

Are aid agencies improving?

SUMMARY

The record of the aid agencies over time seems to indicate weak evidence of progress in response to learning from experience, new knowledge, or changes in political climate. The few positive results are an increased sensitivity to per capita income of the recipient (although it happened long ago), a decline in the share of food aid, and a decline in aid tying. Most of the other evidence – increasing donor fragmentation, unchanged emphasis on technical assistance, little or no sign of increased selectivity with respect to policies and institutions, the adjustment lending-debt relief imbroglio – suggests an unchanged status quo, lack of response to new knowledge, and repetition of past mistakes.

— William Easterly

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1. INTRODUCTION

For long-time observers of foreign aid, the recent wave of attention to ‘make poverty history’ in Africa and other poor countries has some disquieting signs. The United Nations, the World Bank, the International Monetary Fund (IMF), and the national aid agencies have signed on to an ambitious project called the ‘Millennium Development Goals’, in which poverty rates, infant mortality, and other key indicators of low development would be dramatically reduced by the year 2015. To achieve this, aid agencies have embraced and advocated a programme of large aid increases. There is a long debate about how effective is foreign aid at creating economic development and eliminating poverty, going back to Rostow (1960), Chenery and Strout (1966), Bauer (1972), Cassen (1987), World Bank (1998), the UN Millennium Project (2005a), Sachs (2005), and Easterly (2006). Yet despite sharply contrasting views on the effectiveness of aid, there is a surprising degree of unanimity that the aid system is today deeply flawed and could be much improved. For example, UK Prime Minister Tony

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Blair's Commission for Africa (2005), which called for large increases in aid to Africa, had this to say:¹

'the system for allocating aid to African countries remains haphazard, uncoordinated and unfocused. Some donors continue to commit errors that, at best, reduce the effectiveness of aid. At worst, they undermine the long-term development prospects of those they are supposed to be helping. Rich countries pursue their own fixations and fads . . . They tie aid so that it can only be used to buy the donor's own products or services – effectively reducing the value of aid by as much as 30 per cent. . . . They continue to attach unnecessarily detailed conditions to aid packages. They insist on demanding, cumbersome, time-consuming accounting and monitoring systems – and refuse to link with the recipient's systems. They are insufficiently flexible when it comes to reallocating aid to new priorities in the face of a national emergency.' (p. 58)

Similarly, the UN Millennium Project (2005a) led by Jeffrey Sachs, one of the most emphatic proponents of increased aid, has a chapter in its main report entitled 'Fixing the aid system', which begins:

'Many national strategies will require significant international support. But the international system is ill equipped to provide it because of a shortage of supportive rules, effective institutional arrangements, and above all resolve to translate commitments to action.' (p. 193)

The companion Overview Report (UN Millennium Project, 2005b, pp. 38–39) complains that 'Development finance is of very poor quality' (referring to bilateral aid) and that 'Multilateral agencies are not coordinating their support.'

This dissatisfaction with the aid system is not new. Indeed, one of the important early statements of foreign aid policy, John F. Kennedy's 1961 message to Congress proposing a large increase in foreign aid, begins with the statement: 'Existing foreign aid programs and concepts are largely unsatisfactory and unsuited for our needs and for the needs of the underdeveloped world as it enters the sixties.'

Another early statement of problems in foreign aid, the landmark Pearson Commission on foreign aid in 1969, makes complaints that echo current complaints, as set out in Table 1.

Do the recent statements simply reflect dissatisfaction with aid being less than perfectly optimal? Have aid agencies actually made some progress over time on these chronic problems?

In order to evaluate aid agency progress, we need some benchmark of how aid agencies would optimally behave, and what would be the optimal transition path from the initial state towards that behaviour. It would be very difficult to specify such optimal behaviour without a lot of good evidence and theory (presently lacking) about the payoff to many different aid agency interventions, especially when there are so many different things that aid agencies do.

¹ Some authors span the different generations of debate – Stern (1974) dismissed the critique of Bauer, and the same author was in charge of the Blair Commission for Africa (2005).

Table 1. Chronic problems in aid, past and present

| Aid problem or idea | Pearson Commission (1969) | Contemporary statements (2005–2006) |
|---|--|--|
| More aid to poorest countries | ‘IDA [International Development Association of the World Bank] has decided to make a special effort to assist the poorest members in project preparation so that they can benefit more fully from IDA financial assistance’ (p. 226). ^a | The Commission for Africa (2005, p. 99) calls for ‘allocating aid to countries where poverty is deepest’. |
| Donor coordination is a problem | ‘the present multiplicity of agencies and their lack of coordination leads to much unnecessary duplication of effort’ (p. 228). | UNDP (2005): ‘weakly coordinated donors, many of them operating overlapping programmes’. |
| Be selective about to whom you give aid | ‘increased allocation of aid should be primarily linked to performance’ (p. 133). | IMF and World Bank (2005, p. 168): ‘Broad consensus has emerged that development assistance is particularly effective in poor countries with sound policy and institutional environments.’ |
| Aid tying is a problem | ‘aid-tying imposes many different costs on aid-receiving countries . . . [costs] frequently exceed 20 per cent’ (p. 172); the donors should ‘consider the progressive untying of bilateral and multilateral aid’ (p. 189). | The IMF and World Bank (2005, p. 172): ‘Untying of aid significantly increases its effectiveness’ and ‘donors agreed to continue to make progress on untying aid’ (p. 173). UNDP (2005, p. 102) notes ‘price comparisons have found that tied aid reduces the value of assistance by 11%–30%’. |
| Move away from Food Aid | ‘one of the most conspicuous forms of tying aid has been food aid . . . it has sometimes also allowed some low-income countries to neglect agricultural policy’ (p. 175). | The IMF and World Bank (2006b, p. 83): ‘transfer of food in kind was found to be about 50 percent more costly than locally procured food and 33 percent more costly than food imports from a third country’. |
| Technical assistance is a problem | ‘technical assistance often develops a life of its own, little related in either donor or recipient countries to national or global development objectives’ (p. 180). | The IMF and World Bank (2006b): technical assistance ‘is often badly coordinated among donors and poorly prioritized’. |
| Debt relief | ‘There has already been a sequence of debt crises . . . debt service problems of low income countries will become more severe (p. 72). ‘We recommend that debt relief avoid the need for repeated reschedulings’ (p. 157). | Commission for Africa (2005, p. 328): ‘For poor countries in sub-Saharan Africa which need it, the objective must be 100 per cent debt cancellation as soon as possible . . . the relief provided under [recent initiatives] has not been wide enough, or deep enough’. |

^a IDA is the pure ‘aid’ part of the World Bank. It was set up in 1960 to provide highly concessional loans to the poorest countries. The rest of World Bank lending is not considered aid, since it is loans at market interest rates to middle income countries.

This paper takes a different tack – it adopts as the benchmark what the aid agencies (and consultants to the aid agencies) themselves state to be desirable behaviour. The paper is thus investigating the gap between what aid agencies say would be good behaviour and the way they actually behave; ‘progress’ is defined as closing this gap.

Among the vast array of possible aid behaviours, the paper selects the ones that have been the subject of most of the self-criticisms of aid agencies (such as those listed above), and the ones about which there is more consensus on what is 'good' behaviour (these two criteria fortunately overlap quite a bit). This paper thus contributes insight into how much self-correcting behaviour takes place in aid. However, it does not address other very important topics, such as whether the aid agency consensus on good behaviour is actually correct on theoretical or empirical grounds. There is also some arbitrariness and judgment calls involved in the selection of behaviours to evaluate and the consensus against which these behaviours are judged (although the paper will document this consensus as much as possible in the short space available). Thus, the paper can only test a restricted sense of aid progress – are aid agencies doing more of what they themselves say they should be doing more of? – not a general statement of progress towards optimal behaviour in the abstract.

The transitional dynamics towards the aid agencies' self-described 'good behaviour' would likely involve at least two types of changes: (1) aid agency learning, and (2) aid agency responses to increased political support for the true goal of foreign aid – that is, helping the world's poor.

Learning could come at least from three sources: (1) cumulative experience at dealing with some of the chronic problems of foreign aid, (2) reacting to new knowledge in economic research, and (3) reacting to failure. The paper will analyse changes in response to experience to analyse (1), and draw on well-defined episodes of new knowledge and failure to analyse (2) and (3).

There are also powerful political and organizational incentives that drive aid behaviour. Changes in the outside political environment could change these incentives in a positive way that leads to aid progress, for example the reduced incentive to give aid to corrupt or autocratic allies after the end of the Cold War. A benchmark for aid agency progress is that we would expect some improvement in allocating aid towards the most needy and the most institutionally healthy countries (for a given level of income) after the end of the Cold War.

I will try to distinguish learning from changes in political environment wherever possible. However, the two are not completely separable. One of the facets of learning for the aid community as a whole is how to resist or change bad political or organizational incentives so as to make progress towards the real objective of foreign aid – the alleviation of poverty.

What is the alternative hypothesis to aid agency improvement? The most obvious alternative would be stasis, i.e. zero progress. If we detect an absence of progress in cases where the lessons of experience, new knowledge, or previous failures seem painfully obvious, then that may be explained by insuperable political pressures and organizational incentives. Aid agencies may be caught in the kind of bureaucratic paralysis described in the classic work of Wilson (1989). In terms of political economy, the political equilibrium may be static, despite the appearance of some changes in political pressures. Hence, the testable distinction between the two hypotheses is

simply that if there is positive progress, we favour the first hypothesis, while if there is zero progress, we favour the second. For the usual statistical reasons, zero progress would be the null hypothesis and we will see if we can reject that hypothesis.²

We can get additional insight into progress and its sources by analysing separately the behaviour of five major donors: the World Bank (International Development Association or IDA for aid), the US, UK, France and Japan, who had different political environments. The World Bank often took the lead in announcing major policy shifts like increased sensitivity to poverty (1973), to country policies (1980), and to institutional measures like corruption (1996). We would naturally expect the World Bank of the donors to be the most likely to follow its own advice. The US was obviously the main protagonist in the Cold War, so we would expect it to have experienced the most change after its end in 1989. The UK, France and Japan do not have such obvious break points in their aid behaviour, although they may have been influenced by all of the above. We might expect a smooth trend towards increased sensitivity towards need, policies and institutions in these three donors. The UK and France might provide an interesting contrast to Japan, since their aid allocations may have initially been driven by colonial ties (which Japan did not have to the same extent), and the colonial ties may have faded over time in favour of selectivity, so we might expect stronger trends in the UK and France. These differences in political environment may also influence other aspects of aid agency behaviour to be considered below, like handling aid coordination, aid tying, technical assistance, and food aid.

The remainder of this paper will review key events in foreign aid over time, stylized facts, and empirical trends and regression analysis. It will close with a case study of the interlinked case of structural adjustment lending and the debt crisis of low income countries to see how aid agencies reacted to failing efforts. The specific tests are chosen on the basis of what features of aid agency behaviour are observable and lend themselves to tests of positive 'progress'.

2. LEARNING TO RESOLVE CHRONIC PROBLEMS IN FOREIGN AID

The paper first analyses some of the chronic complaints about foreign aid that were mentioned in the introduction – the lack of coordination, aid-tying, and the over-emphasis on food aid and technical assistance.

2.1. Donor coordination

A maddening problem in foreign aid for all concerned is the huge administrative costs for both recipients and donors from the duplication of donor efforts and their

² Admittedly, zero is somewhat arbitrary. Non-zero but very slow progress may also be judged unsatisfactory. Still it is a step forward to see if we can reject the hypothesis of zero progress.

failure to coordinate their efforts with each other. The United Nations (2005) calls for more coordination so ‘developing countries are not overburdened with administrative requirements that vary with every donor’. The Commission for Africa (2005, p. 62) urges: ‘Donor countries must co-ordinate their work better with one another’, noting that currently ‘problems of donor fragmentation and multiple parallel procedures remain pervasive’ (p. 320). The IMF and World Bank (2006b, p. 62) note ‘hosting missions and writing reports for different health programs is estimated to absorb 50–70 percent of the time of a district medical officer in Tanzania’. This also happens with aid agency country analysis as the United Nations Development Program (UNDP, 2005, p. 102) notes: ‘Donors conduct overlapping poverty assessments, public expenditure reviews, fiscal policy reviews, assessments of economic policies and fiduciary analysis and are often unaware of similar studies conducted by others or are unwilling to use them.’ As Table 1 implied, complaints about coordination go back many years, including such landmark studies as the Pearson Commission (1969), Cassen (1987), and World Bank (1998).³ Anecdotally reading the aid agency documents, there is little sign of progress on this issue, although new proposals for ‘harmonization’ continue to emerge from the aid agencies, most recently from the 2005 ‘Paris Declaration on Aid Effectiveness’ (OECD, 2005). Wilson (1989, p. 268) reproduces a famous quote from Harold Seidman on coordination as a perpetual goal of all bureaucracies: ‘if only we can find the right formula for coordination, we can reconcile the irreconcilable’ and ‘harmonize competing and wholly divergent interests’.

One of the big causes of the even more severe coordination problem in foreign aid is that all donors seem to want to give to all sectors in all countries. As the 1998 World Bank report *Assessing Aid* put it, donors want to ‘plant their flags’ everywhere. An obvious change that would alleviate the problem would be for donors to specialize more by country. As the IMF and World Bank (2005, p. 171) note:

‘High fragmentation can have negative implications for aid quality for several reasons: high transaction costs for recipients because more time is taken meeting donor requirements; too many small projects, with consequent limited opportunities to reap scale economies; and smaller or narrower donor stakes in overall country outcomes. A large number of donors also compounds the challenge of donor coordination.’

These arguments are plausible since the idea of gains from specialization is one of the oldest and most durable in economics. Different donors would be likely to have particular historical ties, including a history of previous aid giving, with recipients that would give them a comparative advantage in specializing in a set of recipients that would be smaller than the entire world. The plausible idea that there are fixed costs of any aid transaction between donor i and recipient j also suggests increasing returns and thus a benefit to specialization.

³ A correspondingly large academic literature on donor coordination is summarized in Bigsten (2006).

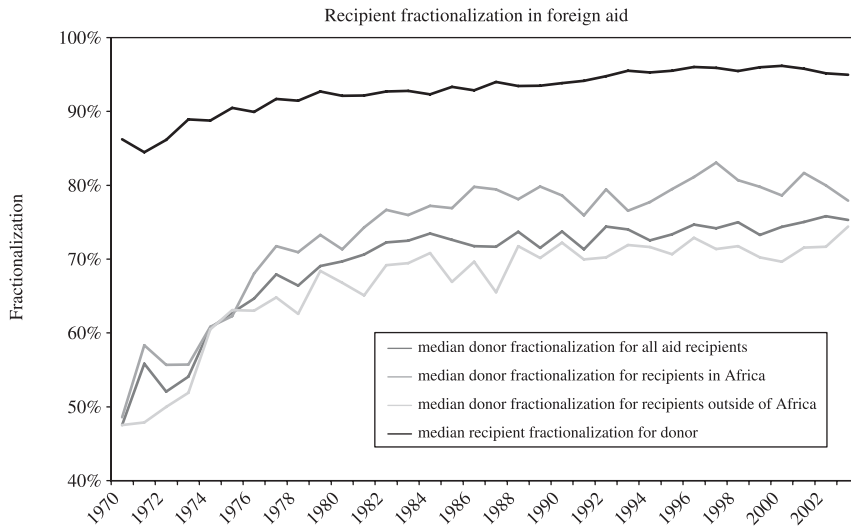


Figure 1. Is there decreasing fragmentation in aid giving?

Notes: Donor index is median for 15 bilateral donors, it is $1 - \text{Herfindahl}$ for recipient country shares of Overseas Development Assistance (ODA) in donor's total. Recipient Index is $1 - \text{Herfindahl}$ for shares of donors' ODA in recipient country total ODA.

Source: OECD Development Assistance Committee (OECD DAC) database. Recipient sample is 103 countries with complete data from 1970 to 2003. Africa sample is 42 countries with complete data over the same period.

Knack and Rahman (2004) confirm some implications of these statements more rigorously. They find that countries with more donor fragmentation have lower quality bureaucracy as measured by international comparative measures.⁴ Coordination may be a problem within all government structures, but it is arguably increasing in the number of *different* governments involved in an international enterprise like foreign aid. This suggests that it would be optimal for donors to specialize more in countries and sectors.

The benchmark expectation about progress is that donors would learn to specialize more in response to the continual drumbeat of protest about lack of coordination. Has fragmentation indeed decreased?

Figure 1 shows a donor fragmentation index (also known as a fractionalization index) for each donor as a function of how many countries it covers as a measure of trends in specialization. The measure is $1 - \text{Herfindahl}$ for aid flows. For the donor i , it is equal to $1 - \sum_j \text{share}_j^2$ of the shares of recipient j in donor i 's aid disbursements. We see that there is no trend towards

⁴ O'Connell and Soludo (2001) found that donor fragmentation was higher in Africa than in other continents, using the same measure used here.

increasing specialization of donors by country. For the typical donor, the fractionalization of recipients increased somewhat from an already very high level over the same period, and has remained at a very high level since then. In this area, there is no sign of learning to specialize in order to lessen coordination problems.⁵

Of course, what really matters is whether the donors' increasing fragmentation of giving translated into increasing fragmentation of receiving, since it is the latter that leads to high transaction costs and more difficult coordination problems. Figure 1 also shows the median fragmentation of aid recipients over time. The index is defined the same way as donor fragmentation, except the relevant shares are the shares of different donors in aid to the recipient country. Recipient fragmentation increased over the same period as donor fragmentation was increasing, unsurprisingly. Africa has higher fragmentation than other aid recipients and it also increased over the same period; this is particularly noteworthy since the median African nation is small both in population size and size of the economy.

2.2. Aid tying

In another area, there is some sign of progress and learning. As mentioned in the introduction, a chronic complaint about foreign aid is that donors insist upon tying aid to purchases from the donor country, which diminishes the value of aid as it limits choices of the recipient (sometimes in absurdly inefficient ways).⁶ The Commission for Africa (2005, p. 92) similarly complains that aid 'comes with a requirement to buy goods and consulting services from donor countries, which forces the recipient country to spend scarce funds on high-cost or inappropriate inputs'.

Figure 2 shows that the share of aid disbursements tied has decreased drastically, particularly since the early 1990s.⁷ Unfortunately, one big unknown on this is the largest bilateral donor, the United States. Actually, the figures below do not accurately reflect what is going on with tying of US aid disbursements – the US government has responded to criticism of aid tying by simply refusing to report the statistics on aid tying (ever since 1996, when it was still high as shown in the figure). Italy and New Zealand also have not reported on aid tying for a number of years. So as UNDP (2005, p. 102) notes, 'The full extent of tied aid is unknown because of unclear or incomplete reporting by donors.' Hence, the positive finding on decreased tying must be tempered somewhat by the continued refusal of some donors even to report whether they are tying or not.

⁵ It could be that donors are increasingly specializing by sector, which may still involve operating in a large number of countries. A fractionalization index by sector ($1 - \text{Herfindahl}$ of sector shares) does not show the same general increase as country fractionalization. However, it does not show any secular decline either, just a lot of variation across donors and across time.

⁶ This accords with an earlier estimate by Jepma (1991).

⁷ This is from OECD DAC data for the shares of total amount of ODA by DAC donors (only OECD members) classified as tied or partially tied.

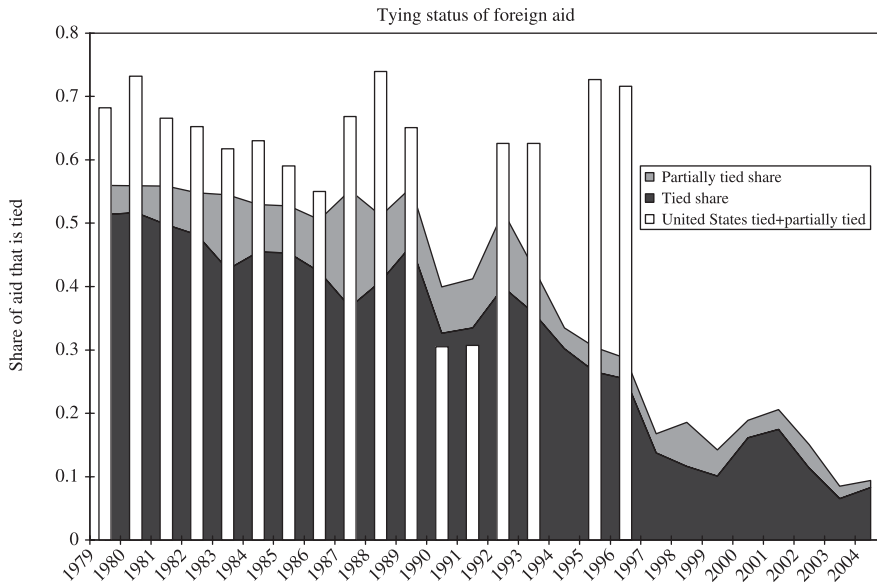


Figure 2. The decrease in aid tying

Source: OECD (various years), Development Assistance Committee, Tying Status of Bilateral Official Development Assistance Commitments (Table 7b).

2.3. Food aid and technical assistance

Two other donor-favoured types of aid alleged to be of dubious value are food aid and technical assistance. Critics have frequently pointed out that food aid (usually in the form of in-kind deliveries of food produced in rich countries) undercuts incentives for domestic food producers by driving down domestic food prices.⁸ It would very likely be superior on economic grounds to give cash grants to people facing starvation to purchase food on local markets (especially since famines and malnutrition are seldom due to inadequate total domestic supplies of food).

Technical assistance is also much-maligned by critics and some aid agencies themselves because it is also frequently tied to hiring consultants from the donor countries. Critics question whether rich country consultants make a significant contribution to poor countries seeking poverty reduction – foreign experts often lack sufficient local knowledge, and they inadequately transfer what knowledge they do have to local actors.⁹ The United Nations Millennium Project (2005a, p. 196) noted that aid was excessively ‘targeted at technical assistance and emergency aid’ and ‘tied to contractors from donor countries’. They recommend subtracting food aid and technical assistance to arrive at what is available for ‘development investments’ (p. 197).

⁸ One of the classic statements of this argument was Isenman and Singer (1977).

⁹ These complaints surfaced long ago in the academic literature, e.g. Loomis (1968).

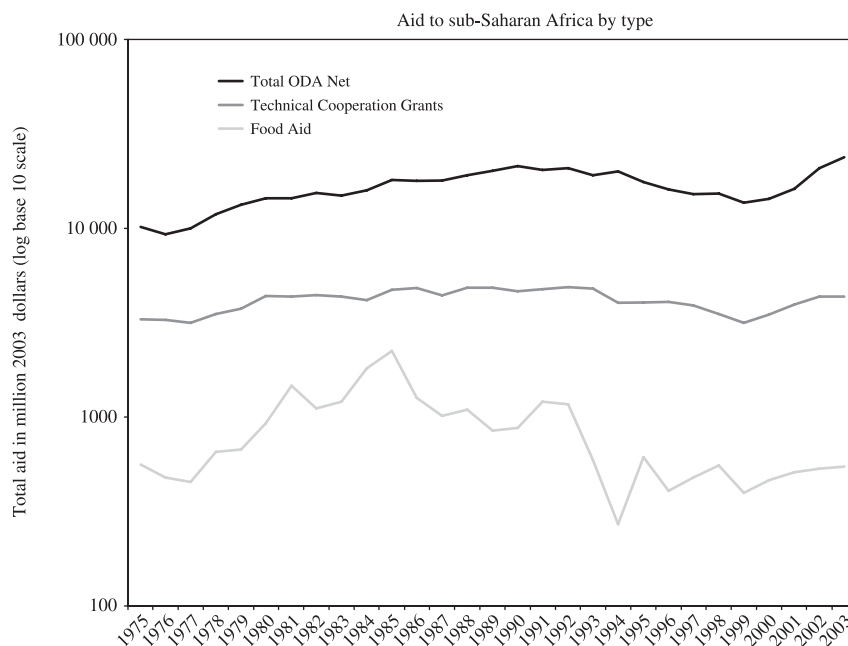


Figure 3. Is there a shift away from food aid and technical assistance?

These types of aid are politically popular in rich countries because they subsidize rich country farmers and consultants. The IMF and World Bank (2006b, p. 7) also criticized both food aid and technical assistance as being insufficiently flexible to be allocated to whatever was the highest priority in the recipient country. Has the aid community learned to resist this type of political pressure and move away from aid instruments of dubious value?

Figure 3, illustrating aid by type to sub-Saharan Africa in real dollars (on a logarithmic scale), shows mixed results. Food aid does seem to have diminished in importance, while technical assistance seems to have remained largely constant. Looking at secular trends by donor (for all recipients), the share of food aid has a steady downward trend in the major food donor, the US. This is evidence of some combination of learning and changing political pressure leading to a shift away from a type of aid widely seen as counter-productive.

Looking at share of technical assistance by donor (for all recipients) presents less evidence of progress. The US and Japan have an upward trend in the share of technical assistance, while the UK and France show some recent decline but no dominant trend over the whole period. This is looking only at quantity of technical assistance dollars; it could be that there have been improvements in the quality of technical assistance.

3. LEARNING NEW THEORIES OF DEVELOPMENT

There have been important changes in development theories and accompanying policy recommendations since the 1960s. To broadly sketch (and oversimplify) the changes, the main emphasis in the 1960s was on mobilizing sufficient financing for infrastructure and industrial capital formation. This period stressed projects that would provide these physical inputs to promote overall industrialization and development in all developing countries. In the 1970s, there was a shift towards trying to improve the world income distribution by directing aid more to the poorest nations. In the 1980s, there was increased awareness of the importance of government policies to give favourable incentives to the private sector, get prices right, facilitate free trade, and maintain macroeconomic stability.¹⁰ This was reflected in a concrete policy change: the introduction of structural adjustment lending by the IMF and World Bank in 1979–80 to give loans to developing countries conditional on them adopting these policies. Then beginning in the 1990s, there was increasing emphasis on the quality of government institutions, such as democratic accountability and control of corruption. The new approaches in the 1980s suggested that individual projects would have high returns only if national government policies were favourable, and then beginning in the 1990s only if institutions were supportive.

This thinking was given further impetus in a famous paper by Craig Burnside and David Dollar (published in the *American Economic Review* in 2000, but with results first available around 1997 and published in the World Bank's *Assessing Aid* in 1998). Burnside and Dollar found that aid raised growth only in countries with good policies, as measured by low inflation, low budget deficits, and high openness to trade. Another version of these results (Collier and Dollar, 1998) also stressed the quality of institutions as affecting the growth payoff from aid. Unfortunately, these results later failed some simple robustness checks such as introducing new data into the same specification (Easterly, Levine and Roodman, 2004). However, whether the Burnside and Dollar results hold (specifically whether aid has a positive effect on growth when policies/institutions are good) is something of a red herring regarding the issue of selectivity. The idea that aid money directed to governments would be more productive if those governments had pro-development policies and institutions is very intuitive (as shown in the introduction, it goes back to the 1960s). What has changed over time is the increasing awareness of *which* policies and institutions are pro-development, as described above, which should have led to increasing sensitivity to policies like inflation and trade openness (beginning in the 1980s), and institutions like democracy and corruption (beginning in the 1990s).¹¹ The IMF and World Bank (2006b, p. 83)

¹⁰ An important impetus in the change in opinion about free trade and development was the Bhagwati-Krueger NBER project of case studies of trade protection and growth in the 1970s. Anne Krueger effectively advocated the pro-free trade position when she was chief economist of the World Bank in the early 1980s, supported by researchers such as Bela Balassa.

¹¹ Drazen (1999) presents a strong political economy argument in favour of tough selectivity as promoting political reform in the recipient.

indeed argue ‘The results for policy elasticity of aid likewise show a strengthening of the relationship between aid and the quality of policies and institutions.’

This source says this statement is based on Dollar and Levin (2006). Actually, Dollar and Levin (2006) have a more restricted finding.¹² They did not test changing selectivity to policy indicators of the type discussed above. Instead they tested two measures of institutions: democracy and rule of law. They find donors are generally selective with respect to democracy, but the selectivity elasticity has been falling over time. On the rule of law, they found that donors formerly had the opposite of selectivity – they had a significant tendency to give aid to countries with *weak* rule of law (controlling for per capita income and other variables) in 1985–89. Subsequently, they find the relationship reverts to insignificance (albeit positive) for 1995–99 and 2000–2003.¹³

So let us consider this question anew. How much did aid agencies learn from these new waves of thinking about development? How is such learning reflected in their behaviour? It is indisputable that the aid agencies gave different advice to poor countries based on progress in development economics, and so in this respect at least there was definitely learning.

I again run cross-section regressions for allocation of (log) aid across countries, always controlling for (log) population size, (log) per capita income, and year dummies, year by year for all available years. I now introduce variables one at a time that reflect the increased emphasis on need, policies and institutions.

3.1. Responding to need

One of the chronic problems in foreign aid is directing aid to where it is most needed – giving more aid to the poorest people in the world and less aid to the less poor. This is an issue where there have been important changes in both political pressure and the state of development knowledge. A large literature on aid discusses how foreign policy considerations often distort aid inflows away from the needy towards the strategically important countries.¹⁴ This was thought to be a particular problem during the Cold War. The IMF and World Bank (2006b, p. 7) assert that there is progress but still some way to go: ‘While aid selectivity is increasingly based on need

¹² The statement was probably based on the 2004 working paper version of Dollar and Levin, but the revised version from 2006 does not change in important ways as far as the discussion in this paragraph.

¹³ An earlier exercise by Goldin *et al.* (2002) asserted that donors had become more selective in the 1990s using the World Bank’s Country Policy and Institutional Assessment (CPIA) policy index. Although this index is confidential and not available to researchers in general, I did have data on this policy index at the time from within the World Bank and found (with a co-worker Amar Hamoudi) these results turned out only to hold in a sub-sample of aid recipients (IDA borrowers) that also excluded India and Indonesia. If all aid-receiving countries are included, or if India and Indonesia are included, then ‘good policy’ countries received significantly less aid per capita than ‘bad policy’ countries at the end of the 1990s, contradicting the Goldin *et al.* (2002) claims.

¹⁴ Some examples of recent works in this literature are Alesina and Dollar (2000), Andersen *et al.* (2005), Akram (2003), McGillivray *et al.* (2002), and Boschini and Olofsgård (2002). An earlier wave of research included Maizels and Nissanke (1984), McKinlay and Little (1979), McGillivray (1989, 1992), and White (1992).

(poverty level) . . . there is evidence that other factors still determine a large share of aid disbursements.’ The IMF and World Bank (2006b, p. 83) later give the source for increasing selectivity based on need: ‘Dollar and Levin (2004) indicate that . . . the poverty elasticity of aid had strengthened for most of [bilateral] donors.’ (Curiously enough, Dollar and Levin make no such claim – neither in the working paper version in 2004, nor in the revised 2006 version.)

As far as new knowledge in the aid community, an important benchmark was World Bank President McNamara’s Annual Meetings speech in September 1973 in Nairobi. He called attention to the concept of absolute poverty and the plight of the poorest people in the world, which was an increased emphasis on poverty compared to the aid community’s previous tendency to treat the ‘Third World’ as one homogeneous bloc that should all have their growth financed.¹⁵ McNamara’s speech did not come out of a void – it reflected shifting emphasis in the development literature towards more concern with poverty and income distribution (for example, the famous book by Chenery, 1974).

Have aid agencies indeed learned over time how to resist the political pressures to lend, and succeeded at moving closer to their mission of poverty, of which they have become increasingly aware over time? To distinguish such learning from changes in intensity of political pressure, I create a dummy for the Cold War and use it as a slope dummy for the coefficient of aid on per capita income.

I look for a trend in the response of aid to per capita income. In this and regressions to follow, I use a basic parsimonious specification in a panel dataset of yearly aid received from all donors from 1960 to 2003 by recipient country, regressing log of aid received in real dollars on time dummies for each individual year, log of per capita income (in PPP dollars), and log of population.¹⁶ I adopted what seemed to be a plausible specification *a priori* and did not experiment with alternative forms, so as to avoid the kind of data mining that is all too common in the aid literature. The source for data on nominal aid dollars (gross Overseas Development Assistance [ODA]) are from the OECD Development Assistance Committee (OECD DAC), and are converted to real dollars (with a base year of 2003) using the deflator for exactly this purpose provided by the OECD DAC, which takes into account exchange rate movements and dollar inflation.

The regression uses clustered standard errors to recognize that errors for a given country are likely correlated, as well as robust *t*-statistics to handle heteroscedasticity. Table 2 shows that the base specification (Regression 1) shows strong sensitivity to per

¹⁵ There had been *some* differentiation between lower and higher income ‘Third World’ countries previously, as reflected in the creation in 1960 of the International Development Association of the World Bank to give concessional loans to low income countries.

¹⁶ The source for per capita income is Penn World Tables (PWT) Version 6.1 through the year 2000. The source for population is the World Bank’s World Development Indicators (WDI). Per capita income is updated through 2003 using constant price per capita GDP growth rates from WDI. Missing values in earlier years in PWT 6.1 are also filled in using WDI per capita growth rates whenever data is available.

Table 2. Learning to respond to needs? Pooled cross-section, time series regression of log real dollar aid receipts by country recipient on country characteristics, 1960–2003

| | Regression 1960–2003 | | | | Regression 1974–2003 | |
|---|----------------------|--------------------|--------------------|--------------------|----------------------|------------------|
| Right-hand side variables | 1 | 2 | 3 | 4 | 5 | 6 |
| Log of per capita income in year aid received | -0.491 (5.09)** | 20.712 (1.95) | -0.566 (6.13)** | -0.199 (1.13) | -0.228 (1.40) | 3.398 (0.25) |
| Log of population | 0.546 (15.07)** | 0.547 (14.82)** | 0.547 (15.03)** | 0.545 (14.81)** | 0.546 (14.92)** | 0.5 (14.06)** |
| Log per capita income * time trend | | -0.011 (2.01)* | | | | -0.002 (0.29) |
| Log per capita income * Cold War dummy | | | 0.145 (1.23) | | 0.028 (0.25) | |
| Log per capita income * McNamara dummy | | | | -0.356 (2.26)* | -0.339 (2.27)* | |
| Observations | 4719 | 4719 | 4719 | 4719 | 4719 | 3536 |
| R-squared | 0.51 | 0.52 | 0.51 | 0.52 | 0.52 | 0.56 |

Notes: Robust *t*-statistics in parentheses (clustered standard errors by country).

* significant at 5% level; ** significant at 1% level.

Includes year dummies (not shown).

capita income (sometimes called the ‘poverty elasticity’), and an elasticity with respect to population that is less than one (reflecting the well-known small country bias, in which small countries receive higher per capita aid).¹⁷ Regression 2 introduces a time trend in the coefficient on per capita income, and finds it to be significant and negative. (The coefficient on per capita income by itself is positive, but the magnitudes are such that, including the time trend, the elasticity of aid with respect to per capita income is always negative.) Regression 3 considers an alternative hypothesis – that there was a one time shift after the end of the Cold War; it includes a slope dummy for the Cold War (= 1 if the year is less than 1990). Per capita income is still significant, but the slope dummy is insignificant – there is no evidence that the Cold War distorted aid allocation away from the neediest countries.

Regression 4 explores an alternative story: that there was a one time shift in sensitivity to need associated with the ‘McNamara revolution’ towards increased emphasis in poverty in the 1970s. A dummy for the post-McNamara years interacted with per capita income is indeed highly significant and negative in Regressions 4 and 5 (the latter also includes the Cold War dummy which is still insignificant). What’s more, Regression 6 shows that there is no tendency towards further increases in aid sensitivity to per capita income after the post-1973 shift. (Of course, there could have

¹⁷ The bias towards small countries could be optimal if there is a fixed cost of implementing an aid programme in each country. It also could be a way for donors to diversify risk if their projects are influenced by each country government’s actions. However, it could also reflect donors’ desire to maximize their visibility (good for aid fund raising from legislatures) by operating in as many countries as possible.

Table 3. Real aid dollars regressed on need and population size

| | Log per capita income | <i>t</i> -stat | Log of population | <i>t</i> -stat | Observations | R-squared |
|-----------|--------------------------|----------------|----------------------|----------------|--------------|-----------|
| 1960–1964 | 0.118 | (0.58) | 0.860 | (8.99)** | 88 | 0.52 |
| 1965–1969 | –0.286 | (1.34) | 0.734 | (8.63)** | 91 | 0.51 |
| 1970–1974 | –0.315 | (1.41) | 0.674 | (7.02)** | 95 | 0.44 |
| 1975–1979 | –0.493 | (3.09)** | 0.481 | (6.00)** | 101 | 0.5 |
| 1980–1984 | –0.573 | (3.63)** | 0.495 | (8.29)** | 110 | 0.43 |
| 1985–1989 | –0.736 | (5.81)** | 0.470 | (10.16)** | 114 | 0.64 |
| 1990–1994 | –0.677 | (6.73)** | 0.485 | (11.98)** | 142 | 0.61 |
| 1995–1999 | –0.611 | (5.88)** | 0.512 | (12.05)** | 144 | 0.67 |
| 2000–2003 | –0.577 | (5.86)** | 0.519 | (14.26)** | 140 | 0.66 |

Notes: Each row represents a cross-section regression of averages for the years shown of log of real aid dollars received by each country on recipients' log per capita income and log of population.

Robust *t*-statistics in parentheses.

* significant at 5%; ** significant at 1%.

been some other explanation for the change besides the McNamara policy shift. All that we have established is that there was a one time shift around the mid-1970s.)

Hence, the first result is that there does seem to be learning over time to respond to need, but this effect is concentrated around a one-time shift around 1973, possibly associated with the changing emphasis in development knowledge exemplified in the McNamara policy shift. The main missing result is that there is no evidence that the political opportunity created by the end of the Cold War led to a de-emphasis of strategic considerations and more emphasis on the need of the recipient.

Although the regressions in Table 2 have the virtue of considering alternative parsimonious hypotheses, the specifications may be too restrictive for the poverty elasticity. As a robustness check, the paper next performs regressions for successive 5-year averages for the base specification of log real aid regressed on log per capita income and log population (Table 3). Again, there is evidence of a regime shift in the mid-1970s. Prior to that, aid was weakly related to need or even had the wrong sign. Since the mid-1970s, per capita income has always been a significant determinant of aid receipts. This exercise shows why the linear trend in poverty elasticity after 1974 fails: the poverty elasticity first increases in absolute value, peaking near the end of the Cold War, but then there is some rather puzzling erosion in response to need since then (especially relative to the expectation that the end of the Cold War would have led to reallocation from strategic countries to needy countries).

One important note is that the discussion of Tables 2 and 3 applies two different criteria for evidence of increased selectivity. The result on the time trend in the per capita income coefficient or the McNamara dummy in Table 2 shows that the *change* in coefficient is statistically significant (at the 5% level). Table 3 shows that the *level* of the per capita income elasticity first becomes significant in 1975–79. The two tests are obviously not equivalent and both give useful information. I will continue applying both types of tests in the rest of the paper.

Table 4. Poverty elasticity by donor

| | Cross-section regression for each five-year average period for log of aid from donor shown on log per capita income and log population | | | | | | | | | Regression of log real aid on log population, log per capita income, year dummies, and income slope dummies for post-McNamara speech (1973) and end of Cold War (1990) for whole time period | |
|--------|--|-----------|-----------|--------------|--------------|--------------|--------------|--------------|--------------|--|--|
| | 1960–1964 | 1965–1969 | 1970–1974 | 1975–1979 | 1980–1984 | 1985–1989 | 1990–1994 | 1995–1999 | 2000–2004 | McNamara shift for poverty elasticity | Post-Cold War shift for poverty elasticity |
| IDA | | 0.09 | -0.11 | -0.57 | -1.14 | -1.27 | -0.54 | -0.24 | -0.50 | -0.79 | 0.49 |
| US | 0.83 | 0.23 | 0.22 | 0.06 | 0.05 | 0.07 | -0.12 | -0.36 | -0.58 | -0.20 | -0.44 |
| UK | -0.84 | -0.69 | -0.32 | -0.38 | -0.15 | -0.23 | -0.25 | -0.25 | -0.64 | 0.35 | -0.23 |
| France | | | -0.26 | -0.38 | -0.45 | -0.60 | -0.83 | -0.47 | -0.45 | -0.43 | -0.01 |
| Japan | | -0.25 | -0.08 | 0.32 | 0.03 | -0.25 | -0.27 | 0.13 | 0.30 | 0.36 | 0.26 |

Notes: Table shows coefficient of log of real aid dollars regressed on log of per capita income, controlling for log of population. Those coefficients statistically significant at the 5% level are shown in bold, with robust standard errors. Regressions with less than 40 observations are omitted.

We can get some additional insight by looking into the behaviour of the poverty elasticity for the International Development Association (IDA) and the four major bilateral donors for the same five-year averages. The log of total aid from each donor is regressed on the log of population and the log of per capita income for the recipient country. The coefficient on per capita income (the poverty elasticity) is reported for each donor in Table 4. As more evidence for the ‘McNamara revolution’, IDA is the donor that shows the biggest increase in the magnitude and significance of the coefficient, beginning in 1975. France is the other donor with a similar pattern. Japan is the only donor whose relationship to need is never significant. The US coefficient on need is not significant until the last period, which may reflect the dominance of its strategic interests during the Cold War and the revival of interest in helping poor countries in the new millennium. However, there seems to be a lot of fluctuation of the sensitivity to need of all donors, including IDA. In the latest period, 2000–2003, there is an interesting convergence of all donors except Japan at a statistically significant (at the 5% level) poverty elasticity of around -0.5. But again, this is not equivalent to saying the change in elasticity from 1995–99 to 2000–2003 is statistically significant, which it is not for any of these donors.

This exercise also allows us to assess the significance of *differences* in coefficients. The coefficients on the McNamara dummy and the shift in coefficient after the Cold War (the negative of the Cold War dummy) in regressions for each donor are exactly equivalent to Regression 5 in Table 2. There are interesting differences among donors.

IDA is the only major donor with a significant McNamara shift (apparently McNamara convinced only his own organization²). The US is the only donor with a significant increase in sensitivity to need after the Cold War (IDA actually has a puzzling *decrease* in sensitivity to need after the end of the Cold War), which is plausible since the US was the main Western protagonist in the Cold War and thus most likely to have used aid politically during the Cold War. With the US, the post-Cold War expectations are confirmed, while for IDA and the other donors they are not.

3.2. Importance of government policies

I consider two measures of policy. First, I used a widely known indicator of trade openness (the broad Sachs–Warner openness dummy that captures tariffs, quotas, black market premiums, prevalence of export marketing boards, and a socialist economic system). The data end in 1998.¹⁸ The second policy measure I consider is a dummy that takes on the value 1 if inflation is greater than 40%, and 0 otherwise.¹⁹

I next turn to running the same kind of regression as above to test more comprehensively for time trends in response to policy that would represent learning. Given the collinearity of policy indices (and their collinearity with the other things being tested elsewhere in this paper like other slope dummies), I still introduce the policy variables and their slope dummies one at a time. As described above, there is a well-defined shift in development knowledge around 1980 towards stressing selectivity in these types of policies. Hence, the test for learning to be selective is very simple – I test the significance of a slope dummy on policy for the period beginning in 1980. Table 5 shows the results. There is no evidence for a shift in aid allocation in response to policies of the recipient after 1980. Actually, aid is never significantly related to openness, while it is significantly related to high inflation (but not more so after 1980).

Again, this format may be too restrictive, so again the paper does an exercise estimating the relationship between aid allocation and policies (controlling for income and population) for all aid and for the five major donors for averages of five-year periods from 1960 to 2003 (Table 6). For all aid, the only period in which openness is significant is 1990–94. Looking at the results by donor, the UK and Japan do have a significant tendency to respond to openness, but it does not increase over time. Curiously enough, the relationship between IDA aid allocation and openness is never significant.²⁰ The results by donor for high inflation do show some tendency for inflation to be significant more often after 1980 (including for IDA), although significance is

¹⁸ The original data from Sachs and Warner (1995) ended in 1994. Easterly *et al.* (2003) updated the index to 1998.

¹⁹ Bruno and Easterly (1998) and Easterly (2005) suggested 40% as a threshold where the association of inflation and growth is robustly significant and negative. The results in the aid selectivity figure are less significant with a continuous measure of (log) inflation.

²⁰ This could be related to the difficulty in enforcing conditionality analysed in Svensson (2003) and documented in Easterly (2005).

Table 5. Learning to respond to policies? Pooled cross-section, time series regression of log real dollar aid receipts by country recipient on country characteristics, 1960–2003

| | Regressions | | | |
|---|--------------------|--------------------|--------------------|--------------------|
| | 1 | 2 | 3 | 4 |
| Log of per capita income in year aid received | –0.369 (3.12)** | –0.369 (3.12)** | –0.524 (5.39)** | –0.525 (5.40)** |
| Log of population | 0.522 (10.84)** | 0.521 (10.84)** | 0.529 (15.49)** | 0.528 (15.37)** |
| Sachs-Warner openness dummy (=1 if open) | 0.202 (1.14) | 0.22 (0.81) | | |
| Openness dummy * Dummy for post-1980 period | | –0.029 (–0.13) | | |
| Dummy for high inflation (>40%) | | | –0.538 (4.54)** | –0.599 (2.99)** |
| High inflation dummy * Dummy for post-1980 period | | | | 0.102 (0.44) |
| Observations | 3091 | 3091 | 4719 | 4719 |
| R-squared | 0.41 | 0.41 | 0.53 | 0.53 |

Notes: Robust *t*-statistics in parentheses (standard errors clustered by country).

* significant at 5% level; ** significant at 1% level.

still sporadic. Hence, there is some support for the increased significance test of increasing selectivity with regard to inflation.

Table 6 calculates the coefficients on the variables ‘Openness dummy * Dummy for post-1980 period’ and ‘High inflation dummy * Dummy for post-1980 period’ for each individual donor in regressions identical to those in Table 3, i.e. regressions for pooled annual data of log real aid on log income, log population, year dummies, the respective policy, and the aforementioned policy slope dummies. For the two policies and five donors, only one of these policy slope dummies is significant at the 5% level – the shift in response to high inflation for the UK.

The overall picture is that there is little evidence that donors are learning to be increasingly selective with respect to policies in the recipient countries.²¹

3.3. Importance of institutions

What did the aid community learn from the research on the importance of institutions to development in the 1990s? Is there increased sensitivity in aid allocation to institutional variables like democracy and corruption? A confounding factor here is the end of the Cold War. According to a widely accepted narrative, donors were happy to indulge corrupt dictators who were allies in the Cold War, but showed less

²¹ Alesina and Dollar (2000) emphasize the importance of strategic considerations and alliances in aid allocation, measured by proxies such as UN voting patterns and former colonial possessions, which tend to distort aid away from good policies and institutions.

Table 6. Results of regressing log of real aid dollars by donor on inflation and openness of recipient in successive five-year periods, controlling for log per capita income, log of population, and year dummies

| Coefficient on log of real aid on high inflation dummy | 1960–1964 | 1965–1969 | 1970–1974 | 1975–1979 | 1980–1984 | 1985–1989 | 1990–1994 | 1995–1999 | 2000–2003 | Post-1980 shift in coefficient on high inflation dummy |
|--|-----------|---------------|--------------|-----------|-----------|---------------|---------------|---------------|---------------|--|
| All ODA | 0.34 | -0.586 | -0.051 | -0.413 | 0.237 | -0.312 | -0.713 | -0.853 | -0.448 | 0.102 |
| IDA | | | 4.684 | 0.205 | -1.044 | -1.125 | -0.23 | 0.657 | -1.224 | -0.206 |
| US | 0.179 | 0.344 | -0.163 | -0.633 | -0.353 | -0.288 | -0.237 | 0.022 | 0.904 | -0.028 |
| UK | | -2.625 | -1.745 | -0.925 | -0.056 | -0.87 | -0.49 | -0.527 | 0.185 | -0.844 |
| France | | | | | -0.281 | -0.815 | -1.148 | -1.052 | -0.583 | -0.659 |
| Japan | | 1.325 | -0.259 | -0.926 | 0.041 | -0.360 | -1.631 | -1.900 | -0.884 | -0.225 |

| Coefficient on log of real aid on Sachs–Warner openness dummy | 1960–1964 | 1965–1969 | 1970–1974 | 1975–1979 | 1980–1984 | 1985–1989 | 1990–1994 | 1995–1999 | Post-1980 shift in coefficient on openness |
|---|-----------|--------------|--------------|--------------|-------------|--------------|--------------|--------------|--|
| All ODA | 0.66 | -0.414 | 0.159 | 0.076 | -0.226 | 0.181 | 0.682 | 0.334 | -0.029 |
| IDA | | | 0.082 | 0.412 | 0.445 | 0.528 | 0.245 | 0.077 | -0.046 |
| US | 0.542 | -0.183 | 0.717 | 0.119 | -0.315 | 0.438 | 0.629 | 1.358 | 0.091 |
| UK | 1.362 | 2.986 | 2.184 | 2.001 | 2.12 | 1.461 | 1.086 | 0.882 | -0.977 |
| France | | | -1.62 | -0.904 | -0.449 | -0.077 | 0.737 | 0.412 | 0.802 |
| Japan | | 1.10 | 1.64 | 1.80 | 1.25 | 1.10 | 2.04 | 0.99 | -0.247 |

Notes: Coefficients significant at 5% level are shown in bold. Regressions with less than 40 observations are not shown. Openness measures end in 1998 (Sources: Sachs and Warner, 1995, updated by Easterly *et al.*, 2003). All regressions control for log of per capita income and log of population. Source for aid data and dollar deflator: OECD Development Assistance Committee online database. Last column shows coefficient on slope dummy for post-1980 period on inflation and openness in pooled annual regression of log of real aid on log per capita income and log population, year dummies, and level of respective policy variable.

tolerance after the Cold War ended. The end of the Cold War also coincides (and may have contributed to) with the increased awareness of ‘governance’ in aid agencies, including democratic accountability and donor criticism of anti-democratic practices.

The timing of increased awareness of corruption as a factor influencing the effectiveness of aid and development prospects in general in the aid community is difficult to be exact about. I have chosen one widely publicized benchmark: World Bank President James Wolfensohn’s address to the World Bank/IMF Annual Meetings in September 1996. A World Bank report the following year concurs in highlighting this as a break in aid community awareness of corruption (World Bank, 1997). There is no similar watershed statement on the importance of democracy, but it is widely accepted that donors were discussing democracy as a factor in aid and development much more in the later periods than in earlier ones. In addition, there was increased emphasis on institutions in general in the aid community, as represented by the World Bank’s Kaufmann and Kraay (1996, 1998, 2000, 2002, 2004) indices of ‘good governance’ (which included separate indicators for both democracy and corruption), culminating in the 2001 World Development Report on institutions for development.²²

²² Another landmark on corruption is the founding of Transparency International by a former World Bank official in 1993.

The paper relates aid allocation by country to a measure of democracy in the recipient (the Polity IV index of democracy that runs from 0 for the least democracy to 10 for the most democracy) from 1960 to 2003.²³ The other key test is to see how donors' response to corruption has changed over time. Unfortunately, data on corruption (from the International Country Risk Guide) is only available since 1984).²⁴

To be more systematic about this and to test whether there was a change after the Cold War, I again run the same base specification as above, introducing the democracy and corruption variables and their interaction terms with different time periods. On average, as shown in Table 7, aid does respond to democracy positively. Contrary to the conventional wisdom, there is no difference in the sensitivity to democracy during the Cold War and that after the Cold War. Since the post-Cold War period coincides with increased rhetoric by donors in favour of democratic accountability, there is also no sign that this shift in rhetoric had an effect on aid allocation.²⁵

The results on corruption are rather similar. The average sensitivity of aid to (freedom from) corruption is positive and significant.²⁶ Contrary to conventional wisdom, donors were not more tolerant of corruption during the Cold War.²⁷ Looking for an alternative pattern that corruption responded to the shift in awareness about corruption after 1996, I also test a slope dummy for the post-1996 period. There is no evidence for this pattern. I also tested a variant in which a dummy takes on the value of 1 for the worst corruption cases (less than 2 on the 0 to 6 ICRG indicator of freedom from corruption). There is no evidence for a shift in response to the worst corruption cases either. The bottom line is that there is evidence for some sensitivity to corruption, but there is no evidence for learning by the aid agencies in response to new emphases in the literature about corruption.

Next consider more detailed results on democracy by donor and with an unrestricted format in which a separate coefficient on democracy is calculated for each subsequent five-year period. Again, the paper performs cross-section regressions for log aid on log income, log population, and democracy and then shows the coefficient on

²³ Polity IV has three measures of degree of democracy or autocracy: a 0 to 10 index for democracy, a 0 to 10 index for autocracy, and democracy – autocracy for 'polity' ranging from –10 to 10. The democracy and autocracy indices were computed separately because the database authors believed that autocracy was a somewhat different phenomenon than democracy and not its simple opposite. In practice, however, democracy and autocracy have a strong inverse correlation of –0.86, so for example, a country getting a 10 for autocracy would very likely get a zero for democracy. (Source: Polity IV web site at University of Maryland: <http://www.cidcm.umd.edu/inscr/polity/>.) I use the first measure because of its specificity to measuring 'democracy', which is the concept of interest to donors.

²⁴ There is some question about how reliable this corruption information was, or how widely it was available. Of course, this is partly endogenous, as any donor that cared about corruption (or all donors together) could invest effort in gathering the available data. Other indicators of corruption became available with Transparency International beginning in 1995, and with the World Bank Kaufmann and Kraay exercise to measure corruption and other institutions based on a weighted average of all other ratings (available beginning in 1996). There is a high correlation between these measures.

²⁵ This finding is very similar to Dollar and Levin (2006).

²⁶ One confounding issue here is that there may be reverse causality – higher aid could cause higher corruption. Svensson (2000) found evidence for this in countries that are ethnically divided.

²⁷ Alesina and Weder (2002) find no evidence that more bilateral or multilateral aid goes to less corrupt countries (1970–95).

Table 7. Pooled cross-section, time series regression of log real dollar aid receipts by country recipient on country characteristics, 1960–2003, including year dummies (not shown)

| Right-hand side variables: | Regression | | | | | |
|--|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|
| | 1 | 2 | 3 | 4 | 5 | 6 |
| Log of per capita income in year aid received | -0.421 (4.73)** | -0.42 (4.69)** | -0.624 (6.44)** | -0.628 (6.48)** | -0.623 (6.41)** | -0.589 (5.76)** |
| Log of population | 0.51 (13.05)** | 0.511 (13.01)** | 0.458 (9.41)** | 0.461 (9.45)** | 0.457 (9.40)** | 0.452 (9.28)** |
| Democracy index (0–10, with increase meaning more democracy, from Polity IV) | 0.045 (2.37)* | 0.052 (2.13)* | | | | |
| Democracy * Post Cold War dummy (=1 if year >1989) | | -0.015 (0.66) | | | | |
| Corruption index (0–6, with increase meaning less corruption, from ICRG) | | | 0.143 (2.03)* | 0.064 (0.69) | 0.15 (1.89) | |
| Corruption index * Post Cold War | | | | 0.123 (1.36) | | |
| Corruption index * Dummy for period following World Bank emphasis on corruption (=1 if year >1996) | | | | | -0.024 (0.25) | |
| Dummy for worst corruption (=1 if ICRG Corruption <2) | | | | | | -0.249 (-1.25) |
| Worst Corruption * Dummy for year >1996 | | | | | | 0.101 (0.45) |
| Observations | 4154 | 4154 | 1776 | 1776 | 1776 | 1776 |
| R-squared | 0.41 | 0.41 | 0.50 | 0.50 | 0.50 | 0.49 |

Notes: Robust *t*-statistics in parentheses (clustered standard errors).

* significant at 5% level; ** significant at 1% level.

democracy (Table 8). The last part of the exercise tests the coefficient on the variable Democracy * Post Cold War dummy (=1 if year >1989) in regressions exactly the same as those in Table 7 for each individual aid donor. The results show some differences by donor. France and Japan show a positive shift in response to democracy (although in France, it was a movement away from rewarding autocracy towards *no* sensitivity to democracy).

To test robustness of these results for both total ODA and by donor for democracy, I next explore several variations on the definition of democracy. Several ways of entering democracy are considered: (1) change in the 0–10 Polity IV scale over the five-year period, (2) a dummy = 1 for ‘democratic transitions’ defined as a change in

Table 8. Coefficients on democracy in regressions for log of real aid dollars by donors on log of per capita income and log population by donor

| Democracy defined in levels: 0–10 democracy index from Polity IV | | | | | | | | | | |
|--|-----------|-------------|--------------|--------------|--------------|-------------|-------------|-------------|-------------|--|
| Coefficient of log of real aid on democracy | 1960–1964 | 1965–1969 | 1970–1974 | 1975–1979 | 1980–1984 | 1985–1989 | 1990–1994 | 1995–1999 | 2000–2003 | Coefficient on shift of democracy coefficient after 1989 |
| IDA | | 0.06 | 0.09 | 0.00 | 0.06 | 0.05 | 0.02 | 0.06 | 0.10 | 0.005 |
| US | –0.04 | 0.13 | 0.02 | –0.01 | 0.02 | 0.07 | 0.07 | 0.06 | 0.11 | –0.003 |
| UK | 0.13 | 0.38 | 0.34 | 0.20 | 0.22 | 0.11 | 0.11 | 0.11 | 0.12 | –0.091 |
| France | | | –0.13 | –0.18 | –0.12 | –0.10 | 0.02 | –0.04 | –0.04 | 0.083 |
| Japan | | 0.12 | 0.09 | 0.03 | –0.02 | 0.12 | 0.17 | 0.15 | 0.09 | 0.086 |

Note: Coefficients significant at the 5% level are shown in bold.

the Polity IV democracy measure of 5 or more,²⁸ (3) entering both (1) and the level of the Polity IV variable together, and (4) considering the Freedom House measure of democracy instead of the Polity IV measure. The strongest estimates for learning come in the regressions that enter a dummy for a large democratic transition (movement of 5 or more on the 0–10 Polity IV scale) for 1995–99.²⁹ All ODA, the US, the UK, and Japan, but not France, have a significant coefficient on the democratic transition for 1995–99. When the regression includes both the level of democracy and the transition dummy, both are significant for all ODA, the UK, and Japan in 1995–99.³⁰ On the downside, none of the transitions are significant in 1990–94, which was supposed to be the post-Cold War watershed period, and only UK aid has a significant coefficient on transition during 2000–2003 (results available in the unpublished appendix).

The overall results are only weakly supportive of increased sensitivity after 1990. Of all the permutations of log of aid on development (including both the previous exercise and the results described in the previous paragraph), we have a minority of significant coefficients of the right sign at the 5% level. Before 1990, out of 177

²⁸ The definition of democratic transition chosen here corresponds well to Brender and Drazen's (2005) list of 'new democracies'. Of their 36 'new democracies', 2 are industrial countries and not in this paper's sample, 29 are captured by this paper's criterion, and 5 are not. This paper's criterion also resulted in the inclusion of a number of 19 other democratic transitions that were not on Brender and Drazen's list. However, when we consider the large number of observations (352 in the panel of five-year changes) defined *not* to be democratic transitions/new democracies in either this classification or that of Brender and Drazen, there is a strong association between this classification and that of Brender and Drazen.

²⁹ To match the five-year change to the average aid for the period, the change is defined as from the year before to the last year of the five-year period. Thus for example, for aid 1990–4, the transition is the change in democracy from 1989 to 1994.

³⁰ Alesina and Dollar (2000) found democracy to be significant for all ODA in a five-year panel for 1970–95, controlling for strategic interests like colonial linkages and similarity in UN voting patterns. It was not significant for the same regression for 1980–95. For the same bilateral donors we consider here, they found democracy conditional on strategic interests to be significant for aid in a panel of five-year averages for 1970–94 for the UK, the US, Japan, but not for France. Although the results here are similar, the calculation in this paper is different in that it does not condition on strategic interests, which seems appropriate for evaluating absolute performance of donors relative to objectives and development knowledge.

Table 9. Results by donor on corruption – coefficient on corruption measure in regression of log aid on log per capita income, log population and corruption

| Coefficient on log of real aid on freedom from corruption/1/2 | 1980–1984 | 1985–1989 | 1990–1994 | 1995–1999 | 2000–2003 | Shift in coefficient after 1996 |
|---|-----------|---------------|-----------|--------------|--------------|---------------------------------|
| IDA | | | 0.308 | 0.021 | 0.635 | 0.096 |
| US | -0.337 | -0.079 | 0.095 | 0.537 | 0.315 | 0.232 |
| UK | 0.024 | 0.156 | 0.293 | 0.484 | 0.285 | 0.066 |
| France | -0.204 | 0.147 | 0.122 | 0.067 | -0.035 | -0.087 |
| Japan | -0.116 | -0.415 | 0.254 | 1.043 | 0.214 | 0.444 |

| Coefficient on log of real aid on dummy for worst corruption (=1 if corruption is <2 on 0 to 6 scale) | 1980–1984 | 1985–1989 | 1990–1994 | 1995–1999 | 2000–2003 | Shift in coefficient after 1996 |
|---|-----------|--------------|-----------|---------------|--------------|---------------------------------|
| IDA | | | -0.597 | -0.758 | -1.11 | -0.477 |
| US | 0.43 | 0.348 | -0.716 | -1.299 | 0.098 | -0.034 |
| UK | 0.424 | -0.571 | -0.261 | -1.164 | -0.517 | -0.139 |
| France | 0.03 | -0.499 | -0.331 | 0.565 | 0.197 | 0.024 |
| Japan | 0.839 | 1.276 | -0.915 | -2.848 | -0.205 | -0.689 |

Notes: Regressions for five-year averages of log of real ODA on log per capita income, log population and corruption measure; regressions with less than 40 observations are not shown. Corruption measures begin in 1983, measure runs from 0 (most corrupt) to 6 (least corrupt).

Last column shows coefficient on slope dummy on corruption after 1996 in a pooled regression of annual log real aid by donor on log per capita income, log population, and year dummies, with standard errors clustered by country. Coefficients significant at the 5% level are shown in bold.

Source: International Country Risk Guide.

estimated coefficients, 32 are significant and of the right sign (another 7 were significant but of the wrong sign). After 1990, out of 102 estimated coefficients, 32 are significant (all of the right sign). Hence, before 1990, 18% of the estimated coefficients are of the right sign and significant, while after 1990, 31% of the estimated coefficients are significant of the right sign. This is a shift towards increased statistical significance of democracy after 1990, but not overwhelmingly impressive. Obviously, 5% of the coefficients would be significant at the 5% level (half positive and half negative on average) in a random set of independent regressions in which there was no true relationship, although this is not an exact benchmark for our exercise since our regressions are not independent.

I do the same exercise for the response of donors over time to corruption, considering both the continuous corruption rating and the 'worst corruption' dummy. The results (Table 9) are somewhat similar to democracy. There are more significant coefficients after 1995, which supports the idea that the change in awareness of corruption signified by the Wolfensohn speech in 1996 affected donor behaviour. On the downside, most of the significance is concentrated in 1995–99 and mostly disappears in 2000–2003 (except for Wolfensohn's IDA itself). Applying the other test

Table 10. Results of selectivity tests differentiated by donor

| Exogenous event | Donor most affected | Prediction of shift | Increased sensitivity to: | Predicted effect on donor most affected? | Predicted effect on all donors? |
|---|---|---------------------|---------------------------------|--|---------------------------------|
| World Bank president McNamara initiative towards emphasizing poverty more, 1973 | World Bank (IDA) | One-time shift | Need | Yes | Yes |
| Increased emphasis on policies after 1980 | World Bank (IDA) because of structural adjustment lending | One-time shift | Inflation Openness | No No | No No |
| End of Cold War, 1990 | USA | One-time shift | Need Democracy Corruption | Yes No No | No No No |
| Increased awareness of corruption, World Bank President Wolfensohn speech, 1996 | World Bank (IDA) | One-time shift | Corruption | No | No |
| Steadily increasing selectivity with respect to need, policies, institutions | UK | Trend | Need | No | Yes |
| | | | Inflation | No | No |
| | | | Openness | No | No |
| | | | Democracy | No | No |
| | France | Trend | Need | No | No |
| | | | Inflation | No | No |
| | | | Openness | No | No |
| | | | Democracy | Yes | No |
| | Japan | Trend | Corruption | No | No |
| | | | Need | No | No |
| | | | Inflation | No | No |
| | | | Openness | No | No |
| | | | Democracy | No | |
| | | | Corruption | Yes | |

of whether we can reject equality of coefficients before and after 1996 (based again on the pooled annual regression specification from Table 7), the results are not supportive of a post-1996 shift. Only Japan shows a significant change in coefficients.

We can summarize all of the results on selectivity differentiated by the donor that we would have expected various political events or shift in knowledge to affect most, to see if that improves the pattern of success. Table 10 shows the summary. The one-time shift for all donors towards increased sensitivity to need after the McNamara speech in 1973 was already noted, including the World Bank itself. The US, the main Cold War protagonist, shifted towards increased sensitivity to need after the end of the Cold War. Otherwise the results are pretty bleak. The World Bank shows no sign of increased sensitivity to policies despite the policy revolution it led after 1980. The data fail to confirm the conventional wisdom about the US lending to corrupt dictators during the Cold War and then changing its stripes afterwards. The World Bank failed

to heed its own campaign against aid to corrupt rulers after 1996. The three donors – the UK, France and Japan – that may have been less directly affected by the Cold War or by World Bank-led changes in development wisdom, fail to show any general trend towards improved selectivity over time in response to need, policies, or institutions.

4. LEARNING FROM FAILURE

The other element of learning I will explore in the paper is aid agencies' response to failure. How quickly do aid agencies learn that something is not working, and change their behaviour accordingly? I examine three closely related episodes: structural adjustment lending 1979–2005, debt relief over the same period, and projection of growth rates. In all three cases, I concentrate on the low income countries that are also the primary recipients of foreign aid.

4.1. Structural adjustment

Structural adjustment loan was the name given to rapidly disbursing loans from the IMF and World Bank made conditional on policy reforms in the recipient government. They were introduced in late 1979, itself a reflection of the learning process in aid agencies of the importance of national government policies for development. (The IMF is not usually considered an aid agency. However, the paper will argue that the IMF was equivalent to an aid agency in its policy towards low-income countries in the structural adjustment and debt relief episodes.) Among the policy objectives of structural adjustment lending was correction of excessive budget and current account deficits, which was supposed to prevent the development of debt crises.³¹

Structural adjustment loans (SALs) were supposed to generate 'adjustment with growth', in the language used in IMF and World Bank documents in the 1980s. African countries were among the first to receive structural adjustment, but the failure of growth to revive in Africa quickly made the loans controversial.

Of course, the failure in Africa (as well as the other examples of failure to learn in this section) could reflect reverse causality and adverse selection – more structural adjustment loans (and later in this section, more debt relief) are given to countries that are experiencing economic crises and low growth. A useful metaphor is that of a patient coming to an emergency room – nobody would blame his condition on the hospital staff treating him.

However, formal econometric studies that control for reverse causality and adverse selection suggest a zero or negative effect of structural adjustment loans on growth, and even little success at changing government macroeconomic policies (Easterly,

³¹ Drazen (2000, 2002) has a rich discussion of under what conditions IMF conditionality facilitates economic reform.

2005; Przeworski and Vreeland, 2004).³² The World Bank itself admitted failure of the early part of the adjustment lending period, but argued that it had improved over time:

'In many cases where deep-rooted problems were not amenable to quick fixes, first-round reforms such as trade liberalization were not accompanied by lasting reductions in poverty or improvements in social conditions. . . . Despite some successes, notably in East Asia, it became increasingly clear that adjustment programs would need to incorporate more direct measures to accelerate poverty reduction.' (World Bank, 2001, pp. 26–27)

What did the IMF and World Bank learn from the failure of growth to respond to structural adjustment? Although the SALs were initially designed to achieve one-off correction of macroeconomic imbalances and policy distortions, they were frequently given one after the other to the same country. Even multi-stage structural adjustment would eventually have some positive exit tendency. If the problem was that the recipient country did not pursue the right policies, then it is not clear why new loans were given. The repetition should alleviate the adverse selection problem, since adverse selection may have happened at the beginning but subsequently the recipient was supposed to benefit from structural adjustment to the extent that it could eventually exit from lending. To extend the metaphor above, if the emergency room patient kept having to be readmitted, which could be either because the first treatment did not work or the patient did not take the medicine, one might question whether the emergency room was the right treatment.

One interpretation of this pattern is that the Bank and the Fund followed a counter-productive response to failure – they kept repeating what had previously failed. Alternatively, the repetition of adjustment loans could itself be a consequence or indication of failure – if borrowing countries did not adjust current account balances or achieve growth, they had a high need for further adjustment loans to adjust to their now worsened external position (such as a higher debt to GDP ratio). This suggests the data are more consistent with a diagnosis of moral hazard rather than adverse selection. In fact, the probability of receiving a new structural adjustment loan in a given year actually increased with the number of SALs received in the previous 10 years with the sample over 1988–2005 (see Figure 4).

To judge this pattern, we have to ask what is the optimal probability of repeating structural adjustment? This is difficult to answer in the abstract – again, a multi-stage adjustment process may be optimal and the Bank and the Fund may have learned this in the course of adjustment lending. What seems less likely to be optimal is the upward slope of the graph in Figure 4. If the multiple adjustment treatment is successful, the probability of exit should increase in the number of loans, that is, the probability of another treatment should decrease in the number of previous loans.

³² Svensson (2003) has an insightful discussion of why conditions on aid tend to fail because donors feel pressure to disburse funds even if conditions are not met.

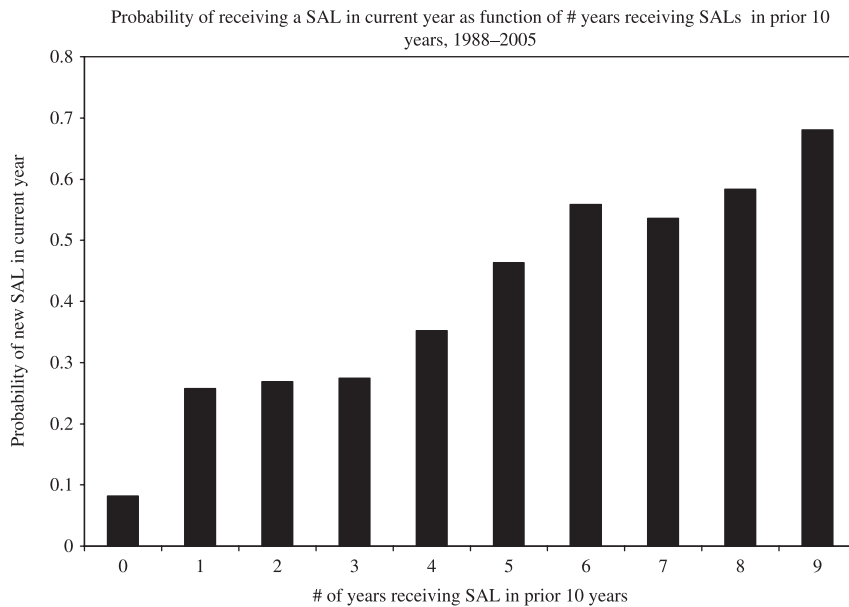


Figure 4. Probability of repetition of adjustment lending against cumulative loans

Against this, there could be adverse selection at work – that countries with more cumulative loans are those with deeper problems and thus may most need another loan. However, the sheer number of loans involved likely exceeded what the designers of structural adjustment had in mind for even the most difficult countries. In 1980–2005, 17 countries had spent 15 or more years under structural adjustment loans. Coupled with the evidence that recipients of structural adjustment loans had little or no tendency to improve their policies from one loan to the next (Easterly, 2005; Van de Walle, 2001), a story of multi-stage adjustment for the most difficult cases is not very plausible. Again, there seems to be evidence for moral hazard in addition to – or possibly instead of – adverse selection.

Other statistics that are useful to examine loan repetition are the Markov transition probabilities (Table 10). Across successive five-year periods, countries receiving one or more adjustment loans in one five-year period had around an 80% chance of getting another adjustment loan in the next five-year period. This compares to an average 42% chance of entering structural adjustment if the country did not have one in the previous five-year period (the sample universe in all these calculations is those eligible for SALs). Over time, the latter probability has been falling, while the repetition probability stayed roughly constant, so the bias towards repetition has increased. A common explanation offered for this phenomenon is that the IMF and World Bank were engaged in ‘defensive lending’, making new structural adjustment loans so that the previous structural adjustment loans could be repaid. Given the Markov transition matrix using the period averages, the ergodic probability of being

Table 11. Transition probabilities for IMF and World Bank structural adjustment loans in successive five-year periods, 1981–2005

| Period | 1986–90 | 1991–95 | 1996–2000 | 2001–05 | Average transition probability for all periods |
|--|----------|---------|-----------------------|---------|--|
| Probability of having one or more SALs in this five-year period conditional on having had one of more in previous five-year period | 0.750 | 0.809 | 0.851 | 0.776 | 0.796 |
| Period | 1986–90 | 1991–95 | 1996–2000 | 2001–05 | Average transition probability for all periods |
| Probability of having one or more SALs in next five-year period conditional on NOT having had one in previous five-year period | 0.606 | 0.414 | 0.333 | 0.333 | 0.422 |
| Markov transition matrix based on average transition probabilities | Time t | | | | |
| Time $t+1$ | SAL | No SAL | Ergodic probabilities | | |
| SAL | 0.796 | 0.422 | 0.674 | | |
| No SAL | 0.204 | 0.578 | 0.326 | | |

in a structural adjustment programme (i.e. the unconditional probability of being in the SAL state) is high – over two-thirds (Table 11).

The IMF Executive Board itself noted the problem that some countries were perpetually under IMF supervision, without any exit in sight. They commissioned a study from the Independent Evaluation Office (IEO) of the IMF on the problem, completed in 2002 (they labelled the phenomenon ‘prolonged exposure’ and criticized the practice).

The IEO report in 2002 called for major reforms in IMF practice to prevent excessively prolonged time under IMF programmes. To test whether this report had an effect on IMF practice, Figure 5 checks whether the average time spent in IMF programmes during 2003–2005 is strongly associated with time in IMF programmes from 1979–2002 (the countries in eastern Europe and the former Soviet Union are excluded because they were not eligible before the 1990s).

The coefficient is around 1 and the constant is close to zero with an R-squared of 0.92, indicating that the IMF continued to lend more than average to the same countries that had spent above average time in IMF programmes before the IEO report. The effect is more than one for one, rejecting any tendency for above average

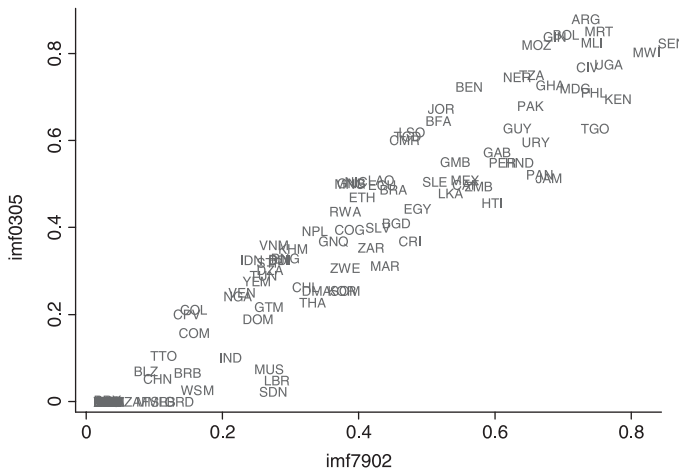


Figure 5. The association between time spent in IMF programmes before (1979–2002) and after (2003–2005) the IEO report criticizing excessively prolonged time under IMF programmes

IMF loan recipients to regress back towards the mean. Again adverse selection could be biasing this association upwards independent of a ‘prolonged exposure’ problem, except that again the amount of time spent in IMF programmes for the worst cases seems too high to represent an optimal course of treatment for even the sickest patients. Once again, moral hazard seems like a factor in addition to adverse selection. Critics from both the ‘left’ and the ‘right’ of the economics profession have united in their criticism of repeated structural adjustment: Sachs (2002) complains about the ‘nearly continuous IMF programs, going on for twenty years or more, despite the fact that under its Articles of Agreement (Article I, Section V), the IMF is supposed to make funding “temporarily available” for emergency relief, not continuously available for a country with unpayable debts.’

Despite the accumulating evidence of failure and the problem of repetition, very little change in structural adjustment lending happened from 1980 to 1999. Finally, in 1999 the IMF and World Bank changed the name of the SALs for low-income countries to Poverty Reduction and Growth Facilities (PRGFs) for the IMF and Poverty Reduction Support Credits (PRSCs) for the World Bank. This did not explicitly address the repetition problem; instead, it was advertised at the time as a shift towards more emphasis on poverty reduction, which apparently was a reaction to the criticism that adjustment programmes did not try hard enough to protect the poorest part of the population.

4.2. Debt relief

The problems with structural adjustment lending had some connection to the second episode to be examined to see whether there was learning from failure: the official

debt crisis of the low income countries (often called the IDA countries, referring to countries eligible for the highly concessional loans of the International Development Association of the World Bank). The debt crisis culminated in the debt forgiveness programme for IDA countries known as the Heavily Indebted Poor Countries (HIPC) Initiative in 1996, with further rounds of debt relief for these same countries continuing through 2005. Sixteen of the 20 countries who spent the most time under IMF programmes from 1979–2005 were IDA countries, showing how the world's poorest countries were also the most dependent on structural adjustment lending. Of these 16 IDA countries, 15 became HIPCs. This was another sign of the failure of structural adjustment lending. The SALs were not sufficiently productive that they generated resources (or perhaps the credible incentive) to pay them back – even though the loans were highly concessional, zero interest loans with a 10-year grace period and a 40-year maturity.

The announcement at the 2005 G-8 summit of 100% multilateral debt cancellation for the HIPCs was the latest in a long string of G-7 or G-8 summits granting progressively greater relief for low income debtors. As highlighted in the table in the introduction, low-income debt has been problematic pretty much from the beginning. The following gives some of the incremental steps in debt relief over the past two decades, usually decided by the G-7 summit that year. Both those who want generous debt relief and those who want to 'get tough' with debtors have criticized what Sachs (2002) called 'the endless rounds of debt rescheduling'. Each set of progressively more favourable terms is named after the location of the G-7 summit:³³

- 1987 Venice Terms: interest rate relief on official debt of low-income countries.
- 1988 Toronto Terms: reduction in present value of bilateral debts allowed up to 33%.
- 1991 London Terms: allowable debt reduction in present value raised to 50%.
- 1994 Naples Terms: allowable debt reduction in present value raised to 67%.
- 1996 Lyons Terms and HIPC Debt Initiative: former raises allowable bilateral debt reduction 80%, latter writes down some Bank and Fund debt, 'once and for all', with a 'sunset clause' to prevent repetition. Write down of multilateral credits to debt level that is 'sustainable', defined as 200–250% of exports.
- 1999 Cologne Terms and 'Enhanced HIPC': allowable debt reduction raised to 90%, threshold for sustainable debt lowered to 150% of exports.
- 2004 – World Bank and IMF extend 'sunset clause' of HIPC initiative for the fourth time, to end 2006, closing eligibility for HIPC to new countries as of end-2004. However, countries that are eligible as of end-2004 that do not fulfil HIPC conditions by end-2006 will be considered for another extension.³⁴

³³ Source is from Sachs (2002) and Easterly (2002).

³⁴ International Monetary Fund and International Development Association (2006, p. 4).

- 2005: G-8 Gleneagles summit agrees to 100% multilateral debt cancellation for HIPC countries (Multilateral Debt Relief Initiative or MDRI).

Although some of the official debt originated with non-aid channels like export credit agencies or commercial banks, much of it was from concessional loans made by bilateral aid agencies, the IMF and World Bank. The idea of the aid loan was that it enabled aid to be rotated amongst different countries – an aid loan would first have a productive impact in low-income country A, who could then pay it back, where it could then be lent again to low-income country B, and so on. Another justification was that the aid loans would finance investments whose positive returns would make possible debt repayment. The record of debt relief is suggestive that the aid loan did not deliver on the promise of beneficial recirculation of aid funds, and that positive returns to aid projects either were not realized or were not used to repay debt.

It seems that aid agencies have been slow to learn the lesson that low-income debt was not fulfilling its purpose, and in fact actions of the aid community may have made the debt problem worse. This is shown first of all by the protracted process of debt relief, in which a little more relief was dribbled out each year. Many officials in aid agencies understood well the problem of moral hazard, and moral hazard is not an easy problem to solve in general. Still, it would likely have helped if the aid community as a whole had been able to make at least a partially credible commitment to some kind of one time only debt relief as opposed to an open-ended process of each year giving additional debt relief. As a result, poor countries had perverse incentives to borrow more in the (correct) expectation that the debt would later be forgiven. The moral hazard problem developed more quickly than the learning of aid agencies how to address moral hazard. (Again, a competing explanation could be adverse selection – that those countries with the most severe problems kept needing additional rounds of debt relief in a multi-stage treatment. However, it would still seem better to do the treatment all at once for the adversely selected countries, so that they also don't have moral hazard.)

Nothing in the latest rounds of debt relief appears to clearly address the problem of moral hazard. The IMF Executive Board acknowledged the risk, although not specifically mentioning the perverse incentives that were created by repeated rounds of debt relief:

'Directors considered that the forward-looking DSF (Debt Sustainability Framework) will become an even more important tool for helping countries avoid unsustainable debt re-accumulation post-MDRI while seeking additional financing to attain the MDGs [Millennium Development Goals] . . . They emphasized that the primary responsibility to avoid new debt problems rests with the countries themselves, with technical assistance from the Fund and the World Bank. Directors acknowledged that a large number of low-income countries are increasingly aware of debt issues and have made significant progress toward strengthening their debt management capacity.' (International Monetary Fund, 2006a)

The World Bank Executive Board also stated the problem:

‘Executive Directors and IDA Deputies have expressed concern that this (MDRI) should not lead beneficiary countries to immediately begin re-accumulating debt levels that could become unsustainable. (World Bank, 2006a, p. 10)

The main solution offered to perverse incentives to re-borrow is that the IMF and the World Bank pledge to themselves limit their own new lending. Their main instrument for deciding how much to limit lending is a ‘Debt Sustainability Analysis’, which analyses the ability of the country to repay new loans. This seems to miss the crucial points that (1) the perverse incentives created by moral hazard makes ‘willingness to pay’ more relevant than repayment ability, (2) aid agencies had already done ‘debt sustainability analysis’ throughout the 1980s and 90s, but it failed to prevent the HIPC crisis.

The aid agencies have been slow to re-examine the wisdom of making *any* new aid loans, despite the problems with the old loans. One solution to non-credible loans ripe with moral hazard is to *ex-ante* give grants. Although the Bush administration has been pushing IDA in this direction for several years, the World Bank’s other members have been slow to agree. (Grants may make sense to replace non-credible loans, but may have other problems such as not requiring the kind of long-run investment that would generate returns to repay loans.) Data on aid loans to Africa over 1960–2003 do not show any pronounced downward trend, either over the whole period or the debt relief period 1979–2003, although there is a modest fall after the mid-1990s. Despite the debt cancellation for HIPCs, the IMF and the World Bank continue to make new loans to HIPCs.

As to the ‘debt sustainability analysis’, it seems to suffer from a problem that contributed to the repetition of adjustment loans and the development of the HIPC debt crisis in the first place: excessive optimism about growth. The optimism of IMF and World Bank growth projections have been noted for decades (see for example World Bank, 1991), but apparently, as the IMF Independent Evaluation Office 2002 report notes still, ‘internal incentives in the IMF encourage overpromising in programs’ (p. 12). The IEO notes more hopefully that ‘the recent initiative to improve the Fund’s analysis of public and external debt sustainability emphasizes the need to discipline projections’ (p. 216).

Growth projections would be harmless rhetoric except that they influence the calculation of how much new debt countries can handle. Excessive optimism leads to overlending, as the IMF IEO report noted in the same report chastising the IMF for its practice of many repeated loans to the same borrowers. On average for IMF programmes in the 1990s, the target GDP growth was 4%, but actual growth was only 2% (Baqir *et al.*, 2003). Since population growth is about 2% also, this means the actual growth of income per person was close to zero.

We now have a track record on HIPC growth projections since the HIPC programme began in 1996. Has the practice of over-predicting growth rates, which contributed to the development of the HIPC crisis, been corrected in the process of resolving that crisis? We have a sample of 75 forecasts over 1996–2005 of 1–5 years

ahead that could be compared to realized actuals. Each HIPC has had about three growth forecasts made over time, as the country has moved through successive rounds of becoming eligible for debt relief. Growth forecasts were excessively optimistic in 76% of the cases in which they can be compared to actual subsequent growth (each case represents an average over between 1 to 5 years, defined by the overlap between when the forecast was made and the data that has since become available, with fewer years in the later rounds of course). The excess optimism actually got worse from earlier to later rounds, with an average overprediction of 1.1 percentage points in the first stage, 1.5 percentage points in the second stage, and 1.7 percentage points in the third stage.³⁵

IMF and World Bank staff are very much aware of the problem of excessive optimism. A 2004 IMF and World Bank document on debt sustainability said ‘To the extent that debt dynamics in the program baseline scenario appear significantly more benign than would be implied by the country’s previous record, careful justification for the more optimistic outlook would be required’ (International Monetary Fund and International Development Association, 2004, p. 27). Despite this self-awareness of the problem of over-promising, the incentives seem to remain as strong as ever. A quick check of the most recent HIPC documents shows forecasts clinging to optimistic forecasts. African countries on average have never had five consecutive years of 5% growth. However, the April 2006 Cameroon HIPC document projected 5.0% growth for 2006–2015, and 5.3% for the whole period 2006–2025 (International Monetary Fund, 2006b). Similar recent examples of long-run forecasts around 5% include 2005–2006 reports for Congo (Brazzaville), Ethiopia, Mali and Rwanda.

The latest IMF and World Bank report on debt sustainability analysis in 2006 again noted that:

‘Baseline projections tended to be more favorable than historical averages – reflected in consistently lower debt-burden indicators – and it remains important to guard against excessive optimism.’ (IMF and World Bank, 2006a)

The cycle of repeated adjustment lending, repeated debt relief, and over-optimism on growth rates in recent years does not seem to promise any escape from the aid syndrome noted way back in 1972 by P.T. Bauer: ‘Concessionary finance used unproductively leads to indebtedness which is then used as an argument for further concessionary finance.’ Here, there seems to be some combination of political pressure and lack of perspective that prevents any real learning to be implemented in escaping the debt cycle.

5. CONCLUSIONS

The record of the aid agencies over time seems to indicate weak evidence of progress due to learning or changes in political support for poverty alleviation. The positive

³⁵ I am grateful to the World Bank’s HIPC Department for providing me with this data.

results are an increased sensitivity to per capita income of the recipient (although it happened long ago in the 1970s), a decline in aid tying, and decrease in food aid as a share of total aid. Most of the other evidence – increasing donor fragmentation, unchanged emphasis on technical assistance, little or no sign of increased selectivity with respect to policies and institutions, the adjustment lending-debt relief imbroglio – suggests an unchanged status quo, lack of response to new knowledge, and repetition of past mistakes.

The paper does not address the reasons for the failure to progress. Since the aid agencies contain many talented economists who are aware of many of the problems documented here (as shown by some of the quotes above), perhaps there is pressure to continue in certain directions in foreign aid regardless of whether they are productive. The political economy that leads to that unhappy result would be a rich area for further study.

This paper also has had little to say about what to do about the donors' failure to make progress. There could be new mechanisms that bypass aid agency bureaucracy, such as Michael Kremer's proposal to create a funded incentive for new vaccine development.

Easterly (2006) argues that the relative invisibility of aid agency actions contributes a lot to the unsatisfactory state of foreign aid. Many different constituencies, both academic and political, have called for increased monitoring and evaluation of aid agencies.³⁶ Optimistically, one can hope that more systematic evaluation would give aid agencies more leverage to resist perverse political pressures and more incentive to learn more from past mistakes.

Discussion

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Bill Easterly has written a provocative and insightful paper addressing a central issue in foreign aid. It is widely agreed that aid to developing countries is often quite ineffective in achieving its goals. The basic question is: why is this? Given the widespread criticism of aid-giving agencies for their practices, one may wonder to what extent ineffectiveness reflects the mistakes of aid givers. Since even the strongest supporters of aid argue that we often do not know what works, the correct question is not whether aid agencies have made mistakes. Rather, given the history of aid ineffectiveness, the more relevant question is: Are aid agencies changing in light of their failures or the criticisms levelled against them? That is, are aid agencies improving?

³⁶ See the discussion of evaluation in Banerjee and He (2003), and the Center for Global Development's programme on the 'Evaluation Gap' (http://www.cgdev.org/section/initiatives/_active/evalgap).

Easterly presents evidence of various sorts to make the case that aid agencies have not learned or improved much. The main question a discussant must address is therefore whether the case is convincing. I think overall that Easterly has made a good case, but far from unambiguous. Some parts of his case are persuasive; others less so.

If one accepts the argument that aid agencies have not improved, the next question is: why haven't they? Easterly says specifically that though the question is important and is the obvious next question, it is impossible for him to address it in this paper. I want to suggest some reasons why there hasn't been improvement, and, in fact, why we perhaps shouldn't expect much in certain respects. Hence, I will divide my comments into two parts: 'whether' and 'why', though as will become apparent the question of whether aid agencies have improved cannot really be separated from the question of why they exhibit the performance they do.

Problems in discerning whether or not agencies have improved

Early on in the paper, Easterly points out that in order to evaluate aid agency progress, we need some benchmark. One such benchmark would be how aid agencies should optimally behave, but he argues that since it would be very difficult to specify such optimal behaviour, he instead will adopt as the benchmark what aid agencies themselves state to be desirable behaviour. The statement is a bit curious, since it neither seems possible to avoid the benchmark of some notion of optimal behaviour, nor does Easterly really do so. I think the paper applies the notion of benchmarks somewhat haphazardly. I will argue that more careful consideration of the implications of the appropriate benchmark for the interpretation of results makes the conclusion of lack of improvement much more ambiguous.

One example is in how one interprets the regression results on the relation between aid received by a country and per capita real income (for example in Table 2). Two general reasons aid may fail can be moral hazard and adverse selection. Is the ineffectiveness of aid in a country due to the actions of aid agencies (e.g., giving aid repeatedly, no matter what performance has been) and/or recipients (e.g., misuse of aid), that is, to moral hazard? Or, is it due to country characteristics that aid cannot easily change, that is, adverse selection (or perhaps 'exogenous heterogeneity')? Whether the problem is one of moral hazard or adverse selection will affect how we interpret his regression results.

To see this point, let us ask in a very simple and stylized way what the optimal behaviour of an aid agency would be in the face of these two problems. If cause of aid ineffectiveness is country malfeasance not affected by conditionality, optimal behaviour may be 'selectivity', that is, cutting off aid to repeated poor performers. If countries with worse behaviour are poorer (as would likely be the case), optimal agency behaviour would imply a *negative* relation between per capita income and optimal aid disbursement. Conversely, if poverty reflects bad conditions a country

can't easily affect, such as geography, optimal agency behaviour would imply a *positive* optimal response to low income.

A main finding in Table 2 is that there was a one-time shift in the mid-1970s to higher sensitivity to low income (a more negative relation between country income and aid received). As the paper puts it, 'there does seem to be learning over time to respond to need, but this effect is concentrated around a one-time shift around 1973 . . .'. But does higher sensitivity to per capita income mean aid givers are 'learning' to respond to need, which would be the case if one viewed the problem primarily as one of adverse selection? Or does it mean the opposite – that aid givers are giving more aid in spite of country malfeasance – that is, incorrectly responding to increased moral hazard problems? Simply on the basis of regression results such as these, one can't say, so that caution is necessary in interpreting the results as suggesting a one-time improvement around 1973, but no continued 'learning' afterwards.

In Table 3 Easterly reports on regressions of log real aid regressed on log per capita income (and log population) for successive five-year averages. In these regressions he finds that prior to the 'regime shift' in the mid-1970s, 'aid was weakly related to need or even had the wrong sign'. But what does the 'wrong sign' mean if the problem is one of moral hazard? These regressions also show that in subperiods after 1989, the coefficient on log per capita income is falling relative to earlier periods. Does this mean aid givers are progressing, regressing, or, perhaps, adapting to a changing mix over time of countries characterized by adverse selection versus moral hazard problems?

Easterly is well aware of the importance of distinguishing moral hazard from adverse selection arguments in assessing the ineffectiveness of aid. However, I think he doesn't pay nearly enough attention to the distinction and its implications in making his case, making it harder to say whether agencies were learning or not.

A similar criticism may be made on the interpretation of the results on response to democracy (or even policy measures in general). Easterly finds that aid responds positively to higher levels of democracy, but the magnitude of the response is often unimpressive. Moreover, there was no change in the response to democracy before and after the end of the Cold War. If the level of democracy is simply a policy choice (corresponding to the moral hazard argument), then it seems optimal to have a positive response. However, the level of democracy is not a simple policy choice. A challenge facing new and more fragile democracies is to strengthen and consolidate the democratic system. Aid should then be given to help in that process so optimal disbursement might exhibit a *negative* relation between aid received and the level of democracy. Since the end of the Cold War witnessed the emergence of many new democracies, the failure to find a difference in sensitivity to democracy before and after need not represent a failure for actions to match words, as Easterly suggests. It may reflect the confounding effects of an increase in new democracies in the sample. If aid agencies were in fact more sensitive to pro-democratic policies, but were also facing more new democracies that needed support, the net effect as measured by the coefficient on the Cold War dummy could go either way.

Another example of the value of more careful consideration of the benchmark of optimal behaviour can be seen in his critique of technical assistance. Technical assistance is rightly criticized as often subsidizing the consultants from donor countries rather than benefiting the recipient and making a significant contribution to poverty reduction. Easterly points out that in spite of these criticisms, there is no sign that the share of technical assistance has significantly fallen over time and has actually risen for the US and Japan.

However, whether or not a fall in technical assistance represents improvement depends crucially on the nature of the assistance. There certainly are types of technical assistance that would be useful (as certainly as there are other types that benefit donors rather than recipients). Perhaps Easterly's knowledge of the exact nature of technical assistance makes him conclude that quality or type of assistance didn't change much over his time period, so an unchanged dollar level indicates no learning. On the basis of what the paper gives us, however, the case that aid agencies are not improving in this dimension seems unproven.

In these examples, another way to put my critique of the paper is that a really convincing case of no improvement requires much 'finer' (or more 'micro') data, more attention to country detail, and less reliance on cross-country regressions or very aggregate statistics. More generally, aid ineffectiveness surely does not represent the same phenomena across all countries. I think that the empirical work would be more effective if the empirical analysis better took this into account.

In contrast, I found the 'analytical narrative' evidence in Section 3 more persuasive. The examples of repeated structural adjustment lending and the failures of HIPC make a strong argument that IFIs are not learning a lot from failures.

Why so little change?

The paper explicitly shies away from this question, but the results make it unavoidable. Not surprisingly, I will suggest a political-economy perspective may help us better understand why there has not been more improvement. The basic problems can be summarized in a number of simple observations. Aid agencies are not benign social welfare maximizers, but self-interested agents with welfare maximization as only one objective. The aid giver is an agent with multiple principals, some of whom (rich donors) have a lot more power than others (poor recipients). Within a recipient country, there are also heterogeneous interests, with different objectives and different power. Much or all of this is perhaps well known, but worth repeating anyway.

A consideration of the objectives of the main players suggests why there may be limited learning or improvement. Let's begin with the objectives of aid agencies. Consider an organization that sees its mission as giving aid to help countries solve their economic problems. A key activity of the organization as a whole would be justifying its continued existence and what it is doing. If it stops giving aid then it may be asked why it exists. Hence, there is a strong incentive to continue lending even in

the face of evidence that aid may be ineffective. There is a need, to use the old expression, to 'push money out the door'.

What would be the objectives of employees of the organization? As in all organizations a key objective of individuals would be not simply to stay employed, but also to advance in the hierarchy (all the more so if one believes or has come to believe that giving aid has social value). Hence, the typical employee would probably not want to question the organization's basic vision of itself and suggest that the organization stops lending. Instead, those who see problems but want to stay in the organization might suggest there may be better ways of lending or that there is a need to 'streamline' existing policies. It is unlikely that they would raise fundamental questions about what the organization is doing. Nor would an employee suggest reading Easterly (2006) and thus focusing on small projects reflecting 'indigenous creativity' rather than large initiatives. (Having done so, I would strongly recommend reading it.) An understanding of why things don't change might well benefit from a formal study of the political economy of the bureaucracy itself, as in Wilson (1989).

What about the objectives of the aid agency's principals and how do they affect how aid is given? There are multiple principals with different objectives and, importantly, differential power to enforce their aims. Who are the strongest interest groups who lobby for specific policies by the aid agency? Certainly not the economically weakest group (otherwise known as 'the poor'), unless a powerful agent can lobby for them. Donors are far more influential and, as Easterly points out, certain practices that have been criticized as ineffective may be in their interests. Moreover, 'donors' are a heterogeneous group, even within a country, so that those who are genuinely concerned with making aid as effective as possible must compete with other interests. As in the case of understanding how bureaucracies work, studying the nature of lobbying by the principals within and outside the bureaucracy would help in understanding why agencies don't improve.

Finally, what about the objectives of aid recipients? Many developing countries are characterized by 'clientelism' – the giving and granting of favours and patronage; the distribution of economic rents in order to ensure political stability. Leaders need to get control of a significant level of resources in order to make clientelistic exchange a basis of their power. The funnelling of aid away from the intended recipients and into the hands of the state elite is an unsurprising result of pervasive clientelism. It may be more than corruption (though there is a lot of that), but the nature of making things work in a state with weak institutions. Clientelistic practices may be the only way to achieve policy goals in such a country, but this takes resources.

Consider the implications of the fiscal crisis in Africa starting in the 1980s on the use of aid. Because state revenues from sources other than aid fell, the crisis increased the need of leaders in clientelist states to expropriate these funds. Bad governance may not only lead to misappropriation of aid, but aid flows may actually have worsened governance in Africa. Van de Walle (2001) finds a correlation between the amount of aid a country received in the crisis and political protest against the government,

but no correlation with the amount of policy reform actually implemented. He argues that heavy reliance on foreign aid further worsened governance, 'A high number of loans weakened central states by disrupting central decision making [and] creating the impression that key decisions were made by foreign bureaucrats and thus undermining the little legitimacy [governments] still possessed.'

Concluding comments

In this paper and elsewhere Easterly has made the case that aid agencies aren't changing very much in response to their failures. Though I think he may be too ready to read lack of improvement in the evidence, overall it is clear that in certain dimensions there was little improvement. Anyone who really cares about the possibility of using aid to alleviate poverty has to listen carefully to him.

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This is an unusually interesting and stimulating paper, which investigates whether aid policies have evolved over time, and whether this evolution suggests learning on the part of aid agencies. A particular strength of the paper is that it infers changes in behaviour, and the extent of learning, partly from observed changes in the flows, composition and allocation of aid. The idea is to evaluate aid policies quantitatively, in terms of what has happened in practice, and not in terms of stated policy commitments, casual observation, or self-evaluations by donors.

The analysis does find some improvements in the allocation of aid. These include reductions in aid tying, and in the relative importance of food aid. Following the new emphasis of the 1970s on redistribution and poverty eradication, aid was redirected towards poorer economies. But no change on a similar scale is observed after the end of the Cold War, even though aid could have been redirected once strategic considerations became less relevant. There is some evidence that aid flows have become more sensitive to the extent of corruption in recipient countries, and perhaps more sensitive to political rights, but these tendencies are far from uniform.

It has often been argued that the potential of foreign aid is undermined partly by a lack of coordination between donors, and because donors attempt too much, rather than seeking to specialize. The calculations summarized in the paper's Figure 1 indicate that donors continue to split their aid among many countries, and recipients to receive aid from many sources, despite the long-standing recognition that more coordination and specialization is needed. Nor is there much evidence that donors are beginning to specialize by sector, even though this could have significant advantages.

The paper's analysis is often persuasive, but at times it may go too far. Some of the recent changes in donor practices, such as movements towards recipient country 'ownership' and wider participation in the aid process, are hard to evaluate in

quantitative terms. There are some other scenarios in which aid agencies could perform well, or learn successfully, but still fail this paper's specific tests. For example, consider the tests of the sensitivity of aid flows to income levels. It would be possible for aid to become more sensitive to low income levels, but also to other country characteristics that are correlated with income. In that case an increased sensitivity to poverty could be hard to detect, unless the model for aid allocation controlled for other relevant variables. The paper allows for this to some extent, but there would be room to go further.

Overall, the paper makes a powerful case that aid agencies and donor governments have been too slow to learn from experience. Persistent weaknesses have not been addressed, despite widespread awareness of them. A full assessment of these claims would be a major undertaking. In the rest of this discussion, I will take them at face value, and ask whether there are characteristics of foreign aid that make learning especially difficult. Learning may not be as easy as it sounds, and it is worth trying to understand why not.

There is a general consensus that aid agencies are attempting something that is unusually difficult. How do we know what works? It has become quite fashionable to assess the weaknesses of foreign aid, and remedies for those weaknesses, in terms of the statistical and econometric literature on programme evaluation. This view tends to reduce the underlying complexity to a series of technical sub-problems, in which randomized trials, or close substitutes for them, should be used to establish which interventions work best. There is a lot to be said in favour of this, and the evaluation of specific treatments is a well-defined problem that lends itself to a rigorous, scientific approach. At the same time, it is only a partial solution. Not all development policies can be evaluated in this way. The approach cannot address the general equilibrium effects of aid, and therefore misses some of the economic and political consequences of large-scale transfers that are central to debates on aid effectiveness.

Another lurking question is whether even the most rigorous and persuasive evidence will always be heeded. There have to be mechanisms for ensuring an institution or organization can learn from that evidence, and respond to it with policy changes. Organizational learning remains something of a black box for economists. We don't know a great deal about how organizations can learn, or how they can improve their methods for aggregating information, evaluating the evidence, and reshaping policy.

In the private sector, learning and evolution are prompted by a mixture of competition and the external evaluations associated with stock markets and the threat of takeover. In the aid context, external evaluation is far from unproblematic. This is partly because, even in retrospect, it is hard to know what works, given the complexity of the counterfactuals. This means that heavy demands, in terms of resources and expertise, are placed on external observers. The understandable temptation to indulge in more casual judgments will often do more harm than good.

If external evaluation is typically problematic, then internal debate becomes more important, but external pressures could easily lead to a defensive attitude towards

internal debate, for the sake of public unity. Aid agencies, as recipients of public funds, have strong incentives to avoid explicit and public self-criticism. Moreover, responsibility for some long-standing problems, such as aid tying, must rest at least partly with politicians and not the aid agencies.

If agencies are to learn, they need mechanisms for internal evaluation and self-correction, and a readiness to contemplate large-scale changes of direction. Some issues are likely to require genuine internal debate, and some degree of internal democracy, avoiding the dangers of 'group think' and conformism to received ideas, including those of immediate superiors. It is easy to see why this might fail in practice. For individuals, the private returns to dissent may easily be lower than the social returns, while the freedom of internal debate is strongly constrained by the need for teamwork, internal coordination, and credibility in the eyes of the outside world.

These points suggest that learning may be an especially difficult process for aid agencies. In the past, changes of leadership have been important, and have had discernible effects on the policies of even the largest institutions. But perhaps this shows that changing direction by other means is either not straightforward, or slow, which would be consistent with this paper's claims. In other words, revolution becomes an imperfect substitute for evolution, even though the latter might ultimately be more desirable and less risky.

A remaining question is whether the analysis undermines the case for foreign aid in general. Some will read a paper such as Easterly's looking for answers to precisely that question: is there too much foreign aid, or too little? My view is that the paper should be interpreted differently. It suggests that aid agencies need to reform in certain ways, individually and collectively, if they are to realize the full potential of foreign aid. The necessary reforms may go beyond specific policies, to encompass changes that promote organizational learning. That is much easier said than done. Nevertheless, the paper makes an important contribution to a diagnosis, and thereby takes us closer to a remedy.

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