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## Financing Development in Africa: Trends, Issues and Challenges<sup>1</sup>

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**Abstract:** *Access to finance is critical to accelerating growth and development in Africa. This paper presents recent trends in various sources of development finance and provides a critical assessment of the costs of meeting the Millennium Development Goals (MDGs) in the region. Furthermore, it examines the key international commitments made to Africa as well as the extent to which donors have fulfilled these commitments. Finally, it examines issues and challenges arising from recent initiatives on aid and debt.*

### Financement du développement en Afrique : tendances, domaines et défis

**Résumé:** *L'accès au financement est important pour l'accélération de la croissance et du développement en Afrique. Cet article présente les tendances de l'évolution récente de diverses sources de financement de développement et fournit une évaluation critique des coûts de réalisation des Objectifs du Millénaire pour le Développement (OMDs) dans la région. En outre, il examine les principaux engagements internationaux en parvenu de Afrique ainsi que le point auquel les donateurs ont accompli ces engagements. En conclusion, il examine les domaines et défis résultant des initiatives récentes sur l'aide et la dette.*

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### 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

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<sup>1</sup> The authors are responsible for any errors and the views expressed here do not represent those of UNECA.

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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.<sup>2</sup>

Several attempts have been made to explain why Sub-Saharan 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 sub-region is a critical factor responsible for its 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 sub-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.

The African region, as well as the Sub-Saharan sub-region, entered the current decade and the new Millennium with an improvement in economic performance. Relative to the 1980s and the early 1990s, there has been a marked improvement in economic growth and development in the region. For example, over the ten-year period 1988-97, average real per capita output growth was negative (-0.4 percent). Since 2000, the region has had positive real per capita output growth with a peak of 3.3 percent in 2004. Consumer price inflation fell from an average of 29.1 percent over 1988-97 to 8.5 percent in 2005. The region also moved from a current account deficit of 8.1 percent (of exports of goods and services) over

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

the period 1988-97 to a surplus of 5.9 percent in 2000 (see Table 1). These achievements have been attributed to positive changes in the region such as: improvements in economic policies, reduction in conflicts, better governance, more open trade and investment policies, and improvements in commodity prices (ECA 2005; 2006).

**Table 1: Economic Performance in Africa \***

	1988-97	2000	2001	2002	2003	2004	2005
Real GDP Growth	2.3 (2.3)	3.1 (3.4)	4.2 (4.2)	3.6 (3.6)	4.6 (4.1)	5.5 (5.6)	5.4 (5.8)
Real per capita GDP growth	-0.4	0.8	1.9	1.4	2.4	3.3	3.2
Consumer Price Inflation	29.1 (34.6)	13.6 (17.4)	12.8 (15.9)	9.9 (12.2)	10.7 (13.4)	8.0 (9.6)	8.5 (10.7)
Fiscal Balance (% of GDP)		-1.2 (-2.3)	-2.1 (-2.5)	-2.3 (-2.4)	-1.4 (-2.4)	-0.2 (-0.8)	1.5 (0.4)
Current Account Balance (% of exports)	-8.1 (-9.4)	4.6 (-0.5)	0.3 (-6.8)	-5.0 (-11.4)	-1.6 (-8.9)	-0.2 (-6.5)	5.9 (-1.7)

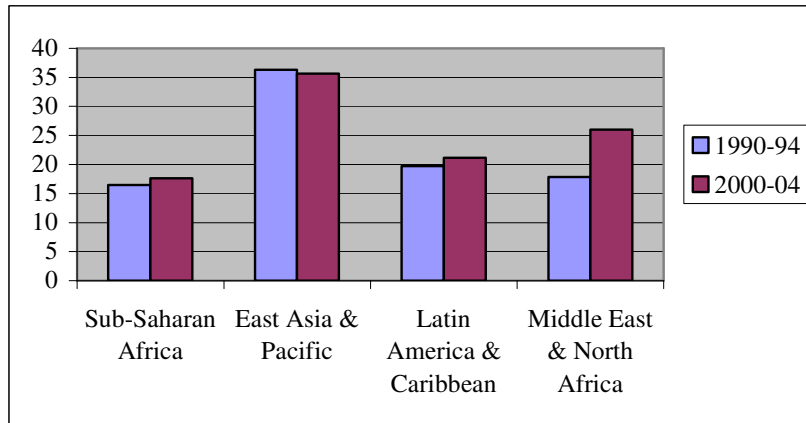
\* The figures in parenthesis are for Sub-Saharan Africa  
 Source: IMF (2006); ECA (2006)

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 (MDGs) 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 2006 MDG report also arrived at the same conclusion. The data presented in the report show that between 1990 and 2002 the number of people living in extreme poverty in Sub-Saharan Africa increased by 140 million. The report also shows that Sub-Saharan Africa lags behind in other areas of the MDGs. Given that the target date for meeting the MDGs is 2015 and there is roughly seven years before the deadline, there is the need for urgent as well as coordinated actions by African governments and the international community to increase the likelihood and prospects for achieving the MDGs in Africa.

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. Ideally, African countries would prefer to use domestic savings to finance the required investments due in part to the fact that it is less volatile than most sources of external financing and does not increase their vulnerability to external shocks over which they have no control. In addition, unlike official development assistance, domestic saving is not subject to 'conditionalities', which could severely limit the policy choices and instruments available to governments. Despite these advantages of domestic saving as a source of financing, history and recent experience have shown that it is not enough to meet the resource needs of African countries. The main reason why domestic saving alone cannot solve Africa's financing problems is that, relative to its investment requirements as well as other developing country regions, Africa saves too little. For example, Figure 1 shows that over the five-year period 2000-2004, domestic savings as a proportion of gross domestic product (GDP) was 17 percent in Sub-Saharan Africa and 26 percent in the Middle East and North Africa. In East Asia and the Pacific it was 35.6 percent and in Latin America and the Caribbean, it was 21.2 percent. Clearly, to increase the prospect for sustained growth in Sub-Saharan Africa, countries in the region must find ways to increase domestic savings and channel them into productive investments.

**Figure 1: Gross Domestic Savings across Developing Regions (% of GDP)**



Source: Computed using data in WDI 2006.

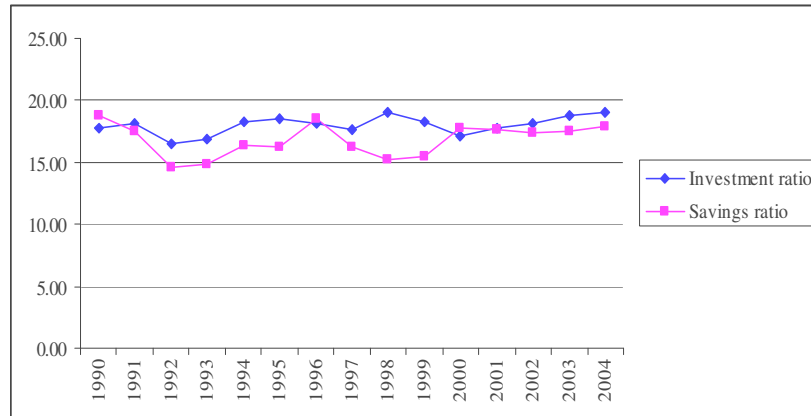
The remaining part of the paper is organized as follows: Section I presents recent trends in various aspects of financing development in Africa. Section II provides a critical appraisal of the costs of meeting and financing the MDGs in Africa and developing countries in general. International commitments and initiatives on financing development are the focus of Section III. Section IV examines the extent to which donors have fulfilled their commitments and pledges to African countries. Section V focuses on emerging issues arising from recent initiatives on aid and debt. The final section contains concluding remarks.

## I. 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 saving is fundamental to economic development.

**Figure 2: Investment and Savings Ratios for Sub-Saharan Africa (1990-2004)**



Source: Computed using data in WDI 2006.

The mobilization of domestic saving 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 2, 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. 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 shows this number is way below the average for other developing countries. 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.

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.

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.

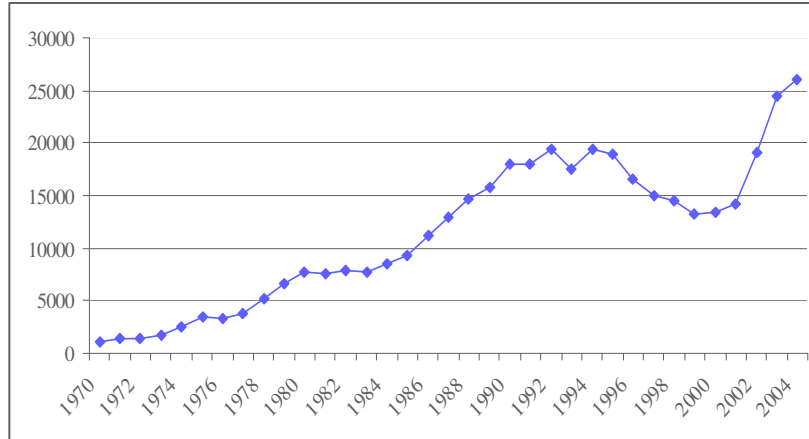
African countries face three main challenges in their efforts to increase and ensure the predictability of government revenue. The first challenge is the uncertainty arising from the volatility of prices of commodities exported by African countries. This is an important

source of instability in government revenue 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 period 2000-2003, 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. 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**

In recent years, there has been an interesting shift in the geographic distribution of official development assistance (ODA). 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. This increase reflects recent efforts by donor countries to scale up the volume of aid to Africa to enhance prospects for meeting the MDGs. 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 flow 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 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. In 2003, private capital flows to the region picked up although not as fast as the increase in net official flows (Table 2).

**Table 2: Sources of External Finance in Sub-Saharan Africa 1998-2005 (US\$ billions)**

	1998	1999	2000	2001	2002	2003	2004	2005
<b>Net Private Flows</b>	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
	-1.3	-0.7	0.4	0.1	-1.0	2.5	1.7	2.3
Medium/long term	-0.5	-0.6	-1.1	-2.1	-1.8	-1.0	1.1	1.5
Short term								
<b>Net Official Flows</b>	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 2 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 3 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.

**Table 3: Net Inward Foreign Direct Investment across Regions (US\$ Billions)**

<b>Group</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
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 & 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

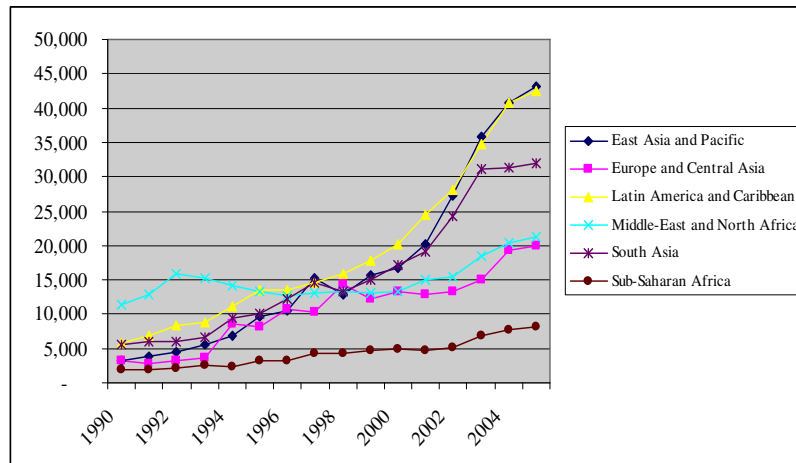
Source: Global Development Finance 2006



**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 transfer money to Sub-Saharan Africa.

## **II. 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.

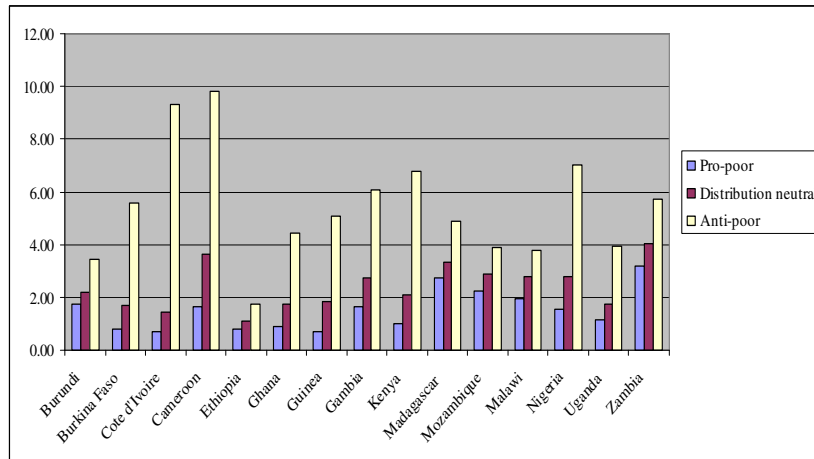
The report of the High Level Panel on Financing for Development, popularly known as the “Zedillo Report”, was the first key document to draw attention to the magnitude of resources that would be required for poor countries to meet the MDGs. In that report, it was suggested that developing countries would 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, their 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 4. 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.<sup>3</sup> 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.

In recent years, several authors have identified methodological problems associated with these estimates of the cost of meeting the

<sup>3</sup> Alternative sources of finance have also been proposed. These include the International Finance Facility (IFF), global taxes on air-tickets or the environment, issue of new Special Drawing Rights (SDR), private donations, and remittances (Atkinson 2004).

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.

**Table 4: Implied Investment-Saving Gap (% of GDP)**

	<b>Pro-poor</b>	<b>Distribution neutral</b>	<b>Anti-poor</b>
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
<b>Average</b>	<b>12.76</b>	<b>15.52</b>	<b>24.52</b>

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### **III. 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 from 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.

#### **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 was held from 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, from 28 February – 2 March 2005. The Paris Declaration focused on five key areas necessary for aid effectiveness: ownership, harmonization, alignment, managing for results, and mutual accountability.

### **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 ODA 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 countries 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 5 presents some of the key commitments on aid

and debt made to Sub-Saharan Africa by each G8 country at the Gleneagles Summit.

**Table 5: G8 Commitments to Africa at Gleneagles**

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

#### **IV. Translating Commitments into Results**

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.

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, 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. Recent evidence suggests that there has been an increase in the proportion of total DAC aid to least developed countries (LDCs) that is untied. Over the period 1999-2001, 55 percent of total DAC aid to LDCs was untied. In 2004, the number rose to 68 percent (OECD 2006a). 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 period 2003-2004, the average is 90 percent. 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 HIPCs 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 and concluded that all countries have fully complied with their commitments on debt relief and so have a score of +1. 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 in 1999 with relatively less restrictive eligibility criteria. About 33 African countries are currently eligible for assistance under the initiative. Of this number, 8 are pre-decision point countries, 7 have reached the decision point, and 18 have reached the completion point. It is estimated that the initiative will lead to \$36 billion in debt relief to African countries.

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 the 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 disbursed outstanding debt as at end-2004. For

the IDA, it is disbursed outstanding debt as at end-2003. It is expected that \$34 billion would be granted to African countries under the MDRI. When this is added to assistance under HIPC, total debt relief to Africa is expected to be \$70 billion. Table 6 presents the main characteristics of the MDRI and HIPC initiatives. 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.

**Table 6: Main Characteristics of the HIPC Initiative and the MDRI**

	<b>HIPC Initiative</b>	<b>MDRI</b>
<b>Country coverage</b>	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
<b>Participating creditors</b>	All multilateral, official bilateral and commercial creditors of external public and publicly guaranteed debt to HIPCs.	IDA, IMF and AfDF only.
<b>Debt relief provided</b>	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
<b>Modality of delivery</b>	Different modalities. Most multilateral and Paris Club creditors also provide interim debt relief.	Stock-of-debt operation at or shortly after the completion point.
<b>Total costs of committed debt relief</b>	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)

## **V. Issues Arising from Recent Initiatives on Aid and Debt**

Since the adoption of the Millennium Declaration, there have been discussions and concerns on the impact 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 economic consequences of scaling-up aid and debt relief to African countries.

### **Scaling-up Aid**

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 are 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. An 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. 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).

***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 (such as schools or clinics) that have large recurrent costs, and 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.

**Debt Relief**

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.

### Conclusion

This paper examined recent trends in development finance in Africa as well as the financing gap that has to be filled if countries in the region are to meet the Millennium Development Goals. It shows that for several countries the financing gap is substantial and depends on the nature of growth as well as the distribution of income. For example, in the case of Burkina Faso, the gap is 12 percent of GDP if growth is pro-poor, 14 percent if growth is distribution neutral, and 26 percent if growth is anti-poor. The paper also examined the key global initiatives and commitments made by donors to African countries, pointing out that in several key areas, donors have not fully met their commitments and that serious efforts need to be made to improve donor performance in these areas to increase the likelihood of the region meeting the MDGs. Finally, the paper examined the impact of recent proposals to scale up the volume of aid and debt relief to Africa. It argues that an increase in aid has the potential to create a Dutch-disease effect, as suggested in theoretical models, but that this negative impact could be neutralized if aid recipients take measures to ensure that a large portion of aid is spent on traded rather than non-traded goods. This will ensure that an increase in aid does not lead to a real exchange rate appreciation thereby reducing the competitiveness of exports. The paper also calls for better management and use of resources from debt relief to ensure that it does not have adverse effects on the economy.

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