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From commitment to action: human development and growth

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SUMMARY: THE POSITION NOW AND OUR PLAN OF ACTION

The main message of this paper is that increased aid must promote both human development and economic growth. Economic growth is crucial for making sustained progress towards the MDGs, for reducing income poverty, for improving human development outcomes and for providing the basis for continued progress. The MDGs on health and education cannot be achieved by focusing solely on interventions aimed at those two sectors.

Growth increases a country's tax base and allows for more spending on health and education. Growth also raises the incomes of poor people and thereby increases their ability to pay for activities and goods that improve their health and education. Finally, investing in health and education is also good for long-term growth, as virtuous circles are generated both at the national and household level. Strengthening this two-way causal relationship between growth and human development requires conscious strategies that incorporate two enabling conditions: a favourable investment climate and empowerment of poor people to make the most of the expanding opportunities. This paper focuses particularly on the need for developing infrastructure, strengthening governance and institutions, and providing vulnerable groups with better social protection.

Higher rates of growth and improved health and education outcomes require additional resources to finance the increased investment and expenditure in developing countries. The funds for these investments will need to come from a combination of private and public sources. In some low-income countries, particularly in Africa, foreign aid will be an important part of the story. This requires careful consideration of a country's absorptive capacity. We argue that many actions can be taken to enhance absorptive capacity and that there is a need for complementary policies to maximise the positive impact of increased aid.

The key points made in the paper are as follows:

There is a two-way causality between growth and human development
- Economic growth reduces income poverty.
- Countries with higher incomes tend to have better human development.
- Better human development outcomes contribute to higher economic growth.

The challenge is to promote both growth and human development
Challenge 1: Investment climate improvements
- Good infrastructure is a key element of a good investment climate.
- Better governance and institutions permit the two-way causality to work better.

Challenge 2: Empowering and investing in people
- Social protection contributes to growth and human development.

We must both increase aid and make it more effective

- Private sources of domestic finance will lead to growth in developing countries.
- In sub-Saharan Africa, frontloaded aid is key for growth and development.
- The quality of policies and institutions affect aid absorption.
- How donors supply aid affects aid absorption and effectiveness.
- Better management of aid inflows and improved relationships between donors and recipients are crucial.
- Scaling up aid in fragile states poses challenges.
- Better absorption will require attention to the workings of labour markets.

Plan of action

1. Promote economic growth and mobilisation of domestic revenue in order to finance and sustain improved health and education services and to reduce poverty.

2. Promote a good investment climate, with enhanced support for trade and regional integration, strengthening financial sectors and raising agricultural productivity.

3. Promote greater investment in infrastructure. Of the additional US$25 billion of annual aid for Africa, the World Bank estimates that $6-9 billion should be allocated for infrastructure.

4. Support the participation of poor people in economic growth, including the empowerment of the poor and better social protection.

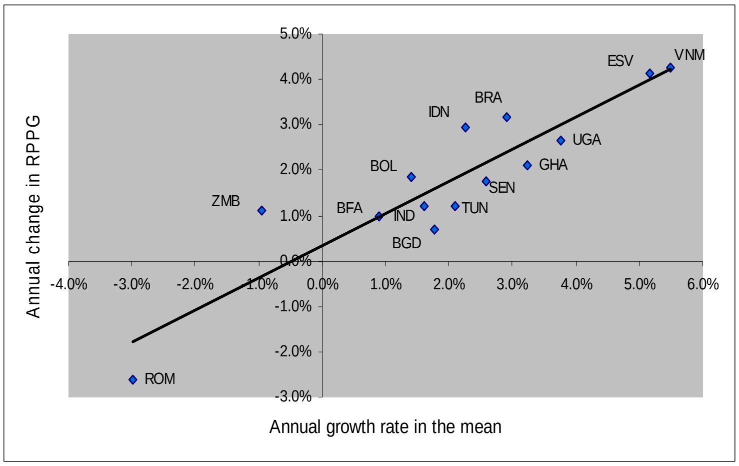
5. Facilitate absorptive capacity in recipient countries, though expanding productive capacity, better management of resources, and sound macroeconomic management.

A. BACKGROUND: THE TWO-WAY CAUSALITY BETWEEN GROWTH AND HUMAN DEVELOPMENT

Growth, income poverty reduction and improvements in human development outcomes go hand in hand.

Economic growth reduces income poverty.

1. Achieving and maintaining sustainable economic growth should be a core building block of any strategy to reduce poverty. There is clear evidence that higher rates of economic growth are associated with greater poverty reduction. On average, income growth of 1% reduced the poverty headcount by 2.5% during the 1980s and 1990s.[1] This means that poor people participate in growth. On average, their incomes rise as fast, or almost as fast, as those of the non-poor. Historically, if average incomes rose by 1%, the incomes of the poorest quintile also rose by 1%.[2] More recent evidence for the 1990s indicates that the incomes of people below the poverty line rose by only 0.7% when average incomes rose by 1%:[3]



Source: OPPG, 2005

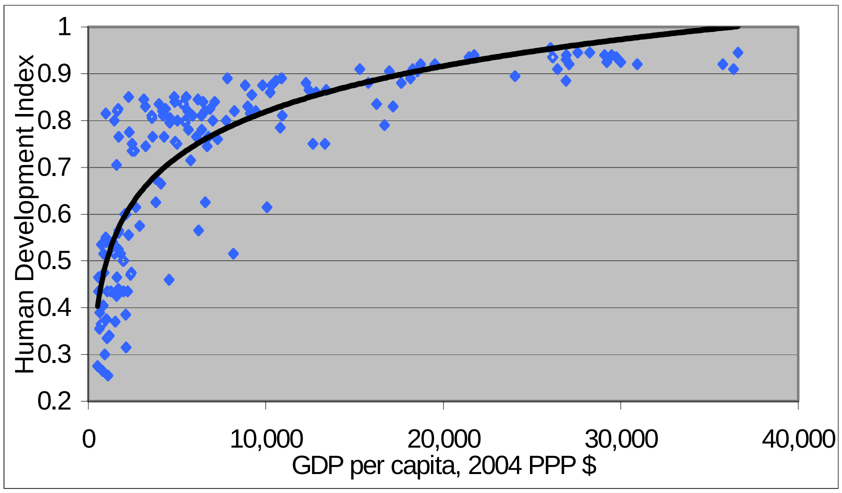
2. But there are big variations across countries. For example, the figure above shows that Tunisia and Indonesia had similar average growth rates (slightly above 2% a year) during the 1990s, but while the incomes of poor people rose by only around 1% in Tunisia, they rose by more than 3% in Indonesia. Such differences between countries can be explained by different initial conditions (such as the level of inequality) and by different growth patterns.

3. Even within countries, not everyone benefits equally. During the 1990s, overall growth was driven by an improved performance of the non-agricultural sectors (they grew six times faster than agriculture).[4] This is part of the explanation for why the incomes of poor people rose less than average incomes: they mostly dedicate themselves to agricultural activities, which had lower growth rates. Poor

people also faced significant constraints to participating in non-agricultural growth. One such constraint was the lack of education, which is discussed later in this paper. More generally, social exclusion can cause some people to remain poor even in growing economies. For example, the government in Vietnam estimates that by the end of this decade 90% of food poverty and 50% of overall poverty will be concentrated in ethnic minority groups, who constitute just 10% of the population.[5] This points to the need for special strategies to ensure that poor and excluded households have equitable access to resources, markets and public services.

Countries with higher incomes tend to have better human development

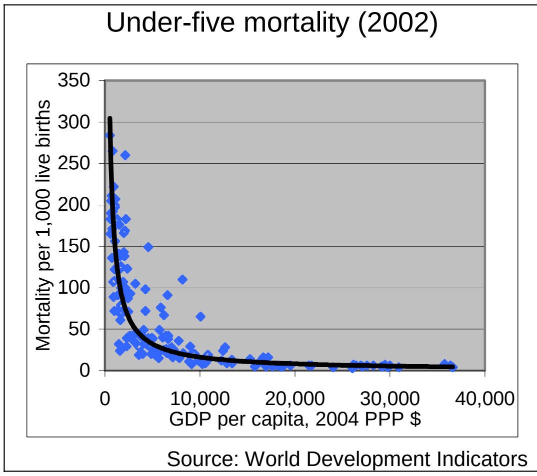
4. Economic growth is not just associated with reduced income poverty. There is also clear evidence on the positive association between economic and human development outcomes. This is evident from a cross plot of countries' GDP per head (in 2002) and their score on the Human Development Index (HDI):

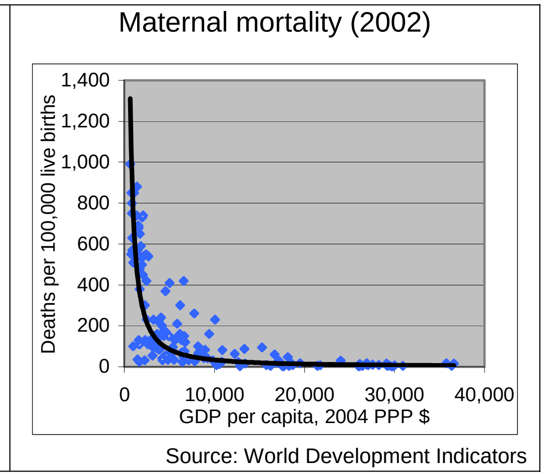


Source: World Development Indicators

5. More specifically, higher GDP per head is associated with improved outcomes of the Millennium Development Goals on health and education. This association is the result of a two-way causality between improvements in economic performance and in health and education outcomes. They will be discussed in turn.

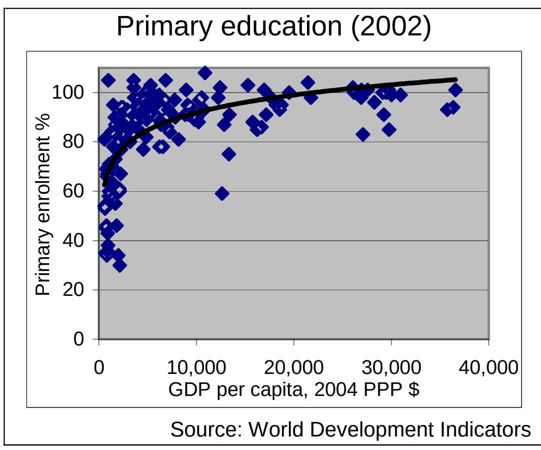
6. First, there is a clear positive association between higher GDP per head and better **health indicators**. The figures below show that under-five mortality rates and maternal mortality rates are much lower in middle-income and high-income countries than they are in low-income countries:

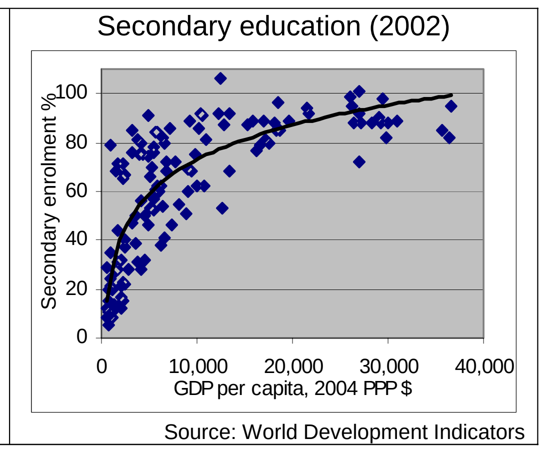




7. In addition to lower child and maternal mortality rates, the disease burden is also generally lower in wealthier countries. For example, the HIV prevalence rate is 3.2% for the least developed countries, 1.8% for low-income countries, 0.7% for middle-income countries and 0.3% for high-income countries.[6]

8. There is also a clear positive association between higher GDP per head and better **education indicators**. This is true for both primary and secondary school enrolment rates:





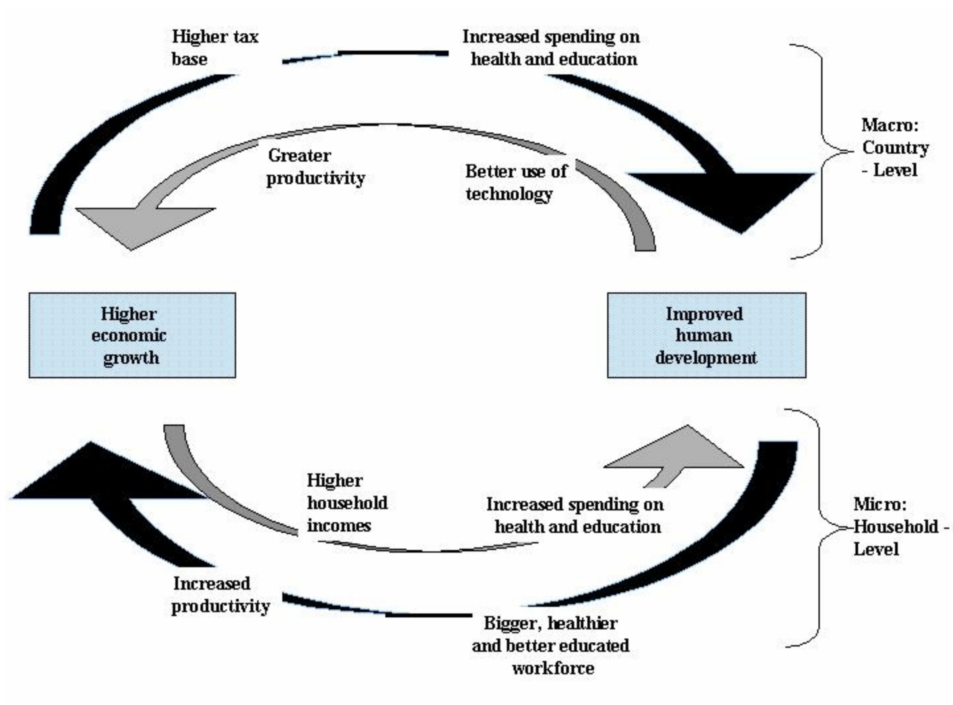
9. Although not an MDG target, secondary education plays a key role in raising future growth rates and in determining the extent to which poor people are able to participate in growth.[7] Most notably, many of the jobs that are created through growth are in the non-agricultural sectors and tend to go to people who have at least some secondary education.[8]

10. This cross-country evidence, showing that improved economic and human development outcomes go hand in hand can be illustrated by the experiences of Indonesia and Chile between 1975 and around 2000. In Indonesia, GDP per head rose by around 4% a year, while life expectancy increased from 49 to 65 years and infant mortality fell from 104 to 40 per 1000 live births. In Chile, GDP per head also rose by 4% a year, while life expectancy increased from 63 to 75 years and infant mortality fell from 77 to 11.[9]

11. But what about countries that have seen a lopsided development path – countries that achieved either good economic outcomes or good human development outcomes without making much progress on the other? The Human Development Report 1996 reviews this question in detail.[10] There are usually clear reasons for such uneven development. For example, transition countries tend to have human development indicators that are similar to those in countries with much higher GDP per head levels. This can be explained by the emphasis that their governments placed on health and education over many decades, combined with limited growth during the 1980s and a collapse in the early 1990s. Many resource-rich countries tend to exemplify the opposite pattern. Their human development indicators are often much lower than those of other countries with similar GDP per head levels. For them, human development investments were not a precondition for future growth. This has resulted in highly unequal development that may not be sustainable over the long run. Take Georgia and Angola as two examples. They have similar GDP per head levels (around US$2,200 when corrected for purchasing power parity), but vastly different human development indicators: while Georgia's health and education levels are almost as high as those of OECD countries, Angola's are among the worst in the world.[11]

Two-way causality between growth and improved human development

12. Having established that economic and human development go hand in hand, this section explores the main links between growth and human development. We distinguish between macro- and micro-level evidence. The diagram below summarises the four channels that will be discussed in turn. While the various links are clear, we have much better empirical evidence on some than on others.[12]

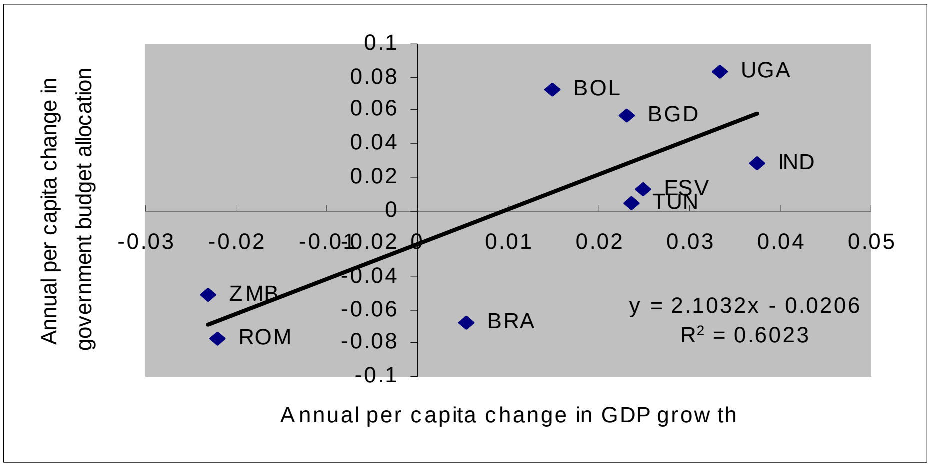


The contribution of growth to improved human development outcomes.

➢ *The **'macro link'**: growth increases a country's tax base and therefore allows for greater spending on health and education.*

13. Many health and education facilities depend on government funding. Not surprisingly, the share of government budgets that is allocated to such human development spending can vary greatly across countries and over time. Even if this share remains unchanged over time, growth in GDP per head can significantly increase the amount of government spending on human development. For example, Kenya and Botswana had similar GDP per head in 1960 and spent approximately 9% of their GDP on health and education over the next three decades. However, because Botswana grew by 6.5% a year while Kenya only grew by 1.6% a year, Botswana spent five times as much on these sectors by 1990 as did Kenya.[13]

14. The key link that is highlighted here relates to tax collection. Growth in the national economy implies an increase in the country's tax base. For example, a rise in household incomes is likely to lead to increased government revenue from the collection of income tax. Also, higher household incomes tend to be accompanied by higher consumption, which raises the prospects for the collection of value-added taxes. An increase in tax revenue opens the possibility of higher government spending, including on health and education. A recent review of nine countries showed that higher growth was indeed accompanied by bigger increases in government budgets during the 1990s:[14]



Source: Wilhelm and Fiestas, forthcoming

15. If wisely spent, the increase in the government's budget for health and education can lead to improved human development outcomes. But there is mixed evidence on the effectiveness of public spending in achieving such improvements. The same study of nine countries showed that, on average, higher expenditure on education and health did lead to improved outcomes in those two sectors. However, there was significant variation across countries, particularly for health outcomes. For example, neither Bolivia nor Zambia increased their per-head health spending during the 1990s. But while infant mortality fell by more than 5% a year in Bolivia, it remained unchanged in Zambia.[15] More generally, public policy faces important challenges to ensure that spending is cost-effective and benefits the poor. In order to reach the poor and avoid the high administration cost sometimes associated with targeting, some basic services may best be provided universally.

16. There are several reasons why we may observe only limited effectiveness of government spending on poor people's human development indicators. In many cases, the benefits of public spending on social sectors accrue disproportionately to the non-poor.[16] There is also clear evidence that country-specific factors determine the effectiveness and efficiency of government spending. For example, countries with higher levels of urbanisation tend to have more efficient public spending.[17] These issues are discussed in more detail in the health and education papers.

17. Finally, there are complementarities between sector-specific spending.[18] For example, better access to basic infrastructure services (water and sanitation) plays an important role in improving child health outcomes.[19] Similarly, the construction of rural roads is critical for access to education.[20] In general, infrastructure improvements are good for both growth and human development outcomes.

➢ *The **'micro link'**: growth raises the incomes of poor people and thereby increases their ability to pay for activities and goods that improve their health and education.*

18. This paper started out by showing that the incomes of poor people tend to rise in countries with sustained economic growth. Households allocate this additional income to a variety of purposes, including health and education. In particular, higher household incomes are more likely to translate into better human development outcomes if women's control over resources is increased. Women's bargaining power in the household has a significantly positive impact on investment in children's education, health and nutrition.[21]

19. For many households, health and education spending constitutes very large outlays, relative to other budget items. Moreover, such spending is often 'lumpy' – it requires comparatively large single outlays (for school fees or hospital bills, for example) as well as long-term commitment (for instance, today's decision to send a child to school has financial implications that will last several years). Higher incomes may be necessary to overcome such constraints and to reduce the opportunity costs that arise when children contribute to household income.[22] For example, the Bolsa Escola programme in Brazil provides income subsidies to families with school-age children in order to reduce dropout rates. It is estimated that the programme can result in between one-third and half of all children from poor households to staying in school.[23]

20. The increased household-level spending on health and education tends to be accompanied by improved human development outcomes. Take the period of 1993 to 1998 in Vietnam as an example. The high rate of growth (6% a year) led to significant increases in household incomes (7% a year). This resulted in an increased demand for education: the average length of schooling rose from 7.5 to 8.1 years over the period, and enrolment rates in secondary schools increased by approximately eight percentage points.[24] In general, a growing economy tends to provide greater job opportunities that lead to an increased demand for education (due to the higher expected returns).[25]

21. Higher incomes can also reduce the volatility of education investments. Taking children out of school is an unfortunate, but all too common, response to adverse shocks.[26] A maintained increase in household incomes is likely to reduce the need for such coping strategies and to allow families to keep children in school.

Better human development outcomes contribute to higher economic growth.

➢ *The **'macro link'**: increased government spending on health and education tends to enhance future growth.*

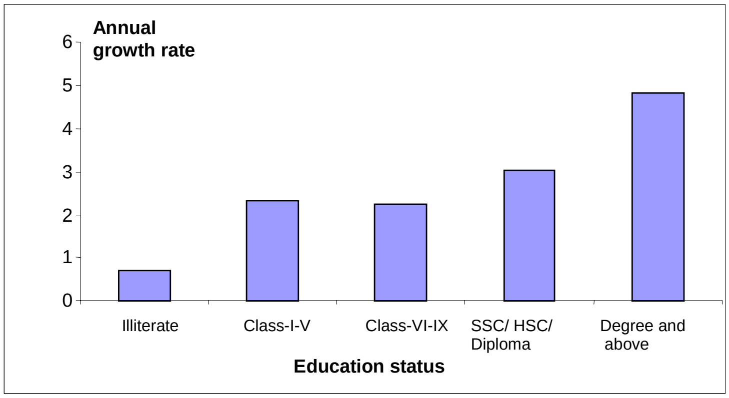
22. A healthy and well-educated population makes an economy more productive. Changes in the size and skill level of a country's labour force are a key factor in determining economic growth rates. If a government's spending on human development is effective, the labour force is increased and becomes more productive as fewer days are lost to illness, the available equipment is used more efficiently and more modern technologies are adopted.

23. Although not fully conclusive, cross-country evidence tends to show that improved human capital outcomes lead to higher future growth (with clearer evidence for the impact of education than of health).[27] It has been estimated that about 22% of the average growth in income per head can be explained by improvements in health indicators. Also, a 10% increase in health investment leads to a 1% increase in the growth rate.[28] Estimations for Tanzania and Zambia indicate that a 15% increase in spending on education would raise the countries' growth rate by 0.1 percentage points a year.[29]

24. Furthermore, a healthy and educated workforce helps to attract foreign direct investment and facilitates its technological spillovers.[30] This suggests that improvements in education and health are important for reversing the outflows of private capital from low-income countries, particularly Africa.

➢ *The **'micro link'**: households reap the benefits from increased investments in health and education through higher future incomes.*

25. If a household invests more in health and education, its members are likely to become more productive, whether they are self- or wage-employed. There is evidence that this higher productivity, in turn, increases future incomes. For example, schooling leads to greater adoption of more productive technologies.[31] These effects can explain why education plays an important role in driving income growth. In the case of urban areas in Bangladesh, for example, the incomes of people who completed secondary education rose three times as fast as those of people with no education during the 1990s:[32]



Source: Sen, 2005

26. Finally, there are not just direct productivity benefits from increased household-level investments in health and education. Improved human development outcomes also have positive externalities that further enhance productivity and growth. For example, an educated mother is more likely to send her children to school.[33] Reducing gender inequalities in education and health also reduces fertility levels, child mortality and under-nutrition, while increasing educational investment in the next generation – all of which are likely to have a positive impact on growth.[34]

B. THE CHALLENGES: CONDITIONS PROMOTING BOTH GROWTH AND HUMAN DEVELOPMENT

27. The first part of this paper highlighted the links between growth and human development. It also indicated that these links are stronger in some countries than in others. In this part of the paper, we will explore the conditions and policies that lead to higher rates of economic growth and better human development outcomes.[35] Making these links effective requires a conscious strategy on the part of government. The essential elements of such a strategy to drive growth and improvements in human development can be grouped under two pillars:[36]

> **Challenge 1** – Creation of **a better investment climate** to expand productivity and job opportunities; and
>
> **Challenge 2** – **Empowerment of poor people** to participate in a growing and productive economy.

28. These two conditions are widely recognised as being essential for bringing about growth that reduces poverty.[37] Investments in both pillars are necessary to build virtuous circles between growth and human development. Improvements in the investment climate stimulate entrepreneurship and expand the possibilities for firms and people to be productive. Through better education and access to information, empowerment enables people to negotiate, take opportunities and participate more effectively in growth processes. What are some of the essential ingredients of the two pillars, and how might they be given greater focus?

Challenge 1 – Investment climate improvements

29. The investment climate can be defined as: 'the policy, institutional, and behavioural environment, present and projected, that influences the perceived returns and risks associated with investment'.[38] Hence, investment is about more than increasing the capital stock. It is also about enhancing the productive activities of enterprises – be they small or large, domestic or foreign. The better the investment climate, the more investment will take place.

30. Many factors contribute to a good investment climate, including: macro-economic and trade policies, infrastructure, and governance and institutions. The fundamentals of a good climate for private investment are essentially the same for all countries. Considerable evidence from firm-level surveys and the analysis of growth episodes around the world have demonstrated the positive links between a good investment climate and growth.[39]

31. Among East Asian countries, where growth has been rapid over many years, several common factors can be identified as having been influential. These include:

- maintaining external and internal political stability;

- implementing prudent and stable macroeconomic policies;
- investing in education and building a highly skilled but low-wage labour force;
- maintaining competent and investor-friendly institutions;
- implementing export-oriented trade policies;
- fostering a strong entrepreneurial culture; and
- encouraging investment by small and medium-scale enterprises.

32. The World Development Report 2005 focused on investment climate issues. It stressed the following key issues, which were also highlighted in the report of the Commission for Africa:[40]

- establishing peace, security and stability;
- addressing policy uncertainty, inconsistency and instability (for instance, prudent fiscal and monetary policies should deliver low inflation, moderate taxes and competitive exchange rates);
- investing in better governance and stronger institutions (such as protection of property rights, enforcement of contracts, absence of corruption and rent-seeking, and removal of unnecessary bureaucracy);
- strengthening financial markets (such as standardisation of financial regulation and broader coverage of financial services);
- removing barriers to competition;
- investing in more and better-managed infrastructure (for instance, better provision of transport, communications, power and water can drive down investors' risks and costs); and
- implementing measures to address shortages of domestic capital, the lack of skilled workers, and the limited size of national markets.

33. The financial sector plays a crucial role in stimulating investment in physical and human capital. It underpins private-sector development, promotes technological progress, and encourages productivity growth.[41] The inflow of private capital and remittances depends on the robustness of the financial sector. Access to financial services can also reduce poverty and promote human development. There are clear linkages between financial sector development, child labour and education patterns.[42] Poor households exposed to high income volatility diversify their income sources by sending children to work rather than to school. Access to financial services helps families to adjust to unexpected changes, to reduce child labour and to increase school attendance.

34. The remainder of this section focuses on two key elements of the investment climate, namely infrastructure, and governance and institutions.

Good infrastructure is a key element of a good investment climate.

35. Good infrastructure is important for both growth and poverty reduction, and plays a key role in facilitating the two-way causality between growth and human development.[43,44] Investments in infrastructure are critical for meeting the MDGs.

For example, better road links improve access to schooling (MDG 2), a dependable and good-quality water source reduces under-five mortality (MDG 4), and better sanitation improves girls' participation in schools (MDG 3).[45]

36. According to some estimates, increasing the stock of infrastructure by 1% could add 1% to the level of GDP.[46] In some cases, such as Mozambique, the impact is known to have been much higher: the Mozal investment, an aluminium smelter that came into operation in 2000, doubled the country's exports, added 7% to annual GDP and created a large number of jobs.[47] Good infrastructure enables firms to break into competitive world markets. It also helps to offset the disadvantages resulting from geographic location and small domestic markets. The significance of good transport infrastructure cannot be overemphasised in the case of landlocked countries. For example, high transport costs add the equivalent of an 80% tax on clothing exports in Uganda.[48] Investment in infrastructure also offers enormous potential for creating additional employment.[49]

37. Despite these evident benefits, the share of resources allocated to infrastructure fell in many poor countries during the 1990s. In Africa, infrastructure spending fell from more than 4% of GDP around 1980 to less than 2% around 2000.[50] The lack of capacity in developing countries becomes clear when compared with developed countries. Australia and Ethiopia have similar degrees of climatic variability, but whereas Australia has 5,000 cubic metres of water storage per person, Ethiopia has just 45 cubic metres. Hydropower provides another example: the United States and Nepal have roughly equivalent economically exploitable hydropower potential, but whereas installed hydropower capacity in the United States is about 70,000 MW, in Nepal it is less than 600MW.[51]

38. The lack of investment in developing countries has led to a substantial backlog, which won't be easy to overcome. While the private sector will have to play a key role in the provision of infrastructure, there is now renewed recognition of the importance of public investment.[52] Infrastructure requirements vary from region to region, reflecting different investment rates in the past and varied urban and industrial development patterns. In Africa, where the deficit is regarded as being the greatest, the list of requirements is long, including rural feeder roads, rail, irrigation, energy, ports, slum upgrading, water and sanitation, and information and communications technology (ICT).

39. Estimates of needs over and above current expenditures vary, but there is no doubt that they are very large. While it is difficult to quantify such investment needs, recent estimates indicate that the costs of maintaining existing infrastructure and filling gaps in terms of access and quality will amount to approximately $550-650 billion per year, or 6.5-7.7% of the GDP of developing countries.[53] The Commission for Africa estimated that sub-Saharan Africa needs to spend around 5% of its GDP on infrastructure between 2005 and 2015, and a further 4% on operations and maintenance.[54] This will mean additional annual expenditure in the order of $10 billion by 2010 and up to $20 billion by 2015, equivalent to a doubling

of current expenditure on infrastructure.[55] The World Bank's Africa Action Plan estimates that of the additional $25 billion of annual aid to Africa by 2010, $6-9 billion should be allocated to infrastructure.[56]

Better governance and institutions permit the two-way causality to work better.

40. Unnecessary bureaucracy and corruption can stifle business activity by creating uncertainty, introducing unwelcome delays, increasing operating costs and limiting competition. Surveys of firms show that these costs can be substantial, amounting to over 25% of sales – or more than three times what is typically paid in taxes.[57] Registering a new business, for example, can take two days in Australia, but more than 200 days in Haiti.[58] The effect of red tape and corruption is to reduce investment. Although a poor regulatory environment affects all firms, it is the small and medium-sized businesses that are least able to afford the additional costs.

41. The significance of governance and institutions goes beyond issues of regulation, taxation and licensing. They affect people's interactions in many different ways. The governance and institutional framework shapes incentives of businesses and individuals and determines the effectiveness with which people participate in markets and interact with government. There is also increasing evidence – summarised in the World Development Report 2004 – that social and human development outcomes are better where there are strong relations of accountability between service providers, government agencies and clients (in other words, there will be better access to public services and healthier and better-educated people).[59] Finally, productivity differences between firms tend to be much smaller in countries that are able to maintain competitive markets. For example, while productivity differentials between firms in the electronic industry are two-fold in Korea, they can be as high as five times in India.[60]

42. Relations between firms and governments shape the business environment and determine, for example:

- the degree of competition and the ease with which firms can enter and exit markets;
- the application of legal arrangements, especially with regard to property, contracts and taxation; and
- the enforcement of rules for the public interest, especially in respect of fairness, health and safety.

43. While identifying the interactions between individuals, firms and governments may be relatively straightforward, changing them to strengthen governance and institutions is immensely complicated and a drawn-out process. But this should not detract from the importance of understanding these issues. Good governance and sound institutions are crucial if the two-way causal relationship between growth and human development is to work to maximum effect. Individuals' empowerment and

ability to participate in growth depend on it. Similarly, a conducive investment climate depends on a favourable regulatory and institutional environment.

Challenge 2 – empowering and investing in people

44. The capability of poor people to participate productively in the economy depends on enhancing their health, education and security. Increasing capabilities, therefore, requires empowering and investing in people. Tools such as 'pro-poor budgeting' (when government and civil society jointly analyse who benefits from public expenditure) can have a positive effect on investment in the human capital of poor people. A good example comes from Uganda, where the publication of budget allocations to district schools led to greater demands from parents for information on the expenditure of schools attended by their children.

45. Interventions to address social exclusion also enhance the capacity of the poor to participate in growth. In many countries, human development and poverty indicators remain particularly severe for socially excluded groups while non-excluded groups are lifted out of poverty by general economic progress. In Nepal, average life expectancy for the Dalit population is almost 20 years less than the national average. In Brazil, the black population accounts for over 70% of the poorest and only 10% of the richest households.[61]

46. Addressing gender discrimination and promoting the empowerment of women may be particularly effective at promoting growth with human development. Gender inequalities in education and employment reduce economic growth. They limit human capital in society and the pool of talent from which employers can draw. Many East Asian countries have been able to be competitive on world markets through the use of female-intensive export-oriented manufacturing industries. High levels of female education and few barriers to their employment in such sectors made this possible. Gender inequality in access to productive assets in agriculture is inefficient since it reduces the productivity of female workers. Evidence from Bangladesh supports the role that credit directed to women can play in reducing poverty by strengthening their productive roles. Policies that promote greater female political participation (for example, reservation of seats for women in local government in India) tend to correlate with higher levels of investment in timesaving infrastructure and human capital.[62]

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Social protection contributes to growth and human development

46. Effective public policy on social protection, through both social insurance and social assistance measures, can stimulate growth. It does so by encouraging poor households in possession of productive assets to engage in riskier activities than they would otherwise.[63] With a minimum income to fall back on, poor people are more likely to invest and take on higher levels of risks that offer the prospect of higher returns. In the longer term, social transfers can promote growth by

encouraging poor people to invest in the health and education of their children, which enables them to become more productive members of society.[64]

47. During a crisis or shock (caused by natural disaster, economic downturn or severe illness) poor people may be forced into selling their productive assets, and nutrition may fall significantly, creating a 'poverty trap'. Policies and interventions which support the poor in dealing with risk and cope with shocks remove a constraint on broad-based growth by reducing the need for the poor to deplete their human, physical and social capital in times of crisis.[65]

48. Social transfers (financed from tax revenues or increased aid flows) can have a major impact on human development outcomes. Social transfers in the form of regular and predictable grants to poor and vulnerable households can help to address gender imbalances and expand access to education. For example, the Cash for Education programme in Bangladesh has helped to achieve gender parity in primary education. Social transfers can also strengthen health outcomes by improving nutrition and enhancing the ability of poor people to gain access to health services and pay for medicines and other costs. In Namibia, for example, pensioners spend 13.8% of the cash they receive on health care.

49. Currently only small fractions of national budgets are dedicated to reach the poor through social transfers. However, evidence shows that even small allocations can have a positive impact.

C. INCREASING AID AND MAKING IT MORE EFFECTIVE

The need for, and impact of, higher aid flows

50. Earlier sections of this paper stressed the need to consider development as a process that entails promoting both growth and human development. An unduly strong emphasis on developing one sector while neglecting the wider imperatives of economic growth will be unsustainable and distorting. In low-income countries, economic growth is also necessary if a long-term dependence on aid resources is to be avoided. Aid is not a permanent solution. However, as we indicate below, for some low-income countries it is only by increasing the flow of external concessional resources that prospects for growth and human development can improve in the short-to-medium term.

51. In this section, we focus on the capacity of recipient countries to absorb increased aid flows. Based on a consideration of the evidence, we argue that absorptive capacity should not be seen as a reason for delaying the scaling up of aid. While absorptive capacity is unlimited in one sense – countries can potentially use funds to finance a large range of projects and programmes – in practice, productive absorption of large inflows could cause concerns in the short-to-medium term and requires attention to issues of timing and coordination.

52. Development agencies can take many actions to enhance absorptive capacity. This requires careful consideration of three issues:

- conditions in partner countries, especially quality of policies and institutions;
- the allocation of resources across countries; and
- the timing and quality of aid.

53. Improvements in these factors can increase the amount and rate of absorption. As we indicate below, the adoption of complementary policies, coupled with key investments in infrastructure, can also facilitate the absorption of aid increases. For example, policies to liberalise imports can limit the distortionary effects of additional currency inflows on the domestic economy.

54. There has been much recent interest in the likely effectiveness of scaling up, leading to the articulation of a variety of views.[66] The recent Commission for Africa report and the report by Sachs et al for the UN's World Summit, provide arguments and evidence in favour of scaling up and 'frontloading' aid rapidly.[67]

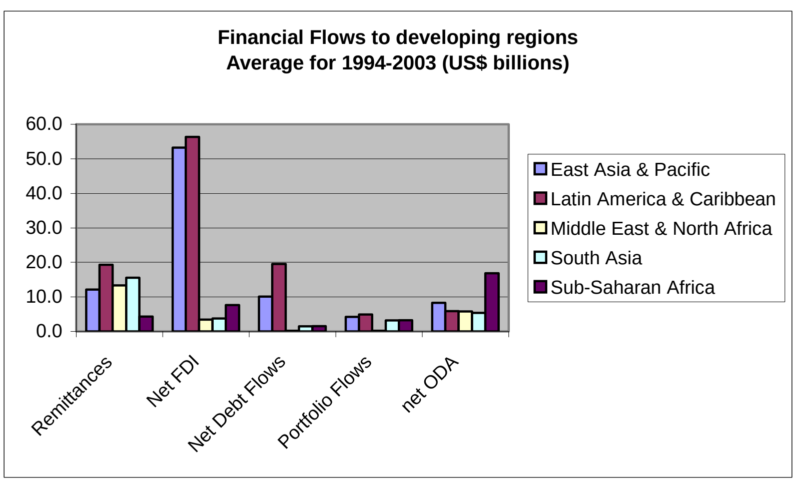
55. There has also been significant interest in whether aid leads to more growth. Most recently, two IMF studies found no positive association between aid flows and growth. This was attributed to the negative impact of an appreciation of the real exchange rate, the so-called 'Dutch Disease' effect (see paragraph 69 for a fuller discussion of this). Note, however, that the validity of this conclusion and the underlying econometric methodology are hotly debated. Other studies provide clear

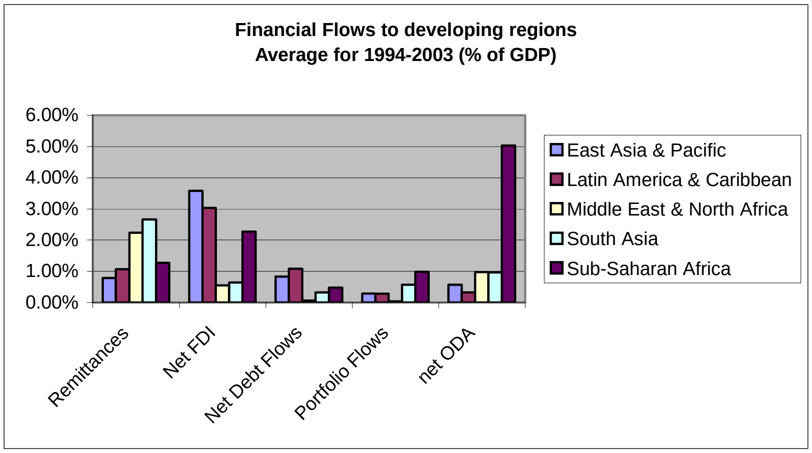
evidence that aid can increase growth, but that its impact depends significantly on the quality of the policy environment and the type of aid provided. In environments with good or improving policies, increasing aid by one percentage point (relative to GDP) increases the rate of economic growth by 0.6 percentage points per year. In average policy environments, such an increase in aid can generate 0.4% of extra economic growth. In bad policy environments, the impact is even weaker as the extra aid would only generate an additional 0.2% of growth.[68]

56. Recent analysis has also shown that different types of aid vary in terms of their effectiveness in increasing economic growth.[69] The growth-enhancing effects of some types of assistance ('short-impact aid') are much higher than of other forms of aid (such as long-term technical assistance). 'Short-impact aid' is aid where the effects on growth materialise over four or five years and includes balance of payments and budget support as well as aid investments in public utilities, roads, transport, finance, energy, agriculture and industry.

Private sources of domestic finance will lead growth in developing countries.

57. In large parts of the developing world, the finance required for growth and development is generated domestically and is provided as some combination of private and government finance. But many countries also rely heavily on external financing. As the figures below show, the financial inflows to developing countries are predominantly private, taking the form of foreign direct investment (FDI), remittances and equity. Measured in absolute amounts and as a share of GDP, official development assistance (ODA) is much smaller than private flows. Although there has been much emphasis on FDI inflows, they accounted for only approximately 13% of gross fixed capital formation in 2000.[70] For least-developed countries, the comparable amount was even lower at 6% (and as little as 1% for Africa, where it was concentrated in the extractive industries).[71]





Source: World Bank; World Development Indicators

58. While true for most of the developing world, the relative strength of private financing is less evident for sub-Saharan Africa. As the figures show, net ODA flows to Africa accounted for approximately 5% of average GDP over a ten-year period (1994-2003), but for less than 1% in other regions. This stark geographic contrast in the pattern of net ODA flows suggests that increasing aid to most parts of the world is unlikely to raise significant concerns about absorptive capacity, but needs careful planning and management for highly aided countries (in terms of shares of aid to GDP), especially in sub-Saharan Africa. The key challenge there is to ensure that aid is used productively. This requires that it is allocated to those places where: (a) other sources of finance are relatively unavailable for investment; (b) the policy and institutional environment is most conducive for growth and human development; and (c) accountability arrangements are sufficiently good to induce predictable flows in the future.

In sub-Saharan Africa, frontloaded aid is key for growth and development.

59. The recent Commission for Africa report considers the continent's external financing requirements and makes four propositions:

- Although private finance is crucial for growth and sustained poverty reduction, its full power in the African context is unlikely to be fulfilled if it is not led by increases in 'frontloaded' and sustained aid. While private finance will in time play its part, kick-starting the growth process requires taxes to remain at modest levels. As the formal economy expands and a robust domestic tax base is built, domestically raised revenues should gradually come to replace aid.
- Aid to Africa should be doubled in value, and increased by $25 billion a year over the next three to five years, commensurate with improvements in the quality of governance and institutions and the quality of aid.

- The capacity to absorb aid should be considered dynamically. As economic and institutional capacity expand, and the quality of governance and the investment climate continue to improve, the capacity to absorb more resources will increase.
- The essential issue regarding absorptive capacity is not whether constraints can be lifted, but how this can be done most productively. Clear strategies need to be worked out at the country level, and donors need to improve the quality of their aid. This can be done, and significant improvements have been observed in country-level policies and the way aid is provided (see below).

Issues concerning the productive absorption of additional aid in highly aided countries, especially in sub-Saharan Africa

60. Current knowledge indicates that aid works best if:

- it is targeted to suit circumstance, reduce poverty, meet specific needs and:
    i. promote peace and security and deliver essential services to communities emerging from conflict and/or years of neglect; and
    ii. support countries where governance and public accountability are demonstrably getting better;
- its quality is improved by:
    iii. reducing recipient countries' burden in managing aid relationships;
    iv. advancing alignment with national priorities and supporting the upgrading of existing systems; and
    v. improving predictability and flexibility to enable resource-constrained governments to advance key reforms and raise public expenditure; and
- it is provided to support change by:
    vi. enabling recipient governments to implement reforms that improve governance and accountability systems; and
    vii. encouraging investment and reducing business risks, promoting human development and increasing poverty-reducing public expenditure.

61. But even high-quality aid that meets these conditions will face constraints.[72] Despite glaring needs, there is a limit to the number of roads, dams, schools, and clinics that can be built and serviced effectively in any one year. For example, the required number of technical experts and managers to plan and budget extra finance may not be available to make productive use of the resources. More generally, increases in aid will yield diminishing returns as the limits of capacity constraints make their effects felt. The extent to which resources can be productively absorbed is circumscribed by macroeconomic, institutional, physical, human, social, cultural and political factors. As shown in the table below, their interaction could either constrain or reduce resource absorption.[73]

Constraints to absorption of additional external resources

	Macro	Institutional	Physical/human	Social/cultural/ political
Macro/national government	Fiscal and debt sustainability, competitiveness, Dutch disease.	Monetary and fiscal policy instruments. Exchange rate management.	Administrative, management, and planning skills, trained technicians, sector specialists.	Stable national political institutions, power-sharing mechanisms, social stability.
Allocative instruments and mechanisms	Intergovernmental fiscal relations.	Public expenditure management. Administrative capacity. Legal framework.	Sector management skills. Connectivity and communications networks.	Power sharing mechanisms, and institutions.
Service delivery/ local government		Local government institutions, private sector capacity.	Road accessibility, water control, geography. Local government skills and capacity.	Cultural norms, ethnic, caste, class, and household demand. Local power structures.

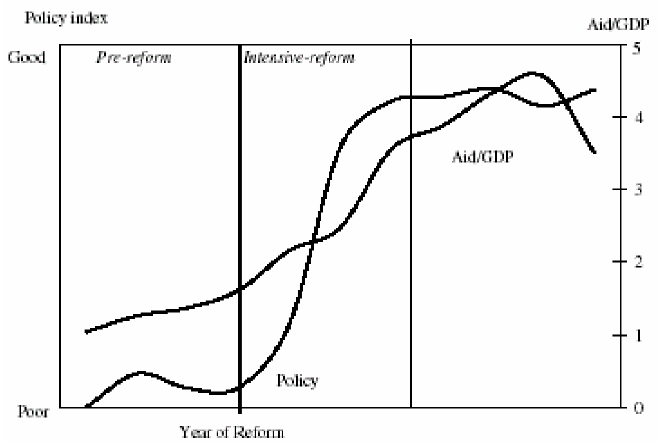
Source: Reproduced from World Bank, 2004:25

The quality of policies and institutions affect aid absorption.

62. Country conditions affect the prospects of using aid well. As discussed above, absorption of larger quantities of aid is more likely where policy environments are better and/or improving. The figure below maps the link between the amount of aid provided in three countries that successfully implemented reforms: Vietnam, Ghana and Uganda.[74] It shows that when country conditions are weaker, donors tend to provide fewer resources. Once reforms get under way, external assistance rises and serves to demonstrate to citizens the benefits of implementing reforms.

63. In many African countries, sharply scaled-up programmatic assistance often followed periods in which relatively little aid had been provided in the form of technical assistance and policy advice. A rapid rise in assistance in the form of sector and general programme aid and budget support only became possible once governments committed themselves to implementing reform programmes. In countries where governance and public accountability are weak, where there might be differences in policy perspectives, and where conditions are less propitious for receiving large amounts of programmatic aid, donors can nonetheless increase aid and provide it in ways that promote sustainable development (see below).

Relationship between policy and institutional environment and aid



Source: Collier and Dollar, 2004

How donors supply aid affects aid absorption and effectiveness.

64. The terms and conditions by which donors provide aid makes a big difference to how well aid is absorbed and used. As indicated above, better-quality aid is: (a) aligned to country policies and strategies for reducing poverty; (b) making use of, and supports, national systems; (c) coordinated and harmonised with other donors; (d) provided predictably over the longer term, and (e) not disruptive of annual budgeting practices.

65. Relative to other regions, sub-Saharan Africa receives much lower-quality aid and has done so for almost 30 years. If the quality of aid to Africa were to improve to levels common in other developing regions (a step improvement of 24%), per head GDP growth in sub-Saharan Africa would rise by about 1.8% a year. Enhanced absorption of aid would be possible if better-quality aid reduced the burden of transaction costs on governments, lowered significantly levels of public debt, provided flexible on-budget programme resources and substituted for technical assistance.[75]

66. Donors also need to deliver aid more predictably, allowing recipients to plan and manage financial flows much better. Given that external concessionary resources account for a large part of the budgetary income of many African countries, it will not be possible for governments to scale up social sector expenditure without regular and assured disbursements from donors.

67. Good practice guidelines on aid effectiveness produced by the OECD therefore recommend donors should: (a) reduce the burden of transactions they place on already stretched governments; (b) channel assistance in ways that don't

undermine public decision-making; (c) strengthen local systems, and; (d) conduct business so that government accountability to citizens is promoted.

68. Recent estimates show the tying of aid raises average costs to recipients by 15-30%, and more than 40% in the case of food aid. The OECD estimates that tied aid reduced the actual value of bilateral ODA to Africa by $ 0.7-1.3 billion in 2002. This is a conservative approximation, as the indirect costs of aid tying are not considered, for instance those arising from higher transactions costs through parallel procurement, monitoring and evaluation procedures stipulated by donors.

Better management of aid inflows and improved relationships between donors and recipients are crucial.

69. While higher aid flows would undoubtedly bring many benefits to aid-recipient countries, the impact could be undermined if authorities do not manage the impact of the inflows very well. A common problem arising from higher aid inflows is the appreciation of the real exchange rate. Recent evidence indicates that the economic effects of an aid-induced appreciation in the real exchange rate can be managed well. Additional aid will require complementary trade and exchange rate management policies. To ensure that aid does not cause macroeconomic problems, governments should invest it to expand productive capacity. Monetary authorities should intervene to help stabilise the volatility stemming from short-term exchange rate and interest rate fluctuations.[76] The more aid is used for purchasing imports, and/or for boosting foreign reserves (as and when necessary), the smaller will be its impact in appreciating the real exchange rate.[77] As investments in better infrastructure increase, it should be possible for firms' production and distribution costs to be lowered, which will improve export competitiveness and facilitate further economic growth.

70. To increase absorptive capacity, governments should use aid to improve the efficiency of the public sector, ensuring that appropriate investments are made towards training mangers, building technical expertise, and expanding the quantity and quality of infrastructure. Investing in the people today (and intensifying efforts to combat the incidence of HIV and AIDS and the impact of tropical diseases) will expand future capacity to accelerate development. Developing countries will have more skilled people to design and build the necessary infrastructure, to deliver services, and to provide the managerial know-how for planning, organising, and implementing activities.

The challenge of scaling up aid in fragile states.

71. Donors are paying increasing attention to the challenges of delivering aid in fragile states in recognition of the fact that without greater attention to such countries, poverty reduction and collective security goals will not be achieved OECD/DAC Ministers concluded that the risk of inaction was far greater than donors taking action when they met in London recently (14 – 15 January 2005). At this

meeting, Draft Principles of Good International Engagement were adopted. These include:

a. ensuring transparent information on aid flows to countries regarded as having fragile states and or governments;

b. making aid more effective at reducing conflict, improving the understanding and analysis of risk factors, and being willing to provide better responses to risk, for example by addressing issues of inequality and human security;

c. sustaining a commitment to reducing poverty in difficult environments and developing more innovative ways of being effective;

d. engaging in countries over the longer term, and providing less volatile and more predictable funding, even when threatened by temporary setbacks;

e. increasing funding by about 40%, which should be possible without damaging the norms of efficient aid allocation;[78] and

f. investing in those interventions that can help countries with weaker and less stable institutions to experience rapid turnaround. The benefits of these interventions can be as high $80 billion.[79]

Better absorption will require attention to the workings of labour markets.

72. An important concern about absorptive capacity relates to the effect of extra aid on labour markets, particularly if the emphasis is on improvements in human development outcomes. Education and health services are labour-intensive activities, relying on skilled staff that are often in short supply. Low pay, low motivation and poor working conditions are key problems that lead to absenteeism and migration to OECD countries.[80]

73. The impact of increased aid flows for health and education can be constrained by thin labour markets in these sectors. While higher wages can attract more people into those sectors in the medium and long term, they can have adverse short-term effects as teachers and health workers may be taken away from existing providers. These issues are reviewed in detail in the accompanying papers on health and education.

D. PLAN OF ACTION

74. Economic growth is crucial for making sustained progress towards the MDGs. This paper outlined the causal links between growth and human development. An excessive emphasis on improving one or two sectoral outcomes while neglecting broader development issues is unlikely to be sustainable. Increased aid is required *both* for stimulating growth and for raising levels of public expenditure on health and education. While private resources drive development efforts in many parts of the developing world, sustained flows of predictable aid are required to accelerate progress in low-income countries, particularly in Africa.

75. Given the linkages between growth and human development, what should be done to ensure that additional resources are directed to productive uses? Below, we suggest five areas for action:

1. Economic growth and poverty reduction are closely linked. Higher rates of economic growth will improve health and education outcomes and vice versa. This means that **development strategies to improve health and education outcomes should also be concerned with the role of economic growth** and the conditions necessary for enhancing economic growth. The current poverty reduction strategy (PRS) approach provides a good foundation for doing so. This implies that donors need to pay more attention to issues of policy coherence that goes beyond achieving improved sector outcomes. For many partner countries, accelerating growth and development calls for significant resource increases. While aid can provide some of these resources, clear strategies are needed for raising domestic revenues over the medium-to-long term.

2. Higher rates of economic growth require action to overcome the main country-level constraints and to strengthen the drivers of growth. Sustainable economic growth depends on a dynamic private sector. This requires a **good investment climate**, which does not distort incentives and avoids onerous and unnecessary bureaucracy. The World Bank's Africa Action Plan also proposes creating an export push, to support regional integration and to build the skills necessary for economic growth, particularly through expanding post-primary education.[81] Other priorities include: support for trade and regional integration, strengthening of financial sectors (including through microfinance) and raising agricultural productivity (including through improved science and technology).

3. Good infrastructure is important for both growth and poverty reduction. It plays a key role in facilitating the two-way causality between growth and human development. **Greater investment in infrastructure** is critical.

    i. Many countries are not dedicating sufficient resources to infrastructure investments (see paragraph 39 for estimates of the required spending).

The private sector can make an important contribution; models that combine private and public resources can help to meet essential needs. But in many low-income countries, donors can play an important role in filling the investment gaps. The World Bank's Africa Action Plan estimates that of the additional $25 billion of annual aid to Africa by 2010, $6-9 billion should be allocated to infrastructure.[82]

ii. Improved infrastructure also requires integrated planning across the various components and sectors at the country level. This is essential to ensure that limited resources are used to best effect. It is also important to balance investments by paying attention to the complementarities between interventions, say in electricity and water. A new regional mechanism is the Africa Infrastructure Consortium, which brings together key African institutions and donors. It will focus on reducing constraints to infrastructure development and ensure that funding is matched with prioritised infrastructure projects.

4. We also need a better understanding of how we can **support the participation of poor people in economic growth**. This calls for policies to empower poor people, and women in particular, in ways that go beyond improving access to health and education services. For example, increased social protection is a crucial element of a growth and human development strategy even in very low-income countries, and not an extravagance that only rich countries can afford.

5. There is also a need to **facilitate absorptive capacity in recipient countries**. This includes channelling aid towards expanding productive capacity and managing resource inflows well. Trade policies should facilitate imports and reduce export disincentives to mitigate the appreciating impact of increased aid flows on real exchange rates. Better monetary management by central banks should seek to manage exchange rate volatility, avoid high inflation, and not crowd out private investment. Increased investments in infrastructure, human development and professional skills training should help to ensure that aid is used productively and expands existing capacities.

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but also important operational and maintenance costs. Past neglect of the recurrent cost requirements of infrastructure has left potentially valuable projects in a useless state of disrepair.

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[76] See for example Adam, C and D Bevan (2004), *"Aid and the Supply Side: Public Investment, Export Performance and Dutch Disease in Low Income Countries"*, Department of Economics, Discussion Paper Series No.201, University of Oxford, Oxford. Also Nkusu, M (2004), *"Financing Uganda's Poverty Reduction Strategy: Is Aid Causing more Pain than Gain*?", IMF Working Paper 04/170, IMF, Washington DC.

[77] For if fewer units of foreign currency are sold and converted into domestic currency, it will dampen the demand created for goods and services produced locally. In turn, given tight domestic supplies in the short run, this will put less pressure on prices to rise.

[78] OECD/DAC (2005) *CHAIR'S SUMMARY: SENIOR LEVEL FORUM ON DEVELOPMENT EFFECTIVENESS IN FRAGILE STATES,* 13-14 January, London

[79] Chauvet, L and P Collier (2005) *Development effectiveness in Fragile States: Spillovers and Turnarounds*. Background paper prepared for the OECD/DAC Senior Level Forum on Development Effectiveness in Fragile States, 13-14 January, London

[80] Martínez, J and Martineau, T (1998) *Re-thinking human resources: an agenda for the millennium,* Health Policy and Planning 13(4), pp.345-358.; Bach, 2000

[81] World Bank (2005), *'Strengthening the development partnership for achieving the MDGs: An Africa Action Plan'*, Washington DC

[82] World Bank (2005), *'Strengthening the development partnership for achieving the MDGs: An Africa Action Plan'*, Washington DC