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What Does Recent Research Tell Us?

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Eisuke Suzuki
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Development Effectiveness

What Does Recent Research Tell Us?

By

M.G. Quibria*

Abstract

This paper provides a critical review of recent research on aid effectiveness and its implications for policies. This review suggests that much of the "conventional wisdom" that underpins current aid policies has a fragile empirical foundation. In particular, it notes that the so-called principle of "selectivity" that has been the guiding principle in allocating aid has little empirical traction and can be a potential instrument for discriminating against capacity-constrained or geographically disadvantaged countries. The paper also suggests that despite the adoption of the Millennium Development Goals and Poverty Reduction Strategy Papers, which should be the fundamental basis for international aid allocation, much of this process is still driven by the selectivity principle with its emphasis on elaborate, but often largely opaque, evaluation of country policies and institutions. This review also offers newer perspectives on issues of conditionality, "good" policies and institutions, and monitoring.

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I. INTRODUCTION

With the dire paucity in the availability of foreign aid,[1] the expression "development effectiveness"[2] has become a recurring theme in today's international development discourse. The expression is largely self-explanatory. It simply refers to the effectiveness of aid in fostering development.[3] Though intuitively self-evident, the concept of development has evolved and seen a significant connotative metamorphosis over the years. As the view of development has evolved, so has the meaning and content of the expression "development effectiveness" that international development agencies seek to achieve.

As noted by World Bank (2002), the earlier focus of development assistance in the 1940s was the reconstruction of the war-torn economies of Europe and Japan. With rapid progress of the postwar reconstruction work, the focus of development assistance shifted to what has now come to be known as the developing world. At first the goal was to increase the income of these countries, i.e., aggregate economic growth. However, it was soon realized that this was a limited goal. Owing to the complex conflation of population growth and changing income distributions, it was observed that economic growth does

[1] See Appendix A for the formal definition of aid and the recent trend in aid flows.

[2] Expressions such as "development effectiveness" and "aid effectiveness" are used to convey the same ideas. In this paper, "aid effectiveness" and "development effectiveness" are used interchangeably.

[3] According to the DAC Evaluation Glossary (see http://www.oecd.org/dataoecd/29/21/2754804.pdf), effectiveness means "the extent to which the development intervention's objectives were achieved or are expected to be achieved, taking into account their relative importance." Utilizing this definition of effectiveness, aid effectiveness can be roughly defined as the extent to which aid achieved its development objectives, taking into account their relative importance.

not necessarily translate into higher standards of living for the general population. By the 1960s and 1970s, the development agenda was focused on the twin objectives of economic growth and poverty reduction and subsequently, more and more, on the basic needs of the lower economic segments of the population. By the 1990s, reduction of absolute poverty became a priority among the international development institutions.

In recent years, the goals of development have been further expanded to include poverty in all its dimensions—low income, illiteracy, poor health, malnutrition, morbidity, insecurity of income, and powerlessness. This shift toward a multidimensional concept of poverty reflects an emerging intellectual consensus that economic development should be synonymous with improvements in human well- being, which can only be ensured by freedom from poverty in all its manifestations.[4] This broader perspective of development, which envisages an individual's active participation in society through the attainment of a full complement of economic, political, and social freedoms, has also resonated loudly in the testimony of the poor.[5] This multidimensionality of poverty was given concrete expression in the Millennium Development Goals (MDGs),[6] which were adopted at the Development Summit of the United Nations in 2000. These goals, which had been adopted by 189 countries and internal development agencies, underscore eradication of extreme poverty and hunger; achievement of universal primary education; promotion of gender inequality and empowerment of women; reduction of child mortality; improvement of maternal health; combating HIV/AIDS, malaria, and other diseases; ensuring environmental sustainability; and development of global partnership.

The adoption of the MDGs by the international development community has bestowed new clarity and concreteness to the development vision behind international development

[4] Noble Laureate Amartya Sen has been an ardent voice of this approach of development. For a lucid exposition of this approach, which Sen felicitously labels as *Development As Freedom*, see Sen (1999).

[5] In preparation for its *World Development Report 2000/2001* (see http://www1.worldbank.org/prem/poverty/voices/reports.htm), the World Bank collected the voices of more than 60,000 men and women from 60 countries to understand poverty from the perspective of the poor. An important message that emerged from the voices of the poor is that poverty is multi-dimensional which transcends beyond income and is the outcome of the interactions of multitudes of economic, social and political deprivations.

[6] See Appendix B for the details of the MDGs.

assistance in the new millennium. Given this clarity as to the objective of development, the issue of development effectiveness is now framed in terms of the effectiveness of aid in achieving these goals. It has been stated most directly and explicitly by UNDP (2003): "Development effectiveness refers to a fundamental question about *how* to reach the [MDG] Goals. It is about the factors and conditions that help improve people's lives." It goes on to argue that "development effectiveness is about the 'how' of development", about factors and processes that can contribute to the achievement of the goals.

In recent years, a large economic research literature has emerged that seeks to explain factors and conditions that contribute to development effectiveness. While this literature has helped improve understanding of aid effectiveness and the development process, this intellectual advance has been far from unilinear and has often been fraught with many controversies. The present paper provides a critical review of the research literature, focusing on its policy implications.

The paper is organized as follows. Section II provides a background to the current research on development effectiveness and helps to place the ongoing policy debate in perspective. Section III offers a short summary of the current state of debate in this area. Section IV is a review of some of the salient analytical and policy issues that have emerged from the recent empirical research. Section V provides the summary of the main arguments and offers some concluding remarks.

II. THE BACKGROUND

There is a large volume of empirical literature on aid effectiveness that has emerged in the last three decades or so.[7] The earlier studies in this area were principally concerned with the impact of foreign assistance on domestic savings and investment. In recent years, the focus of the literature has shifted from the aid-savings relationship to aid-

[7] Hansen and Tarp (2000) offer an extensive survey of last 30 years' of empirical literature that makes use of cross-country regression analysis. They provide an in-depth discussion of what they call "three generations" of such studies, along with their technical aspects. See also Easterly (2003a) who provides some interesting commentaries on policy issues.

growth relationship.[8] These studies have become increasingly sophisticated over the years in terms of econometric techniques, data coverage, and model specification. Reflecting the influence of new growth theory, the explanatory variables now include proxies to reflect policy and institutional variables, in addition to traditional macroeconomic variables. Finally, in the last couple of years, the literature in this area has started to focus on the relationship between poverty and aid. However, this effort is at the initial stage of development. This shift in focus from economic growth to poverty reflects an emerging consensus in the international development community that poverty reduction should be the main focus of all developmental efforts. This is evident, among others, in the unanimous adoption of the MDGs by the UN millennium assembly. This is also reflected in the vision statements of the multilateral development institutions (although many of them did not have poverty reduction as part of their original mandates). For example, the World Bank now envisions—as it proudly promulgates in its website—"a world free of poverty." Similarly, the Asian Development Bank has adopted poverty reduction as its overarching development objective and its website enunciates its mission as "fighting poverty in Asia and the Pacific." However, skeptics abound, for whom this is just another effort at relabeling of the axes.

The first strand of the studies, which includes Rosenstein-Rodan (1961), was greatly optimistic regarding the impact of foreign aid. These studies, which drew their inspiration from the then fashionable Harrod-Domar growth model and with their putative assumption that aid was an exogenous addition to the aggregate stock of capital of the country, would suggest that foreign aid would lead to a dollar-for-dollar increase in savings and investment. However, the empirical evidence that emerged from these studies did not fully corroborate this overly optimistic expectation about savings and investment. While some studies—such as Rahman (1968) and Weisskopf (1972)—note a negative association between aid and savings (as well as aid and growth), others such as Papanek (1972) and Newlyn (1973) subsequently questioned the empirical validity of

[8] As Morrissey (2004) has noted, the meaning in which development effectiveness is now most commonly used is derived from the empirical aid-growth literature, where a positive significant coefficient on the aid variable is interpreted as evidence that aid has been effective in promoting growth.

such pessimistic conclusions. The balance of evidence from this literature, as summed up by Hansen and Tarp (2000), suggests that aid leads to an increase in total savings, but not by the same magnitude as the amount of aid flow.

The focus of the subsequent stream of empirical studies shifted from the impact of foreign aid on investment to the impact on economic growth, partly out of the recognition that investment is not the only factor of growth as posited in the Harrod-Domar model. A widely cited study of this genre was the one by Mosley, Hudson, and Horrel (1987), which was undertaken at the behest of the development committee of the World Bank and the International Monetary Fund (IMF). The quantitative finding from the study is twofold: First, aid is ineffective in promoting development: there was no significant correlation between aid and growth rate of GNP in developing countries. Second, the reasons for the ineffectiveness of aid are the fungibility[9] and the consequent leakage of aid into unproductive expenditure in the public sector; and the adverse effect of the infusion of foreign aid on the private sector through relative price changes.

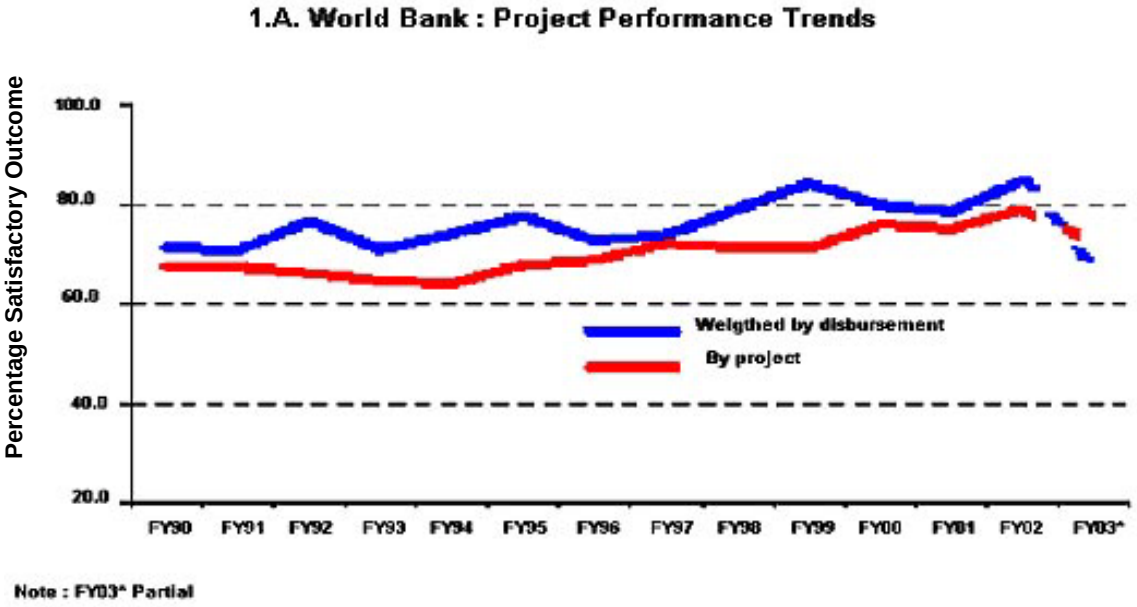
However, this finding of ineffectiveness of aid at the macro level is in contrast with the results at the micro level. At the micro level, all donor agencies report regularly through their annual "aid effectiveness" reports about the success of the vast majority of their projects and programs. Figure 1 shows the performance trends of the World Bank and the ADB projects/programs, which have been completed, in recent years. The performance picture that emerges from the figure is certainly not one of aid ineffectiveness.[10] This contrast between micro and macro studies has given rise to what Mosley (1987) has

[9] Roughly speaking, fungibility of aid refers to foreign assistance not being used for the purpose it is intended. An inflow of foreign aid, even though earmarked for a specific sector or project, helps to relax the recipient government's resource constraint and enables financing its own priorities at the margin. These priorities may include low-priority investment projects and unproductive consumption expenditures. There is a considerable volume of empirical literature on fungibility, as has been reviewed by Devarajan and Swaroop (2000). The overarching message of this literature appears to be that aid is only partially fungible. In developing countries, aid does not necessarily translate into tax reductions; it helps finances both capital and consumption expenditures. With respect to inter-sectoral fungibility, the evidence is mixed: there is a good deal of diversity in the extent of fungibility across sectors and countries.

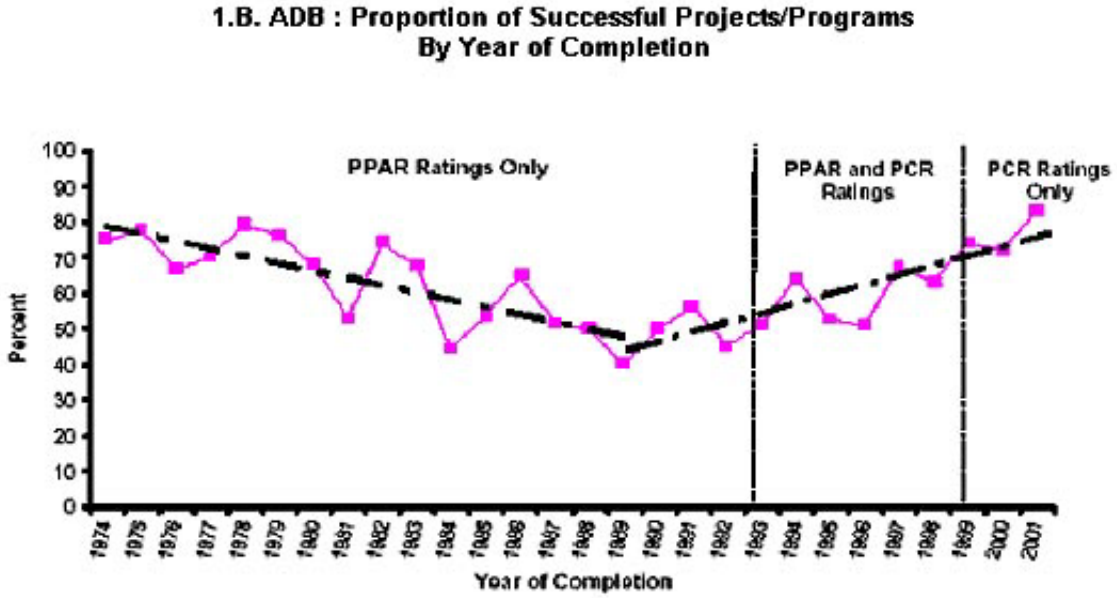
[10] Based on their review of development projects, Cassen and associates (1994) have argued that development interventions by international development agencies have been effective and yielded respectable returns.

labeled as the “micro-macro paradox”, an apparent puzzle that has helped to pique wide interests in development effectiveness issues.

Figure 1. Project Performance Trends of World Bank and ADB



Source : World Bank (2004a)



Source : ADB (2004)

The empirical works of Boone (1994, 1996), which rely on elaborate panel data (covering a sample extending from 1971 to 1990 in 117 countries) provide further confirmation of the Mosley results. His empirical results suggest that aid is ineffective because, as Boone contends, it tends to finance consumption rather than investment. Though the Boone study confirms the micro-macro paradox of Mosley, the result—aid does not have any augmentative effect on investment—runs counter to the body of empirical evidence from the earlier stream of studies. Perhaps the principal contribution of the Boone study has been to stimulate further professional interests in a research area that was fast approaching rapid diminishing returns.[11]

However, the papers that have done the most to stimulate the interest in the topic are those of Burnside and Dollar (BD) (1997, 2001).[12] They use an extensive dataset that covers 56 countries over the period 1970-1993 to produce a set of aid-growth regressions[13] that seem to provide a satisfactory resolution of the micro-macro paradox. According to BD: (i) Aid is generally ineffective in promoting growth. The simple correlation between growth and aid is zero. This is indicated by the small and insignificant coefficient of aid in the growth regression. (ii) However, this result masks the diversity of outcomes between countries—one with good policies and the other with bad policies. The impact of aid on growth is positive in countries with a good policy environment. This *conditional effectiveness* is indicated by the significant and positive coefficient on the "aid*policy" interaction in the growth regression.[14]

[11] A policy conclusion underscored by Boone relates to the link between political regimes and aid effectiveness. Boone finds that liberal political regimes and democracies, ceteris paribus, have on average 30 percent lower infant mortality rates than the least free regimes. This, he conjectures, is due to the greater empowerment of the poor under liberal regimes (even though the political elite continue to receive the benefits of aid programs). From this, he concludes that a more successful way of reducing poverty is to target short-term aid to support liberal political regimes. A number of authors such as Kosack (2003) and Svenssson (1999) have made similar points on the role of political regimes in aid effectiveness.

[12] BD (2000) is the published version of the working paper (BD 1997).

[13] The regression equation that BD work with takes the following general form: GDP growth (per capita)= other terms+ b. aid+ c. (aid*policy) + d. aid^2 +error

[14] Burnside and Dollar begin with the relation posited above and find that none of the regression coefficients are significant in their full sample. But then they drop some "outlier" observations and find that the aid-squared term becomes insignificant. Next they drop the aid-squared term and experiment

The term "good" policy has been used in a precise sense by BD (1997, 2000) as an indicator of macroeconomic soundness: it is an index of fiscal, monetary, and trade policy indicators. More concretely, it is a linear combination of the budget surplus, inflation, and trade openness. The appeal of the BD proposition of conditional aid-effectiveness is its reductive simplicity: it encapsulates the issue of aid effectiveness into a simple success criterion—i.e., an index of sound macroeconomic policies—which is easily monitorable and fully concords with the prevailing orthodoxy of the "Washington consensus" of development.

The principal lesson that has been widely drawn by the international donor community from the BD work is *selectivity:* aid should be allocated only to countries with good policies. The idea of selectivity, which has become the guiding principle of the World Bank aid allocation policy, has gradually emerged as the conventional wisdom and the operating principle of the international development community. The *Economist* (1999) has expressed this selectivity principle most starkly:

> Countless studies have failed to find a link between aid and faster economic growth. Poor countries that receive lots of aid do no better on average that receive very little…. Rich countries should be more ruthless about how they allocate their largess, whether earmarked or not. Emergency aid is one thing. But mainstream aid should be directed only to countries with sound economic management. In other words, aid could work if properly directed.

The message of selectivity has been further reinforced in a high profile World Bank report (1999), *Assessing Aid: What Works, What Doesn't and Why.* The regression part of the study, which has been based on the same dataset as the BD studies, arrives, quite expectedly, at similar empirical conclusions. However, the report goes beyond those quantitative results. Drawing on the World Bank's extensive evaluation experience, the report provides a more careful yet critical assessment of its own experience with foreign assistance. It goes on to suggest five "policy reforms" for the donor agencies:

(i) First, financial assistance must be targeted more effectively to poorer developing countries with sound economic management.

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with a modified regression equation of the form: GDP growth (per capita) = other terms + b. aid + c. (aid* policy). For this modified equation, they find that the coefficient of aid is insignificant and the aid-policy interaction term is highly significant.

(ii) Second, policy-based aid should be provided to nurture policy reform in credible reformers: conditionality does not work unless there is strong domestic support for reform.

(iii) Third, the mix of aid activities, between projects and programs, should be tailored to country and sector conditions.

(iv) Fourth, projects need to focus on creating and transmitting knowledge.

(v) Fifth, aid agencies need to find alternative approaches to helping highly distorted countries, since traditional methods have failed in these cases.

However, despite the broader scope of the report, the main focus of discussions in the policy community, subsequent to the publication of the report, has been largely the first recommendation, i.e., policy of selectivity. It may be noted that this spotlight on selectivity is neither new nor novel. Almost four decades ago, Bauer, a fervid critic of foreign aid, suggested that aid be allocated "more selectively both politically and geographically" (1966, 32). Bauer (1984) subsequently exhorted donors to be "deliberately discriminating" and recommended that aid be given only to those governments that "promote the welfare of the people" by "effective administration, the performance of the essential tasks of government and the pursuit of liberal economic policies." However, what gave the argument of BD its added cogency is its apparent rigorous empirical grounding.

Despite the putative merit of selectivity, its implications for equity in poor countries can be quite adverse. There is a good deal of evidence that suggests a high correlation between low income and poverty on the one hand and limited capacity—analytical, institutional and administrative—to design and implement "good" policies on the other. If aid resources are allocated only to countries that can devise and implement good policies, this would mean excluding poorer countries with the least capacity yet would need help the most. In other words, selectivity would preclude and punish countries where aid is most required and can have the greatest equity impact.

Moreover, if selectivity and efficiency is the paramount concern, that is likely to result in an allocation of aid resources that would militate against the prospects of attaining

MDGs, which are now the accepted international development goals. Achievement of MDGs globally is predicated on the availability of sufficient aid resources across the developing countries and with a degree of equity.[15] If the supply of aid resources remains fairly inelastic and their allocation is guided solely by efficiency and selectivity then this would result in resources being channeled to a few large countries with good policies. However, this outcome is neither equitable nor desirable from the perspective of global poverty reduction.

III. THE CURRENT DEBATE

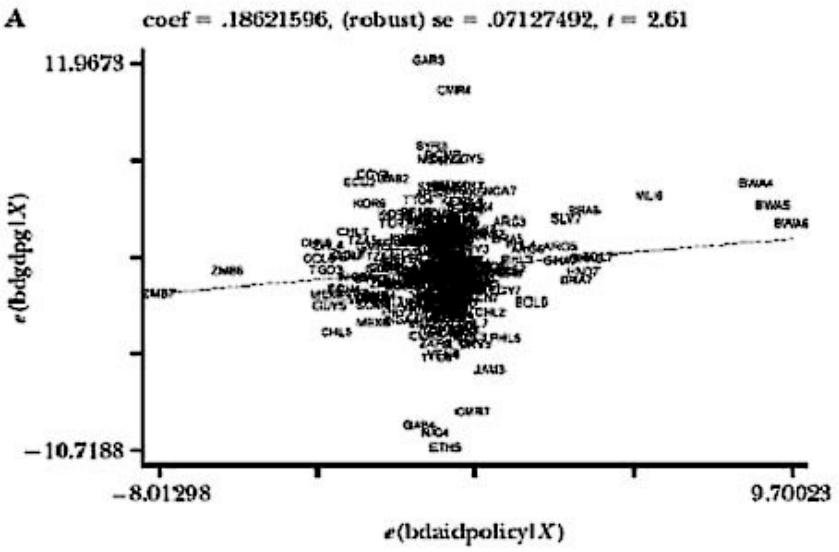
The BD papers have proved to be seminal and helped generate a sizeable empirical literature on aid effectiveness. This literature has on one hand examined the robustness of the BD empirical findings and on the other hand advanced alternative hypotheses on aid effectiveness.

The robustness enquiry, which examines the BD conditional effectiveness proposition, has proceeded at three different levels. First, a number of authors—for example, Dalgaard and Hansen (2001), Hansen and Tarp (2001), Hudson and Mosley (2001), Lensink and White (2001)—have undertaken a similar type of empirical investigation as BD, involving growth regressions. Their enquiries, however, have differed in terms of regression models, data sets, and the use of estimators. But none of these authors have found a significant interaction effect between the BD policy index and aid. Second, Easterly, Levin, and Roodman (2004), who re-estimated the BD model with an updated (with a longer timeframe) and extended (with greater country coverage) dataset, have not found any statistically significant aid-policy interaction term either. Figure 1, which is taken from Easterly (2003a), compares the partial scatter from BD on economic growth and the interaction term aid*policy and the corresponding partial scatter from Easterly, Levin, and Roodman (2004). The latter used the same model but more data. The partial scatter shows the unexplained portion of economic growth against the unexplained

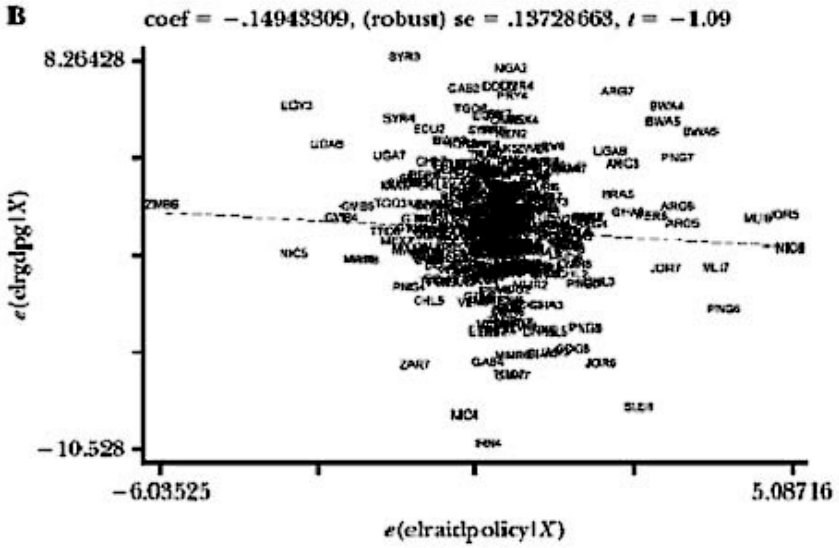
[15] According to a set of estimates by Devarajan, Miller, and Swanson (2002), attainment of MDGs will require a substantial increase in the flow of aid resources to the poorer countries with "poor " policies and a total additional foreign aid in the range of $40-70 billion, an amount that would be roughly equivalent to doubling the present ODA budget.

portion of the interaction term aid*policy that is unexplained by the other right-hand-side variables of the regression equation. The contrasts between two scatter plots are noteworthy. In one case, the correlation between economic growth and the aid*policy interaction term is positive while in the other case, it is negative. Finally, Roodman (2004), who has conducted further robustness tests along with two other competing hypotheses on aid effectiveness, has noted that the BD (2000) result is not robust with equally plausible definitions of “aid”, “policies”, and “growth”. Indeed, his robustness tests have demonstrated that overall, the evidence is weakest for the BD story, as compared to other competing aid effectiveness hypotheses. In light of the above discussion, it can be safely concluded that the evidence in support of the BD conditional-effectiveness proposition is anything but statistically robust.

Figure 2 : Partial Scatters of Growth against Interactive Aid and Policy Term



Source: Burnside and Dollar (2000).



Source: Easterly, Levine and Roodman (2003).

Note on Partial Scatter Plots: The codes for the data points are the World Bank 3-letter abbreviations for the country name while the numbers indicate successive 4-year average points. The partial scatter plot provides a two-dimensional representation of the relationship between growth and aid*policy, controlling for the other regressors. The procedure for producing the partial scatter plots involves first regressing growth against all of the regressors in the growth equation except aid*policy and collecting these growth residuals. The next step then involves regressing aid*policy against the same regressors and collecting the aid*policy residuals. The figures then plot the growth residuals against the aid*policy residuals along with the regression line.

In addition to the robustness analysis, the recent literature has produced three other interesting results that have an important bearing on issues of development effectiveness. First, the empirical works by such authors as Hadjimichael et al (1995), Durbarry (1998), and Lensink and White (1999) have shown that aid contributes positively to growth but its marginal contribution is subject to diminishing returns.[16] Hansen and Tarp (2001) have provided further confirmation of this result. They formulate a unified empirical framework that allows various types of nonlinearities in the aid-growth relationship such as quadratic aid and policy along with aid-policy interaction. They find that when the empirical relationship introduces nonlinearity in the impact of aid, it drives out the significance of the aid*policy interaction effect. This, in other words, means that aid has a positive effect on growth but the positive impact seems to taper off as the volume of aid increases (due perhaps to absorptive-capacity constraints).[17] However, this result is not conditional on the existence of "good policy." Rodman (2003), who has carried out the most extensive robustness tests of the cross-country aid-growth relationships, has found this result as "the most robust and far-reaching" of all regression results.

Second, Guillaumont and Chauvet (2001) have shown that a country's structural

[16] This diminishing return possibly reflects the absorptive capacity constraint, an idea that dates back to Millkan and Rostow (1957), Rosenstein-Rodan (1961), and Chenery and Strout (1966). This absorptive capacity constraint stems from limits in the quality and quantity of human capital and physical infrastructure. A practical way to glean the telltale signs of the absorptive capacity constraint is through the annual portfolio performance reviews carried out by the donor agencies. These reviews identify the ongoing implementation issues with the agency portfolio and highlight sectoral and national constraints to smooth implementation and achievement of intended development objectives. However, in interpreting these results, one need to be careful in not attributing implementation delays due to cumbersome policies, procedures and practices across donor agencies that put an enormous demand on the administrative skills of the poor countries to the absorptive capacity constraint. For an interesting account of the bureaucratic rigmarole in the supply of foreign assistance, see Easterly (2003b)

[17] A recent paper by Clemens, Radelet, and Bhavnani (2004) further corroborates this finding. The principal innovation of the paper has been to recognize the heterogeneity of aid and distinguish among various types of foreign assistance. They divide into foreign assistance three categories: (i) emergency and humanitarian aid, which is likely to be negatively correlated with growth; (ii) aid that influences growth only in the long run, such as aid to support democracy, environment, health and education; and (iii) aid that could plausibly stimulate growth in four years, such as various types of policy-based lending, investments in infrastructure, and aid for productive sectors such as industry and agriculture. Clemens, Radelet, and Bhavnani confine their attention on the last type of assistance, which accounts for almost half of all foreign assistance. Their statistical results suggest that there is a positive, causal relation between this type of aid and economic growth—albeit subject to diminishing returns—over a four-year period. This basic finding, it may be noted, is not conditional on the recipient's quality of institutions or policies. The paper also reports that the statistical results are robust, and relatively free from the econometric estimation problems typical of growth regressions.

vulnerability (to external shocks) has a significant impact on the effectiveness of aid. Adding a "vulnerability" variable to the BD formulation, they find that policy, aid, and vulnerability all have a significant impact on growth. They however find that the aid-policy interaction term is no longer significant. They also find that aid is more effective when structural vulnerability is high. Aid flows help to promote growth—or, help contain negative growth—in countries that are structurally vulnerable to external shocks. Guillaumont and Chauvet's vulnerability index has four components: instability of agricultural income (a proxy for natural disasters), volatility of export earnings, the long-term trend in the terms of trade, and the initial population. Collier and Dehn (2001) have provided further confirmation of the Guillaumont and Chauvet result regarding the role of structural vulnerability to external shock on aid effectiveness.[18] They find that the interaction term involving the change in aid and the change in export prices are significant. This result has an interesting implication for aid programs, which has been succinctly stated by Roodman (2003):

> If the result persists under more sophisticated econometric testing, it would argue for the value of aid programs… which are designed to help countries through terms of trade shocks. It would also cast an interesting light on the debate over the value of IMF "bail-outs" for countries struck by external shocks of various kinds. At any rate, the Collier and Dehn result on shocks cannot substitute for the classic BD [Burnside and Dollar] story as an organizing principle for aid policy. A result on the value of *increasing* aid under certain circumstances does not speak to the question of appropriate *levels* of aid.

Third, somewhat related to the above, the recent research by Dalgaard, Hansen, and Tarp (2004) suggests that non-economic structural factors have an important bearing on aid effectiveness. In particular, they find that geography and climate-related factors have a highly significant impact (both directly and through the aid*tropics interaction effect) on growth, and hence on aid effectiveness. In general, they contend that geographically

[18] In a recent paper, Chauvet and Guillaumont (2004) have argued that given the wide prevalence of political instability in developing countries, the discussion of aid effectiveness should explicitly include the role of political instability. They conjecture that political instability would affect aid effectiveness in two opposite ways. First, political instability is in some sense akin to economic variability due to an external shock, which can be cushioned (ensured) by external economic assistance. Second, political instability is also somewhat different from economic variability: while the latter can be exogenous, the former is essentially endogenous. The adverse effect of an endogenous political instability cannot be compensated by resource inflows. On balance, they contend that the negative effect of political instability, even in the presence of substantial of foreign assistance, will dominate.

challenged countries would display a lower level of effectiveness, a fact that should be taken into account in any calculus of aid allocation.

Finally, in conclusion, it may be noted that notwithstanding the seeming popularity of growth regressions as a tool for analyzing aid effectiveness, this body of literature as a whole has been criticized on analytical and estimation grounds. First, much of the cross-country empirical literature on aid effectiveness has no rigorous theoretical underpinning that guides the specification of the empirical model. In other words, much of the empirical modeling effort relies on ad-hoc specifications that have little or no theoretical basis. Second, like other applications of growth regressions, the results are notoriously fragile to changes in model specification, which makes it difficult to derive robust policy conclusions. Third, estimating growth regressions is beset with many technical econometric issues such as parameter heterogeneity and endogenous regressors, measurement errors, influential observations and error correlation.[19] In light of all this, it has been suggested that this empirical approach, based on cross-country growth regressions, to analyzing aid effectiveness be abandoned in favor of in-depth longitudinal studies of individual countries that specify a growth model appropriate to the country's economy as the foundation for empirical analysis.

IV. SOME RELATED ISSUES

The recent empirical research on development effectiveness has highlighted a number of critical analytical and policy issues. The following focuses on three such issues.

A. Growth versus Poverty Reduction

Although poverty reduction has been accepted as the overriding objective of international development assistance, this concern has not found adequate reflection in the current research: paradoxically, much of the current research effort has been couched in terms of economic growth rather than poverty reduction. This neglect is partly due to the

[19] See Templeton (1999) for explanation and in-depth discussions of these econometric issues.

comparative advantage of economists in handling growth empirics and partly due to misunderstanding among many economists that growth and poverty reduction are essentially synonymous. The evidence of the latter is reflected in such statements as "the aid bureaucracies [these days] define their final objective as "poverty reduction, [which is] today's more politically correct name for 'growth" (Easterly 2003a, 34).

Nevertheless, reflecting the current international priorities, some recent papers in this area have attempted—although they have often adopted an indirect and circuitous approach—to incorporate poverty concerns. In this regard, some recent contributions of Dollar and his collaborators may be noted. In these works, their aim seemed to have been to derive the maximum leverage out of the BD growth regressions. In order to address different poverty questions, these efforts have been largely limited to slight tweaking or relabeling of the growth regressions and put them to different uses. Burnside and Dollar extend the growth-aid empirical relationship derived in BD (1997, 2000) to poverty in BD (1998). Taking infant mortality as a proxy for poverty and substituting it as the dependent variable, the paper closely mimics the aid-growth type regression to show that aid reduces infant mortality under good economic management. However, this is far from obvious whether this relationship is robust with respect to other indicators of poverty. Moreover, the various deficiencies and fragilities of the BD growth-regressions, as noted earlier, would apply equally to this effort.

Collier and Dollar (2001, 2002) take a step further from the growth regressions and go on to derive a "poverty-efficient" allocation rule—that is, the rule for allocating aid that would maximize reduction in global poverty. According to Collier and Dollar, the impact of aid on poverty depends on two factors: (i) the impact of aid on per-capita income growth, and (ii) the impact of per-capita income growth on poverty reduction. The first is derived from the BD growth-aid relationship and the second is given by the growth elasticity of poverty.[20] In their optimizing exercise, they also make the patently

[20] As Srinivasan (2001) has rightly noted, a parameter such as growth elasticity of poverty that establishes a relationship between two endogenous variables is far from stable-- and does not represent any "deep parameter' in the Lucas sense (Lucas, 1976) nor does it reflect any deeper processes. The use of such parameters, as it is known from the now- famous Lucas critique, can be highly misleading for policy simulations.

unrealistic assumption[21] that the growth elasticity of poverty is a constant at 2 across countries. The optimal allocation is obtained when the marginal productivity of aid in terms of poverty reduction are equal across recipient countries. As the growth elasticity of poverty is uniform and constant across countries, this would in turn imply that the optimal allocation would obtain when the marginal contribution of aid to economic growth are equalized across countries. Their empirical results suggest that the existing allocation of aid is inefficient and if aid allocation were to follow their efficiency principle,[22] then the impact of aid, in terms of poverty reduction, nearly double.

However, as it should be fairly obvious, their approach to optimal allocation is highly simplistic. First and foremost, poverty reduction is not mediated only through economic growth, as postulated by Collier and Dollar. Poverty reduction is also effected by social and human investments—more generally by social empowerment (World Bank 2000). There are social and human investments[23] that can have both direct and indirect bearing on poverty reduction through their impact on human "capabilities." The currently accepted multidimensional concept of poverty, which has been encapsulated in the MDGs, goes beyond income poverty. Collier and Dollar's approach to deriving the optimal allocation ignores this multidimensionality and the role of foreign assistance in promoting social and human investments—and in reducing poverty.

Second, it should be noted that the Collier-Dollar poverty efficient allocation, which is intended to maximize global poverty reduction, is not the appropriate formulation if the objective is to attain poverty reduction, in its multidimensionalities, in each country

[21] Collier and Dollar also assume that donors have absolutely no influence on the recipients' policies. This assumption, while simplifying the algebra, does not necessarily accord with reality.

[22] It may be noted here that the growth-aid relationship reported in BD (2000) and Collier and Dollar (2001, 2002) are different in one important way. Recall that the regression model they posit is: GDP growth (per capita) = other terms+ b. aid+ c. (aid*policy) + d. aid^2. In BD (2000), the aid-squared term was found insignificant, whereas in Collier and Dollar (2001, 2002), the aid-squared term has a significant and negative sign. However, without the negative sign of the aid-squared term, Collier and Dollar's poverty efficient rule would not have yielded an interior solution.

[23] In a recent paper, Mosley, Hudson, and Veschoor (2004) have constructed a "pro-poor (public) expenditure" index, which is a weighted average of the proportion of GDP spent on poverty-related activities such as health and education. Their empirical investigation confirms that this index, along with inequality and corruption, is a key determinant of poverty reduction. They also offer an alternative formulation to Collier-Dollar's poverty-efficient allocation of aid.

within the same timeframe, as envisioned in the MDGs. The fundamental basis for allocating aid across countries by international development agencies should be the Poverty Reduction Strategy Paper (PRSP) and MDG assessments.[24] These assessments should define the country requirements for foreign assistance to achieve the MDG benchmarks.

Third, as noted by Collier and Dollar (2002), if aid allocation were not politically constrained—i.e., they provided ad hoc limits to allocation to big countries, poverty efficient allocation would have implied that aid budgets be allocated overwhelmingly to India with its reasonable policies and high incidence of poverty. However, such an allocation would militate against the principle of relative global equity, as envisioned in the attainment of MDGs across the developing world.

In light of the above, there are reasons for skepticism as to whether—or to what extent—the insights on aid effectiveness defined in terms of economic growth would apply to the case when the goal of development is poverty reduction in its multi-dimensionalities. However, one thing seems fairly obvious that the impact of development assistance—depending on its quality and composition—can often be widely different in terms of growth and poverty reduction in a particular context. Therefore, if poverty reduction is the objective, then it would seem more appropriate that the empirical analysis—or, for that matter, regression analysis— speak directly to the question of poverty reduction.

[24] Poverty Reduction Strategy Papers are nationally owned participatory poverty reduction strategies prepared by governments through a participatory process involving civil society and development partners, including the World Bank and the IMF. The PRSP describes a country's macroeconomic, structural and social policies and programs to promote growth and reduce poverty, as well as associated external financing needs. There are five core principles underlie the development and implementation of PRSPs. These principles are that PRSPs should be: (i) country-driven or involving broad-based participation by civil society and the private sector in all operational steps; (ii) results-oriented or focusing on outcomes that would benefit the poor; (iii) comprehensive in recognizing the multidimensional nature of poverty; (iv) partnership-oriented or involving coordinated participation of development partners (bilateral, multilateral, and non-governmental); and (v) based on a long-term perspective for poverty reduction. See the World Bank website HTUhttp://www.worldbank.org/poverty/strategies/progrep.htmUTH for more details.

B. Defining Good Policies and Institutions for Aid Effectiveness

The aid-effectiveness proposition advanced by BD and the World Bank (1998) in its report, *Assessing Aid*, is predicated on a notion of "good" policies/institutions. In the face of mounting evidence of the statistical fragility of the conditional-effectiveness proposition, Dollar and his collaborators have made use of successively different indices of good policies and institutions in different works. Beginning with the *BD policy index*, which has essentially been a proxy for sound macroeconomic policy, this list includes the *index of economic management*—which is a combination of the BD policy index and the Knack and Keefer (1995) measure of institutional quality (ICRGE) index[25] the Kaufman, Kraay, and Zoido-Labotan (2002) (KKZ) index of governance[26] and finally, the World Bank's country policy and institutional assessment (CPIA) index[27] which has 20 components in four categories: macroeconomic policies, structural policies, public sector management, and social inclusion.

As noted earlier, these authors have taken their work from the positive to the normative domain and used it for more active policy advocacy. A case in point is Collier and Dollar (2001, 2002) who use the CPIA to devise an optimal aid allocation policy. The main conclusions that emerge from these papers is that optimal allocation of aid would entail targeting aid to countries with low per capita income but high CPIA; and reduction of global poverty would entail a combination of the optimal aid allocation rule and improvements in CPIA in Africa.

While few would deny that "good" policies and institutions can contribute to enhancing aid effectiveness, there is a diversity of views regarding what constitutes good policies/ institutions in a specific instance. In that context, there is also skepticism— both at the

[25] In *Assessing Aid*, the BD policy index has been replaced by the economic management index.

[26] In their most recent paper (Burnside and Dollar 2004), BD revisited the empirical aid-growth relationship, employing yet another index of institutional quality—this time the KKZ index of governance. The KKZ index is an amalgam of a large number of subjective assessments of institutional quality by primarily by institutional investors.

[27] See Appendix C for more details on the CPIA index.

conceptual as well as practical level— to what extent the currently available indices of policies/institutions truly represent measures of good policies and institutions.

Of all the indices, CPIA is now the most widely used operational tool at the World Bank for measuring good policies/institutions. There is however a large measure of skepticism outside the World Bank about CPIA as an index of "good" policies/institutions. In particular, the application of CPIA as an aid allocation tool has elicited widespread criticism in the development community. Dalgaard, Hansen, and Tarp (2004) have expressed three such reservations. First, CPIA is an elaborate index, devised by the World Bank, which has been held "classified" away from public scrutiny. It is not clear, given its classified nature, how the different components of the index cohere and conflict with one another, in terms of its impact on growth and aid effectiveness. Therefore, such an index offers precious little guidance to policymakers regarding growth and aid effectiveness. Second, CPIA may be endogenous as both CPIA and growth are jointly determined. However, this issue cannot be directly investigated, as the index does not belong to the public domain. Nevertheless, some preliminary investigations by Dalgaard, Hansen, and Tarp (2004)—based on the data on CPIA data for 1999 and 2001 from World Bank, *News and Notices for IMF and World Bank Watchers*—suggest the existence of so-called Granger-causality. This implies that the change in the CPIA index over time was simply "caused" by the growth performance. This justifies, as Dalgaard et. note, "a certain amount of skepticism regarding the policy relevance and appropriateness of using these regressions in counterfactual scenarios such as reallocation of aid based on good CPIA ratings. If the CPIA index is Granger-caused by growth it should not be used as an exogenous variable in forecasts and policy simulations." Finally, as Dalgaard et al. report, there is a strong correlation between countries with poor CPIA with countries in the tropics. Which means the use of CPIA index in aid allocation may punish countries with unfavorable initial conditions. It is possible to confuse climate-related problems with poor CPIA ratings and the willingness to reform. Such confusion has dire consequences, as Dalgaard et al. rightly note:

> Ultimately the core question may boil down to this: should we stop giving aid to countries in the tropics? Undoubtedly, these are countries which have

> displayed dismal growth performance in the last several decades and in addition, aid seems to have been far less effective in such regions. Certainly, if the Collier-Dollar allocation rule is used indiscriminately, this will be the result. (Dalgaard et al. 2004, F211).

In addition to the above specific criticisms against CPIA as a tool of aid allocation, there are other criticisms at a general conceptual level that seem to apply equally to other indices of good institutions/policies. First, as noted by Glaeser, La Porta, Lopez-de-Silva, and Shliefer (2004), the indices of good governance and institutions such as ICGER and the KKZ index are really proxies of outcomes, and do not reflect the characteristics of institutions, in the sense of North (1981).[28] As such these indicators of institutional quality are conceptually unsuitable to establish the causal relationship that institutions promote growth. Second, which is related to the first, the most commonly employed indices of good institutions are based on the surveys of investors, both domestic and foreign. In these surveys, the respondents are asked to provide their views on the safety of their investments or their ratings on the "rule of law." Given the manner in which the surveys are conducted, the indices capture more of the investors' perception than formal aspects of the institutional framework. Third, the indices, which implicitly assume as the benchmark the Washington and post-Washington consensus, are largely ahistorical and do not take into account particular country circumstances—its stage of development or its economic history. These indices would tend to give the impression that a country, in its bid for economic development—irrespective of its stage of economic development or its position in the historical trajectory—has to conform to the whole battery of Washington and the post-Washington consensus in the form of the CPIA or the KKZ index. However, for a poor country, to attain the benchmark of perfection is neither feasible nor even desirable. In this connection, three lessons from recent development experiences from the high-performing Asian economies are worth noting.[29]

First, there is no unique, context-free way to achieve desirable institutional outcomes. The process of institutional development is gradual, path-dependent, and cannot be

[28] North (1981, 201-2) defines institutions as a "set of rules, compliances procedures, and moral and ethical behavioral norms designed to constrain the behavior of individuals in the interest of maximizing the wealth or utility of principles." In other words, for North, institution is the overarching framework of rules and constraints that regulate interactions among individuals.

[29] The following arguments and examples are drawn from Rodrik (2003).

superimposed from outside.[30] The experience of People's Republic of China (PRC) in this respect is exemplary. The PRC has achieved a semblance of effective private property rights through institutional innovations unique to itself despite the absence of any *dejure* private property rights until very recently. Rather than privatize land and industrial assets, the PRC government implemented novel institutional arrangements such as the household responsibility system and township and village enterprises (TVEs). Under household responsibility system, land was "assigned" to individual households according to their size. In TVEs, formal ownership rights were given not to private hands, but to local communities (townships or villages). Local governments had a vested interest to ensure the prosperity of these enterprises as their equity stake in TVEs generated revenues directly for them. In the economic and political milieu of the PRC, property rights were effectively more secure under direct local government ownership than they would have been under a private property-rights legal regime. According to Rodrik (2003), the efficiency loss incurred due to the absence of private control rights was probably outweighed by the implicit security guaranteed by local government control.

Second, the transition from the low-growth to the high-growth trajectory typically combines elements of orthodoxy with unorthodox institutional practices. The experience of the PRC here is illustrative. The PRC provided market incentives through a two-track system of reform that combines elements of orthodoxy with unorthodox practices. Its reform to effect agricultural liberalization, property rights, and trade liberalization did not involve comprehensive reform, but a two-track system involving unconventional institutional practices. For example, the PRC did not achieve the benefits of trade liberalization through an across-the-board tariff reduction but by a system of special economic zones.

[30] This was trenchantly expressed by North (2000): " it is important that we understand that even if we did have it right for one economy it would not necessarily be right for another economy and even if we have it right today it would not necessarily be right tomorrow…. we do know a good deal about the institutional foundations of successful development…. What is still missing is how to get there. The key is the way path dependence will constrain the process of institutional and economic change."

Third, a large-scale institutional reform is neither necessary nor feasible to accelerate growth. Indeed, well-known historical episodes of growth acceleration have been achieved through gradual experimentation. Examples from recent economic history include Republic of Korea in the 1960s experimenting with deregulation of the currency and the rise of the real interest rate; the PRC in the 1970s proceeding gradually with experimental liberalization; and India in the 1980s dismantling *some* anti-business practices.

In short, it may not appropriate to judge the performance of a country, which is pretty low in its trajectory of economic development, in terms of the benchmark of an ideal policy and institutional framework. As Dixit (2004) has noted, it is neither necessary nor possible to create Western-style institutions from scratch:

> It may be possible to work with such alternative institutions as are available, and build on them. Of course, to do this we must have a good understanding of how various institutions of governance work, and of how they interact with each other.

Lucas (1993) made a similar point in a slightly different context, when he argued that asking a country to "follow the Korean model" of economic development is "a little like advising an aspiring basketball player to "follow the Michael Jordan model." He then goes on to suggest:

> To make use of someone else's successful performance at any task, one needs to be able to break this performance down into its component parts so that one can see what each part contributes to the whole, which aspects of this performance are imitable and, of these, which are worth imitating.

This is an eminently sensible advice worth heeding whether one is judging institutions, policies or a development model.

In sum, the above discussion suggests that defining good polices and institutions for aid effectiveness is not as clear-cut, unambiguous, context-neutral and ahistoric as it has been made out to be. There is indeed no single blueprint of "ideal" policies and institutions that can be applied to all countries at all stages of development—or against which the performance of different countries at different stages of development can be judged.

C. Conditionality versus Selectivity

An interesting, but relatively unknown, econometric finding of BD (1997) is that aid has no influence on policy reform. This finding has been further corroborated by other econometric studies (for example, Alesina and Dollar 2000) and by country case studies (for example, the external evaluation of the IMF's Enhanced Structural Adjustment Facility (ESAF) by Botchway et al. 1998 and Killick et al. 1998); and has been highlighted in the World Bank's report (1998), *Assessing Aid.* The latter report notes the existence of "surprisingly little relationship between the amount of aid and policies" and speaks of "a mountain of literature [that] conclude[s] with skepticism about the ability of conditionality to promote reform in countries where there is no strong local movement in that direction." In short, the main empirical message that emerges from this sizeable literature on conditionality is that it does not work

The reasons for the ineffectiveness of conditionality are manifold. First, there is often a divergence of views between the donor and the recipient regarding the program. The divergence may not necessarily relate to the content of the program, but to such secondary issues as the best means, the sequence or the timeframe for achieving the program. Second, perhaps the most fundamental problem with conditionality is its dynamic time inconsistency problem. The recipient government may agree to a reform program prior to receipt of the aid but it may renege on the promise as the incentive changes after aid disbursement. In other words, the issue of conditionality goes beyond designing an incentive-compatible contract in a static principal-agent framework of donor-recipient relationship. Given the dynamic nature of interactions as well as the informational asymmetry that exists in a donor-recipient relationship, designing effective conditionality is a much more complex exercise than a textbook static principal-agent model. Third, there are also incentive issues on the donor side that weaken the link between a country's resolve to fulfill the conditionality and its final attainment. This may stem from such sources as the incentive structure in the donor agencies and the "Samaritan's dilemma" for the bureaucracy. The existing incentive systems in donor agencies place a high value to aid disbursement, which encourages aid officials to maximize aid disbursements even if it means some connivance at the failure of

conditionality. Similarly, compassion, rather than individual incentive, may also lead to condoning of the failure of conditionality. There is a "Samaritan's dilemma" for those in the aid bureaucracy who are keen to help the poor in the poor aid- receiving countries. If they enforce the conditionality, that may be help the poor in the long run but hurts them in the short run, a dilemma that may encourage good Samaritans in the aid agencies to overlook the violation of some policy actions in poor countries.

This ineffectivity result has elicited two different types of reactions. The first type of reaction —associated among others with Mosley, Harrigan, and Toye (1995) —is to argue that conditionality works but its application has been flawed in practice. According to this view, conditionality should be more appropriate and simpler, and deviations from the committed reform program should be punished consistently. A critical element for effective reform, according to this view, is country ownership. Country ownership has been variously defined.[31] By and large, it refers to the extent to which a country is committed to pursue the reforms independently of the incentives provided by the donors. However, the meaning of "country commitment" has varied from definition to definition from the broad to the narrow. It has some times been broadly interpreted to mean the commitment of the whole recipient society—including the government, civil society and the private sector. It has some times been narrowly defined to mean only the commitment of the government. Given the various senses the term country ownership has been used, many—for example, Buiter (2004)—find it an "unhelpful" and "misleading" concept "whose time has gone". Nevertheless, despite the fluidity of the concept, donor agencies have stressed ad nauseam the importance of country ownership, though they often tend undermine ownership by maintaining various degrees of control over the design and implementation of the reform program.[32] The World Bank, the IMF, and other

[31] The current World Bank definition of country ownership highlights four key criteria: (i) the locus of initiative must be in the government; (ii) key policymakers must be intellectually convinced; (iii) there must be evidence of public support from the top political leadership; and, (iv) there must be broad-based stakeholder participation. Country ownership thus conceived entails wide consultation by the government with other segments of society, including civil society and the private sector, for fostering of internal consensus. The purpose of such consultation is to elicit new ideas, knowledge, and opinions and to promote consensus on the strategy. Given the degree of subjectivity involved in the above definition, the assessment of ownership remains largely a subjective exercise.

[32] In this regard, Stiglitz (1999, F.594)) has noted that the role of the donors in the design and implementation of reforms should be limited to that of economic advisors " who only apprise them of the prevailing views concerning those consequences." He further opined that when there are conflicting

international donor agencies now build their respective aid programs in poorer countries around the PRSP, which is an attempt to bestow greater ownership to the recipient countries.

The second type of reaction is to accept that traditional policy conditionality does not work and hence be abandoned. However, to make aid more effective, it suggests a different type of conditionality, which is tantamount to selectivity.[33] That is, aid should be given to countries on the basis of ex post policies. Although this approach abandons imposition of ex ante conditionality, it argues that selectivity will ensure superior outcome. In a "repeated game" of donor-recipient interactions, according to this argument, as long as the donor consistently rewards aid to countries that demonstrate good policies, it will elicit good behavior from the recipient.

Gunning (2000) has noted four lines of objections that are leveled against selectivity. First, selectivity will exclude aid to countries with bad policies and this will leave poor people living in those countries to fend for themselves. Second, countries with good policies would be able to generate adequate domestic and foreign private investments and will not require any aid. Third, selectivity will make aid allocation contingent on the definition of good policies. While some aspects of good policy may be objectively defined, others will involve more subjective judgment. This will result in donor-recipient bargaining over the quality and content of the policy package. Fourth, selectivity may run into conflict with ownership. This happens when donors attempt to give a detailed multidimensional definition of good policies.

Gunning (2000) considers the first two objections unsustainable. With respect to the first objection, he argues that poor people in poor countries will not be much benefited by foreign assistance if the quality of the government is dreadful. One way to circumvent the

views on those reforms, the donors would "do a disservice (to the country) in pretending that there is more consensus on those matters than actually is."

[33] It may be noted in passing that traditional ex ante conditionality is in a sense a conceptual dual of selectivity. Conditionality means providing aid to developing countries on the basis of a promise to undertake a stipulated set of policy actions. In other words, it is a set of prior actions before the loan is disbursed. Conditionality thus anchors availability of assistance on ex ante reform. On the other hand, selectivity relates to ex post reform. Aid is made available on the basis of the success of ex post reform.

problem is to avoid the government mechanism and assist the poor through the conduit of NGOs. With respect to the second objection, Gunning argues that even if policies are good, poor countries do not metamorphose into developed countries overnight. In the interim transition period, availability of foreign aid may be key to the transformation process, as the supply of domestic and foreign savings remains paltry.

In sum, ex ante conditionality appears to be largely ineffective in practice. However, selectivity does not provide a neater solution either. The success of selectivity depends on the correct definition and identification of good policies and institutions in different countries at different stages of development. This task can be an insurmountable challenge for aid bureaucracies often less than fully familiar with the economy, society, culture and polity of the concerned country. It also runs afoul of the concept of ownership. In short, neither conditionality nor selectivity has emerged as efficient mechanisms for achieving aid effectiveness—or lived up to their performance expectations.

D. Outcomes versus Policies

With the increasing popularity of the principle of selectivity among donor agencies, there has emerged a debate whether aid should be allocated on the basis of polices or outcomes. Or, in other words, for incentives and other reasons if aid allocation has to be conditional, whether such conditionality should be policy or performance based.

Under performance-based conditionality, donors focus on results in terms of impact and outcomes, rather than on inputs, activities and outputs.[34] The European Commission has recently introduced a particular form of performance-based conditionality in its adjustment aid to African, Caribbean and Pacific (ACP) countries.[35] There seems to be an

[34] Inputs refer to the financial, human, and material resources used for a development intervention—for example, the budget used for constructing schools or health centers. Outputs refer to products, goods and services that result from a development intervention—for example, the number of schools built; the number of health centers opened. Outcomes refer to intermediate indicators of results—such as the number of students graduated from school; the number of visitors to the health centers. And finally, impact refers long-term consequences of the intervention—for example, improvements in health and educational indicators. Given the difficulties in disentangling and distinguishing between the medium-term outcomes and long-term impacts, they are often lumped together under the heading of outcomes.

[35] For a preliminary review of the European Union's experience with performance-based conditionality, see Adam et al. (2004).

emerging agreement in international development community in favor of performance-based conditionality.

There are pros and cons of each choice. The main arguments in favor of policy-based conditionality vis-à-vis performance-based conditionality are that the former are *easier* to observe and monitor and have a *greater* effective incentive effect. Policies are more directly under the control of the government and their implementation can be more easily monitored. On the other hand, outcomes are not under the full control of the government and often reflect exogenous shocks. There is often a large time lag between policy decisions and performance in terms of economic growth and poverty reduction. This time lag and tenuous link between policies and outcomes can greatly dilute the incentive effect on the government for its action.

The main argument for outcome-based conditionality vis-à-vis policy-based conditionality is that it promotes greater ownership and accountability. Some observers argue—for example, Gunning (2000)—that the present practice of a detailed assessment of the entire policy environment is both unnecessary and undermines ownership. As the donors should be more concerned with performance indicators and not the means to attain them, the government should be free to choose its policies on its own accord. This freedom helps to promote ownership of the policies. In addition, under performance-based conditionality, the government has greater discretion in the formulation of policies. This helps to strengthen the accountability of the government by signaling that the policies are the government's choice, a fact that helps to induce greater private sector confidence

All types of conditionality, whether policy-based or performance-based, are likely to be imperfect in the sense that they will not be able to achieve the ideal first-best outcome. Drazen and Fischer (1997) have identified three reasons for such failures: first, governments' policy actions are imperfectly observable; second, results are not fully determined by governments' policy actions but also influenced by luck; third, governments have varying degrees of competence, which cannot readily be distinguished ex ante. In addition, there is often a good deal of uncertainty—and lack of knowledge—

regarding the results chain, which tracks the causal consequence of a development intervention, moving from inputs and activities to outputs, outcomes, and impacts.

Under performance-based conditionality, donors should focus on impact indicators. However, implementation of such a mechanism is fraught with a number of practical difficulties. The results indicators that are commonly suggested for monitoring are GDP growth, changes in poverty, and changes in child mortality, data for which — except for the first— are not necessarily always readily available. Second, most of the performance indicators are likely to change gradually and therefore any meaningful impact assessment can be done after an interval of a few years. But such assessments may reward or punish today's government for the actions of yesterday of another government.

In light of these difficulties, performance-based conditionality that purports to monitor longer-term impact indicators may need to be supplemented by output and intermediate outcome indicators—or even some policy indicators. Depending on the degree of availability and the accuracy with which different types of indicators can be monitored, the optimal choice may of necessity be a mixture, even though the main yardstick for judging performance must be results.

V. CONCLUSIONS

This paper provides a select review of recent empirical literature on development effectiveness of aid. As this review has focused on a whole variety of complex issues, the arguments are not easy to summarize. Nevertheless, we attempt in the following to cull out from the review a number of conclusions that seem to have an important bearing on development effectiveness issues.

First, the single most robust conclusion that has emerged from recent cross-country regression studies is that aid has *in general* been effective in developing countries across a wide variety of policy environments. This result repudiates the idea of conditional effectiveness, a much-vaunted notion that argues that aid works only in countries with good polices and as such should be directed only to those countries. The operational

significance of this empirical result for the development agencies is that it provides a resounding rationale for continued provision— without being " ruthless" and "deliberately discriminating", as has been exhorted by many—of development assistance across the whole spectrum of developing countries for reasons of aid effectiveness.

Second, although aid is generally effective, its productive impact is subject to diminishing returns. The flow of a larger volume of aid, relative to the absorptive capacity of the country, leads to diminishing returns. This would of course highlight the need, at the country level, for determined efforts to overcome such absorptive-capacity constraints.

Third, non-economic and structural factors have an important bearing on aid effectiveness. In particular, geography and environment-related factors can have an important influence on growth and development effectiveness. In general, it has been noted that geographically challenged countries would display a lower level of effectiveness, a fact that should be taken into account in any calculus of aid allocation by donor agencies.

Fourth, structural vulnerability (to external shocks) has a significant impact on development effectiveness. Aid seems to be more effective in promoting growth when structural vulnerability is high. Some of the dimensions of vulnerability identified in the literature include: instability of agricultural income (a proxy for natural disasters), volatility of export earnings, long-term trend in the terms of trade, and initial population.

Fifth, much of the recent discussion in the literature on development effectiveness has been couched in terms of economic growth. Though there is an inexorable link between growth and poverty reduction, the two concepts are not identical. Nor are the processes underlying the two phenomena. Hence, the insights derived from studies of economic growth do not necessarily apply verbatim to issues of poverty reduction.

Sixth, the notion of selectivity, which has been embraced by many international development agencies, implies that aid should be directed only to countries with good polices. Adherence to the principle of selectivity would result in the exclusion of

allocation to poorer countries with limited administrative and analytical capacities. On the other hand, selectivity will favor allocation to few large poor countries with relatively "good" policies. This would be antithetical to the notion of global equity embodied in the millennium compact, which envisions progress in poverty reduction in multi dimensions across *all* developing countries.

Seventh, the traditional notion of selectivity, which now guides aid allocation policies in many international development agencies, is anchored in concepts of "good" policies. While some of such "good" polices are simply identified and widely subscribed to, others are historical, contextual and path-dependent— and not widely accepted. In light of this difficulty in defining "good" policies, the basis for assessing the performance of a country by donor agencies, if they would like to adhere to some notion of selectivity, should be actual economic and social outcomes—the concrete and measurable results of aid—and not subjective assessments of policies and institutions against the benchmark of the imaginary ideal setup.

Eighth, conditionality based on ex ante policy has proved to be largely ineffective. One way to improve conditionality, as it has been suggested, is to foster "ownership" of policies by the recipient countries themselves. Even though the concept of country ownership is poorly defined, the PRSP process by the international development community is a move in the right direction. When a country is *genuinely* in charge of the development process, this can help foster a sense of identification with the policies and institutions—as well as incorporate local knowledge. Such a process can potentially unleash creative energies that would otherwise elude a development model superimposed from outside.

Ninth, the fundamental basis for country allocation of aid by international development agencies should be the PRSP and MDG assessments, which constitute an integral part of the new international development compact. This would perforce imply discontinuing existing practices in international donor agencies of apportioning development assistance based on CPIA or similar indices. Such practices indeed do not seem to be congruent with the new global development compact for poverty reduction. This new compact

would demand that country needs—i.e., external assistance— be assessed in terms of the shortfalls from the MDG benchmarks and country performance be measured in terms of improvements in the achievement of MDGs over a given time frame to the point of assessment. In the absence of an adequate data infrastructure, such monitoring may however be limited to a few select, strategic variables. If the donor agencies wish to incorporate some elements of incentive in their allocation framework, this can be easily accommodated by offering a greater allocation to a country that registers rapid improvements in those performance indicators compared to a country that shows a slow improvement (adjusting for geographical and other structural disadvantages).

Tenth, the main challenge to growth and aid effectiveness is to identify and eliminate the overriding institutional and policy constraint(s) of a country. Here in this task there can be an important analytical role for donor agencies in developing, in conjunction with the recipient country, a framework of "growth and poverty diagnostics" to identify the over-riding constraints. As the recent economic history of development would suggest, episodes of growth and poverty reduction have been accompanied by relaxation of only a few critical constraints. The process of reform has often taken the path of gradual experimentation, and not across-the-board transformation. If the international development agencies can contribute to the process of identifying the critical constraints through these diagnostic exercises, they would have played an important role in ensuring development effectiveness.

Notwithstanding the relevance and significance of the above conclusions, they by no means offer a quick fix to the vast and multifarious problems of poverty, social deprivation and underdevelopment. Aid effectiveness can only ensure the most efficient use of the available aid resources, but it is by no means a substitute for the large volume of missing resources that would be necessary for addressing the massive problem of global poverty –or for that matter, achieving the MDGs.

Appendix A

Aid: Definition and Measurement

The most common definition of international aid, or development assistance, refers to the measure used by the Organisation for Economic Co-operation and Development (OECD) of "official development assistance" (ODA) that includes grants, loans and debt forgiveness. According to this definition, there are three criteria that ODA has to satisfy, which are: (i) this is undertaken by the official sector of the donor country; (ii) with the objective of promoting economic development and welfare in the recipient country as the main objective; and (iii) at concessional financial terms (i.e., if a loan, have a grant element of at least 25 percent, which is calculated using a discount rate of 10 percent).

ODA should be distinguished from official development finance. The latter includes all financial flows from governments from developed countries and multilateral developing agencies to developing countries. Some of official development finance is provided at terms that are close to the commercial rates. ODA is a smaller subset of the larger flow of official development finance and is targeted at the poorer countries. Chang et al. (1998) has introduced a new measure of ODA, called effective development assistance. The main difference between the new measure of effective development assistance and the OECD measure of ODA is that the former is the sum of grants and grant equivalents of official loans and the latter is the sum of grants and loans for which the grant element is more than 25 percent.

The Development Assistance Committee (DAC) of OECD also makes a distinction between ODA and official aid. The latter comprises flows that meet conditions of eligibility for inclusion in ODA, other than the fact that the recipients are a select set of countries and territories "in transition" (listed in Part II of the Development Assistance Committee List of Aid Recipients).

The conduit for providing development assistance can be either bilateral or multilateral agencies. The bilateral agencies are the government outfits of the donor countries provide such assistance, such as the US agency for International Development or Japanese Bank for International Cooperation. The multilateral development agencies are international development institutions for channeling development assistance such as the Asian Development Bank, the United Nations Development Programme, and the World Bank.

Development assistance can be untied or tied. Tied bilateral assistance is predicated on buying goods and services from the donor country. Such tying reduces the "quality" of aid. There are measures of development assistance that make adjustments for such quality variation.

The volume of ODA has remained largely stagnant over the years, though the share of net ODA as a percentage of the donor countries' GNP has declined over the years (see table and charts below):

Net official development assistance, 1990-2002

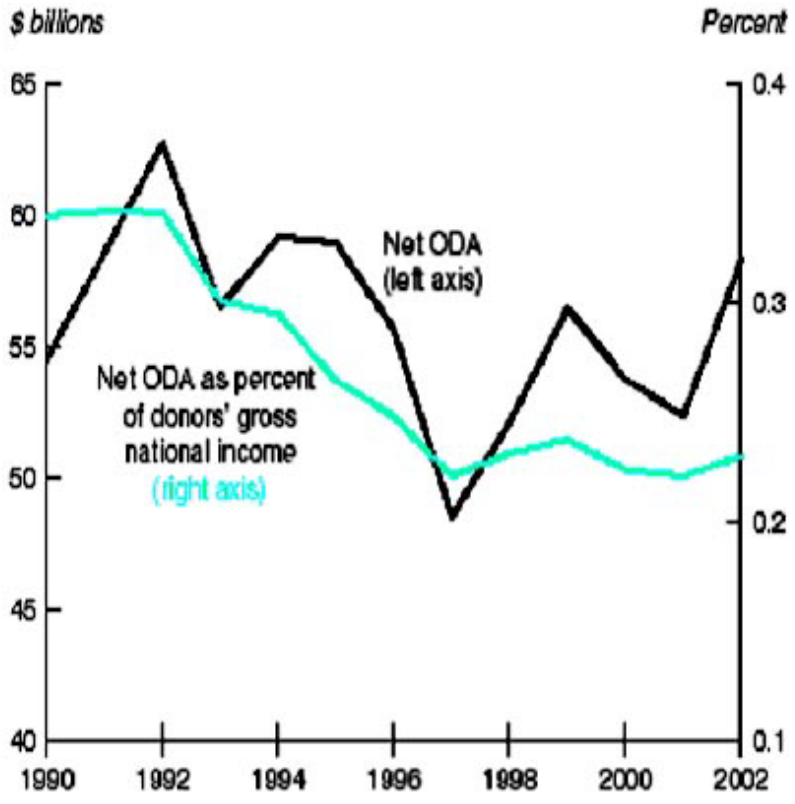
$ billions

	1990	1997	1998	1999	2000	2001	2002	ODA/GNI in 2002 (%)	Percent change in real terms in 2002[a]
Total ODA	54.5	48.5	52.1	56.4	53.7	52.3	58.3	0.23	7.2
G-7 countries	42.5	35.1	38.6	39.4	40.2	38.2	42.6	0.20	9.2
United States	11.4	6.9	8.8	9.1	10.0	11.4	13.3	0.13	15.0
Japan	9.1	9.4	10.6	12.2	13.5	9.8	9.3	0.23	-1.2
Germany	6.3	5.9	5.6	5.5	5.0	5.0	5.3	0.27	-0.2
France	7.2	6.3	5.7	5.6	4.1	4.2	5.5	0.38	22.1
Non-G-7 countries	12.0	13.4	13.5	17.0	13.5	14.1	15.7	0.47	1.8
Memo items:									
EU countries	28.3	26.8	27.6	26.7	25.3	26.3	29.9	0.35	5.8

a. Takes into account inflation and exchange rate movements.

Source: World Bank

Net official development assistance to developing countries, 1990-2002



Source: World Bank (2004b)

Appendix B
Millennium Development Goals (MDGs):
Goals and Targets from the Millennium Declaration

The Millennium Development Goals and targets come from the Millennium Declaration signed by 189 countries, including 147 heads of state, in September 2000 (United Nations 2000). The goals and targets are related and should be seen as a whole. They represent a partnership of countries determined, as the Declaration states, "to create an environment– at the national and global levels alike–which is conducive to development and elimination of poverty.

Goals and Targets	Indicators
Goal 1 : Eradicate extreme poverty and hunger	
Target 1 : Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day.	1. Proportion of population below $1 per day (PPP-values) 2. Poverty gap ratio [incidence x depth of poverty] 3. Share of poorest quintile in national consumption
Target 2 : Halve, between 1990 and 2015, the proportion of people who suffer from hunger.	4. Prevalence of underweight children (under-five years of age) 5. Proportion of population below minimum level of dietary energy consumption
Goal 2 : Achieve universal primary education	
Target 3 : Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling	6. Net enrolment ratio in primary education 7. Proportion of pupils starting grade 1 who reach grade 5 8. Literacy rate of 15-24 year olds
Goal 3 : Promote gender equality and empower women	
Target 4 : Eliminate gender disparity in primary education preferably by 2005 and to all levels of education no later than 2015	9. Ratio of girls to boys in primary, secondary and tertiary education 10. Ratio of literate females to males of 15-24 year olds 11. Share of women in wage employment in the non-agricultural sector 12. Proportion of seats held by women in national parliament
Goal 4 : Reduce child mortality	
Target 5 : Reduce two-thirds, between 1990 and 2015, the under-five mortality rate	13.Under-five mortality rate 14.Infant mortality rate 15.Proportion of 1 year old children immunized against measles
Goal 5 : Improve maternal health	
Target 6 : Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio	16.Maternal mortality ratio 17.Proportion of births attended by skilled health personnel
Goal 6 : Combat HIV/AIDS, malaria and other diseases	
Target 7 : Have halted by 2015, and begun to reverse, the spread of HIV/AIDS	18.HIV prevalence among 15-24 year old pregnant women 19.Contraceptive prevalence rate 20.Number of children orphaned by HIV/AIDS
Target 8 : Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.	21.Prevalence of death rates associated with malaria 22.Proportion of population in malaria risk area using effective malaria prevention and treatment measures 23.Prevalence and death rates associated with tuberculosis 24.Proportion of TB cases detected and cured under DOTS (Directly Observed Treatment Short Course)
Goal 7 : Ensure environmental sustainability	
Target 9 : Integrate the principles of sustainable development into country policies and reverse the loss of environmental resources	25.Proportion of land area covered by forest 26.Land area protected to maintain biological diversity 27.GDP per unit of energy use (as proxy for energy efficiency) 28.Carbon dioxide emissions (per capita) [Plus two figures of global atmospheric pollution : ozone depletion and the accumulation of global warming gases]
Target 10 : Halve, by 2015, the proportion of people without sustainable access to safe drinking water Target 11 : By 2020, to have achieved a significant improvement in the loves of at least 100 million slum dwellers	29.Proportion of population with sustainable access to an improved water source 30. Proportion of people with access to improved sanitation 31.Proportion of people with access to secure tenure

	[Urban/rural disaggregation of several of the above indicators may be relevant for monitoring improvement in the lives of slum dwellers]
Goal 8 : Develop a Global Partnership for Development*	
Target 12 : Develop further an open, rule-based , predictable, non-discriminatory trading and financial system Includes a commitment to good governance, development, and poverty reduction–both nationally and internationally	Some of the Indicators listed below will be monitored separately for the Least Developed Countries (LDCs), Africa, landlocked countries and small island developing states. *Official Development Assistance* 32.Net ODA as a percentage of DAC donors' GNI [targets of 0.7% in total and 0.15% for LDCs] 33.Proportion of ODA to basic social services (basic education, primary health care, nutrition safe water and sanitation) 34.Proportion of ODA that is untied 35.Proportion of ODA for environment in small island developing states 36.Proportion for ODA for transport sector in land-locked countries *Market Access* 37.Proportion of exports (by value and excluding arms) admitted free duties and quotas 38.Average tariffs and quotas on agricultural products and textiles and clothing 39.Domestic and export agricultural subsidies in OECD countries 40.Proportion of ODA provided to help build trade capacity *Debt Sustainability* 41.Proportion of official bilateral HIPC debt cancelled 42.Debt service as a percentage of exports of goods and services 43.Proportion of ODA provided as debt relief 44.Number of countries reaching HIPC decision and completion points
Target 13 : Address the Special Needs of the Least Developed Countries Includes: tariff and quota free access to LDC exports; enhanced programme of debt relief for HIPC and cancellation of official bilateral debt; and more generous ODA for countries committed to poverty reduction	
Target 14 : Address the Special Needs of landlocked and small island developing states (through Barbados Programme and 22nd General Assembly provisions	
Target 15 : Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term	
Target 16 : In co-operation with developing countries, develop and implement strategies for decent and productive work for youth	45.Unemployment rate of 15-24 year olds
Target 17 : In co-operation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries	46.Proportion of population with access to affordable essential drugs on a sustainable basis
Target 18 : In co-operation with the private sector, make available the benefits of new technologies, especially information and communications	47.Telephone lines per 1000 people 48.Personal computers per 1000 people *Other Indicators TBD*
**The selection of indicators for Goals 7 and 8 is subject to further refinement.*	

Source: United Nations Development Programme (UNDP). Millennium Development Goals.

Available: *http://www.undp.org/mdg/Millennium Development Goals.pdf*

Appendix C

Country Policy and Institutional Assessment

The Country Policy and Institutional Assessment (CPIA) is the World Bank index for assessing the quality of a country's present policy and institutional framework. There are 20 items to be assessed, each with a 5 percent weight in the overall rating. They are grouped into four categories, as shown in the summary table below, although the distinctions between categories are not rigid. Each aspect of policy is considered in light of its impact on poverty reduction.

A. Macroeconomic management and sustainability of reforms

1. General macroeconomic performance
2. Fiscal policy
3. Management of external debt
4. Macroeconomic management capacity
5. Sustainability of structural reforms

B. Structural policies for sustainable and equitable growth

1. Trade policy
2. Foreign exchange regime
3. Financial stability and depth
4. Banking sector efficiency and resource mobilization
5. Property rights and rule-based governance
6. Competitive environment for the private sector
7. Factor and product markets
8. Environmental policies and regulations

C. Policies for social inclusion

1. Poverty monitoring and analysis
2. Pro-poor targeting and programs
3. Safety nets

D. Public sector management

1. Quality of budget and public investment process
2. Efficiency and equity of revenue mobilization
3. Efficiency and equity of public expenditures
4. Accountability of the public service

Ratings are done by the World Bank staff, on the basis of their subjective assessments, about the effectiveness of the relevant policies and institutions. A ratings scale of 1-6 is used for each category, with 1 indicating worst and 6 indicating best performance.

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