AID, GROWTH, AND POVERTY REDUCTION

Toward a New Partnership Model

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François Bourguignon and Danny Leipziger[1]

1. Introduction

Over the past half-century, two opposing views have dominated the debate over foreign aid—defined as official development assistance, or ODA—and its justification, usefulness, and potential contribution to growth and poverty reduction. On one side, there are aid skeptics from what Collier (1999) referred to as the "aid dependency school." From Bauer (1982), who argued that aid reduced the incentive to adopt good policies to Kanbur et. al. (1999), who suggested that large gross flows of project aid overwhelm the management capacity of governments, the aid dependency school has offered sophisticated arguments. Just as recent analysis of poor households in developed countries has established reasonable evidence for a dependency syndrome whereby welfare payments create very high implicit marginal tax rates and so discourage work, trapping recipients into continued need for welfare, some aid dependency proponents argue that poor countries are subject to the same trap. Others on the same side are less definitive. They simply emphasize the fact that the work launched by Barro (1991) and others on growth empirics has yielded little evidence in cross-country data of a robust effect of aid on growth—either unconditional or conditional—when other growth determinants are taken into account. Many authors reached this conclusion after intensive data work, including recent contributions by Easterly (2006) and Rajan (2005).

On the other side of the spectrum is the more optimistic view expressed by those who believe that aid can be effective, and suggest that economic development cannot take place in the poorest regions of the world without massive injections of official development assistance. Support for this view draws heavily on a growing "case law" of experiences where foreign assistance was well utilized, including the impressive examples of successful industrializers in East Asia as well as more recent evidence in Africa. It also follows the work of Burnside and Dollar (2000) on the prerequisite of a strong policy environment to use aid effectively as well as Collier and Dehn (2001) and Collier and Hoeffler (2002) on recent evidence that judicious assistance to countries can mitigate a variety of economic shocks. One prominent advocate for massively scaling up aid is Sachs (2005), although the assumptions and feasibility of his implicit "production function" to achieve the Millennium Development Goals (MDGs) requires further elaboration.

This paper summarizes lessons from experience and from the ongoing debate over aid effectiveness. It argues that the dramatic changes in aid policies and institutions that began in the 1990s point to a major ***evolution towards a new partnership model*** that has far-reaching implications. This shift is multidimensional, and includes an increased emphasis on policy-based selectivity in allocating aid, a greater commitment to effectiveness and obtaining results "on the ground", a stronger emphasis on governance, institutions, and local ownership of reforms, and increasing reliance on budget support (rather than project financing) for channeling aid.

The shift is in part due to the changing global environment within which aid is provided. During the Cold War era, the role and allocation of ODA was often motivated more by geopolitical considerations than by its potential for promoting growth and poverty reduction. Where aid effectiveness was a concern, it was not usually framed in macroeconomic terms, but instead raised at the micro (project) level by donors concerned about the narrow impact of their own assistance. In recent years—as the Cold War receded, new international security challenges (terrorism, poverty, or

epidemics) emerged, and many donor countries rationalized public spending—the focus has been shifting to macro level objectives such as economic growth and overall (rather than project-specific) poverty reduction.

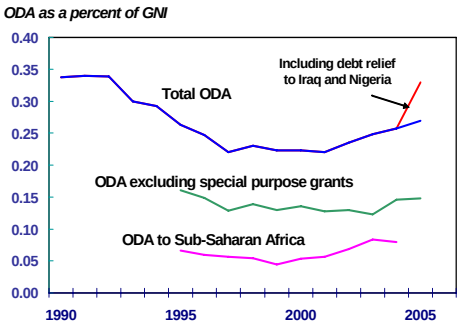
Possibly because this shift is relatively recent and still incomplete, the quest for evidence about the relationship between aid, growth, and poverty reduction remains a vexing empirical issue. While we can point to successful aid recipients, there is also evidence to the contrary, and even more cases where it is simply too hard—or too soon—to tell. We must recognize that it is necessary to wait some time to see whether this model shift is making aid more effective. Donors and recipients are still experimenting with how best to deliver aid and maximize results. But while it is perhaps premature to conclude with certainty that the new approach is consistently generating better outcomes, it is not too early to explore ways to accelerate and deepen the changes that are clearly occurring.

The remainder of the paper is organized as follows. Section 2 reviews trends in aid flows and the recent promises made regarding future increases, and links these developments to the evolving aid model—how the context for the provision of aid has changed, especially during the last decade. Section 3 examines the aggregate links between aid, growth and poverty reduction and highlights some of the methodological issues that complicate efforts to empirically evaluate the underlying causal relationships. Section 4 suggests ways of improving the new aid framework and considers the actions needed to measure effectiveness. Section 5 offers concluding remarks.

2. Recent Trends in Aid Flows

An important outcome of the Financing for Development conference in Monterrey in 2002 was the commitment made by industrial countries to provide more and better aid to developing countries. This commitment was made in the context of what is now termed the Monterrey Consensus. It is based on the agreement on the Millennium Development Goals (MDGs) by the world's Heads of State in 2000, which reflect the multidimensional nature of poverty, the need to focus on outcomes and to systematically track progress at the country level. And beyond Monterrey, it extends to the recognition for a new compact between developing and developed countries to help achieve the MDGs. This compact recognizes the need for actions at the country level by both recipient and donor countries in a partnership in which recipient countries commit to policy and institutional reforms in country-owned strategies and those who provide aid commit their support to those country strategies in predictable and coherent ways.

Figure 1: Aid flows are rising



Source: OECD/DAC.

The early part of this decade has seen a recovery in aid volumes after a period of decline and stagnation. As donors have acted on commitments made prior to and at Monterrey, nominal aid flows have increased by over $26 billion between 2001 and 2004, and—in figures just released by OECD/DAC—by an additional $27 billion in 2005, to a total of $106.5 billion. This raises the average ODA/GNI share to 0.33 percent for 2005—the highest since the early 1990s (Figure 1). Yet, this progress would be more heartening if much of this increase were not attributable to the special debt relief assistance provided by Paris Club creditors to Iraq (nearly $14 billion) and Nigeria (a little over $5 billion). Without this special support, ODA performance lies on the moderate upward trend line observed since 2001—encouraging, but not extraordinary. Excluding debt relief, ODA increased by 8.7 percent in real terms in 2005, up from an average annual rate of 5.6 percent in 2002-4.

With the recent modest increase in aid volumes has come a shift in the allocation of aid towards Sub-Saharan Africa. The share of total ODA allocated to Sub-Saharan Africa has increased from a low of 25 percent in 1999 to an average level of 40 percent in 2002-04, while the share allocated to Asia declined from 44 percent to 34.5 percent.

One priority for scaling up aid flows is increasing the share of flexible aid—ODA net of special purpose grants—which can be targeted at meeting MDG needs. This has changed relatively little over the last decade (Figure 1). Over 70 percent of bilateral aid from DAC countries between 2001 and 2004 was in the form of special purpose grants: debt relief, technical cooperation, food aid, emergency aid, or administrative costs. With the exception of debt relief—which was initiated as additional to aid flows—these components of the overall assistance package may have been less effective at providing the flexible resources that recipients can use to finance expanded programs directed towards the MDGs.

At its July 2005 summit at Gleneagles, Scotland, the G-8 also committed to an increase in total aid for an amount of $50 billion, half of which would be devoted to doubling aid to Sub-Saharan Africa by 2010 (to about $50 billion). Underpinning this commitment are specific pledges by each of the major donors to double their aid to Sub-Saharan Africa in the coming four to five years so that it would receive half the targeted increase in overall aid. These commitments reflect the spirit of Monterrey and point to the willingness of donors to sustain the current increases in aid into the latter part of this decade. But turning these commitments into actual resource flows will likely depend on the extent to which this increased aid is seen as successfully contributing to raising growth and accelerating the pace of poverty reduction in recipient countries.

Many donor countries have made explicit commitments to scale up aid significantly over the medium term. Five of the 22 DAC member countries have already increased ODA to levels that exceed the UN target of 0.7 percent of GNI. The European Union has pledged to increase ODA provided by its member countries from 0.35 percent of GNI in 2004 to 0.7 percent by 2015, with an interim target of 0.56 percent by 2010. Moreover, six EU member countries announced commitments to attain the 0.7 percent UN target prior to 2015. Other donors have made commitments that are not linked to the UN target.

Projections by the OECD/DAC Secretariat based on current commitments of DAC donors imply that ODA will rise gradually over the balance of the decade as a percent of their GNI, reaching 0.36 percent in 2010, which is just slightly above levels attained in the early 1990s. According to these projections, the share of ODA provided by the United States will decline from 26 percent in 2005 to 19 percent in 2010, while that provided by the EU member countries as a group will increase from 54 percent to 63 percent. The projections also imply that ODA as a ratio to GNI in donor countries will increase by about 0.017 of a percentage point per year on average over the period 2005-10. Extrapolating this rate of increase would mean that the UN target of 0.7 percent would not be attained until 2030, 15 years after the 2015 deadline set for attaining the MDGs. The UN Millennium Project (2005) estimates that financing the MDGs requires an increase in ODA (excluding debt relief) to 0.46 percent of GNI by 2010, suggesting that current financing commitments fall short.

The renewed commitment by the donor community to increased aid flows has in turn generated greater scrutiny directed towards the use of funds, and debate over ways of making aid more effective. Following the Rome High-Level Forum on Harmonization (2003) and the Paris Forum in 2004, a consensus has emerged on the need to align donor assistance to country-owned development/poverty reduction strategies; harmonize aid policies and procedures around countries' own institutions and systems and, where these are weak, to monitor governance and strengthen country systems; provide reliable medium-term aid commitments and predictable and timely aid disbursements; and improve donor coordination at the country level.

The emerging partnership model embodying these changes has also renewed interest in finding more appropriate ways of measuring aid effectiveness. While various approaches have been put forward, ranging from cross-country analysis to country studies, the task

remains a challenging one, and the clarity of results until now relatively limited.

3. The Challenge of Measuring Aid Effectiveness

The traditional approach to looking at the relationship between aid and growth has been through cross-country regressions. In this sense, it mirrors much of the recent work on understanding the determinants of economic growth, and in particular, assessments of which economic policies influence growth and by how much. Reflecting recent advances in econometric techniques and computational power, the use of cross-country regressions has become something of a growth industry for analyzing the general determinants of growth as well as the impact of aid on growth more specifically.

The Debate over the Evidence

One prevalent view is that aid has a positive effect on growth, but only if recipient countries exhibit certain characteristics, such as good policy and institutional environments and favorable geography. In other words, while aid does not appear to have a uniformly positive growth effect when considered along with standard determinants of growth, there is evidence that it raises growth in particular environments. This "conditional" view of aid effectiveness has typically focused on the quality of recipient countries' policies as, for instance, with Burnside and Dollar (2000). Recent work that supports this view and focuses on other country characteristics includes: Collier and Dehn (2001), which finds that increasing aid to countries suffering from negative export price shocks raises growth; and Collier and Hoeffler (2002), which concludes that aid is very effective in post-conflict situations where good policies are implemented. But even within this set of studies, divergent conclusions emerge as to exactly which country characteristics are important. Using the same specification as Burnside and Dollar (2000) but including additional data, Easterly et. al. (2003) find no evidence of a significant relationship between aid and growth conditioned on the quality of policies. Guillaumont and Chauvet (2001) also do not find that good policy is significant, and conclude instead that aid works best in difficult environments, especially those associated with volatile terms of trade, natural disasters, and low population. And Dalgaard et. al. (2004) conclude that geography is critical and that aid raises growth only outside the tropics.

An alternative view of this relationship is that aid does not raise growth, and may even hurt growth over the longer run. A number of studies with varying approaches provide evidence for this view. One recent study by Rajan and Subramanian (2005a) finds little robust evidence of a positive or negative relationship between aid inflows into a country and economic growth. In a companion paper which extends the cross-country approach to a cross-country/cross-sector framework, Rajan and Subramanian (2005b) pose the question of why it is difficult to find a robust effect of aid on the long-term growth of poor countries, even those with good policies. They conclude that aid inflows have systematic adverse effects on a country's competitiveness (Dutch disease effects), as reflected in a decline in the share of labor-intensive and tradable industries in the manufacturing sector. Further, these effects appear to stem from the real exchange rate overvaluation caused by aid inflows and differ in this sense from private transfers such as remittances.

A third view of the aid-growth relationship is that while, on average, aid is associated with growth (and thus "works"), it exhibits diminishing returns or that the relationship depends on the form that aid takes. Hansen and Tarp (2001) provide evidence for a non-linear relationship between aid and growth. A recent analysis by Clemens, Radelet, and Bhavnani (2004) disaggregates ODA flows among various categories of assistance and finds a strong, positive, causal relationship between "short-term" impact aid and economic growth (with diminishing returns) over a four-year period (see below).

Limitations of Cross-Country Analyses

The fact that econometric analysis from cross-country regressions appears to be fragile and inconclusive overall in showing causal relationships between aid and growth reflects the underlying limitations of this methodology and is hardly surprising. These include dealing with issues such as:

Reverse causality: Sorting out the direction of causation remains a major challenge in economic research on growth in this area—as in others. Aid can foster growth, but slow growth—for instance due to a succession of crises—may also trigger aid. While the more recent literature attempts to control for this aid 'endogeneity' problem through instrumental variables, it is still not entirely convincing because the quality of instruments themselves is often debatable.

Country specificity: The cross-country method abstracts from country specificity, which can be important in understanding the impact of aid on growth. Sierra Leone, for example, may be a high-aid country, but if the period studied includes civil war years, it will turn out to be a low growth country as well; past aid to conflict-ridden Côte d'Ivoire will appear to have been ineffective if judged only on growth performance; Angola's high growth owes much to oil and little to aid. Moreover, important specific features of low-income economies are often not taken into account in cross-country regressions, which in turn have proven to be rather poor predictors of growth. For instance, much of the empirical growth research based on comparative data has not addressed issues of dualism and structural change in developing countries. Is it possible, under these conditions, to identify the particular role of aid?

Multiple objectives: Aid has various objectives, often not directly related to economic growth. ODA targets goals ranging from political and diplomatic support to friendly governments; peace-keeping, nation-building and other military operations; the fight against terrorism, international crime, drug trafficking and money laundering; strategic support to the commercial interests of donors' own firms; operations aiming at promoting culture or language. Alesina and Dollar (2000) find that much aid is provided for political reasons. A large fraction of ODA received by Egypt and Israel is devoted to supporting the Middle East peace process. Likewise, much of the aid provided to Asian countries in the aftermath of the December 2004 Tsunami was clearly aimed at funding humanitarian needs. A large fraction of ODA flows to many other countries are designed to bolster the fight against international crime or terrorism.

Short-term versus long-term effects: Recent work by Clemens, Radelet and Bhavnani (2004) argues that past research on aid and growth may be flawed because it typically examines the impact of aggregate aid on growth over a short period—usually four years. Yet, significant portions of ODA are unlikely to affect growth in such a brief time. They suggest that aid be divided at least into three categories: (1) emergency and humanitarian aid, which is likely to be negatively correlated with growth; (2) aid (such as support to education, health, the environment, or democracy) that affects growth only over a longer period, or only indirectly, and therefore likely have no relationship to growth within four years; and (3) aid that could plausibly stimulate growth over a few years, which includes budget and balance of payment support, investment in infrastructure, and aid directed to productive sectors like agriculture or industry. The authors estimate that this third category, which accounts for only about half of total aid flows, has a positive causal relationship with growth over a four-year period, with diminishing returns. For example, their results suggest that a $1 increase in this "short-impact" aid raises output (and income) by $1.64 in present value terms in the typical country, and that higher-than-average short-impact aid to Sub-Saharan Africa raised per capita growth rates there by about half a percentage point compared to growth with average aid flows.[2] Disaggregating aid flows in this way appears to be a promising line of investigation, and further work along these lines can hopefully complement these initial results.

Identifying causal mechanisms: The theory underlying many cross-country growth studies assumes that physical capital accumulation is the main driver of growth. Presumably, this is also the channel through which aid is likely to affect growth, provided that it does not crowd out domestic saving and investment. More fundamentally, however, recent advances in growth theory suggest, that the growth process involves a complex set of relationships that includes institutions and how they interact with investment behavior and policies. These structural relationships cannot be identified with cross-country regressions, nor can measures that might mitigate potential adverse impacts

in areas such as external competitiveness. More broadly, the extent to which economic growth may result not only from financial transfers but also from the transfer of knowledge that can help develop the capacity to formulate and implement better policies will not be picked up in cross-country regressions.

Measurement errors: Cross-country research requires assembling large samples of diverse countries at different stages of economic development. While these samples allow large variations in country policies and characteristics, they also create difficulties in measuring variables in a consistent and accurate way across countries and over time. For these reasons, the suggestion by Roodman (2006) that "perhaps researchers have hit the limits of what cross-country empirics can reveal about aid" may be reasonable. Moreover, such analysis is likely to offer few pointers as to the implications for aid policies going forward. As suggested by recent work on the broader determinants of growth (for instance, World Bank, 2005, on the *Lessons of the 1990s*), the approach of using cross-country regressions needs to be supplemented with other approaches that are capable of taking country specificity into account. Going forward, country case assessments and project evaluations have an important role to play in understanding the potential role of aid in contributing to growth and poverty reduction.

Lessons from Micro Evidence and Country Studies

Micro evidence and country studies can be useful in understanding whether and how aid can contribute to growth and poverty reduction. There is evidence from programs and projects that aid can play a significant role in supporting a country's own development efforts, both through the associated resource transfer as well as by helping to build capacity for formulating and implementing reform programs. Many individual programs show very strong results, and many more programs are undergoing impact assessments. They confirm that project and program aid seeks to compensate for a lack of domestic savings by financing higher public investment. If these investments are more productive than those they may have crowded out, higher growth should result.[3]

Increased aid can also finance investments that contribute to better service delivery (health, education, water supply, sanitation). Even abstracting from any longer-term growth effects associated with the provision of these services, non-income poverty should be reduced as a result. And when technical assistance is effective in building capacity, it helps lay the foundations for better policies and stronger institutions which in turn should translate into faster growth and improved service delivery.

In the 1960s and 1970s, Korea and Taiwan (China) received substantial aid flows, which were used productively in accelerating growth and reducing poverty. In the 1980s, Bangladesh and Indonesia benefited from and made good use of large aid flows. Several more recent country cases show the essential role played by foreign assistance in helping countries move out of very difficult situations (including post-conflict environments as with Uganda, Mozambique and Vietnam) and promote growth and poverty reduction.

Less extraordinary but still high and sustained levels of growth, accompanied by high level of aid, have been witnessed in a group of eleven Sub-Saharan non-oil countries. This group has experienced GDP per capita growth rates of about 2.5 percent—enough to reach the poverty MDG by 2015—while receiving aid above 10 percent of GDP over the period 1994 to 2003 (Table 1).[4]

Many anti-poverty programs also show very strong results, as is the case with the multi-country effort to eradicate river-blindness (Onchocerciasis), and the nutrition program in Madagascar (SECALINES). The experience of these countries also shows that some of the difficulties highlighted in the cross-country empirical literature, such as the erosion of export competitiveness due to the impact of aid flows on the real exchange rate, can be managed although there are likely to be policy tradeoffs.

At this stage, the assessment of our ability to appraise aid effectiveness is fairly clear. At a theoretical level, we understand the good and bad effects that aid may have on an economy. At the empirical levels, we have the same balance. On the one hand, we may draw on country case studies that show that aid can provide

Table 1: Africa's G-11—Strong Performers

	REAL GROWTH pc		AID/GDP		GDP pc (2000 US$)		Poverty Reduction	
	mean	standard deviation	mean	standard deviation	1994	2003	% increase p.a.	between years
Benin	2.36%	0.78	11.1	2.9	312	388	0.64	95-99
Burkina Faso	1.90%	2.34	15.2	3.3	207	253	-1.64	98-03
Ethiopia	1.55%	4.21	14.9	5.1	88	102	-0.32	96-00
Ghana	1.97%	0.84	10.1	1.7	228	276	-1.50	92-99
Mali	3.13%	3.00	16.5	4.2	189	261	NA	
Mauritania	1.65%	1.73	23.9	4.8	327	379	-0.99	90-00
Mozambique	5.47%	3.57	31.4	10.9	157	255	-1.75	92-02
Rwanda*	1.36%	13.86	30.8	25.6	159	254	NA	
Senegal	2.03%	1.53	11.1	3.2	398	485	-1.54	94-01
Tanzania	2.01%	2.09	14.1	3.2	249	309	-0.29	91-01
Uganda	3.90%	2.21	13.3	3.0	195	277	-1.80	92-02
AVERAGE	**2.48%**	**3.29**	**17.5**	**6.2**	**228**	**294**	**-1.02**	

Note: Poverty Reduction data based on last two household surveys for which the years in which these were conducted are indicated. NA (Not Available) means no two comparable surveys were available between 1990 and 2003.

* numbers for Rwanda are heavily influenced by the exceptional circumstances of the genocide. If 1994 and 1995 are excluded, real growth per capita is 3.35%, and aid/GDP drops to 23.7%.

Source: Bourguignon, Gelb and Versailles (2005).

a real boost to growth, or at least not handicap performance even when it is a rather large proportion of GDP. And we also know numerous cases where aid has not been able to lift countries onto a sustained positive growth path, including several countries analyzed in depth by Devarajan et. al. (2001). Examples of aid programs that successfully reached their development goals are numerous, but the converse is true as well. On the other hand, we must acknowledge the ambiguous results of aggregate cross-country work showing no clear relationship between aid and macro aggregates like growth. As in other areas of economics, are we simply faced with a difficult—and unsolvable—aggregation problem? Is it the case that the aggregate result of micro interventions, even largely successful ones, is uncertain? Or that the aggregate cross-country approach is so flawed that it lacks robustness and can only lead to ambiguous conclusions?

The shift in the aid model discussed earlier also adds complexity to the task. While there is tantalizing evidence of more effective aid utilization and improved outcomes, the shift is still too recent for the compilation and analysis of sufficient data for us to confirm the changes. There are certainly not enough observations to do so using the conventional cross-country techniques. At the same time, one primary goal of the international development community should be generate micro data—like project, program or policy impact evaluations—that would permit us to get a better sense of whether measurable and sustained progress will materialize, relative to old aid practices.

4. The Evolving Partnership Model and the Agenda Ahead

The change in the way that aid is implemented—the central theme of this paper—is not characterized by a single discrete event or sudden and universal change in policies or approaches. It is instead better seen as an ongoing process, composed of disparate initiatives that proceed at different speeds among various groups of donors, recipients, and global institutions. The shift has its roots in changes in the global environment—such as the passing of the Cold War—and in international events, such as the UN Millennium Summit that placed the MDGs at the center of global development efforts, or the Monterrey Conference that committed donors and recipients to a partnership aimed at reaching the MDGs.

Because it is still evolving, there is no precise definition of the new aid model. Nevertheless, what is clear is that the debate over aid effectiveness and the renewed commitment for increased aid flows by the international community have raised expectations across a number of dimensions. This agenda includes an increased emphasis on policy-based selectivity in allocating aid; a stronger emphasis on governance, institutions, and local ownership of reforms;

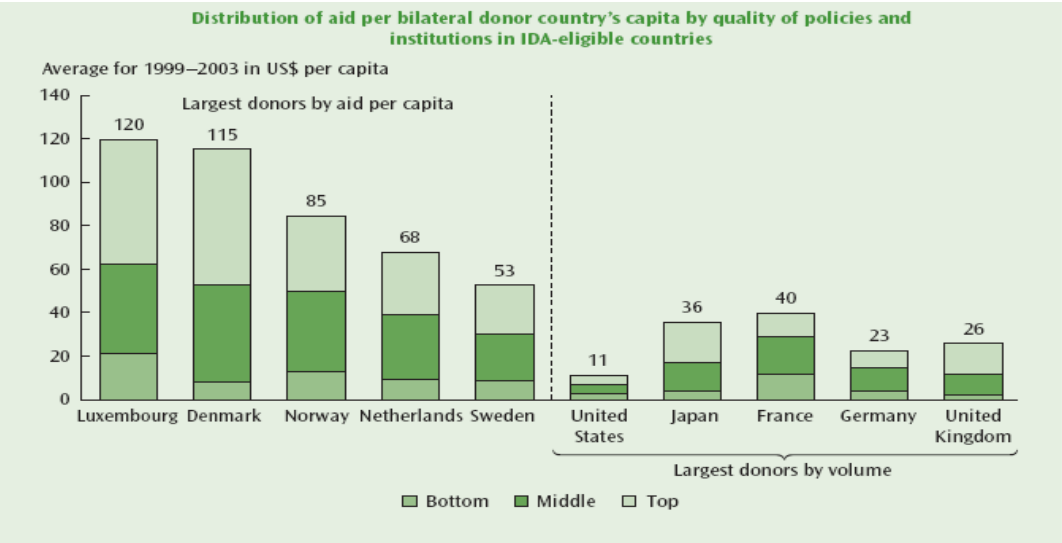
strengthening public sector (especially budgetary) management; improved service delivery; recognizing and responding to absorptive capacity constraints and macroeconomic consequences; improving aid coordination and delivery; and greater commitment to aid effectiveness and measuring results "on the ground." In the remainder of this section, we consider these aspects in more detail.

Country specificity and selectivity: The new approach starts from the premise that aid can only be productive when it supports countries in articulating and implementing coherent development strategies focused on sustaining broad-based growth. Given this dependence on country context, aid cannot and should not be expected to work to the same extent everywhere or at all times in terms of accelerating growth and poverty reduction.

The picture is changing, and we believe in a positive direction. Donors have in general become more selective in allocating aid across countries so that aid volumes and modalities are matched better with recipient countries' income levels, policy and governance environments, and institutional capacities. One aspect of this improved allocation is that more aid is being targeted to poor countries with better policies. An index of policy selectivity, which measures how aid volumes change with the quality of recipient countries' policies and institutions, shows a substantial overall improvement between 1999 and 2003. It also shows that this relationship is much stronger for multilateral aid (including World Bank concessional assistance) than for bilateral aid. And, among bilaterals, it is stronger for some donors than for others. Dividing IDA countries up into three groups based on the quality of their policies and institutions, Figure 2 shows that for most donors, the largest portion of aid went to the Top performers, while relatively little was provided to the Bottom group. A similar index that looks at the relationship between aid flows and the per capita incomes of recipient countries also shows an improvement during this period—bilateral and multilateral donors are now allocating more aid to poorer countries.

The selectivity of aid according to country policies is especially strong among low-income countries where even bilateral donors who are not selective in general tend to favor better performers. Importantly, those donors who tended to concentrate their aid on poorer countries were also more likely to be selective in terms of focusing these flows on countries with better policies and governance. In sum, while efforts to make aggregate

Figure 2: Many donors target countries with good policies



Source: Based on Levin 2005.
Note: IDA-eligible countries are split into three groups—bottom, middle, and top—using the 33.3 and 66.7 percentiles of quality of policies and institutions as measured by the World Bank's Country Policy and Institutional Assessments (CPIAs).

aid more effective are progressing, it remains to be seen if emerging evidence will confirm this empirically in the future.

One side effect of increasing policy selectivity in aid programming is that many poor fragile states are under-funded. At the same time, there is also a clearer recognition now of the challenges of aid effectiveness in such countries, including those in post-conflict situations. In the latter, there is an acknowledgement that higher aid needs to be sustained over a longer period following the cessation of conflict and that aid without institutional strengthening is unlikely to be effective. And in other fragile states with poor policies and governance, assistance is now focused more on basic service delivery, either through NGOs and community groups or through ring-fenced interventions such as social funds as well as on building capacity.

Governance and institutions: Another dimension of the shift is the growing recognition of the critical role of governance and institutions. Even though definitive empirical evidence remains scarce, there is a case to be made that the effectiveness of aid in improving productivity, incomes, and welfare depends on how governments manage all of their resources, not simply those provided by aid. Weaknesses in public financial management systems—in budget classification, formulation, control, and reporting—and regulatory capacity jeopardize the design and the implementation of well-focused budgets. It is essential, therefore, that there be a focus on improving governance and institutional quality in recipient countries and that aid be scaled up in tandem with improvements in these areas. Steps to strengthen systems within countries to monitor and manage public expenditures also need to be emphasized.

In recent years, the pace of economic growth in developing countries, including low-income countries, has accelerated, reflecting partly the progress in improving policies and strengthening governance. These improvements contribute to creating a better enabling environment for higher aid flows to be productive. Improvements are evident on various indicators of country policies and governance (including public financial management). One measure of the quality of policies and institutions—the World Bank's Country Policy and Institutional Assessments (CPIAs)—has risen on average across developing countries over the past five years. And while the improvements in some areas (economic management and structural policies) have been greater than in others (public sector management and accountability), this trend is clear not only for developing countries as a whole but also for groups of countries. Further progress in monitoring governance quality more closely and better strategies on promoting governance reform is an important priority in improving aid effectiveness.

Strengthening public expenditure management: A well-functioning budget system is a crucial feature of the new aid model. The most obvious case in which aid has no effect on growth and poverty reduction is where these flows are mismanaged or misappropriated. While Mobutu's Zaire has been the poster child for this phenomenon, there are many other less egregious examples. What they reflect is the fungibility of aid resources and the weak domestic institutions and budgetary systems responsible for tracking their use—a weakness that often applies as well to managing other domestic public resources.

A key aspect of Poverty Reduction Strategies (PRSs) in many countries has been countries' plans to improve public expenditure management so as to better align the use of public resources with development priorities. One indication of this is the extent to which Highly-Indebted Poor Countries (HIPC) are incorporating Public Expenditure Management (PEM) reform measures — formulated as part of their HIPC expenditure tracking exercises—into their PRSs. In this regard, there is encouraging evidence that some strongly-committed countries have been able to carry through successful major reform programs in a relatively short time span (*Global Monitoring Report*, 2006).

There has also been a broadening of focus from budget formulation to more complex issues of budget execution and reporting. In this context, the importance of strengthening the link between the PRS and the budget process, including by implementing medium-term expenditure frameworks (MTEFs) is now acknowledged. MTEFs are now common in countries

where PRS implementation is more advanced—of the 28 low-income countries where MTEFs are being implemented, 11 have been implementing PRSs for two years or longer, and another 8 have been doing so for at least a year.

Improving service delivery: At the most basic level, improving the use of aid means improving the quality of service delivery, a connection that is reflected in the new approach. As noted in the *World Development Report 2004*, aid is often provided in ways that emphasize accountability to donors at the expense of strengthening the relationships between domestic constituencies – citizens, service providers and policymakers. As a result, the prospects for improving the policies and institutional arrangements needed for delivering basic services are reduced.

The ways in which aid is provided need to be supportive of domestic accountability so that the links in the service delivery chain are strengthened. This requires channeling more aid through recipient countries' budgetary systems, and harmonizing fiduciary and reporting systems. These issues point to the importance of focusing on the need for countries to manage aid flows as well as of fostering a results culture within the development community. This seeks to better understand the mechanisms that connect aid flows to growth and poverty reduction and more systematically tracks outcomes.

An important complement to the PRSs and MTEF is public expenditure tracking surveys (PETS), which allow assessing difficult-to-measure outputs such as public service delivery. In the absence of well-functioning public accounting information and management information systems, a survey may be the only way to diagnose problems of service delivery quantitatively.

Taking account of absorptive capacity: While efforts to increase aid flows are critical, another important element of the new aid model is recognition of the need to consider the limited capacity of recipient countries to absorb larger flows and manage complex donor relations. Various evaluation reports produced by aid agencies on their activities in Africa suggest that aid is more likely to fail when it involves complex interventions—multiple sets of interrelated activities that tax the capacity of government and donor agencies. The problem of project proliferation—and the tendency of recipient countries to become overburdened by the costs of administering aid projects—should be addressed. Roodman (2006) has shown that when projects proliferate beyond a certain level, the effective marginal utility of aid declines sharply, and can even become negative. One of the main lessons learned from successful, high-aid countries (e.g., Burkina Faso, Mozambique) is the need to update the aid delivery system. This requires taking into account the absorptive capacity in recipient countries.

Another constraint to absorption may emerge if the returns to additional aid diminish because the supply of the available complementary inputs (skilled labor, land, physical infrastructure) is limited. And it takes time to build up the availability of skilled labor, scarce management capacity or to improve transport and logistics facilities. Attention is needed to improve the process by which public projects are selected and implemented and to the appropriate phasing and sequencing of public investments. Care must be taken not to overburden local delivery systems with a myriad of often well-intentioned vertical programs, such as those in the health area.

To assist in assessing absorptive capacity at the country level, the World Bank has developed the MAMS (Maquette for MDG Simulation). The model provides an economy-wide perspective on the development process that is focused on country strategies for sequencing interventions to support the MDGs and poverty reduction. It places special emphasis on how scaling up of public services, public infrastructure, and related growth in private production and incomes can together place countries on a path toward achieving MDGs. The MAMS model also permits consideration of factors such as how aid flows affect domestic labor markets or erode competitiveness, and tradeoffs between spending on infrastructure (promoting growth and poverty reduction) and spending on education and health (with stronger direct effects on human development MDGs but weaker short-term impact on growth and incomes).

This modeling work provides insights into aid management and policy options facing governments and

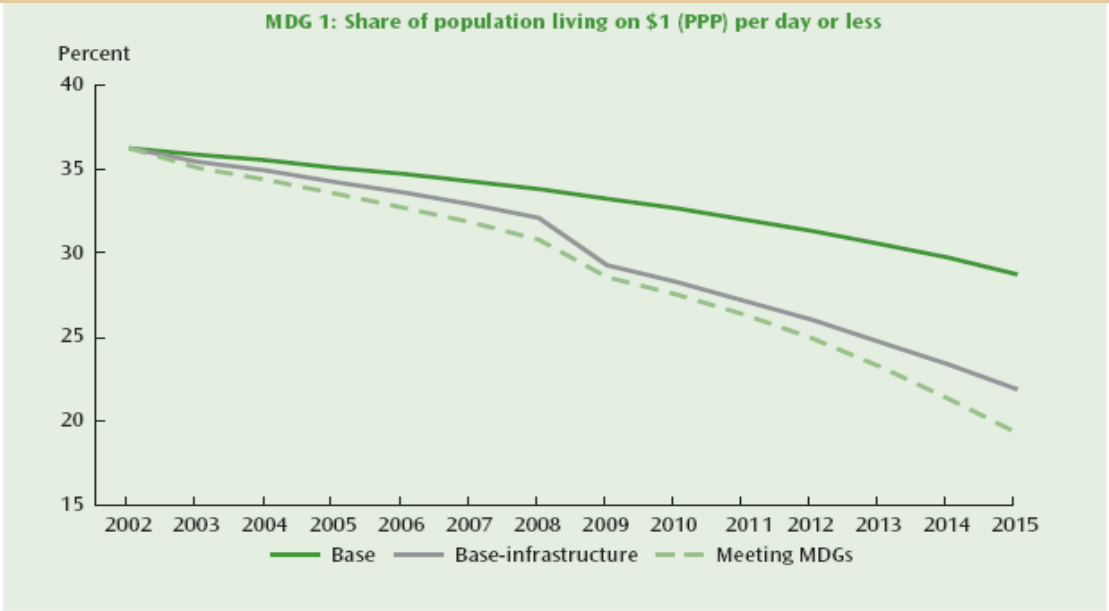
the development community as it seeks to scale up aid and accelerate progress toward the MDGs. First, it underscores the need for careful sequencing of public investment in order to minimize the costs and likelihood of success of MDG-based development strategies. Second, it notes that there remain significant concerns over the impact of large scale aid flows on macroeconomic stability and competitiveness of tradable goods and services sectors. A key challenge is to direct investment towards removing constraints to growth and productivity gains that will prevent Dutch disease effects from emerging. And finally, large-scale frontloading of

Box 1: Absorptive Capacity and the MDGs: Applying MAMS to Ethiopia

For Ethiopia—a poor country for which the MDGs pose enormous challenges—one central concern is how to reconcile broad strategic concerns over policies and programs (impact of higher aid flows on the exchange rate, shortages of skilled labor) with detailed sectoral data on priorities, programs, and implementation. To examine these linkages the MAMS framework has been calibrated to country data to capture select macro and sector-specific constraints and consider alternative scenarios for reaching the MDGs.

Projections of income poverty levels through 2015 under three scenarios are shown in the figure below. The first scenario (Base) is a continuation of present trends. The second scenario (Base-Infrastructure) adds public investment in basic infrastructure (roads, other transport, energy, irrigation), which is considered critical to growth. In this scenario, infrastructure investment is frontloaded (an increase of 10 percent a year until 2009 and 5 percent a year thereafter) and requires an additional 15 percent increase in foreign grants. Under the third scenario, investments in public services are set at the levels to achieve the core human development MDG targets and requires a gradual but substantial increase in foreign grants, rising to around $60 per capita, or about 40 percent of GDP, by 2015—roughly twice current aid as a share of GDP. Productivity gains would help boost annual GDP growth to nearly 5 percent after 2009, and poverty reduction would be accelerated, falling to about 20 percent by 2015. These scenarios illustrate that it is possible to achieve the MDGs—provided there is adequate external grant financing, and expansion of MDG-related services is accompanied by investment in basic infrastructure to raise growth. Additional aid and investment

Projected income poverty in Ethiopia (2003-2015)



Note: The projections use the Ethiopia Maquette for MDG Simulation (MAMS) model, parameterized using data from the Ethiopian poverty assessment (World Bank 2005a).

Box 1 . . . *(continued)*

in basic infrastructure are essential to supporting a sustained economic expansion. Improved governance and institutional capacity are also important to effective delivery of public (and private) services and reduce the costs of improving service delivery over time.

This framework helps illustrate the important role of absorptive capacity and the lags inherent in expanding capacity. To achieve the second MDG—universal primary education completion by 2015—between 52,000 and 160,000 more teachers would be required in addition to the current number of 75,000. Recruiting teachers will require increasing the supply of skilled labor—a gradual process with a lagged response—or raising real wages to attract skilled labor. The latter would pose risks of drawing skilled labor from the private sector, crowding out private growth, and raising the costs of public services. Constraints to absorptive capacity are also evident in the macroeconomic impact of higher aid flows. In the third scenario above, which requires roughly a doubling of aid to GDP by 2015, the real exchange rate appreciates and leads to shrinkage of the export sector unless public investment increases productivity and removes constraints to growth.

The importance of investment sequencing is another lesson from these simulations. Priority must be placed on basic infrastructure investment because of its key role in raising the underlying growth rate and achieving network productivity effects. At the same time, investments must proceed in human services that address binding constraints—such as education to ease skilled labor constraints— and where production lags require earlier attention. Priority should also be given to investments that generate positive externalities and lower costs. Investments in water and sanitation, for example, accelerate improved health outcomes.

aid disbursements (other than for core infrastructure) is costly as it pushes against absorptive capacity constraints.

Taking into account the macroeconomic effects of high aid flows: The emerging aid model also places greater emphasis on the macroeconomic consequences and feedbacks—some unintended—that can occur when aid inflows rise sharply. From a macroeconomic standpoint, aid is similar to any other form of capital flows. In the short run, keeping other capital flows and international reserves unchanged, an *increase* in aid provides additional resources by permitting an equivalent increase in imports (relative to exports) and investment (relative to domestic savings). Over the long run, sustained growth depends on the productivity and the use of these financial flows—official and private. The best outcome occurs when spending raises productivity and relieves bottlenecks in the capacity of the non-tradables sector, which may involve measures to channel aid primarily to finance capital goods imports that would not otherwise be imported or produced locally. On the other hand, if aid is mostly spent on private and public consumption, or imports are mostly of consumption goods, long-term aid dependency could be the outcome.

One possible consequence of significant aid flows over a period of time is that it could lead to pressures for real exchange rate appreciation (the relative price of non-tradables to tradables), which will hurt the tradables sector of the economy (including exports). If the tradable sector is an important actual or potential source of growth, longer-term growth prospects could be harmed. Under these circumstances, even though aid may have short-term benefits in terms of resource transfers, the prospects for long-term growth and poverty reduction might suffer due to the economy's loss in competitiveness. Recent empirical studies on this subject offer mixed results on the Dutch disease effects. Rajan and Subramanian (2005) find that aid inflows have adverse effects on a country's competitiveness, as reflected in a decline in the share of labor-intensive and tradable industries in the manufacturing sector, stemming from the real exchange rate overvaluation caused by aid inflows. By contrast, country studies carried out by the International Monetary Fund (IMF) staff[5] show that the macroeconomic impact of aid will depend on how it is used. When aid is allocated to sectors with low productivity or social sector spending, the macroeconomic consequences are likely to be

exacerbated, while if aid is used to boost supply capacity, the macroeconomic consequences are likely to be mitigated. An important implication is that donors need to work closely with recipient countries to phase in and sequence their assistance as country capacity is enhanced. Policymakers also need to manage the pace and time profile of a possible real appreciation so that it is offset by productivity gains. Finally, aid recipients must coordinate their fiscal, monetary and reserve accumulation policies so as to balance the goals of maintaining a competitive exchange rate, moderate inflation and low real interest rates.

A second and somewhat less obvious adverse side effect of aid is its possible impact on recipient governments' incentives to raise domestic resources, and the corresponding risk that it might foster long-term aid dependency. In addition, as noted in the *World Development Report 2004*, improving the policies and institutional arrangements needed for delivering basic services may become harder because of the lack of accountability that might be associated with aid resources. However, available cross-country analyses and country studies fail to yield clear-cut conclusions on this channel, suggesting that good policies—even if associated with aid—are probably more important than any disincentive effects of aid flows.

Concerns over the risks of perpetuating aid dependency therefore point to the need to pay attention to the impact of increased aid on the recipient country's medium-term fiscal outlook. Where much of the additional aid is expected to take the form of loans, the implications for fiscal and external sustainability will need to be taken into account. And, even in countries where much of the increased aid would come as grants, the implications for recurrent costs and their financing over the medium term will need to be considered along with the potential for increasing domestic revenues, as scaled up aid leads to higher public investments in the short term.

Improving aid coordination and delivery systems: The new aid model incorporates an overdue emphasis on the inefficiency and cost associated with fragmented aid delivery structures and overlapping or duplicative administrative efforts. One clear message is that the increased willingness of donors to make aid available needs to be matched by flexibility in the form in which that assistance is delivered. What is convenient for the donors in terms of the political economy of resource mobilization may not be ideal for recipients. Aid should be provided in ways that are better aligned with country priorities—for example, as articulated in their poverty reduction strategies. It is particularly important to enhance the predictability and time horizon over which aid commitments are made. As countries build a track record of policy performance, they should receive access to timely, predictable and long-term commitments of external support that enable them to plan more effectively to reach their medium-term development goals. This requires that donors coordinate their assistance better at the country level and harmonize their policies and procedures around country systems while ensuring that the quality of those systems improves over time so that fiduciary standards are maintained.

Providing more aid in forms that support the need for projects and investments that accelerate growth is a high priority. And, in many countries, higher recurrent costs associated with improving service delivery will need to be financed through budget support or as targeted assistance to well-designed sectoral programs. But to reduce the risks of aid dependency, budget or sector support will need to be clearly linked to a medium-term budget framework. As noted above, there are promising signs that, with strong commitment, countries can make rapid progress in reforming public expenditure management and adopting suitable budget framework. The challenge is to ensure that these changes become firmly rooted and fully integrated into the broader governance and accountability framework. Finally, in countries that face high risks of debt distress, much of the additional aid will need to take the form of grants, as exemplified in the recent effort to link the grant element of IDA lending to debt sustainability criteria.

Measuring results: One of the major features in the evolution of the new aid model following Monterrey has been the increased focus—by both recipient countries and donors—on measuring and monitoring the results of development assistance. In many ways, this is a natural consequence of the "mutual

Box 2: Impact Evaluation

In contrast with most standard evaluations, an impact evaluation assesses whether the observed outcomes are in fact attributed to the project being evaluated. It does so by comparing the results of the intervention with those of a counterfactual.

There are two basic approaches to constructing the counterfactual. Experimental designs (also known as randomized control designs) construct the counterfactual through the random selection of treatment and control groups. Given appropriate sample sizes, the process of random selection ensures equivalence between treatment and control groups in both observable and unobservable characteristics. The other approach, quasi-experimental designs (also called non-experimental designs), relies on statistical models to construct a counterfactual and includes approaches such as regression discontinuity design, propensity score matching, and instrumental variables. In practice, quasi-experimental methods are much more common than randomized control designs.

In recognition of the importance of expanding the number of high-quality impact evaluations, the World Bank launched the Development Impact Evaluation (DIME) initiative to promote and coordinate its impact evaluation activities. Stocktaking exercises had earlier suggested that few projects have impact evaluation components and that even fewer have implemented those components in a technically sound fashion. In addition, the exercises showed significant differences in the number of impact evaluations across regions and sectors.

DIME supports the systematic evaluation of programs in a selected number of strategic priority themes. In DIME's first year, two dozen evaluations were initiated. These evaluations were of education projects (focused on alternative arrangements for service delivery using the conceptual framework described in World Development Report 2004), conditional cash transfers in low-income countries, and slum upgrading initiatives. As results of these evaluations become available, DIME's focused approach will enable systematic comparison of the effectiveness of specific interventions in different settings (for example, countries and regions) and provide a unique opportunity to demonstrate the learning power of impact evaluation efforts by identifying what works and does not work and by obtaining robust measures of the performance to be expected from successful programs.

Regional units, with support from DIME, are building on the growing number of opportunities for useful evaluations in the context of Bank-supported operations. In addition, they are ensuring that project teams and their counterparts in government have effective access to high-quality technical expertise—drawn from within the Bank and outside it—and critical resources when engaging in an evaluation. The Bank's Africa Region Office, for example, has started work on 20 impact evaluations of projects in the areas of early childhood development, education, health, infrastructure, social protection, agriculture and environment, and private sector development. For the previous 10 years, between one and four evaluations were started per year.

accountability" that underlies the new aid model—recognition that each party shares responsibility for achieving success has directed attention towards measuring and monitoring.

Several elements of this revitalized system are already in place and the emphasis now is on implementation. The PRS approach, with its emphasis on poverty reduction outcomes, has contributed to sharpening the results focus. In many countries, the PRS is also supporting the implementation of a country-led process of measuring and managing progress towards development outcomes. A substantial demand for data has also been created while the need to put in place effective monitoring systems has been underscored. While progress has been slow, especially in developing coordinated country-level monitoring systems, what is encouraging is that in nearly all countries action is either being taken or being considered to set up effective systems, particularly in improving the quality of information and in improving access to the available data. The Marrakech Action Plan that emerged from the 2004 Managing for Development Results roundtable provides a concrete example of donors, recipients, and international agencies working closely to identify, finance, and implement the systems and capacity needed to better manage for development results.

Donors are also enhancing the focus on results in

their country programs, instruments and reporting systems. One aspect of this is to link country programs more tightly to country priorities as expressed in PRSs or development strategies. Another is to strengthen the monitoring and evaluation for their projects and programs. Finally, donors are also working to harmonize their requirements for reporting results with national monitoring systems and to coordinate their support for capacity building in this area with the countries' own monitoring strategies.

Achieving results (improvements in outcomes) on the ground depends on actions by many actors, including service providers, citizens, donors, and different levels of government. Disentangling the contributions of these actors and attributing results to actions of individual actors is often difficult, if not impossible. One can construct a simplified results chain linking actions by external actors to government policies and interventions, which in turn affect development outcomes. But establishing the links along this results chain is complex, although understanding the relationship between specific interventions and policies on the one hand and outcomes on the other is often possible. While attributing changes in outcomes to specific actions by external actors may remain an elusive goal, evaluating the impact of specific government interventions is not only important but also feasible from a methodological point of view.

While different evaluation approaches exist, impact evaluation has emerged as the primary way of testing the links between interventions and outcomes because it rigorously compares intervention outcomes with those from a counterfactual representing what the beneficiaries would have experienced without the intervention. Without impact evaluations, the ability of aid agencies to provide robust evidence-based advice to developing countries and to define the type of interventions or approaches they should support is weak. At the same time, impact evaluations—particularly when conducted in comparable and consistent ways across countries—can provide the necessary benchmarks for program design and monitoring. In areas where the evidence base is already strong, simply monitoring implementation and tracking outcomes may be sufficient—but in practice, such areas appear to be more the exception than the rule.

In the past, impact evaluations were constrained by the lack of data and the technical challenges of developing an appropriate counterfactual comparison. Significant improvements in both these areas over recent years have made impact evaluations easier to implement on a systematic basis: micro data gathered through household surveys or demographic and health surveys are more widely available, and many evaluation methods—from randomized experiments to quasi-experimental techniques—have been developed to construct the counterfactual (see Box 2).

5. Concluding Thoughts: Beyond Financial Flows

Debates over the contribution of aid to growth and development have been frequent and heated. Aid skeptics have marshaled evidence to support their view that there is no strong empirical link between aid and growth, while optimists have compiled examples where aid appears to have been well utilized and effective. While acknowledging that the empirical record is mixed, this paper addresses the question from a different perspective. We have argued that there has been a major shift in the aid model that has radically transformed the environment in which aid is provided and how it is used. Past experience—and critiques—have shaped this shift by revealing weaknesses in the existing approaches that needed to be addressed. With this evolution, many of these earlier critiques become less applicable—not wrong, just less relevant. We are more optimistic that cross-country regressions undertaken two decades from now will indeed show results.

The evolution towards the new partnership model is ongoing and gradual, not sudden or complete. It covers a broad agenda: increased aid allocation selectivity, a stronger emphasis on governance and institutions, strengthening public sector management, improving service delivery, addressing absorptive capacity constraints, improving aid coordination and delivery, and a strong commitment to enhancing aid effectiveness and measuring results. In some areas and contexts, progress has been measurable and the impact substantial, while in others, the shift is just beginning.

While all aspects of this agenda are important and support one another, perhaps the most critical change is the focus on aid effectiveness. A strong focus on more effective use of assistance requires efforts by donors and recipients as well as those international facilitators of assistance, such as the OECD/DAC, to monitor carefully how aid is provided, how it is spent, and how it encourages better management and governance in recipient countries. More than a billion people still live in absolute poverty—a reality which drives wealthy countries to increase their efforts. These efforts must be consistent with (1) national development priorities and strategies; (2) with the efforts of other donors—hence the importance of the Paris Harmonization Agenda; and (3) with the larger set of economic policies that affect developing country prospects. After all, it makes little sense to provide additional aid and even debt relief if poor countries are blocked from exporting into developed country markets. It also is counter-productive to aid effectiveness if gainful employment in countries suffering labor shortages on account of demographic trends is limited because of a lack of international consensus on temporary employment. Most importantly, the form, predictability, and terms on which aid is given can render it either conducive or irrelevant to development success.

Major gains have been made in recent years on this agenda and the international aid architecture is now more supportive of successful outcomes. More progress is needed and this paper has indicated areas for further attention. Further actions are also needed on the part of recipients in areas of governance and accountability to ensure that all resources—both domestic and external—are well utilized. Improvements in systems and greater attention to monitoring are therefore essential. And finally, but perhaps most important, is the results framework in which outcomes are clearly tracked. Taken together, these elements can drive the shift in approach needed to increase the effectiveness of aid going forward.

Notes

1. Senior Vice President and Chief Economist for Development Economics, and Vice President, Poverty Reduction and Economic Management, The World Bank. The authors acknowledge the contributions of Stefano Curto, Jeffrey Lewis, Celestin Monga, and Sudhir Shetty in the preparation of this paper. The views expressed in this paper are those of the authors and do not necessarily reflect those of the World Bank.

2. See Clemens, Radelet, and Bhavnani (2004). The results are highly statistically significant and stand up to various tests, including different specifications, endogeneity structures, and treatment of influential observations. The basic result also does not depend on a recipient's level of income or quality of institutions and policies.

3. The rating of Institutional Development Impact of Bank investment projects prepared by the Independent Evaluation Group of the Bank (IEG) indicates progress from 45.6% for FY00 projects to 54.4% for FY05 closed projects. (Source Business Warehouse as at 03/12/06).

4. The so-called "Africa G-11" group comprises Benin, Burkina Faso, Ethiopia, Ghana, Mali, Mauritania, Mozambique, Rwanda, Senegal, Tanzania, and Uganda (see Bourguignon, Gelb and Versailles, 2005).

5. "The Macroeconomics of Managing Increased Aid Inflows: Experiences of Low-Income Countries and Policy Implications". IMF (PDR Department) 2005; and "The Macroeconomic Challenges of Scaling Up Aid to Africa". Gupta, Sanjeev et al. IMF (African Department) 2005.

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