Chapter 1

Introduction

New Actors, New Approaches

With concern about how to finance the Millennium Development Goals (MDGs) widespread, recent donor pledges to raise aid volumes are welcome. However, aid alone will not suffice — bringing in new actors and sources of development finance will be essential. In many developing countries, this is already happening. This new multiplicity of financing options is thus good news, but it has also brought about major challenges, in particular for efficient aid delivery on the ground and for keeping transaction costs in check. This volume assesses various aspects of the changing "international development finance architecture", first from a global perspective and then from a developing country perspective, drawing policy implications for donors and recipients.

The International Development Finance System is Becoming More Complex

With the Millennium Declaration in 2000, the Monterrey Summit on Development Finance and the Earth Summit in Johannesburg in 2002, world leaders agreed to revitalise efforts to help unlock and more effectively use all development resources including domestic savings, trade and investment receipts and official development assistance. By treating aid as just one of several finance flows and calling for the private sector to become more involved in development, the Monterrey Consensus and Johannesburg Declaration symbolised a shift in consciousness about international development finance. Indeed, important new actors, including private households, foundations and non-governmental organisations (NGOs) have joined bilateral and multilateral donors in financing development. Figure 1.1 gives an idea of the complexity of the new development finance system.

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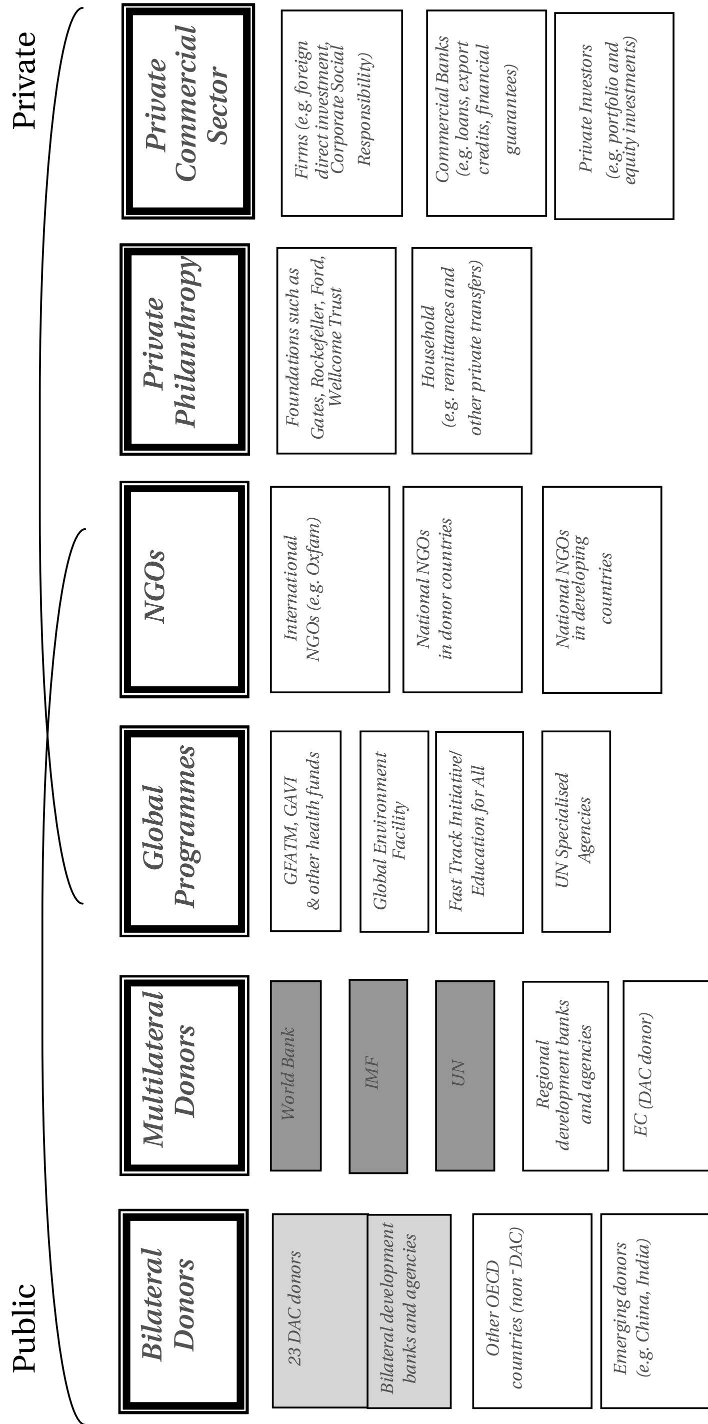
Figure 1.1. The International Development Finance System



Source: OECD DAC/DCD and OECD Development Centre (2006).

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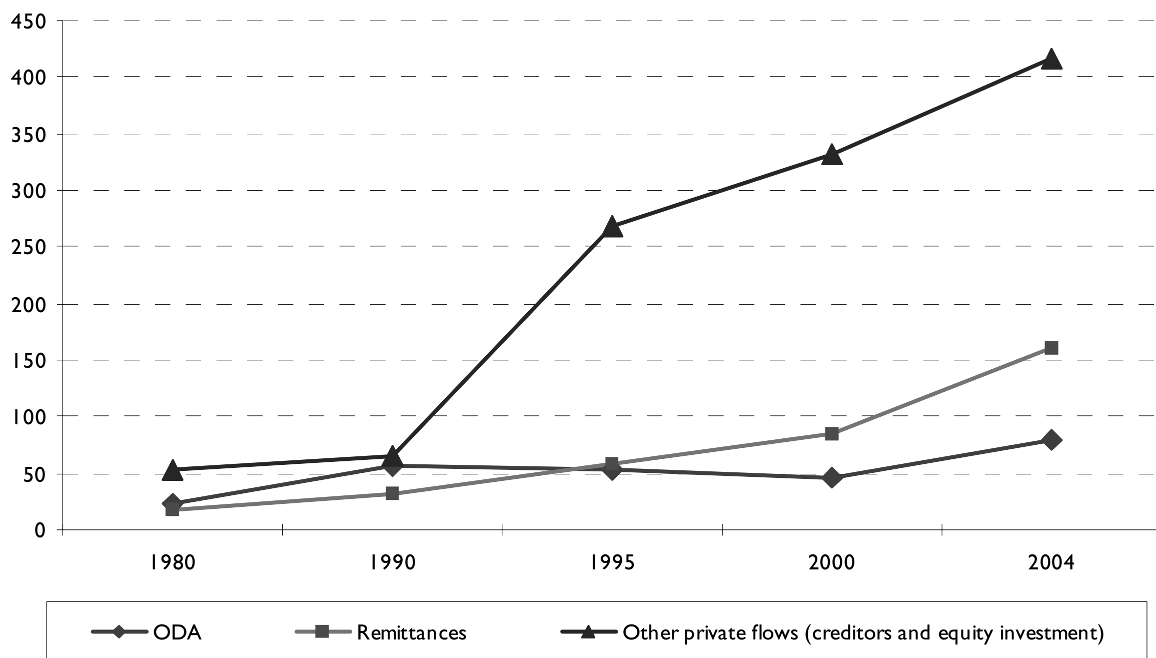
Capital Inflows Have Changed, but Mostly in Emerging Economies

The past 25 years have seen remarkable changes in the composition of capital inflows to developing countries (Figure 1.2). ODA has almost quadrupled (from $22.4 billion in 1980 to $79.5 billion in 2004), but has fallen as a proportion of total developing country inflows, which include remittances, commercial loans and equity investment. While ODA constituted around 35 per cent of total capital inflows in 1990, for example, it now accounts for less than 15 per cent.

Figure 1.2. **Composition of Developing Countries' Capital Inflows**
(1980-2004, $ billion)



Source: Author's illustration based on data from World Bank, UNCTAD, IIF, OECD DAC.

All developing countries have not experienced these trends equally. Figure 1.3 highlights the distinction between emerging economies[1] and other developing countries (Lambert and Cogneau, 2006). Specifically, emerging economies such as Brazil, Mexico, Malaysia and Indonesia have enjoyed high levels of commercial bank loans, trade lending, and equity and portfolio investments. In poorer countries, the emergence of new flows has been less pronounced, but even there ODA's share of total capital inflows decreased from around 65 per cent in 1980 to just over 40 per cent in 2004.

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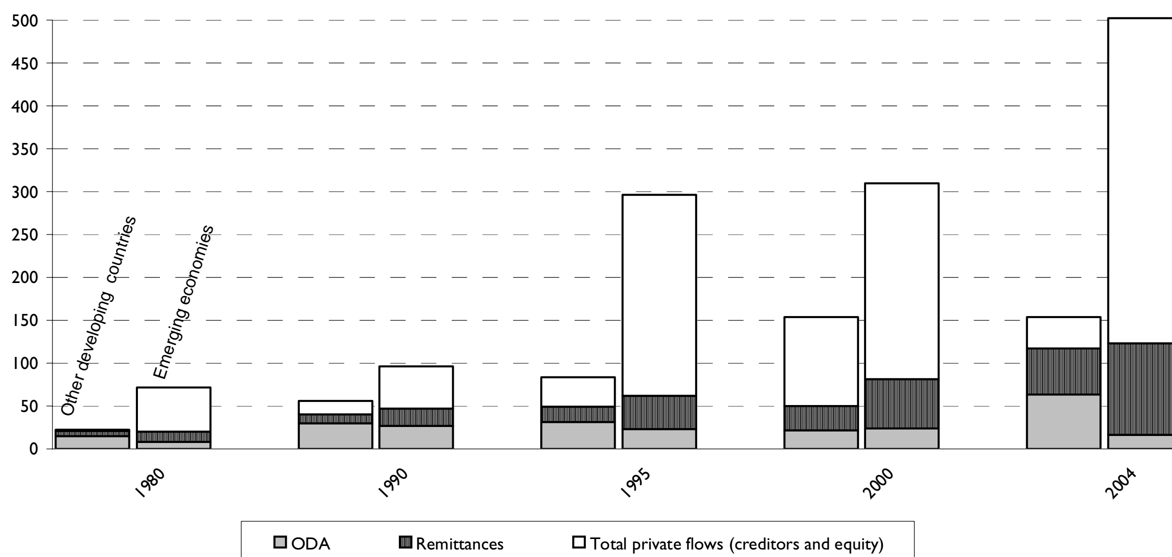
Figure 1.3. **Composition of Capital Inflows in Emerging Economies and Other Developing Countries**
(1980-2004, $ billion)



Source: Author's illustration based on data from World Bank, UNCTAD, IIF, OECD DAC.

ODA Volumes Are Up, but Their "Real" Value Has Been Questioned

Aid remains central to international development policy, as documented by donor pledges for more and better aid at various summits in 2005. After declining throughout the 1990s, ODA has increased since the turn of the century, following the adoption of the MDGs. The OECD (2006) reports an increase of aid to $106 billion in 2005, representing a real increase of 8.7 per cent from the previous year. This follows annual increases of 5.9 per cent, 7 per cent and 3.9 per cent from 2002 to 2004 (Pearson, 2004). In view of these developments, the OECD believes that the increase of around $50 billion to $130 billion by 2010, promised by the European Union and the G8, can be achieved.

A closer look at the breakdown of recent aid increases reveals that a large proportion can be attributed to debt relief and special-purpose grants (Chervalier and Zimet, 2006). Special-purpose grants are crucial for the reconstruction of damage caused by disasters such as the 2005 tsunami, but are not necessarily targeted to the achievement of the MDGs. Similarly, debt relief — under the Heavily-Indebted Poor Countries (HIPC) initiative or Multilateral Debt Relief Initiative (MDRI) — does not necessarily free money for development and has, for the most part, benefited a small number of large countries, including Iraq (it received nearly $14 billion in debt forgiveness grants in 2005) and Nigeria (a little over $5 billion). As the OECD (2006) argues, aid figures are blurred by this "debt relief bubble". Moreover, that Iraq has benefited from increased ODA also evidences the growing influence of security issues on ODA allocations.

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Private Actors Are Entering the Scene

In addition to loans and investment, remittances from private households have emerged as a major source of capital to developing countries. Despite significant discrepancies in the data, several surveys have shown that in some countries remittances account for 15 per cent or more of GDP (World Bank, 2006; United Nations, 2006). The evidence grows that they contribute to the achievement of the MDGs: household surveys in several countries have shown that remittances go partly to fund education, nutrition and health (Katseli *et al.,* 2006; Cox and Ureta, 2003).

Private companies and foundations also play an increasing role, although their contribution to international development programmes is difficult to quantify. Financial support from major foundations, for example, is spent mostly in their countries of origin. Their international support is channelled to developing countries largely indirectly, for example *via* multilateral organisations. This runs the risk of double-counting development finance. A contribution from a foundation may be attributed to the private sector and to the public sector, as flows from multilaterals are considered as ODA by the OECD Development Assistance Committee (DAC) Creditor Reporting System (OECD, 2003). Nevertheless, as an example of the magnitude of private philanthropy, the International Federation of Pharmaceutical Manufacturers and Associations (IFPMA) reports the contributions of the ten major companies that have donated products to the Partnership for Quality Medical Donations since 1998 at $2.7 billion (IFPMA, 2004 and 2005; see also Hudson Institute, 2004; PhRMA, 2003).

Of the many philanthropic organisations active in developing countries, the Bill and Melinda Gates Foundation is perhaps the most well known, having disbursed $1.4 billion in grants by December 2005, with programmes in global health ($843 million) and education ($284 million), as well as initiatives in global development, global libraries, financial services for the poor, agricultural development, water, sanitation and hygiene ($228 million). In terms of funds spent abroad, the Ford Foundation is the largest US foundation involved in financing development.

The Distinction Between Public and Private Financing is Blurry

NGOs exemplify organisations that bridge the divide between public and private finance. Some provide autonomous financing raised, for example, from private donations. Others do not act as finance sources but as implementing agencies or service deliverers in projects financed by the public sector, including ODA. In 2002, transfers to NGOs amounted to $1.2 billion in ODA, an increase of 34 per cent from 1992 (Epstein and Gang, 2006).

The public-private divide is also spanned by so-called global funds, public-private partnerships that have been set up over recent years to spark action around specific global challenges such as the health and education MDGs. Their budgets are now considerable. The Education for All Fast Track Initiative (EFA-FTI), for example, has disbursed $115 million to low-income countries through its Catalytic Fund, linking the initiative's funding to the MDG of universal primary education. The Global Fund to Fight Aids, Tuberculosis and Malaria ("The Global Fund") and the Global Alliance for Vaccines and Immunization ("The GAVI Alliance") have been very active in the health sector. By December 2005, the GAVI Alliance had disbursed $603 million since its launch in 2000; the Global Fund has disbursed $2.38 billion since 2002.

In spite of these large volumes, questions remain about whether global funds have increased overall flows to developing countries (see Chapter 4 of this volume). Arguably, public finances through global funds could equally have been directed through existing channels such as the World Bank. Moreover, the hope that the funds would catalyse private financial contributions has also failed to materialise. Although private contributions to global funds should not be disregarded — for the

GAVI Alliance, they even surpassed public-sector contributions during its first two years — their funding is still composed largely of conventional bilateral and multilateral ODA. Private contributions to the Global Fund, for example, constituted only 3 per cent of total pledges in 2004, coming from foundations (e.g. Gates), multinational companies (e.g. Winterthur) and private individuals (e.g. Kofi Annan).

Policy Implications for Donors and Recipients

These changes in the international development finance system are not easily grasped, neither statistically or analytically. Yet they are having major implications for policy makers in developing countries, who need to make the most of new funding opportunities, and for aid donors, who need to reposition themselves in the system. Drawing from its own expertise as well as that of colleagues within and outside the OECD, the Development Centre has been assessing several significant aspects of this systemic evolution. This volume pulls together some of this key material and presents it systematically so that interested readers can have it in one place and in digestible form[2].

Part I examines the changes in the development finance system from a global perspective. The rise of new actors and the change in approaches are captured in Chapter 2, "Resources for Development in Africa", which describes the evolving aid environment of the continent and draws policy implications for both donor and recipient countries. Much of the recent increase in aid flows from the traditional donors, the members of the OECD DAC, has taken the forms of debt relief, emergency assistance and other special-purpose grants, but overall commitments are on the rise and debt relief is well past its peak. New actors are increasingly visible on the continent, especially non-DAC donors such as China and India. The share of non-aid flows from around the world is increasing. Sub-Saharan Africa (SSA), in particular, may still rely more on official flows than the rest of the developing world, yet it also attracts almost as much FDI as a share of GDP as do other developing regions. As for remittances, they exceeded 2 per cent of GDP in 2004 in 15 SSA countries.

The issue of the optimal choice between financing instruments is at the heart of Chapter 3, "After Gleneagles: What Role for Loans in ODA?" Ever since the Meltzer Report in March 2000 recommended that multilateral development banks should provide support in the form of grants rather than loans, the debate on the optimal composition of ODA has been reinvigorated, not to say heated. Often the debate is cast in terms of "grants *versus* loans", although both are to a degree complementary. Both loans and grants have their role in concessional finance, and this view also applies in the OECD Initiative on Investment for Development (see Box 2.3 in Chapter 2). Loans provide sequential leverage for a given amount of ODA to the extent that reflows finance new loans. Indeed, the pro-loan argument of sequential leverage hinges on the importance of recipient-country contributions to the reflows. Loans exert discipline on resource allocation. A grants-only policy risks denying countries future financial-market access. Grants appeal to debt-trapped countries and apply to the finance of most of the MDGs when their public-goods character is at odds with loan finance. The 2006 Report of the French *Conseil d'Analyse Economique* (CAE) on Development Aid built heavily on the Development Centre work reviewed in this chapter.

Chapter 4, "Innovative Approaches to Funding the Millennium Development Goals", looks beyond traditional means of financing development. It starts from the realisation that OECD governments can fulfil their pledges for increased aid in only three ways: through full accounting as ODA of debt relief granted to poor countries (including Iraq, which received almost $14 billion, and Nigeria, more than $5 billion in 2005); through increasing ODA

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appropriations in ordinary budgets; and through innovative forms of development finance, which also need to be fully accounted for as ODA. As debt relief will not contribute much to ODA in the near future and as budgetary pressures in donor countries are likely to grow, the search for innovative funding mechanisms will have priority. Further, while the Monterrey conference on financing development led to new commitments from donors to raise ODA, the bill for the MDGs remains likely to be higher than the ODA funding. The fast-approaching MDG deadline in the year 2015 increases pressure to find ways now to pay that bill. The chapter helps to classify the many proposals for new forms of development finance. The policy relevance and prescience of this paper have been validated since its first appearance as Development Centre *Policy Brief 24*. The criteria used for evaluating different proposals include revenue potential, speed of availability and political feasibility. Two favoured options, namely the frontloading of funds through an International Finance Facility and raising money through aviation taxes have made tangible progress. A third, strengthened use of public guarantees and better ODA accounting for them, is likely to get more support as guarantees can unlock considerable private capital.

The second part of this volume tells the developing country's side of the story. In Chapter 5, "New Actors in Health Financing: Implications for a Donor Darling", a case study of health financing in Ghana shows both how the new multiplicity of financing options has provided alternatives for developing countries in funding achievement of the MDGs and how it has introduced major management challenges. Health finance in Ghana offers evidence that even in a country and sector that benefit from large ODA volumes, new actors and flows of development finance are manifest and highlight issues that apply well beyond this case study. Developing countries need stronger information systems to forecast flows and design more effective policies. They also need better co-ordination mechanisms in which conventional donors and new actors can participate to ensure that aid is effective.

Chapter 6, "Integrating Global Programmes with Country-led National Programmes", focuses on Ghana as well. Based on a country survey conducted by the OECD Development Centre on behalf of concerned multilateral institutions, it explores the alignment of global/vertical aid programmes (GPs) with planning and implementation systems in recipient countries. New sources of finance may have increased the overall financial envelope, but they have also brought monitoring and co-ordination challenges. For more effective finance, co-ordination mechanisms must include the new funders. In order to take ownership of their own development process, developing countries need to improve inter-ministerial co-operation and to address mismatches between budgets and spending, as well as capacity gaps.

Finally, financing development involves more than an increased level and quality of resources flowing into developing countries: that is the key point that emerges from Chapter 7, "Different Countries, Different Needs: The Role of Private Health Insurance in Developing Countries". This chapter assesses the scope for funds to be raised through insurance mechanisms based on pre-payment and risk pooling the health sector, the focus of MDGs 4-6. It concludes that, generally, private health insurance (PHI) can effectively complement existing health-care financing options, provided that it is well managed, with efficient insurance regulation systems, and adapted to local market characteristics. In many countries, small-scale insurance schemes managed in close co-operation with the beneficiaries of services even offer an interesting alternative to systems in which health care is financed by the state (through tax payments) or on a cash and carry basis. The chapter sorts developing countries into regional groupings in terms of the current status, prospects and domestic policy challenges of using PHI as a major financing vehicle for health care.

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Notes

1. This study follows the definition of the Institute for International Finance (IIF), which classifies 29 countries as emerging economies. "Other developing countries" are the 124 remaining low-income and middle-income countries.
2. The pieces assembled here have various origins, both published and hitherto unpublished. Chapter 2 began as a formal paper [AFP/Meeting(2006)15] presented at a meeting of the Africa Partnership Forum in Moscow on 26-27 October 2006. Chapters 3, 4 and 5 first appeared as Development Centre *Policy Briefs* (Nos. 31, 24 and 33 respectively). Chapters 6 and 7 are original in this volume.

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