

SYMPOSIUM
IRELAND'S POLICY TO AFRICA: TRADE AND AID

Strategic Aid allocation in the 21st Century: Lessons from the 1980's and 1990

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Abstract: An evaluation of recipient countries' experience with foreign aid in the 1980s and 90s shows that there is plenty of evidence that policy conditionality has by and large failed, and that there is no evidence that the policy conditions attached to aid have by and large been appropriate. In that light, is the currently advocated move in aid allocation away from policy conditionality and towards selectivity and recipient ownership of its reform programme therefore appropriate? The paper argues that the evidence on aid effectiveness in the 1980s and 90s suggests otherwise.

1. INTRODUCTION

William Easterly asks in his new book, *The White Man's Burden* (Easterly 2006), why \$2.6 trillion in aid has failed to deliver 12-cents a dose anti-malaria treatment to dying children, and expresses considerable and angry scepticism at the notion that a doubling of aid, as suggested in various well-intentioned quarters, will on its own succeed in achieving this. Easterly's answer to the question why aid has failed to reach the poor is that the aid agencies and international organisations involved are preoccupied with Big Plans that presume a degree of knowledge and understanding about poor country economies that these agencies and organisations do in reality not possess. Lack of accountability to Western (and Japanese) tax payers and lack of feedback from the poor are among the reasons that this unhealthy preoccupation is allowed to persist. The challenge for aid is to find out what works for the poor, not through Big Plans, but through practical, concrete, usually small steps forward, with accountability and feedback mechanisms for every step of the way.

If that is the challenge, then what should strategic aid allocation involve? In this paper, I evaluate the evidence on the effectiveness of aid in the 1980s and 90s and ask whether aid agencies have drawn the right lessons from this evidence. In their rhetoric they have expressed the desire to move away from policy-based aid conditionality (which they rightly perceive to have largely failed) towards selecting countries for the receipt of financial aid that will make good use of it, and towards recipient government ownership of its policy reform programme (Section 2). Their rhetoric is to varying extents matched by their practice (Section 3). Furthermore, Easterly's

assessment of the root cause of aid failure that aid policy presumes more knowledge than aid agencies possess still applies (Section 4). The paper argues that the evidence on aid effectiveness in the 1980s and 90s suggests that tough spending conditionality is appropriate in weak institutional environments so as to ensure that aid reaches its intended beneficiaries; that selectivity should take place on the criteria of the level of poverty and the potential for change of policies; and that financial transfers may facilitate recipient ownership of policy reform and should therefore not as a rule be postponed until such ownership is in evidence (Section 5).

2. THE EVOLUTION OF CURRENT THINKING ON AID

We have now had some five decades of experimenting with international aid. In the 1950s and 60s the emphasis was on large-scale aggregate resource transfers, on “filling the financing gap” required for rapid economic growth. It transpired that large-scale aggregate resource transfers do not automatically bring about economic growth (Easterly 2002). In the 1970s the emphasis shifted to ‘redistribution with growth’, to financing individual projects designed to benefit the poor directly. It transpired that the success of these projects depends crucially on the overall quality of the policy environment (e.g. World Bank 1998). In the 1980s and 90s a colossal effort was thus undertaken to bring about comprehensive improvements in the quality of poor countries’ policy environments. Governments of these countries received low interest loans (which, with grants, make up Official Development Assistance, or ODA, in the OECD definition) from the World Bank and the IMF conditional on implementing structural adjustment programmes (SAPs). Conditions attached to loans pertained to abolishing price controls, fiscal adjustment, trade liberalisation, privatising state enterprises, reforming inefficient financial systems, removing any policy bias against the sector agriculture, improving the efficiency of tax collection and public spending, and reforming and downsizing the civil service (e.g. Easterly 2005). After a good 20 years of experience with policy-based or conditional lending, what is the evidence of its impact? This question has been researched in a very large number of studies.

One set of studies has looked primarily at the extent of compliance with conditions. The broad consensus of this literature is that, by and large, policy conditionality in the sense of compliance with conditions attached to loans, has failed (World Bank 2005a). Here are but a handful of examples. Devarajan et al. (2001) in a study of ten African countries that received large amounts of programme aid find that only three of them (Mali, Ghana and Uganda) reformed successfully, whereas aid actually postponed reform in Kenya, Nigeria, Tanzania and Congo. Botchwey et al. (1989) likewise find many instances of cases where governments did not adopt the reforms agreed upon with donors. For example, the government of Zambia reached an agreement with the IMF to abolish price controls, but in practice continued to enforce them. Killick et al. (1998) find that in 100 World Bank adjustment programmes, slippages occurred in more than 75% of cases. Another set of studies looks at the determinants of compliance rates. Killick et al. (1998) find in a sample of 21 countries that governments selectively comply with those conditions that they believe best serve their interests. Dollar and Svensson (2000) establish econometrically that domestic political variables, which they take as an indicator of “willingness to reform”, determine the compliance rate. Mosley et al. (2003) challenge that analysis and suggest that, instead, the actual, tangible, early results of SAPs determine compliance rates. The latter finding may be revealing in that it suggests that policy conditions were not necessarily appropriate, and that the extent of their appropriateness is actually – quite rationally – a key determinant of a recipient’s inclination to comply with these conditions. So how appropriate were the SAP conditions?

A third set of studies looks at the outcomes associated with implementing SAP conditions. A key methodological problem here is to identify the counterfactual: what would have happened if the SAP had not been implemented? To use an analogy, if I push you on to a cycle path where you are

hit by a bike, a moral assessment of my action hinges crucially on whether I pushed you from the pavement on which you were safely standing or from the road on which you were about to be crushed by a lorry. Easterly (2005) reviews the studies that address this so-called selection-bias problem. “This has variously been addressed by using Heckman-type selection techniques, before and after analysis, or control group methodology. [...] [T]he results from a wide range of independent researchers, World Bank and IMF studies have been all over the map, with positive, zero, or negative effects of adjustment lending on growth.” (p4). Easterly himself in the study cited deploys a new methodology for addressing the selection-bias problem that makes use of the information contained in repeated loans and confirms the findings of studies that find no effect on growth. (And economic growth, after all, is what SAPs were all about.) To sum up, there is plenty of evidence that, by and large, compliance with SAP conditions has not taken place, and there is no conclusive evidence that these conditions were by and large appropriate. These are, however, broad findings and we may conclude otherwise for individual cases. An informative example is that of Uganda. Initially, SAP conditions were not complied with, but the adjustment lending almost instantaneously did bring about growth and some relative stability (Dijkstra and Van Donge 2001), which in turn ‘bought’ a period of time for experimentation with policies that eventually led to (selective) compliance with SAP conditions, more growth, deeper stability and impressive poverty reduction (Verschoor, forthcoming).

This example is consistent with Morrissey (2002) who finds that donors can influence the agenda for policy reform but have little or no influence over its pace. I will return to the role of policy learning, and the contributing role that financial aid can play to policy learning, later in the paper (Section 4). Naturally donors – not only the Fund and the Bank but also the main bilateral aid agencies – are aware that policy conditionality has by and large failed, although it is my impression that the awareness of the poor compliance record is greater than that of the poor policy conditions that recipients were asked to comply with. In response, two new aid policy features have emerged, which I will evaluate in the next section: selectivity in aid allocation, and recipient ownership of its reform programme.

3. CURRENT DONOR PRACTICE

The extent to which the ideas of aid selectivity and recipient ownership are truly new or recycled old ideas is debatable (cf. Easterly 2006: 199-200) but what is beyond dispute is that they feature prominently in current donor rhetoric. For example, both the 2006 World Development Report (World Bank 2005b) and the 2005 Human Development Report (UNDP 2005) identify these two ideas as key components of current donor thinking on strategic aid allocation. To what extent are actual donor practices influenced by them?

Selectivity

The strategy of selecting countries for aid with good policies for their level of poverty has been advocated by World Bank (1998). The idea is simple: if good policies cannot be ‘bought’ with aid, aid ought to favour countries with good policies. The strategy is consciously adopted by most major donors, with some of them (the Netherlands, the United Kingdom) going as far as making use of formula-driven aid allocation rules that guide (though not dictate) the distribution of their aid budget (Oxford Policy Management 2005). Dollar and Levin (2004) have computed for each of 41 aid agencies how sensitive their aid allocation is to poverty and policies. A selection of their results is presented in Table 1. The sensitivity indices are derived from 41 regressions (one for each agency) of the log of aid on the log of recipient country population size, the log of GDP per capita, and the log of a World Bank policy index. They should be interpreted as the percentage response of aid to a one percent change in one aid allocation criterion, holding constant the other aid allocation criterion (and controlling for population size). For example, when for a given level

of policy and population size a country's GDP per capita goes down by one percent, the EC tends to give that country 0.51% more aid. Likewise, when for a given GDP per capita and population size a country's policy index improves by 1%, the EC tends to give that country 2.44% more aid. The figures in bold are statistically significant and suggest that most major donors are selective in their aid allocation on both the poverty and the policy criterion, and that all but two major donors are selective on at least one criterion. More generally, Dollar and Levin find that aid selectivity on policies is a relatively new phenomenon: for the period 1984-89 they cannot reject the null hypothesis that aid was allocated indiscriminately as far as recipient country policies are concerned, whereas for the period ten years later they can reject this hypothesis.

Table 1: Policy and poverty elasticity indices (2002), selected donors

Donor	Policy Index	Rank	Poverty Index	Rank
EC	2.440	12	-0.511	25
France	-0.072	30	-0.279	29
Germany	2.064	14	-0.474	26
IDA	4.233	2	-4.200	1
Ireland	1.383	21	-1.213	11
Japan	1.901	16	0.012	35
Netherlands	2.647	9	-1.271	10
Sweden	3.315	4	-1.023	18
UK	3.657	3	-1.064	16
US	0.664	27	-0.761	20
Total Aid	1.759		-0.490	

Source: Dollar and Levin (2004)

Recipient ownership

Government ownership of its reform programme has been advocated by many authors, among them Killick et al. (1998) who, inspired by their findings that governments only complied with those SAP conditions that they believed to be in their own best interests, propose that:

“Government ownership is at its strongest when the political leadership and its advisers [...] decide of their own volition that policy changes are desirable, choose what these changes should be and when they should be introduced.” (p87) Donors are currently embracing country ownership as a guiding principle for their aid allocation primarily through the Poverty Reduction Strategy (PRS) process, which was formally adopted in 2001 by the boards of the World Bank and IMF, and has subsequently been bought into by other major donors. A crucial element of the PRS process is that governments are invited to articulate their own development strategy in a Poverty Reduction Strategy Paper (PRSP), which then forms the basis for access to (further) debt relief, grants and low-interest loans. With a government “envisioning” its own development strategy in a PRSP, the process is seen to be explicitly based on country ownership, and for that reason a major improvement on previous aid-delivery mechanisms (e.g. Wolfensohn and Bourguignon 2004).

4. EVALUATING AID POLICY IN THE LIGHT OF WHAT WE KNOW ABOUT AID EFFECTIVENESS

We saw above that large-scale aggregate resource transfers in the 1950s and 60s are deemed to have largely failed, that pro-poor projects in weak policy environments in the 1970s are deemed to have largely failed, and that the mammoth task of comprehensive policy reform through aid in the 1980s and 90s is deemed to have largely failed. New aid-delivery mechanisms for the 21st century have emerged in response to the perception of past failure, in particular selectivity and ownership. It is too early to assess impact of these. But we can ask the question whether the claims about the impact that these are likely to have are consistent with what we know about aid effectiveness. In particular, I will ask the question whether donors have drawn the right lessons from the evidence on aid effectiveness in the 1980s and 90s, two decades in which policy conditionality was attempted on a massive scale and failed on a massive scale. The first thing to note is that selectivity on the level of policies and ownership of policy reform programmes (which by definition pertains to change in policies) are not mutually consistent features of a strategic aid allocation strategy. Selectivity on the level of policies is often justified with reference to the Burnside and Dollar (2000) finding that aid does not improve policies but is more effective when policies are better.

The evidence for the 1980s and 90s reviewed above does not in fact suggest that aid never changes policies: it suggests that aid sometimes does change policies (e.g. Devarajan et al. 2001), that when it does change policies, it often does so after the period to which donor conditions applied (e.g. Morrissey 2002), and that domestic political variables (Dollar and Svensson 2000) and recipients' perception of the appropriateness of the policy conditions (Mosley et al. 2003) are among the determinants of the probability that aid will change policies. In the case of Uganda, a period of conditionality failure was followed by policy learning in the form of experimenting with individual SAP conditions, with large positive effects on growth and poverty reduction (Verschoor, forthcoming). Since the duration of the period between aid and the timing of the reforms is country-specific, it is not necessarily worrying that cross-country regressions fail to detect a link from aid to policies. The conclusion that aid should be selective on the level of policies and not on potential for change is however a bridge too far. If applied in the past, it would have failed to give aid to Uganda, which became a successful reformer because of aid. The second thing to note is that the international distribution of aid is decided at too disaggregated a level for the optimal distribution (however computed) to come about. International aid agencies pursuing selectivity in isolation will only by fluke jointly realise the collective optimum. Some aid agencies (e.g. the UK's Department for International Development) take other donors' behaviour into account in their aid allocation decisions, but the aggregate distribution of aid is far from being optimally coordinated (Oxford Policy Management 2005). For selectivity to be pursued optimally, the international aid architecture will have to be able to accommodate such coordination. The third thing to note is that almost all of the evidence of conditionality failure pertains to SAP conditions.

Donors, especially bilateral ones, have stated objectives other than structural adjustment, the most prominent of which would be to influence the pro-poor orientation of a recipient's public spending patterns. Despite some concerns about aid money being fungible (World Bank 1998), the evidence of aid's impact in the 1980s and 1990s strongly suggests that aid is able to influence the pro-poor orientation of public spending patterns in low-income countries, and through that channel impact on social indicators (Mosley et al. 2004, Gomanee et al. 2005a, Gomanee et al. 2005b, Kalwij and Verschoor, forthcoming). From this literature, it transpires that four things are helpful for such aid impact to materialise: an effective platform on which donors and recipient jointly decide on spending priorities, such as a reasonably operational Medium-Term Expenditure Framework (MTEF); an assessment of the proportion of allocated funds that reach intended users, such as

Public Expenditure Tracking Surveys (PETS); an assessment of the extent to which intended beneficiaries actually benefit, for example through benefit incidence analysis (BIA); and a graduated punishment rule for non-compliance with spending conditions (as opposed to an incredible all-or-nothing threat of aid withdrawal). The fourth thing to note is that conditioning aid on owned reforms is analytically indistinguishable from conditioning aid on alien reforms when donors cannot tell the difference between these two types of reforms. This is not merely an academic point.

The literature suggests that policy conditionality has failed because recipients do not perceive reforms to be in their best interests (Killick et al. 1998), because donors have objectives other than policy reform, such as defensive lending (Collier 1997), and because of domestic political factors (Dollar and Svensson 2000). These factors operate together so that, for example, a recipient government under pressure of powerful domestic lobbying decides not to comply with donor conditions, the more so when it anticipates that non-compliance will not be punished because the donor will engage in defensive lending. The same factors may also undermine ownership in the PRS process (cf. Gunning 2001). An impeccable PRSP is no guarantee for impeccable implementation. If an impeccable PRSP attracts money, then incentives are created for writing an impeccable PRSP (Uganda's PRSP was written by external consultants), which may reflect to a larger extent a government's (or its hired consultants') beliefs about donor preferences than its own preferences for reform. Conditions are imposed in a roundabout way and are no more likely to be implemented than the conditions that are directly imposed (as in previous, hard-core conditionality). The possibility that recipients disingenuously signal ownership of reforms, when donors are not in a position to verify true ownership, may undermine true ownership for exactly the same reasons that hard-core conditionality does.

A way round the problem of faked ownership is to insist on a track record of reform, on a period of time during which recipients act out their good intentions. Donors would thus "come in behind reforms rather than anticipating them. For the early stages of reform, perhaps the first three years, the government would be reforming without aid, establishing a good policy environment" (Collier 1997: 72). A potential problem with this position is that reform-minded governments may not hit on the right reforms straight away. The case of Uganda is again informative.

The government of Uganda needed a period of policy learning before it realised that some of the SAP conditions would serve it well. This period of policy learning was made possible because a large amount of financial aid contributed to macro-economic stability and to economic growth (Verschoor, forthcoming).

5. LESSONS

Selectivity and ownership – which both in new (or 'old recycled') and not entirely mutually consistent ways condition aid on past policy reforms – have emerged as prominent features of 21st century donor thinking and practice in response to the widespread policy conditionality failure of the 1980s and 90s. By contrast, my reading of the evidence on aid effectiveness during this period suggests that selectivity on the level of policies may be a bridge too far, and that the assessment of ownership is a quagmire. Specifically, I come to the conclusion that three modifications are called for to current donor thinking and practice: financial aid may contribute to policy learning and thereby to ownership of appropriate policies and should not therefore be as a rule be delayed until ownership is in evidence; identifying reform-mindedness rather than good current policies is crucial for selectivity; conditionality is appropriate when the issue is ensuring that aid-financed pro-poor spending reaches the poor.

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