

## Rethinking the Money and Ideas of Aid

Foreign aid has at times been a spectacular success. Botswana and the Republic of Korea in the 1960s, Indonesia in the 1970s, Bolivia and Ghana in the late 1980s, and Uganda and Vietnam in the 1990s are all examples of countries that have gone from crisis to rapid development. Foreign aid played a significant role in each transformation, contributing ideas about development policy, training for public policymakers, and finance to support reform and an expansion of public services. Foreign aid has also transformed entire sectors. The agricultural innovations, investments, and policies that created the Green Revolution—improving the lives of millions of poor people around the world—were financed, supported, and disseminated through alliances of bilateral and multilateral donors. Internationally funded and coordinated programs have dramatically reduced such diseases as river blindness and vastly expanded immunization against key childhood diseases. Hundreds of millions of people have had their lives touched, if not transformed, by access to schools, clean water, sanitation, electric power, health clinics, roads, and irrigation—all financed by foreign aid.

On the flip side, foreign aid has also been, at times, an unmitigated failure. While the former Zaire's Mobutu Sese Seko was reportedly amassing one of the world's largest personal fortunes (invested, naturally, outside his own country), decades of large-scale foreign assistance left not a trace of progress. Zaire (now the Democratic Republic of Congo) is just one of several examples where a steady flow of aid ignored, if not encouraged, incompetence, corruption, and misguided policies. Consider Tanzania, where donors poured a colossal \$2 billion into building roads over 20 years. Did the road network improve? No. For lack of maintenance, roads often deteriorated faster than they could be built.

Foreign aid in different times and different places has thus been highly effective, totally ineffective, and everything in between. Perhaps that is to be expected in a complex endeavor that has spanned half a century, with scores of countries as donors, a hundred countries as recipients, tens of thousands of specific activities, and nearly \$1 trillion in finance. But hindsight is valuable only if it produces insight. The checkered history of assistance has already led to improvements in foreign aid, and there is scope for further reform. The pressing question: How can development assistance be most effective at reducing global poverty?

The answer is needed urgently. While there has been more progress with poverty reduction in the past 50 years than in any comparable period in human history, poverty remains a dire global problem. More than a billion people live in extreme poverty—on less than \$1 a day. Even more lack basic services that people in developed countries take for granted: clean water, sanitation, electricity, schooling. It is ironic—and tragic—that just as economic reform has created the best environment in decades for effective assistance, donors have cut aid back sharply. In 1997 OECD donors gave the smallest share of their GNPs in aid since comparable statistics began in the 1950s—less than one-quarter of 1 percent. It would take roughly a 50 percent increase even to restore aid to its 1991 level.

There have been many excellent studies of foreign aid.<sup>1</sup> But there are three important reasons to revisit this previously charted territory. First, recent shifts in the global economic and political environment—notably the end of the Cold War and the surge in private capital flows to the developing world—have affected the landscape for development assistance in a way that has left many questioning the very existence of aid. Second, there has been a shift in development strategy that requires a new approach to aid as a tactic within the evolving agenda. Third, there is new empirical evidence that provides insights into the puzzle of what is effective aid and what is ineffective aid.

This rethinking of aid produces the following findings:

- *Financial aid works in a good policy environment.* Financial assistance leads to faster growth, poverty reduction, and gains in social indicators in developing countries with sound economic management. And the effect is large: with sound country management, 1 percent of GDP in assistance translates into a 1 percent decline in poverty and a similar decline in infant mortality. In a weak environment, however, money has much less impact. A \$10 billion increase in aid would lift 25 million people a year out of poverty—but only if it favors countries with sound economic management. By contrast, an across-the-board increase of \$10 billion would lift only 7 million people out of their hand-to-mouth existence.
- *Improvements in economic institutions and policies in the developing world are the key to a quantum leap in poverty reduction.* True, there have been sharp improvements in governance and policies in the past decade, but further reform of the same magnitude would lift another 60 million people a year out of poverty. When societies desire reform, foreign aid can provide critical support—in ideas, training, and finance. Efforts to "buy" policy improvements in countries where there is no movement for reform, by contrast, have typically failed.
- *Effective aid complements private investment.* In countries with sound economic management, foreign aid does not replace private initiative. Indeed, aid acts as a magnet and "crowds in" private investment by a ratio of almost \$2 to every \$1 of aid. In countries committed to reform, aid increases the confidence of the private sector and supports important public services. In highly distorted environments, aid "crowds out" private investment, which helps explain the small impact of aid in such cases.
- *The value of development projects is to strengthen institutions and policies so that services can be effectively delivered.* Aid brings a package of knowledge and finance. Most aid is delivered as investment projects in particular sectors such as roads, water supply, or education. Project finance, however, often does not increase spending in a sector any more than an untied grant would have—that is, aid finance is typically fungible. Thus, choosing such laudable sectors as primary health or education cannot ensure that money is well used. Aid is financing the entire public sector, and the overall quality of policies and institutions is the key to securing a large return from this finance. These findings highlight that the most critical contribution of projects is not to increase funding for particular sectors, but to help improve service delivery by strengthening sectoral and local institutions. The knowledge creation supported by aid leads to improvements in particular sectors, whereas the finance part of aid expands public services in general.
- *An active civil society improves public services.* One good idea that many projects have supported in recent years is a participatory approach to service delivery, often resulting in huge improvements. The best aid projects support initiatives that change the way the public sector does business. The top-down, technocratic approach to project design and service delivery has not worked in areas critical for development—rural water supply, primary education, natural resource management, and many more.
- *Aid can nurture reform in even the most distorted environments—but it requires patience and a focus on ideas, not money.* In some of the poorest countries of the world, the government is not providing effective policies or services, which is why government-to-government transfers have yielded poor results. Still, there are often champions of local or sectoral reform, and aid at times has been effective supporting these initiatives. This work is staff-intensive and results in little disbursement of funds. Successful assistance here aims to help reformers develop and test their ideas.

Making aid more effective in reducing poverty requires five policy reforms. First, financial assistance must be targeted more effectively to low-income countries with sound economic management. In a good policy environment financial assistance is a catalyst for faster growth, more rapid gains in social indicators, and higher private investment (chapter 1). In a poor policy environment, however, aid has much less impact. Clearly, poor countries with good policies should receive more financing than equally poor countries with weak economic management. Up until the early 1990s, however, finance has gone in equal amounts to well managed countries and to poorly managed ones. Furthermore, much of aid continues to go to middle-income countries that do not need it. It is possible to make aid more effectively targeted to poor countries and to better management simultaneously.

Second, policy-based aid should be provided to nurture policy reform in credible reformers. Experience shows that donor financing with strong conditionality but without strong domestic leadership and political support has generally failed to produce lasting change (chapter 2). Continued flows to governments that pay only lip service to reform have been a major problem. Policy-based financing should go only to countries with a strong track record or where there is a demonstrable basis for optimism (to support, for example, the concrete actions of domestically initiated reform efforts or a government newly chosen on a reform platform). New governments in post-conflict situations are often good candidates for support. In countries with poor policies and no credible reform movement, assistance should assume the more modest and patient role of disseminating ideas, transmitting experiences of other countries, training future policymakers and leaders, and stimulating capacity for informed policy debate within civil society. These measures are relatively inexpensive and do not conflict with the proposal that the bulk of finance should go to countries with sound economic management.

Third, the mix of aid activities should be tailored to country and sector conditions (chapter 3). Even where institutions and policies are weak, donors have tried to find something useful to finance. Surely it must be a good thing to finance primary health care or basic education? The evidence, however, is that aid is often fungible, so that what you see is not what you get. In circumstances where similar projects would have been undertaken anyway, donor money for particular projects and sectors does not necessarily "stick"—simply expands the government's budget. Thus even rigorous project selection or reallocation of donor finance to laudable activities cannot guarantee the effectiveness of aid in a distorted environment. To measure the effect of their finance, donors must look at overall allocations and, even more important, at the efficacy of public spending.

The allocation of expenditures alone does not guarantee success, for the quality of public spending is as important as its quantity. In countries with sound economic management (of both macroeconomic policy and delivery of public services), more aid can be in the form of budget support, which would simplify administration and reduce overhead. In countries with basically sound policies but weak capacity for delivering services, project aid should be a catalyst for improving the efficacy of public expenditures. Countries without good policies, efficient public services, or properly allocated expenditures will benefit little from financing, and aid should focus on improvements in all three areas.

Fourth, projects need to focus on creating and transmitting knowledge and capacity. The key role of development projects should be to support institutional and policy changes that improve public service delivery (chapter 4). Even where money may not stick, the local knowledge and institutional capacity created by the catalyst of aid projects can. Where projects are innovative, it is crucial to have objective and rigorous evaluation of outcomes and dissemination of new information. Knowledge about what works in service provision—and what does not—is one of the most important outputs of development assistance. In many cases innovative approaches to service delivery will involve greater participation by local communities and decentralization of decisionmaking.

Fifth, aid agencies need to find alternative approaches to helping highly distorted countries, since traditional methods have failed in these cases (chapter 5). Communities and governments are heterogeneous, and even in the most difficult environments there will be pockets of reform. Donors need to be patient and flexible and look for windows of opportunity to nurture these reform efforts. Typically, ideas will be more useful than large-scale finance. Donors' ability to work in these environments has been hampered by an "approval and disbursement culture" that does not value small-scale, staff-intensive activities. In the past agencies have too often focused on how much money they disburse and on narrow physical implementation measures of the "success" of the projects that they finance. It turns out that neither measure tells much about the effectiveness of assistance. The evaluation of development aid should focus instead on the extent to which financial resources have contributed to sound policy environments. It should focus on the extent to which agencies have used their resources to stimulate the policy reforms and institutional changes that lead to better outcomes. These are not easy questions to answer, but independent reviews of development agencies—with participation of developing country policymakers and project beneficiaries—can help establish whether agencies are doing a good job.

### **Box 1. Defining Aid**

What is the difference between official development assistance and official development finance? The first is a subset of the second and comprises grants plus concessional loans that have at least a 25 percent grant component. Official development finance is all financing that flows from developed country governments and multilateral agencies to the developing world. Some of this financing is at interest rates close to commercial rates. "Foreign aid" is usually associated with official development assistance and normally targeted to the poorest countries. This assistance is the primary focus of this study, but many of the findings are relevant for the larger category of official development finance.

Both types of aid can be divided into bilateral and multilateral components. Bilateral assistance is administered by agencies of donor governments (such as the U.S. Agency for International Development or Japan's Overseas Economic Cooperation Fund). Multilateral assistance is funded by contributions from wealthy countries and administered by agencies, such as the United Nations Development Programme and the World Bank. Of all official development assistance, roughly a third is multilateral.

Some bilateral aid is tied—that is, it must be used to procure goods and services from the donor country. Studies have shown that tied aid reduces the value of that assistance by about 25 percent, and there is widespread agreement that untying bilateral aid would make it more effective. Among OECD countries there has been a clear trend away from tied aid. In 1995 it accounted for only about a fifth of all aid.

## **The New International Environment**

Foreign aid is a post World War II phenomenon. From the start, it had twin objectives, potentially in conflict. The first objective was to promote long-term growth and poverty reduction in developing countries; the underlying motivation of donors was a combination of altruism and a more self-interested concern that, in the long term, their economic and political security would benefit if poor countries were growing. The second objective was to promote the short-term political and strategic interests of donors. Aid went to regimes that were political allies of major Western powers. Thus the strategic and developmental objectives were potentially, but not necessarily, at odds. Consider Bolivia and Zaire. Both received U.S. aid, partly for strategic reasons, yet the outcomes were vastly different. Bolivia used the resources relatively well after

reforms of the mid-1980s and over the past decade has stabilized and laid a groundwork for success. In the former Zaire, by contrast, it is hard to see any benefit from its years as a major aid recipient.

During the 1970s and 1980s foreign aid from OECD countries rose steadily (figure 1).<sup>2</sup> In 1991 official development assistance peaked at \$69 billion (in 1995 prices; see boxes 1 and 2). In the 1990s, however, three events have lowered the absolute and relative importance of foreign aid: fiscal problems in OECD countries, the end of the Cold War, and the dramatic growth in private capital flows to developing countries.

In recent years OECD countries have been struggling to control fiscal deficits and contain growth in government spending. Even though foreign aid is a tiny fraction of budgets, it has been one of the first items for the ax. All major donors reduced aid relative to their GNPs between 1991 and 1997 (figure 2). The decline was especially sharp in the United States—aid was a mere 0.08 percent of GNP in 1997. Sweden and other Nordic countries have traditionally been generous, giving almost 1 percent of GNP. But among large countries, France is the only one that gives more than 0.45 percent. Collectively, OECD countries contributed just 0.22 percent of their GNP in 1997. The end of the Cold War likely influenced some countries' decisions. The strategic importance of aid has ebbed; as a result it risks losing its broad support among donor governments.

At the same time, there has been a surge in private capital flows to developing countries. In the 1970s and 1980s official finance—that is, money from bilateral donors and multilateral institutions—represented about half of all finance going from the developed to the developing world (see figure 1). With private flows expanding to more than \$250 billion in 1996, however, official finance is now only a quarter of all finance available to developing countries.

Private capital flows are heavily concentrated in a few countries, however—and some flows are volatile. A surge in the late 1970s receded after the onset of the debt crisis in 1982. Another big rush occurred in the mid-1990s, but with the financial crises rocking East Asia in 1997 foreign investment dropped sharply. The flow of private money to the developing world fell by \$80 billion between 1996 and 1997. In any event, private flows will continue to go to a small number of (mostly) middle-income countries. In 1996, 26 countries received 95 percent of private investment; the rest went to the other 140 developing countries. In a typical low-income country, foreign aid remains far and away the primary source of external finance, amounting to 7–8 percent of GNP.

## **Box 2. Defining Aid**

The OECD's Development Assistance Committee publishes information on its members' aid to developing countries—that is, grants plus net disbursements of concessional loans that have at least a 25 percent grant component. A different way to measure aid is to extract from each concessional loan the grant element and add that to the figure for pure grants. Using this approach, Chang, Fernandez-Arias, and Serven (1998) developed data on aid for 103 recipients (see figure).

There are three points worth making about this new data. First, the adjusted figure tends to be lower than the traditional measure. Second, the two series are highly correlated and produce similar results in econometric analyses. Most aid is in the form of grants, so the new approach does not have much effect on the overall measure. The macroeconomic effects of aid are the same regardless of which measure of aid is used (see chapter 1). Third, the adjusted aid figures show a sharper decline in aid in the 1990s than the OECD measure. This is because international interest rates have been low in recent years, so the aid component of concessional loans is

smaller. The amount of aid in a loan with a 2 percent interest rate is small if international interest rates are 5 percent and large if they are 10 percent.

Developments in the 1990s have sharply altered the climate for foreign aid. The end of the Cold War opened up new possibilities: with aid no longer constrained by those strategic objectives, it should be possible to make aid more efficient at meeting its primary objective of long-term growth and poverty reduction.<sup>3</sup> Yet, given budget problems and rising private flows, donors are clearly rethinking the importance and value of foreign assistance.

## New Thinking on Development Strategy

Foreign aid, just one way of promoting development, must fit within a broad overall strategy. Past domestic and international political conditions and beliefs about development strategy structured organizations, instruments, and implementation of aid. But those beliefs have undergone enormous, and accelerating, change.

In the early days of development assistance, government was seen as the positive agent for change. Domestic markets in developing countries were thought to be nonexistent and incapable of growth. International markets were tainted by the association with colonialism, as well as by the collapse of markets for commodities and credit in the Great Depression of the 1930s. In many developing countries the first flush of independence created optimism about new governments as agents of political, social, and economic change. Government-to-government aid had a plausible claim as the best way to promote development.

### Box 3. Defining Sound Management: Good Policies and Institutions

Sound management consists of the institutions and policies that will lead to rapid development and poverty reduction in a particular country. Developing countries learn about good and bad policies from their own experience and each other's experience. Sound management is difficult but not impossible to measure using a number of proxy indicators.

The index of economic policy used in box figure 3 combines three factors that have been shown in empirical studies to affect developing countries' growth: inflation, the budget surplus, and trade openness, as measured by Sachs and Warner (1995). A country with poor policies would be one with high inflation, large fiscal imbalances, and a closed trade regime (Nicaragua in the 1980s, for instance). An example of good economic policy would be Uganda in the mid-1990s.

The measure of institutional quality involves an assessment of the strength of the rule of law, the quality of public bureaucracy, and the pervasiveness of corruption. As the crisis of 1997-98 has shown, Indonesia is a country with poor institutional quality. Botswana, with its high-quality institutions, is a different story.

As donors make more of an effort to support good management, they likely will want to broaden the measure beyond the macroeconomic and institutional features illuminated here. For example, efforts to improve education and health are critical for successful development. And government support to agricultural research and extension and to community solidarity efforts made an important contribution to East Asia's success (Ishikawa 1960, 1978). The general point is that the definition of "good management" emerges from the actual experiences of developing countries.

Development economists believed not only that poor countries were held back primarily by a lack of physical and human capital (which was, and remains, true) but also that domestic poverty and international market failures denied developing countries access to investment funds needed for economic growth.<sup>4</sup> Calculating countries' growth "requirements" of investment finance or foreign exchange (or both)—and comparing them with what was available—emphasized the size of the gaps to be filled. The natural tactical response was to fill the gaps with foreign aid through transfers of investible foreign exchange. If money was the problem, then "moving the money" was an appropriate objective for aid and aid agencies. The contribution of aid could then be measured in dollars.

Sadly, experience has long since undermined the rosy optimism of aid-financed, government-led, accumulationist strategies for development. Suppose that development aid only financed investment and investment really played the crucial role projected by early models. In that case, aid to Zambia should have financed rapid growth that would have pushed per capita income above \$20,000, while in reality per capita income stagnated at around \$600 (figure 3). The past 20 years have seen the death of centrally planned economies, stagnation in the leading import-substituting models of the 1970s (Mexico and Brazil), and broad economic failure (if not absolute disintegration) of post-independence Africa, which pursued a state-led strategy.<sup>5</sup> The past 20 years have also seen waves of spectacular increases in incomes and exports of East Asian economies—first, Korea, Taiwan (China), Hong Kong (now returned to China), and Singapore, followed by Thailand, Malaysia, Indonesia, and, after important economic reforms, China; the emergence of Chile as the most dynamic Latin American economy and the recent recovery of others; and successes in Africa, such as Botswana and Mauritius. The evidence suggests that rapid development is possible, and should be based on markets and on effective states playing an economically important facilitating, but not dominant, role.

So, there have been three phases of development thinking. In the first, market failures were seen as pervasive and complete, and government as the only solution to all ills. In the second there was a brief period when government failure was seen as pervasive and complete, and markets (if not the solution) as the only hope. Today's third view—pragmatic but not ideologically satisfying—is that both markets and governments have pervasive failures but that these usually are not complete. This emphasizes that government should focus on areas where the problems in the absence of intervention are greatest—but government must have the capacity to improve the situation. "We need to recognize both the limits and strengths of markets, as well as the strengths, and limits, of government interventions aimed at correcting market failures" (Stiglitz 1989, p. 202).

The development strategy emerging from this view is two-pronged—put in place growth-enhancing, market-oriented policies (stable macroeconomic environment, effective law and order, trade liberalization, and so on) and ensure the provision of important public services that cannot be well and equitably supplied by private markets (infrastructure services and education, for instance). Developing countries with sound policies and high-quality public institutions have grown much faster than those without—2.7 percent per capita compared with -0.5 percent per capita (box 3). Put simply, failures in policymaking, institution building, and the provision of public services have been more severe constraints on development than capital markets.

Together with the new strategy comes a broader agenda. Early development practice focused on growth of per capita income. But in reality, developing countries are concerned with broad improvements in the quality of life—higher incomes, yes, but also reduced poverty, advances in literacy and health, and environmentally sustainable development. The new agenda is reflected in the goals set forth by the donor community, in consultation with developing country partners:

- Reducing by one half the proportion of people living in extreme poverty by 2015.
- Achieving universal primary education in all countries by 2015.

- Making progress toward equality of the sexes and the empowerment of women by eliminating disparities in primary and secondary education by 2005.
- Reducing by two-thirds the mortality rates for infants and children under age 5 and by three-quarters maternal mortality—both by 2015.
- Providing access through the primary health care system to reproductive health services for all women and girls of child-bearing age as soon as possible and no later than 2015.
- Implementing national strategies for sustainable development in all countries by 2005 to ensure that losses of environmental resources are reversed both nationally and globally by 2015.

These goals are elaborated on in *Shaping the 21st Century: The Role of Development Cooperation*, produced by the Development Assistance Committee ([box 4](#)).

#### **Box 4. Functions of the Development Assistance Committee**

Since its inception in 1960, the OECD's Development Assistance Committee (DAC) has functioned as the principal strategy-setting and policy and performance review organ of the major bilateral donors.

Bilateral aid programs are not conceived and implemented in a political vacuum. Indeed they are subject to considerable domestic pressures from political and commercial interest groups in the donor countries. And bilateral aid agencies can be subject to the same kinds of disbursement-driven dynamics as multilateral development banks, creating incentives for staff to be approval-focused rather than result-focused. They can also be more concerned to show the national flag on their development projects than to join collective sector improvement efforts in which donor identities are merged.

The DAC has been the forum where the major donors have worked to keep their programs focused on development objectives, to promote coordination, and to review aid effectiveness. Every three years, each DAC member is subject to an examination of its aid policies and performance by the other members of the Committee, based on studies by the OECD staff and led by two specially designated "examiners" drawn from the Committee. These Development Cooperation Reviews, including the conclusions reached by the DAC, have been published since 1994.

Over the last decade and a half, the DAC has codified and published a comprehensive set of Principles for Effective Aid. These guidelines and best practices cover key policy orientations and operational issues in central areas of aid management such as coordination, project assistance, program assistance, technical assistance, procurement, and evaluation—as well as for such basic dimensions of development as participation and good governance, environment, and gender equality.

The DAC's Working Party on Aid Evaluation brings together the heads of the evaluation units of bilateral and multilateral development agencies to work on evaluation capacities in developing countries.

*Source:* Contributed by DAC staff.

All this points to a different role for aid. Development assistance is more about supporting good institutions and policies than providing capital. Money is important, of course, but effective aid should bring a package of finance and ideas—and one of the keys is finding the right combination of the two to address different situations and problems.