth, outpacing global per capita growth since 2001 after lagging behind for two decades, and helping to reduce poverty. Multiparty democracy has taken a stronger hold, and the number of State-based armed conflicts has been reduced. There has been significant progress towards the Millennium Development Goal of achieving universal primary education by 2015. However, the picture with respect to other Millennium Development Goals, particularly that of reducing the maternal mortality ratio by three quarters is troubling, and based on present trends, no country in Africa will meet all the Goals by 2015.

African Governments have made commitments to promote environmental sustainability and to integrate climate change adaptation strategies into national and regional development policies. The key future policy priorities with regard to climate change and environmental sustainability entail mainstreaming environmental and climate adaptation issues into economic planning. In this regard, twenty-seven African countries have identified their priority adaptation needs through the development of National Adaptation Programmes of Action (NAPAs); the Conference of African Heads of State and Government on Climate Change (CAHOSCC) was established to represent Africa at the fifteenth session of the Conference of the Parties to the United Nations Framework Convention on Climate Change;[d] and under their Climate for Development in Africa Programme, the African Union Commission, ECA and the African Development Bank jointly established the African Climate Policy Centre (ACPC). Moreover, climate change adaptation has been integrated into national development programme design and implementation. Along the same lines, development partners have made commitments to undertake enhanced action on mitigation, support for adaptation, technology transfer and financial resources. The key policy effort that needs to be pursued by development partners is therefore increasing financial and technical support to help Africa adapt to climate change and to develop clean energy.

Challenges remain ahead

Although much has been done on both sides of the partnership – for example, regarding external debt policies – more needs to be done on both sides to meet commitments. For example, in respect of policy coherence for development, there is a need to align trade, climate change, financial regulation, tax policy, corruption, peace and security, and development finance policies of African Governments and their development partners. There are remaining challenges that arise from the need to improve the coherence of climate change, trade and aid policies of OECD member countries and from the need for African Governments to direct the benefits of economic growth and larger Government revenue towards the achievement of the Millennium Development Goals and to enhance efforts to promote collective regional action on key political and economic issues, together with accelerated regional economic integration. Development partners and the wider international community need to respond positively to Africa's call for stronger representation in international institutions tackling wider systemic issues and to deliver on existing commitments to increase the volume and improve the effectiveness of official development assistance (ODA).

The above-mentioned mutual review of development effectiveness (MDRE) outcome reports have become important mutual accountability mechanisms for African countries and their development partners. They also serve as a basis for dialogue on Africa's development agenda within G-8 Africa[e] and other critical international forums. The MDRE reports make policy recommendations on what needs to be done to close any implementation gaps, highlighting best practices and how these can be replicated, as well as avoidable bad practices.

d United Nations, *Treaty Series*, vol. 1771, No. 30822.

e A process of dialogue between the Group of Eight (G-8) and African countries.

Source: UN/DESA based on ECA, "The mutual review of development effectiveness in Africa" (22 March 2010).

Reconciling national priorities with the taxpayer-approved objectives of donor countries has been difficult

Nonetheless, putting these principles into practice has not proved to be easy. Despite the targets agreed by the signatories of the Paris Declaration who had endorsed the principles contained therein, "only 15 per cent of donor missions are undertaken jointly with other donors, well below the 40 per cent target set for this indicator, and only 9 per cent of partner countries undertake mutual assessments of progress in implementing agreed commitments and more broadly their development partnerships, against a target of 100" (World Bank, 2006b, p. 79). Reconciling national development priorities with the taxpayer-approved objectives of donor countries has been difficult. Even now, less than a quarter of aid flows from DAC donors is provided in the form of budget support and in a few instances aid flows are part of multi-annual programmes. While one of the objectives of the Poverty Reduction Strategy Paper (PRSP) agenda was to give recipient countries more of an opportunity to occupy the driver's seat so that donors would then be aligned behind nationally defined development strategies, in practice the PRSPs have been found to come with too many strings attached and to be excessively donor-driven (see below and chap. II; and United Nations, 2009a). And in fact they did prove in many instances to be ineffective in improving ownership and donor alignment (Wood and others, 2008).

Additional donor channels could set back efforts to reduce transaction costs

The newfound prominence of South-South cooperation has emerged amidst the abovementioned efforts of traditional donors, who are applying mainly the lessons learned from the poverty reduction strategy effort of the 1990s. Some DAC members have expressed concern that the aid provided by non-DAC donor countries (many of whom do not report their ODA figures and are not bound by the principles of the Paris Declaration and existing conventions on the provision and use of aid) may undermine progress on jointly agreed commitments to improve aid effectiveness. The presence of additional donor channels in an already crowded field increases the risk of duplication of activities and could lead to a setback for DAC donors who have the intention to reduce transaction costs for aid recipient countries by rationalizing reporting and accountability obligations. Yet, South-South cooperation partners have also expressed their own concern that the "aid effectiveness" process is being driven too much by OECD, and that project aid—the preferred modality of South-South cooperation—could become a casualty of the preference for programme aid as governed by the principles set out in the Paris Declaration. There is still no international venue where these issues can be addressed, except possibly the Development Cooperation Forum held by the Economic and Social Council (see box III.1 above).

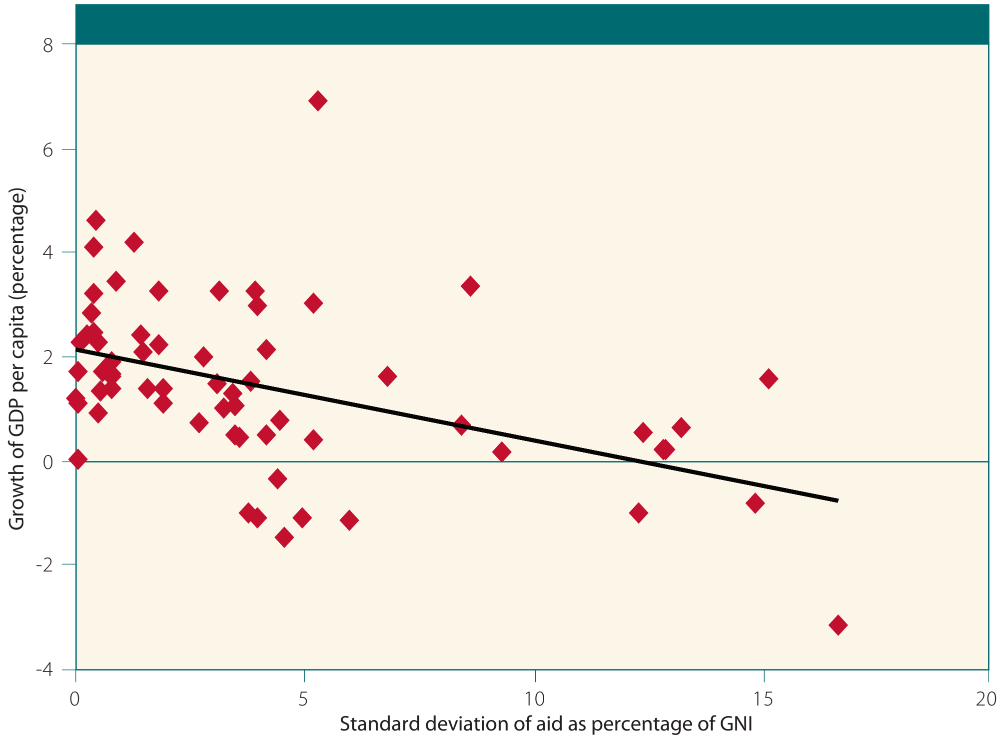
Aid volatility

Aid volatility has compounded macroeconomic instability

In countries where aid flows are a large driver of their economy, aid volatility has compounded macroeconomic instability, affecting private and public investment spending and long-term growth. One study (Kharas, 2008) found that for the average recipient country, ODA flows are five times more volatile than gross domestic product (GDP) and three times more volatile than exports earnings.[6] ODA thus could magnify real business cycles in recipient countries. Measured volatility cannot be associated with donor actions alone: using their own procedures, donors often have to respond—by halting aid disbursements, for example, if the prior year's resources were unutilized—to unexpected and unfortunate economic and political events beyond their control in recipient countries. Figure III.5 suggests that, for a sample of 65 recipient countries, higher levels of aid volatility is associated

6 Volatility is measured as the coefficient of variation against a long-term trend.

Figure III.5
Aid volatility and economic growth in 65 recipient countries, 1970-2007



Source: UN/DESA, based on World Development Indicators Online.

with lower long-term rates of growth of GDP per capita. Least developed countries and small island developing States are among the aid-dependent countries facing the highest levels of volatility in ODA inflows.

The deadweight losses associated with aid volatility can be as large as 15-20 per cent of the total value of aid, which, at the current aid levels, would amount to welfare losses of about $16 billion (Kharas, 2008).[7] To an average recipient, the deadweight loss of aid volatility is about 1.9 per cent of GDP. Per dollar of aid provided, the cost would lie between 7 and 28 cents, depending on the donor. In the same study, the degree of aid volatility varies across donors and losses due to aid volatility are largest in cases where the United States is the major donor, with losses from volatility for every dollar disbursed being more than double those associated with Japan, the next most "volatile" donor.

Conditionality and country ownership

Developing-country "ownership" must be meaningful

Political considerations and concerns about accountability to their own taxpayers have led donors to attach conditions regarding how aid is to be spent. As indicated, funds have often been rigidly earmarked for particular purposes. Determining the role and the mechanisms of conditionality in foreign assistance projects depends very much on establishing a practical and effective characterization of "ownership". The concept of ownership held a prominent place in attempts within the donor community to explain shortfalls in country performance within the context of programme conditionalities: while programme conditionalities were

7 In economics, a deadweight loss is a loss of economic efficiency. In the present case, the efficiency loss is associated with the unpredictability of aid flows.

regarded as sovereign commitments, the recipient Government's insufficient ownership of those commitments was deemed one reason why, in certain cases, they had not been met. Ownership in practice therefore became a criterion for programme success.

Through the Poverty Reduction Strategy Papers, which have often not really been country-owned, the donor community shifted the focus of its aid more towards poverty reduction

By the late 1990s, donor Governments and aid agencies had come to realize that their differing approaches and requirements were imposing high costs on developing countries and making aid less effective (Mkandawire, 2010). In an attempt to address the need to reduce the aid delivery costs being generated, recipient countries sought access to funding "earmarked" for particular purposes. Through the PRSPs, the donor community shifted the focus of its aid more towards poverty reduction. As discussed in chapter II, PRSPs were supposed to generate comprehensive long-term strategies for reducing poverty, while being at the same time sufficiently operational to guide aid efforts and to ensure that their focus was reflected in the allocations of annual Government budgets. Based on a review of how PRSPs had been designed and implemented, a study by Dijkstra (2010) concludes that, in practice, the PRSPs tended to be weakly linked to the actual processes of formulation and approval of Government budgets. Part of the explanation is to be found in the perception that there was too strong a donor influence on the design of the poverty strategy, which eroded the sense of Government ownership of both the strategy and the external funding mobilized in support of it.

True ownership would require that countries have control over their own policies

The question then comes down to determining how to achieve country ownership in practice and reconcile this with the conditions that donors feel compelled to impose in order to justify the use of the money of their own taxpayers. True ownership would require that countries have control over their own policies, yet this often comes into conflict with the mechanism of donor conditionality (Dijkstra, 2010).

Towards a needs-oriented international aid system

Effective partnerships are based on the recognition of national leadership and ownership of development plans

Incoherence in the international aid system has been built up by a process of accretion of elements derived from various sources. The existing system is the product of changing fashions in concepts of development, the responses of donors to the challenge of redeploying their resources more effectively, and well-intentioned, and mostly unilateral, efforts to reform the system. The overarching principles of reform were identified in the Monterrey Consensus of the International Conference on Financing for Development (United Nations, 2002), which called for "[e]ffective partnerships among donors and recipients … based on the recognition of national leadership and ownership of development plans and, within that framework, sound policies and good governance at all levels" (para. 40). The process initiated by OECD under the rubric of aid effectiveness encompasses most of the details associated with successful pursuit of this goal. It is therefore agreed that this reform process must be completed and its promise fulfilled.

Addressing the system's key weaknesses, as highlighted above—namely, fragmentation, instability and unpredictability of aid flows, lack of flexibility and alignment with recipients' priorities, long-term dependence on external aid, and deficient partnership and country leadership/ownership, as well as recipient country problems of absorptive capacity and misuse of funds—will require even more good intentions and political will than has already been demonstrated.

Putting recipient countries in the driver's seat

What is required is a much stronger commitment by donors to accepting the principle of needs-based allocations and alignment of aid flows behind national development strategies, as is consistent with the principles of the Paris Declaration. Rather than such attempts to make gradual improvements as are currently being deployed, what seems to be needed is a more radical shift towards full adherence so as to overcome the continued fragmentation and problems of country ownership which undermine aid effectiveness. Based on this approach:

A much stronger commitment by donors to accepting the principle of needs-based allocations is required

- Sustainable development strategies would provide the framework for policy coherence at the national level and also articulate the nature of the financing gaps that aid flows can fill and the timing of those flows
- Bilateral and multilateral as well as non-governmental donors would be aligned and asked to respond to needs through multi-year commitments
- Alignment with other sources of development financing could be achieved as part of the same process (see below)
- Earmarking of aid funds by donors would become less relevant, although still possible if it served specific purposes (such as rallying private sector support through vertical global health funds), but always with the requirement of coherence with the priorities and financing needs of the development strategy
- Monitoring, evaluation, accountability processes and the updating of funding requirements would be the responsibility of a joint standing committee of donors but one chaired by the recipient country
- Ex ante conditionality would be restricted to recipient countries that had elaborated national development strategies, although donors would not attach further policy conditions to their support; instead, continued support would be decided upon based on monitored progress and outcomes of the implemented strategy

Certain successful past experiences can guide the way towards making such an approach work in practice. In fact, the successful Marshall Plan for post-war reconstruction and development in Western Europe was built on principles similar to those suggested above (see box III.3; and United Nations, 2008, chap. IV). Even though the environment in which developing countries exist today is quite different from that of post-war Europe, the Marshall Plan principles can help provide a coherent framework for coordinating national development strategies with international assistance. Without the provision of an articulate account of a Government's macroeconomic objectives and their relation to detailed programmes for infrastructure investment, sustainable development of the agriculture, energy and industrial sectors, productive job creation, education, health and social protection, among others, it is difficult to see how limited supplies of foreign assistance, financial and technical, could be really effective.

Certain principles derived from the Marshall Plan can help provide a coherent framework

Mkandawire (2010) suggests that far more than contributing resources to rapid economic recovery after the Second World War, the Marshall Plan embodied ideas that took root and shaped the European Union's subsequently effective economic cooperation with Ireland, Portugal and Spain through needs-oriented assistance programmes. The Marshall Plan achieved a coherent framework for coordinating economic recovery and development plans. It relied on domestically generated planning and configured both its time frame and grant-to-loan proportion to meet the problem at hand. At the time, the

Essentially, the Marshall Plan intervened to ease shortages, bottlenecks and other constraints on growth and structural change

Box III.3

Seven virtues of the Marshall Plan

The Marshall Plan was the assistance framework established by the United States of America for the economic recovery of Western European countries in the post-war period (1947-1951). The seven principles under which the Plan operated are summarized below.

1. **Realistic time frame.** The post-war adjustment applied a more realistic time frame than that normally envisaged by the United States Treasury or by an International Monetary Fund (IMF) programme. Instead of 18 months, the timescale was from 4-5 years.

2. **Alignment with an overall economic programme.** The architect of the plan, United States Secretary of State George Marshall, made it clear that there was to be an end to piecemeal assistance, which had suffered from a lack of coordination and had had less impact than expected in stimulating economic recovery. A key requirement, therefore, was that each State recipient of aid had to produce a four-year outline plan for recovery, setting out targets for the main economic variables and providing an account of how the Government intended to achieve its objectives.

3. **Genuinely domestic programming.** Marshall insisted that these plans, together with estimates of the need for assistance, had to be drawn up by the Western Europeans themselves: "It would be neither fitting nor efficacious for (the United States) to undertake to draw up unilaterally a program designed to place Europe on its feet economically. This is the business of Europeans … The role of this country should consist of friendly aid in the drafting of a European program and of later support of such a program…" Marshall thus acknowledged the existence of national sensibilities, admitted that the recipient countries were better informed about the facts of their situation than outsiders, and generally showed a deference towards European traditions and preferences that has subsequently been conspicuously absent from the attitudes of the rich countries and international institutions towards the rest of the world.

4. **Flexible intermediate targets.** A fourth feature of the Marshall Plan was the release of aid in tranches that depended on the countries' intermediate targets' being met. Marshall Plan conditions were different from those established in recent practice and more flexible and were to be met over a longer period than that allowed by IMF rules, for example.

5. **Gradual and asymmetric international integration.** The Marshall Plan acknowledged that the damage to European productive capacities and the great disparity in economic strength between the United States and Europe meant that rapid liberalization of trade and payments would quickly lead to European payments-related crises. It was accepted that Europe would gradually dismantle a wide range of direct and indirect controls on its trade between 1950 and 1958 according to an agreed timetable within the framework of the European Payments Union. This gradual liberalization of trade provided European producers with protection against competition from the United States and gave them time for, and encouragement in, the reconstruction of enterprises capable of producing competitive substitutes for dollar imports. At the same time, the United States agreed to a more rapid improvement in access to its own market for European exports, a policy of asymmetric liberalization which stands in marked contrast to the present approach of the European Union and the United States, which insists on a rapid opening of developing countries' markets and on restricting the range of policy options available for their development.

6. **Significant grant component.** Marshall Aid consisted largely of grants and the small proportion of loans had a large grant component: they were usually offered for 35 years at 2.5 per cent interest with repayments starting in 1953. It is worth emphasizing this structuring of financial help at a time when the terms "aid" and "assistance" are used loosely to cover everything from gifts to loans at market (or above-market) rates of interest. The wisdom of adding to the debts of already heavily indebted economies is highly questionable—all the more so when they are grappling with economic restructuring and institution-building, which is typically the case for countries trying to accelerate their development or to recover from the chaos that normally follows the end of violent conflict. A

Box III.3 (cont'd)

generous supply of grants, monitored within and conditional on a coherent economic programme along the lines of the Marshall Plan, can be more effective than loans in lifting countries out of a "stagnation trap" where heavy debt-servicing obligations hold back the domestic and foreign investment that could improve the longer-run performance of the economy, including its capacity to service debt. Another advantage of grants is that they are not usually subject to the long and complex negotiations, legal and financial, associated with the provision of loans. This is important inasmuch as one of the lessons of the Marshall Plan is that prompt assistance at the start of a promised programme can help to sustain positive expectations, which most likely will have been raised by politicians, and generate a momentum for change that will stand a chance of becoming self-reinforcing.

7. **Coordination among recipients.** Finally, yet another virtue of the Marshall Plan that is still relevant to attempts to tackle current problems is its insistence that there should be a degree of united and cooperative effort among the Europeans themselves, and that the plans of the 16 recipient countries and the allocation of aid should be coordinated within a regional body. This requirement partly reflected United States foreign-policy objectives with regard to a more integrated Europe, and also provided a structure for cooperation in areas where there are significant externalities, economies of scale and other transboundary issues. The peer review of national programmes provided national policymakers with a regional perspective on their own policies and encouraged a culture of regular contact and cooperation among national bureaucracies which is today taken for granted in Europe.

Source: Adapted from United Nations (2008, chap IV, pp. 143-145).

Marshall Plan essentially intervened to ease shortages, bottlenecks and other constraints on growth and structural change.

The currently prevailing view is that programme failures are due to a weak commitment to reform (or a lack of ownership) and a slackening of discipline through postponement of necessary adjustment. In contrast, Marshall Plan resources were seen as investments in social cohesion and structural change and as providing Governments with the breathing space required to make difficult and often painful policies successful (United Nations, 2008). When such policies threatened to cause social upheaval on a scale that might upset the adjustment process, as was the case in post-war Italy at one point, Marshall Aid was available to cushion the social costs through support to the Government budget.

With a multiplicity of donors, there is a need to establish mechanisms of coordination

European recipients of Marshall Plan resources had the advantage of dealing with only one donor (Mkandawire, 2010). In the currently fragmented aid system, with its multiplicity of donors, there is a need to establish mechanisms of coordination, a need that has also been recognized in the "aid effectiveness" process. Operational since 1995, the panel on donor coordination in the United Republic of Tanzania is one example of a country-led approach to improving coordination and making donors accountable for their activities (Helleiner, 2005). (Not all donors agreed, however, to participate in the effort initially.) In the United Republic of Tanzania, formal public expenditure reviews and the application of the medium-term expenditure framework appear to have been effective in fostering wide participation of stakeholders in the budget process. Ngowi (2005) has indicated how these mechanisms have in turn strengthened the links between sector policies and resource allocation, by providing valuable analyses and feedback on budget execution which has improved resource use. However, he also notes that the impact on poverty reduction appears to be weak, though the efforts will perhaps bear fruit in the long term.

A key aspect of the experience of the United Republic of Tanzania has been the role played by a broader macroeconomic framework in relating to donors. To achieve such an arrangement was also the intention of the PRSP approach; this was stymied, however, by the fact that in practice the estimation for the maximum resource envelope was undertaken mainly by IMF. Ngowi (2005) reports that the United Republic of Tanzania

Revenue Authority consistently met its revenue targets and collections reached an average of 12.5 per cent of GDP in the past 10 years compared with a figure of less than 8 per cent in the previous decade.

Recipient countries can take the initiative in rationalizing the operations of donors in their economy

The aid effectiveness principle of country ownership/leadership itself suggests that, in a situation where there is an interest in engagement on the part of both DAC and non-DAC donors, nothing should prevent a recipient country from taking the initiative in rationalizing the operations of those donors in its economy. An example of recipient country donor management is provided by India which allows only donors whose funding exceeds a minimum level to operate in the country. If donor competition is so harnessed as to be in the interest of a recipient country's national strategy, expanding South-South cooperation could play an "anti-trust" role in engaging the donor community. Private foundations must also accept country leadership in their operations in developing countries, which would entail aligning programmes with the domestic development priorities included within recipients' national regulatory frameworks (a course those foundations often espouse) .

Space for experimentation and the possibility of failure should be incorporated in aid evaluation

Country leadership in consolidating all aid flows could minimize the costs arising from earmarking restrictions. Countries would access these funds only if they fit the overall national sustainable development strategy. The United Nations Development Assistance Framework (UNDAF) process of integrating all donor projects into one overall programme aligned with a national development strategy could serve as a model approach for the future if the Framework can manage to further distance itself from the existing practice of acting essentially as a collection box for individual donor project financing. The PRSP experience, governed by the attempt to "plan everything" and obtain agreement from all parties, should be instructive. Because of the high level of uncertainty associated with development programmes, space for experimentation and the possibility of failure should be incorporated in evaluation. Entire responsibility for policy choices should be lodged fully with aid recipients, as is the case, at least in formal terms, at the present time. If aid recipients are to be fully in command of the policy choices they make, however, then outcome evaluation instead of policy conditionality should eventually become the norm for all aid projects and programmes.

As addressing capacity weaknesses by the implementing Government is part of the development effort and of learning, upgraded capabilities need to be looked upon favourably in the context of outcome evaluation. Programmes should be deemed "good enough" if they reflect a broad relationship between means and ends. Embedding the identification of external funding gaps within an overall national strategy will require the determination of the multi-year progress that must be made in domestic resource mobilization and consequent reduction in aid and external debt dependency.

It is donor accountability for which there are no existing sanctions

While there are unavoidable geopolitical considerations that exert pressure on donors to continue support for poorly performing recipients, accountability of the recipient countries is usually inherent in what is in fact a "repeated game" situation: donors can always withdraw in the next funding iteration. It is donor accountability, instead, for which there are no existing sanctions.

Consequently, the proposed aid process requires some ancillary mechanisms to strengthen aid effectiveness. As these suggestions would be desirable even in the absence of a fundamental reorientation towards national strategies as suggested above, progress should be made along these lines irrespective of a fundamental restructuring. Among the key elements are the following:

- All aid flows should eventually be disbursed through general budget support
- Reducing the number of special global funds is in the interest of both donors and recipients, although one would expect that a few large funding pools, such as, potentially, one for climate change, would continue to exist
- Donors should begin progressively to budget aid flows in cycles of two or more years at a time, which will necessitate difficult adjustments in donor country political decision-making
- Some special delivery mechanisms, such as through trust funds (see below), can be established consistent with the overall approach of country leadership

It is also important to note that, even with the reorientation of the aid system towards country programmes, there will still be requirements for global responses to "natural" disasters and humanitarian emergencies and to climate change which must be provided for by the international community. Special global funds with specific modalities could be devoted to natural disasters, as discussed in *World Economic and Social Survey 2008* (United Nations, 2008). The climate change response remains more complex: it still awaits agreement on a global climate regime, which can integrate aid, trade, finance and technology. The challenges in this regard were explored in *World Economic and Social Survey 2009* (United Nations, 2009a) and will be discussed further in chapter V.

Resources will still be needed for global responses to "natural" disasters and to climate change

Reforming channels and resource mobilization for development assistance

While the present target of 0.7 per cent of GNI of OECD/DAC countries, set on the basis of the estimated foreign-exchange needs of developing countries in the 1960s, has remained unfulfilled in the aggregate, a needs-oriented aid system would probably redefine the amount of aid needing to be mobilized. However, in the transition to the new system, the target might still serve as a benchmark to rally political support to address development deficits in the poorest countries, as much as additional targets may need to be set to ensure sufficient resource mobilization for supporting climate change mitigation and adaptation efforts in developing countries, aid for trade and the delivery of global public goods. There will also be continued need for separate pools of funds for disaster relief and humanitarian aid efforts.

As the country needs-based system evolves, most ODA requirements would be defined increasingly through a bottom-up approach

On the way forward, two further fundamental changes should be considered. The first would aim at a better alignment of aid flows with other domestic and external sources of development financing through the use of trust fund mechanisms. The second change would entail increased use of funding sources encompassing innovative forms of international levies and leveraging of international liquidity for development purposes.

Enhancing aid predictability and aligning all sources of development financing

The use of trust fund mechanisms to support individual countries or groups of countries could further facilitate the alignment of donor funding with country priorities, ensure long-term financing and align traditional ODA resource mobilization with innovative forms of development financing. Bilateral donors and existing global funds would contribute to trust funds which would disburse resources in accordance with programmatic and budgetary needs of recipient countries. The trust funds could also be allowed to purchase Government securities of developing countries with a view to tying aid to future domestic

Individual country trust fund mechanisms could facilitate the alignment of donor funding resource mobilization efforts. Experience in this area does in fact exist: in a number of cases, multi-year aid commitments have been converted into bond purchases to fund and front-load resources for research on tropical medicines. Recipient countries, in turn, could also be allowed, periodically, to deposit budgetary savings earned during economic upswings into the trust funds as insurance against external shocks, and to draw upon them in response to shocks.

In sum, the advantages of pooling aid resources into a trust fund are simplification and harmonization of procedures, and better support for national goals, priorities and strategies. It can avoid duplication and overlapping efforts, and minimize the burden of integrating externally supported projects into national development strategies. However, the ownership and management mechanisms of trust funds need to be carefully worked out so that the country ownership is not undermined. Pledges of contributions to trust funds should in principle be neither conditional nor earmarked.

New funding sources to underpin the aid architecture

New forms of international taxation could play an increasing role

New forms of international taxation (such as a small levy on international financial transactions) could play an increasing role in providing the resources needed to create a new development finance architecture. The new tax revenues could be channelled through a global fund into country-based trust funds. Mobilizing resources for development assistance through such innovative forms of financing would reduce volatility in available aid flows and vulnerability to political expediency.

A key innovation is the partnership "modality" in resource mobilization established between developed and developing countries

These new approaches which aim at raising the resources needed for a type of development cooperation—dependent on individual country funding—have been piloted, relatively successfully, under the rubric of "innovative sources of finance". The effort, inspired by the 2002 Monterrey Consensus, has spawned a far-ranging worldwide effort to mobilize aid resources from countries at different levels of development and to pilot them towards meeting the internationally agreed Millennium Development Goals. The Leading Group on Innovative Financing for Development (which was founded following the Paris Ministerial Conference on Innovative Development Financing Mechanisms held in 2006 and whose action stems from the New York Declaration on action against hunger and poverty issued in New York on 20 September 2004) promotes discussion on these issues. The Leading Group currently comprises 55 member countries, 4 observer countries, 15 international organizations and more than 20 non-governmental organizations. A key distinguishing feature of this approach is the partnership "modality" in resource mobilization established between developed and developing countries (United Nations, General Assembly, 2009a).

Innovative funding sources of aid hold the promise of less volatility and vulnerability to political expediency

Based on the pilot projects in place, innovative funding sources of aid hold the promise of less volatility, greater sustainability in the long run, reduced vulnerability to decisions that are based on political expediency, and potentially broader participation in fund generation—participation extending beyond Governments to include, for example, citizens (through direct collection) and the private sector (through the utilization of Web-based checkboxes). Actual innovative sources of finance explored so far include currency transaction taxes, taxes on the arms trade, taxes on carbon emissions, an international financial facility, advance market commitments, "solidarity levies" on items such as international airplane tickets, enhanced efforts to combat tax evasion and illicit financial transfers, and a world lottery (Atkinson, ed., 2005).

An early pilot entailed an international levy on air transport. The level of taxation on air transport is lower than on other means of transport, since aviation fuel is tax-exempt in most countries. One report (United Nations, 2005, chap. IV) estimated that a

5 per cent rate applied to airfares would yield $8 billion per annum and that an indirect tax on passenger transportation could reach $20 billion per annum. Estimates of revenue from a currency transaction tax differ widely because of differences in proposed tax rates. Realistically, a currency transaction tax set at two basis points of market currency transactions can raise revenues in the range of US$ 33 billion-US$ 35 billion per annum; other estimations (Clunies-Ross, 2004) yield higher revenues, namely, US$ 60 billion per annum.

The feasibility of re-channelling the provision of global liquidity for development purposes has increased

The original Monterrey innovative financing proposal that referred to the use of special drawing rights (SDRs) for development purposes is expected to draw renewed interest as a result of recent new SDR allocations. Re-channelling the provision of global liquidity managed on an equitable basis, in reserves and payments, to fund poverty reduction and investment in clean energy becomes a more feasible option, given these recent increased allocations of SDRs.

International tax cooperation could triple the resources available for development

The possibility of improving, through international cooperation, collection of taxes currently evaded has received extensive consideration in the Leading Group. Conservative estimates of the scale of the annual resources potentially available for developing countries from the tax lost on the illicit outflow of profits (profits of both foreign companies and domestic residents) and the tax lost due to the income arising abroad from the accumulated assets owned by residents is, for the mid-2000s, of the order of $200 billion-$250 billion,[8] half of which would be attributable to Asia (FitzGerald, 2010). This estimate, which is more than double the level of ODA from DAC members, suggests that the total amount of international fiscal transfers (aid plus tax) available for development finance could be tripled. All developing countries would be in receipt of these resources, except those developing countries that were themselves tax havens. FitzGerald suggests that, since the tax jurisdictions concerned are all closely connected with financial centres in advanced economies, it would be possible to reallocate a portion of the increase in tax income to maintaining the incomes of inhabitants of tax havens and providing them with an alternative economic future. The logical (but perhaps still politically farfetched) implication is that external assistance financing mechanisms could be based on principles of fiscal federalism applied at the global level rather than on principles of humanitarian charity.

All of the mechanisms utilized by innovative financing can be applied to meeting climate change-related needs

In the Copenhagen Accord,[9] agreed at the fifteenth session of the Conference of the Parties to the United Nations Framework Convention on Climate Change,[10] held in Copenhagen from 7 to 19 December 2009, developed countries committed to a goal of mobilizing jointly $100 billion dollars per year by 2020 to address the needs of developing countries, with the funding to come from a wide variety of sources, “including alternative sources of finance” (para. 8). The implication is that all the mechanisms in the innovative financing agenda are on the table in terms of achieving the announced target. A global carbon tax is often mentioned (Addison, Arndt and Tarp, 2010); however, because of the potential costs required to compensate for its distributive and environmental effects, a concerted carbon tax mechanism would be most suitable for and effective in developed countries but less so in developing ones (United Nations, 2009a, chap. VI). Bredenkamp and Pattillo (2010) have set out the mechanics by which special drawing rights can be used to raise the required flow of $100 billion. The recent international discussion concerning a multilateral financial transactions tax sheds new light on a long-standing proposal to apply a currency transactions tax in order to fund climate change-related efforts.

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8 Other studies, using different methods, arrive at larger estimates, in the order of $850 billion-$1.0 trillion per year (see Kar and Cartwright-Smith, 2008).

9 See FCCC/CP/2009/11/Add.1, decision 2/CP.15.

10 United Nations, *Treaty Series*, vol. 1771, No. 30822.

Existing mechanisms rely heavily on "earmarking" towards specific ends

Progress has been most visible in international responses to tropical diseases, through initiatives utilizing the air-ticket solidarity levy, the Advance Market Commitment (AMC) and the International Financial Facility for Immunisation (IFF), among others. Existing mechanisms rely heavily on "earmarking" towards specific ends. The feasibility of a more general development-oriented levy mechanism, one more in line with a needs-oriented international aid system, needs to be tested.

Governing the aid system globally

There is a need to upgrade aid coordination and accountability at the international level

A coherent aid system centred on putting recipients in the driver's seat would need to be matched and facilitated by upgrading coordination and accountability at the international level. There is a need, too, for a global process for setting standards, monitoring progress, and learning from experience that would be broader than that possible under OECD. A larger set of contributor and recipient countries, meeting on a more politically symmetric partnership basis, can build upon the achievements of the process launched pursuant to the principles set out in the Paris Declaration. The Development Cooperation Forum launched by the Economic and Social Council in 2007 has the potential to serve as the kind of venue in which DAC and non-DAC donors can be brought together to promote mutual accountability and aid effectiveness. The Forum has the mandate to facilitate cooperation among countries receiving aid, multilateral institutions, parliamentarians, local governments and a range of civil society and private sector entities.

Progress is necessary in enhancing policy coherence in other areas

Progress in enhancing coherence in the trade, finance and climate change regimes will facilitate the progress of efforts to achieve greater coherence within the international aid regime. Rebalancing towards a focus on "differentiated" responsibilities in the trade system, after decades of emphasis on the "common" ones will allow developing countries to reduce their dependence on external finance which is often necessitated by a too abrupt international integration. This kind of problem was already well known at the time of, and addressed in, the Marshall Plan (see box III.3; and Reinert, 2005). Ensuring that the international aid system provides long-term development finance, and the policy space needed by countries to progressively improve their domestic resource mobilization, is certainly the best way to mark out a path towards the most robust country ownership and, in addition, it offers the best insurance against aid volatility. Chapter V presents suggestions on how to establish a more sustainable and development-friendly global financial regime, one that would be capable of facilitating the flows of financing needed to actualize the trust fund concept presented above. The *World Economic and Social Survey 2009* (United Nations, 2009a) proposed recasting the international climate change "game" as a win-win strategy to be implemented by the orienting of activities towards solving the problem of energy poverty through clean energy investments in developing countries. This approach is congruent with the poverty reduction objectives of the aid system.

Aligning all aid with national development strategies is an approach based on a concept that has already been generally agreed in principle

Aid has always been perceived as having a "catalytic" role in development. It is considered to be time-bound and only supplementary to much larger flows arising from domestic resource mobilization and foreign investment. Nevertheless, a giant step in upgrading the aid system could be achieved by aligning all aid with national development strategies, an approach based on a concept that has already been generally agreed in principle and has been shown to be feasible in pilot situations. Even if this approach continues to give rise to a host of implementation issues, it is without a doubt preferable to the alternative—the current disorganized, cluttered, bureaucratized and politics-dependent aid system which is still struggling to prove its effectiveness in promoting poverty reduction and development.