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ODA and the Quest for Innovative Sources of Financing Development

Mina Baliamoune-Lutz

European University Institute
Robert Schuman Centre for Advanced Studies
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Abstract

Motivated in large part by recent economic and financial crises in several high-income donor countries, the emergence of new official donors (such as China), and the increasingly important role of private donors (philanthropy), the quest to identify alternative (or innovative) sources of financing development has accelerated in the past few years. At the same time, the issue of aid effectiveness has again become a hot topic. In this paper, I primarily comment on the official purpose of official development assistance and provide an overview of the main issues related to aid effectiveness and innovative sources of development finance.

Keywords

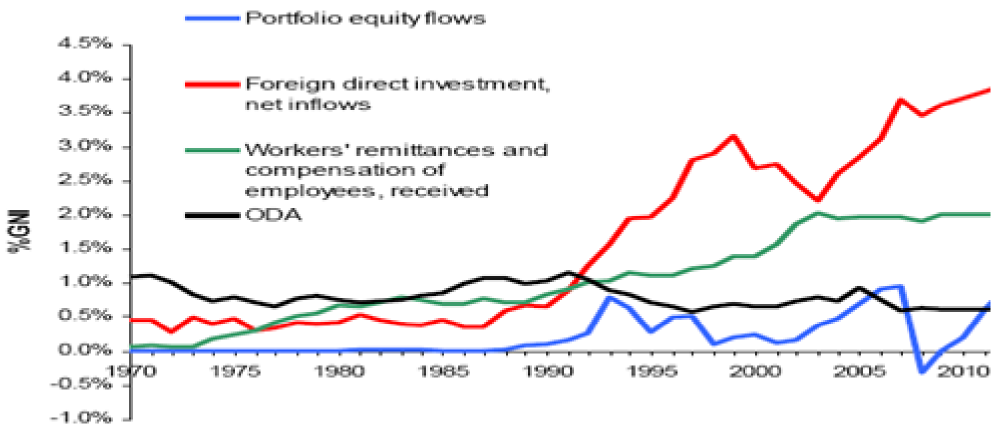
Development assistance, innovative sources of development finance, Aid effectiveness.

Introduction

Foreign aid to developing countries has for most of its existence triggered controversy. On the one hand, there are those who maintain that developing (low-income) economies absolutely need this type of financial inflow to fill the gap between domestic savings and investment and that the outcome from using development aid is generally positive. This group has been mainly inspired by the success of the post-World War II Marshall Plan. On the other hand, there are those who argue that not only is foreign aid ineffective—in part because many of the recipient economies lack the soft and hard infrastructure that European countries had—but it can have a negative impact on the welfare of citizens in recipient countries, including helping to sustain dictatorial regimes, increasing inequality, and worsening governance and institutions.

In recent years, there has been a revival in the 'foreign aid debate' and development aid was again the subject of global attention as illustrated, for example, by several high-level meetings held by the UN (or its agencies) and other international organizations, and by the actions of some renowned artists (such as Bono) and philanthropists such as Bill and Melinda Gates). There has also been a growing emphasis on trying to identify other sources (other than ODA) of development finance and new ways of thinking about how to best promote development and enhance welfare in aid-recipient countries. This was triggered by several factors, including: (i) philanthropy[1] and private investment began to have a more significant role in promoting development (see Figure 1); (ii) aid for trade became increasingly important during the last decade; (3) the emergence of new donors, such as China, and the implications for South-South development cooperation.

Figure 1
Financial Flows into Developing Countries, IMF World Economic Outlook, 2009



Adapted from Nemat Shafik, 2011, "The Future of Development Finance." Working Paper 250, Washington, D.C.: Center for Global Development. www.cgdev.org/content/publications/detail/1425068.

[1] See Helly (RSCAS PP 2013/05, forthcoming)

The 'Official' Purpose of Official Development Assistance

The World Bank (similar to OECD) defines official development assistance as follows.

> Net official development assistance (ODA) consists of disbursements of loans made on concessional terms (net of repayments of principal) and grants by official agencies of the members of the Development Assistance Committee (DAC), by multilateral institutions, and by non-DAC countries *to promote economic development and welfare in countries and territories in the DAC list of ODA recipients*. It includes *loans with a grant element* of at least 25 percent (calculated at a rate of discount of 10 percent) [*emphasis added*].
>
> *(World Bank, World Development Indicators online database)*

First, the above definition clearly states that the ultimate goal of ODA is to promote economic development and welfare in the recipient countries. Assuming one can identify and properly measure indicators of economic development and welfare, an important implication of this definition is that countries that attain a good level of economic development and enhanced welfare of their citizens would graduate from being a recipient country and perhaps even become a donor country as, for example, South Korea did.

Second, considering the definition of ODA, it is legitimate to ask the following question. After receiving ODA for many decades, shouldn't a country that has failed to show significant improvement in economic development and welfare be removed from the list of recipient countries? The facts, in general, suggest that many countries continue to receive ODA in spite of failing to achieve significant improvement in economic development. The short answer the question is 'no', at least in the case of most aid recipients. This is primarily because it is often difficult to accurately identify the source of the problem or constraints, especially when they are rooted in culture and traditions. For example, it was reported that in Malawi men refuse to use malaria-preventing insecticide-treated bednets (ITNs) because they believe that they would make them inactive at night or would cause them to become sterile.[2] Furthermore, even when we are able to determine the reasons ODA has failed to produce development, there are many reasons why simply eliminating ODA may not be desirable for donors and recipient. For donors this may include helping create a favorable attitude in the host country for home businesses operating in an aid-recipient (host) country or securing votes and support at the United Nations General Assembly, for example.[3] From the recipient country's viewpoint, aid not being effective is often blamed on aid being too late too little and thus, these countries argue, one way to enhance effectiveness is for donors to speed up delivery and increase the amounts of aid. In addition, at least for those governments that use ODA for public projects such as schools, roads and hospitals, suspending aid can sometimes have more disastrous effects (more than just aid ineffectiveness) and may have a significant negative impact on the reputation of the incumbent government.

Third, it follows from the above definition that ODA can be a loan with a grant element and some believe that this may have unnecessarily contributed to increasing the debt burden of developing countries, particularly in Africa. In this case, countries might be better off mobilizing resources from other sources.[4]

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2 Edson Dembo, (2012), "Community health workers' perceptions of barriers to utilization of malaria interventions in Lilongwe, Malawi: A qualitative study," MalariaWorld Journal, www.malariaworld.org, November 2012, Vol. 3, No. 11.

3 Axel Dreher, Peter Nunnenkamp and Rainer Thiele, "Does US aid buy UN general assembly votes? A disaggregated analysis," *Public Choice* (2008), 136: 139–164.

4 See the discussion of aid dependence in Ravi Kanbur, "Aid, Conditionality and Debt in Africa," in F. Tarp (ed.), *Foreign Aid and Development: Lessons Learnt and Directions for the Future*, Routledge, pp. 409-422, 2000.

Fourth, it is implied in the definition of ODA that donors know what type of policies and programs promote economic development and welfare in the recipient country. The definition also suggests that through ODA, there could be a prescriptive (ladder) solution to poverty (Sachs, 2005).[5] However, as Easterly (2007)[6] pointed out, 'the assumption that we know what works best for poor countries is flawed and so is top down approach.'

Aid Effectiveness

Many scholars have tried to assess ODA effectiveness and identify the factors that contribute to, or hinder, effectiveness. One of the most talked about studies in this area in the late 1990s and the early 2000s was a study by Craig Burnside and David Dollar[7] —which first appeared in 1997 as a World Bank Policy Research Working Paper. The authors estimated growth equations where the explanatory variables are ODA, and the interplay between ODA and a policy index, as well as other control variables. They find statistical evidence indicating that the interplay between aid and policy has a positive impact. The main conclusion of the study was: "…aid has a positive impact on growth in developing countries with good fiscal, monetary, and trade policies but has little effect in the presence of poor policies" (Burnside and Dollar, 2009, p. 847). In the 2000s, a large body of research tried to assess the robustness of the Burnside-Dollar results. And found that, indeed, they are not robust;[8] in the sense that good policies (as defined in the study) do not determine aid effectiveness.

Related to the issue of effectiveness, a different line of research focused on the effects of aid on institutional quality and governance in recipient countries.[9] Some empirical studies found that aid may promote rent seeking and corruption;[10] it could delay institutional reforms[11] and it seems to be associated with poor accountability. For example, Moss, Pettersson, and van de Walle[12] (2006, p. 1) argue that "states which can raise a substantial proportion of their revenues from the international community are less accountable to their citizens and under less pressure to maintain popular legitimacy. They are therefore, less likely to cultivate and invest in effective public institutions." On the other hand, Tavares[13] shows that foreign aid decreases corruption. Kilby[14] uses panel data of 5-year averages over the period 1970–2000 from 83 aid receiving countries and finds that "World Bank lending, while not specifically targeting high or low regulatory states, is linked to lower subsequent regulation".

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5 Jeffrey Sachs, The End of Poverty: Economic Possibilities for Our Time, London: Penguin Books, 2005.

6 William Easterly, The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good, New York: The Penguin Press, 2006.

7 Burnside, C. and D. Dollar, "Aid, Policies, and Growth," *American Economic* Review (2000), 90(4): 847–68.

8 See for example, H. Hansen & F. Tarp, "Aid and growth regressions," *Journal of Development Economics* (2001), 64, 547–570; C-J. Dalgaard & H. Hansen, "On aid, growth and good policies," *Journal of Development Studies* (2001), 37(6), 17–41; and M. Baliamoune-Lutz & G. Mavrotas, "Aid effectiveness: Looking at the aid-social capital-growth nexus," *Review of Development Economics* (2009), 13(1), 510–525.

9 See J. de Catheu, "Budget support in fragile states: Feeding the beast or building resilience? EUI Working Paper RSCAS 2013/25 (2013).

10 Knack, Stephen, "Aid Dependence and the Quality of Governance: a Cross Country Empirical Test," *Southern Economic Journal* (2001), 68, 2: 310-329.

11 Deborah Bräutigam and Stephen Knack, "Foreign Aid, Institutions and Governance in Sub-Saharan Africa," *Economic Development and Cultural Change* (2004), 255-285.

12 T. Moss, G. Pettersson and N. van de Walle, "An aid-institutions paradox: A review essay on aid dependency and state building in sub-Saharan Africa," Working Paper No.74 (2006), Center for Global Development, Washington DC.

13 J. Tavares, "Does foreign aid corrupt?" *Economics Letters* (2003), 79(1), 99–106.

14 C. Kilby, "World Bank lending and regulation," Economic Systems (2005), 29(4): 384-407.

In addition to a continuation of research on aid effectiveness[15] and OECD work and assessment,[16] in the past few years a growing number of scholars and policymakers began to investigate issues related to alternative (or innovative) sources of development finance. The debate around ODA and its effectiveness is also interesting in view of the ongoing discussions on the Millennium Development Goals (MDGs) post 2015.

Alternative/Innovative Sources of Financing Development

The relatively recent quest for alternative sources of financing development appears to have started with the increasing awareness that gigantic amounts of funding are needed in order to assist developing countries in their efforts to achieve the Millennium Development Goals (MDGs) and that the traditional sources of development finance alone would not be able to do the job. In September 2000, the UN General Assembly adopted a resolution calling for 'a rigorous analysis of the advantages, disadvantages and other implications of proposals for developing new and innovative sources of funding, both public and private, for dedication to social development and poverty eradication programs.' Following this resolution, the UN Department of Economic and Social Affairs requested from UNU-WIDER to undertake a project on 'Innovative Sources for Development Finance'[17] (see Atkinson, 2004).

According to Navin Girishankar (2009, p. 3)[18], "Innovative development finance involves nontraditional applications of solidarity, public-private partnership (PPP), and catalytic mechanisms that (i) support fundraising by tapping new sources and engaging investors beyond the financial dimension of transactions, as partners and stakeholders in development; or (ii) deliver financial solutions to development problems on the ground." Thus, innovative development finance involves much more that just identifying new sources of finance; there should be major emphasis on engaging investors more than in the past and involving the communities (targeted groups) on the ground.

In the preface to the World Economic and Social Survey 2012 (United Nations, 2012), UN Secretary General Ban Ki-Moon remarked that a number of innovative development finance initiatives have been launched in the past decade and that they targeted mostly the funding of global health programs that have helped to provide immunizations and AIDS and tuberculosis treatments to millions of people in developing countries. The Secretary General also noted the following.

> While these initiatives have successfully used novel methods to channel development financing, they have not yielded much additional funding, thus leaving available finance well short of what is needed. This is one reason why proposals to mobilize resources for development through sources beyond ODA, including innovative finance mechanisms, have generated renewed interest from both Governments and civil society.
>
> *(Secretary General Ban Ki-Moon, United Nations, 2012)*

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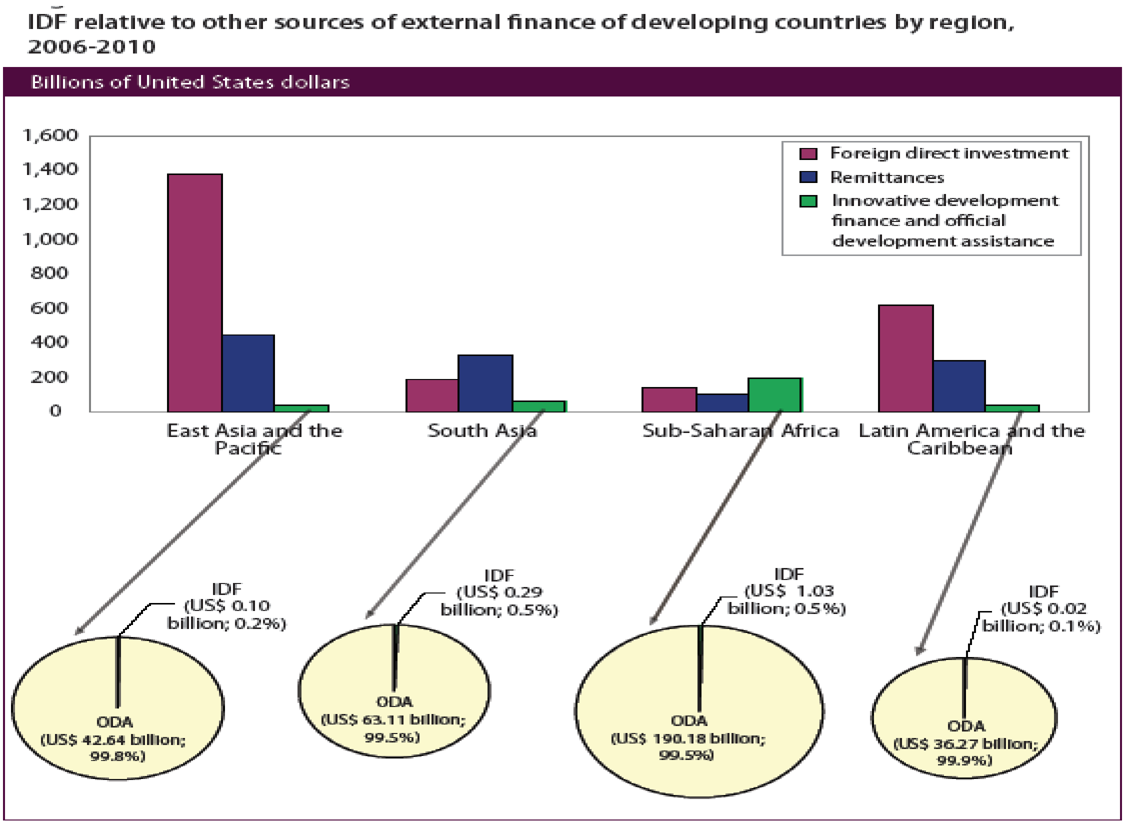
15 See, for example, Baliamoune-Lutz and Mavrotas (2009, ibid), Doucouliagos and Paldam (2009, ibid), and M T. J. Mekasha & F.Tarp (2011), "Aid and growth: What Meta-analysis reveals," UNU-WIDER research paper no 2011/22; and Baliamoune-Lutz Mina Baliamoune-Lutz, "Do Institutions and Social Cohesion Enhance the Effectiveness of Aid? New Evidence from Africa." *Journal of International Commerce, Economics and Policy* (2012), 3(1): 1-19.

16 See OECD's Development Strategy (adopted in 2012)

17 A. B. Atkinson, New Sources of Development Finance: Funding the Millennium Development Goals, UNU-WIDER Policy Brief no. 10, 2004.

18 For a thorough discussion of types and landscape of innovative development finance, see Navin Girishankar, 2009, "Innovating development finance from financing sources to financial solutions," Policy Research Working Paper 5111, Washington, D.C.: World Bank.

Figure 2



Adapted from World Economic and Social Survey 2012: In Search of New Development Finance (United Nations, 2012).
Sources: GAVI Alliance (http://www. gavialliance.org/results/disbursements/); Global Fund to Fight AIDS, Tuberculosis and Malaria (http://portfolio.theglobalfund.org/en/DataDownloads/Index); UNITAID; and World Development Indicators online database (available from http://databank.worldbank.org/ddp/home.do).

As Figure 2 shows, innovative development finance (IDF) is still a very small fraction of total development finance; 0.5% in Africa and South Asia, and 0.1% and 0.2% in Latin America and East Asia and the Pacific, respectively. Figure 2 also shows that the other channels of external finance, FDI and remittances, are more important that the combined amounts of ODA and IDF in all regions except sub-Saharan Africa (SSA).

Fact or Fiction?

Many argue that too much ODA is going to middle-income countries[19] and that the distribution of ODA by income group should be skewed towards low-income countries. The argument here is that for ODA to make a difference it should enhance the purchasing power of the poor in the poorest countries. As can be observed from Figure 3, until the early 1970s, per-capita ODA was very low and almost the same for all three income groups. Then from the late 1970s until the mid-2000s, the gap between in

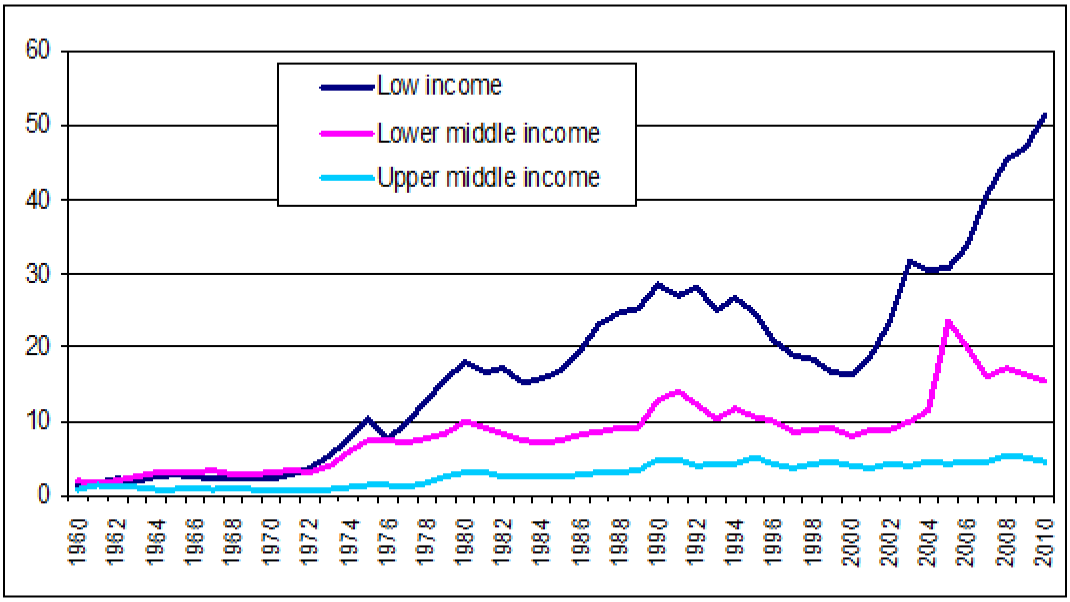
[19] See, for example, William Easterly and Tobias Pfutze, “Where Does the Money Go? Best and Worst Practices in Foreign Aid,” *Journal of Economic Perspectives* (2008), 22(2), 29-52; and Jennifer Kuan, Natalia Martín-Cruz (2009), “Political Inputs to the Aid Allocation Process: Evidence from Spain,” Anales de Estudios Económicos y Empresariales, Vol. XIX, 9-32.

the levels of per-capita ODA across the three groups was for the most part maintained at a comparable size. It was not until the second half of the 2000s that the per-capita ODA to low-income countries (this was due to several factors, including increased foreign aid inflows, a drop in fertility rates, …) started increasing at faster rate. Nonetheless, as Figure 3 shows, low-income countries receive the highest net ODA per capita (and also as a share of GDP, not shown) and their ODA per capita has in recent years increased faster than that of other income groups.

Related to the same issue, Figure 4 shows some interesting trends. Up to the late 2000s, the largest share of ODA went to lower-middle income countries, much more than the share of the group of low-income countries, which also includes the least developed countries (according to the DAC list of ODA recipients). This, however, has changed since 2010 (after a significant surge of ODA to lower middle-income countries in the mid 2005); at which time the low-income countries started receiving the largest share of ODA. The share going to upper middle income countries increased in the late

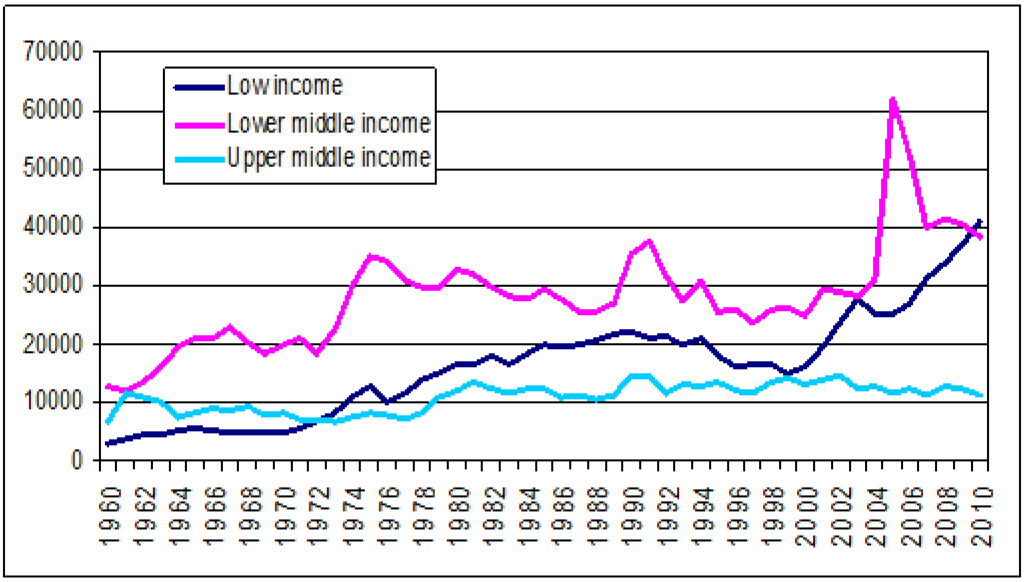
1970s and continued at roughly the same level since then. In addition, at least in the last decade, SSA received the largest share of ODA disbursements (Figure 5).

Figure 3
Net ODA received per capita (current US$)



Source of data: World Development Indicators database on line, World Bank

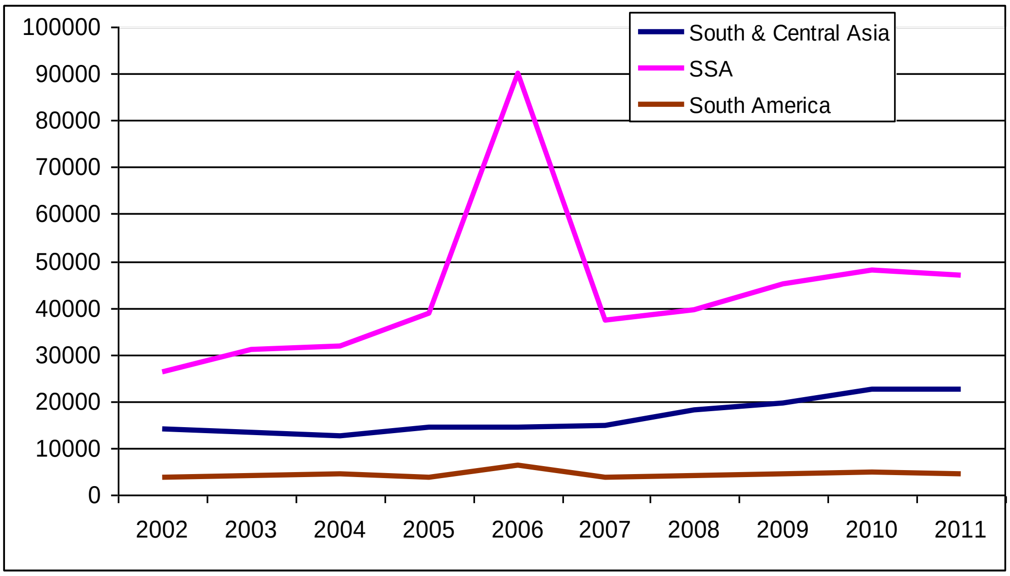
Figure 4
Net official development assistance received (constant 2010 US$ millions)*



Source of data: World Development Indicators database on line, World Bank

* It is important to note that (in 2012) almost half the countries on the DAC list of fragile states were middle-income economies (see FRAGILE STATES 2013: Resource flows and trends in a shifting world, OECD 2012).

Figure 5
Gross disbursements of ODA, (2010 US$ millions)



Source of data: OECD.org

Concluding Remarks

While some continue to argue that aid is ineffective (Moyo 2009; Doucouliagos and Paldam 2009),[20] in a recent interesting paper Mekasha and Tarp (2011)[21] apply meta analysis to data from 68 empirical studies from the aid-growth literature and obtain evidence suggesting that aid is overall effective (aid has a positive impact on growth). In addition, a large body of empirical evidence from micro data shows that aid is generally effective. Perhaps a more important question to ask is when aid is found not to have a positive impact, what can be done to change this outcome? This does not mean that development aid should be eliminated. On the contrary; development aid is still very much needed since, in its absence, large groups of populations in many countries (mostly in Africa) will suffer greatly and it may take another 50 years or longer to reverse this. I provide some recommendations in the next paragraphs.

First, aid tied to trade or to other outcomes should benefit both donor and recipient. In this case, developing countries should endeavor to identify and implement techniques that would allow them to shop wisely for donors (both private and official donors; ODA and IDF). This, in fact, would strengthen *ownership of development priorities* by recipient countries. This is especially important, and arguably feasible, now that China and other emerging countries (such as India, Brazil, and South Arica) are also aid donors. I propose that a *market for development aid (MDA)* be created. In such a market developing countries supply proposals for needed development projects/programs and donors pay the equilibrium price/funds for these projects. Perhaps this would be the best and quickest way for many SSA countries to get good quality infrastructure, and enable a country like Ghana which has joined the group of middle-income countries in 2010, to have the type of infrastructure (including access to safe water and electricity) that Morocco and Tunisia, for example, have had for decades.

Second, as Paul Collier (2012) recently argued, "how aid is spent may become more important than how much of it is spent." Thus, there should be more emphasis on where aid money goes and how it is used. The information on where aid money goes should be freely accessible to the public, transparent, and monitored. The International Aid Transparency Initiative (IATI) which was launched at the Third High Level Forum on Aid Effectiveness, in Accra (in early September 2008) and called upon all donors to "disclose aid information in a timely manner,"[22] is a major step towards achieving this. Recent studies have found that being a member of IATI is a powerful signal of a donor being more transparent across several dimensions of the transparency index.[23] In addition, a number of initiatives which focus specifically on aid to African countries, such as the African Monitor and the initiatives of the Association of European Parliamentarians with Africa (AWEPA) targeting aid effectiveness are good examples towards achieving better monitoring.[24]

Third, it is important to remember that ODA and IDF constitute an area where 'one shoe does not fit all'. Further individualizing aid modalities and aid-based solutions should make aid more effective. The effects of ODA differ in different economies. For example, ODA was found to cause Dutch disease effects (foreign exchange rate appreciation and deterioration in exports and manufacturing) in

[20] D. Moyo (2009). Dead *aid: Why aid is not working and how there is a better way for Africa*. New York, NY: Farrar, Straus and Giroux; H. Doucouliagos & M. Paldam (2009), "The aid effectiveness literature: The sad results of 49 years of research." *Journal of Economic Surveys*, 23,3, 433–461.

[21] T. J. Mekasha & F.Tarp (2011), "Aid and growth: What Meta-analysis reveals," UNU-WIDER research paper no 2011/22.

[22] See http://www.aidtransparency.net/ and http://www.publishwhatyoufund.org/

[23] Anirban Ghosh and Homi Kharas, The Money Trail: Ranking Donor Transparency in Foreign Aid Brookings Institution, 2011.

[24] "Enhancing Mutual Accountability and Transparency in Development Cooperation." Background Study for the Development Cooperation Forum High Level Symposium, United Nations Economic and Social Council, 2009.

some countries but not in others. In addition, as mentioned earlier, culture and tradition may affect aid effectiveness.

Finally, as noted in Girishankar (2009), “innovative fund-raising should be viewed as a complement to—rather than a substitute for—traditional efforts to mobilize official flows, in particular concessional flows.” The World Bank and international official donors should not start thinking that IDF will replace ODA yet. Instead, the thinking should be more focused on how to make ODA, together with IDF, work more effectively and efficiently towards attaining specific development goals. For example, migrant workers’ remittances are significantly above ODA receipts in many developing countries. It is worth exploring the extent to which allowing for more immigrant workers into Europe, United States, and other donor countries could increase remittances to developing countries and gradually lead to a reduction in ODA.

Finally, an area which both ODA and IDF should focus more on is the strengthening of domestic resources of finance, especially taxation and public-private partnerships. As argued, in the following quote, aid should not replace domestic energy and capacity.

> "I believe that it is time to shift the debate from the mechanics of aid delivery to the broader development challenges we will face in the coming years. Aid is only a means to an end. Indeed, if aid is truly effective, it will progressively put itself out of business. Effective aid should therefore be designed with this in mind —to strengthen, not displace, domestic energy and capacity; and to build up, not replace, alternative sources of development finance."
>
> *Donald Kaberuka (African Development Bank President), in his speech at opening of a two-day Second Regional Meeting on Aid Effectiveness on Thursday, 4 November 2010, in Tunis*