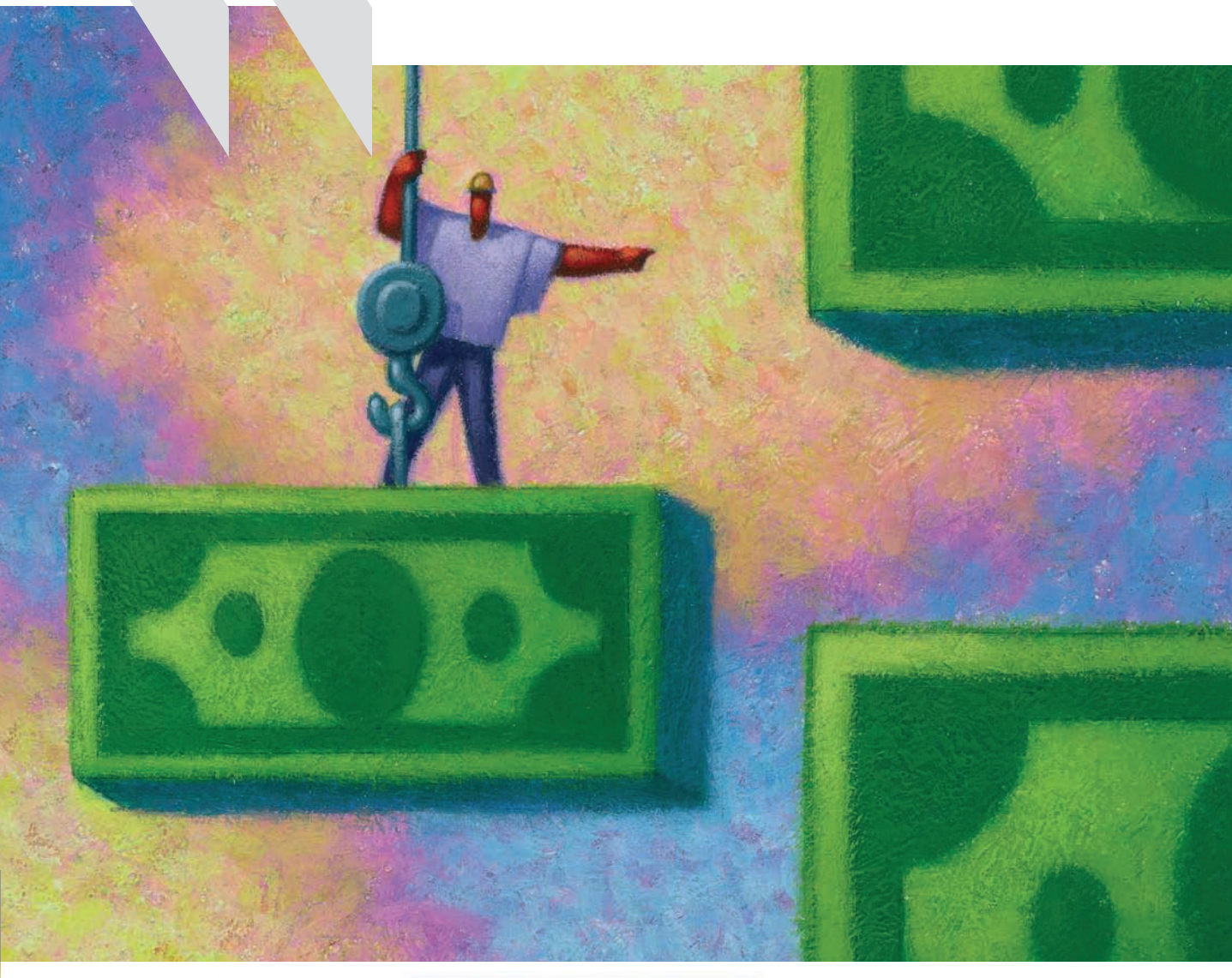
Development Centre Perspectives

Financing Development

AID AND BEYOND



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Development Centre Perspectives

Financing Development

Aid and Beyond

OECD

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The Development Centre of the Organisation for Economic Co-operation and Development was established by decision of the OECD Council on 23 October 1962 and comprises 22 member countries of the OECD: Austria, Belgium, the Czech Republic, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Korea, Luxembourg, Mexico, the Netherlands, Norway, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey and the United Kingdom as well as Brazil since March 1994, Chile since November 1998, India since February 2001, Romania since October 2004, Thailand since March 2005 and South Africa since May 2006. The Commission of the European Communities also takes part in the Centre's Governing Board.

The Development Centre, whose membership is open to both OECD and non-OECD countries, occupies a unique place within the OECD and in the international community. Members finance the Centre and serve on its Governing Board, which sets the biennial work programme and oversees its implementation.

The Centre links OECD members with developing and emerging economies and fosters debate and discussion to seek creative policy solutions to emerging global issues and development challenges. Participants in Centre events are invited in their personal capacity.

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For an overview of the Centre's activities, please see www.oecd.org/dev

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Foreword

The Development Centre has organised its 2007/2008 work programme around strategically selected output areas culminating in the production of regular annual or biannual flagship publications and regional *Outlooks*. These serve as the hubs for associated policy dialogue events organised by the Centre and as instruments for engaging key stakeholders in the Centre's activities. Each thematic output area and its corresponding "flagship" is supported by an *Informal Policy Network* composed of interested principal stakeholders in member-country capitals and delegations, and an *Expert Network* of specialists from the OECD community, other international organisations, the private sector, leading international universities and think tanks. An *Informal Advisory Group* for each output area including the regional Outlooks has been formed from these networks.

This volume on *Financing Development* is one of the Centre's thematic flagships. *Business for Development* is the topic of another title in the series, while *Policy Coherence for Development and Human Security* is the focus of the third. The series is completed by the *African Economic Outlook*, *Latin American Economic Outlook* and *Black Sea and Central Asian Economic Outlook*.

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We extend our acknowledgements to Richard Manning, Chair of the OECD Development Assistance Committee (DAC), Michael Roeskau and Richard Carey, respectively Director and Deputy Director of the DAC Secretariat, as well as their colleagues, for having shared data and provided stimulating exchanges in the context of our joint endeavour, the OECD Global Forum on Development. Our gratitude also goes to David Batt, Director of the APF Support Unit, for his kind collaboration which is consolidated in Brian Ngo's contribution (Chapter 2). The World Bank Global Partnerships office provided key support in the country survey on Ghana which feeds into Chapters 5 and 6. The OECD Directorate for Financial and Enterprise Affairs contributed Box 2.3 in Chapter 2. The OECD General Secretariat contributed Box 4.3 in Chapter 4. Finally, we wish to thank Prof. Louka T. Katseli, Director of the Development Centre, and Deputy Director and Chief Development Economist Javier Santiso for their extremely valuable comments.

The volume has been edited by Robert Cornell, former Deputy Secretary General of the OECD. The OECD Development Centre's Publications and Media Unit, headed by Colm Foy, turned the manuscript into the publication.

Other annual publications are being launched by the OECD Development Centre on *Business for Development* and *Policy Coherence for Development and Human Security.*

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Preface

An aid professional from 20 years ago would hardly recognise the scene today. Adopted at the turn of the century, the Millennium Development Goals (MDGs) have raised resources and renewed hope for development and poverty reduction. They have also provided an impetus for a more effective and performance-oriented aid-management culture. Simultaneously, new private actors with deep pockets and astonishing creativity have emerged sharing the same humanitarian and development objectives as traditional official donors. New official donors have also entered the scene with their own priorities and approaches. To complement traditional grants and loans, both old and new actors are turning increasingly to innovative mechanisms to raise and deliver their funds.

Policy makers in OECD and developing countries have understood that the international development finance system will need to adapt to new challenges. As part of this realisation, the OECD has chosen development finance as the first theme of its *Global Forum on Development* (www.oecd.org/development/globalforum). OECD and developing-country governments, international organisations foundations, NGOs, think tanks, private companies and "emerging donors" are all participating in a series of Forum-linked events over three years (2006-09). The OECD is inviting participants in the events to explore options and, ultimately, to generate momentum for a more effective development finance system.

This volume is the first in a series designed to underpin Global Forum discussions. Its policy-oriented papers present views and recommendations on the introduction of innovative financing mechanisms, on the use of both grants and loans in development finance, and on the challenges of managing diverse financial flows at the country level.

The next book in the series, expected in early 2008, will examine questions of ownership, leadership and capacity in development finance, themes which coincide with the second year's discussions in the Global Forum. It will explore how developing countries can play a stronger role in shaping development finance, at both global and developing country levels, and how development policy makers can help build their capacity to do so. A third volume will focus on the effective use of instruments.

Taken together, the publications in the *Financing Development* series will provide a comprehensive set of recommendations for policy makers throughout the world to help them to cope with the challenges and opportunities presented by a changing international landscape. This first volume describes the nature of that landscape and, thus, is already a major contribution to the essential discussions within the international community that lie ahead.

Louka T. Katseli
Director
OECD Development Centre
March 2007

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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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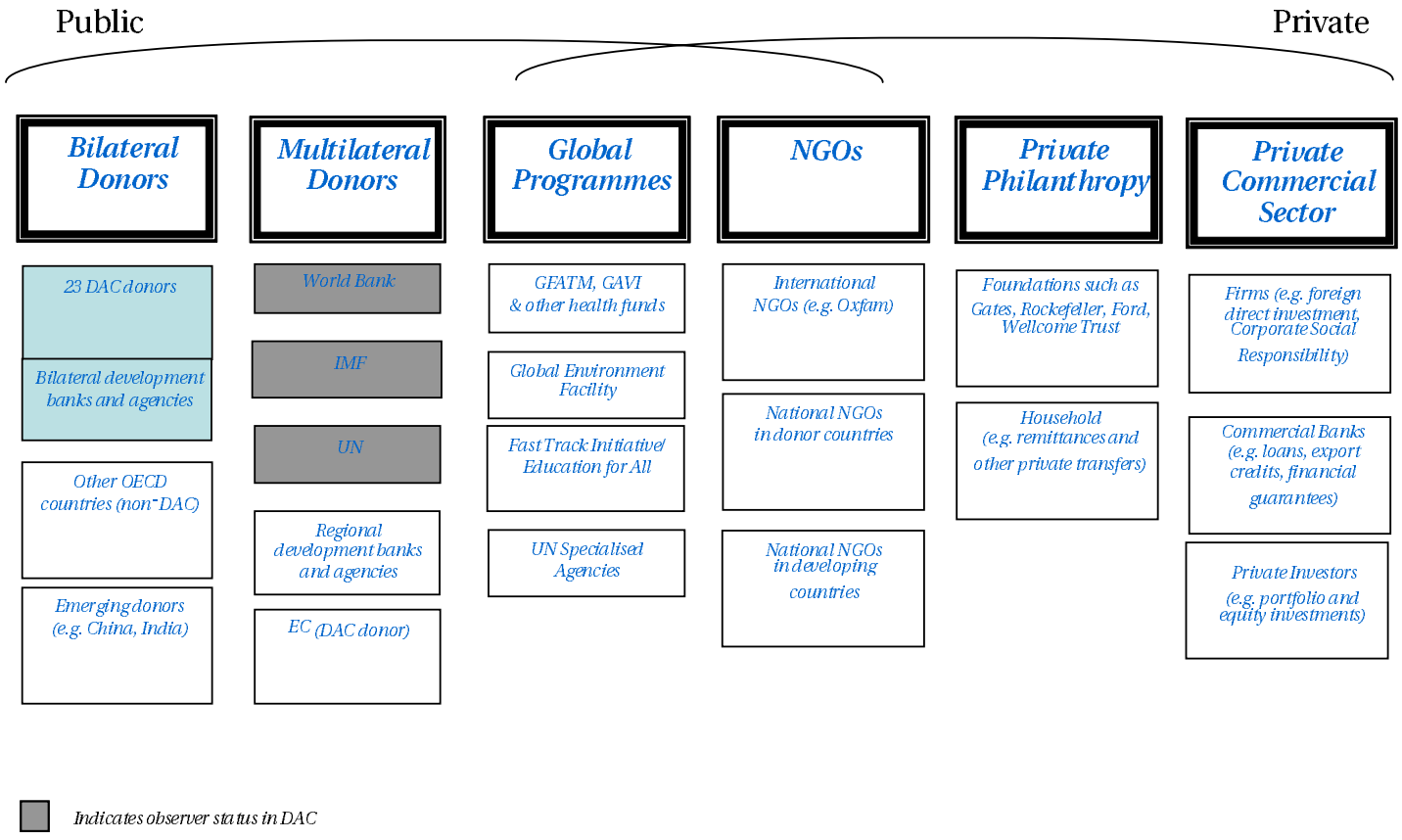
Figure 1.1. **The International Development Finance System**



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

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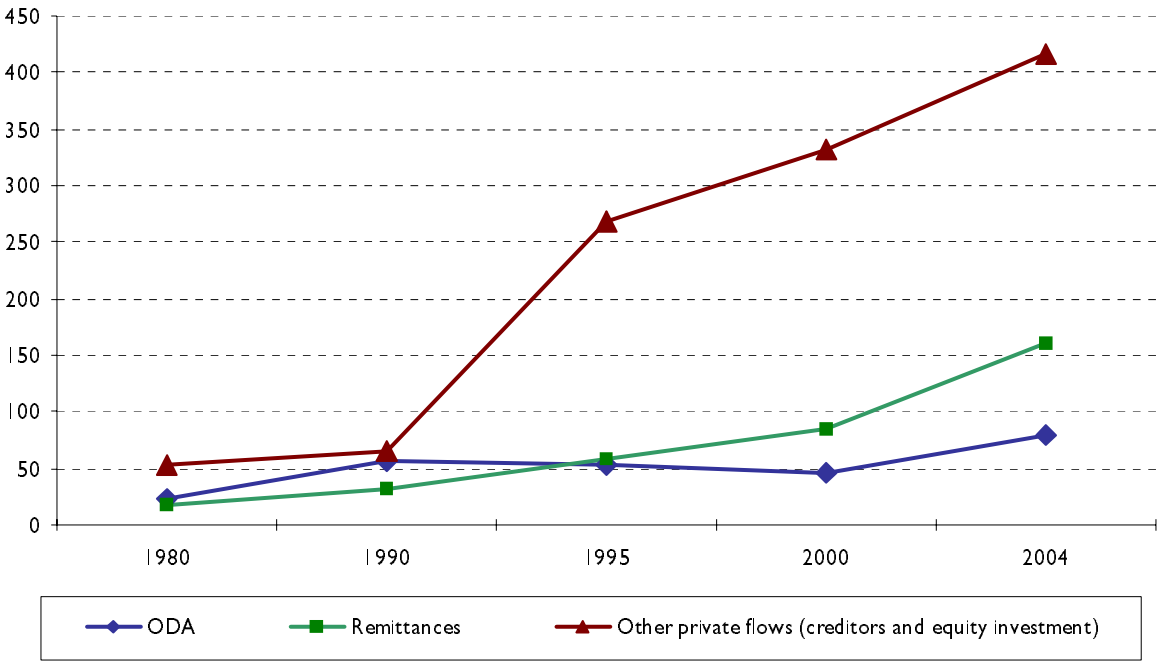
Capital Inflows Have Changed, but Mostly in Emerging Economies

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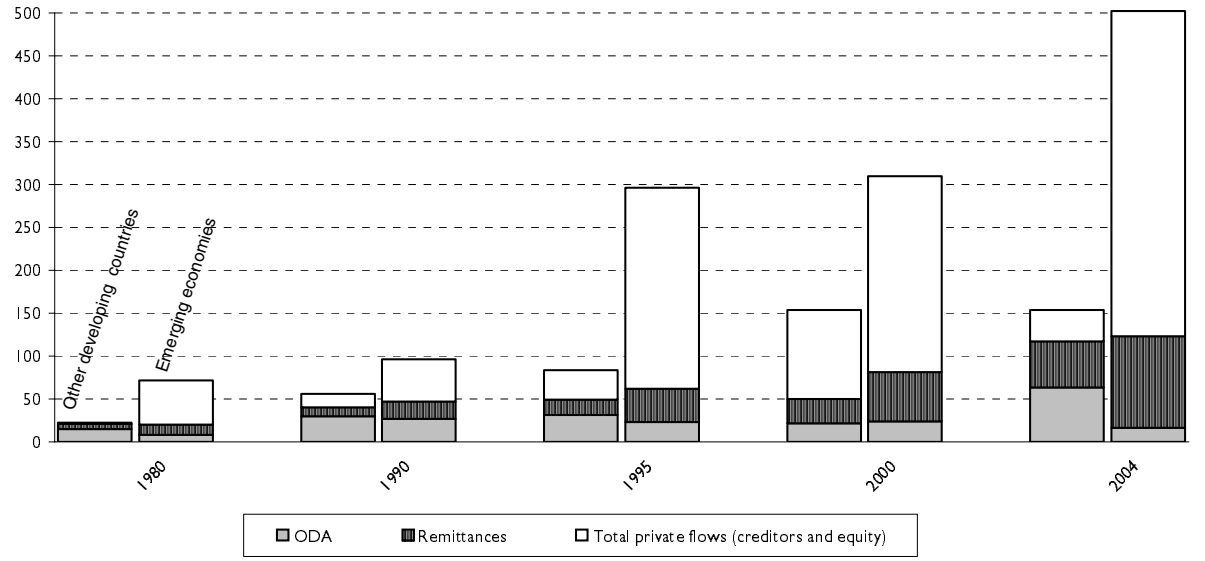
Figure 1.3. **Composition of Capital Inflows in Emerging Economies and Other Developing Countries**
(1980-2004, $ billion)



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

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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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Part I

The Evolving Architecture of Development Finance: A Global Perspective

Chapter 2

Resources for Development in Africa

Abstract

Aid flows from OECD/DAC (Development Assistance Committee) donors have risen sharply in recent years, but debt relief, emergency assistance and other special-purpose grants accounted for a large share of the increase. Aid from traditional donors does not complete the picture, however. Non-DAC donors have increasing relevance and non-aid flows from around the world are rapidly gaining weight. Today, sub-Saharan Africa (SSA) still relies more on official flows than the rest of the developing world, but it also attracts almost as much FDI as a share of GDP as do other developing regions. For 15 SSA countries, remittances exceeded 2 per cent of GDP in 2004. All these diverse developments have policy implications for both donor and recipient countries.

The relationship between Africa and its development partners is undergoing radical change. Key landmark events since 2000 include the adoption of the MDGs in 2000; the Monterrey Consensus in 2002; the endorsement of the Paris Declaration on aid effectiveness and managing for development results in 2005; and the G8 commitments at Gleneagles in 2005 to increase official development assistance (ODA) to Africa by $25 billion a year by 2010, reiterated in St Petersburg in 2006. As a result, issues of scaling-up aid and aid effectiveness have dominated the policy dialogue.

Total aid flows from OECD/DAC donors have risen sharply in recent years, with total ODA reaching a record $106.5 billion in 2005, although debt relief (including the large debt cancellations for Iraq and Nigeria), emergency assistance and other special-purpose grants accounted for a large share of the increase. Recent survey data, based on a partial sample of information provided by donors, suggest only a modest increase in aid allocations to Africa over the next two years. This omits aid by non-DAC countries and discussions on aid delivery and effectiveness will need to take into account their growing role.

As important as it is for Africa, aid is not the only story. While sub-Saharan Africa stands out as relying significantly more on official flows than the rest of the developing world (Figure 2.1), non-aid flows are becoming increasingly more important. Foreign direct

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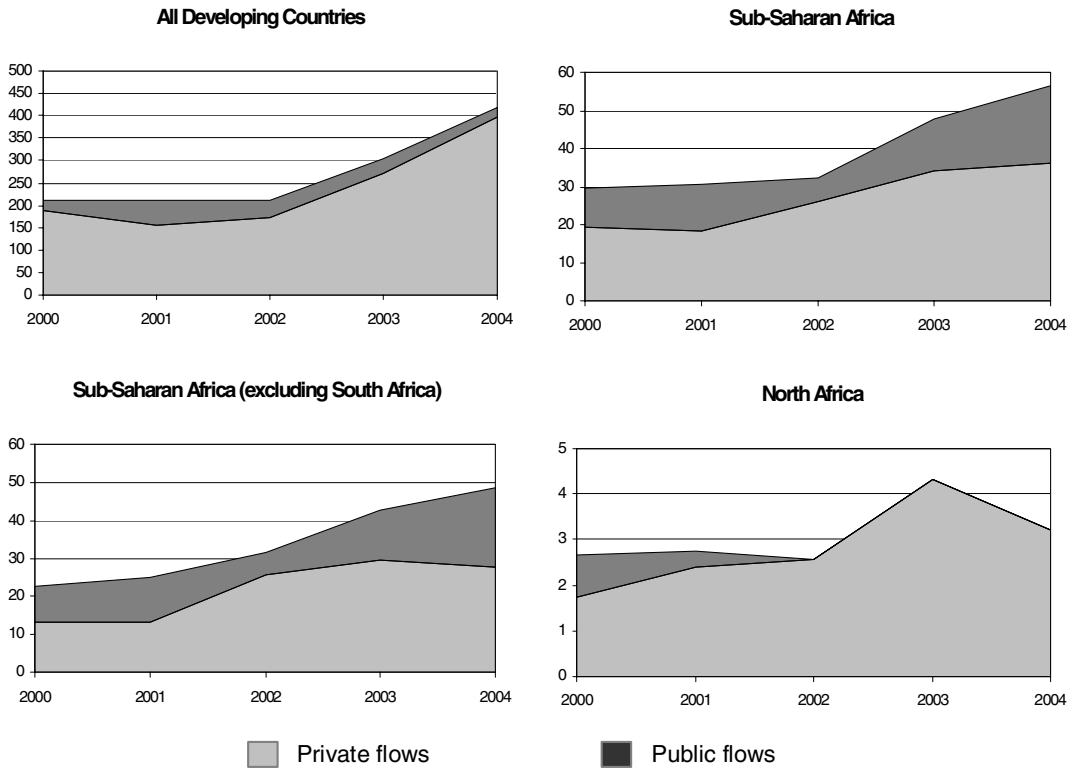
investment (FDI) has grown four-fold in the past decade, reaching an average of $13 billion in the last three years. Today, sub-Saharan Africa attracts almost as much FDI as a share of GDP as do other developing regions. Although — as private flows — remittances cannot be considered development resources, they are a potential source of finance. Estimates put 2005 remittances at $8 billion and would be much higher if unrecorded flows through informal channels could be included. North Africa as a sub-region and South Africa have relied almost exclusively on private flows in recent years. For 15 sub-Saharan African (SSA) countries, remittances exceeded 2 per cent of GDP in 2004.

Figure 2.1. **Aggregate Net Resource Flows 2000-04**
($ billion)



Source: World Bank, Global Development Finance (2006).

Debt relief through the Highly Indebted Poor Countries (HIPC) Initiative and the more recent Multilateral Debt Relief Initiative (MDRI) has significantly reduced the debt burden of many African countries. On average, the HIPC Initiative has helped to reduce debt service for the 28 countries that have reached decision point by an average of $2.5 billion a year. For the 19 countries that have already reached the HIPC completion point, an additional $1.0 billion to $1.5 billion of additional relief will be granted each year through the MDRI.

In addition to foreign financing, realising the ambition of poverty reduction strategies will require continued effort in domestic revenue generation in recipient countries. African countries have managed to raise government revenue by the equivalent of four percentage

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points of GDP since the early 2000s, yet half of them still mobilise less than 15 per cent of their GDP in tax revenues. Without further effort to raise domestic revenue, these countries will continue to face the challenge imposed by the volatility and unpredictabilityof aid flows.

A broader look at the totality of the financial resources available to Africa helps to highlight several important development finance issues, including:

— the implications of FDI for patterns of trade and integration;

— the catalytic role of official aid in promoting other flows such as private capital flows;

— the critical role of improving governance, most notably with respect to the business climate to attract FDI and to capitalise on sharply larger remittances flows; and

— the need to ensure sustainable development finance with domestic resources at its core.

This chapter reviews the trends of aid flows in the context of other financial resources available for development including debt relief, private capital flows, remittances and domestic revenue. It also provides perspectives on their relative importance in Africa and compared with other regions of the world, and it highlights key policy issues that need to be addressed by both African countries and the international community.

Delivery of Aid Commitments

Overall aid flows have sharply increased, but a large part of the increase is due to debt relief and emergency assistance. From a low of $48 billion[1] in 1997, total ODA provided by OECD countries that are members of the Development Assistance Committee (DAC)[2] reached an all-time high of $106.5 billion in 2005, an increase of $27 billion. A significant share of this increase was accounted for by debt cancellation for Nigeria ($5 billion) and Iraq ($14 billion) and exceptional financing for tsunami relief (around $2 billion). Netting out debt relief and the other special-purpose grants[3], estimated programmable aid flows increased by $5 billion to reach $50.4 billion in 2005 (Figure 2.2). After a fall of 25 per cent in real terms from 1993 to 1999, ODA to Africa showed a strong upward trend from 2000 (Table 2.1). The share of debt relief to rising ODA flows is more marked in sub-Saharan Africa where debt cancellations provided by the Paris Club and the HIPC Initiative have been very significant since the late 1990s. ODA flows to North Africa have been more stable, averaging between $2 billion and $3 billion in the past several years.

Meeting the donors' commitment to increase ODA in the next few years will be a major challenge. Commitments made by G8 countries to double yearly aid to Africa by 2010 and by the EU15 countries to provide at least 0.51 per cent of their GNI as ODA by 2010 suggest that aid can reach as much as $130 billion by the end of the decade, with 80 per cent of the increase coming from Europe. Yet very significant effort will be needed by most EU15 countries. For example, Italy will have to triple its ODA between 2004 and 2010 to meet the 0.51 per cent target; several other EU15 countries including Austria, Finland, Germany, Greece and Spain will need to more than double their aid during the same time period. This large increase in aid will need to occur when many of these countries face severe budget constraints.

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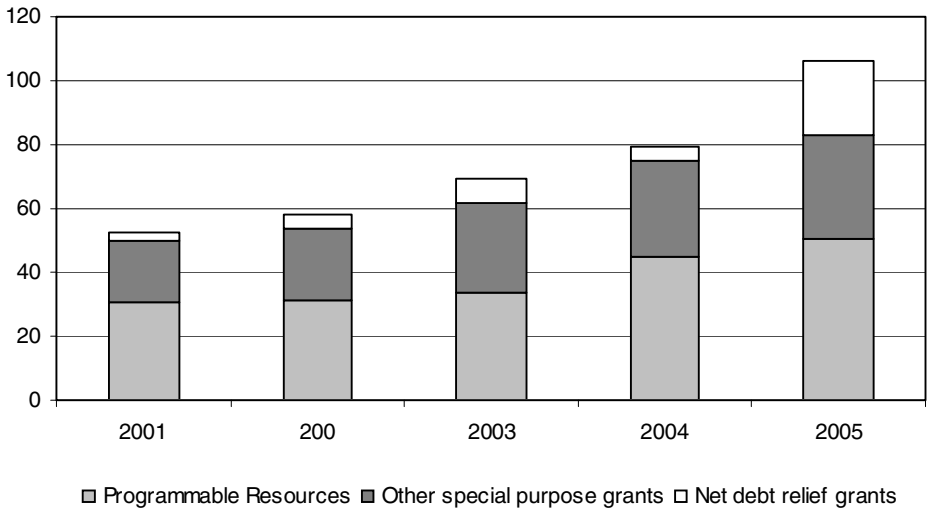
Figure 2.2. **ODA by categories, 2001-05**
($ billion)



Source: OECD Development Assistance Committee (DAC).

Table 2.1. **ODA to Africa**
($ billion)

	2000	2001	2002	2003	2004	2005
Sub-Saharan Africa	13.5	14.3	19.2	24.6[a]	26.2	31.6[b]
North of Sahara	2.2	2.4	2.3	2.2	2.9	n/a
Africa Total	15.7	16.7	21.5	26.8	29.1	n/a

Notes:
a) The outturn in 2003 was heavily determined by the $4.5 billion of debt relief to the Democratic Republic of Congo under the HIPC initiative.
b) Of which $5 billion for Nigeria's debt relief.

Source: OECD-DAC and the DATA Report (2006).

Innovative financing mechanisms may help to scale up aid but progress so far has been quite modest (for more perspective, see Chapter 5). The International Finance Facility (IFF)[4], through the pilot initiative for immunisation for instance, would help to raise frontloaded, reliable funding over a number of years to expand global immunisation efforts. The United Kingdom, France, Italy, Spain and Sweden have made contribution pledges that provide the guarantee to issue bonds in the very near future. Concomitantly France, together with Brazil, Chile, Norway and the UK recently announced a new undertaking, mostly through taxes on airline tickets, that hopes to raise at least $300 million next year in 2007 to help pay for the purchase of medicines. France has already implemented the air ticket levy that would mobilise about $250 million a year. A dozen more countries are actively considering contributing by imposing airline ticket taxes of their own.

Realising the commitment to double aid to Africa by 2010 is increasingly uncertain. A recent survey[5] of DAC member countries and key multilateral agencies highlighted the apparent disconnect between political commitments to sharply increase aid and the results

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on the ground, which point to only a modest increase of ODA for most African countries. This implies, in the best of cases, that substantial increases are being deferred to 2009 and 2010. Also, donors have continued to focus on a small number of well-aided countries; few fragile states figure among those expected to receive significantly more aid in the next three years. Increases in ODA have been very rapid for Tanzania, Ethiopia, Ghana, Uganda, Zambia and Madagascar. The sharp rise in the aid figure for the Democratic Republic of Congo was due to a very large debt relief operation in 2003 (Table 2.2).

Table 2.2. **Top Ten ODA Recipients in Africa**
($ million)

		2002	2003	2004	3-year average	Per cent of all recipients
1.	Congo Dem. Rep.	1 188	5 421[a]	1 815	2 808	11
2.	Tanzania	1 233	1 704	1 746	1 561	6
3.	Ethiopia	1 307	1 553	1 823	1 561	6
4.	Mozambique	2 203	1 039	1 228	1 490	6
5.	Egypt	1 239	988	1 458	1 228	5
6.	Ghana	650	954	1 358	987	4
7.	Uganda	712	977	1 159	949	4
8.	Cameroon	657	900	762	773	3
9.	Zambia	641	581	1 081	768	3
10.	Madagascar	373	539	1 236	716	3
	Other recipients	11 340	12 125	15 415	12 960	50
	Total Africa	21 540	26 781	29 080	25 800	100

Note: *a)* Due to the $4.5 billion in debt relief.
Source: OECD/DAC.

New aid donors[6] play an increasingly important role but information about their aid levels is piecemeal; much more is needed to improve the information base. Economic interactions with China and India also significantly affect Africa through other channels, in particular through trade and investment. Since 2000, a massive increase in trade and investment flows has occurred between Africa and Asia. Today, Asia receives about 27 per cent of Africa's exports, in contrast with only 14 per cent in 2000 (see Goldstein *et al.*, 2006, for a fuller picture). This is almost on par with African exports to the United States and the European Union, Africa's traditional trading partners. Despite all the limitations associated with the poor quality of data, the share of Chinese and Indian FDI flowing into the region is probably higher than for OECD countries, for which sub-Saharan Africa is a minor investment destination (Broadman, 2006; Goldstein *et al.*, 2006).

Strengthening the results orientation of country strategies and their linkages to larger resources is also critical. The Resources and Results Meeting for Ghana provided a good illustration of approaches to scale up programmes in energy, transport and other infrastructure. Work being undertaken by the World Bank and UNDP confirms that opportunities for quick scaling-up exist in several African countries including Burkina Faso, Mozambique, Rwanda and Tanzania and in specific sectors as in Ghana. For this country-level process to take hold, more donor buy-in will be needed.

Enhancing aid effectiveness through harmonisation and alignment has received much more attention as a complement to efforts to increase aid flows. The international effort on aid effectiveness has gained momentum since 2005 when over 100 partner countries and donors endorsed the Paris Declaration, which provides a detailed framework of commitments and targets in ownership, alignment, harmonisation, managing for results and mutual

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accountability. Substantial progress has been made in a number of African countries including Burkina Faso, Ethiopia, Ghana, Mozambique, Tanzania and Uganda, and good progress has been achieved in others (see Annex Table 2.A.5). Harmonisation actions such as joint analytic work, collaborative or joint programming and assistance strategies, programme-based approaches, pooling of financing among donors, use of country systems where feasible and joint or independent assessments of aid at the country level, among others, have begun to reduce transaction costs to countries.

Serious impediments remain to broader and deeper improvement in implementing the Paris principles. They include data constraints, inappropriate staff incentives, institutional rigidities and obstacles to change management. Efforts to establish a baseline (see Annex Table 2.A.4 for details) and to monitor progress will help focus both countries and donor agencies on harmonisation and management for results[7].

Many issues on the management of aid continue to require attention, ranging from inadequate support to fragile states to insufficient response to shocks, the lack of predictability, and the use of conditionality. Scaling up will also require more co-ordination among aid delivery channels — bilateral funds, multilateral funds, global funds and private funds. In particular, global funds need to support country-led strategies and priorities and avoid undermining the capacity of national authorities for coherent planning, financing and service delivery.

Policy Issues on Aid Delivery

From Africa's perspective:

— strengthen national capacity to plan and implement country priorities and to monitor and evaluate outcomes;

— sustain the process of alignment and aid harmonisation;

From the donors' perspective:

— ensure that the recent momentum on aid increases is sustained;

— improve aid predictability by sharing forward information and adopting Paris Declaration agenda compact (budget support, programmatic approach);

— enhance co-ordination between DAC and non-DAC donors.

Debt Relief

Debt relief has been important in driving recent aid increases and will remain a key factor in the medium term. In addition to debt relief by the Paris Club and under the HIPC initiative, 16 African countries that have reached HIPC completion have also began to benefit from larger debt cancellation by three multilateral institutions — the IDA, the IMF and the African Development Fund (AfDF) under the Multilateral Debt Relief Initiative (MDRI). Debt relief from all sources has increased significantly over the past few years. Figure 2.3 shows that sub-Saharan Africa received a rising share of HIPC debt relief, capturing almost three quarters of that provided in 2002-04.

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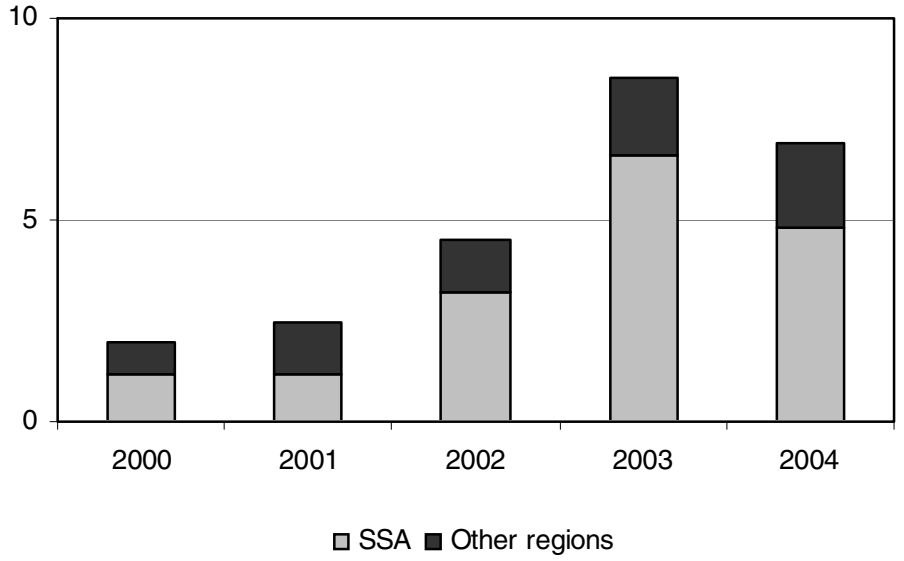
Figure 2.3. **Debt Relief by Region under the HIPC Initiative**
($ billion)



Source: World Bank.

The HIPC initiative is significantly reducing the debt-service burden of poor countries. The 28 countries[8] that reached HIPC decision point prior to 2006 received $2.3 billion per annum in debt relief from 2001 to 2005, equal to 2.2 per cent of their GDP and 9.2 per cent of their exports. The HIPC Initiative will provide cumulatively $40 billion in debt service relief to the 19 completion-point countries and another $18 billion to the 11 decision-point countries. Most of the relief will come from multilateral creditors (50 per cent) and official bilateral donors including several non-Paris Club bilateral creditors (47 per cent). Commercial creditors have played a minor role.

Box 2.1. **The HIPC Initiative**

The HIPC Initiative was launched by the World Bank and the IMF in 1996 to help reduce the debt burdens of 40 of the world's poorest countries. It was enhanced in 1999 to provide deeper and faster debt relief to a larger group of countries. To be eligible for the HIPC Initiative, a country's debt must exceed certain threshold levels: either external debt must be at least 150 per cent of exports or public debt must be at least 250 per cent of revenues (in net present value terms), after debt relief from the Paris Club under *Naples Terms* (67 per cent reduction in net present value of Paris Club debt). Countries obtain debt reduction from all creditors including commercial creditors in an amount that reduces their debt burden to the threshold levels.

Currently 40 countries are eligible for the HIPC Initiative, 33 of which are in sub-Saharan Africa. So far, 29 countries have reached the "decision point" when donors begin to provide the debt relief necessary to meet a specified debt ratio. Of these, 19 have reached the "completion point" — Cameroon is the latest (May 2006) — at which debt relief becomes irrevocable (see Annex Table 2.A.6 for more detail). The 11 remaining countries already eligible for the HIPC Initiative are referred to as the "pre-decision" countries. In addition, 11 other countries have been identified as potentially eligible for HIPC debt relief. They include seven identified as HIPCs in previous HIPC Initiative reports (Central African Republic, Comoros, Côte d'Ivoire, Liberia, Somalia, Sudan and Togo) and four others (Eritrea, Haiti, the Kyrgyz Republic and Nepal).

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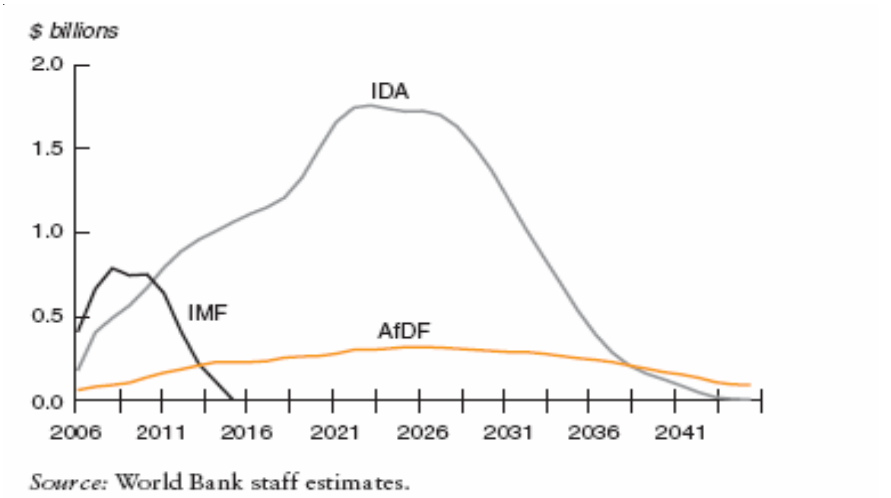
The MDRI extends and deepens the HIPC Initiative. For the 19 HIPCs that have reached the completion point, the MDRI will reduce debt-service payments by about $1 billion on average during 2007-17 and rising to a peak of $1.5 billion in 2022-24. The 15 sub-Saharan African countries eligible for the MDRI as of July 2006 will see their debt service payments reduced by $31.8 billion between 2007 and 2045 (see Annex Table 2.A.7 for detail). Total debt relief provided by the MDRI will rise over time as additional countries reach the completion point. The debt service reduction profile for the 18 countries shows a hump (Figure 2.4) because the bulk of outstanding IMF loans to the 18 countries is scheduled to mature within three to six years while IDA and AfDB loans have a much longer duration.

Figure 2.4. **Debt-Service Reduction under the MDRI, 2006-45**
($ billion)



Source: World Bank staff estimates.

Box 2.2. **The MDRI**

Under the MDRI, IDA, the IMF and the African Development Fund will provide 100 per cent debt cancellation to countries that have reached the HIPC completion point. As of July 2006, the three institutions had approved debt relief under the MDRI for 15 SSA countries: Benin, Burkina Faso, Cameroon, Ethiopia, Ghana, Madagascar, Mali, Mauritania, Mozambique, Niger, Rwanda, Senegal, Tanzania, Uganda and Zambia (see Annex Table 2.A.7 for more detail). The remaining HIPC countries will be eligible for full debt cancellation from the three institutions once they have reached HIPC completion point. Other countries that will be eligible for HIPC debt relief as a result of the sunset clause extension will also benefit from MDRI relief once they reach completion point. For the original 18 highly impoverished countries, including 14 African countries, an estimated $40 billion in debt will be cancelled. About 70 per cent of the debt is due to the IDA. The MDRI is now under implementation by all three agencies.

Heavy debt burdens will continue as an issue for many countries. Debt relief provided under the HIPC and MDRI Initiatives will substantially reduce the debt burden of countries that have already reached the completion point, bringing their debt stock to below 10 per

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cent of GDP on average. For the remaining 11 HIPCs that have not reached the completion point[9], debt as a share of GDP would be about four times as high. Countries that are HIPC eligible but have not yet reach the decision point[10] face the same challenge and are therefore under similar pressure to move expeditiously towards HIPC completion point.

For MDRI countries, lower debt burdens and the prospect of increased market access point to the continued need to focus on debt sustainability and concerns about "free riders". MDRI countries would still require substantial resources to help them meet the MDGs, with a large share of grants in order to maintain a low or moderate risk of debt distress. Also, sharply lower debt burdens and improved sovereign credit risk may entice non-concessional borrowing such as suppliers' and export credit and commercial loans, raising again the potential for renewed risk of debt distress. How fast debt should accumulate in MDRI countries is thus a key question.

Debt Relief and Debt Sustainability Policy Issues

From Africa's perspective:

— carefully monitor new indebtedness to ensure debt sustainability;

— strengthen the debt management system and avoid the temptation to allow the institutions associated with debt management to weaken as debt burdens are sharply reduced.

From the donors' perspective:

— ensure that the large projected debt relief will not affect the scaling up of ODA;

— help countries ensure long-term debt sustainability and avoid the "free rider" issue through the strengthening of creditors' co-ordination.

Private Capital Flows

Private capital flows to Africa have grown sharply in line with overall trends to developing countries[11]. The increase has been broad-based, with foreign direct investment (FDI), commercial bank lending, and portfolio equity all recording substantial gains (Table 2.3). After a long period in the 1970s and 1980s with no upward trend, FDI flows to Africa have grown sharply since the late 1990s. Rising prices of primary commodities (including oil) and improving investment climates partly explain this growth, although large variations across countries remain. The last report on *Doing Business* (World Bank, 2006*b*) confirms that trend, showing that sub-Saharan Africa ranked third in the world in 2005 after Eastern Europe and the OECD countries in the scope and pace of reforms to the business enabling environment (Eifert and Ramachandran, 2004). For portfolio equity flows, most of the increase reflected equity offerings in South African mining companies. After several years of net reflows starting in the late 1990s, Africa has confirmed its renewed access to commercial bank lending (see also Box 2.3).

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Table 2.3. **Net Private Capital Flows to Africa**
($ billion)

	2002	2003	2004	2005 (preliminary)
Net FDI flows	12.1	17.3	14.8	21.6
North Africa	2.6	3.7	3.5	4.0
Sub-Saharan Africa	9.5	13.6	11.3	17.6
Net portfolio equity flows	-0.4	0.7	7.3	7.2
North Africa	0.0	0.0	0.6	0.0
Sub-Saharan Africa	-0.4	0.7	6.7	7.2
Net bank debt flows	-5.5	-3.6	0.9	n.a.
North Africa	0.0	-0.5	-0.6	n.a.
Sub-Saharan Africa	-5.5	-3.1	1.5	3.7
Net bonds flows	3.3	5.6	1.3	n.a.
North Africa	0.6	1.0	0.1	n.a.
Sub-Saharan Africa	2.7	4.6	1.2	0.0
Total (net) private capital flows	6.3	20.0	24.3	n.a.
North Africa	0.0	4.2	3.6	n.a.
Sub-Saharan Africa	6.3	15.8	20.7	28.5

Source: World Bank, *Global Development Finance* (2006).

Private capital flows to Africa and more particularly FDI are vastly underestimated due to very rudimentary monitoring systems[12]. Based on results of projects conducted in 18 African countries, private flows could be two to three times the levels reported in internationally published figures. Vital components of inflows, notably retained earnings and intra-company debt transactions (for FDI) and off-shore borrowing (for debt flows) are often not recorded by exchange control or foreign investment promotion Agencies. For the 18 countries cited above, intra-company loans accounted for 40 per cent of total equity flows but are not reported in official FDI statistics.

FDI inflows have concentrated largely in the extractive industries but have begun to diversify. South Africa and resource-rich countries, notably Angola, Equatorial Guinea, Nigeria and Sudan, have continued to receive the lion's share of FDI, but the reach of FDI flows across Africa is broadening (Figure 2.5). According to UNCTAD (2005), FDI inflows rose in 40 of the 53 countries in Africa in 2004. There has also been greater diversification of investment sectors with manufacturing, finance and tourism the key areas of concentration outside the resources sector.

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Box 2.3. **Using ODA to Promote Private Investment for Development: Policy Guidance for Donors**

Launched in 2003 to support the Monterrey Consensus, the Policy Framework for Investment offers a non-prescriptive checklist of issues for interested governments engaged in domestic reform, regional co-operation or international policy dialogue to create an environment attractive to domestic and foreign investors and enhance the benefits of investment to society. The Framework is part of a broader OECD Initiative on Investment for Development, together with two other projects on drawing lessons on using ODA to mobilise investment and sharing the OECD's experience with investment policy peer reviews as capacity-building mechanisms. The report, *Using ODA to Promote Private Investment for Development: Policy Guidance for Donors,* issued in 2006, has spelled out quite specific recommendations for donor agencies to review the way they do business:

1. Development agencies should ensure that their internal incentive and evaluation systems do not work against staff pursuing longer-term, programmatic and possibly higher-risk interventions. Institutional and policy reforms are not one-off events, and efforts may not come to fruition within an agency's typical three-year or four-year programme cycle or the period of one staff member's posting to a developing country.

2. Staff working on private-sector development, agriculture, infrastructure, public governance, capacity development, environment and gender are often located in different organisations only loosely associated with the core ODA programme. To mobilise investment more effectively, these staff need to work in close association and, ideally, under a common strategic framework.

3. The capacity of staff in development agencies may need to be strengthened, to help them better determine, based on differences in countries' investment climates and stages of development, appropriate approaches and aid instruments to use and how best to sequence reforms.

4. Some development agencies may need to engage more with the private sector in developing countries and encourage their public-sector partners to do so too. Development agencies can facilitate public-private partnerships by strengthening public authorities' capacities to negotiate contracts and exploring how the mitigation of non-commercial risks can be improved, including through co-ordinated responses by donors.

5. Development agencies can help develop the local private sector by procuring as many goods and services as possible in developing countries, subject to value-for-money considerations. This may require some capacity building in the local private sector to enable firms to participate in competitive and transparent processes and so take advantage of these opportunities. Development agencies can also encourage their suppliers and contractors to adopt responsible business practices.

6. Development agencies potentially have a wide selection of ODA instruments at their disposal, including the direct supply of goods or services, free-standing technical co-operation grants, concessional loans, partnership alliances, equity acquisitions and guarantees. Few DAC members use all of these instruments, however, and the use of some, such as concessional loans or equity acquisitions, may be limited to a development bank, a development finance institution or another specialised agency. Given the variety of domains that need to be addressed to mobilise investment, there is a risk that relying on a few aid instruments may inhibit the effectiveness of development agencies' efforts. DAC members should consider whether the selection of aid instruments at their disposal, including through co-ordinated arrangements with other agencies, is right for reaching their objectives, especially in addressing, albeit indirectly, the private sector.

7. To help ensure that the range of DAC members' policies impacts positively on investment mobilisation, development agencies may need to expand their capacity to analyse the impact of non-ODA policies on developing countries and engage with representatives of other policy communities to influence policy formulation processes.

Note: In the context of the loans *versus* grants debate, the fourth and sixth recommendations critically assume a variety of ODA instruments, including concessional loans and guarantees.

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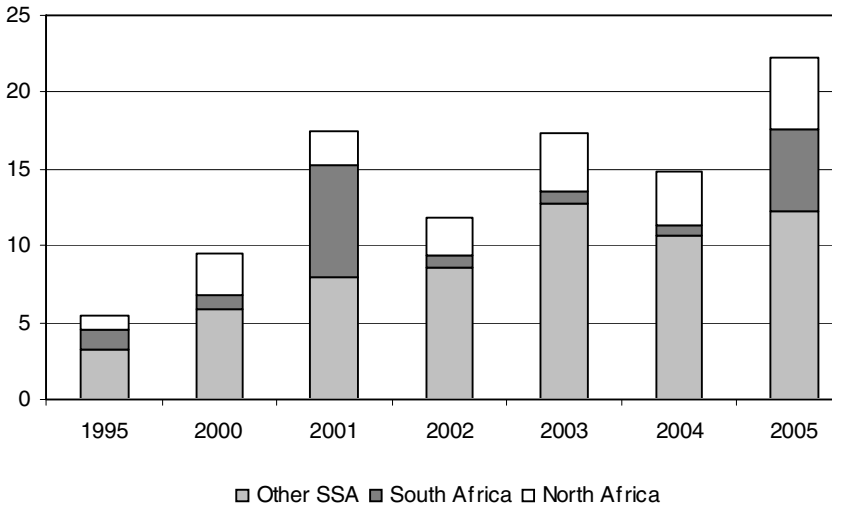
Figure 2.5. **Net FDI Flows to Africa**



Source: World Bank, *Global Development Finance* Database.

South-South FDI has risen rapidly. A recent study[13] of Asian-African FDI flows shows both fast growth and the beginning of diversification into many non-resource sectors including apparel, agro-processing, power generation, road construction, tourism and telecommunications. China is by far the largest investor in Africa; other major ones are Chinese Taipei, India, Malaysia, Japan and Korea. South Africa is the second major source of South-South investment. In 2004, South African firms operated over 600 projects in the rest of Africa, the vast majority in service industries with about 15 per cent in mining, very few in agriculture and only about 20 per cent in manufacturing.

The relatively low FDI flows to Africa mask their important contributions in several countries. They take a very important share of total investment in several non-oil producing African countries (Table 2.4). With one or two exceptions these countries tend to be the better-managed, which highlights the importance of improving the investment climate and overall governance.

Table 2.4. **FDI Flows as Shares of Total Investment in Non-Oil Producing Countries**
(Per cent)

Country	2002	2003	2004
Rwanda	23.6	22.7	108.1
Seychelles	28.4	91.7	75.4
Congo DRC	20.2	36.0	65.2
Ethiopia	20.5	34.2	32.2
Cote d'Ivoire	17.0	12.4	23.6
Zambia	10.5	16.4	26.2
Tanzania	23.1	27.7	22.8
Mali	38.2	14.0	16.6
Mozambique	28.5	27.1	10.8

Source: African Economic Perspectives 2005/06 by OECD and AfDB.

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Private debt flows to Africa have shown a strong upswing in line with overall flows to developing countries. Commercial bank debt flows to Africa reached almost $7 billion in 2005 in net terms, i.e. after principal repayments, driven by abundant global liquidity and steady improvements in credit quality. The growing use of credit ratings in Africa reflects the improving perception by private banks of Africa's potential and gives investors added confidence[14]. Currently, 11 SSA countries are rated, although most ratings remain in the speculative grade. Ratings improve information flow and therefore allow investors, particularly foreign investors, to readjust their perceptions of market and country risk. Credit ratings also increase confidence by signalling the issuer's willingness to be open and transparent with investors. More important, they are the first step toward building a record of government creditworthiness.

Private Capital Flows Policy Issues

— build cross-country co-operation in improving and monitoring data on private flows among government agencies but also involving the private sector;

— better understand the macroeconomic effects of private flows;

— develop linkages between FDI and domestic investments;

— improve the investment climate and local governance to attract private flows.

Mobilising Domestic Revenue

Levels of domestic revenue are generally improving. Raising ambition for poverty reduction strategies will require, besides significant increases in external resources, continued effort to generate and channel domestic revenue in African countries. After remaining basically unchanged between early 1990 and early 2000 (Keen and Simone, 2004, Table A2), total government revenue as a share of GDP has steadily improved in most SSA countries. As Figure 2.6 shows, domestic revenues (excluding grants and including non-tax revenue) improved by almost 4 per cent of GDP from the early 2000s, reaching an average of 25.1 per cent in 2005 for SSA as a whole[15]. Both oil-exporting and oil-importing countries performed credibly[16]. Most of the improvement in revenue mobilisation can be attributed to more effective tax administration.

SSA countries continue to shift away from trade taxes as their principal revenue source, although the pace of this shift has slowed in recent years. The declining reliance on trade-tax revenues has been the product of trade liberalisation policies, most of which were initiated in the 1990s. Continued liberalisation will thus intensify the need to improve the management of trade-tax exemptions and to enhance domestic taxes. This will often involve strengthening the indirect tax system, including the Value Added Tax (VAT). Presently, 34 SSA countries and all countries of North Africa except for Libya have adopted the VAT with an unweighted average rate of 16 per cent.

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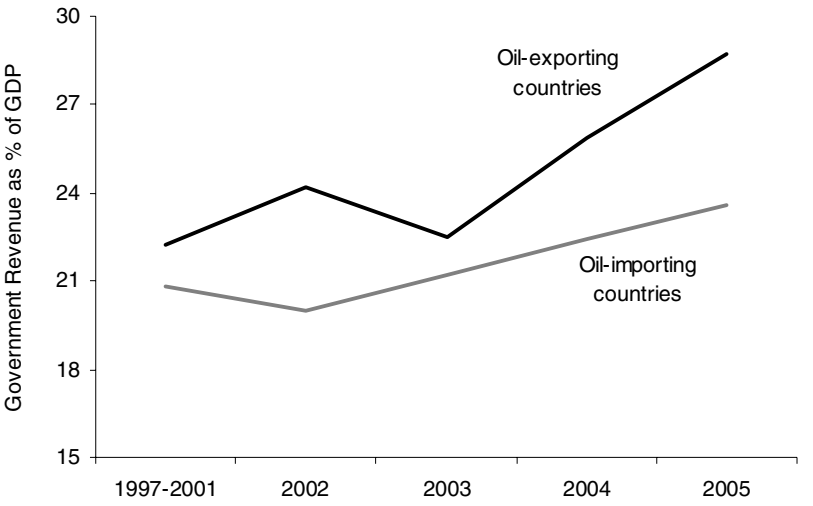
Figure 2.6. **Government Revenue** (excl. grants)



Source: IMF Regional Economic Outlook – SSA (2006).

Despite improved revenue performance, half of the SSA countries still mobilise less than 15 per cent of their GDP in tax revenues, which is generally considered a reasonable target for most low-income countries (Table 2.5). Besides oil-rich Angola, Ghana and the Republic of Congo, countries that collect more than 20 per cent of their GDP in taxes tend to concentrate in the Southern cone. North African economies mobilise a significantly larger share of GDP in domestic resources, averaging above 30 per cent.

Table 2.5 **Tax Revenue as a Share of GDP**
(Average 2003-05, per cent)

Less than 10 per cent of GDP	10 to 15 per cent of GDP	15 to 20 per cent of GDP	More than 20 per cent of GDP
7 countries	15 countries	13 countries	14 countries
- Chad	- Burkina Faso	- Burundi	- Algeria
- Central African Republic	- Comoros	- Cameroon	- Angola
- Congo, Dem. Rep.	- Cote d'Ivoire	- Cape Verde	- Botswana
- Liberia	- Eritrea	- Benin	- Congo, Rep. of
- Madagascar	- Gabon	- Ethiopia	- Egypt
- Niger	- Gambia	- Kenya	- Equat. Guinea
- Rwanda	- Guinea	- Malawi	- Ghana
	- Guinea-Bissau	- Mauritania	- Lesotho
	- Mali	- Mauritius	- Morocco
	- Mozambique	- Nigeria	- Namibia
	- Sierra Leone	- Senegal	- Seychelles
	- Sudan	- Sao Tome & Principe	- South Africa
	- Tanzania	- Zambia	- Swaziland
	- Togo		- Tunisia
	- Uganda		- Zimbabwe

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Domestic Revenue Policy Issues

— sustain efforts to raise domestic revenues. This is particularly relevant for about half of SSA countries where tax revenue as a share of GDP remains low at less than 15 per cent (IMF, 2005, p. 47). The challenge imposed by the large size of the informal and rural sectors in many African countries should also be kept in perspective;

— continue efforts to improve tax administration;

— review tax design to improve domestic tax systems with a declining reliance on trade-tax revenues and to avoid excessive exemptions on both trade taxes and corporate income taxes.

Remittances

Because remittances are private funds, they should not be viewed as a substitute for official development aid. Yet they have been shown to have a significant impact on poverty reduction, which warrants their treatment as part of the financial resources that developing countries can rely on to achieve the MDGs. Although remittances and international migration are tightly related, this chapter focuses solely on the impact on developing countries of inward remittances and will not discuss migration issues.

As a source of foreign exchange, remittances have outpaced private capital flows and ODA. Worldwide remittances have tripled over the past decade to exceed $230 billion overall and $165 billion to developing countries in 2005 (World Bank, 2006*a*) (Table 2.6). Most North African countries are large recipients of recorded remittances. Nigeria and Sudan are the largest recipients in sub-Saharan Africa.

Table 2.6. **Recorded Remittances Compared to Other Flows**
All Developing Countries
($ billion)

	1995	2004
Remittances	58	160
Foreign direct investment	107	166
Private debt and portfolio equity	170	136
Official development assistance	59	79

Source: World Bank, *Global Development Finance*, 2006.

In recorded data, sub-Saharan Africa received only about 5 per cent of remittances to developing countries, but these flows have leaped by 240 per cent over the past decade (Table 2.7). Remittances flowing to 15 SSA countries exceeded 2 per cent of their GDP in 2004 (Table 2.8}. On average, SSA received the equivalent of 1.5 per cent of its GDP as formal remittances.

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Table 2.7. **Recorded Remittances Compared to Other Flows**
Africa
($ billion)

	1995	2004
Remittances	11.9	19.2
Sub-Saharan Africa	4.9	7.7
North Africa	7.0	11.5
Foreign direct investment	7.5	14.9
Sub-Saharan Africa	6.5	11.3
North Africa	1.0	3.6
Private debt and portfolio equity	1.7	3.4
Sub-Saharan Africa	-0.7	2.8
North Africa	2.4	0.6
Official development assistance	16.4	25.6
Sub-Saharan Africa	13.5	26.2
North Africa	2.9	2.9

Source: World Bank, *Global Development Finance*, 2006.

Table 2.8. **Workers Remittances to Selected Countries in Africa, 2000-04**
($ million)

Country	2000	2001	2002	2003	2004 (Est.)	Share of GDP, 2004 (%)
Morocco	2 161	3 261	2 877	3 614	4 218	8.4
Egypt	2 852	2 911	2 893	2 961	3 341	4.4
Algeria	790	670	1 070	1 750	2 460	2.9
Nigeria	1 705	1 303	1 421	2 086	2 751	3.8
Tunisia	796	927	1 071	1 250	1 432	5.1
Sudan	641	740	978	1 224	1 403	7.2
Senegal	233	305	344	511	511	6.7
Kenya	538	517	395	494	494	3.2
Lesotho	252	209	194	288	355	25.
Uganda	238	338	372	297	291	4.3
Mauritius	177	215	215	215	215	3.6
Mali	73	88	138	154	154	3.2
Togo	34	69	103	149	149	7.2
Cape Verde	87	81	85	92	92	9.7
Benin	87	84	84	84	84	2.1
Swaziland	74	74	62	62	62	2.6
SSA	4 935	4 746	5 159	6 762	7 696	1.5

Source: Background data to World Bank, *Global Economic Prospects*, 2006.

Informal remittances are likely to be much larger than formal flows. Evidence from household surveys suggests widespread use of informal remittance channels. Given the weakness of the formal financial system and the high cost of sending remittances to Africa, one would expect that informal remittances could be very large indeed. For example, estimated informal remittances to Uganda could be as much as four to five times formal flows. The surge in remittances is likely to continue in the medium term.

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The macroeconomic effects of remittances are significant. The following effects are worth noting:

— remittances are stable and may be countercyclical, as they tend to rise when the recipient economy suffers a downturn in activity or a natural disaster;

— by generating a steady stream of foreign-exchange earnings, remittances can improve a country's creditworthiness and enhance its access to international capital markets; and

— evidence from household surveys shows that remittances have a significant impact on poverty.Cross-country analysis also show significant poverty-reduction effects of remittances: a 10 per cent increase in per capita official remittances may lead to a 3.5 per cent decline in the share of poor people in the population (Adams and Page, 2005).

Policy Issues Related to Remittances

— Reduce remittance fees[17] to increase the disposable income of poor migrants and to motivate them to send more money home. Options include:

i) increasing access to banking and strengthening competition in the remittance industry;

ii) helping to establish partnerships between remittance service providers and existing postal and other retail networks;

iii) requiring greater disclosure on remittance fees from remittance service providers; and

iv) providing financial education to migrants.

— Capitalise on the impact of remittances through efforts to improve the overall investment climate in remittance recipient countries.

Concluding Remarks

This comprehensive review of the flows of resources for development in Africa points to the continued importance of official aid as the main development financing instrument, particularly for the least-developed countries. For other countries, non-aid flows are beginning to play a more influential role, making it essential to match financing instruments to specific countries' needs and capacities.

Much more effort will be needed to understand better the links between development assistance and other flows. For instance, the OECD/DAC (OECD, 2006) has issued guidelines on how development assistance can help developing countries mobilise more investment (both foreign and domestic) such as by lowering risks, developing economic infrastructure and financial markets and strengthening the capacities of local firms. Development partners can also help to promote remittance flows through support to improve the business climate and strengthen competition in the remittance transfer market to help lower transfer fees. All the efforts mentioned here would also help donors to improve aid allocations among countries in order to optimise synergies and complementarities among various flows.

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Notes

1. ODA figures are shown net of repayments (net ODA). See Annex Tables 2.A.1 and 2.A.2 for more detail.
2. This amount does not include aid provided by non-DAC donors (see note 6 for more detail).
3. Special purpose grants include debt relief, technical cooperation, emergency/distress relief and administrative costs.
4. The IFF is based on two basic ideas: frontloading aid (spending money now for critical development investments to reach the MDGs) and using off-budget commitments, thus helping donors manage fiscal constraints while raising ODA receipts; spending by IFF will count as ODA received but not as ODA provided until the bonds are redeemed.
5. The survey was done in the context of monitoring aid up-scaling in March-April 2006. While the indicative future aid allocations cover only 27 per cent of total ODA, they do reflect the allocation intentions of 16 of the 27 agencies surveyed.
6. One can conveniently regroup "new" donors in three main groups: *i)* OECD countries that are not members of the DAC (Korea, Turkey, Mexico and several European countries) and new EU members that are not members of the OECD; *ii)* the Middle East and OPEC countries and funds; and *iii)* the more disparate group of non-OECD, non-EU donors among which figure the two "heavyweights", China and India.
7. The next high-level forum on aid effectiveness will take place in Ghana in mid-2008. Viet Nam will host a meeting on managing for development results in February 2007.
8. The Republic of Congo reached the decision point in March 2006.
9. These 11 HIPC countries are expected to reach the completion point by the end of 2007.
10. The following SSA countries figure in this group: Central African Republic, Comoros, Côte d'Ivoire, Liberia, Somalia, Sudan and Togo.
11. Net private flows to all developing countries increased sharply to reach $476 billion in 2005, reinforcing a trend underway since 2002.
12. Development Finance International (2004). The project is funded by 18 African countries and by the governments of Denmark, Sweden, Switzerland and the United Kingdom.
13. Based on firm-level data from a new large World Bank Quantitative survey and from filed work in four countries in 2006 — Ghana, Senegal, South Africa and Tanzania — on the African operations of Chinese and Indian businesses. See Broadman (2006).
14. Standard and Poor's reported the upgrade of South Africa's credit rating in early 2006 and no rating actions in the downward direction for the rest of Africa. In the recent period, 20 SSA countries have access to commercial bank lending. They are: Botswana, Burkina Faso, Cameroon, Congo Rep., Equatorial Guinea, Ethiopia, Gabon, Ghana, Guinea, Kenya, Liberia, Mali, Mauritius, Mozambique, Nigeria, Senegal, Sudan, Tanzania and Zambia. South Africa and most North African countries have access to both bond and commercial debt.

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15. Any analysis of domestic revenue and taxation in developing countries faces the fundamental problem of the incompleteness and lack of reliability of the data. The IMF *Government Finance Statistics* is the most reliable source but suffers from incomplete information for most of Africa. The analysis is based on information available from several sources including IMF (2006) and World Bank (2005).

16. The favourable revenue performance of SSA in the past few years is confirmed by the evaluation of the IMF's role in Africa that shows that in the 24 countries assisted by the IMF through the Poverty Reduction and Growth Facility (PRGF) during the 1995-2003 period, total revenue as a share of GDP goes up by an average 1.2 percentage points two years after the start of the programme.

17. The fees charged by remittance service providers are often as high as 10-15 per cent for small transfers typically made by poor migrants. These costs are much higher than the actual cost of carrying out the transactions.

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Annex Tables

Table 2.A.1. **Net ODA disbursements, 1990-2005**
($ billion)

	1990	1995	2000	2001	2002	2003	2004	2005 (preliminary)
Total ODA	54.3	58.8	53.7	52.4	58.3	69.1	79.6	106.5
G8 Countries	42.4	44.7	40.2	38.2	42.6	50.0	57.6	80.1
United States	11.4	7.4	10.0	11.4	13.3	16.3	19.7	27.5
Japan	9.1	14.5	13.5	9.8	9.3	8.9	8.9	13.1
United Kingdom	2.6	3.2	4.5	4.6	4.9	6.3	7.9	10.8
France	7.2	8.4	4.1	4.2	5.5	7.3	8.5	10.1
Germany	6.3	7.5	5.0	5.0	5.3	6.8	7.5	9.9
Canada	2.5	2.1	1.7	1.5	2.0	2.0	2.6	3.7
Italy	3.4	1.6	1.4	1.6	2.3	2.4	2.5	5.1
Memo Item: EU Countries	28.3	31.2	25.3	26.4	30.0	37.1	42.9	55.7

Source: OECD Development Assistance Committee (DAC).

Table 2.A.2. **Main Components of ODA, 1990-2005**
($ billion)

	1990	1995	2000	2001	2002	2003	2004	2005 (preliminary)
Total ODA	54.3	58.8	53.7	52.4	58.3	69.1	79.6	106.5
Bilateral ODA	38.5	40.5	36.1	35.1	40.8	49.8	54.4	81.9
Debt relief	2.9	2.8.	1.8	2.1	4.6	7.0	4.3	23.0
Technical co-operation	11.4	14.3	12.8	13.6	15.5	18.4	18.8	20.0
Emergency/distress relief	1.1	3.1	3.6	3.3	3.9	6.2	7.3	9.0
Administrative costs	2.0	2.9	3.1	3.0	3.0	3.5	4.0	4.0
Special purpose grants (see note)	17.3	23.0	21.2	21.9	26.9	35.1	34.5	56.0
Multilateral ODA	15.8	18.3	17.7	17.3	17.5	19.3	25.1	24.5
Total ODA less debt relief	51.3	56.0	52.0	50.4	53.7	62.1	75.2	83.5
Total ODA less special purpose grants	37.0	35.8	32.6	30.5	31.4	34.0	45.1	50.4

Note: Special purpose grants include debt relief, technical co-operation, emergency/distress relief and administrative costs.
Source: OECD Development Assistance Committee (DAC).

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Table 2.A.3. **Main Components of ODA, 1990-2005**
(2004 constant prices, $ billion)

	1990	1995	2000	2001	2002	2003	2004	2005 (preliminary)
Total ODA	70.4	62.0	66.7	68 0	72.5	75.4	79.6	104.5
Bilateral ODA	49.8	42.4	44.2	44.9	50.2	54.0	54.4	80.4
Debt relief	3.7	2.9	2.3	2.9	6.0	7.7	4.3	22.7
Technical co-operation	14.9	15.3	15.6	17.0	18.4	19.7	18.8	19.6
Emergency/distress relief	1.4	3.5	4.6	4.3	4.8	6.7	7.3	8.9
Administrative costs	2.5	3.0	3.7	3.7	3.7	3.8	4.0	3.9
Special purpose grants (see note)	22.5	24.7	26.2	27.8	32.8	37.9	34.5	55.2
Multilateral ODA	20.6	19.6	22.6	23.0	22.3	21.4	25.1	24.1
Total ODA less debt relief	66.7	59.2	64.4	65.1	66.5	67.7	75.2	81.8
Total ODA less special purpose grants	47.9	37.4	40.5	40.2	39.6	37.4	45.1	49.4

Note: Special purpose grants include debt relief, technical co-operation, emergency/distress relief and administrative costs.
Source: OECD Development Assistance Committee (DAC).

Table 2.A.4. **Paris Declaration Indicators**
(To be measured nationally and monitored internationally)

<table>
<tr><th colspan="2">OWNERSHIP</th><th colspan="2">TARGET FOR 2010</th></tr>
<tr><td>1</td><td>Partners have operational development strategies — number of countries with national development strategies (including PRSs) that have clear strategic priorities linked to a medium-term expenditure framework and reflected in annual budgets.</td><td colspan="2">At least 75 per cent of partner countries have operational development strategies.</td></tr>
<tr><th colspan="2">ALIGNMENT</th><th colspan="2">TARGETS FOR 2010</th></tr>
<tr><td rowspan="2">2</td><td rowspan="2">Reliable country systems — number of partner countries that have procurement and public financial management systems that either a) adhere to broadly accepted good practices or b) have a reform programme in place to achieve these.</td><td colspan="2">a) Public financial management — half of partner countries move up at least one measure (i.e. 0.5 points) on the PFM/CPIA (Country Policy and Institutional Assessment) scale of performance.</td></tr>
<tr><td colspan="2">b) Procurement — one-third of partner countries move up at least one measure (i.e. from D to C, C to B or B to A) on the four-point scale used to assess performance for this indicator.</td></tr>
<tr><td>3</td><td>Aid flows are aligned on national priorities — per cent of aid flow to the government sector that is reported in partners' national budgets.</td><td colspan="2">Halve the gap — halve the proportion of aid flows to government sector not reported in government's budget(s) (with at least 85 per cent reported on budget).</td></tr>
<tr><td>4</td><td>Strengthen capacity by co-ordinated support — per cent of donor capacity-development support provided through co-ordinated programmes consistent with partners' national development strategies.</td><td colspan="2">50 per cent of technical co-operation flows are implemented through co-ordinated programmes consistent with national development strategies.</td></tr>
<tr><td rowspan="6">5a</td><td rowspan="6">Use of country public financial management systems — per cent of donors and of aid flows that use public financial management systems in partner countries, which either a) adhere to broadly accepted good practices or b) have a reform programme in place to achieve these.</td><td colspan="2">Per cent of donors</td></tr>
<tr><td>Score*</td><td>Target</td></tr>
<tr><td>5+</td><td>All donors use partner countries' PFM systems.</td></tr>
<tr><td>3.5 to 4.5</td><td>90 per cent of donors use partner countries' PFM systems.</td></tr>
<tr><td colspan="2">Per cent of aid flows</td></tr>
<tr><td>Score*</td><td>Target</td></tr>
<tr><td>5+</td><td>A two-thirds reduction in the percentage of aid to the public sector not using partner countries' PFM systems.</td></tr>
<tr><td></td><td>3.5 to 4.5</td><td>A one-third reduction in the percentage of aid to the public sector not using partner countries' PFM systems.</td></tr>
</table>

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Table 2.A.4. (contd.)

ALIGNMENT		TARGETS FOR 2010	
5b	Use of country procurement systems — per cent of donors and of aid flows that use partner-country procurement systems that either *a)* adhere to broadly accepted good practices or *b)* have a reform programme in place to achieve these.	Per cent of donors	
		Score*	Target
		A	All donors use partner countries' procurement systems.
		B	90 per cent of donors use partner countries' procurement systems.
		Per cent of aid flows	
		Score*	Target
		A	A two-thirds reduction in the percentage of aid to the public sector not using partner countries' procurement systems.
		B	A one-third reduction in the percentage of aid to the public sector not using partner countries' procurement systems.
6	Strengthen capacity by avoiding parallel implementation structures — number of parallel project implementation units (PIUs) per country.	Reduce by two-thirds the stock of parallel project implementation units (PIUs).	
7	Aid is more predictable — per cent of aid disbursements released according to agreed schedules in annual or multi-year frameworks.	Halve the gap — halve the proportion of aid not disbursed within the fiscal year for which it was scheduled.	
8	Aid is untied — per cent of bilateral aid that is untied.	Continued progress over time.	
HARMONISATION		TARGETS FOR 2010	
9	Use of common arrangements or procedures — per cent of aid provided as programme-based approaches.	66 per cent of aid flows are provided in the context of programme-based approaches.	
10	Encourage shared analysis — per cent of *a)* field missions and/or *b)* country analytic work, including diagnostic reviews that are joint.	*a)* 40 per cent of donor missions to the field are joint. *b)* 66 per cent of country analytic work is joint.	
MANAGING FOR RESULTS		TARGET FOR 2010	
11	Results-oriented frameworks — number of countries with transparent and monitorable performance assessment frameworks to assess progress against *a)* the national development strategies and *b)* sector programmes.	Reduce the gap by one-third — Reduce the proportion of countries without transparent and monitorable performance assessment frameworks by one-third.	
MUTUAL ACCOUNTABILITY		TARGET FOR 2010	
12	Mutual accountability — number of partner countries that undertake mutual assessments of progress in implementing agreed commitments on aid effectiveness including those in this Declaration.	All partner countries have mutual assessment reviews in place.	

Important Note: In accordance with paragraph 9 of the Declaration, the partnership of donors and partner countries hosted by the DAC (Working Party on Aid Effectiveness) comprising OECD/DAC members, partner countries and multilateral institutions, met twice in 2005 to adopt, and review where appropriate, the targets for the twelve Indicators of Progress. At these meetings an agreement was reached on the targets presented under Section III of the present Declaration. This agreement is subject to reservations by one donor on *a)* the methodology for assessing the quality of locally-managed procurement systems (relating to targets 2*b* and 5*b)* and *b)* the acceptable quality of public financial management reform programmes (relating to target 5*a*.ii). Further discussions are underway to address these issues.
**Note on Indicator 5:* Scores for Indicator 5 are determined by the methodology used to measure quality of procurement and public financial management systems under Indicator 2 above.

Table 2.A.5. **Country Implementation Progress on Harmonisation and Alignment**

	Harmonisation road map	Joint/collaborative assistance strategy	Common performance assessment framework	Co-ordinated budget support	Sector-wide approaches	Joint diagnostic/ analytic work	Use of common arrangements	Indepe monitorin
				Substantial progress[a]				
Burkina Faso	***	***	*	*	*	*	**	*
Ghana	*	**	*	*	*	*	**	*
Mozambique	***	**	*	*	**	*	*	*
Tanzania	**	*	**	*	*	*	*	*
Uganda	**	*	*	*	*	*	**	*
				Progress but not as widespread[b]				
Cameroon		***	***	***	***	***	***	*
Ethiopia	*		**	**	**	*	**	**
Malawi	***	**	**	**	*	**	***	**
Rwanda	**	***	**	*	***	*	**	*
Senegal	***	***	***	*	*	**	**	
Zambia	*		***	**	*	**	**	*

Notes:
a) Countries showing substantive progress (at least four areas of substantial action).
b) Countries where actions are being taken but not across as broad a front as in the first category.
* denotes substantial or sustained action; ** denotes moderate action; *** denotes action being initiated and at early stage; blank = little or no action
This table depicts some of the most strategic actions/measures that governments and donors are taking in a selected list of countries to implement harmonisation and alignm countries selected show a range and depth of implementation. This presentation should not be read that such activities are taking place only in the countries listed; rather, actio form or another are taking place in over 60 countries.

Source: World Bank staff estimates.

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Table 2.A.6. **HIPC Debt Relief**[a]
($ million), in NPV terms in the year of decision)

	Reduction in NPV Terms			Nominal Debt Service Relief			
	Original HIPC initiative	Enhanced HIPC initiative	Total	Original HIPC initiative	Enhanced HIPC initiative	Total	Completion/ decision point date
Countries that have reached their Completion Points (18)							
TOTAL[b]	**3 118**	**19 020**	**22 138**	**6 364**	**31 252**	**37 616**	
Benin	0	265	265	0	460	460	Mar-03
Bolivia	448	854	1 302	760	1 300	2 060	Jun-01
Burkina Faso[c]	229	324	553	400	530	930	Apr-02
Ethiopia[c]	0	1 982	1 982	0	3 275	3 275	Apr-04
Guyana	256	335	591	634	719	1 353	Dec-03
Ghana	0	2 186	2 186	0	3 500	3 500	Jul-04
Honduras	0	556	556	0	1 053	1 053	Apr-05
Madagascar	0	836	836	0	1 900	1 900	Oct-04
Mali	121	417	539	220	675	895	Mar-03
Mauritania	0	622	622	0	1 100	1 100	Jun-02
Mozambique	1 717	306	2 023	3 700	600	4 300	Sep-01
Nicaragua	0	3 308	3 308	0	4 500	4 500	Jan-04
Niger[c]	0	664	664	0	1 190	1 190	Apr-04
Rwanda[c]	0	696	696	0	1 400	1 400	Apr-05
Senegal	0	488	488	0	850	850	Apr-04
Tanzania	0	2 026	2 026	0	3 000	3 000	Nov-01
Uganda	347	656	1 003	650	1 300	1 950	May-00
Zambia	0	2 499	2 499	0	3 900	3 900	Apr-05
Countries that have reached their Decision Points (11)							
TOTAL[b]	**0**	**12 613**	**12 613**	**0**	**21 632**	**21 632**	
Burundi	0	826	826	0	1 472	1 472	Jul-05
Cameroon	0	1 260	1 260	0	2 800	2 800	Oct-00
Chad	0	170	170	0	260	260	May-01
Congo, Dem. Rep.	0	6 311	6 311	0	10 389	10 389	Jul-03
Congo, Rep. of	0	1 679	1 679	0	2 881	2 881	Mar-06
Gambia, The	0	67	67	0	90	90	Dec-00
Guinea	0	545	545	0	800	800	Dec-00
Guinea-Bissau	0	416	416	0	790	790	Dec-00
Malawi	0	643	643	0	1 000	1 000	Dec-00
São Tomé and Principe	0	97	97	0	200	200	Dec-00
Sierra Leone	0	600	600	0	950	950	Mar-02
Total debt relief committed[b]	**3 118**	**31 633**	**34 750**	**6 364**	**52 884**	**59 248**	

Notes:
a) Committed debt relief under the assumption of full participation of creditors
b) The total amounts shown are only indicative, as they represent the sum of individual commitments expressed in different NPV terms, corresponding to the time of the decision point of each HIPC.
c) The assistance under the enhanced HIPC Initiative includes topping up with the NPV calculated in the year of the completion point.

Source: HIPC country documents; and World Bank and IMF staff estimates.

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Table 2.A.7. **Multilateral Debt Relief Initiative (MDRI): Cumulative Relief for the 15 HIPC Completion Point Countries**
($ million)

	Benin	Burkina Faso	Cameroon	Ethiopia	Ghana	Madagascar	Mali	Mauritania	Mozambique	Niger	Rwanda	Senegal	Tanzania	Uganda
IDA	691	740	823	2 342	2 994	1 780	1 270	552	1 319	747	351	1 866	2 824	2 791
IMF	51	86	224	121	333	194	94	44	125	91	31	142	311	113
AfDB	381	359	243	770	507	390	587	274	575	202	107	434	639	544
Total	1 123	1 185	1 290	3 233	3 834	2 364	1 951	870	2 018	1 040	489	2 442	3 774	3 448

Notes: For IDA and the IMF, the debt relief is calculated at the exchange rate SDR 1 = US$ 1.47738. For the AfDB, it is calculated at the exchange rate UA 1 = US$ 1.553.
Sources: AfDB, IMF and World Bank. Staff estimates.

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Table 2.A.8. **Government Revenue, Excluding Grants**
(Per cent of GDP)

	1997-2001	2002	2003	2004	2005
Oil-exporting countries	22.2	24.2	22.5	25.9	28.7
Angola	42.6	43.4	37.5	37.9	41.9
Cameroon	15.2	15.2	15.9	15.2	17.2
Chad	7.7	8.0	7.9	8.6	10.2
Congo, Rep. of	26.9	27.2	29.1	32.2	39.7
Côte d'Ivoire	17.6	17.8	16.9	17.6	17.3
Equatorial Guinea	22.7	28.5	28.7	34.4	42.9
Gabon	32.7	31.5	29.7	28.8	28.3
Nigeria	19.8	22.9	21.0	26.7	28.0
Oil-importing countries	20.8	20.0	21.2	22.4	23.6
Benin	15.0	16.3	16.6	16.4	16.1
Botswana	42.7	40.1	40.7	40.6	40.5
Burkina Faso	11.8	11.4	12.1	12.7	12.6
Burundi	17.2	20.3	21.1	20.1	19.5
Cape Verde	20.3	22.6	21.3	22.8	23.5
Central African Republic	8.9	10.8	7.7	8.1	8.2
Comoros	12.2	16.7	16.1	15.3	15.0
Congo, Dem. Rep. of	5.4	7.9	7.7	9.6	11.4
Ethiopia	14.9	16.6	16.4	16.6	16.0
Gambia, The	17.8	16.3	15.7	20.9	20.3
Ghana	17.6	17.9	20.8	23.8	24.9
Guinea	11.1	12.0	10.5	10.4	12.9
Guinea-Bissau	14.8	15.3	15.2	17.2	19.7
Kenya	20.3	19.6	19.7	21.4	21.2
Lesotho	43.0	40.1	41.6	49.8	54.3
Madagascar	10.6	8.0	10.3	12.0	10.8
Malawi	16.9	17.7	22.0	23.2	25.6
Mali	13.5	15.9	16.4	17.4	17.6
Mauritius	19.7	18.3	20.0	19.9	19.7
Mozambique	12.0	12.4	12.9	12.6	13.7
Namibia	32.4	30.5	29.3	29.6	30.8
Niger	8.9	10.6	9.9	10.8	10.2
Rwanda	10.4	12.3	13.5	13.9	14.6
Sao Tomé and Principe	14.4	23.3	25.6	28.4	105.2
Senegal	17.2	19.1	19.3	19.3	20.2
Seychelles	42.6	40.0	49.3	49.1	50.4
Sierra Leone	8.9	12.1	12.4	12.3	12.2
South Africa	23.5	23.3	23.3	24.2	25.9
Swaziland	28.5	25.4	25.3	29.8	32.1
Tanzania	11.2	11.0	11.4	11.8	12.9
Togo	13.5	12.3	16.5	16.2	14.6
Uganda	11.3	12.2	12.2	12.6	12.9
Zambia	19.0	17.9	18.0	18.3	17.6
Zimbabwe	25.0	17.9	24.9	33.8	44.2
Sub-Saharan Africa	21.3	21.1	21.6	23.4	25.1
Excl Nigeria and S. Africa	19.3	19.3	20.2	21.5	23.4

Source: IMF, African Department database.

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Table 2.A.9. **Workers' Remittances, Compensation of Employees and Migrant Transfers**
($ million)

	1990	1995	2000	2001	2002	2003	2004
Angola	0	..	..	..	..	..	..
Benin	101	100	87	84	84	84	84
Botswana	86	59	26	26	27	27	27
Burkina Faso	140	80	67	50	50	50	50
Burundi	0	..	..	..	..	..	..
Cameroon	23	11	11	11	11	11	11
Cape Verde	59	106	87	81	85	92	92
Central African Republic	0	..	..	..	..	..	..
Chad	0	..	..	..	..	..	..
Comoros	10	12	12	12	12	12	12
Congo, Dem. Rep.	..	..	..	..	..	..	..
Congo, Rep.	0	4	10	1	1	1	1
Cote d'Ivoire	44	151	119	116	120	142	148
Equatorial Guinea	0	0	..	..	..	..	..
Eritrea	..	..	3	..	..	..	..
Ethiopia	5	27	53	18	33	46	46
Gabon	0	4	6	5	3	6	6
Gambia, The	10	19	14	7	7	8	8
Ghana	6	17	32	46	44	65	82
Guinea	0	1	1	9	15	111	42
Guinea-Bissau	1	..	2	10	18	23	23
Kenya	139	298	538	517	395	494	494
Lesotho	428	411	252	209	194	288	355
Liberia	..	..	..	..	..	..	..
Madagascar	8	14	11	11	17	16	16
Malawi	0	1	1	1	1	1	1
Mali	107	112	73	88	138	154	154
Mauritania	14	5	2	2	2	2	2
Mauritius	0	132	177	215	215	215	215
Mozambique	70	59	37	42	53	69	58
Niger	14	8	14	22	19	25	25
Nigeria	10	804	1 705	1 303	1 421	2 086	2 751
Rwanda	3	21	7	8	7	7	7
Sao Tome and Principe	0	0	0	1	1	1	1
Senegal	142	146	233	305	344	511	511
Seychelles	8	1	0	2	2	2	2
Sierra Leone	0	24	7	7	22	26	26
South Africa	136	105	344	297	288	435	521
Sudan	62	346	641	740	978	1 224	1 403
Swaziland	113	83	74	74	62	62	62
Tanzania	0	1	8	10	7	7	7
Togo	27	15	34	69	103	149	149
Uganda	0	0	238	338	372	297	291
Zambia	0	..	..	..	..	..	..
Zimbabwe	1	..	..	..	..	..	..
Sub-Saharan Africa	1 767	3 177	4 926	4 737	5 151	6 749	7 683
Algeria	352	1 120	790	670	1 070	1 750	2 460
Egypt, Arab Rep.	4 284	3 226	2 852	2 911	2 893	2 961	3 341
Morocco	2 006	1 970	2 161	3 261	2 877	3 614	4 218
Tunisia	551	680	796	927	1 071	1 250	1 432
Libya	0	..	9	10	7	8	8
North Africa	7 193	6 996	6 608	7 779	7 918	9 583	11 459

Source: Global Economic Prospects 2006: Economic Implications of Remittances and Migration, World Bank. 2006.

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Chapter 3

After Gleneagles: What Role for Loans in ODA?

Abstract

This chapter contributes to the "grants *vs.* loans" debate on ODA policy and makes a proposal. Cancelling of poor-country debt does not mean that the best way to give aid is through grants only. A switch from concessionary loans to grants may limit resources to the poorest countries, worsen their incentives for fiscal discipline and efficiency and raise the burden of adjustment from exogenous shocks. Aid through loans may often prove superior, provided that it maintains debt sustainability. A scheme for soft loans with higher interest rates and cancellation provisions if bad shocks occur would minimise moral hazard and strengthen debt sustainability.

A Tale of Two Aid Instruments

Suppose a DAC donor earmarks $1 billion of taxpayers' money for official development assistance (ODA). The donor may use two instruments — an outright grant or a grant in combination with a market loan to produce a concessional loan of $2 billion with a grant element of 50 per cent. Many now think the choice should be clear: provide grants only, leave loans to the market. This chapter tries to qualify and inform that choice.

Since the 1980s, a crusade of good intentions has militated for total cancellation of poor-country debt. An unlikely alliance has emerged between some academics (Lerrick and Meltzer, 2002; Bulow and Rogoff, 2005) and anti-debt lobby groups to recommend a switch from ODA loans to outright grants as a natural lesson learned from the debt excesses of previous decades. This alliance has argued that loans carry perverse incentives for recipient countries with low governance scores and contribute to a debt overhang (which grants by definition cannot); it also notes a tendency for "defensive lending" (loans that keep up appearances by rolling over debt) by development banks, perceived as natural "loan pushers".

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A major "grants-*versus*-loans" controversy has developed since an influential US Congress Report of the International Financial Institution Advisory Commission (better known as the "Meltzer Commission"; see IFIAC, 2000) concluded that total cancellation of poor-country debt was essential. One of the conclusions of the Meltzer Commission on reforming the World Bank and the International Monetary Fund was that development assistance should be administered through performance-based grants rather than concessionary or soft loans. Under this system, grants would be disbursed not directly to governments but to non-governmental organisations (NGOs), charities or private-sector businesses that would offer the cheapest project bids.

The heavily indebted poor country (HIPC) debt reduction initiative has been seen as proof of failure of the soft-loan strategy. That the debt had to be cancelled shows, according to one line of argument, that the poorest countries simply cannot repay their debt after all (Bulow and Rogoff, 2005). The argument runs that the poorest countries have no access to financial markets for the simple reason that they are unable to repay their debt. It is then hard to see on what premises foreign governments could expect to be better treated than private bankers, all the more so because they have to account to public opinion increasingly hostile to debt. The HIPC initiative makes that point forcefully. Bulow and Rogoff (2005) cite a study from the American Congressional Budget Office according to which the market value of debt for the multilateral banks is markedly lower than par. In other words, according to this line of argument, the poor countries have no access to international financial markets for the same reason that explains why multilateral bank loans are non-recoverable.

Contrary to the institutional argument developed by Bulow and Rogoff, low capital productivity is not necessarily a reason for arguing against a policy of subsidised loans. To finance an initial accumulation of capital despite its low return, for example to fund infrastructure, a loan will be better than a grant. The supported country can become perfectly profitable if the critical mass of capital is achieved. This may justify subsidising loans with lower interest rates and longer maturities. Rising profitability over time justifies greater patience from creditors. Here the role of public development banks is crucial, as they can pool risk better and sustain a longer time horizon than can private actors.

Figure 3.1 shows that bilateral donors have increasingly favoured grants over loans during the past three decades. In recent years the multilateral aid agencies have emulated this preference. Even the regional development banks (except for the Asian Development Bank) have started to provide more grants. The share of loans has substantially declined since the 1980s following the first wave of the developing-country debt crisis initiated by Mexico's default in August 1982. Bilateral ODA is channelled mostly through grants, with the exception of Japan where loans still account for more than half of gross ODA. To a lesser extent, Spain, Italy, Germany, France and emerging non-DAC donors such as China also tend to provide some aid through project and contract loans.

The international agreement on debt relief (Multilateral Debt Relief Initiative, or MDRI) reached by the G8 Finance Ministers in mid-2005 cancelled $56.5 billion in loans owed to the World Bank, the African Development Bank and the International Monetary Fund. At Gleneagles[1], the Heads of State formally endorsed the agreement made by their Finance Ministers. Fourteen countries in Africa and four in Latin America became eligible for immediate debt forgiveness under the plan, and a further nine should benefit over the next few years. The nations are part of the World Bank's HIPC initiative, in which countries commit to good governance, meet an IMF-endorsed financial plan and root out corruption.

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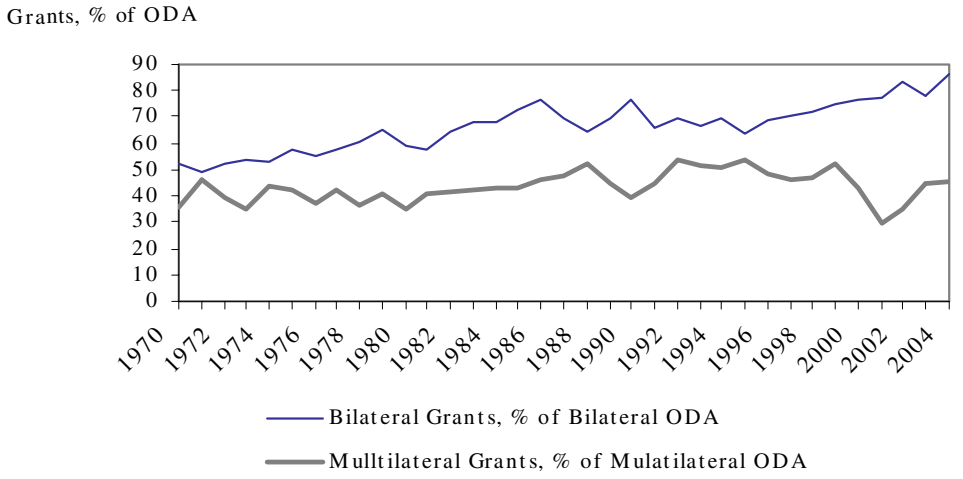
Figure 3.1. **Grants and Loans as Per Cent of ODA, 1970-2004**



Source: Creditor Reporting System (OECD).

Whatever can be said about the relative merits of grants over soft loans, the rising share of grants in ODA has not reduced poverty incidence in the developing world. In fact, where poverty has been reduced — in East Asia and the Pacific — the share of grants in ODA has been lower than elsewhere. By contrast, in Africa both grants as a percentage of ODA disbursements and poverty incidence have been on the rise simultaneously. Table 3.1 reveals some interesting comparisons for East Asia/Pacific and sub-Saharan Africa, obviously without any causal implications, but it may provide a first warning that not all debt is bad, before the international community does away with loans entirely.

Table 3.1 **Grants in Relation to ODA and Poverty Incidence**

		1990	2004
East Asia	-Grants, per cent of ODA[a)]	45.4	61.5
	-Poverty incidence[b)]	30.0	12.0
Sub-Saharan Africa	-Grants, per cent of ODA[a)]	80.8	81.7
	-Poverty incidence[b)]	45.0	44.0
Latin America	-Grants, per cent of ODA[a)]	75.7	102.0
	-Poverty incidence[b)]	48.3	44.0

Notes:
a) ODA disbursements. Net loan reflows explain a share of grants/ODA higher than 100 per cent.
b) Headcount Index (Percentage living in households that consume beneath the poverty line, $1.08 per day at 1993 PPP).

Sources: Creditor Reporting System (OECD), Millenium Development Goals database and ECLAC.

To inform donors' choices on whether and when to spend aid through grants or soft loans, this chapter first discusses the basic assumption behind the pro-grant argument — that soft loans are equivalent to a mix of market loans and grants when capital markets are perfect and open to all. Second, it explores the impact on net transfers to poor countries that the choice is

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likely to entail in terms of allowing poor countries to raise investment and smooth consumption (Reisen and Soto, 2001). Third, it analyses incentives, because "little can sensibly be said about grants and loans without considering incentive effects" (Hartford and Klein, 2005). Fourth, it explains and discusses the need to extend ODA to help smooth consumption by the poorest in the face of adverse shocks. Finally, it presents a new scheme for soft loans that aims at minimising moral hazard and strengthening debt sustainability even under negative shocks.

The Grant/Loan Equivalence

To follow the grant-*versus*-loan debate, a capsule summary of basic ODA analysis is required. Concessional loans as opposed to commercial loans carry *grant elements* that reflect their financial terms: interest rates, maturities (intervals to repayment) and grace periods (intervals to first repayments of capital). The grant element is a measure of the concessionality or softness of an ODA loan[2].

In principle, a private investor can buy a soft loan and then slice it into a market loan and a grant; hence the term *grant/loan equivalence*. Basically, the difference between the cash transfer and the price the investor is prepared to pay (as a first approximation, the annuity divided by the market interest rate) is the grant element. For better understanding, Table 3.2 provides a numerical example.

Table 3.2. **Grant/Loan Equivalence**

Soft ODA Loan	Market Loan
1 per cent interest rate, no grace period, 30 year duration, annual payments	19.5 per cent interest rate (= 4 per cent financing cost for AAA investor +0.5 per cent management fee +15 per cent default risk spread)
• Cash inflow at start = 1 000 • Constant annuities = 38.75 • Investor buys soft loan at 198.72 (38.75: 0.195) • ⇒ Grant element = 81.28 per cent	• Grant = 812.8 • Market loan = 198.72 at 19.5 per cent • ⇒ Cash inflow = 1 000 • ⇒ Annuities = 38.75 for 30 years

Note: Assuming an infinite horizon to facilitate calculation, the annuity (38.75) can be divided by the market interest rate (0.195) to establish the net present value of the underlying income to the investor (198.72).

There is a difference between the grant cost to the donor and the grant benefit to the recipient; different levels of capital cost and returns determine the extent of concessionality (Leipziger, 1983):

— In a *benefit* calculation, concessionality would be calculated as the difference between the interest charged and the market rate of interest that the borrower would otherwise have to pay. A borrower with high capital returns will tend to favour loans over grants because he will receive more capital under a loan scheme.

— In an *opportunity cost* calculation, the concessionality would be calculated as the difference between the interest charged and the opportunity cost of investing the ODA loan. A donor with high domestic capital returns will tend to provide aid through grants instead of a higher aid transfer through loans because he has to forgo more capital under a loan scheme.

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— Thus, a higher return on capital and higher interest rate spreads in the borrowing country both shift the optimal composition of aid towards loans. Donors will prefer grants to loans when their capital returns and borrowing costs are high.

The heart of the Lerrick-Meltzer (2002) argument is that all concessional loans should be thought of as an arithmetic combination between a grant and a market loan[3]; ODA should rather consist of outright grants, and markets or financial intermediaries would provide loans. This would occur at no extra cost either for the donor or for the beneficiary. Yet Lerrick and Meltzer build their case on questionable arithmetic (see Box 3.1).

Box 3.1. **The Tortured Arithmetic of "Development Equivalency"**

Lerrick and Meltzer (2002) maintain that "grants will not cost more than loans", provided the level of aid is the same. They provide the following example: A $100 million, 25-year project financed through a 40-year amortising IDA soft loan requires $100 million of aid resources under the traditional loan system. If the recipient qualifies for 70 per cent grant aid, the same project would be provisioned through 25 annual payments of $11.2 million, with the lender paying the service provider $7.8 million a year and the recipient $3.4 million annually. In the capital markets, the financeable value of the lender's direct revenue stream is, according to Lerrick and Meltzer, $81.5 million at an 8.25 per cent yield; the financeable value of the recipient country obligation is $18.5 million, assuming an 18 per cent yield. Thus, a $7.8 million annual commitment by the official lender would be leveraged by private lenders to supply the requisite $100 million in funding. This calibration is clearly *ad hoc* and questionable.

— First, the assimilation of a $100 million investment to a flow of 25 annuities of $11.2 million supposes a discount rate of 10.2 per cent. Assuming that the market rate is 8.25 per cent (which corresponds to the Lerrick-Meltzer view of the AAA World Bank bond), this assumes a risk premium of less than 2 per cent on the developing-country project considered. Where this comes from is left unspecified and may indeed look extremely optimistic. It will also differ widely from one developing country to another.

— Second, for calculating the financeable value of the recipient-country obligation an 18 per cent yield is assumed. Obviously, such a rate implies a high default premium, although one might think that it is not even high enough for countries with poor governance. Yet such high-risk premiums create doubts about whether the poor-country obligation could be banked and leveraged by private-sector lenders at all. Moreover, Lerrick and Meltzer provide no explanation for the choice of this rate, notably in relation to the discussion in the previous paragraph.

— Third, the Lerrick-Meltzer proposal provides no discussion of risk premiums. The exposure to natural and political shocks can be pooled, hence reduced, more efficiently by development banks than by private lenders, who would have to ask high risk premiums. On the other hand, without matching paid-in capital and additional cash reserves, the multilateral banks' rising borrowing suggested by Lerrick and Meltzer could lead to cuts in their AAA ratings, hence higher spreads.

It is precisely because financial markets are imperfect — in that they do not continuously provide finance to poor countries — that development banks and concessionary loans have a *raison d'être*.

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Lerrick and Meltzer's argument therefore calls for qualification. It is based on the assumption that developing countries have perfect access to international capital markets. Their spending capacity is then determined by their wealth and international interest rates. Grants and concessional loans are in that case fully equivalent. A grants-*versus*-loans controversy makes sense only when developing countries do not have full access to international capital markets. Under liquidity constraints and for any given willingness on the donor's side to commit taxpayers' resources, many developing-country governments will lose in terms of overall resource availability if ODA is available through grants only.

Resource Transfer

What matters to the recipient is the resource transfer — the trade deficit — that aid helps finance. Whether a shift from grants to loans will increase the transfers depends on the scale and terms of the loans relative to the scale of the grants. A shift from concessional loans to grants could reduce the present value of the resource transfer if the face value of the grants were small relative to that of the loans. Simply put, the value today of total financial resources that would otherwise be channelled to developing countries could shrink. This is quite possible because repayments by successful developing countries would cease to refinance soft-loan schemes. A big advantage of loans over grants, at least in theory, is that a given amount of ODA can be leveraged in time as the first borrower partially finances the second and so on.

Many developing-country governments will lose in terms of overall resource availability if ODA is available through grants only, as they do not have full access to private capital markets. If a liquidity-constrained country lacks such access, then lending by a development agency relaxes the constraint. The argument thus comes down to whether or not developing countries suffer liquidity constraints and why, and also whether development institutions may legitimately move in. There is substantial evidence that poor countries do suffer pervasive liquidity constraints, for essentially four reasons:

— A lack of credible institutions that would back their commitments to repay debt limits countries' access to private financial markets for good reasons (Bulow and Rogoff, 2005). Alfaro *et al.* (2005) also conclude from their 1970-2000 empirical investigation that low institutional quality has been the leading explanation for limited market access. Concessional loans in that case make sense only if development institutions are better positioned than private markets to get repaid despite local institutional weaknesses, e.g. due to preferred creditor status or information advantages.

— Another explanation relates to the so-called "Lucas paradox" (Lucas, 1995) — the presence of externalities to physical and human capital that prevent capital from flowing from capital-rich to poor countries. To the extent that it makes the profitability of a private or public capital investment dependent on the presence of complementary (notably public) capital assets — roads, ports, airports, telecommunications, education — such market failure provides a powerful justification for ODA as a way of supporting primitive capital accumulation leading to a critical level of the capital stock beyond which further investment will be profitable. Loans provide here an instrument superior to grants precisely because there is an eventual return to investment. The characteristics of concessional loans (grace periods, long maturities and low interest rates) allow them to be adapted to those of the investments.

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— Cohen and Soto (2004) call attention to another explanation, based on an insufficient integration of poor countries into international trade. With high shares of economic activity not traded internationally, and at current exchange rates, investments in developing countries might be socially profitable but the local relative price of capital too high. This relates to the grants-*versus*-loans debate to the extent that a lack of integration in world markets widens that difference, and it means that a developing country might not have the desired access to outside private market finance. In addition, international loans need to be repaid in foreign currency, which affects the country's repayment capacity.

— A fourth explanation for the insufficient access of developing countries to international capital markets relates to volatility in their resources. High volatility translates into higher spreads as the perceived risk on investment increases. In turn, high spreads limit borrowing capacity. Kharroubi (2005) shows how volatility tends to exclude poor countries from international financial markets.

That the leverage effect through development banks can also work well in the African context is well exemplified by the Development Bank of Southern Africa (Box 3.2).

Box 3.2. **The Development Bank of Southern Africa (DBSA)**

The Development Bank of Southern Africa (DBSA) provides finance to over 500 municipalities and to a wide range of public utilities and private firms in the 14 countries of the Southern African Development Community (SADC). It is the leading provider of advice and finance for public-private partnerships in the region as well as a leading partner with international donors and institutions. The Bank lends around $1 billion per year with an average maturity of around 20 years, on terms reflecting the costs of its capital plus a small premium to generate around $100 million in surplus, which is recycled into technical assistance and capacity-building grants, and a 2 per cent return on assets, which builds reserves. With the Bank now reaching maturity and defaults at well under 1 per cent, repayments now account for almost half of its income; the balance comes from the markets and global development finance institutions. With investment-grade status, the Bank regularly issues bonds on domestic and international markets, but it also acts as a wholesaler for agencies like *Agence française de développement* (AfD) of France and the European Investment and Nordic Investment Banks. The Bank each year funds infrastructure, which benefits an estimated 2 million poor households and creates around 40 000 jobs per year. This state-owned bank provides a model for a new generation of development banks that, although owned by the state, are financially and operationally independent, existing without systematic state subsidies or guarantees. The DBSA has a major development impact at no cost to local taxpayers (but it occasionally benefits through ODA from an indirect contribution from donor countries' taxpayers). Through diligent financial and risk management that maintains its credit rating, it can make loans available to many who otherwise could not access finance and can extend the reach of those that have limited access. The combination of advisory services, finance and partnerships means that its service extends beyond finance to technical assistance and capacity building, creating a virtuous circle where the discipline of the financial markets is introduced through developmental lending.

The authors gratefully acknowledge the information provided by Dr. Ian Goldin, Vice President at the World Bank and previously chief executive of DBSA.

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A big advantage of loans over grants, at least in theory, is that a given amount of ODA can be leveraged in time as the first borrower partially finances the second and so on. Formerly poor Asian countries contribute to replenishing IDA resources. What makes the case in favour of this argument weaker is "defensive lending", namely the tendency of the multilateral banks to lend to the same indebted countries the resources supposedly to be repaid. In a report for the French *Conseil d'analyse économique* (Cohen and Reisen, 2006) the authors produced econometric evidence to show that defensive lending to many African countries was indeed prominent in the 1990s, but not in the 1980s (Table 3.3.). One interpretation is clearly that debt was too high in the 1990s to be repaid. Yet as the 1980s demonstrate, especially for the bilateral development banks, this is not an intrinsic feature of soft loans.

Table 3.3. **Evidence on "Defensive Lending"**
Independent Impact of Debt Service (t-1) on New Loans (t), per cent

	Bilateral Lenders	Multilaterals
1980s	17	40
1990s	14	78

Source: Cohen and Reisen (2006).

Incentive Effects

Donors can rely on little evidence so far on whether or not the social returns of aid are to a degree endogenous to grants and soft loans. Those in favour of soft loans argue that pure grants would be used, at least by "donor darlings", to the point where their marginal utility is zero (equalising their zero cost to the recipient). Moreover, as grants do not imply a burden of repayment, they would undermine efforts to mobilise public revenues and thus lead to greater aid dependency. Frequent debt forgiveness and serial defensive lending, however, may have undermined any disciplinary effect inherent in concessional loans because borrower governments may have come to perceive them as equivalent to grants. Furthermore, those in favour of grants militate for performance-based grants, with close monitoring and targeted accountability.

In a dynamic framework in which recipient countries rely on the continuation of grants and development institutions are keen on producing a given level of ODA, the incentive structure is more complex. For example, if it is possible credibly to tie the renewal of a grant to a given level of financial discipline in the recipient country, then the aforementioned disincentive is compensated by the positive incentive of having the flow of grants renewed. Possible "grant-pushing" behaviour by development institutions might weaken that incentive.

Consequently, the debate needs to be informed empirically. Clearly, the evidence available so far favours soft loans over grants: they have been used more efficiently than grants during the past three decades, despite repeated debt crises. Recent work on aid effectiveness finds that loans do promote growth when governance meets certain standards, while grants do not. Two in-depth studies produced at UN WIDER and the IMF reveal why this is so.

The UN WIDER study performed an empirical test based on annual panel data from 1970 to 1999 for 72 aid-recipient countries. It shows significantly that concessional loans are connected with higher tax revenues, less government consumption, higher investment rates and less local public deficit finance (Odedokun, 2004). The same study also finds that aid recipients

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have a time preference, shown by the high response of concessional borrowing to the level of the grant element. The study concludes that grants stimulate the financing and implementation of projects that fail to meet usual efficiency criteria, particularly in least-developed countries,

The IMF study (Gupta *et al.*, 2004) examines the experience of 107 countries that received foreign aid during 1970-2000 to trace the relative effect of grants and loans on the domestic revenue effort. The results suggest that an increase in overall aid (net loans plus grants) causes a country's domestic public revenues to decline, although the separate effects of its two components are different. An increase in grants causes revenues to decline; for each additional dollar of grants, 28 per cent is offset by lower revenues. In contrast, loans associate with a higher tax effort. The IMF study also finds that in countries where institutions are weakest (as measured by the average corruption index in the *International Country Risk Guide*), any increase in grant aid would be cancelled out by a reduction in public revenues. The IMF authors suggest that the provision of grants should be accompanied by monitored efforts to curb tax exemptions and strengthen tax compliance.

The IMF concern about the budgetary implications of grants gains weight if these imply the need for recipients to co-finance projects, as suggested by the Meltzer Commission. Odedokun (2004) cites a specific example used in the Meltzer report whereby the recipient co-finances 30 per cent of the cost of vaccination of the country's children against measles; he points out that this is equivalent to financing the entire project with a concessional loan with a 70 per cent grant element and no grace period so that the 30 per cent effective loan is paid upfront. Clearly, it is a cause for concern from both the recipient and donor perspectives that the grant disappears as tax gifts to influential groups in the most corrupt countries, stimulates consumption and fails to stimulate growth.

Shock Absorption

The benefits of capital flows derive not only from directing world savings to the most productive investment opportunities, but also from allowing individuals to smooth consumption over different states of nature by borrowing or diversifying portfolios abroad. Developing countries will likely benefit greatly from inter-temporal smoothing of consumption levels. Poor countries tend to be more shock-prone than richer ones; this, the volatility of their resources, provides another critical explanation of why poor countries have no access to the international financial markets. Moreover, because per capita income is low, any downside adjustment will hurt more than in countries with higher consumption levels.

Macroeconomic instability driven by commodity shocks or natural disasters is a recurrent feature in poor countries. For the poorest, natural disasters occurred once every 2.5 years on average between 1997 and 2001. Commodity price shocks also are more severe for poor countries. Low-income countries experienced such shocks on average every 3.3 years. About 26 heavily indebted countries have an export concentration of more than 50 per cent in three or fewer commodities, while 62 per cent of the total exports of the least developed countries are unprocessed primary commodities (see Guillaumont *et al.*, 2003).

Econometric analysis demonstrates that the volatility of poor countries is a key factor of their exclusion from international financial markets (see Kharroubi, 2005). This exclusion is not necessarily the consequence of bad governance or of low average return on capital,

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but actually results from shortcomings in the organisation of the financial markets. The lack of efficient procedures for settling debts in case of negative shocks may become responsible for high spreads and exclusion.

Should these risks dissuade multilateral lenders from concessional loans? Somewhat paradoxically, the answer is negative; they should encourage them. For example, suppose that a country has only one chance out of two of repaying its loans. The expected spread would be double that in rich countries, and in many instances this is enough to explain why poor countries have little access to the financial markets. Now consider a donor hesitating between grants and loans and assume that a loan has only half a chance to be repaid. Then, for any given amount of taxpayers' money, the use of loans as opposed to outright grants allows doubling the contemporary aid volume. This is the essence of the short-term leverage effect that lending allows.

Debt cancellation for the poorest countries should not in fact be interpreted as a negative sign for the future borrowing capacity of poorer countries. It instead invites deeper thinking on a carefully targeted debt cancellation policy as a companion to lending. From this perspective, the comparative advantage of multilateral banks and public creditors depends not on their debt-collection procedures, as Bulow and Rogoff (2005) rightfully point out, but on their capacity for cancelling the debt without imposing harm to the country. Private financial markets, in contrast, suffer from not having clean procedures for debt cancellation. Debtors in distress suffer "bad and ugly" crises, in the words of Stanley Fischer. This is why, far from reducing a country's volatility, private loans actually increase it.

Private lending has also been shown to add to rather than reduce consumption variability, whether as commercial bank lending or as bond portfolio flows (Reisen and Soto, 2001). Global capital markets suffer from major distortions. The problem of asymmetric information causes herd behaviour among investors and, in good times, congestion problems. That some market participants are too big to fail causes excessive risk taking. On the other hand, the liquidity needs of global investors, reinforced by prudential regulation, often prevent them from putting small poor countries on their radar screens. Figure 3.2 shows that emerging-market bond spreads (over US treasury bonds) tend to fall when raw material prices rise and *vice versa*. Debt flows to developing countries have been shown to be negatively associated with growth in the OECD area as low OECD asset returns push capital towards emerging-market debt. US Federal Reserve interest cycles and spreads on emerging-market bonds (EMBI+), debt-related flows, variations in investor risk appetite and emerging-market crises all seem to be closely linked (Kumar and Persaud, 2001).

Low OECD-area interest rates push hard-currency debt flows towards emerging markets; high rates suck them back towards safe havens. As liabilities grow in dollars, yen and euros, mismatches in the balance sheets of emerging-market private and public sectors have often developed, especially when the Fed has kept interest rates lower and for longer than in a typical cycle. Slok and Kennedy (2004) provide significant evidence that the G3 monetary impulse (M2) is an important explanatory variable for the EMBI+ spread (the yield difference of emerging-market bonds over US treasury bonds). This finding was again confirmed in mid-2006 when rising interest rates caused jitters in emerging bond and currency markets.

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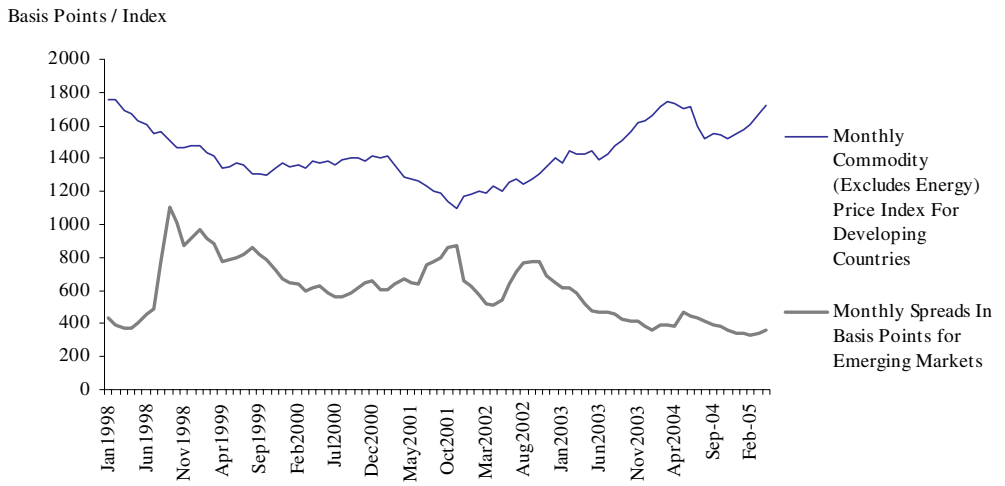
Figure 3.2. **Commodity Prices and Emerging Market Spreads**



Source: Own calculations based on market data.

This background militates quite strongly for a public solution, lenders of first resort with shock-absorbing loan portfolios. Both multilateral and bilateral development banks can and should fulfil that function (see Box 3.3).

Box 3.3. **Findings of the Gurría/Volcker Commission on the Role of the MDBs in Emerging Markets**

- Given the immaturity of their economic and financial institutions, the small size and vulnerability of their markets and the volatility of global financial markets, access of these countries to private capital can be unreliable, limited and costly for them, exposing them to great insecurity even when their long-run growth prospects are strong.
- Lending is a vehicle for policy change and for promoting international goals.
- Services bundled with lending also help to support objectives of the global community: poverty reduction, human development, protection of the environment, financial accountability and standards of public procurement that curtail corruption and promote competition.
- For the non-borrowing member countries of the MDBs, the benefits of MDB lending to EMEs are substantial and they are not costly to taxpayers.
- Lending to emerging markets does not crowd out but rather indirectly supports lending to poorer countries.

Source: Gurría and Volcker (2001).

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Development-friendly Loan Design

Following this reasoning, the authors propose a new scheme of subsidised development loans that changes the way in which the grant element is provided. The proposal builds on and advances the idea developed by Guillaumont *et al.* (2003), who recommend using the subsidy element embedded in concessional loans to finance cushioning rather than subsidising interest rates. The long decline in world interest rates has partially eroded the usefulness of interest subsidies to developing-country borrowers. By contrast, the provision of state-contingent loans — with an explicit relief clause in case of predefined exogenous shocks — is more useful to recipient countries.

The proposed scheme is simply the following. Soft loans would carry higher interest rates than they now do, but would contain provisions that debt service would be cancelled should the borrowing countries experience negative shocks. These provisions will have to be calibrated in order to face raw material shocks and natural disasters by which customers are bound. Furthermore, should a country enter a zone where defensive lending becomes the rule rather than the exception an external audit procedure will lead the development bank to cancel part of its stock of the country's unsustainable debt.

To give a practical example (Table 3.4), developing countries could be classified in four risk groups calling respectively for 25, 50, 75 or 100 per cent of provisions. In the first group, considered as exceptional, ODA worth 100 units would allow a loan of 400 units. In the second, the same provision would allow for a loan of 200 units and in the third, 133. The fourth group would get outright grants.

Table 3.4. **ODA Loan Scheme (Example)**

ODA	Provisions (per cent)	Loans
100	25	400
100	50	200
100	75	133
100	100	0

The key problem entailed by a debt cancellation policy links to the risk of the moral hazard it threatens to introduce. The risk lies in transferring resources from properly managed countries that honour their debt commitments towards countries that fail in this respect. The suggested procedure puts limits to this risk, insofar as the amount of provisions depends on an analysis of country creditworthiness that takes into account institutional risks and *a priori* external and internal conditions that prevent a country from repaying its debts. Moreover a country that shifts from one risk category to a lower one gets rewarded because the grant component of its borrowing becomes a lower proportion of the credit; it can thus rely on a higher leverage effect as a lower volume of ODA is sterilised as provision against risk. The more solvent a country (i.e. the more it can build institutions to honour its debts), the higher the possible leverage. Instead of a fixed discount (as in the 14th replenishment of the International development Association, IDA 14), the proposed solution employs a progressive scale that is a function of the country's good governance.

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A country with no adequate institutional basis for creditworthiness (Bulow's and Rogoff's argument) would be rejected from the debt system as representing too high a risk. Only countries whose governance makes the risk acceptable would thus have access to this system, which would accept (through the public subsidy) the intrinsic risk linked to the country's volatility.

It is useful to compare this proposal with the way the new IDA 14 campaign was designed for 2005-08. The IDA plans to devote around a third of its resources to grants rather than loans. On the basis of criteria of debt sustainability established by the Bank and the IMF, a country can benefit from IDA loans provided that its debt remains below the expected criteria. The debt thresholds are 100 per cent, 200 per cent or 300 per cent of exports depending on the institutional risk as measured by its CPIA (Country Policy and Institutional Assessment, established by the World Bank). If the country does not qualify for new debt because of already accumulated debt, it can obtain IDA grants. (See also Box 3.4.)

Box 3.4. **Reducing Currency Mismatches through Local-currency Lending**

A review of the financial crises that plagued many developing middle-income countries during the 1990s found that currency mismatches in the balance sheets of public and private borrowers not only increased the likelihood of getting into financial crises, but also raised the affected countries' output cost of escaping from crises (Goldstein and Turner, 2004). Over the last few years, multilateral and bilateral development banks have introduced local-currency financing as an additional lending option for their clients, driven by the heightened awareness of the risks entailed in foreign-currency lending and the desire to respond better to the financing needs of sub-national public and small and mid-scale private borrowers. From the perspective of developing countries, local-currency loans carry considerable benefits (ADB, 2005). While entities from OECD countries can either borrow internationally in their domestic currencies or enter into fully hedged transactions if borrowing in foreign currencies, developing-country borrowers usually do not have this option. Development-bank lending can reduce currency mismatches by extending local-currency loans, preferably in co-operation with the local financial sector to complement and catalyse local financial resources. Local financial markets can be developed by setting new benchmarks, by spreading best practice standards in documentation, execution, and innovation, by stretching the yield curve and lengthening maturities and by providing significant diversification opportunities for institutional investors. Local finance can be catalysed by facilitating access (e.g. through partial credit guarantees) of non-government borrowers to local-currency bond markets and by providing instruments that help lengthen maturities. Development banks that offer local-currency lending must take care to avoid crowding out private local actors as either issuers of bonds or as lenders.

In order not to penalise a creditworthy country in comparison with one no longer creditworthy, IDA 14 allows for a one-off 20 per cent cut in grants (sometimes only 9 per cent when the country is emerging from a major conflict). This is meant to reduce the risk of moral hazard by penalising purposefully irresponsible debt policies.

The mechanism proposed here stems from the same idea but applies it more systematically. The leverage effect that debt offers depends indeed on building up provisions, which directly represent the grant portion coming from the donors. The more creditworthy the country, the higher is the leverage effect from which it will benefit. Instead of considering only a lump sum deduction, the solution proposed here applies a progressive scale.

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Conclusion

It is one thing to welcome debt cancellation and another to consider that lending is a bad thing in general. Far from being contradictory, a debt-cancellation policy is a necessary component of sound debt policies. The paradox is quickly settled. Poor countries suffer from high volatility and thus from some dissuasive risk premiums in international financial markets. Subsidising the provisions that the development banks should build up gives the rich countries leverage on aid, which represents a considerable advantage for donors.

Moreover, provisioning corresponds to an explicit and transparent assessment of country risk and thus calls attention to country specifics and policies. Such provisions should be counted as ODA because their cost is not borne by debtor countries. By putting aside a proportion of the volume of ODA available to any debtor country, the scheme actually encourages virtue because required provisions would be lower in less risky countries. Overall, it would provide a powerful incentive for sound fiscal management and a springboard toward full access to international capital markets.

Notes

1. The G8 Summit was held in Gleneagles, Scotland, in July 2005.
2. The OECD Development Assistance Committee (DAC) calculates the grant element as the difference between the face value of the loan and the discounted present value of the service payments the borrower will make over the lifetime of the loan, expressed as a percentage of the face value. To qualify as ODA, a loan must include a 25 per cent "grant element", in comparison with a loan of similar nominal amount and duration carrying a 10 per cent interest rate. The rate of 10 per cent has no relation to the current market interest rate, but was chosen as an estimate of the opportunity cost of public investment for donors, which in turn can be approximated by the donors' social opportunity cost of public spending on ODA (see, for example, Young, 2002).
3. This is a worthwhile discussion. Its merit hinges notably on the unbundling of a concessional loan into its basic components. Not only does this contribute to greater transparency, but it also highlights the use of taxpayers' money (less visible in a concessional loan) and invites greater focus on the rationale for using subsidies in the first place. One of the crucial questions about ODA is why, when and how to use subsidies. With concessional loans, there is a risk that the subsidy is justified simply by the quest for market share under competition with other donors and with financial institutions. Unbundling thus contributes to greater efficiency.

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Chapter 4

Innovative Approaches to Funding the Millennium Development Goals

Abstract

Despite post-Monterrey donor initiatives, the Millennium Development Goals (MDGs) remain underfinanced even as the 2015 deadline for their achievement approaches. Ideas and proposals for new finance sources abound. In evaluating them, their revenue potential, speed of availability and political feasibility have particular importance. Judged by these criteria, it is unlikely that global taxes will be introduced in time. The International Finance Facility, and regional approaches to taxation of air transport, perhaps in combination, may stand a better chance. The most straightforward way to avoid under-funding of the Goals is to raise ODA further.

Doubling ODA or Finding New Sources of Finance

At the United Nations Millennium Summit in September 2000, world leaders adopted the Millennium Development Goals (MDGs), which set clear targets for reducing poverty and hunger, achieving universal primary education, promoting gender equality, reducing infant mortality, improving maternal health, combating infectious diseases, ensuring environmental sustainability and developing a global partnership for development by 2015[1]. The need for additional development funding to achieve the MDGs by that time is widely recognised: with an often quoted figure (e.g. in the Zedillo Report, UN, 2001) of an additional $50 billion per year, roughly the present total of ODA spent by DAC donors. This back-of-the-envelope number seems to be the minimum estimate[2]. If governments exclude the option to abandon the MDGs, they must double existing ODA, find alternative sources of comparable magnitude or strike a balance of the two. The challenge to the international community mounts daily.

It thus seems urgent now to investigate, prioritise and select new forms of financing development in general and the Millennium Development Goals in particular. The debate should not restrict itself to the modalities of resource transfers from rich to poor countries. Options to consider should include co-financing the Goals through income redistribution and tax efforts within developing countries as well. The extent to which the better-off in poor countries participate in the funding of the Goals should encourage contributions from tax payers in the advanced countries.

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The absorption capacity of recipient countries might also have relevance for funding options. Increased assistance will likely run into diminishing capital returns when developing countries fail to create a supporting climate for economic activity. The question is: When is the "saturation point" reached, i.e. at what level does aid no longer have a positive effect on economic growth? This saturation point varies across countries (Collier and Dollar, 2002). In countries with good policies and institutions, it is about 15-25 per cent of GDP, whereas in other countries it is about 5-10 per cent of GDP. By allocating $40-60 billion in additional aid only to countries with "good" policies and institutions, the World Bank (Devarajan *et al.*, 2002) finds that the saturation point is reached in only four of the 65 countries. Heller and Gupta (2002), by contrast, offer calculations showing that if a large increase in aid is to be absorbed effectively, two-thirds of it will have go to two countries outside the LDC group, India and China. These countries not only contain half the world's poor, but also have the necessary absorption capacity.

The achievement of the MDGs and the build-up of absorption capacities are interconnected so that increased assistance can turn a vicious circle into a virtuous one. For example, with the Aids pandemic running unchecked, malaria out of control or widespread malnutrition, countries will be able neither to attract private investment or tourists, nor to boost productivity through improved education. Funding the Development Goals in education, reduced child and maternal mortality and control of infectious diseases may be a precondition for better absorption capacity.

Criteria for Policy Choices

This chapter discusses the nine most "popular" of the current wide array of proposals for new forms of financing the Millennium Development Goals. Such proposals can be sorted according to their funding sources. First, a number of global taxes have been suggested, such as currency transaction taxes, environmental taxes, a brain-drain tax, an international airport tax, taxation of ocean fishing, taxation of arms exports, a "bit" tax on computer use or a luxury-goods tax. Another broad group of funding proposals involves the private sector, either public-private partnerships or exclusively private, corporate or civil society initiatives. Here the focus lies on topic-specific global funds charitable contributions towards the Millennium Development Goals or Global Premium Bonds and lotteries. Third, some proposals represent financial engineering (if not money creation), including a development-focused allocation of Special Drawing Rights at the IMF, the International Finance Facility and the use of public guarantees to stimulate private funding.

What criteria should govern the choices? The political feasibility of new funding forms is important because each year lost in the run-up to 2015 will imply the need for higher resources in the remaining period. Hence, proposals that already command support from the international community should take priority over controversial ones[3]. Beyond these key political considerations and in light of the short deadline, the revenue potential, additionality and speed of availability of the various proposals acquire particular significance:

— Revenue potential implies a tax base sufficiently large and immobile to support a small rate or surcharge for MDG funding without leakages due to tax avoidance or fierce political opposition.

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— New sources need exploration of the extent to which they are truly additional to existing development finance or whether they would merely offset it. As additional finance for development can be achieved through either higher ODA or new sources of finance, the balance between the two will determine the impact of the burden and the political resistance to financing proposals in rich countries. Establishing new forms of funding the MDGs will not serve the purpose if traditional ODA suffers from the introduction of new financing mechanisms.

— The 2015 deadline underlines the need for speedy availability of funding; each year of delay implies higher funding efforts thereafter if donor pledges are to be kept. Upfront commitments from donors might help create a virtuous circle as they strengthen recipient countries' confidence in solid foreign funding of better domestic policies and institutions.

This chapter focuses less on other important criteria. The governments of recipient countries will make the proper reforms and investments only if they have a reasonable degree of confidence in the stability and trajectory of external assistance. Hence, new forms of development finance must be credible, reliable and, above all, durable.

To the extent that new sources of development finance are seen as alternatives (rather than just complements) to existing ODA, a case has to be made that the innovative sources offer a better way to finance a given development effort (Atkinson, 2003). In other words, is there a "double dividend" in connection with a new instrument of finance? This may be the case if a tax serves a corrective function, such as a tax on smoking that partly imposes costs on the smoker which he causes to the health-care system. In some cases, there may even be a "global double dividend" as governments impose corrective taxes even though the aid benefits accrue mostly outside their borders. The "double dividend" argument, however, has to be balanced against the deadweight cost of new sources of finance if they distort economic decisions and diminish wages and profits.

Neither the following text nor the synopsis embedded in Table 4.1 at the end of this chapter will offer a systematic application of all criteria to all nine proposals. The reason is simple: for some proposals, such as private donations, global premium bonds or a tax on global arms sales, too few studies and quantitative scenarios yet exist to allow meaningful judgements of the proposals on all criteria.

Global Taxes

Many NGOs favour new global taxes to fund the MDGs. Most of the ideas for global taxes seek to finance a global public good by imposing a tax on a global public "bad" — such as hot-money movements, cross-boundary pollution or global arms sales. They often assume implicitly that the imposition of the tax does not undermine the revenue potential. Political support for global taxes may be too low to contribute significant revenues within the 2015 deadline. Some leaders nevertheless have voiced support for global taxes; in late January 2004, President Jacques Chirac of France, President Luiz Inácio Lula da Silva of Brazil, President Ricardo Lagos of Chile and the United Nations Secretary-General Kofi Annan decided to establish a technical group to pursue the study of different proposals, including "taxation on certain international transactions such as, among others, certain kinds of arms sales and certain financial transactions"[4] (See Box 4.1.).

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Box 4.1. **Innovative MDG Funding: Practical Steps So Far**

For several years, the international community has sought new tools to ensure sustained financing for development and the fight against poverty. In January 2004, the presidents of Brazil, France and Chile, supported by UN Secretary General Kofi Annan, set up a "Technical Group on Innovative Financing Mechanisms", better known as the Lula Group after Brazil's president Lula da Silva. In September 2004, the Lula group released its report on "Action Against Hunger and Poverty," arguing for alternative financing for development to reach the MDGs.

Political backing has gradually emerged on the usefulness of such financing and on the technical and political feasibility of setting it up. The EU Commission in June 2005 produced a proposal on airline tickets, according to which each member state can choose whether it wants to participate in the scheme. Depending on how many states participate and whether governments make the tax voluntary or compulsory for passengers, it could raise between 568 million euros and 2 763 million euros annually for development. Seventy nine countries endorsed the (Lula) *Declaration on Innovative Sources of Financing for Development* adopted on 14 September 2005 at the United Nations in New York.

On 1 July 2006, France introduced the solidarity levy on airline tickets to finance the purchase of drugs for the poorest countries for malaria, tuberculosis and AIDS *via* an international drug purchase facility (UNITAID). France now imposes a tax of 1 euro on domestically purchased tickets for economy-class flights within Europe, as well as a 10 euro levy on business and first-class tickets. For flights outside Europe, the tax rises as high as 40 euros. The levy has come into force in three further countries by end 2006: Chile, Cote d'Ivoire and Mauritius. Another 16 countries are now committed to implementing the levy: Benin, Brazil, Cambodia, Cameroon, Cyprus, Congo, South Korea, Gabon, Guinea, Jordan, Luxembourg, Madagascar, Mali, Mauritania, Nicaragua and Niger. Most of the countries that are committed to implementing the levy will also pool their resources in support of UNITAID. UNITAID's mission is to scale up access to treatment for HIV/AIDS, malaria and tuberculosis by leveraging quality drugs and diagnostic price reductions and accelerating the pace at which they are made available.

The United Kingdom has championed the International Finance Facility (IFF), a mechanism to frontload MDG finance by issuing bonds. As a first step, on 9 September 2005, the UK in partnership with France, Italy, Spain and Sweden launched a pilot International Finance Facility for Immunisation (IFFIm). This initiative uses the frontloading principles to ensure the provision of an additional $4 billion over the next ten years in support of the work of The Vaccine Fund and the Global Alliance for Vaccines and Immunisation (GAVI) — which comprises UNICEF, WHO, the World Bank, the Vaccine Fund, the Gates Foundation and a range of donor and recipient governments.

A new tax or revenue stream is best when easy to collect — preferably through existing administrative structures — and difficult to evade, according to basic principles of public finance. It should be neutral in its impact on market incentives and on income distribution unless it is deliberately designed (like tobacco taxation or progressive income tax, for example) to influence consumption or redistribute wealth. Priority should go to taxes that discourage inappropriate consumption, excessive resource control, environmentally damaging activities and social inequities. The most "popular" global taxes are discussed below — global environmental taxes, the "Tobin tax" on currency transactions and the global arms tax. Many other tax proposals (see, for example, Jha, 2004) have received less attention in the public debate, such as taxes on aviation (on fuel, tickets or airports), the bit tax on data sent through

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the internet or taxes on world trade (the tax base being, exceptionally, a global public good, not a bad). As the synopsis Table 4.1 at the end of this chapter indicates, global environmental taxes fit best some important criteria of policy choice — revenue potential and external benefits — but their political feasibility may not be assured to help fund the MDGs in time.

Global Environmental Taxes

Increasingly, environmental problems cross national boundaries. Good examples of global spillovers are chemicals that deplete the stratospheric ozone layer, greenhouse gases that lead to global climate change, depletion of ocean fish stocks and habitat destruction that impairs biological diversity. An issue high on the policy agenda of many OECD member countries is how to reduce greenhouse gas emissions in order to combat climate change and to meet the Kyoto Protocol commitments (OECD, 2001).

The OECD defines an "environmentally related" tax as any compulsory payment to general government levied on a tax base deemed to be of particular environmental relevance. So defined, "green" taxes in 2000 yielded on average 2.5 per cent of GDP in OECD member countries, ranging from 1 per cent in the United States to 4.5 per cent in Denmark. Taxes on transport fuels (both petrol and diesel) yielded some 70 per cent of "green tax" revenues, followed by taxes on the purchase or use of motor vehicles (*ca.* 20 per cent). A global carbon tax could affect the consumption of coal, petroleum, kerosene and natural gas. Fuel vendors would likely collect the tax, as tax authorities would levy carbon taxes directly on the sale of fossil fuels, similarly to value-added taxes.

Agnar Sandmo (2003) has made a strong economic case for global environmental taxes, primarily to control climate externalities. In theory, a system of global pollution taxes is said to generate a "triple dividend":

— First, such a tax contributes to improving the global environment as it penalises producers of CO_2 emissions for their adverse effects. According to the Intergovernmental Panel on Climate Change (IPCC), taxes of $100 per ton of carbon could reduce emissions up to 5 billion tons by 2020 (Jha, 2004).

— Second, it can reduce the efficiency loss of financing public expenditure (to the extent that the "green" tax replaces taxes that impact on incentives to earn money and save) and can reduce the tax burden on employment (in combination with a reduction of the payroll tax). The removal of tax exemptions on aviation fuel would not only serve the environment, but also raise efficiency by deleting tax exemptions where other forms of fuel are taxed, often heavily.

— Third, it enhances resources for world development. By how much? The revenue potential appears large — a fuel-consumption tax on CO_2 emissions could by itself finance the MDGs. A uniform tax (or surcharge) of roughly 0.01 euro per litre ($0.048 per US gallon) would correspond to a tax of approximately $21 per metric ton of carbon, yielding annual revenue of $130 billion per year. It would require that the United States opt for it, however; 20 per cent of the tax yield would originate there alone.

Some pessimism concerning the political realism of introducing such taxes is justified. US legislation makes it illegal for the United States to participate in any global taxes. Carbon taxes have also been opposed as allegedly regressive, hurting lower-income families. In fact, the average share of income spent on gasoline is less than 4 per cent and varies little by

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income class, according to the US Consumer Expenditure Survey of 2000. Even a big tax increase would thus have only a small impact on the typical poor family's standard of living. Moreover, there is no evidence that EU members with carbon-related taxes have any intention of reserving that revenue for aid.

Despite strong opposition, in principle, the imposition of a global environmental tax reflects an acknowledgement that dumping toxic materials in the oceans or greenhouse gases in the atmosphere is not "free" and that pollution carries real long-term costs. Several European countries, mostly EU members, have already levied energy/carbon taxes at the national level. This might be the beginning of an important political grouping of countries, which could incite others to join in, especially if global warming and climate change are seen to worsen over time. Given the 2015 MDG deadline, however, little realistic chance exists that a global carbon tax could contribute in time.

Currency Transaction Taxes

James Tobin proposed a tax on currency transactions in 1972 as a way of throwing "sand in the wheels" of international finance and so combating market volatility. What may explain its appeal to some governments and NGOs is that even a very small tax rate imposed on such a large tax base as the foreign exchange market would, at least in theory, yield sizeable revenues. Yet the tax rates would have to be very low given the extreme mobility of the underlying tax base — the spot, forward, future and swap markets for currency transactions. In a study for the German Ministry for Co-operation and Development, Paul Bernd Spahn (2002) suggested a dual tax rate: a usual rate of 0.01 per cent, which he estimated would yield around 17 billion euros if the tax were limited to the European time zone, and a very high tax of between 50 and 100 per cent in times of heavy currency-market turbulence, to combat currency fluctuations during extremely short periods. The Spahn proposal would need ratification by the EU Council and Parliament and could be used as a European contribution to finance the MDGs.

Machiko Nissanke (2003) estimates the revenue generated by a Tobin tax at $17-19 billion for a worldwide tax rate of 0.01 per cent and at $31-33 billion for a rate of 0.02 per cent[5]. Note that even a rate as low as 0.01 per cent would double the spread currently experienced in USD/EUR transactions. Kenen (1996) and Reisen (2002) have pointed to problems that may negate the estimated revenue potential and the double dividend of a global tax on currency transactions. These problems arise from:

— A *declining tax base*. A survey of foreign exchange market activities (spot, forward, swaps) released by the Bank for International Settlements in 2001 estimated the daily turnover at $1 210 billion in 2001, down 19 per cent from $1 490 billion in 1998. The introduction of the euro (12 currencies becoming one), the growing share of electronic brokering in the spot interbank market and consolidation in the banking industry appear to explain this fall. The trend may continue, as the determinants responsible for a shrinking turnover seem permanent, not transitory.

— *Hedging activities* in the foreign exchange market: They imply that a tax would actually lead to more rather than less volatility across key currencies. Trading between dealers (rather than with other financial institutions or with non-financial customers) makes up more than half of foreign-exchange trade turnover. Most daily transactions are done for hedging between traders to avoid over-exposure in currencies accumulated from deal making. Hedging activities are known as "hot potato trading", as dealers try to cover

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themselves against open positions in any single currency. Any speculative selling of, say, the US dollar could leave the seller with a supply of unwanted euros, which he or she will then try to off-load to other dealers. The practice helps to spread risk more evenly. The Tobin tax would tend to discourage hedging, since its multiple transactions would each be taxed. Consequently, the tax base of daily foreign-exchange transactions would shrink.

— *Tax avoidance* through relocation of the foreign-exchange market to tax-free jurisdictions and substitution of tax-free for taxable transactions. Relocation of foreign-exchange market activities to tax havens could occur unless all jurisdictions with major market turnover adopted the tax. Trading could be drawn to new sites, such as offshore tax havens. Relocation could be prevented by a punitive tax on all transactions with such havens, enabling trading to continue with complying sites. This penalty would reduce the risk of opening a migration floodgate by a "first mover", but it would work only with small jurisdictions. If one of the larger established markets did not adopt a Tobin tax, plenty of dealers would shift to that tax-free market and trade among themselves, unaffected by punitive measures. The tax base would clearly erode as a result. To stop substitution of taxable foreign-exchange transactions by tax-free ones, the Tobin tax would have to cover several financial instruments and keep up with new ones created to circumvent the tax. For instance, a tax on spot transactions can easily be avoided by using short-dated forward transactions, which would have to be taxed as well. Because swaps combine spot trades with offsetting forward contracts, they would also have to be taxed. Moreover, taxing currency swaps alone will not do, as a foreign exchange transaction can be replicated by a combination of a currency and treasury-bill swap, thereby evading the currency market (and the tax) to some extent.

Even assuming the Tobin tax were feasible, would it be economically desirable? Would it lower distortions in international capital markets and encourage less volatility or crisis-prone investment and help alleviate poverty? For a stable world economy, short-term volatility (which can be hedged) is less important than longer-term misalignment of exchange rates, notably those of emerging markets. Such misalignment may at times be rooted in boom-bust cycles of private lending and investment to developing countries. The Tobin tax would not be large enough to counter these cycles, whose risk-adjusted returns would, given the sudden swings from euphoria to panic, require extremely high tax rates to balance them.

Taxes on Global Arms Sales

In early 2004, Presidents Luiz Ignacio Lula da Silva of Brazil and Jacques Chirac of France, backed by UN Secretary-General Kofi Annan and Chile's President Ricardo Lagos, relaunched the idea of international taxes on arms sales to revitalise the flagging global drive against hunger and poverty. In its most recent overview (2003), the US Department of State estimated the annual value of the arms trade (either exports or imports) at $51.5 billion for 1999. Even without conceding that the legal and documented arms trade is tax-elastic, the revenue potential of taxes on conventional arms must be quite limited; a 5 per cent tax would yield no more than $2.5 billion annually, with the high risk that taxation of documented trade would stimulate illicit trade.

The UN Register of Conventional Arms contains information provided by around 110 governments on exports and imports of conventional arms. The Register covers battle tanks, armoured combat vehicles, large-calibre artillery systems, attack helicopters, combat

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aircraft, warships, missiles and missile launchers. The UN Register of Conventional Arms Report is made available to all member states, encouraging bilateral and regional dialogues on security concerns. It represents therefore a useful effort of the international community for higher transparency on arms transfers (and hence lower mistrust among governments). One has to wonder whether governments would maintain transparency in this highly delicate area if the information provided by the UN Register was used as a basis for a tax liability.

The biggest obstacle for deriving funds for the MDGs from a tax on global arms sales comes from illicit trade, especially in small arms and light weapons. The *Small Arms Survey 2003* produced by the Graduate Institute of International Studies in Geneva estimated the global small-arms trade in 2000 as worth $4 billion a year, with illicit trade at $1 billion. It stated that most (some 95) countries involved in small-arms trade fail to provide annual reports on their arms exports and imports. The clandestine nature of this trade suggests that the share of the illicit trade could rise further as a result of taxation. As for the world leader in arms production, the United States, a series of lawsuits in the 1980s and 1990s consistently failed to convince the US courts that the firearms industry was responsible for the illegal use of its products.

Embargoed countries provide an illustration of the difficulty of imposing taxes on the global arms trade as they provide evidence of the ease of circumvention. A UN report on arms transfers to embargoed Liberia during the summer of 2002 demonstrates the depth and comprehensiveness of lawbreaking (Small Arms Survey, 2003). The 210 tons of weapons and ammunition imported to Liberia during that period required the systematic evasion of legal prohibitions, including false end-user certificates, false shipping manifests, violations of the ECOWAS moratorium and UN sanctions, flouting of the ban on travel by Liberian officials and payment through prohibited trade in diamonds and other contraband materials.

Voluntary Private Sector Contributions

While funding the Millennium Development Goals will always involve a burden on the private sector of donor countries, it must not necessarily be compulsory. Higher awareness of the Goals could stimulate voluntary funding. Charitable giving has a long tradition in financing worthy development projects; however, the idea of tapping lotteries and in particular global premium bonds, promoted by UNU-WIDER in Helsinki, is fairly new. Global funds, which combine various actors to pursue specific sets of objectives, have a successful precedent — UNICEF, the United Nations Children's Fund, which according to its last (2003) Annual Report covered 33 per cent of its income from NGO and private-sector contributions. As argued below and as summarised in Table 4.1, voluntary private-sector contributions will be able to make only a partial contribution to funding the MDGs as they encounter limits with respect to either revenue potential or additionality.

Private Donations

As Adam Smith stated in his 1759 *Theory of Moral Sentiments:* "However selfish soever man may be disposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it". Indeed, charitable donations by individuals,

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both small-scale donors and super-rich, and by firms can help fund the MDGs. An OECD study of the role of philanthropic foundations in development (OECD, 2003) emphasises the important contributions that such foundations have made, particularly in agriculture (the "Green Revolution"), family planning and the control of infectious diseases. The study also finds that the most effective philanthropic interventions have been long-term investments based on "vision and solid science" and well integrated with local capacities.

To help fund the MDGs through private donations requires that the huge pool of charitable giving available in OECD countries be activated and guided towards development applications. Private donations are most popular in the United States, where they have hovered around 2 per cent of gross national product during the last two decades ($220 billion). By contrast, the OECD estimates total annual expenditure by philanthropic foundations at only $3 billion. There seems to be no reliable method for gauging the extent to which MDG financing might benefit from philanthropic efforts. Clearly, however, any attempt to raise the share of philanthropic money devoted to funding the MDGs needs an understanding, simply not yet established, of its determinants.

A poll of 26 US-based practitioners in small charitable organisations has shed some badly needed light on the barriers to raising the overseas (including the MDG) share of charitable giving (Humphrey, 2003). The poll unearthed the following barriers as particularly relevant:

— an inward orientation and lack of knowledge about the world and global issues in the perceptions of most US citizens;

— a widespread impression in the US public that the government provides a significant amount of money to the outside world so that there is no need for foundations to become involved; and

— fear of funding terrorism, especially relevant for potential individual donors, and — particularly for grassroots organisations — coping with the requirements of the Patriot Act.

Generally, poll respondents felt that the return on a dollar of grant is higher in poor countries than in the United States and, to the extent that these barriers could be at least partly removed by awareness campaigns, the inclination to spend for international causes should also be considerable in the United States.

While charity begins at home, efforts must be made that it does not stop there. The UN can make philanthropy's contribution to the MDGs more visible — including *vis-à-vis* the governments in donor countries, which might also help advocacy for a more favourable tax environment for charitable donations. The United Nations Fund for International Partnerships (UNFIP) was established in 1998 to promote and help build new alliances in furtherance of the Millennium Development Goals with a variety of organisations, including foundations and businesses; UNFIP also acts as facilitator of dialogues and resources.

Global Lottery and Global Premium Bonds

Proposals to establish a global lottery to fund UN development activities have circulated since the early 1970s. According to www.lotteryinside.com, the world gaming industry news site, the total size of world lottery sales was $126 billion in 2001 (Addison and Chowdhury, 2003); 2001 global lottery gross profit was $62 billion. How much of this could contribute to fund the MDGs would depend on the amount generated by new players (such as "development altruists"), on substitution away from other forms of gambling, and on the amount a global

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lottery would capture from existing lotteries. In US lotteries, for example, proceeds generally are divided between winning players (50 per cent), administration (20 per cent), and beneficiaries (30 per cent). Therefore, 30 per cent of lottery sales newly attracted by a global lottery could be used to fund the MDGs. It is impossible, however, to estimate how much new lottery sales could be attracted by a global lottery to fund the MDGs. This would depend on how the global lottery was constructed, as compared to competitors. Addison and Chowdhury (2003) summarise the sparse empirical evidence that lottery demand is stimulated by higher mean prizes, skewness toward very large prizes and low variance of the prize distribution.

A global lottery could function in two ways. National lotteries could run national versions of the global-lottery game or a single global lottery could be sold worldwide and run by one organisation. Instant products such as ticket lotteries ("scratch cards") and video lottery terminals require less organisational infrastructure than number games; for this reason they are a preferred option for MDG funding.

Global lotteries may face political opposition if they are seen to take money away from national charities (Andersson, 2003). Moreover, the incidence of lottery funding may be regressive; low-income groups spend a higher proportion of their income on lotteries than higher-income groups (the better-off gamble on the stock markets…). To the extent that MDG-funding lotteries compete successfully with established lotteries, more will be spent on gambling, reinforcing the regressive incidence of funding the MDGs this way. Another objection may be that, for religious or ethical considerations, gambling is not universally practised.

UNU-WIDER promotes a related but new funding idea. Addison and Chowdhury (2003) suggest a global premium savings bond, modelled on similar schemes in Bangladesh, Ireland and the United Kingdom. A premium bond is like a lottery ticket in that the return depends on a random prize draw, but otherwise it is a bond, hence a savings instrument where the capital is not at risk. Annual premium bond sales presently run at $34 billion in the United Kingdom. The authors suggest a single organisation to sell and administer the bonds; the bond itself is a savings instrument, but the rate of return has a random element. In the United Kingdom, for example, people buy savings bonds, each with a unique number that is entered every month in a prize draw where a random number generator picks the winners. Unlike in pure lotteries, investors in a global premium savings bond never lose their initial investment, although the return on that investment depends on luck. The authors hope that such bonds might meet strong demand in the growing market for ethical investment by both institutional and individual investors.

Unlike a global lottery, which can be administered in either national versions or in a single international version, global premium bonds are best issued and followed by a single organisation, preferably in a basket of major currencies, such as the IMF's Special Drawing Rights. Addison and Chowdhury envisage that the bond proceeds would be used for funding the MDGs. They discuss one drawback of their proposal, namely that bond proceeds are best matched by loans rather than grants. It remains fairly unclear, however, how bond investors would be protected against the possibility of widespread default by countries that receive the proceeds of the bond issues. Alternatively, only what remains from the lottery return component (after payment to the prize winners and cover of administrative cost) could be used. While that would amount to much less funding for the MDGs, it could be provided in the form of direct cash outlays[6]. The WIDER proposal cannot serve as a stand-alone proposal from a revenue perspective, but it can usefully complement other proposals, such as the International Finance Facility, which also would be built around bond issues.

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Topic-specific Global Funds

Topic-specific global funds — such as the Global Fund to Fight AIDS, Tuberculosis and Malaria (the "Global Fund", see Box 4.2) or the Global Environment Facility — are administered and financed by multi-actor coalitions of governments, international organisations, the private sector and civil society. The advantages of such funds, also called "vertical funds", are that they can serve as focal points for generating additional public and private resources to address urgent global problems. Such funds have a long history, starting with UNICEF, established in late 1946, which currently has an annual income of $1.5 billion, of which a third is contributed by the private sector. Their focus on a particular issue or on a small set of closely related issues can help draw public attention to specific problems and mobilise donor resources. Nevertheless, concern has been voiced that they may also result in a less coherent response to global problems, duplicate existing structures and be weak in terms of democratic accountability.

Box 4.2. **The Global Fund to Fight Aids, Tuberculosis and Malaria**

First proposed at the July 2000 G8 Summit in Okinawa, Japan, and endorsed by the UN General Assembly Special Session on HIV/AIDS in June 2001, the Global Fund has collected and distributed a large amount of money to fight AIDS, tuberculosis and malaria since its inception in January 2002. Yet the Fund has been the subject of very little analysis. It defines itself as a public-private partnership to serve governments, NGOs and international agencies and as a financing instrument, not an implementing agency. The mandate of the Global Fund is to raise and disburse large amounts of additional resources to reduce the impact of the three diseases.

The Global Fund's Board of Directors acts as its ultimate decision-making body. The 23-member Board is composed of both voting and non-voting members. Its 18 voting members form two groups: nine donors (including seven governments, a foundation representative and a representative of the for-profit private sector) and nine recipients (seven governments and two non-governmental organisations, one from the developing world and one from the developed world). A Technical Review Panel (TRP) is charged with reviewing all proposals to ensure that they are scientifically and technically sound. The Panel is an independent group of 17 experts in the three diseases and in the fields of prevention, clinical care, health education and health economics.

Proposals are submitted through an inclusive, broad-based partnership in each country, referred to as a Country Co-ordination Mechanism (CCM), which brings together national and local governments, NGOs and the private sector. NGOs can submit proposals directly to the Fund in countries where a CCM either does not exist or does not function adequately due to unusual circumstances (such as conflict, natural disaster or questions of government legitimacy). All proposals must be technically and developmentally sound, must demonstrate that added resources will bring results and must meet high programmatic and financial accountability standards. The Technical Review Panel reviews all proposals and makes funding recommendations to the Board. The Board makes all final decisions on grant awards. Priority for funding is given to proposals from countries and regions with the greatest needs, including the highest burdens of disease and poverty, and those at high risk for disease emergence. The Board stipulated that no funds for any projects would be disbursed until satisfactory financial, monitoring and evaluation controls have been agreed upon for each programme.

Source: http://www.theglobalfund.org/.

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While the Fund has collected an impressive "war chest" against communicable diseases in record time, the question remains whether these figures are "additional" resources and whether they are sustainable[7]. The original intent for the Global Fund was to funnel non-profit and private-sector donations into a single streamlined process, rather than to create many separate bureaucracies to deliver aid. Looking at the pledges in greater detail, the private sector has made very few commitments apart from the Bill and Melinda Gates Foundation, which has played a central role in the fight against AIDS for some time and contributed several $100 million to the Fund. To the extent that the Global Fund fails to attract funds from private sources, the question arises whether its important contributions are based on shifts within donor budgets rather than additional ODA.

Another concern relates to the sustainability of resources collected by the vertical funds. While the Global Fund has mobilised impressive amounts, uncertainty about where the money will come from in the future can strain scarce secretariat resources and divert attention towards fund-raising. The *Financial Times* quotes Global Fund officials as saying, "They are beginning to feel a little like itinerant beggars, spending a disproportionate amount of their time wandering the globe trying to squeeze money out of recalcitrant donor governments"[8].

Disbursement speed may well militate for global funds rather than more traditional donor instruments in the funding of global public goods and the MDGs. The World Bank spends against statements of expenditure by recipients, while the Fund advances money in initial instalments, followed by additional disbursements against periodic requests. The procedure allows the Global fund to provide speedy upfront disbursements. The Global Fund aims at short intervals between initial calls, approvals by its review panels, signatures and finally disbursement. The lag between calls and approvals so far has averaged four months, with another four between approval and signature, then another month to disburse the funds.

Through broadened public-private partnerships (PPPs), the Global Fund aims at raising the effectiveness of country-driven programmes. As grants are disbursed to a wide array of recipients — not only to governments (50 per cent after rounds two and three), but also to NGOs (29 per cent), the private sector (5 per cent), faith-based organisations (4 per cent), academic organisations (3 per cent), community-based organisations (3 per cent) and people with HIV/malaria/tuberculosis (3 per cent) — it claims that PPPs are broadened compared with common donor practice that tilts towards directing funds through governments.

Two major criticisms have been advanced against PPPs, which some see as an attempt by governments to privatise aid and to "flee" their ethical responsibilities: that they generate windfall profits to the private sector and that they foster so-called "project islands", i.e. an incoherent and uneven distribution of project coverage[9]. An unpublished consultancy report for the German BMZ found PPPs characterised by important windfall profits, as private firms get subsidies on investments they would have made anyway.

Financial Engineering

This section lists three proposals: one aims at transforming donor commitments into existing financial-market instruments in order to frontload ODA for the MDGs; the second targets the IMF's Special Drawing Rights in order to redistribute funds from rich donor

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countries to poor countries that qualify for MDG funding; and the third suggests leverage of private funds in high-risk countries by both local and foreign investors through stimulating the use of public guarantees from low-risk donor countries. This chapter (see the summary in Table 4.1), argues in favour of both the International Finance Facility — especially to speed up ODA to fund the MDGs — and a better "scoring" of public guarantees as aid to stimulate risk-taking by both local and foreign investors for infrastructure finance.

The International Finance Facility (IFF)

The IFF, a joint UK Treasury/DFID proposal[10] to increase and frontload development aid, published in January 2003, aims at bridging the gap between the resources already pledged and those needed to meet the MDGs by 2015. The Facility would be built on long-term donor commitments comprising a series of pledges (each lasting 15 years) for a flow of annual payments to the IFF. Annual commitments would start from the $15-16 billion of aggregate Monterrey and post-Monterrey additional sums pledged and would rise by 4 per cent (in real terms) per year. Each pledge would be a binding commitment in order to provide security against which investors could lend. Against these pledges, its assets, the IFF would issue bonds in its own name, its liabilities. For prudential reasons, therefore, the IFF will have to limit the degree to which the donor commitments may be levered; at each disbursement, the Facility will allocate to it a fixed proportion of the donor commitment, taking into account the prevailing cost of long-term debt for the IFF in the donor country's currency and the leverage limit.

The Facility would thus frontload long-term aid flows so that the MDGs could be financed and reached by 2015. It would serve as a temporary finance facility replenished at regular intervals; at each replenishment, donors would make a fresh series of annual long-term funding pledges (each lasting 15 years) as the basis for further borrowing. After raising and disbursing funds for 15 years, the repayment phase would continue for another 15 years. The Facility would be wound up by 2030. The funds raised by donor commitments and by market borrowing could be quickly disbursed through existing mechanisms in the form of grants rather than loans. The IFF will not disburse funds directly to recipient countries, but will instead provide funds for disbursement (subject to conditionality) through existing aid delivery channels, which would act as agents on behalf the IFF.

Some overarching principles would have to be met before funds from the IFF would be disbursed: funds would target low-income countries and be used in an untied fashion for poverty reduction and other MDGs, most notably education and health. Money could also be used to fund additional debt relief. One big advantage of the IFF, given that 2015 is quickly approaching, is that it is a concrete proposal that would deliver the necessary increase in aid to meet the MDGs. Crystallising the political commitments made by donors and providing a stable, predictable source of aid that would enable donor countries to factor aid into their budget planning, the IFF would allow a critical mass of finance to be used simultaneously for a range of projects and an improvement in co-ordination between donors. Nevertheless, the assumptions on which the IFF is based, namely *a)* the continuous commitment of the donor community towards the implementation of the IFF during the life of the Facility and *b)* its heavy reliance on political co-ordination among donor countries, must be questioned (Mavrotas, 2003).

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A key advantage of the IFF proposal is its revenue-raising potential. The Facility could double existing ODA from $50-100 billion per year during the crucial period 2010-15. Another advantage is that it accelerates grant finance rather than loans to recipient countries participating in it. Another positive potential lies in the requirement for donor co-ordination, avoiding the need for poor countries to court myriad donors and deal with different regulations.

A weak spot is that it destabilises the time profile of aid commitments. The IFF proposes to borrow funds to achieve a faster increase in aid in the short term at the cost of reducing future aid when the funds have to be repaid. Growing pension and social security burdens in ageing OECD countries, for example, mean that the opportunity cost of aid will rise in most donor countries; hence, a continuous commitment towards the IFF might be difficult to sustain. Heller and Gupta (2002) therefore develop a proposal exactly opposite to the IFF: donors should deposit contributions today into trust funds, to be used to fund expenditures on behalf of the poor countries over a longer time horizon as absorption capacity increases. This idea needs more thorough analysis to ascertain whether it conflicts with constitutions in donor countries as it shifts a financial burden from current governments (and generations) to future ones.

A Development-focused Allocation of SDRs

Special Drawing Rights, or SDRs, are a form of money that the International Monetary Fund's Board of Governors can create by crediting accounts of the Fund's member states at an exchange rate determined by a basket of major currencies. Countries that run current-account deficits can transfer their SDRs to surplus countries, and the latter must provide them with convertible currencies in exchange. The idea of issuing SDRs for development is as old as it is untried — it goes back at least to the 1970 Brandt Commission's report (Aryeetey, 2004); it has recently been revived by George Soros (2002)[11].

Mr. Soros proposes that the developed countries create new SDRs to raise the supply of "global public goods". Rich countries would donate their SDRs to trust funds managed by a board of "eminent persons" (not public authorities); the rich countries would pay the interest on the SDRs. The board would identify a menu of worthy projects with global or regional benefits, and rich-country governments would select from it the options they wish to support. Once the SDRs are put to use (i.e. when the trust funds receive hard currency), the rich-country governments would charge their public budgets to pay in their own hard currencies. The Soros proposal does present two difficulties:

— linking SDR allocation to finance the MDGs requires a change in the Articles of Agreement of the IMF, which has to be ratified by 100 IMF member countries with 85 per cent of the voting power. This has so far never happened; and

— redistribution of SDRs involves lost interest income to the SDR provider; the SDR rate of interest is the weighted average of the short-term Treasury bill rates of France, Germany, Japan, the United Kingdom and the United States (currently 2.25 per cent a year).

In the past, even modest allocations of SDRs have been opposed on the grounds that they would be inflationary. Today, in the face of the global macroeconomic climate, excessive foreign exchange holdings by emerging markets for fear of financial crises and the need to

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expand liquidity to support the expansion of international trade, this argument would be harder to make. At times when Asia's central banks have accumulated enormous foreign-exchange reserves to stay competitive in view of the declining US dollar, the Soros proposals could be extended to those very countries. In fact, the dollar peggers might face a higher incentive than dollar floaters (such as the euro zone countries) to buy SDRs as a promising alternative to low-coupon (and depreciating) US treasury bonds, which are usually bought by central banks when they buy dollars against selling their own currencies. Rather than providing cheap savings to the US public budget, such countries might consider the potentially lucrative alternative of investing their rising reserves in SDRs, which entail a lower devaluation risk.

Public Guarantees

The Camdessus Report "Financing Water for All", issued in March 2003 by the World Panel on Financing Water Infrastructure, has emphasised the importance of public guarantees to stimulate private investment, local and foreign. (See also Box 4.3 on water issues). This emphasis has to be seen in the context not just of the Millennium Development Goal of clean water supply, but in a broader context of infrastructure investments. Such investments are characterised by high capital intensity, long gestation periods and, where they are ODA financed, front-loading. The inherent sovereign risks are not covered by commercial banks, at least not for long maturities in the poorest countries. The Camdessus Report makes the following specific arguments:

— As a general principle, ODA should be used to facilitate private flows instead of replacing or discouraging them. This is a bit analogous to food aid, where the availability of food for free can discourage local food producers. Likewise, the availability of grant aid can "crowd out" commercial lending and discourage water authorities from becoming more financially self-sustaining. Here guarantees are the better instrument of ODA as catalysts to mobilise other flows and empower local players.

— Guarantees deserve proper reflection alongside other forms of official assistance in the ODA statistics of the DAC. The current reporting conventions reflect guarantees only when they give rise to actual disbursements — for instance, after default by recipients. The World Panel on Financing Water Infrastructure believes that this does not fully reflect the real size of the contingent liabilities accepted at a given moment by a donor country. This is being examined by the DAC Working Party on Statistics.

— Multilateral financial institutions (MFIs) could lend more without a proportionate increase in their borrowings or callable capital if certain constraints were relaxed. A number of MFIs cannot lend without sovereign guarantees, which complicates lending to sub-sovereign entities that cannot avail themselves of government guarantees. Moreover, guarantees by the MFIs are "scored" as if they were loan exposure for 100 per cent of the amount, discouraging their use through the current practice of capital provisioning.

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Box 4.3. **OECD's Contribution to the MDG "Clean Water and Adequate Sanitation"**

An important MDG is the goal of halving by 2015 the proportion of people without access to safe drinking water and basic sanitation. The new Secretary General of the OECD, Angel Gurría, has designated water as one of his three areas of emphasis for the OECD work programme. He has furthermore identified three areas where he thinks the state of knowledge is insufficient: pricing, financing and allocation mechanisms.

The OECD has developed significant capacity on a range of water-related issues, including water pricing and financing, water resources management, water and climate change, water for agriculture, water and poverty reduction, decentralisation and local infrastructure, regulatory reform and network utilities and water safety and health. The crucial issue of the financing of water, of particular interest to the UN Secretary-General's Advisory Board on Water and Sanitation (UNSGAB), is addressed in the work undertaken under several OECD committees.

The DAC has regularly published reports on aid flows to the water supply and sanitation sector, including a publication for the recent World Water Forum in Mexico. DAC work on pro-poor growth and infrastructure has specific sections and recommendations on water and indicates how countries can increase funding for improved water services through growth and income generation. The 2007 edition of the *African Economic Outlook* a joint annual publication of the OECD Development Centre with the African Development Bank, has a special thematic focus devoted to access to water. The Agriculture Committee has been looking at various aspects of water use in agriculture, including pricing, monitoring and policy recommendations to improve the efficiency of agricultural water use. Its 2007-08 programme of work aims to improve estimations of irrigation water subsidies and on approaches for sustainable water supply and use in agriculture is planned.

The Investment Committee is developing principles for enhancing and maximising the benefits of International Investor Participation in Infrastructure, and there is a proposal to develop guidance to apply these principles to the water sector in 2007-08. Finally, the Economic Policy Committee has developed and implemented an extensive work programme on financing water supply and sanitation in a regional co-operation programme with the countries of Eastern Europe, Caucasus and Central Asia (EECCA). This included the holding of two Ministerial Conferences in 2000 and 2005 and the development and implementation of several capacity-development tools to strengthen financial planning in national and local administrations as well as in water utilities. There is a proposal to extend this work beyond the EECCA region and to do additional work on water pricing in OECD and non-OECD countries in 2007-08.

Members of the UNSGAB, OECD member countries and the OECD Secretariat met on 11 July 2006 to explore possible collaboration to contribute to the achievement of the MDGs and the Johannesburg Plan of Implementation on water and sanitation. The exchanges demonstrated that the two institutions have many shared concerns in achieving the MDG on water, for example identifying sustainable financing mechanisms for water and sanitation; encouraging the improvement of the quality of development co-operation; ensuring the relevance of their work in this sector; and better capacity to disseminate and spread best practice and to influence policies in member countries and developing countries. The joint meeting strengthened mutual understanding, helped identify synergies in the work of UNSGAB and the OECD, increased commitment to work together to achieve international goals on water and sanitation and identified entry points for collaboration.

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The broader development argument to strengthen the role of public guarantees resides in: *i)* the stimulus it provides for risk taking by both local and foreign residents in high-risk environments; *ii)* the allocation of scarce local and added foreign savings to projects with potentially high social returns; and *iii)* fostering a sense of ownership in the recipient countries (Winpenny, 2005). Such guarantees, however, must be tailored to avoid excessive risk taking (moral hazard), political interference by well-connected elites and lobby groups (rent seeking), unsustainable debt burdens and misallocated resources. An important conclusion to emerge from a review of operational experience of the IFC — the International Finance Corporation, the World Bank's private-sector arm — is that the efficiency of private infrastructure provision depends heavily on the policy and regulatory environments created by governments. At each stage of a project's life cycle (usually include bidding, negotiation, financial closure, construction and operation), government agencies play a fundamental role that can mean the difference between success and failure. The quality of the enabling environment, perhaps more so than country risk or income levels, will determine much of the pace at which private infrastructure is implemented in the coming years.

In the wake of the World Summit on Sustainable Resources held in Johannesburg in 2002, donors have introduced a range of initiatives to facilitate the mobilisation of finance from domestic and international financial markets. Among them are extended partial credit-risk enhancements to lever additional debt finance into otherwise non-creditworthy sub-sovereign investment opportunities in low-income developing countries. For example, the Emerging Africa Infrastructure Fund (EAIF), a PPP debt fund making long-term loans to private infrastructure projects in sub-Saharan Africa, is now in operation. It uses donor equity as a risk cushion to leverage more than twice the amount of senior/subordinated debt from private lenders in support of African private-sector infrastructure projects. GUARANTCO, the UK Local Currency Debt Guarantee Facility, addresses domestic debt market failure and thereby facilitates long-term local-currency debt issues to finance private infrastructure opportunities. Just like the existing multilateral and bilateral risk-insurance schemes, these agencies and their guarantees constitute important contingent liabilities for DAC donor governments.

Contingent liabilities will be recognised under cash accounting only if and when the contingent event actually occurs and a payment is made. Even under accrual accounting, many contingent liabilities would not be recognised as liabilities unless quantifiable and judged likely to require a future payment by the government. Major contingencies should be quantified when possible. Contingent liabilities can in principle be accounted for by multiplying the *ex ante* default probability by the amount guaranteed and the net present value over the guarantee maturity. Disclosure of contingent liabilities in the annual budget, the mid-year report to the legislature and the final accounts is included in the OECD best practice guidelines. These should be classified by major category, and information on the past calls on the government to meet contingent liabilities should be disclosed[12]. The IMF Manual on Fiscal Transparency stipulates that in a portfolio of similar contingent liabilities, such as a large portfolio of loan guarantees with similar characteristics, there may be sufficient reliable historical data on loan loss experience to allow a reliable estimate of the expected cost of the guarantee programme. This estimate might then be appropriated as expenditure in the budget. It can also be envisaged, as suggested by Daniel Cohen (2002), that contingent liabilities like public guarantees could be handled by setting up an independent trust fund that itself will have limited liabilities. Such funds would be endowed with capital that corresponds to the size of public guarantees; the capital would be raised by an equivalent amount of debt.

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A Synopsis

Comprehensive discussion of the most prominent proposals for new forms of financing the Millennium Development Goals can lead to the conclusion that the most straightforward way to avoid under-funding the Goals is to raise ODA. Given the recent post-Monterrey donor pledges and initiatives, the extra effort needed to double ODA is no longer out of reach. On the other hand, no proposal for an innovative approach is without at least one serious side risk, as discussed in the preceding sections. Moreover, whether through traditional or innovative approaches, funding the MDGs will imply a budgetary problem: the transfer to poor countries must ultimately be borne by the private sector in the donor countries. Yet there are some innovative approaches to funding the Goals that could entail considerable "double dividends".

Table 4.1 at the end of this chapter provides an overview of the innovative funding sources that the chapter has highlighted. Among the most popular global tax ideas — global environmental taxes, the Tobin tax on currency transactions and the global arms tax — the first might satisfy the normative criteria stipulated by public finance orthodoxy. It is also a tax with revenue potential high enough to finance the Goals by itself, and it has several fringe benefits, because environmental taxes help reduce pollution and do not entail distortions to work incentives. Nevertheless political opposition has so far stopped environmental taxes on a global scale; however, some like-minded countries have been making progress with a solidarity levy on air transport under the leadership of the Lula Group.

Among the nine proposals discussed above, the International Finance Facility suggested by the UK Government, perhaps in combination with a Global Premium Bond as advocated by UNU-WIDER and the strengthened use of public guarantees as called for by the Camdessus Report on water finance are the preferred options for new development finance in view of the looming 2015 deadline. They muster important political support, but not yet unanimity. The IFF would provide predictable flows and raise the credibility of existing donor commitments towards the Goals. Global funds with a focus on specific Millennium Development Goals can help draw public attention to specific problems and mobilise donor resources. Public guarantees help stimulate risk taking by both local and foreign residents in a high-risk environment, which works towards some of the Goals, most notably in infrastructure. The Global Premium Bond, as suggested by UNU-WIDER and practised so far on a local basis in the United Kingdom, Ireland and Bangladesh, and the creation of Special Drawing Rights, as recently suggested by George Soros, could provide useful complements to the IFF.

Policy makers may want to pursue a combination of innovative funding approaches. A menu approach will stimulate donor generosity as existing tax schemes and institutions shape preferences with respect to the various forms of funding. More choice, then, should stimulate the supply of funding by appealing to the comparative preferences of donors. Some options, particularly for global taxes, might be feasible when operated on a regional level (as suggested, for example, by the Spahn proposal for currency transaction taxes). A combination of approaches will also be better able to cater to the most urgent needs in the recipient countries. For example, the IFF, relying on traditional disbursement channels, arguably suits the low-income countries more than a strengthened role for public guarantees, whose development impact would be stronger in poor countries with intermediate risk levels.

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Table 4.1. **New Sources for Development Funding**

TYPE	GLOBAL TAXES		
Source	Global "Dirt" Tax	Tobin Tax	Global Arms Sales T
Brief description	Specific reference to a tax on use of hydrocarbon fuels according to carbon content.	Tax on foreign currency transactions (spot, forward, future and swap markets), possibly with dual rates (Spahn tax).	Not specified by proponents presumably on arms covered Register of Conventional Arm
Revenue potential	$180 bn per year if imposed worldwide at a uniform gasoline tax of 0.01euro per litre ($.048 per gallon) . Limited to imposition in high-income countries, figure drops to $61 bn.	$17-19 bn per year with a tax equivalent to 0.01 per cent on global turnover of foreign exchange; $31-33 bn for a rate at 0.02 per cent. Higher tax rates might yield less as tax base is likely to shrink disproportionately.	$2.5 bn max. per year for a ta cent of arms sales if documer were not pushed into illicit tr taxation.
Degree of additionality to traditional development finance	High, but important administrative costs involved. National taxes may be affected, hence the public budget.	High, but important administrative structure costs involved.	High. UN Register of Convent could be used for administrat
Other benefits	Environmental, and allocational as external cost of final energy uses internalised.	Reduces foreign exchange volatility (?)	Reduces arms trade (?)
Major costs and obstacles	The United States and other countries could resist carbon taxes.	Mobile tax base – tax may destabilise exchange rates.	High tax rate elasticity as illic important.
TYPE	PRIVATE-SECTOR CONTRIBUTIONS		
Source	Increased Private Donations	Global Lottery and Premium Bonds	Global Funds
Brief description	Tax incentives, Global Funds, corporate giving, Internet measures to raise charitable donations.	Lottery proceeds to be shared between national lotteries and UN fund; bond issue with lottery prizes instead of interest; capital value preserved.	A public-private partnership governments, NGOs and inte agencies, and a financing inst an implementing agency, wit mandate to raise and disburs amounts of additional resour
Revenue potential	No estimates so far. Total charitable giving sizeable, e.g. 1.5 per cent of GNP in the United States. Revenue potential large; depends on degree of giving for development rather than other purposes, and on tax (income, inheritance) incentives.	No estimates so far. Lottery could reach $6 bn per year.	Considerable. Example: The to Fight Aids, Tuberculosis a has received $4.9 bn in comm through 2008 in 1½ years of e
Other benefits	--	--	Awareness raiser.
Major costs and obstacles	Unpredictability, as dependent on individual, voluntary, action.	Competition with national lotteries. Diversion of funds for "needy" projects in donor countries. Regressive 'tax' impact.	May duplicate existing ODA s DAC harmonisation principle respected.

Table 4.1. (contd.)

Type	Financial Engineering		
Source	International Finance Facility	Creation of SDR	Public Guarantees
Brief description	Long-term pledges of a flow of annual donor funding would leverage more funds from private sources (UK Treasury/DFID) through bond issues.	Periodic creation of SDRs, with donor countries making their SDR allocation available for MDGs (Soros Proposal).	Use of risk mitigation instru offered by public (local or in bodies; covers guarantees, le insurance products available contractual, credit and forei risks .
Revenue potential	$50 bn for 2010-15, building up from 2006 and falling to zero by 2020. Provides predictable flows with agreed disbursement mechanism.	$25 bn, depending on periodicity and political willingness for annual allocation of SDR to poor countries.	No evidence yet other than a
Degree of additionality to traditional development finance	Can crowd out traditional development finance.	Can crowd out traditional development finance.	High as private risk-taking in
Other benefits	Could raise credibility of donors' commitments.	Counteracts deflationary pressures that arise for excessive FX holdings of crisis-prone countries. Can integrate Asian mega-reserve countries into MDG funding.	Levers private investment fro foreign agents to infrastructu sense of ownership.
Major costs and obstacles	Requires sufficient donor countries to sign up, and to continue to make commitments. Not in line with dynamic pattern of ability to pay in donor countries. Constitutional concerns.	Hard to ratify by 100 IMF members with 85 per cent of voting power. Lost interest income to SDR providers. Could be inflationary (?).	Excessive risk taking (moral h political interference by well- elites and lobby groups (rent unsustainable debt burdens.

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Notes

1. These Goals are: *i)* eradicate extreme poverty and hunger; *ii)* achieve universal primary education; *iii)* promote gender equality and empower women; *iv)* reduce child mortality; *v)* improve maternal health; *vi)* combat HIV/AIDS, malaria and other diseases; *vii)* ensure environmental sustainability; and *viii)* develop a global partnership for development. Targets and indicators have been defined for each of them. For details, see www.unmillenniumproject.org.

2. The estimates sum costs of the fight against communicable diseases ($7-10 billion), of primary schooling ($10 billion), of reducing infant and maternal mortality ($12 billion) and of halving world poverty ($20 billion). See also Devarajan *et al.* (2002), who estimate that an additional $40-60 billion in ODA is needed each year to meet the goals in 2015.

3. This study has benefited considerably from the project "Innovative Sources for Development Finance" under the direction of Tony Atkinson (2003) at the UN World Institute for Development Economics Research, WIDER. Atkinson says that he had not felt constrained by political obstacles to the various options to finance MDGs. He argues that it is the role of economists to lay out the options, their costs and their benefits, and that it falls upon policy makers to make the respective choices. This position may conceive the economist's role too narrowly. A full policy analysis, to be effective, should include political and administrative feasibility as well. See, for example, the Sagasti and Bezanson (2001) study for Sweden's Ministry of Foreign Affairs.

4. Embassy of Brazil in London – Meeting of Presidents Lula, Chirac, Lagos and UN SG Annan, 02/02/2004.

5. Nissanke arrives at a somewhat lower revenue potential than Spahn because her estimates include consideration of the recently observed shrinking of the tax base.

6. Particularly for highly indebted countries with a heavy susceptibility to shocks and hence low debt tolerance, aid should be provided in the form of grants or direct cash outlays.

7. In principle, the issue can be investigated on the basis of the DAC Creditor Reporting System data base, but empirical research has to wait for the 2003 figures (the first year when the Fund was fully running). The working hypothesis would be that there is no structural break in the donor data on health-related ODA if the hypothesis of additionality is to be confirmed. Another empirical approach would be on the recipient side, where spending data on communicable diseases (possibly on the basis of data provided by the World Health Organisation) could be checked for a structural break.

8. Alan Beattie, "Agencies Distracted by Worries About the Future", *Financial Times*, Special Report Business and Aids, 28 November 2003, p. 4.

9. See, for example, the debate on PPPs in the German development review *Development & Cooperation*, June 2003.

10. For further details, see the Technical Note provided by the UK Treasury and DIFD under www.hm-treasury.gov.uk/media/35BA7/IFF2003.pdf. See also Mavrotas (2003) for an excellent description and analysis.

11. Ariel Buira, formerly Deputy Governor of the Central Bank of Mexico and currently Director of the G24 Secretariat, had advanced a similar proposal at the International Conference on Financing for Development in Monterrey, with the aim of using SDR allocations as a counter-cyclical policy (Buira, 2002).

12. OECD Best Practices for Budget Transparency (PUMA/SBO(2000)6/FINAL) states on contingent liabilities: "Where feasible, the total amount of contingent liabilities should be disclosed and classified by major category reflecting their nature; historical information on defaults for each category should be disclosed where available. In cases where contingent liabilities cannot be quantified, they should be listed and described."

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Part II

Implications for Policy Making in Recipient Countries

Chapter 5

New Actors in Health Financing: Implications for a Donor Darling

Abstract

Bilateral and multilateral donors still play a prominent role, but other actors have entered the field. This new multiplicity of financing options has provided alternatives for developing countries in financing achievement of the MDGs, and it has also brought major challenges. This chapter, drawing on the experience of Ghana's health sector, shows both. New sources of finance may have increased the overall financial envelope, but they have also brought monitoring and co-ordination challenges. Developing countries need stronger information systems to forecast flows and to plan with them. For more effective finance, they also need co-ordination mechanisms that include the new funders. Finally, in order to take ownership of their own development process, developing countries must find ways to improve inter-ministerial co-operation and to address mismatches between budgets and spending, as well as capacity gaps.

While awareness of global trends in development finance is relatively high (see Chapter 1), less is known about how these trends have translated into changes at the country and sector levels. Health financing in Ghana provides a useful case study. A politically stable, still largely aid dependent, low-income country, Ghana is a donor darling: its ODA-GDP ratio lies at around 12 per cent (2003) and ODA easily remains the dominant capital inflow. Moreover, the country's strong commitment to international endeavours to improve aid effectiveness shows that it considers aid a high priority[1]. The health sector has interest because the social sectors are an important target not just for ODA, but also for financial flows from new actors, including foundations and global funds. ODA for health and education, linked to the achievement of MDGs 2-6, rose by 68 per cent between 2000 and 2004 (OECD, 2006).

Health finance in Ghana offers evidence that even for a donor darling and even in a sector that benefits from large ODA volumes, new actors and flows of development finance are manifest. Following a short overview of health performance and policies in Ghana, this chapter examines the diverse sources of health financing, discussing the official budget of the Ministry of Health as well as other finance flows, and draws policy implications.

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An Overview of Health Performance and Policy in Ghana

Ghana pursues an agency model in the health sector, which separates policy making from service delivery. The Ministry of Health (MoH) is responsible for the overall health strategy and the monitoring of health outcomes; the Ghana Health Service (GHS) co-ordinates health care delivery and disease surveillance. The Ministry follows a five-year Programme of Work (2002-06 at the time of writing), which spells out long-term objectives, strategies and targets for the health sector. It aims at partnership with donors, other ministries, departments and agencies, the private sector, NGOs, communities and individuals. An update of the Programme is developed annually to integrate lessons learned and readjust policy objectives.

After "relatively good health outcomes for modest expenditure of resources" (*2003 Health Review*, MoH, 2004), more recent reviews of Ghana's health-sector performance have reported mixed results. Several improvements between 1997 and 2005 were encouraging: under-five malaria mortality rates declined, tuberculosis cure rates improved, the proportion of supervised births increased and the number of recorded Guinea Worm cases fell significantly. Nevertheless, the 2005 Health Review refers to "stagnation in health outcomes and service delivery volumes" (MoH, 2006). Essential health indicators like child and infant mortality rates remained stagnant, or even deteriorated. Hospital admission rates remained low, bed occupancy rates decreased and the ratios of doctors and nurses to population declined further. This may be a symptom of brain drain in the health sector, which reflects both the high reputation of Ghanaian health workers abroad and the difficulties faced in retaining them in the country (Quartey, 2006).

Apart from human-resource management, a major challenge for Ghana's health sector is the unequal distribution of health-care delivery across the country. There are severe disparities among regions and districts and between rural and urban areas in terms of care quality and access to services. As a result, diseases like malaria are significantly more prevalent in rural than in urban areas.

The recent stagnation in health indicators is particularly striking given exponential increases in the Ministry of Health's budget, which almost quadrupled between 2001 and 2005. As discussed below, problems clearly are not related to finance alone. The stagnation is remarkable also because the priorities set out in Ghana's health strategies appear to correspond well with the sector's major challenges. The Programme of Work identifies four main areas of intervention: Personal Emoluments, Administration, Health Services and Investments in Health Infrastructure. As confirmed by most of interviewees for this survey, the strategic documents prepared by the Ministry in co-operation with donors are generally of high quality and target the right challenges.

Flows and Actors in Ghana's Health Sector

Identifying and quantifying the variety of health finance flows is a challenging exercise. Where data are available, they are not collected or managed systematically; Ghana lacks a central entity responsible for these tasks. Accordingly, even the Ministry of Health acknowledges that its figures must be treated with care (MoH, 2006). Often, particularly for flows that bypass the Ministry's budget, data are not even available.

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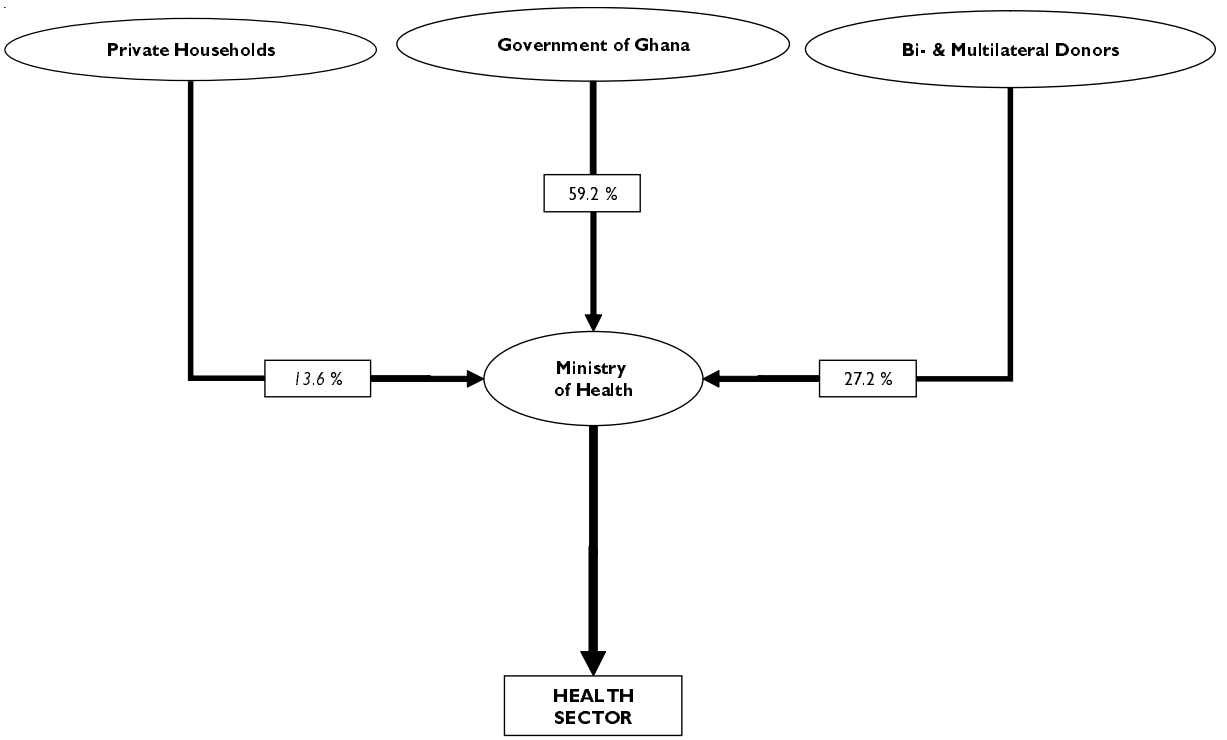
The information collected for this study comes from a variety of sources, including the Ministry of Health, the Ministry of Finance and individual donor organisations present in Ghana. Information on foundations, NGOs and other philanthropic organisations was gathered by contacting major players from each group. As these entities — especially foundations and other philanthropic organisations — often are not physically present in Ghana, a questionnaire was sent to their international headquarters.

Two Pictures of Health Finance in Ghana

As illustrated in Figure 5.1, the budget of the Ministry of Health distinguishes between three sources of funding: allocations from central government (which accounted for 59.2 per cent of the Ministry's total budget of $435 million in 2005), support from bilateral and multilateral donors (27.2 per cent) and internally generated funds from private households (13.6 per cent). The distinctions between these three sources, used in most government documents, paints a simplified picture that does not capture adequately the various financing channels and actors in Ghana's health sector (Figure 5.2). First, it is important to understand that funds from central government derive from different sources, including foreign ones. Second, donors use diverse channels to achieve health outcomes. Third, much private finance bypasses the Ministry of Health's budget. Finally, new actors such as foundations, global funds and NGOs have important roles to play in financing health.

Figure 5.1. **A Basic Picture: the Ministry of Health's Budget**



Source: Authors' illustration. Percentages are derived from MoH (2006*a*).

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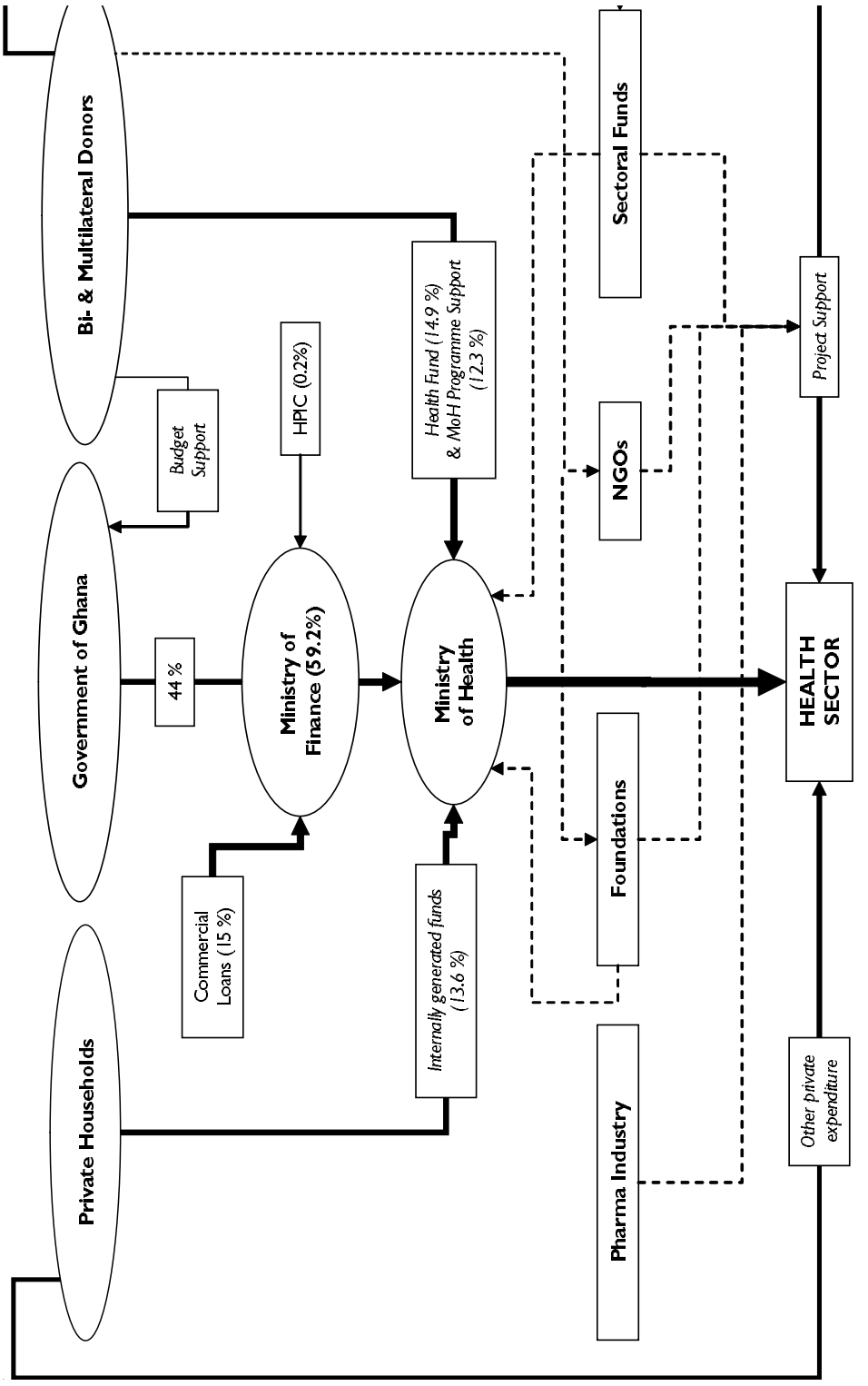
Figure 5.2. A Complex Picture of Actors, Channels and Flows



Source: Authors' illustration. Percentages are derived from MoH (2006*a*) and concern 2005.

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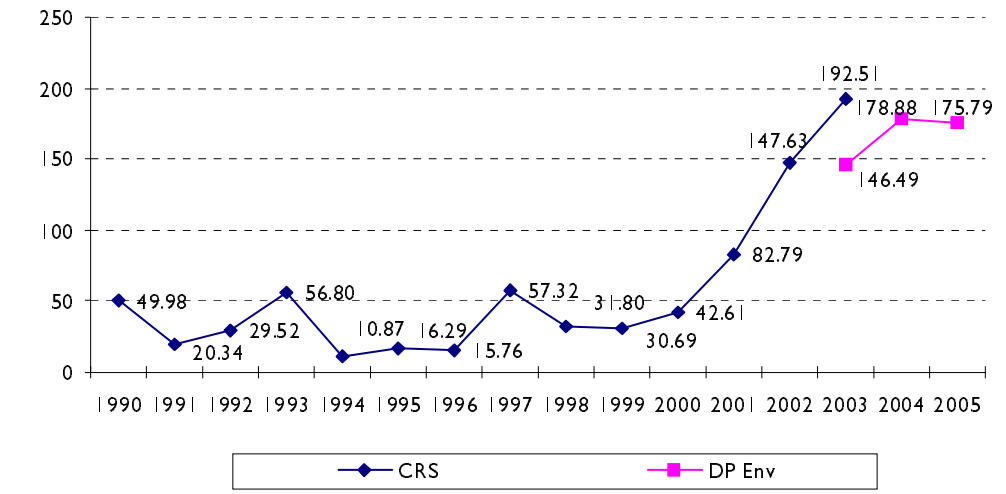
Funds from Central Government Derive from Different Sources

Rising allocations from central government have allowed Ghana to reach the 2001 Abuja Declaration target of allocating 15 per cent of the annual budget to improvements in the health sector. Derived mostly from national sources, these allocations are augmented by three foreign sources. To begin with, a number of donors (including the World Bank, the United Kingdom, the EU and the African Development Bank) have begun using general budget support as an aid modality through the Multi-Donor Budget Support (MDBS) initiative. As budget support has generally not been tied to specific sectors, measuring the extent of its use for health is practically impossible. The share of health finance channelled through central government is likely to increase in the future as several donors are currently considering a move to budget support. Other sources of central government allocations to the health sector include commercial lending (15 per cent) and debt relief (0.2 per cent, from the HIPC initiative).

Donors Use a Diversity of Channels for Aid

Donors have an important stake in the health care sector in Ghana, providing 27.2 per cent of the Ministry's budget. Their support for health increased six-fold between 1999 and 2003, from $30.7 million to $192.5 million (Figure 5.3). This can be seen as part of a larger global shift of ODA towards the social sectors, encouraged by the adoption of the MDGs and the Poverty Reduction Strategy Initiative of the World Bank.

Figure 5.3. **Official Development Assistance to Ghana's Health Sector**
($ million)



Source: Authors' calculation based on the DAC Creditor Reporting System (CRS) 2006 and Ghana Development Partner Envelope Overview (DP Env) 2006.

Note, however, that the volumes actually disbursed in Ghana may differ from those pledged and reported to the DAC. In 2003, for example, ODA disbursements confirmed by local development agencies lay significantly below DAC figures (Figure 5.3). The primary reason behind such discrepancies is that local agencies will not necessarily have figures for

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aid that is not channelled through or managed by them. This may include the remuneration of experts providing technical assistance in Ghana's health sector or scholarships to Ghanaian medical students at universities in donor countries.

Of the 19 donors active in Ghana's health sector between 2003 and 2005, the largest were the World Bank ($136.9 million), the Netherlands ($103.9 million), the United Kingdom ($71.4 million), the United States ($59.9 million) and Denmark ($37.8 million). With 60 per cent of overall ODA, bilateral donors delivered more aid than multilaterals. Most donors have moved to grants, with loans constituting only one quarter of ODA and delivered by only four donors — the World Bank, the Nordic Development Fund, Spain and the African Development Bank.

The bulk of aid for health is now delivered at the sector level. A Sector-Wide Approach (SWAp) includes all but two of the country's 19 donors, several of which are also pooling funds in a shared health account administered by the Ministry of Health. As Hecht and Shah (2006) argue, the Ghana Health SWAp constitutes a "prime example" of a health-sector support programme. Finally, aid for health is also delivered further downstream in the form of project support for local implementing organisations. Indeed, some donors such as the Japan International Co-operation Agency rely exclusively on this channel.

Private Financing Often Bypasses the Ministry's Budget

Health financing in Ghana is partly based on a cash-and-carry system, requiring users to pay for a proportion of health services out of their own pockets. Funds from private households in the form of user fees for drugs and other consumables constitute 13.6 per cent of the budget of the Ministry of Health. WHO figures suggest, however, that households' contributions through the Ministry's budget are dwarfed by those that bypass the budget. According to the WHO National Health Account initiative, between 1998 and 2004 private spending constituted around 65 per cent of total expenditure on health in Ghana compared with the public sector's contribution of 35 per cent (WHO, 2005).

Remittances, the single most important private capital inflow to Ghana, have become a major contributor to household income and indirectly to household expenditure on health. Figures from various sources differ greatly. For 2005, the IMF's Balance of Payments Statistics report private transfers at below $100 million, while the Bank of Ghana reports a vastly higher $1.52 billion. The latter figure is based on household surveys, which may provide a more accurate picture because it includes informal transfer channels not captured by the IMF. Although the use of private capital inflows cannot be determined with certainty, evidence from Ghana suggests that remittances help households cover emergency expenses, e.g. for major illnesses (USAID, 2005).

New Actors Have Begun Financing Health

Figure 5.2 shows new actors that have begun financing health in Ghana. Important flows now come from non-governmental organisations (NGOs), global funds, private donors, the pharmaceutical industry and private foundations as well as private commercial capital.

Non-governmental organisations (NGOs): As estimated by the National Coalition of Health NGOs, 400 NGOs are active in the Ghanaian health sector, with a large majority acting as implementing agencies for donor-funded projects. This means that their self-generated financial contribution to the sector is minimal. Nevertheless, their proximity to local institutions and marginalised individuals, especially in remote areas, renders them a crucial part of the health-

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care system. Faith-based NGOs such as the Christian Health Association of Ghana (CHAG) or the Catholic Secretariat, which represents the Catholic Church, are particularly important in Ghana.

Global Funds: Global funds have had a tremendous impact on health finance in recent years. The two largest global funds in the Ghanaian health sector are the Global Fund and the GAVI Alliance. Since 2000, the former has disbursed $42 million of the $93.4 million pledged in its grant agreement with Ghana, directing funds to fighting malaria (44 per cent), HIV/AIDS (36 per cent) and tuberculosis (20 per cent)[2]. The GAVI Alliance has disbursed around $20 million to Ghana since 2000, targeting hepatitis B (a total of $45 million pledged) and yellow fever ($4.5 million) in a multi-year immunisation plan (2002-06) and providing cash support for immunisation services ($3.6 million) and injection safety ($855 000).

Private donors: It is particularly difficult to determine an exact figure for private donations. They are neither recorded systematically nor captured by national statistics. According to the Ministry of Health, it administered a total of $176 million in financial and in-kind donations between 2004 and 2005. Although these numbers must be treated with caution, they show that private donations constitute a considerable inflow to the sector, especially bearing in mind that the Ministry's total annual budget (excluding donations) amounted to only $435 million in 2005. Moreover, some private donors use informal financing channels, meaning that the magnitude of Ghana's total receipts is almost certainly even larger. The Catholic Secretariat, for example, reported donations of $160 000 in 2004.

The pharmaceutical industry: Of the 14 pharmaceutical companies contacted, only one (Pfizer) provided details of programme support through in-kind contributions. In 2005, the company delivered $1.6 million worth of Zithromax® to fight trachoma (International Trachoma Initiative) and $320 000 worth of Diflucan® to fight opportunistic infections, i.e. infections that predominantly affect people with poorly functioning or suppressed immune systems (Diflucan® Partnership Programme). Pfizer also engages in Ghana through the Pfizer Foundation, which provides grants for training and capacity-building activities in the health sector. Other pharmaceutical industry activities have been captured by the International Federation of Pharmaceutical Manufacturers and Associations (IFPMA, 2004 and 2005). Thus, GlaxoSmithKline supports malaria prevention in Ghana through the African Malaria Partnership and Merck & Co. has supported the dissemination of health-care materials, together with the International Council of Nurses and Elsevier Science. Finally, Abbott Laboratories and Boehringer Ingelheim have donated Viramune® and Determine® within the framework of their joint initiative for the Prevention of Mother-to-Child Transmission of HIV.

Private foundations: Information on the activities of foundations in Ghana remains incomplete. Among the eleven foundations contacted, the Gates Foundation appears to be the largest sponsor of health-related projects. It granted $16.4 million between 2000 and 2005[3]. The Rockefeller Foundation reports $3.4 million in grants to Ghana between 1999 and 2005, including projects by the Ministry of Health, the Forum of African Women and the University of Ghana. European foundations are also gaining importance. The UK-based Wellcome Trust, for example, granted $903 000 to Ghanaian health projects between 2000 and 2006.

Private commercial capital flows: Like many other low-income countries, Ghana has not yet attracted large amounts of private commercial capital. Although the importance of Foreign Direct Investment (FDI) is gradually growing, these investments have predominantly concentrated on the mining and manufacturing industries, with no investment projects identified in the health sector. Commercial bank loans, on the other hand, are important in financing health infrastructure projects. In 2005, they constituted 15 per cent of the total budget of the Ministry of Health.

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Policy Implications: Learning from Country Evidence

Clearly, even low-income countries with high ODA-GDP ratios can experience diversification of capital flows. Such a diversification requires greater consideration in policy planning and implementation. Drawing on experience in Ghana, one can highlight three urgent challenges for developing countries and donors: strengthening information systems, improving co-ordination mechanisms and building developing-country ownership.

Strengthening Information Systems for Better Planning

In order to craft effective policies and plan with longer time horizons, developing-country governments require reliable and predictable information on development finance flows. The growing importance of new funders has increased the need for an information system that tracks both conventional and new flows. The aid community has already recognised the potential value of better information on ODA disbursements. In recent years, donors have been called upon to make their aid more predictable by extending commitments over longer time horizons and linking disbursements to more transparent performance indicators (Chowdhury and McKinley, 2006). Preliminary results from a DAC Survey indicate that a majority of DAC donors is now in a position to discuss multi-annual financial envelopes at the country level. Yet these donors account for only 25 per cent of total ODA (Carey, 2006). The evidence from Ghana is encouraging. Ghana's health SWAp has managed to align donor commitments with the Programme of Work of the Ministry of Health over a five-year period.

Global funds appear to be following suit. Several are providing more predictable financing, even though their own budget situations can be volatile because replenishments rely heavily on funding from aid donors. The GAVI Alliance, for instance, can make five-year funding commitments, but it also applies a sunset clause, which means that after five years funding may cease, leaving developing countries with exorbitant costs if they want to continue related programmes. In another sector, the Global Environmental Facility (GEF) has been criticised for a lack of transparency following its adoption of a new resource allocation framework. New criteria for funding do not seem to have been communicated sufficiently to local actors. In Ghana, where these criteria have led to a significant reduction in funds, implementing partners have expressed apprehension about future funding levels.

The flows of global funds receive close tracking, largely because both governments and donors are heavily involved in their activities. The same cannot be said about financial flows from other new actors, such as NGOs, foundations and private households. On the contrary, their emergence has compounded difficulties in monitoring capital inflows. Public entities such as the Ghana Planning Commission have neither the resources nor the mandates to collect adequate information. The Ministry of Health also faces capacity constraints, particularly in monitoring private flows. As noted above, the reliability of its figures, particularly on private donations, is highly questionable.

Of even greater concern than this inadequacy of information is the apparent reluctance of the Ghanaian government and most donors to acknowledge the potential value of private flows for social and economic development. Studies on Ghana have shown that remittances and private donations, for example, are strongest in times of economic turbulence, helping to reduce household income volatility (Quartey and Blankson, 2004). Despite indications that private flows are an important contributor to health finance, several interviewees did not consider their value significant enough for inclusion in national policy dialogue and budget discussions.

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Improved information about private flows and more evidence about their impact on development could assist developing countries in policy making. In Ghana, for example, household surveys on private health spending, which is partly funded by remittances, could support the current establishment of a new private health insurance scheme (Box 5.1). Specifically, better measures of household income, including remittances, would allow the government to calculate contribution levels that guarantee the financial sustainability of the scheme.

Box 5.1. **The National Health Insurance Scheme in Ghana: Strengthening Domestic Resources for the Health Sector**

Households in many developing countries face the constant risk of having to finance the treatment of serious illnesses directly out of pocket. Health insurance systems, both public and private, based on pre-payment or risk-pooling could help alleviate the exposure to these risks significantly (Drechsler and Jütting, 2005).

The Ghanaian government has recently introduced a National Health Insurance Scheme (NHIS), in the hope of easing the overall burden borne by private households. The law underpinning the NHIS will make membership in an insurance scheme compulsory, with households expected to make premium payments in line with their "ability to pay" (www.ghana.gov.gh). With insurance schemes having existed so far only at the community level, the ultimate aim is to make the NHIS the main purchasing mechanism for health services throughout the country.

This well-intended initiative is not yet founded on solid grounds, with doubts having been voiced regarding its financial sustainability (ILO, 2006). As stated in interviews, NHIS managers believe that contribution levels may have been set at unsustainably low levels given the costs of the scheme. Determining acceptable contribution levels will be a key challenge and will need better information on household income. Further information would allow the government to make a clearer distinction between those who could pay higher contributions for quality packages and those who must remain exempt from payments, currently the core poor, indigenous people and children with insured parents.

Implications

— Conventional donors and new funders should continue efforts to provide forward information and extend the time horizons of their programmes.

— Governments, assisted by donors, should strengthen information systems to improve budgetary planning, including new financial flows and information from households.

Improving Co-ordination for More Effective Development Finance

The endorsement of the Paris Declaration on Aid Effectiveness by over 100 government and agency representatives in 2005 signalled an international consensus that, in addition to higher aid volumes, higher aid effectiveness would be needed in order to achieve the MDGs. At the heart of the Declaration lies the call for better co-ordination between stakeholders in aid. Progress by donors in co-ordinating their activities with each other (harmonisation) and with developing countries (alignment) has been encouraging. These co-ordination efforts must also extend to new actors, however, including global funds, NGOs and foundations.

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Progress in harmonisation and alignment is encouraging

Many donors have ceased financing individual projects and begun using more harmonised means, such as budget and sector support, to deliver their aid. A further sign of progress has been the establishment of government-donor co-ordination bodies at country level. In Ghana, for example, general donor co-ordination has been fostered by a Consultative Group initiated in 1997. In November 2005, the Group agreed on an "Aid Harmonisation and Effectiveness Matrix", which details donor and government commitments, as well as targets related to harmonisation. Nine donors have entered into the new Multi-Donor Budget Support arrangements (HLF, 2006). Some donors have also begun using forms of conditionality that tie funding to agreed results and allow the government to choose its own approach in achieving them. The US Millennium Challenge Corporation is the most prominent example, having recently signed an agreement with Ghana for $547 million over five years.

At the sector level, the shared health account and health SWAp, with joint annual reviews and financial reporting, have brought welcome progress. Yet further efforts are required in harmonising donor activities. The distribution of insecticide-treated bed nets in the fight against malaria in Ghana is a case in point. The US-funded Netmark partnership hopes to promote a sustainable market for bed nets by gradually transferring the cost of their purchase to consumers. Other donors, including UNICEF, are distributing bed nets free of charge. Regardless of the merits of either approach, more co-ordination between donors is imperative, as their activities obviously contradict each other.

Further co-ordination gaps become evident when the priorities of donors do not match the needs of recipient countries. Thus, studies on the health sector have shown that donors often favour HIV/AIDS programmes even in countries where other diseases may have more urgent priority (MacKellar, 2005). In countries where ODA still plays a dominant role, these donor preferences have a large influence over policy making. Evidence of this emerged in the Ghana survey. For example, although malaria is the single most important health problem, accounting for 40 per cent of outpatient visits, no counterpart institution to the Ghana Aids Commission has been established to address this disease.

New actors should join harmonisation and alignment efforts

Co-ordination efforts are more effective when all significant actors participate in them. Indeed, the Paris Declaration encourages the participation of civil society and the private sector in aid co-ordination. In the Ghanaian health sector, however, a number of interviewees claimed that progress in including NGOs and foundations in national co-ordination had been slow. Interestingly, the mechanism that received the most praise for involving the private sector was introduced by the Global Fund, itself a new actor. The Global Fund requires recipient countries to form a Country Co-ordinating Mechanism (CCM), which brings together various stakeholders to take allocation and management decisions. By including several civil society representatives in its meetings, the CCM shows that new actors can make a positive contribution to a more effective and comprehensive development finance system.

A greater challenge for global funds relates to the co-ordination of their activities with recipient country governments and other donors. The importance of their alignment with country systems is singled out in the Paris Declaration and has been chosen as a major theme for the OECD Global Forum on Development. In Ghana, some progress is being achieved.

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The Education for All Fast Track Initiative, for example, appears to be aligned well with the Education Sector Strategic Plan. Similarly, the Global Fund co-ordinates closely with the Ghana Health Service and disburses funds at the sector level.

Although alignment is progressing, global funds, particularly those active in health, have attracted much criticism for contributing to a proliferation of co-ordinating bodies at country level (McKinsey & Company, 2005). The Global Fund has been criticised for making the establishment of its CCM an *a priori* condition for financial support rather than using existing co-ordination mechanisms. The duplication of activities among various mechanisms has resulted in tensions and a lack of clarity about respective roles and responsibilities. HIV/AIDS matters, for instance, are now discussed in a proliferation of meetings, including those of the Ghana Aids Commission (GAC), the Partnership Forum, the Business Meeting, the UNAIDS Technical Working Group, the GAC Sub-Committee, the Regional Aids Committee and the District AIDS Committees.

Implications

— Despite progress in raising aid effectiveness, problems in reconciling mixed priorities must be addressed, both among donors and between donors and recipient countries.

— Global funds, which have exacerbated co-ordination problems at the country level should be encouraged further to adhere the principles of the Paris Declaration.

— Other new actors, such as NGOs and foundations, should participate actively in country-level co-ordination mechanisms.

Building Developing Country Ownership

While stronger information systems and better co-ordination could make development finance more effective, the underlying challenge for both developing countries and donors goes beyond more and better finance, as both the Monterrey Consensus and the Paris Declaration recognised. This involves raising poor countries' ownership of their development process. In Ghana's health sector, the pursuit of ownership faces two major hurdles. First, governments must improve inter-ministerial co-ordination. Second, they must address mismatches between budgets and spending.

Governments must improve inter-ministerial co-ordination

The international debate on harmonisation and alignment largely revolves around the behaviour of external actors. If recipient-country governments are to take the lead in managing their development finance, however, they must improve co-ordination and communication between their own national public entities. This will become even more urgent if donors move to aid systems that rely heavily on the inter-ministerial distribution of funds.

In Ghana, general budget support is expected to become the dominant instrument for aid delivery. This will have large implications for health financing. In contrast to the current system of sector support, the Ministry of Finance rather than the Ministry of Health will become the main recipient and administrator of aid for health. The Ministry of Health will therefore face competition from other line ministries and will need to communicate and

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negotiate more effectively with central government in order to secure funding. These are skills not required of the ministry in the past, given its direct support through sector-based funding. As a consequence, inter-ministerial co-ordination has remained weak, while effective communication with the Ministry of Finance has been practically non-existent according to survey interviewees.

For the Ministry of Health, the move to budget support may thus constitute a "shock", the effects of which are difficult to foresee. On the one hand, new pressures to secure funding may prompt the ministry to integrate better communication and negotiation skills into its day-to-day activities. On the other, as the ministry and several donors fear, the move to budget support could result in a decline in funding for the health sector. To cushion the effects of such a decline, some donors are already considering the option of earmarking parts of their budget support for the health sector.

Governments must address mismatches between budgets and spending

Of the twelve indicators agreed upon for monitoring the implementation of the Paris Declaration, the first is dedicated to the pursuit of ownership. It calls for developing countries to have national development strategies with clear strategic and budgeted priorities. Although such strategies are a welcome first step, it is important to recognise that true ownership has much wider implications. In particular, it implies that governments must have the capacity to implement their strategies.

Ghana's health sector possesses a strong Programme of Work, with clear and budgeted priorities supported by most donors. Moreover, it has enjoyed rising levels of funding. Nevertheless, health performance has begun to stagnate. This indicates that the difficulties faced by the Ministry of Health lie deeper than having a good strategy and reasonable financing. When asked about the sector's major challenges, interviewees agreed that inadequate finance was a problem but thought that the mismatch between budgeting and spending was a bigger one. In fact, budget execution has been very weak in recent years, with spending on some items significantly surpassing the levels agreed upon in the Ministry of Health Programme of Work. Most notably, the government and Ministry of Health have exceeded figures budgeted for personal emoluments and administrative costs by 65 per cent.

This reallocation may be part of an effort to counter the massive emigration of health workers, which is draining the sector of two thirds of its health-school graduates (World Bank, 2006*a*). While brain drain is indeed one of the most challenging and pressing problems facing the health system, it is highly questionable whether reallocating finances will help solve it. Furthermore, the mismatch between budgetary planning and actual spending indicates that both government and donors appear to lack clear and feasible strategies to address the human-resource needs of the country.

Encouragingly, the Programme of Work lists the improvement of staff motivation and health-worker incentives as major priorities, but salaries alone cannot improve such incentives. Given the large wage gap between Ghana and anglophone OECD countries, the primary destinations of Ghanaian migrants, even a significant increase in salaries is unlikely to entice health workers to remain in the country. Moreover, even well-paid health workers need basic equipment in order to carry out their jobs well — but overspending on salaries has left outlays on service delivery 25 per cent under budgeted figures.

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Interviewees in Ghana tabled several alternative responses to brain drain that may allow the government to adhere to its budgetary planning. These included the temporary "bonding" of health workers to Ghana in return for their education and the improvement of training for basic health staff, such as nurses, who are crucial for health care delivery and less likely to leave the country. Interviewees also called for more coherence between donors' development co-operation and immigration policies; if the objective of development co-operation is to improve health outcomes, then immigration policies should not undermine the health system by fuelling brain drain. Given strong demand for foreign health workers in OECD countries, smart solutions must be found urgently. In addition to providing more aid for basic health equipment, OECD countries could for instance design visa policies that foster circular migration, providing benefits to both sending and receiving countries (Katseli *et al.* 2006).

Implications

— Ministries need new negotiation and communication skills to benefit fully from new aid-delivery mechanisms.

— They must make efforts to spend according to plan, even if faced by systemic challenges like brain drain.

Conclusion

Bilateral and multilateral donors still play a prominent role in addressing financing needs, but other actors, such as global funds, foundations and NGOs, have entered the field of development finance. Private capital flows from investors (FDI), banks (commercial loans) and private households (remittances), which are particularly evident in emerging economies, are becoming significant even in low-income countries.

This new multiplicity of financing choices has provided alternatives for developing countries in financing their achievement of the MDGs, but it has also brought major challenges. 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 other actors can participate.

Domestically, many poor countries face capacity gaps that cannot be filled by increased finance or improved effectiveness alone. These include skills shortages in ministries and unpredictable human resources in the public service, both of which undermine a country's ability to take ownership of its development process. If ownership is indeed a prerequisite for development, then addressing such capacity gaps should be an urgent priority for both governments and the donors seeking to assist them.

Development finance should be regarded as a means rather than an end in itself. For governments, this implies that they must work to reduce their dependence on external assistance by raising domestic revenues and boosting the capacity of households to contribute to basic human needs. For donors, it may mean rethinking the role of aid as a complement to other financial sources, not a substitute. Major donors are already taking note. Germany has proposed that, during its presidency of the G8 in 2007, world leaders focus on strategies to attract international private investment to Africa.

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Notes

1. Ghana is an active member of the OECD DAC Working Party on Aid Effectiveness, will participate in the 2006 Survey on "Monitoring the Paris Declaration" and has agreed to host the Third High-Level Forum on Aid Effectiveness in Accra in 2008. Indeed, the Working Party is currently co-chaired by Helen Allotey, Executive Director in the Ghana Ministry of Finance and Economic Planning.
2. This breakdown will change in the course of the next Global Fund disbursement round: HIV/AIDS (50 per cent of funds), malaria (29 per cent) and tuberculosis (21 per cent).
3. The number is derived from considering exclusively those projects with a direct reference to Ghana. If various countries were among the target group, the amount was divided by the number of countries mentioned.

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Chapter 6

Integrating Global Programmes with Country-led National Programmes

Evidence from Ghana

Abstract

This chapter examines the extent to which global programmes (GPs), as new actors in development finance, align with the principles of the Paris Declaration on Aid Effectiveness in Ghana. It finds that global programmes' funding priorities correspond well with objectives set out in national plans and strategies, although there is a perception that in some cases the availability of GP funds leads to a distortion in national priorities. Government is taking increasing ownership of funding proposals and project development, but significant capacity gaps remain. Harmonisation between GP co-ordination mechanisms and other donor-recipient co-ordination systems remains a major challenge, particularly in the health sector. GP co-ordination challenges are greatest when inter-governmental co-ordination structures are weak. Finally, views on predictability and sustainability are highly specific to GPs.

Recent years have seen a proliferation of new actors in development finance. This chapter deepens the discussion on global programmes (GPs), which have emerged to address global or regional concerns related to the provision of public goods, build consensus on shared goals and objectives and enable multiple stakeholders to commit resources (financial, technical, personnel and or/reputation) and to share in the benefits and risks.

Commissioned by the Multilateral Development Banks, OECD-DAC and UNDP, this survey examines how well GPs in Ghana apply the principles of the Paris Declaration on Aid Effectiveness. GPs, particularly in health, have attracted much criticism for contributing to a proliferation of co-ordinating bodies at country level. How well do they align with planning and implementation frameworks of recipient countries? Do they complement traditional ODA streams, or do they increase difficulties in harmonising development finance flows? Finally, do the problems and solutions suggested for global health programmes apply more broadly to other sectors such as education and environment?

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The following conclusions are based on a series of interviews with representatives of government bodies (including the line ministries, the Ministry of Finance and other official bodies), donor organisations (bilateral and multilateral) and non-governmental actors (see list of interviewees in Annex I). With the help of a general template for the country surveys, a simplified questionnaire was developed to guide interviews (see Annex II for the questions and Table 6.1 below for description of the acronyms used here).

Table 6.1. **Overview of Global Programmes Surveyed**

Global programme	Principal objectives	Active in Ghana since	Funds pledged/disbursed
Education for All Fast Track Initiative (EFA-FTI)	Universal primary education	2004	From Catalytic Fund: • 2005: $8 million • 2006: $11 million • 2007: $11 million
Global Environmental Facility (GEF)	• Biodiversity • Climate change • International waters • Land degradation • Ozone layer • Persistent organic pollutants.	1997	$11 million approved since 2000 (not including regional projects)
Global Fund to Fight Aids, Tuberculosis and Malaria (GFATM)	Infectious diseases: • HIV/AIDs • Tuberculosis • Malaria	2002	Over five years: • $94 million pledged • $46 million disbursed
Global Alliance for Vaccines and Immunisation (GAVI)	Hepatitis B, yellow fever vaccines; cash support for immunisation services	2000	$20 million 2000-04

Ghana's Ownership of Global Programmes' Objectives and Strategies

This section first compares GP funding priorities to the objectives set out in Ghana's second Growth and Poverty Reduction Strategy (GPRS II, 2006-09) and relevant sector plans, based on the assumption that correspondence between them is an indicator for ownership. In this context, the section discusses incentives that arise from the availability of GP funding for activities with lower government priority. It also examines a further indicator of ownership, government leadership of the development and submission of proposals to GPs.

Correspondence of GP Funding Priorities and Ghana's Strategies

GP funding priorities correspond well with objectives set out in Ghana's national plans and strategies. However, there is a perception that, in some cases, the availability of GP funds leads to a distortion in national priorities.

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GP funding priorities generally correspond well with objectives set out in the GPRS II and sector plans (Table 6.2). The alignment of objectives has been particularly close in the EFA-FTI, due in part to fortuitous timing. Ghana's Education Strategic Plan (ESP) was finalised by the Ministry of Education, Youth and Sports in May 2003, shortly after the creation of the EFA-FTI in 2002. The ESP declared basic education as a primary objective and included relevant education sector recommendations from EFA in a matrix[1]. Ghana's first poverty reduction strategy (2001-05) also included access to basic education as a principal aim. Its proposal to join the EFA-FTI was endorsed soon afterwards in 2004 and the disbursement of $8 million in 2005 was able to complement government expenditures, filling in important gaps in non-salary expenditure (e.g. schoolbooks).

With EFA-FTI funds available only for universal primary education, the question arises whether Ghana will be able to sustain a shift in priorities. Although access to basic education remains a primary aim, GPRS II has widened the country's access-related goals to include seven years of secondary education (three years of junior high; four years of senior high).

The availability of GP funding for lower-priority activities was perceived as a problem in the health and environment sectors. Some interviewees expressed the view that the government and donors had been "tempted" into over-emphasising HIV/AIDS at the expense of malaria, the leading cause of deaths in Ghana, especially among children under five years old and pregnant women. In terms of financial volumes, HIV/AIDS has indeed received more emphasis than malaria from GFATM — grant agreements for HIV/AIDS amount to $45.8 million, compared with $27.4 million for malaria. Further research may be needed on the redeployment of government resources as a result of this difference in funding. Moreover, given the high degree of priority given to HIV/AIDS in GPRS II and the Health Sector Programme ofWork (2002-06), the issue of prioritisation among diseases may not necessarily be related to GFATM alone.

Similar concerns were raised in interviews on the GEF. GPRS II clearly shows rising government attention to environmental issues, with priority given to land degradation and its impact on the modernisation of the agricultural sector. Climate change has a relatively low degree of priority, although ratification of international climate change conventions indicates Ghana's concern for the issue. Some interviewees claimed that climate change had been given disproportionate amounts of funding by the GEF, with one interviewee claiming that there were incentives to "disguise" problems as climate change issues in order to attract GEF funding. This situation may already have been resolved to some extent; while the perception holds true for GEF allocations since 1997 ($18.1 million for "climate change" compared with only $0.95 million for "land degradation")[2], it does not for funding since 2000 (only $0.1 million for "climate change"; as above for "land degradation").

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Table 6.2. **GP Priorities and Country Strategies**

	EFA-FTI	GEF	GFATM	G
GP funding priority	Universal primary education	• Biodiversity • Climate change • International waters • Land degradation • Ozone layer • Persistent organic pollutants.	Infectious diseases: • HIV/AIDS, • Tuberculosis • Malaria	Hepatitis B, ye vaccines ; cash immunisation
GPRS II Objective	Ch. 4.3 on "Education, Skills, Manpower and Sports Development for Accelerated Growth", and Policy Matrix section on "Education" include: • Slow progress in achieving universal basic education • Improve access to education at all levels • Gender gaps • Teaching quality • Efficient delivery • Science and technology	Ch. 3.2.1 on "Modernised Agriculture" devotes a section to "Environment": • Stem land degradation; regulate the impact of climate change • Promote efficient and accessible industrial and domestic waste management • Promote integrated ecosystem management; human-centred biodiversity conservation • Environmentally friendly technologies Policy Matrix section on "Agriculture-led growth" devotes a section to "(c) restoration of degraded environment and natural resource management" Policy Matrix section on "Environment-related factors in vulnerability and exclusion" includes dealing with "desertification and drought" as a result of climate change.	Ch. 4.4 on "Improving Access to Health Care, Malaria Control and Prevention of HIV/AIDS" includes systemic goals and disease-related goals • Equity gap • Sustainable financing • Efficient "service delivery" • Malaria control • HIV/AIDS prevention "Health", "Health-Related Vulnerability and Exclusion", "Malaria Control" and "HIV/AIDS" are separate key areas of focus in the policy matrix.	Immunisation mentioned.
Sector Strategies	Education Sector Strategic Plan (2003-15) has four focus areas: 1. Equitable access to education 2. Education quality 3. Educational management 4. Science and Technology Within (1): • Policy Objective EA4 Provide and ensure access to free basic education • Policy Objective EA5: Provide compulsory universal basic education	The National Action Programme to Combat Drought and Desertification includes more than 20 related action plans and programmes.	Second Health Sector Five Year Programme of Work (2002–06): beyond systemic issues, HIV/AIDS is the major challenge National Strategic Framework for HIV/AIDS (2001-05; 2006-10) National Malaria Control Programme linked to global Roll Back Malaria (RBM) partnership. 'Medium Term Strategic Plan for Malaria Control in Ghana' (1998-2002).	Second Health Year Programm (2002–2006) - EPI" is a priori intervention.

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Ghana's Leadership of the Development and Submission of Proposals

Government is taking increasing ownership of funding proposals and project development, but significant capacity gaps remain.

Formally, the government has a high degree of ownership of funding proposals and project development. In all cases surveyed, it is an official signatory of proposals. Ghana's proposal for EFA-FTI endorsement, for example, was developed and submitted by the Ministry of Education/Ghana Education Service. Before approval by the FTI Secretariat, however, it required local donor support, co-ordinated by UNICEF, the nominated "lead co-ordinating agency".

In the health sector, interviewees largely agreed that the Ghana Health Service and its National Programme Officers were taking greater control of planning application processes. Ultimate responsibility for the submission of grant proposals to the GFATM lies not with the Ministry of Health, however, but with the Country Co-ordinating Mechanism (CCM), a multi-stakeholder body that includes donors and is chaired by a representative of the Ministry of Health. GAVI proposals are submitted by the Ministry of Health but must be endorsed by a further multi-stakeholder group, the Interagency Co-ordinating Committee (ICC).

While GEF proposals can be developed by non-state actors, they are officially submitted to and co-ordinated through the GEF focal point within the Ministry of Environment and Science. Yet there remains a high degree of confusion about the proposal process among both government actors and donors. The relationship between the World Bank and the GEF Council, for example, is poorly understood. For this reason among others, donors — particularly the three official implementing agencies (World Bank, UNDP, UNEP) — tend to take a strong "hands-on" approach in the development of ideas and interaction with the GEF secretariat. This points to the need for greater capacity support to help boost country leadership of the application process.

Management and Co-ordination Mechanisms: Harmonisation and Alignment

This section focuses on the management and co-ordination arrangements used for GP programmes and projects. It evaluates how well these mechanisms harmonise with existing donor co-ordination mechanisms. Because GP funding is often directed at cross-cutting issues, the section also discusses a fundamental requirement for effective programmes: strong internal capacity for inter-ministerial co-ordination.

Harmonisation between GP co-ordination mechanisms and other donor-recipient co-ordination systems remains a major challenge, particularly in the health sector.

Overall donor harmonisation is progressing. The November 2005 Consultative Group meeting agreed on an "Aid Harmonisation and Effectiveness Matrix" with details of both donor and government commitments, and on setting targets linked to the Paris Declaration[3]. The harmonisation of GP practices, however, remains a major challenge in Ghana, particularly in the health sector. While some GPs use existing systems for their activities, others have created entirely new and parallel co-ordination mechanisms and governance structures.

EFA-FTI activities appear well-harmonised through co-ordination systems led by the Ministry of Education and the Ghana Education Service. Reporting procedures are aligned well with the Education Sector Annual Review.

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GAVI funds are channelled through the Ghana Health Service and pooled with funds from other donors. The subsequent release of funds follows Ministry of Health procedures, and financial reporting is based on regular government audit requirements. Independent audits are carried out by external consultants (PricewaterhouseCoopers) in order to verify the monitoring of health outcomes. The creation by GAVI of an Interagency Co-ordination Committee (ICC) has added an additional body with associated transaction costs to the Ghanaian health system. Interviewees largely agreed, however, that the ICC has a complementary rather than duplicative function, perhaps because it has provided a new space for government, donors and non-state actors to discuss a precisely-defined and technical issue, immunisation.

The GFATM's Country Co-ordinating Mechanism (CCM), by contrast, received both donor and government criticism for duplicating existing systems[4]. Some interviewees questioned whether the creation of a CCM should have been an *a priori* condition for GFATM funding. Though the CCM has been praised for giving civil society a stronger voice than other co-ordination bodies, greater participation may also have been achieved by adapting existing mechanisms. Further, the GFATM has been criticised for introducing parallel reporting mechanisms, which draw on scarce resources, particularly at local levels. On the other hand, procurement systems appear to be aligning with government systems.

The co-ordination of activities to address HIV/AIDS provides a useful example. GPRS II announces policy measures to strengthen the capacity and core functions of the Ghana Aids Commission (GAC), which was created in 2001 to co-ordinate the national cross-sector response to the disease. The GFATM, however, appears to be undermining this approach by co-ordinating its HIV/AIDS activities through the CCM and using the health SWAp and Ghana Health Service, rather than the GAC, as financing channels. Table 6.3 illustrates the proliferation of co-ordination mechanisms in the area of HIV/AIDS.

Unlike other GPs, the GEF has not created an additional decision-making body. A single person within the Ministry of Environment — the "GEF Focal Point" — is responsible for co-ordinating actors. Yet the Focal Point appears to lack institutional support for effective decision making. Existing national mechanisms, such as the Natural Resource Management Group, have no clear mandate to deal with GEF matters and have accordingly discussed them only on the periphery of their meetings. This co-ordination gap was evident in early June, when the Ministry of Lands and Forestry called a meeting to discuss priorities for GEF funding under the new Resource Allocation Framework. Although a large group of stakeholders had been assembled, no concrete decisions could be taken because the GEF Focal Point was not in attendance. Apparently, a miscommunication had occurred between the Ministries concerned about the exact purpose of the meeting.

The presence of three GEF implementing agencies adds further complications. Indeed, doubts were raised about the ability of the three to work together nationally rather than competing. Interviewees on the government side agreed that co-ordination was more effective at the local level because only one implementing agency was involved. Another difficulty involves the additional complexity of co-ordinating GEF projects that require regional and international co-ordination, such as the river-basin project. Despite these co-ordination difficulties related to the GEF, alignment with country systems appears to be progressing. As with the other GPs, government procurement laws and budgeting are also being used for the GEF, although reporting follows the formats of the three GEF implementing agencies (World Bank, UNDP and UNEP). In order to address the co-ordination gaps, both donors and government representatives have signalled their intention to integrate discussions on GEF

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more fully into national co-ordination mechanisms. As a further solution, one interviewee called for the creation of a GEF committee to provide broader support to the GEF focal point within the Ministry of Environment and Science.

Table 6. 3. **HIV/AIDS Co-ordination Mechanisms**

Co-ordination mechanism	Main task	Participants	Frequency of meetings
Ghana AIDS Commission	• Policy formulation • Co-ordination of national response • Resource mobilisation • Monitoring and evaluation	46 members 15 line ministries 30 Representatives of identified bodies	Quarterly
CCM	• General oversight of GFATM programmes • Co-ordination and submission of national proposals • Monitoring and evaluation	41 members; 7-member Executive Committee; GAC = statutory member	Quarterly (or more frequently if needed)
Partnership Forum	• Review of national response and strategic decisions	Representatives of Development Partners and Stakeholders	Twice a year
Business Meeting	• Negotiation of programme of work • Budgeting the national response • Strategic issues for national response	Representative of Development Partners, Stakeholders and GAC Management Staff	Quarterly
UNAIDS Technical Working Group	• Support of GAC interventions • Research • Collation of best practices • Discussion of technical issues	UN Theme Group Development Partners GAC	Monthly
GAC Sub-Committee	• Specific technical issues	Members of the Commission Copt Specialists	3 times a year
Regional AIDS Committee	• Co-ordination of interventions at regional levels	15 members selected from the Decentralised Agencies of Regional Coordination Council	Monthly
District AIDS Committees	• Co-ordination of intervention at district levels	15 members of the Decentralised Agencies of the District Assemblies	Monthly

GP Funding and Inter-ministerial Co-ordination and Communication

GP co-ordination challenges are greatest when inter-governmental co-ordination structures are weak.

The GEF example illustrates how the absence of adequate co-ordination between government bodies — in this case the Ministry of Lands and Forestry and the Ministry of Environment and Science — can pose difficulties for overall GP decision making. Indeed, the frequent allocation of GP funding to address cross-sectoral issues renders inter-ministerial co-ordination and communication all the more important. Beyond supporting capacity for better co-ordination, GPs must be careful not to exacerbate tension between government bodies, as appears to have happened between the GAC and the Ministry of Health, both of which have crucial roles to play in addressing HIV/AIDS.

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A further dimension of country-level co-ordination concerns co-operation between the Ministry of Finance and the line ministries. The Ministry of Education expressed concern about delays in disbursement of EFA-FTI funds, as these were directly linked to disbursements from the Ministry of Finance and Economic Planning (MoFEP). With several donors expected to move from health-sector basket funding to general budget support, it will be crucial for the health GPs to assess their impact on communication and co-ordination between the MoFEP and the Ministry of Health.

Sustainability and Predictability of Finance

Views on predictability and sustainability are highly specific to GPs.

Views on the sustainability of GP funding were mixed. While GAVI's introduction of pentavalent vaccines has raised questions about their affordability once GAVI's five-year commitment comes to an end, the very fact of five years of predictable funding received praise — such predictability is greater than that provided by most traditional donors. GAVI's country profile on Ghana indicates that 21 per cent of routine vaccine costs have been financed by the government, while GAVI is still paying for 75 per cent of new vaccines.

Several donors expressed concern that GFATM funding had led the government to reduce its own financing for HIV/AIDS, malaria and tuberculosis and that government funding would not return once GFATM funds decreased. A similar concern was voiced with respect to the EFA-FTI. While EFA-FTI has provided significant funding for the improvement of education services, donors are concerned that government financing will continue to be allocated to expenses such as personal emoluments, which will not necessarily improve service delivery.

The new Resource Allocation Framework for GEF biodiversity and climate change projects has raised some confusion. The Framework provides an indicative allocation for the replenishment period and is adjusted every two years on the basis of a country's potential to contribute global benefits for the environment as well as its actual capacity to implement GEF projects. Following a considerable reduction in the availability of funding for Ghana, key local actors remain confused about how the Framework criteria were applied. This calls for an improvement of communication by GEF to the country level.

Concluding Observations

GPs have left a significant "financial footprint" in Ghana, providing highly-needed support for the fulfilment of country-owned objectives, as exemplified in the education, health and environment sectors. Further analysis remains to be done, however, on whether GPs have raised additional resources, for example by catalysing an increase in donor funds, or whether they have in fact diminished resources, for example by reducing the government's financial contribution to crucial national priorities.

A further pertinent question is whether the value of GPs' financial contributions outweighs the transaction costs associated with their "institutional footprint" in Ghana. In some cases, their institutional presence at the national level has filled gaps in national policy

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dialogue; in others, it has duplicated existing co-ordination efforts. This illustrates the need for more careful, case-by-case assessment of local conditions before decisions on the establishment of co-ordination mechanisms and the disbursements of funds are taken.

A prior evaluation of government capacity to co-ordinate multiple financial flows, donors and instruments would also contribute to GP effectiveness. In Ghana's environment sector, for example, GEF funding may have a role to play in boosting national capacity to co-ordinate a multitude of actors on the donor and government sides. In Ghana's health sector, the GFATM and the GAVI must participate in country-wide efforts to streamline co-ordination activities, clearly dividing roles and responsibilities among different stakeholders and institutions. While the EFA-FTA constitutes a successful example of GP integration into country systems, care will be needed to ensure that it continues to support evolving government priorities and complement its activities.

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ANNEX I

List of Interviewees

Name	First Name	Position	Organisation
Abu-Juam	Musah	Project Co-ordinator	Ministry of Lands, Forestry and Mines
Adomako	A.A.	Co-ordinator, Capacity Building	Ministry of Education, Science, and Sports
Agostini	Paola	Environmental Economist	World Bank
Agyapong	Kwame	Planning, Budgeting, Monitoring and Evaluation Division	Ministry of Education, Science, and Sports
Allotey	J A	Executive Director	Environmental Protection Agency
Amoa	Sakyi Awuku	Director General	Ghana Aids Commission
Arthur	Anthony	Project Co-ordinator	Ministry of Education, Science, and Sports
Brown Farhat	Angela	Co-ordinator, Human Development	Ministry of Finance and Economic Planning
Dwumfour	Edward F	Senior Natural/Environmmental Resource Management Specialist	World Bank Ghana Office
Essuman	Ato	Chief Director	Ministry of Education, Science, and Sports
Guest	Will	Deputy Programme Manager	DFID
Jong	Marius de	First Secretary, Development Co-operation	Royal Netherlands Embassy Ghana
Kane	Makane	UNFPA Representative	UNFPA
Moskov	BethAnne	Health Office Chief	USAID Ghana
Nsowah	M.K	Acting Director-General	Ghana Education Service
Obro	Beatrice	Donor Co-ordinator	Ministry of Education, Science, and Sports
Osei Nsenkyire	Edward	Chief Director	Ministry of Environment and Science
Oteng-Yeboah	Alfred	Deputy Director-General	Council for Scientific and Industrial Research
Otoo	Ernest	Planning, Budgeting, Monitoring and Evaluation Division	Ministry of Education, Science, and Sports
Owusu-Ansah	Matilda	HIV/AIDS Advisor	DFID
Rose	Laura	Task Team Leader	World Bank
Rozga	Dorothy	Representative	UNICEF
Sarpong	A Manu	Administrator; Principal Recipient	Global Fund, Ghana (GHS)
Taylor	Don	Education Advisor	DFID
Trajkovska	Elena	Supply Officer	UNICEF
Vries	Peter de	Project Officer, Education	UNICEF

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ANNEX II

Modified List of Questions

1. Which global funds are most relevant for your work? What is your specific role?
2. The fund's presence in Ghana.
   a) When and how did funding begin?
   b) Levels of funding
   c) Time periods
3. Preparation of application
   a) Who is responsible for drawing up proposals/applications?
   b) Who is consulted in the preparation of applications (e.g. national/local administration, donor partners, NGOs and religious organisations)?
   c) Are there conditions related to the preparation procedure?
4. Content of the application
   a) How is the application linked to the existing sector plans?
   b) How is the proposal linked to the PRSP?
   c) Are there conditions related to the content of the application?
5. Review/approval of the application
   a) Who is responsible for reviewing/approving the application?
   b) What is the time lag between submission and approval?
6. Disbursement of funds to Ghana
   a) Who manages fund disbursement at global level?
   b) Who receives the funding in Ghana?
   c) What procedures are there for disbursement (conditions, tranches etc.)
   d) What are the time lags between approval and disbursement?
7. Organisation/management — national level
   a) Who leads the management of funds at national level (e.g. public officials, donors, specially created entities)? Are others involved?
   b) How are roles and responsibilities divided between various actors? Have separate management/ governance structures been established for particular funds? How do they function?
   c) Are there complementarities, conflicts or duplications between these and other governance arrangements?

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8. Organisation/management — local level

a) Who administers activities at local level (e.g. public authorities, civil society organisations, donors, others)? Are others involved and if so how?
b) Through which channels does funding reach them? What disbursement procedures are followed? What are the time lags in disbursement?

9. Budgeting/Fiduciary systems

a) Who is responsible for budget planning, disbursement and procurement procedures?
b) Are other actors involved and if so how? Specifically, what is the role of donors?
c) How well is budgeting aligned with a Medium-Term Expenditure Framework or other existing arrangements?

10. Monitoring, reporting and evaluation

a) Who is responsible for monitoring and evaluation?
b) Are others involved and if so to what extent?
c) How is reporting linked to existing procedures? Does it complement or duplicate them?
d) Who submits reports, and who receives them?
e) What are the consequences of positive/negative reviews?
f) How flexible are the conditions of further funding/disbursement?

11. Communication/awareness

a) Who are the main contact points at country level and how do they communicate (a) with Fund headquarters, (b) to the public?
b) How aware are important actors of the availability of funding?

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Notes

1. See Annex C of the Education Sector Plan.
2. Source: Project Database at www.gefonline.org.
3. See information on Ghana at www.aidharmonization.org.
4. Indeed, comments largely mirrored findings presented in the recent McKinsey study on health GPs. *Global Health Partnerships: Assessing Country Consequences*, McKinsey & Company, November 2005; commissioned by the Bill & Melinda Gates Foundation.

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Chapter 7

Different Countries, Different Needs: The Role of Private Health Insurance in Developing Countries

Abstract

Provided it is carefully managed and adapted to local needs and preferences, private health insurance (PHI) can complement and help overcome the limits of traditional health financing options in low-income and middle-income countries. Those countries may be grouped in three broad regional clusters that share similar characteristics and policy challenges with respect to the role of PHI. Latin America and Eastern Europe have already developed insurance industries but face important market and policy failures. MENA's and East Asia's projected strong growth of PHI needs to be accompanied by efficient regulation. Finally, in South Asia and sub-Saharan Africa, PHI will play only a marginal role in the foreseeable future, while scaling up small, non-profit insurance schemes is of critical importance.

Although private health insurance (PHI) is becoming an increasingly important tool to finance health care, surprisingly little is known about its role in national health systems in low-income and middle-income countries (Sekhri and Savedoff, 2005). This chapter analyses characteristics of PHI in the developing world and evaluates its significance for health protection.

Especially for developing countries, the literature reveals a strong controversy over the pros and cons of shifting to private insurance (Preker *et al.*, 2006; see also Box 7.1 on the OECD countries). In a very simplified and stylised way, the debate can be divided into two camps. Critics of PHI argue that private insurance will divert scarce resources away from the poor, lead to cost escalation and allow cream skimming, adverse selection and moral-hazard behaviour. According to this view, PHI largely neglects the social aspect of health protection[1]. Proponents of PHI, on the other hand, claim that private insurance can bridge financing gaps by offering value for money and avoiding waiting lines, low-quality care and under-the-table payments — problems often observed when households can use public health facilities for free or participate in generally mandatory social insurance schemes (Zweifel, 2005).

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Box 7.1. **Private Health Insurance in OECD Countries**

The role and performance of private health insurance (PHI) in developed countries is examined in a landmark study by the OECD (Colombo and Tapay, 2004). This first comparative analysis of PHI markets in OECD countries identifies several policy issues arising from the interdependence of PHI with public health coverage schemes. It furthermore assesses the impact of PHI on health policy objectives, particularly focusing on the challenges and benefits associated with different insurance mixes and exploring areas where private health insurance might pose challenges to health system performance. The publication is a particularly useful guide to governments to help them ensure that PHI markets contribute to the performance of health systems.

Although neither camp is short of anecdotal evidence substantiating its arguments, neither takes account of the current development and diversity of health-financing options. The essentially categorical discussion fails particularly to acknowledge regional differences based on people's values, countries' institutional capacities and previous patterns of economic development.

Against this background, this chapter provides an overview of the current contribution and the problems of PHI in the developing world. Its regional approach aims to identify clusters of countries that share common structural characteristics and face similar policy challenges obstructing the integration of PHI into national health systems. The scope of the analysis goes beyond other research in the field as previous studies either focused on specific types of PHI (e.g. community-based programmes: Preker and Carrin, 2004; Ekman, 2004; micro-insurance: Dror and Jacquier, 1999) or restricted the analysis to countries where the insurance industry is already well established (e.g. Latin America: Barrientos and Lloyd-Sherlock, 2003, Iriart *et al.*, 2001; South-East Asia: WHO, 2004). To the authors' knowledge, such broad discussion of PHI in developing countries is the first of its kind, and they hope it will motivate further research in the field. More data and information on private insurance mechanisms are urgently needed in order to find sustainable instruments for health financing in the developing world, especially to reduce high out-of-pocket (OOP) payments and the incidence of catastrophic health shocks (Bennet and Gilson, 2001).

Data and Methodology

Private health insurance in the developing world has multiple facets. PHI may be defined as financial resources being channelled directly to a risk-pooling institution with no or relatively little involvement of the state. The main distinction between social and private health insurance is the type of contract between the risk-pooling entity and the insured individual or group. Whereas social insurance relies on tax-like contributions, PHI rests on a private contract between the insurance company and its clientele, setting the level of insurance premiums in exchange for a given benefit coverage (Figure 7.1). As participation in these schemes is rarely mandatory, PHI is often referred to as voluntary health insurance.

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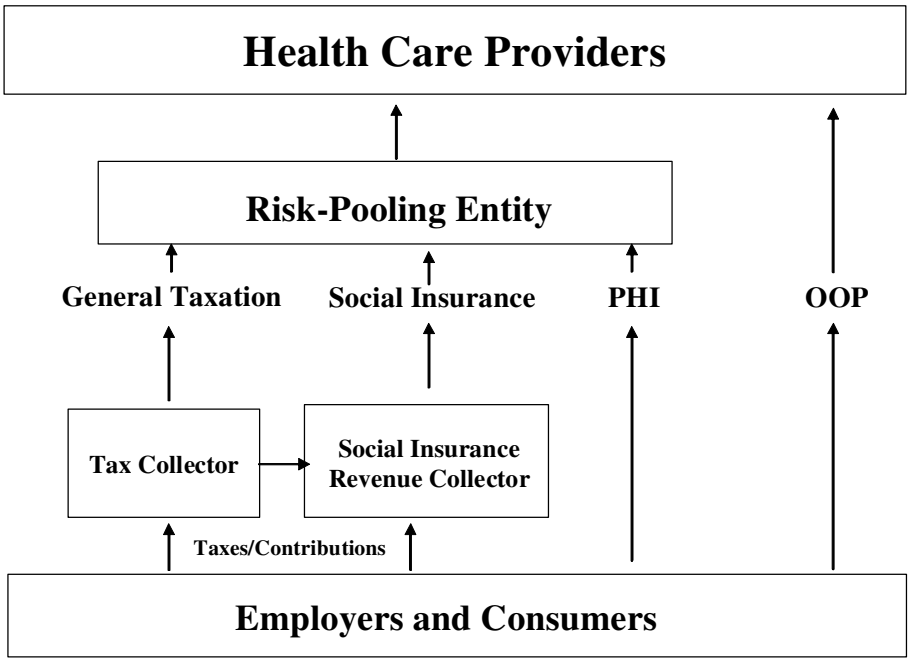
Figure 7.1. Systems of Health Care Financing



Note: OOP = out of pocket expenditure.
Source: Adapted from Normand and Busse (2000).

Health financing through insurance involves both prepayment and risk pooling (OECD, 2004). Following this general classification, there are nevertheless several possibilities of how health care can be financed through private prepaid contributions. The spectrum of PHI in developing countries ranges from large commercial to small non-profit schemes, which can be run by private entities, non-governmental organisations (NGOs) or, as is often the case, communities. Furthermore, insurance programmes might offer individual contracts or cover particular groups of people, e.g. employer-based schemes that rarely extend beyond the formal labour market.

Despite recent efforts in the international community (most notably by the WHO) to collect information on the quantity of financial resources used for health, data on health-care financing remain scarce; especially for low-income and middle-income countries. To overcome this problem, this study employs various sources including WHO's National Health Accounts (NHA) and country case-studies as well as reports from actuarial firms and re-insurance companies (Table 7.1). Some of the findings should nevertheless be treated with caution due to the lack of reliable time-series data; if anything, one can assume underestimation of the extent of private health insurance.

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Table 7.1. **Main Data Sources and their Evaluation**

Data source	Information contained	Quality assessment
WHO: National Health Accounts	Spending on private risk-sharing programmes.	Quality varies largely and depends on country that collects the information.
WHO: World Health Report	Data on health care systems and financing.	Comprehensive compilation with no specific focus on health financing.
European Observatory on Health Systems and Policies	Thorough analysis of health care systems in Europe and parts of Central Asia, including description of health financing mechanisms, type of insurance schemes, coverage rates etc.	Quality varies depending on the specific country being analysed; generally reliable and detailed information.
La Concertation	Health insurance systems in West Africa with a particular focus on community-based financing.	Reliable source, but scope very limited; might miss many new schemes as development is very dynamic.
Swiss Re-Insurance Company (sigma publications)	Data and analyses on insurance markets around the world.	Reliable source, but health not a main focus. Primarily pro-profit, commercial insurance.
ILO STEP programme (Strategies and Tools against Social Exclusion and Poverty)	Mostly on community-based programmes and the development of social insurance.	High quality country case studies with a focused view on certain aspects of health insurance.
Partnerships for Health Reform (PHR; now Partners for Health Reform plus)	Focus on community-based health financing and decentralisation in Africa, Asia/Near East, Eurasia and Latin America & Caribbean.	Reliable source but potential bias towards private mechanisms through USAID involvement.
World Bank (Health, Nutrition and Population)	Issue-specific information covering various aspects of health care financing and a comprehensive list of countries.	Reliable information to specific issues of health financing, but no systematic collection of country data.

Source: Authors' own compilation.

The analysis consists of three steps (Figure 7.2). The first assesses the significance of PHI in low-income and middle-income countries by considering expenditure on private risk-sharing programmes. Specifically, it determines the share of PHI spending relative to total health expenditure (THE) as recorded by WHO statistics. Based on the World Bank country classification, it considers 154 of the 192 member countries of WHO; of these, 73 recorded spending on private prepaid programmes in 2002 (WHO, 2005). The second step focuses more closely on countries with relatively high PHI spending[2] by employing regional overviews, country case-studies and in-depth analyses of specific risk-sharing programmes. It presents the dominant structure of schemes as well as the price-setting mechanisms and methods of premium collection used. The third step identifies common patterns and trends in PHI development based on countries' economic development and institutional capacity. This allows compilation of regional clusters and description of policy challenges.

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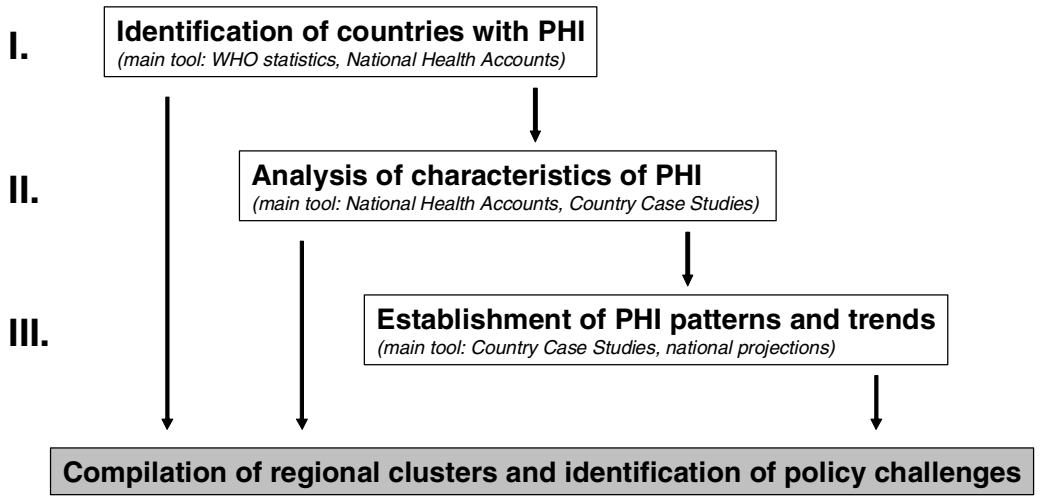
Figure 7.2. **Analytical Framework**



Source: Authors' own illustration.

Empirical Evidence of PHI in Low-Income and Middle-Income Countries

Private risk-sharing markets still have little significance in low-income and middle-income countries. Collectively, all six regions considered here account for merely 10 per cent of global insurance premium income (Figure 7.3). This small share is particularly striking considering that these regions host more than 85 per cent of the world's population. It also does not reflect the countries' economic potential as their share of global GDP amounts to around 23 per cent (Swiss Re-Insurance Company, "Swiss Re", 2005).

This picture may gradually change because insurance markets in developing countries are on a rise. Measured in terms of premium volume, the insurance industry in low-income and middle-income countries grew more than twice as fast as in industrialised economies during the past ten years (10.4 per cent as compared with 3.4 per cent in the life insurance sector and 7.3 per cent as compared with 2.6 per cent in the non-life sector)[3]. This development has been particularly strong in Asia and Eastern Europe, where the industry expanded by 10.5 per cent and 13 per cent respectively between 1998 and 2003 (Swiss Re, 2004*a*). Even though growth rates have recently dropped below their long-term average, analysts still see a significant development potential for the insurance industry.

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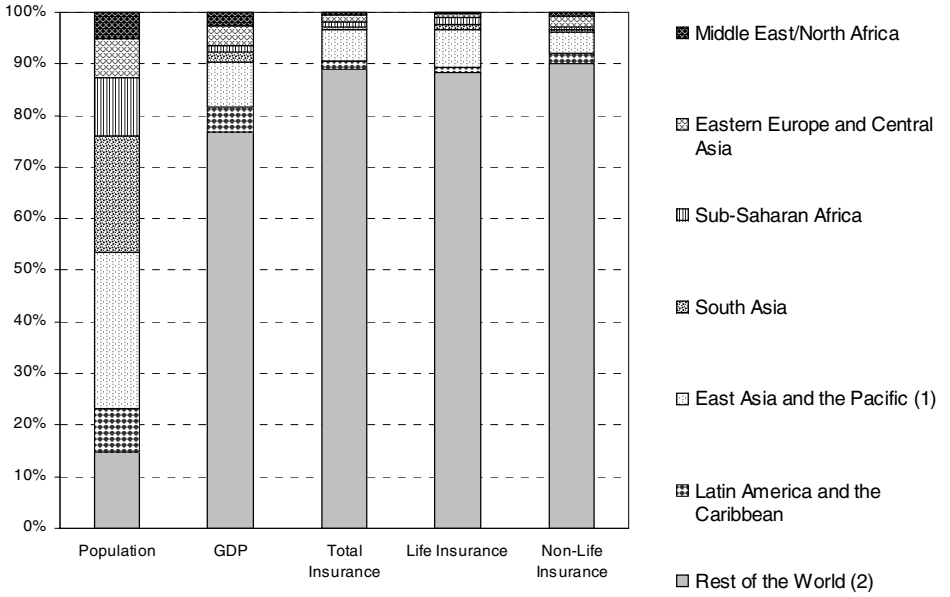
Figure 7.3. **Relative Importance of Private Insurance Markets in 2003***



Notes: * Measured as share of global insurance premium income. (1) East Asia and the Pacific excluding Japan; (2) Rest of the World predominantly covers OECD countries.
Source: Authors' own calculations. Data: Swiss Re (2005).

Private Health Insurance in Latin America and the Caribbean

Latin America has experienced tremendous growth of the private insurance industry in recent years. The volume of insurance premiums increased significantly, especially after regulatory changes and liberalisation efforts in the 1990s, which introduced PHI in many Latin American countries. The high inflow of capital and the increased presence of foreign insurance providers have often not been met by an equally growing demand for these products, however.

Significance of PHI

The private health insurance industry has benefited from the overall development of the insurance market. In 2002, spending on PHI was recorded for a remarkable 22 countries and it amounted to more than 5 per cent of total health spending in ten countries (Table 7.2). The industry is particularly significant in Uruguay where over 60 per cent of the population is covered through private schemes (Sekhri and Savedoff, 2005). High coverage is also reported for Colombia, where half of the population is estimated to have private health insurance (US Department of Commerce, 2000). Measured in terms of total expenditure on health care, PHI is important in Chile and Brazil as well, due largely to the insufficiencies of publicly financed insurance schemes. About a quarter of the population is covered through private health insurance in each country (US Department of Commerce, 2000). Similar observations apply to Argentina and Jamaica, where PHI spending accounts for around 15 per cent of total health expenditure. Although not yet reflected in coverage rates (estimated at 3 per cent of the population), PHI has also gained significance in Mexico, where the industry is experiencing "vigorous growth" (Swiss Re, 2002).

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Table 7.2. **Relative Importance of PHI in Latin America and the Caribbean***

Country	Importance of PHI	Country	Importance of PHI
Argentina	15.5	Honduras	3.6
Barbados	7.2	Jamaica	13.8
Bolivia	3.8	Mexico	3.0
Brazil	19.4	Nicaragua	2.0
Chile	28.2	Panama	5.2
Colombia	5.4	Paraguay	7.1
Costa Rica	0.3	Peru	8.6
Dominican Republic	0.3	Suriname	0.2
Ecuador	1.5	Trinidad and Tobago	4.7
El Salvador	3.4	Uruguay	53.3
Guatemala	2.7	Venezuela	2.2

Note: * PHI expenditure as per cent of THE in 2002, not including countries without PHI or where data were not available.
Source: Authors' own calculations. Data: WHO (2005).

Characteristics of PHI

Many Latin American countries have adopted PHI schemes based on the principles of managed care. In this respect the private insurance market is influenced primarily by US-type Health Maintenance Organisations (HMOs). HMOs are private prepaid health programmes in which members pay monthly premiums to receive maintenance care (i.e. medical checks, hospital stays and emergency care). Care is often provided through the organisations' own group practice and/or contracted health care providers, which limits consumer choice. Similarly, it is not usually possible to consult a specialist before seeing a pre-selected primary care doctor who serves as a gatekeeper for all health needs.

Although managed care can be an effective way to control and limit health-care spending (see, for example, some evidence for the United States in US Department of Commerce, 2000; and Phelps, 1997), it is doubtful whether HMOs will help contain cost escalation in Latin America. With the North American market close to saturation, foreign investors have targeted primarily the growing upper-middle class in Latin America to maximise profits. In fact, Stocker *et al.* (1999) point out that financial rewards have been the main motives for HMOs entering the Latin American market. Other goals traditionally valued by some HMOs in the United States (e.g. preventive care or quality control) have received only minor attention, while mandatory co-payments have further deteriorated the situation for vulnerable groups (Stocker *et al.*, 1999).

Prospects for PHI development

Multilateral lending agencies strongly supported the entry of private and especially international insurers. This led to increased and often predatory competition, characterised by hostile takeovers of local insurers as well as a number of mergers and acquisitions. This development has not yet materialised in more competitive products such as lower premiums. Although market concentration recently decreased as some small start-up companies entered, the industry remains non-competitive and premiums high. Consequently, private health insurance predominantly addresses upper income percentiles. Poor families need to remain in the existing social insurance schemes or are left without any insurance at all. Such inequities have been reported for Argentina, Chile, and Colombia (Barrientos and Lloyd-Sherlock, 2003); Brazil (Jack, 2000); and Peru (Cruz-Saco, 2002).

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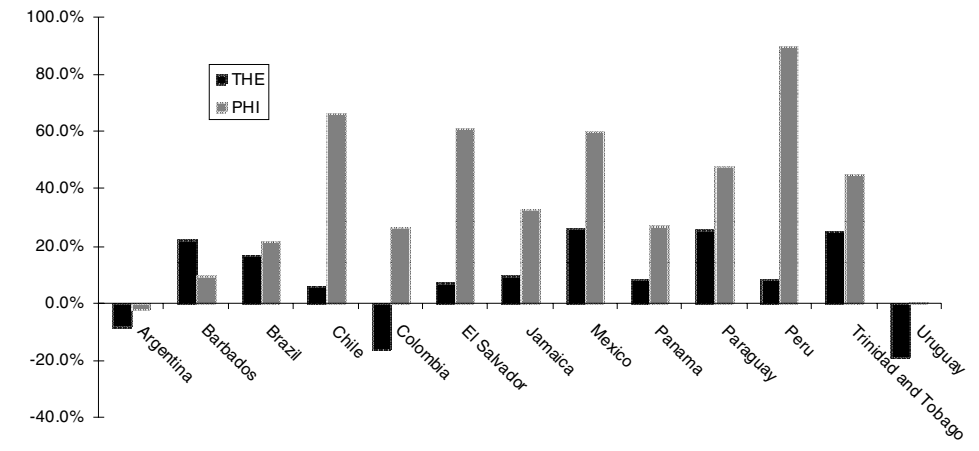
PHI frequently face both the inherent problems of health insurance markets and "the administrative weakness and political conflicts present in the health sector in Latin America" (Barrientos and Lloyd-Sherlock, 2003). Previous experiences raise concerns whether the introduction of private schemes will provide a solution for the apparent problems of health-care financing in Latin America. In many countries, basically all relevant indicators of a successful health insurance system have not improved or have even deteriorated since private schemes were introduced. PHI has not contained health costs, promoted equity or reduced vast disparities between coverage in urban and rural areas (ILO, 2000).

Problems in the introduction of PHI have been reported for many countries. In Chile, a large part of the wealthy population has opted out of the social insurance system, making public health care *de facto* an insurer of last resort (Barrientos, 2000). Chile's highly fragmented insurance market[4] is characterised by superfluous coverage (Jack, 2000) while a stop-loss clause has allowed insurance companies to limit coverage for catastrophic health care costs. Cream skimming is common, and private providers primarily target good-risk individuals; e.g. only 6.9 per cent of people older than 65 are members of a private scheme (ISAPRE) compared with 26.7 per cent in the 25-54 age group (Jack, 2000; Baeza, 1998). Severe difficulties have also been reported for Argentina, Colombia and Brazil, where the regulatory frameworks could not prevent inequalities and inefficiencies from arising, either because such frameworks were not in place when PHI was introduced or because they were ill adapted to the local situations. Overall, regulation remains a critical issue because the implementation of adequate legislation is costly; regulation-induced transaction costs are estimated to account for 30 per cent of total premium revenue in Chile (Kumaranayake, 1998).

Although PHI expenditure continues to increase in most Latin American countries (Figure 7.4), it is difficult to derive a clear development trend. The sustained expansion of the health insurance industry arises primarily from escalating health care costs in the private sector and the consequent increase of PHI premiums. After the insurance industry flourished in the 1990s (Cruz-Saco, 2002), recent studies mainly indicate a slowdown of activity.

Figure 7.4. **Total Health Expenditure and PHI Spending in Latin America and the Caribbean***



Note: * Percentage change between 1998 and 2002. Only countries in which PHI spending exceeded $10 in 2002.
Source: Authors' own calculations. Data: WHO (2005).

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Private Health Insurance in the MENA Region

Private expenditure is an important financial source for health-care systems in the MENA region. Nonetheless, PHI is a relatively new phenomenon in most of the countries. Private funds are used predominantly for out-of-pocket expenditure. Only Morocco, Lebanon and Saudi Arabia have sizeable PHI industries. A large share of private health expenditure goes to prepaid programmes in Oman and Saudi Arabia.

Significance of PHI

Spending on PHI was recorded for nine countries, five of which channelled more than 5 per cent of their total health expenditure through private prepaid programmes (Table 7.3). PHI covers the largest share of the population (around 15 per cent or 4.5 million people) in Morocco, due mostly to the non-existence of public insurance. People must choose either to purchase voluntary schemes or to remain without coverage. Half a million people (12.6 per cent of the population) are reported to have coverage in Lebanon. In other countries, PHI is restricted mainly to foreigners (5 million to 6 million expatriate workers in Saudi Arabia) or high-income individuals (around 250 000 in Tunisia and Jordan, which corresponds to 2.5 per cent and 5 per cent of each country's population).

Table 7.3. **Relative Importance of PHI in MENA***

Country	Importance of PHI	Country	Importance of PHI
Algeria	1.2	Morocco	15.5
Egypt	0.4	Oman	8.9
Iran	1.5	Saudi Arabia	9.2
Jordan	3.8	Tunisia	7.8
Lebanon	12.2		

Note: * PHI expenditure as per cent of THE in 2002, not including countries without PHI or where data were not available.
Source: Authors' own calculations. Data: WHO (2005).

Characteristics of PHI

Some MENA countries have surprisingly diversified health insurance markets. Apart from public sources, health-care coverage is offered by various private providers, including private non-profit and for-profit companies, mutual benefit societies and mutual funds for private and public-sector companies. In Lebanon, a country with fewer than 5 million inhabitants, 70 insurance firms provide PHI (NHA Lebanon, 2000). Furthermore, insurers offer both comprehensive and supplementary coverage, while participation in these schemes depends predominantly on the extent of available public insurance.

Insurance markets in the region often lack policy harmonisation and institutional accountability. Experience from Jordan suggests little co-ordination between the Ministry of Industry and Trade, which is responsible for PHI regulation, and the Ministry of Health (NHA Jordan, 2000). Similar observations apply to Lebanon, where each branch of the insurance industry has a distinct supervising ministry. Evidently, these shared responsibilities impede public oversight, which may lead to market inefficiencies like overlapping health

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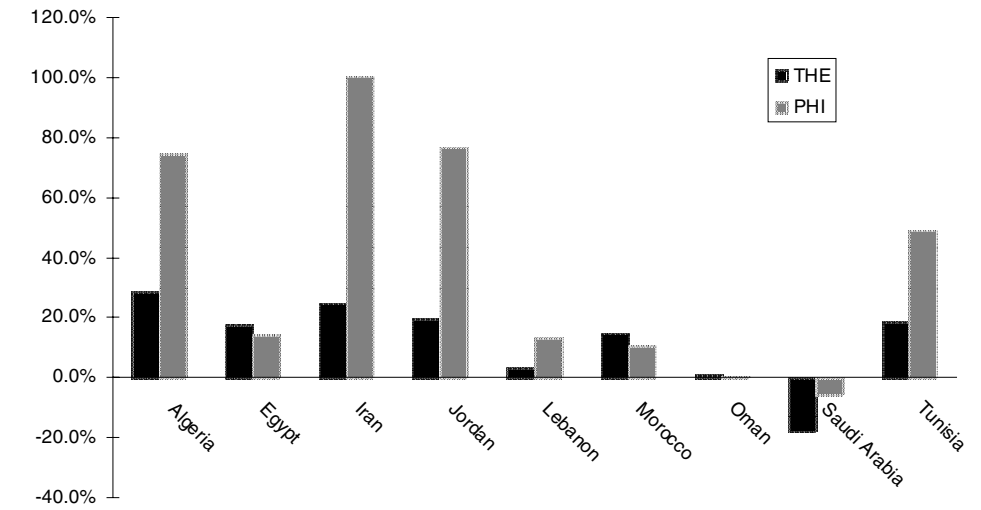
care coverage (reported for Jordan and Iran). Better co-ordination mechanisms between respective ministries could decrease uncertainty among the population about crucial coverage and, as a consequence, improve market outcomes. Similar objectives can be attained by clearly defining areas in which PHI may support, complement, or substitute for other forms of health care coverage. Particularly important would be a clear distinction between private and public responsibilities in health care financing.

Prospects for PHI development

Exclusion of high-cost/low-income individuals is reported for Lebanon, Morocco, Tunisia and Jordan. Furthermore, schemes concentrate mostly in urban areas and often do not extend to the rural population. Some countries (e.g. Morocco, Saudi Arabia) have recently started to promote the development of PHI through either the liberalisation of insurance services or the extension of existing schemes to a wider population. Requiring private coverage for expatriate workers in Saudi Arabia, for example, is merely the first step towards establishing more private involvement in the health-care system. Driving factors for the dynamic development of PHI in MENA are increasing health-care costs, which the state can no longer finance, a growing and more diversified consumer demand and overall economic growth (Figure 7.5).

Figure 7.5. **Total Health Expenditure and PHI Spending in MENA***



Note: * Percentage change between 1998 and 2002.
Source: Authors' own calculations. Data: WHO (2005).

Without efficient regulatory instruments, it will be difficult to prevent cream skimming, cost and premium escalation and fraud, which are reported for most countries in the region. Equity targets will be equally at stake if the state does not achieve sound administrative and regulatory capacities. In Lebanon, the lack of effective control mechanisms is seen to have contributed to recent cost and premium escalation in the health-care sector. As argued by the NHA report, moral hazard behaviour led to over-supply of coverage and provision, which

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could partly explain the highly uneven distribution of health-care costs. In Lebanon, low-income individuals spend on average 20 per cent of their household income on health care; the highest-income group spends a mere 8 per cent.

Insufficient public oversight and especially inappropriate incentive structures also cause inefficiencies in the allocation of resources. Reimbursement policies in Lebanon, for example, have channelled too many resources into the development and prescription of high-tech curative treatment, while health-financing institutions including PHI have neglected primary and preventive care. Apart from contributing to the general escalation of health care costs, the focus on curative care may also fail to meet the needs of the local population for preventive measures such as vaccination and immunisation. In Morocco, too, PHI schemes appear maladjusted to local requirements. If PHI were to become a major pillar of the country's health-financing system, schemes would need to take into account the specific situation of the poor. Their current design, which primarily covers minor health risks, does not provide sufficient protection against impoverishment in the event of catastrophic costs associated with major treatment.

Private Health Insurance in Eastern Europe and Central Asia

Despite a relatively developed non-life insurance market (per capita spending of $52.6, the highest rate in all regions analysed in this study), private health insurance in Eastern Europe and Central Asia is still in its infancy. In many countries, PHI entered the market as part of the general reform process towards market-based economic systems. This development was often supported by health-sector reforms and government-driven PHI pilot programmes that tried to establish PHI as a pillar of health-care financing (e.g. in Estonia, Hungary and Moldova).

Significance of PHI

Except for Slovenia, PHI has so far failed to become a significant channel of health-care financing. Although expenditure on PHI has increased in many countries, there is little evidence of a substantial expansion. Average per capita spending on PHI in all 11 countries with available data amounted to merely 7.16 international dollars in 2002, less than 1 per cent of THE in most countries of the region (WHO, 2005). Only the Russian Federation (6.5 per cent), Turkey (4.1 per cent), and Romania (1.9 per cent) surpass the 1 per cent threshold (Table 7.4), but even there the extent of PHI remains limited; for example only 650 000 people (1 per cent of the population) are estimated to have private coverage in Turkey (Colombo and Tapay, 2004; Turkey, 2002).

Table 7.4. **Relative Importance of PHI in Eastern Europe and Central Asia***

Country	Importance of PHI	Country	Importance of PHI
Belarus	0.1	Lithuania	0.1
Bulgaria	0.4	Romania	1.9
Estonia	1.0	Russian Federation	6.5
Georgia	0.9	Turkey	4.1
Hungary	0.4	Ukraine	0.7
Latvia	0.4		

Note: * PHI expenditure as per cent of THE in 2002, not including countries without PHI or where data were not available.
Source: Authors' own calculations. Data: WHO (2005).

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Characteristics of PHI

PHI caters to a niche market for high-income individuals seeking additional or superior coverage to supplement existing public schemes. As in Romania, PHI is often offered by large multinational organisations for their employees or it is used by residents travelling abroad because such services are not covered through compulsory social insurance (Romania, 2000). Except for Hungary, private pro-profit health insurance is the dominant form of PHI; it generally is not affordable for a large share of the population.

Evidence of market exclusion of the poor is manifold. In Azerbaijan, private voluntary health insurance covers approximately 15 000 people, less than 0.1 per cent of the population. Insurance premiums vary from $600 for hospital treatment in insurance-owned facilities to up to $17 000, depending on the specific insurance package (Azerbaijan, 2004). Average per capita income amounts to around $700, so it is apparent why PHI is limited to few individuals. In fact, insurance companies do not seem to believe "that there is a viable market among the general population" (Azerbaijan, 2004). Such observations are confirmed for Belarus (Belarus, 1997), Estonia (Estonia, 2000), Georgia (Georgia, 2002), and the pro-profit market in Hungary (Hungary, 2004).

Prospects for PHI development

In an environment of escalating health-care costs, contributions to private pre-paid schemes have increased tremendously in a number of countries (Figure 7.6). Various factors have nevertheless prevented PHI from becoming an important source of health financing in Eastern Europe and Central Asia. As documented in Dixon *et al.* (2004), many countries experienced severe difficulties when markets were opened for private health insurance. In Kazakhstan, for example, most insurance companies went out of business shortly after market entry. The authors identify a lack of public regulation as well as missing oversight of company solvency as the main explanation for this failure. In other countries, privatisation has not yet been accomplished thoroughly (e.g. government joint stock companies sell private health insurance in Uzbekistan) or is limited to certain sectors of the health insurance market (i.e. private insurance covers only co-payments under the public health insurance regime). Albania opened the market for private health insurance in 1994, but failed to attract suppliers. As of 1999, only one insurance company had entered the market, offering insurance services mostly to people travelling abroad (Albania, 1999). The private insurance industry has still not consolidated while the country's social health insurance scheme is on its way to becoming the primary purchaser of health care services (Albania, 2002).

Apart from regulatory deficiencies, the lack of non-profit or low-profit insurance companies may also have contributed to the relative insignificance of PHI. Hungary appears to be the only country to have succeeded in promoting the development of PHI through a mix of institutional reforms and public subsidies. It created the legal framework for the establishment of non-profit private health insurance in 1993, primarily based on the model of the French *mutualité*.

Another dynamic market may develop in Turkey, which witnessed an increase of coverage from 15 000 to 650 000 people between 1990 and 2002. Subscribers to private schemes primarily acquire higher-quality service in addition to their public coverage. The significant increase of both insurance companies offering and people having PHI arose mostly from the country's economic development, which brought diversified consumer demand. High premiums, however, have recently reduced the growth of PHI; the average annual premium per person increased from $200 to $800 between 1994 and 2002.

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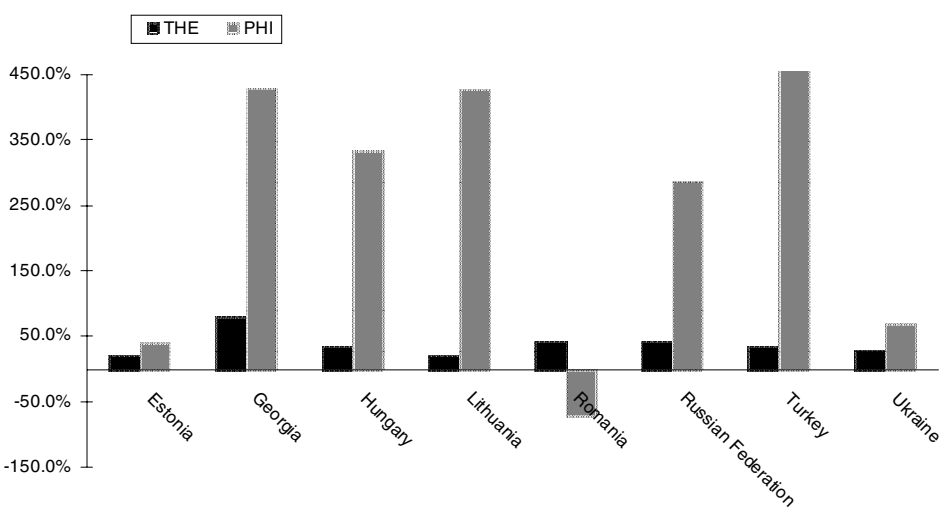
Figure 7.6. **Total Health Expenditure and PHI Spending in Eastern Europe and Central Asia***



Note: * Percentage change between 1998 and 2002 (Estonia: 1999 and 2002).
Source: Authors' own calculations. Data: WHO (2005).

Whether PHI will gain a more prominent role is above all a political decision. The determination to support the development of PHI actively varies considerably across countries. Whereas the Ministry of Health in Belarus is "broadly in favour of the extension of voluntary (i.e. private) health insurance" (Belarus, 1997), Estonia has renounced all policy attempts "to increase the share of private insurance" (Estonia, 2000).

Private Health Insurance in Sub-Saharan Africa

Like the whole insurance industry, PHI is not significant in sub-Saharan Africa. Except for South Africa, where private insurance is a major pillar of the health-care system, PHI is only a niche product or appears in the form of small community-based schemes with low coverage and limited financial protection.

Significance of PHI

Private prepaid schemes are a significant source of total health financing in just a couple of countries. Spending on PHI was recorded for 20 countries, seven of which reported it as 5 per cent or more of total health expenditure (Table 7.5). The health insurance market is particularly well established in South Africa, where 46.2 per cent of all expenditure on health care was channelled through PHI in 2002 (WHO, 2005). Measured in financial flows, PHI also plays a significant role in Namibia and Zimbabwe (the latter being the only low-income country in which PHI spending exceeds 10 per cent of THE). Since private pro-profit health insurance is almost exclusively reserved for high-income individuals, the large share of PHI spending is not reflected in equally significant coverage rates; e.g. only 8 per cent of the population in Zimbabwe is estimated to have private health insurance (Campbell *et al.*, 2000) although PHI expenditure accounts for 19 per cent of the country's total health expenditure.

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Table 7.5. **Relative Importance of PHI in Sub-Saharan Africa***

Country	Importance of PHI	Country	Importance of PHI
Benin	5.0	Niger	2.7
Botswana	7.6	Nigeria	5.0
Cape Verde	0.0	Rwanda	0.1
Chad	0.2	Senegal	1.9
Côte d'Ivoire	4.2	South Africa	46.2
Ethiopia	0.2	Swaziland	8.1
Kenya	3.9	Tanzania	2.0
Madagascar	5.0	Togo	2.1
Malawi	1.0	Uganda	0.1
Mozambique	0.2	Zimbabwe	18.8
Namibia	22.4		

Note * PHI expenditure as per cent of THE in 2002, not including countries without PHI or where data were not available.
Source Authors' own calculations. Data: WHO (2005).

Innovative approaches have recently started to increase the significance of PHI in other African countries and among other income groups as well. The increasing emergence of community-based health insurance (CHI), which usually operates on a non-profit basis, has been particularly strong in sub-Saharan Africa (Jütting, 2004). New schemes were recently implemented in Benin, Burkina Faso, Cameroon, Côte d'Ivoire, Ghana, Guinea, Mali, Nigeria, Senegal, Tanzania, Togo and Uganda (ILO, 2000).

Characteristics of PHI

In the foreseeable future, private pro-profit health insurance will hardly become significant in African countries. (South Africa, where PHI has existed for many years, is an exception and clearly not representative of the region. Hence it is not discussed here[5].) Community-based health insurance, on the other hand, promises far greater albeit not unproblematic development potential. CHI is established through "local initiatives of rather small size … with voluntary membership" (Wiesmann and Jütting, 2000); CHI programmes have been initiated by health care providers (e.g. hospitals), NGOs or local associations (Atim, 1998; Criel, 1998). Schemes are generally limited to specific regions or communities and thus reach only small numbers of people. Moreover, insurance packages are not comprehensive but generally offer supplementary coverage for certain medical treatments.

A recent survey of health insurance systems in 11 francophone West and Central African countries (*La Concertation*, 2004) identified a total of 324 community-based health insurance schemes, almost 90 per cent of all 366 registered insurance programmes considered operational. Besides offering moderate premiums to clients, CHI can generally adapt better to the specific needs of the clientele and adjust programmes accordingly. Although health coverage through CHI will typically remain low, recent empirical findings (e.g. Jütting, 2005) suggest that schemes can indeed increase accessibility to health care and improve financial protection of households. In this respect, CHI can serve as an important tool to reduce periodic expense shocks that would otherwise be induced by unanticipated OOP spending (Ekman, 2004).

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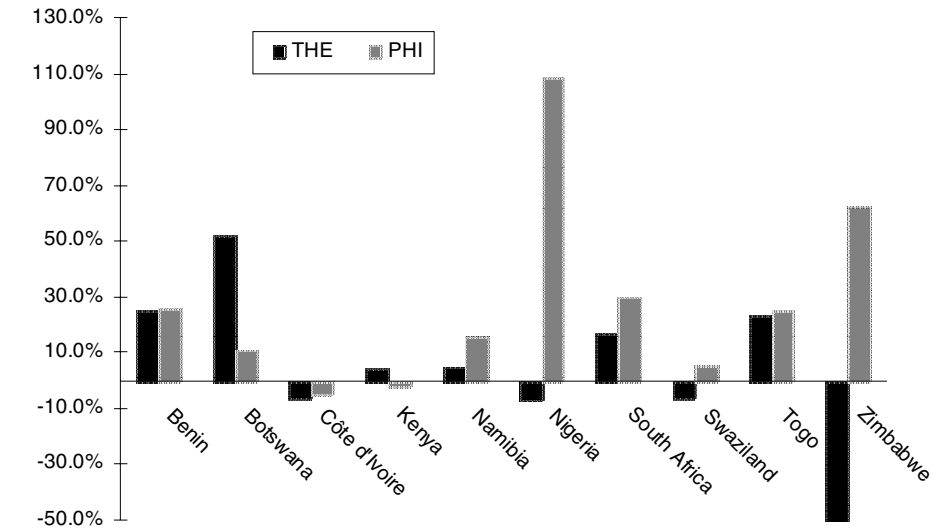
Prospects for PHI development

One advantage of CHI could also prove problematic for its future development. While the schemes' small size ensures their flexibility to adapt to local conditions, it also deprives them of financial stability and opportunity for consolidation (*La Concertation*, 2004). In West-African countries, eight of ten schemes cover less than 1 000 people while half of them even cover fewer than 650. Low coverage is not just an African problem, but in fact is characteristic for community-based programmes around the world (Baeza *et al.*, 2002). Although preferable from an organisational and participatory point of view, this situation is hardly sustainable. More co-operation and possibly partnerships between existing programmes therefore seem advisable, along with the targeting of more constituents in the development of new schemes. Only the expansion of the financial base will ensure growth and long-term stability of CHI in sub-Saharan Africa. The UMASIDA health insurance schemes in Tanzania (Mutual Society for Health Care in the Informal Sector) give an illustrative example of this process as it resulted from the regrouping of five associations in the informal sector (Kiwara, 1999). Public policies could support the consolidation of programmes, which essentially needs to be based on collective effort of the communities running the schemes.

For the same reason, CHI needs to start operating more professionally. Currently, schemes are limited in both the number of people they cover and the extent of financial protection they can provide. They generally neither rely on large risk pools nor dispose of security mechanisms like guarantees or re-insurance funds. Professionalism would also include a gradual move from very low insurance premiums to contributions that allow both financial stability and true insurance-based health care coverage. Most schemes currently cover only small risks and fundamentally rely on co-payments; expenses for specialists or hospital treatment are rarely included. This is particularly unsatisfactory because it does not protect individuals from catastrophic health costs.

Figure 7.7. **Total Health Expenditure and PHI Spending in Sub-Saharan Africa***



Note: * Percentage change between 1998 and 2002. The chart includes only countries in which PHI spending exceeded $1 in 2002.
Source: Authors' own calculations. Data: WHO (2005).

Considering the institutional weakness of many sub-Saharan African countries and the limited financial resources of the African people (46.5 per cent of the population lives on less than one dollar a day), PHI will mainly evolve in the non-profit, community-based insurance segment. In francophone countries, 142 new schemes are currently being implemented while 77 are planned for the near future. Due to the low contribution level of community-based schemes, a significant increase in PHI spending does not accompany this dynamic development (Figure 7.7). The implementation of community-based schemes that offer only limited coverage obviously is not an end in itself, but it can serve as a building block for the future development of more efficient forms of health insurance in sub-Saharan Africa.

Private Health Insurance in East Asia and the Pacific

Considering the region's large population and economic potential, private insurance is surprisingly insignificant in East Asia and the Pacific. Nevertheless, economic growth, escalating health care costs and recent pandemics like the Severe Acute Respiratory Syndrome (SARS) of 2003 have intensified the quest for new health financing options and increased the demand for private health insurance.

Significance of PHI

PHI in East Asia and the Pacific clearly plays a secondary role in health care financing. In 2002, spending on private prepaid programmes was recorded for seven countries, but it surpassed 5 per cent of THE only in the Philippines (Table 7.6). Given the region's high OOP spending rate, PHI could nevertheless become an important source of future health care financing if resources for direct payments can be channelled to prepaid schemes. Furthermore, high levels of household saving might help to underpin the growth of the insurance market (Swiss Re, 2004*a*).

Table 7.6. **Relative Importance of PHI in East Asia and the Pacific***

Country	Importance of PHI	Country	Importance of PHI
China	0.3	Philippines	10.9
Indonesia	3.3	Thailand	4.3
Malaysia	3.3	Vietnam	3.0
Papua New Guinea	1.1		

Note: * PHI expenditure as per cent of THE in 2002, not including countries without PHI or where data were not available.
Source: Authors' own calculations. Data: WHO (2005).

Characteristics of PHI

With the exception of Thailand, where the government-sponsored Health Card Program has already attracted 28.2 per cent of the population (WHO, 2004), PHI caters only to niche markets. No particular form of health insurance dominates the region, which reveals the whole spectrum of possible PHI arrangements including private for-profit, HMO, no-profit, and community based health insurance (WHO, 2004). Depending on the efficiency and outreach of mandatory social schemes, private programmes offer both comprehensive and

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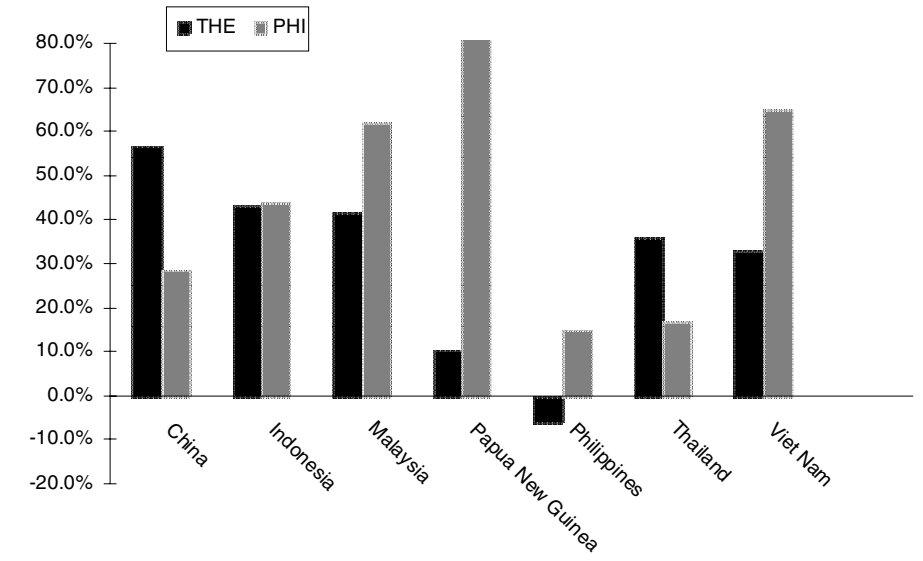
supplementary coverage. Specifically, rural areas, often insufficiently serviced by public insurance, have recently witnessed the emergence of community-based health insurance schemes similar to those found in sub-Saharan Africa (e.g. in China and Viet Nam). PHI in urban areas, on the other hand, appears mostly in the form of private for-profit schemes providing additional coverage to high-income individuals.

Prospects for PHI development

Private health insurance has an important growth potential and already has experienced dynamic development (Figure 7.8). As a response to increasing health costs that overburden existing social security systems, many countries have embarked on the development of private risk-sharing programmes. Thailand's Health Card Program offers an illustrative example of how such government initiatives can be supported by subsidised premiums and an extensive publicity campaign. Similarly, Viet Nam has recently started to investigate new policy tools to finance health, including user fees, health insurance, and health-care funds. Adams (2005) argues that beyond increasing public contributions to the health sector "there is also increasing scope for private health insurance provision". The health sector is also being re-organised in Indonesia where large parts of the population are currently not covered under social insurance. The government is considering various forms of private health insurance, including managed care and community schemes. PHI's contribution to universal coverage remains limited, however, as the number of people insured and services covered under the schemes remains small (WHO, 2004).

Figure 7.8. **Total Health Expenditure and PHI Spending in East Asia and the Pacific***



Note: * Percentage change between 1998 and 2002.
Source: Authors' own calculations. Data: WHO (2005).

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China is predicted soon to become a dynamic market for insurance providers (Swiss Re, 2004*a*). Following massive reforms in 1998 (urban areas) and 2002 (rural areas), the Chinese health-care system is currently being restructured after coverage rates of social insurance dropped significantly in the 1980s and 1990s (64 per cent of the population in rural areas and 15 per cent in urban areas did not have health or accident insurance at the end of the 1990s; Swiss Re, 1998). Particularly challenging are escalating health costs that have increased tremendously since trade liberalisation and the shift to open-market policies in the 1980s. In the reform process, "China has carried out some of the most interesting experiments with new forms of health insurance financing" (Ginneken, 1999). At the same time, the government's role in providing medical insurance is declining to make room for increased private involvement (Swiss Re, 2003).

In developing their markets for private health insurance, East Asian countries face a trade-off between promoting a new industry with supportive policies and simultaneously ensuring ample regulation and consumer protection. As noted by Sekhri *et al.* (2004), measures to increase competition among insurers may encourage innovation, efficiency, and responsiveness of private schemes; at the same time, such policies may also "lead to higher administrative costs, small risk pools that are not economically viable and aggressive pricing practices that can create market instability and insolvency".

Private Health Insurance in South Asia

Of all regions studied here, South Asia represents the smallest and least significant insurance market. Its share of the world's total insurance premium income accounted for only a mere 0.6 per cent in 2003, although the region houses 22.7 per cent of the world's population and contributes 2.1 per cent of the world's GDP (Swiss Re, 2004*b*).

Significance of PHI

WHO data indicate spending on private health insurance in only three countries: Bangladesh, India and Sri Lanka (Table 7.7). Other parts of South Asia either did not have PHI at the time the data were collected or spending on private programmes was too small to be recorded in national statistics. In fact, even in these three countries per capita spending on PHI is basically negligible (between 0.01 and 0.17 international dollars in 2002)[6].

Table 7.7. **Relative Importance of PHI in South Asia***

Country	Importance of PHI	Country	Importance of PHI
Bangladesh	0.1	Sri Lanka	0.5
India	0.6		

Note: * PHI expenditure as per cent of THE in 2002, not including countries without PHI or where data were not available.
Source: Authors' own calculations. Data: WHO (2005).

The insurance industry in South Asia became largely marginalised during a period of nationalisations in the 20th century. It has now started to regain some of its vigour and vitality as countries begin to re-open their markets for private insurance companies. Yet important obstacles like severe "poverty, lack of awareness, and, perhaps, strong belief in fatalism" (Pereira, 2005) still prevent the development of private insurance markets. India as a relatively

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developed economy with a strong middle class population (roughly 300 million people) certainly offers the most promising environment for PHI to evolve. Not surprisingly, it is already estimated to have the largest market for private health insurance with schemes covering 33 million people or 3.3 per cent of the Indian population (Sekhri and Savedoff, 2005).

Characteristics of PHI

Among South Asian countries, India provides an interesting example for studying private health insurance, for a number of reasons. Not only does it dominate the region in population size and economic potential, but it also reveals a wide selection of health financing options recently expanded to encompass innovative forms of private health insurance. In fact, the country is clearly moving away from a state-financed system; public expenditure on health as a percentage of GDP declined from 1.3 per cent in 1990 to 0.9 per cent in 2004. This process has involved the exploration of different forms of health insurance, including private pro-profit, community and employer-based schemes as well as mandatory public insurance. Especially after the passing of the Insurance Regulatory Development Authority Bill in 1999, private health insurance has witnessed dynamic development as foreign and domestic providers have entered the market.

In a country as large and diverse as India, it would be surprising to find only one type of health insurance. Public schemes have only recently started to emerge and are still limited to a small segment of the population. Consequently, the market leaves considerable room for alternative programmes to evolve, which will continue to boost the development of PHI. Private schemes already cater to various health insurance needs, regions and income groups. Specifically, large pro-profit insurance companies and employer-based schemes cover primarily upper-middle and high income groups in urban centres and people working in the formal sector. Community-based schemes and insurance offered by NGOs, on the other hand, typically target poorer populations living in rural areas. As in sub-Saharan Africa, these schemes reach the population by adapting the services they offer and the premiums they charge to the economic capacities of the local population. In the long run, such programmes could become an important foundation on which to construct more comprehensive health insurance. Some of the larger insurance companies even target poor population groups specifically (e.g. *Jan Arogya Bima* with around 7.2 million people insured in 2001). Such schemes, however, generally employ risk-rated premiums (e.g. based on age) and pre-existing disease clauses, which allow exclusion of bad-risk individuals (WHO, 2004).

Prospects for PHI development

With the exception of India, it is unlikely that private health insurance will play an important role in South Asian health systems in the near future. Absent further reforms and continued political determination to establish a sizeable PHI market — as well as economic development and a considerable reduction of poverty — private health insurance will remain a niche product for a few privileged individuals. As in sub-Saharan Africa, development potentials will be found predominately in small community-based schemes and in insurance offered through NGOs and other non-profit organisations. Due to the lack of time-series data for South Asian countries, no patterns for spending behaviour on PHI can be derived. Bangladesh, India and Sri Lanka showed a slightly increasing trend of PHI expenditure between 1998 and 2002, but on a very low level (less than $1) that prevents any inference of general patterns.

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Regional Challenges to Integrate PHI into a Health System

The previous discussion has revealed important regional differences in the development of private health insurance, differences that find reflection in the problems countries have experienced with the introduction of PHI. One can distinguish three groups of countries:

— those that have already witnessed significant growth of private insurance after the liberalisation of markets. They now need to integrate PHI better into their health systems (Latin America) or establish alternative insurance mechanisms (Eastern Europe);

— those in which PHI is mostly a new phenomenon, but where the socio-economic environment will likely foster the development of private health insurance (East Asia and the MENA region); and

— those in which PHI will probably remain a niche product in the foreseeable future, but where innovative approaches may induce initial development of health insurance mechanisms (sub-Saharan Africa and South Asia).

Reducing Market and Policy Failures: Latin America and Eastern Europe

The track record of private health insurance in most of Latin America and Eastern Europe is disappointing. Many countries have seen that the introduction of private insurance does not cure every problem of the health-care system. Health costs have not decreased, quality of care mostly has not improved and coverage rates have not gone up. On the contrary, many countries have even experienced deterioration in the health sector, especially as regards equitable access to financial protection. Most problems originate from regulatory frameworks insufficient to integrate PHI into the existing structures effectively.

Chile, where private ISAPRE schemes first entered the market in 1981, only gradually responded to regulatory demands and established a supervising agency ten years after the initial reforms. Similar delays occurred in Argentina, Colombia and Brazil — in Brazil, "regulation of the private insurance market was virtually non-existent until 1998" (Jack, 2000) — negatively reflecting not only on the efficiency of the system but also the reputation of PHI.

In Eastern Europe too, countries have learned that successful implementation of PHI demands more than merely opening markets for private providers. Many governments have failed to provide proper risk-sharing and risk-adjustment mechanisms and lacked strategic planning. Insufficient policy co-ordination has left the health sector highly fragmented while the pros and cons of private insurance were insufficiently communicated to the public. The radical move toward market structures has evoked confusion and uncertainty among the population about both the possibility and the need to obtain PHI for treatments that are not covered otherwise.

Although Eastern Europe and Latin America have had similar experience with the introduction of PHI, their responses seem to differ significantly. Most Latin American countries are determined to maintain PHI, but countries in Eastern Europe are predominantly shifting back to other forms of health financing, most notably social health insurance. The challenge in the former will be to improve the integration of PHI into the health care system, which will not be easy given the early shortcomings that have weakened trust in private insurance. In the latter, countries will have to explore alternative solutions to organise health care spending, ideally using their experience with private insurance to structure other forms of health financing.

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Controlled Growth through Efficient Regulation: MENA and East Asia

PHI can be expected to grow in MENA and East Asia, largely because of the importance of private spending on health (high OOP expenditure) and the countries' recent economic development. Although PHI is more advanced in MENA, both regions are in a good position effectively to influence its future growth. Experience from Eastern Europe and especially Latin America has demonstrated that introducing PHI without prior modification of the regulatory framework is prone to malfunctioning. It requires pro-active policies that allow an efficient integration of PHI into existing structures.

In many countries, the establishment of private health insurance is perceived as a way to release pressure from overburdened health financing systems: e.g. in Saudi Arabia, China and Indonesia. For this to materialise, countries face a trade-off between promoting a new industry with supportive policies and similarly ensuring ample regulation and consumer protection. Countries must therefore find a balanced mix between sufficient regulation and liberal policies that give PHI room to develop.

Strategies for developing a functioning private health insurance market vary significantly between the two regions. Whereas the state has traditionally had an active role in providing social insurance in East Asia, countries in the MENA region either relied on public health care (Yemen, Saudi Arabia) or did not have any health insurance mechanisms at all (Morocco). In this respect, the development of a functioning PHI system will probably be less challenging in East Asia, because countries can rely on existing know-how in dealing with insurance systems. As the Thailand Health Card Program illustrates, governments already take an active stance in promoting the development of a private insurance system. Similar projects could succeed in other countries of the region also, and close co-operation between the public and private sectors (e.g. Public Private Partnerships) might prove particularly beneficial. In the MENA region, on the other hand, PHI has sometimes developed in an institutional vacuum. A lack of policy harmonisation, low institutional accountability and insufficient co-ordination between respective ministries have obstructed public oversight, which may explain some of the problems experienced with private health insurance. Many countries will need to make up for earlier shortcomings. Unlike Latin America, this process should nevertheless be relatively smooth given the early stage of PHI development.

Small-scale Programmes a Start for the Better: Africa and South Asia

In many African and South Asian countries, private health insurance is the only available form of risk pooling. That PHI currently only reaches a small number of people is therefore not necessarily a reason for concern *per se*. Many PHI schemes are designed as supplementary insurance, however, covering better-quality treatment and charging premiums affordable only by high-income individuals. Such schemes appear ill adjusted to the needs of large parts of the population, an assessment that particularly applies to private commercial health insurance. Experience from Ghana nevertheless illustrates that PHI can well be suited for low-income groups when the schemes are adjusted to local conditions (Okello and Feeley, 2004). In Ghana, the poor were persuaded by information campaigns to purchase only relatively cheap policies covering inpatient health care. Hospital services are rarely needed, yet pose a severe risk of impoverishment when they occur.

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Why is this adjustment so difficult? Dror and Jacquier (1999) identify a mismatch between supply and demand for PHI, which prevents large, generally for-profit insurance providers from interacting efficiently with potential clients. In order to ensure broader health coverage, the authors propose micro-insurance programmes, which can harmonise accumulated reserves with community-specific risk and benefit priorities. Such programmes can have various forms, including schemes operated by NGOs, communities, voluntary associations, hospitals, firms or even private financial institutions (as demonstrated by the Grameen Bank).

The roles of NGOs in administering private non-profit health insurance are manifold, occasionally making them a "leading force in health insurance provision for the informal sector" (GTZ, 2003). NGOs can facilitate the functioning of schemes or manage insurance programmes entirely. Small insurance schemes are also offered by health care providers including hospitals and local medical centres. Such programmes have the advantage of bringing insurance closer to the target population, even though evidence from Zaire seems to indicate that they too fail to integrate the chronic poor into their coverage (Jütting, 2004; Criel *et al.*, 1999) — a perception that is confirmed for the hospital-based Lacor Health Plan in Uganda (Okello and Feeley, 2004).

Small insurance programmes need to balance limited financial capacities with the health needs of their clientele. They consequently represent merely a starting point for the development of more efficient insurance mechanisms. Furthermore, schemes that limit coverage to high cost/low frequency events may not be the best option when local conditions demand large-scale preventive care (e.g. immunisation and vaccination campaigns). Limited coverage may also run the risk of impeding the long-run development of PHI (*La Concertation*, 2004). Private schemes will become a true alternative to other forms of health financing only if they are able to expand their services and provide a wider range of coverage. In many African countries, CHI faces the challenge of offering an attractive product and maintaining affordable premiums. Although low cost/low coverage programmes may facilitate the initiation of a scheme, CHI eventually needs to develop beyond this stage if it wants to attract larger parts of the population.

Conclusions and Outlook

Private risk-sharing programmes are gradually gaining importance in the health-care systems of low-income and middle-income countries. As documented above, prospects for PHI development are promising in a number of countries, due to five main factors:

— many countries have difficulties with traditional ways of financing health care and look for alternatives so as to achieve universal coverage;

— economic growth leads to higher income and diversified consumer demand;

— public entities frequently lack people's trust and confidence, but as PHI is generally associated with private health care providers it often enjoys wider popularity;

— globalisation and economic opening will lead to more trade in the health care sector; and

— PHI offers many possibilities for innovative and flexible approaches, which may help reach marginalised individuals and overcome institutional weaknesses.

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Nevertheless, the introduction of PHI is not an end in itself and demands a careful consideration of its impact on a country's health system. It will neither cure all shortcomings of the previous system nor remain free of possibly negative consequences for existing structures. Private risk-sharing programmes are an alternative way to finance health care; as such, they expand a country's options to cover health costs and/or lay the foundation for further development towards universal coverage. It is particularly important that a country have clear concepts of what role PHI should play in the existing system and how it should develop better to serve future health-care needs.

As this review has demonstrated, the role of PHI varies significantly based on a country's economic development and institutional capacity. For the potential benefits of private insurance to materialise, countries need to observe carefully the specific environment surrounding PHI and adapt their development strategy to local needs, preferences and conditions. Similar recommendations also apply to international donor agencies or NGOs that seek to support the development of alternative health-financing mechanisms. Experience has shown that private health insurance offers room for innovation that should be used effectively.

PHI is certainly not the only alternative nor the ultimate solution to alarming health-care challenges in the developing world. Yet it is an option that warrants — and already receives — growing consideration by policy makers around the globe. Thus, the question is not whether this tool will be used in the future, but whether it is applied to the best of its potential to serve the needs of countries' health-care systems.

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Notes

1. A joint conference of WHO, ILO and GTZ on "Social Health Insurance in Developing Countries" (http://www.shi-conference.de/) recently proclaimed that "the extension of social protection in health is the key strategy to reduce financial barriers to access health care and moving towards universal coverage".
2. Although this study does not apply a strict rule for when contributions can be considered high, it generally considers spending around and exceeding 5 per cent of total health expenditure.
3. In accordance with EU and OECD conventions, health and accident insurance are considered to belong to the non-life insurance segment, although some countries or insurance companies may employ a divergent classification (Swiss Re, 2004*b*: 28).
4. In 1995, 35 private insurance companies offered close to 9 000 distinct insurance programmes in Chile.
5. Interested readers may wish to consult the existing literature on the subject (e.g. Söderlund and Hansl, 2000).
6. Coverage rates can nevertheless be quite significant, as is indicated by the Grameen Bank health insurance programme in Bangladesh. The WHO (2004) reports that around 140 000 people are covered under this scheme, which was initiated in order to reduce defaults of the bank's microcredit loan programme (Desmet *et al.*, 1999).

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