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Aid Effectiveness and the Millennium Development Goals

By Steven Radelet

Abstract

This paper focuses on key ways in which donors can improve the quality of foreign assistance and make it more effective in achieving the Millennium Development Goals (MDGs). The paper makes three central arguments. First, donors should be much more goal and results oriented in their assistance programs, and should work with low-income countries to ensure that poverty reduction strategies (PRSs) have specific, well-defined goals both in the short-run and long-run. PRSs should be expected to specifically refer to the MDGs, even if governments choose to adopt goals that do not exactly coincide with the MDGs. PRSs should provide both a "baseline scenario" with targets consistent with the most likely policy changes and levels of financing and a "high achievement" scenario with much more ambitious targets which lays out the additional policy, institutional, and financing changes needed to reach these goals. Second, donors must go beyond the rhetoric of "country selectivity" and actually begin to allocate aid more seriously to poorer countries with strong and moderate governance. Although there has been some improvement in aid allocation in recent years, much more can be done. Donors should establish basic rules for allocating aid based on the extent of poverty and the quality of governance, not to be dogmatic and rigid, but to provide some defenses against other forces that push aid allocations towards political and commercial considerations. Third, country selectivity should be conceived as much more than simply allocating more money to countries with stronger governance: it should change the way donors deliver aid to different countries. Well-governed countries should have a much greater say in designing aid programs, should receive more of their aid as program funding, and should receive longer-term commitments from the donor community. In these countries, foreign assistance should finance a broader set of activities, with most (but not all) of the funding channeled through the recipient government. Poorly governed countries should not only receive less money, they should receive more of it as project aid, it should come with a shorter time commitment, should be focused on a narrower set of activities, and much of it should be distributed through NGOs.

This paper was prepared as a background study for the Millennium Project Task Force on Poverty and Economic Development. It does not necessarily reflect the views of the United Nations Development Programme, its Executive Board or its Member States.

Aid Effectiveness and the Millennium Development Goals

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Abstract:

This paper focuses on key ways in which donors can improve the quality of foreign assistance and make it more effective in achieving the Millennium Development Goals (MDGs). The paper makes three central arguments. First, donors should be much more goal and results oriented in their assistance programs, and should work with low-income countries to ensure that poverty reduction strategies (PRSs) have specific, well-defined goals both in the short-run and long-run. PRSs should be expected to specifically refer to the MDGs, even if governments choose to adopt goals that do not exactly coincide with the MDGs. PRSs should provide both a "baseline scenario" with targets consistent with the most likely policy changes and levels of financing and a "high achievement" scenario with much more ambitious targets which lays out the additional policy, institutional, and financing changes needed to reach these goals. Second, donors must go beyond the rhetoric of "country selectivity" and actually begin to allocate aid more seriously to poorer countries with strong and moderate governance. Although there has been some improvement in aid allocation in recent years, much more can be done. Donors should establish basic rules for allocating aid based on the extent of poverty and the quality of governance, not to be dogmatic and rigid, but to provide some defenses against other forces that push aid allocations towards political and commercial considerations. Third, country selectivity should be conceived as much more than simply allocating more money to countries with stronger governance: it should change the way donors deliver aid to different countries. Well-governed countries should have a much greater say in designing aid programs, should receive more of their aid as program funding, and should receive longer-term commitments from the donor community. In these countries, foreign assistance should finance a broader set of activities, with most (but not all) of the funding channeled through the recipient government. Poorly governed countries should not only receive less money, they should receive more of it as project aid, it should come with a shorter time commitment, should be focused on a narrower set of activities, and much of it should be distributed through NGOs.

[1] I am grateful to Rikhil Bhavnani and Sabeen Hassanali for excellent research and other support. This paper was prepared as a background study for the Millennium Project Task Force on Poverty and Economic Development. It does not necessarily reflect the views of the United Nations Development Programme, its Executive Board or its Member States.

The Monterrey Consensus signaled a new partnership between rich and poor countries aimed at achieving the Millennium Development Goals (MDGs). The agreement, adopted by heads of state at the International Conference on Financing for Development in Monterrey, Mexico, in March 2001, contains commitments by all countries for specific actions to help low-income countries achieve the MDGs.[2] The Consensus recognizes that the main responsibility for accelerating development lies with the governments of poor countries themselves, which must put in place appropriate policy and institutional frameworks and make the sometimes difficult decisions necessary to ensure full implementation. It also acknowledges that poor countries themselves cannot achieve the goals, or even make significant progress towards them, without the cooperation and assistance of the international community. Accordingly, the industrialized countries committed to taking steps in a range of areas, including trade (especially in improving market access and reducing agricultural subsidies), investment, debt relief, and official development assistance (ODA).

Donor commitments at Monterrey on ODA came in two parts. First, donors committed to increasing the *quantity* of aid. The Consensus reaffirmed the international community's goal, first made in the late 1960s, of ODA flows reaching 0.7% of donor GNP. Specifically, the heads of state agreed to "urge developed countries that have not done so to make concrete efforts towards the target of 0.7% of gross national product (GNP) as ODA to developing countries" (paragraph 42). Second, donors committed to improving the *quality* of aid. The Consensus acknowledges that donors must significantly improve the way they deliver aid to make it more effective. Towards this end, it calls on donors (in paragraph 43) to make greater efforts to harmonize their operational procedures, make further progress in untying aid, use budget support mechanisms where appropriate, adopt development frameworks that are owned and driven by developing countries, target a greater share of aid to the poor, and improve the measurement of results.

This paper focuses on key ways in which donors can improve the *quality* of aid and make it more effective in achieving the MDGs. It briefly reviews, but does not focus primarily on, the *quantity* of funding that will be necessary to achieve the MDGs, since that critical issue is being studied elsewhere. I make three central arguments.

First, donors must be much more goal and results oriented in their ODA programs. Clear goals are important for both the recipient and the donor. Recipients should set specific, measurable goals in their poverty reduction strategies (PRSs), and these goals should be set with direct reference to the MDGs. Goals need not necessarily precisely replicate the MDGs, but the PRSs should compare national goals with the MDGs and explain any significant differences. PRSs should lay out a baseline set of operational targets for the short run and medium run that are consistent with the most likely policy changes, institutional capacity, and donor funding. But they should also lay out a more ambitious framework consistent with fully achieving the MDGs (or similar national goals), and detail the changes in domestic policies, foreign policies (such as trade access) institutions, and foreign financing that will be needed to meet these more ambitious targets.

Second, donors must further improve the allocation of ODA to better achieve the MDGs. There has been some halting progress in this direction in recent years, with more aid being allocated to poorer countries with better governance and a stronger commitment to development. But much more progress is required in this regard, including the need to allocate additional funds to countries that are vulnerable to periodic economic shocks, and to those emerging from conflict.

[2] The text of the Monterrey Consensus can be found at http://www.un.org/esa/ffd/0302finalMonterreyConsensus.pdf

Third, donors should better align the ways they deliver aid with the realities on the ground in different kinds of recipient countries. "Country selectivity" should mean more than donors simply allocating more ODA to well-governed countries. Aid delivery mechanisms should differ significantly between well-governed and poorly governed countries. For example, in well-governed countries donors should provide most of their aid as long-term commitments for budget support to the central government, whereas in poorly governed countries, smaller, shorter-term projects implemented by non-government organizations (NGOs) are more appropriate. Donors must hone much more differentiated strategies to match the particular circumstances of the recipient, some of which will require significant shifts in donor organizations.

There are a range of other important issues affecting aid effectiveness that I do not touch on here. These include donor choices on allocating funds between bilateral and multilateral organizations, the debate about "horizontal" versus "vertical" funding mechanisms, grants versus loans, tied aid, and donor harmonization. While each of these is an important topic, they are beyond the scope of this paper.

2002 Global ODA Levels – One Year After Monterrey

In 2002, global ODA flows totaled $58.3 billion, up a significant 11% from $52.3 billion in 2001 (Table 1). Part of this increase is due to the weakening of the dollar and inflation. In real terms (keeping constant 2001 prices and exchange rates), the 2002 figure was $56.1 billion, an increase of 7.2%. This change represents the largest increase in ODA (in real terms) since 1998, and it returns global ODA to the nominal level reached in 1991-92. Several countries increased the size of their ODA disbursements significantly: Canada and Italy by over 30% in real terms (shown in column f); Greece, Ireland and France by over 20% each, and Belgium and the United States by about 15% each. The United States made the largest increase in absolute dollar terms of $1.9 billion, with France increasing its disbursements by over $1 billion. The increases in global ODA were perhaps partly in response to the agreements forged in the Monterrey Consensus, although a large part of the increase, especially from the U.S., was aid to allies in response to the war on terror.[3] At the same time, several countries decreased their ODA budgets, including Austria, Denmark, Japan, New Zealand, Spain, and Switzerland.

In terms of ODA as a share of donor GNI,[4] Denmark remains at the top of the pack with disbursements equal to 0.96% of its GNI. Norway, Sweden, the Netherlands, and Luxembourg all contribute more than the internationally agreed upon target of 0.7% of GNI. The United States remains at the bottom of the list in this regard, with ODA at only 0.13% of GNI, up slightly from the 2001 level. The U.S. is now the only DAC country with ODA disbursements less than 0.20% of GNI. For the DAC as a whole, ODA disbursements in 2002 were the equivalent of 0.23% of GNI.

Increasing ODA to the international target of 0.7% of GNI would represent a tripling of the 2002 level of 0.23% of GNI, i.e., and additional approximately $110 billion. However, the target of 0.7% was set rather arbitrarily several decades ago. While there is no doubt that a significant increase in aid (along

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[3] Note that the two new high profile U.S. ODA programs – the Millennium Challenge Account and the Emergency Plan for AIDS Relief – will not disburse any money until 2004, so they are not responsible for the increase in U.S. ODA in 2002. The largest part of the increase in U.S. ODA was disbursements to Afghanistan, Pakistan, Jordan and several other countries involved in the war on terror.

[4] The Monterrey Consensus referred to ODA in terms of donor Gross National Product (GNP), while aid statistics normally are reported as a share of donor Gross National Income (GNI). The two terms can be used interchangeably.

with several other things) will be necessary for low-income countries to achieve the MDGs, it is not clear that 0.7% will be necessary.

Two independent estimates have been made of the amount of ODA needed to achieve the MDGs. The first was by the UN-commissioned High-Level Panel on Financing for Development (UN, 2001). This panel, chaired by former President of Mexico Ernesto Zedillo, estimated that an additional $50 billion in additional ODA per year would be required to achieve the MDGs. The second, by World Bank economists Shantayanan Devarajan, Margaret Miller, and Eric Swanson (2002) estimate the resources required both from the perspective of accelerating economic growth to achieve the overall poverty goal, and from amounts needed to achieve individual goals. They find that countries would need an additional $40-$70 billion to support the policy and institutional changes necessary to achieve the goals. Both of these studies emphasize that ODA alone will not allow countries to achieve the goals, and that the estimates above are contingent on developing countries making important policy and institutional changes. Taking the $55 billion midpoint of the second estimate, which is close to the first estimate, total ODA would have to double to about 0.46% of donor GNI, well below the target of 0.7%. A third estimate is now under construction by the Millennium Task Force secretariat. This estimate is not yet finalized, but preliminary results suggest that a figure somewhere between $55 billion and the $110 billion consistent with 0.7% will be needed. Thus, while 0.7% may not be necessary, significant increases over current amounts of ODA will be required for low-income countries to come close to achieving the MDGs.

A More Goal and Results Oriented Approach

In recent years, many low-income countries have produced Poverty Reduction Strategies (PRSs) as the blueprint for their development plans, priorities, and policies, and as the basis for donor support. One of the first PRSs was Uganda's Poverty Eradication Action Plan (PEAP), which was developed beginning in 1995. The IMF and World Bank introduced Poverty Reduction Strategy Papers (PRSPs) in 1999, initially as a requirement for low-income countries to receive debt relief though the HIPC initiative and as a requirement for concessional funding from the IMF and the World Bank. More than twenty-five countries have now completed full PRSPs, and dozens of others have drafted interim PRSPs. The PRSPs are designed to increase the input to and ownership of development strategies by low-income countries and to provide a link between these strategies and donor support.

PRSPs are far from a perfect instrument, and country experience has varied significantly.[5] Some are of reasonably high quality, while others are of poor quality. Some PRSPs truly reflect the input of stakeholders in an attempt to make the difficult tradeoffs necessary to forge a development strategy, while others are written by consultants with a view towards writing what the donors want to hear rather than what the country really believes it needs. Despite this uneven experience, the quality appears to be improving over time, and there is little doubt that the PRSP process is a step in the right direction of seeking greater recipient input in setting priorities and implementing key policies.

MDGs in Poverty Reduction Strategies

[5] For a joint IMF/World Bank progress report on the PRSP process, see http://www.worldbank.org/poverty/strategies/progrep.htm. For additional commentary on the PRSP process see the ELDIS website at http://www.eldis.org/poverty/prsp.htm.

Among other things, PRSPs are supposed to state clear goals and focus on results. World Bank and IMF staff are asked to assess whether the indicators contained in PRSPs define adequate goals for poverty reduction, establish appropriate indicators for progress, and set annual and medium term targets. There are no specific links between the PRSPs and the MDGs, since the MDGs were adopted in 2000 after the PRSP process had already been adopted. Harrison, Klugman, and Swanson (2003) found that for many PRSPs (although not all), the stated goals were reasonably consistent with the MDGs. Their study examined targets in 27 PRSPs for malnutrition, primary enrollment, child mortality, maternal mortality, and access to water. Where quantified targets were set, the PRSPs were at least as ambitious as the MDGs with respect to malnutrition, enrollment, and water. However, the PRSPs generally were less ambitious than the MDGs for child and maternal mortality. In addition, in over one-third of the cases there was not sufficient data for comparison, suggesting the PRSPs did not set specific enough targets in these areas, implying somewhat less ambition than the MDGs. Thus the quality of PRSPs is inconsistent in this area: some have goals and targets consistent with or even more ambitious than the MDGs, while others do not.

One possibility would be for the international community to require that countries base their PRSP targets fully on the MDGs. However, there is an obvious tension between this option and the idea of full country ownership of the PRSPs. The MDGs were adopted by a senior level international conference through the UN, not at the local level in specific developing countries. Some countries may set higher or lower goals in some areas, or may give higher priority to achieving (or going beyond) certain goals but not others. On the one hand, strictly imposing the MDGs and their specific quantitative targets to some extent violates the idea of countries fully "owning" their own programs. On the other hand, almost all low income countries adopted the Millennium Declaration in 2000, and the MDGs provide a useful consistent framework to measure global progress.

Reconciling these two ideas, however, is not a major problem, and can be done by making the MDGs a specific point of reference for country targets, while not necessarily making them the targets themselves. *All PRSPs should include specific references to the MDGs when establishing national goals, directly compare national goals to the MDGs, and briefly explain any significant differences*. To move in this direction, IMF and World Bank management should make this change in the guidance they give their staff for evaluating PRSPs. Thus, for example, whatever target a country sets for primary school enrollment, the PRSP should compare this target with the MDG target of ensuring universal primary school enrollment by 2015, and explain any significant differences.

Realistic versus Ambitious Targets

A second, and perhaps more important tension, is between "ambition" and "realism" in setting PRSP targets. Some observers are concerned that the targets set in the PRSPs are unrealistically high, raising expectations that cannot be fulfilled and setting government up to be considered failures. Christiansen, Scott, and Wodon (2002), writing in the World Bank's Sourcebook on Poverty Reduction Strategies, argue that "(m)ost often [PRSP targets] are overambitious; they are technically and fiscally unattainable, which defeats their role as effective incentives to action." Their concern is that unrealistically high targets only serve to set up a government for failure and loss of credibility. According to this view, overly ambitious targets undermine incentives and can actually slow progress, since when they are seen as too difficult it is easier to give up on them than to make more effort, only to fail in the end. Moreover, overly ambitious targets with inadequate financial support could tempt governments to resort

to inflationary financing to meet the targets, which could upset macroeconomic balances and ultimately retard growth and poverty reduction.

By contrast, others believe that the targets in the PRSPs are too low, and that the MDGs cannot be achieved without more ambitious, higher targets. In this view, loftier targets – especially when coupled with clear plans of how to get there -- will lead to greater resource mobilization, stronger efforts, and ultimately better results. When donors encourage poor countries to aim lower – as does the World Bank's PRSP Sourcebook – it ensures weaker outcomes. That is, setting mediocre targets only leads to mediocrity. Proponents of this view argue that governments should aim high, establish a plan for getting there, and then marshal the resources necessary to achieve their goals.

There are three different reasons why some PRSP goals might be considered overly ambitious:

- ***Technically unattainable***. Some targets may simply not be possible, even with an ideal policy environment and far larger financial resources. For example, cutting the infant mortality rate from 150 per thousand to 50 per thousand in, say, one year, simply would not possible. Similarly, reducing poverty at a rate consistent with sustained economic growth of, say, 15% per year is not feasible. Goals that are truly technically infeasible obviously should be changed.

- ***Fiscally "unattainable."*** Some targets are unattainable because of insufficient funding. Christiansen, et al (2002) conclude that "[PRSP] targets are often … fiscally unattainable. For example, in many countries, the cost of reaching the targets set forward in the Poverty Reduction Strategies largely exceeds the amount of debt relief granted under the HIPC agreement." They go on to argue that these fiscally unattainable goals should be moderated to make them more attainable. In fact, these goals are not actually "unattainable" in the strict sense – they are only unattainable under current budget constraints. With increased funding, they could be attainable.

- ***"Unattainable" because of other constraints***. Some goals may be unattainable because of policy or constraints. For example, reducing the child mortality rate may be constrained because of prohibitions on drug imports that are protecting domestic producers. Increasing cotton production may be limited by European and American cotton subsidies. Other goals may be unattainable because key institutions may not have the capacity to implement necessary changes, even with the appropriate policies and adequate funding. Still others may be constrained by cultural norms. For example, increasing the enrollment rate for girls may be constrained by traditions and practices that keep girls at home. Some of these goals could be attained with policy changes or focused institutional strengthening; others may only be attainable over a longer period of time as institutions are strengthened and cultural norms evolve.

To the extent that goals are "unattainable" because of financial, policy, or institutional constraints, poverty strategies should spell out the financial resources, policy reforms, or institutional changes needed to achieve the goals. When goals truly are unattainable, PRSs should explicitly say why. Even for tougher issues, such as cultural norms, clearly stating the constraints and the steps needed to remove them over time would be a major step forward.

To be sure, PRSs must contain "realistic" annual goals and targets that take account of existing budget realities, the political economy of policy reform, institutional constraints, and likely foreign assistance inflows. Throwing realism out the window would not be responsible, and would make short term

economic planning very difficult. At the same time, it is equally important to provide a parallel framework that lays out the changes needed for a country to achieve far more ambitious goals, even if they do not seem realistic in the short run. Towards this end, PRSs (whether PRSPs or otherwise) should provide at least two (and perhaps more) scenarios.

- ***A baseline scenario*** that would lay out development goals, a macroeconomic framework and sectoral priorities consistent with current levels of domestic and international financing, "realistic" policy changes; and current institutional constraints. It should describe the expected progress under this scenario towards achieving key longer-term goals and the MDGs consistent. It should also clarify key tradeoffs that might have to be made in a constrained environment between further progress in one goal versus another.

- ***A high achievement scenario*** with more ambitious targets, consistent with achieving the MDGs or similar national goals, detailing the level of financing and additional policy and institutional changes needed to achieve these goals. Generally, these scenarios would require more than simply changing the spending line and the goal. Higher funding may require other accompanying changes in order to meet the goal. For example, providing more AIDS patients with anti-retroviral drugs would require increased funding, but also additional training of health workers and a procurement and delivery system. In most countries, the high achievement scenario would be relatively close to the baseline scenario in the early years, since it may be difficult to relieve financial, policy, and institutional constraints in the short run. Moreover, in general there is likely to be more than one combination of policies and financing that could lead to broadly similar progress towards these more ambitious goals, and where relevant these alternative scenarios should be spelled out. The high achievement scenario would need to face head-on the challenge of strengthening key institutions, such as the budget authority, the Ministry of Health, the Ministry of Education, and regional and local governments, and spell out the key changes over time needed to make these institutions more effective.

At a minimum, laying out an ambitious scenario would clearly identify to all parties the major constraints inhibiting an accelerated pace of development, which could act as a first step towards relieving those constraints and making more progress possible. A more ambitious vision could encourage greater domestic debate about policy and institutional weaknesses that slow development progress, and encourage greater discussions with the international community about what might be possible. Domestic actors could begin to see the expected benefits that might follow from additional policy changes, and the international community could see the level of development progress expected for different levels of funding. There are obvious risks to both domestic political leadership and to international organizations in publicizing a more ambitious scenario, but also potential rewards in being able to more quickly achieve critical development goals.

For the donor community, this approach would require some changes. Consultative group meetings should determine not only the amount of funding that donors are willing to commit, but the likely implications of that funding (and alternative levels of funding) for progress towards the goals under a given set of policies. Moreover, this approach implies re-aligning donor priorities with those spelled out in the PRS. Too often donors push their own priorities to satisfy interest groups in their own country rather than responding to the recipient country's highest priorities. To achieve the ambitious targets set out in PRSs, donors must be willing to fund well-designed activities, projects, and programs consistent with those goals, and not push funding in lower-priority areas.

Improved Data and Monitoring and Evaluation

Implementing these changes also means vastly improving data collection and monitoring and evaluation of development activities. The quality of the data needed to monitor the MDGs is nothing short of pathetic in some countries. Key data are missing, and where they are available they are often inaccurate. Most shocking is the poor quality of data in government budgets, which is the most central of policy documents. Another is on tariffs: there is no international data base with comparable data on even average tariff rates, much less tariff dispersion or commodity specific tariffs. The quality of data on health and education indicators is weaker still.

The poor quality of data is important: policymakers cannot adequately figure out how to get where they want to go if they do not know where they are. Leaders cannot figure out which interventions have worked and which have not, and thus cannot appropriately decide how to allocate new financial and personnel resources going forward. The good news is that with concerted efforts, data quality can improve. For example, the quality of macroeconomic data, especially monetary and debt data, and to some extent trade data, has improved markedly over the past two decades, mostly because the IMF demanded it and countries had to produce it. With partnerships between recipient and donor countries, including sufficient financing, the quality of other data can improve as well. This should be a major focus for multilateral development banks going forward.

More serious targets combined with better statistics provide the foundation for improved monitoring and evaluation and results-based management of aid programs. Some donors are beginning to seriously implement a results-based approach, led by the Global Alliance for Vaccines and Immunizations (GAVI) and the Global Fund to Fight AIDS, Tuberculosis, and Malaria (GFATM). Stronger monitoring and evaluation begins with setting clear, monitorable targets and establishing solid baseline data, as described earlier. It requires involving monitoring staff from the beginning of a project, not bringing them in half way through.

Monitoring is required for financial accountability, progress on building institutional capacity, and progress on achieving substantive goals. A key objective is to maintain a focus on results by providing continued funding to activities that show results, and reducing funding to those that do not. Donors have to be much more willing to cut off funding for activities that are not working and to allocate those funds to more promising areas. But the main intent is not punitive. Rather, the idea is to keep programs on track by detecting problems at an early stage and enabling policymakers to make adjustments and corrections as soon as possible. Strong monitoring and evaluation also allows the lessons learned from one activity to be incorporated into other activities. Improving monitoring and evaluation systems faces many obstacles, including poor data, the difficulty of measuring certain activities (such as the quality of technical assistance), establishing the appropriate counterfactual, and establishing the appropriate incentives for independent monitors. Some progress has been made in recent years in this direction. For example, the "Partnership in Statistics for Development in the 21st Century" (PARIS 21) is designed to promote evidence-based policymaking and monitoring in developing countries. The group promotes the importance of basic statistics and the connection of data to sound policies.[6] In addition to GAVI and GFATM, the World Bank and some other donors have begun to move towards more evidence-based programs. More serious efforts by most donors in these areas will be necessary to improve the effectiveness of foreign aid in helping to achieve the MDGs.

[6] For more information on PARIS 21, see www.paris21.org/index.htm.

Improving the Allocation of ODA

The international community has reached a broad consensus that ODA is most effective in reducing poverty and supporting economic growth when it is aimed at countries with the deepest poverty and with policies and institutions that support economic development. Experience suggests that aid given for political purposes to countries with poor governance -- such as for Cold War allies – has had little development effect, whereas aid provided to countries with better governance and a commitment to strong development policies -- such as Korea, Botswana, or Thailand – has had a stronger impact.

Empirical research supporting the idea of "country selectivity," in which aid is allocated to countries with greater needs and better governance, began in earnest in the mid-1990s, focussing first on rates of return to investment projects and later on the relationship between aid and growth. For example, Isham, Kaufmann, and Pritchett (1995) found a strong link between a country's civil liberties and the rates of return on aid-financed investments. Burnside and Dollar (2000) and Collier and Dollar (2002) took the next step, finding that foreign aid is positively associated with growth in countries with better policies and institutions, and not associated with growth in countries with poor policies and institutions.[7] The Burnside, Dollar, and Collier studies have come under attack from two directions in recent years. From one direction, several studies challenge the finding that the positive aid/growth relationship depends on good policies, finding instead that aid is positively correlated with growth (with diminishing returns) regardless of the policy environment.[8] From another direction, Easterly, Levine, and Roodman (2003) found that the initial Burnside and Dollar results were not robust to new data points, different time frames, varying definitions of aid, and alternative definitions of policy. They found no clear relationship between aid and growth.

While the empirical debate continues, the idea that aid works better in countries with stronger policies and governance has influenced the policies of the World Bank, the regional development banks, and several bilateral donor agencies. This idea makes intuitive sense to many development practitioners, and has become the consensus view in the development community. Based partly on these ideas, the World Bank has developed a Performance Based Allocation (PBA) system as the basis for distributing its IDA funding, which in large part relies on the Bank's ratings of each country's policies, institutions, and governance (IDA, 2003). The African and Asian Development Banks use similar systems. Perhaps the clearest manifestation of the country selectivity approach is the United States' new Millennium Challenge Account, in which ODA will be provided to a very small group of low-income countries with a record of strong governance, social investments, and economic policy (Radelet, 2003).

The Governance-Income Relationship

In considering the country selectivity approach, it is important to recognize that the empirical evidence (such as it is) does not simply say that aid works best in countries with better policies and governance, period. A more appropriate interpretation is that aid works best in countries with stronger governance *after controlling for the level of income.* That is, for two countries at the same level of income, aid is likely to have a larger impact on growth in the country with better policies and governance. The difference is important. Since richer countries tend to have stronger governance ratings than poorer

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[7] Burnside and Dollar concentrated on policies (trade policy, budget deficits and inflation), whereas Dollar and Collier included broader policy and institutional, and governance measures.

[8] For example, Delgaard, Hansen, and Tarp (2002); Hansen and Tarp (2000); and Lensink and White (1999a, 1999b).

countries, looking only at raw governance scores suggests to some people that aid only works in the countries that are richer and better governed – precisely the countries that don't need aid. If donor agencies simply allocated aid to countries with better governance, they would systematically eliminate some of the poorest countries of the world that have low absolute governance scores, but may have reasonably strong governance for their level of income. This implies that when looking at a country's raw governance score, a modification is required to adjust for the level of income. The Appendix shows a simple way to make this adjustment, and shows an income-adjusted governance ranking of low-income countries.

Aid Allocation: Are Donors Becoming More Selective?

The debates about country selectivity in recent years have led to donor pledges to improve aid allocation. However, ODA continues to flow in large amounts to middle income countries with less poverty and to countries with poor governance. As a result, much of current ODA is wasted -- aid quickly becomes ineffective in countries with poor policies and weak governance, while countries with better governance get less aid than they can effectively use.

Figure 1 shows the simple average of ODA receipts per capita (in constant 2002 dollars) across six country groups in 1996 and 2002: low income countries with poor, mediocre, and strong governance, and higher income countries divided into the same three governance groups. The low income group includes all countries (with populations over 1 million) with per capita incomes below the 1996 IDA historical cutoff of $1,505, and the high income group is made up of all countries (with populations over 1 million) with income above that level that received ODA. The poor, mediocre and strong governance groups are the countries in bottom, middle and top third of modified governance scores (after controlling for income, as described in the Appendix). The 2002 groupings are created in a similar way, using the 2002 IDA historical cutoff of $1,415.

The figure shows that in 1996, low-income countries with strong governance received only slightly more ODA per capita than those with weaker governance. The higher income group received less aid per capita, but not substantially less. Note that if the figures were calculated as ODA *per person below the poverty line*, the difference between the lower and higher income groups would be even smaller, since a lower percentage of people in the richer developing countries live below the poverty line.

By 2002, the story had not changed appreciably. Among the low income countries, the countries with stronger governance received only slightly more than countries with weaker governance. The difference between the lower and higher income groups was even smaller, suggesting even less allocation by need than in 1996. Furthermore, within the higher income group, there was essentially no difference in ODA receipts between the three governance sub-groups. The implication is that by this simple measure, there has been little, if any, improvement in the allocation of ODA towards poorer countries with better governance.

Allocation Rules to Constrain the Political Allocation of Aid

In an extension of the basic empirical framework developed by Burnside and Dollar, Collier and Dollar (2001, 2002) show how a reallocation of ODA to countries with the most severe poverty and better policies and institutions could approximately *double* aid effectiveness. They derive a "poverty-efficient" allocation of aid aimed at maximizing the extent of poverty reduction that could be realized with a given amount of aid by first deriving a relationship between policy/governance scores and

economic growth, and then the relationship between economic growth and poverty reduction. They find that an optimal allocation of aid flows would almost double the number of people lifted out of poverty, an outcome that they estimate would require a *tripling* of aid budgets under current allocations.

The Collier-Dollar model provides a mathematical formula for allocating aid amongst countries to make aid as "poverty efficient" efficient as possible. The World Bank's PBA system provides similar formal rules for aid allocation, although the two differ in some ways (and thus arrive at somewhat different allocation rules). One could imagine a range of formal models that would achieve similar ends, each with slightly different allocation rules, depending on which policies and governance measures were included, which were given the most weight, and the precise income categories and poverty measures chosen. Long hours have been spent in donor meetings arguing the finer points of these PBA systems, with different analysts arguing for slightly different formulations. For example, countless meetings took place in Washington, DC, during 2001 and 2002 to debate the qualification standards for the new Millennium Challenge Account.

These debates are important, as surely it is important to get these systems right and not omit worthy countries. But at the same time, there is a danger that these debates risk missing the forest for the trees. The empirical basis for these models, and for the efficacy of any particular policy or institutional measure, is not strong enough for any one approach to be declared the absolute superior approach. At the same time, almost any one of them is far superior to the current allocation of aid. As Collier (2002) has pointed out, the idea is not to set aid allocations by a rigid, mechanistic formula that must be precisely adhered to like a straightjacket. Rather, the idea is to establish a system that provides some analytic guidance for donor agencies interested in allocating their aid more effectively, and to provide them with some defenses against the overt manipulation of aid for political or commercial purposes. There is no doubt that some ODA will continue to be allocated for these non-development purposes, many of which are legitimate national security goals of donor countries. But if donor agencies start with a transparent, objective formula aimed at maximizing the poverty effectiveness of aid, it will be harder for other parts of the bureaucracy to change aid allocations, since the costs of a re-allocation will become more transparent.

Aid, Economic Shocks, and Post Conflict Situations

Going beyond the basic rules of aid allocation, aid can be highly effective in cushioning against economic shocks within the group of well-governed countries. Collier and Dehn (2001) found that when aid increased during a negative export shock, the aid in effect arrested the economic downturn emanating from the shock. Each extra $1 in aid reduced the contraction in output by $2, making the return on aid especially high during these periods. Unfortunately, donors are not very good at taking advantage of this situation, as Collier and Dehn find no evidence to suggest that aid flows systematically increase following severe shocks. Only two donor mechanisms have bee established specifically to provide flows following shocks -- The EU's STABEX program and the IMF's Contingent Compensatory Finance Facility -- and both failed to be effective.[9] Standard bilateral and multilateral aid flows are too slow and cumbersome to react quickly enough to export shocks to take advantage of these high returns, especially since most ODA comes as project aid. More flexible donor mechanisms, as discussed later in the paper, could help aid cushion against these adverse shocks and thereby increase overall aid effectiveness.

[9] STABEX was so slow that disbursements usually occurred after the recipient economy was well into recovery. The program is now closed. The CCFF – now the CFF (after dropping "Contingent") is very rarely used.

Aid also has the potential to be highly effective in post-conflict situations. Collier and Hoeffler (2002) find that, under a poverty-efficient allocation of aid, about twice as much aid should be allocated to post-conflict countries as to similar non-conflict countries, since post-conflict countries are starting from a lower economic base, have the potential for rapid catch-up growth, and have a higher absorptive capacity for aid. Mozambique, for example, has received large amounts of aid in the decade since its civil war has ended, which (along with policy reforms and institutional changes) has led to very a high rate of economic growth. The World Bank (2003) also argues for significant aid to post-conflict countries, not just because the economic rates of return are potentially higher, but as a way of reducing the risk of a country slipping back into conflict.

Improving Aid Delivery

Improving the allocation of aid is only one step toward making aid more effective. Donors must also significantly improve the way that they deliver aid.

Aid Delivery Strategies in Different Countries

Donors have a variety of different objectives for foreign aid in different kinds of countries. In many countries, the primary goal is economic development, including accelerating economic growth, reducing poverty, and improving the delivery of social services. In many cases, there is a twin goal of supporting political development, most often in the form of consolidating democracy. In other countries, however, longer-term economic and political development take a back set to the more immediate goal of preventing conflict or preventing a re-emergence of conflict. In still others, a major goal is to provide humanitarian assistance following either a natural disaster or in the context of political instability. In addition, many bilateral donors provide aid to support their own foreign policies goals. For example, significant portions of U.S. foreign aid currently go to support allies in the war on terrorism, and historically much aid has gone to try to support the Middle East peace process. Similarly, the French government has supplied significant amounts of aid in order to maintain influence in its former colonies in Africa. All of these are legitimate goals for foreign aid. In many cases, of course, donors are trying to achieve more than one of these goals at once.

At the same time, circumstances on the ground vary widely in recipient countries. Some have much greater need than others, in terms of the extent of poverty and in terms of economic vulnerability. Some have relatively good governance, while in other governance is quite poor; similarly, some suffer intense and ongoing political instability, whereas others are much more stable. Some governments have a strong commitment to good development policies, whereas others give only lip service to poverty reduction and development. Institutional capacity also varies widely, with different governments being more or less able to implement their development strategies. The quality and abilities of agencies outside the government – NGOs, the private sector, charitable organizations -- to help implement development programs also varies widely.

Yet despite these differences in donor objectives and circumstances on the ground, donors tend to deliver aid similarly in most recipient countries. Yet this makes little sense. Aid should be delivered to countries with better governance very differently than to countries with poor governance. To date, the move towards greater "country selectivity" has been conceived primarily as allocating more ODA to countries with better policies and stronger institutions. However, the idea that aid is likely to be more

effective in well-governed countries should influence more than just the amount of aid that donors provide -- it should change the way that donors administer aid, in several important ways:

- *First, in well-governed countries, recipients should have a much greater say in setting priorities and in designing aid-financed programs than in poorly governed countries*. In recent years there has been much discussion of, and in some cases actual movement towards, providing recipients with much greater "ownership" of aid financed programs. This approach began with the PRSP approach, and has been taken very seriously by some new donor organizations such as the Global Alliance for Vaccines and Immunizations (GAVI) and the Global Fund to fight AIDS, Tuberculosis, and Malaria (GFATM). The extent to which "country ownership" has actually taken hold is a subject of debate. There is a clear tension between, on the one hand, the need for recipients to be involved in and committed to programs to ensure their success, and on the other hand, the need for donors ensure programmatic responsibility.

  Providing recipients with more flexibility, greater latitude, and more ownership is precisely the right way for donors to move in well-governed countries, but not necessarily in poorly governed ones. Donors should move to a much more differentiated strategy with respect to country ownership. Countries with stronger governance should be given the responsibility for setting the broad priorities and designing programs financed by ODA. This should start with the design of poverty reduction strategies, and should be carried through to specific donor activities that grow out of the PRS process. Donors should be prepared to finance activities designed by recipients and reflecting recipient priorities, subject to strong technical review. By contrast, in weak, failing, and poorly governed countries where governments have shown little commitment to good development policy, donors should retain a strong role in setting priorities and designing programs. In many poorly governed countries, donors still talk about increased country ownership, even when they have no intention of actually allowing it. The mismatch between words and deeds is unhelpful for donor and recipients alike. In other words, the rhetoric of "country ownership" should be matched with more reality in well-governed countries, while it should be significantly diminished or even dropped in poorly governed ones.

- *Second, donors should provide a greater share their financing as programmatic or budget support in well-governed countries, while primarily (or even exclusively) using project financing in poorly governed countries*. ODA in the form of budget support or as programs (including Sector Wide Approaches, or SWAps) gives the recipient greater flexibility to use funds for their highest priority, adapt to changing needs, and to finance recurrent as well as capital costs as necessary. Budget support allows ODA to be more consistent with the government's development strategy (since the budget should provide the blueprint for allocating public sector resources) and more easily integrates ODA with government financial resources aimed at development activities. ODA in this form tends to strengthen government financial institutions, whereas project support can weaken them by pulling resources away from budget systems to individual satellite projects. Well-governed countries should be given the discretion and flexibility that comes with receiving programmatic financing and budget support, so long as they have adequate financial systems in place (including regularly published budgets, appropriate accounting and auditing standards, and regular public monitoring) and are able to continue to show results.

  In poorly governed countries, programmatic funding and budget support makes much less sense. Donors should not provide broad program support in countries with high levels of corruption, opaque budget procedures, and poor monitoring and auditing. To provide budget support under these circumstances, where there is little confidence that funds will be used appropriately would be

irresponsible. The most likely outcomes will be no discernable progress on development goals (and possibly some retrogression) and a loss of support for aid by taxpayers in donor countries. In poorly governed countries, donors should continue to direct their funds at well-defined projects that can be carefully monitored and that provide recipient governments with much less discretion.

- *Third, consistent with programmatic and budget support, donors should support a broader range of activities in well-governed countries, while in poorly-governed countries they should look for narrower targets of opportunity.* In effect, donors can finance the PRS as a whole in well-governed countries, including a wide array of activities in different sectors. Of course, this does not mean that anything and everything should be funded, as there is still a need to set priorities and allocate resources to the highest priorities. Nor does it mean that every donor should fund all aspects of a development strategy – individual donors should focus on the areas they do best in order to avoid duplication and overlap. But it does mean that the donors as a group, working closely with the recipient government, should be thinking in terms of supporting a full-fledged development strategy, rather than individual projects. By contrast, in poorly governed countries, donors should have a narrower focus. In the weakest states, international support should focus on basic consumption or social services for the poor, while in slightly stronger countries support could broaden to particular sectors where the government has shown some commitment and potential for progress.

- *Fourth, most (but not all) donor assistance should be channeled through the government in well-governed countries, while a larger share should go through NGOs in poorly governed countries.* Aid to the central government can be more easily aligned with the government's development strategy, and can be better integrated into the budget. However, not all ODA should go though the central government, since it is likely to have limited capacity to implement all worthwhile projects. Providing all aid funds to the central government could create a larger than necessary public sector, and forgo the possibility of providing aid effectively through other agencies. In some circumstances, provincial and local governments can provide services effectively through donor-financed programs. In principle, local and provincial governments are better placed to articulate local priorities and to take advantage of local strengths to implement programs focused on the MDGs. However, many local and provincial governments are weak, even in well-governed countries. Thus, these approaches should include provisions for capacity building, and probably should be limited in scale in many countries.

  In order to achieve the MDGs as quickly as possible, some ODA should be channeled through NGOs, which can often help deliver services cheaply and effectively. There are many examples of effective ODA-financed NGO activities that are helping to achieve the MDGs (such as Love Life in South Africa, The AIDS Support Organization in Uganda, the Grameen Bank in Bangladesh, and many others). Utilizing NGOs can help alleviate absorptive capacity issues by expanding the number of agencies that provide services. In poorly governed countries, a much larger share of ODA should go through the NGOs, since the government's capacity is weaker and, in many cases, cannot be trusted to be an effective development partner. In countries with the weakest governance, no aid should go through the government at all.

  However, NGOs are not a panacea, and donors should consider several issues in working with NGOs. First, NGO activities should be consistent with the government's PRS and the budget, assuming that the PRS was developed with broad participation including NGOs. Second, not all NGOs make effective development partners, and not all represent the broader constituencies that

they claim to represent. Third, providing funds to NGOs could potentially undermine government capacity by drawing scarce talent away from the government to work in NGOs. (However, as long as the bulk of funds are provided to the government in well-governed countries, this problem will be minimized). Fourth, providing some funds to NGOs can provide some healthy competition for the government. Fifth, working with NGOs can exacerbate the sometimes acrimonious relationship between the government and NGOs, which at times is fueled by donor funds. There is a tension between, on the one hand, NGOs expanding available services, providing competition for government and pushing them to provide important services more effectively, and on the other hand, the risk that some NGOs undermine governments and work in areas that are not national priorities.

The key point is that to achieve the MDGs, donors should work with effective partners at all levels of government and with those outside the government, and that the appropriate mix of effective partners is likely to be very different across recipient countries.

- *Fifth, donors should provide longer-term financial commitments in well-governed countries than in poorly governed countries*. All donor support -- in well-governed or poorly governed countries, whether program or project support -- should be provided on a timeline consistent with recipient budget cycles. Too many donor funds are provided outside of normal budget cycles, making planning unnecessarily difficult for recipients. In addition, donors need to make longer-term commitments, at least for well-governed countries. ODA funds are typically committed at most three years in advance, too short for planning purposes for many long-term investment projects. Achieving the MDGs will be a long-term process for many low-income countries, requiring a long-term commitment to sound policies and institutional change, along with long-term financing. Many of the policy and institutional changes needed to achieve the MDGs will take many years, and recipients need the assurance of a long-term commitment in order to undertake these changes with greater confidence.

  Of course, long-term donor commitments should be contingent on recipients continuing to achieve their short and medium run targets and otherwise continuing with good governance. But donors must better recognize the time required to achieve long-term development goals, including the MDGs. Consider the following: a country with income of $300 per capita that records economic growth per capita of 5% per year (a rapid rate equivalent to overall GDP growth of about 7% per year) will take 32 years to reach per capita income of $1,415, the current cut-off for IDA eligibility. Donors must give recipients – especially those committed to strong development policies -- more assurance that they are in for the long haul. This does not mean that donor funding should be expected to remain at very high levels for extended periods of time. The amount of donor funding should be expected to gradually decline over time as incomes grow and the country achieves its medium term development goals. For the most successful developing countries during the last 30 years, aid flows have declined gradually over time. For example, for the 22 countries that have permanently graduated from IDA – a group of fairly successful developing countries -- the half life of aid was about 12 years, meaning that the real dollar value of aid declined by 50% over 12 years and by 75% over 24 years (Clemens and Radelet, 2003). Long-term donor commitments should aim to follow a similar pattern.

In making these five points, I have made a clears distinction better well-governed and poorly governed countries. Of course, some countries fall between these sharp divisions of poor and well governed, and others are in transition between these two poles. For countries in this middle group, mixed strategies are

called for in terms of the degree of donor involvement in setting priorities and programs, the form of funding (program versus project), the range of activities funded, the implementation partners on the ground, and the length of financing commitment.

Three Basic Strategies for Three Country Groups

These considerations suggest that donors should have three well-defined and distinctive strategies that they use to deliver aid in different kinds of low-income countries, depending primarily on the quality of their governance. Somewhat different approaches will be necessary for middle-income countries, as discussed below.

Low-Income, Well-Governed Countries

Donors should be most generous and most flexible in these countries. These countries have substantial needs along with a track record of strong governance (relative to countries of similar income levels). Donors should provide the largest amounts of financing to this group of countries, and it should be delivered predominately as budget support or program aid. The recipients should be given much of the responsibility to set priorities and design aid-financed activities consistent with their own development strategies, which presumably will reflect the MDGs. The central government should be the largest recipient of ODA and should take the lead in coordinating the donors, but (depending on the country) local and provincial governments and NGOs should also receive significant funding. Delivering aid through programs rather than projects will also allow donors to respond more quickly when these countries are hit by negative economic shocks. Programs should be monitored and evaluated carefully, with donors encouraging some experimentation with new ideas and approaches. Programs that show results should be funded generously, while those that do not should receive less funding or be shut down. Donors should focus less on micromanaging activities and more on measuring and achieving results. Donors should be willing to clearly commit specific funding for five-to-ten years in these countries, subject to the strict requirements that recipient show continued good governance and achieve reasonable results. Continued good performance should merit longer term funding, with the amount of funding gradually declining in the long term as these economies grow and gain access to private capital markets.

Low-Income Countries with Average Governance

These countries also require significant funding, but they should receive less than in the well-governed countries, and it should be delivered differently. Although recipients should play an active role in setting priorities and designing projects, donors should be actively involved in ensuring broad-based participation and technical rigor. Budget and program support should be limited, if used at all, and should be monitored very carefully. Most funding should come in the form of well-designed projects consistent with the country's overall development strategy, focusing on key activities where achieving results seems most likely. Donors should focus primarily in areas where the government has shown the strongest commitment and there is potential for progress. The length of financial commitments should be shorter than for well-governed countries, perhaps around three to five years, contingent on progress and results. A larger share of funding should go through NGOs. Project performance should be monitored carefully in these countries, with clearly delineated performance standards. Strong performance should be met with increased financial support with longer commitments, while weak results should lead to less aid. Donors must be prepared to reduce funding when countries do not meet agreed performance standards.

Low-Income, Poorly Governed Countries

This group of countries roughly corresponds to the countries the World Bank refers to Low Income Countries Under Stress (LICUS) and the OECD calls "Difficult Partnerships." Some of these countries are failed states, others are failing, while still other could be considered weak or fragile. These countries must be dealt with on a careful, case-by-case basis, as the circumstances on the ground can vary widely. Some countries are in a downward cycle, where the political and economic situation appears destined to get worse before it gets better. Others are struggling to end conflict; still others are emerging from conflict and are beginning to show progress. Some countries are not faced with conflict, but are mired with poor governance, high levels of corruption, and governments with little interest in political or economic development. In these countries, bilateral aid will be heavily influenced by strategic and security considerations. For example, the United States has expressed strong concern about "failed states" as part of the war on terrorism and has allocated substantial sums to weak states that are its allies in the war.

Foreign aid to poorly governed countries should be tightly focused on humanitarian relief and providing basic services to the poor. Donors should focus on a very limited set of very high priority activities with the potential for quick results that can be demonstrated to policymakers and the general public to help consolidate the process of further reform (World Bank, 2001). Donors should play a much stronger role in setting priorities and designing activities here than in countries with strong governance, where country ownership can be put into practice. Program aid and budget support, by and large, is out of the question, and in some countries, no aid should be provided at all. Since governments are very weak, significant amounts of aid should be directed at civil society groups and NGOs. The World Bank (2001) and Collier (2002) have suggested establishing Independent Service Providers (which Collier likens to an expenditure-side version of an Independent Revenue Board) to oversee the delivery of basic services. Working in these countries is much riskier than other places. As a result, programs in poorly governed states require very careful monitoring, regular re-appraisal, flexible responses as initiatives begin to work or fail, and a higher tolerance for failure than when working in other countries.

Within this set of countries, aid has the most potential to be effective in post-conflict situations, as discussed previously. As discussed previously, Collier and Hoeffler (2002) find that, under a poverty-efficient allocation of aid, about twice as much aid should be allocated to post-conflict countries as to similar non-conflict countries. However, the World Bank (2003) warns against the typical donor pattern of providing significant aid in the first year or two after the conflict ends when the country is very visible on the international agenda, followed by a sharp decline in aid. It argues instead for a slower ramping up of aid as peace is solidified, augmented by other international measures of support, especially peacekeeping forces. Aid flows should build to a peak four to five years after the conflict and gradually diminishing thereafter.

One of the most difficult questions for donors working in poorly governed countries is when to continue providing some aid and when to stop. Since aid tends to be least effective in poorly governed countries, continuing with disbursements may have a high opportunity costs since the same aid could be used more productively elsewhere. Moreover, aid flows, if not directed carefully, can help sustain bad governments or further weaken the quality of governance (Knack, 2001). However, there may be significant costs from entirely disengaging, including a greater risk of further destabilization and violence, or a deterioration of health and education systems (OECD 2001). It is probably true, as the

OECD argues, that it is important for the international community -- not all donors, but perhaps some -- to maintain dialogue even with the most difficult governments.

Middle-Income Countries

Most foreign aid should be directed at low-income countries, since they have the greatest needs and the least access to alternative sources of financing. Middle income countries tend to have a larger domestic tax base and greater access to international capital markets, both of which should help these countries finance social expenditures, infrastructure and poverty reduction programs. However, many middle income countries still have large numbers of poor people, a fact which sometimes is obscured by very unequal distribution of income. For example, Birdsall (2002) estimates that in Brazil in the 1990s, the *median* household income was only about one-third as high as the *mean* level of income, with the former hovering very near the higher of the two international poverty lines of $2/day. (Of course, the $2/day poverty line is nearly double the average income of all of sub-Saharan Africa). In Honduras, the median household income was less than half of the mean, with the median well below the $2/day poverty line.

The primary responsible for fighting poverty in middle income countries lies with their own governments, which must forge policies that support broad based economic growth, job creation, and investments in health and education. Official finance from donor agencies can play a supporting role. Clearly, any official financing provided to middle income countries should be much less concessional than funds for low-income countries, so as to reserve the bulk of donor resources for low-income countries. For most purposes, non-concessional financing, such as from IBRD, is appropriate. However, middle income governments are reluctant to borrow on market terms to finance social expenditures. For example, it makes little sense for countries like South Africa, Botswana, and Brazil to borrow from international capital markets to finance HIV/AIDS programs. Some international financial agencies are providing HIV/AIDS funding on grant terms for middle income countries as well as low income countries, such as the Global Fund to Fight AIDS, Tuberculosis, and Malaria.

Whereas donors probably allocate too much ODA to middle income countries (from a Collier-Dollar type poverty-efficiency point of view), donors should still provide some funding to these countries. Bilateral donors should consider providing limited financing to middle income countries for programs clearly aimed at providing services and financing investments directed at the poor, where governments are unable to obtain financing from other sources. Multilateral donors that provide non-concessional finance should look for creative ways to ensure that governments are investing in the poor and breaking down barriers that exclude the poor from economic opportunities, even if their funds are not directly aimed at them. For example, IBRD-financed loans for infrastructure projects could be made contingent on the government implementing policies aimed at poor. It might be possible to consider using some donor funds, in effect, to slightly soften the terms of IBRD loans under these conditions. The basic point is for donors to ensure that any funds provided to middle income countries are used as leverage to ensure policies changes that favor the poor.[10]

Obviously, the quality of governance matters as much in middle income countries as it does in low-income countries. As with poorer countries, the quality of governance should determine both the amount of money and the way in which it is delivered to different middle income countries. Donors

[10] I thank Masood Ahmed for these suggestions.

should provide more money and provide it more flexibly to well-governed middle income countries, with less going to more poorly governed countries.

Concluding Observations

This paper has suggested several concrete ways in which donors could make aid more effective to achieve the MDGs. Donors should work with low-income countries to ensure that poverty reduction strategies have specific, well-defined goals both in the short-run and long-run. The international community should expect that PRSs specifically refer to the MDGs, even if governments choose to adopt goals that do not exactly coincide with the MDGs. PRSs should provide a "baseline scenario" with short, medium, and long run targets consistent with the most likely policy change and levels of financing. In addition, they should provide a "high achievement" scenario with much more ambitious targets and a more rapid pace of development, laying out the additional policy, institutional, and financing changes needed to reach these goals.

Donors must go beyond the rhetoric of "country selectivity" and actually begin to allocate aid more seriously to poorer countries with strong and moderate governance. They should establish basic rules for allocating aid based on poverty and the quality of governance, not to be dogmatic and rigid, but to provide some defenses against other forces that push to allocate aid based on political and commercial considerations. Donors should also introduce more flexible mechanisms that can provide aid to cushion against negative economic shocks.

Country selectivity, however, must go well beyond simply allocating more money to countries with stronger governance. Well-governed countries should have a much greater say in designing aid programs, should receive more of their aid as program funding, and should receive longer-term commitments from the donor community. Poorly governed countries should not only receive less money, they should receive more of it as project aid, it should come with a shorter time commitment, and much of it should be distributed through NGOs.

Appendix: Adjusting Governance Scores for Levels of Income

There are many possible governance or policy indicators that could be used to measure country performance. The original Burnside and Dollar analysis used a policy variable combining inflation, the budget deficit, and trade policy; a later version added an institutional quality score. The World Bank's Performance-Based Allocation system uses the Bank's Country Policy and Institutional Assessment (CPIA), which combines 20 different policies and institutional ratings. For simplicity, here I will use the country governance ratings produced by Dani Kaufmann and Aart Kraay of the World Bank Institute.[11] To create this database, the authors compile 275 governance indicators from 20 sources and 18 organizations. They construct six composite indices of various components of governance: control of corruption, rule of law, political stability, voice and accountability, quality and effectiveness of government institutions, and regulatory quality. The scores are scaled so that the world median is zero, a ranking one standard deviation above the median is given a score of 1, etc. The six indices can then be averaged to provide one aggregate governance score.

Generally speaking, the higher a country's level of income, the higher its expected governance score, since higher income countries have the financial resources necessary to build effective economic and political institutions. Figure 2 shows the simple relationship between per capita income and governance scores, with the very clear evidence that the lowest governance scores are among the poorest countries, and the highest scores are among the richer ones. If donor agencies simply used raw governance scores to allocate aid, they would systematically eliminate some of the poorest countries of the world that may have a low score relative to the rest of the world, but may have a strong score relative to other countries with similar income. Both the original Burnside-Dollar and Collier-Dollar studies found that aid worked best in countries with better governance*, after controlling for levels of income*.

To capture this effect, I first estimate a simple relationship between governance and income levels for all countries in the world for which data are available. As is evident from Figure 2, governance scores rise quickly as income increases at low levels of income, and rise more slowly as income levels rise. To capture the diminishing relationship between income and corruption, I estimate the following exponential relationship:[12]

$$G = \alpha - \beta * e^{(-GNP/\delta)}$$

Where G is a country's composite governance score, GNP is its per capita income (measured at purchasing power parity), e is the base of the natural logarithm, and α, β, and δ are the estimated parameters. α is the estimated maximum governance score (that is, the horizontal asymptote of the function), α-β is the y intercept (or the estimated governance score for the hypothetical country with zero income), and δ is the speed of convergence (or degree of curvature) of the function. Figure 2 shows the estimated curve. The regression results are shown in Table 2. The estimated maximum governance score is 2.21 (the actual highest score is Finland at 1.94), and the estimated y intercept is –1.02. The estimation results are quite good, with the function explaining about 78% of the variation of governance scores.

The path of the curve provides the expected (or normal) governance score for a country, given its level of income. Thus, a country's vertical distance above or below the curve gives its governance score

[11] The data and supporting documents can be found at http://www.worldbank.org/wbi/governance/govdata2002/index.html
[12] Thanks to David Roodman for suggesting this functional form.

controlling for its level of income. A country falling right on the curve would have a score of zero, implying that it has exactly the expected governance score for that level of income. A country above the curve would have a positive score, indicating better than expected governance, while a country falli ng below the curve would have a negative score, indicating worse than expected governance. Table 3 shows each ODA and OA recipient ranked by their 2002 governance score after controlling for its income level. Chile, Mongolia, and Madagascar top the list, with their controlled governance score about one unit above the predicted level for their income.[13] On the other end of the scale are Belarus, Argentina, and Turkmenistan, each of which has a governance score about one unit below the norm for their income level.

[13] The units here are in standard deviations of the distribution of the governance scores, as calculated by Kaufmann and Kraay. Recall that under their methodology, a score of one denoted one standard deviation above the world median (scored at zero), whereas negative one denoted one standard deviation below the global median.

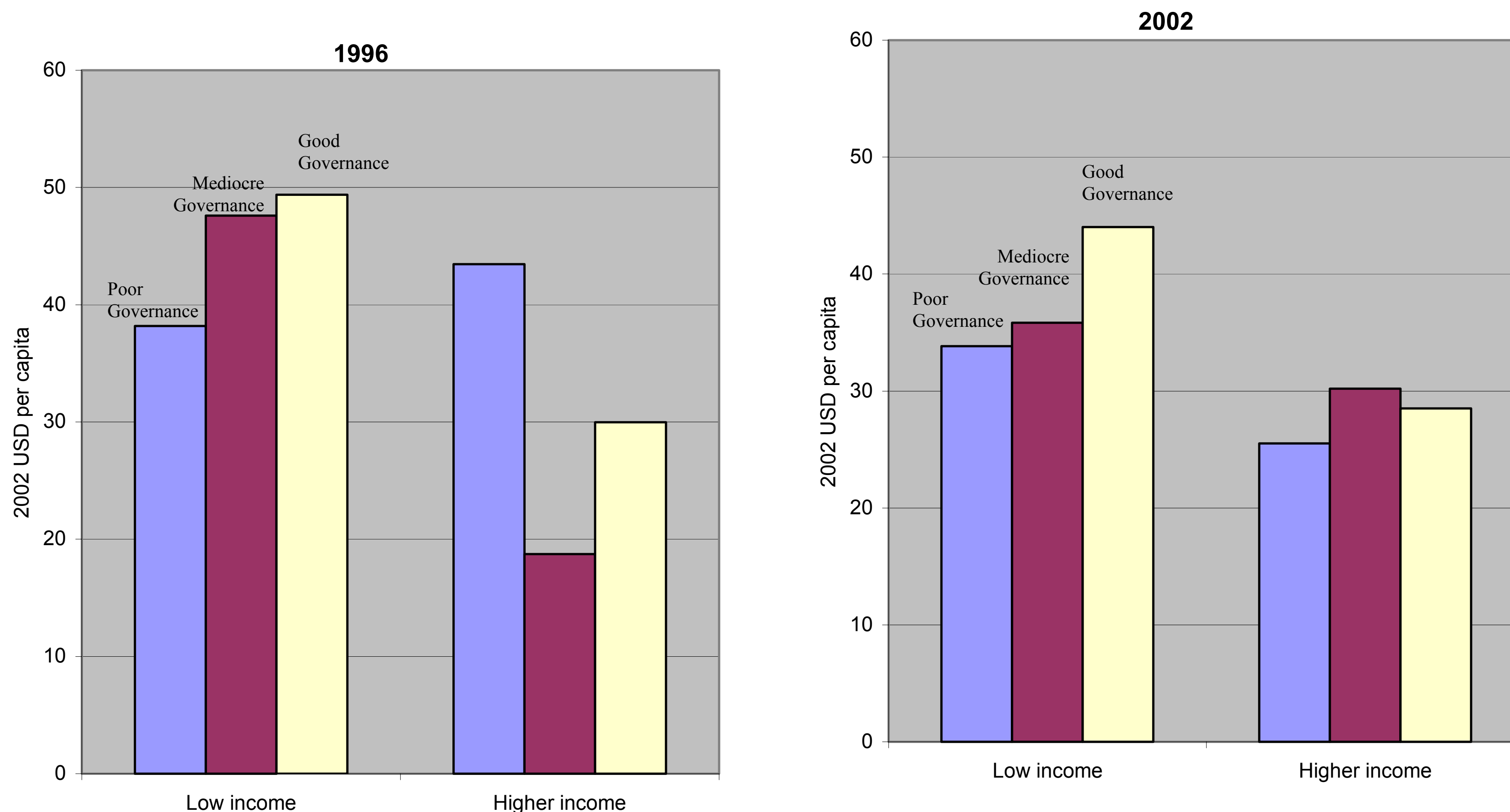
Table 1. ODA Disbursements from DAC Countries

	$ million			Per cent change 2001-2002			Per cent of GNI				
	2001 actual [a]	2002 actual [a]	2002 volume [b]	national currency	U.S. dollars	volume terms [b]	1987-1991 average	1992-1996 average	2000	2001	2002
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)
Australia	873	989	916	7.8	13.3	4.9	0.38	0.33	0.27	0.25	0.26
Austria	533	520	488	-7.3	-2.4	-8.4	0.18	0.18	0.23	0.29	0.26
Belgium	867	1 072	996	17.4	23.6	14.8	0.44	0.36	0.36	0.37	0.43
Canada	1 533	2 006	2 011	32.7	30.9	31.2	0.46	0.41	0.25	0.22	0.28
Denmark	1 634	1 643	1 540	-4.7	0.5	-5.8	0.92	1.02	1.06	1.03	0.96
Finland	389	462	434	12.9	18.8	11.5	0.65	0.40	0.31	0.32	0.35
France	4 198	5 486	5 125	24.2	30.7	22.1	0.60	0.58	0.32	0.32	0.38
Germany	4 990	5 324	4 980	1.4	6.7	-0.2	0.40	0.33	0.27	0.27	0.27
Greece (c)	202	276	253	30.2	37.0	25.5	..	0.15	0.20	0.17	0.21
Ireland	287	398	360	31.9	38.8	25.7	0.18	0.25	0.29	0.33	0.40
Italy	1 627	2 332	2 157	36.2	43.3	32.6	0.35	0.25	0.13	0.15	0.20
Japan	9 847	9 283	9 731	-2.9	-5.7	-1.2	0.31	0.26	0.28	0.23	0.23
Luxembourg	139	147	139	0.4	5.6	0.2	0.23	0.37	0.71	0.76	0.77
Netherlands	3 172	3 338	3 068	0.0	5.2	-3.3	0.93	0.81	0.84	0.82	0.81
New Zealand	112	122	110	-0.9	9.1	-1.1	0.24	0.23	0.25	0.25	0.22
Norway	1 346	1 696	1 517	11.9	26.0	12.7	1.12	0.97	0.76	0.80	0.89
Portugal	268	323	293	14.2	20.2	9.2	0.23	0.28	0.26	0.25	0.27
Spain	1 737	1 712	1 559	-6.3	-1.4	-10.3	0.16	0.25	0.22	0.30	0.26
Sweden	1 666	1 991	1 848	12.4	19.5	10.9	0.90	0.91	0.80	0.77	0.83
Switzerland	908	939	863	-4.6	3.4	-5.0	0.32	0.36	0.34	0.34	0.32
United Kingdom	4 579	4 924	4 581	3.2	7.5	0.0	0.30	0.30	0.32	0.32	0.31
United States	11 429	13 290	13 140	16.3	16.3	15.0	0.19	0.14	0.10	0.11	0.13
TOTAL DAC	**52 335**	**58 274**	**56 109**	**8.5**	**11.3**	**7.2**	**0.33**	**0.29**	**0.22**	**0.22**	**0.23**
of which:											
EU Members	26 288	29 949	27 821	8.4	13.9	5.8	0.44	0.40	0.32	0.33	0.35

a) At current prices and exchange rates.

b) At 2001 prices and exchange rates.

Figure 1: Aid Allocations, Income and Governance, 1996 and 2002 Average ODA/OA receipts per capita (constant 2002 dollars)



Note: All ODA/OA recipient countries are included, except those with populations under 1 million. There are 119 countries included in 1996 and 117 in 2002. The figures shown are simple (unweighted) averages across countries. Low-income countries have GDP per capita below the IDA cutoffs for 1996 and 2002, which were $1505 and $1415, respectively. Within each income group, countries are divided into the top, middle and bottom thirds of their governance scores, after controlling for income, as described in the Appendix.

Sources: ODA figures: OECD DAC. Governance scores: see the Appendix.

Table 2: The Estimated Income/Governance Relationship

The estimated relationship is:

$$G = \alpha - \beta * e^{(-GNP/\delta)}$$

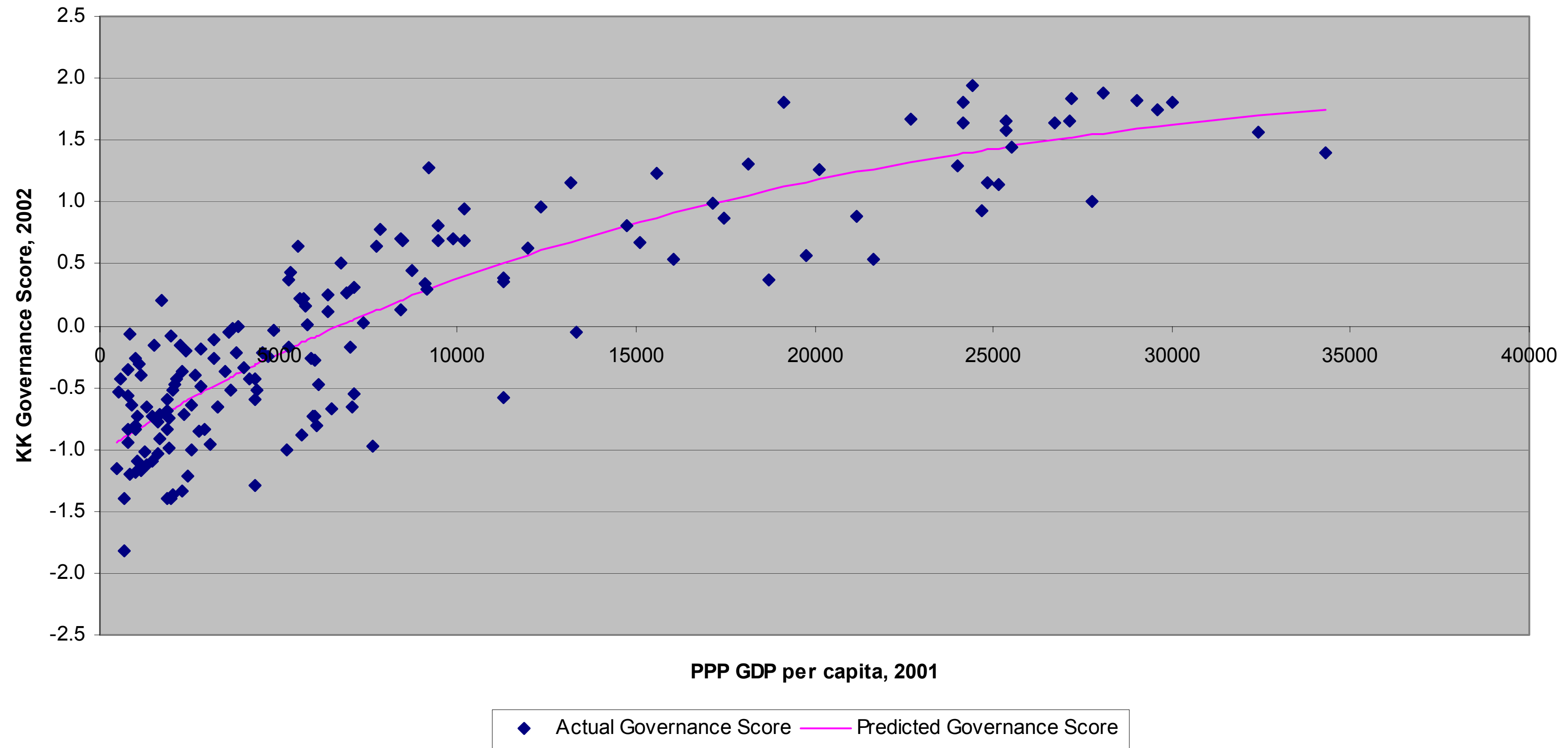
G is a country's composite governance score,
GNP is its per capita income (measured at purchasing power parity)
e is the base of the natural logarithm
α, β, and δ are the estimated parameters

- α is the estimated maximum governance score (that is, the horizontal asymptote of the function)
- α-β is the y intercept (or the estimated governance score for the hypothetical country with zero income)
- δ is the speed of convergence (or degree of curvature) of the function.

Number of obs	159
R-squared	0.78

Parameter	Coefficient	Std. Err.	t-value
α	2.21	0.36	6.1
β	3.23	0.32	10.1
δ	17561	3864	4.5

Figure 2. Governance and Income



Sources: Governance scores, from www.worldbank.org/wbi/governance//govdata2002/index.html; income data from World Development Indicators, 2003; and author's calculations.

Table 3. Governance and Income

Country	PPP GDP per capita, 2001	KK score, 2002	Predicted KK score	Deviation
Chile	9190	1.28	0.29	0.99
Mongolia	1740	0.21	-0.72	0.93
Madagascar	830	-0.07	-0.88	0.80
Dominica	5520	0.65	-0.15	0.80
Botswana	7820	0.77	0.14	0.64
St. Vincent and the Grenadines	5330	0.42	-0.18	0.60
Senegal	1500	-0.16	-0.76	0.60
Mauritania	1990	-0.08	-0.68	0.60
Benin	980	-0.26	-0.85	0.59
St. Lucia	5260	0.37	-0.19	0.56
Estonia	10170	0.94	0.40	0.54
Mali	810	-0.35	-0.88	0.53
Burkina Faso	1120	-0.31	-0.83	0.52
Latvia	7730	0.64	0.12	0.51
Malawi	570	-0.42	-0.92	0.50
Grenada	6740	0.50	0.00	0.50
Uruguay	8400	0.70	0.20	0.50
Costa Rica	9460	0.81	0.32	0.49
Ghana	2250	-0.16	-0.64	0.48
Lithuania	8470	0.69	0.21	0.48
Malta	13160	1.16	0.68	0.48
Mozambique	1140	-0.40	-0.82	0.42
Lesotho	2420	-0.21	-0.61	0.40
Tanzania	520	-0.54	-0.93	0.40
Jamaica	3720	-0.03	-0.41	0.38
Morocco	3600	-0.05	-0.43	0.38
Jordan	3870	-0.01	-0.39	0.38
Sri Lanka	3180	-0.12	-0.49	0.37
Poland	9450	0.69	0.32	0.37
Cape Verde	5570	0.22	-0.15	0.37
Barbados	15560	1.24	0.87	0.36
India	2840	-0.19	-0.54	0.36
Belize	5690	0.22	-0.13	0.35
Hungary	12340	0.96	0.61	0.35
Singapore	22680	1.67	1.32	0.35
Mauritius	9860	0.70	0.36	0.34
Zambia	780	-0.57	-0.89	0.31
Thailand	6400	0.25	-0.04	0.29
Antigua and Barbuda	10170	0.68	0.40	0.29
Panama	5750	0.16	-0.12	0.29
Namibia	7120	0.32	0.05	0.26
Bolivia	2300	-0.38	-0.63	0.25
Bulgaria	6890	0.26	0.02	0.24
Niger	890	-0.64	-0.87	0.23
Moldova	2150	-0.43	-0.65	0.22
Vanuatu	3190	-0.27	-0.49	0.22

Country	PPP GDP per capita, 2001	KK score, 2002	Predicted KK score	Deviation
Fiji	4850	-0.03	-0.25	0.21
Malaysia	8750	0.45	0.24	0.21
Vietnam	2070	-0.48	-0.67	0.18
Philippines	3840	-0.22	-0.39	0.17
Armenia	2650	-0.40	-0.57	0.17
Tunisia	6390	0.11	-0.04	0.15
Gambia, The	2050	-0.53	-0.67	0.14
Nepal	1310	-0.66	-0.79	0.13
Romania	5830	0.01	-0.11	0.12
Eritrea	1030	-0.73	-0.84	0.11
Cambodia	1860	-0.59	-0.70	0.11
Egypt, Arab Rep.	3520	-0.37	-0.44	0.07
Peru	4570	-0.22	-0.29	0.07
Slovak Republic	11960	0.63	0.57	0.06
Trinidad and Tobago	9100	0.34	0.28	0.06
Honduras	2830	-0.49	-0.55	0.05
Ethiopia	810	-0.84	-0.88	0.05
Kenya	980	-0.81	-0.85	0.04
Uganda	1490	-0.74	-0.76	0.03
China	4020	-0.34	-0.37	0.03
Guyana	4690	-0.25	-0.27	0.02
Guinea-Bissau	970	-0.84	-0.85	0.01
Comoros	1870	-0.69	-0.70	0.01
Togo	1650	-0.72	-0.74	0.01
El Salvador	5260	-0.18	-0.19	0.01
Czech Republic	14720	0.81	0.81	0.00
Croatia	9170	0.29	0.29	0.00
Slovenia	17130	0.99	0.99	0.00
Bangladesh	1610	-0.78	-0.74	-0.03
Solomon Islands	1910	-0.75	-0.69	-0.05
Yemen, Rep.	790	-0.94	-0.88	-0.05
Papua New Guinea	2570	-0.64	-0.59	-0.06
Brazil	7360	0.02	0.08	-0.06
Mexico	8430	0.13	0.21	-0.08
Djibouti	2370	-0.71	-0.62	-0.09
Lebanon	4170	-0.44	-0.34	-0.09
Albania	3680	-0.52	-0.42	-0.10
Swaziland	4330	-0.43	-0.32	-0.11
South Africa	11290	0.39	0.51	-0.12
Pakistan	1890	-0.84	-0.70	-0.15
St. Kitts and Nevis	11300	0.35	0.51	-0.15
Turkey	5890	-0.26	-0.11	-0.16
Korea, Rep.	15090	0.67	0.84	-0.17
Ecuador	3280	-0.66	-0.48	-0.18
Syrian Arab Republic	3280	-0.66	-0.48	-0.18
Cameroon	1680	-0.91	-0.73	-0.18

Country	PPP GDP per capita, 2001	KK score, 2002	Predicted KK score	Deviation
Gabon	5990	-0.28	-0.09	-0.19
Dominican Republic	7020	-0.17	0.04	-0.21
Rwanda	1250	-1.02	-0.80	-0.21
Guatemala	4400	-0.53	-0.31	-0.22
Sierra Leone	470	-1.16	-0.94	-0.22
Chad	1070	-1.09	-0.84	-0.25
Hong Kong, China	24850	1.16	1.42	-0.27
Ukraine	4350	-0.59	-0.32	-0.28
Lao PDR	1620	-1.03	-0.74	-0.29
Kyrgyz Republic	2750	-0.85	-0.56	-0.29
Guinea	1960	-0.99	-0.69	-0.30
Indonesia	2940	-0.84	-0.53	-0.32
Nigeria	850	-1.20	-0.87	-0.32
Central African Republic	1300	-1.13	-0.80	-0.33
Cote d'Ivoire	1490	-1.10	-0.76	-0.34
Congo, Rep.	970	-1.19	-0.85	-0.34
Tajikistan	1170	-1.17	-0.82	-0.35
Cyprus	21190	0.88	1.24	-0.36
Bahrain	16060	0.53	0.91	-0.38
Macedonia, FYR	6110	-0.48	-0.08	-0.40
Georgia	2560	-1.00	-0.59	-0.41
Azerbaijan	3090	-0.96	-0.50	-0.45
Burundi	690	-1.40	-0.90	-0.49
Russian Federation	7100	-0.55	0.05	-0.60
Israel	19790	0.56	1.16	-0.60
Uzbekistan	2460	-1.22	-0.60	-0.62
Iran, Islamic Rep.	6000	-0.73	-0.09	-0.64
Bosnia and Herzegovina	5970	-0.73	-0.09	-0.64
Kazakhstan	6500	-0.67	-0.03	-0.64
Angola	2040	-1.36	-0.67	-0.69
Haiti	1860	-1.40	-0.70	-0.70
Colombia	7040	-0.66	0.04	-0.70
Zimbabwe	2280	-1.34	-0.63	-0.71
Sudan	1970	-1.40	-0.68	-0.71
Kuwait	18700	0.36	1.09	-0.73
Algeria	6090	-0.81	-0.08	-0.73
Macao, China	21630	0.53	1.26	-0.73
Venezuela, RB	5670	-0.88	-0.13	-0.74
Saudi Arabia	13330	-0.05	0.69	-0.75
Paraguay	5210	-1.01	-0.20	-0.81
Congo, Dem. Rep.	680	-1.82	-0.90	-0.91
Turkmenistan	4320	-1.30	-0.32	-0.98
Argentina	11320	-0.58	0.51	-1.08
Belarus	7620	-0.98	0.11	-1.09

Sources: Governance scores, from www.worldbank.org/wbi/governance//govdata2002/index.html; income data from World Development Indicators, 2003; and author's calculations.

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