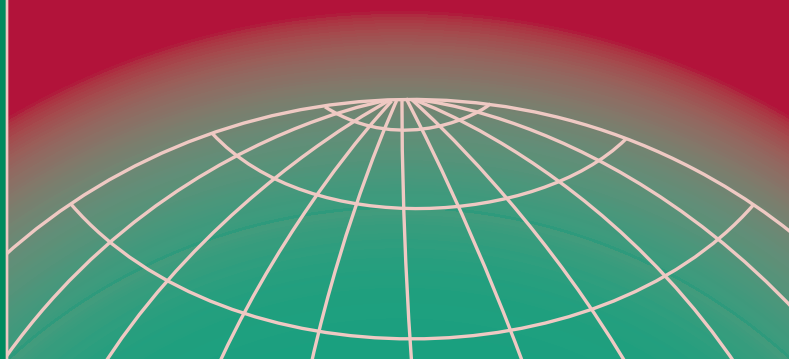


# Poverty reduction and good governance

*Report of the Committee for  
Development Policy on the sixth session  
(29 March–2 April 2004)*



Department of Economic and Social Affairs

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Development Policy on the sixth session  
(29 March–2 April 2004)



United Nations  
New York, 2005

## **DESA**

The Department of Economic and Social Affairs of the United Nations Secretariat is a vital interface between global policies in the economic, social and environmental spheres and national action. The Department works in three main interlinked areas: (i) it compiles, generates and analyses a wide range of economic, social and environmental data and information on which States Members of the United Nations draw to review common problems and to take stock of policy options; (ii) it facilitates the negotiations of Member States in many intergovernmental bodies on joint courses of action to address ongoing or emerging global challenges; and (iii) it advises interested Governments on the ways and means of translating policy frameworks developed in United Nations conferences and summits into programmes at the country level and, through technical assistance, helps build national capacities.

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## Foreword

At its sixth session, the Committee for Development Policy continued its practice of addressing a number of development issues receiving attention in the international community. On this occasion, the Committee focused on resource mobilization in the least developed countries (LDCs), the measurement of progress in improving governance, and transition strategies for countries that graduate from the list of LDCs.

Within the overall global objective of reducing poverty by half by 2015, a central challenge remains that of improving the economic and social conditions of the more than 600 million inhabitants of the LDCs. To meet this challenge, the Programme of Action for the Least Developed Countries for the Decade 2001-2010 calls for growth rates in the LDCs of at least 7 per cent a year and investment rates of 25 per cent of gross domestic product. Achieving these targets will require the mobilization of substantial financial resources, domestically and externally. Domestic resources are indispensable for economic growth, for increasing human capabilities and for making progress in eradicating poverty. External receipts—in the form of official development assistance (ODA), revenues from trade, workers' remittances, foreign direct investment (FDI) and other private flows—play an essential role in complementing domestic resources. The Committee addressed each dimension, identifying obstacles to and measures for mobilizing resources to achieve the targets set by the Programme of Action.

Good governance can be instrumental in achieving poverty reduction. It is important both as a social goal and for its role in supporting an equitable pattern of growth. The challenge is to build capable governments that can guarantee peace and security, provide an enabling political and legal environment for development and promote equitable distribution. Despite the increased emphasis being placed on improving governance, it is difficult to judge success in achieving it. The Committee therefore examined how to evaluate progress towards good governance in the context of the quest to achieve the Millennium Development Goals. Measuring progress

involves deciding, among other questions, whose criteria are being used to evaluate progress and who does the measuring. The Committee concluded that good governance can contribute to poverty reduction only if its measurement and assessment is oriented to national requirements and conditions and is not biased towards external preconceptions.

The Committee also dealt with matters related to its triennial review of the list of least developed countries and made proposals on smooth transition strategies for countries that graduate from the list of least developed countries.

The present volume contains the report that the Committee submitted to the United Nations Economic and Social Council on these matters, as well as two papers, each prepared by a member of the Committee, that were used to assist the Committee in its deliberations. It is hoped that the analyses and recommendations that these documents contain will enhance discussions on development at all levels, will contribute to improved policies and actions and, as the ultimate objective, will play a role in improving the well-being of the world's poor.



José Antonio Ocampo  
Under-Secretary-General  
for Economic and Social Affairs

## Preface

The Committee for Development Planning was established in 1965 as a subsidiary body of the Economic and Social Council. Its original terms of reference were subsequently modified and, in 1998, the Committee was renamed the Committee for Development Policy (CDP).

The Committee provides inputs and independent advice to the Council on emerging cross-sectoral development issues and on international cooperation for development, focusing on medium- and long-term aspects. The Council is an intergovernmental body responsible for formulating policy recommendations to Member States and to the United Nations system on matters pertaining to development. It is also responsible for coordinating the work of the United Nations specialized agencies, its own subsidiary functional commissions and the five United Nations regional commissions.

Each year, the Council advises the Committee about the theme(s) that the Committee should consider at its annual session. The General Assembly, the Secretary-General and the subsidiary bodies of the Council can also propose, through the Council, issues for consideration by the Committee. In addition, the Committee itself often makes suggestions to the Council concerning its work programme.

The Committee is also responsible for undertaking, once every three years, a review of the list of least developed countries (LDCs), on the basis of which it advises the Council regarding countries which should be added to the list and those that could be graduated from the list. In its identification of LDCs, the Committee considers three dimensions of a country's state of development: (a) its income level, measured by gross national income (GNI) per capita; (b) its stock of human assets, measured by a Human Assets Index (HAI); and (c) its economic vulnerability, measured by an economic vulnerability index (EVI).

The annual meeting of the Committee usually takes place in March or April of each year and lasts five working days. During this period, the Committee discusses the agreed topics and drafts its own

report on the basis of inputs from members. The report is subsequently submitted to the Council at its substantive session in July and is also disseminated among the development community.

The reports of the Committee are available on the Internet at [www.un.org/esa/policy/devplan/](http://www.un.org/esa/policy/devplan/).

## Membership and participation in the sixth session of the Committee

In accordance with the resolutions of the Council, the Secretary-General nominates 24 experts, in their personal capacity, as members of the Committee for three-year terms. The Council has responsibility for deciding on appointments to the Committee. In making the nominations for the Committee, the Secretary-General takes into account the need to have a diversity of development experience, including ecologists, economists, and social scientists, as well as geographical balance, gender balance, and a balance between continuity and change in the membership of the Committee. The members appointed for the term starting on 1 January 2004 and expiring on 31 December 2006 are as follows:

- Ms. N'Dri Thérèse **Assié-Lumumba** (Côte d'Ivoire) Research Associate, Université de Cocody;
- Ms. Patricia **Bifani-Richard** (Chile-Italy) Psychologist, Sociologist;
- Mr. Albert **Binger** (Jamaica) Professor and Director of the Centre for Environment and Development, University of the West Indies;
- Mr. Olav **Bjerkholt** (Norway) Professor of Economics, University of Oslo;
- Ms. Gui Ying **Cao** (China) Research Scholar, International Institute for Applied Systems Analysis;
- Mr. Eugenio B. **Figuroa** (Chile) Executive Director of the National Centre for the Environment;

- Mr. Leonid M. **Grigoriev** (Russian Federation) Deputy Director, Expert Institute;
- Mr. Patrick **Guillaumont** (France) Chairman, Centre for Study and Research for International Development;
- Ms. Heba **Handoussa** (Egypt) Adviser, Economic Research Forum for Arab Countries, Islamic Republic of Iran and Turkey;
- Mr. Hiroya **Ichikawa** (Japan) Professor of Economics, Department of Comparative Culture, Sophia University;
- Ms. Willene **Johnson** (United States of America) Adviser, Board of Governors, Federal Reserve System;
- Ms. Marju **Lauristin** (Estonia) Professor of Social Communication, Department of Journalism and Communication, Tartu University;
- Mr. Milivoje **Panic** (United Kingdom of Great Britain and Northern Ireland) Fellow of Selwyn College, University of Cambridge;
- Mr. Eul Yong **Park** (Republic of Korea) University Chair and Professor of Economics and Management, Handong University;
- Ms. Carola **Pessino** (Argentina) Professor, Universidad Torcuato di Tella, and Executive Director of the Centre for Social Economics Evaluation and Research for Poverty Alleviation;
- Ms. Suchitra **Punyaratabandhu** (Thailand) Dean, School of Public Administration, National Institute of Public Administration, Bangkok;
- Mr. P. Jayendra **Nayak** (India) Chairman and Managing Director of Unit Trust of India Bank, Mumbai
- Ms. Sylvia **Saborio** (Costa Rica) Development Consultant and Adjunct Professor, Georgetown University, Washington, D.C.;



- Mr. Nasser Hassan **Saidi** (Lebanon) First Vice-Governor of Banque du Liban;
- Mr. Udo Ernst **Simonis** (Germany) Professor of Environmental Policy, Berlin Science Centre;
- Ms. Funmi **Togonu-Bickersteth** (Nigeria) Director, Centre for Industrial Research and Development, Obafemi Awolowo University;
- Mr. Geedreck **Usvatte-Aratchi** (Sri Lanka) Consultant in economics and public finance, Central Bank of Sri Lanka;
- Mr. Samuel **Wangwe** (United Republic of Tanzania) Principal Research Associate, Economic and Social Research Foundation;
- Mr. Kerfalla **Yansane** (Guinea) Lead consultant, African Peer Review Mechanism, Secretariat of the New Partnership for Africa's Development.

The Committee elected the following officers for its sixth session:

|                          |  |
|--------------------------|--|
| <i>Chairperson:</i>      | Ms. Suchitra <b>Punyaratabandhu</b><br>(Thailand)                                      |
| <i>Vice-Chairperson:</i> | Mr. Milivoje <b>Panic</b><br>(United Kingdom of Great Britain<br>and Northern Ireland) |
| <i>Rapporteur:</i>       | Ms. Sylvia <b>Saborio</b><br>(Costa Rica)  |

## Contents of this publication

At its sixth session, held at United Nations Headquarters in New York from 29 March to 2 April 2004, the Committee addressed three topics: resources mobilization and enabling environment for poverty eradication in the context of the implementation of the Programme of Action for the Least Developed Countries for the Decade 2001-2010; commitment to good governance, development and poverty reduction; and matters related to the 2003 triennial review of the list of least developed countries. The report of the Committee on its sixth

session has been issued as part of the official records of the Economic and Social Council, 2004, (Supplement No. 13 (E/2004/33)) and is also available on the Internet at [www.un.org/esa/policy/devplan/](http://www.un.org/esa/policy/devplan/). The views of the Committee on the three topics are contained in its report and reproduced in this volume.

In addition to the topics addressed in the report of the Committee on its sixth session, this volume also contains two reports which, along with other background material, provided a basis for discussions at the sixth session of the Committee on the first two topics on its agenda: a summary of the report of the expert group meeting on resource mobilization for poverty eradication in the least developed countries (held in New York on 19 and 20 January 2004); and a report on commitment to good governance, development and poverty reduction.

It is hoped that these materials relating to the work of the Committee will contribute to discussions on these matters at all levels, leading to practical solutions, policies and actions by all concerned.

## Note

The designations employed and the presentation of the material in this publication do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries.

The term "country" as used in the text also refers, as appropriate, to territories or areas.

The designations of country groups are intended solely for statistical or analytical convenience and do not necessarily express a judgement about the stage of development reached by a particular country or area in the development process.

## **Executive Summary**

The present report contains the main findings and recommendations of the sixth session of the Committee for Development Policy, held at United Nations Headquarters from 29 March to 2 April 2004. The Committee addressed three major themes. The first involved measures to improve resources mobilization and the enabling environment for poverty eradication in the context of the implementation of the Programme of Action for the Least Developed Countries for the Decade 2001-2010 (the theme adopted by the Economic and Social Council for its high-level segment in 2004). The Committee also addressed the question how to evaluate progress towards good governance in the context of the implementation of the Millennium Development Goals. In addition, the Committee dealt with matters related to its 2003 triennial review of the list of least developed countries.

With regard to the theme of the Economic and Social Council's high-level segment, the Committee draws attention to the fact that economic growth and poverty reduction require the mobilization of financial resources at both national and international levels, and that the resources mobilized will depend on a variety of factors, including the development of effective partnerships with donors allowing for increased quantity and quality of aid, as well as the ability to mobilize domestic resources. Among the obstacles to resource mobilization are weak fiscal and financial policies, macroeconomic instability, limited formal savings and capital flight, as well as external indebtedness and difficulties in generating new exports. The Committee makes a number of recommendations aimed at removing some of the obstacles that constrain the mobilization of domestic resources, as well as enhancing the impact of aid, attracting foreign direct investment (FDI) and enhancing the local productive capacity. It also notes that channelling investment to the areas where the poor are most active is a key element in a sustainable growth-enhancing strategy for poverty reduction.

The Committee considers that good governance could be instrumental for achieving the goals of poverty reduction only if the

process of measurement and assessment is not biased in favour of external criteria relevant to the donors, investors and international monitoring bodies, as opposed to the internal perspective of the country. In designing institutions and mechanisms for good governance in developing countries, an interactive process between donors and recipient countries is thus essential. On the one hand, measures imposed by donors have often lacked success when they failed to pay due consideration to the culture and history of recipient countries. On the other hand, recipient countries need assistance from donors to bring their institutions and social, political and economic processes closer to those required by good governance. A specific proposal of the Committee was that least developed countries be invited to participate in the deliberations of institutions where global norms and standards for aspects of good governance are established.

With regard to the 2003 triennial review of the list of least developed countries, the Committee confirmed the conclusion of its fifth session that Cape Verde and Maldives qualified for graduation from the list of least developed countries and recommended that they be graduated from the least developed country category. At the same time, the Committee stressed the need for a smooth transition strategy to be put in place by both the countries themselves and the international community. The session included presentations from and exchanges of ideas with selected international organizations on the benefits available to least developed countries; this interaction contributed to the Committee's proposals on smooth transition strategies for countries that graduate from the list of least developed countries. Among the measures to ensure a smooth transition for those countries, the Committee proposed that the United Nations convene an ad hoc country advisory group, in which the graduated country, in cooperation with its development partners, would identify measures to ensure that its development was maintained. The guiding principle of this initiative is that specific transition support measures, monitoring arrangements and the period of transition will be decided on a case-by-case basis so that the development progress of graduated countries is not interrupted or reversed.

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## **I. Resources mobilization and enabling environment for poverty eradication in the context of the implementation of the Programme of Action for the Least Developed Countries for the Decade 2001-2010**

1. The Programme of Action for the Least Developed Countries for the Decade 2001-2010 (A/CONF.191/11) calls for growth rates in the least developed countries of at least 7 per cent and investment rates of 25 per cent of gross domestic product (GDP) to provide a basis for improving the economic and social conditions of the more than 600 million inhabitants of the 50 least developed countries (para. 6 of the Programme of Action). Achieving and sustaining the target rate of growth will require mobilizing substantial financial resources domestically and externally. Moreover, it will require policy makers to accommodate structural, fiscal and other growth-enhancing reforms, while at the same time maintaining domestic macroeconomic stability to support growth and striving to meet the needs of the poor. This is a complex and demanding task for any country, but especially so for least developed countries facing severe inadequacies in terms of institutional, human and financial resources.

2. The amount of financial resources that individual least developed countries can mobilize will depend upon: (a) their ability to mobilize domestic resources, through improved budgetary management and revenue collection and improved private savings and investment opportunities; (b) their ability to generate foreign exchange, through increased exports and remittances; (c) their ability, in partnership with donors, to reduce existing debt burdens while increasing the quantity, quality and effectiveness of new aid flows; and (d) their ability to attract private capital (investment and commercial inflows) and reverse capital flight, where it has occurred.



3. Growth will, by itself, generate opportunities for further growth as unemployed and underemployed human and other resources are mobilized for productive purposes, generating income, saving and new investment opportunities.

## A. Challenges to resource mobilization

### 1. *Macroeconomic conditions*

4. A key obstacle to mobilizing resources in least developed countries is macroeconomic instability, aggravated by the lack of depth and resilience of the domestic market economy. As least developed countries are primary commodity producing countries, both their export revenues and domestic incomes are subject to the vagaries of international markets and local weather. In this environment, the formulation and implementation of monetary and fiscal policies are particularly difficult. In addition, data to inform policy decisions are often scarce, and techniques and institutions for funding government activities are poorly developed.

5. Measures to improve public sector finances, on both the expenditure and revenue sides, have been attempted in many least developed countries with limited success. Financial sector reforms have also been undertaken to create a robust and healthy financial sector, including liberalizing interest rates, privatizing State-owned banks, allowing foreign participation in the banking sector, curtailing lending by State-owned banks and closing loss-making bank branches (often in rural areas). The results have been generally disappointing: for the most part, financial sectors in least developed countries have remained narrow and underdeveloped, offering only a limited range of products and demonstrating a strong reluctance to take long-term risks. Moreover, limited headway has been made in strengthening prudential regulation and supervision, leaving domestic financial systems vulnerable and crisis-prone.

## 2. *Formal and informal savings*

6. The informal sector plays a key role in reallocating resources and generating employment for the survival of a large proportion of the population deprived of other alternatives. Informal subsistence strategies are rooted in traditional links of kinship and solidarity, reflecting the cultural particularities of these societies. One challenge is to establish links between the informal and formal systems so that financial transfers increasingly flow through the banking system and, in so doing, further deepen and broaden financial intermediation for the economy as a whole. A case in point is the transfer of remittances: if carried out through formal financial channels, they could have a far greater local multiplier effect. Similarly, access to credit by small and medium-sized enterprises and many rural activities in least developed countries is hampered by the lack of adequate collateral, either because they possess few assets or because those assets they possess are not properly registered or held communally. Hence, measures need to be adopted to ensure that property rights can be exercised and additional financial resources mobilized.

## 3. *Generating new exports*

7. Despite enjoying some preferential treatment for their exports, the vast majority of least developed countries have found it difficult to diversify their exports, partly because they have been unable to diversify and modernize their productive structures in the first place. In addition, they have been constrained by their limited capacity to identify new export opportunities, the absence of institutions and facilities to comply with international trade standards, and limited infrastructure for moving products from points of production to ports and markets. More needs to be done to provide farmers and other potential exporters with access to credit, technical assistance and marketing support to develop new lines of activity. In addition, attention needs to be paid to services, where least developed countries may be able to find niche markets in a rapidly globalizing world.

#### **4. *Reducing external debt burdens and enhancing the impact of aid***

8. The debt burdens of most least developed countries had, by the early 1990s, reached unsustainable levels. The Heavily Indebted Poor Countries (HIPC) Initiative has ameliorated the situation, but has not resolved the problem. Many potentially eligible countries have not yet benefited from the Initiative, while debt sustainability has not necessarily been achieved in those countries that have benefited, largely because of unrealistic assessments of economic growth used in estimating sustainability. Without effective debt relief, the development prospects of least developed countries are bleak.

9. Least developed countries also require fresh resources. Until recently, aid flows stagnated. Donor countries need to fulfil the internationally accepted targets for development assistance. Equally important is to increase the efficiency of aid through more effective delivery systems, improved harmonization of donor procedures and mutually agreed strategies. Poverty reduction strategies, as elaborated in Poverty Reduction Strategy Papers (PRSPs), have now become the main tool of policy dialogue between least developed countries and their development partners. However, the macroeconomic and sectoral underpinnings for PRSPs need to be sufficiently developed so that subsequent aid allocations effectively reflect the priorities established in the PRSPs.

#### **5. *Improving the investment climate***

10. Foreign direct investment (FDI) flows to least developed countries increased from an annual average of \$600 million per year during 1986-1996 to \$3.7 billion per year during 1996-2000 and to \$5.2 billion in 2002. However, these FDI flows are highly skewed towards natural resource-endowed countries in the group. Other least developed countries have not been successful in attracting FDI flows owing to such factors as their low level of human capital, weak infrastructure, unstable macroeconomic environment, weak legal, judicial and regulatory systems, corruption and the high cost of doing business (often because of excessive bureaucracy). Improving the invest-

ment climate is essential not only to attract FDI, but also to stem the flight of domestic capital and even prompt its return.

## B. Recommendations

### 1. *Institutionalizing appropriate governance systems*

11. Weaknesses in governance, such as lack of transparency and accountability in the public sector and occurrences of corruption, reduce the ability of least developed countries to participate in the global marketplace through trade, attract FDI and, increasingly, obtain external assistance as well. Least developed countries should strive for governance systems that are characterized by participation in and transparency of decision-making processes and that embody pro-poor policies, social safety nets, policies for the sustainable use of resources and effective monitoring. To this end, ways should be found to harness the power of new information and communication technologies.

### 2. *Achieving macroeconomic stability*

12. Governments should strive to develop the capacity to meet the standards for the design and implementation of sound fiscal, monetary and financial policies. In particular, given the unpredictability and volatility of commodity prices, least developed countries should establish national vulnerability reduction funds that would use the increased resources available during surges in commodity markets to temper the effects of cyclical downturns in prices.

### 3. *Improving financial management*

13. Central banks should be granted enough independence to carry on their function as monetary authorities without undue pressure to finance the Governments' fiscal deficits. Additionally, countries should work with international institutions to adopt appropri-

ate financial sector standards and to build the capacity for regulation and supervision. Action should also be taken to strengthen public financial management and accountability, both to ensure that public resources are used according to the established priorities and to assure stakeholders that these resources are being managed in a prudent manner. On the revenue side, steps should be taken to widen the tax base, increase tax compliance and improve tax administration. Action to widen the tax base should include simplifying procedures, particularly those for establishing and regulating business, with a view to encouraging informal activities to operate as formal businesses and to enabling small and medium-sized enterprises to increase their productivity levels.

#### 4. *Fostering domestic savings*

14. In order to improve the generation and mobilization of domestic savings, three key conditions need to be met: incentives to save need to be enhanced, including ensuring positive real interest rates; the spread and reach of savings institutions should be sufficient to encourage savings and pooling of resources; and access to financial services should be such that households can save in forms that may be used as collateral for obtaining credit for investments.

15. Among the options recommended for consideration are the creation of microfinance networks—including mobile banking systems going to poor areas and collecting small amounts of money on a regular basis—to reduce the cost of borrowing and enhance the saving capacity of individuals; support to rotating savings and credit associations that permit the use of small amounts of capital for starting business ventures or buying land; and development of legal and regulatory frameworks that encourage commercial banks to establish links with locally based financial institutions, such as community banks and other credible microfinance institutions.

#### 5. *Improving debt management and sustainability*

16. To enable least developed countries to mobilize additional resources, the debt issue needs to be addressed, consistent with the

Programme of Action for the Least Developed Countries and the commitment to collective responsibility for the integration of the least developed countries into the global economy and the achievement of the Millennium Development Goals. To ensure that the debt of least developed countries is sustainable in the long term, donors should increase the share of official development assistance (ODA) in the form of grants, particularly to countries with high economic vulnerability. The total amount of loans on concessional terms for investment, especially in infrastructure and productive sectors such as agriculture and industry, should reward countries with successful policies and support their efforts towards growth and attraction of private capital. Least developed countries should improve their external debt management and be supported in such efforts, inter alia, by robust analysis of debt sustainability. International joint actions for debt reduction, like the HIPC Initiative, ought to reflect a higher degree of participation by poor countries.

#### 6. *Improving ODA coordination and the PRSP process*

17. Development assistance for the least developed countries needs to be increased in quantity and made more effective through improved coordination among donors with recipients' development strategies. The potential for increasing aid effectiveness should be unleashed through untying of aid, aligning of support with country priorities, giving more aid as budget support on long-term commitments, and harmonizing donor policies and practices in all forms of aid delivery. Aid effectiveness can also be improved by reducing the uncertainty and unpredictability of aid flows through long-term commitments.

18. The PRSPs offer an opportunity to improve coordination among donors and to reduce the transaction costs of external assistance for recipients. Action needs to be taken to improve participation in the formulation of development strategies and policies through PRSPs and to prioritize the allocation of resources with a view to eradicating poverty. Action should be taken to make the macroeconomic frameworks for PRSPs part and parcel of national

debates in the formulation of poverty-focused development strategies and policies. Poverty and social impact analysis of alternative macroeconomic policy scenarios should be carried out, with the support of development partners. The increasing focus on ownership and programme aid will require additional support for capacity-building to enable recipients to better manage external assistance.

### *7. Using ODA as a catalyst for FDI*

19. Ways could be explored to use ODA as leverage for increasing the flow of FDI to least developed countries, without reverting to tied aid. This would include expanding the policy dialogue beyond the traditional Government-to-Government formula, so as to include private sector agents from both donors and least developed countries, in order to build the local capacity to compete effectively in world markets, including the ability to take advantage of the opportunities offered by various trade preferences such as the European Union (EU) Everything-but-Arms arrangement and the African Growth and Opportunity Act of the United States of America.

### *8. Improving productive capacity*

20. Entrepreneurial capacity in least developed countries needs to be enhanced if the potential of small and medium-sized enterprises is to be realized. Training in business development and management should be provided to build the capacity of entrepreneurs in this important sector of the economy of least developed countries. Similarly, the productive and social infrastructure in these countries needs to be expanded and upgraded. Roads, bridges, ports and other infrastructure are required to enlarge markets within and between countries. Human capital also needs to be strengthened through social infrastructure, including schools, technical training and agricultural extension, as well as health services. Finally, investment in communication and information technologies increases productivity and allows the poor a stronger voice in decision-making and the mobilization and allocation of resources.

## **II. Commitment to good governance, development and poverty reduction**

1. Since the early 1990s, the notion of “good governance” as being necessary for sustainable development and poverty reduction has gained widespread currency, especially among international organizations. It is referred to in the United Nations Millennium Declaration (see General Assembly resolution 55/2), an agenda for reducing poverty and improving lives that world leaders agreed upon at the Millennium Summit in September 2000.<sup>1</sup>

2. Domestic concerns over what would later be labelled good governance had long been present in all regions of the world. However, during the cold war, these concerns were not accorded much importance in donor-recipient relationships. What helped put good governance at the forefront of the international agenda was a conjunction of several factors, principally the end of the cold war, a sense that market-based structural adjustment policies had failed to rekindle economic growth in many countries, and concern that aid was often ineffective in achieving its objectives. Bad policies and bad governance in recipient countries were considered largely responsible for these failures. Hence, good governance has become a condition for development assistance from donor agencies.

### **A. The evolving concept of good governance**

3. Governance has been variously defined as the management of society by the people or as the exercise of authority to manage a country's affairs and resources. A consensus has yet to emerge as to its core meaning and how it could be applied in practice. Currently, there are two distinct streams of discourse on good governance: one is rooted in academic research and the other is donor-driven. Academic discourse has dealt mainly with the way in which power and authority relations are structured in different contexts, whereas



the donor-driven discourse has focused more on State structures designed to ensure accountability, due processes of law, and related safeguards. Academic discourse is directed mainly towards better understanding of institutional linkages among the State, civil society and the private sector. Donor-driven discourse is oriented towards enhancing policy effectiveness.

4. The concept of good governance achieved prominence in donor discourse around 1990, when the World Bank adopted it as a condition for lending to developing countries. In the beginning, the notion was rather apolitical and focused primarily on improving the quality of public sector management. By the mid-1990s, most donors' concept of good governance had expanded to include the notions of transparency, accountability and participation. The aspect of predictability was added to the mix in the wake of the financial crises of the late 1990s, along with calls for improvements in corporate governance and international financial market stability. Currently, the concept of good governance is being explored at three separate—if interacting—levels. The first is the national level which covers all of the standard elements of a political, economic and administrative nature. The second is the global level which encompasses all of those elements introduced by the process of globalization, including the regulation of global public goods and stability in capital flows. The third is the corporate level.

5. That the notion of corporate social responsibility or good corporate governance is gaining momentum in some developed countries can be interpreted as reflecting an attempt either to transcend social dilemmas that arise when choices made by profit-maximizing firms yield outcomes that are socially undesirable, or to reconcile the private sector's profit maximization motives and the public interest. The initiatives taken by the Japanese business community, the International Chamber of Commerce, the World Business Council for Sustainable Development and other entities, all of which have adopted codes of conduct relating to global environmental problems, are good examples in this regard.

6. The Committee focused its attention on governance at the national level. While the concept of what constitutes good gover-

nance at the national level will continue to evolve, it is currently predicated upon mutually supportive and cooperative relationships among government, civil society and the private sector. Hence, the nature of the relationships among these three groups of actors, and the need to strengthen viable mechanisms to facilitate their interaction, assume critical importance. Good governance is also regarded as entailing some combination of participation, transparency of decision-making, accountability, rule of law and predictability.

7. “Good” governance is a normative concept. As such, the values that provide the underpinning for governance are those postulated by the defining institutions or actors. Recognition of this fact is particularly important in the context of the donor-recipient relationship, insofar as the presence of such values might lead to an insistence that donor-derived standards of conduct be adopted in non-donor politico-cultural contexts.

8. Finally, governance has an instrumental value, as a means to an end. This raises the question, “Good governance for what?” It is the view of the Committee that standards of good governance ought to be applied within the national, global and corporate domains to serve the goals of poverty reduction, sustainable growth, social equality and participation.

## **B. Measuring good governance for poverty reduction**

9. How to measure good governance, as well as which indicators to select, is based on analytical frameworks that are normative in character. Hence, the same indicator may elicit different interpretations depending on which value judgements are utilized. Likewise, different sets of indicators may be used to measure governance, depending on the nature of the ends in question.

10. The Committee reviewed several approaches to the measurement of good governance at the national level and found some useful examples where the goals of social equality and poverty reduction had been explicitly included in the construction of questionnaires and self-assessment methodologies. Three examples of good governance models for developing countries are presented below.

### 1. *Economic Commission for Africa (ECA) project*

11. The objective of this project is to monitor the progress towards good governance in a sample of 28 countries in the five sub-regions of Africa.<sup>2</sup> At present, the methodology and data-collection instruments have been developed, but the fieldwork is still under way.

12. Six components of good governance have been identified: (a) a political system that encourages input from all groups of civil society; (b) impartial and credible electoral administration, and an informed and active citizenry; (c) strengthened public sector legislative and administrative institutions; (d) transparency, predictability, and accountability in decisions by government and public bodies; (e) effective public sector management with stable macroeconomic conditions, effective resource mobilization, and efficient use of public resources; and (f) adherence to the rule of law in a manner that protects personal and civil liberties and gender equity, and ensures public safety and security with equal access to justice for all.

13. Three survey instruments are being used: (a) an expert panel on issues pertaining to governance; (b) a survey measuring the perception of the adult population; and (c) factual information and empirical data. Together, these three instruments yield data on 83 indicators, intended for use in country reports, subregional reports, and a pan-African governance report.

### 2. *Asian Development Bank/Viet Nam*

14. The Poverty Task Force of the Asian Development Bank has produced a proposal intended to serve as an input for the implementation of the Comprehensive Poverty Reduction and Growth Strategy of the Government of Viet Nam. Five areas of governance have been identified for improvement: (a) a more efficient public service; (b) more transparent public financial management; (c) wider access to justice and ensuring its universal application; (d) more participative and responsive government; and (e) a government that fights corruption at all levels.

15. Eight outcome and process indicators have been developed to assess progress in the five areas, namely: (a) level of information publicly available regarding services, policies and planning arrangements at all levels; (b) extent of access of the poor to such basic government services as health, education, infrastructure, water and power at the local level; (c) level of budget transparency regarding provincial and local taxation, budgeting and spending patterns in each sector; (d) extent to which, at the national level, the level of expenditure that is targeted to pro-poor purposes is predictable from year to year; (e) extent to which the decisions and verdicts of courts and tribunals are publicly available; (f) extent to which local government is responsive and follows up on service delivery problems that are brought to its attention by the poor; (g) extent to which the Grass-roots Democracy Decree has been implemented in each commune so as to improve opportunities for public participation; and (h) extent to which laws combating corruption are effective.

### **3. *African Peer Review Mechanism***

16. The African Peer Review Mechanism (APRM) is a mutually agreed instrument voluntarily acceded to by the member States of the African Union (AU). It is a self-monitoring mechanism intended to foster the adoption of policies, standards and practices that will lead to political stability, sustainable development and regional and continental integration through sharing of experiences and of successful best practices, including identifying deficiencies and assessing the need for capacity-building.

17. The African Peer Review Mechanism is open to all member States of AU. At present, 16 members have voluntarily acceded and several others have indicated their intention to join. The main principles of the Mechanism processes include national ownership and leadership, transparency and broad-based participation.

18. The African Peer Review Mechanism focuses on four main areas with specific objectives, standards and codes, criteria and indicators in terms of which the programmes and policies of the participating countries will be assessed. These include:

(a) *Political governance*, with the following objectives:

(i) prevention and reduction of intra- and inter-State conflicts; (ii) constitutional democracy, including free and fair competition for power, and the rule of law; (iii) promotion and protection of economic, social and cultural rights and civil and political rights, as well as the rights of women, children and all vulnerable groups; (iv) separation of powers, including the protection of the independence of the judiciary and of an effective legislature; (v) accountability and efficiency of public office holders; and (vi) fighting political corruption;

(b) *Economic governance*, with the following objectives:

(i) macroeconomic policies conducive to sustainable development; (ii) sound, transparent and predictable government policies, including public finance management; (iii) fighting corruption; and (iv) promoting regional integration;

(c) *Corporate governance*, with the following objectives:

(i) enabling environment for economic activities; (ii) good corporate citizenship, including social responsibility; (iii) good business ethics; (iv) fair treatment of all stakeholders; and (v) accountability of corporate officers and directors;

(d) *Socio-economic development*, with the following objectives:

(i) promotion of self-reliance; (ii) sustainable development and poverty eradication; (iii) delivery mechanism and outcomes in key social areas, including education, and combating HIV/AIDS; (iv) affordable access to key social services, water, sanitation, energy, finance, shelter and land; (v) progress towards gender equality; and (vi) encouragement of broad-based participation in development by all stakeholders.

19. The above examples use different indicators to reflect different dimensions of governance. Although there is a broad understanding of the concept, a great deal of variation exists in the specification of measures. Scales, indices and weights to measure good governance are used for a variety of purposes—for cross-national comparisons and rankings, but also for tracking the development record of a country over time. In the former case, the issue is how to develop indica-

tors that are valid and can be reliably measured internationally. In the latter case, indicators are generally custom-tailored to the country context. Validity of measurement is a problem with some of the indices. Reliability is another problem, particularly when numerical scores assigned to indicators are based on subjective appraisals.

20. Of particular relevance to developing countries would be the development of indicators that focused on governance in an instrumental sense, as the ability of a country to make use of the interaction with the rest of the world to deliver development and poverty reduction. Governance in this instrumental sense would entail: (a) the ability to conduct relations with other countries in trade and finance, environmental affairs, conflict situations and donor-recipient settings according to internationally accepted rules of behaviour and mutually agreed norms; and (b) the ability to use resources domestically in efficient, transparent and accountable ways, while allowing for different kinds of regimes and different politico-cultural contexts.

21. If objective and measurable criteria could be developed for governance as constituting such an instrumental ability, international bodies could assess and rank countries for the benefit of both donor countries and the developing countries themselves.

## C. Recommendations

22. As an intrinsic good, good governance is a sine qua non for the attainment by a society and an economy of the maximum welfare possible given limited resources availability. **For developing countries, good governance is a necessary condition for expanding their ability to generate income and reduce poverty in the future.** Good governance also enhances economic efficiency and reduces transaction costs through the effective application of the rule of law, transparency in government and corporate management, and accountability for every institution and individual in society. To the extent that good governance catalyses civil society to increase the rate of physical and human capital accumulation, it can also help to reduce developing countries' dependency and vulnerability, and even ameliorate the impact of economic vulnerability.

23. Designing institutions and mechanisms for good governance in developing countries should be an interactive process between donor Governments and international organizations and recipient countries. On the one hand, measures imposed are likely to fail when insufficient consideration is given to the culture and history of the recipients. On the other hand, recipient countries need assistance from donors in ensuring that their institutions and social, political and economic processes resemble more closely those required by good governance.

24. Developing countries should continue to participate in the discourse on good governance and should develop expertise and capacity in this area. Improving governance should be part of their national policy agenda and should be implemented in ways that are relevant to their particular conditions.

25. International institutions that establish global norms and standards for aspects of good governance should involve developing countries, including the least developed countries, in their deliberations. Moreover, such bodies should themselves be subject to good governance principles.

## Notes

- 1 In the United Nations Millennium Declaration, world leaders resolved “to create an environment—at the national and global levels alike—that is conducive to development and to the elimination of poverty” and stated that “success in meeting these objectives depends, inter alia, on good governance within each country” and “also depends on good governance at the international level and on transparency in the financial, monetary and trading systems” (see General Assembly resolution 55/2, paras. 12 and 13).
- 2 See Economic Commission for Africa, “The UNECA and good governance in Africa”, presentation by K. R. Hope, Sr.; to the Harvard International Development Conference, 2003 (Boston, 4 and 5 April 2003), available at: [http://www.uneca.org/eca\\_programmes/development\\_policy\\_management](http://www.uneca.org/eca_programmes/development_policy_management) (p. 8).

### **III. Matters related to the 2003 triennial review of the list of least developed countries**

1. The Committee has been mandated since 1971 to conduct triennially a review to determine the countries to be added to or graduated from the list of least developed countries, and to make recommendations in that regard to the Economic and Social Council and the General Assembly. The first set of criteria for identification of least developed countries was established by the Committee for Development Planning in 1971. The criteria were improved both by that Committee and by its successor, the Committee for Development Policy, in 1991, 2000 and 2003.

#### **A. Criteria for the identification of the least developed countries**

2. In its report on its first session held in 1999,<sup>1</sup> the Committee for Development Policy reaffirmed that the least developed country category should include countries with a low per capita income, a low level of human resource development and a high degree of economic vulnerability.<sup>2</sup> The Committee thus bases its identification of the least developed countries on criteria designed to measure three dimensions of a country's state of development: (a) its income level, measured by gross national income (GNI) per capita; (b) its stock of human assets, measured by a human assets index (HAI); and (c) its economic vulnerability, measured by an economic vulnerability index (EVI). The type of vulnerability to be considered in the identification of the least developed countries is structural vulnerability: the Committee does not consider that vulnerability caused by government policies should be taken into account.

3. For each triennial review, the Committee determines threshold levels for the three above-mentioned criteria. These thresholds are



used to identify the countries to be added to or graduated from the category. As endorsed by Economic and Social Council and General Assembly resolutions, *to become eligible for graduation* a country must meet the threshold for two of the three criteria; *to qualify for graduation*, it must do so in two consecutive triennial reviews. To be added to the list, a country must satisfy all three criteria.

4. The Committee has consistently recognized that further improvements could be made to the criteria, particularly when new or more reliable data for individual indicators become available. For example, this was the case with the addition to the EVI of a sixth component—namely, the proportion of people displaced by natural disasters—in the 2003 review. Similarly, the 2000 review had included two changes in relation to the human assets criterion (then called the Augmented Physical Quality of Life Index (APQLI)): per capita daily calorie intake was replaced by per capita daily calorie intake as a percentage of daily requirements; and life expectancy at birth was replaced by the under-five child mortality rate.

5. The Committee emphasizes that the identification of least developed countries should be viewed as a dynamic and open process, requiring periodic refinement of the criteria, in the light of socio-economic development and ongoing improvements in and the availability of reliable and internationally comparable data. In preparation for the 2006 triennial review of the list of least developed countries, the Committee, at its seventh session in 2005, will thus examine possible further refinements to the criteria.

6. In addition, the Committee has fully recognized that small countries are economically more vulnerable to external shocks than large ones because their economies are heavily dependent on external trade, are less diversified and suffer from diseconomies of scale. In particular, most small island and landlocked least developed countries face a range of structural handicaps, such as high international transportation costs and relative isolation from major world markets. For those reasons, the Committee is currently considering how the notion of remoteness of countries could be included in the economic vulnerability criterion to be used in the 2006 triennial review of the list. Noting the increasing importance of e-readiness for development, the

Committee will also reflect on whether that factor might be taken into account in the next review in determining the list of least developed countries.

## B. Period of transition from least developed country status

7. The Committee has identified two periods of transition for countries graduating from the least developed country category. The *pre-graduation transition* period refers to the three-year period between a triennial review of the list that finds a country eligible for graduation and the subsequent triennial review when its qualification for graduation is confirmed by the Committee. The *post-graduation transition* period begins when the General Assembly endorses a recommendation made by the Economic and Social Council to graduate a country from the list, on the basis of the Committee's finding that it qualifies for graduation.

8. These two periods of transition have different policy implications, as elaborated in recommendations 3 and 4 in chapter I above. In the case of post-graduation transition, in particular, a smooth transition strategy would relate to further steps to be taken to ensure that the graduated country continues to build on the progress achieved thus far. The Committee proposes that post-graduation transition cover a period to be decided by an advisory group—on a country-by-country basis—to be established after the Committee's recommendation to graduate a least developed country is endorsed by both the Economic and Social Council and the General Assembly (see sect. D, recommendation 4(b), below). The Committee stresses that the primary aim of a smooth transition strategy—as discussed in the following sections—relates to post-graduation support measures provided by the international community to the graduated country.

### C. Smooth transition strategies for countries that graduate from the list

9. The Committee emphasizes that, when a country that has long been recognized as “least developed” qualifies for graduation, the graduation reflects the country’s success in its development and in its ability to achieve a favourable transformation of its economy. The Committee views such success as attributable to a mix of sound domestic policies and propitious external conditions. The support provided by bilateral and multilateral partners thus plays an important role in the successful development of graduated countries. Consequently, a sudden withdrawal of support to the graduated country by its bilateral and multilateral development partners could have adverse effects, possibly reversing some of the development progress achieved.

10. The Committee has consistently drawn attention to the importance of smooth transition measures for graduated countries, as elaborated in the reports of its third, fourth and fifth sessions. As stressed in the report of its fourth session,<sup>3</sup> the Committee considers “smooth transition as a principle of paramount importance to the graduating countries, insofar as these countries are likely to remain dependent, to varying degrees, on external support”.<sup>4</sup> In addition, the Committee stresses that the cost to development partners of measures in support of a (post-graduation) smooth transition would be negligible. As a result, the Committee has made a series of recommendations (see sect. D below) to ensure a smooth transition of countries that graduate from the least developed country category.

11. A number of representatives of international organizations that could contribute to smooth transition strategies—the World Trade Organization, the secretariat of the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD/DAC), the World Bank, the United Nations Development Programme (UNDP), the Economic and Social Commission for Asia and the Pacific (ESCAP) and the United Nations Conference on Trade and Development (UNCTAD)—

addressed the Committee. Those representatives presented their individual perspectives on graduation and its possible consequences from the point of view of their organizations. They also provided information about their facilities in the areas of trade-related assistance, development finance and technical cooperation that could support the smooth transition of graduated least developed countries.

12. The Committee was informed that the World Trade Organization had a number of special dispensations and programmes of assistance specifically designed for the least developed countries, but it was emphasized that entitlement to these was determined by the members of the World Trade Organization, not by its secretariat. In the case of market access, any specific decision on preferential treatment rested with the individual trading partners, albeit within the framework of the World Trade Organization. Other organizations indicated that their assistance and cooperation with a country would not be directly or automatically affected if the country was graduated from least developed country status. At the World Bank, graduating least developed countries remain eligible for financing from the International Development Association (IDA): this is particularly the case for the countries currently being considered for graduation, since they are among the (few) small island States that are, as an exception, eligible for IDA funding even if they exceed the per capita income threshold for eligibility. The Committee took particular note of the flexibility that was applied in implementing some of the arrangements related to least developed countries status, notably through the Enabling Clause in the case of the World Trade Organization, and also took note of the fact that OECD/DAC members could extend their offer of untied aid to least developed countries that graduated from the category.

13. The Committee also examined an updated background document prepared by UNCTAD entitled “Benefits and anticipated implications of graduation from least developed country status”.<sup>5</sup>

## D. Recommendations

### *Recommendation 1: Graduation of Cape Verde and Maldives from the least developed country category*

14. The Committee reviewed its conclusion at its fifth session that Cape Verde and Maldives qualified for graduation from the list of least developed countries, according to the criteria endorsed by the Economic and Social Council. The Committee confirmed that Cape Verde and Maldives did qualify for graduation for the reasons elaborated in the report of its fifth session<sup>6</sup> and recommended to the Council that they be graduated from the least developed country category.

### *Recommendation 2: Smooth transition strategy for countries graduating from the least developed country category*

15. The Committee stressed the need for a smooth transition strategy to be put in place by both the countries themselves and the international community, as elaborated in recommendations 3 and 4 below. In order to avoid a negative shock from graduation, and as with all development strategies, the developing countries themselves (in this case, graduated least developed countries) should play the central role in the formulation and implementation of the smooth transition strategy. All development partners—notably relevant organizations of the United Nations system, donor countries and members of the World Trade Organization—should facilitate this transition through the continued provision of development financing, trade-related assistance and technical cooperation, as well as the maintenance, for a transition period, of existing preferential treatment applicable to least developed countries.

### *Recommendation 3: Pre-graduation smooth transition measures*

16. The Committee recommended to the Economic and Social Council that the pre-graduation transition period (sect. B above) should trigger the preparation of a vulnerability profile by the United

Nations Conference on Trade and Development (UNCTAD), in cooperation with the least developed country concerned. It further recommended that the vulnerability profile include both information about the effective benefits available to the country as a least developed country, and measures that could be required to prepare the country for smooth transition if it was deemed to qualify for graduation after the second consecutive triennial review.

***Recommendation 4: Post-graduation  
smooth transition strategy***

17. Among the measures to ensure a post-graduation smooth transition for countries graduated from least developed country status (see also chap. III.B), the Committee recommended that the Economic and Social Council endorse the following recommendations and proposals, all of which should be applied in the cases of Cape Verde and Maldives:

(a) That there be the provision of adequate technical assistance—by both bilateral and multilateral development partners—to graduated countries so as to ensure a smooth transition from the least developed country category, including the maintenance of adequate technical assistance through the Integrated Framework for Trade-related Technical Assistance to Least Developed Countries;

(b) That the United Nations convene an ad hoc country advisory group in which the graduated country, in cooperation with its bilateral and multilateral development partners, would identify measures—in the areas of trade-related preferences, development finance and technical cooperation—to ensure that its development progress would not be interrupted or reversed, the guiding principle being that specific transition support measures, monitoring arrangements and the period of transition would be decided on a case-by-case basis inasmuch as graduation was likely to present different countries with different challenges;

(c) That, with regard to trade-related preferences, in particular, this being considered essential by the Committee, key development partners—such as the European Union with regard to its Everything-

but-Arms initiative—take the initiative to ensure that graduated countries continued to benefit from existing trade preferences for the required smooth transition period after graduation.

## Notes

- 1 *Official Records of the Economic and Social Council, 1999, Supplement No. 13 (E/1999/33).*
- 2 *Ibid.*, annex II.
- 3 *Ibid.*, 2002, Supplement No. 13 (E/2002/33).
- 4 *Ibid.*, para. 159.
- 5 An earlier version was contained in annex II of the report of the Committee on its fourth session. The updated version of the document is available on the Committee's home page (<http://www.un.org/esa/analysis/devplan/index.html>) maintained by the United Nations Secretariat.
- 6 *Official Records of the Economic and Social Council, 2003, Supplement No. 13 (E/2003/33).*

## Annexes

### **Background papers submitted to the Committee**





## Annex I

### **Report of the Expert Group Meeting on resource mobilization for poverty eradication in the least developed countries**

#### **Background to the Expert Group Meeting**

1. In order to facilitate the discussions of the Committee for Development Policy at its sixth session (29 March-2 April 2004), an expert group meeting on resource mobilization for poverty eradication in the least developed countries was held at United Nations Headquarters in New York on 19 and 20 January 2004. The meeting focused on innovative approaches to domestic resource mobilization in some least developed countries (LDCs) and new approaches to debt sustainability in these countries.

2. The Expert Group Meeting was provided with two background papers: "Innovative Approaches to Domestic Resource Mobilization in Selected LDCs" by S. Wangwe and P. Charle, and "New approaches to debt relief and debt sustainability in LDCs" by O.Bjerkholt.<sup>a</sup> This is a summary of the report of the Expert Group Meeting that was prepared by Mr. Al Binger, a member of the Committee for Development Policy, for use by the Committee in its deliberations.

3. The first part of the report provides an overview of the current challenges faced by the LDCs in reducing the high rates of widespread poverty. The second part discusses innovative approaches to domestic resource mobilization in LDCs, and addresses how domestic resource mobilization can be managed more innovatively and with greater effectiveness. The third part examines new approaches to debt

relief and debt sustainability. It provides a brief overview of the debt situation in LDCs, and examines the need for innovative ideas to reduce foreign debt. The last section discusses specific measures to accelerate poverty reduction in LDCs. The report is intended to contribute to the debate on resource mobilization for poverty eradication in the LDCs, leading to practical solutions, policies and actions by all concerned.

## The poverty reduction challenge in LDCs

4. Most LDCs are characterized by the large number of poor people, identified as those living on less than US\$ 2 a day. For instance, in the period 1995-1999, for the group of LDCs for which data is available, 81 per cent of the population lived on less than US\$ 2 a day, while 50 per cent lived in extreme poverty, such as less than US\$ 1 a day. An extrapolation of these patterns indicates that, with a total LDC population of 613 million people, the number of people living on less than US\$ 1 a day in all LDCs was 307 million, while the number living on less than US\$ 2 a day amounted to 495 million.

5. Poverty in LDCs is pervasive: the number of people living in poverty has more than doubled over the past thirty years. This lack of progress towards poverty reduction is most noticeable in the African LDCs. Poverty is, in general, more severe in rural than in urban areas, with the poorest of the rural poor living in remote areas. In sub-Saharan Africa, three fourths of the poor, particularly the extremely and chronic poor, work and live in rural areas, and more than half are expected to do so in 2025. The remoteness, but also the lack of natural, physical, human and social resources, as well as social and political exclusion, are aspects of persistent rural poverty. People in irrigated zones within rural areas face a much lower poverty risk.<sup>b</sup>

6. The poverty situation in LDCs indicates that a significant proportion of the population has been left out of the development process. In the developed and some middle-income developing countries, poverty reduction involves income transfers, social welfare systems or targeted job creation programmes. But, in situations of gen-

eralized poverty (as in the majority of LDCs), where the available resources in the economy, even if equally distributed, are barely sufficient to cater for the basic needs of the population on a sustainable basis, poverty reduction can be achieved on a major scale only through economic growth.

7. The majority of LDC economies are highly dependent on the export of commodities for earning foreign exchange and generating economic growth. For these countries, the export value of primary commodities and the incidence of extreme poverty are closely related. To illustrate, from 1997-1999, 80 per cent of the people experiencing extreme poverty in the LDCs lived in primary commodity exporting economies. The number of people living in extreme poverty in the commodity-exporting LDCs increased by 105 million between the periods 1981-1983 and 1997-1999. In contrast, over the same period of time, the number of people living in extreme poverty in LDCs with more diversified economies increased by only 10 million. Moreover, for the latter group of countries, the incidence of extreme poverty fell from 30 per cent during 1981-1983 to 25 per cent during 1997-1999.

8. The international economy can play a key role in helping LDCs break the cycle of generalized poverty and economic stagnation. However, the current form of globalization is tightening rather than loosening the poverty trap. For the vast majority of LDCs, sustained economic growth will require significant foreign resources to reverse the existing negative net resource transfers that results from their high indebtedness.

9. A major challenge for the LDCs is to take the necessary steps to create an enabling environment that makes these countries attractive for foreign investors. The elements of a conducive enabling environment would include such factors as sound macroeconomic policies, good governance, rule of law and protection for investors. However, for LDCs, the establishment of such a supportive environment is an essential but insufficient requirement for mobilizing the necessary investments. It is also necessary for these countries to put in place additional policies and incentives that foster the development of their private sector and provide the ability to exploit the opportuni-

ties of international trade. This means a more productive agricultural sector, which now provides the major source of employment and livelihood in these countries; the development of more effective small and medium-sized enterprises; and, where possible, the expansion or establishment of larger-scale enterprises.

10. Mobilizing domestic financial resources for the development of the private sector in LDCs is difficult for a number of reasons: the high cost of finance and debt servicing reduces the availability of financial resources at the national level; the financial sector is underdeveloped, risk averse, and offers only a limited range of products; and there is limited access to financial services in the more remote areas. There is, therefore, a need for LDC Governments to become innovative in mobilizing domestic financial resources to support the development of the private sector. Additionally, international development partners will need to live up to their commitments to provide both debt relief and development assistance. This would provide LDC Governments with the resources to finance social expenditures and the infrastructure critical for sustained economic growth, as well as to invest in developing the capacity needed to ensure good governance.

## **Innovative approaches to domestic resource mobilization in LDCs**

11. There is a need for innovation and greater effectiveness in domestic resource mobilization, with a particular focus on the linkages to poverty reduction and growth. In this context, a sound fiscal policy, responsible social spending, and a well functioning and competitive financial system are crucial elements for economic and social development.

### ***Financial sector reform policies for growth and poverty reduction***

12. Measures should be taken to put in place a solid financial infrastructure that enables enterprises to enter the market and operate effectively, as well as to help restructure firms to operate efficiently in competitive national and global markets. Furthermore, with

respect to the poor, who usually operate either in the non-monetized system or in the informal financial sector, there is a need to encourage participation in the formal financial sector. The approach to be adopted should focus on two areas: reducing the risk associated with lending; and providing incentives for financial institutions to diversify financial products in order to cope with the operational requirements of businesses and households. In these two areas, the following actions are recommended:

- Development of collective investment schemes should be promoted—directly or indirectly—in order to open up investment opportunities for small-savers and increase the mobilization of domestic savings;
- Capacity-building in formulating viable projects should be strengthened (for example, advising on feasibility studies and project write-up) to meet the requirements of banks;
- Small businesses should be encouraged to form consortia or business associations (including farmer associations) that can guarantee certain loans to the businesses operated by members;
- Local governments in most LDCs are often too dependent on tax revenues and should, therefore, explore other sources of revenue. One alternative is market-based borrowing, such as issuing marketable instruments (or “certificates”) which could attract household savings and investments from the corporate sector and financial institutions. The success of this approach would depend on the financial conditions of the local government, that is to say, whether it is operating under a balanced budget and maintaining up-to-date audited annual accounts and a highly transparent system of public accounts;
- Closer links between formal and informal financial markets should be developed by encouraging formal financial institutions to mobilize deposits and allocate credit through informal and community-based banks and microfinance agents in areas where the reach of formal banks is limited. Fiscal policies, as well as regulatory and supervisory structures, should be designed to encourage these developments;

- Not-for-profit financial cooperatives, such as credit unions and savings and credit cooperatives should be encouraged to further support savings mobilization. Banks could improve their services to small-scale farmers and enterprises by syndicating small loans with financial cooperatives and community banks, thereby promoting resource mobilization and financial intermediation. In this context, there is a need for continued improvement in the legal framework governing links between financial cooperatives and locally based financial institutions, such as community banks and other financial institutions. Improvement in internal auditing and the procedures of financial cooperatives are also recommended;
- Action should be taken to restructure and recapitalize existing development financing institutions to spearhead national and regional investment financing, and enable firms to make long-term investments in a competitive environment. Furthermore, central banks should be encouraged to promote the growth, efficiency and geographical spread of development finance institutions. This could be achieved by providing equity capital, or by creating an enabling environment for existing financial institutions to diversify their products;
- There is also a need to diversify financial instruments and products available for financing productive investments. In particular, the development of capital markets, leasing activities, venture capital, bond markets, securitization (structured finance), derivatives (financial contracts whose value is derived from the value of another asset), factoring (a form of receivables finance) and microfinance are some of the instruments that can be developed to fill gaps in the existing financial system;
- Capital markets should be revitalized to enable them to raise larger amounts of finance for companies. Action needs to be taken to introduce institutional procedures and mechanisms to create confidence on the part of investors. Corporate and financial sector governance needs to be improved, in partic-

ular in the areas of regulation and supervision, transparency, and contract enforcement. This could entail improving the conduct of public companies, disclosure requirements, and shareholders' rights, as well as the regulatory and supervisory role of central banks;

- The small size and limited diversity of many LDC economies suggest that a regional approach to resource mobilization is needed to lower transaction costs and the risks involved in financial sector development and other forms of domestic resource mobilization. For instance, mechanisms should be established to link emerging domestic capital markets with regional and international capital markets.<sup>c</sup> Also, to the extent possible, regional monetary authorities should be created as they stand a better chance of enjoying independence and credibility than national central banks;
- Action should be taken to build local capabilities in risk management. This encompasses development of trust and policy credibility, as well as governance procedures. Macroeconomic risks can be reduced by pursuing sound macroeconomic policies, improving coordination between fiscal and monetary policies, and careful management of government borrowing. Market risks can be mitigated by improving capital market efficiency, reducing interest rate volatility, developing secondary markets for treasury bills and improving liquidity management by Governments. Microeconomic risks can be lowered by improving the accuracy, reliability and timeliness of financial information, enforcing financial contracts, providing efficient and reliable payment systems, risk-sharing and credit risk insurance schemes, and enhancing diversification in small markets;
- Furthermore, the development of credit rating agencies stands out as one of the possible options that would help reduce risk and check the high lending rates charged by financial intermediaries in the country. Credit rating agencies can help the financial intermediaries overcome asymmetric



information and its related problems: adverse selection (a phenomenon under which potential borrowers with higher credit risks are the ones who most actively seek and get loans) and moral hazard (the risk that borrowers might divert loans and therefore lower the probability of repayment). Equally important, credit rating agencies could help to de-emphasize the high importance attached by financial intermediaries to track records, a requirement that results from mistrust and lack of information about potential borrowers.

### *Microfinancing*

13. Microfinance has been introduced in a number of countries to enhance the access to finance by small businesses. Its effectiveness has been limited by its narrow coverage and a weak, and not always appropriate, regulatory system. One problem with microfinance institutions (MFIs) in the past has been that they were often paternalistic. Some MFIs have been used for political ends and most have been subsidized in ways that were detrimental to achieving sustainability. In the changed environment of political and economic liberalization in most LDCs, the situation is likely to be different. To create a conducive environment for a proper functioning of MFIs, it is important that LDC Governments take into consideration country conditions. Key areas in this respect include: access to services; a regulatory and incentive framework; proper financing for institutions; and the use of 'second-tier' institutions (financial intermediaries or networks providing financial and institutional support services to retail intermediaries), where appropriate.

14. Experience around the world has shown that micro-entrepreneurs do not need subsidies and that micro-lenders cannot afford to subsidize borrowers. Low-income entrepreneurs want rapid and continued access to financial services, rather than subsidies. Most micro-enterprise clients see the "market interest rate" as the rate charged by the money lender or curb market, which is often double the interest rate charged by micro-lending institutions. Subsidies in the form of lower interest rates often send the signal to borrowers

that the money comes from government or donors who regard the poor as objects of charity. Borrowers may perceive this as a signal not to repay.

15. Microfinance offers the potential for sustainability and growth. Due to its demonstrated success in providing benefits to the poor, international donors and Governments are increasingly willing to support MFIs. Many Governments have set up facilities that channel funds from multilateral agencies to MFIs. Scaling-up this successful approach will require partnerships among civil society, government and donors to provide seed money for expansion. For example, despite their high liquidity, private banks in Thailand were reluctant to lend without collateral—a situation that also exists in LDCs. In order to increase the availability of credit, the Thai Government became the guarantor so that banks made loans directly to communities, who then decided how they could utilize such funds. Furthermore, scaling-up microfinance may also require commitments of grant resources to help offset the overhead cost associated with operating these facilities. For instance, in the case of Bangladesh's Grameen Bank, a pioneer in this field, experience has shown that MFIs may remain constrained by high expenses per unit transacted, and a reliance on donors and socially conscious investors.<sup>d</sup>

16. Generally, in building policies, regulations and incentives for financial institutions that serve the poor, several principles and practices are essential:

- Institutions lending to micro- and small enterprises should be encouraged to enter the market and expand, and be free to set their own lending interest rates. Incentives should be provided to these intermediaries;
- Entry thresholds, such as minimum capital requirements, should be kept low enough to allow specialized institutions that meet performance standards to operate as recognized financial intermediaries;
- Supervisory and reporting requirements should be kept simple and focus on key performance indicators.

### *Government assistance*

17. To help build financial institutions that serve the majority of the population, LDC Governments should adopt and promote new approaches to funding, such as:

- Grant funding over a period of time to finance the operating costs and loan portfolios of promising start-ups;
- Capitalization for financial institutions that meet performance standards;
- Access to refinancing from development banks and other second-tier intermediaries (financial intermediaries or networks providing financial and institutional support services to retail intermediaries (see below)); and
- Partial loan guarantees to encourage the build-up of leveraged credit lines by local banks to specialized financial intermediaries. When an institution has reached the scale and efficiency to cover costs and manage fully commercial sources, it will be able to access international commercial funds.

### *Use of 'second-tier' institutions*

18. Second-tier institutions (financial intermediaries or networks providing financial and institutional support services to retail intermediaries), such as development banks, have major roles to play over the next five to ten years as wholesalers of capitalization, sources of refinance, and institutional development support, in the following areas:

- Building an agreed set of standards of eligibility criteria for accessing support services;
- Organizing performance benchmarking systems;
- Encouraging an exchange of experiences among participating retail institutions;
- Serving as a wholesaler or broker of seed funding, capitalization funds, refinance of loan funds, and institutional development support;

- Encouraging linkages between commercial banks and specialized financial intermediaries; and
- Helping ensure that the appropriate legal, regulatory and supervisory structures and incentives are in place.

*Mobilizing resources through fiscal policies and tax reform*

19. Many LDCs are experiencing unsustainable fiscal deficits, high debt-service costs and declining official development assistance, all of which adversely affect their development process. A particular challenge for these countries is the application of fiscal measures for domestic resource mobilization through tax and non-tax instruments. Fiscal policies should be equitable and create minimal disincentives for economic efficiency. However, most tax administrations lack the resources required to function in an efficient manner and most taxpayers have limited capacity to keep the necessary accounts. That has often led the tax administration to focus on businesses that are the least resistant and the most easily identifiable. These types of businesses tend to be overtaxed, which, in turn, leads to tax evasion and corruption. Interest groups of taxpayers may also make it difficult to reform a tax system which would increase their tax burden. Another major challenge is that of capturing tax revenues from the informal sector, which often requires a reform of the tax system to ensure compliance among taxpayers.

20. A desirable feature of a tax reform is that it should not introduce changes in relative prices and should leave the allocation of resources undisturbed. This is achievable by broadening the tax base and keeping tax rates as uniform as possible. Reforms should also focus on establishing an efficient and simple tax structure with the following common elements: low rates, a broad base, few exemptions, few surcharges, few temporary measures and, where there are exceptions, clear guidelines. A successful reform of the tax administration additionally requires political commitment and a well-trained staff. It is also important to find the appropriate incentives for taxpayers and tax administrators. These incentives should go along with measures

that minimize the cost of tax compliance and establish procedures for detecting violations and imposing appropriate penalties.

21. Mobilization of resources through fiscal policies should be accompanied by efficient spending of fiscal resources. In particular, the allocation of government spending should be poverty sensitive. Furthermore, domestic resources can be mobilized by reorienting fiscal expenditures towards areas that attract private savings and investment. This could, for instance, involve public expenditure policies for infrastructure development, communication, and human capital development. In LDCs, fiscal spending on, and investment in, rural roads and utilities would have a positive impact, not only in opening up the rural economies and thereby improving rural incomes, but also in creating a favourable environment for financial service providers to operate in rural areas, thus further stimulating the mobilization of resources.

## New approaches to debt relief and debt sustainability in LDCs

### *Overview of external debt in LDCs*

22. The build-up of foreign debt is not only a result of the high levels of external borrowing, but also a consequence of varying exogenous and endogenous factors, such as adverse movements in the terms of trade for agricultural commodities and some minerals (particularly in relation to strategic imports such as petroleum), governance failures, unsuccessful macroeconomic and structural reforms, poor debt management and internal conflicts. In general, the build-up of debt and the resulting debt-servicing obligations have taken up large parts of the scarce budgetary resources of the LDCs that could otherwise have been directed to productive and social areas.

23. Since the mid-1980s, the debt overhang of developing countries has become a major item on the agenda of official creditor nations. Traditionally, the Paris Club approach has been to reschedule debt-servicing payments, often combined with new lending from the International Monetary Fund (IMF) and multilateral development banks.

24. The Heavily Indebted Poor Countries (HIPC) Initiative, which was launched in 1996 in response to the growing international pressure for debt forgiveness for the poor countries, was intended as a comprehensive approach to address the external debt problem of poor countries. However, the World Bank itself, at the technical level, has been critical of the HIPC Initiative, pointing out procedural and conceptual flaws. The procedural weaknesses have resulted in a slow disbursement of funds, owing to the various conditionalities that must be met in order to access the HIPC resources. Conceptual weakness included the assumptions that went into defining the level of the debt sustainability target. Some have argued that the concept of the debt sustainability level was not based on sound economic principles, and that projections of economic growth and export performance were over-optimistic. Additionally, questions were raised about the generic “one-size-fits-all” approach, and about the extent to which the debt-relief proposal was linked to sustainable development. The HIPC Initiative has also failed to take into consideration the extent of capacity weaknesses in the participating countries, and the need for effective governance in such key areas as transparency, rule of law and security for the investor. Lastly, the HIPC Initiative did not represent a source of the new financial flows which are required to stimulate economic growth and thereby generate the resources for sustainable debt servicing.

25. In most LDCs, such basic infrastructure as well-defined property rights, roads, schools, hospitals and clean water are inadequate to serve as a basis for profitable economic activity. Since the principal problem of these countries is a lack of infrastructure, it is unlikely that debt relief will stimulate inflows of private foreign capital, nor that there will be higher investments and growth. These are reasons to suggest that LDCs should not be targeted for debt relief but for direct aid to assist these countries in building their institutions and infrastructure, and eventually to make them attractive for both domestic and foreign investment. In this context, there has also been concern that debt relief may crowd out existing aid flows in that it does not necessarily represent new financial resources. To illustrate, aid flows to the HIPCs increased continually from 1970 to the mid-1990s. Since 1996, however, aid flows have decreased significantly. As a share of

GDP, the decline is also salient: while in the early 1990s, aid flows were about 17 per cent of the GDP of the recipient countries, since 1996, they have only been about 12 per cent. Together, the fall in aid flows and the postponed reduction in debt service have caused a significant decline in the net resource transfers to the HIPC.

26. The apparent weaknesses of the original HIPC Initiative raises the question whether trying to retool and launch an enhanced HIPC is the best available option to the international community, and points to the need for innovative ideas to reduce foreign debt.

*Using annual debt-service payments  
to establish public-private partnerships  
for national energy efficiency initiatives*

27. With the exception of those LDCs with significant oil and gas production, expenditures on imports of oil and gas represent a large share of the limited foreign exchange available to most LDCs. Additionally, in the case of the landlocked developing countries and small island developing countries, the high cost of transportation contributes to high domestic energy prices, negatively impacting on poverty reduction, directly through the high cost of energy services, as well as indirectly, through its negative impacts on economic growth and competitiveness.

28. In many developing countries, petroleum is used less cost-effectively than in the developed world. In the majority of LDCs, opportunities exist for improving energy efficiency, and consequently for a reduction in the amount of energy resources imported. But, on many occasions, a major constraint to undertaking energy efficiency initiatives is the high cost of domestic financing and the absence of supportive government policies. In this respect, foreign creditors should be encouraged to use annual debt repayments as investment resources in energy efficiency projects in LDCs, which could yield rates of return higher than the commercial interest rates in the creditor countries. Over time, the savings in foreign exchange from reduced petroleum imports would provide LDCs additional resources for repaying their outstanding foreign debt and making the associated interest payments.

*Using debt-service payments to  
establish public-private partnerships  
for renewable energy development*

29. By virtue of their geographical location, the vast majority of LDCs has significant renewable energy resource endowments in the form of solar, wind, biomass, ocean and hydro power. One of the major recommendations from the World Summit on Sustainable Development (WSSD) for fostering sustainable development in LDCs is the development of renewable energy resources, to reduce both dependency on petroleum imports and the resulting negative impact on global climate change, as well as to create local employment.

30. There are opportunities to lower the cost of petroleum imports by raising energy efficiency but, for LDCs, the cost of capital and the absence of supportive government policies often act as obstacles. The development of public-private partnerships for renewable energy development could make a contribution to reducing the pressure of foreign debt on the economy, while providing employment, environmental and social benefits. This would include additional markets for rural farmers who could become producers of biomass fuel for electricity.

*Using annual debt-service payments to  
establish public-private partnerships for  
infrastructure and new export markets*

31. Limited infrastructure development is an obstacle to economic growth and poverty reduction in a large number of LDCs. To illustrate, as a result of high transportation costs, the cost of inputs and everyday necessities are high, and farmers are often unable to transport their products to markets (resulting in high levels of waste). Experiences from a number of developing countries in the use of public-private partnerships to finance roads and water supply projects represent a possible approach for LDCs. For instance, toll roads, constructed through private investment, could improve the weak infrastructure that makes poverty reduction more difficult in rural areas. As with the energy proposals above, capital investment could come from the conversion of debt payments into capital investment.



Repayment of loans would be drawn from the profits from the fees charged to users of the infrastructure.

32. A significant number of LDCs are either coastal countries or small island developing countries and, as such, they often have significant resources in their exclusive economic zones. However, the limited availability of financial resources restricts the benefits they are able to derive from what is, for some countries, a large natural resource endowment. For example, fisheries are constrained by small boats and inadequate equipment that involve high personal risks and provide limited economic benefits to fishing families. As the traditional fishery resources of the developed countries become depleted, there is a growing opportunity for profitable investments to service an established and relatively risk-free market. Similarly to the foregoing proposals on energy efficiency and renewable energy development, private–public partnerships converting debt payments into capital investments could provide financial resources for establishing profitable ventures in some LDCs.

## Specific measures to accelerate poverty reduction in LDCs

33. In a number of LDCs, adverse economic conditions are increasing the number of the poor. Especially in the rural areas, where the majority of the poor try to make their livelihood, the macroeconomic changes recommended by the multilateral financial institutions have, so far, not resulted in sufficient levels of economic growth to increase employment and income. Actions to accelerate production and productivity should provide the foundation for increased opportunities for the unemployed and underemployed, generating income earnings and making existing livelihoods more rewarding and sustainable.

### *Increasing access to financial resources*

34. Evidence from microfinance clients in developing countries has demonstrated that access to financial services enables poor people to increase their incomes and build assets, offers the potential for growth and helps safeguard poor households against vulnerability.

MFIs have been credited with addressing the structural determinants of poverty, the economic and social status of women, and other sources of vulnerability. In general, MFIs offer a range of financial services, including credit, savings and insurance to poor enterprises and households, often helping to even out income fluctuations and maintaining consumption levels during lean periods. Typically, MFIs are located near their clients, and utilize lending technologies that are simple and inexpensive for both the client and lender.

35. The early MFIs were launched by non-governmental organizations and banks such as the Grameen Bank (Bangladesh, 1976), the Kenyan Rural Enterprise Programme, Banco Solidario (Bolivia, 1992), and Bank Rakyat Indonesia (BRI, 1984). In Ethiopia, formal MFIs began emerging in 1995. By 2001, there were 19 MFIs serving over 600,000 clients, which represented 15 per cent of poor rural households registered with the National Bank of Ethiopia, deposits with MFIs totalled about US\$ 20 million and the sector was growing steadily.<sup>e</sup> In West Africa (in Burkina Faso, Guinea, Mali and Senegal, for example), where MFIs are in the early stages, MFI programmes demonstrate the viability of making financial services available to the rural poor. Additional examples of MFIs operating in rural areas are BRAC in Bangladesh, SHARE in India and Zambuko Trust in Zimbabwe. An impact assessment study of BRAC in Bangladesh showed that members who participated in the programme for more than four years increased household expenses by 28 per cent and assets by 112 per cent. Access to financial services enabled BRAC clients to reduce their vulnerability by smoothing their consumption, building assets, and receiving services during natural disasters.<sup>f</sup> A study of SHARE in India revealed that three fourths of the clients saw improvements in their economic well-being and half the clients graduated out of poverty. Participation in the Zambuko trust had a positive impact on the consumption of high protein foods in extremely poor client households. In general, experiences from an increasing number of successful MFIs show that with new methods of lending, often involving small loans without collateral and at full-cost interest rates (repayable in frequent instalments), the vast majority of clients repaid on time.<sup>g</sup>

*Establishment of farmer support services facilities  
in rural areas to improve agricultural sector incomes*

36. The objective of any policy to reduce poverty in rural areas involves raising the incomes of farmers, by increasing their productivity and the income received from their products. In the case of African LDCs, the need for an increase in productivity is apparent from the fact that the population of sub-Saharan Africa increased by more than 3 per cent annually in the 1980s and early 1990s, while food production increased by less than 2 per cent.

37. The constraints in sub-Saharan Africa are agro-ecological and socio-economic. There is a lack of water and the soils are often hard to cultivate. About 38 per cent of the land base in eastern and southern Africa is arid or semi-arid desert. Of the remaining 62 per cent (where at least 86 per cent of the rural population lives), just under half can produce one rain-fed cereal crop per year. Socio-economic constraints include subsidized food imports from Organization for Economic Cooperation and Development (OECD) countries, food prices which have been kept low in order to favour consumers over producers, lack of market transparency, lack of access to such resources as land and credit, and inadequate knowledge and limited research to improve agriculture.<sup>h</sup>

38. In view of these constraints, Governments, with the support from international donor agencies, in partnership with NGOs and the private sector—particularly those involved in agricultural inputs, marketing, or agro-industry, should consider establishing farmer support services in rural areas. These services should assist farmers with access to credit, technical assistance, capacity-building, marketing information and crop and product diversification.

*Development of rural infrastructure*

39. In many LDCs, weaknesses in basic national infrastructure (such as transport, utilities and communications) are major constraints on agriculture. Infrastructure constraints affect the cost and continuity of production and the quality of products. For instance, numerous studies have indicated that the provision of roads reduces

the costs of inputs and outputs, and leads to an increase in agricultural output, crop area and yield. Infrastructure helps make the more remote rural areas part of a broader market, contributing to the marketability and profitability of agriculture. It also promotes information flows between communities and rural and urban areas, and thus has the potential of linking farmers to markets for goods, input supplies and agricultural services. More generally, rural infrastructure plays a vital role in empowering people, connecting isolated communities and providing rural people with access to political and decision-making entities. In this context, LDCs and their development partners need to identify critical infrastructure requirements and address them on a priority basis.

*Making international aid a catalyst  
for economic development in LDCs*

40. Several of these measures to accelerate poverty reduction require external financial assistance in the form of aid and loans. Without an increase in development assistance to the LDCs to develop financial services for the poor, improving infrastructure, implementing land reform, building mechanisms for good governance, and supporting small and medium enterprises to create a diversified and modern rural sector, the chances of achieving the Millennium Development Goals appear limited for the majority of LDCs.

41. It is important to consider both the quantitative and qualitative aspects of aid. To enable donors to test the effectiveness of their support, new approaches (such as the performance-based conditionality being implemented by the European Union (EU)) are required, focusing on outcomes in key economic and social sectors (rather than on the implementation of specific policy measures or actions). Mechanisms focusing on outcomes in key economic and social sectors, and a good governance regime as a prerequisite for assistance, should create an enabling environment for a new partnership between the international donor community and LDCs to promote economic growth, which is the only sustainable means of reducing poverty.

### *Accountability of multilateral financial institutions*

42. The relationship between economic growth and poverty in developing countries is complex, and, so far, no general understanding has been reached over the best approach to achieving poverty reduction. Yet, over one billion people, including 400 million in LDCs, are now living in countries whose Governments are preparing Poverty Reduction Strategy Papers (PRSPs) as a condition for concessional aid and debt relief. Efforts to improve the standard of living of the poor should continue, but unless the actual policy solutions are well grounded in a deep understanding of the causes of poverty, and how those causes have been, and can be, effectively addressed, they could end up with worse results. In the past, the lack of accountability of the development partners of LDCs may have contributed to additional hardships in a number of these countries. In this respect, as part of the overall accountability of Governments for good governance, and to improve the effectiveness of the World Bank and the IMF, multilateral financial institutions should be held accountable for the policy advice that they provide to LDCs.

### *Other measures to accelerate poverty reduction in LDCs*

43. Other measures to accelerate poverty reduction in LDCs range from the establishment of agricultural commodity insurance, to strategies to promote export diversification, to action to end the dumping of surplus food production from developed countries in LDCs. The key elements of such measures should be formulated in further detail, but fall beyond the scope of this report.

## Conclusions

44. Several challenges need to be addressed in order for the vast majority of LDCs to achieve the international poverty reduction goal envisioned by the Millennium Development Goals. Despite implementing macroeconomic reforms and fiscal policies recommended by the multilateral financial institutions, economic growth in many

LDCs is inadequate. In order to address the resource constraints which limit the ability of LDCs to foster economic growth and poverty reduction, Governments need to develop innovative approaches for mobilizing domestic financial resources. Domestic resource mobilization can be managed more innovatively for greater effectiveness. This report makes a number of suggestions ranging from providing better access to financial services for the poor, through microfinancing systems, to financial sector reform policies for growth and poverty reduction.

45. Foreign debt remains a major challenge not just for LDC Governments but for the international community as a whole. For many LDCs, previous initiatives like the HIPC Initiative have not been successful in providing adequate debt relief, reflecting weaknesses in design and erroneous assumptions about the ability of the LDCs to grow at high enough rates to escape the debt trap. The report makes a number of suggestions for new approaches to managing external debt by using it as a source of investment in low-risk, public-private partnerships. In addition to reducing economic vulnerability, these types of partnerships would increase employment and help drive economic growth.

46. The structure of most LDC economies is based on a very limited range of exports which continues to decline in price against strategic imports. Policy makers and the international donor community should develop policies to counter this trend. LDC Governments have to become more innovative in mobilizing domestic financial resources to support the development of the private sector. Additionally, development partners will have to live up to their commitments to provide debt relief and development assistance, and liberalize trade in agricultural products.

## Notes

- a** Available from [www.un.org/esa/policy/devplan/](http://www.un.org/esa/policy/devplan/).
- b** See *Rural Poverty Report 2001: The Challenge of Ending Rural Poverty*, International Fund for Agricultural Development, p 21.
- c** See V. Mulinde, "Financial Institutions and the Mobilization of Resources for Development", in *The African Economy: Policy, Institutions and the Future (Routledge Studies in Development Economics)*, S. Kayizzi-Mugerwa, ed. (Routledge, London and New York, January 1999).
- d** See Jonathan Morduch, "The role of subsidies in Microfinance: evidence from the Grameen Bank", *Journal of Development Economics*, vol. 60, No. 1 (October 1999), pp. 229-248.
- e** See Daniel C. Hardy, Paul Holden and Vassili Prokopenko, "Microfinance Institutions and Public Policy", International Monetary Fund, Working paper WP/02/159.
- f** Elizabeth Littlefield, Jonathan Morduch and Syed Hashemi, "Is Microfinance an Effective Strategy to Reach the Millennium Development Goals?", Consultative Group to Assist the Poor, Focus Note, No. 24, January 2003.
- g** See "Microfinance: A synthesis of lessons learned", *Essentials*, No. 3, United Nations Development Programme, Evaluation Office, December 1999.
- h** Henk Breman, J.J. Rob Groot and Herman van Keulen, "Resource limitations in Sahelian agriculture", *Global Environment Change*, No. 11 (2001), pp. 59-68.

## Annex II

### **Report on commitment to good governance, development and poverty reduction: methodological issues in the evaluation of progress at the national and local levels**

#### Background

1. This report was prepared by Ms. Suchitra Punyaratabandhu, a member of the Committee for Development Policy, as a background paper for deliberations by the Committee at its sixth session (29 March-2 April 2004) on how to evaluate progress towards good governance in the context of the implementation of the Millennium Development Goals. The first part of the report reviews the concept of good governance as it has evolved over the past 15 years. Key defining properties of the concept of good governance are presented. The second part of the report examines current efforts to measure governance. As might be expected, different working definitions have led to the specification of different sets of indicators and indices of governance. The third part briefly reviews studies on governance that examine the relationship between good governance and other desired outcomes, such as poverty alleviation and policy performance. The report concludes by summarizing the key issues in the evaluation of good governance.

#### The concept of good governance

2. Governance has been variously defined as “the management of society by the people”,<sup>a</sup> “the exercise of authority or control to



manage a country's affairs and resources",<sup>b</sup> or as a complex system of interactions among structures, traditions, functions (responsibilities) and processes (practices) characterized by the three key values of accountability, transparency and participation. Good governance has also been described as the striving for rule of law, transparency, responsiveness, participation, equity, effectiveness and efficiency, accountability, and strategic vision in the exercise of political, economic and administrative authority.

3. While it is striking how quickly governance became a popular concept in the 1990s, "there has hardly been a consensus as to its core meaning, and less and less of a common idea as to how it could be applied more concretely".<sup>c</sup> The term does not possess a standard meaning. Nor has its meaning remained constant in the decade or so of its being accorded a central place in donor frameworks for development.

4. The lack of specificity in the meaning of the term "governance" becomes apparent when its evolution is examined. The concept achieved prominence in donor discourse around 1990, after the end of the cold war. Governance was conceived broadly as "the exercise of authority and control in a society in relation to the management of its resources for social and economic development".<sup>d</sup> International donor agencies, the World Bank in particular, operating within the boundaries delineated by their statutes, adopted an essentially apolitical concept of governance.<sup>e</sup> This orientation helps to explain the focus of the international donor community on the improvement of the quality of (recipient country) public sector management, better service delivery, rule of law, and elimination of corruption, together with compliance with donor policies, for example, the reduction of excessive military expenditures.<sup>f</sup>

5. By the mid-1990s, the notion of good governance had expanded to include transparency, accountability and participation. For example, the Ad Hoc Working Group on Participatory Development and Good Governance, set up in 1993 by the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD), stated as its first key conclusion that democratization and good governance are central

to the achievement of the development goals for the twenty-first century.<sup>9</sup> Major elements of good governance, as identified by DAC members, included: the rule of law; strengthening public sector management and transparency/accountability by improving accounting practices, as well as budgeting and public expenditure management; and combating corruption. The framework proposed by the Ad Hoc Working Group was subsequently endorsed by the 1997 DAC High Level Meeting.

6. By 2000, more elements were added to the concept of good governance by the DAC. The statement issued by the 2000 DAC High Level Meeting took note that “good governance requires a broad approach to partnership extending beyond government and parliaments to include civil society and the private sector”. Moreover, in addition to the requirements of transparency and accountability, a new dimension was stipulated, namely, predictability. This last element was introduced in light of the financial crises in the latter part of the 1990s, which led to a call for improvements in corporate governance and stable financial frameworks.

7. In the future, new elements will likely be added to the definition of good governance. At present, at least three major features can be identified as the key defining properties of the concept of good governance.

8. First, good governance is predicated upon mutually supportive and cooperative relationships between government, civil society and the private sector. The nature of the relationships among these three groups of actors, and the need to strengthen viable mechanisms to facilitate interactions, are of critical importance.

9. Second, good governance is defined as the sum, or a combination, of the following elements: participation, transparency of decision-making, accountability, the rule of law and predictability. Democratic practices, civil liberties and access to information are sometimes added to the list. Donor assistance to strengthen governance in developing countries has focused on empowerment and capacity-building with the objective of enhancing these elements.

10. Third, good governance is subjective in concept. The values providing the underpinning for governance are the values postulated

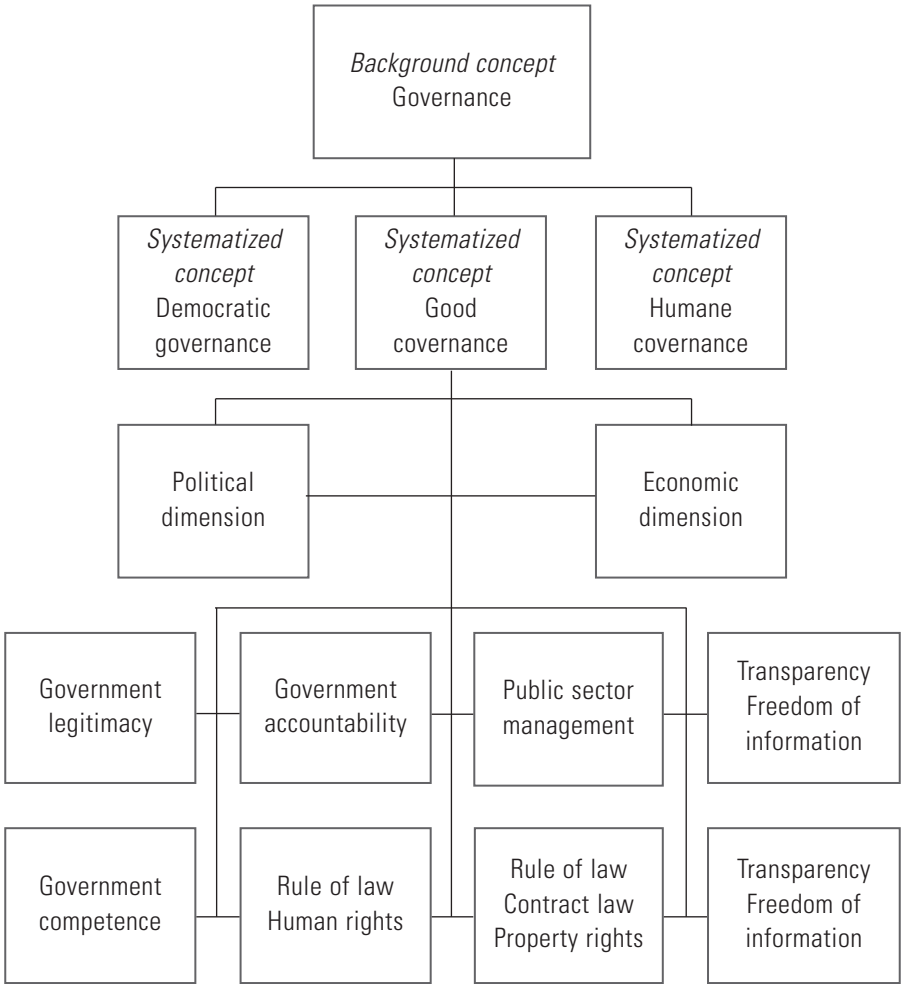
by international donor institutions. For instance, it has been observed that “if donor-conceptualized standards of good governance were more fully elaborated and insisted upon, it would almost certainly imply an insistence that Western-derived standards of conduct be adopted in non-Western politico-cultural contexts”.<sup>h</sup> Moreover, scholars have raised the problem of inherent contradictions among the elements, and observed that not only do efforts to promote good governance often have the opposite effect, but “what in one respect (for example, economic growth) is good governance, is clearly bad governance in other respects, such as labour conditions, democratic content of government and civil liberties”.<sup>i</sup> In this context, the Asian “little tigers” are cited as an example.

11. Good governance as conceived by the World Bank, the United Nations Development Programme (UNDP), the Organization for Security and Co-operation in Europe (OSCE), the United States Agency for International Development (USAID) and other donor agencies consists of two major dimensions: political and economic (see figure 1). The political dimension can be broken down into four key components: government legitimacy; government accountability; government competence; and rule of law (human rights). The economic dimension also has four components: public sector management; organizational accountability; rule of law (contracts, property rights); and transparency (including freedom of information). This does not encompass all aspects of the concept of governance, but provides a framework for discussion. As the following section points out, initiatives to develop measurements of governance have been selective in the choice of dimensions and concepts.

## Measuring good governance: scales and indices

12. “Whatever we wish to manage in society, we must measure and monitor”. These opening remarks by Dr. Mark Orkin, Chief Executive Officer of the Human Sciences Research Council of South Africa, delivered at a conference on good governance and democracy in 2002, probably reflect the sentiments of donor institutions and

Figure 1.  
**Dimensions of Good governance**



**Source:** T. Landman, "Map-Making and Analysis of the Main International Initiatives on Developing Indicators on Democracy and Good Governance" (Human Rights Centre, University of Essex, Colchester, United Kingdom, July 2003. p. 92).

**Note:** Adapted from OSCE (1991); World Bank (1992), 1994, 1997); Falk (1995); Weiss (2000); British Council ([www.britcoun.org](http://www.britcoun.org)), *Good Governance Sourcebook* (DG Europe Aid); UNDP (2002); USAID (1998a, 1998b); DFID (2001).

recipient countries alike.<sup>j</sup> The remarks make reference to the failure to achieve consensus by supranational agencies on a set of indicators for the measurement of good governance. Four main attempts were cited: the Common Country Assessments (CCAs) of the United Nations Development Assistance Framework (UNDAF); the OECD/DAC “incubator”, with technical assistance from the World Bank; the road map towards the implementation of the Millennium Declaration; and the report by the “Friends of the Chair” of the United Nations Statistical Commission on development indicators. Reviewing these efforts, Orkin concluded, “Indeed, the further the show went down the road, the worse it got. The initial set of items had political substance, but was still qualitative; the next set of items lost the political substance in quantifying them, and concentrated on free-market conditions; the third set omitted the indicators altogether; and the last document promised to tackle the problem sometime later!”<sup>k</sup>

13. Two main reasons for the failure to measure good governance have been presented.<sup>l</sup> First, disputes about governance indicators are “endemically ideological”. Decisions regarding what to measure and which indicators to use are based on public administration and political frameworks, and these are normative in character. This gives rise to a situation where the same indicator may have contradictory interpretations, depending on which ideological underpinning is utilized. Second, some regimes, although forced into compliance by trade and aid considerations, are reluctant to produce and disseminate governance indicators that reflect adversely on their progress towards good governance. This reluctance is compounded when indicators are used in cross-country comparisons and rankings.

14. The preceding is intended as a cautionary note to accompany the following review of current initiatives for measuring good governance. In this regard, one additional observation is warranted, namely, that good governance is by and large treated as an instrumental value. In other words, it is a means by which to achieve desired ends. This begs the question, “Good governance for what?” The response to the question varies, depending on the nature of the “what”: such as, “governance for poverty reduction”, or “governance

for economic development/ efficiency". For this reason, different sets of indicators are used to measure governance, depending on the nature of the ends in question.

*Human Rights Centre, University of Essex,  
United Kingdom*

15. In 2003, the Human Rights Centre of the University of Essex (United Kingdom of Great Britain and Northern Ireland), issued a report entitled "Map-Making and Analysis of the Main International Initiatives on Developing Indicators on Democracy and Good Governance".<sup>m</sup> The report formed part of a project commissioned by the Statistical Office of the Commission of the European Communities (EUROSTAT). One of the project's main objectives was the provision of a synopsis of different approaches and methodological options available for measuring democracy and good governance. The final report of the project acknowledged from the outset, however, that good governance remained an "essentially contested concept," since there was no consensus on its definition or content.<sup>n</sup> Different definitions lead to different measures of the concept. Conceptual confusion compounds the methodological problem of how to develop meaningful cross-national indicators on which there is agreement. In the absence of a clear conceptual framework, controversy surrounds the tools of measurement.

16. The report also identified different categories of data collection. Public perceptions of good governance tend to be based on surveys of 20- to 50-person target groups, such as "important persons" in government, business and industry, using non-random sampling techniques. Standards-based data, drawing upon ideal-type frameworks of good governance, are employed in the construction of indices and scales, which are then used to evaluate progress towards the achievement of the ideals. For example, Freedom House civil and political liberties scores, which are standards-based ordinal scales, have been used in studies on good governance. A third category of data is so-called events-based data, which consist of an enumeration of specific positive and negative events that reflect the promotion of, or impediments to, good governance.

17. Furthermore, the report by the University of Essex reviewed different ways in which indicators to measure good governance have been categorized. UNDP, for instance, makes the distinction between objective indicators, such as economic performance, and subjective indicators, which reflect respondents' opinions and are perceptual. Another way to categorize indicators is to adopt a systems approach, whereby indicators are identified as either input, process or output. Input indicators measure "the performance of an obligation bearer," process indicators measure the implementation process, and outcome indicators measure the progress achieved.

18. The report also noted that "There are always trade-offs between the different types of indicators. Those that achieve global coverage tend to have a higher level of abstraction and may not provide the kind of differentiation required for policy analysis or policy decision-making. Those indicators that provide highly detailed event counts are difficult to produce across a large global sample of countries".<sup>o</sup>

19. Five types of measures of good governance were identified:

- Civil and political liberties or political freedoms as proxy measures for the rule of law and governance. Freedom House scales are the prime example of this type of measure. Users include the Heritage Foundation and the Wall Street Journal, who have produced annual scores for 161 countries from 1995-2003;
- Frequency of political violence as an inverse measure of good governance. Measures of this type focus on "bad" rather than "good" governance. Global data bases exist for political stability indicators: for example, military coups, political assassinations, riots and demonstrations;<sup>p</sup>
- Expert assessments and opinion of good governance (generally to assess investment and business climates). The United Nations University World Governance Survey Project (WGS), a collaborative effort with UNDP, has used expert opinion surveys on good governance for 16 developing countries and countries with economies in transition.<sup>q</sup>

Other organizations, such as Transparency International, Political Risk Services and Business Environmental Risk Intelligence (BERI) also produce rankings of countries across a range of indicators, including, for instance, political stability, the legal system and the judiciary, and the prevalence of corruption;

- Objective measures of good governance, such as the “contract-intensive money” indicator (CIM). CIM is the ratio of non-currency money to the total money supply and is based on figures supplied by the International Monetary Fund (IMF). The logic of using CIM as an indicator of good governance is that, in highly uncertain environments (that is to say, where the rule of law does not prevail), individuals will choose to hold a larger proportion of their assets in the form of cash;<sup>f</sup>
- Mixed measures that combine aggregate data, scales and expert opinion, such as the so-called Kaufmann, Kraay, and Zoido-Lobaton (KKZ), combined indices of the World Bank.<sup>g</sup> A factor analytic technique is used on 300 different indicators of good governance to generate six indices: voice and accountability; political instability and violence; government effectiveness; regulatory burden; the rule of law; and graft. The six indices are available for 160 countries for 1996-2002.

20. The report of the University of Essex provides an overview and assessment of the methodological strengths and weaknesses of each initiative (see table 1). All the initiatives, with the exception of BERI, have global coverage, are based on “good” to “reasonable” time-series data, and are updated annually. The Fraser Institute, Freedom House and World Economic Forum scales are widely used. The weaknesses of the initiatives are also identified.

21. The report concludes by emphasizing the need for conceptual clarity with regard to good governance. The components of good governance must be specified in further detail, together with the purpose of measurement. Furthermore, the report makes a number of



Table 1.  
**Content and assessment of the main initiatives measuring good governance**

| Initiative                                      | Type of measure  | Geographical coverage | Temporal range                                  | Strengths   | Weaknesses  |
|---|--|-----------------------|---|---|---|
| Freedom House                                   | Scale-based indicators for political and civil liberties   | Global                | 1972-present                                    | Global coverage; long time series; widely used; updated annually      | Lack of transparency in coding; unknown source material mixes economic assessments with political assessments; ideological biases; aggregation problems |
| Heritage Foundation/<br>Wall Street Journal     | Abstract scale of economic freedom   | 161 countries         | 1995-2003, updated annually                     | Global coverage; reasonable time series (1995-2003); updated annually |   |
| Fraser Institute                                | Standards-based scales   | 123 countries         | 1975-2002                                       | Global coverage; good time series (1975-2002); used widely            | Mixes objective and subjective measures   |
| Political Risk Services                         | Expert opinion on corruption, rule of law, expropriation risk, repudiation of government contracts, quality of the bureaucracy | 140 countries         | 1982-2003, updated annually                     | Global coverage; reasonable time series (1982-2003); updated annually | Unrepresentative sample of opinion; scores may represent underlying economic conditions; narrow measure of good governance                              |
| Business Environmental Risk Intelligence (BERI) | Expert opinion; political risk index   | 50 countries          | 1972 to the present, updated three times a year | 50 countries  | 1966 to the present; lack of transparency in coding   |

Table 1 (cont'd)

| Initiative                     | Type of measure   | Geographical coverage | Temporal range              | Strengths  | Weaknesses   |
|--------------------------------|---|-----------------------|-----------------------------|--|--|
| Transparency International     | Corruption Perception Index (CPI)                                       | Global                | 1995-2002, updated annually | Global coverage; reasonable time series; updated annually      | Unrepresentative sample of opinion; narrow measure of good governance  |
| World Economic Forum           | Competitive scale   | Global                | 1979-2002, updated annually | Global coverage; good time series (1979-2002); widely used     | Mixes objective and subjective indicators (i.e., those on good governance)   |
| Contract Intensive Money (CIM) | Based on IMF data   | 140 countries         | 1989-1990                   | Global coverage; objective indicators; updated annually        | Narrow proxy measure of good governance; culturally biased   |
| KKZ Combined indices           | Reduction of 300 different indicators on six aspects of good governance | Global                | 1996-2002                   | Global coverage; robust number of indicators that are combined | Short time series (1997-1998); combines different sets of indicators; point estimates are so insecure that middle 'rump' of countries cannot be ranked |

**Source:** T. Landman (2003), "Map-Making and Analysis of the Main International Initiatives on Developing Indicators on Democracy and Good Governance", University of Essex, Human Rights Centre, Colchester, United Kingdom, July 2003.

suggestions, including for the development of a core set of indicators and merging different data sets into one global data set of measures.

*United Nations Economic Commission for Africa*

22. The objective of a project on good governance being undertaken by the United Nations Economic Commission for Africa (ECA) is to monitor the progress of African states towards good governance.<sup>†</sup> The project includes 28 countries in five sub-regions of Africa. As of mid-2004, the methodology and data collection instruments had been developed and the fieldwork was in progress.

23. The project has identified six components of good governance:<sup>u</sup>

- A political system that encourages broad input from all elements of civil society;
- Impartial and credible electoral administration and an informed and active electorate;
- Strengthened public sector legislative and administrative institutions;
- Transparency, predictability and accountability in political, oversight and regulatory decisions by government and public bodies;
- Effective public sector management with stable macroeconomic policy, effective resource mobilization and efficient use of public resources;
- Adherence to the rule of law in a manner that protects personal and civil liberties and gender equity and ensures public safety and security with equal access to justice for all.

24. Three survey instruments are being used. The first instrument seeks opinions from an expert panel on issues pertaining to governance. The expert panel consists of at least 100 persons, including academics, lawyers, business leaders, professionals working with independent civil society organizations, and religious leaders. The second instrument measures the perception of the general adult population, represented by heads of household or the next senior member in a

household. The third instrument is designed to collect factual information and data.

25. The three instruments yield data on 83 indicators covering political representation, institutional effectiveness and accountability, as well as economic management and corporate governance. The indicators are grouped into five clusters:

- Political representation;
- Institutional checks and balances;
- Effectiveness and accountability of the executive;
- Human rights, law enforcement and the rule of law;
- Economic management and corporate governance.

Intended project outputs include Country Reports, Sub-Regional Reports, an Africa Governance Report and additional research papers.

*Asian Development Bank—  
governance indicators for Viet Nam*

26. During 2001-2002, the Government-donor-NGO Poverty Task Force of the Asian Development Bank (ADB) produced a series of papers on the Viet Nam Development Goals (VDGs). The papers address the developmental vision of Viet Nam and the Government's efforts to meet international goals, and are intended to serve as an input for the implementation of the Comprehensive Poverty Reduction and Growth Strategy (CPRGS) of the Government. Based on the premise that good governance is essential to poverty reduction, one of the papers addresses measurement and proposes governance indicators.<sup>v</sup>

27. The parameters for reform are taken from a joint report produced by the World Bank, ADB and UNDP.<sup>w</sup> Five key areas of governance were identified for improvement: a stronger, more efficient public service that is capable of implementing policy and delivering better public services to all; better and more transparent public financial management; wider access to justice and ensuring universal application; more participative and responsive government, particularly at

local levels; and a government that fights corruption and waste at all levels (see table 2).<sup>x</sup>

28. Based on these five parameters, the Poverty Task Force proposes eight core governance indicators:

- Level of information publicly available regarding services, policies and planning arrangements at all levels;
- Extent of access of the poor to basic government services such as health, education, infrastructure, water and power at the local level;
- Level of budget transparency regarding provincial and local taxation, budgeting, and spending patterns in each sector;
- Extent to which, at the national level, the level of expenditure that is targeted to pro-poor purposes is predictable from year to year;
- Extent to which the decisions and verdicts of courts and tribunals are publicly available;
- Extent to which local government is responsive and follows up on service delivery problems that are raised with them by the poor;
- Extent to which the Grass Roots Democracy Decree has been implemented in each commune so as to improve opportunities for public participation;
- Extent to which laws combating corruption are effective.

29. Furthermore, the Poverty Task Force paper proposes, for each of the preceding governance indicators, a number of outcome and process indicators.

30. There are two steps in ensuring that indicators are monitored accurately. First, the indicators must be clear and mutually comparable among different regions of Viet Nam. Second, where data gathering systems are currently insufficient, new systems must be created (as has been proposed by the World Bank). For each outcome indicator, two data gathering methods (process indicators) are proposed:

Table 2.  
Possible Governance/Public Management Outcome Indicators for Viet Nam

| Outcome   | Transparency  | Accountability  | Participation  | Predictability   |
|---|---|---|--|--|
| <p>A stronger, more efficient public service which is capable of implementing policy and delivering better services to the people at all levels</p> | <p>Extent to which information is publicly available regarding services, policies and planning arrangements all levels</p>            | <p>Degree of redress that the poor can obtain when faced with poor access to, and/or low quality, services from the Public Service</p> <p>Whether civil servants are being paid and promoted in accordance with merit</p> | <p>The extent to which the poor has an opportunity to participate in the policy-making and implementation process at the local level</p>     | <p>Extent of access of the poor to basic government services such as health, education, infrastructure, water and power at the local level</p>                           |
| <p>Better and more transparent public financial management</p>  | <p>Level of budget transparency regarding central, provincial and local taxation, budgeting and spending patterns for each sector</p> | <p>The extent to which expenditure that is incurred at all levels of government is open to independent scrutiny and reporting</p>   | <p>Whether the poor has the opportunity to participate in budget formulation at each level of government</p>                                 | <p>Extent to which, at the national level, the level of expenditure that is targeted to pro-poor purposes is predictable from year to year</p>                           |
| <p>Wider access to justice and a level playing field</p>  | <p>Extent to which decisions and verdicts of courts and tribunals are publicly available</p>  | <p>Ability of the poor to access the court and tribunal system to seek redress, including against Government agencies</p>   | <p>Extent to which there is a process for consultation with civil society in the process of preparation of laws, decrees and regulations</p> | <p>Extent to which the law is applied by all institutions fairly and predictably in all fields of activities, including in the resolution of administrative disputes</p> |

Table 2 (cont'd)

| Outcome  | Transparency   | Accountability  | Participation   | Predictability  |
|--|--|---|---|---|
| <p>More participative and responsive government, particularly at local levels</p> <p>A government which prevents, and fights, corruption and waste at all levels</p> | <p>Extent of formal recognition of the role of civil society in government at all levels</p> <p>Extent to which information on corruption and waste is made public</p> | <p>Extent to which local government is responsive to and follows up on problems that are raised with them by the poor</p> <p>Extent to which there are institutional mechanisms for pursuing corruption and waste</p> | <p>Extent to which the Grass Roots Democracy Decree has been implemented in each commune so as to improve the opportunities for public participation</p> <p>Extent to which there are institutional mechanisms available to civil society to raise issues of corruption and waste</p> | <p>Extent to which services provided at the local level to the poor are delivered in accordance with client charters</p> <p>Extent to which laws for combating corruption are effective</p> |

**Source:** Paper prepared by the Poverty Task Force of the Asian Development Bank on "Localizing MDGs for Poverty Reduction in Viet Nam: Ensuring Good Governance for Poverty Reduction", in the series on "Strategies for Achieving the Vietnam Development Goals" (June 2002).

- (1) One quantitative method that can be measured using existing systems;
- (2) One qualitative method that will require systematic client surveys of selected citizens and civil servants.

The proposed framework for measuring the recommended outcome indicators is set out in table 3.

31. Although measuring good governance in Viet Nam is still in its early stages, the Government has made official statements regarding its vision of what must be achieved. The vision is for “a country that has efficient Government institutions at all levels, is governed by the rule of law, and ensures a fair, equitable society for all Vietnamese citizens, whilst ensuring national security and being compatible with the needs of a more market-oriented economy, as well as uplifting the standard of living, particularly of the poor”.<sup>v</sup>

### *The World Bank Revisited*

32. The World Bank was the first major donor institution to adopt the concept of good governance as a condition for lending to developing countries. Since the late 1970s, the World Bank has taken the lead in pioneering efforts to develop indicators to measure the quality of development policy. Policy quality is measured by an index called the Country Policy and Institutional Assessment (CPIA). The index is based on staff assessments of policy quality. These assessments are assigned numerical scores, although the assessments are qualitative and judgemental in character. The CPIA is a confidential document, that is to say, it is only accessible by Bank staff. The information that is made available to the public are the International Development Association (IDA)-eligible country standings in the form of quintiles (“top fifth”, “lowest fifth” and so forth).

33. The CPIA Index consists of four clusters of indicators, totalling 20 items: economic management (four items); structural policies (six items); policies for social inclusion/equity (five items); and public sector management and institutions (five items). The last cluster of indicators is synonymous with concepts of good governance in that it comprises the following:



Table 3.

**Proposed Governance/Public Management Monitoring Framework for Viet Nam**

| Outcome Indicator   | Process Indicator   |
|---|---|
| Level of information available to civil society regarding services, policies and planning arrangements                          | <ol style="list-style-type: none"> <li>1. Percentage of communes providing information on services, etc.</li> <li>2. Clients survey of citizens regarding local awareness of services, etc.</li> </ol>  |
| Extent of access of the poor to basic government services such as health, education, infrastructure, water and power            | <ol style="list-style-type: none"> <li>1. Percentage of poor with access to particular basic services in each province</li> <li>2. Client survey of availability of particular services at the provincial level</li> </ol>  |
| Level of budget transparency regarding central, provincial and local taxation, budgeting, and spending patterns for each sector | <ol style="list-style-type: none"> <li>1. Information published in the National Budget enables identification of expenditure/revenue by sector and province</li> <li>2. Percentage of budgets that are published and available at the provincial, district and communal levels</li> </ol> |
| Extent to which expenditure is pro-poor and is incurred in accordance with budget allocation and plans                          | <ol style="list-style-type: none"> <li>1. Percentage of expenditure of National Budget identified as pro-poor</li> <li>2. Audit/review of expenditure indicating that budget was in fact spent on the poor</li> </ol>   |
| The law is applied by all institutions fairly and predictably, including in the resolution of administrative disputes           | <ol style="list-style-type: none"> <li>1. The increased independence of legal institutions is provided for by the law</li> <li>2. Citizens surveys regarding perceptions of the application of the rule of law by governments</li> </ol>  |
| Impact of implementation of the Grassroots Democracy Decree on involvement of civil society in local government                 | <ol style="list-style-type: none"> <li>1. Percentage of communes that provide arrangements for local participation in local government</li> <li>2. Citizens survey of perceptions of the level of involvement of civil society in local government</li> </ol>                             |
| Extent to which laws for combating corruption are effective   | <ol style="list-style-type: none"> <li>1. Effectiveness of mechanisms provided by laws</li> <li>2. Results of client surveys on perceptions of effectiveness of laws</li> </ol>   |

**Source:** Paper prepared by the Poverty Task Force of the Asian Development Bank on "Localizing MDGs for Poverty Reduction in Viet Nam: Ensuring Good Governance for Poverty Reduction", in the series on "Strategies for Achieving the Vietnam Development Goals" (June 2002).

- (a) Property rights and rule-based governance;
- (b) Quality of budgetary and financial management;
- (c) Efficiency of revenue mobilization;
- (d) Quality of public administration; and
- (e) Transparency, accountability and corruption in the public sector.

New items may be added to the CPIA index, and old ones removed, from time to time, but the total number always remains 20 items.

34. The CPIA is used to calculate a “Country Performance Rating” (CPR), which is then employed in the World Bank’s formula for allocating IDA funds. The complicated formula, which is difficult to interpret, involves, in its final stage, the use of a “governance factor” in computing the CPR. The governance factor is calculated from the five indicators listed above, together with an additional indicator called “management and sustainability of the development programme” and a “procurement practices criterion”.

35. A weakness of the CPIA methodology is that the index is based on assessments by World Bank staff rather than by impartial external professionals.<sup>2</sup> The World Bank is in a donor relationship with the countries being assessed, and it must be assumed that the staff conducting the CPIA evaluation are well informed about the relationship between the Bank and the Government. A concern is that the assessments can be judgemental and lacking validity (that is to say, the scores do not measure what they are supposed to measure).

### *Findings*

36. The foregoing indicators reflect different dimensions of governance. Although there is a broad, diffuse understanding of the concept, a great deal of variation exists in the specification of measures. Scales and indices to measure governance are used for a variety of purposes: for cross-national comparisons and rankings, and also for tracking the development record of a country. In the former case, the question is how to develop indicators that are universally valid and can be reliably measured worldwide. In the latter case, indicators are generally custom-tailored to the country. One concern with some of

the indices is the validity of measurement. Reliability is another, particularly when numerical scores are assigned to indicators that are based on subjective appraisals.

## Studies on governance

37. A key question is whether good governance results in poverty reduction, improved economic performance and other desired results. However, the connection between governance and poverty reduction is tenuous. On the one hand, there is some empirical evidence to suggest that weak governance reinforces poverty.<sup>aa</sup> On the other hand, the link between governance and poverty reduction is sometimes accorded *a priori* status and assumed to be true.<sup>bb</sup> Further research on the relationship between governance and poverty reduction is needed if the question is to be answered decisively. In the absence of conclusive evidence, it is plausible to suggest that the link sometimes exists, but that, at other times, there is no link. Some examples of the latter case are certain Asian economies, not known for their good governance, where per capita GDP has continued to grow considerably. In other words, good governance may sometimes be correlated with, but is not a necessary condition for, poverty reduction.

38. Studies on the relationship between governance and other variables, such as poverty reduction and participation, fall into two categories: studies commissioned by donor agencies and studies undertaken by academics. The latter category tends to employ a more sophisticated, and generally more rigorous, methodology than the former. It is, however, beyond the scope of this paper to conduct a full review of such studies. A few examples are provided for illustrative purposes.

### *Studies commissioned or executed by donor agencies*

39. Case studies generally take the form of technical papers employing qualitative analysis. For example, the OECD Development Centre has a research programme on Good Governance and Poverty Alleviation. A series of papers has been produced by the Centre, linking governance to poverty alleviation in a number of

LDCs. Each paper typically has the following sections: an overview on the status of poverty; the role of the Government in poverty alleviation; the role of donors; the role of non-governmental organizations (NGOs); governance and policy; and empirical evidence on governance and poverty alleviation. The empirical evidence is often ad hoc and far from robust. The conclusions drawn from the data tend to rely extensively on the interpretations of the authors and, on occasion, appear to be based on preconceived assumptions.<sup>cc</sup> To the extent that authors have been selected on the basis of their expertise, these types of reports are authoritative, as well as relevant, as their analyses may have implications for external assistance.

40. Donor agencies also undertake evaluation studies, designed to examine the effectiveness of their work in the area of governance. For example, the United Nations Human Settlements Programme (UN-HABITAT) Community Development Programme, in conjunction with the Institute of Social Studies in the Hague, Netherlands, has conducted a three-year evaluation of the effectiveness of its work. The study documents the work of the Community Development Programme in Bolivia, Costa Rica, Ecuador, Ghana, Sri Lanka, Uganda and Zambia from 1986 to 1996. The evaluation focuses on concepts and practical approaches the Programme uses to reduce poverty. Three concepts are examined: participation; community management; and government enablement of community action. Data were collected from household surveys, as well as from a large sample of community leaders and government officials. The immediate output of the research is 21 global and country-specific reports.

41. Amongst the 17 research findings generated by the evaluation, several are of interest in the context of governance and participation:<sup>dd</sup>

- Government enablement is not yet a properly formulated concept;
- Reducing poverty requires integrating economic, social and physical development at the local level;
- Community organizations are more effective when their efforts are supported systematically by governments;

- Governments improve their planning and economize on the use of public resources when they draw upon, rather than disregard, community initiative;
- Community management skills enable people to participate democratically in their own organizations;
- Participation is not enough: people need the capacity in order to be able to participate effectively.

### *Academic research on governance*

42. Research on hypothesized causal linkages between good governance and other desired outcomes is typically reported in (but not confined exclusively to) academic journals rather than in donor institution publications. The research methodologies employed are usually rigorous and meet academic standards.

43. Some of the papers published by donor institutions make reference to academic research. For example, the report of the Poverty Task Force states that “empirical research in a number of countries establishes that where there is weak governance this reinforces poverty”.<sup>ee</sup> Research findings by a number of scholars are cited in support. For instance, measures of trust and civic cooperation are linked to economic growth.<sup>ff</sup> Others have reported that there is a relationship between trust and the efficiency of the judiciary, corruption, bureaucratic quality, tax compliance and civic participation.<sup>gg</sup>

44. Of methodological interest are attempts to validate instruments for measuring governance. To illustrate, one analysis of governance in East Asia and Latin America<sup>hh</sup> mentioned three objectives: to assess the extent to which available data can capture the institutional characteristics of governance; to assess the extent to which governance is related to development performance; and, to determine the degree of correlation among the measures of institutional characteristics of governance. Five institutional characteristics of governance were identified: (i) an accountable executive; (ii) an efficient and professional public bureaucracy; (iii) rule of law; (iv) transparent and participatory policy-making; and (v) a strong civil society. Data were obtained on a sample of 21 Latin American countries and eight

Southeast and East Asian countries. Socialist and transition economies, such as China, Cuba, Lao People's Democratic Republic and Viet Nam, were excluded from the sample.

45. Indicators to measure each of the institutional characteristics were taken from multiple sources. Accountability of the executive is measured by a composite of two indicators, "executive constraints" and "regulation of executive recruitment" from Gurr's Polity III.<sup>ii</sup> Quality of the bureaucracy is measured by a composite of two indicators: The first, "bureaucratic quality", is taken from the International Country Risk Guide (ICRG). The second, "bureaucratic efficiency", is taken from BERI. Rule of law is an ICRG indicator called "rule of law tradition". A strong civil society is measured by a composite of four indicators, two of which - "civil liberties" and "political rights" - are taken from Freedom House, and the other two - the "competitiveness of political participation" and the "regulation of political participation" - from Gurr's Polity III. The authors acknowledge that the indicators for civil society at best "indirectly depict some of the necessary conditions under which a strong civil society might emerge."<sup>ii</sup> Two observations should be made. First, the limitations of the indicators (for example, mixing objective with less reliable subjective indicators) have already been discussed in this paper. Secondly, despite all efforts, the authors of the study were unable to obtain even indirect measures of transparency of the decision-making process. This institutional characteristic was therefore dropped from the analysis.

46. Development performance, the dependent variable, was represented by three indicators: real per capita GDP, infant mortality rate and adult literacy rate. Separate regressions were run on each of the three development performance indicators. Most of the four indicators of the institutional characteristics of governance appear to be statistically significant, and have the correct sign, in the three regressions. There are some anomalies (for example, some indicators have the "wrong sign", and the "accountable executive" indicator is not statistically significant in some of the equations).

47. Furthermore, the authors of the study point to the lack of existing data in measuring certain aspects of governance ("transparency in decision-making", for example), and provide a methodology for

undertaking future research on the linkage between governance and development performance, while relying on the use of existing data sets.

## Conclusions

48. The preceding review of the current status of measuring governance, together with examples of research to assess the effect of good governance on its desired outcomes, such as poverty reduction and other areas of development performance, reveals a proliferation of measurement instruments. The different indices of governance attempt to capture different aspects of governance, which illustrates that governance is not so much an elusive concept as it is multidimensional. Furthermore, the concept itself has been evolving over the years. Predictability and participation, for example, have been added over time. As long as the concept is evolving, stability of the meaning and concept of good governance cannot be expected.

49. Further work remains to be done in the measurement of good governance, particularly in developing new instruments for this purpose, in fine-tuning existing indicators, and in addressing the consistency and reliability of the various instruments. Further attention should also be given to the definition of good governance, a concept that is often perceived as being formulated by donor institutions and developed countries. One approach to addressing the definition is to separate its various components or dimensions. For each component or dimension, outcome indicators should be kept separate from process indicators. Still, a key problem remains how to reach agreement on a standard meaning for each dimension. How should transparency and accountability be defined? Is a standard definition even possible? Moreover, even if agreement were reached, indicators for any given dimension are still likely to vary depending on the substantive context. Transparency indicators for public policies, for example, are different from transparency indicators for financial management.

50. The current instruments for measuring good governance purport to measure the same underlying concept (“governance”). This raises the question whether it is appropriate to treat these instruments as equivalent or substitutable for one another, in the way that

certain language testing scores are regarded as substitutable for measuring language ability. One approach would be to relate the different indices: a high correlation, for instance, would be interpreted as high equivalence.

51. Good governance is often regarded as an instrumental good: it is advantageous because it is hypothesized to result in beneficial outcomes, such as poverty reduction and development performance. Although there is some empirical evidence to support the hypothesis, further corroboration is needed. For instance, in the light of the superior economic performance of some countries that are not ranked very highly with respect to good governance, it is possible that good governance may not turn out to be a necessary condition for poverty reduction.

52. Further analysis should not only focus on how to measure, but also on how to enhance good governance. If the determinants of good governance can be identified, and appropriate frameworks for enhancing good governance developed, assistance should be channelled towards strengthening governance institutions and mechanisms rather than penalizing poor governance by withholding development cooperation.

53. Lastly, the Committee for Development Policy conducts a triennial review to determine which countries should be added to, and graduated from, the list of LDCs and continues its work on the methodology to be used for the identification of LDCs. In the future, the Committee may wish to examine the relationship between good governance and LDC status.



## Notes

- a** Martin Albrow, "Society as Social Diversity: The Challenge for Governance in the Global Age", *Governance in the 21st Century* (OECD, Paris, 2001).
- b** H. Schneider, "Participatory Governance: The Missing Link for Poverty Reduction", Policy Brief No. 17 (OECD Development Centre, Paris, 1999), p. 7.
- c** M. Doornbos, "'Good Governance': The Metamorphosis of a Policy Metaphor", *Journal of International Affairs*, vol. 57, No.1: 3-17 (Fall 2003), p. 4.
- d** H. Schneider, *loc. cit.*
- e** John Martinussen, "The Limitations of the World Bank's Conception of the State and the Implications for Institutional Development Strategies", *IDS Bulletin*, vol. 29, No.2 (1998), pp. 67-74.
- f** There are two distinct streams of discourse on good governance: donor agency and academic. Academic discourse has dealt mainly with the way in which power and authority relations are structured in different contexts, whereas donor-directed and policy-oriented discourse on governance has focused more on state structures designed to ensure accountability, due processes of law and related safeguards. Academic discourse is directed towards better understanding of institutional linkages between the State and civil society; donor-driven discourse is oriented towards enhancing policy effectiveness. This report addresses good governance from the donor perspective.
- g** OECD Development Assistance Committee, "Final Report of the Ad Hoc Group on Participatory Development and Good Governance", Part I (OECD, Paris, 1997).
- h** M. Doornbos, *loc. cit.*, p. 8.
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