The attached draft of Chapter III of the 2001 Development Co-operation Report is circulated for INFORMATION and COMMENT, prior to Council declassification on 10 January 2002. Section IV and the Annex are drawn from the paper submitted to the Senior Level Meeting on "ODA Demand and Supply: Current Perspectives" [DCD/DAC(2001/29/REV1)].
TABLE OF CONTENTS

CHAPTER III  PERSPECTIVES ON FINANCING THE MILLENNIUM DEVELOPMENT GOALS ..... 3

I. The focus of increasing international attention ................................................................. 3
   Results of the Conference .................................................................................................. 4

II. Highlights of recent trends in external flows and domestic resource mobilisation .......... 5
   External Flows .................................................................................................................. 5
   Private flows .................................................................................................................... 5
   Official Development Finance .......................................................................................... 7
   Debt .................................................................................................................................. 8
   Debt stocks ....................................................................................................................... 8
   Debt Relief ....................................................................................................................... 9

II. Domestic Resources ......................................................................................................... 9
   Domestic Savings ............................................................................................................. 10
   Taxation .......................................................................................................................... 10
   Public/Private Sector Investment Levels ........................................................................... 11
   Trade revenues .............................................................................................................. 13

III. Financing for Development -- opportunities and challenges ........................................ 13
   a) Opportunities ........................................................................................................... 13
   b) Challenges ................................................................................................................. 14
   c) Resource and policy needs ....................................................................................... 14
   d) The contribution of stronger policy coherence ...................................................... 14

IV. Current perspectives on the demand and supply of ODA ................................................ 16
   Concluding remarks ....................................................................................................... 20

ANNEX 1 ISSUES IN THE ASSESSMENT OF AID REQUIREMENTS ..................................... 22
   Methodological issues ..................................................................................................... 23
   Income poverty reduction through trade liberalisation and private investment ............... 25
   Estimating the costs of meeting social development goals ............................................. 26

Tables
   Table III.1. Total Net Resource Flows from DAC Member Countries and Multilateral Agencies to Aid Recipients ........................................................................................................ 9
   Table III.2. Debt outstanding at end-2000 by groups of countries ..................................... 9
   Table III.3. Ready Reckoner 1: ODA growth scenario ....................................................... 19
   Table III.4. Ready Reckoner 2: DAC Countries’ ODA levels in 2010 and 2012 under real ODA growth scenario ................................................................. 19

Charts
   Chart III.1. Perspectives on domestic resource mobilisation ............................................ 13

Boxes
   Box III-1. The Third United Nations Conference on the Least Developed Countries ........ 3
CHAPTER III

PERSPECTIVES ON FINANCING THE MILLENNIUM DEVELOPMENT GOALS

I. The focus of increasing international attention

3.1 The need to marshal our intellectual and financial resources to attack global poverty is one of the most urgent problems facing the global community.

3.2 The Millennium Development Goals (MDGs) set a number of ambitious goals and with a rapidly approaching deadline – 2015. For the developing countries as a whole, the extent to which progress is still “on track” will obviously be influenced by different developments such as the global economic slowdown in evidence since early 2001, the events of 11 September and the outcomes of the Doha Trade Ministerial and the forthcoming International Conference on Financing for Development. But at a more disaggregated level – and particularly for the poorer countries and for Sub-Saharan Africa -- it is likely that by 2015, and unless major new and significant inroads are made, far too many of the world’s poorest countries and citizens will fall well short of the MDGs.

3.3 The objective of identifying and implementing strategies for sustainable development finance structures to underpin the MDGs (in terms both of increased financial flows and their developmental effectiveness) is now at the forefront of the international debate. A number of recent and forthcoming major international conferences are now focused on this issue:

- The Third United Nations Conference on the Least Developed Countries felt that present and envisaged financing levels would not be sufficient to achieve the MDGs, despite a number of very positive developments [see Box III.1].
- The Genoa G8 Summit stressed the importance of an effective strategy by the international community to stimulate faster growth and poverty eradication in the poorest developing countries. They outlined trade, foreign direct investment and spending on social sectors as the key, mutually reinforcing, components of such a strategy.
- The Doha Trade Ministerial launched a new round of trade negotiations with the needs of developing countries at the very heart of its programme of work. This is a major achievement in light of the major contribution that trade can make to growth and poverty reduction.
- The joint World Bank/IMF Development Committee (meeting in Ottawa in November 2001) regarded the forthcoming International Conference on Financing for Development as a milestone in efforts to halve the incidence of poverty by 2015 and reach the other MDGs. It urged all governments to enhance the coherence of policies that impact on development.
- The International Conference on Financing for Development (FfD), to be held in Monterrey, Mexico on 18-22 March 2002, will be the first ever UN Conference exclusively devoted to this theme and forms a critical part of the process of implementing the outcome of the Millennium Summit. The Conference is seen as a key event in agreeing on, and implementing, a strategy for better resource mobilisation.

1 See the “Special Module” at the end of part II for details.
Box III-1. The Third United Nations Conference on the Least Developed Countries (LDC III)

LDC III (Brussels, May 2001) addressed the broad range of issues and challenges facing the Least Developed Countries, but with growth and financing as major themes. Despite a number of very positive developments, the Conference felt that present and envisaged financing levels would not be sufficient to achieve the MDGs.

Results of the Conference

The Conference gave several reasons for optimism about for reversing past trends and spurring growth in the least developed countries:

− There is now broad international agreement on the prerequisites for development -- good governance and sound policies, open trade and investment regimes, and adequate infrastructure and financing.

− The Heavily Indebted Poor Countries (HIPC) initiative offers a fresh start to countries whose prospects had been blighted by excessive debt obligations.

− The PRSP process now provides a framework to integrate aid and other resources into medium-term expenditure frameworks aimed at sustained growth and social progress.

− The emergence of mutually accountable compacts between donors and recipients may ensure greater predictability of aid flows, and improved response to external shocks.

The Conference provided a valuable opportunity for the poorest countries to express their needs and views, and assess donor responses. Among the themes that emerged were:

− Frustration at the complexity of donor procedures. It will be important to seize the opportunity provided by PRSPs to harmonise and simplify donor procedures.

− A renewed focus on agriculture. Aid to agriculture has declined markedly. Yet agriculture is the basis of many poor countries’ economies. Within the donor community, Japan and the United States signalled their intention to reinforce their aid to this sector. Sensible use of biotechnology may help.
3.4 This chapter focuses on the volumes and structures of financing for development required to support the MDGs and their policy implications for all stakeholders, particularly for governments in developed and developing countries. After a review of recent trends in finance for development (section II), its looks at the opportunities and challenges provided by the upcoming International Conference on Financing for Development (section III) and provides perspectives on the demand and supply of ODA (section IV).

II. Highlights of recent trends in external flows and domestic resource mobilisation

External Flows

3.5 Total net resources flows to developing countries fell to USD190 billion in 2000, a reduction of 24% (USD61 billion) compared to 1999 (see table III.1). This resulted from a sharp turnaround in private flows (in particular, equity and direct investment) and a sizeable reduction in official development finance (in particular, non-concessional financing). The initial signs of recovery in external flows since the East Asian crisis have not therefore been sustained in 2000, in part due to the deteriorating global economic outlook as well as the re-emergence of financial difficulties in a number of the major recipients of private external flows.

Private flows

3.6 Private flows have accounted for the largest and growing share of total external flows to developing countries in the 1990s, but they have been highly concentrated in a relatively small number of countries, with a only a small share going to the low-income countries (other than China and India). Private flows slowed down considerably following the 1997/98 crises in emerging markets, dropping further to USD117 billion in 2000. Indications suggest that private flows will fall further in 2001.

3.7 The recent decline in private flows to developing countries reflects:
- Heightened risk aversion towards investment in developing countries and a shift to quality (as indicated for example by the widening spreads on emerging market bonds);
- Reduced demand for external private capital in crisis countries (due to lower investment and excess capacity);
- The beginning of the global economic slowdown, confirmed in 2001; and
- The impact of crises in Argentina and Turkey and deterioration in the economic and political situations in other emerging markets such as Ecuador, Russia, and Venezuela.

3.8 Foreign Direct Investment (FDI) flows to developing countries fell by USD26 billion in 2000 to USD120 billion, despite holding up well during the Asian financial crisis. This represents the first fall in FDI flows in over a decade. The beginning of the global economic slowdown and reduction in large-scale privatisation projects in developing countries have contributed to this situation.

3.9 In fact, global FDI, as estimated before 11 September 2001, is expected to fall from around USD1 trillion in 2000 to about USD510 in 2001. This unprecedented decrease will particularly affect FDI in developed countries. The global economic slowdown and an associated sharp reduction in merger and acquisition activity (both numbers of transactions and share values) are the main factors. In developing countries, decreases are expected in both Latin America and Asia, while FDI levels in Africa is likely to be less impacted.
Table III.1. Total Net Resource Flows from DAC Member Countries and Multilateral Agencies to Aid Recipients

<table>
<thead>
<tr>
<th></th>
<th>Current $ billion</th>
<th>Per cent of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. OFFICIAL DEVELOPMENT FINANCE (ODF)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Official development assistance (ODA)</td>
<td>82.4 84.5 87.6 75.4 88.8 85.9 65.5</td>
<td>49.7 21.0 34.4</td>
</tr>
<tr>
<td>of which: Bilateral</td>
<td>55.5 59.6 59.1 47.9 50.1 52.1 49.5</td>
<td>33.5 15.9 26.0</td>
</tr>
<tr>
<td>Multilateral</td>
<td>16.1 18.3 18.4 16.7 15.4 14.9 13.5</td>
<td>9.7 4.8 7.1</td>
</tr>
<tr>
<td>2. Official Aid (OA)</td>
<td>21.0 18.1 20.1 12.2 22.0 31.7 26.1 8.2</td>
<td>12.7 3.5 4.3</td>
</tr>
<tr>
<td>of which: Bilateral</td>
<td>5.2 5.5 7.1 4.0 4.0 4.5 4.9 4.9</td>
<td>3.1 1.2 2.6</td>
</tr>
<tr>
<td>Multilateral</td>
<td>0.7 1.3 1.3 1.5 1.6 2.5 2.9 2.9</td>
<td>0.4 0.4 1.5</td>
</tr>
<tr>
<td>3. Other ODF</td>
<td>21.0 18.1 20.1 12.2 22.0 31.7 26.1 8.2</td>
<td>12.7 3.5 4.3</td>
</tr>
<tr>
<td>of which: Bilateral</td>
<td>11.4 12.2 14.0 5.7 5.9 12.8 10.4 -1.4</td>
<td>6.9 1.6 -0.7</td>
</tr>
<tr>
<td>Multilateral</td>
<td>9.6 5.8 6.1 6.5 16.0 18.9 15.6 9.7</td>
<td>5.8 1.8 5.1</td>
</tr>
<tr>
<td>II. TOTAL EXPORT CREDITS</td>
<td>-3.0 6.3 5.6 4.0 4.8 8.3 4.0 7.7</td>
<td>-1.8 1.1 4.0</td>
</tr>
<tr>
<td>III. PRIVATE FLOWS</td>
<td>86.3 134.7 170.7 272.8 240.2 131.8 161.1 117.0</td>
<td>52.1 77.9 61.5</td>
</tr>
<tr>
<td>1. Direct investment (DAC)</td>
<td>41.6 52.1 59.6 68.9 102.3 119.8 145.6 119.5</td>
<td>25.1 19.7 62.8</td>
</tr>
<tr>
<td>of which: to offshore centres</td>
<td>9.4 10.8 6.3 16.7 19.1 20.3 37.9 29.8</td>
<td>5.7 4.8 15.7</td>
</tr>
<tr>
<td>2. International bank lending (a)</td>
<td>4.8 32.1 76.9 86.0 12.0 -76.3 -79.6 -36.0</td>
<td>2.9 24.6 -18.9</td>
</tr>
<tr>
<td>3. Total bond lending</td>
<td>28.7 32.0 24.7 78.5 83.7 34.2 28.8 18.9</td>
<td>17.3 22.4 9.9</td>
</tr>
<tr>
<td>4. Other (including equities) (b)</td>
<td>5.5 12.5 3.5 33.8 37.0 48.4 59.5 7.8</td>
<td>3.3 9.7 4.1</td>
</tr>
<tr>
<td>5. Grants by non-governmental organisations</td>
<td>5.7 6.0 6.0 5.6 5.2 5.6 6.7 6.9</td>
<td>3.4 1.6 3.6</td>
</tr>
<tr>
<td>TOTAL NET RESOURCE FLOWS (I+II+III)</td>
<td>165.7 225.5 263.8 350.3 320.4 229.0 251.0 190.3</td>
<td>100.0 100.0 100.0</td>
</tr>
</tbody>
</table>

Memorandum items (not included):
- Net Use of IMF Credit (c) | 3.3 0.6 15.6 0.3 14.4 18.8 -12.8 -10.6 |
- Non-DAC donors (ODA/OA) | 1.3 1.0 0.8 0.9 1.0 0.9 0.6 1.0 |

For cross reference:
- Total DAC net ODA (d) | 56.5 59.2 58.9 55.6 48.5 52.1 56.4 53.7 |
- of which: Bilateral grants | 33.4 35.2 36.2 36.5 31.3 32.5 33.9 33.0 |

a) Excluding bond lending by banks (item III.3.), and guaranteed financial credits (included in II).
b) Incomplete reporting from several DAC countries (including France, the United Kingdom and the United States). Includes Japan from 1996.
c) Non-concessional flows from the IMF General Resources Account.
d) Comprises bilateral ODA as above plus contributions to multilateral organisations in place of ODA disbursements from multilateral organisations shown above.
p) Provisional.
3.10 **International bank lending** to developing countries continued at negative levels in 2000. But at minus USD36 billion, the situation is less severe than during the Asian financial crisis when it tumbled to levels of minus USD76 - USD79 billion as loan repayments exceeded new credit by a very wide margin. Bank lending resumed to some extent in 2000, with modest credit amounts extended to a few countries (including Argentina, Brazil, and Turkey). However, net bank lending flows remained at negative levels as further repayments by Asia continue to offset new credits and following a surge of deposits by developing countries into international banks.

3.11 Net **bond lending** fell to USD19 million in 2000, a level only a quarter of that in the immediate pre-Asian crisis period. Growing uncertainty about the global economic outlook and widening spreads led to declining net issuance. Spreads on countries with particular challenges widened more sharply than for those with satisfactory performance, underlining investors’ continued aversion to risk. Bond issuance was also reduced as several countries in Asia continued to run current account surpluses, reducing the demand for international financing, and companies in some East Asian countries are still struggling with debt overhang, limiting their access to capital markets. Bond issuance in 2001 is estimated to rebound as interest rates cuts in several OECD countries facilitate access by developing countries to the global bond market.

3.12 For **other financial flows including equity**, only USD8 billion has so far been reported by DAC countries due to very incomplete reporting². More complete data from other sources suggest that equity flows rebounded after the East Asian crisis due to technological innovation in the information and communication industries, motivating investors to purchase technology stocks in developing as well as industrial economies. Furthermore, investors exploited lower transaction costs and easier access to equity placements in developing countries. More emerging market companies have been able to issue American Depository Receipts (ADRs) and to list shares in stock exchanges in major industrial economies. The reduction in equity placement at end 2000 and continuing into 2001 reflects the weakening of industrial equity markets, reduced investor confidence, a flight from technology stocks, and in some cases concern about the slow progress in financial and corporate reforms.

**Official Development Finance**

3.13 Net **Official Development Finance (ODF)**, i.e. concessional and non-concessional financing from official sources, fell by USD20 billion in 2000 to USD66 billion, its lowest level in a decade. The decline in 2000 is mainly explained by a reduction in both bilateral and multilateral non-concessional lending (i.e. other ODF), which fell to USD8 billion, a reduction of 68% compared to 1999. This reflected both reduced new official lending at market rates, and increased repayments as Asian borrowers recovered somewhat from the financial crisis. However, ODF is expected to recover in 2001 as a consequence of the official support packages for Argentina, Turkey and Brazil.

3.14 Net **official development assistance (ODA)** received by developing countries in 2000 was USD50 billion³, down USD2.5 billion on 1999. The share of ODA going to the least developed countries

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² DAC statistics on “other private flows including equity” tend to be generally underestimated due to incomplete reporting by major source countries, including France, the United Kingdom and the United States.

³ Note: This data covers ODA from both DAC and multilateral sources to developing countries. It differs from other presentations which cover ODA from DAC countries to developing countries and to multilateral agencies. On that latter basis, ODA in 2000 was $54 billion (see e.g. table 4 in the Statistical Annex).

³ Brazil, Argentina, Mexico, China, Korea, Indonesia, Russia, Turkey and India (by descending order of debt).
(LLDCs) rose slightly, from 19% of the DAC total in 1999 to 22% in 2000, but it remains well below the 1989-90 level of 27%.

3.15 These changes in ODA volume and robust economic growth averaging 3.7% in DAC Members during 2000 boosted GNI thus pushed the ODA/GNI ratio down from 0.24% to 0.22%.

3.16 Among other notable features of the 2000 data are:

- Japan’s aid fell by USD1.8 billion (15% in real terms), but adjusting for an exceptional USD3 billion bond put at the disposal of the Asian Development Bank in 1999, there was an underlying rise in Japan’s ODA of approximately 8% between 1998 and 2000.

- France’s aid fell by USD1.5 billion (16%), but about USD1.2 billion of this is due to the removal of French Polynesia and New Caledonia from the list of ODA-eligible countries and territories. For many years the third largest donor behind Japan and the United States, France now ranks fifth after both Germany and the United Kingdom.

- Aid from the United Kingdom rose by 38%, partly as a result of the timing of contributions to multilateral agencies, but also reflecting the UK government’s commitment to substantially increasing aid. The real increase over the last two years totalled 22%.

- Fourteen of the 22 Member countries of the DAC reported a rise in ODA in real terms in 2000.

Debt

Debt stocks

3.17 The total amount of external debt of developing and transition countries outstanding at end 2000 amounted to USD2.3 trillion, down 9% on 1999, after allowing for the impact of exchange rate movements (see table III.2). The nine major borrowing countries collectively accounted for almost half the total. Most of the 2000 decline was due to the strengthening of the US dollar, which reduced the dollar value of the debt denominated in other currencies. But there was a small actual contraction in the debt stock (minus 0.4%), despite the rebound in growth rates and buoyant exports in many countries.

3.18 In terms of income groups, half the debt was owed by middle-income countries, 26% by low-income countries, and 23% by high-income and transition countries. Heavily Indebted Poor Countries (HIPCs) were responsible for 7% of total debt.

3.19 Official financing accounts for 71% of the debt due by HIPCs and for only 24% of that of Upper Middle-Income countries. Private financing has thus become critical for countries retaining or gaining market access whereas the poorest ones remain heavily dependent upon official funding. Within the category of market financing, there was a further shift away from bank credits to debt securities in 2000, with windows of opportunities being used by borrowing countries to actively manage their external debt. However, market conditions were very volatile throughout the year, with a tendency for borrowing conditions to tighten and for investors to better differentiate among debtor countries.
Table III.2. Debt outstanding at end-2000 by groups of countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Official and officially guaranteed credits</th>
<th>Market financing</th>
<th>Other</th>
<th>TOTAL</th>
<th>Changes¹</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>USD billion</td>
<td>Bank loans¹</td>
<td>Debt securities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Least Developed Countries</td>
<td>97.4</td>
<td>24.2</td>
<td>0.2</td>
<td>16.9</td>
<td>138.6</td>
</tr>
<tr>
<td>Other Low-Income Countries</td>
<td>314.3</td>
<td>85.8</td>
<td>27.0</td>
<td>32.4</td>
<td>459.4</td>
</tr>
<tr>
<td>China</td>
<td>75.5</td>
<td>34.3</td>
<td>13.8</td>
<td>0.2</td>
<td>123.7</td>
</tr>
<tr>
<td>India</td>
<td>55.9</td>
<td>11.1</td>
<td>4.5</td>
<td>19.6</td>
<td>91.1</td>
</tr>
<tr>
<td>Indonesia</td>
<td>80.4</td>
<td>26.5</td>
<td>2.7</td>
<td>0.2</td>
<td>109.7</td>
</tr>
<tr>
<td>Lower Middle-Income Countries</td>
<td>234.4</td>
<td>77.9</td>
<td>58.7</td>
<td>45.1</td>
<td>416.1</td>
</tr>
<tr>
<td>Philippines</td>
<td>28.9</td>
<td>7.5</td>
<td>15.4</td>
<td>2.0</td>
<td>53.8</td>
</tr>
<tr>
<td>Thailand</td>
<td>29.2</td>
<td>20.5</td>
<td>12.2</td>
<td>2.4</td>
<td>64.3</td>
</tr>
<tr>
<td>Upper Middle-Income Countries</td>
<td>177.4</td>
<td>230.1</td>
<td>310.5</td>
<td>29.0</td>
<td>747.1</td>
</tr>
<tr>
<td>Argentina</td>
<td>32.4</td>
<td>30.3</td>
<td>82.5</td>
<td>8.9</td>
<td>154.1</td>
</tr>
<tr>
<td>Brazil</td>
<td>40.2</td>
<td>52.4</td>
<td>79.3</td>
<td>0.0</td>
<td>172.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>31.2</td>
<td>34.1</td>
<td>74.4</td>
<td>0.3</td>
<td>139.9</td>
</tr>
<tr>
<td>Turkey</td>
<td>31.8</td>
<td>31.2</td>
<td>20.8</td>
<td>12.9</td>
<td>96.5</td>
</tr>
<tr>
<td>High Income and Transition Countries</td>
<td>167.6</td>
<td>182.4</td>
<td>138.2</td>
<td>44.1</td>
<td>532.2</td>
</tr>
<tr>
<td>Russia</td>
<td>62.0</td>
<td>22.6</td>
<td>16.7</td>
<td>0.2</td>
<td>101.5</td>
</tr>
<tr>
<td>Korea</td>
<td>28.4</td>
<td>46.9</td>
<td>46.8</td>
<td>0.0</td>
<td>122.1</td>
</tr>
<tr>
<td>TOTAL</td>
<td>991.0</td>
<td>600.5</td>
<td>534.6</td>
<td>167.4</td>
<td>2293.5</td>
</tr>
</tbody>
</table>

Changes¹

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Official and officially guaranteed credits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Least Developed Countries</td>
<td>22.0</td>
<td>-79.5</td>
</tr>
<tr>
<td>Other Low-Income Countries</td>
<td>-35.9</td>
<td>18.7</td>
</tr>
</tbody>
</table>

Debt Relief

3.20 A major effort is under way to reduce the repayment burden of Heavily Indebted Poor Countries (HIPCs). Most of these are least developed countries in Sub-Saharan Africa. Their debts are largely owed to international financial institutions, but ODA loans, bank loans and export credits from DAC countries are also involved. (See Chapter 4 for comment on ODA and debt relief.)

II. Domestic Resources

3.21 The bulk of finance for development must come from domestic resources, regardless of the size of a country and its level of development. Not only that, but without improvements in the structures, institutions and governance systems required for domestic resource mobilisation, it will always be an uphill struggle to attract higher levels of external finance.

3.22 Two interlinked problems characterise the situation in many developing countries. The level of domestic resource mobilisation and allocation is weak, resulting in sizeable shortfalls in the contribution of this sector to financing for development. There are basic structural problems to be addressed, e.g. low
savings rates, large government sectors, inadequate attention to the gender dimension of savings and investment and inappropriate tax regimes.

3.23 Major efforts are therefore required to strengthen the critical contribution of domestic resource mobilisation to meeting the MDGs. But this applies also has implications to the ability of developing countries to attract and benefit from external resources. Much of what is required to attract foreign investors is equally necessary for promoting domestic investment (e.g. a sound macroeconomic framework, a business friendly enabling environment, etc.). When this is lacking for domestic investors, it is unlikely that developing countries will be able to attract higher levels of foreign investment. And the contribution to the economy from what foreign investment there is will be limited or eroded due to the lack of an adequate policy framework and weak linkages with an underdeveloped local private sector5.

3.24 This section focuses on four key areas of domestic resource mobilisation – domestic savings, taxation, public/private sector investment levels, and trade – where major efforts are needed to better mobilise domestic resources for development (see Chart III-1).

**Domestic Savings**

3.25 Low-income countries generally have low savings rates -- on average 8% as share of GDP compared to 18% in middle-income and 22% in high-income countries in the 1990s. While saving rates vary considerably among countries, the gap between advanced and developing countries in savings mobilisation is sizeable. Efforts are thus needed to encourage higher savings levels, including:

- Macroeconomic and monetary policies that reduce or maintain low inflation;
- Exchange rates regimes that avoid unsustainable large current account deficits; and
- Funded pension systems compared to pay-as-you-go system to provide long-term resources for investment.

3.26 To mobilise savings, efforts are required to strengthen the enabling environment, the institutions and the policies that promote savings, including savings by women. Women have a strong interest and capacity to mobilise savings as a means of improving family welfare – as women tend to allocate a greater share of household income to health, education, and nutrition-related expenditures. Presently, many women rely on informal savings clubs and networks, but formal programmes are also needed to promote and mobilise women’s savings effectively.

**Taxation**

3.27 Tax revenues account for about 14% of GDP in low-income countries, compared to 20% in middle-income countries and over 30% in high-income countries. The potential of the tax base to mobilise finance for development is therefore seriously under-utilised in developing countries. Efforts are needed in several areas to reform the tax system to mobilise higher tax revenues to finance the infrastructure and social services required to support development. These need to address:

- The structure of taxation, i.e. taxing personal income more effectively, taxing the economy more broadly, and acting on of foreign trade and foreign investment taxes that create distortions. For example, low-income countries raise a much larger share of their tax revenue

---

5 The World Bank’s “Global Development Finance, 2002” shows that large gaps in technology and skills between foreign and domestic firms reduces the impact of spillovers.
from trade taxes – an average of 24% compared to only one% in high income countries. This can represent a major disincentive to other efforts to improve supply-side capacities to exploit expanding trade opportunities.

- The quality of tax administration, to increase the capacity to collect taxes as well as the application of and compliance with tax laws. In addition to bringing more revenue, a well-designed, enforced and administered tax system can promote investment by creating a more transparent and predictable environment.

**Public/Private Sector Investment Levels**

3.28 A strong and vibrant private sector is crucial to producing the economic growth necessary for sustainable development. It is the best source of long term and sustainable job creation and hence plays an important role in poverty reduction. It is also essential if developing countries are to exploit more fully the benefits of open trade and provide supply and other linkage networks with foreign investors. Economies with a high ratio of private to public investment generally benefit from higher growth rates.

3.29 However, the public sector generally accounts for a larger share of the economy in many developing countries than in industrial countries. A heavy public sector can sometimes hamper development, diverting or crowding out resources from the private sector, for example by absorbing credit from the financial sector. Credit to the private sector averages about 20% of total credit in developing countries, compared to 80% in high-income countries. Countries therefore need to design and implement policies and build the institutions that promote private sector development in general, including small and medium sized enterprises run by women.
Chart III.1. Perspectives on domestic resource mobilisation

Private Investment Is Strongly Associated With Economic Growth
Investment and Economic Growth in Selected Developing Countries, 1970-98

Source: World Bank


**Trade revenues**

3.30 Trade revenues are often omitted from discussions of development finance. Yet they already represent a sizeable component of finance in a broader view of finance for development. In addition, there is major but as yet unexploited potential to further increase the contribution they can make to development finance. Estimates of the gains for developing countries from full merchandise trade liberalisation world-wide are in the order of USD200 billion. Estimates that take into account full services liberalisation and dynamic effects (e.g. through higher productivity) are much higher --over USD500 billion. Together with the income and employment generation effects of enterprises involved in expanding trade, this demonstrates the important contribution that expanding trade can make to meeting the financing required to reduce poverty and underpin other MDGs.

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3.31 The above picture of recent trends in external flows and the present weakness in mobilising domestic resources shows that actions are needed on all fronts (domestic and external resources, concessional and private) and by all stakeholders (governments in developed and developing countries, the private sector and civil society) if there is to be significant improvement in mobilising the financing needed in support of the MDGs. The International Conference on Financing for Development, to which we now turn, offers major opportunities but also major challenges to the international community to address the key issues and find solution to mobilise the finance needed for the MDGs.

**III. Financing for Development -- opportunities and challenges**

3.32 The International Conference on Financing for Development (FiD), to be held in Monterrey, Mexico on 18-22 March 2002, presents both a major opportunity and a major challenge for all shareholders to put in place the means and structures required to mobilise the financing for development needed to support the Millennium Development Goals (MDGs)

a) **Opportunities**

3.33 The Monterrey Conference offers a strategic opportunity for the international community to identify the scope and dimensions of the financing agenda and the ways and means to organise their efforts carry it forward. The MDGs (and the indicators associated with them) provide an agreed and sharp focus for the debate -- the volume and composition of resources, and associated policies and structures, needed to meet the MDGs.

3.34 Preparations for the Conference take an holistic approach, looking at national, international and systemic issues in the context of globalisation and interdependence. It brings in all shareholders -- governments of developed and developing countries (including Finance as well as Development Ministries/Agencies), international organisations beyond United Nations bodies (including the World Bank, IMF, WTO and OECD), the private sector and civil society. Emphasising the critical importance of policy coherence and good governance, the Conference seeks to prepare a platform to mobilise resources for development based on the principles of ownership, partnership and shared accountability.
b) Challenges

3.35 On substantive issues, challenges arise from the presently serious mismatch between goals and means (the resources from all sources -- domestic and external, private and concessional). This concerns not only the volume of additional funding needed to support the MDGs but also the policy and institutional structures required for its effective use. Like Doha, the FfD process also entails a major capacity building agenda (institutional, individual, supply side) and, equally, there is concern about mobilising the means and building or strengthening the structures for meeting that agenda.

3.36 There are also important challenges concerning the processes needed to better bring together the different stakeholder groups in ways that result in constructive proposals to define and carry out the “Monterrey agenda”. It will be important to address not only what developed countries need to do in respect of their own policies, but equally what developing countries themselves need to do (beyond the requirements for domestic resource mobilisation) and how developed countries can help them. There is also a need to: strengthen the development dimension in discussions on systemic issues; to give developing countries more voice and to pay more attention to implementation modalities, capacities and support, particularly in less advanced developing countries. And there is also a need to better recognise, use and co-ordinate the different contributions and products of the broad family of international institutions addressing global governance issues, rather than creating new international structures to address them.

c) Resource and policy needs

3.37 There have been numerous attempts at identifying the volume of resources required to meet the MDGs\textsuperscript{6}. Leaving aside methodological issues associated with such calculations, it is nevertheless clear that there is a major mismatch between present and required resource levels and structures, particularly for the poorer developing countries. For example, to halve poverty, Africa will need strengthen the policies and resources needed to increase its economic growth rate from its present level of around 2% per annum to 6-8% per annum, sustained over a 12-15 year period.

3.38 Meeting these financing needs and avoiding substantial shortfalls poses major policy challenges to developing and OECD countries alike. Doing so will not be easy, but there is growing convergence on what needs to be done:

- Supporting the macroeconomic, structural and governance requirements for higher and sustainable growth rates as a precondition for poverty reduction.
- Implementing a more holistic approach to mobilising finance for development, with more attention to the synergies and complementarities between domestic resources, external resources (including ODA), trade and systemic or global governance issues.
- Increasing the volume, stability and long-term predictability of financial flows.

d) The contribution of stronger policy coherence

3.39 Strengthening policy coherence for development (the theme of chapter II) has an important role to play in moving towards the volumes and structures of financing for development needed to support the

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\textsuperscript{6} See, for example, the Zedillo Report” (Recommendations of the High Level Panel on Financing for Development, mandated by the United Nations Secretary-General) for a synthesis of such estimates.
MDGs. The decade of the 1990s witnessed a major increase in the flows of international capital to developing countries, in which private capital became much more significant in total than ODA. Factors accounting for this phenomenon, beyond globalisation in general, include deregulation, regional integration, and advanced information technology. Although this has provided much needed capital, mostly for the larger and more advanced the developing countries, it has also led to an increased volatility of flows, to debt crises and to wider financial crises. Coherence issues occur in various areas.

3.40 **Financial sector reform** is important, both nationally and internationally, for enhancing incentives for efficient investment and economic growth and to minimise the risk of financial crises. Orderly sequencing of reforms is crucial and should include prudential regulation of the banking sector, institutional capacity-building and better co-ordination between exchange rate policy, monetary policy, and controls or taxes on capital flows. A related issue of concern is that developing countries should be adequately represented in international forums discussing reforms in financial architecture in order to strengthen their ownership of resulting codes and standards and to strengthen their commitment and ability to implement them. The latter issue will be the focus of the DAC Development Partnership Forum, to be held on 27-28 February 2002.

3.41 **Portfolio investment** provides valuable financial capital, mainly to middle-income developing countries with fair to good credit ratings. But short-term capital movements are a major cause of volatility which, in recent financial crises around the world, has increased poverty. Related problems are capital flight, bank secrecy and tax havens. Policy coherence means recognising these risks and installing adequate regulatory measures integrated into international financial architecture and into the monetary policies of countries that either import or export capital.

3.42 **Debt relief** for HIPCs is internationally recognised as necessary if poverty is to be reduced. To be effective it has to be additional, considering both the extent to which the debt could and would have been serviced without relief and the risk of reducing other forms of ODA and other financial transfers. The amounts of debt relief must be sufficient for debt sustainability, for investment in economic growth and for adequate social and other expenditures of importance for reducing poverty. Creditors must consider the risks and responsibilities involved in making loans to poor countries, and must share the consequent costs of failed credits.

3.43 **Foreign direct investment** (FDI) in developing countries has grown extremely rapidly until recently. It has mainly benefited a few emerging market economies in East Asia and Latin America. Low-income countries lack the policy and institutional environments, vibrant enterprise sector, infrastructure, economic dynamism and market size of better-off nations, which are needed to attract FDI. Much of what they do receive is channelled into extractive industries with limited or even negative impacts on political and social stability, and on poverty. Any negotiating process towards an international agreement on investment rules, which could secure enhanced access to development finance, needs to include developing countries as fully-fledged partners. In addition, it is also necessary to look at how aid and other policies in development countries could be better linked up to contribute to developing country own initiatives to strengthen enabling environments, remove impediments, and provide market based incentives to promote FDI in developing countries.

3.44 **International trade** is a powerful tool for reducing poverty. The potential impact on the national incomes and welfare of developing countries, produced by eliminating or reducing remaining restrictions on imports, would dwarf recent ODA flows. While some trade liberalisation reforms have been undertaken, further reforms are possible and necessary, although they become progressively more

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7. Twenty-three such countries account for 90% of FDI. Of these, China and Brazil alone account for about half of FDI flows to developing countries, and ten middle-income countries for 70%.
politically difficult when key “domestic” policy objectives like employment and regional development are affected. The major areas of importance for enhanced policy coherence concern the overall international trade regime, preferential trading arrangements, trade in services, export finance, transfer of technology, and agricultural subsidies and food trade. One of the most longstanding policy coherence issues is that developed countries takes various measures to enhance trade opportunities and capacities for developing countries at the same time as they maintain other measures (e.g. tariff and other barriers, subsidies to domestic production) which restrict their opportunities to more fully exploit their comparative advantage. The Doha Ministerial Declaration has a strong development agenda, with the needs of developing countries at the very heart of its programme of work, which will need to address many such issues.

IV. Current perspectives on the demand and supply of ODA

3.45 DAC Members are facing a potentially powerful new set of pressures to significantly increase the supply of aid over the next decade.

− If the PRSP/PRGF process is successful, there is the expectation that higher levels of aid will be forthcoming to finance increased social and other public investment. The IMF has indicated its readiness to factor such higher aid flows into its assessment of fiscal sustainability if they are provided on a medium-term basis.

− Preparations for the Financing for Development Conference underline the need for increased social investment and call for at least a doubling of ODA together with a public campaign in developed countries for a large increase in aid levels to meet the MDGs.

− Fighting poverty is increasingly seen as an integral part of a proactive global security policy and essential for a sustainable globalisation process.

3.46 While the methodologies underlying the estimation of additional aid requirements are far from straightforward (see Annex 1), specific numbers for additional ODA have been introduced into the debate:

− The World Bank estimates that USD54 billion in additional aid is needed to enable low-income countries that have good policies or might sufficiently improve their policies, to reach the goal of halving the proportion of people living in poverty by 2015.

− The WHO Commission on Macroeconomics and Health (CMH), in its report published on 20 December 2001, estimates that up to USD31 billion in additional aid could be needed and justified for the health sector alone by 2015 at the country level, with a further USD7 billion required for the supply of global public goods.

− UNESCO estimates that some USD14 billion is required for the Education for All Initiative (EFA). The World Bank will be making a new estimate of the EFA financing gap, based on a country-by-country analysis, prior to the Spring 2002 meeting of the Development Committee.

3.47 All of these numbers are explicitly conditional on effective overall governance and economic management in developing countries and the emergence of effective national sector strategies for health and education. The very stringent requirements spelt out in the CMH Report make it clear that there is nothing easy or automatic in the realisation of the preconditions for such increases in aid.
3.48 Thus **effective demand** for significant aid increases depends on major policy and institutional improvements in developing countries. But such improvements also depend on donor-side action, including the real prospect of medium-term aid commitments on which to base effective sector strategies and macroeconomic management.

3.49 Hence effective demand for and effective supply of significant increases in aid are fundamentally interdependent. Without a very much higher level of mutual accountability in donor-recipient relations than ever achieved in the past, aid increases will be neither justified nor realised.

3.50 On the **supply side**, in judging the practicability of a “significant” increase in the supply of aid, it is useful to have a clear view of the basic arithmetic. The “ready-reckoner” Tables III-3 and 4 below are helpful in this respect. They show that:

- A gradual rise in the ODA/GNI ratio from the present level of 0.22% to 0.32% by 2010 would, assuming real annual GNI growth of 2.5% in DAC Member countries, raise real ODA levels by some USD46 billion annually to USD100 billion compared with USD54 billion in 2000. ODA would double by 2012, at an ODA/GNI ratio of 0.34%.

- The potential budgetary effort of the G7 - and especially of the USA and Japan - would be decisive. The second reckoner shows that if all the ODA/GNI ratios of DAC Members increased by 0.1% between 2000 and 2010, USD38 billion of the extra USD46 billion would come from the G7.

3.51 While many donors are now committing to medium-term aid increases, the short-term outlook for overall DAC aid performance is subject both to budgetary constraints due to lower world-wide growth and to special factors in major countries. And some of the DAC’s high aid performers have indicated that public support for maintaining their current ODA/GNI level may be affected by the declining overall DAC aid performance.

3.52 As noted above, ensuring a high level of aid effectiveness would be essential to justifying aid increases. Fundamental issues would need to be confronted if the aid effort on both the donor and recipient sides were to be scaled up significantly. Without better effectiveness, a large increase in flows may only lead to even longer project pipelines, corruption and relaxation of policies. Even in well-performing developing countries, there would be important macroeconomic impacts to be managed (e.g. the exchange rate and inflation).

3.53 Better effectiveness would imply building the capacity on both the donor and recipient sides to handle a doubling of aid. Institutional development, human capacity building and arrangements for the governance of aid, both nationally and globally, would need to be strengthened. The PRSP process, embodying the principles of the CDF regarding local ownership etc. would have to reach a high level of functionality. Effective performance monitoring based on quality data would be essential. The international community is working on this agenda. Building up the aid system to effectively manage a doubling of ODA volume could take as much as ten years.
3.54 **Institutional capacities and constraints** on both the partner and the donor community sides that may prevent the delivery of sharply higher aid flows require urgent attention. These include:

- The issues being addressed by the DAC Task Force on Donor Practices\(^8\), whose work to streamline the functioning of a multi-donor aid system is even more crucial in the context of any planned build-up of aid volumes.

- The governance and capacity issues being discussed in the DAC Network on Good Governance and Capacity Development (GOVNET).

\(^8\) For information on the work of this Group, see [add website address]
### Table III.3. Ready Reckoner 1: ODA growth scenario

<table>
<thead>
<tr>
<th>Year</th>
<th>ODA/GNI ratio (%)</th>
<th>Real ODA growth scenario - USD billion (1)</th>
<th>Resulting increase in ODA - USD billion</th>
<th>Memo item : Rate of growth of real ODA (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>0.22</td>
<td>54</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>0.23</td>
<td>58</td>
<td>4</td>
<td>7.1</td>
</tr>
<tr>
<td>2002</td>
<td>0.24</td>
<td>62</td>
<td>8</td>
<td>6.9</td>
</tr>
<tr>
<td>2003</td>
<td>0.25</td>
<td>66</td>
<td>12</td>
<td>6.7</td>
</tr>
<tr>
<td>2004</td>
<td>0.26</td>
<td>70</td>
<td>16</td>
<td>6.5</td>
</tr>
<tr>
<td>2005</td>
<td>0.27</td>
<td>74</td>
<td>21</td>
<td>6.4</td>
</tr>
<tr>
<td>2006</td>
<td>0.28</td>
<td>79</td>
<td>25</td>
<td>6.2</td>
</tr>
<tr>
<td>2007</td>
<td>0.29</td>
<td>84</td>
<td>30</td>
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</tr>
<tr>
<td>2008</td>
<td>0.30</td>
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<td>35</td>
<td>6.0</td>
</tr>
<tr>
<td>2009</td>
<td>0.31</td>
<td>94</td>
<td>40</td>
<td>5.9</td>
</tr>
<tr>
<td>2010</td>
<td>0.32</td>
<td>100</td>
<td>46</td>
<td>5.8</td>
</tr>
<tr>
<td>2011</td>
<td>0.33</td>
<td>105</td>
<td>51</td>
<td>5.7</td>
</tr>
<tr>
<td>2012</td>
<td>0.34</td>
<td>111</td>
<td>57</td>
<td>5.6</td>
</tr>
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</table>

(1) At 2000 prices, assuming 2.5% annual GNI growth.

### Table III.4. Ready Reckoner 2: DAC Countries’ ODA levels in 2010 and 2012 under real ODA growth scenario

<table>
<thead>
<tr>
<th>USD million</th>
<th>ODA/GNI in 2000 (%)</th>
<th>ODA in 2000</th>
<th>Real ODA in 2010 under growth scenario (1)</th>
<th>ODA/GNI in 2010 (%)</th>
<th>Real ODA in 2012 under continuation of growth scenario (1)</th>
<th>Real increase</th>
<th>ODA/GNI in 2012 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>0.27</td>
<td>987</td>
<td>1 738</td>
<td>0.37</td>
<td>1 925</td>
<td>938</td>
<td>0.39</td>
</tr>
<tr>
<td>Austria</td>
<td>0.23</td>
<td>423</td>
<td>780</td>
<td>0.33</td>
<td>870</td>
<td>446</td>
<td>0.35</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.36</td>
<td>820</td>
<td>1 343</td>
<td>0.46</td>
<td>1 472</td>
<td>652</td>
<td>0.48</td>
</tr>
<tr>
<td>Canada</td>
<td>0.25</td>
<td>1 744</td>
<td>3 108</td>
<td>0.35</td>
<td>3 450</td>
<td>1 706</td>
<td>0.37</td>
</tr>
<tr>
<td>Denmark</td>
<td>1.06</td>
<td>1 664</td>
<td>2 331</td>
<td>1.16</td>
<td>2 493</td>
<td>827</td>
<td>1.18</td>
</tr>
<tr>
<td>Finland</td>
<td>0.31</td>
<td>371</td>
<td>628</td>
<td>0.41</td>
<td>692</td>
<td>321</td>
<td>0.43</td>
</tr>
<tr>
<td>France</td>
<td>0.32</td>
<td>4 105</td>
<td>6 899</td>
<td>0.42</td>
<td>7 594</td>
<td>3 489</td>
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</tr>
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<td>Germany</td>
<td>0.27</td>
<td>5 030</td>
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<td>0.37</td>
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<td>4 736</td>
<td>0.39</td>
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<tr>
<td>Greece</td>
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<td>433</td>
<td>0.30</td>
<td>485</td>
<td>259</td>
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<tr>
<td>Ireland</td>
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<td>402</td>
<td>0.40</td>
<td>444</td>
<td>209</td>
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<tr>
<td>Italy</td>
<td>0.13</td>
<td>1 376</td>
<td>3 137</td>
<td>0.23</td>
<td>3 585</td>
<td>2 208</td>
<td>0.25</td>
</tr>
<tr>
<td>Japan</td>
<td>0.28</td>
<td>13 508</td>
<td>23 445</td>
<td>0.38</td>
<td>25 925</td>
<td>12 418</td>
<td>0.40</td>
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<tr>
<td>Luxembour</td>
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<td>183</td>
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<td>0.88</td>
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<tr>
<td>Netherlands</td>
<td>0.84</td>
<td>3 135</td>
<td>4 492</td>
<td>0.94</td>
<td>4 821</td>
<td>1 686</td>
<td>0.96</td>
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<tr>
<td>New Zealand</td>
<td>0.25</td>
<td>113</td>
<td>203</td>
<td>0.35</td>
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<td>1 264</td>
<td>1 820</td>
<td>0.90</td>
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<td>691</td>
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<td>0.38</td>
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<td>Spain</td>
<td>0.22</td>
<td>1 195</td>
<td>2 236</td>
<td>0.32</td>
<td>2 498</td>
<td>1 303</td>
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<tr>
<td>Sweden</td>
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<td>2 590</td>
<td>0.90</td>
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<td>983</td>
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<td>Switzerland</td>
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<td>890</td>
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<td>0.44</td>
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<td>724</td>
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<td>United Kingdom</td>
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<td>7 577</td>
<td>0.42</td>
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<tr>
<td>United States</td>
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<td>0.20</td>
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<tr>
<td>Total DAC</td>
<td>0.22</td>
<td>53 737</td>
<td>99 565</td>
<td>0.32</td>
<td>111 073</td>
<td>57 336</td>
<td>0.34</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>G7</td>
<td>0.19</td>
<td>40 219</td>
<td>78 438</td>
<td>0.29</td>
<td>88 073</td>
<td>47 854</td>
<td>0.31</td>
</tr>
<tr>
<td>Other</td>
<td>0.45</td>
<td>13 519</td>
<td>21 127</td>
<td>0.55</td>
<td>23 060</td>
<td>9 482</td>
<td>0.57</td>
</tr>
</tbody>
</table>

(1) At 2000 prices, assuming 2.5% annual GNI growth, and annual increases of 0.01% in ODA/GNI ratios, starting in 2001.
Efforts being undertaken in the DAC Working Party on Financial Aspects of Development Assistance, pursuant to the Recommendation on Untying ODA in the Least Developed Countries, to strengthen procurement systems and capacities in partner countries.

The efforts under the New Partnership for African Development (NEPAD) to promote peer reviews of political and economic governance aimed at fostering the emergence of “capable states” and to radically improve the “reputation” of Africa vis-à-vis investors, both domestic and foreign.

3.55 **Budget aid and public expenditure management and capacity building** are also central to managing higher aid flows. The IMF envisions putting into place a medium-term approach to PRSP financing, based on normative scenarios for concessional finance and higher prior commitments by donors. More can be done to address these issues in the context of work on PRSPs and the associated PRGF-supported program:

- First, programs could be presented in ways that give clearer signals to the donor community in the PRSP process. Medium-term projections could be based on a more normative scenario for grants and concessional loans driven by the poverty and growth goals, rather than a continuation of declining trends with unfilled financing gaps.

- Second, it may be possible, especially for strong performers, to obtain prior commitments of higher donor assistance, as programs are being formulated, and accordingly to program larger deficits and spending at the outset. In addition, programs could define contingent expenditures (drawing on priorities set in the PRSP) that would be executed if additional fungible external assistance on concessional terms were forthcoming. Indeed, it would be desirable that all PRGF-supported programs have this feature, in place of the standard but much-misunderstood adjuster for deviations in program financing. Again, these elements of the new approach call for improved measurement and tracking of government expenditures.

- Attention is required to the interface between finance in support of country-led PRSPs and sectoral finance available as a result of special global initiatives. The latter includes, for example, the HIV/AIDS fund set up in Summer 2001, and more generally, global sectoral initiatives (e.g. health, education, trade capacity). Various structures connecting inter-agency working groups and steering groups and global Trust Funds to country-level strategies and operations are beginning to emerge in this context.

**Concluding remarks**

3.56 The various available estimates concerning additional ODA requirements converge at, or are consistent with, the view that the doubling of aid, with the increase directed at countries with good governance and policy environments, would provide a basis for meeting the Millennium Development Goals. This holds true regardless of the methodological approach taken.

3.57 The timeframe to achieve this rough doubling of aid is not made clear in the various estimates (except for the WHO Commission). The ready reckoners (tables III.3 and III.4) show a time profile in which aid doubles over 12 years, by 2012. The ODA/GNI ratio rises to 0.32% in 2010 (equivalent to the average for 1992-93) and to 0.34% by 2012. It would not seem unfeasible to handle such an increased

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ODA volume with improved effectiveness, considering the learning process OECD and partner countries have gone through. That process has resulted in the current focus on country-led poverty strategies, on the importance of policies and of participation by civil society, and the efforts to reduce “transaction costs” of development co-operation.

3.58 The international community is already embarking on an agenda that could match the ambitions of the Millennium Development Goals. The elements of such an agenda are:

- The “Doha Development Agenda”, which places development objectives at the heart of the broad work programme agreed for the WTO at Doha in November 2001.

- The recognition by the Development Committee at its meeting in Ottawa in November 2001 that “a substantial increase in current ODA levels would be required if the opportunities emerging from policy improvements in low-income countries are to be realised and the MDGs to be met”.

- The collaborative work programmes on harmonisation of donor practices agreed by the Development Committee and the DAC in 2001.

- The comprehensive approach to development financing, founded on strong domestic governance and policies in developing countries and coherent governance at the global level, which is emerging in the preparations for the International Conference on Financing for Development in Mexico in 2002.

3.59 The final conclusion from this analysis is that the MDGs can be reached, if serious efforts are made both by developing country governments and OECD Members. Developing countries must proceed with policy reforms in several areas for pro-poor growth and social development, including income and asset redistribution. OECD Members need to contribute to reducing global poverty and enhancing political stability by enhancing both ODA and policy coherence for poverty reduction. The more coherent policies become in terms of their impact on poverty in developing countries, the less increases in aid budgets will be required.
ANNEX 1
RECENT ASSESSMENTS OF AID REQUIREMENTS: SOME OBSERVATIONS

1. Various methods have been used to estimate the additional aid that is required to meet the Millennium Development Goals (MDGs). This annex briefly assesses the projections and calculations of several international development organisations, in particular the World Bank, WHO, UNESCO, UNICEF and the High-Level Panel on Financing for Development.

2. Estimating the amount of aid required to meet the MDGs involves evidence-based calculations of financing gaps to meet both:

- The income poverty MDG of halving the proportion of people living in extreme poverty by 2015, through pro-poor economic growth.

- And the other MDGs reflecting social and environmental poverty dimensions, through direct interventions.

3. This annex assesses both kinds of calculations, as well as the projections of the World Bank on the impact of trade liberalisation on poverty outcomes and discusses the links between these various approaches.

Income poverty reduction through aid for pro-poor growth

Cost Estimates

4. An IMF/World Bank staff paper for the Development Committee\(^\text{10}\) identifies 65 low-income countries that face an “uphill” struggle to reach the income poverty goal and where aid would make a difference - provided there is a “sound policy foundation”. These countries are divided into two groups according to their policy performance: 43 countries with “reasonably good policies and governance” and 22 countries lacking this prerequisite. A simple model of the Harrod-Domar type combined with country-specific poverty data is then used to calculate the additional resources needed to reach the overall income poverty goal through the aid-growth-poverty reduction link. It assumes that aid will make a sustainable difference for poverty reduction only in the 43 good performers and they are estimated to need an additional USD39 billion per year (a doubling of present levels).

5. Meanwhile, the paper calls for every effort to be made to support policy reforms in the remaining 22 “uphill” countries and, then, to provide them too with adequate ODA flows. If the policy performance of these countries improves quickly, additional ODA of about USD15 billion per year - three times the present level - would be called for in the medium term to help them reach the target.

\(^{10}\) Financing for Development (September 18, 2001), prepared by the Staffs of the World Bank and the IMF for the Development Committee.
6. Thus, the IMF/World Bank illustrative estimates of the total requirements of increased aid to reach the poverty reduction goal in “uphill” countries amounts to USD54 billion/year, if the majority of these low-income countries maintain their current “reasonably good policies and governance”, and the poor performers improve theirs. This would roughly double current ODA as an indication of the magnitude of aid required to halve income poverty in each country.

7. The remaining 86 developing countries are assumed not to require increased ODA for two reasons. First, they are mostly “on track” to halve their income poverty incidence through pro-poor growth. Second, many middle-income countries have the economic ability to reduce poverty through policy reforms for improved income distribution and general or targeted social development programmes. The paper also suggests that aid reallocation within this group could improve aid effectiveness and increase the number of people lifted out of poverty.

Coverage of countries and types of aid - some issues

8. The exclusion of the “on track” countries is questionable, since they contribute to global and regional poverty reduction goals and will have huge numbers remaining below the minimum poverty line and falling short of other MDGs as well. These countries could use additional assistance, effectively, to reduce poverty faster than called for by the MDG targets, and would still account for a large share of the world’s poor in 2015. There are also incremental needs the paper leaves out: for reconstruction and prevention programmes related to conflict and terrorism (e.g. the need for current Afghanistan-related aid to be additional); also there are rising needs for disaster relief, which may continue to grow with increased frequency of natural disasters and growing population density. And humanitarian aid programmes rarely get sufficient funding to deal with all of the extreme privation that they seek to address, and which are closely related to MDGs.

9. Another issue is the paper’s assumption that all 22 “uphill poor performers” would become good performers, which is clearly unrealistic. They account for USD15 billion of the USD54 billion. However, it is plausible that there would be some improvements in performance within this group. In addition, some consideration should be given to selective increases even among “poor performers”, if additional funding were available, for programmes related to achieving the MDGs that can meet effectiveness criteria (e.g. programmes for health or education going through proven NGOs). Thus, the net decrease in ODA needs would likely be only a share of the USD15 billion.

10. Other recent reports include the Report of the High-Level Panel on Financing for Development (the “Zedillo Report”). Based on an UNCTAD study, which suggests that halving poverty in Africa would require additional aid of about USD10 billion/year, assuming general adoption of good policies, the Report considers the aid requirements of other low-income countries and suggests a need of at least USD20 billion over and above current spending in order to cut income poverty by half. It then estimates the total cost of achieving the other MDGs at an additional USD30 billion, for a total of USD50 billion.11

Methodological issues

11. Several methodological issues arise. These kinds of estimates derive from a very simple model, where growth depends on investment in the physical capital stock and where the difference between

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projected savings and the investment needed to reach a target rate of growth is seen as a “financial gap”, to be filled by external flows, both aid and non-aid. The relationship between investment and growth depends on a fixed co-efficient, the Incremental Capital-Output Ratio (ICOR). The assumption is that aid and non-aid flows will have a systematic impact on raising investment and that rising investment will have a systematic effect in increasing the rate of growth. Historically, the evidence does not show such systematic relationships. However, the testing of the model has looked at a wide range of countries over a period of time when policies and governance in many of them were well below the “reasonable standards” attained in the group of countries where the World Bank/IMF paper believes that increased aid will have an impact. In those countries which do not reach such standards, it is implicitly assumed that the aid-investment-growth-poverty reduction relationship does not work.

12. Another methodological issue is that fixed coefficients for the impact of aid on economic growth, and of economic growth on poverty reduction, may not fully allow for the possibility that rapidly increased aid may be less effective, and that unit costs of meeting MDGs would rise on the margin, due for example to:

- Absorptive capacity constraints (including governance and capacity).
- Macroeconomic distortion effects such as Dutch disease and negative savings incentives.
- Reduced/distorted incentives for effective use of ODA resources.

13. On the other hand, there may be increasing returns to scale of aid if it lowers transaction costs and improves the institutional environment, e.g. through infrastructure and social sector development, enhancing human capital or boosting institutional capacity for law and contract enforcement. Hence an overall assumption of constant returns to scale may be reasonable on balance, especially when combined with the stated prerequisite of generally improved policy stances, and a reallocation of aid to good performers.

14. The elasticity of poverty reduction with respect to economic growth is a function of not only the pace of growth, but also of its quality in terms of composition, distribution and sustainability. The conversion rate of growth into poverty reduction varies considerably across countries and regions because of different degrees of inequality in literacy, land holdings and other assets. World Bank studies find that while growth in mean income is the most important factor for poverty reduction, it explains slightly less than half of the growth of incomes of the poor, but there are wide divergences from this average.

15. These caveats underline the importance of improved policy and institutional frameworks for enhanced aid effectiveness. An enabling environment for pro-poor growth can increase the impact of aid on growth and the impact of growth on poverty reduction. It follows that changing the pattern of aid allocations could enhance its effectiveness for poverty reduction. World Bank research indicates that a “poverty-efficient” allocation of ODA (using 1998 data) would be 68% for countries with high poverty

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13. For instance, between 1960 and 1994 the poverty reduction impact varied by a factor of four to five times per percentage point of economic growth per capita between different states in India, and similar differences can be found comparing East Asia and Latin America. (See The Quality of Growth, World Bank 2000; David Dollar and Aart Kraay: Growth IS Good for the Poor, World Bank, 2000; Martin Ravallion: Growth, Inequality and Poverty: Looking Beyond Averages, World Bank, 2000.)
incidence and good policies, and 28% for countries with high poverty and poor policies\textsuperscript{14}. This would imply increasing aid to the first group by 150%, assuming no increase in the overall ODA volume. Comparing this with the estimated doubling of aid to good performers in the Development Committee paper in a context of overall doubling of ODA, the latter seems too low.

16. An important contribution to improving the environment for effective aid and pro-poor growth would be to rationalise aid delivery mechanisms and harmonise procedures, which is the mandate of the DAC Task Force on Donor Practices. More integrated and co-ordinated aid forms such as programme and sector assistance and medium-term aid commitments in support of country-led strategies and programmes for reducing poverty, in combination with support for capacity building, could significantly increase the absorptive capacity of low-income countries. Increased financing of global public goods may also enhance the poverty reduction impact of aid and growth by reducing transaction costs of aid.

17. The implication of focusing on meeting the MDGs is that much more aid should be allocated to LLDCs and LICs, especially to those with good policies, governance and institutions. If the primary allocation criteria were the number of people below the poverty line, the largest developing countries - Bangladesh, India, Indonesia and Pakistan - would get a much larger share of the increasing ODA volume than African countries, where the depth of poverty and the need for institutional capacity development support are much greater. (We exclude China from this list on the assumption that its access to capital markets means that increased aid is not a major constraint to poverty reduction.) In the event that African countries would not yet have reached absorptive capacity constraints for effective use of aid, this would raise the issue of whether a small-country bias is acceptable, even if it means fewer people in the world will be moving out of poverty. A related issue is the relative importance of meeting the MDGs at the global, regional and country level. This makes a big difference to the prospects for reaching them and for the implied aid requirements. Furthermore, the current recognition of the need to go beyond effectiveness criteria alone in order to deal with terrorism and conflict issues may reduce the overall impact of aid on poverty although it should be designed to pave the way towards “reasonable standards of governance and policies” that ultimately will reduce conflict and poverty. Hence, it is vital that the aid increases justified in the short to medium term to deal with terrorism and conflict be additional.

Reducing poverty through trade liberalisation and private investment

18. Putting the importance of ODA for poverty reduction in perspective, it must be recognised that policy coherence for poverty reduction is also very important for the prospects of achieving the MDGs. This is true for both the policies of developing countries and those of OECD Member countries in other areas than development co-operation. It includes the important area of other resource flows to developing countries than ODA, e.g. trade, FDI, portfolio investments and other private capital flows; the private financing of global public goods; and NGO projects financed with private funds and contributions\textsuperscript{15}.

19. Of special interest in the post-Doha context are the long-term projections of growth and poverty reduction in the new World Bank Report \textit{Global Economic Prospects and the Developing Countries 2002} (GEP). Its baseline scenario implies that the incidence of extreme income poverty (under USD1/day) will be reduced by more than half from 1990 to 2015 at the global level, and very nearly halved excluding China. However, the GEP makes clear that not all regions will meet the income poverty MDGs. It shows


\textsuperscript{15} The Development Committee paper states that tariff and non-tariff barriers imposed by rich countries, together with their agricultural subsidies, cost developing countries much more than the $57 billion that they receive in foreign aid.
that Africa in particular will fail to meet the goal by a wide margin. In the GEP “Successful WTO Development Round Scenario”, poverty is reduced by a further 15% globally, of which over half in Africa. The GEP assessment of the infant mortality goal finds that it will only be reached in South Asia.

20. The GEP projections make no mention of increased aid requirements. They assume explicitly that trade liberalisation will generate large income gains for developing countries that, implicitly, will be associated with rising investment and employment and that public revenues will then be available for social investment. This is the underlying long-run scenario for successful development used as a reference point by all major international organisations and embodied for example in the current Facilitators Paper for the International Conference on Financing for Development. However, such a scenario has large implicit public and social investment requirements. The emphasis on trade capacity development at Doha, embracing both the often costly requirements for participating in the WTO system and the public investments needed to underpin a supply response to trade opportunities bears witness to this. In particular, low-income countries suffer a major deficit in human capital, notably in areas related to health and education, and they have limited resources to meet the challenges of sustainable development. There can be no dynamic flow of foreign investment to countries with these human capital and public investment deficits. An UNCTAD study postulates that one of the reasons for the lack of a supply response in Least Developed Countries and the weakness of the investment-growth link is the extremely low levels of per capita spending on health and education and other social investments. Hence the aid requirements for underpinning a trade and investment-led strategy for poverty reduction are critical. This leads to the third approach to estimating aid requirements.

Estimating the costs of meeting social development goals

21. Along with the income poverty reduction goal, the MDGs include goals for overcoming deficiencies in education, health and the environment. The interactions between the goals are complex. Reducing income poverty will affect these goals by increasing the demand of the poor for health and education services, but also by increasing the public revenues available to provide such services.

22. On the other side, social development boosts economic growth by enhancing the productivity and incomes of the poor. There is wide agreement that human capital is the most important production factor of all, but economists remain divided over how best to evaluate the various aspects of human capital formation. Education and training are key aspects, and so are health, access to basic services and social stability. The report of the WHO Commission on Macroeconomics and Health estimates that economic growth would be around 0.5% higher if health interventions were scaled up massively so that the disease burden in low-income countries was significantly reduced. This causal link from social development to pro-poor growth can enhance the effectiveness of social sector expenditures, whether from domestic resources or ODA.

23. Evidence shows that both primary and secondary schooling have important effects on overall growth. According to the World Bank, primary education continues to be the most effective investment for pro-poor growth in developing countries; investment in girls’ and women’s education generally yields the highest returns. While returns decline at higher levels of schooling and incomes, investment in tertiary education is a critical area in terms of building trade and investment capacity.

16. UNCTAD; The Least Developed Countries 2000 Report, p45.
24. The fact that social development is both a cause and an effect of economic growth complicates the task of estimating the total financing requirements of reaching the MDGs. It means that to some extent, aid required and used for achieving improved social indicators will at the same time help to generate economic growth and reduce income poverty and vice versa. And such aid may well take the form of social sector and environmental protection support. These interactions need to be recognised and orchestrated to best effect.

25. A way to consider the double impact of aid on social and economic development would be to calculate the costs of achieving the social goals by themselves, while trying to avoid the double counting implied by the interdependence between the different social goals. Using such an approach based on some country-level data, World Bank staff have made a rough estimate of the total aid requirements for reaching the social and environmental MDGs and found them to be broadly in the range of those calculated for reaching the income poverty reduction goal, indicating convergence in the two approaches to calculating the level required for achieving the MDGs at around a doubling of aid from present levels. Specific estimates made by other organisations for health and education also tend to line up with this order of magnitude.

26. For education, a recent UNESCO document refers to ongoing efforts by the World Bank, UNESCO and other organisations to estimate the financial resources needed to achieve Education for All. These include attempts both at establishing a global financing goal and at identifying specific resources at the country level. The annual additional resources needed to achieve universal primary education have been variously estimated to be:

- USD8 bn/year: OXFAM
- USD9 bn/year: UNICEF
- USD10 bn/year: World Bank
- USD15 bn/year: UNESCO

The World Bank is undertaking country-by-country estimates of the costs of financing education sector strategies under the Education for All initiative. These estimates are scheduled to be ready by Spring 2002.

27. For health, the report of the WHO Commission on Macroeconomics and Health has preliminary estimates of the potential aid requirements for implementing country-level programmes of “essential interventions” for improving the health of poor people in low-income countries at around USD30 billion in 2015, compared to the current level of USD6 billion.

28. Both the EFA programmes and the proposed approach of the WHO Commission are firmly conditioned on the formulation of high-quality sector programmes and good PRSPs.

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