

**Peter Boone and [Jean-Paul Faguet](#)**  
**Multilateral aid, politics and poverty: past failures and future challenges.**

**Book section**

**Original citation:**

Boone, Peter and Faguet, Jean-Paul (1998) *Multilateral aid, politics and poverty: past failures and future challenges*. In: Grant, Richard and Nijman, Jan, (eds.) *The global crisis in foreign aid. Space, place and society series*. Syracuse University Press, Syracuse, USA, pp. 11-28. ISBN 9780815627722

© 1998 [Syracuse University Press](#)

This version available at: <http://eprints.lse.ac.uk/27222/>

Available in LSE Research Online: May 2013

LSE has developed LSE Research Online so that users may access research output of the School. Copyright © and Moral Rights for the papers on this site are retained by the individual authors and/or other copyright owners. Users may download and/or print one copy of any article(s) in LSE Research Online to facilitate their private study or for non-commercial research. You may not engage in further distribution of the material or use it for any profit-making activities or any commercial gain. You may freely distribute the URL (<http://eprints.lse.ac.uk>) of the LSE Research Online website.

This document is the author's submitted version of the book section. There may be differences between this version and the published version. You are advised to consult the publisher's version if you wish to cite from it.

Forthcoming as Chapter 2 in R. Grant and J. Nijman (eds.). 1998. *The Global Crisis in Foreign Aid*, Syracuse: Syracuse University Press.

## **Multilateral Aid, Politics and Poverty**

Peter Boone

London School of Economics and Political Science

Jean-Paul Faguet

London School of Economics and Political Science

March 1996

The last half-century of foreign aid programs has comprised a broad economic experiment without historical precedent. Beginning modestly with the goal of promoting economic development and alleviating poverty, no one could have guessed in 1944 that five decades later industrial countries would be giving annual grants equal to 8% of recipient countries' GNP. Nor could anyone have predicted the spectacular growth in the number and size of bilateral and multilateral aid agencies. Gross disbursements of aid by industrialized countries in 1994 amounted to over \$100 billion dollars, nearly three times the GNP of Ireland, or half the GNP of Australia.

And yet fifty years on most of Africa and much of Asia is still mired in chronic poverty. The scale of global inequality remains vast: several dozen of the poorest countries register a *yearly* GNP per capita<sup>1</sup> barely equal to a few days' pay in the richest countries. Human development indicators present an equally stark picture. Of those reporting data, more than twenty countries have primary-school gross enrollment ratios below 75%<sup>2</sup>, and some as low as 19%, and in forty-two countries (mostly African, Arab and South Asian) more than ten percent of children die before age five. These figures are much better than they were fifty years ago, but it would be a mistake to conclude that past improvements imply we can be complacent with our current efforts at poverty reduction. In Figure 1 we have extrapolated past trends in order to project the pattern of child mortality to 2025. The top two poverty maps show the gradual progress made in reducing child mortality over the last thirty years. But as shown in the lower map, even if this progress continues unabated, by 2025 more than 10% of children will continue to die before age 5 in thirty-four countries (mostly African), and this figure rises to above 20% in ten countries.<sup>3</sup>

---

<sup>1</sup>World Bank (1994a)

<sup>2</sup>World Bank (1994a)

<sup>3</sup>These figures were projected from historical data compiled by the United Nations. Logarithmic projections were made based on trends from 1950 (before which very little data is

Figure 1A

Child Mortality in 1965  
(Deaths of Children Aged 0-5 per thousand)

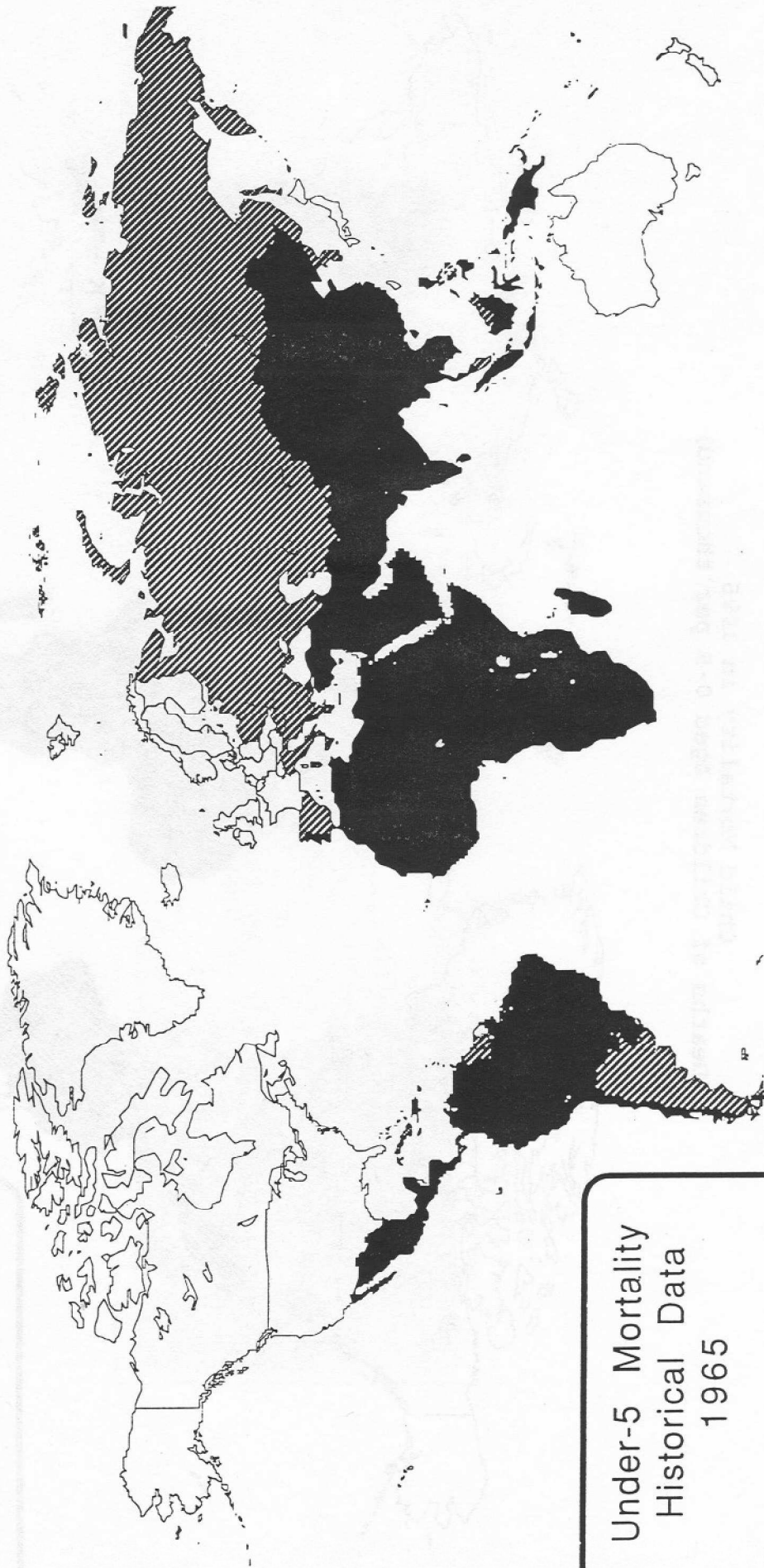
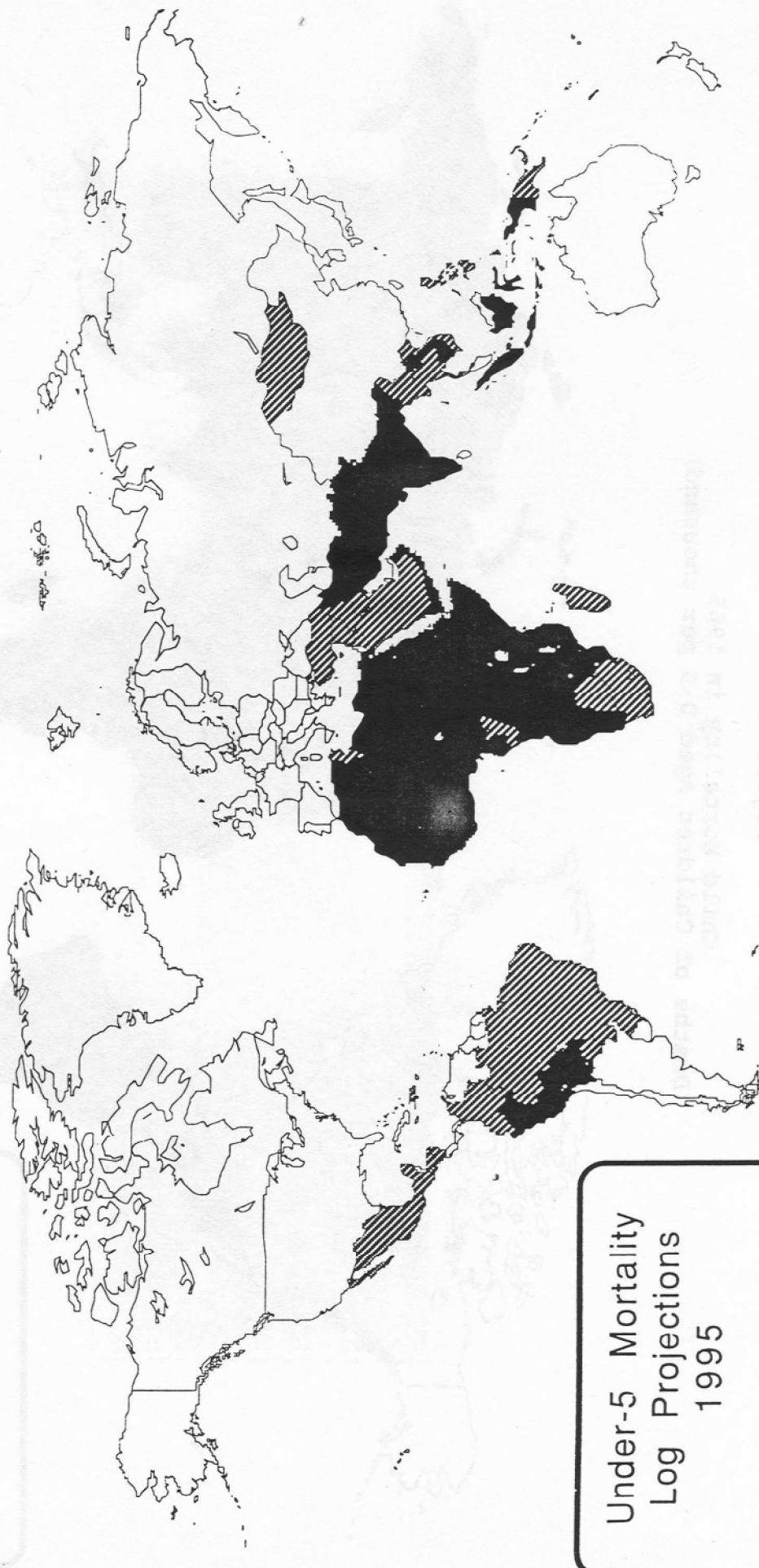


Figure 1B

Child Mortality in 1995  
(Deaths of Children Aged 0-5 per thousand)

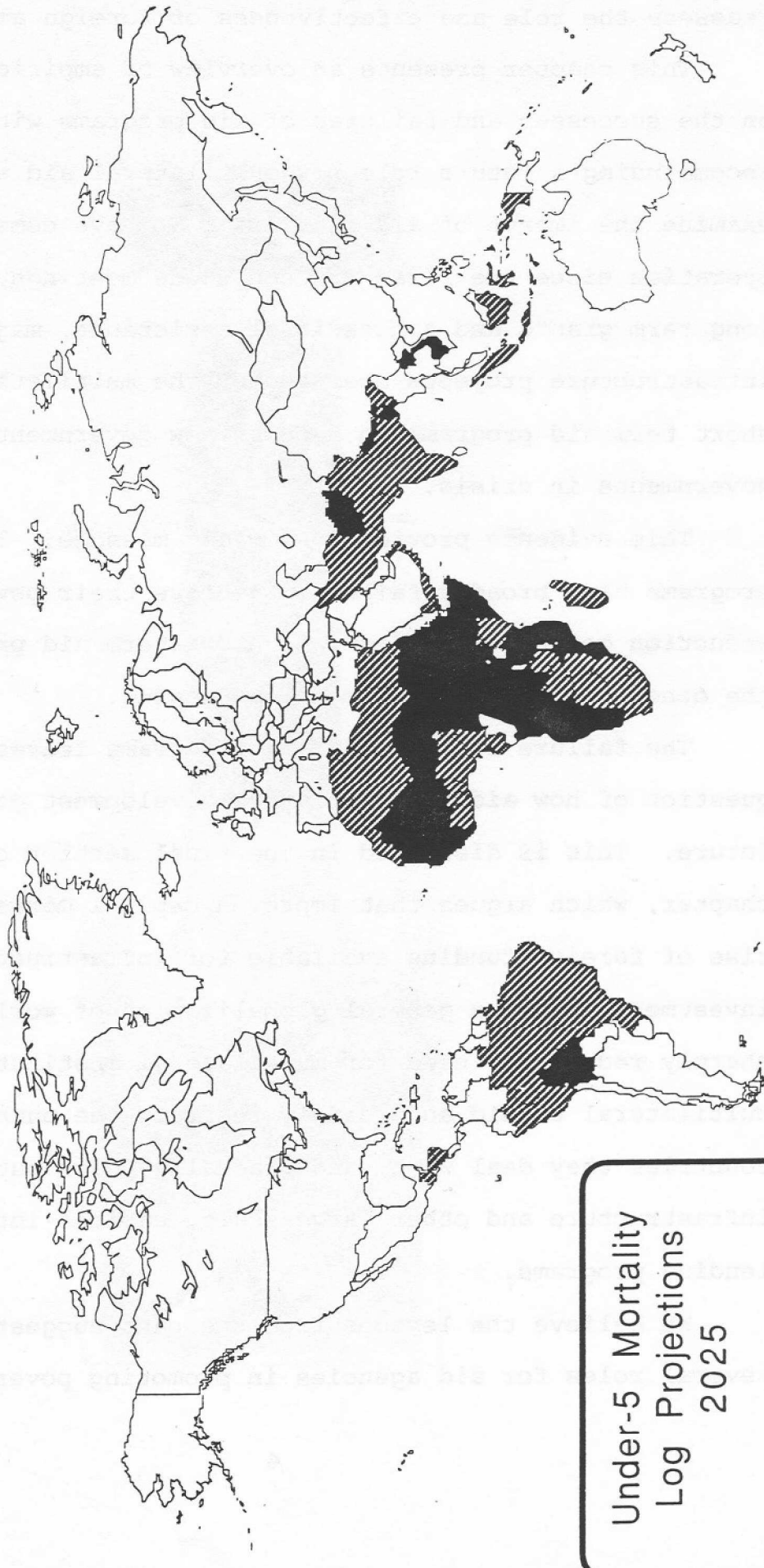


Under-5 Mortality  
Log Projections  
1995

- 0.00 to 40.00
- 40.01 to 100.00
- 100.01 to 1000.00

Figure 1C

Child Mortality in 2025  
(Deaths of Children Aged 0-5 per thousand)



The main theme of this chapter is that we need to do much more to address poverty in the future. No reader should be surprised that the human costs of poverty will continue to be large in the future. Much more worrying is the observation that fifty years of aid work and investment have not done more to reduce deprivation to achievable levels in most of the world. And if the trends that brought us here continue, thirty years hence the global situation will be little better in relative terms, and much worse in absolute terms as population growth in the poorest countries multiplies the masses of their poor. It is time to ask what five decades of work have accomplished, and to reassess the role and effectiveness of foreign aid.

This chapter presents an overview of empirical evidence on the successes and failures of aid programs with the aim of recommending a future role for multilateral aid agencies. We examine the impact of aid programs that have come into operation since the first Bretton Woods meetings, including long term grants and concessional assistance, major infrastructure projects operated by the multilaterals, and short term aid programs to support new governments or governments in crisis.

This evidence provides one clear message: long term aid programs have broadly failed to achieve their poverty reduction goals. Some forms of short-term aid programs, on the other hand, have been more successful.

The failure of long term aid programs leaves open the question of how aid can best serve development goals in the future. This is discussed in the final section of this chapter, which argues that improved capital markets, the rapid rise of foreign funding available for infrastructure investment, and the general globalization of world markets sharply reduce the need for multilateral institutions. Multilaterals should accordingly restrict the number of countries they deal with, and gradually phase out their infrastructure and other large-scale, capital-intensive lending programs.

An important role remains for aid agencies, however, in the provision of short term aid

---

available for developing countries) and 1970.

to new governments, governments in crisis, and governments embarking on serious poverty reduction programs. We believe that foreign aid can and should be used as a creative tool to encourage countries to embark on serious poverty reduction programs, and in the conclusions we discuss several means to achieve this.

Multilateral agencies may also play a role promoting the development of commercial markets for infrastructure investments. The advantage of using private markets instead of development institutions to provide capital instead of development institutions is that loans and projects are subjected to market discipline. But for this to function efficiently, we need to carefully consider international laws, regulations and procedures that can best ensure efficient private capital flows.

Thirdly, multilateral aid can provide technical assistance and support for world public goods such as the environment. Fourthly, these institutions should continue to take advantage of the substantial technical expertise which they have accumulated in a number of technical areas. But they should be forced to compete in a market with other providers of such services. This implies much smaller and less capital-intensive organizations.

The chapter is organized as follows: Section 2 outlines early arguments for and against aid, showing the theoretical ambiguity surrounding the question of the potential impact of aid. Section 3 summarizes evidence from previous research on the impact of foreign aid on growth, investment and human development indicators. Section 4 examines the effectiveness of public infrastructure programs and relates these to the debt crisis in Sub-Saharan Africa, arguing that the major legacy of large aid flows in the sixties and seventies is not higher income but rather a large debt burden. Section 5 discusses several examples of short term aid programs that have been successful, and Section 6 concludes with a general discussion of the future role for development assistance.

## 2. Early Arguments For and Against Aid

Despite the rapid growth in aid, there have never been compelling theoretical



underpinnings or empirical evidence showing that foreign aid programs actually work. John Maynard Keynes took the view that capital shortages were a primary cause of poverty. The World Bank was created in part due to his assessment that developing countries needed financing for major public and private investment projects. This argument was developed fully in the fifties and sixties by economists such as Rostow (1990) and Chenery (1966). Aid proponents argued that developing countries have low savings because of their absolute poverty. Since they cannot afford to save, and world capital markets are imperfect, they need a "jump start" with foreign aid in order to take off.

But careful examination calls this argument into question. During the late nineteenth century and in the interwar period world capital markets functioned quite well. Britain was a major exporter of capital to the new world, where both private and public investment, most notably railways, were financed by bond issues. This capital mobility reemerged after the second world war. Korea financed substantial investment through foreign borrowing beginning in the early sixties. A true explosion of international capital flows began in the 1970s.

The idea that poor countries have low savings because households cannot afford to save is also dubious. Today the richest 20% of the population earn 50% of total income in low-income countries. It is really the high-income elite that conduct what investment and savings go on in these countries, and they command the resources to do so. The question should then be rephrased: Why do the high-income elite save and invest in some countries while in others they do not?

The early critics of foreign aid programs, notably Bauer (1973) and Friedman (1958), argued that the root cause of poverty was not capital shortage but rather government failure. If low investment is due to a lack of opportunities to invest, say due to corruption and distortionary economic policies, then giving aid will not lead to higher investment or growth. Growth can only come from removing the distortions that prevent development and poverty alleviation, which itself requires a fundamental shift in economic policy. If aid allows

governments to reduce distortions, say through reducing tax rates or strengthening the government so it can enforce laws, then aid could still lead to growth and investment. But if governments do not have incentives to change these policies, and if aid does not change the basic incentives of government, then foreign aid will fail and aid funds will be wasted.

Table 1 Basic Facts about Aid (in the sample of 97 countries)	
Average Aid/GNP ratio 81-90: range 0.00-0.54, sdev 0.112 71-80: range 0.00-0.35, sdev 0.035	0.086 0.056
in Base Sample: 81-90: range 0.00-0.144, sdev 0.039 71-80: range 0.00-0.146, sdev 0.045	0.042 0.046
Grant component (1980)	0.93
Restrictions on Procurement (fraction by category): Untied: Partially tied: Tied:	0.71 0.05 0.25
Uses of Aid (fraction by type): Emergency Aid Food aid Social and Admin. Infrastructure Program aid Economic Infrastructure Other	0.05 0.13 0.20 0.06 0.32 0.24
Sources of Aid Multilateral Bilateral (of which): France Japan OPEC United Kingdom United States Other	0.25 0.75 0.13 0.15 0.07 0.04 0.18 0.43
Aid as a fraction of GDP from Donor Countries (members of DAC) 1970 1980 1990	0.34 0.35 0.34

Source: OECD(1992)

Note: Social and administrative infrastructure applies to health care, education, technical assistance to governments, etc. Economic Infrastructure is highways, electricity, irrigation, and other large public investment projects. Program aid is balance of payments support.

### 3. The Cross-Country Impact of Aid

Given the ambiguity surrounding the theoretical case for aid, we now turn to its empirical effects. We begin by examining the impact of the largest component of aid flows: non-military concessional assistance, called Official Development Assistance, which includes all non-military aid with at least a twenty-five percent grant component. Basic summary statistics are shown in Table 1. The empirical results in this chapter summarize previous research examining the impact of foreign aid on economic and human development indicators using cross-country regressions.<sup>4</sup> We present simple graphs that summarize the relation between aid and improvements in human development indicators based on regression results from approximately 100 developing countries.

There are two major difficulties with measuring the impact of aid in cross-country regressions. The first is the potential simultaneity bias caused by the fact that aid is given to relatively poor countries, so that a simple regression of, for example, infant mortality on aid would erroneously predict that higher aid leads to higher infant mortality.<sup>5</sup> In order to get around this problem, we take advantage of the fact that a large portion of the variance in aid flows is caused by political determinants. Former French colonies, for example, receive substantially more aid than their equally poor neighbors. It is possible to test whether the additional aid that these countries receive, when compared to other similar countries, has positive effects on growth and human development indicators. In previous research we have taken advantage of this insight, using appropriate instrumental variables, to test the impact of aid and also to conduct a large number of robustness and sensitivity tests.

---

<sup>4</sup>There is surprisingly little research using cross-country regressions to examine the impact of aid. There was substantial research on the impact of aid using cross-country regressions in the 1970s. This literature abruptly ended when the problems with measurement error and potential cause and effect biases were realized. See Papanek(1973) for references to this literature and problems encountered. Paul Mosley has written several articles examining the cross-country impact of aid more recently, see e.g. Mosley et. al. (1986). The regression results reported here are discussed and justified more fully in Boone(1994a) and Boone(1994b).

<sup>5</sup>See Papanek (1973).

The second problem, as shown in Table 1, is that aid is targeted to many different expenditure categories, so by pooling different types of aid we may bias our results.<sup>6</sup> But in fact the allocation of aid is quite flexible. Contrary to popular belief a surprisingly small fraction of aid is tied (30%, see Table 1), and 30% of aid is pure cash grants (not reported). In targeted aid donors and recipients initially negotiate over how to allocate aid, after which recipients can freely dispose of project receipts and benefits over long periods of time. Recipients can additionally avoid expenditures on maintenance if they choose (see discussion related to infrastructure in World Bank (1994)). The overall implication is that aid is highly fungible.<sup>7</sup>

The one exception to this is for those small countries that receive very large amounts of aid. In these countries one investment project can be 50% of GNP, meaning that aid is no longer fungible, and that these projects will necessarily cause sharp increases in investment. But when aid comes in smaller amounts it is once again fungible; in this section we report results from a subsample of countries with aid/GNP ratios less than 0.15.

Figures 2 and 3 show that in our sample of 96 countries most aid goes to consumption, and there is no significant impact on investment. These are CPR (component plus residual) plots which show the residuals from regression equations (reported in the appendix) after controlling for other factors that are potentially correlated with aid and the dependent variable. All regressions are run on World Bank data using long time averages over ten years in order to control for business cycle effects.

In Figure 2 the marginal propensity to consume from aid is insignificantly different from one (point estimate 1.08, t-statistic 3.56), while the marginal propensity to invest is

---

<sup>6</sup>Cassen(1994) and Killick(1990) discuss some of the problems encountered when trying to measure the aggregate impact of aid.

<sup>7</sup>Pack and Pack(1993), and Khilji and Zampelli(1991) found that governments were able to, ex-post, fully redirect expenditures agreed to under aid programs to alternative uses. Pack and Pack(1990) found that aid flows were not fungible in Indonesia, and they concluded this was due to the large amounts of aid that Indonesia was receiving.

insignificantly different from zero (point estimate 0.03, t-statistic 3.5). This implies that over long time periods most aid is used to raise consumption with little overall impact on investment. In results not shown here, we divided the sample into those countries where aid led to higher public consumption, and a remaining group where aid was not used to raise government expenditure. This allowed us to test whether aid allocated through the private sector had a different impact from aid allocated through government consumption. But we found that even when government did not spend aid itself, all funds went to private consumption. This implies that neither the private nor public sector has a strong incentive to invest in these countries.

Given that most aid goes to consumption, it is not surprising that it has no significant impact on growth. Figure 4 shows this. The point estimate from this regression is insignificant, but it implies that a 10 percent increase in the annual aid/GNP ratio causes a 0.4 percent rise in the average growth rate over the full ten years. These results imply that the factors which cause high investment and growth in developing countries do not correlate with, nor are engendered by, foreign aid receipts. They are strong evidence that capital shortage is not the major cause of poverty in developing countries.

Figures 5, 6 and 7 show that the poor do not benefit when a country receives higher aid flows. Infant mortality is highly related to nutritional standards, sanitation, provision of basic health services, housing conditions, and maternal education. Evidence from many countries (e.g. Chile, China and Sri Lanka) shows that infant mortality improves quickly when these basic factors improve, so infant mortality can be considered a "flash" indicator of the conditions of the poorest groups in the population.<sup>8</sup>

Figure 5 shows that aid does not correlate with more rapid improvements in infant mortality. Figure 6 shows that higher aid flows do not have a significant impact on improvements in life expectancy. Figure 7 shows that aid does not correlate with

---

<sup>8</sup>See Flegg (1982) for empirical evidence on the determinants of infant mortality.

Figure 2

The Impact of Aid on Public and Private Consumption  
(decade averaged data, 71-80, 81-90)

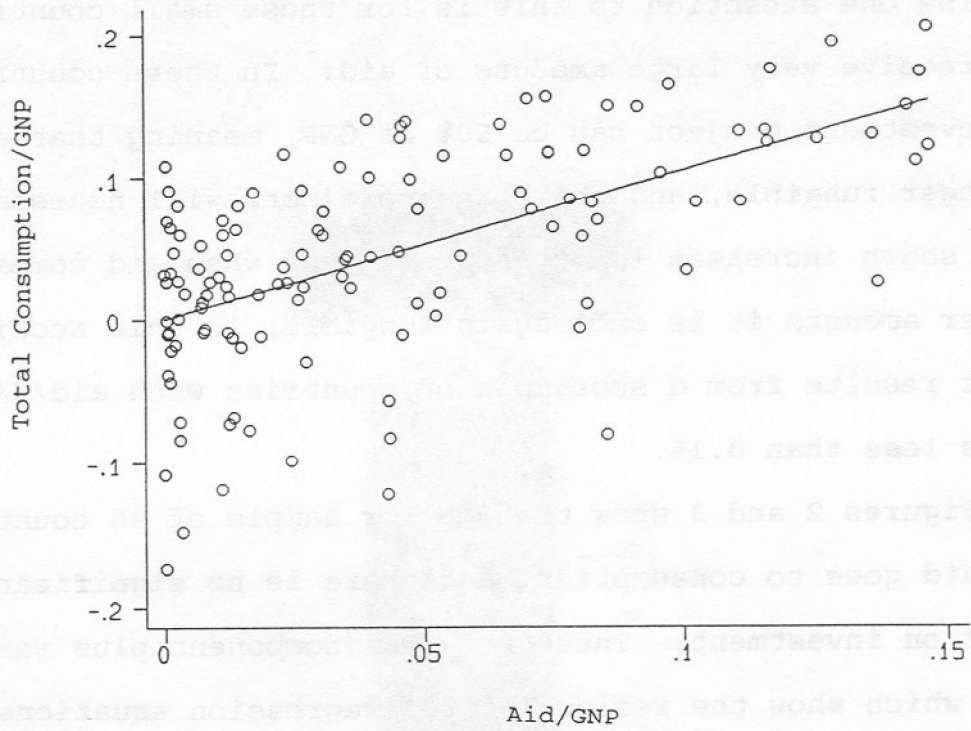


Figure 3

The Impact of Aid on Public and Private Investment  
(decade averaged data, 71-80, 81-90)

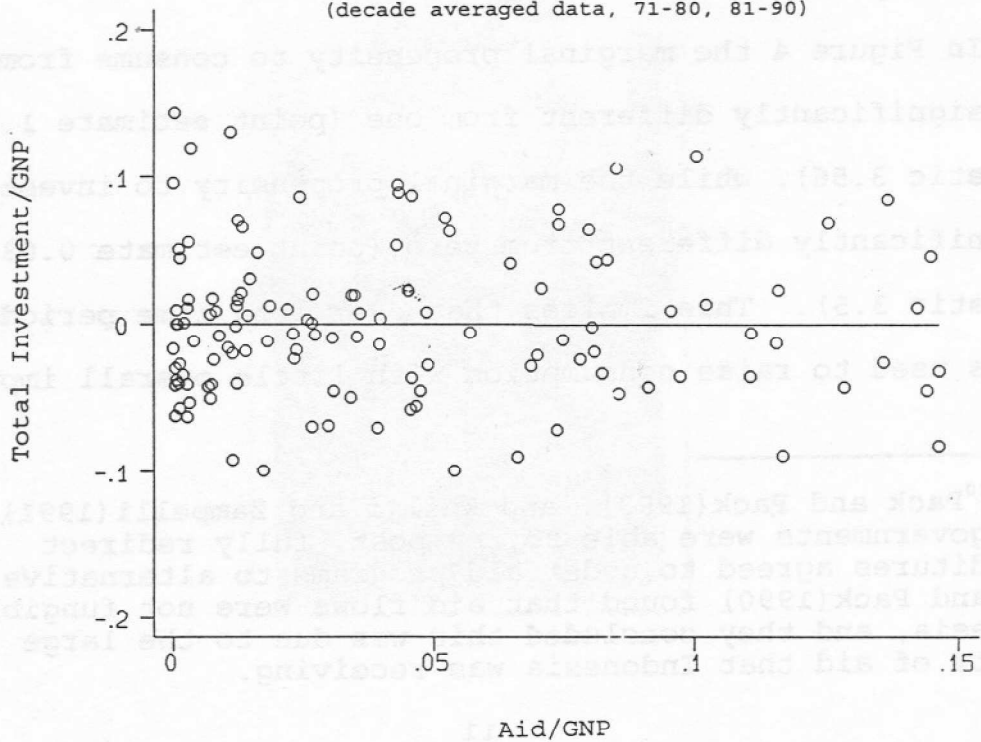


Figure 4

The Impact of Aid on Growth  
(decade averaged data, 71-80, 81-90)

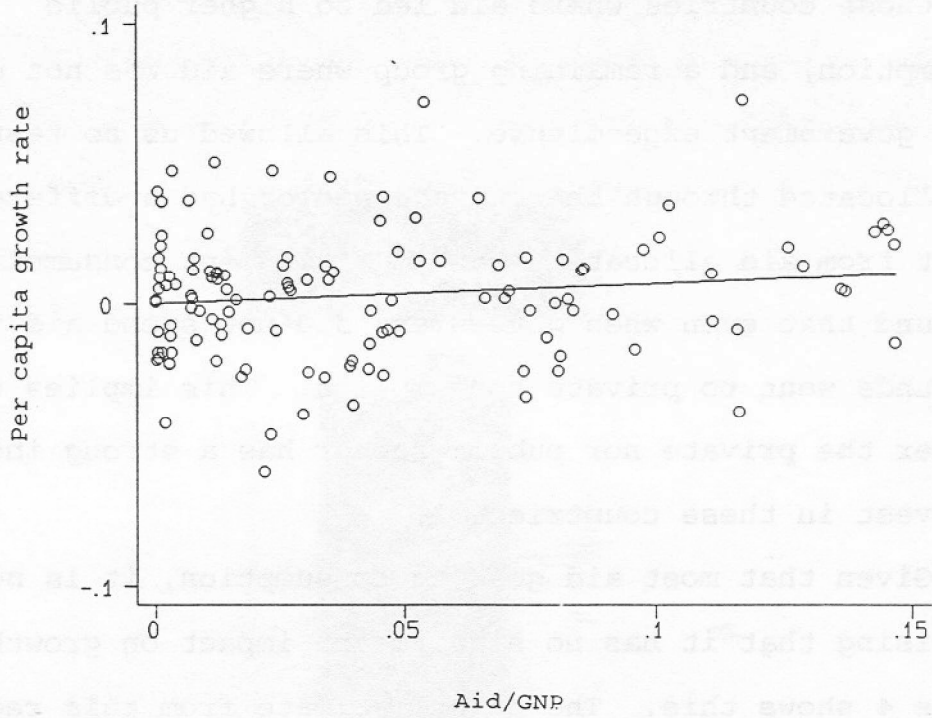


Figure 5

The Impact of Aid on Infant Mortality  
(decade averaged data, 71-80, 81-90)

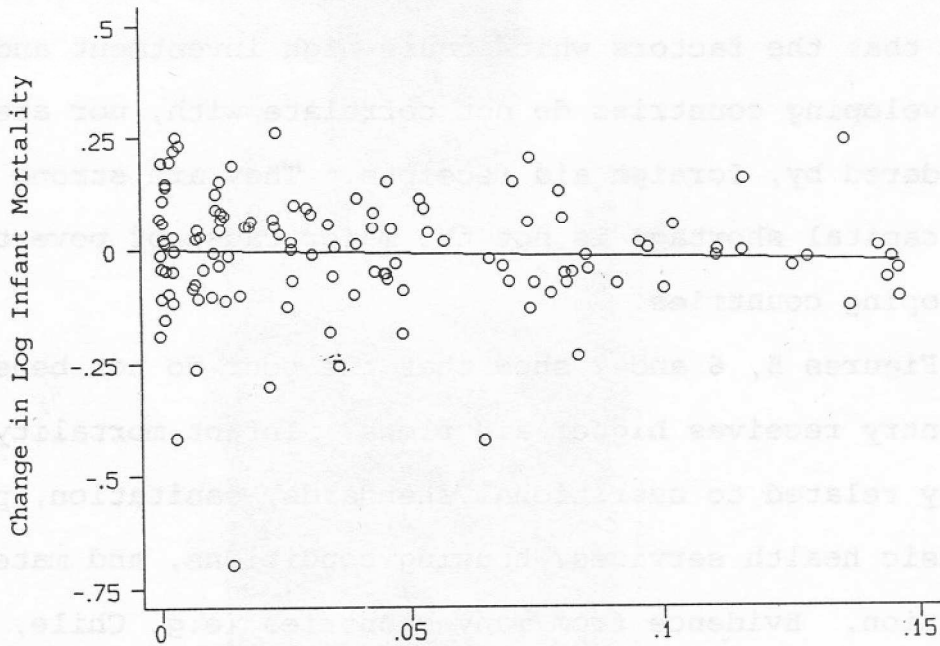




Figure 6

The Impact of Aid on Life Expectancy  
(decade averaged data, 71-80, 81-90)

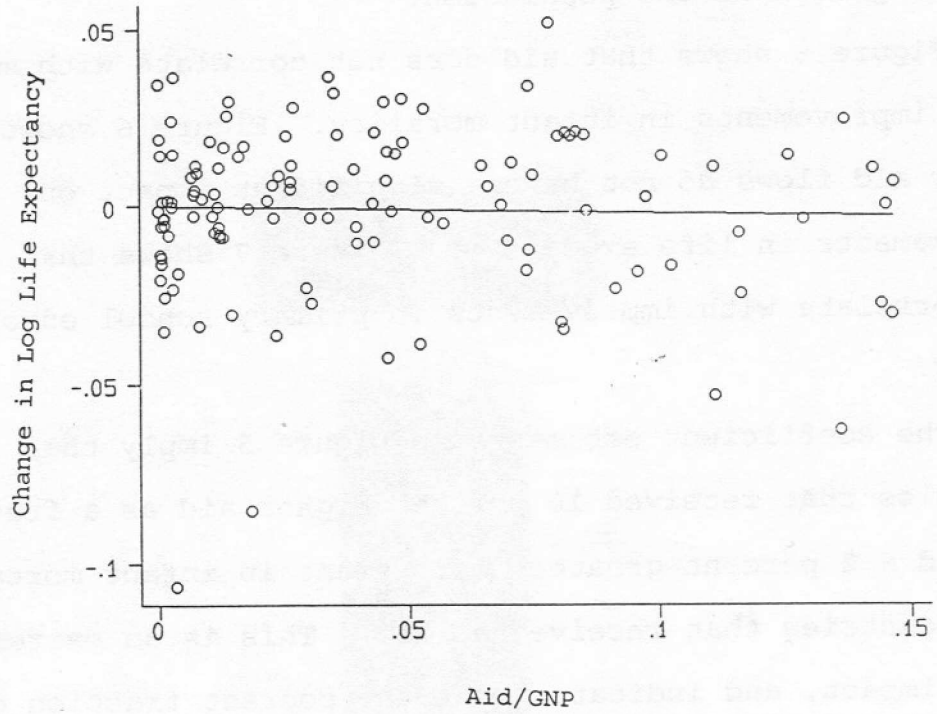
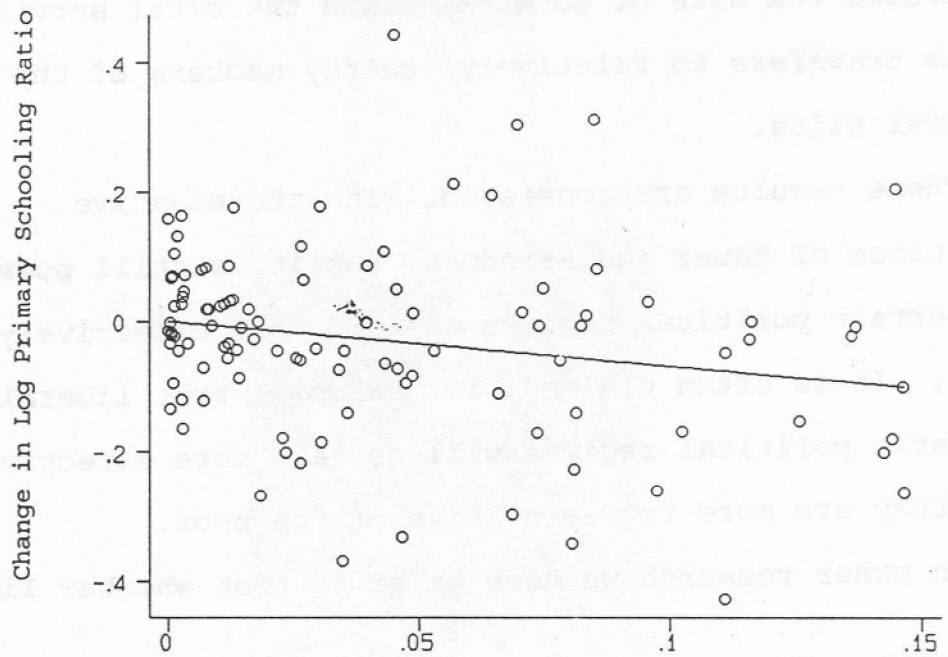


Figure 7

The Impact of Aid on Primary Schooling  
(decade averaged data, 71-80, 81-90)



improvements in primary school enrollment ratios.

The coefficient estimates in Figure 5 imply that countries that received 10 percent higher aid as a fraction of GNP had a 2 percent greater improvement in infant mortality than countries that received no aid. This is an extremely small impact, and indicates that the poorest fraction of the population do not receive much of the benefits of aid programs. But there is no question that aid funds are spent. It seems likely that long term aid receipts are actually used to increase the size of government and the civil service, or to make transfers to relatively wealthy members of the political elite.

These results are consistent with the negative predictions of Bauer and Friedman, but it is still possible that certain political regimes use aid more effectively than others. It is often claimed, for example, that liberal and democratic political regimes will use aid more effectively since they are more representative of the poor.

In other research we have tried to test whether liberal political regimes use aid more effectively. We conducted similar regressions to those reported in Figures 2 through 7, but in this case we allowed for different impacts of aid according to the degree of political liberties in the recipient countries. We used indexes of political liberties calculated by Raymond Gastil, and as an alternative we used the categorization of countries into liberal democracies and "other" regimes as determined by Derbyshire and Derbyshire(1992).

The clear implication of these results was that all political regimes use aid in a similar manner. Most aid goes to consumption, having little impact on investment or growth and no significant impact on basic human development indicators. This was true regardless of how democratic or liberal the political regime was.

It should not be surprising that liberal democracies do not use aid more effectively than other regimes. Even in democracy the poor are relatively weak actors in the political process precisely because they lack education and good health. When governments receive additional funds it is only natural that they allocate them to their strongest political supporters.

Lack of improvement in human development indicators, and the continued high levels

of infant mortality in aid recipient countries, are clear signs that poverty reflects government failure. Caldwell (1986) and Drèze and Sen (1989) show that countries can radically improve basic human development indicators when they choose to. Examples from Cuba, Sri Lanka, China and the Indian State of Kerala show that concerted efforts on the part of government to introduce good public health programs lead to dramatic improvements in infant mortality and life expectancy. These programs are not costly. The World Bank (1993) estimates that a health program costing 3.1% of GNP in low income countries, and 0.9% of GNP in middle income countries would be sufficient to bring life expectancy and infant mortality indicators near to OECD standards. This argument is neatly illustrated in Figure 5. The two outliers in the bottom left corner are Costa Rica and Chile, two countries famous for their effective health programs.

#### 4. Is Public Infrastructure Oversold?

Public infrastructure investment is the bread and butter of multilateral aid programs - approximately 20% of Official Development Assistance is used for public infrastructure (included in the data described in the previous section). Overall, infrastructure commitments are 24% of total development assistance; the IBRD and IDA alone provided 13.6 billion dollars of infrastructure investment in 1991, or more than half the total infrastructure investment provided by all aid programs. Has this been successful? and is it really needed?

There are two arguments for donor provision of public infrastructure investment. First, as explained above, capital shortage may be the cause of poverty. Second, it is argued that cash-strapped governments cannot afford public infrastructure, and poor infrastructure is an important bottleneck in the development process.

But it is extremely difficult to empirically measure the potential benefits of public infrastructure. Aschauer (1989) estimates that public capital in the United States has a 60 percent annual return, and Uchimura and Gao (1993) estimate that investments in Taiwanese and Korean infrastructure earn returns of 77 percent and 51 percent respectively. But these

and other similar studies are based on growth regressions where simultaneity bias may overestimate the results. It could be that a common factor is driving both growth and investment, or that public infrastructure spending is responding to higher growth. In either case such growth regressions will sharply overestimate the returns to public infrastructure.

The World Bank provides direct measures of the efficiency of the projects it finances. It examines rates of return on public infrastructure projects across regions and sectors for projects where the financial returns should reflect social marginal products (some transport, agriculture, industry, etc.). Table 2 shows the Bank's estimated returns on these projects ranging from 8 to 21 percent. Returns vary systematically across regions, with Sub-Saharan African projects earning the lowest returns.<sup>9</sup>

These figures suggest that individual projects earn lower rates of return than one would expect for capital-poor, developing regions of the world. Government regulators in North America and Europe typically concede rates of return around 15% to public utilities, and many technological firms demand returns of 25% or more to finance projects. The Bank's estimates suggest either that development agencies should look much harder for worthwhile projects, or that the policy environment in these countries is so generally distorted that good projects cannot be generated.

These numbers are probably not good proxies for the overall impact of aid on macroeconomic performance. First, World Bank estimated returns are generally biased upward at the time projects are begun, and over time are reduced as projects are implemented. World Bank data shows that returns on public investment projects that were initially estimated to average 24.4% were subsequently revised downwards to 15.8%. This suggests a Bank tendency to overestimate project benefits prior to project approval.

More importantly though, the satisfactory performance of individual projects may not reflect the broad macroeconomic impact of aid. Recipient governments can use foreign aid to

---

<sup>9</sup>See Killick(1991) for an overview of other literature on this issue and description of some of the problems in measuring these returns.

Table 2 Re-estimated Rates of Return on World Bank Infrastructure Projects for Evaluated Projects by Region (unweighted averages)		
	1974-75	1985
Eastern Africa	15.0	9.5
Western Africa	27.0	8.4
East Asia and Pacific	20.6	20.6
European, Mediterranean and North America	11.5	14.7
Latin America	16.2	14.8
Total	17.0	15.8

Source: World Bank (1988) page 9.

reduce their own public investment programs, allowing them to increase expenditures in other areas. In cases where aid is not an increment to government spending but rather a substitute, it may well achieve nothing. Governments can also fail over time to maintain public infrastructure projects. The evidence from the previous section suggests these factors may be empirically large enough to swamp the benefits of investment projects.

#### 4.1 Can Centralized Allocation of Infrastructure be Efficient?

While the overall effectiveness of infrastructure programs is unclear, there is still an important question as to how best to allocate assistance for infrastructure investment. The founders of the World Bank, to take the most important example, anticipated that the Bank would primarily provide guarantees to private investors but not enter into substantial direct lending. But over time it became clear that the pool of such private projects was too small to justify large-scale bank activities. Nor was there sufficient capacity in developing countries to measure infrastructure needs and feasibility. The Bank thus evolved to become almost entirely a direct lender.

But is centralized allocation of funds through large development institutions the best

means to select and choose infrastructure projects? Internal investment criteria and discipline in the World Bank, as in other development agencies, can never be expected to mimic market conditions. Mosley (1991) reports that loan approvals and disbursements are at the center of the Bank's internal incentive structure. The impact of these loans cannot be assessed for long periods of time, and it is impossible for any bureaucracy to single out blame for failed programs years after a project was begun. It is thus understandable that the project selection process often fails to weed out projects with poor prospects.

Neither do the normal forces of market mechanisms provide external discipline to the operations of the World Bank and other multilaterals. They earn very high credit ratings because their bonds are guaranteed by all member countries. Recipient countries are required to pledge that the World Bank is senior to all other creditors, and the IMF and regional development banks have similar clauses. This is reinforced by the fact that commercial banks look to multilateral activity for signs of a country's or government's creditworthiness. The result is that governments service multilateral debt before attending to other creditors. Multilaterals can thus safely lend to developing countries without facing the risk of losses that other commercial lenders face.

In addition to this, politicians, motivated by the possibility of private or political gain and the reality of electoral cycles or political instability, will be willing to enter into projects even when the social returns are low or negative. In a system where neither markets nor borrowers play a discriminating role in project selection, Bank staff are left alone to cope with the entire burden of quality control and monitoring in Bank lending. Such a system presents a risk that loan programs can provide a mechanism for an explosion of debt and inefficient public infrastructure investment in developing countries through easy access to multilateral credit facilities.

#### 4.2 The Dangers of Inefficient Investment

The build-up of official debt to Sub-Saharan African countries with little effect on

growth, the most striking example of the failure of international development programs, is precisely such a case. From the late fifties and early sixties it was already apparent that aid projects were not generating sufficient government revenues to allow recipients to repay their loans. This led to the creation of the International Development Agency (IDA), sister agency to the IBRD, which was made responsible for providing long term lending with a ten year grace period and concessional interest rates to developing countries.

But during the 1960s and 1970s substantial bilateral assistance continued at non-concessional rates. By 1969 past principal and debt service was beginning to mount. The Pearson (1969) report warned that there was an impending debt crisis in Sub-Saharan Africa and called for donor countries to increase the portion of concessional lending to recipient countries.

But the warnings of these reports were never fully heeded, and today official debt makes up three quarters of Sub-Saharan Africa's external obligations. Without official aid programs African countries would not have been able to build up the severe levels of indebtedness they have.

This failure of foreign aid to cause growth is generally consistent with the findings and arguments made above in sections three and four. A large part of aid was probably used for consumption, most likely via permitting governments to increase transfers and/or the size of government. Further, as shown in table 2, and despite a probable upward bias, the World Bank's estimated returns on investment projects in African countries were generally low. This puts into question the ability of donors to screen projects with adequate rigor, and leads us to conclude that the fact that market mechanisms are not guiding the process is an important reason why lending to Africa got out of hand.

##### 5. When does aid succeed?

There are, of course, numerous examples of successful aid programs. Many specific aid projects have worked well, bringing significant benefits to their host countries and target

populations. Famine relief and immunization drives are prime examples of inexpensive programs where relatively small amounts of assistance may be decisive.

Sachs (1994) presents a clear case in favor of aid to assist countries attempting financial stabilization, or entering into large-scale liberalization programs. He shows that during the last century virtually every country that successfully stabilized received foreign assistance. Amongst many others these include Austria (1922), Germany (1924 and 1946), Bolivia (1986), Poland (1990), and Estonia (1992).

Such short term aid also has clear theoretical backing for its potential usefulness. During high inflation the tax base is often eroded as enterprises delay payments (known as the Tanzi effect). Seignorage revenues also fall as people stop using domestic money. To get out of the trap of high inflation and low revenues the government needs to muster the political strength to make tough budget decisions, and raise credibility so that households and enterprises will once again trust the domestic currency. Here foreign assistance provides bridge financing while budget measures take hold and governments gain political strength. Additionally, international support usually raises government's credibility.

Foreign assistance has also played a key role in encouraging shifts in economic policies and political structures during revolutionary periods or economic crises. United States aid to Taiwan played a decisive role in ensuring nationwide land reform in the early 1950s (Cheng (1961)). The Taiwanese also followed US advice to introduce export-oriented policies in the 1960s when US AID threatened to cut aid to the Chiang Kai-Shek regime.

In Korea the government maintained closed, distorted markets throughout the 1950s. The decisive factor which caused the Korean government to embark upon market liberalizing reforms was the US administration's threat to end aid in the early 1960s. The American commitment to reduce aid to Korea provided the political impetus for the government to stabilize its macroeconomic policies, open the economy and promote exports.

Another common example of aid providing decisive political support was the Marshall plan to assist reconstruction in postwar Europe. This was also largely short-term political aid



aimed at boosting liberal regimes and supporting market liberalization.

These experiences suggest that conditional aid programs, as proposed by the IMF for example, could also be effective means to bring about good policies. But the empirical evidence on the success of IMF conditionality at introducing greater macroeconomic stability even in the short run is mixed.<sup>10</sup> Most of the countries which enter into IMF-sponsored programs do not achieve long term stability or growth, and hence must return to the Fund some years later to negotiate another program. The underlying factors that cause instability are apparently not affected by the short term conditional programs that the IMF prescribes.

Nor do World Bank conditional aid programs have clear positive or long-lasting impacts. Mosley (1991) summarizes results from several case studies. It is not evident, firstly, that World Bank conditionality is strongly enforced, nor that it is even enforceable given the range of commitments made. Bank conditionality generally involves several dozen specific conditions, but in practice countries can implement only a fraction of these and still not risk loan suspension. The real reason behind this may in turn reflect the incentive structure of the Bank - if it measures its own performance by success in approving and disbursing loans, then it is not really in the interest of Bank staff to suspend loans due to noncompliance of conditionality. There is reason to think that other multilaterals' conditional programs operate similarly.

The most recent examples of success are seen in the formerly socialist countries. Here IMF conditionality has played a fundamental role in promoting financial stability and liberalization. The IMF helped design and finance the Polish stabilization and liberalization program which became the model for Russia, Czechoslovakia, Ukraine, and most other CIS countries. The IMF has also played a critical role training staff in the new central banks in these countries, and providing technical assistance to ministries. Many of the price and trade liberalization programs in CIS countries are timed in conjunction with specific requirements by

---

<sup>10</sup>See Khan(1992) for a survey of the effectiveness of conditionality.

the IMF, showing the decisive role it can play in bringing about change.

The lesson here is that foreign aid programs can be successful during and after periods of political change. These are times when (new) interest groups are still forming and the role of government is being redefined. Very often the government has the mandate to carry out rapid reform, or is in a position where a few key reformers can introduce changes that eventually become self-sustaining. But once interest groups are entrenched, and governments settle into more stable political patterns, the potential for major reforms is greatly diminished. In these cases even conditional foreign aid is a weak instrument when used to affect changes in economic policies.

#### Whither Multilateral Institutions? Whither Foreign Aid?

The evidence from the last fifty years points to three broad conclusions. First, poverty and the lack of economic development are not driven by capital shortages. Aid programs have transferred large capital flows to developing countries, but investment has not risen significantly in response and consumption has increased instead. This suggests that a lack of investment opportunities is the main reason for low investment and savings. Poor investment possibilities could in turn be driven by the lack of clear property rights, political instability, and poor economic policies and a lack of credibility on the part of the government.

Secondly, we must attribute to government failure the lack of improvement in human development indicators in many countries. This failure may be caused by political deadlock, or by political regimes that simply choose to spend resources on uses other than the provision of basic services to the poor. A small number of the poorest nations have shown that concerted efforts by government can lead to sharp improvements in development indicators. Amongst the remaining poor countries today, the missing ingredient appears to be political will rather than financial capital.

Finally, both examples and sound theoretical reasons support the position that short term aid can be effective during revolutionary periods when governments have the opportunity

and/or a mandate to carry out major reforms. During these periods aid can strengthen governments that choose to introduce major liberalization programs or enfranchise the poor in the political system. And reforms that lead to better education and health for the poor may well result in their political voice being strengthened, and so become self-sustaining.

What role does this leave for multilateral institutions? The world economy has changed radically since the end of the second world war. Economists have changed their views toward the role of the public sector in the economy: throughout the world governments are privatizing activities that used to be considered well within the public domain. The private sector is held to be generally more efficient, and doesn't face the incentive problems discussed above that both governments and aid agencies face.

This narrowing of the public domain should also be applied to aid programs. In recent years there has been a spectacular rise in foreign investment for public infrastructure in developing countries. Today foreign investors can travel easily and communicate instantaneously with most regions of the world, and their resources have followed. Examples include toll roads in Mexico, dams in Argentina, telecommunications facilities in Mongolia and energy and power plants in China. Poor countries can and should seek to harness these financial flows by adjusting their macroeconomic policies to promote investment.

This means that multilaterals should gradually phase out their major infrastructure programs. They can instead promote more rapid growth of foreign private investment flows, and assist countries in designing policies and legal reforms to best promote domestic investment and access to funds. They could also piggyback on these projects, providing partial financing or guarantees against political instability, nationalization, etc. that such international agencies could enforce.

Market discipline will then be the guiding factor that determines the choice of investment projects, leaving multilaterals in a passive role in the project selection process. This discipline will pressure governments to maintain an economic climate conducive to investment in the long term, thus providing a more credible, clear and binding conditionality

than the current programs of the World Bank and other donors. It will also reduce, though certainly not eliminate, the possibility of another major debt crisis in these countries.

Several of the multilateral agencies have built up considerable technical and research expertise. They have every reason to continue to take advantage of this. But technical assistance should also be subject to more competition and openness. The Bank could sharply reduce its size, and instead move to a system where it contracts more services from private consulting firms or experts.

Finally, the evidence on aid programs suggests that long term aid can be sharply reduced and possibly replaced by short and medium term programs more directed at poverty reduction. The clearest examples of the successful use of foreign aid have been during periods of revolution and crisis. Aid can be helpful during stabilization, as famine relief, and to provide the political support new governments and reformers often need when they push through major economic and political reform. To achieve this, we should bring much greater competition into the aid allocation process. We should target aid to countries that introduce major poverty eradication campaigns, and countries that take measures to liberalize their economies. This aid should be highly conditional, and we should be prepared to stop foreign aid if reforms slow or are reversed. When government failure is a major cause of poverty, aid must be used as a tool to change government incentives. In this way we can support reformist factions within existing governments, and give greater incentives for all governments to embark on programs to help the poor.

## References

Aschauer, David A. "Is Public Expenditure Productive ?" Journal of Monetary Economics 23 (1989): 177-200.

Bauer, P.T. Dissent on Development. London: Weidenfield and Nicholson, 1971.

Boone, Peter. "The Impact of Foreign Aid on Savings and Growth." Center for Economic Performance Discussion Paper No. 627, London School of Economics (1994a):

Boone, Peter. "Politics and the Effectiveness of Foreign Aid." Center for Economic Performance, Discussion Paper No. 628, London School of Economics (1994b):

Brandt Commission. Common-Crisis: North South Cooperation for World Recovery. London: Pan, 1983.

Caldwell, John C. "Routes to Low Mortality in Poor Countries." Population and Development Review 12 (2 1986): 171-212.

Cassen, Robert et. al. Does Aid Work ? Second ed., Oxford: Clarendon Press, 1994.

Chenery, Hollis and A.M. Strout. "Foreign Assistance and Economic Development." American Economic Review 56 (1966):

Cheng, Chen. Land Reform in Taiwan. Taipei: China Publishing Company, 1961.

Conteh-Morgan, Earl. American Foreign Aid and Global Power Projection: The Geopolitics of Resource Allocation. England: Dartmouth, 1990.

Dreze, Jean and Amartya Sen. Hunger and Public Action. Oxford: Oxford University Press, 1992.

Friedman, Milton. "Foreign Economic Aid." Yale Review 47 (4 1958): 500-516.

Griffin, Keith. "Foreign Capital, Domestic Savings and Economic Development." Oxford Bulletin of Economics and Statistics 32 (February 1970): 99-112.

Khilji, Nasir M and Ernest M Zampelli. "The Fungibility of U.S. Assistance to Developing Countries and the Impact on Recipient Expenditures: A Case Study of Pakistan." World Development; 19(8), August 1991, pages 1095-105 (1991).

Killick, Tony. The Development Effectiveness of Aid to Africa. World Bank Working Paper Series No. 646, Washington, D.C.: World Bank, 1990.

Levy, Victor. "Aid and Growth in Sub-Saharan Africa: The Recent Experience." European Economic Review 32 (9 1988): 1777-95.

- Maizels, Alfred and Machiko K. Nissanke. "Motivations for Aid to Developing Countries." World Development 12 (9 1984): 879-900.
- McKinlay, R. D. and R. Little. "A Foreign Policy Model of U.S. Bilateral Aid Allocation." World Politics 30 (1 1977): 58-86.
- McKinlay, R.D. and R. Little. "A Foreign Policy Model of the Distribution of British Bilateral Aid: 1960-70." British Journal of Political Science 8 (1978a): 313-322.
- McKinlay, R.D. and R. Little. "The French Aid Relationship: A Foreign Policy Model of the Distribution of French Bilateral Aid: 1964-1970." Development and Change 9 (1978b): 459-478.
- McKinlay, R.D. and R. Little. "The U.S. Aid Relationship: A test of the Recipient Need and Donor Interest Models." Political Studies 27 (2 1979): 236-250.
- Mosley, Paul. Aid and Power: The World Bank and Policy Based Lending. Vol. 1 and 2. London and New York: Routledge, 1991.
- Mosley, Paul, John Huson, and Sara Horrell. "Aid, the Public Sector and the Market in Less Developed Countries." Economic Journal 97 (September 1987): 616-641.
- Organization for Economic Cooperation and Development. Development Cooperation Report. Paris: OECD, 1992.
- Pack, Howard and Janet Rothenberg Pack. "Is Foreign Aid Fungible? The Case of Indonesia." Economic Journal 100 (399 1990): 188-94.
- Pack, Howard and Janet Rothenberg Pack. "Foreign Aid and the Question of Fungibility." Review of Economics and Statistics 75 (2 1993): 258-65.
- Papanek, G. F. "The Effect of Aid and other Resource Transfers on Savings and Growth in Less Developed Countries." Economic Journal 82 (327 1972): 934-951.
- Papanek, Gustav F. "Aid, Foreign Private Investment, Savings and Growth in Less Developed Countries." Journal of Political Economy 81 (1 1973): 121-130.
- Pearson, Lester B. Partners in Development: Report of the Commission on International Development. New York: Praeger, 1969.
- Rostow, Walt Whitman. The stages of economic growth: A non-communist manifesto. Third ed., New York and Melbourne: Cambridge University Press, 1990.
- Sachs, Jeffrey. "Russia's Struggle with Stabilization: Conceptual Issues and Evidence." 1994.
- Uchimira, Kazuko and Hong Gao. "The Importance of Infrastructure on Economic Development." World Bank Latin America and Caribbean Regional Office, Washington D.C.

(1993):

Weisskopf, Thomas E. "The Impact of Foreign Capital Inflow on Domestic Savings in Underdeveloped Countries." Journal of international Economics (1972): 25-38.

World Bank. Evaluation Results for 1988: Issues in World Bank Lending over Two Decades. Washington, D.C.: World Bank, 1988.

World Bank. World Development Report 1993. Washington D.C.: World Bank, 1993.

World Bank. World Development Report 1994. Washington D.C.: World Bank, 1994a.

World Bank. World Tables. World Bank, Washington D.C.: World Bank, (1994b): 750.

## Appendix

### Regression Results and Techniques

The regression results reported here are fully described in Boone(1994a) and (1994b). In these papers Boone presents results using alternative instruments, subsamples, and regression techniques. The main findings are robust when we use fixed effects, generalized least squares, and when we instrument aid using alternative measures of political factors that determine aid flows.

In this paper we have presented results from regressions where we create an instrument for aid by first regressing the aid/GNP ratio of recipients on a range of factors that may be correlated with aid and with the regression residual. For example, income per capita is correlated with both the consumption/GNP ratio and the aid/GNP ratio. By regressing aid on income per capita, and then taking the residuals from this equation, we can purge the correlation between aid and income per capita.

This procedure can be implemented by simply including as right hand side variables those factors that are correlated both with aid and the regression residual. In earlier work cited above we include alternative sets of right hand side variables. The empirical results here are robust once we control for income per capita on the right hand side. But since aid may also be correlated with terms of trade shocks, debt rescheduling, income and population growth rates, and regional dummies, we also include these in the regressions here.

Table A1 reports basic regressions for the main variables in this study. As stated above, the econometric results reported in Table A1 are qualitatively similar when we directly instrument aid flows, and when we use alternative regression techniques and right hand side variables.

The data on foreign aid was provided by the OECD, and all remaining data is from the World Bank. LGNPCAP is the log of GNP relative to OECD countries, and TERMS OF TRADE is the cumulative loss of income measured as a proportion of GNP over the decade.



The terms of trade loss/gain is calculated by the World Bank(1993).

DEBT RESCHEDULING is a dummy set to one in 1981 to 1990 if the country entered into Paris Club negotiations during that period.

Table 5  
 Regressions Showing the Impact of Aid on Consumption,  
 Investment, Infant Mortality, Life Expectancy and Schooling  
 (panel data using base sample with decade-averaged data 1971-80,81-90)

	I	II	V	VI	VII
Dependent Variable:	Public & Private Cons. GNP	Investment GNP	$\Delta \log$ Infant Mortality	$\Delta \log$ Life Expectancy	$\Delta \log$ Primary Schooling
RHS variable:					
AID/GNP	1.016 (4.83)	0.030 (0.17)	-0.202 (0.42)	-0.024 (0.29)	-0.688 (1.30)
LGNPCAP	-0.098 (2.54)	0.035 (1.06)	0.034 (0.32)	-0.005 (0.31)	-0.212 (2.17)
LGNPCAP <sup>2</sup>	-0.007 (1.17)	-0.002 (0.44)	0.018 (1.04)	-0.004 (1.28)	-0.041 (2.40)
Per capita GNP growth rate	-0.076 (3.03)	0.873 (4.12)	-0.563 (0.97)	0.076 (0.76)	1.254 (1.90)
Population growth rate	-1.931 (2.17)	1.988 (2.66)	4.449 (2.00)	-0.072 (0.18)	0.667 (0.30)
Terms of Trade	0.105 (0.27)	-0.168 (0.53)	0.200 (0.23)	0.089 (0.59)	4.198 (4.28)
Debt Rescheduling	-0.008 (0.48)	0.003 (0.26)	0.040 (1.02)	-0.005 (0.78)	-0.014 (0.34)
Sub-Saharan Africa	-0.033 (1.74)	-0.007 (0.44)	0.062 (1.44)	-0.028 (3.40)	0.062 (1.31)
Asia	-0.061 (2.91)	0.021 (1.17)	-0.010 (0.20)	0.002 (0.30)	0.047 (0.90)
Latin America	0.017 (0.99)	-0.040 (2.86)	0.015 (0.38)	0.002 (0.24)	0.034 (0.84)
log(Dependent variable at start of period)			1.001 (11.1)	1.101 (6.38)	0.865 (7.53)
Level of Dependent variable at start of period			0.000 (0.13)	-0.006 (1.78)	-0.003 (1.68)
Time	-0.021 (1.38)	0.012 (0.95)	-0.016 (0.45)	0.004 (0.67)	-0.005 (0.12)
Constant	0.670 (12.5)	0.296 (6.56)	-0.487 (2.10)	0.007 (0.01)	0.693 (1.99)
R2	0.615	0.463	0.963	0.980	0.869
SEE	0.063	0.053	0.145	0.025	0.148
N	123	123	123	123	105

Notes:

1. OLS estimates, t-statistics in parentheses, standard errors are adjusted for a random individual specific component.