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The present and the future of development economics

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Aid and Poverty Reduction

by Oliver Morrissey

Aid effectiveness has attracted considerable attention in the economic development literature since the late 1990s, both in terms of research publications and policy debates. Something of a consensus is emerging that aid does have a positive impact on growth, although debate remains as to whether or not good policy is necessary to ensure aid effectiveness. Recently, research has begun to examine the impact of aid on poverty reduction. This reflects the increasing emphasis being placed on poverty reduction in policy debates, and demands that the objective of reducing poverty requires an increase in aid to poor countries (e.g. the UN Millennium Project and the report of the Commission for Africa). In this context, what do we know about the effects of aid on reducing poverty?

Many will be familiar with arguments along the lines that growth reduces poverty, so if aid is effective in increasing economic growth it will contribute to reducing poverty. Advocates of this argument tend to suggest targeting aid to countries with large numbers of poor people that also display an ability to use aid to increase growth (typically, good policy is accepted as evidence of this ability). This is a reasonable argument (if growth benefits the poor and aid increases growth, then aid benefits the poor), but is not the whole story. On the one hand, growth is not necessarily pro-poor (even if sustained growth is important for sustained poverty reduction). On the other hand, growth is not the only way that aid can benefit the poor; in stagnant economies aid may be able to benefit the poor, and even in a growing economy aid may ensure greater benefits go to the poor.

It is important to allow for the various ways in which aid can impact on the poor. Furthermore, it is important to take a broad concept of poverty. Improvements in aggregate welfare (better health and education for example) may benefit the lives of the poor just as much as reductions in income poverty. Aid that generates income-earning opportunities or that provides social services, such as donor-funded projects in health or sanitation, can increase welfare directly and may be targeted on the poor (even if targeting is imperfect). Aid that contributes to economic growth should lead to long-run increases in aggregate welfare. Furthermore, much aid is directed through government spending, and aid can increase welfare by increasing expenditures towards those social services that contribute to welfare. Box 1 summarizes the main channels.

The research findings discussed here allow for these various channels, especially through the level and allocation of public spending. Although some studies do use data on poverty, comparative cross-country data on poverty over time is extremely scarce, and such data as exist are based on income measures of poverty (which do not capture all dimensions of poverty and are not fully comparable across countries). Researchers avail of the fact that there is a strong correlation between levels of poverty and levels of aggregate human welfare across countries, specifically as measured by the human development index (HDI) and the infant mortality rate (IMR). If there is evidence that aid is associated with higher welfare (higher HDI or lower IMR), then it is likely that aid benefits the poor (at least by improving access to public services).

Evidence on Aid and Welfare

In an effort to try and capture some of the channels through which aid affects welfare, one can include government spending in addition to aid as an explanatory variable. One has to be careful in doing this to avoid double-counting, as much of the aid directly finances government spending (and is therefore 'present' in both variables). The results presented here control for this (in effect, by stripping out the aid component of government spending). This still leaves the question of how to measure spending to capture only those components most likely to benefit the poor. The literature suggests that social sector expenditures – health, education, and sanitation – are the most likely to be pro-poor. Social spending not only increases human welfare but tends to do so in a manner that is pro-poor. Thus, one can define 'pro-poor public expenditure' (PPE) as the sum of spending on health, education, and water and sanitation (as a share of GDP).

Tables 1 and 2 present results for HDI and IMR respectively. Three explanatory variables are reported. Initial GDP controls for the tendency of richer countries to have higher levels of welfare. The PPE variable captures the efficiency of public spending in increasing welfare. If the coefficient is positive and significant, this implies that public spending (and aid that finances such spending) contributes to increasing welfare. The coefficient on the Aid variable captures the effects of aid, either directly through aid projects or indirectly through growth (as it is lagged).

Box 1: Channels for Aid affecting Poverty

Direct: Aid projects may be targeted at the poor (e.g. microcredit) or may support the provision of public services that are likely to benefit the poor, e.g. rural health or primary education.

Indirect via growth: To the extent that aid is effective in increasing economic growth this provides opportunities for sustainable poverty reduction.

Indirect via government spending: Most aid is delivered through support for government spending. If aid allows for higher levels of spending on social sectors (especially health, education, clean water and sanitation) this contributes to higher levels of human welfare. The poor can be expected to benefit from enhanced access to better quality public services.

Pro-poor policy: Aid underpins a donor-recipient relationship and may encourage recipient governments to place poverty reduction higher on their policy agenda. An example would include Poverty Reduction Strategy Papers.

There is robust evidence that aid improves welfare indicators, HDI and IMR, and this effect is predominantly through direct impacts (aid provides incomes or social services) or growth. This beneficial effect of aid is present for low-income and middle-income countries. We only provide illustrative results here, but this is a common finding in a number of recent studies. However, only for middle-income countries is PPE associated with increased welfare, and here only for the HDI measure. This suggests an issue of concern, as government spending does not appear to be very efficient. This may be in part because the levels of PPE spending are quite low, especially in the poorest countries.

Aid effectiveness in benefiting the poor could be enhanced if the efficacy of public spending is increased. Attempts to increase the targeting of expenditure in areas that are more likely to benefit the poor could yield a high pay-off. The use of aid to guide or influence the allocation of government spending offers a way to increase the leverage of aid on poverty alleviation (the final channel in Box 1). Increasingly, aid is being used in the way we consider, to support public spending under the HIPC initiative for example.

Debt Relief, Aid, and the Poor

In most respects debt relief is equivalent to aid and can be treated accordingly. Under HIPC, countries are required to establish a good record of implementing economic and social policy reform and prepare a Poverty Reduction Strategy Paper (PRSP) indicating how they will tackle poverty reduction. The funds

	Table 1. Aid, Public Expenditure, and the HDI			Table 2. Aid, Public Expenditure, and Infant Mortality		
	Dependent variable Log(HDI)			Dependent variable Log(IMR)		
	All countries	Low-income	Medium-income	All countries	Low-income	Medium-income
GDP (initial)	0.137	0.185	0.096	-0.327	-0.187	-0.420
	(4.57)**	(3.15)**	(3.58)**	(4.03)**	(2.20)*	(3.30)**
PPE	-0.005	-0.017	0.027	-0.018	-0.005	-0.096
	(0.57)	(1.35)	(2.01)	(0.73)	(0.27)	(1.55)
Aid_{t-1}	0.021	0.031	0.021	-0.049	-0.037	-0.068
	(2.93)**	(2.33)*	(3.13)**	(2.65)**	(2.03)*	(2.21)*
N	289	128	161	311	138	173
R-squared	0.17	0.17	0.35	0.17	0.11	0.25

Notes: The data cover an unbalanced panel of four four-year and one five-year period averages over 1980 to 2000 for 104 countries. All variables measured in logs; estimates are fixed effects. Absolute values of t-ratios in parentheses; *, **, indicate significance at 5% and 1% levels respectively. PPE is a measure of 'pro-poor' public spending. Explanatory power for fixed effect estimates reported by R^2 rather than adjusted R^2. The F-statistic tests the joint significance of all coefficients (rejects the null that all are jointly zero).

Sources: Gomanee, K., O. Morrissey, P. Mosley and A. Verschoor (2005), 'Aid, Government Expenditure and Aggregate Welfare', *World Development* 33:3, 355-370. See also P. Mosley, J. Hudson, and A. Verschoor (2004), 'Aid, poverty reduction and the new conditionality', *The Economic Journal*, 114, F217-F243.

made available by debt relief would be then channelled into poverty-reduction, typically through a Poverty Action Fund (PAF) that identifies pro-poor expenditures (i.e. the PRSP has a similar emphasis to PPE above).

To qualify for debt relief countries must demonstrate their ability for sound economic management through satisfactory implementation of policy reforms over three years under IMF and World Bank programmes. The inherent defect with this approach is that the resources to fund pro-poor expenditures are not released fully until the end of the process. The essential pro-poor policies in PRSPs can be considered under two headings – those relating to the provision of and access to public services (like PPE) and those relating to the rural sector; increased public spending on the provision of social services is a central element of PRSPs. The role of debt relief itself is to provide increased government resources to finance these pro-poor policies.

It is generally easier to identify and implement pro-poor expenditures than it is to implement an economic reform programme that includes pro-poor policies. If the primary objective is poverty reduction, therefore, the prior policy is pro-poor expenditures. Pro-poor policies, however desirable, are of secondary priority. The current approach to HIPC conditionality reverses these priorities. This is not necessary, as eligibility for the release of resources (aid and debt relief) could be based on pro-poor expenditure criteria. Reversing these implicit priorities could enhance the provision and effectiveness of debt relief.

Aid can and does contribute to poverty reduction, by contributing to growth, by providing direct benefits to the poor, and by supporting and financing increased social sector spending. It is evident that more can be done, especially in improving the effectiveness of public spending in delivering improvements in welfare, especially of the poor. Aid and donors will continue to play an important role. It is also evident that greater coherence is needed – debt relief should be aligned with aid in tackling poverty, and this means that the emphasis should be on pro-poor spending and providing services. This can be achieved before or in conjunction with macroeconomic policy reform, it does not need to wait until after.

Box 2: Pro-Poor Debt Relief Sequencing

Aid resources should be deployed to support pro-poor expenditures, the only condition being the existence of expenditure monitoring.

Debt relief should be initiated subject only to a PRSP plan being in place. This facilitates the initiation of pro-poor policies.

Debt relief can be accelerated when an appropriate package of pro-growth policies is in place.

Source: O. Morrissey (2004), 'Making Debt-Relief Conditionality Pro-Poor', chapter 12 in T. Addison, H. Hansen and F. Tarp (eds), Debt Relief for Poor Countries, *Palgrave/WIDER.*

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Effectiveness of Development Cooperation

by Pertti Majanen and Riitta Oksanen

Effectiveness for poverty reduction and the MDGs

The Finnish Government adopted a new development policy in 2004. The white paper links Finland's development policy and development cooperation to the framework of the Millennium Development Goals and the Millennium Declaration. The main goal of Finland's development policy is to contribute to the eradication of extreme poverty from the world. In striving towards this goal, Finland emphasizes the rights-based approach and the principles of sustainable development. The 2004 development policy defines three main strategies for implementation: (i) promotion of policy coherence for development; (ii) improving the quality and effectiveness of development cooperation; and (iii) strengthening of partnerships for development. More than one year into the implementation of the new policy, interesting experiences can be shared from all three areas. In this article, the focus is on Finland's efforts to improve quality and promote effectiveness in development cooperation.

Doing more and better to implement the MDG # 8

In the 2004 development policy, Finland made an explicit commitment to implement the Millennium Development Goal number 8. This goal focuses on the establishment of a global partnership for development, and particularly on the responsibilities of the donor countries. Finland is committed to do both more and better to implement the MDG8.

The MDG8 is related to increasing the finance for development, including more ODA, development of a non-discriminatory trading system and dealing comprehensively with the debt problems of developing countries. In terms of volume, Finnish ODA will be increased to achieve the 0.7 per cent GNI share. The growing ODA will be allocated according to criteria that reflect the priorities of the development policy. This means increasing financing for LDCs, for sub-Saharan Africa and for NGO-cooperation.

But resources are scarce even if they are increasing. Best use must be made of them through improving efficiency and effectiveness. Parallel to the quantitative commitments, Finland strongly emphasizes the importance of quality. Systematic work has been on-going already since the 1990s for quality improvements in Finland's development cooperation.

Finland's quality agenda for increased effectiveness of development cooperation

Finland's development policy establishes a 'quality agenda' for increasing effectiveness. Efforts focus on the following priorities:

Strengthening ownership and poverty-focus through alignment: Finland's support to partner countries is always channelled in the framework of the partner's own priorities. During the past years, the poverty reduction strategies of the poor countries have become the basis for aligning Finnish contributions. All new bilateral support is identified in the context of PRSs. Programme-based modalities with joint financing arrangement (e.g. budget support and pooled funds for sector programmes) are increasingly used. Stronger ownership and increased poverty-focus are the prerequisites for sustainable results and effectiveness. Finland promotes the same principles also when contributing through the EC and multilateral institutions.

Harmonization**:** Harmonization has been high on the international agenda since the Millennium Declaration and the Monterrey conference on development finance. The OECD-DAC is the key forum to follow-up the commitments made. Finland's national harmonization action plan was approved in 2004. The challenges and priorities have been identified using the DAC Good Practice Papers on harmonization as a frame of reference.

Finnish priorities include e.g.: Finland participates in partner country-led harmonization processes for practical results. In some countries harmonization efforts are integrated in the implementation of PRS-processes and sector programmes (e.g. Mozambique), in others the governments have launched specific harmonization processes (e.g. Vietnam). Revision of the administrative and management guidelines for Finnish development cooperation has been started to accommodate the principles of harmonization. An example is the development of the financial management system to improve the predictability of Finnish funding. An inter-departmental harmonization team has been established in the Ministry for Foreign Affairs to coordinate, facilitate, and monitor implementation. One challenge that was recently highlighted is to strengthen communication between the country teams that are responsible for implementation and the policy teams.

Focusing on fewer but bigger cooperation programmes: Concentrating Finland's relatively limited contributions in a strategic way on fewer but bigger well-selected entities is one of the keys for improved effectiveness and impact. Major efforts have been put into this process since 2001. It takes time since existing commitments need to be completed in a responsible manner. The objective is to focus Finland's bilateral cooperation increasingly on eight long-term partner countries (Ethiopia, Kenya, Mozambique, Tanzania, and Zambia in Africa; Nicaragua in Latin America; and Nepal and Vietnam in Asia). In these countries Finland's support will be focused on three sectors or development programmes (and budget support may be used to complement this).

Complementarity and division of labour based on strengths and comparative advantage: Finland's involvement will increasingly be based on an analysis of the value that our participation adds. This approach combined with the strategy of focusing on fewer cooperation programmes is the basis for establishing complementary cooperation relations with other development partners. Reducing the number of actors involved at sector or programme level in partner countries, and doing this based on an analysis of comparative advantages, is one of the obvious challenges of the next few years. Finland welcomes the initiative and leadership taken by some partner countries in the form of establishing joint assistance strategies (e.g. the JAS in Tanzania) to facilitate the process.

Results- and outcome-based management: A shift of focus is necessary in the management of development cooperation. The tradition has been to emphasize the resources and the input side, and to micro-manage activities and operational details. Quoting the discussions on management for development results in the Paris High-level Forum on Aid Effectiveness this spring: Two simple guiding questions must increasingly complement the traditional emphasis. These are: 'Are we being effective?' and 'How do we know?'. In Finland, too, work is on-going to improve our results-based management systems. Major efforts are put into developing the state budget, including a budget for development cooperation that uses result indicators. At the same time, the Ministry has introduced a new annual reporting mechanism emphasizing the follow-up of outcomes and results. This mechanism is based both on internal monitoring by the Ministry and external evaluation by the national Development Policy Committee.

In results- and outcome-based management we have a shared interest with the governments of developing countries. The partner governments are accountable to their parliaments and people for the correct and effective use of national and external funds. To justify the continued use of public funds and to maintain tax payers' support, the donor governments have to provide open information on the results and secure the good quality of development cooperation. It is, therefore, in our common interest to strengthen the poverty-monitoring systems in the partner countries. This is an important governance issue.

Decentralization of the management of development cooperation: Compared to many peer institutions, Finland's development cooperation management is still centralized and Helsinki-based. Decentralization will be piloted in four embassies in 2005. A mapping of experiences of our peer institutions has just been finalized. A clear message that we get from colleagues is that for the effectiveness of development cooperation, decentralization of its management to the embassies is the right solution. Decisions need to be taken as close to the reality of implementation as possible. This is particularly important in the context of programme-based cooperation (budget support, pooled funding of sector programmes).

Working in close cooperation internationally to promote effectiveness

For Finland, close international cooperation for the promotion of effectiveness has been very important. The OECD-DAC has been the leading forum in this area during the past years. Close involvement of representatives of partner countries as well as multilateral institutions in the DAC-work has been an important resource and very obviously contributed to the quality of results. Good practice papers on harmonization and alignment, work on budget support, sector programmes and strengthening of public financial management capacities are examples of the results of the DAC work that Finland finds particularly useful. The OECD-DAC also provides the framework to finalize the mechanism for future monitoring of progress in effectiveness before the UN Millennium Event in September 2005.

Effectiveness is also high on the EU agenda in the discussion on achieving the MDGs. The EU made eight commitments when preparing for the Monterrey conference in 2002: increasing ODA levels to achieve the 0.7 per cent target; promotion of harmonization; further work on untying of aid; increased trade related technical assistance; further work to identify relevant Global Public Goods; further exploration of innovative sources of financing; influence on the reform of the international financial system; and efforts to restore debt sustainability in HIPCs. The EU is now preparing for the UN Millennium Event 2005 by taking stock of progress made and by discussing new commitments for accelerated progress.

In addition to the formal cooperation, Finland is actively involved in the informal cooperation in the so-called Nordic+ group (Denmark, Iceland, Norway, Sweden, Ireland, the Netherlands, UK). Sharing of views and experiences is particularly useful in effectiveness issues for peer encouragement – and when needed, also for peer pressure.

Development cooperation efforts will only be effective if complemented by coherent policies and actions in other sectors that are relevant for poverty reduction in developing countries. Promotion of policy coherence for development is an enormous challenge that calls for new kinds of partnerships both at home and abroad. In its development policy, Finland is on this road.

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Reshaping the International Aid Architecture

Aid Works, But Let's Make it Work Better by the Joint Determination of Aid Allocations

by Mark McGillivray

I. Introduction

Growth in developing countries would be lower in the absence of aid. This is clear from the results of recent research on the macroeconomic impact of aid, evidence from micro studies, and field experience. One can reasonably infer that by implication poverty would be higher without aid. Aid works, on balance, therefore. Yet it is also true that aid has many failings.

Reform to the international aid architecture should not simply be reform for the sake of having reform. It should aim at improving the developmental effectiveness of aid by *inter alia* addressing these failings. This note addresses three perceived failings: (i) insufficient consideration of absorptive capacity constraints; (ii) under- and over-aiding; and (iii) year-on-year aid instability. It looks at why they are failing, and floats some proposals that aim to fix them. These proposals involve greater inter-donor coordination of aid allocation decisions than currently appears to exist. Ideally, this coordination should result in the joint determination of country level aid allocations, involving all donors, bilateral and multilateral. The case for this becomes stronger the greater the level of global aid, especially if it reaches the levels called for to achieve the Millennium Development Goals.

II. Aid Effectiveness Issues

Absorptive Capacity Constraints

While aid is positively associated with growth, there can be too much of a good thing, with aid being subject to diminishing returns. This is based on the findings of a number of studies that tested for non-linearity in the aid-growth relationship, with aid being positively related to per capita income growth up to a certain level of aid relative to recipient GDP and negatively related thereafter. This is a seemingly highly robust finding, with almost all studies testing for such a relationship finding evidence of its existence. These studies find that negative returns set in when the aid inflow reaches anywhere between 15 and 45 percent of GDP. This has been interpreted as indicating limited aid absorptive capacities, with recipient governments being limited in the amounts of aid they can use efficiently. Even if this constraint was removed, there will still be an upper limit to the amounts of aid that an economy can efficiently absorb. This issue is especially relevant to fragile states (those with critically poor policy regimes and weak institutions) as they will inevitably have very limited absorptive capacities, as conventionally defined. Increased aid to these countries, in line with proposals to achieve the MDGs, could actually increase poverty. Yet diminishing returns will in principle always be an issue in all countries; an economy can only efficiently absorb aid up to a particular level no matter how good its policies and institutions might be.

Absorptive capacity constraints need to be addressed urgently. Clarity is required over the precise levels at which aid impact becomes negative. The wide range of levels currently reported in the research literature is of little operational use to policy makers. Moreover, these aid levels, expressed as ratios of GDP, have typically been obtained from panel data for diverse samples of countries. One size will not fit all: country- or category-specific levels are required. It must also be recognized that empirical evidence of diminishing returns is based almost entirely on aid flows that have gone to recipient country governments. There are other potential, non-government channels through which aid might be efficiently provided. There will presumably be optimal levels of aid that each channel can absorb, and information is needed on these levels. The different forms in which aid is provided will require individual consideration. Information is also needed on how to increase the absorptive capacities of the various channels. Both the research and donor communities should collaborate to work towards the provision of this information. The donor community should provide aid amounts up to but not beyond these optimal levels, working directly with government and non-government sectors in developing countries.

Under- and Over-aiding

In an ideal world the donor community would provide aid to all recipient countries up to the point at which the incremental impact on poverty falls to zero in each.[1] Moreover, in such a world the incremental efficiency of aid should be equal in all recipients, so that reallocating a given amount of aid from one country to another results in no change in global poverty. The second of these criteria is perhaps an impossible dream. But the first is not, and it should be a guiding principle for donors.

The current evidence suggests that fragile states as a group are substantially under-aided, having received far less aid than their populations, per capita GDPs and policy and institutional performance levels would predict.[2] But there appears to be tremendous diversity within this group, with some countries being over-aided and others being under-aided, in this sense. The under-aided countries are typically those of little global political or strategic significance and supported by relatively few donors. While this information doesn't quite tell us how donors are performing in terms of the first above-mentioned criterion, it certainly rings alarm bells. Nor does it tell us anything about less fragile states; under- and over-aiding is relevant to all aid recipients.

What would appear to be needed is the better absorptive capacity information, and coordination among donors to minimize deviations from the maximum levels of aid consistent with these capacities. While this ideally requires agreement among donors regarding aid allocation criteria and allocative processes, it certainly requires much greater coordination among them.

Aid Instability

Year-on-year instability in government revenues is bad for growth and poverty reduction. Yet research shows that aid inflows are more volatile than other sources of developing country government revenue. Fragile states are particularly subject to this phenomenon, as aid to these countries appears to be roughly twice as volatile as aid to other low-income countries. Possibly worse still, the volatility of flows to the under-aided countries is roughly twice that of the aid to the over-aided countries. This would on the surface be a relatively straightforward matter to address. Donors need to be more conscious of aid allocations over time, seeking to stabilize year-on-year variations, possibly through increased use of longer-term partnership agreements. But it is also a matter of greater coordination among donors, as a lack thereof could *inter alia* simply make smaller year-on-year variations much larger.

III. What's Next?

The absorptive capacity, under- and over-aiding and instability issues discussed above all converge. The second and third of these issues arise if there is deviation, spatial and inter-temporal, from aid levels corresponding to full capacity or optimal levels. Thus there is a clear message for the research community, which is to do more work and provide more operational clarity on absorptive capacities. It is up to donors to both evaluate and use where appropriate this information. Yet this is only part of the story. Donors need to decide how to use it, on what to do. This includes decisions on appropriate channels within recipient countries, so as to alleviate absorptive capacity constraints. Beyond this, what donors will hopefully do is better coordinate among themselves to ensure that variations from optimal, poverty reducing country level allocations are minimized.

One way of achieving the preceding outcome is, of course, some sort of global fund that administers all aid. But that will not happen. Less utopian is the joint determination of recipient country level allocations. This would involve all donors, bilateral and multilateral, or if not at very least the largest agencies, coming together to finally decide how much aid will be allocated in the following year or years and then acting in accordance with these decisions. If the DAC, in conjunction with major multilateral agencies can organize senior level fora on selected policy issues, why cannot it organize a similar annual event specifically to coordinate inter-recipient aid allocation? Recognizing that politics imposes constraints on bilateral agencies, selected multilateral agencies could play a 'balancing' role in this process, ironing out any residuals between actual and optimal allocations to the full extent possible. This is broadly consistent with the 'Multilateral Balancing Fund' recently proposed by DFID. If joint determination is not possible across the board, for all country-level aid allocation decisions, then it at least should be possible for certain country groups. The fragile state group, arguably that with the greatest per capita need for aid, is a good starting point.

1 *This reasonably assumes an inverted-U relationship between aid and poverty, consistent with the absorptive capacity issue just discussed. Ideally this relationship would be observed directly, using data on aid and poverty. But given the lack of poverty data one would need to use GDP data instead, drawing appropriate inferences for poverty reduction. The best approximation of this outcome is the level of aid at which the incremental impact on per capita GDP growth reaches zero.*

2 *The fragile state for the current purposes is defined as one belonging to the bottom two quintiles of the World Bank's Country Policy and Institutional Assessment (CPIA).*

This paper was originally prepared for the OECD Development Centre Workshop 'The International Aid System: What's Next?', held on 4 February 2005 at the OECD Headquarters in Paris.

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Aid Volatility & Aid Heterogeneity

by George Mavrotas

Aid volatility issues of growing importance for the attainment of the MDGs

Recent years have witnessed a growing interest in aid effectiveness issues and although recent empirical work seems to suggest that overall aid works in enhancing growth a number of issues still remain unresolved. An issue that has attracted particular attention quite recently is related to the volatility of aid inflows.

- The issue of volatility of aid inflows is now becoming particularly important in view of the ongoing discussion and debate on how to finance the Millennium Development Goals (MDGs). Aid volatility, and in particular the unpredictability of aid flows, is of crucial importance for the attainment of the MDGs.
- Aid volatility issues have also been raised recently within the context of the British proposal for an International Finance Facility (IFF), a mechanism to frontload aid flows so that MDGs can be met by 2015.
- Very recently, aid volatility issues have also been briefly discussed in connection with aid to *difficult partnership countries* and *fragile states.*
- Finally, there has been much recent debate on whether more aid can be spent effectively in developing countries, particularly in sub-Saharan Africa, in view of potential absorptive capacity constraints and diminishing returns to aid.

However, despite these pressing policy questions, there has been surprisingly little empirical work on the measurement of aid volatility. Using simple measures of aid volatility a few papers have found that aid volatility is bad for economic growth, *ceteris paribus*, and that aid is often among the most volatile sources of foreign exchange income.

Lehtikuva / AFP PHOTO / Jewel Samad

The international community responded rapidly to provide aid to the victims of the tsunami disaster

More recently, it was found that aid flows are more volatile than domestic fiscal revenues and tend also to be pro-cyclical; another finding was that fiscal planners are highly uncertain of aid receipts, the information content of aid commitments being either very small or statistically insignificant.[1]

Linking together aid volatility and aid heterogeneity is crucial

One drawback of much of the recent work on aid volatility (and actually of the aid effectiveness empirical literature as a whole) is the use of a single aggregate for aid. However, distinguishing among different aid modalities is crucial, because different types of aid are likely to have different degrees of volatility. Furthermore, different aid modalities have different conditionality. Certain types of aid such as emergency aid and, arguably, programme aid, should exhibit a high degree of volatility, since they are designed to deal with local economic and social crises. On the other hand, sector aid volatility, which is designed to promote investment in physical and human capital, is more likely to be detrimental to long-term economic and social development.

New evidence on aid volatility

The present article briefly discusses new evidence obtained on the volatility of aid by a very recent WIDER empirical study on the subject conducted by Fielding and Mavrotas (2005). The key purpose of the above study (which was prepared within the WIDER project 'Development Aid: A Fresh Look') was to determine the factors driving the cross-country variation in aid volatility. The approach employed differs from previous studies in a number of ways:

- First, the important issue of aid heterogeneity was taken into account instead of treating aid as a single aggregate. In view of this, the WIDER study focused on two types of aid, namely sector-specific aid (i.e. 'project' aid) and non-sector allocable aid ('programme' aid) which, if taken together, make up more than 95 per cent of total aid volumes.

- Second, the key volatility concept that was employed was that of a shock to aid, so the aid series were conditioned on an information set of lagged macroeconomic variables.

- Third, the work explored the factors affecting aid volatility by using a modelling framework that includes the size of aid flows, per capita income, institutional quality and policy regime in aid recipients.

- Finally, the study examined aid volatility using data for 66 aid recipients spanning the period 1973-2002 thus incorporating more recent data on aid volatility as compared to earlier work.

Key findings of the WIDER aid volatility study

- Sector aid volatility is positively correlated with programme aid volatility:

- a 1 per cent increase in aid as a proportion of GNI is associated with a fall in conditional sector aid volatility of around 0.16-0.17 per cent, and a 1 per cent increase in per capita income is associated with a rise in volatility of around 0.35-0.40 per cent; similar results were found regarding programme aid volatility, despite the fact that programme aid is rather more volatile than project assistance;

- the institutional quality of the aid recipient seems to reduce the volatility of sector aid;

- more open economies, which tend to be smaller and richer, *ceteris paribus*, experience more volatile sector aid flows;

- the quality of institutions and the degree of openness in aid recipients do not seem to be important factors concerning the volatility of programme assistance.

Some policy implications

- The above empirical findings emphasize *inter alia* the importance for donors of speedy implementation of the Rome Declaration on Aid Harmonization, which will lead to substantial reductions in aid volatility.

- More generally, it is imperative that donors explore new sources of financing accompanied by less volatility (for example, the IFF) so that the MDGs can be attained by 2015.

- Last but not least, the WIDER study points to the importance of aid heterogeneity in explaining the volatility of aid inflows. This has crucial policy implications with respect to progress towards achievement of the MDGs, since the differing degrees of volatility would not be apparent if a single aggregate for aid were employed. This is particularly important for aid recipient governments who are attempting to manage aid volatility by some combination of adjustment to tax and spending plans, adjustment of foreign exchange reserves or domestic non-monetary financing. For these countries, improved forecasting of both short-term and medium-term aid is also crucial.

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Equity, Economic Growth, and Aid in Finland

by Markus Jäntti

Finland is now a solid member of the European Union and the OECD. While Finland is not one of the richest countries, as measured by GDP per capita, its economic performance has been quite adequate. Finland is far from the top of the 'league table' of aid donors and lies behind both UN recommendations and its own set goals. Finland is, however, more or less in the middle pack of aid donors among OECD countries.

It is worth recalling, however, that Finland is a fairly late arrival among the high-income countries. Finland was a recipient of multilateral aid as late as in the 1970s. Drawing on recent work commissioned by the World Development Report team and conducted in part at WIDER, I point to the severity of several crises that occurred since 1860, including the famine of 1867-68, the civil war in 1918, and mass migration in the 1960s. I also point to a number of equity-oriented reforms, undertaken in part to resolve social conflicts, which may have contributed positively to economic development. Thus, while Finland is known as a quite tranquil, prosperous, ICT-intensive, and egalitarian country in the European periphery, things were remarkably different 140 years ago.

The Great Famine of the 1860s

The three deepest dips in Finnish population growth post 1860 occurred in 1867-68, 1918, and 1969 (population growth was of course very slow during World War II). The famine of the 1860s occurred after several years of poor harvests, driven in large part by bad weather conditions. A very bad harvest in 1867 led to mass migration from the hardest hit rural areas into the larger cities, where the migrated persons were gathered in various temporary poor houses and often put to work in various public works projects. While many deaths occurred even in the countryside, so to speak on location, mortality in the urban areas and poor houses reached very high levels. A significant cause of death was typhoid fever and other illnesses that could spread easily in the dense and unhygienic conditions that prevailed in the poor houses and which the undernourished migrants contracted easily.

The poor harvests were driven by bad weather conditions, but Finnish agriculture had throughout the 19th century suffered from poor harvests driven by bad weather. It seems, the very large increase in mortality that occurs during a famine requires additional problems. An important circumstance that contributed to the social upheaval during the 1860s was the fact that Finland, at that time an autonomous part of the Russian empire, had by the Czar been granted the right to issue its own currency, the silver Markka. With the need to build up foreign currency reserves in anticipation of the issue of the Markka, Finnish economic policy (which as conducted independently of Russia) was during those years very restrictive. This may have contributed both to lower purchasing power among the rural communities, making it more difficult to make up for the shortfall in grain by buying it from markets, and to an unwillingness on the part of central government to import, rather than export, grain. Indeed, when a decade later Finland was to move to the gold rather than silver standard, many who had in the 1860s supported the tight fiscal stance had considerably more sympathy for its critics.

Civil War in 1918

The causes of the Finnish civil war of 1918 are under considerable debate. The immediate reason was the fact that parliament, which had a socialist majority, was dissolved by the then narrowly non-socialist controlled senate (government). A contributing factor to this political crisis and its escalation into a bloody civil war was that despite having been on the agenda for several years, a land reform to provide farms for crofters – farmers who rented a less than 0.5 hectare farm – was yet to be implemented.

The civil war was fairly brief, lasting from January to early May in 1918. Some idea of the level of hostilities, however, can be gleaned from the causes of death on the 'red' (i.e., socialist) and 'white' (non-socialist or bourgeoisie) sides. The overall death toll was 34,277 persons (27,426 reds, 4,821whites and 2,030 others). Of the reds that died, however, less than one in five, i.e., 5,324, persons died in battle. Most of the reds died of executions and murders (7,207) or perished from hunger or diseases in prison camps (11,785) after the war. While a number of whites were also murdered, the vast majority of those on the white side who did die were killed in action.

Land Reform Act of 1918

A land reform act which allowed crofters to purchase, through a publicly-regulated process, their farms was enacted in the fall of 1918, just months after the prison camps closed. A few years later parliament passed a law that gave public loans to farmers who had acquired farms using the land reform act in order to enlarge their farms.

The land reform act was passed by a coalition of moderate bourgeoisie parties and social democrats. It can, at least in part, be understood to have been enacted to avert further violent unrest. Indeed, the 1920s were a period during which many modern progressive reforms were enacted. Legislation that made primary schooling compulsory was enacted in 1926, although its full implementation took a few decades. Infant and maternity care was centrally developed, progressive income and wealth taxation was introduced starting in 1920 and the separate taxation of married couples income was enacted in 1936 after having been debated since the inception of progressive income taxation.

Thus, many equity-oriented reforms were enacted quite soon after a bloody civil war. The reality of politics is quite complex and assigning a conscious, united will to further equity to these reforms would probably be unjustified. Their enactment did, however, require much consensus. It seems reasonable to assign part of the reason that so many reforms of this type came into place to the recent memory of civil war and the turmoil that both preceded and followed it.

LEHTIKUVA / HEDE-FOTO

Helsinki was seriously damaged during World War II

Post World War II developments

Finnish economic policy in the post-World War II period has often been characterized as corporatist and driven by consensus. Arguably, however, central government continued to provide in the 1950s and late 1960s what it had done in the 1920s, namely an institutional framework within which private producers could operate with little fear of unproductive conflict. In the agricultural society of the 1920s, land reform may have been the chief way of solving conflict in the economy. In the 1950s and 1960s, wage and price freezes and social policy legislation were used as methods to pacify the now industrial conflicts. In the late 1960s, governments refined their ways to intervene by participating directly, starting in 1969, in the wage settlements between labour unions and employers organization.

This latest stage of state intervention, government-sponsored collective bargaining, is the best known way in which central government has intervened in the economic process in Finland. It is arguably just a different way of resolving conflicts.

Finnish economic development from the 1950s onwards is fairly well-known. State intervention, using a variety of methods over time, was frequent. Economic growth and industrialization proceeded at a fairly rapid pace, as witnessed by Finland’s catching up, in relative terms, the income levels of other industrialized nations. While Finland now has one of the most equal distributions of income in the world, historical data suggest that inequality has not been low for a very long time. Indeed, inequality seems to have increased substantially from 1950 to the late 1960s.

What can we learn from Finnish experiences? An important lesson is that while Finland is today a country with low income inequality, stable political conditions, and an extensive social safety net, these are of fairly recent origin. Finland has experienced during the past 4-5 generations substantial humanitarian crises and is a late arrival among the rich club of nations. The development of various equity-oriented reforms – land and educational reform, various mechanisms for handling social risks, such as old-age pensions and family benefits – pre-dated rapid economic development. Even if the causal effect on growth of such reforms can be debated, at the very least many of these reforms created a setting in which economic actors – chief among them labour unions and employers – had fewer conflicts to resolve and could, therefore, concentrate on productive activities.

It is useful to recall in the current debate on development aid that Finland received substantial assistance from other countries during its ‘golden age’. Early on in the form of Marshall Aid and through multilateral organizations, such as the World Bank, whose first loan to Finland was given in 1949. The last World Bank loan was granted as late as in 1972. It is possible that a critical examination of the Finnish development experience would help in the design of bilateral aid and bolster the case for a more pluralistic view of how multilateral aid institutions are run. While the Finnish experiences can not provide the blueprints for development cooperation, they can and should be noted. In particular, state intervention and the management of social risk have worked through many different mechanisms and have at the very least been compatible with, and have possibly been supportive of, beneficial long-term development.

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Effective Aid to the Pacific: Big Challenges in Small States

by Simon Feeny

The Pacific region covers Melanesia, Polynesia, and Micronesia. Its developing countries and territories include the Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, Vanuatu, and Wallis and Futuna. Although important differences exist, Pacific countries are generally characterized by political instability, large inefficient public sectors, large informal sectors, ethnic tensions, and a vulnerability to external shocks such as natural disasters and falls in the prices of their key exports. Although some Pacific countries are rich in mineral resources, they are primarily reliant on agriculture and fishing for income and employment. Development in Pacific countries is constrained by their geographic remoteness, and the small size of their domestic markets. Recently, there has been a renewed interest from the international community in the Pacific region, due to the poor performance of a number of countries and concerns over regional security and stability. Questions have been raised regarding whether foreign aid to the region has been effective and how to make it more effective in the future. This article offers answers to these questions.

Pacific Countries are Large Recipients of Foreign Aid

Pacific countries receive the highest amounts of per capita aid in the world. Most aid has been bilateral from Australia, Japan, France, and New Zealand. The majority of aid flows have been provided in the form of grants with a large component provided as technical assistance. In 2002, Pacific countries received an average of over US$700 of aid per capita and aid flows accounted for an average of 20 per cent of countries Gross National Income (GNI). These figures are very high in comparison to other regions in the world (see Table 1).

Yet Pacific Countries Have Experienced a Mixed Record of Development

Despite receiving large amounts of foreign aid, Pacific countries have failed to prosper. While there have been some important improvements in some measures of well-being, real per capita incomes in some Pacific countries have fallen in recent years and poverty and inequality have increased. This makes the achievement of the Millennium Development Goals (MDGs) in the region particularly challenging. Melanesian countries have fared particularly poorly. Recent deterioration of living standards has been most acute in the Solomon Islands and in Papua New Guinea. These two countries are now commonly referred to as fragile states. However, the World Bank's Country Policy and Institutional Assessment (CPIA) ratings indicate that at least another three countries could be classified as fragile states. These countries are Kiribati, Tonga, and Vanuatu, each of which belong to the bottom two quintiles of the ratings. CPIA ratings for other Pacific countries are not available but many of them have experienced similar problems.

Recent Aid Initiatives

Providing aid to the Pacific highlights many of the challenges donors face when engaging with fragile states throughout the world. When there are serious doubts over the capacity of recipient public sectors to manage aid inflows effectively, alternative mechanisms for providing aid can be used. Foreign aid can also be used to strengthen the capacity of public sectors. The difficulties experienced by some Pacific countries have led to unique responses from Australia. Civil and political unrest in the Solomon Islands led to the Regional Assistance Mission to the Solomon Islands (RAMSI) in 2003. The Mission, led by Australia, includes the personnel from ten countries positioned in the Solomon Islands to restore peace and security and stabilize government finances. Further, in 2004, the Enhanced Co-operation Program (ECP) in Papua New Guinea led to a number of Australian public servants taking positions in various government departments to help strengthen law and order and improve the level of economic and public sector management. Although it is too soon to effectively evaluate the effectiveness of such interventions, and the ECP's future is uncertain given recent challenges in the Papua New Guinea Supreme Court, these interventions are likely to provide important lessons for other donors when engaging with fragile states.

Has Foreign Aid Been Effective?

For some commentators, the association between poor growth rates and high levels of foreign aid has been enough to conclude that aid has been ineffective in the Pacific. Some commentators have gone further suggesting that aid has been part of the region's problems rather than the solution. However, evaluating aid effectiveness is more complex than examining simple associations. Pacific countries have experienced poor economic growth rates for a number of reasons. When evaluating the impact of foreign aid it is important control for these other factors and this is the role of empirical aid effectiveness research.

Surprisingly little empirical research has focused on evaluating aid effectiveness in the region. Pacific countries are often excluded from the analyses of previous aid effectiveness studies, examining the impact of foreign aid on economic growth, due to the paucity of their data. Although it is clear that foreign aid to the Pacific has not been a resounding success, it is heartening that the few studies investigating the issue indicate that foreign aid has been effective at increasing economic growth in selected Pacific countries. This evidence suggests that foreign aid has not contributed to the poor economic performance of these countries and that their growth rates would have been lower in the absence of aid.

Table 1: Aid to the Pacific, 2002

Region	Average Aid per capita $US	Average Aid as a % of GNI
Africa	82	13
Asia	51	8
Americas	71	3
Europe	81	5
Pacific	701	20

Source: OECD International Development Statistics Online Database 2005

Issues When Evaluating Aid Effectiveness in the Pacific

The finding that foreign aid spurs economic growth in the Pacific is encouraging. However, it is often asserted that the relationship between economic growth and poverty reduction in Pacific countries is weak. This is because the benefits of economic growth often don't reach those in isolated rural areas. The importance of sustained economic growth in the region should not be understated. But, since poverty reduction and the achievement of the MDGs are the central objectives of international donors these are the yardsticks that should be used for evaluating aid effectiveness. Unfortunately, poor data availability often prevents such an exercise.

However, recent research evaluating the impact of aid to Melanesian countries has attempted to move the emphasis of aid effectiveness placed on economic growth. The research finds that although foreign aid has been associated with higher overall economic (GDP) growth, aid has had no impact on agricultural GDP growth. Since the majority of people in the Pacific (and in many other developing countries) live in rural areas, reliant on agriculture for their livelihoods, increases in agricultural GDP are more likely to be associated with improvements in well-being. Anecdotally this finding is not too surprising. Although some aid projects in Melanesia have a rural focus, the vast majority of aid projects are national in nature and based in urban areas. Although the rural sector could benefit from such projects, and from economic growth in general, there is a strong case for more targeting of foreign aid to the rural areas of the Pacific. Providing greater assistance to those in rural areas will reduce the rising tide of rural-urban migration, reduce vulnerability to external shocks and stem increasing levels of inequality. Removing the emphasis from economic growth to agricultural growth is potentially important for evaluating aid effectiveness since it can provide greater insights into the impact of foreign aid on poverty.

There are a number of important reasons why evaluating aid effectiveness in the Pacific is particularly difficult. The first is that the availability and reliability of data for Pacific countries creates problems for empirical research and makes accurate tracking of development progress difficult. Second, a large proportion of foreign aid provided to the Pacific is in the form of technical assistance projects aimed at improving governance. Improving governance is currently the focus of aid donors in the Pacific. Examples of aid activities include improving law and order, strengthening institutions, and reform of the public sector. Such projects are designed to impact on long-term development and their effects are therefore very hard to capture empirically. Studies commonly evaluate the impact of aid on economic growth in the short term. Similar arguments apply to aid projects in the health and education sectors. The benefits from such projects are likely to take many years to have substantial impacts and their effectiveness should not therefore be assessed using conventional methods.

Conclusion

Pacific countries have been large recipients of foreign aid yet some have experienced recent economic and social decline. Some Pacific countries are referred to as fragile states and provide a big challenge for foreign aid donors. Despite the poor economic record of many countries in the Pacific, there are some encouraging signs that foreign aid has been effective at spurring economic growth. The current emphasis of aid donors to the Pacific is to improve the level of governance. Evaluating aid of this nature is difficult since its beneficial impacts may take years to materialize. Further, while it is true that good governance is crucial for development, improving governance is difficult and will take time. With only ten years left to achieve the MDGs in the region, short-term poverty reduction and improvements in well-being must also be priorities. Greater targeting of aid to those in the rural and agricultural sectors will assist with these goals.

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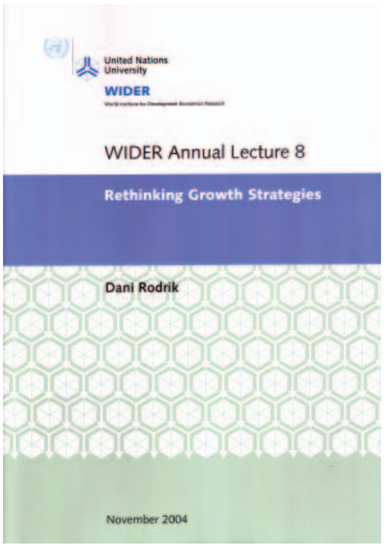

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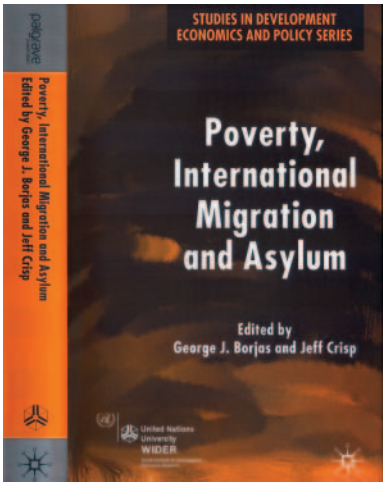

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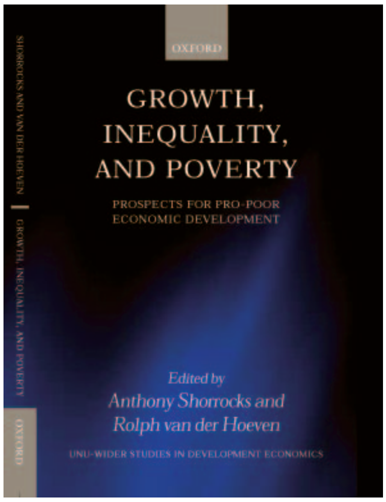

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