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CONFERENCE NEWS

Financing Social Policy

Report of the UNRISD International Workshop, 1–2 March 2007, Geneva

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Introduction

Social policy is a central instrument to promote an inclusive and democratically anchored development process. In recent years, the general perception of the costs and benefits of social policy has changed, and policy makers are increasingly aware of the positive potential social policy entails. Nevertheless, the challenge is to build social programmes on financial arrangements that are themselves sustainable, equitable and conducive to economic development.

The United Nations Research Institute for Social Development (UNRISD) initiated a project in 2006 to examine options and constraints for financing social policy in developing countries. The research, which is funded by the Ford Foundation, explores the developmental impact associated with specific financing techniques and revenue sources, the latter covering taxation, social insurance contributions, social and pension funds, mineral rents, remittances and aid. The project is situated within the UNRISD research programme *Social Policy and Development*, which takes a broad approach to social policy, defining the concept as going beyond basic protection and poverty reduction goals to impact on the productive, reproductive, distributive and protective spheres simultaneously.

UNRISD has commissioned 13 papers on the theme of financing social policy, and these were presented at a two-day workshop in Geneva on 1–2 March 2007.[1] This workshop, which brought together the commissioned researchers, as well as academics, government officials, representatives of donor agencies and experts from the United Nations, including staff from the International Labour Organization (ILO), the United Nations Conference on Trade and Development (UNCTAD) and the World Health Organization (WHO), was a forum for discussion of the outline of the project, and for identification of key research questions, cross-cutting issues and preliminary policy implications. During the second stage of the project, UNRISD plans to commission in-depth and comparative country case studies in different geographical regions on the six major revenue sources around which the project is framed.

In opening the workshop, UNRISD Director Thandika Mkandawire stressed the importance of learning from the experiences of successful cases in social policy. Previous work at UNRISD brought out the multiple roles of social policy, beyond the protective function

[1] Three of the 13 papers presented at the workshop were commissioned under the prior UNRISD research project, *Social Policy in a Development Context.*

emphasized in conventional debates. The central preoccupation of social policy in successful states has not been poverty reduction; rather, a whole range of social policy measures have been introduced at lower levels of the industrial development process. The issue of finance and social policy emerges repeatedly in the research on late industrializers, which inspired the design of this project. If they are to generate real solutions, Mkandawire argued, debates on social policy in developing contexts must engage the financial dimension. The UNRISD approach insists that financing social policy should be concerned not only with efficiency, but also with equity, social cohesion and inclusion, as well as the more conventionally recognized social policy functions.

In her opening remarks, Research Coordinator Katja Hujo outlined the background and main research issues being addressed by the project.

Project Background and Overview

A key lesson from the previous five-year research project *Social Policy in a Development Context* was that the dominant policy models of the past—populist/redistributive regimes based on soft monetary and fiscal policies, and liberal/conservative regimes based on austerity policies, privatization and downsizing of public welfare provisioning—have failed to provide a long-term strategy that is developmental, democratic and socially inclusive. One of the reasons for this lies in the fact that economic and social policy have to work in tandem in order to be mutually reinforcing. An integrated approach is based on the premise that social policy has multiple roles, which have to be balanced against each other. An unduly narrow focus on one role, be it redistribution or production, or the outright neglect of others (often gender equality and democratization), can endanger the political or economic viability of the policies, and certainly undermine their success in terms of social development.

Approaching the topic of financing social policy leads to questions of resource mobilization, resource allocation, and the actors and institutions involved in these processes. The current approach is dominated by a micro perspective on how best to allocate a given amount of resources. Although efficient allocation of resources for social policy is important, taken in isolation this perspective entails serious shortcomings: it sidelines the impact of welfare arrangements on economic development, and vice versa. However, what is crucial about social policy *in a development context* is to identify how such policy can actually support and enhance a dynamic accumulation process that allows for the creation of income, which can then be taxed and redistributed toward socially desirable ends.

Accounting for the developmental impact of social policy is even more important considering one of the central dilemmas confronting policy makers: the so-called affordability of public social expenditures. In general, public finance seeks to match revenues and expenditures in the medium term. However, in the case of prolonged economic stagnation, social transfers are quickly over-stretched. By going beyond demand stabilization and protection, the use of social transfers evolves into a quasi-permanent substitute for income building and the creation of formal employment. If this is the case, budgetary pressures and indebtedness tend to increase, and eventually constrain the fiscal and economic space for social policy—even if political commitment is in place. In developing countries with limited capacity for debt-financing, more commonly, the state either fails to deliver on entitlements to citizens or the insured, or it shifts part of the burden toward individuals, families and communities (for example, by increasing the amount of unpaid care work or out-of-pocket payments).

Debates surrounding the affordability of social policies have intensified in recent decades. Several trends contributing to this process can be identified. The first was the paradigm shift in the 1970s from the Keynesian welfare state model toward the liberal market model. One implication was that social policy was no longer seen as a central instrument for social development and stabilization, but increasingly as a cost factor and potential cause for fiscal crisis, inflation and market distortions. Additionally, demographic changes like ageing and lower fertility rates challenged social insurance schemes that were financed out of contributions from the active working population. Growing inequality, as well as unemployment or increased informal employment, put pressure on revenues and expenditures alike, whereas economic integration and liberalization of goods and capital markets increased competition in general, and more particularly tax competition.

Most industrialized countries are in the process of adjusting their tax/welfare regimes to meet these challenges (and they are usually well equipped to do so), while also trying to maintain their basic policy regime

or social contract. Developing countries, however, struggle more for a variety of reasons. They are confronted with a huge mismatch between means and ends: social investment and transfers are desperately needed, while state revenues and administrative capacities are limited. Institutional legacies are posing additional difficulties. Existing social protection schemes are often fragmented, stratified and regressive, and social contracts in support of redistribution are weak. Furthermore, adjustment and stabilization policies, plus balance of payments and currency crises, have increased volatility, income and asset concentration, external debt, budget deficits, unemployment and informal sector employment. And last but not least, Washington consensus policies (the triad of privatization, liberalization and deregulation) have frequently resulted in lower administrative capacity; declining revenues due to the substitution of difficult-to-collect taxes for easy-to-collect ones; high fiscal costs related to privatization policies; decreased domestic economic activity to tax; and subsidies or tax exemptions that are designed to attract foreign investors but squeeze fiscal revenues.

Growing criticism with regard to the theoretical underpinnings of these policy blueprints, together with ample empirical evidence on the development failures they produced, eventually fed into new debates that gradually extended to the global policy-making level. Key events like the World Summit for Social Development, the declaration of the Millennium Development Goals (MDGs), together with Bretton Woods initiatives such as debt relief for the poorest countries (HIPC) and poverty reduction strategies (PRSPs), illustrate the rising profile of social issues. The recognition that social policy has highly beneficial effects even in middle- or low-income countries, which were traditionally believed to be "too poor" to afford welfare policies, opens a window of opportunity for countries wanting to embark on such a strategy. Additionally, recent trends in global trade and international commodity prices, not to mention growing remittances and aid flows, have the potential to ease the financing constraints for some countries in the South, as long as macroeconomic stability can be safeguarded and governments show more willingness to upgrade their social agenda beyond poverty reduction and emergency measures.

In the light of these opportunities and constraints, various challenges emerge: to combine transformative social policy with employment-intensive development strategies; to go beyond the recommendations of the post–Washington consensus by stressing the importance of universal approaches, redistribution policies and the macro role of social policy; and to forge political and external coalitions in support of reforms.

In turning to possible guidelines for designing financing regimes for social policy in a development context, Hujo identified three criteria: basic normative principles, aspects of governance (implementation, capacity) and developmental impact. Moreover, choices between different options will be influenced by basic decisions regarding the desired balance of public versus private instruments, targeted versus universal schemes, the scope of solidarity and redistribution built into the system, and the type of care regime that is implicitly or explicitly chosen. The main question explored in the UNRISD research is whether different resources and financing techniques have diverse developmental and distributional impacts, and, specifically, their effect on (i) production and reproduction, (ii) protection and redistribution, and (iii) social inclusion and democratization. The research also takes into account the context of a country's social and economic policy regime, as well as historical trajectories.

With this basic framework in mind, Hujo outlined for participants the main areas being examined under the project.

- *Taxation reform*—The reform of tax systems in developing countries is one of the most important tasks regarding the financing of social policy. Taxation revenue is generally deemed superior to other sources in terms of stability, distributional justice and meeting the goal of universal coverage. Tax systems are also said to enhance ownership and state accountability. Whereas the goals of taxation reform seem to be widely accepted (increasing the volume of tax funds, enhancing their progressive structure and gender equality, and improving transparency and efficiency), past reforms implemented under the guidance of multilateral donors have been associated with some undesired outcomes, like shrinking state revenues or implementation failures.

- *Social insurance and coverage*—Is the extension of social insurance programmes a viable option for developing countries? Social insurance can be organized according to different models, such as public, private or occupation-

ally based insurance schemes, and pre-paid (funded) versus redistributive (pay-as-you-go) schemes. The challenge is to balance the goals of coverage, adequacy of benefits and financial sustainability, especially in developing countries with large informal sectors and high percentages of hard-to-cover groups.

- *Pension funds and development*—Pension funds have been a major financing source for investment in different countries, and in this sense they are a good example of how to combine the productive and protective roles of social policy (whereas pay-as-you-go systems constitute an example of how to combine social protection with social cohesion through forging a generational contract). Investment policies are crucial: high social returns are desirable from a developmental point of view, whereas profitable low-risk investments are necessary from a protective point of view. Privatization policies have performed poorly on both accounts, by imposing high transition costs on governments and substantial social costs in terms of coverage, uncertainty of benefits, greater gender inequality, etc.
- *Mineral rents and development*—Mineral-rich countries in the developing world frequently under-perform in terms of human development. Are resource-rich countries fortunate because they are wealthy, or do they suffer from a resource curse? How can the economic and political challenges associated with rents from mineral or other natural resources be managed? What are necessary external and internal preconditions? What lessons can be learned from successful cases?
- *Remittances and social development*—In a context where global capital flows are increasingly volatile and aid commitments lagging behind, the steady growth of global remittance flows has led to euphoria in academic and policy circles. Remittances are seen as stable, counter-cyclical development finance "from below", providing foreign exchange at the macro level and increasing income, consumption and investment for receiving households at the micro level. Yet problems associated with migration include brain drain, care drain, social disintegration, remittance dependency and "Dutch disease" effects. Questions therefore arise as to the impact remittances have on the different dimensions of social development, how they shape patterns of social provisioning and the implications they entail for social policy.
- *Aid and social policy*—International donors have agreed to substantially increase official development assistance (ODA) for low-income countries in order to accelerate the MDG process. Additional funding for poor countries can ease financial constraints, but like natural resource rents, increased aid flows pose a variety of political and economic challenges (related to condition-ality, accountability, Dutch disease effects), which have to be addressed successfully in order to make aid more effective for development.

In concluding her remarks, Hujo emphasized four points. First, social policy instruments should be based on principles of universality, solidarity, integration, efficiency and sustainability. Second, the financing mix is country-specific, and even low-income countries have achieved good social outcomes by dedicating above-average resources and efforts to social policy. Third, the processes and institutions involved in resource allocation are important with regard to human development outcomes. Finally, economic and social policy have to work synergistically at the micro and macro levels in order to advance societies' well-being.

Financing Social Policy: Challenges and Constraints

This research project is based on the view that financing social policies is especially challenging for developing countries, given the particular nature of the economic and institutional constraints they confront. The first two presentations laid the groundwork for a discussion of the predominant social policy models and reform trends, and their suitability for the developing world. The recurrent message of this discussion was the need for strong interlinkages between social and economic policies.

In his presentation, Rubén Lo Vuolo explored the limits and potential of current approaches to the problems of social exclusion in labour markets in Latin America. He made a staunch critique of the prevailing conceptual framework around social protection, elsewhere designated "social risk management",[2] as

illustrated by shortcomings in the areas of pension reform, workfare and microfinance programmes. Set against a backdrop of the failure of social liberalism, as articulated under the Washington consensus, to attend to the needs of vulnerable groups and segments of Latin American societies, social risk management has emerged as a revision of World Bank orthodoxy that attempts to reassert the dominance of the market while acknowledging a legitimate role for the state. The revision lies in a renewed emphasis on state institutions as requisite for reducing market instability, reinforcing competition and improving overall market functioning, ultimately aiding in the reduction of poverty. In essence, this approach retains the orthodox faith that economic growth will produce spillover effects by means of employment generation, while the state provides *social protection* to assist individuals in managing social risk. This protection is provided through a modular system of *safety net* programmes that are tailored to the specific risk patterns of different groups; these programmes are then expected to function according to a logic of *social insurance* that diversifies risk and stabilizes individual consumption and savings patterns.

According to Lo Vuolo, there are clear limits to the application of such mechanisms to a developing context such as that of Latin America. Not only do these policies fail to recognize the disproportionate effect of economic volatility on the poor, but they also overlook the direct link between economic volatility and the economic and social policies supported by the international financial institutions (IFIs). Furthermore, employment does not guarantee social security coverage for the very large numbers of informal, semiformal and temporary workers, or the working poor. In this sense, social risk management's emphasis on individual responsibility in determining one's position in the labour market is misplaced in these contexts; informality is not chosen by workers but rather is imposed by employers and the state. These shortcomings are made evident in three policy areas promoted by the World Bank: pension reform, workfare programmes and microfinance programmes. In general, these policies are characterized by incentives based on false premises (for example, where employment is assumed to be a problem to be solved by social policy when it is fundamentally a macroeconomic phenomenon), low coverage among the poor, a low impact on poverty due to selectivity and targeting, and unjustifiably high administrative costs. In the case of microfinance, poor people become indebted in exchange for access to impoverished markets, ultimately benefiting financial sectors instead of promoting higher incomes or savings.

Alternatives to the social risk management framework—such as the Employer of Last Resort (ELR), and the Renda Básica de Cidadania (Basic Citizenship Income) in Brazil—have advantages and disadvantages when applied to the Latin American context, explained Lo Vuolo. Proponents of the ELR propose an economic model in which the state offers remunerated employment for anyone seeking it. By emphasizing the role of the state in job creation, this approach questions the minimialist view of the state put forth in the orthodox macroeconomic framework. The Renda Basica, implemented in Brazil in 2005, directly addresses poverty through an explicit legal change in income transfer policies. Nevertheless, it struggles to reconcile the principle of universality with implementation mechanisms and technologies that are rooted in a tradition of targeting, not to mention the fact that the programme lacks a sustainable financing source. On balance, these alternatives make important strides, on the one hand by encouraging policy makers to rethink the proper role of the state in the economy vis-à-vis employment, and on the other, by vindicating universal and unconditional social policies.

Lo Vuolo concluded his remarks by emphasizing the need to advance toward the construction of a universalistic social protection system, one that is based not on "one" policy, but rather on a "system of consistently articulated policies". These policies should place formal employment at the centre of the problem and, more importantly, recognize that unemployment is a pathology of economic, not social, policy. In particular, social policies should be *preventive* and *proactive* in nature, not reactive or emergency responses; furthermore, they should aim at consolidating long-term support for universalism and unconditionality. Policies that emerge from the prevailing social risk management discourse may seem revisionist at first glance, but ultimately, they retain fundamentally flawed elements of the orthodoxy.

Enrique Delamonica and Santosh Mehrotra followed with a presentation on "pro-poor" financing of social services. Echoing Lo Vuolo's point that good social policies are those rooted in a system of consistently

[2] Robert Holzman and Steen Jorgensen (2000). *Social Risk Management: A New Conceptual Framework for Social Protection and Beyond.* Social Protection Discussion Paper 0006. World Bank, Washington, DC.

articulated policies, Delamonica introduced a framework for analysing pro-poor services based on a set of interrelated synergies at the macro level. Economic growth, poverty reduction, reproductive labour and social development are all interdependent and should reinforce each other to produce positive human development outcomes. If it is true that economic growth depends on sound macroeconomic policies, and technological and structural change, it likewise depends on social policy, income poverty reduction and reproductive labour. In the same way, both income poverty reduction and social development cannot be sustained without economic growth working in tandem with socially oriented, gender-sensitive redistributive social policies. In turn, achieving these pro-poor outcomes requires an understanding of the "complex fiscal causalities" involved. Just as social policy has multiple roles, the multiple roles of fiscal policy—including income distribution, output and employment, and social services delivery—should not be overlooked.

In the quest to achieve pro-poor social services, the choice of financing mechanism matters. Social service financing can be broadly classified into the following categories: self-provision (where the state is absent and households or individuals must carry the burden); user fees; pre-paid schemes and generalized insurance; earmarked taxes; indirect taxes; and direct taxes. These mechanisms can be assessed according to two criteria: the degree of *progressivity* versus *regressivity*; and the extent to which they are rooted in *solidarity-based* versus *individualistic* principles.

Weighing the different financing tools against these two criteria yields instructive results. At one extreme, the most regressive and individualistic financing mechanism is, not surprisingly, self-provision, while direct taxation emerges as the most progressive and solidarity-based of the mechanisms. User fees are widely criticized for being detrimental to the poor and, in fact, have largely been reversed since the 1990s. Generalized insurance based on pre-paid contributions poses an alternative to user fees that spreads risks and lowers costs, but high degrees of market segmentation (and regressivity in cases where insurance markets are not income differentiated) make contributory programmes less pro-poor. As concerns taxation mechanisms, indirect taxes such as the heavily-promoted value-added tax (VAT) are notoriously regressive and, insofar as consumption patterns vary according to gender, are also gender biased. Earmarked taxes, on the other hand, tend to be criticized on the basis of fungibility arguments (whereby general tax funds are diverted away from social services), but they actually have the potential to address gender bias and to be quite progressive, if one considers the possibility of luxury taxes or taxes on second homes. Finally, direct taxes (such as income or property taxes), though the most progressive and solidarity-based, are plagued with implementation challenges since they spark high levels of political resistance and are costly to enforce.

In reference to the political aspects of financing mechanisms, Mehrotra highlighted the fact that *governance* is key to improving the effective utilization of funds for the poor. Not only are Type I (leakage) and Type II (undercoverage) errors pervasive in targeted programmes for social services in developing countries, but the contractual basis for many of these services is an invitation to corruption. Evidence of "grand larceny" by public officials in programmes that are ostensibly for the poor cannot be ignored; but at the same time, social audits and transparency initiatives (such as the Right to Information Act in India) can, paradoxically, decrease support for social programmes among the rich, who are reluctant to back government policies plagued with corruption and targeting errors.

Overall, for the financing of social services to be more pro-poor, there must first be a shift in focus from expenditure-side policies to revenue generation. The tendency to advocate more regressive taxation mechanisms simply because they are easier to implement sidesteps deeper political and technical challenges which, if properly addressed, would pave the way for longer-term, more sustainable, and more equitable financing systems.

Hujo commented that both presentations took up important theoretical debates and presented alternative approaches. Lo Vuolo's remarks were innovative, offering a strong critique of a revised orthodoxy that is only just beginning to emerge in policy circles. Indeed, critical research requires overcoming the time lag commonly associated with sifting through illusory revisionist discourse in order to pose alternatives "in the moment". The alternatives such as the ELR and the Renda Básica raise important issues—the ELR establishes work as a right rather than an emergency response; and the Renda Básica demonstrates the common disconnect between formal rights and implementation that characterizes the Latin American context.

In their presentation, Delamonica and Mehrotra offered a good classification of the various financing instruments to help frame further research on the "social contract" behind sustainable and equitable financing regimes. In this vein, their focus on synergies was especially relevant, bearing in mind that particular institutional mixes display path dependencies. An understanding of the institutional complementarities within "varieties of capitalism" that produce the most equitable and sustainable outcomes is crucial, and speaks directly to concerns about the political feasibility of redistribution in the developing world.

One participant acknowledged the theoretical superiority of direct taxation, but noted the extreme difficulties confronting developing countries that wish to implement tax reform in the face of enormous informal sectors, not to mention high degrees of uncertainty and unpredictability of income levels. Determining whom (individuals or households?) and what (income or assets?) to tax is paramount. In response, Mehrotra pointed out that precisely because informality is so pervasive in developing countries, more attention should be paid to proposals, such as the one recently presented in India, that would foster social insurance systems in the informal sector.

Furthermore, even in developing countries, the potential for direct taxation is not being reached. Existing tax collection methods are inefficient, but instead of improving technological capacity (for example, computerization can immensely improve countries' tax take at a relatively low cost), policy makers and donors alike simply push for regressive, but easy-to-collect taxes. In fact, it is not difficult to devise criteria that identify potential taxes that would be progressive in nature—ownership and use of cars or mobile phones, or airline travel, for example. Lo Vuolo reinforced this point by attacking the IFIs' contradictory uses of the "state capacity" argument. The emphasis on targeting in social policies conflicts with the support of regressive tax instruments: how is a state expected to have the capacity to target 60 per cent of its population (the poor), while it is assumed that it lacks the capacity to tax 20 per cent (the rich) with a progressive tax system? These arguments reveal gaping holes in orthodox logic.

Taxation and Aid

Building on the discussion of constraints and challenges for financing social policy in developing countries, the second session delved more deeply into the topics of taxation and aid, drawing primarily on evidence from low-income countries. Among other issues, the two presentations considered the implications of aid and other forms of external resource dependence (for example, commodity-based taxes) for developing countries' own capacities not only to finance and implement social policies, but also to diversify their resource bases.

In her presentation, Alice Sindzingre explored the conditions and constraints stemming from the finance regime that hinder the contribution of social policies to development in low-income countries. She concentrated on sub-Saharan Africa. While the principal constraints can be traced to processes of state formation and the historical structure of the tax regime in a given country, several additional factors compound the challenges facing low-income countries.

First, traditional dependence on commodities and trade-based taxation (in some cases representing upwards of one-third of government revenues) implies a high degree of volatility in revenue generation, impeding sound fiscal planning that would be based on predictable inflows. Second, external determinants like trade liberalization and foreign aid also have implications for tax systems. Given the historical dependence of low-income countries on trade taxes, trade liberalization severely aggravates existing revenue collection, eroding fiscal resources without putting in place sustainable alternatives. Studies by the International Monetary Fund (IMF) show mixed results for the recovery of lost trade revenues, but the positive trends largely reflect gains in middle-income countries from the implementation of the VAT. In contrast, low-income countries, by and large, have not enjoyed revenue gains from the VAT due to problems with the refund and credit mechanisms, underpayment and high levels of informality.

Additionally, the nature of poverty reduction programmes themselves has been detrimental to low-income states' ability to finance developmental social policies, as social spending requirements can keep states from investing in productive sectors given the tradeoffs low-income countries permanently face due to budget constraints. It is important to note here that the composition and efficiency of social spending, not the levels *per se*, matter most. Many social programmes are also donor-financed and targeted in nature, which pose additional challenges for constructing developmental social policy systems. Finally, dependence on foreign aid makes states vulnerable to aid fluctuations and cre-

ates a disincentive for states to tax their own citizens. Consequently, the nexus of political accountability shifts from citizens to donors: as policies are perceived to be handed down from external actors, the credibility of governments and political institutions vis-à-vis citizens is constantly called into question.

Developmental states in Asia hold important lessons for low-income countries in terms of the political economy of taxation. One of the most important is that it is not the level of taxation ratios that matters, since many of the developmental Asian states exhibited relatively low levels of taxation. Rather, growth-oriented policies, complemented by heavy investment in education, secured a place for social policies that contributed to economic growth while simultaneously ensuring political legitimacy. Indeed, low-income countries get caught in a "taxation trap", wherein low levels of taxation, redistribution and low-level social services are locked into a vicious cycle, and as a consequence, political legitimacy is entirely de-linked from social policy. While there is no doubt that the Asian developmental experiences are instructive in a number of ways, their experiences result from a particular set of historical, political and economic processes that may or may not apply to low-income country contexts.

Oliver Morrissey followed with a presentation that examined the role aid plays in increasing financing for public spending on social service delivery in developing countries. The primary justification for foreign aid, and one that is often overlooked, is its role in the provision of public goods in the form of social services. Because there are international "spillover ranges" (positive externalities) associated with the provision of social services in low-income countries (and, conversely, per capita over a given period, foreign aid shows, on average, a small but significant effect on government social spending (which increases by 1.7 per cent for every 10 per cent increase in aid).[3] The effect of tax revenue on increases on social spending, however, is significantly larger, at 3.2 per cent. Aid has a greater impact on social spending in low-income countries than in middle-income countries, not only because middle-income countries tend to spend more, on average, on social services regardless of aid or tax revenues, but also because aid to middle-income countries is more likely to go toward investments in infrastructure.

Besides impacting on government social spending, aid also affects measures of aggregate welfare. These effects work through three primary mechanisms. First, aid can influence welfare directly, either by creating income-earning opportunities or through the direct provision of social services. Second, aid can improve aggregate welfare indirectly over the long run, by contributing to economic growth. Finally, as mentioned, aid can work through governments, increasing expenditures on social services which, in turn, impact positively on welfare indicators. There is robust evidence that aid does indeed pass through government social spending to reduce poverty and improve human welfare. Again, the effects on human development indicators are more pronounced in low-income countries; however, government social spending is less likely to impact on aggregate welfare in these same countries. Only in middle-income countries can the positive impact on aggregate welfare be fairly attributed to increases in government social spending. One of the reasons for the disconnect between increasing social spending through aid and aggregate welfare improvements in low-income countries is the low quality of

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