Assessing Aid: What Works, What Doesn't and Why?
World Bank Policy Research Report
David Dollar and Lant Pritchett
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The November 1998 release of *Assessing Aid* represents a landmark attempt by the World Bank to study what makes aid effective. Amidst increasing international concerns about foreign aid dependency and decreasing aid outlays by all major Organization for Economic Cooperation and Development (OECD) donors, the World Bank and other members of the aid community are under significant pressure to show evidence that aid actually works. *Assessing Aid* works hard to provide concrete evidence that aid can work and to describe the conditions that support successful programs. It also works to find a balance between the interests of donor nations and the needs of developing nations. The result is an important re-evaluation of how international assistance programs are designed, implemented, and monitored.

While there are many individual conclusions and prescriptive suggestions in the *Assessing Aid* report, its central finding is that aid works best when it supports local governments that practice "good management" of their social, political, and economic institutions. This finding leads to the overarching conclusion that aid should be a mix of ideas and money that is tailored to the conditions in recipient nations. While the report gets many things right, there are some aspects of its analysis and underlying assumptions that demand careful consideration in order to provide an accurate assessment of the work the World Bank has done.

The central question I ask in this review is how much does *Assessing Aid* add to the existing body of literature? To answer this question I will delve into the history behind the report, address its assumptions, and evaluate its analytical framework.

Historically, developmental aid programs have generated everything from great successes to disastrous failures. Successful programs have supported humanitarian relief efforts, improved child immunization rates, reduced the burden of specific diseases (such as river blindness), reduced infant mortality rates, supported agricultural advancements that have feed millions, and improved access to schools, clean water, sanitation, power, and health clinics. But failed programs are common and occur under many different conditions. In Somalia in 1987 the failure of aid agencies to respond to growing drought conditions, despite repeated calls for help from government officials, had disastrous human consequences. [Hancock] Well-intentioned but misguided food aid has disrupted domestic farm sector prices and harmed local producers [Raffer, O'Hanlon, Hellinger] In other situations developmental aid has been disbursed repeatedly to nations such as Tanzania, Zambia, and the Democratic Republic of Congo. [AA] There is little evidence that aid has made a difference in the plight of the citizens in those nations. Aid to Africa has had a particularly abysmal record. Even the World Bank has acknowledged that 73% of its African aid programs have failed.[Meltzer] There is a growing sense among international governments, lending organizations, and the public that we need to develop a better formula for allocating aid monies.

During the last decade there has been a surge in criticism of how the World Bank, International Monetary Fund (IMF), and other international aid institutions do business. Popular media critics such as Michael Maren *(The Road to Hell)* and Graham Hancock *(Lords of Poverty)* depict an aid culture in which corruption is rampant and donor organizations lack basic expertise, focus, clear intentions, communication skills, and cultural understanding.[Maren, Hancock] They argue that the aid community is more concerned with competing to lend money and disburse aid than it is with holding managers, programs, governments, and it own institutions accountable for failure. But these critics, and others in popular literature, have a tendency to fall into simplistic and sometimes patronizing analyses that either depict developing countries as backward, corrupt, and unable to generate returns on aid investment, or argue that donor agencies are paternalistic, incompetent, and driven almost entirely by self-interest. Though there may be elements of truth to both claims, it is not productive to lay blame on one party or another. Conflicts of interest exist on both sides of the donor-recipient equation.

Lending institutions and private foundations have also sponsored examinations of developmental aid. The 1992 Wapenhans Report, published by the International Bank of Reconstruction and Development's (IRBD), acknowledged a constant institutional pressure to lend in what it called an "approval culture" with a "pervasive preoccupation with new lending." [Rafferp 173] The report argued that the over-emphasis on the approval and disbursement of loans led to "poor design, poor management and poor implementation" of programs.[Rafer p.173] It also noted a lack of institutional transparency and financial accountability on the part of lenders, which results in a system that unfairly places the risks of borrowing entirely upon aid recipients. In some situations lenders even stand to "gain financially from their own failures or negligence at the expense of their clients" because the same lenders are funding the long-term recovery programs designed to pull recipients out of financial crises. [Rafer p. 177] A separate report by the Department For International Development (DFID) clarified these concerns: "the financial leverage of donor agencies in recipient countries, coupled with low levels of political scrutiny 'at home', combine to create a hazardous vacuum of accountability." [DFID]

In 1997 a Brookings Institute's analysis of development aid (A *Halfpenny on the Federal Dollar)* concluded that donors should be more selective on the front-end of aid disbursement. [O'Hanlon] It argued that the soundness of local policies should be a primary decision-making factor prior to disbursing loans. This represents a shift from established practices of using loan conditions to pressure recipient nations to implement "good" policies while loans were in place. The study also argues that understanding "how and why aid flows failed" is the next critical step in the process to make aid work.

Mounting criticisms of foreign aid from the public and private sectors set the stage for the release *of Assessing Aid.* The report has several features that set it apart from other literature in the field. It has an unusually heavy focus on empirical evidence that lends a scientific credibility to the work. The authors, led by David Dollar, use regression models that incorporate policy, economic, and institutional index scores derived from empirical data on aid programs in 56 developing countries during 1970-93. These models form a useful and detailed analytical framework designed to isolate the factors that contribute to the success or failure of aid initiatives. The results are used to develop a series of conclusions about why aid works in some situations and not in others. Prescriptive policy recommendations are then discussed based on the evidence the authors have developed. Throughout, the report is not afraid to tackle difficult issues that international institutions have shied away from in the past. The authors acknowledge that corruption has been a critical factor in the failure of multiple aid programs, and discuss the conflicts of interest that arise from institutional incentives to lend. The report calls for a fundamental "rethinking" of the role international aid should play in promoting development, including whether it should be used at all.

All the data and analysis in *Assessing Aid* generates the report's central finding:
Aid does the most to support economic growth and reduce poverty when local governments practice "good management" of social, political, and economic institutions. This finding is built upon the detailed set of conclusions and policy recommendations summarized below.

The conclusions of the report are: [AA p. 2-4]

1. "Improvements in economic institutions and policies in the developing world are the key to a quantum leap in poverty reduction."
2. "Effective foreign aid is a natural compliment to private investments."
3. Sector specific development projects are often fungible, but they can serve to strengthen local institutions and policies across sectors.
4. Projects that involve local "ownership" and social investments are most effective.
5. Aid can work even in poor policy environments if donors focus on sharing of knowledge and technical capacity rather than money.

The policy recommendations are: [AA p 4-6]

1. Aid resources should be allocated more effectively to "good-policy / high-poverty" countries.
2. Policy-based aid should be used to "nurture policy reform in credible reformers."
3. Aid activities must take into account the local policy strengths and weaknesses.
4. Projects should be more focused on sharing technical capacity and knowledge.
5. Donors need to be less proactive when it comes to financial aid disbursement to nations with distorted policy environments.

Much of the following discussion is devoted to a critical examination of the assumptions surrounding the conclusion that improvements in economic institutions and economic growth are the keys to poverty reduction. Those assumptions have important implications. But in order to get to that discussion we must start by clarifying the primary goal of developmental aid.

The authors *of Assessing Aid* establish early on that they believe "all aid is ultimately aimed at promoting growth and reducing poverty." A 2001 analysis of IMF annual reports by the U.S. General Accounting Office (GAO), among others, shows that lenders have explicitly promoted economic growth as the primary means to achieve poverty reduction since at least the early 1990's.[HGAO, O'Hanlon, Raffer] While not new, it is important that the World Bank begins with this explicit statement of its goals. The goals of recipient nations and donors have not always been aligned. Institutional pressures to lend have created a culture in which donors have more incentive to disburse aid than they do to be concerned about the success of aid programs or the needs of recipient nations. On the flip side of the equation, some recipients of aid have been more interested in collecting aid money than enacting the types of reforms that aid is supposed to be supporting. This lack of a cohesive agenda between donor and recipient fosters miscommunication, distrust, and may even be used as a rationalization for corruption. The perception that each party is serving its own self-interest fosters corruption on both sides of the assistance equation. *Assessing Aid* refers to a 1995 article in *The Economist* that highlights "a curious mating ritual" in which Kenya and its donors played a game of words and postures that cost the international community $7.1 billion between 1990-1996 in official developmental assistance. There is little to show for that money. By making a clear statement of the goal the World Bank has for its aid programs. *Assessing Aid* may alleviate some of the need for these kinds of expensive games,

Assessing Aid argues that economic growth is the most effective mechanism we have to reduce poverty. The methodology used to support this argument is important so I will expand upon it here. *Assessing Aid* uses empirical data to describe what aid *can* accomplish in good policy environments. The data indicate that in countries with good policy environments and an average amount of aid dollars (about 2% of GDP), an increase in aid equivalent to 1% of GDP promotes economic growth of 0.5 percentage points. Move to mediocre policy environments and the observed growth effect of a 1% increase in aid drops to zero. There is also some evidence of a negative correlation in the poorest policy environments, though the statistical indicators were not significant.

Linking this data to poverty reduction is a major goal of the report. The report's analysis finds that a 1% increase in per capita income, one measure of growth, is correlated to a 2% reduction in poverty. So using transitive mathematics, the authors argue that, in good policy environments, a 1% increase in aid leads to a 1% reduction in poverty.

If we follow this logic, then aid will be most effective for poverty reduction when targeted to good policy environments. Historically aid has been given to well and poorly managed nations alike, and in many cases to decidedly "middle-income" developing nations. The *Assessing Aid* analysis suggests that the ideal aid recipient would be a nation with good policy scores and a high poverty burden. Targeting aid to where it is most needed and where it will do the most good should lift the greatest number of people out of poverty. This more efficient allocation of aid monies has the potential to generate enormous improvements in the productivity of aid monies. The report projects that a $10 billion increase in aid that is targeted to nations with sound policies could lift 18 million more people out of poverty than a blanket increase in aid to all nations. [AA p. 47]

These conclusions make good sense. Targeting aid to high poverty, good policy environments generates the greatest marginal effect. But it is essential to examine just how "good management" is measured. The report defines good management policies as those that promote low inflation, small fiscal deficits, trade openness/liberalization, private investments, political stability, the rule of law, and democratic institutions. High inflation rate, high fiscal deficits, debt overhang, market distortions (excessive government subsidies in particular economic sectors), lawlessness, and corruption are high in the list of bad management characteristics. Each of these factors are incorporated into indexes that measure "financial depth," "political instability," and "economic management." (See the statistical annex *of Assessing Aid for more* details.) *Assessing Aid* then uses regression analysis of GDP per capita growth against these indexes.

The economic management index is of particular interest because it is includes measures of inflation rates, budget surplus, trade openness, and institutional quality. The important question to ask is how are each of these components "graded." While the Brookings Institute argues that a there is a "widespread consensus about what constitutes a 'good' policy framework" (*Assessing Aid's* authors take this same view), there is actually significant room for debate about what constitutes sound economic policy in developing nation environments [GAO, Hellinger, Culpeper] The GAO notes a lack of consensus between economists about what levels of inflation truly represent a danger to economic stability (7-11% versus 20-40%).[GAO] The crash of the Argentine economy, which was often viewed as a model of how free markets support reform, provides more evidence that we are still trying to figure out how to use economic policy to support developing nations. Now lending institutions and economic experts are trying to figure out what went wrong. Given the amount of debate that actually exists regarding what constitutes sound economic policy, serious consideration should be given to a re-evaluation of the measures that are included in the economic management index as indicators of economic stability.

Without providing an overly detailed critique of the economic and statistical analysis tools used in the report (see Beynon if you are interested),[Beynon] there are a couple of issues that are worth noting. The first arises from the use of growth in per-capita income as a measure of poverty reduction. It is important to question the very assumption that economic indicators are the best ways to measure practices that will reduce poverty. Should the international aid community allow measuring gross national product, inflation, and deficits to become a proxy for more direct assessments of whether people are lifted out of poverty? Per-capita income growth can hide vast disparities in income distribution. Although the authors mention inconclusive data on changes in the distribution of wealth in recipient countries, the discussion of the issue is lacking despite its significant humanitarian importance.[Beynon, Hellinger, Culpeper] The second concern is that the predictive models are quite sensitive to re-specification.[Benyon] This raises doubts about how robust the model's predictions are under a variety of circumstances.

The argument can be made that investments in human capital, targeted spending in health and education sectors, and measures to increase the assets of the poor can directly influence levels of poverty as much or more than per capita economic growth [Hemnger, Benyon, Culpeper, Merrick] In fact investments in health, education, sanitation, and food supplies are often considered prerequisites for sustainable economic development.[DFID, Mernck] But these investments are capital and resource intensive and, during early phases of program implementation, may *increase* budget deficits, inflation rates, and international debts. Thus a strictly econometric interpretation of *Assessing Aid* would dictate that we measure policy performance in a way that will effectively punish governments that are making fundamentally sound development investments.

The report argues, using evidence, that projects that focus on specific sectors such as health and education are often fungible, and do not raise overall spending in that sector. This occurs when donor funds that are targeted to health or education "free" government funds that would have otherwise been spent in that sector to be spent elsewhere. This concern leads the authors to the conclusion that financial aid should be reserved for nations with good economic management, while policy-based projects are more appropriate for nations with a history of high sectoral fungibility. But critics maintain that the data used to support claims of high sectoral fungibility are "perhaps not as convincing as the World Bank suggests" and that direct investments in human capital, health, and education may be more powerful than Assessing Aid believes.[Beynon, Merrick]

The details of economic measurements in *Assessing Aid* are not the only areas of the report that raise questions. Throughout the report, democracy and free-markets are equated to good policy. But unwavering belief in market liberalization and globalization is a distinctly Western ideology. It is flawed logic to assume that these ideologies are always in the best interest of developing nations. Opening capital markets and pushing globalization may leave little room for social ventures that are not profit driven, stifle socialist ideologies, hasten environmental degradation, and leave many of the poor behind.[Walt] Even the World Bank has acknowledged that structural adjustment programs of the past have not paid enough attention to their impact on the poor.[Ahmad] In nations that are not ready to institute those changes, free markets may actually heighten existing disparities in health and income [Hellinger, Walt, Ahmad]

While democracy and free markets are often powerful forces for social change, they have not proven to be a panacea for every nation that has tried to make those changes. In his testimony before the International Financial Institution Advisory Commission in October of 1999, Doug Hellinger (Executive Director of The Development Gap) provided evidence that some nations have seen increases in unemployment and disruption of domestic production capacity as the result of market liberalization.[Hellinger] He argued that "trade liberalization policies have strengthened the position of foreign producers before local firms have had the time to become competitive." [Hellinger p. 2] In Nigeria, many of the promises of the democratic institutions that arose with the end of the military dictatorship in 1999 have remained unrealized and violence and political unrest are on the rise. [NYT, Economist-Nigeria]

The free market focus *of Assessing Aid* is coupled with enthusiastic promotion of private investments. The report concludes that "effective foreign aid is a natural compliment to private investments" and that $2 of private investment follows every $1 of aid money when good policies are in placed. [AA p. 3] But it is not clear that private investments are an unquestionably good thing for developing nations. They are only beneficial if they support local production capacity and serve to lift people out of poverty. That is not always the case.

Julie Heam eloquently depicts just such a situation in "The NGO-isation' of Kenyan Society." [Hearn] In this case USAID is systematically pushing expensive curative health care services into the private sector using foreign non-governmental organizations (NGO). This market-based policy is based on the concept that private sector providers have a comparative advantage over the public sector. But as Hearn points out, that comparative advantage often lies in the private sectors' closer ties to donors and better access to foreign grants. This policy was apparently made without substantial consideration of the local government's goals. The grants could just as well have gone to the Kenyan government, which has many more year of experience providing curative health care services to Kenyans, and could have used the money to strengthen public sector health care. This policy actually undercuts the government's ability to provide services to its people. There is reason for concern because these international grants may not be sustainable. Once they run out, private NGOs may lose their advantage and even pull out, leaving a public sector that lacks critical health care expertise.

Concerns about the absolute benefit of private investments have been raised by other authors. Hellinger discusses at length how international private investments have crowded out local producers and undermined domestic capacity in agricultural and industrial sectors.[Hellmger] Culpeper maintains that "it is by no means certain that the trends of the 1990's, with their phenomenal growth in private foreign investments in developing countries, will be sustained, stable, or durable. " [Culpeper p. 141] If private investments are not sustainable then it is not clear that they will truly promote growth of the long haul. A system that attracts international investors without fostering long-term commitments may create a new breed of external dependency by undermining the ability of the local public and private sector players to perform on their own.

Despite the criticisms raised above, the report does a number of things very well. Its discussion of the importance of local "ownership" and investments is exemplary. Dollar and colleagues argue that "foreign aid cannot take the lead in promoting reform if there is little local movement in that direction." [AA p. 48] Historically, policy conditional aid has been a tool that was used by powerful nations to increase their sphere of influence. A separate study by David Dollar found that World Bank loan often had as many as 45 separate conditions. [AA p. 52] This damaging process undermines local ownership and commitment to reform.[AA, Maren, Raffer] *Assessing Aid* acknowledges that the donor community must find a way to move away from these conditional lending practices, citing a "mountain of literature on structural adjustment lending and its effect on policies" that consistently "conclude with skepticism about the ability of conditionality to promote reform in countries where there is no strong local movement in that direction."[AA p 51] Raffer and Singer suggest a return to a system of lending that is more contractual than conditional.[Raffer] Such a system would require commitment and accountability for both partners in the development contract.

The report's authors also call for the World Bank and IMF to take into account the unique economic, demographic, and cultural situations of recipients of development assistance when programs are being developed and funding decisions are being made. This is highly desirable and supported by many people in the development field.^[Maren, Hillanger, Meltzer, Culpepper, DFID, Merrick] The decision making framework developed in the report suggests that taking into account these factors should allow resources to be focused on "high impact" countries where donors can get a greater return for the money they invest. If the donor community takes the above conclusions to heart, the World Bank , IMF, and non-governmental organizations should be willing to focus their efforts in "high impact" areas where there is a commitment to progress, good management exists, and poverty levels are high. This policy decision would require that lending organizations become more selective in their aid disbursement, and in many cases withdraw aid from nations that are found to have mediocre or bad policy environments.

In theory, such action might create incentives for nations with sociopolitical environments that do not meet the World Bank's definition of good policy environments to make reforms. This may be an important step to take, but decreasing the proactive nature of international lending is not without its consequences. If aid monies are withheld, people who live under governments with poor policy environments may be disproportionately affected. *Assessing Aid* does not ignore this issue. The authors advocate patience on the part of donor organizations and a focus on building technical capacity in nations with poor policy environments. But there is a difficult reality here because balancing the need to hold corrupt or inept governments accountable for poor management may effectively punish the poorest and most destitute people in those nations. The humanitarian consequences of decreasing donor proactivity are very complex and need to be explored in depth, especially when we begin to consider health issues such as infant mortality, maternal mortality, and HTV/AIDS, which have traditionally required large amounts of aid to make a difference. This is especially concerning given that *Assessing Aid's* authors note 89% of the nations in Africa do not meet their criteria for good policy environments. If donor organizations can truly find a way to use technical capacity building to foster sincere improvement by local governments, then this may be an effective solution.

So, *Assessing Aid* does some things well, but it also relies upon some troubling assumptions. Its measurements of institutional and economic performance and its belief in the supremacy of free-markets and private investments raise some serious concerns. The criteria used to evaluate economic and political management in *Assessing Aid* are not dissimilar to the institutional and structural conditionalities imposed by the IMF and other lenders over recent decades. The IMF also believed it was requiring recipient nations to institute "sound macroeconomic and structural policies." [GA0] This critique of lending policies prior to the *Assessing Aid* report may well apply: "the strict conditionality imposed by the IBRD and donors is based on a firm confidence that they know what is best for recipient countries, that they have got hold of the sacred truth, that is the market-ruled principles ('basics') of neoclassical economics." [Raffer p.171] If donors continue to allow themselves to disburse aid monies based on political conditionalities, whether we call them "good management" or "structural adjustments," the current culture of the aid business will not change.

In the end we come away with the feeling that there are a host of problems inherent in the developmental aid system, as it currently exists. Not only are donor institutions characterized by excessive proactivity and misaligned incentives, but there are a host of governments in the developing world that are either unwilling or unable to make a serious commitment to creating an environment where true reform and development are possible. If the two way street of miscommunication and deception between donors and recipient nations continues, it seems the current situation is doomed to persist, or perhaps worsen.

The model for decision making that is laid out in *Assessing Aid* is valuable. *Assessing Aid* crystallizes many of the complex economic and political issues that have played a role in both the successes and failures of development assistance in recent decades. But to apply the principles of the report to all situations would not be appropriate or realistic.[Beynon] It is worth considering whether donors and recipients might be better served by small assistance programs that focus on reducing the burden of epidemic diseases and malnutrition on developing economies. There may be some movement in that direction at the World Bank.[Merrick] Some of the most effective programs in the history of the aid business have been small projects based on collaboration between donors and developing nations. UNICEF's "Facts-of-Life" booklet is one prime example.[Econ-Know] Aid agencies need to focus on a more long-term vision of reform and look to create a program mix that supports long lasting changes.

Book review by Charles Davenport.

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