

**Financing Development in Africa:
Trends, Issues and Challenges in the context of the Aid for
Trade Initiative¹**

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Abstract:

In the context of the Aid for Trade initiative, the mobilization of domestic and external finance is critical to success in obtaining resources to finance the investment needed to meet the laudable objectives in the Millennium Declaration. This paper presents the new trends in financing development in Africa and to discuss the challenges facing the continent in this area. The challenges arising from the increase of resources is important but not insurmountable. The countries need to allocate these resources to the productive sectors in order to improve their competitiveness and better integrate the international economy.

JEL Classification :

O16- F34

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I. Introduction

The reduction and eventual eradication of poverty, hunger, and starvation in Africa is one of the main challenges facing African leaders and the international community. According to the March 2005 report of the Commission for Africa, “African poverty and stagnation is the greatest tragedy of our time.” Understanding the nature of this tragedy requires an examination of poverty statistics for the developing world in the last three decades. In 1970 there were 1.2 billion poor people in the developing world. Of this number there were 104 million in Sub-Saharan Africa, 830 million in East Asia, 208 million in South Asia, 36 million in Latin America, and 27 million in the Middle East and North Africa (Cooper 2005). Between 1970 and 2000, there was a tremendous reduction in the number of poor people in the developing world. More specifically, the number fell from 1.2 billion in 1970 to 647 million in 2000. However, most of the reduction came from East Asia where the number of poor people fell from 830 million in 1970 to 114 million in 2000. Sub-Saharan Africa happens to be the only sub-region where there was a tremendous increase in the number of poor people during the period. With a head-count ratio of 54.8 percent in 2000, it also has the highest proportion of domestic population that is poor.²

Several attempts have been made to explain why Africa has such a disproportionately high number of poor people and, more generally, determine the causes of poor economic performance in the sub-region (Collier and Gunning 1999; Sachs et al. 2004). What is emerging from this literature is that the lack of high and sustained economic growth in the region is a critical factor responsible for the region’s inability to make significant progress in the fight against poverty. It is also becoming clear that the nature and character of growth is important in terms of increasing prospects for poverty reduction. In particular, for growth to have a significant positive impact on poverty it has to be pro-poor in the sense that a higher percentage of the benefits accrue to the poorest segments of society. With regards to the historically poor growth record of the region, the literature suggests that the following factors are important: Political instability and poor governance; macroeconomic instability exacerbated by policy reversals; poor investment climate; geography; legacy of colonialism; and an inhospitable external environment as reflected in, for example, trade policies in OECD countries that make it difficult for exports of African countries to penetrate their markets.

² The head-count ratio discussed here is based on Purchasing Power Parity and a poverty line of \$1.50 per day.

Despite these relative improvements in economic performance, it is becoming clear that with the current growth record the region will not be able to achieve the Millennium Development Goals of the United Nations. A recent study by the Economic Commission for Africa shows that, if current trends continue, Sub-Saharan Africa is unlikely to meet the target of halving the proportion of people whose income is less than \$1 a day between 1990 and 2015 (ECA 2005).

The mobilization of domestic and external finance is critical to success in obtaining resources to finance the investment needed to meet the laudable objectives in the Millennium Declaration. Clearly, to increase the prospect for sustained growth in Sub-Saharan Africa, countries in the region must find ways to increase domestic savings and international resources and channel them into productive investments.

The objective of this paper is to present the new trends in financing development in Africa and to discuss the challenges facing the continent in this area. The remaining part of the paper is organized as follows. Section II presents recent trends in various aspects of financing development in Africa. Section III provides a critical appraisal of assessments of the costs of meeting the MDGs in Africa and developing countries in general. Section IV presents alternative proposals for financing the MDGs and section V deals with the international commitments and initiatives on financing development. Section VI examines the extent to which donors have fulfilled their commitments and pledges to African countries. The final section of the paper focuses on emerging issues arising from recent initiatives on aid and debt.

II. Trends in Financing Development in Africa

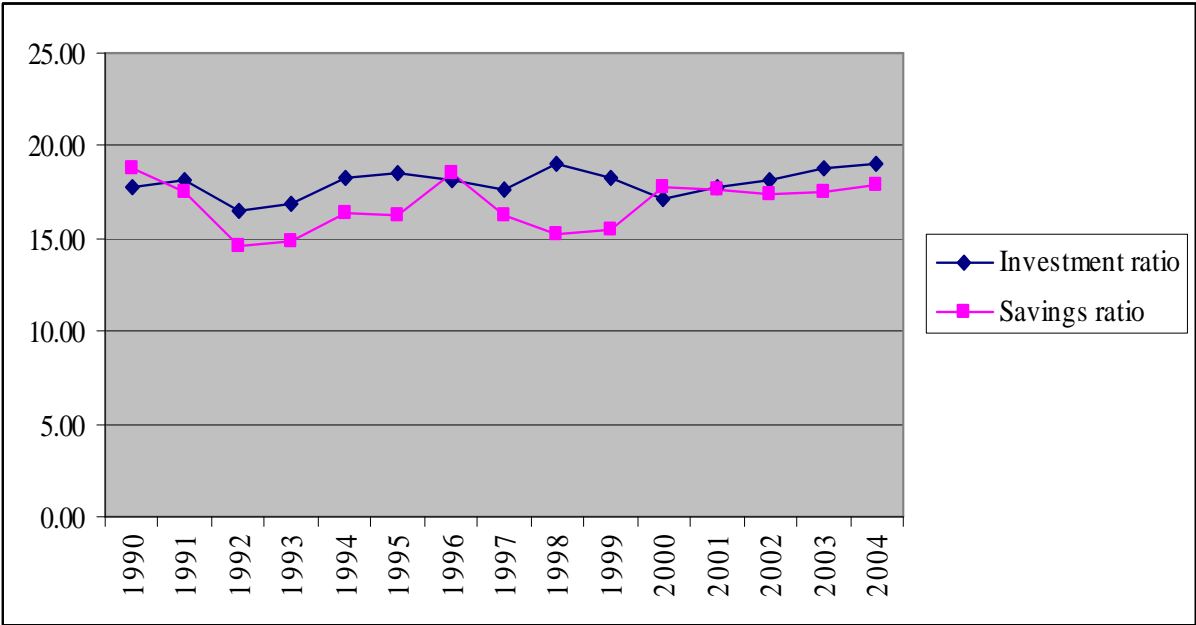
Domestic Savings and Investment

Domestic savings can play a key role in financing development in any economy. It can provide resources for investment, boost financial market development, stimulate economic growth, and enable economies protect the living standards of ageing populations. According to Rodrik (1998), differences in savings rates can explain the difference between thriving and stagnant economies. In particular, countries with very impressive growth performance have high savings ratios and have gone through spectacular savings transitions. Consequently, domestic savings is fundamental to economic development.

The mobilization of domestic savings could provide the much needed resources to finance investment in economic and social infrastructure in Africa. At the moment, investment ratios are very low in several countries in the region. Relative to developing countries in

Asia and Latin America, Sub-Saharan Africa has the lowest investment ratios. For example, over the period 2000-2004, domestic investment as a proportion of GDP was 18 percent in Sub-Saharan Africa and 31 percent in East Asia and the Pacific. As can be seen from figure 1, domestic investment ratio in Sub-Saharan Africa is low because domestic savings ratio is also low and the region has difficulties attracting sustained private capital flows. Lifting this investment and savings constraint is a major challenge for African policymakers and the way in which it is dealt with will determine, to a large extent, the region's ability to achieve sustained economic growth in the medium-to-long term.

Figure 1: Investment and Savings Ratios for Sub-Saharan Africa (1990-2004)



Source: Computed using data in WDI 2006.

Historically, Sub-Saharan Africa saves less than 20 percent of its GDP. Over the period 1990-1994, the average ratio of domestic savings to GDP in the region was 16 percent. There was a slight improvement in this ratio to 17 percent over the period 2000-2004. However, as figure 1 show, this number is way below the average for East Asia and the Pacific (35 percent), Latin America and Caribbean (21 percent), and Middle East and North Africa (26 percent). Concerted efforts must be made by African leaders to increase domestic savings if the region is to experience sustained growth and increase the likelihood of catching up with other developing country regions.

The low aggregate savings ratio observed in Sub-Saharan Africa masks the wide differences in savings patterns across countries in the region. There are several countries in the region with savings ratio comparable to those in East Asia. For example, over the

period 2000-2004, five countries--Algeria, Botswana, Republic of Congo, Gabon and Nigeria--had savings ratios greater than 30 percent. The ratios range from 51 percent in the Republic of Congo to 32 percent in Nigeria. What is interesting about these countries is that they are oil and or diamond exporting nations that saw an increase in export revenue due to a rise in the price of these commodities. It is therefore not clear whether these countries can sustain the current increase in domestic savings especially if there is a decline in the world price of their exports. Despite this uncertainty and vulnerability, it is worth noting that the increase in savings has enabled the five countries to increase investment ratios, although the increase in the latter is not as large as in the former. A key challenge facing these countries, therefore, is how to translate these increases in domestic savings into productive investment to ensure and increase prospects for sustained economic growth.

Table 2: Classification of Savings Ratios in Africa (2000-2004)

Classification	Range	List of Countries	Number of Countries
High	Savings ratio greater than 30 percent	Algeria, Botswana, Republic of Congo, Gabon, Nigeria	5
Moderate	Savings ratio greater than 20 but less than or equal to 30 percent	Angola, Cote d'Ivoire, Libya, Mauritius, Namibia, Tunisia	6
Low	Savings ratio is positive but less than or equal to 20 percent	Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Democratic Republic of Congo, Egypt, Ethiopia, Gambia, Ghana, Guinea, Kenya, Madagascar, Mali, Morocco, Mozambique, Niger, Rwanda, Senegal, Seychelles, South Africa, Sudan, Swaziland, Tanzania, Togo, Uganda, Zambia, Zimbabwe	28
Negative	Savings ratio less than zero	Burundi, Cape Verde, Comoros, Eritrea, Guinea-Bissau, Lesotho, Liberia, Malawi, Mauritania, Sao Tome and Principe, Sierra Leone	11
No data		Djibouti, Equatorial Guinea, Somalia	3

Apart from the five outliers mentioned earlier, 11 countries had negative savings ratios over the period 2000-2004. Several of these are either in political crises or are post-conflict economies and so it is not surprising that they had difficulties mobilizing domestic savings. For example, Sierra Leone and Liberia have just emerged from very disruptive political conflicts. There are however countries such as Lesotho and Malawi that had negative savings ratios although they did not have any serious political crises during the review period. Majority of the other countries in the region had positive but low savings ratio. Table 2 shows that 28 countries in the region are in this category which is interesting because it includes both small and big countries. In particular, it includes a big country such as South Africa that has a developed financial system and is expected to have a better ability to mobilize domestic savings.

The low savings ratio observed in African countries is a consequence of inadequate public and private sector savings. Consequently, the government as well as individuals and firms have a role to play in boosting savings in the region. On the private side, there is the need to improve access to the banking system and also to create an incentive for individuals and firms to save domestically rather than abroad. On the public sector side, efforts are needed to boost the ability of governments to mobilize domestic resources. This requires the design and reform of current systems of tax collection as well as efficiency in the use of public resources. Increasing the government's ability to mobilise domestic resources is an important step towards increasing the predictability of government revenue. African countries face three main challenges in their efforts to increase and ensure the predictability of government revenue. The first challenge is the instability and uncertainty arising from the volatility of prices of commodities exported by African countries. This instability causes an important uncertainty for the public budget and affects the ability of governments to finance development. To respond to this challenge, African countries need to strengthen efforts to diversify their economies to reduce dependence on commodities. The second major challenge facing African countries is to improve the efficiency of the fiscal system. Several studies show that the level of revenue from taxes is very low in Africa compared to other developing countries. An improvement of the efficiency of the tax system will increase the level of resources obtained by African countries (Adam 1999, Agbeyegbe 2004, Bird and Casanegra De and Jantscher 1992, Chambas 2005). The third challenge facing African countries is how to reduce dependence on trade taxes. For example, over the 2000-2003 period, taxes on international trade represented more than 20 percent of government revenue in 29 of the 44 countries in Africa for which we had data (Osakwe 2006). Several African countries have recently embarked on a series of reforms to reduce their dependence on trade taxes. However, considerable efforts still need to be made to strengthen the capacity of the fiscal system to collect non-trade taxes. Effective fiscal reforms in African countries are needed to increase the resources of governments as well as their capacity to contribute effectively in financing development.

Official Flows

Recent data suggests that, at the global level, there has been a tremendous increase in the total value of Official Development Assistance (ODA) and Official Aid from the Development Assistance Committee (DAC) and non-DAC donors in the last three decades. Total official flows to all regions of the world increased from about US\$6.9 billion in 1970 to US\$ 68.1 billion in 1991. There was a decline in the 1990s but this trend has been reversed since the 2000 Millennium Declaration. As at 2004, the figure stood at an all-time high of US\$87.3 billion. A large part of ODA from DAC donors represents support to social and administrative infrastructure. Table 3 shows that over the period 2003-2004, about 34.1 percent of aid from DAC members went to this category. It represents a big increase in the share of this category which was 26.7 percent in the period 1983-1984. Commodity aid and programme assistance accounted for 4.1 percent compared to 12.1 percent over the period 1983-84.

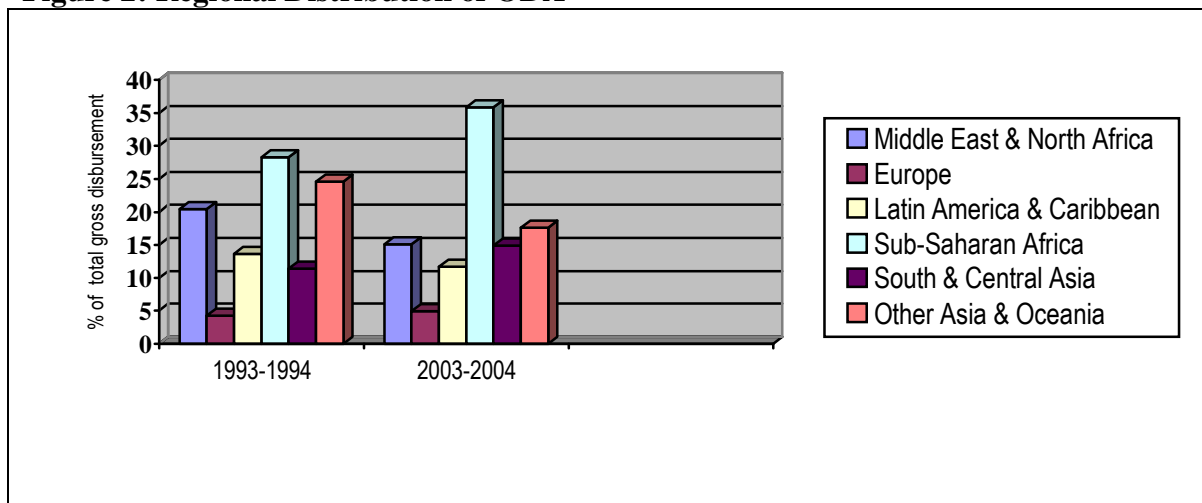
Table 3: Major Aid Uses (% of total bilateral commitments)

CATEGORY	1983-1984	2003-2004
Social and Administrative Infrastructure	26.7	34.1
Economic Infrastructure	18.8	13.1
Agriculture	11.4	3.2
Industry and other Production	8.9	2.6
Commodity Aid and Programme Assistance	12.1	4.1
Emergency Aid	1.6	9.1
Other	20.5	33.7

Source: OECD (2006b)

There has also been an interesting shift in the geographic distribution of official flows. In the 1970s, countries in Asia accounted for a large share of ODA. However, since the 1979 oil-price shock, Sub-Saharan Africa accounts for a larger share of ODA. For example, over the period 1993-94 about 27 percent of ODA went to Sub-Saharan Africa. The other sub-regions of the world got less than 25 percent. For the period 2003-2004, Sub-Saharan Africa accounted for about 36 percent of ODA (figure 2). This increase reflects recent efforts by OECD countries to scale up the volume of aid to Africa to enhance prospects for meeting the MDGs.

Figure 2: Regional Distribution of ODA



Source: Computed using data in WDI 2006.

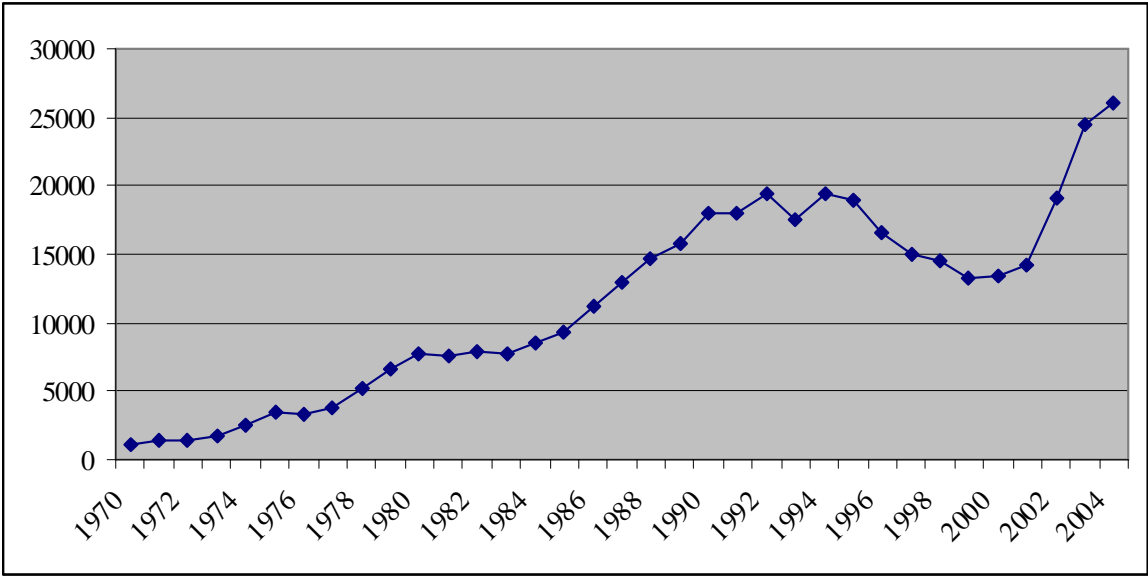
Historically, official flows have played an important role in the economic development of countries in Sub-Saharan Africa. As is obvious from figure 3, ODA to Sub-Saharan Africa has been on the increase since the 1970s. It reached a peak of US\$19 billion in 1992 and declined for most parts of the 1990s. Since the 2000 Millennium Declaration, however, ODA to the sub-region has been on the increase again reaching a peak of US\$26 billion in 2004. That said, it should be noted that when expressed as a percentage of GDP, ODA to the sub-region in 2004 was 5 percent of GDP which is still below the 6 percent figure recorded in 1990.

Within the African region, the distribution of aid flows is uneven with only a few countries accounting for a significant percentage of aid flows to the region. For example, in 1990 the big recipients of aid flows to the region were: Egypt (\$5.4 billion); Kenya (\$1.2 billion); Tanzania (\$1.2 billion); Morocco (\$1.1 billion); Ethiopia (\$1 billion); and Mozambique (\$1 billion). The other countries received less than 1 billion dollars each. As a result of the new focus and priorities given to the region by G8 countries, aid flows to several countries in the region has increased. For example, in 2004 each of the following ten countries received at least \$1 billion dollars of ODA: Ethiopia, Democratic Republic of Congo, Tanzania, Egypt, Ghana, Madagascar, Mozambique, Uganda, Angola, and Zambia. That said, in per capita terms, the main recipients of ODA in the region in 2004 were: Cape Verde (\$282); Sao Tome and Principe (\$218); Seychelles (\$124); Swaziland (\$104); Zambia (\$94); and Senegal (\$92).

Since the launch of the Enhanced Heavily Indebted Poor Countries (HIPC) initiative in 1999, there has been a change in the composition of aid commitments to Sub-Saharan Africa. For example, the share of project aid in total aid to the sub-region has decreased

while that of debt forgiveness has increased from under 10 percent in 1990-1994 to about 18 percent over the period 2000-2003. While there has been an increase in the relative share of debt forgiveness, over the period 2000-2003, project aid still accounts for more than 60 percent of aid commitments to Sub-Saharan Africa (Gupta, Patillo and Wagh 2006). Given the relatively low domestic savings ratios of countries in Sub-Saharan Africa, the sub-region has and will continue to rely on access to ODA as a major source of financing development, except drastic steps are taken to boost private capital flows and or mobilize domestic savings.

Figure 3: ODA to Sub-Saharan Africa (US\$ millions)



Source: Computed using data in WDI 2006.

Private Capital Flows

Private capital flows is another key source of external finance in Sub-Saharan Africa. In the late 1990s, it was a more important source of external finance to the sub-region. For example, in 1998 and 1999, net private flows to the sub-region were 13.7 and 16.7 billion dollars respectively. Over the same period, net official flows to the sub-region region were 10.6 and 10.3 billion dollars respectively. Relative to 1999, however, net private capital flows to Sub-Saharan Africa was low over the years 2000-2002 due in part to the impact of the Asian financial crises on investors attitudes towards foreign investment. Since 2003, private capital flows to the region has picked up although not as fast as the increase in net official flows (table 4).

Table 4: Sources of External Finance in Sub-Saharan Africa 1998-2005 (US\$ billions)

	1998	1999	2000	2001	2002	2003	2004	2005
Net Private Flows	13.7	16.7	9.9	12.1	6.3	15.8	20.7	28.5
Net equity flows	15.5	18	10.7	14	9.1	14.3	18	24.7
FDI inflows	6.9	9.0	6.5	15.0	9.5	13.6	11.3	17.6
Portfolio equity inflows	8.7	9.0	4.2	-1.0	-0.4	0.7	6.7	7.2
Net debt flows	-1.8	-1.3	-0.7	-2	-2.8	1.5	2.8	3.8
Medium/long term	-1.3	-0.7	0.4	0.1	-1.0	2.5	1.7	2.3
Short term	-0.5	-0.6	-1.1	-2.1	-1.8	-1.0	1.1	1.5
Net Official Flows	10.6	10.3	10.7	10.7	16.6	23.3	25.1	25.2
Bilateral aid grants (excludes technical cooperation grants)	10.1	9.9	10	10	14	22	24.2	28.4
Net debt flows	0.5	0.4	0.7	0.6	2.6	1.2	0.8	-3.2

Source: Global Development Finance 2006

A large part of recent private capital flows to the sub-region are in the form of equity as opposed to debt. In 2005, net equity flows accounted for 86 percent of net private capital flows to the sub-region. Furthermore, between 1998 and 2002 net debt flows to the region was negative reflecting largely the fact that during this period several countries in the region were more interested in servicing existing debt rather than accumulating further debt. The decline in the debt-equity ratio of private capital flows in the sub-region is a welcome development as it could limit the incidence of debt overhang in several countries in the region. It is also interesting to note that there has been a shift in emphasis from short to medium and long term debt. This would help to avoid maturity mismatches that have been a feature of debt in the region.

Recent equity flows to the sub-region have also been in the form of foreign direct investment (FDI) inflows, as opposed to portfolio equity inflows that are highly volatile and often leave countries vulnerable to sudden reversals and investors sentiments. Table 4 shows that since 2000 most equity flows to the region has been in the form of FDI. The increasing reliance of African countries on FDI rather than debt should be encouraged because it will reduce the accumulation of excessive external debt with the associated debt-service burden. FDI is also a good source of financing development because it has a potentially important role to play in stimulating growth and development. African countries should put in place more effective policies to attract FDI and increase their share of development finance from this source.

Table 5: Net Inward Foreign Direct Investment across Regions (US\$ Billions)

Group	1997	1998	1999	2000	2001	2002	2003	2004	2005
All developing countries	168.7	172.4	183.3	168.8	176.9	160.3	161.6	211.5	237.5
East Asia and Pacific	62.1	57.8	50.8	44.3	48.5	57.2	59.8	64.6	65.3
Europe and Central Asia	24.6	27.4	29.8	30.2	32.7	34.9	35.9	62.4	75.6
Latin America and the Caribbean	66.7	74.1	88.3	79.3	71.1	48.2	41.1	60.8	61.4
Middle East and North Africa	2.1	2.7	2.4	4.1	3.4	3.7	5.6	5.3	9.1
South Asia	4.9	3.5	3.1	4.4	6.1	6.7	5.6	7.2	8.4
Sub-Saharan Africa	8.3	6.9	9	6.5	15	9.5	13.6	11.3	17.6
Angola	0.4	1.1	2.5	0.9	2.1	1.7	3.5	1.4	1.5
South Africa	3.8	0.6	1.5	1	7.3	0.7	0.8	0.6	6.3

Source: Global Development Finance 2006

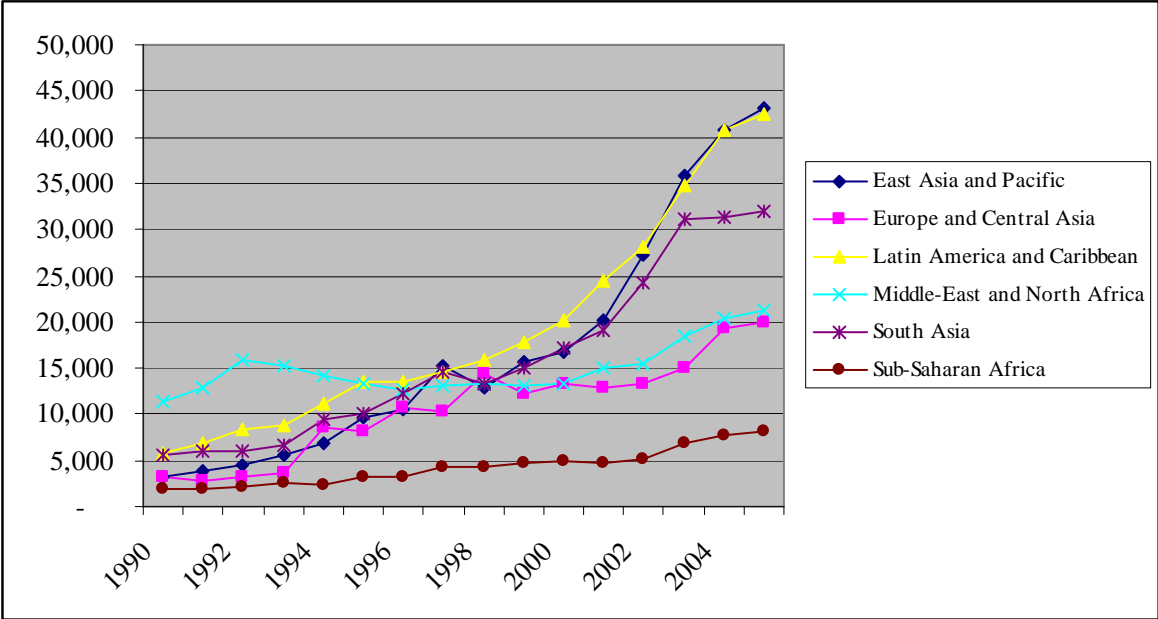
Table 5 shows that the sub-region currently attracts less FDI than most developing countries. That said, it should be noted that in 2005 there was a big boost in FDI flows to the Sub-Saharan Africa. Net inward FDI flows to the sub-region reached an all-time high of \$17.6 billion. According to UNCTAD (2006), this rapid increase in FDI flows was due to high commodity prices and rising corporate profits. As in previous years, a large percentage of FDI inflows to the sub-region in 2005 went to a few countries. South Africa tops the list with inflows of \$6.3 billion, followed by Nigeria and Sudan. In North Africa, the main recipients are Egypt and Morocco. The large FDI inflow to South Africa was due largely to the acquisition of a bank (ABSA) in South Africa by Barclays Bank, United Kingdom, for \$5 billion. It is also interesting to note that FDI inflows into Sub-Saharan Africa in 2005 were mainly in the oil and gas sector, although there were few investments in services, particularly the banking sector. As in previous years, Sub-Saharan Africa continues to face difficulties in attracting significant FDI inflows into the manufacturing sector, reflecting largely the lack of diversification of their production structures, low human capital base, and poor infrastructure.

Remittances

In economies with very low domestic savings and poor access to international capital markets, migrant workers remittances can play a vital role in development finance. In several regions of the world it is indeed growing at an unprecedented rate (figure 4). In 2004 it accounted for 1.5 percent of GDP in Sub-Saharan Africa, 1.7 percent in East Asia and Pacific, 2 percent in Latin America and Caribbean, 4.1 percent in Middle East and

North Africa, and 3.6 percent in South Asia. In 2005, the total value of remittances from all regions was \$232 billion which is marginally below the total value of net inward FDI to all developing countries (237 billion) for the same year. The true value of remittances may be larger given the fact that some remittances are transmitted through informal channels and so are not reflected in official statistics.

Figure 4: Workers Remittances across Developing Regions (US\$ millions)



Source: Computed using data from WDI 2006

In Sub-Saharan Africa, remittances are also becoming important. As indicated earlier, in 2004, remittances to the sub-region were about 1.5 percent of GDP. Although this is lower than the 5 percent figure recorded for ODA in the same year, it is clearly not an insignificant source of financing for the sub-region. In terms of monetary value, the magnitude of remittances to Sub-Saharan Africa is still relatively small compared to receipts by other developing country regions. For example, estimates available for 2005, suggest that Sub-Saharan Africa received \$8.1 billion in remittances compared to \$43 billion and \$42 billion for East Asia and the Pacific and Latin America and Caribbean respectively. The sub-region also received less from this source than countries in South Asia and Middle East and North Africa. That said, it should be noted that the low figure reported for Sub-Saharan Africa may be due to the fact that relative to other sub-regions, it transfers more remittances through informal channels. It may also be due to the fact that financial institutions in the sub-region are less developed than in the other sub-regions and so it is more difficult and costly to transfers remittances.

III. Assessing the Cost of Financing the MDGs

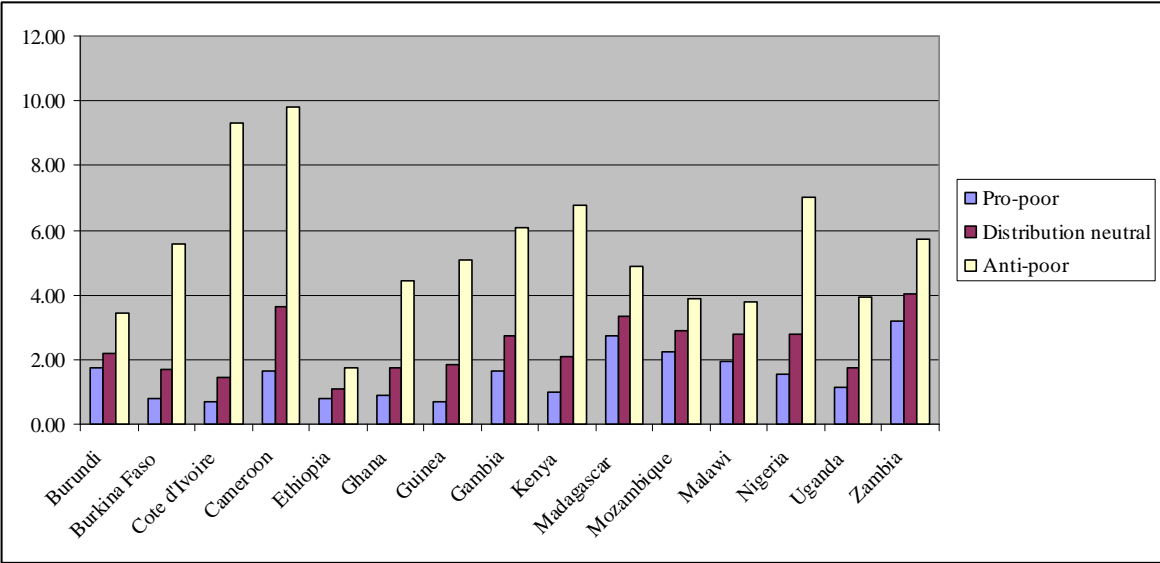
A key outcome of the September 2000 United Nations Millennium Summit was the specification of quantitative targets for poverty reduction and the attainment of goals in areas such as health, education, environment, gender equality, child mortality, and global partnership for development. Since the adoption of the Millennium Declaration, attempts have been made to assess the cost of meeting the eight goals. This usually involves a number of steps. The first is to calculate the growth rate required for a country or group of countries to achieve the MDGs based on a given theoretical model and assumptions on the elasticity of poverty with respect to per capita income. The second step is to compute the investment needed to attain this required growth rate and then obtain estimates of the gap between the required investment and domestic savings—called financing or resource gap. Given the resource gap, the amount of aid needed to meet the MDGs is derived.

The report of the High Level Panel on Financing for Development, popularly known as the “Zedillo Report”, was the first key document to draw attention to the magnitude of resources that would be required for poor countries to meet the MDGs. In that report, it was suggested that developing countries would need an additional \$50 billion per year in order to achieve the MDGs. Similar estimates were obtained by Devarajan, Miller and Swanson (2002). They estimated that an additional \$54 to \$62 billion of ODA per year would be required to raise growth rates to the magnitude needed to meet the targets for poverty reduction. In particular, they argue that if developing countries improve economic policies the additional ODA would be \$54 billion per year. However, if the necessary changes in policies and institutions are not put in place then about \$62 billion would be needed per year in order to meet the poverty reduction targets specified in the MDGs.

These studies focused on global estimates of the cost of meeting the MDGs and so do not have country-specific results, which to a large extent will depend on country-specific circumstances and policy environments. For example, the incidence of wars, quality of economic policies, effectiveness of public service delivery, and the degree of inequality in a country will determine progress made by a country in meeting the MDGs and hence affect the cost of meeting the goals. Unlike the above-mentioned studies, the estimates provided by Sachs et al (2004) suggests that African countries would need an additional ODA of \$40 per capita each year to achieve the MDGs. In aggregate terms, there finding is that the sub-region would need roughly \$25 billion in additional ODA per year. They argue that Sub-Saharan Africa is stuck in a poverty trap and that only a big-push in the form of scaling up of aid will enhance the likelihood of meeting the MDGs in the sub-region. This result is similar to the findings of the March 2005 report of the Commission for Africa. The report focused on the cost of meeting the MDGs in Sub-Saharan Africa and suggests that an additional \$25 billion per year in aid over three to five years would be needed for Sub-Saharan Africa to have a good chance of meeting the MDGs.

Kakwani and Son (2006) provide an interesting and country-specific estimate of the cost of meeting the MDGs in 15 countries in Sub-Saharan Africa. In contrast with previous studies, they argue that the cost of meeting the MDGs will depend on the expected distribution of income in a country. In particular, the costs are likely to be less in economies in which growth is accompanied by a more even distribution of income compared to one in which growth leads to increased inequality. Based on their estimates for the 15 countries considered, the average per capita growth rate required to meet the first MDG for the sample is: 1.51 percent if growth is pro-poor; 2.4 percent if growth is distribution neutral; and 5.43 if growth is anti-poor. The average per capita growth rate required for each country is presented in figure 5.

Figure 5: Average per capita growth rates required to meet MDG 1 (2005-2015)



For the pro-poor category, Cote d'Ivoire has the lowest growth requirement (0.68 percent) and Zambia has the highest (3.19 percent). However, for the Anti-poor category, Nigeria has the highest growth requirement (7.01 percent) and Ethiopia has the lowest requirement (1.72 percent). Given the per capita growth requirement for each category, the authors also computed the investment-saving gap necessary to achieve the target growth rate. The implied investment-saving gap for each country (as a percentage of GDP) is presented in table 6. For pro-poor growth, the average gap is 12.8 percent of GDP, for distribution neutral growth the gap is 15.5 percent, and for anti-poor growth the gap is 24.5 percent. In principle, the resource gap could be filled through increased ODA, private capital flows, or external borrowing. However, given the debt situation of African countries and their limited access to private capital markets, ODA is the most viable source for financing this resource gap. Consequently, the authors also calculated the per capita foreign aid requirement. The

results suggest that the average per capita GDP requirement across countries in 2002 US dollars is: \$354 if growth is pro-poor; \$380 if growth is distribution neutral; and \$511 if growth is anti-poor.

Table 6: Implied Investment-Saving Gap (% of GDP)

	Pro-poor	Distribution neutral	Anti-poor
Burundi	24.28	25.79	29.43
Burkina Faso	11.80	14.42	26.05
Cote d'Ivoire	1.12	3.38	27.06
Cameroon	2.91	8.82	27.42
Ethiopia	13.90	14.92	16.72
Ghana	12.01	14.55	22.69
Guinea	3.00	6.28	16.01
Gambia	20.07	23.35	33.33
Kenya	7.06	10.28	24.40
Madagascar	19.92	22.62	27.24
Mozambique	22.47	24.46	27.45
Malawi	20.15	22.70	25.64
Nigeria	-2.23	1.65	14.26
Uganda	16.34	18.43	23.79
Zambia	18.62	21.13	26.24
Average	12.76	15.52	24.52

Source: IDA and IMF (2006)

In recent years, several authors have identified methodological problems associated with these estimates of the cost of meeting the MDGs. Reddy and Heuty (2006) questions the reliability of existing estimates of the cost of achieving the MDGs. They argue that they are based on implausible and restrictive assumptions about growth rates, depend on poor quality data, and cannot be taken seriously given the presence of large uncertainties about the future. Easterly (2005) also argues that the estimates are unreliable because they are based on models that have been discredited in the economics literature. There are three models that are typically used for these estimates of the cost of the MDGs. The first is the financing-gap or two-gap model of growth which assumes that growth is proportional to investment and that the latter can be financed by domestic savings and foreign aid. In this setting, foreign aid is used to fill the gap between required investment and available domestic savings. The second is the poverty trap model which assumes that poor countries are stuck in a poverty trap and would need massive aid in order to be on a path of sustained economic growth. The model used by Sachs et al (2004) is in this category. Finally, some

researchers use the expenditure-to-outcomes model of health and education to derive estimates of meeting some of the sectoral goals in the Millennium Declaration.

IV. Alternative Proposals for Financing the MDGs

Having identified the costs of meeting the MDGs and the financing gap, recent efforts have been directed at how to fill the gap. A number of developed countries have made commitments to scale-up aid but it is not clear if, and when, they will honour these commitments. This existence of a time lag between ODA pledges and fulfillment by donors has led to calls for new and innovative sources for financing the MDGs and development in general.

Several proposals have been made on innovative and alternative approaches to financing development. The International Finance Facility (IFF) proposed by the UK government is one of the popular proposals that have attracted attention. It was first put forward by Gordon Brown, Chancellor of the Exchequer, in 2003. The main objective of the IFF is to front-load future aid commitments by borrowing from international capital markets. In other words, it will ensure that financial resources from future aid pledges are available for use by recipient countries in a timely manner. It is therefore a mechanism to ensure that donors honour their commitments and on time. Furthermore, it is a convenient approach to avoid the political constraints that prevent larger aid allocations in rich countries and will increase the stability as well as predictability of aid flows.

Despite these advantages, critiques argue that, based on existing versions of the proposal, the IFF is unlikely to create additional resources for development. The reason is that it is expected to be executed through the issuance of bonds and interest needs to be paid on these bonds. With a large interest or premium on these bonds, the IFF may actually have a net effect on aid flows that is negative, especially if the premium is not paid by the donor governments. As a result of the attractiveness of the IFF approach to several donors, in September 2005, an International Finance Facility for Immunization (IFFIm) was launched to frontload \$4 billion of commitments over ten years. France, Italy, Spain, Sweden, Norway, the UK, and South Africa are already contributors to this facility.

Global taxes have also been proposed as potential sources of development finance. These include global environmental taxes, taxes on currency transactions (Tobin tax), and air-ticket taxes. In a sense, some of these are not really new proposals. For example, James Tobin put forward the idea of a currency transactions tax several decades ago, although the objective then was to reduce financial market volatility and not to use it as a source of development finance. Similarly, the idea of a global environment tax has a long history in the public finance literature. It has originally proposed as an incentive mechanism to reduce carbon emission and damage to the environment. However, in recent years it is considered

as a potentially viable source of development finance. Recent research suggests that substantial amounts could be raised through minor environmental and currency transactions taxes. For example, Atkinson (2004) shows that a tax on gasoline of about 0.01 Euro per litre levied on high-income countries could raise \$50 billion dollars per year. Similarly, a tax of 2 basis points (0.02 percent) on currency transactions could raise \$28 billion per year. The main obstacle to the implementation of these taxes is that they require universal agreement by high-income countries and it is not clear that all parties will support the proposals. That said, one global tax proposal that has moved from concept into reality is the idea of an air-ticket tax. France and Chile were the first to enact legislation to levy taxes on airline tickets for use in financing development. The revenue or part of it will be put in a Global Fund set up to combat HIV/AIDS, Malaria and Tuberculosis. The legislation took effect in France in July 2006. At a Conference on Innovative Financing for Development, held in Paris in February 2006, eleven governments made commitments to implement the proposal. So far, eighteen countries have pledged to implement this tax.

The issue of new Special Drawing Rights (SDR) with a development focus is another proposal that has been widely discussed. George Soros and the Zedillo Panel are major proponents of this idea. They are of the view that new SDRs should be created to fund global public goods and supplement aid flows to developing countries. The proposed use of SDRs for development finance is quite different from the role that they have played historically, which is to increase international liquidity. SDRs are interest-bearing international instruments issued by the International Monetary Fund and allocated to its members in proportion to their quotas. They supplement IMF members' holdings of official reserve assets such as gold and foreign exchange reserves. Since the 1997-98 Asian financial crises, several developing countries have been accumulating foreign exchange reserves to reduce their vulnerability to financial crises. Part of this accumulation of reserves is financed by running current account surpluses and the other part is financed through borrowing on terms less generous than those that would be available on SDRs. In particular, the interest rates on these loans are several percentage points above those payable on SDRs. Consequently, the issue of new SDRs or a change in the allocation of current SDRs in favour of developing countries will reduce the real cost of borrowing to these countries and free-up some resources for financing development. The key challenge to creating new SDRs or reallocating existing ones in favour of developing countries is that any change in allocation that is not based on IMF quotas requires an amendment of the IMF Articles of Agreement. But any amendment to the Articles of Agreement would require approval by 85 percent of the members and it is quite difficult to get the approval of large shareholders with veto power such as the United States.

An increase in private donations has also been proposed as an alternative approach to financing development. However, given the fact that most private donations in rich countries are directed at domestic concerns rather than international development, it is

unlikely that a substantial amount can be raised from this source. That said, to the extent that an increase in private donations encourage governments in rich countries to be more generous, it may play a vital role in mobilizing international resources for development.

Another proposal that has been made to finance development is to increase the flow of migrant remittances. This option is attractive because it is a stable source of capital flows and is often counter-cyclical making it a source of social security for recipients. As indicated earlier, remittances already play a vital role in financing development in some developing countries such as South Asia and Middle East and North Africa. In Sub-Saharan Africa, its role is increasing but it is still less important compared to ODA. Remittances often finance consumption but are also used for financing infrastructure projects that are vital to reduce transactions costs and enhance competitiveness. The key policy that has been suggested for increasing the flow of remittances to developing countries is to reduce the cost of sending money by making bank services more accessible to migrants.

V. Initiatives and Commitments on Financing Development

This section presents and examines the key global initiatives and commitments on financing development made by donors since the 2000 UN Millennium Summit. These initiatives and commitments are reflected in the Monterrey Consensus, the Rome, Marrakech and Paris Declarations, and the G8 Gleneagles Summit Declaration.

The Monterrey Consensus

The Monterrey Consensus adopted by heads of state and government at the International Conference on Financing for Development, held 21-22 March 2002, represents the first comprehensive and global attempt to address the challenges of financing development in developing countries. It was also the first time that development-finance and related issues became the main focus in international financial discussions. In the Monterrey Consensus world leaders noted with concern the financial gap to be filled in order to attain the MDGs. They called for a new partnership between developed and developing countries and committed themselves to mobilizing domestic financial resources, attracting international capital flows, promoting international trade as an engine for development, increasing international financial and technical cooperation for development, sustainable debt financing and external debt relief, and enhancing the coherence and consistency of international monetary, financial and trading systems for development.

Regarding the mobilization of domestic resources, the Consensus emphasized the importance of an enabling domestic environment for mobilizing resources, increasing

productivity, reducing capital flight, encouraging the private sector, and attracting international investment and assistance. It also stressed the importance of good governance, sound macroeconomic policies, investments in infrastructure, and the development of the financial sector in successfully mobilizing domestic resources for development. In the area of attracting international capital flows, the Consensus stressed the need for a transparent, stable, and predictable investment climate, enforcement of property rights, and sound macroeconomic policies and institutions. It also called on international and regional institutions to increase their support for private foreign investment in infrastructure development and other priority areas.

The Consensus considers international trade as a very important external source of development finance. Consequently, it called for members of the World Trade Organisation (WTO) to implement the outcome of the Fourth WTO Ministerial Conference held in Doha in November 2001. It also stressed the need to address the marginalization of LDCs in the multilateral trading system and emphasized the need for developed countries to grant duty and quota free market access for LDC exports into their markets. It invited multilateral and bilateral financial and development institutions to support national efforts to benefit from trade and integrate into the multilateral trading system. It also encouraged developing countries to reduce trade barriers among themselves.

On ODA, the Monterrey Consensus stressed the need for concrete actions to be taken by donors to achieve the internationally agreed targets for ODA to developing countries of 0.7 percent of gross national product (GNP) and 0.15 - 0.20 percent for ODA to least developed countries (LDCs). It also called for actions to increase the effectiveness of aid. In this regard, donors were urged to take actions to harmonize aid, support and enhance efforts to untie aid, enhance the absorptive capacity of recipient countries to utilize aid, improve targeting of aid to the poor, and enhance recipient countries' inputs into and ownership of technical assistance programmes. The need to explore innovative sources of financing was stressed with the understanding that such new sources should not unduly burden developing countries.

On external debt, the Consensus emphasized the importance of sustainable debt financing for mobilizing resources for investment and called on debtors and creditors to share responsibility for preventing and resolving unsustainable debt situations. In addition, it welcomed recent initiatives taken to reduce outstanding indebtedness and called for further measures, including debt cancellation, to deal with the unsustainable debt burdens of developing countries. It also stressed the need for flexibility in the application of the eligibility criteria for the enhanced HIPC and asked for future reviews of debt sustainability to take into account the impact of debt relief on the ability of recipients to achieve the MDGs.

Rome, Marrakech and Paris Declarations

In the Monterrey Consensus, world leaders set the broad principles, guidelines, policies and actions for financing development. Although they highlighted the importance of aid harmonization for effective development outcomes in recipient countries, there were no clear guidelines and commitments from donors to ensure that the objective will be achieved until the High-Level Forum on Harmonization held 24-25 February 2003, in Rome. In the Rome declaration, donors' acknowledged the need to reduce transactions costs of aid delivery in recipient countries. They also stressed the need for country ownership of aid programmes and to implement good practice standards or principles in development cooperation. Against this background, they committed to: provide development assistance in accordance with partner country priorities, implement good practice standards or principles in development assistance delivery and management, adapt harmonization efforts to the country context, and harmonize donors' policies and procedures.

As a follow-up to the Rome declaration, an international roundtable on managing for development results was held in Marrakech in February 2004. The outcome of this meeting was the Joint Marrakech Memorandum endorsed by the heads of the African Development Bank, Asian Development Bank, Inter-American Development Bank, European Bank for Reconstruction and Development, the World Bank, and the chairman of the Development Assistance Committee of the Organisation for Economic Cooperation and Development. In the memorandum, they committed to fostering a global partnership on managing for development results.

While the Monterrey Consensus, the Rome declaration and the Marrakech Memorandum defined the main objectives for the aid effectiveness agenda and led to an expansion in activities aimed at improving the effectiveness of aid delivery, the Paris Declaration on Aid Effectiveness represents the first-bold attempt by donors' and developing countries to take monitorable actions to reform the way aid is delivered and managed. The latter declaration was the outcome of the High-Level Forum on Aid Effectiveness held in Paris, 28 February – 2 March 2005. The Paris Declaration focused on five key areas necessary for aid effectiveness. These are: ownership, harmonization, alignment, managing for results, and mutual accountability. Regarding ownership, the declaration stressed the need for partner countries to exercise effective leadership over their development policies and to co-ordinate development actions. On alignment, donors' made commitments to base their overall support on partner countries' national development strategies, institutions and procedures. They also made commitments to provide reliable indicative commitments of aid over a multi-year framework and to disburse aid in a timely and predictable fashion according to agreed schedules. Reducing the proportion of aid that is tied is also a key aspect of this area of the declaration.

In the area of harmonization, donors' committed to make their actions more harmonized, transparent and collectively effective. On managing for results, they made commitments to manage and implement aid in a way that focuses on the desired results and uses information to improve decision making. Finally, regarding mutual accountability, donors' and developing countries made commitments to enhance mutual accountability and transparency in the use of development resources. This requires holding both parties accountable for development outcomes. An important feature of the Paris Declaration is that indicators of progress and targets were set for each of the five areas to increase transparency in monitoring the implementation of agreed commitments.

The Gleneagles Declaration

The G8 Summit in Gleneagles in July 2005 added momentum to the commitments made by world leaders in Monterrey to increase aid flows and reduce the burden of external debt on developing countries to enhance their prospects for meeting the MDGs. The G8 declaration also recognized the need for substantial increase in official development assistance to consolidate and build on recent progress in Africa and stimulate the growth to reduce aid dependency. On aid, the declaration indicates that the commitments of G8 countries and other donors will increase ODA to all developing countries by \$50 billion a year by 2010 compared to 2004. Half of this increase will go to Africa, representing a more than doubling of aid to Africa compared to 2004. On debt, the G8 agreed to a proposal to cancel 100 percent of outstanding debts of eligible HIPC to the IMF, International Development Association (IDA) and African Development Fund, and to provide additional resources to ensure that the financial capacity of the international financial institutions is not reduced. They also re-affirmed their commitments to the Paris Declaration on aid effectiveness and stressed the need for developing countries and their governments to take the lead on development and be accountable for their actions. Table 7 (in annex) presents some of the key commitments on aid and debt made to Sub-Saharan Africa by each G8 country at the Gleneagles Summit.

VI. Translating Commitments into Results

In the past three decades, donors' have made several promises and commitments to developing countries, and Africa in particular. However, some of these commitments have either not been complied with or have been partially implemented. Consequently, since the Monterrey Consensus several efforts have been made by both developed and developing countries to hold donors' accountable for the pledges and commitments made to developing countries. For example, African Finance Ministers held a meeting on Financing for Development in Abuja, on 22 May 2006. As stated in the report of the conference, the meeting was a first step by African Finance Ministers to lead a process that translates development commitments into action. Against this background, this section focuses on the

extent to which donors have lived up to their promises and pledges to Africa in three key areas: scaling-up of aid; improving aid effectiveness; and debt relief or debt cancellation. Due to data limitations, some parts of our analysis will focus on commitments made by the G8 countries with the understanding that there are other donors as well.

Scaling-up Aid

The key target that donors have set for themselves on aid is to attain an ODA to GNI (Gross National Income) ratio of 0.7 percent. This target was set in 1969 and was supposed to be achieved by 1975. However, only a few countries have met the target. For example, in 2004, Norway, Denmark, Luxembourg, Sweden, and the Netherlands met the target. Countries such as Portugal, Belgium, France and Switzerland have also made significant progress although they are yet to meet the target. Among DAC Members, Japan, the United States, and Italy have the lowest ODA/GNI ratios. More effort is needed by these countries to increase the DAC average which was 0.26 percent in 2004 (Table 8 in annex).

The G8 Research Group at the University of Toronto, Canada, has developed a very useful methodology for assessing the extent to which G8 countries comply with the commitments made at their annual summits. The assessment uses a three-category scoring method: Full or near full compliance with a commitment results in a score of +1; Complete or nearly complete failure to implement a commitment results in a score of -1; and an “inability to commit” or “work-in-progress” leads to a score of 0. An inability to commit refers to factors outside the executive branch that impedes the implementation of a commitment while “work-in-progress” refers to an initiative that has been launched by a government but is not yet near completion. Using this scoring methodology, the performance of the G8 countries in terms of meeting the commitments made to Africa and the developing world on scaling-up aid falls into the category “work-in-progress”. This is because the G8 countries have only met part of the commitments made on scaling-up aid to developing countries and Africa in particular. One of the reasons while the G8 countries as a group have not fully complied with their commitments to scale-up aid to Africa is that some countries have not made much progress in following through on their commitments to double ODA to Africa. For example, Table 9 shows that Italy, Japan, and Russia have failed to implement their commitments and so have a score of -1. The United States, one of the big donors, has made some progress in complying with its commitments although it is not enough to double aid to Africa by 2010. In contrast, Canada, France, Germany, the United Kingdom and the European Union have all fully complied with their commitments in this area and so have a score of +1.

Aid Effectiveness

The quantity of aid is important but the overall effectiveness of any form of aid depends to a large extent on its quality. Consequently, in discussions on aid, it is now popular to talk about the quality of aid and how aid could be made more effective in recipient countries. There are various factors that determine the overall quality of aid and hence its effectiveness. These include the proportion of aid that is tied, the extent to which aid is in the form of grants or concessional loans, the proportion of aid that goes to poor as opposed to relatively rich countries, the state of governance in recipient countries, and the administrative or transactions costs associated with aid. Table 10 presents the percentage of bilateral ODA from DAC Member countries to LDCs that is untied. To the extent that more than half of the LDCs are in Africa, the table captures their experience with tied aid as well. It is clear from the table that there has been a reduction in the percentage of aid from DAC Member countries that is tied. Over the period 1999-2001, 55 percent of total DAC aid to LDCs was untied. In 2004, the number rose to 68 percent. Looking at individual DAC countries, however, there are wide differences in performance. For example, countries such as Finland, Ireland, Luxembourg, Norway and the United Kingdom have successfully moved away from tied to untied aid. The United States, New Zealand, and Greece have a very low ratio of untied to total aid and so are at the bottom of the list. More progress needs to be made by these countries, especially the United States, if the DAC average is to improve significantly.

Regarding the composition of aid, there has also been progress in this area. The share of grants in total ODA has increased over the years. For DAC countries, the average was roughly 49 percent over the period 1980-84 (Gupta, Pattillo, and Wagh 2006). For the 2003-2004 period the average is 90 percent (table 11). In DAC countries such as Australia, Austria, Canada, Greece, Ireland, Luxembourg, Netherlands, and New Zealand, grants represent 100 percent of ODA. At 60 percent, Japan has the lowest ratio of grant to total ODA. An improvement is needed in this area if Japan is to catch up with the other donors. The increasing share of grants in total ODA is a welcome development in African countries. Several countries in the region are already heavily indebted and are looking for ways to reduce their debt burden. Reducing the proportion of loans in total ODA prevents further accumulation of debts in these countries.

The Center for Global Development has published an index of aid effectiveness that captures various aspects of aid quality. The index penalizes donors for tied aid, deducts debt repayments by poor to rich countries, favours aid to countries with good governance and high poverty rates, penalizes donors for overloading recipient governments, and rewards governments that allow taxpayers to write –off charitable contributions. Based on the index for 2006, aid from Netherlands, Denmark, Sweden and Norway are the most effective (Roodman 2006). Japan, Italy, the United States and New Zealand had very low scores and hence aid effectiveness.

Debt Relief

Debt relief is one area where G8 countries and other donors have made significant progress in meeting their commitments. At Gleneagles, they promised that all debts owed by eligible HIPC to IMF, IDA, and the African Development Fund would be cancelled. The G8 research Group has also examined the extent to which the G8 countries have honoured their commitments on debt relief. The results are presented in table 12. They show that all G8 countries have fully complied with their commitments on debt relief and so have a score of +1.

Table 12: Compliance on Debt Relief

Country	Lack of compliance (-1)	Work-in-progress (0)	Full compliance (+1)
Canada			X
France			X
Germany			X
Italy			X
Japan			X
Russia			X
United Kingdom			X
United States			X
European Union			X
Overall score			100 percent

Source: IDA and IMF (2006)

The outstanding performance of the G8 in the area of debt relief is due in part to their commitment and support to the HIPC initiative and the Multilateral Debt Reduction Initiative (MDRI). The HIPC initiative was established in 1996 to reduce debt burden of eligible countries. As a result of slow progress in attaining the debt reduction objective of the initiative, an enhanced version was launched on 1999 with relatively less restrictive eligibility criteria. As of July 2006, 40 countries have either qualified or are currently considered or potentially eligible for debt relief under the initiative. Of the forty countries, nineteen have reached the completion point, ten have reached the decision point and eleven are pre-decision point countries (see table 13). In addition, of the nineteen countries that have reached the completion point, fifteen are in Africa.

Table 13: Status of Countries under the HIPC Initiative (as of end-July 2006)

PostCompletion-Point Countries (19)		
Benin	Honduras	Rwanda
Bolivia	Madagascar	Senegal
Burkina Faso	Mali	Tanzania
Cameroon	Mauritius	Uganda
Ethiopia	Mozambique	Zambia
Ghana	Nicaragua	
Guyama	Niger	
Interim Countries (Between Decision and Completion Point) (10)		
Burundi	The Gambia	Sao Tome and Principe
Chad	Guinea	Sierra Leone
Republic of Congo	Guinea-Bissau	
Democratic Republic of the Congo	Malawi	
Pre-Decision-Point Countries (11)		
Central African Republic	Haiti	Somalia
Comoros	Kyrgyz Republic	Sudan
Cote d'Ivoire	Liberia	Togo
Eritrea	Nepal	

Source: IDA and IMF (2006)

In addition to supporting debt relief under the HIPC initiative, G8 countries were also behind the launching of the MDRI in 2005 to reduce the debt burden of eligible HIPCs and provide additional resources for them to meet the MDGs. Under the MDRI, the IDA, IMF and African Development Bank (AfDB) will provide 100 percent debt relief on eligible debt to countries that have completed the HIPC process. Although these three institutions are responsible for delivery of debt relief under the MDRI, each institution has its own guidelines on how it intends to implement the agreements. For example, while only HIPCs are eligible for MDRI provided by the IDA and AfDB, the IMF also considers non-HIPCs with per capita income of \$380 or less. Furthermore, for the IMF and AfDB, eligible debt is debt disbursed outstanding debt as at end-2004. For the IDA, it is disbursed outstanding debt as at end-2003. Table 14 presents the main characteristics of the MDRI and HIPC initiatives. As at mid-July 2006, committed assistance to African countries under the HIPC initiative and assistance delivered or expected to be delivered under the MDRI was US\$50 billion. Of this amount, \$34 billion was committed under the HIPC initiative and \$15.9 billion was for the MDRI. Within the HIPC allocation, \$21.6 billion represents assistance to the fifteen African countries that have reached the completion point as at mid-July 2006,

while \$12.5 billion represents assistance to ten African countries that have reached the decision point.

Table 14: Main Characteristics of the HIPC Initiative and the MDRI

	HIPC Initiative	MDRI
Country coverage	IDA-only, PRFG-eligible countries with debt indicators above the HIPC Initiative thresholds, which have been engaged in qualifying IMF- and IDA-supported programs.	HIPC countries having reached completion point
Participating creditors	All multilateral, official bilateral and commercial creditors of external public and publicly guaranteed debt to HICPs.	IDA, IMF and AfDF only.
Debt relief provided	External public and publicly guaranteed debt is reduced to the HIPC Initiative thresholds, as calculated at the time of the decision point	Debt disbursed before end-December 2004 (IMF and AfDF) and end-December 2003 (IDA) and still outstanding at the time of qualification (after the provision of HIPC Initiative debt relief) is reduced to zero
Modality of delivery	Different modalities. Most multilateral and Paris Club creditors also provide interim debt relief.	Stock-of-debt operation at or shortly after the completion point.
Total costs of committed debt relief	US\$41.3 billion in end-2005 Net Present Value (NPV) terms	US\$18.3 billion in end-2005 NPV terms

Source: IDA and IMF (2006)

In summary, while donors have made significant progress in meeting commitments on debt relief, they have made relatively less effort in fulfilling the pledges made on scaling-up aid and improving aid effectiveness. Urgent actions need to be taken in these areas to enable African countries obtain the required resources needed to attain the MDGs.

VII. Issues arising from Recent Initiatives on Aid and Debt

Since the adoption of the Millennium Declaration there have been discussions and concerns on the consequences of the scaling up of aid and debt relief on African countries. There is no doubt that African countries need more aid flows to enable them increase the likelihood of achieving the MDGs. But more aid flows will also impose serious challenges on these economies and policymakers must prepare themselves to deal with these challenges if they are to maximize the benefits of aid and minimize the costs. Several papers have tried to identify the challenges facing African countries as a result of the recent decision by donors to scale-up aid to the region (Bourguignon and Sundberg 2006, Gupta, Powell and Yang

2006; Heller 2005). These challenges include: how to increase absorptive capacity of aid in recipient countries; how to prevent aid dependency; how to maintain domestic revenue levels during the period of increased aid flows; and how to ensure that aid does not lead to loss of competitiveness through real exchange rate overvaluation. In this section we discuss the issue of financial space for African economies as well as examine the economic consequences of scaling-up aid and debt relief to African countries.

Financial Space for African Countries

The idea of fiscal space in dealing with the new financial opportunities to be made available to African countries has also been introduced in the literature. There is the view that African countries need fiscal space to deal with pressing infrastructure and social investments needed to achieve the MDGs. This view is interesting because it represents a big departure from the orthodox views on fiscal policy as advocated by the Washington Consensus.

Although there is no generally accepted definition of the term “fiscal space,” it is often used to refer to the availability of budgetary room that allows a government to provide resources for a desired purpose without any prejudice to the sustainability of a government’s financial position” (Heller 2005). We consider the concept of fiscal space, as in Heller (2005), too narrow to capture the issues raised by African countries on the need to have adequate resources to finance investments in infrastructure and other social programs. In particular, the notion of fiscal space focuses too much attention on domestic governments’ fiscal operations and less on other important sources of financing development. In this regard, we prefer to use the concept “financial space,” which is more comprehensive and takes into account the different actors and sources of financing development. Financial space here is defined as the ability of a government to mobilize external and internal financial resources to finance its development needs and priorities. This notion will encompass both the capacity of the government and the different actors of the economy including the banking system and the private sector to increase the level of available resources and at the same time improve the management of these resources through better governance of the economy. This notion of financial space also includes the capacity of a government to implement domestic reforms necessary to increase the resources available to it. There are several ways of increasing financial space in an economy. These include mobilization of domestic resources, foreign aid, debt relief, private capital flows etc. In the sub-sections below we examine the impact of two key aspects of financial space: scaling-up aid and debt relief.

Scaling-up Aid

The international community has embarked on an important programme to increase aid to African countries and to improve its effectiveness. The most important objective of these efforts is to help African countries to meet the MDGs and to improve the life of millions of people living in poverty in the continent. The increase in aid flows has intensified debates on the macroeconomic consequences of aid in recipient countries, as reflected in the increasing literature on the subject (Bourguignon and Sundberg 2006; Gupta, Powell and Yang 2006). Some of the issues raised in the literature include the Dutch disease problem, the effect on growth, the impact on fiscal sustainability and the issue of predictability of aid. We examine some of these issues in the following sub-section.

Dutch disease

The “Dutch disease” effect is probably the most widely discussed potential adverse effect of an increase in aid flows. The idea is that in a small open economy where prices of traded goods determined on the world market, an increase in aid inflows may lead to an increase in the price of non-traded goods resulting in a real exchange rate appreciation. This appreciation of the real exchange rate will have a negative impact on the competitiveness of an economy. The assumption here is that a large part of the inflows is spent on non-traded goods. To the extent that this is not the case, the potential adverse effect of aid flows from this source may not be observed in an economy. It should be noted also that the possibility or potential for a Dutch disease effect also depends on the share of aid spent on productive investment relative to that spent on consumption of final goods. If aid is financing productive investment, it will improve productivity and enhance growth. In addition there will be less pressure on internal prices and a more muted change in the real exchange rate.

The evidence from empirical studies on the impact of the scale-up of aid on the real exchange rate and relative prices is mixed. In a recent study of 13 African countries by Chowdhury and McKinley (2006), eight countries had a positive correlation between the net aid inflows and real exchange rates, suggesting that increased aid flows is accompanied by a depreciation of the real exchange rate. In five countries, the correlation is negative. For the link between the aid inflows and the inflation, the study suggests that the correlation for all the countries is positive, indicating that increasing aid is associated with an increase in inflation, and this has consequences for competitiveness of the economy. To examine the robustness of these results, we have computed the correlation between aid per capita and selected variables for all African countries for which we have data (table 15). As can be seen from the table, an increase in aid has a significant and positive contemporaneous effect on the real effective exchange rate. Since the definition of the real effective exchange rate we used in the analysis is such that an increase represents a real appreciation, our results suggest that an increase in aid inflows leads to an appreciation of the real exchange rate.

However, it could be argued that it takes some time before the real effects of aid flows are felt in an economy. Consequently, we also computed the correlation using one-period lag of aid per capita. This did not result in any significant change in the results. Regarding inflation, both the contemporaneous and lagged correlation results suggest that there is no significant relationship between the two variables. In both cases the signs were negative but insignificant.

Table 15: Correlation of Aid with Selected Variables*

	Number of Observations	Contemporaneous	Lagged (one period)
Real effective exchange rate	235	0.181 (0.006)	0.192 (0.004)
Real GDP per capita growth	639	0.039 (0.332)	0.056 (0.171)
Health expenditure per capita	280	0.282 (0.000)	0.333 (0.000)
Education expenditure (% of total expenditure)	67	-0.054 (0.663)	-0.072 (0.564)
Inflation	639	-0.048 (0.226)	-0.050 (0.221)

* P-values in parenthesis

Our results therefore confirm the idea that the relationship between these variables varies across countries and possibly historical periods. Despite these mixed results, the potential for a Dutch disease is a real concern for African economies. But the risk could be mitigated by increasing the level of aid directed to productive investment to improve productivity and to help the economy respond to pressure from the demand side.

Aid and growth

An important and compelling reason for increasing aid to Africa is to accelerate growth and increase the likelihood of attaining the MDGs in the region. Assessments of the performance of African countries show that it would be difficult for them to achieve the MDGs if current trends continue. Clearly, high and sustained growth is needed to reduce poverty in African economies. Thus it is important to know if scaling up aid will accelerate growth in Africa. This issue has been discussed at length and several papers have examined the link between aid and growth (Clemens, Radelet and Bhavnani 2004, Burnside and Dollar 2000, Easterly, Levine and Roodman, 2003). There are three main views on the relationship between aid and growth (Radelet 2006). The first is that aid has a positive effect on growth, but with diminishing returns as the volume of aid increases. The channels through which aid has a positive effect on growth include: augmenting savings and making it possible to finance investments; increasing worker productivity through investments in health or education; and providing a channel for the transfer of technology from rich to

poor countries. The second view on the link between aid and growth is that aid has no effect on growth. Arguments put forward to support this view are that aid is often wasted, supports bad governments, reduces domestic savings, and undermines private sector incentives for investment. In addition, it is often argued that recipient countries do not have the capacity to absorb large amounts of aid. The third view on the relationship between the two variables is that aid has a conditional relationship with growth. In particular, it works best in countries with good institutions and policies. For example, a recent study on aid to African countries showed that in eleven of “good performance countries” high growth is linked to high aid flows (Bourguignon, Gelb and Versailles, 2005, World Bank, 2005). To provide a simple test of these views, we computed the correlation between aid per capita and growth of real GDP per capita for all African countries for which data were available. Table 14 shows that for both contemporaneous and lagged correlations, the relationship is positive but insignificant at conventional levels.

Aid and fiscal sustainability

The potential effect of aid on fiscal sustainability has also been discussed in the literature (Heller, 2005). One of the key concerns here is the impact of increasing aid on fiscal attitudes as well as efforts of the recipient countries to collect tax and increase government revenues. There is a feeling that an increase in aid will not encourage countries to intensify domestic resource mobilization efforts and increase fiscal revenues. However, this view is not supported by evidence from recent studies indicating that the relation between aid and tax collection is very weak (Bourguignon, Gelb and Versailles, 2005). Another interesting and related issue here is that of public expenditure management. It has been argued that if higher aid inflows are used to finance labour-intensive public services (eg schools or clinics) that have large recurrent costs, then if there is an unexpected fall in aid levels, the ability of the government to continue with the provision of these services may be limited. Consequently, effective fiscal planning is crucial for economies dependent on aid flows.

Volatility of aid

A concern and challenge facing aid recipients is how to deal with uncertainty surrounding both aid commitments and disbursements. This concern is serious because recipient countries have to formulate and implement medium-term development strategies and it is difficult to do this effectively if they are not certain about the timing and amount of aid that would be available to them over the horizon considered. The uncertainty surrounding aid is also a problem because studies have shown that it has negative consequences for output (Lensink and Morrissey 2000). Added to the volatility problem is the inefficiency resulting from conditions and procedures associated with aid delivery. In several countries, the multiplicity of donor programmes and their poor alignment with recipient government

priorities often lead to inefficiencies. This inefficiency contributes to the weak impact of aid on growth and development.

Provision of social services

Aid is often used to finance the provision of social services, especially health and education. The idea is that these investments would have a positive effect on productivity and hence growth and poverty reduction. Table 15 shows that there is a strong positive and statistically significant relationship between health expenditure per capita and aid per capita. This relationship holds for both contemporaneous and lagged aid. With regard to education, the results indicate that there is no statistically significant relationship between aid per capita and the share of education in total government expenditure.

Debt Relief

Debt relief is one of the major components or sources of the expected increase in resources to African countries to help them finance activities and actions needed to meet the MDGs. As at mid-July 2006, total HIPC initiative assistance commitment and assistance delivered or expected to be delivered to African countries under the MDRI was about \$50 billion. If donors follow through on their commitments, this will represent a significant inflow of resources to eligible African countries. It will also present challenges to these countries. These include how to manage the additional resource flows emanating from debt relief and ensure that they are effectively used for poverty reduction; how to increase domestic absorptive capacity to absorb these inflows and ensure that they do not result in real exchange rate appreciation and a reduction in export competitiveness; and how to ensure that current debt relief does not encourage excessive new borrowing and the accumulation of further debt. As indicated earlier, one of the main objectives of debt relief is to free-up resources for financing social programs that are expected to have significant impact on poverty reduction. In this section we examine the link between debt relief and social expenditure, inflation and growth.

Debt relief and social expenditures

There is the widely-held view that debt relief will free-up resources for financing social programs that are vital for alleviating poverty. In particular, debt relief is expected to lead to an increase in expenditures on education and health, which is expected to have positive effects on productivity and hence contribute to poverty reduction. Despite the popularity of these views, it is not clear that an increase in debt relief will actually boost social expenditures. Recent empirical studies have tried to examine the extent to which debt relief leads to an increase in social expenditures. For example, Chavin and Kraay (2005)

examined the link between debt relief and social expenditures. They found no evidence of a statistical relationship between debt relief granted over the period 1989-1993 and the share of government expenditure on health and education over the period 1994 to 1998. That said, they also found that debt relief between 1994-1998 was associated with an increase in the shares of education and health in total spending over the period 1999-2003, although the evidence is not robust. In terms of country-specific evidence, Nannyonjo (2001) argues that in Uganda, debt relief had a positive impact on social expenditures in the late 1990s, particularly in the education and health sectors. Dessy and Vencatachellum (2006) have also examined this issue using African data. They found that debt relief had a positive impact on the share of education and health in total spending over the period 1989-2003.

Debt relief and growth

One of the concerns about the high external debt of poor countries is that it stifles growth and so makes it even more difficult for a country to generate enough resources to repay its existing stock of debt. High debt can reduce growth through its negative impact on investment. It can also reduce growth by reducing the incentives of governments to adopt structural reforms. Several attempts have been made to examine the link between debt and growth. However, until recently, most of the studies use data for both emerging markets and low income countries without taking into account the fact that the heterogeneity between emerging markets and low income countries has implications for the relationship between debt and growth. For example, unlike emerging markets, low income countries have very limited access to international capital markets. In addition, they have relatively different economic structures and rely on foreign aid. These differences suggest that the relationship between debt and growth will differ across the two groups of countries. In a recent study, Pattillo, Poirson and Ricci (2002) found that external debt has a negative effect on growth after a critical threshold for debt is reached. In particular, they found that when the Net Present Value of debt is greater than 160-170 percent of exports and 35-40 percent of GDP, external debt stifles growth. With regard to the link between debt relief and growth, Clements, Bhattacharya and Nguyen (2005) present evidence suggesting that debt relief under the HIPC initiative will add 0.8-1.1 percentage points to the annual per capita GDP growth rates of the countries in their sample. These findings support the widely-held view amongst African policy makers that debt relief will increase the prospects for growth and development in the region.

In conclusion, this paper highlighted the need to scale up resources to help Africa meet the MDGs. The challenges arising from the increase of resources is important but not insurmountable. The countries need to allocate these resources to the productive sectors in order to improve their competitiveness and better integrate the international economy. Also African countries need to implement efficient policies to be able to manage the effects of the scale-up of the resources.

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Annexes

Table 7: G8 Commitments to Africa at Gleneagles

Country	Interim Target	Final Target
European Union	<ul style="list-style-type: none"> • ODA/GNI target of 0.56 percent by 2010 • Double ODA between 2004 and 2010 • 50 percent of the increase will go to Sub-Saharan Africa 	<ul style="list-style-type: none"> • 0.7 percent by 2015
Germany	<ul style="list-style-type: none"> • 0.51 percent ODA/GNI in 2010 	<ul style="list-style-type: none"> • 0.7 percent in 2015
Italy	<ul style="list-style-type: none"> • 0.51 percent ODA/GNI in 2010 	<ul style="list-style-type: none"> • 0.7 percent in 2015
France	<ul style="list-style-type: none"> • 0.5 percent ODA/GNI in 2007 of which two-third will go to Africa 	<ul style="list-style-type: none"> • 0.7 percent in 2012
United Kingdom	<ul style="list-style-type: none"> • Double bilateral spending in Africa between 2003/4 and 2007/8 	<ul style="list-style-type: none"> • 0.7 percent in 2013
United States	<ul style="list-style-type: none"> • Double aid to Sub-Saharan Africa between 2004 and 2010 	
Japan	<ul style="list-style-type: none"> • Increase aggregate ODA volume by \$10 billion over the next five years • Double ODA to Africa over the next three years 	
Canada	<ul style="list-style-type: none"> • Double international assistance from 2001 to 2010 • Double assistance to Africa from 2003/4 to 2008/9 	
Russia		<ul style="list-style-type: none"> • Cancel \$11.3 billion worth of debts owed by African countries • Write off the entire stock of HIPC countries' debts on non-ODA loans

Table 8: ODA Amount and Ratios for DAC Members in 2004

Country	ODA (US\$ million)	ODA/GNI (%)
Norway	2199	0.87
Denmark	2037	0.85
Luxembourg	236	0.83
Sweden	2722	0.78
Netherlands	4204	0.73
Portugal	1031	0.63
Belgium	1463	0.41
France	8473	0.41
Switzerland	1545	0.41
Ireland	607	0.39
United Kingdom	7883	0.36
Finland	655	0.35
Germany	7534	0.28
Canada	2599	0.27
Australia	1460	0.25
Spain	2437	0.24
Austria	678	0.23
Greece	465	0.23
New Zealand	212	0.23
Japan	8906	0.19
United States	19705	0.17
Italy	2462	0.15
Total DAC	79512	0.26

Table 9: Compliance on Increasing Aid Quantity

Country	Lack of compliance (-1)	Work-in-progress (0)	Full compliance (+1)
Canada			X
France			X
Germany			X
Italy	X		
Japan	X		
Russia	X		
United Kingdom			X
United States		X	
European Union			X
Overall score		X	

Table 10: Proportion of Bilateral Aid to LDCs that is Untied

	1999-2001 (average)	2004
Australia	0.42	0.91
Austria	0.34	0.68
Belgium	0.49	0.99
Canada	0.40	0.76
Denmark	0.77	0.80
Finland	0.69	1.00
France	0.54	0.85
Germany	0.43	0.66
Greece	...	0.41
Ireland	1.00	1.00
Italy	0.30	0.80
Japan	0.76	0.81
Luxembourg	...	1.00
Netherlands	0.86	0.96
New Zealand	...	0.36
Norway	0.99	1.00
Portugal	0.42	0.99
Spain	0.25	0.95
Sweden	0.69	0.98
Switzerland	0.84	0.95
United Kingdom	0.62	1.00
United States	0.01	0.03
Total DAC	0.55	0.68

Source: OECD (2006a)

Table 11: Selected Terms and Conditions of ODA

	Grant share of total ODA (per cent)		BILATERAL ODA LOANS								
			Grant element (per cent)		Average maturity (years)		Average grace period (years)		Average interest rate (per cent)		
	2003	2004	2003	2004	2003	2004	2003	2004	2003	2004	
Australia	100	100	-	-	-	-	-	-	-	-	-
Austria	100	100	-	-	-	-	-	-	-	-	-
Belgium	99.6	98.6	78.1	83.5	29.8	29.7	10.8	10.7	0.7	0.0	
Canada	99.6	100	90.1	-	38.3	-	14.0	-	-	-	
Denmark	98.5	98.0	-	-	-	-	-	-	-	-	
Finland	98.8	98.7	-	48.6	-	7.9	-	-	-	0.0	
France	89.0	87.2	45.3	50.9	18.0	19.2	6.0-	7.9	3.0	2.3	
Germany	91.9	85.0	68.0	62.7	35.4	32.4	7.1	6.4	1.4	1.7	
Greece	100	100	-	-	-	-	-	6.6	-	-	
Ireland	100	100	-	-	-	-	-	-	-	-	
Italy	87.7	95.7	90.7	90.4	38.1	37.5	19.8	18.9	0.2	0.2	
Japan	57.1	59.7	70.9	72.3	33.1	31.5	9.8	9.5	1.5	1.2	
Luxembourg	100	100	-	-	-	-	-	-	-	-	
Netherlands	100	100	-	-	-	-	-	-	-	-	
New Zealand	100	100	-	-	-	-	-	-	-	-	
Norway	98.0	98.7	-	-	-	-	-	-	-	-	
Portugal	99.8	99.9	-	61.2	-	31.8	-	22.1	-	3.3	
Spain	78.0	82.8	69.3	75.3	27.2	28.2	10.2	10.1	1.3	0.7	
Sweden	98.7	99.8	51.8	-	13.0	-	-3.0	-	0.0	-	
Switzerland	97.6	99.2	-	-	-	-	-	-	-	-	
United kingdom	92.8	94.8	-	-	-	-	-	-	-	-	
United states	99.7	99.8	68.3	68.3	30.0	30.0	5.0	5.0	1.0	1.0	
Total DAC	89.7	90.5	68.5	68.9	31.4	30.1	9.5	9.2	1.6	1.4	

Source: OECD (2006b)