

## 4

# Reconstructing the Aid Effectiveness Debate

*Machiko Nissanke*

### 4.1. Introduction<sup>1</sup>

In the early 1980s, there was a radical change in aid delivery structure from project aid towards policy-based programme aid. Structural adjustment programmes (SAPs) had become a favoured conduit for both multilateral and bilateral aid, with strict policy conditionalities instituted. Policy conditionality was justified on the grounds that donors should actively influence the policy and conduct of recipient countries through aid leverage. *Ex ante* conditionality, whereby foreign aid and budget supports were delivered conditional on the promises of implementation of stabilization-cum-structural reforms, had become a dominant feature in the donor–recipient relationships. As Kanbur (2005) notes, conditionality itself is nothing more than the rules and procedures according to which a donor transfers resources to a recipient. What is debated, however, is the *nature* of conditionality, in particular that of policy conditionality, which has been practised to date in one form or another.

By the mid-1990s, however, despite adding an array of political and economic conditionalities, the donor community had to face the uneasy reality: *ex ante* policy conditionality was not effective in tying the recipient governments to the reform agenda of donors (see, for example, Killick 1996, 1997; Collier 1998; Collier and Dollar 2004). This sparked off a new round in the aid effectiveness

<sup>1</sup> The author is grateful to Alf Morton Jerve, Yasutami Shimomura, the project team at the Japan Bank for International Co-operation JBIC, and other participants in the workshops organized by the JBIC, for stimulating discussions and suggestions on evaluating aid effectiveness of project aid to infrastructure development. Their inputs helped to sharpen the analysis summarized in sect. 4.4.2 of this chapter. The author is particularly grateful to Yasutami Shimomura for his insights into drawing policy implications from our comparative analysis. The author is also grateful to the anonymous referees for their detailed comments, additional references, and helpful suggestions. Naturally, the author takes full responsibility for any remaining errors.

debate against the background of declining public support for foreign aid in donor countries (World Bank 1998). The poor record of compliance and enforcement of policy conditionality was recognized in various evaluation reports on the World Bank's adjustment loans (World Bank 2005c).<sup>2</sup>

Thus, the efficacy of policy conditionality has been a central question in the aid effectiveness debate over the last decade or so. In the debate, *ex ante* policy conditionality has been examined largely from a narrow perspective of the 'moral hazard' problem; that is, the problem arising from granting foreign aid without a firm commitment on the part of recipient countries to reform programmes. Assessed from this perspective, it has been argued that policy conditionality was faulted on incorrect rationales given to adjustment lending, since an effective mechanism to deal with the moral hazard problem was absent. Collier (1998) argues, for example, that none of the three rationales for programme lending—namely the use of aid as an incentive for reform, financing the 'cost of adjustment', and 'defensive lending' to service external debt—is soundly based. Similarly, Easterly (2003) explains the failure of *ex ante* conditionality in terms of incentive systems affecting donor behaviour. He suggests that despite a continuous breach of policy conditionality by recipient governments, donor agencies have kept 'moving money' and 'pushing loans' under the constant pressure of improving their own performance indicators, assessed in terms of aid disbursements.

In recognition of the difficulty of overcoming the moral hazard problem *ex ante*, it has been proposed that the aid allocation rule should be overhauled, so that aid is allocated on an *ex post* policy performance basis. Thus, while *ex ante* conditionality is seen as 'incentives-based' aid allocation on promises for policy change, *ex post* conditionality is claimed to be 'selectivity-based' on retrospective assessments of performance. That is, instead of using conditionality to induce policy change, it is suggested that aid should be used to target financial flows on those governments that have already established good policy environments (World Bank 1998). Creating star performers by engineering aid allocation, Collier (1998) further argues, would induce non-reforming governments to change their policies through the pressures of emulation, and would result in enhanced overall aid effectiveness. It has been argued that by adopting an *ex post* selectivity approach donors can affect growth and poverty reduction more effectively through their allocation of aid and debt relief.

Further, the aid effectiveness debate has been conducted in parallel with the search for lasting debt relief measures to deal with the severe debt overhang conditions found in the heavily indebted poor countries (HIPC). The donor community launched the HIPC Initiative in 1996 and three years later enhanced its scope and depth, as a real and durable exit option from the

<sup>2</sup> See Alesina and Dollar (2000); Burnside and Dollar (2000), and Dollar and Svensson (2000) for a summary of empirical findings.

protracted debt crisis for HIPC<sup>3</sup>. Under the HIPC Initiative, the process conditionality is instituted as part of formulating the poverty-reduction strategy papers (PRSPs), which is supposed to be a recipient-driven process.<sup>4</sup> The debt sustainability analysis has been routinely integrated into the PRSP process and the HIPC debt relief negotiations. Finally, the comprehensive development framework, introduced in 1999 in place of structural adjustment programmes, emphasizes the importance of ownership and partnership in aid relationships. It has been heralded as a new aid architecture, where a selectivity based aid allocation is used as *ex post* policy conditionality and the debt sustainability analysis is integrated into the 'performance-based' aid allocation process.

The principal objectives of this chapter are (i) to assess the analytical and empirical basis of the selectivity-based, Country Policy and Institutional Assessment (CPIA)-centred aid allocation currently in operation and the associated debt sustainability analysis embedded therein;<sup>5</sup> and (ii) to present the case for fundamentally reconstructing the aid effectiveness debate by offering alternative perspectives and approaches. Towards these objectives, the chapter is structured as follows. Section 4.2 first presents the analytical basis of the CPIA-based selectivity approach and then discusses the CPIA-centred aid allocation mechanism adopted by the International Development Association (IDA) facility at the World Bank. Section 4.3 critically evaluates the CPIA rating system and empirical evidence presented for the selectivity-based, CPIA-centred aid allocation mechanism and debt-sustainability framework. In section 4.4, alternative approaches to evaluating aid effectiveness are proposed in the form of (i) the need to institute incentive-compatible state contingent aid and debt contracts to address the vulnerability of low-income countries to external shocks stemming from their dependence on commodity export earnings; and (ii) the need to adopt a distinctively institutional approach to examining the role of aid in economic development, wherein development management is seen as more *process* oriented, rather than *output* oriented. This chapter focuses more on the second approach. Hence, after briefly discussing how state-contingent aid and debt contracts could address the difficulty in overcoming the aid dependence and debt sustainability of low-income countries in the face of external shocks (section 4.4.1), it proceeds to discuss the institutional approach in more details (section 4.4.2). In particular, using

<sup>3</sup> See Addison, Hansen, and Tarp (2004) for a critical evaluation of the HIPC Initiative—in particular, chaps 3, 4, 5, and 12.

<sup>4</sup> Mosley, et al. (2004) propose a new conditionality to tie aid specifically to poverty reduction in the form of the pro-poor expenditure PPE index in the PRSP process.

<sup>5</sup> CPIA stands for Country Policy and Institutional Assessment. It is a scoring matrix used by the World Bank to assess country policy and institutions of developing countries for aid allocation. See sects. 4.2 and 4.3.1 below for more details on how the CPIA is constructed and used. See also Gibson et al. (2005) and Haut (2007: chap. 2) for similarly critical discussions on this question and related topics.

the case studies of aid-financed infrastructure development projects, it illustrates how this approach could be used for examining aid effectiveness in a broader context of institutional development of recipient countries. Section 4.5 offers concluding remarks, where I emphasize the need to shift the aid effectiveness debate away from the conventional perspectives of viewing aid as leverage for donor-inspired policy and institutional reforms, where *ex ante* or *ex post* policy conditionality prevails and ‘marketing’ institutional models deemed appropriate by donors becomes a dominant feature of aid relationships.

## 4.2. The CPIA-based selectivity approach to aid allocation as *ex post* policy conditionality<sup>6</sup>

### 4.2.1. Analytical rationales for the selectivity approach to aid allocation

Donor–recipient aid relationships are usually examined in the principal–agent theoretical model wherein recipients are agents implementing the conditions desired by donors; that is, the principals (Killick 1996, 1997). Conditionality is then the means of using leverage accorded by ‘aid giving’ to promote donor objectives. As such, it can be administered in a cooperative manner between the principals and the agents (Killick 1996). However, in reality, there are conflicts and congruence between the objectives and interests of donors and recipients. In particular, it is often assumed that donors have altruistic preferences (for example, caring about the voiceless poor), whereas recipient governments are typically constrained in pursuing such objectives by domestic political economy considerations. Furthermore, it is admitted that in aid relations characterized by asymmetric powers, conditions are more likely to be drafted and imposed by donors and accepted, often unwillingly, by recipients.<sup>7</sup> As a consequence, it is this *coercive* nature of policy conditionality which has largely shaped donor–recipient relationships over the recent decades. This can be best illustrated in the ‘languages’ used to analyse the multiple roles of policy conditionality in the aid relationships. For example, Collier and Gunning (1996) classify the objectives of policy conditionality into four categories:

- (i) paternalism, where donors believe they know what is best for the recipient;
- (ii) bribery, when donors persuade recipients to implement reforms that are otherwise not undertaken;

<sup>6</sup> Sects. 4.2 and 4.3 draw in a large part on the analysis and discussion presented in Nissanke (2008).

<sup>7</sup> White and Morrissey (1997) suggest that (i) it should not be assumed that recipients are necessarily unwilling to reform; (ii) where recipients are willing, conditionality can be counterproductive; and (iii) if recipients are unwilling, donors can only exert leverage, since the threat to withhold aid is credible only when donors are actually ready to cut aid. See the text below for further discussion on this issue.

- (iii) restraints, when donors place conditions to prevent the recipient from policy reversal on reforms;
- (iv) signalling to the private sector and other donors that the reform programme is sincere.

From a similar perspective, the World Bank (2005c) discusses rationales for conditionality in terms of:

- (i) compensation by the donor to the recipient government for adopting the policies preferred by the former, when each party has different beliefs on the appropriateness of the policy;
- (ii) restraint/counterbalance device for the government in the face of domestic opposition to policy reforms; and
- (iii) signalling of commitments to reforms to potential private investors.

Using the principal–agent framework, Killick (1996, 1997) explains the inherent tension engendered by policy conditionality in aid relationships in terms of: the asymmetrical burden of risks between donors and recipient governments; the high short-term economic and political costs associated with reform measures compared with slowly emerging benefits; and the high monitoring and enforcement costs. In particular, he notes that the involuntary nature of policy conditionality undermines the legitimacy of reforms. Thus, when reform measures are not home-grown, recipient governments try to evade commitments and regress when the opportunity arises, as they are supposed to bear political risks and adjustment costs. Yet, the incentive structures to monitor and enforce aid contracts are weak when the donor agencies are prone to a ‘pro-lending’ ethos, and hence donor commitment to enforce conditionality and sanctions is not seen as credible. Killick concludes that ‘(ex ante) conditionality does not meet its promise of greater aid effectiveness... A further cost is that conditionality distorts the nature of the discourse between the donors and developing country governments’ (1997: 493). He suggests that a new model of donor–recipient relationships should be based on ‘selectivity’ along with other principles such as ownership, support, and dialogue.

In evaluating the efficacy of conditionality when donor and recipient preferences for policy reform and aid vary, White and Morrissey (1997) also show that *ex ante* conditionality tends to create conflicts between donors and recipients even when recipient governments are sincere about economic reforms. They conclude that conditionality is neither an effective mechanism to induce reform on unwilling governments nor an appropriate mechanism for genuine reformers. They suggest that the switch to *ex post* conditionality could reduce such conflicts, if it is solely based on performance measures that are truly independent of external shocks or unavoidable implementation problems that are beyond the control of recipient governments.

Consequently, the new aid architecture, as emerging today from the aid effectiveness debate, has adopted the *selectivity* rule as a guiding principle for aid allocation. However, it is well-known that the analytical and empirical basis for the selectivity approach rests almost entirely on cross-country regression results of the growth–aid relationship, such as the study by Burnside and Dollar (1997 and 2000). They draw a very strong policy conclusion from the significant positive coefficient on the policy–aid interaction term in their cross-country regressions. According to these authors, while aid generally does not have any significant effect on the rate of economic growth or investment, the growth-enhancing effect of aid can be found only in a *good policy* environment.<sup>8</sup> These empirical studies have been severely challenged on technical grounds. For example, Easterly, Levine, and Roodman (2003) argue that the regression results obtained by Burnside and Dollar are not robust as they are extremely sensitive to how the included key variables such as aid, policy, and growth are defined and measured. Dalgaard and Hansen (2001) question the theoretical underpinning of the Burnside–Dollar study as well as the sensitivity of their econometric results to the data samples. Guillaumont and Chauvet (2001) argue that aid is most effective when it is available to countries disadvantaged by large external shocks and climatic conditions. Their cross-country pooled regressions show that the external environment factor rather than the policy environment is a determining factor in improving aid effectiveness.

Hansen and Tarp (2000, 2001) further challenge the validity of the empirical analysis by Burnside and Dollar, comparing their results with a large number of past and current empirical studies on the aid–growth relationships. They conclude that the difference between the results obtained by Burnside and Dollar and others stems mostly from the model specification and other technical issues.<sup>9</sup> Hence, they caution strongly against basing aid allocation rules on the single-cause explanations. Wangwe (2003), assessing the three criteria adopted by Burnside and Dollar for defining good policies, that is, budget surplus, inflation, and openness, concludes that they are too narrow.

In recognition that the policy-performance indicators used in the original Burnside–Dollar study are too limited, the World Bank subsequently presented

<sup>8</sup> They also found that aid is subject to diminishing marginal returns. While Lensink and White (2001) agree on the existence of such an aid-Laffer curve, they suggest that this is due to the limited absorption capacity of recipient countries in using aid productively, and that the threshold level above which aid starts having a negative effect on growth in the Laffer curve is about 50 per cent of the aid/GDP ratio, much higher than the level suggested by Collier and Dollar (2001, 2002).

<sup>9</sup> See also Hudson (2004) and Morrissey (2004) for discussions on econometric issues arising from the differences in model specification, sample size, and estimation methods adopted in these studies.

a more comprehensive matrix—the Country Policy and Institutional Assessment—for assessing and ranking countries according to their institutional and policy environment for long-term growth and poverty reduction. Using the CPIA as a screening device, further studies by Collier and Dollar (2001, 2002, 2004) reiterate the earlier claims by Burnside and Dollar that aid and policy can interact in such a positive manner for economic growth that ‘aid enhances the growth effect of policy and good policy increases the growth effect of aid’ (Collier and Dollar 2001: 1788).

Acknowledging that aid is used by donors for objectives other than accelerating economic growth, Collier and Dollar (2001, 2002) extend their analysis to arrive at a poverty-efficient allocation of aid as a benchmark for assessing the performance of actual allocation in terms of achieving the poverty reduction objective.<sup>10</sup> On the basis of similar cross-country regressions, they advocate that aid should be given to countries with ‘good’ policy while allowing for the differences in the incidence of poverty to arrive at a poverty-efficient allocation as close as possible within the aid-policy configuration. The technical basis of their cross-country regression results on the aid-growth-policy trajectory remains rather fragile and unconvincing as the basic thrust of their econometric exercises is the same as the original Burnside–Dollar study. Further, the use of the CPIA index can be objected to on several technical grounds, including its endogeneity to the growth process, as discussed below.<sup>11</sup>

Despite these criticisms, the selectivity rule had a strong appeal for the donor community as an effective instrument to overcome the moral hazard problems in dealing with recipient governments. In particular, their poverty-efficient aid allocation proposal has indeed become influential in the policy debate on the feasibility of achieving the Millennium Development Goals (MDGs), where poverty reduction is singled out as the most important objective of giving aid and publicized as such in order to mobilize public support for securing aid budgets in donor countries.<sup>12</sup> On the basis of their simulation analysis, it is claimed that the MDG target in poverty reduction is more likely to be met by a combination of more efficient aid allocation, policy reform, and more generous aid. Their estimates proclaim, for example, that the proposed poverty-efficient aid allocation would reduce the number of poor people by an extra 18 million

<sup>10</sup> A poverty-efficient allocation of aid is defined as one in which the marginal cost of poverty reduction is equalized across recipient countries. Collier and Dollar (2004) discuss aid-allocation rules for achieving other donor objectives such as a *security-efficient* allocation.

<sup>11</sup> Dalgaard et al (2004) suggest using instruments such as ‘the fraction of land in tropics’ for the CPIA index for the regression analysis so that the endogeneity problem of the CPIA index is dealt with. See also Tarp (Chap. 2 in this volume) and the discussion below for further critical issues on the construction of the CPIA index.

<sup>12</sup> Their proposal was, for example, used as a guide in US aid allocation of the Millennium Challenge Account (Collier and Dollar 2004).

per year compared with what can be achieved by poverty reduction under the allocation practiced hitherto.

#### *4.2.2. The CPIA-based aid allocation system*

These optimistic predictions have provided the donor community with a basis of adopting the CPIA-based allocation for IDA loan disbursement and HIPC debt relief as its performance-based allocation system (PBA) at the World Bank since 2002 (IDA-13, IDA-14, IDA-15) (IDA 2004, 2007). The PBA now uses the CPIA comprising of sixteen criteria grouped in four equally weighted clusters: (i) economic management; (ii) structural policies; (iii) policies for social inclusion and equity; and (iv) public sector management and institutions, as shown in Table 4.1.

In IDA-14, the country performance ratings (CPR) is arrived at by first constructing the composite index, wherein the CPIA is given 80 per cent weight with 20 per cent weight allocated to the portfolio performance ratings (PORT). The latter is derived from the Bank's Annual Review of Portfolio Performance (ARPP) for reflecting the percentage of IDA-funded project at risk in a country. The composite index is further moderated by a governance factor (*GOV*), which is made up of six criteria: five are drawn from Cluster D of the CPIA rating (measuring public sector management and institutions as shown in Table 4.1 and one from the ARPP (World Bank

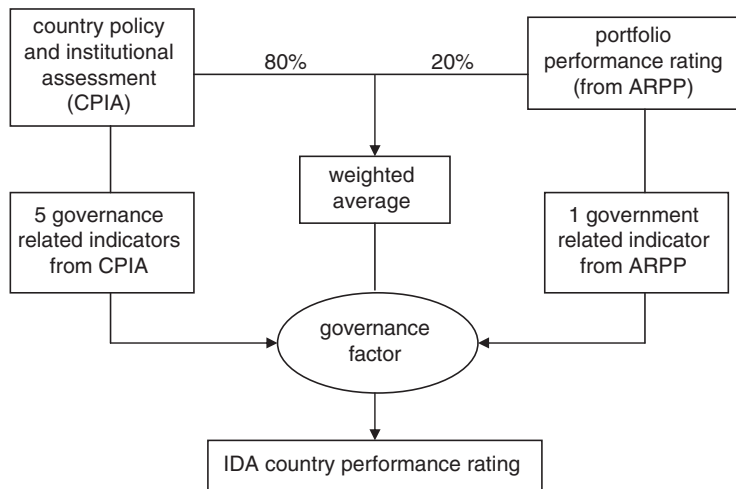
**Table 4.1.** 2004 criteria included in CPIA

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A. Economic management
Macroeconomic management
Fiscal policy
Debt policy
B. Structural policies
Trade
Financial sector
Business regulatory environment
C. Policies for social inclusion/equity
Gender equality
Equity of public resource use
Building human resources
Social protection and labour
Policies and institutions for environmental sustainability
D. Public sector management and institutions
Property rights and rule-based governance
Quality of budgetary and financial management
Efficiency of revenue mobilization
Quality of public administration
Transparency, accountability, and corruption in the public sector

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*Source:* World Bank (2005a: box 2, annex 1).



**Figure 4.1** IDA country performance rating

Source: IDA (2007a: chart 1).

2005a; IDA 2007a)).<sup>13</sup> Thus, the process of determining CPR is illustrated in the Bank’s documentation as Figure 4.1.

The actual formula used to determine CPR in IDA-14 is:

$$\text{Country performance rating} = (0.8 * \text{CPIA} + 0.2 * \text{PORT}) * (\text{Gov}/3.5)^{1.5}$$

The governance rating is divided by 3.5, which is the midpoint of the CPIA scale, and then raised to an exponent of 1.5. This means that for governance scores above 3.5 the rating is increased, while for scores below 3.5 it is decreased. Finally, IDA annual allocation received by each country is determined according to the following formula:

$$\text{IDA Country allocation per annum} = \text{base allocation} + f(\text{Country performance rating}^{2.0}, \text{Population}^{1.0}, \text{GNI/capita}^{-0.125})$$

Thus, in IDA-14, IDA country allocation, addition to the base allocation of SDR 1.1 million per annum to all IDA-eligible countries, is a function of CPR as defined above, the population size, and a country’s needs reflected in per capita gross national income (GNI).<sup>14</sup> Clearly, these mechanisms and formulas make

<sup>13</sup> The CPIA, portfolio performance ratings, and governance factor were publicly disclosed only in 2007.

<sup>14</sup> Only in exceptional circumstances is the performance-based country allocation adjusted in light of countries’ access to alternative financial sources or their emergence from conflict or severe natural disaster.

the CPIA the dominant factor in the IDA allocation, while variables such as population (*POP*) and gross national income per capita (*GNIPC*) are merely a moderating factor. This is confirmed by the World Bank, stating that ‘there is a modest bias in favour of the IDA eligible countries with a lower GNI per capita’ (World Bank 2005a: annex 4). Thus, as Kanbur (2005: 5) notes, ‘the performance rating has a much higher weight than the measure of the need’ where ‘the need’ is captured by the income criterion. In short, ‘aid productivity’ is given precedent over the ‘need’ in the donor’s impact analysis (*ibid.*: 11). Similar ‘rule-based’ methods are adopted for allocating highly concessional resources at both the Asian Development Bank and African Development Bank (IDA 2007a).<sup>15</sup>

Furthermore, the debt sustainability analysis (DSA) conducted in parallel within the debt sustainability framework (DSF) is embedded in the current IDA facility, and it is used to determine the outright grant component with an upfront reduction of 20 per cent in overall IDA allocation to a country.<sup>16</sup> To assess debt sustainability, debt burden indicators, calculated in the net present value (NPV) of debt obligations, are compared to indicative thresholds over a twenty-year projection period (IMF-IDA 2004). Based on a few empirical analyses carried out by economists at the World Bank and the International Monetary Fund such as Kraay and Nehru 2004 and IMF-IDA 2004, the DSAs are then conducted regularly to assess the risk of debt distress, judged by indicative debt burden thresholds that are determined by the CPIA rating.

That is, the DSF classifies countries into one of three policy performance categories (strong, medium, and weak) according to the CPIA rating and uses different indicative thresholds for debt burdens for each category as shown in Table 4.2. It is assumed that countries with weak policies and institutions (that is, with a low CPIA rating) would face a repayment problem at the lower level of debt burden than countries with a higher CPIA rating (IMF-IDA 2005).

Finally, countries are classified into three categories—low risk, medium risk, and high risk of having debt distress—depending on actual and estimated debt burden in relation to indicative thresholds. This classification is used annually in the IDA allocation to determine the grant component: countries with high risk would get 100 per cent of aid in grants, those with medium risk would have

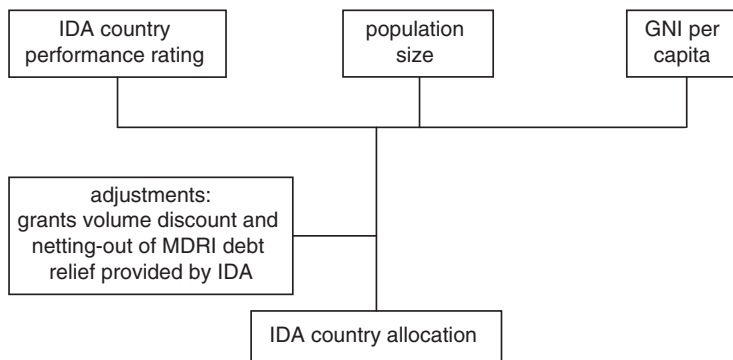
<sup>15</sup> The formulae adopted by the Asian Development Bank and the African Development Bank give slightly different weights to each variable in arriving at the volume of final allocation. It may be worth noting that the Asian Development Fund gives twice as much weight to the ‘needs’ variable than that adopted in the IDA allocation, whereas the African Development Fund adjusts the performance rating by the post-conflict enhancement factor (IDA 2007a).

<sup>16</sup> In contrast to the debt sustainability analysis carried out under the HIPC initiative which used backward-looking three-year averages, the new DSF is seen as a forward-looking analysis with its focus on the future path of relevant debt-burden indicators. It has been presented as (i) an analytical tool to assess potential debt-related vulnerabilities; and (ii) an operational tool that helps design a borrowing/leaning path by sovereign borrowers as well as by lending institutions and creditor governments (IMF 2005).

**Table 4.2.** Debt-burden thresholds under the DSF

	Net present value of debt as percentage of			Debt service as percentage of	
	Exports	Gross domestic product	Revenue	Exports	Revenue
Weak policy (CPIA < 3.25)	100	30	200	15	25
Medium policy 3.25 < CPIA < 3.75	150	40	250	20	30
Strong policy (CPIA > 3.75)	200	50	300	25	35

Source: World Bank and IMF websites.



**Figure 4.2** IDA country allocation

Source: IDA (2007a).

50 per cent in loans and 50 per cent in grants, and those with low risk would receive IDA 100 per cent in loans. The IDA allocation is also adjusted by netting out the Multilateral Debt Relief Initiative (MDRI). Hence, the overall current system used for IDA country allocation can be illustrated as in Figure 4.2 (IDA 2007). It should be noted that with a 20 per cent upfront reduction applied on the grant component, justified in terms of the need to address the resulting incentive problem, this allocation method actually severely penalizes countries with a lower CPIA rating, which are doomed to be high risks.

The strong bias towards the performance-based allocation noted above has been further intensified in the process of simplification of the formula at the Mid-Term Review of IDA-14 with the stated aim of reducing the volatility for IDA-15 (IDA 2007a, 2007b). After much discussion, the new formula adopted for IDA-15 is:

$$\begin{aligned} \text{Country performance rating} &= (0.24 * \text{CPIA}_{A-C} + 0.68 * \text{CPIA}_D + 0.08 * \text{PORT}) \\ \text{IDA Country allocation} &= f(\text{Country performance rating}^{5.0}, \text{Population}^{1.0}, \\ &\quad \text{GNI/capita}^{-0.125}) \end{aligned}$$

As evident in this new formula, the exponent applied to the CPIA dominant performance rating is raised from the value of 2 to that of 5 for IDA-15, signifying the much increased weight given to the performance rating measured in CPIA compared with the 'needs' variables (IDA 2007b).<sup>17</sup>

### 4.3. Critical appraisal of the selectivity approach as *ex post* policy conditionality

#### 4.3.1. A critical review of the CPIA

In assessing the selectivity aid allocation rule, based so much on one index, the CPIA, it is critical to examine first how the CPIA itself is constructed, in relation to a more fundamental question as to who defines (and how to define) good policies for country-specific conditions. At the outset, it is important to note that the CPIA is not an *objective* measure of the quality of policies and institutions, but a set of *subjective* scores (1–6 rating scores) by Bank staff, based on questionnaires organized with country teams at the World Bank (World Bank 2005b).

Furthermore, the CPIA is constructed in terms of mixed-score parameters: while some parameters rank policy choices and institutional quality, others reflect outcomes or, more often, both outcomes and policy choices. Hence, the World Bank's assertion that policies and institutional arrangements assessed through the questionnaires can be classified as *input*, which are within the country's control, as opposed to *outcome* (for example, the growth rate), which is influenced by elements beyond the country's control, should be seriously questioned. In reality, such a separation is often fictitious, as is apparent on closer inspection of score guidelines listed under each of the CPIA categories (World Bank 2005d).

Many indicators can be seen as reflecting outcomes influenced by exogenous events. For example, the ability of governments to pursue aggregate demand policy or fiscal policy, consistent with price stability and achieving external and internal balances, is often undermined in the face of large external shocks typically facing fragile low-income countries. The aptitude of governments in providing public goods depends also on their revenue-raising capacity which, in turn, is affected by exogenous events outside their control. Thus, what is assessed is often endogenous to growth, contrary to the claim that the criteria

<sup>17</sup> There are a few exceptions that IDA-15 makes in applying the formula for IDA allocation (IDA 2007b).

used in the CPIA are 'in principle independent of growth outcomes' (Collier and Dollar 2004: F255). At the same time, some scores are distinctly related to policy choice variables, as illustrated in rating score under trade policy, which is based mostly (75 per cent) on the 'trade restrictiveness' measured in terms of tariff and non-tariff barriers deployed.

While many of the criteria used are not necessarily controversial in their own terms (for example, those listed under policies for social inclusion/equity), it should also be recognized that the quality of institutions and the implemental capacity for socio-economic policies, evaluated under the CPIA, are often a reflection of structural characteristics of low-income economies. Hence, they should be treated as a manifestation of their stage and level of economic development rather than that of societal subjective preferences or simple choice parameters of recipient governments. These structural characteristics should evolve and change as development proceeds. For example, all three dimensions listed as criteria upon which financial sector policy is assessed (financial stability; the sector's efficiency, depth, and resource mobilization strength; and access to financial services) are a function of the level and stage of economic development. The financial sector develops in tandem with real sector activities as demand and supply for financial services interact dynamically over time (Nissanke and Aryeetey 1998; Nissanke 2004).

Thus, the CPIA-based aid allocation formula cannot be seen as a fair rule, since it gives a common scoring for all countries with the equal weighting of the different factors, irrespective of the level of development and structural characteristics of each country.<sup>18</sup> Indeed, a closer evaluation of the criteria listed in the CPIA reveals that these scores overlap largely with those included in the extended policy conditionality list that the recipient governments had to comply with in return for aid disbursements under the SAPs. The nature of policy conditionality remains largely intact. What has changed is the method of aid allocation mechanisms from *ex ante* conditionality to performance-based *ex post* conditionality. This is not surprising, since the CPIA is based on the premise that 'the broad thrust of World Bank policy advice over the last two decades has been correct' (Collier and Dollar 2004: F246).

While concepts such as ownership and partnership or dialogue are recognized and promoted as an important dimension for success in producing the desired development outcomes through aid delivery, the selectivity rule- and performance-based aid allocation, as practised today, is still an imposition of one particular development model by the donor community on recipient countries as an uniquely appropriate, universal model to be adopted by all countries. From this perspective, the CPIA cannot be treated as truly

<sup>18</sup> With reference to his criticism of the CPIA, Kanbur (2005) also remarks that a common scoring for all countries is justified only if we endorse the assumption of 'a common development model for all countries', postulated in a cross-country 'average relationship'.

performance-based parameters measured in terms of choices of policies and institutions leading to desired development outcomes, as claimed. It is instead a matrix contaminated with 'intermediate variables' that measure the extent to which a recipient accepts policy choice parameters seen as desirable by donors (Kanbur 2005).

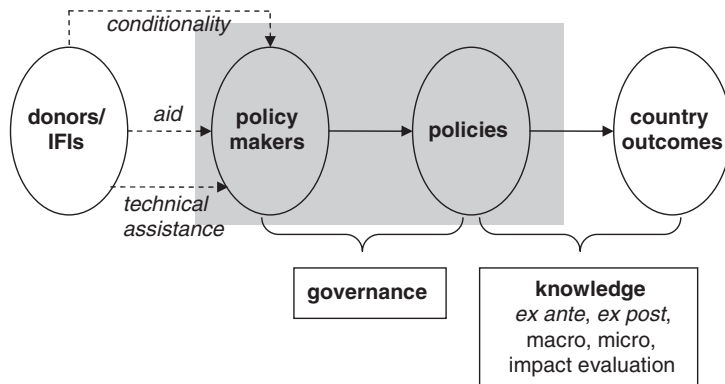
Consequently, the aid relationships emerging under the 'new aid architecture' are far from ideal for making incentive structures efficient for either donors or recipient governments. Nor are they conducive to forging a genuine partnership between donors and recipients in their common efforts to build local institutions and capabilities to overcome the technical and financial constraints to sustainable development in light of locally prevailing conditions and characteristics; that is, in a country-specific context.

#### 4.3.2. A critical review of empirical evidence used for the selectivity approach

While the empirical studies on aid effectiveness reviewed above had a very strong and direct effect on policymaking and actual aid allocation mechanisms adopted by multilateral and bilateral donors, their analytical weaknesses have subsequently been exposed.<sup>19</sup> Bourguignon and Sundberg (2007) attribute this weakness to the treatment of the complex causality chain linking external aid to final outcomes as the 'black box' in these cross-country regressions, as well as to the heterogeneity of aid motives, and the limitations of the tools of analysis. They argue the need for disentangling the causality chain inside the black box as a first step towards gaining a deeper understanding of the impact of aid on economic development. As shown in Figure 4.3, they identify three types of links in the black box: (i) policies to outcomes (knowledge); (ii) policymakers to policies (governance and institutional capacity); and (iii) donors to policymakers (financial resources, technical assistance, and aid policy conditionality). Such detailed analyses of the causality chain cannot be effectively conducted through simple reduced-form cross-country regressions at the aggregate level, which have been a popular analytical tool in empirical research on aid effectiveness.

Indeed, as discussed in section 4.2.1 above, the empirical basis used to rationalize the current performance-based selectivity approach to aid allocation as *ex post* conditionality is extremely thin. The methodological flaws found in these cross-country regression studies are so fundamentally flawed that the World Bank's flagship publication *Assessing Aid: What Works, What Doesn't, and Why* (1998), based on their empirical regression analyses, is singled out as one of the bank's most problematic research publications in the 'Deaton

<sup>19</sup> It is known that CPIA and PBA have been used explicitly in the Dutch aid allocation (see Hout 2007) and in US aid allocation of the Millennium Challenge Account. However, it is to be noted that the CPIA is not used as a driver in aid allocation by all bilateral donors but rather as useful background information.



**Figure 4.3** The causality chain: inside the black box

Source: Bourguignon and Sundberg (2007: fig. 1).

Report’, an influential evaluation report of World Bank research for 1998–2005, conducted by a group of independent academics (Deaton et al. 2006). The Deaton Report refers to the empirical results in the papers by Burnside and Dollar (1997, 2000) as unconvincing at best. It also points out the similar methodological weakness in the subsequent papers by Collier and Dollar (2001, 2002, 2004) which were heavily used to build the Bank’s case for aid, resting on the claim that external aid works for economic development, only contingent upon a set of ‘good policies’.

Thus, in relation to the cross-country evidence reported in these research papers, the Deaton Report points out many problems that are inherent in trying to use the cross-country evidence to make solid inference about the effectiveness of aid. Warning against the practice of selectively using the empirical evidence to support an advocacy position, the Report assesses that ‘much of this line of research appears to have such deep flaws that, at present, the result cannot be regarded as remotely reliable, much as one might want to believe’ (World Bank 1998: 53). It criticizes the Bank for its failure ‘in the checks and balances within the system that has led to Bank to repeatedly trumpet these early results without recognizing their fragile and tentative nature’. It warns that ‘it is very unclear empirically where the line can be drawn, or which policies matter, and in our view, the jury is very much still out on any quantitative assessment of the issue’ (ibid.). Indeed, several recent studies such as that of Rajan and Subramanian (2005), which use a similar cross-country regression but with a more-refined and advanced econometric technique, show that the empirical evidence reported in the earlier Bank studies is not robust and cannot be validated.

A similar set of technical problems are also inherent in the empirical studies carried out by Kraay and Nehru (2004) and IMF-IDA (2004) in support of the debt sustainability framework and analysis reviewed in section 4.2. In

particular, a critical issue arises as to the way the results of empirical studies on debt distress are actually used in the debt-sustainability analysis, and then in the aid-allocation mechanism. As discussed by Cohen et al. (2008), simulation exercises on debt distress similar to the Kraay and Nehru study show that the likelihood of a debt crisis in low-income countries is indeed triggered by external shocks such as negative price shocks to earnings from exports of primary commodities as much as (if not more than) the governance index developed by Kaufmann, Kraay, and Mastruzzi (2005).<sup>20</sup> These findings shed serious doubts on the central position assigned to the CPIA rating in the debt sustainability analysis and framework reviewed above.<sup>21</sup>

#### 4.4. Alternative approaches to understanding aid effectiveness

##### 4.4.1. *The case for contingent facilities as incentive-compatible contracts*

The failure of the current framework to assign a more central role to vulnerability to shocks in guiding both the aid allocation and debt sustainability process remains largely unjustified. While the commodity issues were not featured in the early debate on the causes for the debt crisis affecting commodity-dependent low-income countries,<sup>22</sup> there is by now almost unanimous agreement—including at the World Bank and IMF—that vulnerability to external shocks represents a major factor behind the low-income country debt crisis and the renewed accumulation of unsustainable external debt stocks despite the HIPC Initiative. Demonstrating the depth of the commodity crisis in the 1980s, Maizels (1992) convincingly reveals how the beginning of the debt crisis of poor countries in the late 1970s coincided exactly with that of the ‘conveniently forgotten’ commodity crisis.

Drawing on Maizels’ empirical research and Krugman’s (1988) classical analysis on debt overhang and forgiveness, it was previously argued that a *state-contingent* debt contract is required as an *ex ante* debt relief mechanism to deal with the debt crises facing commodity-dependent, low-income countries (Nissanke and Ferrarini 2004). This is because the state-contingent schemes could make a distinction between the consequences of a debtor’s own efforts and events beyond its control. Such a contract can specify their contractual

<sup>20</sup> The governance index developed by Kaufmann, Kraay, and Mastruzzi (2005) is used as a substitute for the CPIA index which was not publicly available till recently. The index covers six dimensions of governance: voice and accountability; political stability and the absence of major violence and terror; government effectiveness; regulatory quality; rule of law; and control of corruption. However, Kaufman (2005) warns of using it mechanically for ranking countries, as margins of error are not trivial and caution is required in interpreting the results.

<sup>21</sup> See Nissanke and Ferrarini (2007) for further critical discussion on the debt sustainability framework incorporated into aid allocation.

<sup>22</sup> See Nissanke and Ferrarini (2004) for detailed discussion.

obligations contingent on the nature of states, and hence deal explicitly and effectively with the uncertainty associated with exogenous shocks and systemic risks that are present in any inter-temporal financial transaction. For example, as Krugman (1988) notes, the trade-off between debt forgiveness and financing in a typical negotiation can be improved by indexing repayment to the 'state of nature', which can be verifiable. I argue that the currently dominant selectivity approach to aid allocation fails to offer incentive-compatible, *state-contingent* aid contracts which would allow an automatic access to contingency financing when recipient countries are hit by adverse unforeseen events. It is critically important to establish genuinely flexible, state-contingent aid and debt contracts in order to align incentives of borrowers/recipients and lenders/donors.

Cohen, Jacquet, and Reisen (2005) also argue that subsidized contingent loans are superior to outright grants in financing productive investment in countries facing high vulnerability to external shocks such as natural resource price volatility. They show that debt and debt cancellations are two complementary instruments which, if properly managed, perform better than either loans or grants taken in isolation. Taking these arguments further, Cohen, et al. (2008) proposes a new contingent facility: the countercyclical loan (CCL). The CCL facility is assigned to transform the grace period of a typical concessional loan into a fixed initial grace period and a floating grace period, which the country can draw upon when a negative shock occurs. More concretely, they propose to reduce the grace period of a typical concessional loan from ten to five years and to keep the remaining grace periods as an asset that the country can draw upon when a negative shock takes place, where the negative shock is defined as an export shock, whereby current exports fall below a moving average of the past five years.

By indexing the contingency facility to the debtor's capacity to pay, rather than to a verifiable state of nature, the CCL may not completely eschew the potential 'incentive' problem. However, it plentifully demonstrates that any technical issues associated with creating an 'efficient' contingent facility can be overcome if a strong political commitment to such a facility exists. Yet, despite advances in the quest for a technically feasible contingency facility, donors have failed so far to show sufficient interest in devising an effective mechanism of protecting vulnerable countries against the negative impacts from external shocks on economic growth and debt sustainability. Insofar as vulnerability to shocks represents a key determinant of debt distress, any DSF that does not effectively translate vulnerability assessments into appropriate policy responses in terms of volume and timing of aid is bound to fail in providing a lasting solution to debt distress of low-income countries.

As discussed above, neither the CPIA-based aid allocation rule nor the CPIA-based debt-sustainability framework currently adopted satisfy the conditions required for making aid really effective and debt truly sustainable, or for improving donor–recipient relationships. The CPIA is not a truly performance-based, outcome-centred assessment. In reality, the selectivity applies at least

partly on the basis of the policies implemented that donors deem appropriate. The CPIA-based selection in aid allocation and debt relief is at best an 'eclectic mix' of outcome-based selectivity and policy conditionality. Yet, the present system is seen and promoted as 'programmatically policy-based lending offering a particularly promising way to reconcile the debate between the traditional *ex ante* approach and the aspirations of a results-based approach to conditionality' (World Bank 2005c: 20).

In reality, the current system of aid allocation and debt sustainability framework leaves many critical issues unresolved. First, policy-related selectivity criteria continue to be set by donors. This mechanism would surely undermine the 'ownership' of policies and reform programmes, as recipient governments in the need of foreign aid and debt relief would have strong incentives to opt for policies prescribed by donors rather than alternative policies they might have chosen otherwise. Second, the mechanical 'programmatically' application of the selectivity rule is problematic, since the relationships between the quality of policies and institutions on the one hand, and developmental outcomes on the other, are much more tenuous in a short-term framework than implicitly assumed under the current framework. It often takes considerable lead time for changes in policies and institutions to produce tangible results in development indicators, including poverty indicators. Third, the performance-based system could heavily penalize fragile low-income countries which are more exposed to exogenous shocks, since their performance is more likely to be influenced by many factors beyond the control of governments, such as terms of trade shocks or climate-related conditions.

In fact, in the absence of efficient state-contingent contracts, and without due attention to critical unresolved issues in the performance-based system, the aid relationships that have emerged under the selectivity rule are still predominantly characterized by donors taking a very short-leash approach with intensive monitoring. Aid is disbursed in small tranches with the use of performance indicators as a monitoring device to measure progress. For example, the European Union (EU) adopted performance-based conditionality (at least partially) in twenty-eight budgetary aid programmes in 2001 and introduced a 'variable financing tranche' as a part of financing conventions with African, Caribbean, and Pacific (ACP) countries (Adam et al. 2004). These authors observe that while this mode may have promoted a 'culture of results' it has not succeeded in shifting responsibility for policy formulation to recipient countries (*ibid.*).

In a more detailed study of Uganda, where foreign aid has financed about a half of government expenditure over the recent decade, Adam and Gunning (2002) argue that the use of sector-specific detailed performance indicators, chosen jointly by the government and the EU, has changed donor-recipient relations with beneficial effect. However, they note several difficulties encountered, not only in deciding on genuine outcome indicators and verifying them but also in dealing with the tension between the monitoring and incentive

functions of performance indicators. In the end, the donors had to rely on short-run critical process undertaking, and to lock into micro-management based around a large number of input or process indicators which were discredited under traditional *ex ante* conditionality. This inevitably undermined genuine programme ownership and narrowed the space for effective policy debate. Furthermore, it is clearly acknowledged that the weak and uncertain link between inputs (that is, efforts undertaken by a recipient) and outcome indicators, upon which aid disbursement is based, makes it difficult for incentive structures to work in aid contracts.

There is clearly a critical gap between the rhetoric and the practice under the new aid architecture.<sup>23</sup> The performance-based aid disbursements requiring close monitoring on the part of donors could easily result in a high volatility in aid flows and severe disruptions to the development process in low-income recipient countries, whose aid dependence is overwhelming. Despite the claim that greater ownership and partnership have been achieved under the new aid architecture, donor–recipient relationships are still built on shaky ground, where recipient governments and donors tend to position themselves in an ‘aid power game’, which could result in an inferior non-cooperative equilibrium.

In this context, certain presumptions incorporated in the principal–agent framework should be critically re-evaluated in its application to the analysis of aid relationships. For example, recipient governments are often assumed to change their behaviour only in order to get more aid in future, as if they do not have a stake in enhancing the welfare of their domestic agents. It is not unusual to start discussions with the assumption that donors are always benevolent, and development-minded, acting on pure altruism, while recipient governments are seen as untrustworthy towards the international agencies as well as predatory towards domestic agents, using redistributive fiscal instruments largely for political and personal gains. This assumption is not only too restrictive for the model to be of general use as an analytical tool, but also not reflective of the reality in which aid relationships should be contextualized: much wider, more complex international political and economic relations.<sup>24</sup> It is true that some recipient governments with politically narrow-based regimes may well behave in a predatory manner towards domestic agents. However, this would not justify the assumption that *all* recipient governments can be characterized by such attributes.

To make aid work for development, it is imperative to depart radically from the use of such a misrepresentative, rather one-sided, analytical framework to model donor–recipient relationships. Indeed, as discussed above, there is an

<sup>23</sup> See Gibson et al. (2005) for a similar criticism on the new aid architecture.

<sup>24</sup> See Maizels and Nissanke (1984), among others, for discussion on donors’ motivation for giving aid.

urgent need to make aid and debt contract incentives compatible by providing a contingent financing facility to low-income countries which are often susceptible to large exogenous shocks. The recent debate on grants-versus-loans has been triggered by the desire on the part of some donors to eliminate the recurrent problems of debt overhang by providing official development assistance (ODA) in outright grants only.<sup>25</sup> However, as Cohen, Jacquet, and Reisen (2005) note, such a debate becomes somewhat misleading and largely irrelevant if the key issues of maintaining debt sustainability of these low-income countries can be properly addressed.

#### *4.4.2. Aid effectiveness contingent on donor–recipient relationships and their impact on recipient capacity and institutions*

As the academic debate on aid effectiveness and conditionality has evolved and unfolded, the need for forging effective partnerships between the donor community and the government and civil society of recipient countries has also increasingly been recognized as one of the conditions for increasing aid effectiveness and the ownership of aid programmes by the recipient countries. Thus, aid effectiveness does also rest critically on the nature of recipient–donor relationships, efficient aid delivery procedures and mechanisms, as well as on the progress of building capacity and institutions conducive to economic development in recipient countries. In fact, the non-compliance of traditional *ex ante* conditionality can be explained by the unfortunate aid relationships developed, in which ‘policy’ conditionality was dictated by the donor community. Clearly, the issue of aid effectiveness or aid dependence and debt sustainability cannot be effectively analysed and debated without reference to the unequal aid relationships. Equally, the appropriateness of economic policies and political institutions cannot be judged or assessed in isolation from prevailing country-specific conditions. While the blame for the policy failure has been placed too readily on recipient governments and institutions in terms of poor policy environments and their incapacity, the donor community has to take a fair share of the responsibility for the poor relationships that have evolved over the last few decades. As Bourguignon and Sundberg (2007) note, the donor community has imposed policy conditionality with imperfect knowledge of the local environment.

As discussed above, Bourguignon and Sundberg (2007) suggest that to gain a deeper understanding of aid effectiveness it is critical to examine the causality chain linking external aid to final developmental outcomes. As noted above, in standard cross-country regression analyses on aid effectiveness conducted using macro-level economic data, such as those examining the aid–growth

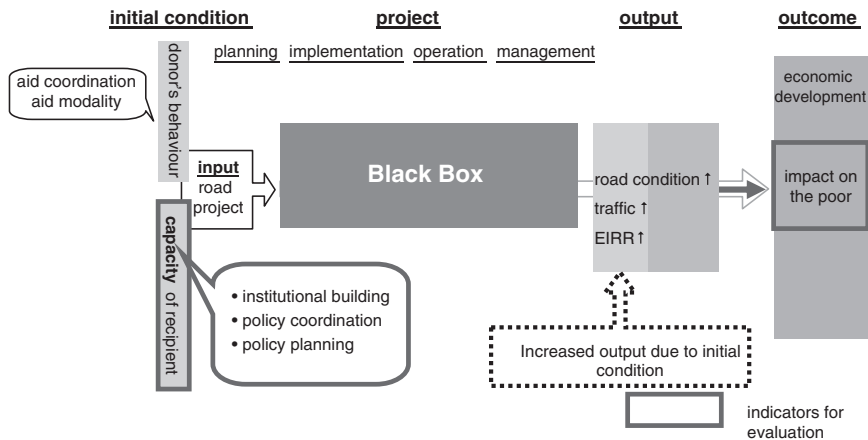
<sup>25</sup> See Odedokun (2004); Bulow and Rogoff (2005); Nunnenkamp, Thiele, and Wilfer (2005); and Cohen, Jacquet, and Reisen (2005) for detailed discussion on the grants-versus-loans debate.

relationships, the complex causal links are treated as a 'black box'. These studies also tend to treat aid as a single aggregate, despite the fact that aid is delivered in different modalities and forms of cooperation.

As Bourguignon and Sundberg argue, it is also suggested that opening the 'black box' is critical for understanding aid effectiveness, as discussed in detail in Jerve and Nissanke (2007, 2008). This is because aid effectiveness is indeed the outcome of a *time-bound* causality chain starting with initial conditions and inputs leading to changes in development outcomes in terms of conventional indicators such as GDP growth, poverty rate, income inequality, and human development indicators. However, the approach of this chapter departs from the established line of argument in a rather critical way. The current aid-effectiveness debate tends to be almost singularly dominated by a static and instrumental view of development processes. From this particular perspective, it has been argued that aid becomes effective when the 'right' policies and institutions are in place. It is based on the assumption that there are universally applicable 'right' policies and institutions and donors can condition aid transfer on the existence or adoption of such 'right' factors. Hence, it is argued that aid should be used, through either *ex ante* or *ex post* policy conditionality, as leverage for policy reforms that donors identify as good for development.

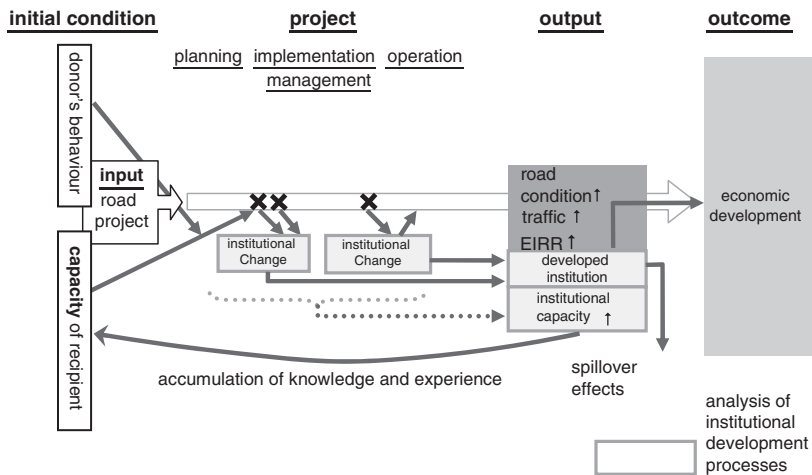
In contrast to this currently dominant view, donors should recognize that development is an iterative process where positive ('right') outcomes are the result of the gradual and often unpredictable development of local institutions and sociopolitical configuration. Seen from this alternative perspective, development management becomes more *process* oriented, rather than *output* oriented. It is further suggested that through providing development aid in different forms of cooperation (financial resources, technical advice, and so on), donors could act as an important partner in such processes. Hence, successful development depends on long-term processes of institutional development; and the effectiveness of aid as a contribution to national development processes hinges on its ability to stimulate such processes.

Using a metaphor of the black box, the main differences between the currently dominant approach and the approach of this chapter can be contrasted, in the case of examining aid effectiveness for infrastructure development and service delivery, by taking the example of a road project (Figures 4.4–4.6). As shown in Figure 4.4, most of the previous empirical studies on aid effectiveness for infrastructure development were carried out by extending aid-project evaluation from micro level studies to macro measures, or studying how projects have contributed to improving developing indicators. They involved either (i) *ex ante* policy analysis: analysis of initial inputs and conditions (recipient country's policy, governance, capacity, and so on) that could maximize the impacts; or (ii) *ex post* impact studies: quantitative analysis of the impact of infrastructure projects, measured in such indicators as economic growth and poverty reduction. The main question raised in such conventional studies on



**Figure 4.4** Conventional analysis of aid effectiveness to infrastructure development and service delivery

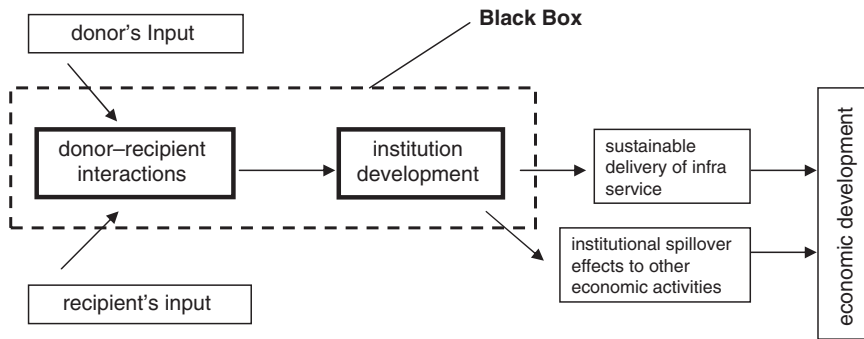
Source: Adapted from Jerve and Nissanke (2007) and JBIC Secretariat.



**Figure 4.5** Institutional analysis of aid effectiveness to infrastructure development and service delivery

Source: Adapted from Jerve and Nissanke (2007) and JBIC Secretariat.

aid effectiveness is how donors can influence, by using aid as leverage, the quality of policy and institutions to maximize the impacts. Hence, the focus of these studies is the beginning and the end of the causal chain, rather than understanding inside the ‘black box’.



**Figure 4.6** Institutional analysis of the black box

Source: Jerve and Nissanke (2007) and JBIC Secretariat.

In contrast, this chapter takes a distinctively institutional approach to examining aid effectiveness in carrying out a comparative analysis of project aid to infrastructure development in Southeast Asia and sub-Saharan Africa. It is conjectured here that what takes place in the black box in terms of institutional changes/transformation and spill-over effects would determine not only the financial and organizational sustainability of infrastructure service delivery and the quality of services as project outcome but also economic development outcomes at large. Beyond just providing grants or concessional loans, project aid in this perspective could be a vehicle that could make a significant contribution towards institutional changes and transformation throughout the project cycles of planning, implementation, operation, and management. It provides a crucial conduit for the transfer and accumulation of knowledge and expertise in the learning-by-doing process for sectoral development. Importantly, beyond sector-specific benefits, the aid-inspired learning process could also have the potential of producing institutional capacity and development of other institutions economy-wide through spillover effects. For this to happen, donors should become involved as a developmental partner and create an environment conducive to mutual learning. This potential process of institutional changes and transformation and spillover effects through project aid is illustrated in Figure 4.5. Thus, project aid can contribute to institutional development at a broader level, and this in turn could affect macro-aid effectiveness. For example, referring to Japanese infrastructure project aid, Arakawa and Wakabayashi (2006) emphasize that the experiences at the project level have led not only to capacity-building of the sector aid supported but also the establishment of comprehensive country systems at the national level.

Figure 4.6 further illustrates how inside the 'black box', aid can be instrumental in stimulating institutional development that could be an important channel for new ideas, exchanges of experiences, and the gradual building of

competence and capacity in organizations critical for sustainable infrastructure services in the case of project aid, but more generally for economic development. Such potential beneficial effects of aid on the development process are critically contingent upon the nature of the donor–recipient relationships. If the relationship is characterized by mutual trust and confidence, development aid would be a conduit for the close interactions of numerous stakeholders, which can evolve over time into dynamic institutions, adaptable to changing local conditions with flexibility and resilience.

The synthesis of the case studies on aid effectiveness for infrastructure development in eight countries of Southeast Asia and sub-Saharan Africa has led to several useful observations regarding the sustainability of economic infrastructure service where donors participated through project aid (Jerve and Nissanke 2008). The following three points can be highlighted in relation to the aid-effectiveness debate addressed in this chapter.

First, long-term commitment by local stakeholders on the recipient side is vital for the sustainability of infrastructure services. This should manifest itself in political will by leaders and successive governments to commit to sustainable quality infrastructure services within home-grown long-term development plans and visions. Leaders' strong political commitment would ensure a high priority in fund allocation over the medium and long term to sectors and regions where a specific donor-assisted infrastructure project is placed. In particular, the predictability of sufficient and stable fund allocation over a long-term horizon is crucial for sustainable operation and maintenance of infrastructural services. For this to happen, large infrastructure projects should be placed in the context of national development plans that include sectoral or regional master plans.

Second, donors' long-term commitment should be forthcoming, not only to a financed project but also to recipients' development vision and master plans, as a support for robust allegiance on the part of recipients to capacity-building and institutional development for ensuring sustainability of infrastructure services. In particular, high priority and long-time commitment on both sides work as a 'hidden or implicit guarantee' for the predictability of multi-year aid pledges and budget allocation to a project and sector development. Naturally, the predictability of sufficient and stable fund allocation is crucial for sustainable operation and maintenance of infrastructure services. But, importantly, this provides project management with a longer time horizon and could induce more readily positive institutional changes at all levels, that is, at project, sector, and national levels. Further, in the case of project aid, mutual trust can be nurtured through close face-to-face cooperation, knowledge transfer, and learning-by-doing on the ground between those participating in an infrastructure project, both donors and recipients, to achieve the common goals of sustainable delivery of infrastructure services. Such an opportunity of mutual learning involving both private and public sectors is less likely to be present in other aid-delivery modalities such as budget support.

Third, the driving force for achieving the development mission should come from recipients' endeavours in utilizing and strengthening their own institutions, both formal and informal. In this sense, the presence of initial capacity among local institutions embedded in the social-political system of recipient countries is useful. However, it is suggested that if strong commitments by both donors and recipients to development are present as discussed above, donors could stimulate the 'endogenously driven' process of development of local institutions and capacity. Here again it is important to emphasize that donors should try to identify and nurture aspects of strength found in local endogenously developing institutions, and their advice should build on their strengths. It is not at all helpful if donors try to introduce or impose their 'model' institutions on recipients by pointing to a long list of weaknesses or deficiencies in local institutions and systems.

Policy implications arising from these findings and approaches to aid effectiveness are clearly quite different from those originating from the conventional perspectives of viewing aid as leverage for donor-inspired policy and institutional reforms, where *ex ante* or *ex post* policy conditionality prevails and 'marketing' institutional models deemed appropriate by donors is a dominant feature of aid relationships.

### 4.5. Concluding remarks

Under the SAPs, policy reforms were in many cases forced upon recipient countries as stringent conditions in return for debt relief and foreign aid. Recipient governments often found it impossible to implement these policies in their domestic political economy context, as they were certain to generate a sharp configuration of winners and losers. Plus the timeframe for implementation was often unrealistic. These reform packages were sometimes so contentious that donor governments themselves would have found them hard to implement or to sell to their own domestic constituencies. Thus, donor-recipient relationships have been severely impaired by the two-decade-long experience with *ex ante* policy conditionality whereby a series of restrictive policy conditionalities were imposed as a universally applicable basis for reforms.

The weaknesses associated with the past practice of policy conditionality have been debated and the new emerging aid architecture is supposed to address these issues. In the process, the need for forging effective donor-recipient partnerships has been widely accepted as one of the key conditions for increasing aid effectiveness and the ownership of aid programmes by the recipient countries. Yet, the conventional way of debating the effectiveness and enforcement problems of policy conditionality has so far been inhibiting, for it has hardly departed from the assumption that policy reforms recommended by donors are generally appropriate for dealing with economic

problems facing developing economies. Indeed, the principal–agent framework widely used in the aid effectiveness debate is flawed as it is built on the assumption that donors are the principals while recipient governments are merely the agents of donors. However, the true ownership of aid would require donors to become agents of developing countries.<sup>26</sup>

It is not surprising to observe, therefore, that in many low-income countries it has not been easy to work towards a new aid relationship based on a genuine partnership and ownership of policy reforms. Instead of providing aid for enhancing recipients' efforts in building an institutional foundation with the necessary technical capacity for developing their own home-grown strategies and policies, donors continue to police whether recipient governments adopt and adhere to economic policies and institutional governance structures recommended by donors.

Yet, unless an uncompromised 'policy space' is accorded to recipient countries in setting their own development agenda and policy strategy, the real ownership of economic reform programmes cannot be in the hands of recipient countries. The lack of sense of ownership and partnership could propagate and promote 'cheating' behaviour on the part of the agent-recipients. Rather than impose monolithic models, there should be a room for open discussions and debate on different development models. In this context, Morrissey (2004) emphasizes the importance of allowing a process of *policy learning* and *policy experimentation* and leaving the *policy choices* to recipient governments for the sake of establishing ownership as well as encouraging partnership. Donors should play the role of 'second fiddle' in this policymaking process, providing technical assistance and information services. There should also be policy space for *institutional innovations*. In this context, Rodrik argues that 'effective institutional outcomes do not map into unique institutional designs' and that

there is no unique, non-context specific way of achieving desirable institutional outcomes. Since what works will depend on local constraints and opportunities, we should bear in mind that institutional prescriptions should be contingent on the prevailing characteristics of the local economy and that institutional design has to be context-specific. (Rodrik 2004: 9)

What is urgently required is mutual respect so that the two parties can fully and truly engage in learning from each others' development experiences, taking into account their different historical and cultural backgrounds. Recipient governments are increasingly required to be accountable to the donor community. This by itself may not pose a problem, but significant pressures from donors on important policy matters could place recipient governments in

<sup>26</sup> The author is grateful to one of referees for drawing attention to this critical weakness of the analytical framework applied to the aid effectiveness debate.

conflict with their responsibility towards their own citizens. Such situations can easily undermine the democratic credentials of recipient governments. It is high time to depart from unproductive aid relationships and to work towards cultivating mutual trust and respect, conducive to producing positive global public goods, sustainable economic development, and enduring political stability in recipient countries.

On reflection, it can be said that the aid effectiveness debate conducted mainly at the aggregate macro-relationships level may not shed real light on how to make foreign aid effective for economic growth and poverty reduction. Remark- ing that aid is given for many different purposes and in many different forms, Hansen and Tarp (2000, 2001) suggest that the unresolved issue in assessing aid effectiveness is not whether aid works, but how and whether we can make the different kinds of aid instruments at hand work better in varying country circumstances. Assessed from these critical perspectives, the CPIA-based *selectivity* rule is certainly not an ideal base to conduct meaningful policy dialogue between donors and recipients. The allocation process is a mechanical application of the index which is a mix of ranked policy and institutional parameters as well as outcomes. Indeed, in the prevailing economic analysis of the *ex post* conditional- ity game, there is little discussion on how to build and develop information endowments based on confidence and mutual trust in donor–recipient relation- ships. Yet, in game theory, sufficient and continuous information flows between the parties is accepted as one of the critical conditions for reaching a superior cooperative equilibrium (with an efficient mechanism for conflict resolution).

Further, it is also well known that in inter-temporal resource transactions a coherent *incentive-compatible* aid–debt contract is necessary to ensure an align- ment of the incentive structures governing aid relationships. Hence, the absence of an unconditional contingent financing facility available upon veri- fication of large exogenous shocks to recipient countries should be seen as one of binding constraints for improving aid relationships.

Finally, it should be recognized that while aid is treated as a single entity in most cross-country regression studies on aid-related macroeconomic relation- ships, aid is delivered in a host of different forms. Hence, it is somewhat misleading to conduct a debate at a general level, such as whether aid should be given in grants or loans.

In this context, this chapter has discussed aid effectiveness as applied to project aid provided to infrastructure development. In contrast to the prevail- ing dominant perspective of using aid as leverage for donor-inspired policy and institutional reforms, this chapter has presented a distinctively institutional approach wherein aid effectiveness is assessed in its role in stimulating long- term processes of institutional development in recipient countries. From this perspective, a strong case is advanced for the need to reconstitute the aid- effectiveness debate. Aid can contribute to economic development only through establishing and nurturing productive donor–recipient relationships

based on true partnerships and ownership as outlined in this chapter. Such relationships would encourage and stimulate the process of policy learning and experimentation as well as institutional experimentation and innovation. Performance assessments could then be made in an environment conducive to nurturing mutual trust and respect on the basis of transparent and free flows of information between donors and recipients. Further, recognizing that the recipients' own institutions could be strengthened or transformed as a part of development processes, aid should be provided even to countries with weak institutional conditions in terms of their capacity for policy formation, implementation, or governance which may initially fail to meet the standards set by donors. Hence, the intellectual hegemony used to justify the CPIA-based aid allocation mechanism currently adopted by many multilateral and bilateral donors is challenged.

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