

Development Research Group

Knowledge in Development Note 6

Aid and the Millennium Development Goals

June 2007

The MDGs set forth a series of quantified targets for achieving progress on various aspects of development between 1990 and 2015. Some of these targets, including the key goal of reducing by half the proportion of people living on less than a dollar a day, is expected to be met worldwide. But in the Africa region overall, none of the targets are expected to be achieved. Progress is widely believed to depend in part on increased aid volumes, but also on improvements in the ability of developing country governments to use resources effectively.

Support for increased aid by taxpayers and parliaments in donor countries depends on demonstrating that aid has sustained positive impacts on development in recipient countries. Ineffective aid programs risk undermining support for the increases in aid envisioned in the 2002 Monterrey Consensus which called for developed countries to devote 0.7 percent of their GNP to official development assistance (ODA).

Research can help inform donor agencies and their constituencies on the effectiveness of alternative approaches to aid. Is aid more effective in certain policy and institutional environments? Is aid more effective at achieving the MDGs when targeted to certain sectors? Is aid fungible across sectors? How can donors design and implement more successful projects? When should aid be provided as budget support, or as project aid, or as technical assistance? Do successful donor-funded projects aggregate to a successful program? Should aid be redirected drastically toward scaling up proven interventions, and away from interventions that have not been (or cannot be) subject to rigorous impact evaluation?

What we know

Targeting aid to priority sectors is difficult

- It is difficult for donors to ensure that aid earmarked for favored sectors, such as health, education, or infrastructure, is fully additional, even if aid is provided mostly for projects. In general, when a donor provides aid for investment in a sector, much of it is passed through as investment in other sectors, as non-investment public spending, or as a reduction in tax revenues.¹
- Pending any new evidence from the Heavily Indebted Poor Countries' (HIPC) experience, donors should assume that aid is largely fungible across sectors, and the Millennium Project's goal of directing a greater share of aid toward priority sectors is mostly illusory.

Aid generally is an ineffective tool for encouraging market-liberalizing policy reform

- Most empirical studies have concluded that there is no relationship between aid and policy reform, for adjustment loans in particular and for aid in general.²
- One study even finds that policy reform in the 1980s was faster where aid volumes were *lower* (correcting for reverse causation and controlling for other factors).³
- Conditionality appears to be effective only in the early stages of reform, when it can bolster the position of reform advocates in government.⁴
- The World Bank use of conditions has fallen sharply since the late 1980s, and the content of conditionality has shifted from short-term economic adjustments to institutional reforms in social sectors and in public sector governance.⁵

Aid can have unintended adverse effects on accountability and capability of governments

- Countries receiving higher aid levels (other things equal and correcting for possible reverse causation) tend to exhibit a deterioration in their quality of governance.⁶ Industries more dependent on strong public sector institutions – as proxied by levels of intermediate-goods purchases from other industries – grow more slowly in countries with higher aid inflows.⁷
- There is some evidence that aid’s negative impact on the quality of governance tends to be greater where aid is “fragmented” among a larger number of donors.⁸

Project success is determined by country performance, but also by donor performance

- There is strong evidence that World Bank projects are more successful in countries with better policies and institutions.⁹
- World Bank aid, particularly IDA aid, has become better targeted toward countries with more favorable policy and institutional environments.¹⁰
- Studies have found that donor-controlled variables have no impact on the success of World Bank adjustment programs,¹¹ but can affect the performance of World Bank projects.
- Studies have found that more resources devoted to country analytic work,¹² and to project supervision,¹³ have a positive impact on the performance of World Bank projects.
- The quality of the project, as designed by the donor, is the most important determinant of project success, but it is tied to recipient country characteristics: good policy environments tend to receive good projects, while bad environments tend to receive bad projects.¹⁴

Ongoing research inquiries

Does aid effectiveness depend on the quality of the policy and institutional environment?

- Recent analyses show that the earlier cross-country conclusion that aid contributes to growth only in a favorable policy environment¹⁵ is not robust when using an updated and expanded dataset.¹⁶
- More generally, cross-country growth regressions have not produced a consensus on the impact of aid, whether unconditional or conditional, on policy or other variables. The most common finding in these regressions is diminishing returns to aid: aid is positively associated with growth up to a point, beyond which additional increases in aid are associated with lower growth.

What forms of aid contribute the most to development?

- One study finds that aid contributes to short-run growth in per capita income, when humanitarian aid and aid for education and institution-building are excluded on grounds that they either should not affect growth or would affect it only in the long run.¹⁷ However, this study does not address the question of whether categories of aid one would expect to contribute to long-run growth actually do so. Its findings also appear to conflict with evidence on fungibility of aid: to the extent that aid is fungible, disaggregating aid by various categories is not very meaningful, because governments can use aid earmarked for infrastructure for education if they wish.
- The trend toward greater budget support at the expense of project aid suggests a need for more research on the desirability of one versus the other, in different environments (such as strong or weak public expenditure management systems). An argument for more budget support is the tendency of project-based aid to undermine the capacity and accountability of government institutions. Yet anecdotal evidence suggests that the move toward budget support is accompanied by greater donor intrusiveness on the composition of the budget. As donors and recipients gain more experience with budget support, they may learn more about its potential deficiencies, as they have with project-based aid.

How can aid be made more predictable?

- Aid commitments by donors are a poor predictor of actual aid disbursements. Aid levels tend to be more volatile than fiscal revenues; moreover shortfalls in aid and in fiscal revenues tend to coincide.¹⁸
- There is some evidence that aid volatility has worsened in recent years. This trend may be partly a function of (1) the trend towards budget support and away from project aid, and (2) increased reliance on performance-based aid allocation systems.

- A Bank study¹⁹ provides recommendations for minimizing the problem of aid unpredictability. Simple spending and savings rules built around a buffer reserve fund of 2-4 months of imports can help smooth public spending. Aid can be pre-committed several years ahead with only small efficiency losses resulting from misallocation to poor performers, using a strategy of “flexible pre-commitment.” Guidelines can be set to limit the volatility of budget support while keeping it performance-based.

Future research directions

Can donors make public spending more “pro-poor” in aid recipients?

In HIPC countries donors have taken stronger steps to ensure that resources made available by debt relief are used to increase categories of public spending considered to be “pro-poor.” Research could investigate whether donors are more effective in this set of countries in ensuring that aid for pro-poor categories of spending are truly additional.

What variables best predict how well aid is used? Is aid overall becoming better targeted over time toward countries with favorable policy and institutions?

- As new measures of the quality of public expenditure systems and other measures of policies and institutions become available for large numbers of countries, research can explore whether the impact of aid is conditional on these measures.
- If aid is fungible across donors, any effects of targeting by the IDA, MCA, or similar performance-based allocation systems can potentially be nullified by other donors. Cross-country data on aid flows over time can help determine whether performance-based aid systems affect aggregate flows.

What are the impacts of aid and donor policies on human resource management in recipient countries?

- To what extent does large-scale aid have “Dutch disease” effects of bidding up wages for workers with skills in demand by donors?
- To what extent does aid divert talented staff from government agencies to better-paying jobs with donors? How can these problems best be mitigated by, say, changing donor incentives or providing budget support conditional on civil service pay restructuring? Case study and micro-level evidence could be useful—for example, tracking the employment of persons ranking highly on Pakistan’s civil service exam.

How can impact evaluation best be used to guide aid decisions?

- Although some have argued that “development” is an over-ambitious goal for aid given the limited knowledge we have on how to accomplish it,²⁰ the Bank has made significant progress in learning what works, what doesn’t and why. Impact

evaluation has been developed in numerous Bank projects and is building the evidence base for how to make aid more effective.

- Despite its importance, however, demonstrating that particular interventions are associated with improved outcomes is only part of the story in deciding how far to scale them up. The generalizability of findings is often problematic. Aid may support projects that the government would have financed anyway; donors may “cherry pick” those with the highest chance of success. And because resources are fungible, aid may in fact be allowing the government to finance unproductive investments. In such cases, establishing a counterfactual is difficult.
- Projects may have spillover effects that are difficult to measure. When it supports projects that show better ways of attaining outcomes, aid has a valuable demonstration effect, and a narrowly defined “impact evaluation” would miss this effect. Spillover effects can also be negative, however. For example, project success may be enhanced by hiring high-quality administrators away from government jobs where social returns to their labor are higher. Attempting to identify and measure these spillovers is an important but difficult area for research.
- Aid funds should not necessarily be reallocated from interventions that have not been (or cannot be) rigorously evaluated to scale up interventions demonstrated to succeed. The potential payoff contingent on success must be considered, as well as the likelihood of success. Some types of interventions—for example, reforming the budgeting processes of central governments—cannot be subject to randomized experimentation, but their potential payoffs may be extraordinarily high. Designing more rigorous evaluations of these interventions, where randomization is impractical and the degrees of freedom for analysis are limited, is an important research challenge.

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Endnotes

Most Bank documents cited in this summary are available through the documents and reports portal of the World Bank <http://www-wds.worldbank.org/>. The word “processed” describes informally reproduced works that may not be commonly available through library systems.

¹ World Bank. 1998. *Assessing Aid: What Works, What Doesn't, and Why: A World Bank Policy Research Report*. Washington, DC: World Bank and Oxford University Press. Also see T. Feyzioglu, V. Swaroop and M. Zhu. 1998. “A Panel Data Analysis of the Fungibility of Foreign Aid.” *World Bank Economic Review* 12(1): 29–58. On a specific example from Vietnam, D. van de Walle and R. Mu. Forthcoming. “Fungibility and the Flypaper Effect of Project Aid: Micro-Evidence for Vietnam.” *Journal of Development Economics*.

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⁵ World Bank. 2005. *Review of World Bank Conditionality*. Operations Policy and Country Services Department, World Bank, Washington DC.

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⁷ R. Rajan, and A. Subramanian. 2007. "Does Aid Affect Governance?" *American Economic Review Papers and Proceedings* 97(2): 322-327.

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⁹ D. Dollar and V. Levin. 2005. "[Sowing and Reaping: Institutional Quality and Project Outcomes in Developing Countries](#)." Policy Research Working Paper 3524, World Bank, Washington, DC.

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¹³ C. Kilby. 2000. "Supervision and Performance: The Case of World Bank Projects." *Journal of Development Economics* 62: 233–59.

¹⁴ W. Wane. 2004. "[The Quality of Foreign Aid: Country Selectivity or Donors' Incentives?](#)" Policy Research Working Paper 3325, World Bank, Washington, DC.

¹⁵ C. Burnside and D. Dollar. 2000. "Aid, Policies, and Growth." *American Economic Review* 90(4):847–68.

¹⁶ W. Easterly, R. Levine, and D. Roodman. 2004. "Aid, Policies, and Growth: Comment." *American Economic Review* 94(3):774–80.

¹⁷ M. Clemens, S. Radelet, and R. Bhavnani. 2004. "Counting Chickens When They Hatch: The Short-Term Effect of Aid on Growth." Working Paper 44. Center for Global Development, Washington, D.C.

¹⁸ A. Bulir, and A. Javier Hamann. 2003. "Aid Volatility: An Empirical Assessment." *IMF Staff Papers* 50(1): 64-89.

¹⁹ B. Eifert, and A. Gelb. 2005. "[Improving the Dynamics of Aid: Towards More Predictable Budget Support](#)." Policy Research Working Paper 3732, World Bank, Washington, DC.

²⁰ W. Easterly. 2007. "Was Development Assistance a Mistake?" *American Economic Review Papers and Proceedings* 97(2): 328-332.