

Are aid agencies improving?¹

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Abstract: The record of the aid agencies over time seems to indicate weak evidence of progress over time 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.

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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 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 program 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 Commission (2005), 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 Blair’s Commission for Africa (2005), which called for large increases in aid to Africa, had this to say:²

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)

² Some authors span the different generations of debate -- Stern (1976) dismissed the critique of Bauer, and the same author was in charge of the Blair Commission on Africa (2005).

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 the attached table:

Table 1: Chronic problems in aid, past and present

<i>Aid problem or idea</i>	<i>Pearson Commission (1969)</i>	<i>Contemporary statements (2005-2006)</i>
<i>More aid to poorest countries</i>	“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) ³	The Commission for Africa (2005, p. 99) calls for “allocating aid to countries where poverty is deepest.”
<i>Donor coordination is a problem</i>	“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 ”
<i>Be selective about whom you give aid</i>	“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”
<i>Aid tying is a problem</i>	“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%.”
<i>Move away from Food Aid</i>	“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..”
<i>Technical assistance is a problem</i>	“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.”
<i>Debt relief</i>	“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.”

³ 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.

Despite the recurrence of chronic complaints about aid, there are other areas where aid agencies take a much different approach to poverty today than they did decades ago – for example, aid agencies used to favor much more state intervention whereas today they are more market-oriented. There have also been important political changes that could make aid effectiveness more likely – with the end of the Cold War and the spreading awareness of other parts of the world, the political environment for aid agencies is arguably better today than ever before. 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 behavior. This of course presumes that aid agency staff and management have as their objective the goal of helping the world's poor (either because they are self-selected altruists or because of well designed principal-agent contracts where the principal wants poverty alleviation). This paper focuses on areas where there is considerable consensus on what optimal behavior would look like, which will be set out in each sub-section in the rest of the paper. The transitional dynamics towards that behavior 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 – i.e. 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 analyze changes in response to experience to analyze (1) and well-defined episodes of new knowledge and failure to analyze (2) and (3).

There are also powerful political and organizational incentives that drive aid behavior. Changes in the outside political environment could change these incentives in a positive way that leads to aid progress, e.g. 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 favor the first hypothesis, while if there is zero progress, we favor the second. For the usual statistical reasons, zero progress would be the null hypothesis and we will see if we can reject that hypothesis.⁴

We can get additional insight into progress and its sources by analyzing separately the behavior 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 as obvious break points in their aid behavior, although they may have been influenced by all of the

⁴Admittedly, zero is somewhat arbitrary. Nonzero 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.

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 favor 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 behavior 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 behavior are observable and lend themselves to tests of positive “progress.”

I. Learning to resolve chronic problems in foreign aid

The paper first analyzes 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.

a. Donor coordination

A maddening problem in foreign aid for all concerned is the huge administrative costs on both recipient and donor sides from the duplication of donor efforts and their 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 UNDP (2005, p.) 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 the opening table implied, complaints about coordination go back many years, including such landmark studies as the Pearson Commission (1969), Cassen (1987), and World Bank (1998).⁵ 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) reproduces a famous quote 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.”⁶

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 or to specialize by sector. 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.⁵³ A large number of donors also compounds the challenge of donor coordination.

Knack and Rahman (2004) confirm some implications of these statements more rigorously. They find that countries with more donor fragmentation have lower quality

⁵ A correspondingly large academic literature on donor coordination is summarized in Bigsten (2005)

⁶ Wilson (1987), p. 268. The quote is from Harold Seidman

bureaucracy as measured by international comparative measures.⁷ 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.

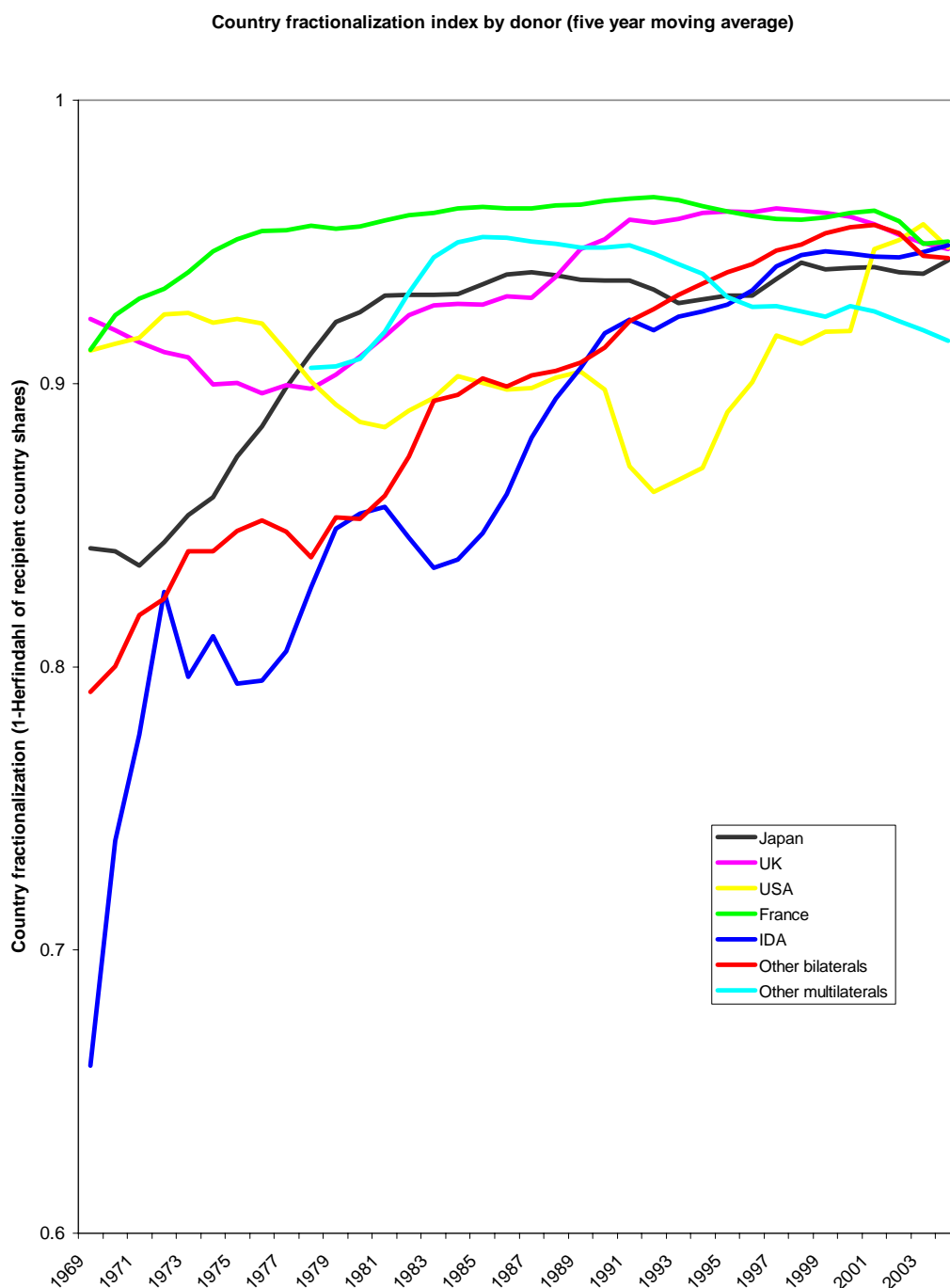
The benchmark expectation about progress is that donors would learn to specialize more in response to the continual drumbeat of protest about lack of coordination. Has fragmentation indeed decreased?

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 minus the Herfindahl index for aid flows. For the donor i , it is equal to 1 minus the sum across j of squares of the shares of recipient j in donor i 's aid disbursements. We see that there is no trend towards 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.

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 – Herfindahl of sector shares) does not show the same general increase as country fractionalization (figure 2) However, it doesn't show any secular decline either, just a lot of variation across donors and across time.

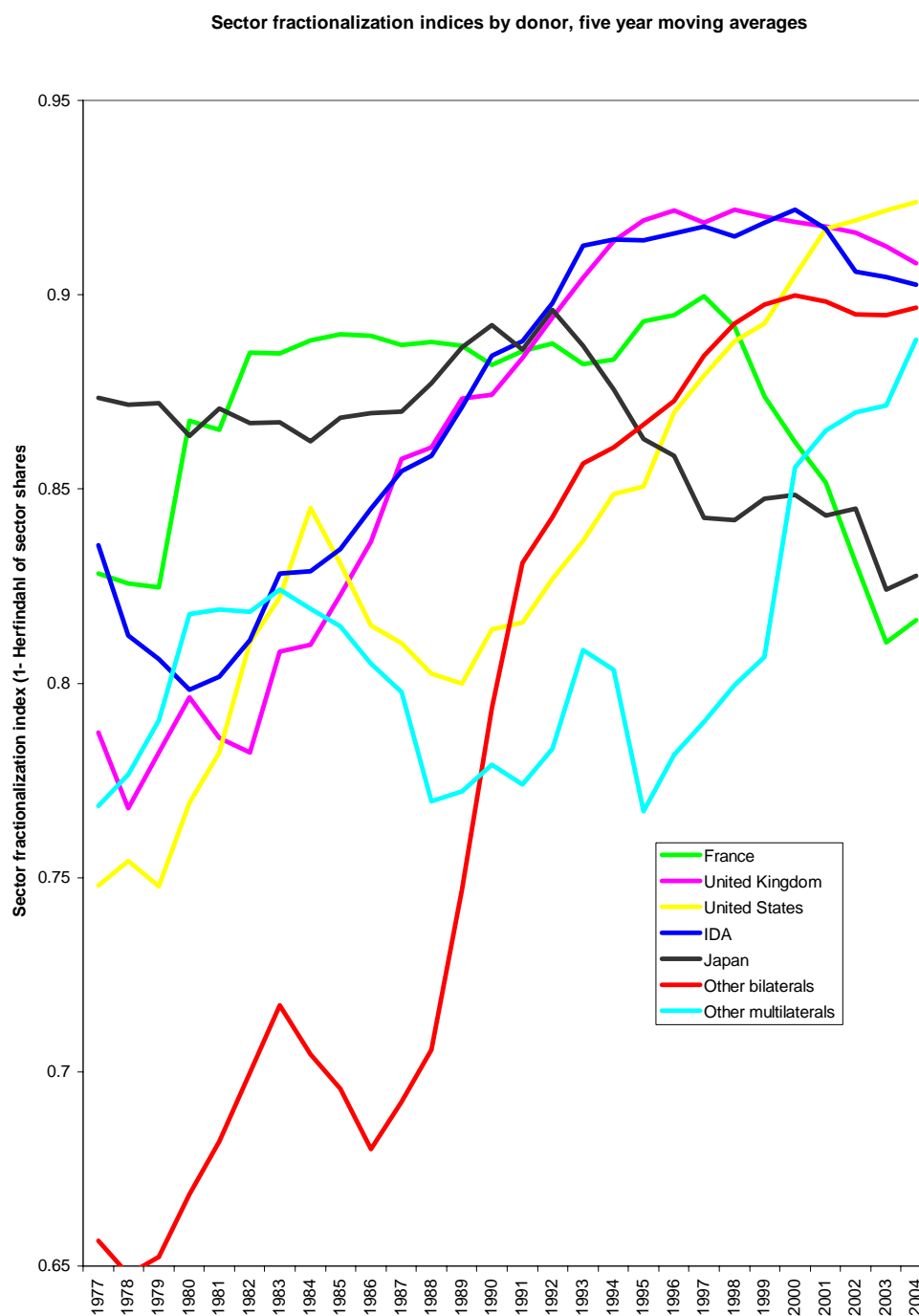
⁷ O'Connell and Soludo 2001 found that donor fragmentation was higher in Africa than in other continents, using the same measure used here.

Figure 1: Is there increasing specialization by country?



Notes: source OECD DAC database for aid flows, fractionalization= 1- Herfindahls based on gross ODA shares by country recipient for each donor. Other bilaterals: Australia, Belgium, Austria, Canada, Denmark, Finland, Germany, Ireland, Italy, Switzerland, Sweden, Norway, New Zealand. Other multilaterals: Arab Agencies, IFAD, Other UN, SAF&ESAF, UNDP, UNFPA, UNHCR, UNICEF, UNRWA, UNTA, WFP, IDB, EC (see Appendix 1 for acronym definitions)

Figure 2: Is there increasing specialization by sector?



Source: OECD DAC data on aid flows, 1 – Herfindahl shares by sectors (listed in Appendix 2). Other bilaterals: Australia, Austria, Belgium, Canada, Denmark, Finland, Germany, Netherlands, Norway, Sweden, Switzerland. Other multilaterals: AfDB, AsDB, EC, IDB

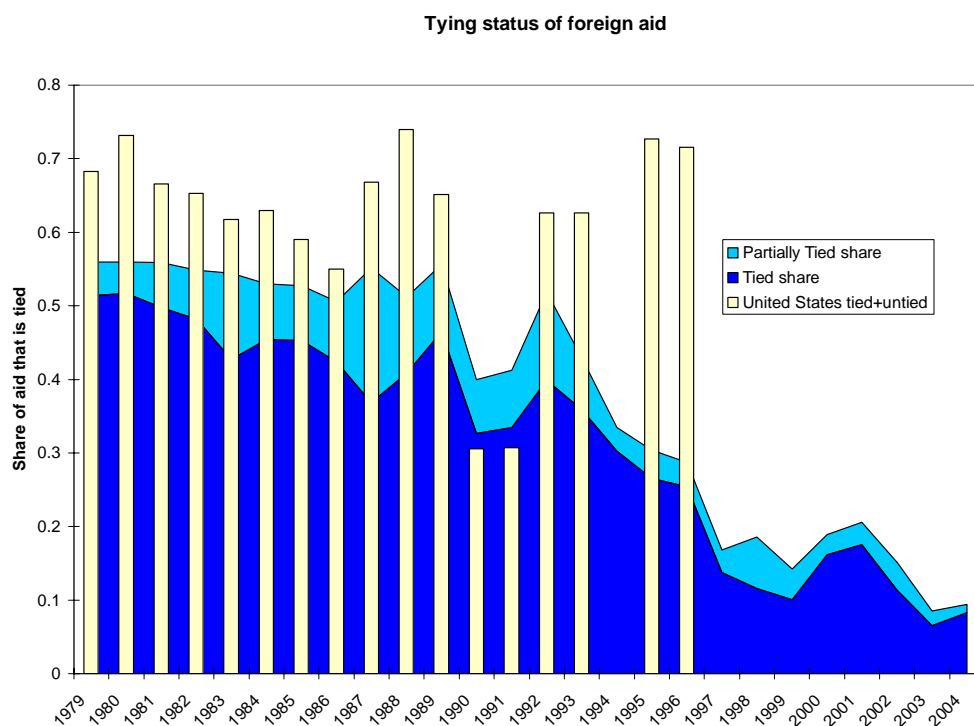
b. Aid tying

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).⁸ 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 3 shows that the share of aid disbursements tied has decreased drastically, particularly since the early 1990s.⁹ 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 to even report whether they are tying or not.

⁸ This accords with an earlier estimate by Jepma (1991).

⁹ 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 3: The Decrease in Aid Tying

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

c. Food aid and technical assistance

Two other donor-favored 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.¹⁰ 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).

¹⁰ One of the classic statements of this argument was Isenman and Singer 1977.

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.¹¹ The United Nations Millennium Project (2005, 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)

These types of aid are politically popular in rich countries because they are subsidizing rich country farmers and consultants. The IMF and World Bank (2006, 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 4 for 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. Even the decline in food aid since the 1980s may simply reflect more the surge in such aid during the famines of the 1980s than any long-run trend. However, looking at secular trends by donor (the five year moving average of shares of food aid in total ODA, with data beginning in 1966), we see in Figure 5 that the share of food aid has a steady downward trend in the major food donor, the U.S. 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.

¹¹ These complaints surfaced long ago in the academic literature, e.g. Loomis 1968.

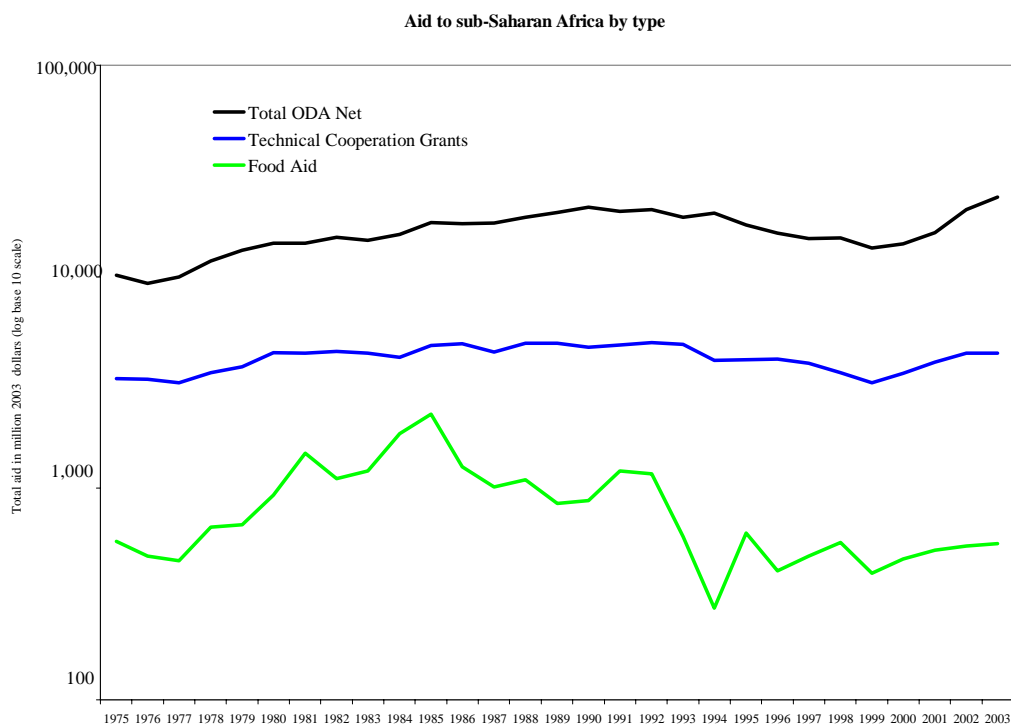
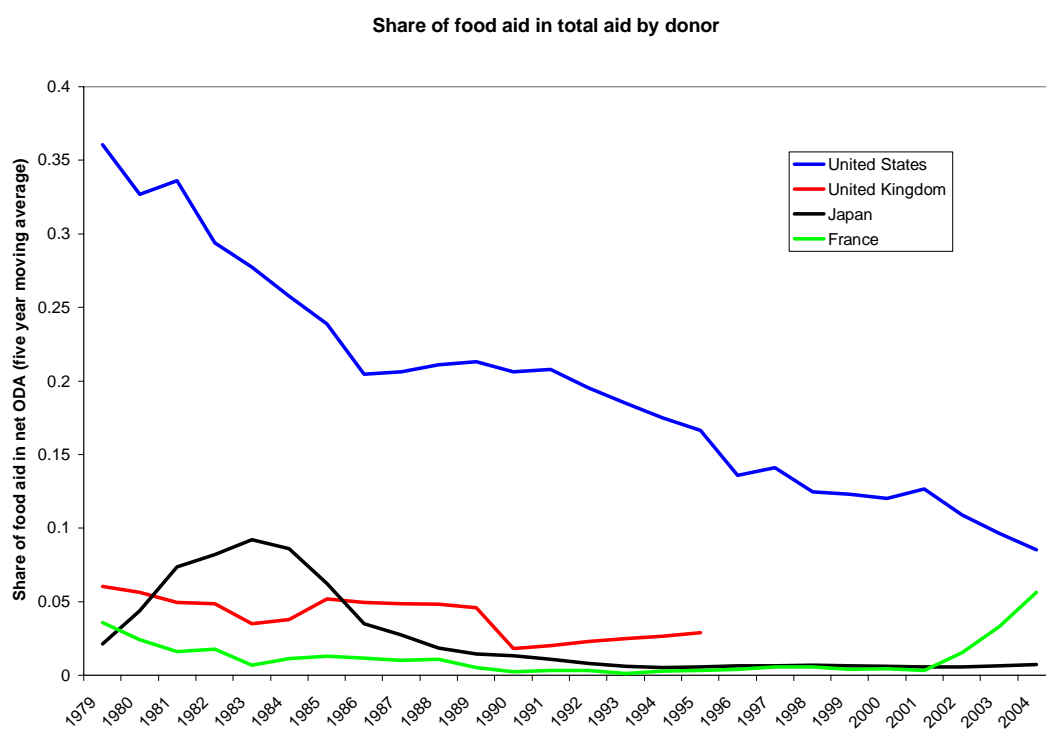
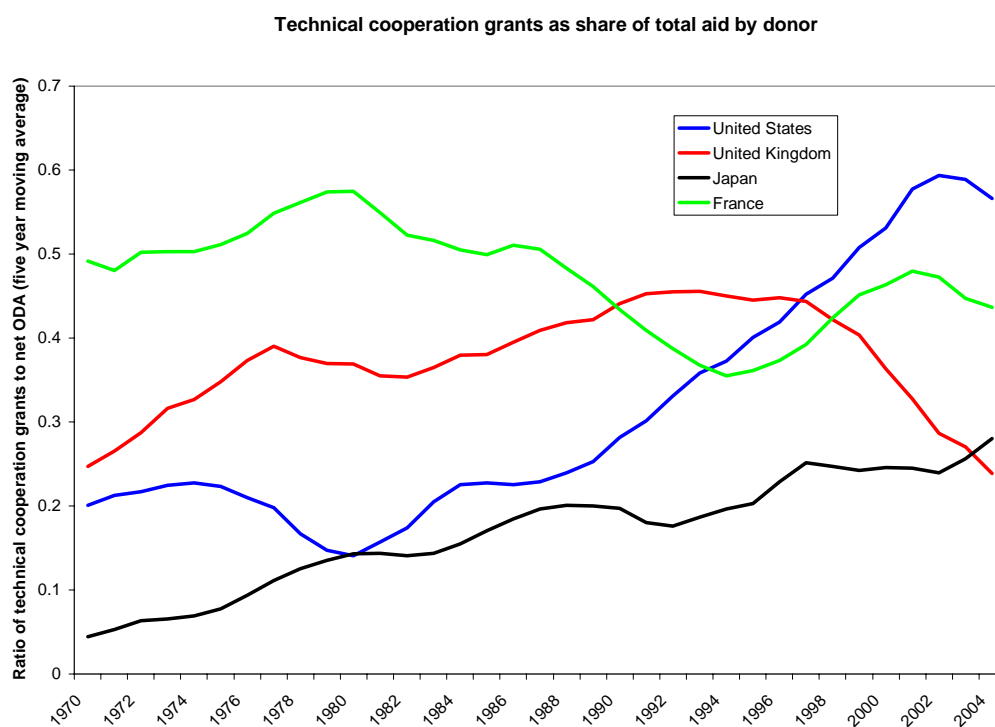
Figure 4: Is there a shift away from food aid and technical assistance?

Figure 5: Has the share of food aid changed with some donors?



Looking at share of technical assistance by donor presents less evidence of progress. The US and Japan have an upward trend in the share of technical assistance (also displayed as a five year moving average), while the UK and France show some recent decline but no dominant trend over the whole period (figure 6). This is looking only at quantity of technical assistance dollars; it could be that there have been improvements in the quality of technical assistance.

Figure 6: Shares of Technical cooperation by Donor



II. 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 favorable incentives to the private sector, get prices right, facilitate free trade, and

maintain macroeconomic stability.¹² 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 favorable, 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 AER in 2000, but 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 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 2003). 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).¹³ The IMF and World Bank (2006b, p. 83) indeed argue

¹² 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.

¹³ Drazen (1999) presents a strong political economy argument in favor of tough selectivity as promoting political reform in the recipient.

“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.¹⁴ 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 negative 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 2000-2003.¹⁵

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 behavior? 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.

¹⁴ 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.

¹⁵ An earlier exercise by Goldin, Rogers, and Stern (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.

a. 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.¹⁶ 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 (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 the working paper version in 2004, nor 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.¹⁷ 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

¹⁶ Some examples of recent works in this literature are Alesina and Dollar (2000), Andersen, Hansen, Markussen (2005), Akram (2003), McGillivray, M, Leavy, J., & White, H. (2002), and Boschini and Olofsgård (2002). An earlier wave of research included Maizels and Nissanke (1984) McKinlay and Little (1979), McGillivray, M. (1989, 1992), and White (1992).

¹⁷ 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.

increasingly aware over time? To distinguish such learning from changes in intensity of political pressure, I create a dummy for the Cold War and using 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.¹⁸ 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 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 heteroskedasticity. Table 2 shows that the base specification (regression 1) shows strong sensitivity to per 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).¹⁹ 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

¹⁸ The source for per capita income is Penn World Tables 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.

¹⁹ The bias towards small countries could be optimal if there is a fixed cost of implementing an aid program 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.

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 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.

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

Right-hand side variables	Regression 1960-2003					Regression 1974-2003
	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 -1.4	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

Robust t-statistics in parentheses (clustered standard errors by country), * significant at 5% level; ** significant at 1% level, includes year dummies (not shown)

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, Table 3 presents regressions for successive 5-year averages for the base specification of log real aid regressed on log per capita income and log population. 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. We see 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 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.)

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

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

	Log per capita income	t-stat	Log of population	t-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

Robust t statistics in parentheses, * significant at 5%; ** significant at 1%

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 percent 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.

We can get some additional insight by looking into the behavior of the poverty elasticity for the International Development Association (IDA) and the four major bilateral donors for the same five year averages shown in Table 3. 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 shown for each donor in Table 4. If the poverty elasticity is statistically significant at the 5 percent level, then it is shown in bold type. As more evidence for the “McNamara revolution,” IDA is the donor that shows the biggest increase in magnitude and significance 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 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 percent level) poverty elasticity of around -0.5. But again, this is not equivalent to saying the change in elasticity from 1995-1999 to 2000-2003 is statistically significant, which it is not for any of these donors.

The last two columns in Table 4 allow us to assess the significance of *differences* in coefficients. It reports 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 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 organization?). 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.

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. Table shows coefficient on log per capita income (poverty elasticity). Coefficient shown in bold if significant at 5 pe									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	McNa-mara 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 percent level are shown in bold, with robust standard errors. Regressions with less than 40 observations are omitted

b. 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 1998.²⁰ The second policy measure I consider is a dummy that takes on the value 1 if inflation is greater than 40 percent, and 0 otherwise.²¹

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 type 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).

²⁰ The original data from Sachs and Warner (1995) ended in 1994. Easterly, Levine and Roodman 2003 updated the index to 1998.

²¹ Bruno and Easterly 1998 and Easterly 2005 suggested 40 percent 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.

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 percent)			-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

Robust t-statistics in parentheses (standard errors clustered by country)
* significant at 5% level; ** significant at 1% level

Again, this format may be too restrictive, so Table 6 shows the results of 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. 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.²² 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 still sporadic.

²² This could be related to the difficulty in enforcing conditionality analyzed in Svensson (2002) and documented in Easterly (2005).

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

The last column of Table 6 shows 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 5, 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 five percent level – the shift in response to high inflation for the UK.

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.

<i>Coefficient on log of real aid on high inflation dummy</i>	1960-	1965-	1970-	1975-	1980-	1985-	1990-	1995-	2000-	Post-1980 shift in coefficient on high inflation dummy
	1964	1969	1974	1979	1984	1989	1994	1999	2003	
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	-0.025
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	-0.219

<i>Coefficient on log of real aid on Sachs- Warner openness dummy</i>	1960-	1965-	1970-	1975-	1980-	1985-	1990-	1995-	Post-1980 shift in coefficient on openness
	1964	1969	1974	1979	1984	1989	1994	1999	
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 percent 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, Levine and Roodman (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 on-line 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.

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.²³

c. 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 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.²⁴ 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

²³ 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.

²⁴ Helping Countries Combat Corruption: The Role of the World Bank, Poverty Reduction and Economic Management, THE WORLD BANK, S E P T E M B E R 1 9 9 7.

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.²⁵

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 2003.²⁶ 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).²⁷

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 favor of democratic accountability, there is also no sign that this shift in rhetoric had an effect on aid allocation.²⁸

The results on corruption are rather similar. The average sensitivity of aid to (freedom from) corruption is positive and significant.²⁹ Contrary to conventional wisdom, donors were not

²⁵ Another landmark on corruption is the founding of Transparency International by a former World Bank official in 1993.

²⁶ 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 index 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 -.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.

²⁷ 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 high correlations between these measures.

²⁸ This finding is very similar to Dollar and Levin (2006).

²⁹ 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.

more tolerant of corruption during the Cold War.³⁰ 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.

³⁰ Alesina and Weder (2002) find no evidence that more bilateral or multilateral aid goes to less corrupt countries. (1970-1995) .

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
Robust t-statistics in parentheses (clustered standard errors)						
* significant at 5% level; ** significant at 1% level						

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. Table 8 is analogous to Table 6: it performs cross-section regressions for log aid on log income, log population, and democracy and then shows the coefficient on democracy (shown in bold if significant at the 5 percent level). The last column of

Table 8 shows 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. Table 8 shows 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).

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 (coefficients significant at 5 percent level shown in bold)

<i>Democracy defined in levels: 0-10 democracy index from Polity IV</i>										
Coefficient of log of real aid on democracy										Coefficient on shift of democracy coefficient after 1989
	1960-1964	1965-1969	1970-1974	1975-1979	1980-1984	1985-1989	1990-1994	1995-1999	2000-2003	
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

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 the Polity IV democracy measure of 5 or more,³¹ (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

³¹ The definition of democratic transition chosen here to 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.

transition (movement of 5 or more on the 0-10 Polity IV scale) for 1995-99.³² 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 1995-99.³³ 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.

The overall results are only weakly supportive of increased sensitivity after 1990. Of all the permutations of log of aid on development (including both Table 8 and Table 9), we have a minority of significant coefficients of the right sign at the 5 percent level. Before 1990, out of 177 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 percent of the estimated coefficients are of the right sign and significant, while after 1990, 31 percent 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 percent of the coefficients would be significant at the 5 percent 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.

³² 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 1990-94, the transition is the change in democracy from 1989 to 1994.

³³ Alesina and Dollar (2000) found democracy to 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: Coefficients on democracy in regressions for log of real aid dollars by donors -- alternative definitions of democracy and transitions

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	Transition or level
<i>1. Results by donor on democratic transition, defined as the change from beginning of period to end of period in the 0-10 Polity IV democracy scale</i>										
All ODA	0.07	0.00	-0.05	0.02	0.07	-0.05	-0.01	0.02	0.03	Transition
IDA		0.04	0.10	-0.07	0.02	-0.01	-0.01	0.05	0.08	Transition
US	0.02	-0.01	-0.03	-0.09	0.10	0.06	0.03	-0.02	0.07	Transition
UK	0.33	0.03	0.09	-0.08	-0.02	-0.20	-0.01	0.05	0.15	Transition
France			0.11	-0.10	-0.09	-0.05	0.02	-0.13	0.07	Transition
Japan		-0.02	0.05	0.01	0.08	0.06	-0.02	0.07	-0.07	Transition
<i>2. Results by donor on democratic transition, defined as dummy=1 if the change from beginning of period to end of period in the 0-10 Polity IV democracy scale being 5 or greater, 0 otherwise</i>										
All ODA	0.62	0.15	-0.69	-0.05	0.40	-0.69	-0.02	0.56	0.16	Transition
IDA		0.64	1.49	-0.53	-0.18	-0.12	-0.06		0.34	Transition
US	-0.06	-0.17	-0.71	-0.40	1.67	0.03	0.30	1.26	0.89	Transition
UK	2.74	3.52	1.37	-0.53	-0.62	-1.03	-0.03	1.21	1.40	Transition
France			-0.99	-0.82	-1.11	-0.56	0.29	0.13	0.21	Transition
Japan		-0.08	0.59	0.22	0.26	0.71	-0.06	1.84	-0.46	Transition
<i>3. Results by donor on democracy level and democratic transition, defined respectively as in 1 and 3</i>										
All ODA	0.06	0.09	0.06	0.02	0.06	0.08	0.06	0.07	0.06	level
	0.45	-0.18	-0.89	-0.09	0.32	-0.75	-0.13	0.79	0.06	transition
IDA		0.04	0.09	0.01	0.06	0.05	0.04		0.10	level
		0.42	1.32	-0.55	-0.25	-0.19	-0.15		0.15	transition
US	-0.04	0.15	0.03	0.00		0.07	0.07	0.07	0.10	level
	0.05	-0.79	-0.77	-0.40	1.67	0.00	0.14	1.50	0.69	transition
UK	0.07	0.32	0.33	0.21	0.23	0.11	0.12	0.11	0.10	level
	2.56	2.18	0.30	-0.92	-0.92	-1.12	-0.32	1.54	1.20	transition
France			-0.13	-0.18	-0.11	-0.09	0.01	-0.04	-0.04	level
			-0.86	-0.71	-0.96	-0.44	0.28	0.01	0.31	transition
Japan		0.12	0.08	0.03	-0.02	0.12	0.19	0.16	0.09	level
		-0.15	0.38	0.17	0.29	0.58	-0.51	2.32	-0.65	transition
<i>4. Democracy defined in levels: 1 (most democratic) to 7 (least democratic) from Freedom House</i>										
All ODA			-0.15	-0.01	-0.09	-0.09	0.01	-0.12	-0.10	level
IDA			-0.23	0.00	-0.25	-0.14	0.00	-0.08	-0.14	level
US			-0.26	-0.05	-0.20	-0.08	-0.13	-0.05	-0.20	level
UK			-0.55	-0.38	-0.63	-0.48	-0.40	-0.25	-0.25	level
France			0.38	0.25	0.33	0.35	0.21	0.00	0.03	level
Japan			-0.26	-0.08	0.00	-0.22	-0.17	-0.22	-0.16	level

Notes: Coefficients significant at 5 percent level with robust standard errors are shown in bold. Regressions with less than 40 observations are not shown (also a couple of regressions with dummies always equal to zero were omitted.)

Table 10 considers the response of donors over time to corruption, considering both the continuous corruption rating and the “worst corruption” dummy.. The results 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 behavior. 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 of whether we can reject equality of coefficients before and after 1996 (shown in the last column, 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.

Table 10: Results by donor on corruption -- coefficient on corruption measure in regression of log aid on log per capita income, log population and corruption (significant coefficients shown in bold)

<i>Coefficient on log of real aid on freedom from corruption/1/2</i>	<i>1980-1984</i>	<i>1985-1989</i>	<i>1990-1994</i>	<i>1995-1999</i>	<i>2000-2003</i>	<i>Shift in coefficient after 1996</i>
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
<i>Coefficient on log of real aid on dummy for worst corruption (=1 if corruption is <2 on 0 to 6 scale)</i>	<i>1980-1984</i>	<i>1985-1989</i>	<i>1990-1994</i>	<i>1995-1999</i>	<i>2000-2003</i>	<i>Shift in coefficient after 1996</i>
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). Source: International Country Risk Guide

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 5 percent level shown in bold.

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 11 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.

Table 11: 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	NO	NO
			Openness	NO	NO
End of Cold War, 1990	USA	One-time shift	Need	YES	NO
			Democracy	NO	NO
			Corruption	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
			Corruption	NO	NO
	France	Trend	Need	NO	
			Inflation	NO	
			Openness	NO	
			Democracy	YES	
			Corruption	NO	
	Japan	Trend	Need	NO	
			Inflation	NO	
			Openness	NO	
			Democracy	NO	
			Corruption	YES	

III. 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 behavior 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.

a. 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.³⁴

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 could reflect reverse causality and adverse selection – more structural adjustment loans 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

³⁴ Drazen (2002, 2000) has a rich discussion of under what conditions IMF conditionality facilitate economic reform.

policies (Easterly 2005, Przeworski and Vreeland 2004).³⁵ 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. To extend the metaphor above, if the emergency room patient kept having to be re-admitted, which could be either because the first treatment didn't work or the patient didn't 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). 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 9).

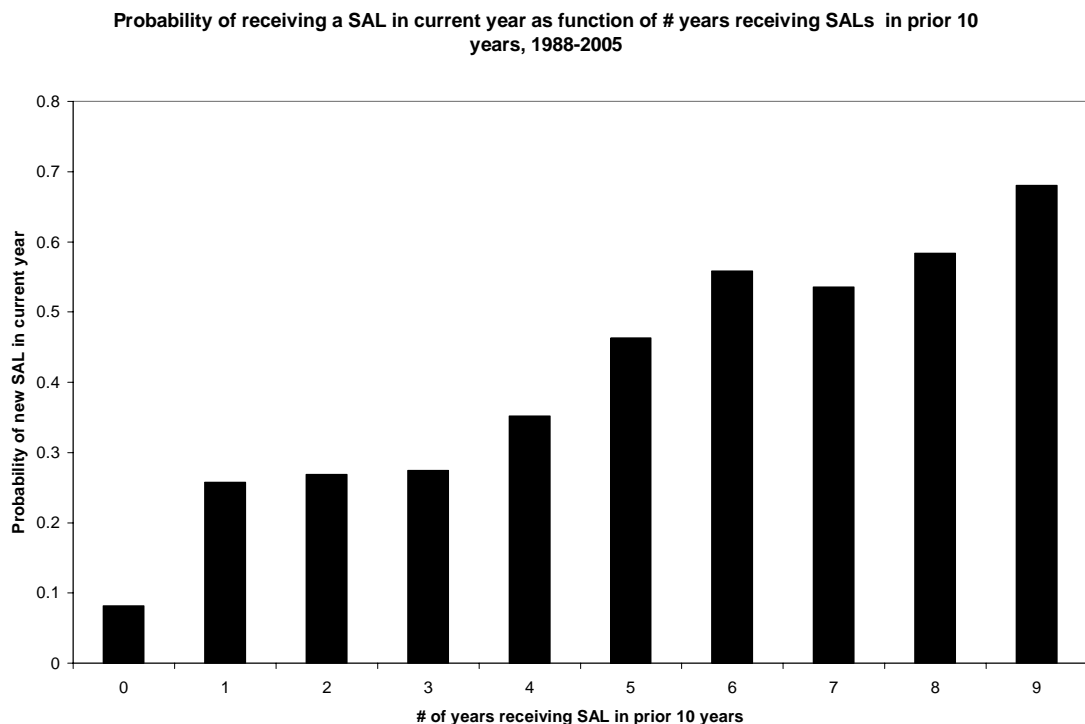
To judge this pattern, we have to ask what is the optimal probability of repeating structural adjustment? This is difficult to answer in the abstract – again, a multi-stage adjustment process may be optimal and the Bank and the Fund may have learned this in the course of

³⁵ 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.

adjustment lending. What seems less likely to be optimal is the upward slope of the graph in Figure 9. If the multiple adjustment treatment is successful, the probability of exit should increase in the number of loans, i.e. the probability of another treatment should decrease in the number of previous 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.

Figure 9: Probability of repetition of adjustment lending against cumulative loans



Other statistics that are useful to examine loan repetition are the Markov transition probabilities (Table 11). Across successive five year periods, countries receiving 1 or more adjustment loans in one five year period had around an 80 percent chance of getting another adjustment loan in the next five year period. This compares to an average 42 percent 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 in a structural adjustment program (i.e. the unconditional probability of being in the SAL state) is high – over two-thirds (Table 11).

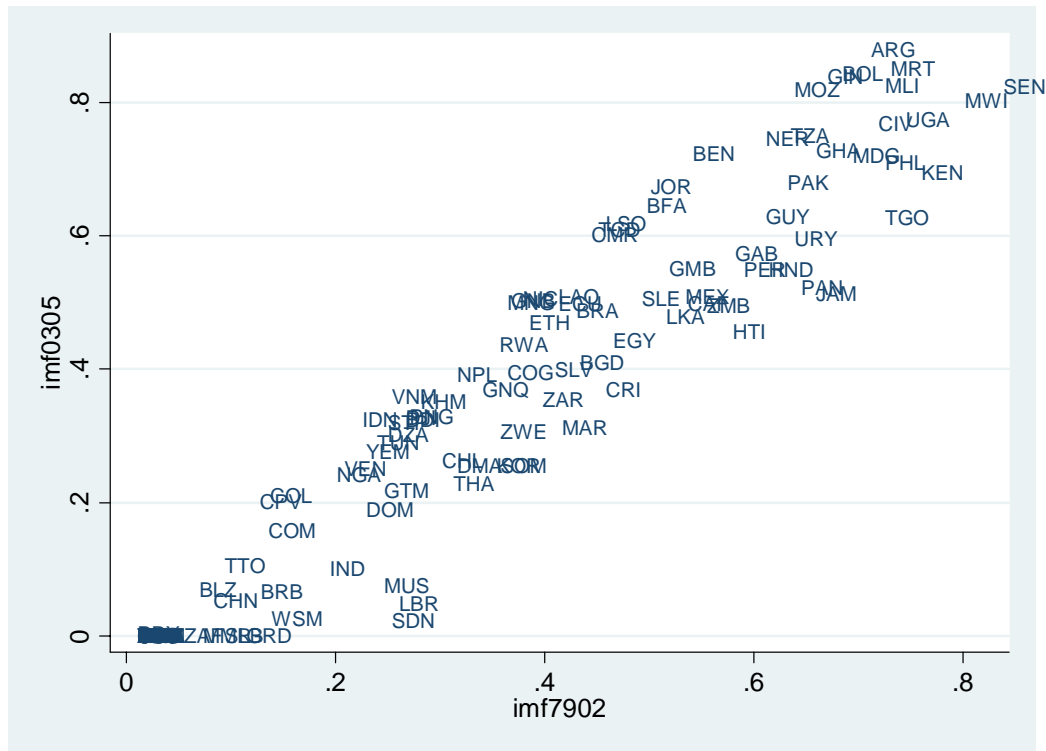
Table 11: Transition probabilities for IMF and World Bank Structural Adjustment loans in successive five year periods, 1981-2005

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	
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		

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 of the IMF on the problem, completed in 2002 (they labeled 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 programs. To test whether this report had an effect on IMF practice, figure 10 checks whether the average time spent in IMF programs during 2003-2005 is strongly associated with time in IMF programs from 1979-2002 (the countries in eastern Europe and the former Soviet Union are excluded because they were not eligible before the 1990s).

Figure 10: The association between time spent in IMF programs before (1979-2002) and after (2003-2005) the IEO report criticizing excessively prolonged time under IMF programs



The coefficient is around 1 and the constant is close to zero with a 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 programs before the IEO report. The effect is more than one for one, rejecting any tendency for above average 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 programs for the worst cases seems too high to represent an optimal course of treatment for even the sickest patients. 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 programs did not try hard enough to protect the poorest part of the population.

b. 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 program 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. As table 12 shows, 16 of the 20 countries who spent the most time under IMF programs 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.

Table 12: Top 20 countries by amount of time spent in IMF programs 1979-2005

Country	Percent of time in IMF programs, 1979-2005	HIPC	IDA
Senegal	84%	1	1
Malawi	79%	1	1
Kenya	77%	0	1
Uganda	76%	1	1
Argentina	73%	0	0
Mauritania	73%	1	1
Mali	71%	1	1
Ivory Coast	71%	1	1
Bolivia	70%	1	1
Madagascar	69%	1	1
Ghana	68%	1	1
Tanzania	67%	1	1
Uruguay	66%	0	0
Guyana	65%	1	1
Philippines	64%	0	0
Togo	64%	1	1
Guinea	64%	1	1
Mozambique	63%	1	1
Pakistan	62%	0	0
Niger	62%	1	1
Sum		15	16

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 favorable terms is named after the location of the G-7 summit³⁶

- 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%

³⁶ Source is from Sachs (2002) and Easterly (2002).

- 1996 – Lyons Terms and HIPC (Heavily Indebted Poor Countries) 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 percent of exports..
- 1999 –Cologne Terms and “Enhanced HIPC.” Allowable debt reduction raised to 90 percent, threshold for sustainable debt lowered to 150 percent 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 fulfill HIPC conditions by end-2006 will be considered for another extension.³⁷
- 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

³⁷ International Monetary Fund and International Development Association (2006), p. 4

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.

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.³⁸

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.³⁹

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 analyzes 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

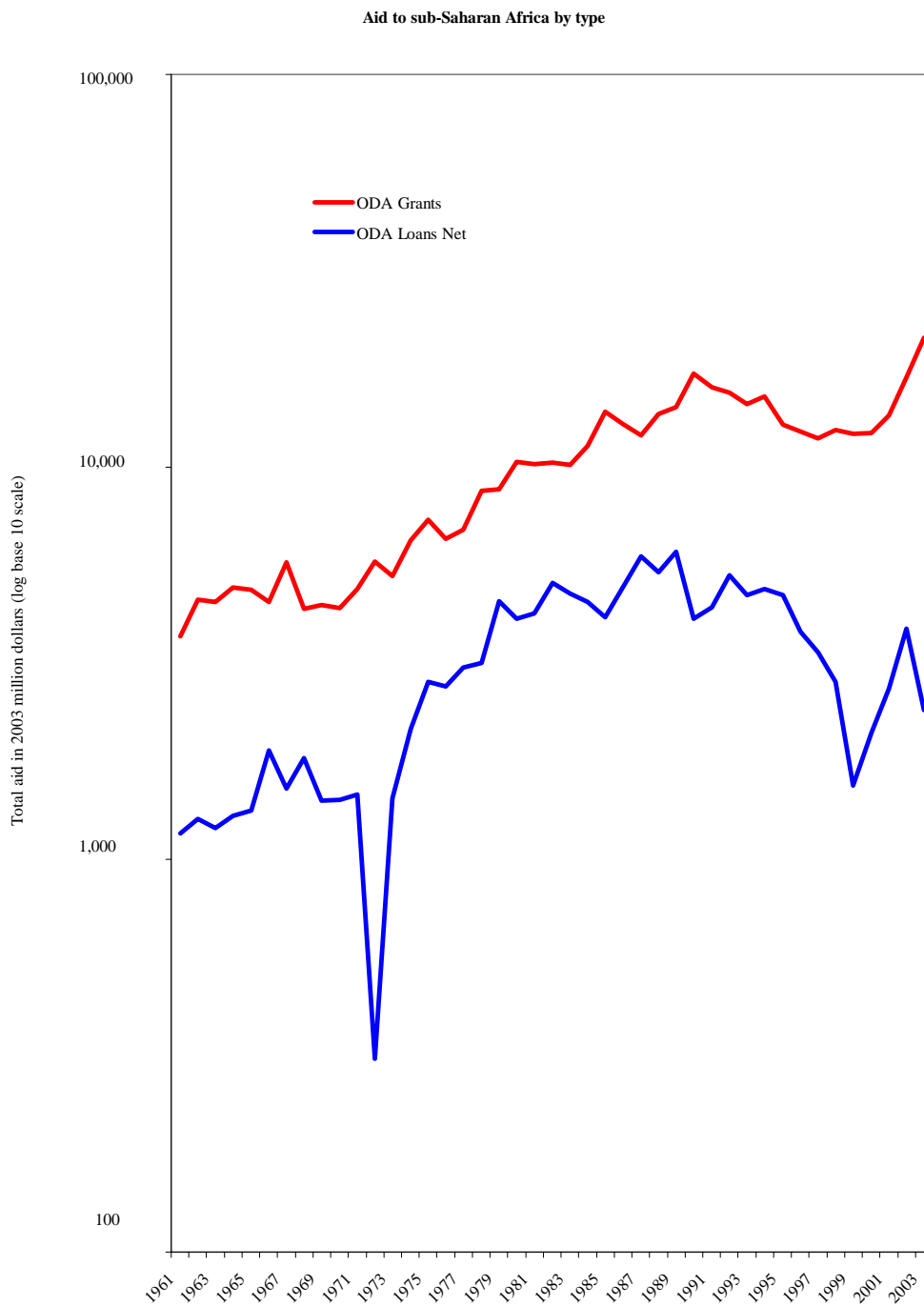
³⁸ International Monetary Fund (2006a)

³⁹ p. 10, World Bank (2006a)

repayment ability, (2) aid agencies had already done “debt sustainability analysis” throughout the 80s 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.) Figure 10 below shows that aid loans to Africa do not show any pronounced downward trend, although there is some fall after the mid-1990s. Despite the debt cancellation for HIPCs, the IMF and the World Bank continue to make new loans to HIPCs.

**Figure 12: Grants and Loans to
Africa**



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.”⁴⁰ 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.”⁴¹

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 programs in the 1990s, the target GDP growth was 4 percent, but actual growth was only 2 percent.⁴² Since population growth is about two percent 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 program 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 3 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 percent 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

⁴⁰ Independent Evaluation Office (2002), p. 12

⁴¹ Ibid., p. 216

⁴² Baqir, Ramcharan, and Sahay (2003)

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.⁴³

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.”⁴⁴ 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 percent growth. However, the April 2006 Cameroon HIPC document projected 5.0% growth for 2006-2015, and 5.3% for the whole period 2006-2025.⁴⁵ 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.⁴⁶

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 (1972): “Concessionary finance used unproductively leads to indebtedness which is then used as an argument for further concessionary finance.” Here, there

⁴³ I am grateful to the World Bank’s HIPC Department for providing me with this data.

⁴⁴ International Monetary Fund and International Development Association (2004), p. 27

⁴⁵ International Monetary Fund (2006b)

⁴⁶ International Monetary Fund and the World Bank (2006)

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.

IV. 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 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.⁴⁷ 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.

⁴⁷ see the discussion of evaluation in Banerjee and He 2003, and the Center for Global Development's program on the "Evaluation Gap" (http://www.cgdev.org/section/initiatives/_active/evalgap)

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Appendix: Definition of sectors for sectoral Herfindahl calculation (from OECD DAC foreign aid database)

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- I.1. Education
 - I.1.a) Education, Level Unspecified
 - I.1.b) Basic Education
 - I.1.c) Secondary Education
 - I.1.d) Post-Secondary Education
 - I.2. Health
 - I.2.a) Health, General
 - I.2.b) Basic Health
 - I.3. Population Pol./Progr. & Reproductive Health
 - I.4. Water Supply & Sanitation
 - I.5.a) Government & Civil Society-general
 - I.5.b) Conflict, Peace & Security
 - I.6. Other Social Infrastructure & Services
 - II.1. Transport & Storage
 - II.2. Communications
 - II.3. Energy
 - II.4. Banking & Financial Services
 - II.5. Business & Other Services
 - II.ECONOMIC INFRASTRUCTURE AND SERVICES
 - III.1.a) Agriculture
 - III.1.b) Forestry
 - III.1.c) Fishing
 - III.2.a) Industry
 - III.2.b) Mineral Resources & Mining
 - III.2.c) Construction
 - III.3.a) Trade Policies & Regulations
 - III.3.b) Tourism
 - IV.1. General Environment Protection
 - IV.2. Women In Development
 - IV.3. Other Multisector
 - IV.MULTISECTOR / CROSS-CUTTING
 - IX. ADMINISTRATIVE COSTS OF DONORS
 - VI. COMMODITY AID / GENERAL PROG. ASS.
 - VI.1. General Budget Support
 - VI.2. Dev. Food Aid/Food Security Ass.
 - VI.3. Other Commodity Ass.
 - VII. ACTION RELATING TO DEBT
 - VIII. EMERGENCY ASSISTANCE & RECONSTRUCTION
 - VIII.1. Emergency Food Aid
 - VIII.2. Other Emergency and Distress Relief
 - VIII.3. Reconstruction Relief
 - X. SUPPORT TO NGO'S
 - XI. UNALLOCATED/UNSPECIFIED