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Financing Development 2008

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FORE WORD

Foreword

Whose Ownership? is the second volume in a series of OECD Development Centre publications on *Financing Development*. It follows the first volume, published in 2007, entitled *Aid and Beyond*. The series has been conceived to accompany the OECD Global Forum on Development, an informal series of events in which policy makers, researchers and representatives of civil society and the private sector are discussing how to make development finance more effective. More information on the Global Forum on Development is available at www.oecd.org/development/globalforum.

In its second year of activities, culminating in an Annual Plenary on 20 May 2008, discussions in the Forum have been focused on how the principle of ownership can be put into practice. *Whose Ownership?* was officially launched at the Plenary. The publication is also devised as a basis for discussions on ownership at, and following, the Third High-Level Forum on Aid Effectiveness, to be held in Accra on 2-4 September 2008.

OECD Development Centre colleagues provided invaluable comments on the various chapters, particularly Dilan Ölcer and Henri-Bernard Solignac Lecomte. Gratitude also goes to colleagues in the OECD Development Co-operation Directorate, particularly its Director Richard Carey and Counsellor Brian Hammond, who continue to be partners in the organisation of the Global Forum on Development. Thanks are also due to the Swiss Agency for Development and Co-operation, the French Ministry of Foreign Affairs and the Dutch Ministry of Foreign Affairs for supporting the Development Centre's activities on development finance, including the Global Forum.

Chapter 1 has benefited greatly from the co-ordination of case studies by Bill Morton of the North South Institute in Canada and Antonio Tujan Jr. of Ibon Foundation in the Philippines. The authors of the chapter would also like to thank Matthew Martin (Development Finance International), James Deane (BBC World Service Trust), Simon Burall and Alan Hudson (both of the Overseas Development Institute, UK) for their advice in the organisation of an Informal Experts' Workshop on *Ownership in Practice*, held in Sèvres, France, on 27-28 September 2007. Earlier versions of Chapter 2 included substantial contributions from Louka T. Katseli, former Director of the OECD Development Centre, Daniel Cohen, Special Advisor to the Development Centre, and George Mavrotas, Chief Economist of the Global Development Network. Chapter 3 benefited from the valuable research assistance from Aline Gatignon and Karin Weber, and Development Centre colleagues Ki Fukasaku, Charles Oman and Ken Ruffing provided stimulating comments on Chapter 4.

Finally, we would like to thank Robert Cornell, former Deputy Secretary General of the OECD, for editing the volume and the Development Centre's Publications and Media Unit, headed by Colm Foy, for turning the manuscript into the publication.

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Preface

Over the past decade, the principle of "ownership" has found widespread support in the international debate on development co-operation. The 2002 Monterrey Consensus and 2005 Paris Declaration on Aid Effectiveness agree: countries must *own* their development policies if their financial inflows are to reduce poverty or stimulate growth.

Unfortunately, if discussions in the OECD Global Forum on Development are anything to go by, both donors and developing-country governments are having a hard time putting ownership into practice. Is this because poverty reduction strategies are too strongly driven by aid donors? Is it because governments do not give sufficient space for parliaments or civil society to contribute to better policy? Or is it because the increasing complexity of development finance simply overburdens developing-country administrations seeking to take ownership of their development policies?

These questions are captured aptly by the title of this year's volume of *Financing Development 2008: Whose Ownership?* The publication takes a variety of approaches to the ownership question, inspired by discussions and case studies at our Ownership in Practice Workshop in September 2007. It casts an experts' eye on the many efforts being taken to render the traditional aid system more effective, but they also peer beyond the system to examine the ever-growing importance of new actors in development finance: non-governmental organisations and private banks.

Policy makers now have a number of opportunities to deepen their understanding of ownership, notably at the 3rd High Level Forum on Aid Effectiveness (HLF-3, Accra, 2-4 September 2008) and the UN Follow-up Conference on Financing for Development (Doha, 29 November to 2 December 2008).

We will see how well they have done in one year's time, when our third volume of *Financing Development* focuses on an array of financing instruments for development. It will examine how policy makers can help catalyse private investment, support think tanks in generating home-grown knowledge for development and rethink the role of conditionality in aid relationships.

Javier Santiso

Director, OECD Development Centre
May 2008

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EXECUTIVE SUMMARY

FINANCING DEVELOPMENT: WHOSE OWNERSHIP?

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The 2002 Monterrey Consensus and 2005 Paris Declaration on Aid Effectiveness agree that countries must *own* their development policies if their financial inflows are to reduce poverty or stimulate growth. Unfortunately, donors and developing-country governments alike are struggling to put the principle into practice without much success. In 2007/8, the OECD Global Forum on Development, a series of events exploring how to finance development more effectively, has made this failure its major concern.

Financing Development 2008 asks: "Whose ownership?". It is therefore a companion to the debates and discussions taking place in the Global Forum.

The authors take a variety of approaches to the ownership question. Inspired by the discussions and case studies presented at a workshop on "Ownership in Practice", held in Paris in September 2007, Chapter One asks what developing-country ownership really means. From an effectiveness perspective, who should own development policies and who actually owns them? Related to these questions, Chapter Two looks critically at the international development finance system and finds that its complexity interferes with developing-country ownership. Looking beyond governments, how might aid effectiveness principles apply to the activities of other actors? Chapter Three examines the role of non-governmental organisations in development financing by asking whether NGOs might need their own version of the Paris Declaration. The relationship between ownership, investment and the private sector is the subject of Chapter 4.

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CHAPTER ONE

Broader Ownership for Development

Following an account of how ownership emerged in the intergovernmental discourse, the authors of Chapter One take a close look at the definition of the principle in the 2005 Paris Declaration on Aid Effectiveness. They argue that the Declaration, which refers to ownership as developing countries "(exercising) effective leadership over their development policies and strategies…", is the most poorly defined of the Declaration's principles.

In particular, the authors draw attention to the controversial way in which progress in putting ownership into practice is currently being measured. Whether or not a country owns its development policies is determined mainly by the World Bank and is linked directly to a country's adoption of a Poverty Reduction Strategy Paper, a document requiring the Bank's approval. Given the active role donors still appear to play in designing these Papers, their dominance in the production of development knowledge and reluctance to explore alternatives to policy conditionality, the term "ownership" has thus become for its critics a euphemism for developing countries' adoption of externally conceived policies.

The authors also point to the fact that the interpretation of ownership by the Paris Declaration centres on government, despite the recognition that actors outside government have crucial roles to play in implementing development programmes. While the participation of these actors in the design, implementation and monitoring of policies is improving, a number of actors, particularly parliaments and the media, remain sidelined. The Paris Declaration does contain commitments related to participation, but moving forward by setting measurable targets for participation may prove difficult. First, governments are currently not open to revising the Declaration. Second, externally imposed democratic processes may be regarded as an illegitimate interference by donors in national affairs.

To conclude their Chapter, the authors outline four recommendations for policy makers seeking to put ownership into practice. They ought to:

- Attack the barriers to local knowledge production, so that developing countries can explore and choose among alternative policy frameworks using their domestic resources;
- Commit to legal frameworks that promote wide societal participation in policy design, debate, implementation and monitoring;
- Establish more diverse participatory-ownership monitoring mechanisms; and
- Review conditionality and adapt human-resource policies.

The Accra High-Level Forum (HLF-3) in September 2008 will be the first such meeting hosted by a developing country, and one can hope that it will take up ownership as a central theme. Even if the Declaration itself remains untouched, the principal output planned for the Forum, the Accra Action Agenda (AAA) could provide a vehicle for broadening and deepening the interpretation of ownership.

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CHAPTER TWO

Ownership in the Multilateral Development Finance Non-System

The second chapter highlights the disorder and inconsistencies in the international development finance architecture and emphasises various symptoms and challenges associated with its lack of coherence. It also suggests some possible avenues for reform in order for the aid system to raise delivery efficiency.

International development finance has evolved into a complex system with emerging actors, both private and public, raising sources by using new instruments and channels. Rather than the scaling up of programmable aid resources, there is a scaling up of the number of aid providers. This multitude of actors and financing channels, combined with the broadening goals of traditional development assistance (which now also include global and regional public goods) make up an international development finance architecture which can be characterised as spontaneous disorder, or a non-system.

As long as the multilateral system stays at current levels of incoherence, its capacity to deliver development is dubious. Not only may there be vested interests within the donor community, but the current system also enables mission creep, duplication of country allocation, fragmentation, loss of leverage and a weakening of traditional multilateral agencies. Through the channelling of Official Development Assistance (ODA) resources multilateral agencies and its experts may hamper, rather than strengthen, a true democratic recipient-country ownership. The current international development finance architecture is obviously too complex and inefficient to be owned as it implies an excessive burden on recipient countries.

In order to increase the efficiency of development finance in delivering results, reforms are needed. Although a multitude of multilateral delivery channels may be useful for diversified policy advice and aid stability thanks to diverse sources, a harmonised approach will raise the standard of aid delivery and lower the absorption cost to recipients. As part of required streamlining, institutional specialisations and coherence-performance measures of the multilateral system are suggested.

Furthermore, a country-based delegated co-operation arrangement is proposed in order to help strengthen recipient countries' capacity and leadership. Such an arrangement implies that a lead donor acts with authority on behalf of other donors and takes on responsibility for one element of a project cycle, a complete sector or even a country programme.

CHAPTER THREE

A Paris Declaration for NGOs?

A declaration similar to the Paris Declaration on Aid Effectiveness, which exists for official donors, is very much needed for NGOs as well.

The primary reason for such a declaration is the lack of co-ordination among donors and fears about redundancy in aid delivery that would be costly for the recipients. Further, the significant size of the international NGOs' budgets, which according to recent data have been underestimated in the past and grown dramatically during the last decade, calls for an understanding of best practices about how NGOs deliver their support to poor countries. Consequently, Northern NGOs can be considered as donors in their own right and therefore the principles of the Paris Declaration ought to apply to them equally.

The core principles of the Paris Declaration on Aid Effectiveness, namely better co-ordination and harmonisation among donors, better alignment of donors with the agendas of recipients, and more mutual accountability between donors and recipients, are not sufficiently put in practice among international NGOs. These deficiencies cause among others unequal distribution of international NGO activity around the world, place a disproportionate administrative burden on well-intentioned local organisations, and create greater access to funding of *mala fide* local organisations. Moreover, they lead to decreased ownership by local organisations.

Increased harmonisation and co-ordination would lead to efficiency gains through improved distribution of resources, reduced overhead costs for local organisations, and decreased leakage of aid.

A number of legal and financial obstacles are both causes and symptoms of the current substandard underdeveloped alignment and accountability practices of Northern NGOs. For Southern NGOs, legal disempowerments include restrictions on applying for funding in a donor country, the shortage of legally formalised feedback mechanisms within Northern NGOs, and the absence of formal feedback mechanisms external to organisations. This leads to financial imbalances between Northern and Southern NGOs, reinforced by disadvantageous contracts that Southern NGOs sign and the lack of a local fundraising pool of Southern NGOs. Changing the unequal power relations between Southern and Northern NGOs can contribute significantly to increased alignment and accountability.

The "Nordic plus" donors have already started their efforts to align their NGO aid to the principles of the Paris Declaration. For instance, their embassies in several countries are co-operating in developing decentralised co-financing systems and the reporting systems are also being streamlined. Other important steps towards more harmonisation, co-ordination, alignment and accountability are taken by organisations such as BRAC and ActionAid International, and other NGOs are starting to work with common codes of conduct and charters. These efforts need to be deepened, expanded and accelerated to increase the efficiency and effectiveness of NGO aid.

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CHAPTER FOUR

Private Banks in Emerging Democracies

Some empirical studies have analysed the political drivers of private international liquidity, but paradoxically very few have looked at the political economy of bank flows. Even less research exists on the role of politics in explaining cross-border banking movements towards emerging democracies. In order to find out whether private banks contribute to political development and reform ownership by lending to emerging democracies, the chapter links compiled indicators on democracy, policy uncertainty and political stability to international bank lending flows from data developed by the BIS. It specifically tries to answer two questions. Do bankers tend to prefer emerging democracies? Do they reward democratic transitions as well as policy and political stability?

The chapter finds that politics matter and that increases in democracy indicators have a positive impact on the entry of private foreign claims. Private banks reward emerging economies and tend to increase their lending to them. Annual growth in bank flows usually booms in the three years following a democratic transition, especially in Latin America. Yet a transition towards democracy not only favours foreign bank inflows but also implies that emerging borrowers have easier access to foreign private bank lending. Furthermore, foreign banks seem to be indifferent to increases in micro-democratic breakdowns emerging from democratic transition.

The common view is that bankers tend to avoid politically unstable countries. However, bankers tend to be neutral to democratic political instabilities, as has been the case in Latin America.

Banks also seem indifferent as to whether centre, left or right-wing governments are in power and whether they have an absolute majority or operate in coalition with other parties.

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CHAPTER ONE

Broader Ownership for Development

ABSTRACT

The first of the five key principles in the 2005 Paris Declaration on Aid Effectiveness is "ownership". This principle implies recipient-country control of aid-financed development strategies and policies. Yet implementing ownership has proved both difficult and controversial, caught between donors' need to ensure that public money is well spent and recipients' demands for policy autonomy. Issues of conditionality, knowledge generation, socially inclusive implementation and good monitoring dominate the debate. This chapter provides an ample menu of recommendations to resolve them.

Felix Zimmermann and Ida McDonnell

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Aid policy makers, experts and practitioners will anchor discussions in Accra in September on five principles agreed by governments in the 2005 Paris Declaration on Aid Effectiveness. The first but most poorly defined of these principles is developing-country ownership of development strategies and policies. This Chapter singles it out. Drawing on the relevant literature and on discussions and case studies of the OECD Global Forum on Development[1], it argues that the Declaration's interpretation of the principle remains donor-driven and centred on government. Accordingly, policy makers seeking to put ownership into practice ought to adopt a more comprehensive understanding of it. Specifically, they should:

- Attack the barriers to local knowledge production, so that developing countries can explore and choose among alternative policy frameworks using their domestic resources;
- Commit to legal frameworks that promote wide societal participation in policy design, debate, implementation and monitoring;
- Establish more diverse monitoring mechanisms for participatory ownership; and
- Review conditionality and adapt human-resource policies.

OWNERSHIP IN THE PARIS DECLARATION: HOW DOES IT HOLD UP?

The Emergence of Ownership in the Intergovernmental Discourse

Ownership means many things to many people, but under any meaning it is widely regarded as a precondition for effective aid. The principle emerged in the mid-1990s, when the OECD Development Assistance Committee (DAC) released its report on *Shaping the 21st Century*. Setting out a number of international goals, later to become the Millennium Development Goals, the report stated: "These goals must be pursued country by country through individual approaches that reflect local conditions and locally owned development strategies" (OECD, 1996, p. 6). In line with this concept, the World Bank adopted the Comprehensive Development Framework (CDF) in 1999, with country ownership as one of its four principles. Bank President James Wolfensohn's proposal for the CDF, subsequently endorsed by the Development Committee, found it "clear to all of us that ownership is essential. Countries must be in the driver's seat and set the course. They must determine goals and the phasing, timing and sequencing of programs" (Wolfensohn, 1999).

To put the CDF into practice, the World Bank and International Monetary Fund (IMF) conceived a new instrument to guide their country programmes, the Poverty Reduction Strategy Paper (PRSP). The bulk of World Bank and IMF funding became contingent on countries agreeing to design and implement PRSPs. This new approach marked a break with past practice by assigning leading roles in the design and implementation of strategies to recipient-country policy

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makers. The PRSPs, however, remained subject to approval by the Bank and the Fund in their Joint Staff Advisory Notes.

As the PRSP approach has matured, the Bank's interpretation of the ownership principle has become more refined. In 2005, it developed a sophisticated checklist of 17 good practices in encouraging country ownership (Entwistle and Cavassini, 2005). They fall under six headings, the first of which requires leadership within and participation across the executive in the design of PRSPs. Others concern the important role of institutions such as parliaments and the centrality of government-stakeholder dialogue.

The ownership principle has also been widely accepted as a guiding principle for effective development finance in the UN community. In 2002, the signatories of the Monterrey Consensus on Financing for Development agreed that "Effective partnerships among donors and recipients are based on the recognition of national leadership and ownership of development plans" (United Nations, 2002, p. 14).

By the time international policy makers assembled in Paris in 2005 to agree on making aid work better, it had become clear that ownership was recognised as one of the five most important principles of aid effectiveness. The Paris Declaration on Aid Effectiveness affirms it as the first such principle and defines it as developing countries exercising "effective leadership over their development policies, and strategies". In paragraph 14, developing-country signatories commit to translate these strategies into prioritised, results-oriented operational programmes, expressed in medium-term expenditure frameworks and annual budgets. In the following paragraph, donors commit to respect partner-country leadership and help strengthen their capacity to exercise it.

To accelerate progress in implementing their commitments, signatories to the Paris Declaration agreed on 12 measurable targets and indicators, one of which relates directly to ownership. It calls for at least 75 per cent of aid-recipient countries to have "operational development strategies by 2010". The first monitoring survey of the Paris Declaration (OECD, 2007) makes clear that progress in achieving this target is determined largely by the World Bank as part of its progress report on the implementation of the CDF and its Aid Effectiveness Review. According to the Bank, five of the 29 countries surveyed had development strategies "largely developed towards achieving good practice", while there were no cases of strategies achieving "substantially good practice".

The Bank's PRSP approach and the Paris Declaration are thus inextricably linked, with the Declaration relying almost entirely on the World Bank for interpretation and definition of the principle. Given the Bank's decade of work to define and promote the principle, the Paris Declaration and its commitments take a significant step forward in putting ownership into practice. Yet the link between the Declaration and the PRSP approach lies at the heart of much of the criticism of the treatment of ownership by the Declaration.

The Paris Declaration's Interpretation of Ownership Remains Donor-Driven

Some experts (e.g. Johnson, 2005) regard ownership as the right of developing-country representatives to be heard in the design of development programmes and as their freedom to choose programmes without coercion. Others go further, arguing that true ownership implies a country's leadership in defining development priorities and suggesting that policies ought to be "home-grown" rather than externally conceived (Girvan, 2007*b*). Despite these differences, there is common ground that recipient-country governments need to play a more pro-active role in managing donors and determining how their aid is allocated (Rocha Menocal and Rogerson, 2005).

Judging by discussions and case studies presented at the OECD Global Forum on Development, several governments have taken a strong lead in designing their development policies and managing their donors. In Viet Nam (Box 1.1.), the Socio-Economic Development Plan 2006-2010, the Official Development Assistance Strategy Framework and Decree 131 on aid provide a strong framework for aid management (Thi Than Anh, 2007). In Indonesia, the People's General Assembly decided in 2002 that foreign aid should be only complementary to other funding sources and that IMF agreements would not be extended beyond 2003 (Marut, 2007).

Box 1.1. Viet Nam's Efforts in Taking Ownership

To optimise benefits from the aid-effectiveness agenda, Viet Nam has invested considerable efforts in different initiatives that demonstrate increasing exercise of ownership. First, senior government officers have played a recognised role in influencing the international agenda through their active participation in regional and global forums on aid effectiveness. Second, to hold in-country stakeholders to account, Viet Nam has produced one of the world's earliest local versions of the Paris Declaration, the Hanoi Core Statement (HCS). Third, it has set up processes and structures to drive forward the translation of the Paris principles into practice.

Viet Nam's active engagement in the global dialogues on aid effectiveness has enabled the country to capitalise on the most advanced approaches to improving aid quality. Through such participation, the government's senior officials have gathered the world's best practices as well as solidified their cross-learning network with participants from other partner nations. The global forums offer the country opportunities to stay updated and engaged with the most innovative thinking on reforming the global aid business. In return, by sharing practical developments as well as challenges at the country level, Viet Nam has enriched the discussions with its own ideas and tested solutions to common aid problems. The country's co-chairmanships of the OECD-DAC Joint Venture on Monitoring the Paris Declaration and the OECD-DAC Reference Group on the Paris Declaration justify the depth of its involvement in the global talks on aid effectiveness.

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The adaptation of the universal principles to the local context, and not simply taking the global formulas as given, has helped the country maintain its true ownership of the agenda and develop the framework for reinforcing local stakeholders' accountability. The Hanoi Core Statement has provided a country-specific instrument for holding in-country donor organisations to deliver what they promise. For instance, HCS Commitment No.28 has been used to promote donor transparency and accountability to the government through a new practice of donors' regular self-reporting on their aid flows to the on-line, government-owned Development Assistance Database (DAD).

Source: Based on Thi Thanh Anh (2007)

At first glance, these positive experiences appear to prove that the adoption of the ownership principle by aid donors has borne fruit. A closer look, however, reveals that recipient countries' strengthened negotiating position may have other causes, related in particular to the emergence of new sources of development finance alongside traditional aid donors. In Viet Nam, ODA accounts for only 4-6 per cent of GDP and less than 11 per cent of the total government budget. Bolivia has deepened its relationship with emerging donors, particularly Venezuela (Barja, 2007). A number of African economies have attracted enormous levels of investment and aid from China (Reisen *et al.*, 2006). Greater financial independence from traditional donors has given many developing countries the freedom to explore other policy solutions to their development problems rather than adopting policies encouraged by the donors under the Washington Consensus. In Latin America, for example, several countries have experimented with new development models (Santiso, 2006). Box 1.2. describes how Bolivia has done it.

Box 1.2. Bolivia Takes Charge of its External Finances

After several years of social unrest and political instability, the democratic victory in 2006 of Evo Morales and his MAS party created a new situation. This new government contributed to resolution of the structural fiscal problem, began the return to government-led development and benefited from both significant foreign debt reduction (under the multiple debt relief initiative (MDRI)) and a favourable terms-of-trade shock. Morales and the MAS came to power with a very strong agenda of regaining Bolivian sovereignty (therefore ownership) and of controlling Bolivia's development, a reaction against two decades of governments that had very close relationships with the international development architecture.

The Morales government broke new ground by producing a National Development Plan (NDP) without international consultations. In July 2006, it presented the NDP to the country and to the international community represented in Bolivia in the hope of gaining commitment to support it "without conditionality". The initial foreign reaction was supportive, but also suggested that the plan had to be improved and become more specific and operational. Throughout 2006, the government continued presenting its NDP expecting support and alignment without opening it up for discussion and negotiation, "because that would mean opening the door to conditionality".

Over time, the government was able to develop agreements with multilateral agencies such as the World Bank and the Inter-American Development Bank (concessional loans) as well as the Andean Development Corporation (commercial loans). It won bilateral co-operation from Venezuela and Cuba (newcomers), the United States, European governments and China, plus initial agreements with Japan. All of these cases involved different degrees of alignment and less harmonisation. A recent large contract with Indian private investors is also something new.

Source: Based on Barja (2007)

These stories of countries taking ownership with real policy choices, thanks in part to a diversification of funding, highlight the central question for any assessment of the Paris Declaration's interpretation of ownership. To what extent does the Declaration encourage the generation of alternative policy frameworks and home-grown solutions? In answering this question the link between the Paris Declaration and the World Bank's PRSP approach becomes important and contentious.

PRSPs: Controversial Tools

In theory, country-designed PRSPs, the prime determinants of ownership according to the Declaration, embody a country's freely chosen development policy framework. Nevertheless, progress reports on their implementation suggest that in practice donors continue to play a leading role in the design of strategies (Eurodad, 2007). Civil-society organisations recently consulted by the World Bank claim that the PRSP process remains heavily Bank-driven in places like Rwanda, Benin and Zambia (World Bank, 2007). A common criticism argues that recipient countries continue to "choose" to privatise their social sectors despite evidence that this may not suit local circumstances (Berthélemy *et al.*, 2003).

The very nature of PRSPs as negotiated documents requiring World Bank approval suggests that they contradict the principle of country-owned agendas (Rocha Menocal and Rogerson, 2005). This explains why the term "ownership" has become for its critics a euphemism for developing countries' adoption of externally conceived policies. The policies might be country-owned, but remain donor-driven (Girvan, 2007*a*). According to Eurodad, a network of European NGOs, the definition of ownership needs revisiting to ensure that policies are country-selected rather than simply government support for Bank-selected options (Eurodad, 2007).

A redefinition would need initially to examine why recipient countries continue to lack true choices between alternative policy frameworks. There are two closely related reasons. First, alternative policy solutions are simply unavailable, given the dominant position of donors, particularly the Bretton Woods Institutions, in the global production of development knowledge. Second, donors remain reluctant to explore alternatives to policy conditionality, a direct barrier to local decision-making. The Paris Declaration does not go far enough in addressing either of them.

Donors remain the dominant producers of development knowledge

The Paris Declaration commitments on supporting country capacities, especially for public financial management, take a first step in addressing local capacity to take the lead in a development-finance system. Local administrators face enormous challenges in dealing with a complex set of external financing institutions (Drechsler and Zimmermann, 2007). Ironically, new aid modalities such as general budget support compound these challenges. The Paris Declaration supports them, but they see donors engaging heavily in policy, often in closed-door negotiations (Tomlinson, 2006; ActionAid/CARE, 2006).

The development of alternative policy solutions is more than an administrative problem. Many developing countries lack endogenous economic expertise to conduct their own analyses and develop policy alternatives (Martin, 2007). Governments have a hard time critically evaluating the analytic work of donors, even in countries that could afford to look elsewhere. Nigeria, which derives only 0.5 per cent of its income from official aid, has followed IMF policy prescriptions simply because alternative policy frameworks were not available to it (Olofin, 2007). The shortage of economic expertise is particularly acute among actors outside government, for example in local think tanks that could have the potential to produce alternative policy recommendations given their familiarity with the local economy and, ideally, their independence from both governments and donors (Box 1.3.). Many developing countries lack independent think tanks able to monitor the performance of government and provide actionable policy recommendations based on applied economic research (Santiso and Whitehead, 2006).

Box 1.3. Local Think Tanks: Home-Grown Solutions for Better Fiscal Policy

Fiscal policy lies at the heart of democracy and the relationship between the state and its citizens. Poor fiscal policy, particularly poor-quality public spending, undermines citizens' trust. This in turn makes them less willing to pay taxes, reducing government revenue — a vicious cycle that prevents governments from addressing poverty and inequality and undermines trust in the democratic system (OECD Development Centre, 2007).

Independent local institutions such as think tanks can play an important role in promoting transparency on fiscal policy by monitoring public figures and stimulating national debate on alternative policy options. More than other institutions of civil society, think tanks bring alternative ideas to the table and offer a balance between knowledge and practical orientation.

Unfortunately, foreign aid and development projects have often overlooked their potential. In many developing countries, think tanks are simply absent. In others, they lack two fundamental qualities for effective work: capacity for applied economic knowledge and independence. Their main constraint is funding. While many US think tanks enjoy large budgets and big permanent staffs, their developing-country counterparts' resources remain minimal. In their paper on the history of the Corporacion de Estudios para Latinoamerica (CIEPLAN), one of Latin America's most respected and influential research institutions, Meller and Walker (2007) identify financial questions as an "Achilles Heel". They point to a false perception among external actors that, given Chile's economic success, think tanks no longer need financial support. In fact, middle-income countries still lack private endogenous resources to fund think tanks, while public funding may undermine their independence. During the Pinochet dictatorship, CIEPLAN had protection against government interference through the financial and moral support of the Ford Foundation, the International Development Research Centre (IDRC), the Swedish Agency for Research Co-operation with Developing Countries and the United Nations Development Programme (Puryear, 1991). Now they struggle for survival.

Collaboration between foundations and official donors in the financing of think tanks working on fiscal policy could be worth pursuing. While donors have expertise on fiscal policy and political capital, foundations know innovative practices from the private sector and are less constrained by the need to deliver short-term results within political cycles. Together, they could invest in permanent endowments for think tanks that have financial needs, proven records of research quality and political relevance. As US think tanks illustrate, endowments could provide long-term stability and sustained financial certainty for think tanks to carry out ambitious and complex research projects.

The William and Flora Hewlett Foundation and the IDRC have already begun work in this area. In late 2007, they announced an initiative that combines long-term general support grants for think tanks with the provision of technical assistance as well as access to expert networks. The project, set to run for at least ten years, is open to other funding agencies. Replicating such an initiative widely may well provide a boost to the generation of local knowledge for a truly country-owned development-finance system.

Note: Ángel Alonso Arroba provided the material for this box.

Donors remain reluctant to discuss the implications of policy conditionality

The omission of a stand on economic policy conditionality from the Paris Declaration's section on ownership is more striking than its lack of reference to development knowledge. Arguably, the recognition that economic policy conditions had not led to desired results throughout the 1980s and 1990s gave impetus to the acceptance of the ownership principle. The Paris Declaration does include one donor commitment related to conditionality, in the section on alignment with recipient-country priorities. In paragraph 16, donors agree that conditions ought to be drawn "wherever possible" from a partner's national development strategy — by which they mean PRSPs.

One could regard this commitment as an implicit admission by the Declaration's signatories that externally imposed conditions have not proved effective, raising the question why donors have not agreed to do away with policy conditions entirely or to set targets for their reduction. Their reluctance may lie in the belief that conditions can in certain circumstances help lock in urgent reforms that do not yet have broad local support (Koeberle, 2005). This view opens the way, however, for conditions to become scapegoats for governments seeking to avoid national debate about unpopular policy measures. Policy conditions directly undermine ownership not only by imposing "unpopular" policies on a country and stifling national debate about alternatives, but also by shifting governmental accountability towards donors rather than citizens (Reality of Aid, 2004; Molina, 2007).

In response to the apparent paradox between conditionality and ownership, some donors have begun experimenting with new forms of conditionality, particularly performance-based conditions. In theory, such conditions, which tie the disbursement of aid to the achievement of agreed results or outcomes, promote ownership by leaving the choice of policies with recipient countries. They also provide donors with a high degree of quality assurance for their aid disbursements. Yet performance-based approaches do carry risks. External shocks could put performance beyond the control of developing-country officials, and strict performance conditions could thus prove harsh and inflexible. Results-based conditions may also stifle innovation by discouraging policy makers from experimenting with unproven, more risky approaches, preferring to follow donor prescriptions for want of alternatives. To address these risks, performance-based conditions need flexibility in use.

The generation of alternative policy solutions — by encouraging the home-grown production of knowledge and addressing the inherent problems associated with conditionality — deserves attention.

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THE PARIS DECLARATION'S INTERPRETATION OF OWNERSHIP CENTRES ON GOVERNMENT

The principle of participation has emerged alongside ownership as a defining principle of aid effectiveness. At the heart of the call for greater participation is the view that aid will be most effective with a broader constituency consulted and engaged in the definition of national development priorities. The OECD DAC's *Shaping the 21st Century* report made clear the link between participatory approaches and ownership. "As a basic principle, locally owned country development strategies and targets should emerge from an open and collaborative dialogue by local authorities with civil society and with external partners, about their shared objectives and their respective contributions to the common enterprise" (OECD, 1996, p. 14).

The literature on ownership aligns closely with this interpretation. Johnson (2005) argues that country ownership, not simply government ownership, is desirable to ensure the smooth implementation of a development programme. Buiter (2007) sees ownership as multidimensional, played out at more than just the government level. Eberlei (2001) defines ownership as materialising when a majority of the population has representation in the formulation of national development strategies. Koeberle (2005) regards ownership as a commitment to aid-supported reforms by both country authorities and a majority of domestic stakeholders. Finally, Anam (2007) links ownership directly with the pursuit of good governance, arguing that transparency and accountability towards stakeholders outside government are at the heart of effective development finance.

The potential benefits of participation by actors outside government in the policy process are beyond dispute. Local civil society organisations (CSOs), for example, can enrich the design of policies thanks to their proximity to the ultimate beneficiaries. As providers of social services, local CSOs often have practical insights on how aid can be delivered most effectively (Advisory Group on Civil Society and Aid Effectiveness, 2007). Given their proximity to people far from the political process, they can also act as citizens' representatives, advocating social empowerment and monitoring the implementation of government policies. Taken together, these activities can help ensure that policy is truly country-owned, not merely government-owned.

Participation by Actors Outside Government is Improving

If the participation of actors outside government in the design, implementation and monitoring of policies is crucial in ensuring a broad-based ownership, does the Paris Declaration give sufficient recognition to participatory approaches? The Advisory Group on Civil Society and Aid Effectiveness (2007) points out that the Declaration includes three relevant pledges. In committing to lead the co-ordination of aid, developing countries also agree to encourage the

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participation of civil society and the private sector (commitment 14). They agree to "reinforce participatory approaches by systematically involving a broad range of development partners when formulating and assessing progress in implementing national development strategies" (commitment 48). Donors, for their part, commit to "make maximum use of country, regional, sector or non-government systems" where alignment with central government-led strategies proves impossible (commitment 39).

Government-stakeholder dialogue also figures high in the World Bank's checklist of good practices in encouraging ownership. The Bank assesses whether mechanisms exist for systematic consultations, whether capacity building activities support the development of negotiation skills among government and other stakeholders, whether PRSPs are translated into local languages and whether the monitoring and evaluation systems of PRSPs include information sharing with local stakeholders. Evidence suggests that PRSP processes have helped open new policy space for CSO influence (Booth, 2003), particularly since the second generation of PRSPs (ActionAid/CARE, 2006).

Yet a Number of Actors Remain Sidelined

The Paris Declaration's support for participatory approaches thus appears strong, but not all reviews agree. The Economic Commission for Africa (ECA, 2006*a*) has argued that the preparation of PRSPs rarely includes interlocutors beyond ministries of finance and development planning, citing the short time-frames involved as the main reason for this omission. While selected CSOs do participate more, the criteria for their selection remain unclear. In Uganda, critical groups such as the media, trade unions and religious groups have been excluded from the PRSP consultations (Piron and Norton, 2004; ECA, 2006*b*).

The media, which can catalyse policy debates, form a crucial pillar for broad-based country ownership. They provide citizens with information about policies for poverty reduction and furnish a space for the beneficiaries of public services to question their quality and propose changes. Investigative, civic journalism can expose corruption, pressuring governments into better public policy (Ekanya, 2007). According to Dean (2007), however, the international development discourse has marginalised these important roles. Donor support for the media remains fragmented and not strategic, often relying on the individual interests of programme officers. This marginalisation is evident in the lack of specific references to the media in the Paris Declaration and, even more surprisingly, in the otherwise comprehensive World Bank checklist on ownership.

MPs Have Been Sidestepped, but Signs of Increasing Engagement Have Appeared

National institutions, including political parties, got sidestepped in the early stages of the PRSP process. Parliaments in particular can contribute to country ownership by monitoring public policy, participating in public debate and becoming effective channels of information to citizens. The Paris Declaration includes an important reference to parliaments in its third paragraph, which calls on donors and developing countries to improve their accountability to citizens and parliaments. Yet the Economic Commission for Africa (2006*a*) finds that in most countries the first-generation PRSPs were neither discussed nor endorsed by parliaments. When Members of Parliament were consulted, the process was rushed and MPs found themselves commenting on foregone conclusions. Tanzania, for example, deemed a two-hour workshop sufficient to brief MPs about the PRSP and to solicit their views on previously identified priorities.

Ghana, a welcome exception, formed a special Parliamentary Committee on Poverty Reduction to scrutinise the PRSP and monitor its implementation. There are other signs of improvement. Donors, moving to new aid modalities such as budget support, have begun to appreciate the importance of effective parliaments as monitors of government policy (Hudson, 2007). The World Bank's checklist on ownership recognises parliaments' importance in contributing to country ownership, calling for parliamentary committees to contribute to the formulation and monitoring of PRSPs. The second generation of PRSPs has seen MPs in Burkina Faso, Cameroon and Tanzania monitoring and scrutinising the implementation of strategies (ECA, 2006*b)*.

Donors Need To Tread Carefully in Encouraging Domestic Processes

Supporting the participation of civil-society organisations, parliaments or the media in domestic policy dialogue is a double-edged sword for donors. On the one hand, they know that participatory approaches broaden country ownership; on the other, their support of them may undermine a government's authority and reduce its space for decision making. The dilemma is particularly tricky when donors make aid disbursements conditional on them. Such process-based conditions have widespread support, even among some of the staunchest opponents of economic policy conditionality. Proponents claim that they enhance government transparency and foster human rights without detracting from governments' freedom to choose development policies (Buiter, 2007). Nevertheless, even without questioning the potential of externally imposed conditions to encourage human rights and democratic behaviour, they clearly impose significant administrative burdens on developing countries. Some countries have protested by judging such conditions unconstitutional, arguing that elected governments have the right to establish their own procedures for consultations (ECA, 2006*b*). As in the case of policy and performance-based conditionality, process-based conditions require further attention from policy makers serious about promoting country ownership.

The participation of institutions outside government in the policy process deserves greater action. While developing-country governments need to continue improving the climate for participation, donors need to review their support models for participatory approaches.

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AN OPPORTUNITY FOR DEEPER AND BROADER OWNERSHIP

With the case made that the interpretation of ownership by the Declaration remains donor-driven and centred on government, this section argues that policy makers should prioritise putting ownership into practice. The Declaration's indicators and targets may not be open for revision at the Third High Level Forum on Aid Effectiveness in Accra, but the way is open to address challenges not yet covered in the Declaration and to highlight issues already there. By taking up the following recommendations, policy makers would signal their seriousness about deeper and broader ownership, which encourages home-grown alternative policy frameworks and facilitates the participation of actors outside government in the design, implementation and monitoring of policies.

Attack the Barriers to Local Knowledge Production

The Paris Declaration's indicators focus on technical capacity building in government administrations, but they do not address the gap in knowledge production between developing countries and donor agencies, a gap which stifles true country ownership. Policy makers should identify concrete local knowledge needs in developing countries. The Economic Commission for Africa calls for a renewed emphasis on higher education, regional centres of excellence and enhanced capacities for information technology (ECA, 2006*a*). The African Development Bank and OECD Development Centre's forthcoming *African Economic Outlook 2008* argues for greater attention to technical and vocational skills development, and this chapter has proposed permanent endowments for the more robust developing-country think tanks. Add to these challenges the need for more support to local NGOs, the media and parliaments to enable them to contribute alternative policy recommendations to national policy debates. These groups often lack the capacity and resources to understand and engage in technical policy dialogue on development finance (ECA, 2006*a*). They require training programmes; the media, for example, would benefit greatly from training in investigative journalism. They also tend to be unaware of aid-effectiveness principles and their potential role in contributing to their implementation.

Commit to Improving Local Legal Frameworks for Participatory Approaches

Alongside capacity gaps, many actors outside government still face extremely hostile environments with human rights under threat. Many countries, for example, do not protect sufficiently the right to assemble and freedom of information (see Banda, 2007, on Zambia). Policy makers should commit to protecting these rights in order to foster participation and broad country ownership (Foresti *et al.*, 2006). Developing-country governments should also pledge concrete legislative steps to improve the ability of parliaments, the media and others

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outside government to monitor public expenditure. Such legislative steps could include giving parliaments a constitutional role in the oversight of development resources and reinforcing national institutions such as auditors and anti-corruption commissions. Earmarked proportions of national budgets, for example, could support the role of these institutions. Governments could foster public debate by establishing independent broadcasting authorities and repealing laws that discourage or even censure investigative journalism (Ekanya, 2007). They could also include measures to improve transparency and timely public access to official documents, including documents related to aid management. Accordingly, they and donors should work together to communicate actively about loan agreements and the conditions attached to aid disbursement (Hudson, 2007). They may even envisage sending important documents to parliament for scrutiny, discussion and approval.

Establish More Diverse Monitoring Mechanisms for Participatory Ownership

The Paris Declaration contains measurable indicators or targets to encourage participatory approaches to country ownership. This is highly unlikely to change soon, because the Declaration's signatories want to focus on the already agreed indicators. They may be right. Given the time it took to negotiate the existing Declaration, entering new negotiations would stall progress on existing aid-effectiveness commitments. Moreover, developing new substantive indicators (e.g. to measure progress in encouraging the freedom of information) risks duplicating other international policy documents, including the Millennium Declaration and other UN conventions.

Nevertheless, broad participation in policy design is a crucial determinant of ownership in practice and deserves closer monitoring. The Declaration's commitments on ownership also merit surveillance by more diverse groups of stakeholders than is currently the case. While the introduction of the PRSP approach has brought a welcome recognition of the ownership principle, developing countries and civil society can claim justifiably that the World Bank should not be the sole arbiter in measuring ownership. Policy makers should mandate a wider group of stakeholders to monitor progress on the ownership-related commitments, particularly those related to participation. The Advisory Group on Civil Society and Aid Effectiveness, a mix of officials and civil society stakeholders from both donor and developing countries, could be asked, for example, to monitor progress on commitments 14, 39 and 48, each of which touch upon participation. The Group could identify monitoring tools and indicators that do not overburden recipient-country administrations, drawing on existing international standards and codes related to transparency, freedom of information and human rights (Buiter, 2007). This work would have to look beyond civil-society organisations themselves, to include others outside government, including the media and parliaments.

Review Conditionality and Adapt Donors'

Human-Resource Policies

As noted above, conditionality remains a controversial issue in discussions on ownership, with both policy-based and process-based conditions criticised heavily for undermining ownership. Although some donors have started to favour performance-based approaches, the risks of these approaches have not yet fully been explored. Drawing on the donor commitment in paragraph 16 of the Paris Declaration to reduce externally imposed conditions, mandated further analytical work could explore how to minimise conditionality's negative impact on ownership. Developing countries have called for discussion of conditionality in Accra (HLF-3 Steering Committee, 2007). In line with the first recommendation above, local think tanks and knowledge centres can perform the analysis, which could identify how performance-based conditions could best substitute for policy conditions. Studies would have to address the risks associated with performance-based approaches by investigating, for example, the viability of safeguard clauses in aid agreements that could ensure developing countries of financial liquidity in the event of external shocks (Winpenny, 2005). The work would also have to develop better methodologies for measuring outcomes (Zimmermann, 2007), thus providing incentives for donors to commit to a reduction in policy conditions.

In their attempts to foster participatory approaches, donors also should review their use of process-based conditions and their support models for those outside government. As they move to budget support for governments — encouraged by the Paris Declaration — providing financial support to groups outside government will become increasingly difficult. Yet requiring developing-country governments to support them directly is inherently problematic; governments have very little incentive, for example, to foster parliamentary criticism of their own activities (Hudson, 2007).

Donors may thus have to resort to more subtle behavioural changes to encourage ownership, for example by adapting their human-resource policies in field offices. This could include a change in the technical expertise required of donor field staff. Rather than using qualified economists who tend to develop and propose their own solutions, agencies ought to send professional facilitators into the field with the task of brokering policy discussions among local stakeholders; agencies' policy experts could remain donor capitals, providing services to developing-country officials only on demand. Donors ought also to improve their communications strategies on aid-effectiveness principles, raising awareness of the principles in their field offices and encouraging their implementation.

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CONCLUSION

The Accra High-Level Forum (HLF-3) in September 2008 will be the first such meeting hosted by a developing country, and one can hope that it will take up ownership as a central theme. Even if the Declaration itself remains untouched, the principal output planned for the Forum, the Accra Agenda for Action (AAA) could provide a vehicle for broadening and deepening the interpretation of ownership.

Note also the upcoming UN Follow-up Conference on Financing for Development in Doha, Qatar, from 29 November to 2 December 2008. The Conference will provide a further opportunity for the international community to discuss how to raise development finance and render it more effective. It will assess progress in implementing the 2002 Monterrey Consensus, which covers sources of development finance beyond aid, including domestic resources, investment and trade. Looking ahead, a focus on these flows in addition to aid might well be a rewarding exercise for decision makers seeking to put ownership into practice. Aid may remain donor-driven, but domestic resources, backed by well-monitored fiscal and budgetary policies, are inherently country-owned. For this reason, the Global Forum will devote its third year to an exploration of the most successful examples of public-private co-operation in financing development.

This chapter has recommended action on ownership along the following lines:

- Attack the barriers to local knowledge production, so that developing countries can explore and choose among alternative policy frameworks using their domestic resources;
- Commit to legal frameworks that promote wide societal participation in policy design, debate, implementation and monitoring;
- Establish more diverse participatory-ownership monitoring mechanisms; and
- Review conditionality and adapt human-resource policies.

These recommendations acknowledge that actors outside government have ample room to improve their impact on ownership. For a start, local elements such as parliaments, journalists, think tanks and NGOs ought to work together more, sharing their expertise in monitoring government policy. Supporters of participatory approaches ought to be aware that these groups do not always have the will to hold the executive to account. Parliamentarians may worry more about keeping their seats; the media may have more concern for raising money by writing less controversial stories; and some NGOs, particularly those acting as service deliverers for government projects, may think twice about biting the hand that feeds them.

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NOTES

1. The Global Forum on Development is a series of policy dialogue meetings focused on making development finance more effective. See www.oecd.org/development/globalforum. This Chapter makes multiple references to case studies prepared for an Informal Workshop on "Ownership in Practice", held as part of the Global Forum in Sèvres, near Paris, on 27-28 September 2007. The 12 studies were commissioned through the Development Finance Network (DEFINE), an informal, global network of think tanks working on development finance. In addition to the OECD Development Centre, two DEFINE members played active roles in commissioning papers: the IBON Foundation from the Philippines and the Canadian North-South Institute.

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CHAPTER TWO

Ownership in the Multilateral Development-Finance Non-System

ABSTRACT

The complexity of the international development-finance architecture is evolving as new actors and instruments enter the arena. This throws into question the capacity of aid to deliver development. This chapter highlights the current disorder and inconsistencies in the multilateral development finance system and the associated challenges: duplication, mission creep, loss of leverage and the heavy burden put on recipient-country administrations. To promote effective and democratic ownership of development finance, it identifies avenues for reform of the current system. It suggests streamlining the multilateral division of labour and country-based delegated co-operation arrangements.

Helmut Reisen

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INTRODUCTION

The international development-finance system has become highly complex. New actors, both public and private, have emerged as important sources of finance. Traditional donors have begun using new financing instruments to deliver their aid. The goals of development assistance — already numerous — have broadened to include global and regional public goods. One would like to think that the international aid architecture is an orderly process guided by simple principles, but the trends clearly show that we have a *non-system*. Unlike some of its elements (such as the Bretton Woods sister organisations), this non-system does not result from coherent design, but is a child of spontaneous disorder. Increasing complexity throws into question the capacity of the aid system to deliver development.

Policy makers from both donor and recipient countries look for guidance on how to deal with this complexity. The evolving multilateral system and its ability to deliver results deeply concern them. The channelling of Official Development Assistance (ODA) resources to multilateral institutions and their experts from developed countries may stand in the way of a system truly led by recipient countries, as vested interests within the donor community become cemented through the scaling-up of resources. For example, suggestions from political leaders (such as the G8) to increase aid efficiency tend to refer to instruments such as the IMF/IDA Debt Sustainability Framework (DSF) that are owned by the international organisations and not by the recipient countries. In view of such palliatives, two questions arise. How can democratic ownership of development finance be strengthened? How can the international development finance architecture truly be reformed to make it effective in promoting development?

To prepare some ground for answering these questions, this Chapter highlights three key trends: the international proliferation of official donors; the creation of new financing instruments and channels; and the emergence, or re-emergence, of new official donors. The Chapter also draws attention to some of the symptoms and challenges associated with the complexity of international development finance. It documents the phenomenon of duplication and mission creep among multilateral agencies. It points to the weakening of traditional multilateral agencies and their loss of leverage as a result of recent trends in international development finance. It highlights the burden of complexity for recipient country administrations. Finally, it identifies some avenues for reform of the architecture, focusing on streamlining the multilateral division of labour and on a blueprint for country-based delegated co-operation arrangements.

An Increasingly Complex International Development Finance System

The international development finance system, or "non-system", is clearly becoming more complex. This disharmony stems from the international proliferation of official donors, the creation of new financing instruments and channels, the entry

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(or re-entry) of new official donors, and the emergence of global public goods as a new goal for the international development architecture.

International donor proliferation

Any look at the international aid architecture must begin with the OECD Development Assistance Committee (DAC) Creditor Reporting System (CRS), which gives an overview of ODA-eligible institutions. Table 2.1. lists the categories of ODA channels used by the CRS. Using these categories as a base reveals an official aid architecture that includes:

- 23 DAC members with a varying number of agencies;
- 47 UN agencies, funds and commissions;
- 4 EC bodies;
- 2 IMF trusts, 5 World Bank Group bodies;
- 12 regional development banks and funds;
- 97 other multilateral institutions (incl. Global Environment Facility (GEF) and Global Fund to Fight AIDS, TB, and Malaria (GFATM));
- 32 international non-governmental organisations; and
- 5 main public-private partnerships.

Table 2.1. ODA-Eligible Institutions

Broad Category of Channel	Name of Category
Government	Donor government/ Extending agency Recipient government
NGO	NGO – in donor/third country NGO – in recipient country NGO – international
PPP	Private-Public Partnerships
Multilateral	Multilateral - UN Multilateral WB/IMF/Regional banks Multilateral – other
Private	Churches Foundations Universities/research institutes Enterprises Other
Other	Other

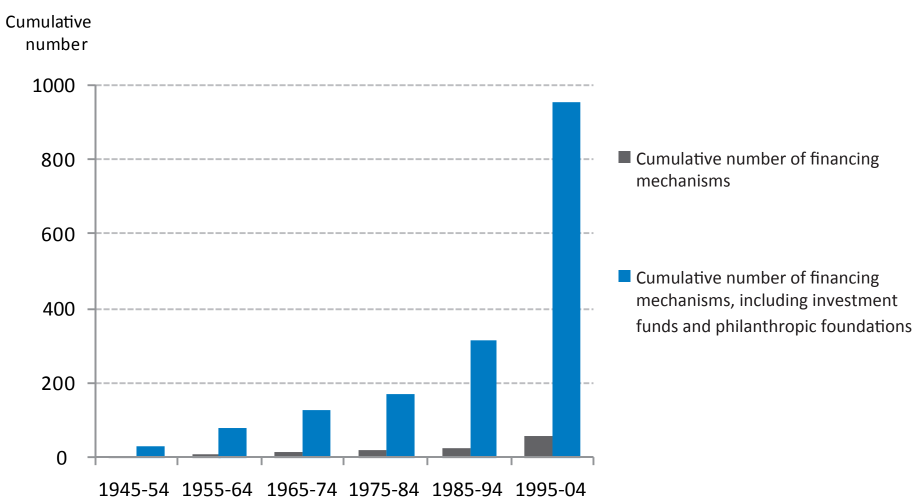
Source: The CRS Directives for ODA Reporting Instructions [DCD/DAC/STAT(2005)8].

StatLink http://dx.doi.org/10.1787/314406088434

As will become clearer below, however, looking at the international development finance architecture requires a step beyond ODA eligibility. In recent years, this non-system has witnessed a strong, dynamic creation of both public and private institutions financing development and public goods, but with virtually no exits. All in all, the UNDP counted 1 000 development finance mechanisms by 2004 (Figure 2.1.). These institutions, apart from the official bilateral and multilateral donor community collected in Table 2.1., comprise:

- *Emerging Official Donors and Lenders*, in particular China and the oil-rich countries;
- *Global Programmes*, also called sectoral or vertical funds, especially active in health (e.g. the Global Fund to Fight Aids, Tuberculosis and Malaria(GFATM)), in environment (e.g. the Global Environment Facility(GEF)) and education (e.g. the Education for All Fast Track Initiative);
- *Non-Governmental Organisations* (NGOs), on the international level (such as Red Cross International), with Northern origins or based in the developing countries themselves;
- *Private Philanthropy and Transfers*, such as the Bill and Melinda Gates Foundation and the private remittances from migrants back to their home countries; and
- *Private Capital Flows*, in particular foreign direct investment and other participatory direct finance through firms and funds, portfolio flows through stock and bond purchases, and lending through commercial banks and export credit agencies.

Figure 2.1. Cumulative Number of Development Financing Mechanisms*



Notes: *denotes official international financing mechanisms to finance global public policy goals.

Source: Kaul and Conceicao (2006).

StatLink http://dx.doi.org/10.1787/314220668558

The growing role of non-traditional donors, the recent proliferation of sectoral or vertical funds and the expansion of private foundations bring needed resources as well as new ideas, expertise and approaches. Yet this expanding number of actors, mostly of Northern origin, also focuses attention on the fragmentation of aid and possible loss of efficiency. The donor community must come to terms with the need to co-ordinate a growing number of players in country-level aid efforts.

Ownership and the Creation of New Instruments and Aid Channels

Debt relief as a major vehicle for ODA

Recipient countries have to deal not only with more donors, but with more aid channels as well. In spring 2005, the World Bank and International Monetary Fund (IMF) implemented a new Debt Sustainability Framework (DSF) in Low-Income Countries, which seeks to provide guidance on new lending to low-income countries whose main source of financing is official loans. They have developed the framework to monitor better and prevent the accumulation of unsustainable debt in the wake of the Highly Indebted Poor Country (HIPC) initiative and the Multilateral Debt Reduction Initiative (MDRI). Debt relief under the HIPC framework and the MDRI has reduced the debt stock of post-decision-point HIPCs by an estimated $96 billion in end-2006 net-present-value (NPV) terms. Debt relief by DAC donors (China, for example, does not count debt relief as aid) has been an important part of measured ODA, but the way beneficiaries are selected and subsequent IDA resources are allocated stand in the way of generating policy ownership in low-income countries.

The DSF has two pillars. First, IDA lending is now informed by criteria developed within the Country Policy and Institutional Assessment (CPIA) approach; this gives rise to a traffic-light system that combines actual debt burdens and CPIA-dependent thresholds into a ranking of countries according to categories of debt distress. Second, the IMF and the World Bank have put in place a standardised debt-sustainability assessment (DSA) procedure to assess debt-burden indicators over time (20 years) and under alternative scenarios. The DSF is not the right framework to help low-income countries own their development policies. It is pegged to governance indicators subject to criticism and at odds with others. Analyses of debt sustainability have to be based on broader determinants, namely those that drive endogenous debt dynamics (such as growth and currency effects), than those used under the DSF. The DSF has to integrate the growth effects of new lending in order to escape its current anti-lending bias.

The World Bank's Country Policy and Institutional Assessment (CPIA) index suffers from many serious shortcomings (Arndt and Oman, 2006), indirectly undermining the validity of the DSF. Most compilers produce composite indicators that lack transparency in themselves. The scoring criteria are opaque because of the diversity and large number of underlying indicators they embody. The underlying conceptual framework — the meaning of governance — remains unclear, so there is lack of clarity about how the scores are finally arrived at. To make the CPIA the dominant factor in the IDA allocation has been heavily criticised, because the CPIA-centred allocation of aid fails to introduce an incentives structure supportive of a genuine donor-recipient partnership, and the CPIA-dependent debt thresholds submit sustainability concerns to the policy-performance prerogatives of the aid allocation system (Nissanke and Ferrarini, 2007).

The emergence of global programmes

One of the most prominent discussions in the OECD Global Forum on Development has concerned the emergence of global programmes as important new financing mechanisms. These programmes, conceived as focused responses to global challenges that require collective action, have sprung up in the areas of health, environment, trade, finance and security. They include GFATM, GEF, the Global Alliance for Vaccines and Immunization (GAVI), the Education for All Fast Track Initiative (EFA FTI), and the Consultative Group on International Agricultural Research (CGIAR).

Their focus on a particular set of challenges, as opposed to a country-wide or sector-wide approach, means that most global funds fall into the category of "vertical funds". The key drivers behind the emergence of these funds have been the need for innovative approaches and new partners, particularly the private sector, to address specific problems. Proponents of the funds argue that the traditional aid system is ill-equipped to address emerging global issues with the necessary speed and scale. Global funds, on the other hand, can achieve economies of scale and contribute rapidly increasing levels of financing to deliver their services. They thus satisfy a desire for specific results on widely shared goals. Their focused approach can enhance learning and can sustain public understanding and support in donor countries for new development initiatives and the delivery of global public goods. Global funds are the right choice when:

- They generate global public goods — products, services or policy regimes at the global level, that is, their benefits, not just their activities, spill across national boundaries;
- They provide benefits that the members engaged in global partnerships could not deliver if they acted alone; and
- They provide additional financial and political resources whose benefits outweigh the increased management and financial burdens they place on the partners and developing countries they are intended to benefit.

Global programmes pose the risk of creating significant development gaps and distortions at the country level, however, particularly in countries with severe budget and skill constraints. They often compete with or turn to country assistance programmes for resources or attention. This is illustrated in some cases by important investments forgone, problems of sustainability and predictability of financial flows, high transaction costs, displacement of scarce qualified technical and managerial capacities and generally weak sectoral and national accountability and monitoring mechanisms.

Some have argued that the finance mobilised does not outweigh the added cost of resource mobilisation and programme organisation (Lele *et al.*, 2006).

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Although the share of these funds in total ODA is just above 3 per cent, several vertical funds (particularly in health and education) have became sufficiently large to dominate these sectors' public investment programme in several low-income countries, raising problems of ownership and strategic allocation of budget resources in the sectors.

The "Emergence" of New Official Donors

Over recent years, a number of emerging creditors have increased their aid and lending to low income countries (LICs). Sketchy evidence indicates that China has become by a large margin the largest creditor in this group[1]. In May 2007, finance ministers released the *G8 Action Plan for Good Financial Governance in Africa*, declaring to "commit to applying responsible practices in our lending decisions. To this end, we urge all borrowers and creditors to share information on their borrowing and lending practices. The *debt sustainability framework*, developed by the IMF and the World Bank, provides an important guiding tool for decisions on new borrowing and lending and we encourage its broad use by all borrowers and creditors as a way to prevent new lend-and-forgive cycles". The document carefully avoided naming and blaming specific countries, but it is no secret that China was on the finance ministers' minds.

Western governments worry that China may be undoing years of international efforts to rein in over-indebtedness in Africa, to reduce the continent's exposure to foreign currency-denominated debt and to encourage good governance by making loans conditional on political and economic reforms (for a presentation of the risks connected to bilateral non-DAC aid, see Manning, 2006); some accuse China of free riding on the development efforts deployed by the international community. By contrast, Africa's governments notably have generally welcomed China's engagement. Indeed, from an ownership perspective, two points need stress in this context:

- Allowing low-income countries to borrow again unleashed much-needed investment in infrastructure to boost economic capacity. Africa now benefits not only from a diversification of its client mix as a result of China's increased resource demand, but also from speedy delivery and competitive prices of infrastructure. Arguably, Africa benefits more from competition between major importers of its raw materials than from well-drafted standards, the credibility of which has not been boosted by Western companies' involvement in recent corruption scandals.
- China's loans (as well as the private financial markets) have lowered the demand for lending by the World Bank and the IMF. This has weakened the leverage that these organisations could exert on economic policies of their poor-country borrowers. Clearly, there is a risk that poor countries may move away from the mainstream advice at their own peril, but the demise of the Western donor cartel may also strengthen competition across economic-policy paradigms, with recipient countries free to choose. Ultimately, reform ownership and accountability may thus be strengthened.

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Moreover, a recent OECD Development Centre Study (Reisen and Ndoye, 2007) finds very little empirical evidence of "imprudent lending" to debt relief beneficiaries up to 2006. Their debt (service) ratios have declined below debt-distress levels set by the DSF, and there is even some evidence that the HIPC-only countries might now be underleveraged. Free riding by China on the debt relief granted through bilateral and multilateral initiatives is hardly visible. The major beneficiaries of new lending, mostly through official export credits (from both China and OECD agencies), are the resource-rich countries (Angola, Nigeria, Sudan) that did not directly benefit from HIPC and MDRI. Moreover, China also has granted debt relief (mostly to HIPC beneficiaries) and its subsidised export buyer credits would be considered as concessional by current DAC reporting standards.

The Use of ODA for Financing Global Public Goods

Although ODA should not in principle be used to finance global public goods (GPGs), an argument exists that public policy for ODA and its institutions represents the proper locus to consider the provision of certain GPGs in cases where the only way to enlist developing countries is to include the provision in a global development package that allows beneficiaries to achieve their original objectives at no extra cost. In other cases GPGs are strongly perceived to be local public goods, part of local development strategies and thus appropriate for ODA-financed provision. In still others, the provision of GPGs is related to complementary goods and services, including technical assistance and capacity building, that are important elements of any development process and which ODA should finance (Jacquet and Marniesse, 2004).

A central issue related to the provision of GPGs concerns possible crowding out with ODA funds. Reisen *et al.* (2004) employ data from the OECD CRS to attribute ODA to the provision of global public goods, regional public goods and traditional aid over 1997-2001. They report empirical evidence that the average offset coefficient between GPG-related ODA and traditional aid is significantly higher than zero, namely 25 per cent. They conclude, however, that an increase in GPG spending will not likely affect adversely the flow of aid transfers to the poorest countries. Moreover, they show that the largest sectors, namely narcotics control and economic policy and planning, each consume about 15 per cent of total GPG commitments. Narcotics control carries an important benefit to the donor country in its fight against drug addiction at home, and much of ODA classified as economic development and planning aid goes to OECD-based consultants and research (such as the OECD Development Centre) and hence involves no cash transfer to low-income countries.

Reisen *et al.* (2004) further present a highly stylised, standard model of public goods, adapted to the special donor-recipient relationship, to highlight the underlying tensions between deleting the under-provision of GPGs (where a maximum effect per ODA dollar is reached by earmarking) and recipient countries' "ownership" (where free transfers maximise the utility of the ODA dollar for the poor). Donors tend to provide GPG funding only for earmarked use. The model thus groups ODA allocation into funds that may be spent exclusively on the

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public good and contributions to the poor country's private good. This implies that the recipient country cannot freely allocate the transfer at home. Because one of the two goods is public, the donor country benefits from it in a "double" way: it not only draws direct utility from it (owing to higher consumption of the global public good), but also benefits from increased welfare in the recipient country (via altruism). This explains why the earmarked transfers naturally lead to a higher supply of the public good. It implies a clear crowding-out effect. When total transfers remain constant but more is spent on the public good, this is detrimental to conventional development assistance. On the other hand, the under-provision of the public good is mitigated, which increases efficiency. The less "ownership" the recipient countries have on the use of the funds, the better the world's provision with international public goods.

TOO COMPLEX TO BE EFFICIENT, TOO COMPLEX TO BE OWNED

While new actors abound, old ones have weakened. The UN system weakens as it becomes increasingly subject to "cherry picking", with selected voluntary contributions rising strongly while core universal functions remain underfinanced. The UN Development System has attracted considerable attention for its overlapping roles and mandates. Three agencies in Rome are concerned with food security: FAO, WFP and IFAD; two UN organisations deal with health services for youngsters and young women: UNFPA and UNICEF; UNDP has three service lines related to AIDS, notwithstanding the UN organisation created to deal with Aids, UNAIDS; and the environment sector is taken care of by three UN bodies: UNDP, UNEP and UNIDO.

Country overlap, mission creep and duplication are not confined to the UN system, however. At the multilateral and regional development banks the duplication in country allocation seems to have intensified, with most overlap in Central Asia (ADB, EBRD, World Bank, Council of Europe Development Bank and European Investment Bank).

The IMF has a problem of vanishing clients. In the late 1990s, the Fund was simultaneously supporting the transition in Eastern Europe and Russia, providing large-scale assistance to Asian and Latin American countries in crisis and helping Africa. Thanks to loose G3 money and carry trades built thereon, thanks to new credit-default derivatives that facilitate the purchase of emerging-market bonds regardless of default risk and thanks to rising raw material prices, petrol exporters such as Russia are awash with oil revenues. Asian countries have built up huge foreign exchange reserves hoping never to have to rely on the IMF again, and traditional Fund clients such as Argentina and Brazil are repaying their debts. Africa, as shown above, turns increasingly towards China's loans.

The so-called Crockett Report (Committee to Study Sustainable Long-Term Financing of the IMF, Final Report, 2007) notes: "It is already the case that the income derived from lending is not sufficient to cover the Fund's projected

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operating expenses, unless the intermediation margin were to be raised to unsustainable levels." (IMF, 2007, p. 3). The Report recommends switching the core funding of the IMF from surpluses that result from its lending activities (and from periodic levies on Fund members) to an endowment. It states that the most likely source of financing for such an endowment would be the proceeds from a limited sale of Fund gold, which should be ring-fenced to exclude further sales. The gold sale is projected to generate book profits worth 1.7 billion SDR.

The fate of the World Bank resembles in many ways that of the IMF. With the unfolding of financial liberalisation, growth in private capital flows to emerging countries has undermined the Bank's traditional role as a financial intermediary in the service of development. The institution, which regards itself as a "knowledge bank" , has moved towards promoting poverty-reducing policies and fighting corruption, but it needs financial leverage to promote good policies. In the early 2000s, it had found an instrument to this end with the debt reduction programmes and the revival of development aid. Yet China's willingness to extend credit to African countries in exchange for better access to their raw-material resources challenges the Bank's clout. Strings attach to Chinese credits too, but they entail none of the scrutiny involved in the Bank's assistance.

The International Development Association (IDA), the concessional lending arm of the World Bank, has a replenishment mechanism based on three-year cycles of negotiations and agreements with donors. The rising share of debt-sustainability IDA grants and lower share of soft loans over the past replenishment (IDA-14) potentially leads to competition with the UN, which has traditionally used grant funding for its operations. Should China decide to reimburse its IDA debt at once, the entire IDA revolving loan system would be at risk.

In their struggle for survival, international organisations can be generally expected to modify their mission statements over time. To quote Babb and Buira (2005, p. 59): "Founded at the end of World War II to help lay the foundations of a new era of stability and prosperity, the World Bank and the International Monetary Fund (IMF) are widely viewed as having evolved in ways that would have surprised their founders. A term that has gained popularity among World Bank and IMF critics is "mission creep," or the systematic shifting of organisational activities away from original mandates."

In an exercise to highlight duplication, the UK's National Audit Office (2005) has mapped the relationship between multilaterals and the Millennium Development Goals (MDGs). For each MDG and for human rights, humanitarian emergencies and conflict, Table 2.2. shows the key multilateral institutions that have stated objectives related to them. This analysis is based on the multilaterals' own corporate information. The multilateral duplication and overlap in serving the MDGs is striking, costly and inefficient. The lack of specialisation and the duplication in activities detract from the effectiveness of development finance.

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Table 2.2. Unclear Institutional Assignment to the MDGs

Selected Multilaterals Working on the Millennium Development Goals		
MDG / Thematic Area	Main Multilaterals	Other Multilaterals with a Role
MDG1: Eradicate extreme poverty and hunger	UNDP, World Bank, AfDB, AsDB, IFAD, EC, FAO, WFP	CGIAR, IADB
MDG 2: Achieve universal primary education	World Bank, UNICEF, UNESCO	UNFPA, UN-RWA
MDG 3: Promote gender equality and empower women	UNDP, World Bank, UNIFEM, UNICEF	UNFPA
MDG 4: Reduce child mortality	WHO, UNFPA, UNICEF	World Bank, WFP, UNRWA
MDG 5: Improve maternal health	WHO, UNFPA	World Bank, WFP
MDG 6: Combat HIV/AIDS, malaria and other diseases	UNAIDS, World Bank, WHO, UNDP, UNFPA,UNICEF	UNIFEM
MDG 7: Ensure environmental sustainability	UN Habitat, World Bank, AsDB, UNDP	CGIAR, UNIDO
MDG 8: Develop a global partnership for development	World Bank, EU, UNDP, UNIDO, ILO, UNCTAD	UNDP
Human rights	OHCHR	UNIFEM
Conflicts and humanitarian emergencies	UNCHR, OCHA, ECHO, WFP, UNICEF, WHO	UNDP

Source: National Audit Office (UK), DIFD (2005).
StatLink http://dx.doi.org/ 10.1787/314426374882

Recipient-country administrations suffer from this complex system, overburdened by the number of interlocutors. Questions have arisen about their ability to absorb additional aid. Knack and Rahman (2007) analyse the impact of donor fragmentation on the quality of government bureaucracy in aid-recipient countries and find that donor fragmentation leads to an erosion of bureaucratic quality. Using a formal model of a donor's decision to hire government administrators to manage projects, they predict that donors hire fewer administrators when their share of other projects in the country increases and when their concern for the success of other donors' projects grows. They show that the model's predictions are consistent with results from cross-country empirical tests, using an index of bureaucratic quality available for aid-recipient countries over 1982–2001.

Knack and Rahman (2007) measure bureaucratic quality by using an index available for most countries from the International Country Risk Guide (ICRG), a commercial service providing information on political risks to overseas investors and lenders. As Figure 2.2. shows, the "Weberian scale" of bureaucratic

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development is correlated at 0.62 with the ICRG Bureaucratic quality index, averaged over all years through 1990 for which all data are available. These findings point to another policy issue. Could countries absorb more aid if it ever did materialise as more net cash inflows?

Figure 2.2. Donor Fragmentation and the Erosion of Bureaucratic Quality

Source: Knack and Rahman (2007).

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MANAGING COMPLEXITY IN INTERNATIONAL DEVELOPMENT FINANCE: AVENUES FOR REFORM

Multilateral development finance has become too complex for both donors and recipients. The proliferation of donors on the ground entails high transaction costs for all recipient countries. To lower such costs and improve effectiveness of development assistance, ministers of developed and developing countries

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who signed the Paris Declaration on 2 March 2005 reaffirmed their commitment to increase alignment of aid with partner countries' priorities and systems, to eliminate duplication of efforts, to rationalise donor activities and to reform and simplify donor policies and procedures so as to encourage "collaborative behaviour".

The Paris Declaration is a step towards a more coherent system, but it will not be easy to implement. It will also not suffice to deal with fragmentation, duplication and role assignment, i.e. the lack of coherence in the entire multilateral development finance non-system. The UN High-Level Panel on System-Wide Coherence, another initiative to foster harmonisation, has focused on the UN system only, not on system-wide coherence. To be sure, some overlap between multilaterals may be useful. A degree of competition may create diversity in policy advice and service delivery and may add to the stability of aid flows. That said, however, a more harmonised approach will have a major role to play in raising the standards of aid delivery.

What instruments would a central "aid architect" have at hand for a coherent, efficient assignment of multilateral tasks? A mapping process, which could help identify possible areas of consolidation between multilateral organisations, can help address fragmentation and poor co-ordination of agencies at country level, and can identify comparative advantages to help prioritise with tight budgets (National Audit Office, UK, 2005). An assignment rule more directly linked to policy objectives could be based on the avoidance of country overlap, on efficiency in reaching the poor, and/or on selectivity of aid in response to policy quality.

Following this, the celebrated Tinbergen Rule comes to mind. The rule states that there must be as many policy instruments as there are policy objectives. In achieving any objective, the policy instrument that has the most direct impact on the objective will most likely do so at the least social cost. Srinivasan and Zedillo (2005), discussing the role of the WTO in the multilateral concert therefore conclude: "This rule applies to institutional mandates as well. It is more efficient to have institutional specialization —a World Bank for long-term development finance, an IMF for global financial system stability and short-term macroeconomic management, an ILO for labour issues, and the WTO for trade — than to have each of them involved in the mandate of one more of the others. Unfortunately, there is a growing overlap of mandates between the World Bank and the IMF on poverty alleviation but no evidence that this is producing better results. The ILO is also encroaching on trade issues." (Srinivasan and Zedillo, 2005, p. 410).

Multilateral Performance Measures and Role Assignment

On an operational level, multilateral performance measures may help identify comparative advantages across multilateral organisations (Obser and Wolff, 2007). Growing evidence is being created on the effectiveness (x-efficiency) of multilateral organisations. The focus generally falls on management systems (i.e. elements of current management orthodoxy), perceptions of the preparedness of organisations for local partnerships and the alignment with country systems.

There has been criticism that current multilateral performance measures have only weak links to MDG contributions (National Audit Office, UK, 2005). Thus far, the sources for multilateral performance measures are DAC peer reviews, country programme evaluations, reports by civil society, Global Monitoring Reports, the Multilateral Effectiveness Framework of the UK's DFID and other bilateral agency assessments. The DAC Evaluation Network and UN Evaluation Group Joint Task Force is working on a peer review of the evaluation function in multilateral organisations through pilot peer reviews in UNDP and UNICEF. Similarly, the MDB Evaluation Group focuses not on entire organisations but on their evaluation systems, and assesses whether the institutions have professional and credible mechanisms in place to evaluate the programmes for which they have provided resources.

In recent years, two Multilateral Assessment Frameworks have emerged: the Multilateral Organisations Performance Assessment Network (MOPAN) and the Common Performance Assessment System (COMPAS). MOPAN is a partnership of likeminded donors, which in 2003 began jointly to survey the partnership behaviour of multilateral organisations at country level. Surveys are based on the perceptions of MOPAN-member embassies or country offices, arising from their day-to-day contacts with multilateral organisations. MOPAN conducts a joint Annual Survey of multilateral organisations' (MOs') partnership behaviour with national stakeholders and other donor organisations at country level. Each year, the Annual Survey covers three to four MOs and is conducted in eight to ten countries. Note that the MOPAN Annual Survey is not an evaluation and does not cover actual results on the ground. It also avoids inter-agency comparisons. Hence the MOPAN surveys provide no basis for inter-agency decision making. Further, this approach does not lead to firm conclusions about effectiveness.

In response to international commitments on performance and accountability, the Multilateral Development Bank Working Group on Managing for Development Results (MfDR) proposed COMPAS. The coalition of MDBs involved in this initiative includes the African Development Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank and the World Bank. COMPAS aims to provide a common source of information on the results orientation of the five MDBs, based on seven categories of data:

- Country-level capacity development;
- Performance-based concessional financing;
- Country strategies;
- Projects and programmes;
- Monitoring and evaluation;
- Learning and incentives; and
- Inter-agency harmonisation.

With the focus on group synergies and not on individual comparisons across institutions, COMPAS is not built to enhance inter-agency choice and multilateral coherence directly. In particular, it fails to address to what extent regional development banks serve to reduce the underfunding of regional public goods. Nevertheless, it clearly has more orientation towards results than does MOPAN.

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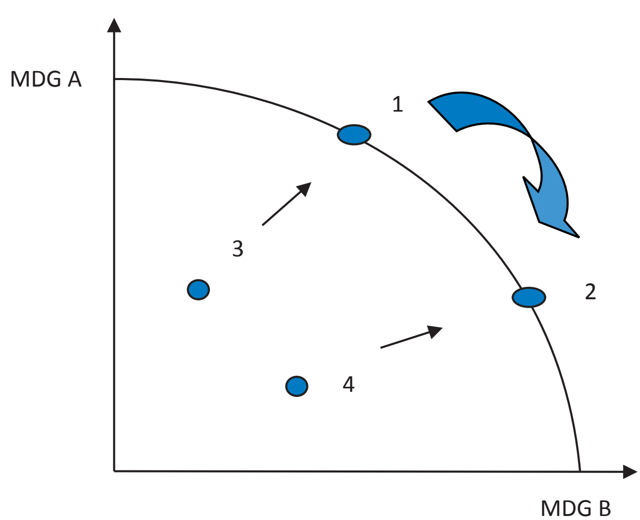
It aims to pool information about how MDBs contribute to development results (outputs and outcomes), to monitor and synthesise MDBs' progress over time and to contribute to lesson-learning, accountability and transparency (Obser and Wolff, 2007). The COMPAS goal is to facilitate comparability of data between MDBs (e.g. regarding programme outputs and outcomes), and ultimately to contribute to harmonisation of practices among institutions. With COMPAS, the MDBs have succeeded in drafting a set of common indicators that may form the basis for future reporting by the banks.

These considerations lead to the conclusion that multilateral performance measures are certainly a useful instrument to raise multilateral effectiveness. By contrast, they neither aim at raising the coherence of the multilateral finance non-system overall nor can deliver it. They focus on single organisations or groups of them. They are self-driven instruments, and they do not cut ministerial agency dependence and patronage.

Figure 2.3. illustrates the point in a simple diagram where ODA resources are spent between two MDGs: A (say, health) and B (say, education). Multilateral performance measures can reduce slack and thus raise x-efficiency of a group of single multilaterals. As in the figure, they can help move the system from point 3 to point 1 and from point 4 to point 2, hence raising the utility of a given amount of ODA resources to both donors and recipients. They fail to inform an allocative shift under a given budget constraint, say from point 1 to point 2; thus they fail to improve the coherence of the multilateral system. For example, if the international community decides to move the priority from health to education, neither COMPAS nor MOPAN will inform about the efficient allocation of resources to finance the change.

Figure 2.3. Multilateral Assessment Frameworks



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A specific suggestion is to provide a high-level mandate to replicate Delivering as One (the UN reform proposals advanced in late 2006) for the entire non-system of development finance. This will require involving the finance, health, environment and other ministries in the assignment process, as each of them is involved with different parts of the architecture: the UN, the Bretton Woods institutions, the regional development banks and funds such as GFATM and GEF. Possibilities for merger and closure in order to reach a clear command structure should be explicitly required from any consultancy report and considered by policy makers. Further, the agenda of evaluation networks has to broaden to include core aspects of system-wide coherence.

TOWARDS A COUNTRY-BASED DELEGATED CO-OPERATION ARRANGEMENT

To help strengthen recipient countries' capacity and leadership and to reduce high transaction costs, Cohen *et al.* (forthcoming 2008) suggest a "country-based delegated co-operation arrangement". The OECD/DAC defines delegated co-operation as a working arrangement whereby one donor (or a "lead donor") acts with authority on behalf of one or more other donors (the "delegating donors" or "silent partners"). The level and form of delegation may vary, ranging from responsibility for one element of the project cycle for a specific project to a complete sector programme or even a country programme. The Nordic Plus countries have in fact used the delegated co-operation principle to improve aid effectiveness[2].

A country-based delegated co-operation arrangement could be structured around the creation of a country-wide co-ordination council and the formation of sectoral councils according to the following structure:

- General council: seven members, of which two from the government, four or five from the top donors (four in the case of an IMF programme, in which case the IMF occupies a seat) plus a secretariat jointly managed by the country and the lead donor (which can be a multilateral agency); and
- Sectoral councils (education, infrastructures, health…): also seven members, of which two from the government and four or five from the top sectoral donors, with a general council secretariat member as observer. (NGOs or philanthropic organisations could have seats in sectors such as health, education or emergencies, where they have a strong presence.)
- Membership in each of the councils could be reviewed every three years depending on developments, while overall monitoring could be delegated to the OECD/DAC.

Usually, the largest donors in each country account for the bulk of aid — in fact, in most countries, the share of the first five donors exceeds 80 per cent of total aid. In 32 out of the 49 countries that Cohen *et al.* (forthcoming 2008) examine, multilateral donors appear in the top five. Most multilateral agencies appear as lead donors in most African countries. Other donors frequently appearing include

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France, Portugal and the United States. France and Portugal always appear when their former colonies are concerned. The United States has a leading presence in countries of strategic relevance such as Egypt, Eritrea or Sudan but also in Liberia and Botswana, probably for historical and good-governance considerations. More important, small donors that are not former colonial powers also show up in the top-five list, especially Scandinavian countries, most notably Norway, Denmark and Sweden.

A partnership scheme based on delegated co-operation would induce donors to specialise more without engaging in extensive and costly intra-donor negotiations; small donors in particular would be induced to delegate their authorities on a co-operative and rotating basis among themselves. Furthermore, NGOs, including the business sector, could gain a new status as full partners in development, especially in sectors where they have a demonstrable comparative advantage, e.g. health, education or humanitarian assistance.

The introduction of sectoral councils, of course, is not new. A few countries, most notably Tanzania and Uganda, have set up co-ordination schemes at the sectoral level. Transaction costs remain high, however, as these schemes involve all donors active in the country. There are exceptions. In Ghana, for example, delegated co-operation is reducing the number of donors appearing in co-ordination meetings. This is not to say that co-ordination has ceased to be a nightmare in the health sector. Significant progress has been made by the Education for All Fast Track Initiative (EFA FTI), a global programme hosted by the World Bank. Local agencies involved in supporting the education sector nominate a co-ordinating agency to lead FTI assessment and endorsement and serve as the liaison with the Ministry of Education, other concerned government agencies and the FTI secretariat. Such examples are rare, however, and do not necessarily provide incentives for improved rationalisation of the system across sectors and recipient countries.

Although there is little sign that donors systematically organise a division of labour in general, the EU has made some progress. The EU General Affairs and External Relations Council adopted guiding principles for a development-related division of labour among EU donors. Some arrangements already in the EU and its sub-regions (for instance, Nordic Plus in Scandinavia), could serve as a basis for extending a formal division of labour. The German Development Institute proposes that EU members first commit to rules of conduct in several pilot countries and gain experience. They should limit both the number of sectors per donor and the number of donors per sector. The EU Commission recently outlined a proposal for an EU Code of Conduct on Division of Labour in Development Policy. It presents operational principles for EU donors to improve complementarities and division of labour. *Inter alia*, it calls for EU donors to *i)* focus their active involvement on a maximum of three sectors identified by the partner government as having priority and in which the donor has "a comparative advantage"; *ii)* redeploy their resources for other in-country activities following local negotiations; *iii)* enter into delegated co-operation partnership arrangements if needed; and *iv)* establish a limited number of priority countries through an informed dialogue within the EU.

To generate the collective political will and commitment to see reforms through demands a concerted effort by key governments of both developed and developing countries. Any reform will have to start from outside, as vested interests in agency survival are strong. Reform from outside the aid system, at a level not lower than the prime minister, will keep the overall budget under control and make reform inroads with the risk of procrastination minimised. The late American computer specialist Alan Perlis once said: "Fools ignore complexity. Pragmatists suffer it. Some can avoid it. Geniuses remove it."

NOTES

1. In an effort to cast more light on the activities of new donors, the World Bank, in collaboration with the OECD/DAC, the United Nations Development Programme (UNDP), and the United Nations Department of Economic and Social Affairs (UNDESA), conducted a survey of nine developing countries (Brazil, Chile, China, India, Malaysia, Russia, South Africa, Thailand and República Bolivariana de Venezuela). Only three countries (Chile, Malaysia, and Thailand) have responded to the survey so far.

2. The Nordic Plus countries comprise Denmark, Finland, Ireland, Netherlands, Norway, Sweden and the UK.

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CHAPTER THREE

A Paris Declaration for NGOs?

ABSTRACT

In their statements on the Paris Declaration, International NGOs argue that its signatories, official donors, do not go far enough in harmonising and aligning their efforts. New data reveal Northern NGOs as much larger than hitherto assumed. Consequently they also look like donors in their own right, and therefore the principles of the Paris Declaration ought to apply equally to them. The current practices of international NGOs with respect to harmonisation, co-ordination, alignment and accountability leave much to be desired. Legal and financial imbalances between developing-country and developed-country NGOs contribute to suboptimal performance by the latter on central elements of the Paris Declaration, such as increased local ownership and mutual accountability. International NGOs need a Paris-like declaration for themselves. In some quarters progress towards this end is already under way.

Dirk-Jan Koch

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INTRODUCTION

International Non-Governmental development Organisations (INGOs) push official donors to implement and expand the Paris Declaration on Aid Effectiveness. The Paris Declaration is based on key principles such as better co-ordination and harmonisation among donors, more alignment of donors with the agendas of recipients and more mutual accountability between donors and recipients. International NGOs have issued an impressive number of policy statements and reports on the Declaration (e.g. ActionAid 2005*b*; ActionAid, 2007*b*; Better Aid, 2007; Eurostep, 2007; Reality of Aid; 2007). These statements differ. Some, supportive, argue that the Declaration does not go far enough in ensuring the harmonisation and alignment of bilateral donors (e.g. United Nations Non-Governmental Liaison Service, 2005). Others, more critical, claim that the Declaration needs to expand and better address inequality in the aid system (Better Aid, 2007). Yet these statements resemble each other in one key respect. None of them contains any reflection on how the INGOs put the principles of the Paris Declaration into practice themselves.

Such reflection is needed. This Chapter offers some tentative answers to questions including: Do NGOs harmonise their procedures? Do they promote mutual accountability? Do they align their priorities to those of their partner organisations and stimulate ownership? The Chapter concludes that the performance of NGOs on these questions requires substantial improvement. It pleads therefore for a Paris-like declaration on NGO aid effectiveness. It would not replicate the Paris Declaration, because NGOs require a tailor-made aid-effectiveness agenda. Yet the underlying principles, such as increased ownership, harmonisation, co-ordination, alignment and accountability should remain the same.

Some initiatives already deal with civil-society aid effectiveness. For example, INGOs have representation in an Advisory Group on Civil Society and Aid Effectiveness. After regional consultations with diverse stakeholders and after a large international forum in Ottawa, they will provide clear recommendations for the Working Party on Aid Effectiveness as it finalises plans for the Accra High Level Forum. The regional consultations regularly provide suggestions on how to improve the effectiveness of NGO aid. A North-South Civil Society Dialogue on Aid Effectiveness occurred in Nairobi in late 2007, although by January 2008 it had reached no consensus on a resolution. A new, separate joint effort would start a common code of conduct for international NGOs.

Conversely, the umbrella organisation of European NGOs, Concord, claims in a letter to the European Commission that the Paris Declaration should not apply to them. They view themselves primarily not as donors and claim that the principles of the Paris Declaration were negotiated without them. They conclude that "the EU process leading up to the Accra High Level Forum should remain focused on the effectiveness of aid delivered by member states and European institutions" (Concord, 2008).

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The developing-country partners of these European NGOs do not have such qualms. In contributions to the discussion on the Paris Declaration they proposed useful suggestions for developed-country NGOs. The Civil Society Organisation (CSO) of Southern and East Africa proposes, for example, that "Northern CSOs should be transparent and accountable to the Southern CSOs by declaring the full amounts they receive from donors in the name of Southern CSOs" (Afrodad, 2007). Other compelling arguments also demand more attention to how international NGOs perform with respect to the principles of the Paris Declaration. The big ones receive large shares of official aid; some of their budgets surpass those of some of the signatories to the Paris Declaration. The aid budget of World Vision International exceeds that of Italy. Plan International spends more than Greece, and the Save the Children Alliance more than Finland. Unquestionably, these INGOs engage in many important activities that do not involve transfers of funds to Southern organisations, such as lobby campaigns, but this does not imply that they cannot be viewed as donors as well.

After an introduction on the mounting size of INGOs, this Chapter will turn to NGO parallels with the two main elements of the Paris Declaration. It first highlights the need for increased co-ordination and harmonisation in INGO aid. The high levels of regional concentration among INGOs and the heavy reporting burdens they place on local organisations suggest potential efficiency gains if they would adhere to the technical elements of the Paris Declaration. This would not require a major overhaul of the power relations between local civil-society organisations and their international non-governmental donors. It would simply involve smarter planning, greater flexibility in reporting requirements and a better division of labour between NGO donors. One case study of a local NGO, BRAC (see Box 3.1.) shows that positive developments have already occurred in this area.

Second, the analysis focuses on current alignment and accountability practices within the NGO sector and concludes that there are clear shortcomings. During the last 40 years, hardly any responsibilities have shifted from Northern to Southern NGOs; the most important decisions still get made at the INGOs' headquarters. One exception is ActionAid International, discussed in Box 3.2. An increasing number of Southern CSOs, academics and policy makers challenge this *status quo* (see, for example, Afrodad, 2007; Michael, 2004 and Netherlands Ministry of Foreign Affairs, 2002). The Nordic Plus donors are reshaping the NGO aid landscape by developing civil-society funding mechanisms surprisingly close to the core principles of the Paris Declaration.

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Box 3.1. BRAC: A Success Story in Donor Harmonisation and Co-ordination

The large Bangladeshi NGO called BRAC (Bangladesh Rural Advancement Committee), which has established a pooled funding arrangement, exemplifies success in co-ordinating and harmonising donors. BRAC, a national, private organisation, was founded in 1972 as a small-scale relief and rehabilitation project to help the country overcome the devastation and trauma of the Liberation War. It focused initially on resettling refugees returning from India. Today it is one of the largest Southern development organisations, employing almost 100 000 people and working with the twin objectives of poverty relief and the empowerment of the poor (BRAC, 2005*a*). It was also the first developing-country organisation to open field offices across the world, in Afghanistan, Sudan and Tanzania as well as the United States and the United Kingdom.

BRAC's Donor Consortia

BRAC has succeeded in getting the donors for its largest programmes to work together in funding consortia. Within a consortium, each donor receives the same programme proposals and budget and then contributes to the programme like all the other donors. Once a proposal is accepted, individual donors have very little say over how their funds will be spent. This establishment of donor co-ordination represents a considerable achievement. As Sarah Michael explains:

To achieve this not only with individual donors but with whole consortia, in which donors have little say over individual components of a long-term programme and must accept this as a whole, where donors all receive the same standardised reports, and where donors sacrifice the individual prestige often available to them as the funders of a particular project or campaign, is a feat which is rarely matched by other NGOs. (Michael, 2004, p. 27).

The first donor consortium for BRAC's Rural Development Programme (RDP) was formed at the end of 1989. Eight different donors funded RDP III (1995-1999) to a total of $55 million (BMB Mott MacDonald, n.d.). BRAC now has two donor consortia (BRAC, 2005*b*), one for the BRAC Education Programme and one for the Challenging the Frontiers of Poverty Reduction Programme. The donors are CIDA (Canada), Department for International Development (DFID), the European Commission (EC), Oxfam Novib, The Royal Netherlands Embassy, The Royal Norwegian Embassy and the World Food Programme (WFP).

BRAC has engaged with the donor consortia and individual donors in a healthy dialogue of advice, response and adaptation regarding its plans (McGregor, 1998). It has formal meetings with donor representatives twice a year. These meetings have served as an effective forum for reporting progress and airing concerns for both sides. The donor consortium agrees on shared reviews and evaluations as well as a common system of reporting. In all such cases, participating donors must agree to adapt their individual reporting requirements and procedures to a single common system (CGAP, 2001).

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Benefits of Donor Consortia

According to Wright (1996), writing on BRAC and other Bangladeshi organisations, the primary argument for a joint funding approach is that all the necessary but unattractive parts of a plan, such as headquarters overheads, are properly funded and all the donors share equally or at least proportionately in these costs. Thus, an individual donor cannot select the most attractive parts of programmes to fund. This has enabled BRAC to strengthen its structure and turn itself into a learning organisation. Its strong Research and Evaluation Division (RED) has a team of 160 regular staff. RED also collaborates extensively with other research institutes, mainly in Europe, and carries out joint studies with them. (RED, n.d.; Ojanperä, 1997).

Financial Independence

The large amount of donor financing that BRAC receives accounts for only 25 per cent of its budget expenditure. BRAC itself provides the other 75 per cent of its budget through revenues from service charges as well as from commercial activities it has developed (Michael, 2004; Aga Khan Foundation, 1997). BRAC does not depend on any type of donor funding or even on the donor consortia. Avoiding dependence has been a key concern. The level of financial independence and the increasing level of power and control that BRAC has over its donors through consortia have resulted in its becoming a very powerful local NGO (Michael, 2004).

Other than BRAC, the SNGO Proshika also exemplifies joint funding arrangements, as do the pooled funding arrangements established by donors in Tanzania under the umbrella of The Foundation for Civil Society (Advisory Group on Civil Society and Aid Effectiveness, 2007, p.15).

Note: Karin Weber provided the material for this case study

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Box 3.2. ActionAid International's Radical Restructuring

Three recent changes have made ActionAid International one of the most progressive international NGOs: a new accountability, learning and planning system, an overhaul of its organisational structure and the relocation of its headquarters from London to Johannesburg.

ActionAid was founded in 1973 as a British charity based on child sponsorship and delivering specific services to individuals. ActionAid International began work in 2003, with its International Secretariat based in Johannesburg. The founding members of ActionAid International are ActionAid affiliates in Brazil, Greece, Ireland, Italy, the United Kingdom and the United States. Programmes in Kenya, Uganda, Nigeria, India, and Ghana have formed national boards and are expected to become full affiliates in the next three years. In short, ActionAid International has become a coalition of Northern and Southern affiliates fighting poverty through advocacy and lobbying at the local, national and global levels (ActionAid, 2007a; Blagescu and Lloyd, 2006).

During the 1990s, ActionAid, like many large NGOs, had rigid accountability and reporting systems characterised by central control and bureaucracy. They were designed for upward accountability to managers and donors. Fieldworkers generated information from the community and sent their data to managers, who then eventually informed donors. Within this system, staff and local partners devoted much time and effort to planning and reporting, with little scope left for learning. Voluminous reports tended to describe project activities in great detail but give less emphasis to the wider outcomes, impacts and changes perceived by the groups of people with whom ActionAid and ActionAid's partners work. These reports were in English with only a limited number of copies printed, resulting in low accessibility for partners and communities (Jordan and Van Tuijl, 2006; David and Mancini, 2003).

The Accountability, Learning and Planning System

In 1999 ActionAid introduced a new internal system called ALPS (ActionAid Accountability, Learning and Planning System), intended to create time and energy for learning and to strengthen accountability. ALPS has five central, overarching themes: *i)* increasing downward accountability; *ii)* ensuring real participation; *iii)* promoting a culture of learning; *iv)* ensuring gender analysis throughout and *v)* recognising and sharing power. (Jordan and Van Tuijl, 2006; David and Mancini, 2003). The system seeks to increase accountability to the poor and to ActionAid's partners while maintaining traditional accountability to managers and donors (Scott-Villiers, 2002). One of its radical elements is the decision to make annual participatory review and reflection processes (PRRPs) mandatory at each level of the organisation.

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Organisational Structure

ActionAid also developed a new organisational structure to strengthen co-ordination. ActionAid (n.d.) says that its previous structure enabled only minimal co-ordination and consensus between the different countries. ActionAid International seeks to build an international organisation governed and managed with vision and leadership by people from both developed and developing countries. National boards enhance legitimacy and accountability to supporters, collaborators, partners and poor people in the countries where the organisation is active. ActionAid International has an International Board of 11 members from ten different countries (the board will eventually consist of up to 21 members). Its first chair is Noerine Kaleeba from Uganda. According to Blagescu and Lloyd (2006), ActionAid International is one of only four INGOs that have institutionalised external stakeholder engagement in their corporate decision making by inviting representatives of their stakeholder groups on to their International Board as independent trustees. In addition, it incorporates strong member control over its International Board of Trustees; all affiliates represented on the board can have a say in the meeting agendas.

Move to Johannesburg

ActionAid International moved from London to Johannesburg in early 2004. According to ActionAid (2005*a*), the move represented a fundamental shift in running operations. "ActionAid International has dramatically broken the mould of a traditional development charity, where decisions were inevitably the property of the donor countries and the receiving countries were expected to be largely passive" (p. 1). The move also brought a shift from control to genuine partnership, to strengthen ActionAid's accountability to inhabitants of the countries where it operates. ActionAid International employs almost 2 000 people worldwide (almost 90 per cent from developing countries). Finally, ActionAid International (n.d.) declares itself different from other development INGOs in that their country programmes in the South control about 70 per cent of the income, spent on community and national work, while the international secretariat controls only 30 per cent.

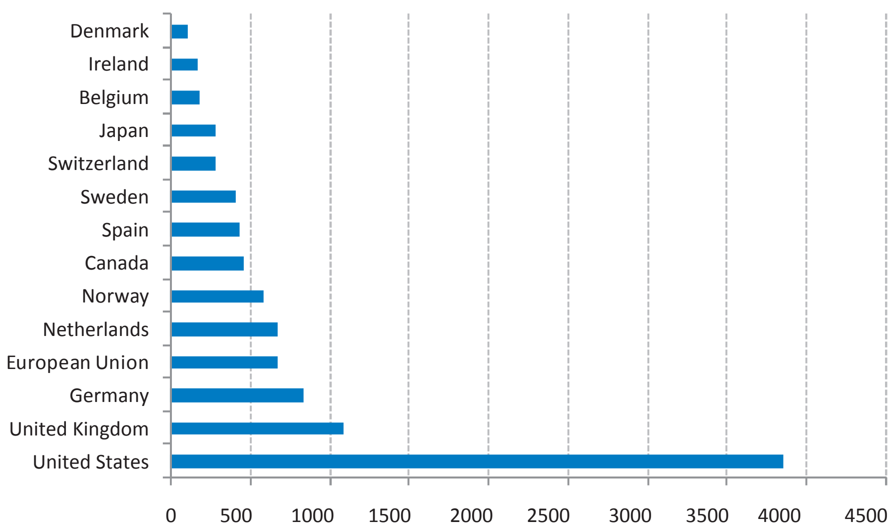
Note: Karin Weber provided the material for this case study

THE BIG NGOs ARE FAR LARGER THAN USUALLY THOUGHT

The sheer size of INGOs provides a primary reason for a "Paris Declaration" applicable to them. It has been widely underestimated. Recent estimates vary from $1.6 billion annually (AWID, 2006), to $4 billion (Agg, 2006) to $12 billion (Fowler, 2005). Gatignon (2007) estimates that the annual budget of international OECD-based development NGOs actually reached $26.9 billion in 2005. She based her finding on research using various databases and publications from, among others, the Urban Institute, Concord and the OECD/DAC. The share originating from private donations amounts to $16.5 billion and that from governmental support to $10.4 billion. The same year OECD donors provided $84.1 billion in Official Development Assistance (ODA, including aid to INGOs and excluding debt relief).

The numbers vary substantially between countries. For instance, the budget available to US-based NGOs in 2005, $16.2 billion, almost equalled that for US ODA, $19.6 billion. Conversely, Japanese NGOs received only $0.5 billion, while Japanese ODA reached $8.1 billion. These differences are noteworthy, but the key point is that INGOs are much larger than previously thought. Figure 3.1. gives an overview of the level of funding that official donors provide to NGOs in their countries, as reported to the OECD. The US government supplies the most aid to NGOs in absolute terms, followed by the United Kingdom. Ireland (25 per cent of its total aid) and Norway (21 per cent) spend relatively large amounts on international NGOs, but Japan (2.1 per cent) and France (0.5 per cent) spend relatively little.

Figure 3.1. ODA to International NGOs, 2005 ($ million)



Source: OECD International Development Statistics (Gatignon, 2007).
Note that these figures exclude private giving to NGOs.

StatLink http://dx.doi.org/10.1787/314303726005

In the late 1990s a number of academics predicted that the era of the big NGOs as financial intermediaries would soon come to an end, as they were coming to depend increasingly on public donors whose aid budgets seemed set to dwindle (Biekart, 1999; Fowler, 2000; Malhotra, 2000). Nearly a decade later the opposite has actually happened; the budgets of INGOs have increased dramatically. Despite some increased emphasis on lobbying and advocacy, most of them still operate firmly within the same resource-transfer paradigm. Figure 3.2. shows

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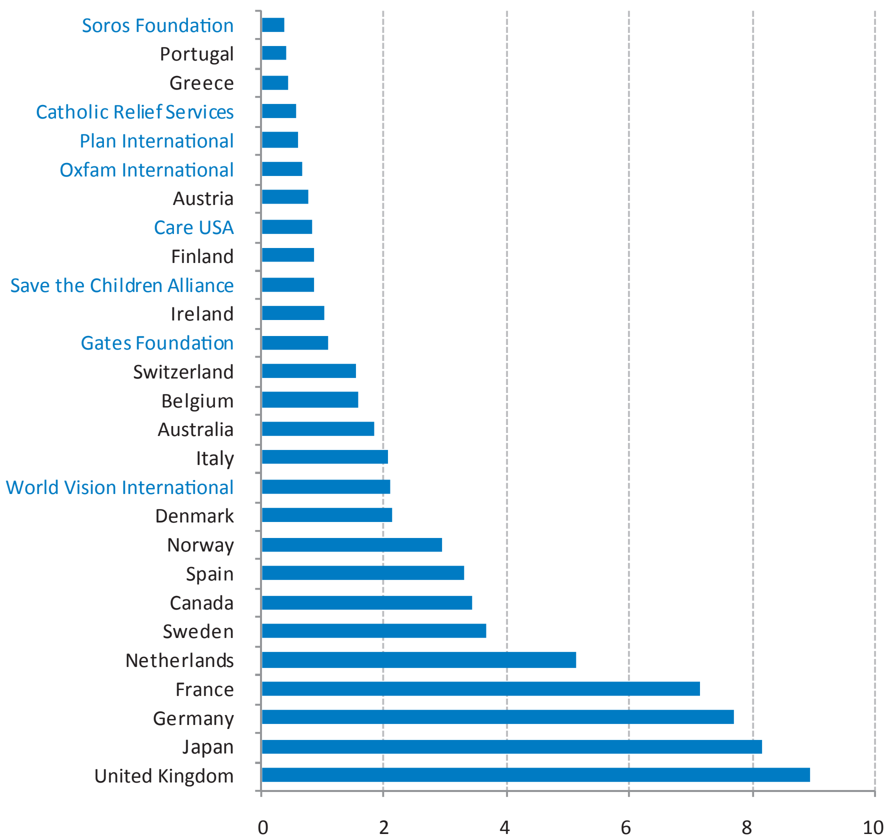
that international NGOs are large enough to enter the charts alongside the official donors (note that the United States is absent from the figure). Treating them as donors is therefore appropriate.

Figure 3.2. Budgets of Official Donors and NGOs ($ billion)



Source: OECD International Development Statistics for Bilateral aid and Annual Reports of international NGOs for NGO aid.

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INTERNATIONAL NGOS NEED CO-ORDINATION AND HARMONISATION

Problems of co-ordination and harmonisation plague official aid. OECD's 2006 monitoring report on the Paris Declaration noted 1 832 project implementation units financed by official donors and only 10 per cent of donors' field missions joint ones (OECD, 2007). How do the NGOs score on these co-ordination and harmonisation elements? A group of Swedish NGOs initiated a study in 2007 into the effects of the Paris Declaration on civil society in Kenya. Interestingly, the researchers also investigated co-ordination, harmonisation and co-operation between Northern NGOs in Kenya. Their conclusions were harsh. "Northern NGOs present in Kenya have not harmonised or aligned or even co-ordinated their activities, and even in times of crisis joint efforts have been difficult to initiate. Even among the Swedish NGOs joint or co-ordinated activities appear to be accidental" (Skalkaer Consult, 2007, p. 28). The authors conclude in their recommendations (p. 29) that "there is a need for a civil society development effectiveness process (or a Paris Declaration for CSOs)." This section highlights three of the negative aspects of the lack of co-ordination and harmonisation among international NGOs:

- The unequal distribution of international NGO activity around the world;
- The disproportionate administrative burden on well-intentioned local organisations; and
- The greater access to funding of *mala fide* local organisations.

Unequal Distribution of NGOs around the Globe

The lack of co-ordination among international organisations results in an unequal distribution of INGO activity across the globe. The distribution can be analysed from various angles, such as thematic priorities or intervention strategies, but this discussion focuses on the geographic distribution of aid, as it illustrates clearly the negative repercussions of a lack of co-ordination. It has never been mapped adequately because of the paucity of data. A new dataset using numbers from 60 of the world's largest development NGOs produces the results shown in Map 3.1., which displays per capita NGO expenditure in developing countries. Countries shown in darker shades receive greater amounts of NGO aid per capita. One can readily see that certain countries (Zambia, East Timor, Zimbabwe, Nicaragua etc.) receive more than 20 times as much aid per capita as others (Central African Republic, Yemen, Côte d'Ivoire, Pakistan, Nigeria etc.).

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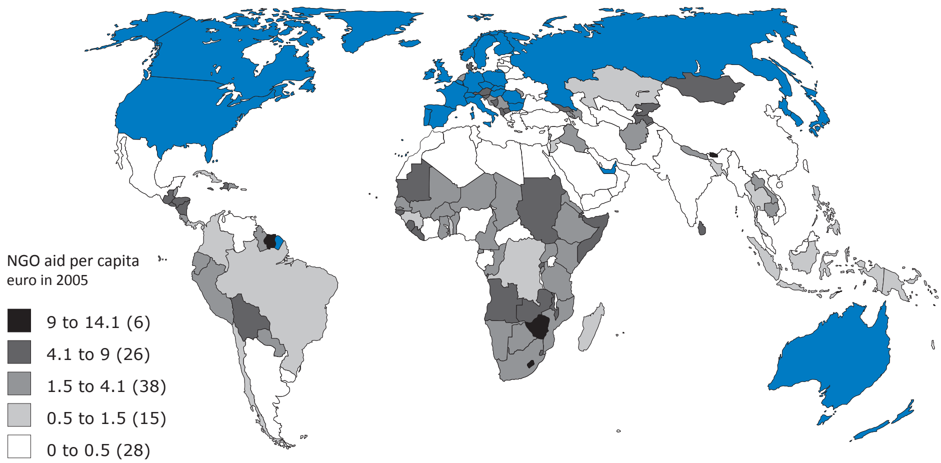
Map 3.1. Distribution of NGO Aid in 2005



Source: Koch, 2007. Brackets contain the numbers of countries that fall within the categories.

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The numbers of INGOs active in recipient countries differ widely. In some countries, such as Ethiopia, five of World Vision's organisations, seven of Oxfam's, six of Care's and 12 of Save the Children's are active, the last mostly with their own offices. In relatively small countries such as Guatemala, Sri Lanka and Zimbabwe, more than 40 of the 60 largest international NGOs have a presence — in stark contrast to Congo-Brazzaville, Yemen and the Central African Republic, where only handfuls of these organisations operate. INGOs tend to spread their resources; each is active in 44 countries on average. Unfortunately, these 44 countries are often the same for all INGOs. The families of international organisations (e.g. the Oxfam alliance or the Protestant alliance, Aprodev) conduct regular mapping exercises to establish which organisation is active where, but do not follow up with joint planning to ensure a more rational and equitable division of labour (Koch and Loman, forthcoming).

Negative consequences appear both for countries with few INGOs present and for those with many. With few international NGOs, the administrative burden on local NGOs is not a problem. They do not have to deal with more than 1 000 incoming donor missions annually or produce 2 400 quarterly reports, like the Tanzanian government. Rather, they lack donors. They are the victims of a lack of co-ordination as INGOs apparently fail to ensure a division of labour that covers all poor countries adequately. In contrast, the negative consequences of excess supply of NGO aid have become evident in recent years both in emergency aid situations (Tsunami Evaluation Coalition, 2006) and in regular aid circumstances (Laan, 2007). These consequences include the duplication of aid efforts and an increase in corruption — in short, waste of aid money. The extent to which poor co-ordination also hampers equal thematic coverage and an equal spread over intervention strategies requires more research.

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Heavy Reporting Burdens

Heavy reporting requirements weigh down many well-intentioned local organisations. Numerous signs show the negative effects on local organisations of the number of reports that international donors demand. Case studies involving Ghana (Porter, 2003), Zambia (INTRAC, 2006), India (Ebrahim, 2003) and Tanzania (Goddard and Assad, 2004) all point out that local NGOs spend a disproportionate amount of time on writing reports for donors. Porter (2003, p. 136) states: "In some countries the massive demands of the report culture… seem to be bringing Southern NGOs to their knees. In India and Mexico many NGO staff argue that they spend more time filling in forms than working directly for the poor!" Often, local NGOs are reluctant to air their concerns about these onerous report requirements, because they depend on INGOs (ActionAid, 2003). When they do feel free to share their opinions, it becomes clear that more staff time is spent on these reports than before, which diverts valuable human resources away from actual programme work (*ibid*). Box 3.1. describes BRAC, which succeeded at the very beginning of its operations in harmonising and co-ordinating its donors. This has undoubtedly helped it to become one of today's largest Southern development NGOs.

Why do Northern NGOs not harmonise their reporting requirements more? There are three apparent reasons, despite the scope for improvement and the potential major advantages for local organisations:

- They have an ambiguous attitude towards harmonising their own procedures (Capacitate, 2007). While recognising that more harmonisation would increase efficiency, many of them claim a trade-off between diversity, the trademark of a healthy civil society, and harmonisation. They feel that if they harmonise their procedures they will have less ability to support marginalised groups, social movements and atypical organisations. They fear that they could then fund only small numbers of well-established organisations (Advisory Group on Civil Society and Aid Effectiveness, 2007). This fear is understandable but not reasonable, because the key issue is not whether organisations harmonise, but how they do so. On evaluation, for instance, Dutch organisations have shown that pooling resources for joint evaluations yields benefits. Joint evaluations generally have better quality, are less burdensome for local partners and promote inter-organisational learning without leading to the drawbacks often attributed to alignment and co-ordination (GOM, 2003).
- They have stringent reporting requirements *vis-à-vis* their back donors. Independent auditing firms such as KPMG (2004) have encouraged back donors to harmonise their procedures regarding NGOs, but they have made no progress. Even organisations (e.g. Dutch and German ones) with very similar reporting requirements to their back donors do not succeed in harmonising their procedures.
- Harmonisation apparently incurs high start-up costs for NGOs. Such initial costs are well documented for bilateral aid, and they are probably even higher for NGOs, given the greater numbers of donors and recipients.

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Briefcase NGOs

A third negative repercussion of the unco-ordinated and unharmonised operations of Northern NGOs is the rise of the "briefcase NGOs", now a common term. These local organisations are often one-person enterprises, little more than single entrepreneurs and their briefcases. They specialise in writing proposals and reports but are bad at nearly everything else (May and Magongo, 2005; Mercer, 2003). The lack of information sharing among INGOs has enabled these local entities, which lack constituencies, members or popular support, to dance with the donors. When a donor finally comes to realise that a local organisation is not living up to expectations or is even corrupt, and then cuts its funding, the local organisation simply looks for and often finds another donor. The numbers of self-regulating systems within the non-profit development sector (e.g. the International NGO Accountability Charter) are increasing, often initiated by apex bodies or umbrella organisations. These highly relevant initiatives go some way toward addressing the problem, but they have yet to overcome the information-sharing deficit that lets dubious local NGOs thrive.

To sum up, various efficiency gains can be realised through increased harmonisation and co-ordination. The first arises from improved targeting and better distribution of resources. The second relates to reduced overhead costs for local organisations, which can spend more money on their actual work rather than on writing reports and receiving incoming field visits. The third relates to decreased leakage of aid as the number of fraudulent local recipients declines.

HOW DO INGOs PERFORM ON ALIGNMENT AND ACCOUNTABILITY?

Official donors started to develop and implement the Paris Declaration partly because of their dismal record on alignment and accountability. The 2006 OECD survey on the Paris Declaration found that on average only 42 per cent of donor aid gets recorded in the budgets of recipient countries and thus is open to scrutiny by their parliaments. It also found that only 44 per cent of the recipient countries had some kind of mutual accountability system, which enabled recipient governments to compel donors to stick to their commitments. How do the international NGOs perform with respect to these important principles?

A recent statement on the Paris Declaration by Southern NGOs included clear recommendations regarding Northern NGOs: "Northern CSOs should be transparent and accountable to the Southern CSOs by declaring the full amounts they receive from donors in the name of Southern CSOs"; and "Donors should enhance direct funding to Southern CSOs and reduce the role of intermediary agencies." (Afrodad, 2007, p. 2). The Netherlands Ministry of Foreign Affairs has gone so far as to claim in a letter to the Dutch parliament that; "The transfer of tasks and responsibilities to Southern organisations has been insufficient… a fundamental repositioning of Northern international aid agencies is needed" (Netherlands Ministry of Foreign Affairs, 2007, p. 1). Statements like these

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indicate that alignment and accountability practices among Northern NGOs require attention.

The definition of "alignment" in any future Paris-like declaration for NGOs would differ from that which applies to official aid. Alignment does not refer to the need to adapt support to the strategies of recipient governments, but rather to the agendas of developing-country NGOs. The last thing that this Chapter seeks to suggest is that all aid to those NGOs should fall within the parameters of the national poverty-reduction strategies of recipient-country governments. Local NGOs need encouragement to develop their own agendas, which may at times complement the efforts of national governments but may equally run counter to them. This is one reason why local organisations deserve support. The desired form of accountability in any future declaration for NGOs ought not to deny that INGOs need to be accountable to their constituents and their donors. It should stipulate mutual accountability between Northern organisations and their Southern partners.

Three key elements of the Paris Declaration on alignment and accountability are: *i)* predictability of aid flows; *ii)* avoiding parallel implementation structures; and *iii)* alignment of support to national (*in casu* organisations') agendas. Deeper underlying power imbalances between Northern and Southern NGOs also drive accountability and alignment deficiencies. This section highlights both legal disempowerment of local NGOs and financial imbalances.

Predictability of NGO Aid Flows

The predictability of aid flows from INGOs to their partners has two aspects. A positive element is that there are few signs of delays. This contrasts starkly with official aid, which is plagued by slow disbursement (Save the Children UK, 2006). In fact, aid flows from NGOs to their partner organisations are fairly stable (Koch and Loman, forthcoming). A problem that the partner organisations encounter is the failure of INGOs to guarantee that they will continue funding after the expiration of contracts. This creates a sense of instability and reduces long-term investment by local organisations (Ashman, 2001).

Parallel Implementation Structures

The extent to which INGOs have developed parallel implementation structures differs widely. A substantial number, notably nearly all Dutch and German ones, made a strategic decision in the late 1980s not to open more field offices and to shut down existing ones. Local organisations initially criticised this decision because it increased the distance and decreased the frequency of contacts (Steering Committee, 2002). In light of recent developments, however, local organisations now widely regard these kinds of decisions as judicious, because they now face increasing competition from the local subsidiaries of INGOs. With increasingly decentralised funding, Northern organisations constantly open field offices in developing countries and compete for the same contracts as their erstwhile partners (Smillie and Minear, 2003). This attracts significant criticism

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from local NGOs. Local subsidiaries also implement projects themselves. Care, for example, has 14 500 employees worldwide (more than the IMF and the World Bank combined). A number of big organisations have large-scale service-delivery programmes akin to those run by local governments. The only difference is that the NGOs cannot be voted out of office if they do not perform (World Bank, 2005). This criticism can also be levelled at BRAC, although it performs well on harmonising and co-ordinating its donors.

Alignment with Local Agendas

The literature on the relationship between Northern and Southern NGOs is most replete on the extent to which the former dominate the latter's agendas. This domination manifests itself in the themes that organisations select, how they work and which discourse they use. As one representative from a workshop on the relationship has said, "… if you want funding, you have to make sure you include the words 'sustainable livelihoods'" (ActionAid, 2003, p. 7). Multiple accounts relate how Northern organisations dictate to their Southern partners and the feelings of disempowerment that this causes. It would be superfluous to repeat what others have said in this respect (e.g. Townsend *et al.*, 2002; Wallace, 2000). Instead, an attempt to highlight the legal and financial barriers that explain the perpetuation of this imbalance can illustrate why INGOs adhere insufficiently to central principles of the Paris agenda, such as alignment and accountability.

Legal Disempowerment of Local NGOs

Three types of legal impediments skew power relations away from Southern organisations and thus hamper adequate alignment and accountability practices of international NGOs:

- Few legally formalised feedback mechanisms within Northern organisations;
- Funding restrictions; and
- The absence of other feedback mechanisms.

Legally formalised feedback mechanisms within the INGOs

The Paris Declaration is very clear on the need for increased mutual accountability, and formalised feedback mechanisms are integral to it. In the INGOs they are very weak.

Boards or councils of trustees govern nearly all international NGOs. Despite differences in the amount of power that they delegate to the NGOs themselves, they remain legally responsible for the organisations. A measure of the power of citizens and organisations from developing countries lies in whether they have representation on the INGOs' governing bodies. An analysis of such bodies for a representative sample of 55 of the largest development NGOs worldwide shows that they have a total of 693 members, of whom a mere 42 — 6 per cent — come

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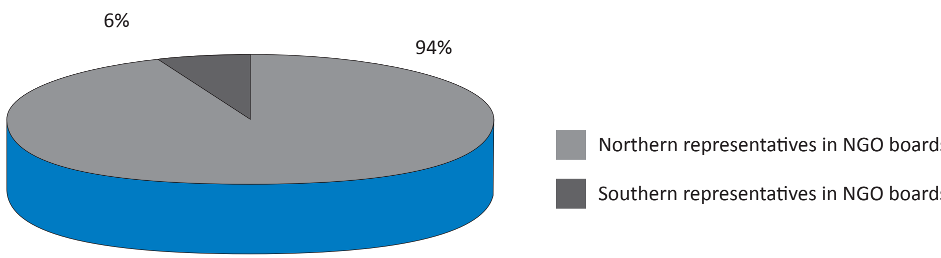
from developing countries (Figure 3.3.). The percentage is lower still in terms of whether these board members have official functions (e.g. chairperson, treasurer, secretary). Certain countries place legal restrictions on numbers of foreign board members. In Belgium, for example, at least half of NGOs' board members needed to have Belgian nationality until 2002. Also, understandably, organisations may restrict board membership for recipients to avoid conflicts of interest (Dietz and de Ruyter, 2007). Nevertheless it seems paradoxical that international NGOs, which actually developed the term "empowerment", grant their partners even less power than that of, for example, pupils in high schools, patients in hospitals and students in universities. In nearly all developed nations, the clients of non-profit institutions have a voice in their management. If they are not represented directly on governing boards, legally binding participatory principles apply. Clients, students or patients elect their representatives, who can in turn participate in decision making. Sometimes this role is confined to issuing non-binding advice, and sometimes certain elements are exempt from potential involvement. Nonetheless, some type of mutual accountability exists.

Figure 3.3. Developing-Country Members of Boards of International NGOs



Source: Annual reports of international NGOs.

StatLink http://dx.doi.org/10.1787/314374544887

The absence of such an institutionalised feedback loop from the NGO world has attracted criticism from eminent scholars in the field. The leading institute on NGO practices has long argued that "Northern NGOs need to strengthen and formalise their mechanisms for receiving feedback from Southern partners." (INTRAC, 2001, p. 5). Blagescu and Lloyd (2006) state in The *Global Accountability Report 2006* that a simple countervailing-power instrument like a complaints procedure is more common and better developed in the for-profit sector and in institutions such as the World Bank than in international NGOs.

Some progress in developing feedback loops has occurred. Partner consultations do take place, but they are non-binding. Some NGOs have started to experiment with international advisory councils, but often poorly define their competences. Experiments with partner-satisfaction surveys have been tried too, to gather statistical information about the opinions of local NGOs on the INGOs. Nevertheless, recipient-country organisations and individuals generally have few formal intra-organisational mechanisms for influencing INGO policies. ActionAid is an exception (see Box 3.2.).

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Funding restrictions

The opportunities for developing-country organisations to apply for funding directly from official donors are limited, especially in capitals, where the largest sums for civil society funds are available. Nearly all donors restrict their co-financing schemes to their national organisations. This actually resembles aid tying, where the nationality of goods and service providers becomes more important than portfolio quality. The Dutch Ministry of Foreign Affairs opened its non-decentralised funding to all Southern organisations and organisations from other donor countries in 2002, but had to abandon this in 2004 after an amendment by the Dutch parliament (Steering Committee, 2006).

The only co-financing system that systematically allows Southern organisations to apply for funding at the headquarters level is that of the European Union. Most proposals for these budget lines must be joint proposals with Northern organisations. Developing-country NGOs prefer this approach because it ensures their involvement earlier and better in the drafting of grant proposals. A recent statement on aid effectiveness by Afrodad (2007, p. 2) says, "Joint proposal writing by both the Northern and Southern CSOs should be encouraged in fundraising for aid from donor countries."

The absence of other feedback mechanisms

One final legal imbalance merits attention: the meagre extra-organisational formal procedures at the disposal of Southern organisations and individuals to influence Northern organisations. The dominant role played by donor-country parliaments has already been illustrated by the effective abolition of direct centralised funding to Southern NGOs in the Netherlands. Martens *et al.* (2002) provide an insight into why "the broken feedback loop in aid" persists. They claim that ultimately the domestic suppliers of goods and services in the aid sector, such as consultancy companies, export credit agencies, experts and NGOs can end up as the beneficiaries of aid. They are part of the constituency of decision makers in donor countries; meanwhile, the intended beneficiaries' interests are geographically and politically too remote to rival the influence of these direct beneficiaries. Indeed, Northern governments and parliaments rarely consult Southern organisations directly when deciding on future support to NGO aid.

Financial Imbalances

Alongside legal or formal imbalances, there is an apparent financial imbalance, to a certain extent an inevitable one because most of the finances pass through the INGOs. Yet certain underlying financial systems contribute unnecessarily to the unequal relationship between INGOs and their local partners. They reflect weak alignment and accountability and reduce their potential strengthening. The two main elements that appear to do the most harm are:

- Disadvantageous contracts for Southern NGOs; and
- Their lack of local fundraising.

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Disadvantageous contracts for Southern NGOs

A striking difference persists between the contracts that INGOs sign with their back donors and the ones they sign with recipients. One study of Dutch co-financing agencies, for instance, showed that while Dutch NGOs often receive core grants (institutional subsidies, which organisations can spend on overheads and programmes alike), they did not grant core subsidies to their partners (CIDIN, 2006). Whereas Northern NGOs' contracts often last for around four years (Koch *et al.*, 2007), the relationships they have with their Southern partners are often shorter. Their unwillingness to finance the organisational development of developing-country organisations is well documented (Bornstein, 2003; Cooley and Ron, 2002; Low and Davenport; 2002). They appear to be more often interested in executing their specific projects than in strengthening the capacity of Southern organisations (CIDIN, 2006).

Certain invasive regulations illustrate disadvantageous contractual terms. American organisations are known to have particularly intrusive anti-terrorism (Fowler, 2005) and anti-sexual and reproductive-rights regulations (Centre for Reproductive Rights, 2003). Local organisations can receive money from USAID only if they pledge that they will not, even with their own money, work with sex workers or have contact with people or organisations on a terrorism list. The European Commission has very precise financial regulations that infringe the ownership of local organisations (Partners Limited, 2005). There are also significant differences between Northern organisations with respect to the contracts they sign with Southern NGOs. Continental European NGOs have traditionally kept their local partners at arm's length and handed more responsibility to them, while American NGOs have top-down implementing structures all the way down to the community level (Ashman, 2001; Morse and McNamara; 2007).

Room thus exists to create more equal funding relationships. Donor consortia offer a particular example of such relationships (Box 3.1. describes one). In them, INGO donors commit themselves to fund the core costs of local organisations on an equal basis and to reduce the administrative burden on local organisations by allowing one report for all donors and planning joint missions, reviews and evaluations. Studies have shown that donor consortia tend to lead to decreased power for local organisations in the beginning, as they can no longer play the donors off against one another; but in the end they create stronger and more powerful local organisations (Wright, 1996). Local organisations can develop their own strategic plans to which international donors can then contribute, which leads to stronger organisations in the long term. This is precisely the direction in which the official donors are moving, and there is no obvious reason why non-governmental organisations should continue with project-based, individual reporting practices.

Local fundraising for local organisations

More local resource generation seems essential for a more equitable financial relationship (Vincent, 2007). Local organisations remain highly dependent on

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international funders. Levels of dependency are high at 76 per cent in Tanzania, 72 per cent in the Central African Republic (Koch and Ruben, forthcoming) and 80 per cent for recurrent revenue in Uganda (Barr *et al.*, 2003). Dependence is much lower in Bangladesh (Gauri and Galef, 2005). Most local organisations have become too dependent on donors, with well-known consequences. Dependence contributes to a lack of downward domestic accountability, just as happened to recipient governments that became too donor dependent. It is no accident that all the NGOs that Michael (2004) considers powerful have strong internal revenue-generating mechanisms. This allows them to set and develop their own priorities, bargain with donors and maintain functional frame organisations. Despite recent attempts to enhance local revenue-generation capacities (Cordaid, 2005), many local organisations prefer the relatively easy-money flow from donors to the even more tedious process of local fundraising. This is understandable in the short term, but it contributes to perpetuation of financial imbalances.

To sum up, severe imbalances persist between Northern and Southern NGOs, and they affect negatively the performance of Northern NGOs on key principles of the Paris Declaration, alignment and accountability. The broken feedback loop in international NGO aid leaves local organisations and individuals with few formal mechanisms to influence the policies of INGOs that affect their activities. They are marginalised. Moreover, certain financial practices, such as the way contracts are structured and the low independent resource base of local NGOs, hamper their development. Financial and legal imbalances both contribute to poorly developed alignment and accountability practices in the NGO sector and are expressions of it. If the principles of the Paris Declaration are to become the guiding philosophy of the international NGOs, they need to be addressed.

Some of the Nordic Plus donors are already making significant progress towards bringing their NGO aid more in line with the principles of the Paris Declaration. A recent study of these donors shows that in an increasing number of countries their embassies are coming together and developing decentralised co-financing systems (Scanteam, 2007). Such actions often follow the principles of the Paris Declaration more closely than financing systems currently used by NGOs in terms of, for example, harmonisation and co-ordination. The proof of the pudding will be in the eating, but first signs indicate that this will lead to longer-term gain to all parties as resource flows to local organisations become larger, more predictable and more often in the form of core funding than under traditional methods. Reporting requirements also become streamlined, reducing transaction costs.

One example of the changes set in motion by the Nordic Plus donors is the Foundation for Civil Society in Tanzania, now governed entirely by Tanzanians. Enormously successful, the Foundation operates under a joint Memorandum of Understanding with seven embassies. The development partners have signed four-year contracts that include core funding. The Netherlands Ministry of Foreign Affairs has signed a contract worth $8 million; the CIDA contract amounts to $4 million and the Danida contract to $3 million. The size and the terms of the contracts are unheard of for African NGOs. They indicate that certain donors are prepared to make real headway towards NGO aid following the principles of the Paris Declaration.

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CONCLUSION: A Paris-like Declaration for NGOs is Much Needed

This chapter has highlighted deficiencies in co-ordination and harmonisation among international NGOs. Their disproportionate concentration in certain geographic areas, the unduly heavy reporting burden on local organisations and the opportunities for *mala fide* local organisations are all negative repercussions. The performance of international NGOs with respect to accountability and alignment has been suboptimal, leading among other things to decreased ownership of local organisations. Legal and financial obstacles appear as both causes and symptoms of the current underdeveloped alignment and accountability practices of INGOs. A broken feedback loop in NGO aid appears in the virtual absence of local organisations and individuals from the governing bodies of international NGOs and in the absence of complaint procedures. Certain financial imbalances between Northern and Southern organisations surface in a comparison of contracts that Northern NGOs sign with their back donors with those they sign with their Southern partners. The latter often hamper partners' organisational development. Low local fundraising aggravates this problem.

Various NGO-led initiatives attempt to improve current accountability, co-ordination, harmonisation and alignment practices. The international NGO accountability charter provides a good example, as does the Sphere Project (a Humanitarian Charter and Minimum Standards in Disaster Response). These joint NGO efforts to strengthen performance by common codes of conduct and charters merit praise. Unfortunately, they mostly do not exceed the noncommittal stage. A few progressive institutions have taken critical steps towards bringing NGO aid better into line with the Paris Declaration principles. The examples of ActionAid International and BRAC as well as the joint, decentralised funding schemes of the Nordic Plus donors show that change does not come about easily, but can have a major positive impact on the effectiveness of NGO aid. Such initiatives need deepening, expansion and acceleration. The NGO community needs a Paris-like declaration.

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CHAPTER FOUR

Private Banks in Emerging Democracies

ABSTRACT

Private capital movements have risen in recent decades, and bank flows have been part of this story. Some empirical studies have analysed the political drivers of private international liquidity, but paradoxically very few have looked at the political economy of bank flows. Even less research exists on the role of politics in explaining cross-border banking movements towards emerging democracies. This Chapter provides an empirical investigation of the political economy of cross-border bank flows to emerging markets and tries to answer two questions. Do bankers tend to prefer emerging democracies? Do they reward democratic transitions as well as policy and political stability? One of the major findings is that politics do matter, and international banks tend to have political preferences; annual growth in bank flows usually booms in the three years following a democratic transition, especially in Latin America.

Javier Rodriguez and Javier Santiso

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INTRODUCTION

Private capital movements have risen in recent decades, and bank flows have been part of this story. Academics and policy makers have seen such movements as both panacea and anathema. Some empirical studies have analysed their political drivers, but paradoxically very few have looked at the political economy of banking. Hardly any research exists on the role of politics in explaining cross-border banking movements. Bankers' democratic preferences are particularly under-researched. We need to know more about banks' political preferences and their potential impact on both economic and political development.

A new agenda is emerging for private international banks. Political issues such as human rights do appear on their radar screens. But what about democracy? What about political regimes? Do private banks take them into account in decisions on whether to invest in a country? Put another way, do they have political preferences? This paper will show that banks tend to love democracies more than initially suspected, particularly emerging ones (an argument that remains to be tested once China experiences a democratic transition).

This paper focuses only on the specific set of private flows involved in cross-border lending by international banks. The questions raised are narrow. Do banks react positively (i.e. with increased lending) when an emerging democracy appears? Do they do so after democratic transitions? Is there any relation between democratic consolidation and bank lending?

The issue is not whether private banks prefer democracies worldwide but whether they contribute to political development and reform ownership by lending to emerging democracies.[1] Their overall democratic preferences emerge quickly from a look at cross-border banking claims. By the end of 2005, the stock of cross-border claims of Bank for International Settlements (BIS) reporting banks was $21 450 billion (BIS, 2006), with most of the claims directed to developed OECD economies, all democracies. Only $2 396 billion, less than 11 per cent of the total, went to emerging market economies, with most of that to emerging democracies such as South Korea, Brazil and Mexico. China concentrates a stock of only $114.6 billion in cross-border bank claims, less than 0.53 per cent of the world stock. Banks therefore clearly prefer lending (more than 99 per cent of their claims) to democracies. This is not surprising or new information. It is more interesting to look at whether banks tend to prefer lending to new, emerging democracies. Do they react to democratic transitions and are they sensitive, once transition is achieved, to democratic consolidation? Much research has covered the contribution of banking to economic development but none has focused on how bank lending affects political development.

This Chapter uses newly compiled sets of indicators on democracy, political stability and policy certainty, linking these datasets with international banking flow data developed by the BIS. This allows empirical investigation of the political economy of cross-border bank flows in emerging markets and thus a contribution to the rapidly growing literature on the determinants of international private

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capital flows and the overall analysis of the political preferences of bankers regarding democracy.

The chapter proceeds as follows. It first reviews the literature on the issue and develops a theoretical argument on why banks should prefer emerging democracies. It then focuses on the political economy of bank flows to emerging markets in order to gauge whether bankers have a political regime preference. It also specifically discusses banking activity in Latin America, a region where democratic transitions have been very dense, and rival political hypotheses such as the influence of policy instability.

THE POLITICAL ECONOMY OF BANK FLOWS IN EMERGING MARKETS: A REVIEW

Private capital flows towards emerging economies have surged in recent decades, far surpassing public official flows. The paradox is that until recently little empirical research has analysed the drivers of private international bank activity (Sapienza, 2004). Although some surveys examine the factors behind international banks' decisions to establish operations overseas, especially in developing countries (Galindo *et al.*, 2003; Buch, 2003; Wezel, 2004) and the economic determinants of cross-border claims (Buch and Lipponer, 2004), studies have not focused on political variables and institutions that might explain cross-border bank movements.

The institutional and political environment can strongly influence international capital transactions. Scholars have growing interest in how strongly law and politics are key drivers of international private capital flows (Rajan and Zingales, 2003) and financial crises (Santiso, 2006; Martínez and Santiso, 2003; Stein and Streb, 2004; Whitehead, 2004). Empirical studies have highlighted that corruption exerts a distortionary influence on growth and FDI (Mauro, 1995; Wei, 2000a; Wei, 2000*b*). The quality of legal systems has a strong impact on financial development (Djankov *et al.*, 2003) and particularly on M&A (Rossi and Volpin, 2005) and project finance deals (Esty and Megginson, 2003).

The Lucas paradox — i.e. that in theory capital should flow from rich to poor countries, but in practice it does not (Lucas, 1990) — has been explained as resulting from institutional quality (or lack of it). Empirical evidence for 1971-1998, based on cross-country regressions using a sample of 50 countries, shows that the most important variables in explaining the paradox are secure property rights and non-corrupt governments (Alfaro *et al.*, 2003). Another study (Alfaro *et al.*, 2005) confirms these findings, showing that the historical determinants of institutional quality had a direct effect on private capital flows during 1970-2000. Good institutions and/or bad monetary policies are also important in explaining the high volatility of capital flows during that period. A country that improves its institutional framework and increases its growth will receive more private capital flows. Countries that have better institutional quality and lower policy volatility will receive more stable capital flows. Countries with lower inflation volatility

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tend to experience less uncertainty in terms of capital inflows. For FDI, empirical evidence suggests that political variables are important and that multinational firms prefer to invest in democracies[2]. In sharp contrast to official development assistance by Western governments, which registered negative net flows to newly democratic regimes in the three years after transition, private direct investors significantly increased FDI in the three years following shifts to democratic rule in 23 countries since the mid-1970s (Pei and Lyon, 2003)[3].

Politics also matter for the more direct impact on banking dynamics. Governments are not disinterested parties in financial systems. They set the rules of the game and the security of financial contracts, for example. World history is full of examples of the strong links between political institutions and the development of financial systems, as highlighted by neo-institutionalist economists and historians. The decision to privatise banks is highly political (Clarke *et al.*, 2004), and in emerging economies, public or private bank ownership matters for performance; politics interfere with banking performance (Micco *et al.*, 2005).

Another recent empirical analysis uses quarterly data on gross bilateral private banking transactions between 19 source and 51 recipient countries from the mid-1980s until 2002 and employs various panel methodologies. It highlights politics and institutions as key determinants of international private banking activities (Papaioannou, 2004). This research, including not only inter-bank loans but also significant amounts of portfolio and FDI flows related to bank activity, shows that a fall of 5 per cent in the political risk of the recipient country is accompanied by a 2 per cent rise in the volume of bilateral bank lending. The results are quite impressive because they show as significant all forms of risk identified in previous studies, namely economic, financial and political risk (Erb *et al.*, 1996). The most important of the three in explaining foreign bank capital movements is political risk, which confirms the findings of previous researchers (Gelos and Wei, 2002). Other key results showed that well functioning institutions are key drivers of international bank flows. Banks tend to invest more in countries with non-corrupt bureaucracies, high-quality legal systems and non-government controlled banking systems. Corporate governance practices and political reforms such as privatisation can significantly increase the liquidity of domestic financial intermediaries and thus foster local investment.

Other studies have emphasised that legal systems can explain the specific formats of international bank contracts. Government ownership of banks around the world is associated with weak growth rates, weak protection of property rights, lower productivity, weak bank performance and low levels of financial development (Barth *et al.*, 2001; La Porta *et al.*, 2002). State-controlled financial systems tend to promote political rather than profit-maximising objectives. The Papaioannou (2004) estimates suggest that an increase of 1 per cent in a government's holdings in the banking system decreases the level of cross-border bank lending by 1.6 per cent. As suggested by García-Herrero and Martínez-Peria (2004), the claims of US, Spanish and Italian banks in 90 countries tend to be sensitive to transaction costs (informational costs) but also to government intervention in the financial sector as well as country risk, which includes not only economic and financial variables but also political factors. These results fall in line with other

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studies that have emphasised economic and political determinants of foreign banking activity (Martínez-Peria *et al.*, 2005).

These studies highlight that foreign banks seem particularly concerned with political risk when considering investing and lending abroad. They tend to invest in countries with high-quality institutions and to allocate credit to countries not characterised by corruption and with efficient legal systems. The results imply that improving the efficiency of bureaucracies in recipient countries, tackling the issues of corruption and enhancing legal systems, particularly financial ones, are crucial in attracting foreign banks. The question of political regime preference remains untouched by most of these studies, however. Do international private banks have a democratic preference when considering their activity in emerging markets? More specifically do they increase or decrease their bank lending after democratic transitions? And why?

Banks are not homogeneous and their activities worldwide are quite diverse[4]. This study considers only private banks, not multilateral development banks. The BIS international banking database tracks only private bank lending. Analyses of multilateral bank lending as well as Official Development Assistance merit specific studies, although international development finance has already caught the attention of many scholars. There is a particular abundance of literature on the politics of development lending and of international debt (for an extensive review see, for example, Carlos Santiso, 2004). An interesting historical study could compare bank lending behaviour before and after the debt crisis of the 1980s, checking in particular behaviour during the 1970s[5] when democratic breakdowns multiplied. Because of the lack of BIS data for the period this is not feasible.

The chapter also focuses on a specific banking activity — lending flows — for which there is a large and complete dataset available from the BIS. Banks are in fact very large entities and their activities range from bank lending to portfolio investments, through their fund-management subsidiaries, for example. Some are also involved in remittance business or insurance activities. For some banking activities abroad a lack of disaggregate data prevents the kind of analysis presented here. For example, there are hardly any data disaggregated by country (including emerging economies) on international derivative contracts comparable to the BIS data on bank lending and borrowing.

The BIS data include banking claims and liabilities, i.e. information on lenders and borrowers. The focus here lies on lending rather than borrowing (liabilities being the counterpart of claims and reflecting in the end the same kind of information). One question is set aside because of a lack of data. The BIS data set does not include disaggregated data on borrowers. Further research using other datasets (probably country case studies) could examine whether bankers in non-democracies tend to differentiate between borrowers. Do they discriminate between sovereign, authoritarian governments (and sub-national authorities) and private borrowers? This would test whether banks differentiate between undemocratic governments and their suffering subjects when making credit decisions.

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The BIS monitors the foreign claims held by mostly OECD-country banks on the rest of the world. It provides the most comprehensive data on international banking activity. It defines the claims as those extended by international banks to residents outside the countries in which the banks are headquartered. Foreign claims may cover financial assets such as loans, debt securities and equities, including equity participation in subsidiaries. The BIS data allow study of stocks or flows of claims or liabilities, and they differentiate them by countries but not by public and private borrowers in specific countries. The analysis here centres on flows, i.e. new claims, rather than stocks in order to test whether international private banks react positively or negatively to democratic transitions, and whether they increase or decrease their lending with the later consolidation of democracy. This enables evaluation of the political development contribution of banks. They are known to be key actors in economic development in emerging countries (as well as developed countries) but do they also contribute to their political development? Between 1980 and 2005, more than 80 countries took significant steps towards democracy, particularly in Latin America and Eastern Europe. For that reason, Latin American and Eastern European countries receive special attention.

In Latin America, the number of countries functioning as democracies — defined as regimes where governments come to and remain in power as the result of contested elections — peaked at over 80 per cent in 1989 and has remained at that level ever since. Eastern European countries also experienced a massive shift in political regimes, all of them becoming emerging democracies over the past two decades. Meanwhile, private capital flows towards emerging markets skyrocketed. Private international banks pour large amounts of money into emerging markets through their lending operations, but FDI has pride of place. Privatisation opened windows of opportunity and international banks invested heavily in emerging markets. In Latin America foreigners, especially Spanish banks, invested large amounts. In Central Europe, foreigners have also bought or built 80 per cent of the top local banks since the fall of communism, Austrian and Belgian banks being particularly involved. Both in Latin America and in Eastern Europe, private international bank lending has also been very active.

BANKS’ PREFERENCE FOR EMERGING DEMOCRACIES: HYPOTHESIS AND ARGUMENTS

Why would banks prefer emerging democracies? Why would emerging democracies be good business for them? In making decisions, bankers analyse key policies, especially fiscal, monetary and trade policies. More generally, other variables such as privatisation and growth have been identified as basic drivers of banking activity and entry into countries. In considering all the variables, this paper centres attention on young democracies.

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Look first at the key policies. Empirical research shows a complex relationship between democracy and fiscal policy. Democratically elected politicians are supposed to be prone to seek to minimise taxation and maximise spending, leading to an increase in budget deficits. Some studies find no significant relationship between countries' level of democracy and their average spending on social security and education (Mulligan *et al.*, 2004). Many others (Tavares and Wacziarg, 2001; Block, 2002; Block *et al.*, 2003; Keefer, 2005) indicate, as suggested by Converse and Kapstein (2006) that young democracies tend to exhibit initial increases in public spending, with current expenditure picking up in election years and followed later by a long-term decline. Brender and Drazen (2004) find also that political budget cycles are strongly present only in newly democratised countries. In a sample of 68 democracies from 1960 to 2001, the traces of political budget cycles appear in the first four elections following democratisation. Thus emerging democracies' financial needs tend to increase in the very first years of their existence, leading them to boost their borrowing activity and to become potentially good clients of international banks.

Given monetary policy's importance to the economic well-being of banks, one must also question how young democracies perform in this regard. Several studies reveal that democratic institutions enhance the quality of monetary policy making. As Converse and Kapstein (2006) underline, young democracies perform quite impressively on inflation; from an average of 125 per cent the year of the democratic transition, consumer price inflation drops to around 50 per cent on average in four years. This pattern is not uniform among regions, however. In Latin America, where hyperinflation has been very damaging, levels of inflation, while reduced, have remained very high four years after democratic transition; on average they reach 390 per cent in the year of transition and 123 per cent four years later, still high and damaging for banks. Yet the more general trend characterises the major recipients of bank lending, also the major countries of the region. In countries such as Mexico, Brazil or Argentina, inflation has slowed dramatically in the years following democratic transitions and above all after democratic consolidations.

Good trade policy also leads to more banking activity, particularly increased lending through trade finance and export credits. Several studies corroborate the theory that democracy increases trade openness. Milner and Kubota (2005) show, for example, that higher levels of democracy are associated with more liberal trade regimes, particularly in newer developing-world democracies. These findings are consistent with other studies showing greater degrees of democracy significantly associated with higher trade-to-GDP ratios. Converse and Kapstein (2006) found in their 114 cases of democratisation between 1960 and 2003 that such trade ratios increased by nearly 10 percentage points in the three years following democratic transitions, jumping from an average of 59 per cent of GDP in the year of transition to 69 per cent of GDP three years later[6].

Privatisation in young democracies also tends to favour more banking activity. Privatisation operations are highly attractive for banks, implying high fees for those involved as advisers and lucrative lending operations to finance takeovers by private operators. Several empirical studies document that democracy is substantially and significantly associated with the extent of privatisation (for a

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review and analysis see Biglaiser and Danis, 2002). Democracies privatise more than non-democracies and young democracies especially use heavy privatisation programmes in order to finance increasing social demands. Privatisation has been particularly intensive in Latin American and Eastern European emerging democracies. Latin America accounted for 55 per cent of total privatisation revenues in the developing world in the 1990s, the proceeds reaching nearly $180 billion (Chong and López de Silanes, 2004).

All the key policies, but mainly fiscal and trade policies, tend to support greater bank lending to emerging democracies. The results are more mixed for monetary policies. Privatisation booms, particularly intense in emerging democracies, also provide good reasons for banks to support increasing lending activity. Young democracies also grow faster in the first years following transition, as Rodrik and Wacziarg (2005) show. They found in an extensive sample of 154 countries that the first five years following democratic transition saw significantly higher economic growth and lower variance in growth rates.

These conclusions on growth might not be as clear as appear at first sight, however. The link between democracy and economic performance remains tenuous. Both the theoretical and the empirical literature are split over the effects of democracy on growth. Some scholars have questioned "development" theories, arguing that democracy has a questionable and statistically insignificant effect on economic growth (Przeworski *et al.*, 2000)[7]. On the effects of democratic transition on economic development, some argue that the causality runs from economic development to a higher probability of transition to democracy (Boix and Stokes, 2003; Boix, 2003). Others conclude that transitions to democracy do not necessarily become more likely when a country is more developed as measured by per capita income (Przeworski, 2004*c*). Feng (2003) reaches the same conclusion, using large samples of countries over long periods to show that the effect of democracy on growth is statistically insignificant. He also finds, however, that political democracy has a significant impact on private investment. Reductions in political instability and policy uncertainty have a positive impact on the economy.

Still others have established strong links between democracy and growth and between the quality of institutions and long-term growth (Acemoglu *et al.*, 2005; Persson and Tabellini, 2003; Persson, 2004), or found positive effects of democracy and the rule of law on economic performance, with the latter having a much stronger impact (Rigobón and Rodrik, 2004). The relation between democracy and the rule of law is not systematic, however, as highlighted by examples in Latin America where transitions to democracy have proceeded without consolidation of the rule of law. In the absence of meaningful judicial systems, democratisation often has not culminated in the consolidation of the rule of law (Malone, 2003), a key driver of private capital flows to emerging markets.

Growth performance improves after the transition to democracy. Moreover, growth under democracy appears more stable than under authoritarian regimes. Based on a sample of 40 countries and comparing their economic performances before and after they became democratic over the past 40 years, Shen (2002) shows

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that the ten-year average growth rate is a half percentage point higher after transition to democracy. The five-year average growth rate after the adoption of democracy is even higher; a full percentage point. More than 60 per cent of the sample countries experienced growth acceleration after democratic transition. Rodrik and Wacziarg (2005) also reveal that major democratic transitions had positive effects on economic growth in the short run and tended to associate with a decline in growth volatility. Their findings are based on a large sample of countries, cover a long period (1950-2000) and confirm that particularly low-income countries experienced a short-term boost in growth after democratic transition.

Papaioannou and Siourounis (2004) arrive at a similar conclusion by analysing the evolution of GDP growth before and after permanent democratisations in 1960-2000. According to their estimates, democratisation leads on average to an approximate increase of 0.7 per cent to 1.0 per cent in real per capita growth. It is associated not only with higher growth but also less volatile growth rates, confirming previous findings (Rodrik, 1997, 1999). Democratisation has the strongest impact on growth volatility in highly unstable countries such as those in Latin America.

Persson and Tabellini (2005*a*) conducted decisive research underlining that democratisations induce growth acceleration and therefore are good for banking business. Drawing on previous and complementary research (Persson, 2004; Persson and Tabellini, 2004; Persson and Tabellini, 2005*b*) and considering different forms of democracy, they show that becoming a democracy accelerates growth by 0.75 percentage points. With an estimated convergence rate of 6 per cent per year, they also show that the long-run effect on income per capita is 12.5 percentage points. The findings are based on a very large sample of about 150 countries, include 120 regime changes over 1960-2000 and are consistent with previous studies (Papaioannou and Siourounis, 2004). Another result reveals that new presidential democracies grow on average 1.5 percentage points more than new parliamentary democracies. This is particularly interesting for Latin American countries, where presidential regimes dominate.

Other factors, more related to institutional quality and public goods outputs, may also have relevance for explaining increased bank lending in newly democratised countries. Democracies have more incentives to provide benefits for the public than do autocracies. They tend to be much more transparent than non-democracies, releasing more information on tax revenue collection (Bueno de Mesquita *et al.*, 2003). Based on a large empirical study tracking the missing data in the World Bank's World Development Indicators, Rosendorff and Vreeland (2004) found that the missing data are in fact correlated with regime type, thus showing that democracies are much more transparent than non-democracies. This is key; the institutions that matter for economic development are in the end those that induce governments to limit taxes on income, make rulers accountable and provide information on government policies, thereby allowing informed citizens to sanction misbehaviour (Przeworski, 2004b; Benhabib and Przeworski, 2004). Not surprisingly, foreign direct investors (international banks included) tend to prefer more transparent countries (Mody *et al.*, 2003), where transaction costs related to corruption are lower, for example.

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Strong economic arguments, already tested empirically, thus help to explain a potential political preference for emerging democracies by banks. The empirical test of this preference remains an open question, however.

BANKS AND EMERGING DEMOCRACIES

Proximity and cultural factors seem to be variables behind these trends in bank flows. GDP, population, surface area in square kilometres, interest rates and even levels of corruption represent other key drivers of such flows (Papaioannou, 2004). This chapter focuses not on these variables but on determining if political factors make some difference in the granting of international bank financing. To do so it uses variables such as the democratic transition year, the level of democratisation, the stability of economic policy, the political stability of ministries and the differences between presidencies in different emerging countries.

As many researchers highlight, the analysis of democratisation and private bank flows raises a number of methodological issues. Data availability is one, along with the measures used to gather the data. Most of the datasets present availability weaknesses, but more importantly the hypotheses, concepts and definitions behind them are open to question. One important issue regards causality. Private bank money may flow towards emerging democracies just because windows of opportunity such as privatisations have suddenly opened. Banks may rush towards emerging democracies not because they are democracies but because they privatise their banks.

Democracies — at least in Latin America — had a strong propensity to privatise during the last decades of the 20th century. They tended to prefer fully to privatise assets while autocracies tried to maintain control over their economies. In the end, as highlighted by Giavazzi and Tabellini (2004), political and economic liberalisations have been closely connected. They feed on each other, so that it is difficult to discern the direction of causality. Analysis of the timing of different events does indicate, however, that the causality is more likely to run from political to economic reforms. Democratisation appears to lead to economic liberalisation, with the extent of liberalisation gradually increasing in the years following the transition to democracy. This would suggest that the political shifts induce economic liberalisation to a far greater extent than the other way around, particularly in Latin America, where in most cases political liberalisation took place before bank privatisation[8].

The first approach to the question "Do bankers prefer democracy in emerging markets?" analyses the correlation between the BIS data series and political databases, using the standard classification of democracy of Przeworski *et al.* (2000)[9]. Two series indicate the level of democratisation. The first, called "Consolidation of Democracy", was formulated by Schmitter and Schneider (2004). It measures the extent to which democracy consolidates itself. It provides yearly figures for a series of countries. The greater the value, the stronger democracy is rooted. The second indicator, more commonly used in economic literature, is

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the "Democracy Score" formulated by "Polity IV". It measures countries' existing levels of democracy. It also has an annual series. Its value ranges from zero to ten, where proximity to ten means a higher level of democratisation and vice versa. The years in which democratic transition took place in different countries also are useful to gauge whether banking flows increased after transition.

An increase in the democracy indicators has a positive impact on the entry of private foreign claims, although in some countries there is a lag of two or three years. This pattern is particularly important in Latin America, a region that experienced the most impressive democratic transitions over the past decade along with Eastern Europe (see Rodriguez and Santiso, 2007 for further detail).

Next, how did democratic transition affect private bank inflows? Taking the year of transition, one can observe the growth rates of banking flows before and after transition. The results are striking; see Rodriguez and Santiso (2007) for full details. Before democratic transition, the annual growth of flows in the three previous years has a mean equal to 1.04 per cent. After transition, banking flows in the following three years accelerate, growing at an average of 4.37 per cent. For Latin American countries alone in the three years prior to transition, annual average growth was negative at -1.53 per cent, then jumped to 4.28 per cent for the three years after transition. Clearly, at least in Latin America, bankers tend to love new emerging democracies and increase their lending to them. A transition towards democracy tends to favour foreign bank inflows. The other side of this coin is that emerging borrowers have had easier access to foreign private bank lending, once they became democracies.

Another way to look at the democratic preferences of bankers is to consider the quality of the political regimes that emerged from democratic transition. Once democracy is in place, do foreign bankers take quality into account, i.e. do they react to democratic breakdowns at the micro level? Democratic breakdown is usually associated with the collapse of democracy (Linz, 1978). Since the 1980s, in fact, no Latin American country has experienced such a collapse, but there has been abundant discussion regarding the quality of these democracies. "Delegative democracies" have been criticised, for example, for being inadequately constrained by a weak network of state institutions whose role is to check executive abuses of power. In line with Barndt (2003), however, one can argue that democratic breakdowns can occur not only at the macro level but also at the micro level. Across the continent, "executive assaults" abound. These are events in which an elected president tries to restrict the access of certain individuals to state power by temporarily suspending their ability to avail themselves of the constitutional attributes of democracy meant to be enshrined in the regime. Executive assaults are in the end attempts by presidents to dismantle democracy at the micro level, such as the attempt (an example from Barndt) by Banzer in Bolivia in 1999 to quash peasant protests by detaining the leaders and restricting the right to gather in public.

Based on a collection of executive-assault data since the onset of the third wave of democratisation in the region from the beginning of the 1980s for ten country-periods, Barndt reported 204 observations and more than 120 cases of assault.

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All countries except Chile experienced at least one case of assault and several experienced more than ten. Table 4.1. quickly confirms that foreign banks seem indifferent to the proliferation of executive assaults; they tend to increase their lending presence regardless of increases in micro-democratic breakdowns.

Table 4.1. Executive Assaults and Foreign Bank Presence in Latin America

Executive Assaults		Foreign Bank Presence (% of total banks' assets)			
Country	Period analysed	% of country-year with at least one assault	1990	2005	Increase
Argentina	1983-2002 (20 years)	30	10	61	51
Bolivia	1982-2002 (21 years)	19			
Brazil	1985-2002 (18 years)	38	6	49	43
Chile	1990-2002 (13 years)	0	19	62	43
Colombia	1979-2002 (25 years)	88	8	34	26
Ecuador	1979-2002 (25 years)	58			
Mexico	1979-2002 (25 years)	n.a.	0	90	90
Paraguay	1989-2002 (14 years)	28			
Peru	1980-2002 (25 years)	87	4	61	57
Uruguay	1985-2002 (18 years)	11			
Venezuela	1979-2002 (25 years)	42	1	59	58

Source: Authors, 2006, based on Barndt (2003) for the data on democratic assaults; Clarke *et al*. (2004); and own estimates for the data on the share of foreign banks in total assets.

StatLink http://dx.doi.org/10.1787/314426438868

BANKS AND POLICY INSTABILITY IN EMERGING DEMOCRACIES

Given that bankers prefer emerging democracies, this section shifts the focus away from political regimes to policy stability in order to gauge whether bankers

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prefer it too. The common and generalised perception is that they tend to be risk-averse and avoid politically unstable countries for generally good reasons, because instability has a negative economic impact, particularly on growth, debt levels, fiscal deficits and inflation rates. In their core decision making on political risk, banks are put off by political instability in general because it increases policy instability, which in turn impacts negatively on growth and discourages private investment. Yet they do not seem sensitive to all kinds of instability. They show some neutrality toward democratic political instability, in spite of which they have continued to invest in Latin American emerging democracies in recent decades.

Latin America is known as one of the world's most politically unstable areas. Between 1945 and 2000, it saw around 160 occurrences of regime transition — shifts from non-democracies towards democracies and vice-versa[10]. The region contains fewer than 10 per cent of the countries in the world, but it had more than 35 per cent of the regime transitions in the period. It averaged three regime transitions per country. South Asian countries in comparison had 1.4 transitions per country during the same years (Cheibub, 2003). Peru, for example (not the most unstable in the region by any means) had frequent political changes not only among the players in the game, but also in the playing field and the game itself. Since its independence in 1821, the country has had 13 constitutions and 108 governments, only 19 of which were elected and only nine of which completed their terms. Over the past two decades, democracy reappeared with three constitutional presidents installed between 1980 and 1992; a regime classified as semi-authoritarian between 1992 and 2001; and a fully democratic regime with two constitutional presidents since 2001 (Moron and Sanborn, 2006).

Latin American democracies have tended to stabilise over the decades. Policy instability is captured by an Economic Policy Stability Index. The index draws on the Fraser Institute's *Economic Freedom of the World Index* (EFW Index, Source: Freedom House Index), used among others by Tommasi (2005). A graphical analysis (Rodriguez and Santiso, 2007) of foreign claims by country against the Economic Policy Stability Index shows a strong relationship between both series. The greater an economy's stability, the higher the inflows of foreign claims.

In the analysis of democratic changes and banking flows, the possible effect on foreign claims was observed mainly after abrupt changes in the indicator (as in the case of transition). Bank flows are more sensitive to political stability; less abrupt changes in the index also have effects on flows. Table 4.2. shows correlations of the indicators of democracy and the economic policy stability index with foreign claims. Generally the correlations are high with the stability index and lower with the democracy indicators. They cover each of the 30 countries included in the database for the periods of data availability. Algeria stands out as an exception; not only is the overall result not confirmed, but greater economic policy stability is associated with smaller inflows.

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Table 4.2. **Correlations of Foreign Claims with Economic Policy Stability Index (EFW), Consolidation of Democracy Index (CoD) and Democracy Score (DS)**

Foreign Claims vs	**EFW** 1985-2004	**CoD** 1984-2000	**DS** 1984-2004
Russia	0.92	0.90	0.75
India	0.90	---	---
Poland	0.87	0.48	0.50
Peru	0.86	0.24	0.25
Brazil	0.85	0.46	0.22
Paraguay	0.80	---	---
Turkey	0.80	0.86	0.10
Greece	0.79	0.51	0.27
Romania	0.78	0.40	0.49
Hungary	0.76	0.54	0.34
Portugal	0.76	0.57	---
Slovenia	0.76	0.67	0.50
Czech Rep	0.74	0.71	0.52
China	0.73	---	---
Venezuela	0.71	---	0.30
Ukraine	0.71	0.83	0.57
Morocco	0.71	0.88	---
Slovakia	0.70	0.64	0.66
Colombia	0.69	---	-0.73
Tunisia	0.69	-0.30	0.59
Chile	0.68	0.57	0.53
Mexico	0.66	0.70	0.83
Argentina	0.66	0.77	0.07
Guatemala	0.65	0.90	0.86
Spain	0.64	0.08	---
Uruguay	0.48	0.72	0.35
Bolivia	0.45	0.49	0.06
Bulgaria	-0.01	-0.28	-0.08
Nicaragua	-0.77	0.13	-0.24
Algeria	-0.95	-0.47	-0.54

Note: EFW stands for *Economic Freedom of the World* (Fraser Institute data); CoD *Consolidation of Democracy* data (Schmitter and Schneider data); and DS *Democracy Score* (Polity IV data).

Source: BIS, The Fraser Institute, Schmitter and Schneider (2004), and Polity IV.

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BANK FLOWS AND POLITICAL STABILITY IN EMERGING DEMOCRACIES

This section analyses the entry of banking flows into Latin American countries and their possible relationship with the stability of ministerial and gubernatorial offices. As already demonstrated, banks have tended to boost their activity in the region, increasing their lending after the return of democracy despite the long track record of political instability in Latin America. Political regime instability has almost disappeared since the third wave of democratisation in the sense of no major democratic breakdowns in the region. This contrasts with the previously large number of *coups d'état* and other successful efforts to remove sitting governments through illegal and sometimes violent action — more than 70 in Latin America over the last half century alone and nearly one per year from the 1800s to the 1970s. Yet this does not mean that political instability has disappeared. Regular events such as elections, cabinet reshuffles or political crises still remain. What impact does such democratic instability, political change within a democratic regime, have on bank flows?

Democratic political instability can be measured in terms of cabinet turnover; i.e. changes in the composition of a cabinet within a government's lifetime (Huber and Martínez-Gallardo, 2003). A dataset developed by Martínez-Gallardo (2004) records within the limits of source availability all the changes in the composition of cabinets in seven Latin American countries between 1988 and 2000. Cabinet changes include both terminations (ministers who resign from their posts and take up work elsewhere) and reshuffles, where ministers move from one portfolio to another. All such changes take place, therefore, within the rules of the democratic game.

Democratic instability thus defined has been quite intensive in Latin America with notable differences between countries and presidential mandates within them. By the end of President Figueres' four-year mandate (1994-1998) in Costa Rica, 15 of his 25 original ministers still held the same positions, while just two of the ministers originally appointed by Colombian President Ernesto Samper remained in the government (and both moved to different portfolios). The average time spent in office by ministers in Figueres' cabinet was 35 months; the average for their Colombian counterparts over the same period was less than half that (15 months).

Cabinet stability for the countries included in the dataset (Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Venezuela, Ecuador, Bolivia, Peru, Paraguay, and Uruguay) also varies with respect to reshuffles and terminations. Reshuffles have been substantially less common than terminations, less than 10 per cent of all the movements recorded. Abrupt changes (terminations) have been more common. The relative frequency of reshuffles also varies across countries, ranging from only 4 per cent of movements in Colombia and Ecuador to 8-11 per cent in most countries (Chile, Bolivia, Venezuela, Brazil, Peru, Paraguay and Costa Rica), 12 per cent in Mexico, 14 per cent in Uruguay and even 21 per cent in Argentina[11].

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Changes in ministerial tenures should have some impact on bank flows to the extent that they could affect the quality of democratic policy making and the performance of governments. Ministerial cabinets are consistently more stable under situations of higher growth rates and in more constant environments for law and order. Cabinet changes are, in one way or another, political responses to shocks. Ministers may be changed owing to shifts in presidential strategy, opposition pressure, or exogenous shocks such as financial crises. Obvious examples are the departure of finance ministers in the wake of financial disruption or economic crisis. A political shock might cause a party to pull out of a ruling coalition, forcing ministers who are members of that party to abandon the executive. Vacancies produced by such events can be filled with politicians or technocrats from within the cabinet in order to smooth the change. After the 1994 devaluation in Mexico, for example, President Zedillo replaced his minister of finance with another cabinet member in an effort (unsuccessful) to overcome the crisis (Santiso, 1999).

Bankers seem indifferent as to whether centre, left or right-wing governments are in power and whether they have an absolute majority or operate in coalition with other parties. They show the same indifference to political instability as measured by cabinet turnover (Table 4.3.). The correlations of foreign claims with ministerial stability and the average duration of ministers in office are insignificant at 0.10 and 0.06 respectively. Bank flows just do not appear as sensitive to ministerial turnover measured by time in office.

An econometric exercise checks and confirms the results (Table 4.4.). Several empirical studies analyse the determinants of bank flows (Papaioannou, 2004). The purpose here is simpler: to verify the previous findings for political variables using another tool. The analysis uses panel data on 29 countries for 1984-2004 (annual frequency). The explanatory variables for bank flows are economic (GDP, population, human capital proxies and interest rates) and political (the "consolidation of democracy", "democracy score" and "economic policy stability" indicators, plus ministerial stability and the composition of governments).

Foreign claims, apart from depending on GDP and population, also correlate positively with levels of democratisation in recipient countries. The results are confirmed with both the "consolidation of democracy" indicator (CoD in Table 4.4.) and the "democracy score" indicator (DS). The economic policy stability indicator (EFW) also influences financial inflows, but the results are less trustworthy because the EFW data are available only every five years for 1985-2000, which means a smaller pool of information. A country receives more financing when its gross domestic product increases, its population is higher, more financing came the previous year and the country enjoys both greater democratisation and more economic policy stability. Ministerial stability and the composition of governments or banks do not appear as determinant factors, nor do interest rates or human capital.

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Table 4.3. Foreign Claims and Ministers' Stability in Latin America

		Presidency Including months	**Foreign Claims** % of total Latam	**Ministers Stability** % total	**Ministers Average** Duration in months
Argentina	Menem	*Jul-89/Apr-95*	14.73	53.45	46
	Menem 2	*May-95/Nov-99*	18.35	34.48	28
	De la Rua	*Dec-99/Dec-01*	17.34	31.03	22
Bolivia	Zamora	*1989/1993*	00.12	32.50	27
	de Lozada	*1993/1997*	00.16	32.50	33
	Banzer	*1997/2001*	00.42	42.50	39
Brazil	Collor	*Jan-90/92*	29.52	21.88	29
	Franco	*92/Dec-94*	28.83	42.71	44
	Cardoso	*Jan-95/Dec-98*	31.39	31.25	30
	Cardoso 2	*Jan-99/Dec-02*	25.87	20.83	20
Chile	Alwyn	*Dec-89/Dec-93*	06.36	37.29	22
	Frei	*Jan-94/Dec-99*	08.63	55.93	41
	Lagos	*Jan-00/...*	09.03	23.73	16
Colombia	Gaviria	*Jun-90/May-94*	03.47	35.78	42
	Samper	*Jun-94/May-98*	04.60	45.87	59
	Pastrana	*Jun-98/May-00*	04.17	29.36	32
Ecuador	Borja	*Aug-88/Jul-92*	01.87	18.10	23
	Duran	*Aug-92/Jul-96*	01.25	28.45	38
	Bucaram	*Aug-96/Jan-97*	01.07	12.07	14
	Alarcon	*Feb-97/Jul-98*	00.98	16.38	19
	Mahuad	*Aug-98/Jan-00*	00.75	18.97	25
	Noboa	*Feb-00/Dec-02*	00.34	15.52	18
Mexico	Salinas	*Jan-88/Dec-93*	27.27	41.98	40
	Zedillo	*Jan-94/Dec-00*	23.60	41.98	37
	Fox	*Jan-01/Act*	38.21	22.22	19
Paraguay	Rodrigues	*1954/1993*	00.33	26.98	20
	Wasmosy	*1993/Mar-98*	00.40	36.51	26
	Cubas Grau	*Apr-98/Mar-99*	00.34	17.46	11
	Gonzales Macchi	*Apr-99/Aug-03*	00.30	23.81	16
Peru	Fujimori	*Apr-90/Mar-95*	01.41	44.90	57
	Fujimori 2	*Apr-95/Mar-00*	02.88	51.02	61
	Paniagua	*Apr-00/Jul-01*	02.97	13.27	14
Uruguay	Lacalle	*Apr-90/Mar-95*	01.52	53.70	36
	Sanguinetti 2	*Apr-95/Mar-00*	01.58	38.89	23
	Battle	*Apr-00/Act*	01.09	25.93	15
Venezuela	Perez	*Jan-89/May-93*	09.66	36.92	60
	Velasquez	*Jun-93/Jul-94*	08.53	13.08	19
	Caldera	*Aug-94/Dec-98*	04.66	33.85	47
	Chavez	*Jan-99/Jun-00*	04.55	18.46	38
	Chavez 2	*Aug-00/Act*	03.94	10.77	22

Source: based on BIS and Martínez-Gallardo (2004).

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Table 4.4. Foreign Claims Determinants

Foreign Claims (FC)			
	Log_FC		**Log (FC)**
Log_GDP	0.792 (0.078)*	**Log_FC (-1)**	0.393 (0.022)*
Log_Population	0.712 (0.325)*	**Log_GDP**	0.307 (0.067)*
DS	0.034 (0.012)*	**Log_Population**	0.855 (0.265)*
Constant	-9.44 (5.23)	**DS**	0.03 (0.01)*
		Constant	-11.46 (4.26)*
R - sq	0.776	**R - sq**	0.844
Obs.	483	**Obs.**	463
Groups	26	**Groups**	26

Foreign Claims (FC)			
	Log_FC		**Log (FC)**
Log_GDP	0.372 (0.089)*	**Log_GDP**	1.206 (0.14)*
Log_Population	1.123 (0.495)	**Log_population**	0.268 (0.42)*
CoD	0.035 (0.013)*	**EFW**	0.103 (0.045)*
Constant	-13.22 (7.99)	**Constant**	-5.179 (6.92)
R - sq	0.642	**R - sq**	0.561
Obs.	336	**Obs.**	206
Groups	24	**Groups**	27

Estimation by fixed-effects
Log_FC(-1) is a lag of one period of foreign claims

*Significance at the 5% level

Note: EFW stands for Economic Freedom of the World (Fraser Institute data); CoD Consolidation of Democracy data (Schmitter and Schneider data); and DS Democracy Score (Polity IV data). We show the standard deviation in brackets.

Source: IMF, IFS, World Bank, The Fraser Institute, Polity IV, and Schmitter and Schneider.

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CONCLUSION

Banks are willing to increase their lending to newly emerging democracies. They also prefer emerging democracies where policies are stable, but they seem indifferent to democratic political instability. The preference for emerging democracies is particularly striking in regions such as Latin America and Eastern Europe, where democratic transitions have multiplied in the past two decades; cross-border bank lending tends to rise in the years following authoritarian breakdowns.

Solid economic reasons explain why international banks prefer emerging democracies. Good fiscal and monetary policies and institutional quality in emerging democracies favour banking business. This preference needs testing for other flows such as FDI, portfolio investment and the lending behaviour of public institutions such as the multilateral development banks. According to some studies, financial markets do not particularly reward democracies, with no apparent, significant difference in the interest rates paid by democracies and non-democracies in emerging markets[12].

Bankers' preferences may lie in ethical as well as economic considerations, as the introduction to this paper suggests. Banks might prefer lending to emerging democracies not only because it is good business in economic terms, but also because it is good business ethically, a pledge of support for democracy, freedom and responsible public order, "all things living" along their journey *In Search of a Better World* as envisaged by the Anglo-Austrian philosopher Karl Popper in his collection of essays and lectures on the need for a new professional ethic.

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NOTES

1. In terms of bank assets the picture does not change; bank assets *vis-à-vis* developed OECD countries account for 37 per cent of world GDP and those *vis-à-vis* emerging economies for less than 3 per cent.

2. In the first study evaluating the political regime preferences of multinational firms, Rodrik regressed an indicator for democracy on the value of investment by majority-owned US affiliates abroad and found that countries with weaker democratic rights tend to attract less US capital (Rodrik, 1997). Two subsequent studies expanded the data, one focusing on 62 emerging economies during the 1990s (Harms and Ursprung, 2002) and the other focusing on 69 developing and emerging market economies covering 1972 to 1999 (Busse, 2003). Both indicate that, on average, FDI per capita is higher in democratic countries (but this positive relationship did not hold for some periods such as the 1970s).

3. Multinationals seem also to prefer to invest in countries run by left-wing governments. A study conducted on a cross section of 48 developing and developed countries shows that the left-right orientation of the chief executive in the host country has a statistically significant effect on the amount of FDI flowing to that country. Countries ruled by left-wing parties tend to receive more FDI (Martin Pinto, 2003), as left-wing governments are perceived as more willing to control conflicts and social demands.

4. The study leaves aside the political role of international bankers themselves, as individuals. Narratives of their political involvements in both developed and developing countries are part of a very large literature ranging from historical biographies and sagas on international bankers like the Warburg, Rothschild and JP Morgan founders and dynasties to broader academic studies. See, for example, the great Morgan biography by Strouse (1999); also Carosso (1987), Ferguson (1998) and Sampson (1982).

5. Wellons (1987) analysed the huge growth of "sovereign debt" during the 1970s in conjunction with the recycling of petro-dollars to developing countries and found that significant over-lending to sovereign developing-country borrowers was driven by large international OECD-based commercial banks' well-founded belief that their own home-country governments were unlikely to allow the "sovereign" borrowing-country governments to default on payment.

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6. Other studies by López-Córdoba and Meissner find a positive relation between trade openness and democracy from 1895 onwards. The impact of openness by region shows some variation, and the authors note that commodity and petroleum exporters do not seem to become more democratic by exporting more commodities and oil (López-Córdoda and Meissner, 2005). While the impact of democracy on trade openness seems strong, there is much more discussion on the impact of trade on democracy. Rigobón and Rodrik (2004) find results totally different from those of López-Córdoba and Meissner, while Papaioannou and Siourounis (2005), find a much weaker impact of trade openness on democracy.

7. For a critical analysis of the new institutionalism literature, see Przeworski, (2004*a*).

8. In the classification of Giavazzi and Tabellini, all Latin American countries except Chile, Mexico and Peru liberalised their economies first and afterwards experienced political liberalisation. One can nevertheless discuss the assigned timing of both political and economic liberalisation. In Mexico, for example, permanent democratisation dated from 1994, whereas many scholars considered that 1988 or 2000 were the years when full democratisation took place.

9. Regimes are classified as democracies if in a given year they satisfy simultaneously four criteria: *i)* the chief executive is elected; *ii)* the legislature is elected; *iii)* more than one party competes in the elections; *iv)* incumbent parties have in the past lost an election and yielded office or will do so in the future. All regimes that fail to satisfy at least one of these criteria are classified as non- democratic (Przeworski *et al.*, 2000, pp. 18-29). Hence the political regime classification is simplified and becomes a dichotomous variable that takes a value of O if a country is a democracy and 1 if it is not according to the four cumulative criteria.

10. As highlighted by Epstein *et al.* (2005), the classification of political regimes is one of the most hotly debated issues in the study of democratisation. The problem arises because the predominant situation over the past few decades has in fact involved movements into and out of an intermediate category that clearly dominates the dynamics of regime transition. In their data covering all countries from 1955 to 2000, only 16 transitions from full democracy to autocracy and 22 reverse transitions from autocracy to full democracy occurred, while 149 transitions into or out of partial democracy took place. From 1955 to 2005, partial democracy always represented less than 30 per cent of all regimes. Nor are dictatorships all the same, and many, as Przeworski *et al.* (2000) argue, exhibit the full gamut of seemingly democratic institutions (Przeworski and Gandhi, 2004). For conceptual discussions regarding the problems of defining and measuring democracy, see also Cheibub and Gandhi (2004) and Bollen and Paxton (1998; 2000).

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11. The number of reshuffles vs. terminations also varies across portfolios. Finance, for example, accounts for only 4 per cent of reshuffles (i.e. 96 per cent terminations) while Interior has 14 per cent (86 per cent terminations). One might expect that a large number of Finance terminations would have a bigger impact on the banking sector.

12. Saiegh (2004*a*,*b*) provides very stimulating research on this issue, examining the effect of political institutions on country risk and interest rates. He shows that emerging democracies are more likely to reschedule their debts than are authoritarian regimes and appear to pay higher interest rates. These findings are based on data for developing countries covering 1971-1998.

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WHOSE OWNERSHIP?

Whose ownership? is the question. If only the answer were as easy to formulate. Donors and developing-country governments alike are struggling to put the principle of ownership into practice without much success. This despite agreement that countries must own their development policies if their financial inflows are to reduce poverty or stimulate growth.

The authors of *Financing Development 2008*, designed to accompany discussions in the OECD Global Forum on Development, take a variety of approaches to the ownership question. They ask what developing-country ownership really means. From an effectiveness perspective, who should own development policies and who actually owns them? The authors find that the very complexity of the international system of development finance prevents countries from assuming leadership of their relationships with donors. Looking beyond governments, they also ask how aid effectiveness principles might apply to the activities of other actors, such as non-governmental organisations. Finally, the authors shed light on the relationship between ownership, investment and the private sector.

The resulting messages and recommendations are of great value to those seeking to make development finance more effective, particularly policy makers monitoring and trying to facilitate the implementation of the 2002 Monterrey Consensus and 2005 Paris Declaration on Aid Effectiveness.

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