

New Perspectives on Aid Effectiveness

David Roland-Holst and Finn Tarp[†]

Abstract

Over the last five decades, development assistance has evolved in response to a dramatically changing global political and economic landscape. In this paper, we examine this evolution and discuss how the effectiveness of aid has been and will be seen in the eyes of donors, intended beneficiaries, and outside observers. From an historical perspective, we note that the effectiveness debate has been confined by preoccupation with macro institutions and outcomes. We also discuss how the relative importance of aid has changed with rapid growth of trade and private capital markets. Looking ahead, we argue that care should be taken when applying macro performance evaluation to development assistance because this approach increases the risk that aid will be politicized and allocated inefficiently. Rationing credit and other assistance by macro-criteria inevitably screens out credit- or need-worthy recipients, while many beneficiaries in attractive macro settings may be less deserving. Simplistic macro rules-of-thumb not only compromise more rigorous credit and need standards; they reinforce the adversity of people living under substandard governance. In reality, aid and lending relationships involve complex contractual and agency relationships that are essentially microeconomic in nature. We discuss how conceptual innovations in modern microeconomic theory might be enlisted to improve aid effectiveness. In passing, we also review some implications for public donor institutions of another globalization phenomenon, rapidly emergent private policy agencies in the form of NGOs.

[†] Paper prepared for the Annual Bank Conference on Development Economics, June 24-26, Oslo, Norway (ABCDE-Europe 2002). David Roland-Holst is James Irvine Professor of Economics at Mills College and Director of the Rural Development Research Consortium (RDRC) at the University of California (dwrh@rdrc.net). Finn Tarp is Danida Professor of Development Economics and Coordinator of the Development Economics Research Group (DERG) at the University of Copenhagen, Denmark (finn.tarp@econ.ku.dk). Special thanks are due to John Rand for excellent research assistance and to Tony Addison for useful comments on an early draft. Opinions expressed here are those of the authors and should not be attributed to their affiliated institutions.

Introduction

Foreign aid has undergone many fundamental shifts since the middle of the last century. During the 1960s and 1970s, a multilateral agenda of development goals, institutions and procedures was added to traditional bilateralism. Thinking about development policy was drastically modified from the early 1980s onwards; and the evolving donor-recipient relationship today can best be described as uncertain and circumspect. In parallel, the global economic context in which foreign aid is implemented has been transformed in ways unimagined at the time of Bretton Woods.

Emerging from debates about the ‘micro-macro’ paradox from the 1980s, the analysis of aid effectiveness became dominated by macro-econometric approaches during the 1990s. Convincing evidence emerged that aid works at both the macro and micro level, but the putative lessons learned from this inference vary greatly, and disagreements persist about both necessary and sufficient conditions for effective economic assistance. This is true both with reference to more narrow debates about appropriate economic policy and to the wider institutional context within which aid is implemented. The donor-driven nature of many aid programs has, since the mid-1990s, inspired repeated calls for a new kind of partnership (Helleiner 2000). One response has been the increased use of the concept of ‘ownership’ in the rhetoric of aid policy, but what this means in theory and practice is less clear.

After an historical survey of the aid effectiveness literature in Section 2, we provide a brief empirical narrative on the changing relative importance of aid in the present era of globalization (Section 3). Rapid and sustained growth of trade and international capital flows have essential implications for both the appropriate role and the effectiveness of development

assistance. Historical trends imply that aid should increasingly be focused on its core mission, assisting the most disadvantaged and helping to correct those market failures that most critically affect basic human needs, such as public health, subsistence, and livelihood. Beginning from this more restrictive context, there are still many opportunities for broadening and deepening public commitments to development priorities. With the diminution of aid's relative size in the multilateral economic environment, we are entering an Age of Complementarity, where private sector interests can and must be leveraged by donor institutions in pursuit of socially beneficial policy objectives.

As a modest contribution to renewing perspectives on development assistance, the fourth section of this paper puts forward a series of ten precepts, or operational principles, for guiding more effective aid relationships in the future. In particular, we argue that great care should be taken when applying macroeconomic or (worse) political performance evaluation to development assistance. These approaches increase the risk that aid will be allocated in both economically and socially inefficient ways. Rationing credit by macro-criteria inevitably screens out credit- or need-worthy recipients. At the same time, many beneficiaries in attractive macro settings may be less deserving. Simplistic macro rules-of-thumb not only compromise more rigorous credit and need standards; they reinforce the adversity of those living under substandard governance. In reality, aid and lending relationships involve complex contractual and agency relationships that are essentially microeconomic in nature. This is so both at the level of national donor-recipient interaction and when microeconomic actors are engaged directly. We suggest that real ownership will remain elusive unless this is recognized more explicitly and comprehensively. In this paper, we begin a discussion about how conceptual innovations in modern economic theory might be enlisted to overcome imperfections in the underlying microeconomics of aid relationships, thereby improving aid effectiveness.

A fifth section of the paper briefly reviews an important institutional phenomenon associated with globalization, the rapid emergence of Non-governmental Organizations (NGOs) and the implications of this emergence for pursuit of effective development assistance. While this discussion is only relevant to a subset of NGOs, these institutions have arisen to meet a manifest desire on the part of economically and politically significant, private, and usually multilateral (mainly OECD) constituencies to participate in the design and conduct of global development assistance. Seen in this way, the NGO movement is a force and not only must – but should – be more constructively reckoned with by established bilateral and multilateral aid institutions. Again the issue for the latter group is complementarities, how best to leverage the intentions and energies of the former in pursuit of *bona fide* development objectives. To do this, and especially to do it with a minimum of politicization, is a great challenge, but it is one that must be met if the full promise of North-South cooperation is to be realized.

Retrospective¹

Economic development since the middle of the last century has been spectacular. There are many encouraging examples of development successes, yet there is also evidence of a widening gap between the most and the least successful. Too many countries lag behind, particularly in Africa, and around 1.2 billion people have to manage their lives with an income of less than a dollar a day. Political leaders have over and over again asserted that widespread poverty and existing imbalances in socio-economic conditions are unacceptable and should be

¹ In what follows we draw in part upon many of the papers published in Tarp (2000). This volume synthesized contributions from some 29 authors who are cited in what follows by name only.

corrected through urgent and concerted action. Yet, foreign aid commitments are under political pressure and their usefulness was widely questioned during the 1990s.

The roots of foreign aid can be traced back to at least the 19th century, but the economic and social development of the third world, as such, was clearly not a policy objective of the colonial rulers before the Second World War. Such an objective would – as argued by Erik Thorbecke – have been inconsistent with the underlying division of labor and trading patterns within and among colonial blocks. Thorbecke goes on to outline how the concept of foreign aid as a contributing factor to development evolved within the broader framework of development theory and strategy during the last five decades of the 20th century.

In the aftermath of the last world war, Europe faced an acute need for reconstruction and a critical shortage of capital. The response was the Marshall plan, implemented from 1948 to 1953 and driven in part by fear of communism and the desire of the USA to secure American hegemony in global trade and investment. The plan was massive even by today's standards, and also very effective. It helped mitigate an acute scarcity of foreign exchange in Europe, and gave rise to many of the elements of the existing system of aid delivery. However, the needs of the developing areas of the world *per se* were not yet in focus. The International Bank for Reconstruction and Development (IBRD), established at the Bretton Woods Conference in 1944, was originally concerned with reconstruction elsewhere, and the International Development Association (IDA) was only created in 1960 to channel resources to the poorest countries on 'soft' conditions. Developing regions did receive support from the colonial powers before 1960, notably from Britain and France, and the volume of French aid as a share of GNP actually increased to more than 1% by the early 1960s. A major part of the rapidly increasing bilateral flows during the 1950s came from the USA, whose aid/GNP share grew to well above 0.5%; but considerable continuity from colonial to post-colonial institutions

was characteristic (Peter Hjertholm and Howard White). Colonial ties were strong and influential.

After the success of the Marshall Plan, attention increasingly turned to developing countries, many of which became independent around 1960. Hjertholm and White note that this created a constituency for aid, and that the first meeting of the nonaligned movement in 1955 gave a focus to this voice, as did the various organs of the UN, notably the United Conference on Trade and Development (UNCTAD). The transition towards somewhat more independent, multilateral relations, vis-à-vis traditional bilateralism inherited from colonialism, was beginning to emerge. In parallel, the 1960s saw a distinct increase in the share of multilateral aid and the role of aid started shifting towards a broader agenda of socio-economic goals that clearly went beyond the exclusive focus on promoting economic growth, characteristic of the 1950s. The Economic Commission for Africa (ECA) came into being in 1958, and as the first of the three regional development banks, the Inter-American Development Bank (IDB) was established in 1959. The multilateralism of aid became even more pronounced in the 1970s, which saw an increased focus on employment, income distribution and poverty alleviation as essential objectives of development and indeed aid.

Economic progress was visible during much of the third world during the first two decades from 1960. Irma Adelman refers to this as the golden age of economic growth, but this era came to an abrupt end when crisis set in at the beginning of the 1980s. It soon became evident that the downturn was of a more permanent nature, not temporary as in 1973; and it was gradually recognized that the development strategies of the previous decades were no longer sustainable. Economic circumstances in developing countries and the relations between North and South had changed radically, so adjustments were needed in economic policies. Achieving macro-economic balance (externally and internally) appeared as an essential pre-

requisite for renewed development; and macroeconomic stabilization and adjustment became important and, in much of the rhetoric of the day, nearly synonymous with economic transformation and development. Reliance on market forces, outward orientation, and the role of the private sector, including NGOs, were emphasized. In parallel, poverty alleviation somehow slipped out of view in mainstream agendas for economic reform, while still very much at the center of attention in for example UNICEF's Adjustment with a Human Face approach.

In parallel, bilateral donors and international agencies such as the World Bank grappled with how to channel resources to the developing world. Net aid flows were seriously affected by flows related to recurrent indebtedness, and by the late 1970s it had become increasingly difficult to channel fresh resources to many developing countries. The various kinds of macro-economic program assistance (such as balance of payments support and sector budget support), which were not tied to investment projects, and which could be justified under the headings of stabilization and adjustment, appeared an ideal solution to this dilemma. Financial program aid and adjustment loans became fashionable and 'policy conditionality' more widespread.² Maintaining the flow of resources had found a rationale, which corresponded well with the major tenets of the on-going 'neo-classical counter-revolution' and the guidelines for 'good policy' summarized under the heading of the 'Washington consensus'. All in all, aid continued to grow in real terms until the early 1990s and actually represented a rising share of the growing GNP of the donor community, more than tripling during the period 1970-1990 (see

² Paul Mosley and Marion Eeckhout describe in detail the movement from project to program assistance and Ole Mølgård Andersen provides a sector perspective on these issues.

Figure 3.1 below).³ However, after 1990, total aid flows started to decline both in absolute terms and as a share of GNP.

There are many reasons for the decline in aggregate flows, including prominently the decline of communism and the end of the Cold War. Weakening patron-client relations among the developing countries and their former colonial masters certainly also played a role, and the traditional support of development aid by vocal interest groups in the developed countries receded. Other concerns, notably the environment and distrust of bilateral and multilateral agencies have also played a role. These institutions have been subjected to criticism and at times characterized as blunt instruments of commercial interests in the developed world or as self-interested, rent-seeking bureaucracies. In any case, the widespread perception that aid is at best ineffective in fostering growth at the macro level no doubt also had an important role to play. A superficial look at available data does indeed seem to suggest that aid is ineffective in promoting growth, and anecdotes about failed projects at the micro level contributed to an increasing sense of aid fatigue in donor countries. Finally, the acute awareness of cases of bad governance, corruption, and ‘crony capitalism’ led during the 1990s to skepticism about the sincerity and credibility of aid-receiving governments and the potential role aid might have played in underpinning economically or socially irresponsible regimes.

Raymond Hopkins points out that the use of governments to transfer resources has become less legitimate as governments are less trusted (on both the donor and the recipient side). It could be argued that the fact that more countries have democratized should mean that their governments are now more legitimate recipients of aid than they were in the past (when they were one-party states). In any case, a sense of ambivalence and even failure spread during

³ This trend prevailed despite the fact that US assistance started falling already in the mid-1960s as a share of GNP to less than 0.2% at the end of the century.

the 1990s, and such perceptions obviously represent a serious challenge to any economic development rationale for aid. These reservations should not undermine the primary ethical impetus for aid, the betterment of basic human circumstances, but they do justify more rigorous thinking about aid's design and implementation. After all, while aid has generally fallen in relation to other resource flows, aid still represents a sizeable amount of resources. The impact of these should be maximized.

Foreign aid has throughout its history been subjected to close scrutiny both by academic researchers and other interested observers. A massive outpour of studies over several decades bears witness to this, and it is characteristic that the boundary between policy advocacy (one way or the other) and research has not always been clearly delineated. Be that as it may, most development economists and aid practitioners have at one stage or the other come across the so-called 'micro-macro' paradox, formulated by Mosley (1987). This thesis suggested that while aid seems effective at the micro-level, it is harder – or actually impossible – to identify any positive impact of aid on the macro-economy. Much of this was spurred by the focus of the 1980s in uncovering the impact of the stabilization and structural adjustment packages. As a corollary of the adjustment programs in many countries, the use of a wider variety of analytical tools in aid impact assessment became common. Evaluation methods such as the internal rate of return (IRR) of projects came under severe criticism as the perception that aid (channeled through sovereign governments) is fully fungible spread. The IRR approach also became problematic as donors started to embrace goals for aid, such as environmental sustainability and broader social goals.⁴ In parallel, the difficulties of macroeconomic evaluation summarized under headings such as 'before-and-after' and 'with-and-without' were

⁴ If analysts cannot value for example environmental costs and benefits, it is difficult to account for them in rates of return calculations. The same goes for participation by communities in the design of projects at local level.

the topic for many discussions, and methodological issues gradually came to play an important role in the aid effectiveness debate.

In spite of all this, aid fatigue persisted. The strong faith in the operation of markets and skepticism regarding governments, including both recipients and donors, reinforced this circumspection. After all, foreign aid has to a large extent always been a state-to-state relationship. Fatigue was also influenced by the fear that foreign aid was generating aid dependency relationships and as such would have negative incentive effects. The increasing perception that ‘conditionality’ was in effect failing to promote policy reform started to creep in at the turn of the century, and it became clear that the relationship between donors-and-recipients left much to be desired. Ravi Kanbur argues that the accounts of failure are legion, and he has produced a fascinating summary of both the background and the present state of affairs. He notes that while there is reason to view the donor-recipient relationship as one of unequal power, imposing conditionality is in practice much more subtle. In fact, there is strength in the weakness of the recipients, and above all, weakness in the strength of the donors. The basic reason is, Kanbur argues, that donors and recipients are so enmeshed, at the level of governments, agencies and individuals, that it is actually not clear where the strengths and weaknesses lie. Conditionality was no doubt ‘imposed’ on unwilling recipients at the time of signing adjustment documents, but ‘the recipients know, the donors know, and in fact everybody knows, that these are paper conditions; the outcome will be driven by the need of both sides to maintain normal relations and the flow of aid’.

All of this motivated a renewed interest in new kinds of donor-recipient relationships and the effectiveness of aid. In response, calls were made for increased national ownership of

aid programs,⁵ and both World Bank researchers and others started digging into the aid-growth relationship. This was facilitated in part by the availability of much better data and in part by insights emerging from new growth theory and the rapidly increasing number of empirical studies of growth. Early work in this vein by Boone (1996) suggested that aid does not work and is simply a waste of resources. This was followed up with an analysis by Burnside and Dollar (1997, 2000).⁶ They argue that some aid does work, and provided an attractive and seemingly self-evident solution to the ‘micro-macro’ paradox. Aid works, but only in countries with so-called ‘good policy’. They based this on an aid-policy interaction term that emerged as statistically significant in their macro-econometric analyses of the aid-growth relationship.

Burnside and Dollar, and more recently also Collier (2002), have used the above framework as basis for suggesting that aid should be directed to ‘good policy’ countries to improve aid’s impact on poverty alleviation. This is in part justified by reference to the seeming inability of aid to change policy, emerging from other Bank funded research edited by Devarajan, Dollar and Holmgren (2001). While these policy recommendations were considerably toned down in the Bank’s Monterrey document (World Bank 2002), the basic thrust somehow remains, that macroeconomic performance evaluation and policy criteria (established by the World Bank) should play a key role in aid allocation. In an apparent rhetorical parallel, the World Bank President has on many occasions asserted that a development program must be country-owned, not owned by donors or the World Bank.

Heated discussions about what constitutes ‘good policy’ have ensued from the work of Burnside, Collier and Dollar. They are in many ways extensions of more general debates and views about development strategy and policy, and it is characteristic that the concept of ‘good

⁵ The interested reader may wish to consult <http://www.wider.unu.edu/research/research.htm> for WIDER papers on the reform ownership and development issue (research project 2.2/2000-2001).

⁶ The Burnside-Dollar study formed the analytical core of a World Bank (1998) study on the subject.

policy' has been gradually expanded by the World Bank to include a much wider and much more complex set of characteristics than originally considered. Discussions have centered around what can be learned from the kind of cross-country growth regressions that underlie much of the recent empirical work on aid effectiveness;⁷ and academic debate on aid effectiveness has certainly covered new and important territory when it comes to issues of empirical methodology and interpretation. Generally speaking, it appears that robustness is an issue that should not be taken lightly when research is used for formulating policy.

There are many thought-provoking contributions to this debate, which cannot for reasons of space be reviewed here.⁸ Dalgaard, Hansen, and Tarp (2002) offer new theoretical and empirical insights and provide an up-to-date account. They note that the single most common result in recent empirical studies is that aid has a positive impact on real GDP per capita growth, but displays diminishing returns. They go on to conclude that the recent empirical evidence that aid works is convincing, and that political decisions on curbing aid cannot be justified, arguing that aid has no impact on growth. This is encouraging, and it suggests that it is now time to move on to consider how the effectiveness of aid can and should be improved – rather than focusing on whether aid works. In trying to move forward, it is hard not to be struck by fact that the inferences drawn and putative lessons learned from the past 5-10 years vary greatly. Disagreements persist about necessary and sufficient conditions for effective economic aid. What we have learned about what aid can do, what aid should do, and

⁷ Solow (2001) suggests that there is a case for focusing more directly on TFP or factor augmentation functions as the proper left-hand-side variables in empirical work and thinking more seriously about legitimate right hand side variables. Current practice is in his view much too haphazard.

⁸ See for example Hansen and Tarp (2000, 2001) and a 'Policy Forum' in the *Journal of International Development* (Vol. 12, No. 3). Interested readers may also want to examine the August 2001 (Vol. 37, No. 6) special issue of the *Journal of Development Studies* with contributions by many authorities in this area. Draft versions of many of these contributions were originally put out as University of Nottingham CREDIT working papers at the following web-site: www.nottingham.ac.uk/economics/research/credit.

how to do it remains clouded; and the gap between rhetoric and practice in aid relations continues to be a matter of concern to many independent observers and analysts.⁹

In sum, while the last 50 years of the 20th century saw a move away from colonial to post-colonial aid and increasing multilateralism, the early 21st century is best characterized as an era of uncertainty. The evolving donor-recipient relationships are today quite unclear and circumspect. In his reflections on this, Hopkins lists a variety of possible motivations for sustaining aid in the future, and he identifies three targets that may be useful to keep in mind as having wide appeal among diverse elements in the donor and recipient communities. They include: (i) state strengthening, (ii) improved market management, and (iii) emergency safety nets. Hopkins recommends these targets as focus in the promotion of future aid. There are by now several such lists in existence, and they certainly do signal the need to try to work out more clearly what role aid should assume in the future.

Aid and Globalization

Over the period discussed in the previous section, the world economy has changed in ways that every educated person knows are unprecedented and irreversible. Most notable in the present context is the rapid proliferation of international trade relations that have been built upon a stratum of open multilateralism. Regional and global agreements to liberalize international commerce have changed the economic landscape and nearly every agenda for economic policy in ways that are pervasive and still only partially understood. In the present context, it is reasonable to ask: How can the mission of aid best be pursued in an era of

⁹ In discussing present aid modalities, Helleiner (2000) notes that there 'is still a curious "disconnect" between donors' general rhetoric on these issues and actual practice on the ground'.

globalization? Without offering any definitive answers, this section provides a brief historical narrative to elucidate this question.

The growth of trade, growth of economies, and their interaction over recent decades have filled volumes with statistical tables, policy analysis, and academic research. Our purpose here is to focus more narrowly on the components of economic change that might be more relevant to aid's place in the global economy. Even though there exists much work on this narrower topic, we believe that a new perspective on the facts and prior analysis might be beneficial.

Consider for example the very animated debate about absolute levels of global development assistance. While we believe that even greater levels of commitment to the world's poor are necessary to secure sustainable progress for them and for the rich, historical data indicate that global aid levels certainly kept pace with both incomes and population in the developing world during the 1970s and 1980s. Figure 3.1 presents ratios of total aid to Trade, GDP, and Population, respectively, of non-OECD countries for the period 1971-1999. Aid, Trade, and GDP are measured in constant dollars and the ratios normalized to unity in the initial year.

[Figure 3.1 about here]

These series show total aid rising steadily in relation to income and population until the early 1990s, and it might seem appealing to some that Aid/GDP is now twice what it was in 1971 and that Aid/Capita has increased threefold. Yet, it should be borne in mind that the international composition of these ratios vary tremendously between high and low growth economies of the South, and perhaps the most revealing aspect here is the downturn from 1991-92.

How does all this relate to globalization? The third series, measuring Aid relative to total world exports and imports, reveals the implications of the well-known fact that trade has been growing faster than GDP and, despite a recent upturn, aid flows are about the same magnitude relative to trade as they were in the 1970s. Obviously these two economic entities have little causal relationship, but the trends do indicate that flourishing international private commerce has not been associated with a boom in charitable activity, a linkage that one often observes in domestic economic cycles. Put a little differently, the sense of public humanitarian mission that animated development assistance programs in the early decades has not been sustained by the dramatic growth of private sector commercial interest in the international economy.

Although trade can facilitate poverty alleviation, it operates in very different ways, and with a different mission, than aid. The primary impetus of aid is real and social investment, and its putative mission can generally be characterized as an effort to facilitate better human living standards by direct transfers, investments, and overcoming institutional and market failures. From this perspective, aid more closely resembles activities on the capital account, including one dramatically emergent phenomenon, foreign direct investment (FDI). While FDI is a private sector activity, and thus is animated by very different primary objectives, it has been known to confer many benefits on developing economies that are consistent with aid objectives, including human resource development, technology diffusion, and, ultimately, poverty alleviation and more sustainable growth. In this sense, it has long been recognized that

there may be essential complementarities between private and public foreign investment in developing countries, where the latter means aid.¹⁰

The extent to which the complementarities actually matter depends upon their real and potential economic significance. To get an idea of this, look at the trends presented in Figure 3.2 below. These depict, for non-OECD countries, levels of GDP, Trade, Aid, and inbound FDI for the period 1971-1999, normalized from constant US dollars to unity in 1971. The most arresting feature of this data is of course the meteoric rise in inbound FDI, which has increased almost exactly one hundredfold over the last three decades.¹¹ This trend must inspire reflection on the appropriate strategy to public foreign investment, or development assistance, going forward.

[Figure 3.2 about here]

To depict this issue in even higher relief, Figure 3.3 presents ratios of aid to non-OECD inbound FDI, accompanied by the aid to trade ratio of Figure 3.1. The series of Aid/FDI depicts the ratio of absolute (constant USD) levels for each year. In relative dollar terms, private capital inflows were about four times the level of development assistance by 1999, and forward commitments by both public and private interests suggest that this disparity will be widening. That being the case, we believe we have already entered what can be termed the Age of Complementarity in development assistance. This is a new era where aid strategies must be focused more tightly upon their core missions, paring away components of the grander aid agendas of the 1960s and 1970s. At the same time, aid institutions must allocate new resources

¹⁰ Mozambique is an excellent example of the complementarity of aid and FDI. If aid had not been used to stabilize the post-war economy and to help start rebuilding institutions, it is unlikely that Mozambique would have received as much FDI in recent years as has actually happened.

¹¹ Recall, the distribution of these private capital inflows has been very unequal across the developing countries.

to more strategic partnership that can leverage private financial resources to further socially beneficial objectives in recipient countries.

[Figure 3.3 about here]

We believe that perspectives on aid must change in two ways to deal with this situation. First, there must be broader and more refined awareness of the implications of coexistence between public and private investment in developing countries. Several topics related to this will be covered in the next section, but of particular importance will be a better understanding of the primary behavioral drivers and institutional mechanisms behind private investment, particularly ownership and contracts. World Bank and others have drawn public attention to the concept of ownership, but the real microeconomics of property rights and entitlement, as these are implicated in the marketplace, is more complicated than rhetoric about stake holding and community participation.

A second priority for more effective aid complementarity would be official multilateral initiatives to improve public/private communication on development priorities. Obviously, institutions like the IMF and others have been contending with this ‘partnership’ for a long time, but it is not clear that more traditional bilateral and multilateral aid agencies have awakened to the realities of aid and globalization or made the strategic adjustments necessary to more fully exploit complementarities with private capital markets. Indeed, multilateral coordination of public aid alone is still a significant challenge. Public-private coordination has until now remained primarily a domestic policy matter, with trade and commerce ministries simply working to promote market access abroad.

Detailed examples of how this strategy might develop are too numerous for the present discussion, but two might be illustrative. Consider one of the primary missions of development

assistance in its earliest days, to provide liquidity for public investment in the absence of well-developed international capital markets. Obviously, the issue of capital market failure is very different today, but it has not disappeared. While investment resources are available today for an enormous spectrum of investment activities in the developing world, there are still areas where the public must take initiative. These are the traditional social investment and long term infrastructure projects like public health in rural areas, offering very low and/or highly uncertain private rates of return, but still essential to the economically most disadvantaged. This is what we mean by refocusing on the core mission of assistance.

At the other extreme, we see private entities stampeding into infrastructure investments like media, telecoms, and energy. In situations like this, private markets appear to be delivering technological progress to developing countries rapidly and (relatively) efficiently, and one might reasonably question the need for public assistance. To do so is to underestimate the potential of complementarity, however. In the case of media, for example, OECD countries have long histories of regulatory evolution that can be conferred to developing countries, helping them to better use the resources of private sector development for socially beneficial ends. Aid certainly has a potential role here, and in this way bilaterals and multilaterals can have an essential influence on the quality, if not the quantity, of inbound investment and its ultimate social impact. The same logic applies to public and private health, pharmaceuticals, food safety, etc.

Ten Precepts for Aid Effectiveness

From the discussion of the last two sections, it is clear that the role of aid has evolved rapidly in recent years, in response to a combination of economic and political forces.

Although aid no longer serves quite the same objectives or enjoys the prominence it once did, it can still be a potent catalyst for poverty alleviation around the world. John Healey and Tony Killick argue that aid can be used to reduce poverty, and we agree. Similarly, aid can be used to promote integration as discussed by Oliver Morrissey. Given its diminished political and economic significance on a global scale, however, the effectiveness of aid design and implementation is more important than ever. In this section, we survey ten areas where more insight can be gained in this regard. While these topics only cover a subset of the issues relevant to aid effectiveness, we hope they will offer fresh perspectives to renew the energies of those who want aid to work better for its many direct and indirect beneficiaries.

Macro and General Equilibrium Perspectives

We begin by looking at aid issues from an economy-wide perspective. This includes traditional macroeconomic topics and performance criteria, as well as those related to general equilibrium linkages transmitting effects between actors in the economy. The former, reviewed by Hansen and Tarp (2000), have received much attention in the aid effectiveness literature over the five past decades, while the latter are often relegated to academic research and absent from policy dialogue.

1. Macro criteria, misallocation, and rationing: Macro performance generally, and aggregate real income growth in particular, are certainly high priorities for development policy. Yet, we are convinced that macro criteria cannot – and should not – stand alone in evaluating the effectiveness of most development assistance. Whether or not, and under whatever circumstances, macroeconomic growth and poverty alleviation might be correlated is an interesting and policy relevant empirical issue. Poverty itself, however, is a microeconomic

phenomenon and needs to be addressed as such with a significant component of development assistance.¹² More importantly, macro characteristics can be dangerously misleading as criteria for aid allocation. With the exception of short-term macroeconomic assistance, using macro criteria for aid eligibility is likely to lead to serious misallocation. Ultimately, the target beneficiaries of aid intended for poverty alleviation are microeconomic institutions: small enterprises, households, and individuals. Their credit-worthiness and need-worthiness cannot be effectively assessed with macroeconomic metrics, let alone with heuristic and quasi-political rules-of-thumb like ‘good’ or ‘bad’ government policies. In countries with poor macro conditions, including adverse business cycles and weak or compromised policy institutions, many credit- and need-worthy candidates would be ineligible for credit they might use effectively.¹³ At the same time, a macro bias in favor of other countries would promote substandard credit allocation at the micro level. In other words, rationing credit by macro-criteria inevitably screens out credit- or need-worthy recipients. At the same time, many beneficiaries in attractive macro settings may be less deserving.

It is clear from the literature on aid effectiveness, as well as the institutions supporting much of this research, that a macro bias is reinforced by sovereign credit relationships. Bilateral and multilateral institutions are generally entering aid relationships with national entities, and therein arises the preoccupation with quantitative and qualitative macro policy criteria. Our essential argument is that that greater care should be taken when applying macroeconomic performance evaluation to development assistance. This approach increases the risk that aid will be politicized and allocated inefficiently. Assessing economies with

¹² The interested reader may wish to look at the papers from the WIDER growth and poverty conference (see <http://www.wider.unu.edu/conference/conference-2001-1/conference1.htm>) for further references.

¹³ A particular case that comes to mind where there is reason to caution against the over-use of macro criteria relates to post-conflict societies. Tony Addison addresses the complex issues related to aid and conflict, and one can certainly note that simplistic rules of thumb would rule out aid to post-conflict countries such as East Timor and Afghanistan at present; but these are precisely the countries that need better macro-policy institutions.

generic government policy ratings carries similar misallocation risks. Simplistic macro rules-of-thumb not only compromise more rigorous credit and need standards, but reinforce the adversity of those living under substandard governance. It is a regrettable fact that many of the world's poorest people live in conditions of substandard national, regional, and/or local governance and, unlike their enfranchised counterparts in OECD countries, lack any tenable means of changing these institutions.¹⁴ It would be gravely ironic for aid agencies to compound the misfortunes of these people with discriminatory aid allocation.

Finally, we would argue that the use of the ownership concept is often misplaced in the national (government) macro-context. There is of course nothing wrong with 'ownership' *per se*, on the contrary. But governments have varying degrees of ownership over policies and some are not 'owned' at all. In fact, many governments do not even present a single policy line. Different parts of government adhere to different policies, depending on how close they are to donors and the preferences of state actors in each ministry. What genuine ownership is in such settings is neither very effective nor transparent, particularly when microeconomic actors are omitted. As we argue later in this section, it is precisely such actors whose incentives and interests which will determine much of aid's real effectiveness.

2. Foreign exchange risk, local currency credit, and macro moral hazard: Having argued against excessive reliance on macro criteria for aid appraisal and allocation, we want to emphasize what we consider to be the two critically important focal points in the context of sustained development assistance (as opposed to short term macro stabilization): quality of contracts and microeconomic appraisal. Both these issues will be discussed in more detail from a micro perspective below. But the fact of sovereign relations makes contract quality just as

¹⁴ Readers, interested in cross-country empirical approaches, may wish to consult Dalgaard, Hansen and Tarp (2002) for an elaboration of why the endogeneity of policies and institutions should be taken more seriously than in much of the existing analytical work.

important at the macro level. Better contracts, particularly those that capture the realities of incentive problems and principal-agent relationships, can improve aid effectiveness at both macro and micro levels. And they can potentially help infuse the ownership concept with real meaning. It would also facilitate more truly independent monitoring of aid relations, as advocated by for example Helleiner (2000) and others.

As a macro example, consider the currency of denomination for development assistance loans. Many critics of foreign assistance have argued that dollar or other 'hard currency' denominated credit has conferred excessive foreign exchange risk upon poor borrowers. Some have even asserted that this risk constitutes a de facto subsidy to hard currency donors as borrowers are obliged to hold their foreign exchange reserves, effectively financing the lenders' current account deficits. In response to this and other initiatives, there is significant emergent interest in promoting local currency aid and other commercial finance. At its most recent annual meeting, for example, the Asian Development Bank (ADB) floated the idea of converting its future assistance to local currency bond finance. This would achieve at least two objectives, transferring foreign exchange risk to the lender and promoting the development of domestic financial markets in the borrowing country.

While such objectives seem quite laudable, they ignore a serious problem of moral hazard, one that actually does arise in the macro management context. Countries with substantial aid obligations of this type would experience great temptation to mitigate their external liabilities with inflationary policies. With this in mind, it might be advisable to develop a middle ground for aid finance, using a weighted basket of currencies to overcome both lender and borrower incentive problems.

Policy Coherence in Bilateral Relationships

The emergence of multilateral aid agencies has done much to remove historical biases in aid allocation, but bilateral assistance remains very important to poor countries. Because of their sustained commitments in this area, it is therefore particularly regrettable that donor countries often pursue economic policies that partially or completely contradict the principles of their assistance programs. We believe that the cause of aid effectiveness could be advanced dramatically if bilateral donors would simply improve their own policy coherence, better harmonizing their agendas for domestic economic management, trade policy, and development assistance. Two areas that are particularly important are agriculture and tied aid.

3. *Richer farmers, poorer farmers - OECD agricultural support and global immiserization:* It is now well understood that domestic agricultural support programs in OECD countries represent a huge implicit tax on rural households in developing countries. Chronic upward trends in this assistance have sustained excess agricultural supply in rich countries, leading to long-term downward pressure in global food prices and the real incomes for farmers in unsubsidized, largely poor countries.

Recent estimates (Beghin, Roland-Holst, and van der Mensbrugge 2002) indicate that current OECD farm programs reduce rural incomes in poor countries by \$62 billion annually. This figure is over 20% more than even the most ambitious goals for increased development assistance presently under discussion. Moreover, these benefits would go directly to the poorest households in the developing world, conveniently bypassing bilateral and multilateral agencies, and national, regional, and even local administrative mechanisms. Even more ironically, these estimates show that taxpayers in OECD countries essentially pay twice for every dollar of development assistance, once to reduce the incomes of the rural poor and once in an effort to offset this immiserization.

Clearly, the agricultural support and development assistance agendas arise in different policy contexts. However, it cannot be denied that they come from the same governments and, thanks to general equilibrium effects, interact in the same global economy. For this reason, it is perhaps even more important to heed the initiative of the Doha trade round and improve the coherence between national farm agendas, global poverty alleviation, and open multilateralism. The Doha trade round deserves to become a genuine Development Round, where developing countries become more substantive actors and where negotiated results more generally reflect developing country interests. A major challenge to international society is to ensure, in practice, that also the poorest countries are integrated in the global economy. Allowing narrow-minded domestic interests in developed countries to stand in the way for achieving this goal is, to put it plainly, sheer hypocrisy.

4. Tied aid, market reform, and the WTO: Much development assistance in recent decades has been administered with a strong dose of free market ideology. Despite high-minded liberalism, however, donor countries often revert to anti-competitive practices that could be challenged in their own domestic jurisdictions and contradict some intra-OECD commercial agreements. The persistent use of sole-source expenditure or tied aid practices represents a post-colonial anachronism that contradicts the efficiency principles of both aid effectiveness and (domestic and external) market liberalization.

From a general equilibrium perspective, tied aid constitutes not only a monopolistic practice. It is an anti-competitive export promotion technique. Indeed, it may only be a matter of time before the WTO hears a complaint about this practice, but would it not make more sense for bilateral actors to take the initiative and improve the coherence of their own policies in this context?

5. *Aid versus strategic assistance*: A number of bilaterals have been accused of misallocating development assistance in pursuit of strategic objectives, either because they are distorting the definition of eligible activities or because beneficiary governments compromise their own aid programs. While geopolitical aspirations are endemic to most national policies, it does little service to the cause of aid effectiveness to implicate military and other strategic assistance into aid budgets. For this reason, we advocate establishment of a set of international standards about what constitutes *bona fide* development assistance. While it would be difficult to achieve consensus on a restrictive list of admissible aid activities, agreement would be desirable at least with respect to a set of concrete objectives such as poverty alleviation and other international development goals. A more concerted multilateral approach like this could help reduce aid misallocation, aid arbitrage, and other problems, such as fungibility and rent-seeking.

Micro Perspectives: Contracts, Incentives, and Sustainable Credit Mechanisms

In reality, and in spite of all the rhetoric of the aid community, aid and lending relationships involve complex contractual and agency relationships that are essentially microeconomic in nature. Even though the beneficiary signatories to aid agreements or contracts often have macroeconomic authority, they behave as microeconomic agents and their strategic environment is often partially in conflict with that of the donor/lender. Nowhere is this incentive paradox more apparent than in lending for development assistance.

In this section, we discuss aspects of contract theory that may contribute to overcoming these incentive problems. In many cases, we place special emphasis on the idea of ownership, particularly localization of ownership. By this we do not mean abstract or rhetorical ideas of stake holding or community participation, but contractual ownership with its appurtenant real

entitlements and responsibilities. Whether because of its paternalistic bilateral tradition or the bias of sovereign lending arrangements, the aid relationship has been relatively weak in recognition of local ownership principles. We believe this has been detrimental to aid effectiveness for many reasons, not least of which because it has diluted accountability and promoted such practices as rent-seeking, fungibility, and aid arbitrage.

6. Decentralizing sovereign credit: Bilaterals and, particularly, multilaterals often find themselves in the dilemma of extending 15-30 years credit to governments that are clearly influenced by more short-run (3-5 year) policy priorities. This reinforces the macro/heuristic rule biases discussed earlier because national government have the authority to barter longer term repayment commitments for short term liquidity or political gain. Sovereignty is obviously not negotiable, but there may be ways to restructure lending agreements that limit the uncertainty associated with political transition. The most attractive of these is decentralization, where contracts for loans and grants enlist agencies at regional and local levels. Ideally, this would include both performance criteria and direct financial responsibility such as co-payment provisions. Most decentralization entails parallel conferral of local authority and, in the case of co-payment, might require new systems of domestic entitlement, including direct income that can be taxed for debt service.

For example, an upland water retention scheme could be coupled with local water resale rights to finance co-payment. National and even regional governments might not be congenial to such statutory reforms, but provisions of this kind have two important virtues. They help overcome the primary aid incentive problem and improve domestic policy coherence, better aligning real entitlements with financial responsibility and performance. Lenders and donors might complain that regional and local governments are even more unpredictable than national ones. To this we would reply that credit- and need-worthiness

should be assessed at the beneficiary level and, despite its relative convenience, national accountability often fails to meet the same standard. Consider the most extreme form of decentralization, micro-credit, about which we have more to say next. The much-touted success of this approach is a direct result of the attributes we emphasize, local eligibility and accountability.

7. Micro-credit reconsidered: As was just mentioned, micro-credit can be viewed as one of the most extreme forms of aid decentralization, extending both assistance and fiduciary responsibility directly to the microeconomic level. Moreover, we argue that the success micro-credit has enjoyed is directly adducible to the microeconomic nature of the contracts underlying this form of assistance. Individuals are the atomic unit for eligibility, evaluation, and financial accountability (as well as ownership), and this aligns incentives to produce superior performance characteristics. There are lessons in this experience for designing aid contracts at the local community, regional, and national levels.

Having said this, the experience with micro-credit has not been uniformly positive. Indeed, recent experience in Bangladesh and a few other areas has revealed substandard loan portfolios and serious risks beyond recognized loan loss provisions. We believe these cases justify a reconsideration of the appropriate role and design of micro-credit schemes. Like many forms of aid, micro-credit is best suited when designed to overcome market failure. The failure in question here is the local capital market, with the effect of credit rationing. In most applications of micro-credit programs, however, the remedy is two-fold, credit provision and interest rate mitigation. The latter creates a new source of policy risk. While credit is often rationed at the local level in developing countries, there is negligible empirical evidence on what is or should be the real local risk premium or market rate of return. For this reason, it may

not make sense to assume – as is often done – that local lending rates are too high. Thus, well-intentioned micro-credit schemes may over-allocate credit and accumulate loan losses at unsustainable rates. In this context, it is worth noting that non-performing loan rates are not by themselves a problem, it is the pricing of risk that is critical. A financial aid scheme that presumes to increase credit allocation and fix prices at the same time is assuming a great deal about the quality of its administrator's expectations. We believe that micro-credit policies should be focused on overcoming quantity constraints, especially by facilitating market-based financial intermediation. This approach, for example, is currently working well by promoting commercial bank participation in the remittance market.¹⁵

8. *Grants versus negative interest rates*: There has been much discussion recently about increasing the grant proportion of development assistance, both in terms of converting future aid from loans to grants and by forgiving outstanding loans. While loan forgiveness has many advocates, particularly on behalf of the poorest and most indebted countries (per capita or per dollar of GDP), there is significant and influential opposition to large-scale loan-to-grant conversion. The main objection in this context is that development assistance funds represent a kind of global commons, or community credit pool that should be managed on a renewable basis.

We instinctively side with the opponents of large-scale conversion, sharing their concerns about the sustainability of assistance, but we also believe that both sides in this debate are ignoring behavioral fundamentals. As long as an artificial dichotomy is maintained between grant and loan aid, there will be significant inefficiencies in global aid allocation. A better long term approach would be a comprehensive and standardized set of guidelines for concessional

¹⁵ IDB (2001) provides details on this. The interested reader may also wish to consult WIDER research project 3.2/2000-2001 for interesting references on insurance against poverty issues (see <http://www.wider.unu.edu/research/research.htm>).

assistance, supported by a continuous spectrum of aid schemes ranging from outright grants to commercially rated credit. This can best be achieved by standardized aid contracts that stipulate interest rates varying from -100% (that is, pure grant aid) to LIBOR plus some commercial margin. Negative interest rates are an obvious efficiency refinement of the concept of concessional credit, while contract standardization would help to harmonize public and private credit instruments and, eventually, facilitate interaction between the two (as will be discussed below). Moreover, such transparency might actually help clarify the respective roles of different donors. In practice, their operations often overlap in ways that are seldom easy to relate to the underlying differences in aid and lending instruments and conditions.

9. *Public goods in poor countries, a more emphatic case for grants:* The idea of continuous aid pricing (positive and negative interest rates) can easily be defended on efficiency grounds, but in itself provides no guidance about what kind of projects should qualify for which interest rates. For the sake of illustration, we want to highlight the argument for public goods in very poor countries. In this situation, we believe that outright grants clearly dominate subsidies.

Consider the diagram (Figure 4.1) below, with aggregate private goods measured on the vertical axis and aggregate public goods on the horizontal axis. Most empirical evidence suggests that social preferences for the two types of goods are related to average per capita income, where low income groups strongly prefer (essential) private goods and higher income groups have more diversely oriented preferences. In such a situation, subsidizing public goods (budget line A'C) will be relatively more beneficial to the wealthy (UW), while grants (budget line A'B) will be relatively more beneficial to the poor (UP2).¹⁶ When the objective of aid is

¹⁶ Note that $UP_0 \square UP_1 \square UP_2$ and $UW_0 \square UW_2 \square UW_1$

income progressive (such as poverty alleviation or basic human needs provision), grant support of public goods provision appears to be more appropriate.

[Figure 4.1 about here]

10. Privatization contingency and aid contracts: It is well known from game theory that principal-agent relationships, such as those between lenders and borrowers, require contingent contracts to overcome moral hazard arising from incomplete information. We have already discussed the information problems endemic to aid relations in several contexts and, despite wide recognition of these, contingencies in aid loans are still relatively simplistic. Generally speaking, these confine themselves to mutual exclusion and renegotiation clauses, and offer little recourse from the already imperfect bilateral relationship between lender and borrower.

As a partial, even an experimental step toward more efficient aid contracts, we would like to propose a privatization contingency. In particular, a clause of this kind would stipulate that (in previously agreed circumstances of nonperformance), part or the entire outstanding loan would automatically be resold into the commercial credit market.¹⁷ Clearly, this could induce significant short-term write-downs for public lenders, but long-term real renegotiation and rescheduling costs can be quite high. More importantly, however, partial remarketing could be expected to have a very tonic capital market discipline effect. This in turn would attenuate both (lender) loan losses and (borrower) liability accumulation, reducing the likelihood of boom and bust credit cycles.

¹⁷ There is a clear role here for monitoring by independent assessors as discussed in the next section.

All in the Family: Nongovernmental Organizations and “Cohabitation”

Beneath the veneer of official agreements and facilitating public institutions, globalization is largely about the proliferation of multilateral private agency. This is represented not only by international private commerce, via trade and financial linkages, but also in the rapid international emergence of Non-governmental Organizations (NGOs). While this discussion applies only to a subset of NGOs, a significant proportion of these institutions have arisen to meet a manifest desire on the part of economically and politically significant, private, and usually multilateral (mainly OECD) constituencies. Their desire is to participate, directly or indirectly, in the design and conduct of global assistance activities, most of which are relevant to economic development. Seen in this way, the emergence of NGOs has pervasive implications for the pursuit of development assistance. To put it more bluntly, the NGO movement is a force and not only must, but should, be reckoned with by established bilateral and multilateral aid institutions.

For this reckoning to be a constructive and beneficial experience, the principles of complementarity need to be recognized by all parties. For aid agencies, the question is again one of appropriate division of labor and strategic leverage. What can NGOs accomplish in the stead of public agencies, and how best can their intentions and energies be leveraged, both in pursuit of *bona fide* development objectives? To meet this challenge, and especially to do it with a minimum of politicization, is not easy. Some progress has already been made in this direction, with leadership from the World Bank and several committed bilaterals, but greater reconciliation of public and private assistance agendas is needed if the full promise of North-South cooperation is to be realized.

Given the differences in jurisdiction and policy accountability between public aid agencies and NGOs, there are substantial limits to joint activities, but this should not rule out, at minimum, real commitments to improved communication, coordination, and case-by-case collaboration. In particular, we would like to encourage examination of more coordinated effort in three areas.

?? Coordinated and regular consultation in the formulation and discussion of global development priorities, including joint public dialogue, research, and dissemination. Standards for participation in activities of this kind would obviously be subject to public agency authority and careful negotiation. We believe that democratic voices within the NGO movement need to be elevated from the sidewalk to more constructive venues for policy dialogue, but only on a basis qualified by their constituency.

?? Collaboration and secondment to official aid activities. Over the last few decades, NGOs have demonstrated remarkable commitment and resourcefulness in areas where human needs are most acute. Just as we have argued that public aid agencies should be refocusing their activities on the most essential development priorities, the expertise, resources, and tenacity of NGOs offer valuable opportunities for collaboration at the operational level. The World Bank, for example, now finds itself to be the largest financier in the war against HIV/AIDS. At the same time, NGOs such as Medecins sans Frontieres have developed a well-recognized capacity to deliver primary and urgent health care in the epicenters of this public health crisis. Some bilaterals have already made much progress in this kind of collaboration, but it would be desirable to extend the lessons from their experience to a broader agenda of development policy and priorities.

?? Assessment, auditing, and evaluation. There has been an animated discussion of aid review and performance accountability in recent years, particularly with reference to the multilateral institutions. The most stubborn aspect of this debate is neither standards nor, ultimately, the results so far. What most polarizes the debate in this area is the question of independence.

Even as private sector auditing standards are being re-examined in the OECD countries, the World Bank, IMF, and many other public aid agencies are operating with evaluation models that ignore minimum standards of objectivity and independence. Performance auditing by internal staff, who are obliged to review offices and individuals who may some day have authority over them, has been discredited by most authoritative observers. We believe that current insistence on this approach is a regrettable kind of institutional denial, merely postponing an inevitable acceptance of more ethically defensible standards and a very (economically and perhaps politically) costly re-appraisal later on.

When the time does come for more objective program evaluation, both independent auditors (firms and individuals) and NGOs have a vast well of experience to draw upon. The fact that some NGOs are less than congenial to the institutions in question may be advantageous, since this will stimulate diversity of thinking in review and, ultimately, formulation. What is needed is responsible orchestration of these independent and partially discordant voices, meaning that review of this kind is best done collectively, perhaps even with anonymity conditions.

Conclusions

This paper was originally motivated by informal discussions about how changes in the global economy have influenced the development process and, inevitably, must inform the strategies of those who seek to facilitate development. A searching examination of the literature on historical aid practices revealed important insights about what has been accomplished. Generally speaking, aid did promote growth, but aid could have been made more effective. The second section of this paper gave an overview of these issues.

Rather than dwelling upon aid effectiveness in retrospect, however, we have sought to use the lessons of the past and embed them in a vision of a rapidly changing global economy. We observed that the relative significance of public development assistance is much smaller than it once was and it is likely to continue shrinking. At the same time, there are important new agents on the international scene that affect the developing world's prospects. To be effective as a smaller player in this new environment, public aid agencies must recognize that they have entered an Age of Complementarity with other influential actors in the global economy. For this reason, we have argued that aid agencies must focus on core priorities, sharpen their implementation skills, and develop new strategic capacity for complementary relationships with, among others, private capital markets and NGOs.

It should be noted that the ideas presented here are part of a work in progress. We are relatively agnostic about the political implications of our analysis and recommendations, striving foremost for intellectual honesty and objectivity. Having said this, a few salient aspects of this work seem worthy of emphasis. Firstly, we have noted a tendency in the aid effectiveness literature, and by extension in aid policy, toward excessive preoccupation with macro performance criteria and outcomes. While the correlation of these with material living

standards in developing countries is an interesting empirical question, poverty and its attendant experiences are microeconomic phenomena. For this reason, we believe that aid research and resources should be targeted accordingly. Moreover, we argue repeatedly that more attention to the microeconomic properties of development aid will improve its effectiveness. In this context, another important issue we emphasize is the decentralization of economic accountability, including ownership in the literal sense of contractual entitlement and responsibility down to the local level. We believe this more concrete approach to ownership will significantly improve the incentive characteristics of development assistance.

In order to stimulate discussion and a renewal of thinking in this area, we have put forward a set of ten precepts for design and implementation of more effective development assistance. In addition to what has already been mentioned, we suggest that bilateral donors make greater effort to achieve policy coherence, reconciling or at least clarifying many policies that are in partial or direct conflict with generally accepted principles of development aid. These include, among other things, domestic agricultural support, tied aid, and strategic assistance.

At the microeconomic level, we advocate a more flexible approach to the grant/loan dichotomy, more generous granting for public goods provision in the poorest countries and, finally, a privatization contingency in development lending agreements. This last idea might seem controversial. We believe it to be a vital step in reforming the lending relationship and, more profoundly, an essential example of the complementarity we advocate throughout this paper, linking development assistance directly with emergent private capital markets. If the ideas presented here are allowed to evolve in the aid policy environment, we expect to see more robust and dynamic linkages between public and private finance in the developing world. Aid agreements with better private incentive (ownership) characteristics, coupled with the

tonic influence of private capital market discipline, may bring us closer to the dual goals of social and economic efficiency. If this happens, both the developing and the developed world will be beneficiaries.

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Figure 4.1: Grants versus Subsidies

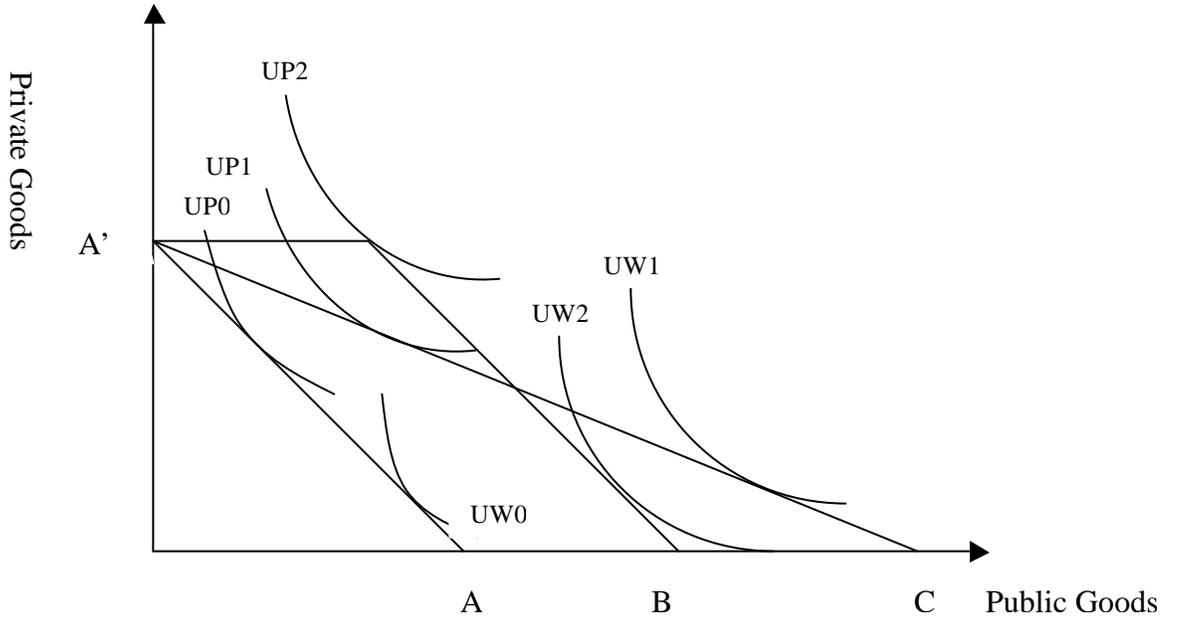
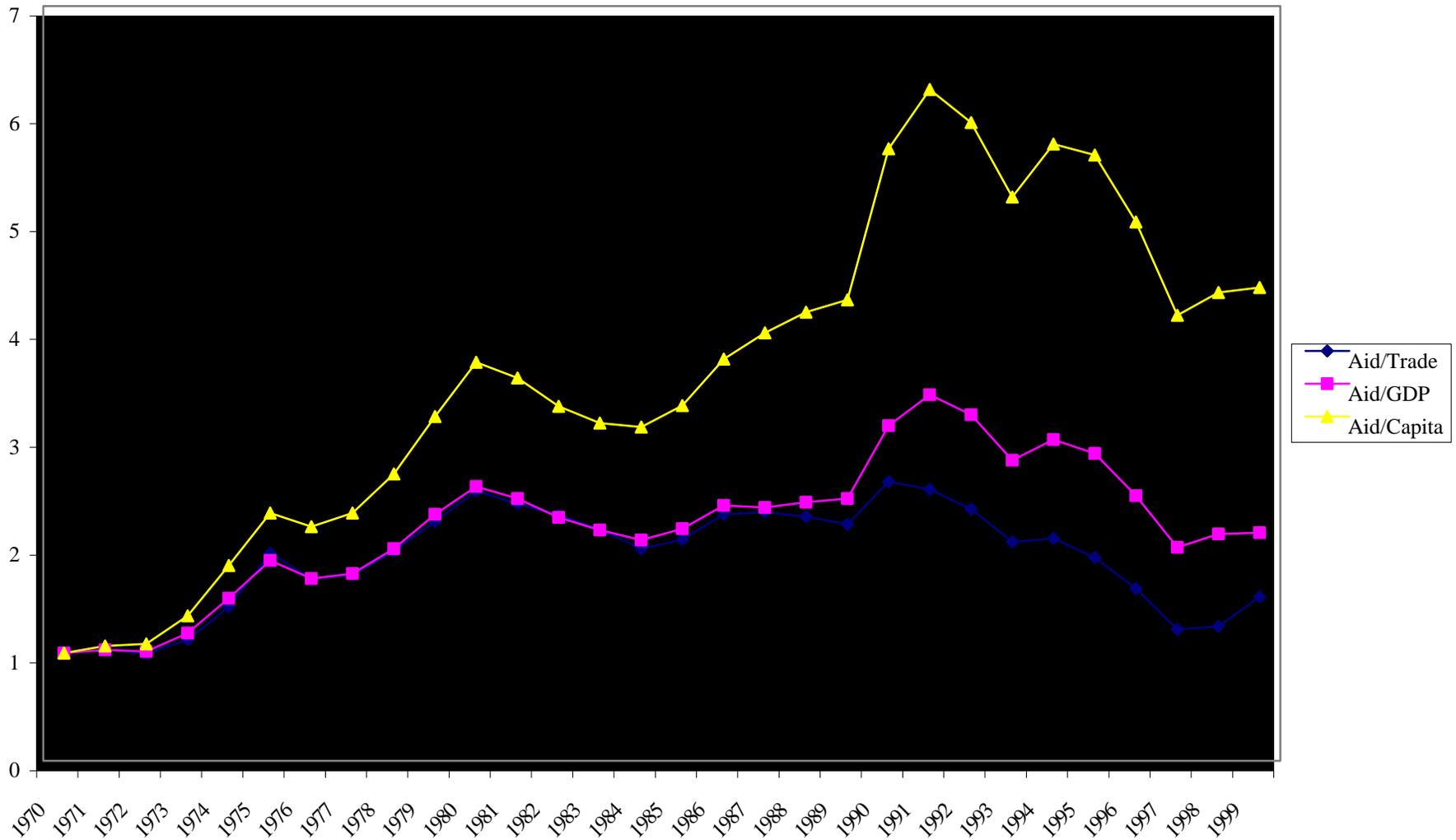
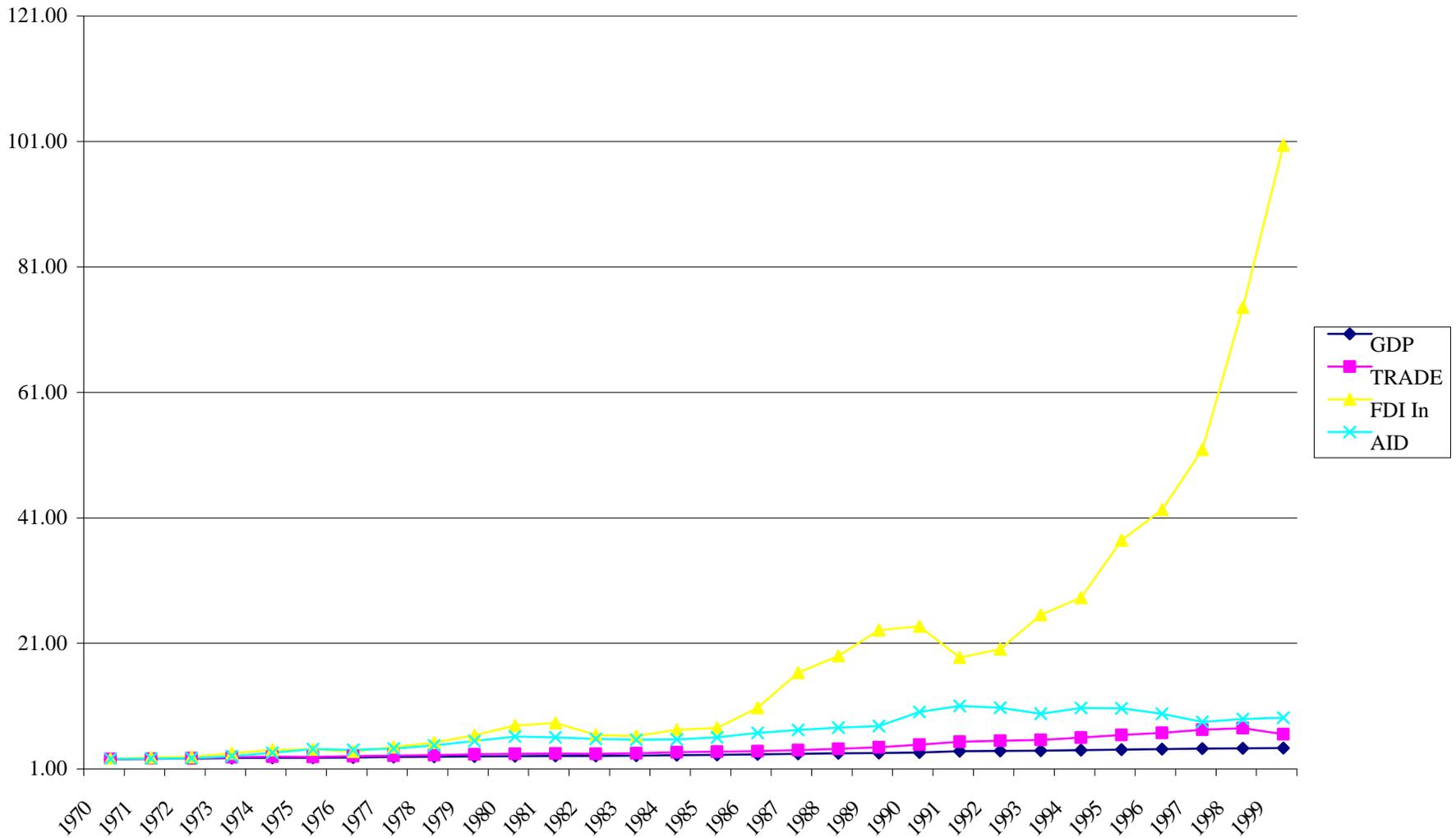


Figure 3.1: Aid to Trade, GDP, and Population Ratios
(normalized to unity in 1971)



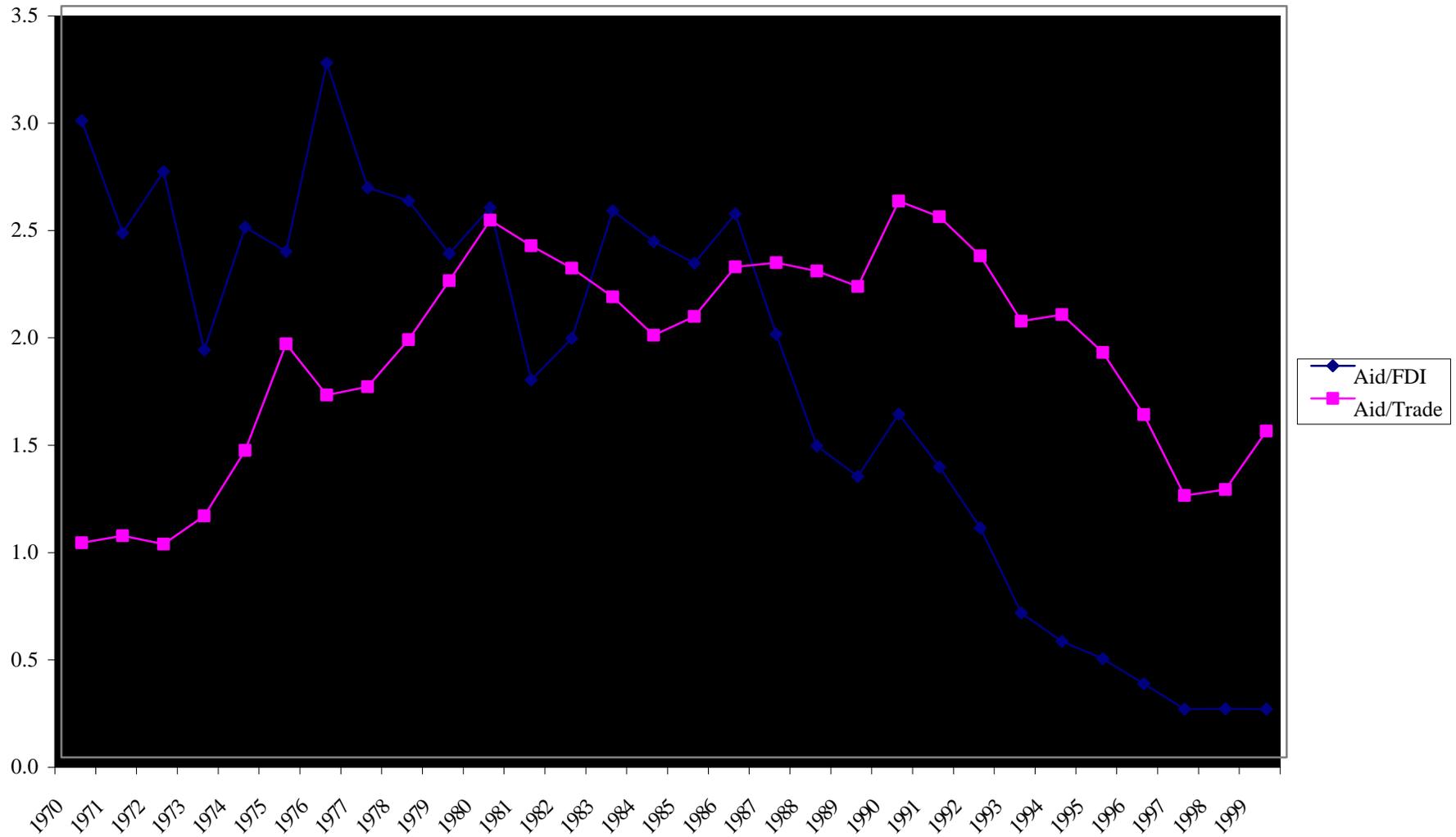
Source: World Bank (2001) and OECD (2002)

Figure 3.2: Macroeconomic Trends for NonOECD Economies
 (normalized from constant USD to unity in 1971)



Source: World Bank (2001), OECD (2002) and UNCTAD (various years)

Figure 3.3: Aid to Trade and Inbound FDI Ratios
 (Aid/Trade normalized to unity in 1971, Aid/FDI ratio of constant USD levels)



Source: World Bank (2001), OECD (2002) and UNCTAD (various years)

Figure 3.1	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Aid/Tr	1.00	1.03	0.99	1.12	1.43	1.93	1.69	1.73	1.95	2.22	2.50	2.38	2.28
Aid/GI	1.00	1.03	1.02	1.18	1.51	1.86	1.69	1.74	1.97	2.29	2.54	2.43	2.26
Aid/Ca	1.00	1.06	1.08	1.34	1.81	2.30	2.17	2.30	2.66	3.19	3.70	3.55	3.29

Source: World Bank (2001) and OECD (2002)

Figure 3.2	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
GDP	1.00	1.04	1.10	1.17	1.20	1.21	1.27	1.32	1.38	1.43	1.47	1.50	1.50
TRADI	1.00	1.06	1.14	1.28	1.39	1.33	1.47	1.55	1.62	1.74	1.82	1.87	1.85
FDI In	1.00	1.27	1.33	1.90	2.45	2.56	2.20	2.91	3.62	4.80	6.34	6.76	4.83
AID	1.00	1.09	1.14	1.44	1.98	2.57	2.48	2.68	3.18	3.87	4.57	4.47	4.22

Source: World Bank (2001), OECD (2002) and UNCTAD (various years)

Figure 3.3	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Aid/FC	2.97	2.44	2.73	1.90	2.47	2.36	3.24	2.65	2.59	2.35	2.56	1.76	1.95
Aid/Tr	1.00	1.03	0.99	1.12	1.43	1.93	1.69	1.73	1.95	2.22	2.50	2.38	2.28

Source: World Bank (2001), OECD (2002) and UNCTAD (various years)

1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
2.15	1.97	2.05	2.29	2.30	2.27	2.19	2.59	2.52	2.34	2.03	2.06	1.89	1.60	1.22
2.14	2.05	2.15	2.37	2.35	2.40	2.43	3.11	3.40	3.21	2.79	2.98	2.85	2.46	1.98
3.13	3.10	3.30	3.73	3.97	4.16	4.27	5.68	6.23	5.92	5.23	5.72	5.62	5.00	4.13

1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
1.55	1.62	1.68	1.73	1.82	1.90	1.97	2.04	2.27	2.31	2.35	2.42	2.48	2.57	2.65
1.91	2.10	2.18	2.26	2.43	2.64	2.86	3.27	3.76	3.92	4.04	4.42	4.83	5.15	5.67
4.66	5.67	5.94	9.17	14.78	17.44	21.57	22.14	17.16	18.52	23.99	26.72	35.86	40.75	50.33
4.10	4.13	4.48	5.16	5.61	5.99	6.27	8.49	9.47	9.16	8.22	9.13	9.11	8.23	6.92

1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
2.55	2.40	2.30	2.53	1.97	1.45	1.31	1.60	1.35	1.07	0.67	0.54	0.46	0.34	0.23
2.15	1.97	2.05	2.29	2.30	2.27	2.19	2.59	2.52	2.34	2.03	2.06	1.89	1.60	1.22

1998 1999

1.25 1.52
2.10 2.12
4.34 4.39

1998 1999

2.69 2.76
5.91 4.97
72.96 98.82
7.39 7.59

1998 1999

0.23 0.22
1.25 1.52