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Aid Effectiveness: Can It Be Improved?

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1.Introduction

The last fifteen years have seen an intensive discussion on the effectiveness of aid. Part of the debate focused on the (often confusing and conflicting) evidence from growth regressions regarding the effect of aid on economic growth in recipient countries. A different discussion (probably of more interest to policy makers) concerned the implications of different forms of aid and different types of conditionality for the incentives for recipient governments to use the aid as intended by the donor. One of the most influential contributions to this discussion was the Assessing Aid report, published by the World Bank in 1998. It is often taken for granted that the lessons from this debate have by now been largely implemented. This is not the case. The debate is now focused on new concerns, notably on the fragmentation of aid and the lack of harmonization amongst donors. The Paris and Accra declarations bear witness to this development. This has left an unfinished agenda. In this paper we argue that there remains a gap between the rhetoric which suggests that the lessons of the debate on the failure of conditionality have been fully absorbed and the reality which is quite different.

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1.Introduction

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2. New Thinking on Aid

Development aid has been subject to fundamental critiques (such as that of Peter Bauer) since its very start. However, this hardly affected mainstream thinking until well into the 1990s. Then two of its fundamental tenets were shaken. First, it became clear that a large number of developing countries had access to international capital markets: the traditional justification for aid (that it addressed a capital market imperfection) was no longer self-evident. At the same time the belief that conditionality could be used to change the policies of a recipient government was shaken by both theoretical analyses and empirical evidence on the "failure of conditionality".[1] The aid business has never quite recovered from this onslaught.

It did change, however. The fungibility critique triggered a gradual shift from project finance to what used to be called program lending and is now usually referred to as sector support or general budget support. Donors started saying that not they, but the recipient government should be "in the driver's seat". This is what nowadays is called "ownership": governments should decide on development policies without donor pressure, they should be accountable for those policies to their domestic political institutions (notably parliaments) rather than to donors, and, most importantly, donors should decide whether they were willing to support the government's programmes without trying to influence them through conditionality. In theory at least, ownership implied that donors would be presented with a set of policies on a "take it or leave it"

[1] See Collier *et al.* (1997), World Bank (1998).

basis. Finally, donors recognized that if the traditional conditionality did not work it should be replaced by results-based aid: countries would get more or less aid depending on their success in reaching agreed long-run objectives ('impact variables") such as those enshrined in the Millenium Development Goals.

In the next section section we consider to what extent these developments changed not just the appearance, but also the reality of donor policies.

3. What Donors Preach and What They Practice[2]

Superficially at least it appears that by now donors have fully internalized the lessons from this debate on conditionality. There are, for example, numerous references in donor documents to the importance of ownership. However, the reality of aid is very different from the rhetoric. I illustrate this for five aspects of aid: the use of project aid, selectivity, ownership, the tying of aid to advice and the use of results-based aid.

First, much aid continues to be provided as project finance even though the critique that project finance usually makes little sense (because of fungibility) is well understood. Much of the aid of the regional development banks, the UNDP and the World Bank is still project aid. (The Bank would have changed beyond recognition if the switch from project to program support advocated by the *Assessing Aid* report would have been fully implemented.) In private donors defend this practice by arguing that project finance gives them the more direct control which is necessary when they do not trust a recipient government enough to give it budget support. While the empirical evidence on fungibility makes clear that this sense of control is often simply an illusion, many donors retain a strong preference for project finance.

Secondly, an outcome of the earlier debate was that aid cannot be effective in all countries.[3] Indeed, usually what prevents development is not so much lack of capital as "government capability and credibility" (Rajan, 2008). This has become widely accepted but only in a half-hearted way. Notably, donors are still reluctant to withhold aid from countries with a poor policy environment, weak institutions and strong incentives to use aid in ways which are unlikely to reduce poverty. This reluctance reflects the incentive structure in donor agencies (where careers are, of course, based on disbursing rather than withholding money) and is reinforced by the belief of policy makers that strict selectivity would mean abandoning poor people who have the bad luck to live in countries with dysfunctional governments and poorly functioning institutions. There is a second reason for the donors' lack of enthusiasm in accepting the position that aid allocations need to be selective, favoring well functioning governments. This is that selectivity would seem to force donors to focus on those countries which need it least: if their policy environment is so good as to make aid effective then they would already have access to the

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[2] This section draws on Gunning's contribution to the Bourguignon *et al.* (2008) report on the Millenium Development Goals.

[3] For an excellent review of the econometric evidence on aid effectiveness see Tarp (2006).

international capital market. This point is not well taken. It often takes successful reformers quite long to get access to international capital markets. Ghana, for example, managed to float a substantial international loan only in 2006.

For whatever reason aid allocations remain remarkably unselective. Easterly (2008) presents shocking evidence on this. Aid remains highly fragmented over countries and sectors and this fragmentation has not decreased but *increased* over time. Most seriously, aid is neither well focused on the poorer countries nor on the better governed ones. The share of aid going to the low-income countries is only about 60% (and has stood at that level for about four decades) and the least developed countries got only 42% of aid in 2004. Countries classified (by Freedom House) as "unfree" or as "unfree + part free" reveived 78% of all aid and, again, there has been little change in this percentage over time. Easterly finds no evidence that a lower classification (i.e. a reduction in "freedom") induces a fall in aid: aid allocations in fact appear quite insensitive to such changes in status. More than two-thirds of aid goes to corrupt countries.[4]

Thirdly, donors' attachment to "ownership" often does not extend beyond lip service. It is still insufficiently appreciated that aid aimed at long term development (as opposed to, say, humanitarian aid) is an appropriate instrument for only a subset (probably only a small subset) of poor countries. In countries where donors feel that full ownership may lead to undesirable outcomes donors usually, instead of ending the relationship, revert to previous mechanisms of donor control. The resulting combination of the rhetoric of ownership (sometimes practiced genuinely) and occasional heavy handed paternalism gives conflicting signals to the recipient government. Clearly, this unsatisfactory state of affairs is related to the previous point, lack of selectivity. If donors were more selective they would not find themselves in situations where they felt they could not rely on ownership.[5]

Fourthly, a logical implication of ownership is that the donors' finance-cum-advice package is "unbundled", i.e. that recipient governments are free to decide where to hire the technical expertise needed to design, execute and evaluate development policies. In fact development finance and technical advice often continue to be combined in a single package, in what is in effect a form of tied aid. It is, of course, very desirable that the expertise and cross-country perspective of the IFIs, regional development banks and bilateral donor agencies remain available to developing countries. If finance and advice were "unbundled" a developing country government might still turn to, say, World Bank expertise but not because it came as part of a package but rather because that source of advice had proved itself in competition with other agencies. Here there is good news: partly as a result of the increased use of budget support there

[4] Easterly (2008), mainly Table 3. Easterly classifies only countries with a score of 2 or less in the corruption component of the International Country Risk Guide as corrupt. He notes that this a very high level of corruption.
[5] This is not to say that aid has no role in other types of countries but rather that there budget support is not appropriate. For example, in some post-conflict failed states there is in fact no state apparatus able to deliver public services. In such circumstances it may well be effective if donors provide those services, either directly or through contracts with service delivery organization.

is indeed a movement in this direction. In the field of evaluations joint (donor-government) evaluations of sector programmes are rapidly becoming more common. A further separation between finance and expertise would provide a powerful signal that the government rather than the donors are responsible (and hence accountable) for development policy.

Finally, the earlier debate on conditionality concluded that selectivity should be combined with a switch to results-based aid. Donors would provide aid on the understanding that after a reasonable period (say 3 to 5 years) the amount of aid would be adjusted (up or down) on the basis of the results.[6] Results would not refer to policy changes or to intermediate outcomes but to progress towards ultimate targets such as reduced poverty or child mortality.[7] The literature on the "failure of conditionality" had made clear that tying aid to promises of policy changes could not work in theory (running into a typical problem of time inconsistency) and certainly did not work in practice. Results-based aid would link disbursements to progress achieved towards targets agreed beforehand.[8] There is no more powerful way than this to signal that donors respect ownership: by tying aid to results (preferably ultimate impacts) donors would indicate that they recognize that it is for the recipient government to decide what policies are appropriate. There has been little progress in this area. Only the EC has adopted such a policy, including a fixed and a variable component in its aid, the variable component being linked to progress towards specific targets such as primary school enrolment.

Other donors have not followed this "mechanistic" approach. Sector support is provided after particular targets have been agreed. Recipient governments know that "bad" performance may lead to aid reduction and, conversely, that success may lead to an increase in aid. However, they have no clue as to the magnitude of such adjustments. If the aid relationship is seen as a contract, the terms of the contract are therefore quite unclear. There is much anecdotal evidence that recipient governments indeed see current aid relationships in those terms. The implication is that quantitative targets provide little incentive to recipient governments. If the aid relationship is seen as a contract it is a contract which leaves everything that matters unspecified.[9]

Is progress in this area possible? Donors are, understandably hesitant to commit to providing aid for a long period during which the policy environment may change drastically. This is well taken. The implication, however, is not to abandon results-based aid but rather to distinguish

[6] Impact indicators typically change slowly hence more frequent assessments make no sense. Cf. Guillaumont Jeanneney and Guillaumont (2008).

[7] It is reasonable to require that the impact measures are the same for all donors. Indeed, as Guillaumont Jeanneney and Guillaumont (2008, section 4.3.3) argue an important advantage of results-based lending is that it will naturally strengthen in this way the donor harmonization which is central to the Paris and Accra declarations.

[8] Two obvious issues arise: what to do with a government which has not yet had the time to establish a track record and how to deal with influences on the outcomes which are beyond the government's control (such as commodity price shocks or natural disasters). There are no easy answers to these reservations but the literature contains practical suggestions for dealing with these issues. For example, Collier *et al.* (1997) proposed to give new governments the benefit of the doubt for a grace period and to use regression analysis to estimate the impact of terms of trade shocks.

[9] Adam and Gunning (2002) document this for the health and education sectors in Uganda. Adam *et al.* (2004) discuss the experience with EC results-based lending in a number of countries.

between measures of results (such as poverty or child mortality) and monitoring variables (such as measures of corruption or violence). Aid contracts should be written in terms of the former but it would be quite legitimate if donors used the latter as possible “show stoppers”. For example, the outbreak of a civil war might be a legitimate “show stopper”, leading to cessation of the regular aid program. Barring such extreme cases the program would continue and future aid levels would be tied to results at the end of an agreed period. The use of monitoring variables as show stoppers might well overcome the reluctance of donors to move further in the direction of results-based aid.

It should be stressed that: regular aid programs aimed at achieving long-term objectives such as the MDGs are an appropriate form of assistance in only some developing countries, those that are relatively well governed. (Other developing countries such as the failed states require a different approach.) For that group of countries there remains enormous scope for improving the effectiveness of aid programs. The recent Paris and Accra agreements are a big step forward, notably in their focus on donor harmonization. Here we have sketched a complementary agenda. We have suggested that donors should be more selective in deciding what countries qualify for an aid program; should (for those countries) abandon project aid; should accept developing country ownership, notably by separating finance from policy advice; and, finally, should remove the ambiguity in aid contracts by tying aid to results. None of this is new. It is in effect to a large extent what donors have preached for a long time. The challenge is to go further in implementing these lessons.

4. Aid, Shocks and Insurance

In recent years there has been a renewal of interest in the question whether aid can play a special role in vulnerable countries, notably countries exposed to trade shocks. Three modalities have been discussed. The first two involve additional budget support or debt relief extended to vulnerable countries, either *ex ante* (to help them cope with shocks) or *ex post* (as a form of compensation). The third modality does not involve aid to governments but rather a more direct involvement of donors in making insurance available to private agents in developing countries. We consider these three cases in turn.

Under the first modality aid is not paid in compensation but rather in expectation of future negative shocks. In effect vulnerable countries get more aid than they would otherwise qualify for. Guillaumont and Chauvet (2001) have found that such aid is more effective than other aid.[10] This has since been found to be one of the few robust results in the econometric literature on aid effectiveness. Nevertheless donors do not appear to give weight to vulnerability in their aid allocation. Guillaumont (2008) presents a detailed aid allocation formula in which vulnerability is rewarded.

[10] It is not clear what mechanism is operating here. One interpretation is that the additional aid is used by the government partly to finance external borrowing or forward transactions in international markets, partly to finance domestic compensation schemes.

The second modality, aid as compensation for negative shocks, is a clear form of 'aid as insurance'. Such schemes have operated in the past (those of the IMF and the EC are well known examples) but have become rather discredited largely because delays in payment of compensation often meant that the schemes increased rather than reduced the revenue volatility for the recipient government. Obviously, this is not a fundamental objection. It is certainly possible to design a quickly disbursing scheme.[11] Jacquet and Naudet (2008, section 4.6) have for example suggested that French debt relief could be linked to commodity prices.

One can of course ask why developing countries cannot cope with commodity price risk themselves, by using forward markets and by accumulating and drawing down assets. In fact many developing countries (notably the oil producers) are increasingly using such methods. This is not to say that there is no role for aid but rather that its rationale must be a market imperfection, e.g. the inability of a credible government to borrow in response to a negative shock. This would certainly apply to a substantial group of developing countries and here aid can indeed be effective.

Under the third modality donors are directly involved in providing insurance, usually in some public-private partnership, e.g. in commodity risk management (where farmers can now effectively buy crop price insurance), health insurance or rainfall insurance. In many African countries there is virtually no health insurance. There are good economic reasons for this market failure. An insurer's promise to guarantee decent quality health care is simply not credible since the care people know is of dreadful quality. Conversely, the insurer cannot establish his credibility since as long as no premiums are paid quality cannot be improved. Here there is a very strong rationale for donor involvement: aid can break this vicious circle. Dutch aid has now enabled the Health Insurance Fund to start group based health insurance in a number of African countries. Clearly, such schemes can be replicated in many ways.

In the case of rainfall insurance: a drought often affects a large part of a country so that even risk pooling at the national level is an inadequate response. Such risks require reinsurance so that risk can be pooled at a higher (in the limit: at the global) level. Multinational insurance companies are well aware of this but are poorly placed to offer insurance contracts to, say, peasants in an Indian or African village. Conversely, microfinance institutions are able to reach such target groups at low costs but usually are unable to pool risk sufficiently. Linking the two, microfinance institutions and multinational insurance companies, is feasible but may require complex institutional arrangements, probably involving both public and private partners. This is an area where donors can play an important role. Evidence is accumulating that the absence of insurance has a remarkably strong negative effect on investment and growth.[12] Hence the payoff

[11] Collier *et al.* (1999), Guillaumont Jeanneney and Guillaumont (2008).

[12] Elbers *et al.* (2007) estimated a structural microeconomic model of growth under risk on panel data for rural households in Zimbabwe. They found that the capital stock is about half of what it would have been in the absence

(in terms of economic growth and ultimately poverty reduction) to interventions related to risk coping may well be underestimated.

5. Conclusion

We have noted that while donors stress the importance of ownership a large gap remains between rhetoric and practice. Notably, there has been little change in the direction of results-based aid in spite of the fact that this is logical implication of ownership. One explanation is that donors see problems in applying the idea in practice, for example, how one should adjust aid allocations for negative trade shocks, droughts and other factors beyond the government's control. There are no easy answers here, but there are certainly ways to make reasonable adjustments.[13] The alternative explanation is that donors' objections are fundamental rather than practical, reflecting a continuing reluctance to embrace ownership. This reluctance is not at all surprising. Since donors are in fact *not* selective they correctly perceive ownership (and its corollary results-based aid) as inappropriate in many developing countries. Their wariness in fact reflects their fiduciary responsibility. This brings the debate full circle to the conclusion reached a decade ago: that aid can be effective but that this requires selectivity. This conclusion is, of course, unpalatable for many donors and developing countries.

The original case for aid was that it corrected a market imperfection, the inability of developing countries to borrow internationally. This case has largely disappeared and this may be considered a major success. However, contrary to what is often suggested (e.g. Rajan, 2008) it is not true that any well-intentioned government of a poor country has access to international capital. The old rationale remains relevant for a substantial (but hopefully rapidly shrinking) number of developing countries. On the other hand there are other market imperfections which call for new types of donor involvement. A prominent example is risk sharing, nationally through insurance schemes, internationally through aid for vulnerable countries, notably those not yet able to deal with commodity price volatility.

Hence much can be done to improve aid effectiveness.

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of risk (or, equivalently, under actuarially fair insurance). Elbers, Gunning and Pan (not yet published) find very similar results for rural households in Ethiopia.

[13] See e.g. Collier *et al.* (1997), Gunning (2005).

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