Chapter

6

Aid effectiveness, coordination failures, and ownership

A. Introduction

Analyses of aid effectiveness usually focus on the empirical regularities in the relationship between aid inflows and development outcomes without looking at the underlying processes. In order to promote better aid effectiveness, however, it is necessary to understand the mechanisms that link aid with development. Any serious attempt at analysing the question of aid effectiveness has thus to be able to address at least some of the following questions:

- What are the main mechanisms for allocation and utilization of aid flows?
- How have these interacted with domestic policies and development strategies?
- How have the resulting outcomes influenced the overall processes of resource mobilization and allocation?
- Has aid exerted a stabilizing influence at the macro level, or has it increased vulnerability?
- Has aid increased the quantity and quality of public services, and, if so, how has this affected overall productive potential and competitive position?

This chapter addresses these questions with respect to the LDCs. It begins with an overview of the shifting paradigms of the international aid system, focusing in particular on the World Bank's and the donor community's diagnosis of past aid ineffectiveness, and the assumptions which underlie current changes designed to increase aid effectiveness through partnership, ownership and selectivity. Much of the recent debate on aid effectiveness has been founded on cross-country regression analyses which focus on national correlates of the impact of aid. But a central contention of this chapter is that although national policy certainly matters, aid effectiveness has been undermined by the nature of the international aid delivery system, in particular by the working of a diverse and uncoordinated aid delivery system in the era of liberalization. Section C provides an overview of the modalities of the aid delivery system during the adjustment period and up to the present. This is followed in section D by a discussion of the lack of correspondence between evaluations of aid effectiveness at the micro level and the macro level. Sections E, F and G analyse the implications of the international aid delivery system for the macro effectiveness of aid. Section H assesses the new concepts of policy "ownership", "partnership", and "selectivity" in the light of this analysis, and the main conclusions and policy implications are set out in the final section.

Although national policy certainly matters, aid effectiveness has been undermined by the nature of the international aid delivery system, in particular by the working of a diverse and uncoordinated aid delivery system in the era of liberalization.

B. The commonality and diversity of the international aid system

1. Shifting paradigms of the international aid system[1]

There have been three major shifts in donors' approaches to aid since the 1950s. During the earlier decades, up to the late 1970s, foreign aid mainly took the form of project aid in support of the investment plans of the recipient countries. Insufficient savings and/or insufficient import capacity (to import capital goods) were identified as the key constraints on investment, in the tradition of two gap models. The role of foreign aid was to boost investment by reducing the savings gap or the foreign exchange gap. Aid-financed investment, therefore, was seen as the solution to the problem of development. Typically, the recipient Governments would draw up development plans of one sort or another and, on the basis of such plans, produce a list of investment projects. Donors would then choose which projects to finance. Most investment projects consisted of a package (usually managed from the donor side) of aid-financed imports of capital goods and the provision of technical and managerial expertise, coupled with local production and employment financed by recipient Governments. With the exception of food aid, therefore, aid mainly consisted of investment support in the context of project aid.

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During the 1980s a mainstream consensus emerged – expressed in IMF- and World Bank- inspired structural adjustment programmes – that put the blame for the lack of effectiveness of aid squarely on inappropriate domestic economic policies. The approach to aid policy, therefore, shifted away from a strategy of aid-financed investment towards a strategy of aid-induced economic reforms. Aid policy lost its near-exclusive preoccupation with aid as a resource transfer to finance investment and came to consider aid also as a means of forging policy change. Access to aid was made contingent upon the adoption of an appropriate policy framework through the imposition of policy conditionality. Throughout the 1980s and the 1990s policy conditionality was mainly concerned with the adoption of economic reforms through stabilization, liberalization and deregulation of the economies of aid recipients.

The shift in emphasis towards policy conditionality led to the making of the "donor community" as an entity with a dominant, if not overriding, voice in the domestic policy discourses of the recipient countries. Structural adjustment programmes, propelled by the IMF and the World Bank, and the shift in emphasis towards programme aid, created a common platform amongst donors jointly to exert policy leverage on recipient countries. In their relationship with donors, therefore, LDCs no longer only faced a multitude of different parties, but also the donor community as a single negotiating partner in its own right.

Under structural adjustment policies, programme aid gained prominence alongside project aid and became a key instrument to render access to aid contingent upon acceptance of policy conditionalities. As structural adjustment policies took hold, programme aid changed its emphasis in terms of the balance between its main constituent elements – from import support to budget support and debt relief. This was in part a consequence of economic reforms in progress, and in part a reflection of shifting donor concerns. In quantitative terms net disbursements via programme assistance formed a small part of aid flows. According to OECD/DAC figures, programme assistance, inclusive of debt relief, constituted no more than 20 per cent of aid to developing countries in the late 1990s. Under the impulse of structural adjustment, however, project aid also

changed its tune – away from the more traditional investment support within the framework of a development plan and towards semi-autonomous, donor-managed public sector activities with often a considerable recurrent cost component, notwithstanding the almost general practice of listing projects within the development budget (Wuyts, 1996). It is these processes which, as will be shown later in this chapter, have had important consequences for the macro effectiveness of foreign aid.

In the latter half of the 1990s there has been a rapid change in donors' thinking about aid policy, and although this process of rapid change is still unfolding, it has all the makings of a new paradigm. Increasing realization of the failure of adjustment programmes in the low-income countries first led to a rethinking of policy conditionality. The World Bank critique of aid, *Assessing Aid,* conveyed three principal messages; first, aid works in "good" policy environments; second, aid cannot buy "good" policy; and third, aid allocation does not appear to be based on policy environment (World Bank, 1998). The second proposition drew on a growing number of evaluation reports, case studies and research papers, which indicated that sustainable and effective policy change critically depends on local "ownership" of policies. *Assessing Aid* combined this message with the remnants of the old thinking during the conditionality era, i.e. "we" know what "good" policies are, but we cannot force "them" to "own" such policies by old-style conditionality. Consequently, if there is no internal political platform within a country to set and "own" the right policy environment, aid will fail to be effective. If, however, such a platform (rooted in democracy, good governance and good policies) does exist – it was argued – aid will not only prove to be effective, but also essential for sustained development. The conclusion which has been drawn from this is that aid effectiveness can be increased by directing aid to countries with "good" policies, and persuading the laggards to "own" good policies by giving them advice, consultation and incentives through withholding of aid. This is expressed in the idea of *ex-post* conditionality or "selectivity".

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The driving force for change is coming more from serious concerns on the part of aid practitioners, associated with bilateral donor agencies, or multilateral agencies such as DAC/OECD, UNDP and World Bank Operations Evaluation Department (OED). Helleiner's report on aid to the United Republic of Tanzania and its follow-up (see Helleiner et al., 1995), and the OECD/UNDP joint project on aid to Mali (see OECD/UNDP, 1999), constituted the beginning of a new "official" approach to aid effectiveness which was very distinct from the conditionality paradigm. The new Comprehensive Development Framework (CDF), launched by the World Bank's president in 1999, also seems to herald a new approach by the World Bank, which is self-styled as part of a new development paradigm as set out in the 1999 *Annual Review of Development Effectiveness* by the Bank's Operations Evaluation Department (see World Bank, OED, 1999a).

The summary of the World Bank/OED document (World Bank, OED, 1999b) points out that "in the era of adjustment the Bank often ignored local knowledge and expertise and was assumed to have all the answers – its only problem was selling those answers to the clients" (p.3). The new CDF is said to pay attention to institutions and hence the specificity of local situations, and "aims to put the country in the driver's seat in formulating and implementing development strategy which must involve also the private sector and the civil society". Donors and multilateral institutions are expected to harmonize their programmes and practices, and work with country "partners" in a framework of mutual accountability. Blanket liberalization and privatization policies are to give way to

"liberalization, regulation, and industrial policy to match state capability"(p.2). The new approach is holistic in the sense that "it has to go beyond macroeconomic management and incorporate governance, human, and social development objectives". This multiplication of objectives echoes the general tendency in donors' thinking during the 1990s where a multiplicity of issues such as poverty, environment, gender and governance are mentioned alongside economic growth (see, for example, OECD, 1999).

2. Some central assumptions

Whether or not the new vision will lead to improved aid effectiveness depends on the extent to which it is based on a realistic diagnosis of the problems of the existing aid institutions and practices. Perhaps the central proposition of the new approach is that aid *will* be effective under "sound" economic policies by recipient Governments.[2] In other words, other things being equal, "sound" economic policy in the recipient country is not only *necessary* but also *sufficient* for aid effectiveness. This is also echoed by the following quotation from USAID (1991: ix) in the context of aid to Africa: "AID should put its time and energy into the development of analytically sound reform programme and worry less about the type of reform assistance it provides". But this view rests on a number of important implicit assumptions about the international aid delivery system.

Whether or not the new vision will lead to improved aid effectiveness depends on the extent to which it is based on a realistic diagnosis of the problems of the existing aid institutions and practices.

The first is that there are no major negative externalities associated with the "type of assistance provided" which can overshadow the possible returns. For example, if foreign assistance leads to the creaming off of scarce skilled personnel from the civil service and the private sector, and engages them in activities with a low social rate of return, there would be cause to be concerned about the type of assistance. However, if the total size of foreign aid relative to the domestic economy were small, there would be perhaps less cause to "worry" about the "type of assistance".

The second implicit assumption, therefore, is that the size of aid flows relative to domestic macroeconomic magnitudes is small. While this is normally the case for individual projects, it may not be true at a more aggregate level. In the case of the LDC economies in particular, as observed in chapters 1 and 2, aid flows overshadow the domestic sources of finance. Indeed, given the large size of the aid flows relative to government budget and external trade flows in the LDCs, macroeconomic stability as well as the efficiency of investment in most of these countries would be themselves largely dependent on the nature of the aid delivery system.

The third implicit assumption is that aid is well coordinated with the policies and priorities of the recipient countries. This is the case, for example, in the common pool approach to aid, in which aid is deposited by donors in a common pool for utilization by the host Government according to some mutually agreed development plan.[3] But in the era of adjustment and liberalization, government-led coordination withered. Donors were able to coordinate their policy conditionality around IMF and World Bank adjustment programmes. But at the same time, the donor community was, and is, by no means a homogeneous entity. On the contrary, as pointed out by Kanbur, Sandler, and Morrisson (1999), donors have contrasting histories, experiences, and ideas, and these influence the projects and programs they are willing to support. Thus, relatively strong coordination of policy conditionality has coexisted with great diversity in terms of aid delivery. This tension between the

commonality of policy conditionality and the fragmentation of the aid delivery system has played a significant part in reducing aid effectiveness and in disrupting the developmental processes in the LDCs during the past two decades.

C. The diversity of the aid delivery system and the "coordination problem"

Currently, in most Asian and African LDCs between 30 and 50 bilateral and multilateral official aid agencies are engaged in aid projects, which number at least a few hundred in each country. To this should be added hundreds of foreign NGOs and aid charities with their own aid delivery channels and a variety of objectives and work practices. Although most of the recorded official aid flows are reflected in the recipient countries' government budgets mainly as development expenditure, the magnitude, allocation and utilization of aid moneys are by and large outside centralized and coherent government decision-making processes in these countries. The various outside aid agencies play a dominant role in the design and implementation of aid projects, partly in conjunction with local ministries and agencies and partly by setting up parallel management frameworks – and increasingly through NGOs.

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This diverse and fragmented aid delivery system is well characterized in a recent joint report by OECD and UNDP on Mali, which is one of the rare studies of the aid system largely from the viewpoint of the recipient country and in a comprehensive national framework (see OECD/UNDP, 1999). A summary of the main findings of the Mali report can give a picture of the aid delivery system that is not atypical of the prevailing situation in other LDCs. Mali is a typical LDC economy in that foreign aid plays a dominant role in macroeconomic aggregates. According to World Bank figures, foreign aid has constituted about 80 per cent of government expenditure, about 20 per cent of GNP, and between 90 and 200 per cent of gross domestic investment, and on average has financed over 50 per cent of imports in Mali over the past two decades (World Bank, 2000b).[4] The case of Mali is also instructive in that, having had a representative and democratically elected Government since the early 1990s, it represents the current aid delivery system at its best, least diluted by corrupt practices of aid-dependent autocratic rulers. Mali has also been one of the countries in sub-Saharan Africa which according to the World Bank has had a relatively successful policy reform record (World Bank, 2000a).

The diversity of the aid delivery system in Mali is highlighted by the fact that, for example, in 1996 the donor community comprised about 30 bilateral agencies and 20 multilateral agencies and a very large number of NGOs, "each with its own strategies, values, culture and customs, and work procedures" (OECD/UNDP 1999: 22). The fragmentation of the aid delivery system and its lack of integration in the national management structures and economy also stand out. According to the Mali aid report (p. 22):

> Frequently, national institutions and procedures and sometimes also national managers are not called upon in the first instance to manage aid operations, which in large part are conducted by parallel structures and expatriate staff using donors' procedures. This is illustrated by a large number of projects conducted outside the Three year Investment Programme (TIP) and the Special Investment Budget (SIB)… A similar lack of integration is found with the country's economy. Aid is not integrated into public and private economic channels. Tied aid and tax-exemptions

> for aid-related imports generate parallel channels and procedures. Similarly, donors' remuneration practices are not in line with local conditions and create distortions in government's pay policy.

The difficulties of aid coordination, and integration into the national economy, are further exacerbated by lack of information. "The national authorities are often unable to state exactly the amount of aid flows that have been negotiated, and some [aid] agencies have difficulty keeping track of their own operations (commitments, disbursements, actual expenditure as compared with budgeted expenditure, the cost of consultants in staff months, projects in preparation, etc.)" (p.12). A consequence of this is that the aid flows given in Malian statistics represent only between one and two thirds of the official figures published by OECD and UNDP in their development co-operation reports (p. 21). Although formal government institutions in charge of coordination of foreign aid exist, these are normally bypassed by the donors and the line ministries. "In practice, sectoral ministries often submit requests to the donors themselves; in other cases, the donors may even indicate the requests they would like to see submitted to them" (p. 21). This, according to the report, has led to a proliferation and duplication of projects, disregard of national priorities in project choice, and a general breakdown of aid coordination.

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Although comprehensive economy-wide surveys of the aid delivery system for many other LDCs are not available, the existing evidence does not suggest any better coordination than the Malian case for most countries, and perhaps even worse in the case of some.[5] The following observation by one of the long time observers of the international aid scene paints a picture similar to the Malian case for the sub-Saharan African LDCs in general:

> A remarkably high percentage of bilateral development assistance to low-income Africa goes directly to overseas contractors' foreign personnel, or to local suppliers, non-governmental organizations, or even local government officials (topping-up their inadequate salaries), without going through any local government budgetary system. The local governments frequently have no information on these flows or on the projects they support. Indeed most donors cannot or will not supply information on these flows to the local government even when they are asked to do so. Externally-supported projects frequently exist as "islands" within the local economy and society, supplying certain services to a select few but otherwise unconnected in any way to indigenous development processes (Helleiner, 1997).

This has been recognized as a general problem by the donor agencies themselves for some time; as, for example, a recent aid evaluation report by the World Bank indicates, "the development assistance system is too fragmented and onerous, particularly for the poor and weak countries" (World Bank/OED, 1999: 3).[6] However, the operation of this "fragmented and onerous" system for such a long period of time has had important implications for aid effectiveness both at the micro and macro levels.

D. Consequences for aid effectiveness

One of the well-known paradoxes of the aid system is that the evaluation of the individual aid projects at the point of exit, assessed by donors, often indicates "satisfactory" outcomes with high rates of return, but at the macro level the results are much less satisfactory. For example, a recent World Bank evaluation shows that over 70 per cent of its projects during the 1990s were

evaluated at the point of exit as satisfactory (World Bank/OED, 1999a). The same document at the macro level, however, maintains that "the fight against poverty is being lost, and the efficacy of the development assistance system is being questioned" (p. 1). High rates of "satisfactory" evaluation of projects are also common amongst the bilateral and other multilateral donors, which are difficult to reconcile with poor economic performance at the aggregate macro level.[7]

There are a number of reasons which may explain this apparent discrepancy between the assessed micro and macro impact of foreign aid, some relating to the nature of assessment itself and others to the negative feedbacks between aid projects and other developmental processes in the recipient countries. One reason for over-optimistic evaluation of projects by the donors can be that the assessments are based on donors' objectives and criteria, which may not necessarily be in tune with the long-term developmental needs of the recipient countries. The project managers in donor agencies are accountable to their own governments rather than to those who are affected by foreign aid in the recipient countries.

The agencies' incentive structures are hence such that short-term objectives, such as timely disbursement of aid moneys and satisfactory evaluation at the point of exit, may overshadow the longer-term and broader developmental impact of their projects. For this reason the evaluation of the sustainability of the aid projects normally produces much poorer results than spot evaluations at the point of exit. For example, only about 30 per cent of the World Bank projects in Africa during the 1990s were assessed as likely to sustain their "satisfactory" performance after delivery (World Bank/OED, 1999a, p. 37). And this 30 per cent success rate has itself been based on prospective assessment of sustainability by the donor at the point of exit rather than on observed long-term performance of the projects.

The poor integration with the domestic economy and national management structures often leads to the projects losing direction and finance once the donor agency exits after the completion of the project.

The apparently low rates of sustainability of the aid projects are not due solely to the incentive structures of the donor agencies at the design and implementation stage of the projects, i.e. the focus on short-term donor-centred results. An even more important reason is that the poor integration with the domestic economy and national management structures often leads to the projects losing direction and finance once the donor agency exits after the completion of the project. According to the Mali aid review, less than 20 per cent of the projects in Mali received counterpart financing by the recipient Government or other local beneficiaries, and because of this, "the probability of projects being sustained beyond the period of external financing is often diminished" (p. 22). This is, of course, only one of the implications of the fact that aid-funded projects are increasingly taking the form of islands amidst an increasingly impoverished public sector.

The poor integration with the domestic economy poses even more serious problems for the macro effectiveness of aid. But before these problems are examined, a number of points concerning the measurement of what constitutes aid and aid effectiveness are in order. First, what the donors regard as aid, i.e. the net official loans and grants registered in the international financial statistics, are normally largely at variance with the official statistics on aid in the recipient countries. For example, the aid flows given in Malian statistics represent only between one and two thirds of the official figures published by the OECD and UNDP in their development cooperation reports (p.21). Secondly, not all aid has or is meant to have a developmental impact. For example, a growing proportion of aid over the past two decades has been allocated to emergency

and humanitarian causes without direct developmental impact (see chapter 2). Thirdly, to the extent that aid is tied to the purchase of possibly inappropriate and expensive goods and services from the donor country, the return to investment financed by such aid is accordingly less. This effect, however, will be to a large extent captured by low returns to individual projects reflected in the micro effectiveness of aid discussed above.

Technical cooperation is a form of aid that epitomizes the debilitating effects of a combination of the above factors on aid effectiveness. It forms a substantial part of aid to the LDCs. Technical cooperation is tied aid in more than one sense of that term. First, it is tied in the sense that often "its provision is a condition associated with the provision of finance and other forms of assistance" (Helleiner, 1997: 3). Secondly, it is tied in the sense that it takes the form of direct, and often unsolicited, provision of experts, instructors or educational services by the donor. Much of the funds allocated under technical cooperation accrue directly to the individuals and institutions in the donor country without being reflected in the balance of payments or government accounts of the recipient country. This may be part of the explanation of the large discrepancy in registered aid funds in the donor and recipient accounts. The evaluation of the impact of technical cooperation in the LDCs particularly in sub-Saharan Africa, either in terms of its role in technology transfer or in capacity building, also indicates quite abysmal results (see, for example, the UNDP study by Berg, 1993). According to the UNDP study, the elements enumerated above, i.e. multiplicity and duplication, wrong incentive structures, and lack of integration with domestic structures, have all played their role in the failure of technical cooperation. In addition, there have been important negative externalities associated with technical assistance, ranging from distorting government pay structures, discouraging learning and capacity building in public institutions, to additional monetary costs for the recipient governments. As pointed out by Helleiner (1997: 3), technical assistance "typically has carried enormous costs not only in terms of the opportunity cost of the donor funds but also in local costs associated with 'servicing' inexperienced and expensive foreigners". Such negative externalities, however, form an important part of the explanation of the poor macro effectiveness of foreign aid in general, to which we shall now turn.

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E. Macro effectiveness of foreign aid: (1) aid and economic volatility

The aid delivery system can influence the macro effectiveness of aid, and the overall efficiency of resource use in the recipient country, in various ways. A first question is whether foreign aid flows are reliable. Since aid flows are large relative to other macroeconomic aggregates in the LDCs, their instability can lead to macroeconomic instability with obvious negative consequences for the efficiency of resource use. Such instability would in addition make the task of investment planning difficult and lead to lower rates of both private and public investment. The second related question is whether the volatility of aid flows has been covariant with other sources of foreign exchange and government revenues in the LDCs, and if so, in which direction. Depending on the responsiveness of aid to the short-term liquidity problems of the LDCs arising from external shocks, it can influence the vulnerability of the LDC economies in a negative or positive way. For a number of reasons this role of foreign aid, namely its liquidity provision role, can be critical in the case of the LDCs. As discussed in chapter 1, the LDCs have been extremely vulnerable to short-term external shocks arising from natural causes or the vagaries of the international

economy. Furthermore, lack of recourse to international capital markets makes these economies almost totally dependent on foreign aid to alleviate or smooth out the consequences of external shocks for their foreign exchange and government revenues. The alternative would be to carry large foreign exchange reserves, which would be too costly for the LDCs. Whether foreign aid has intensified or compensated for the instability resulting from external shocks is therefore of paramount significance.

Foreign aid seems to have been more volatile than government current revenue in almost all the LDCs.

In order to examine the relative volatility of aid flows, we have measured in table 40 the coefficient of variation of annual changes in aid flows, government revenues excluding grants, and export revenues. The volatility of aid is measured both in domestic currency, for comparison with government revenue, and in dollar terms to be compared with exports. As shown in table 40, foreign aid seems to have been more volatile than government current revenue in almost all the LDCs, and it has shown higher annual variations even with respect to the extremely volatile export revenues in the majority of countries listed in the table.[8] Apart from the relative volatility of aid, what matters from the point of view of overall economic stability is whether the short-term variations in aid have alleviated or intensified the effect of external shocks. To determine this, the correlation coefficients between annual variations of aid and government

TABLE 40: VARIABILITY AND CO-MOVEMENT OF AID, GOVERNMENT REVENUE, AND EXPORTS IN LDCS, 1970–1998

	Coefficient of variation of annual growth rates				Correlation coefficient between Annual variations in aid and[a]	
	Aid in domestic currency	*Government revenue*	*Aid in $*	*Export revenue $[b]*	*Government revenue*	*Export revenue*
Bangladesh	3.71	0.88	2.90	1.37	0.671	-0.076
Burkina Faso	1.57	1.38	1.86	2.23	0.425	0.452
Burundi	1.71	1.14	2.68	13.70	0.288	-0.099
Dem. Rep. of the Congo	4.67	3.45	5.55	4.58	0.789	0.223
Ethiopia	1.75	1.53	2.24	2.12	-0.207	-0.237
Gambia	2.44	0.88	2.85	2.00	0.478	0.002
Lesotho	1.44	0.79	2.93	2.10	0.112	0.635
Liberia	3.27	1.74	3.27	2.79	0.369	0.377
Madagascar	1.61	1.40	2.69	2.32	-0.326	0.149
Malawi	1.30	0.46	2.05	2.88	0.131	0.241
Maldives	2.57	1.23	2.43	1.95	0.656	0.001
Mali	2.05	0.73	2.12	1.73	0.048	0.191
Myanmar	3.71	1.03	4.05	2.23	-0.250	-0.099
Nepal	1.16	0.48	1.77	1.25	0.046	0.341
Rwanda	2.02	0.87	2.08	6.53	-0.078	-0.408
Sierra Leone	1.42	1.33	2.51	15.07	0.567	0.163
Solomon Islands	2.14	0.63	3.24	1.77	-0.283	-0.095
Sudan	1.93	0.71	3.35	4.22	0.425	0.148
Togo	2.48	1.66	2.66	3.26	0.460	0.385
Uganda	1.66	2.25	2.66	4.60	-0.065	-0.376
United Rep. of Tanzania	1.21	0.53	1.79	3.95	0.455	-0.117
Vanuatu	2.74	0.61	2.79	1.61	0.135	0.144
Zambia	1.40	1.30	2.49	7.61	0.543	0.256
Mean	**2.17**	**1.18**	**2.74**	**4.00**	**0.234**	**0.096**
Median	**1.93**	**1.03**	**2.66**	**2.32**	**0.288**	**0.148**

Sources: World Bank, *2000b; World Bank, 2000c*, UNCTAD calculations.

a Measured in domestic currency for government revenue and in United States dollars for export revenues (including factor incomes). Official exchange rate is used for conversion.

b Export revenues include income from abroad.

revenue, and aid and exports, are shown in the last two columns of table 40. Also, the histogram of the estimated correlation coefficients for the two series are reported in charts 47 and 48. As can be seen, the correlation between short-term variations of aid and the other two variables is rather weak, and in the

CHART 47: HISTOGRAM OF THE CORRELATION COEFFICIENTS BETWEEN AID AND GOVERNMENT REVENUE VARIATIONS IN THE LDCs, 1970–1998

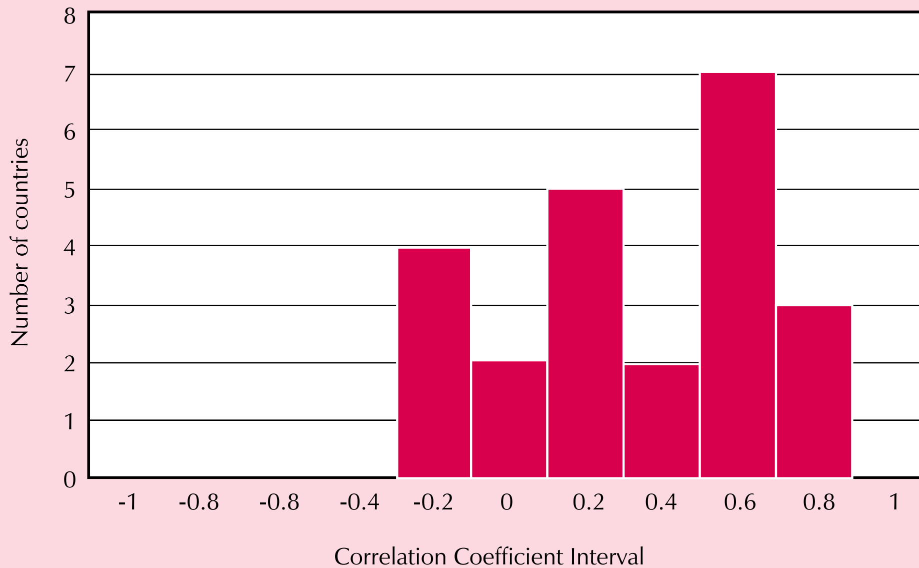
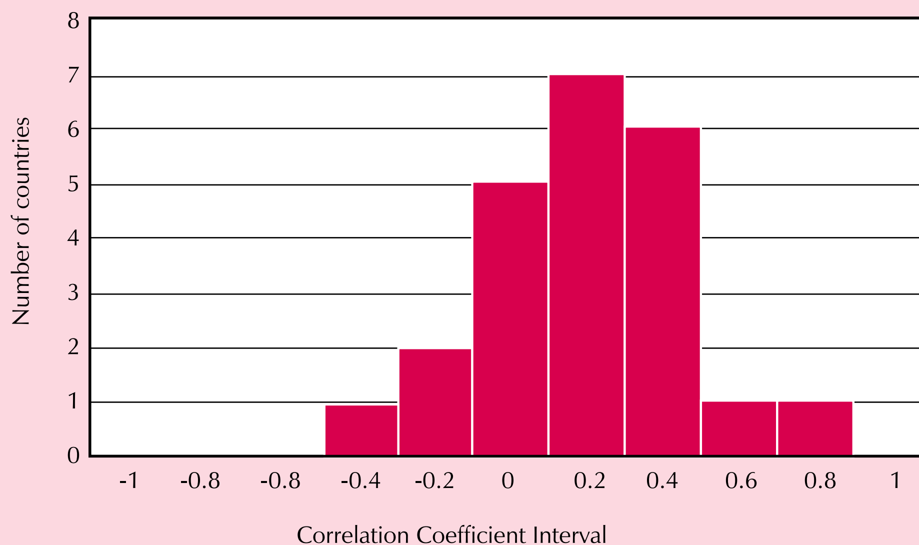


CHART 48: HISTOGRAM OF THE CORRELATION COEFFICIENTS BETWEEN AID AND EXPORT REVENUE VARIATIONS IN THE LDCs, 1970–1998



Source: As table 40.

majority of cases, there seems to be, if anything, a positive correlation between aid and the other two variables. It appears, therefore, that foreign aid by and large has not alleviated the effect of short-term external shocks in the LDCs, and has, if anything, reinforced the effect of such external shocks.

These results, which are in conformity with other findings in the literature, are not unexpected.[9] There is no reason why the multi-donor-driven and uncoordinated aid delivery system should particularly generate a stable and predictable flow of funds. Even if the overall committed aid budgets of the donor countries are relatively stable, disbursements to individual recipients can be quite volatile as a result of changing economic and political conditions, unexpected humanitarian emergencies in other recipient countries, and administrative delays. With regard to the covariance of the aid flows and other macro variables, there seem to be in fact a number of in-built mechanisms in the aid delivery system which are likely to generate a pro-cyclical variation in aid flows. Despite the growing emphasis on programme aid during the past two decades, the logic of the international aid delivery system has essentially worked against the potential role of aid in short-term liquidity provision. Bilateral donor agencies are more concerned with the stability of aid disbursements from the point of view of the overall commitments of the donor country than with unexpected external shocks in the recipient country. This also applies to programme aid, which apart from being a small part of bilateral aid often committed to specific programmes, is also subject to stop-go short-term conditionalities that essentially preclude it from playing its "quick disbursement" role. Furthermore, the IMF has failed to fulfil its function as the provider of contingency funding in the case of the LDCs, as its funding has been subject to conditionalities involving delays and large transaction costs, and the net resources provided have been in any case well short of the requirements to deal with the LDC shocks (Helleiner, 2000). On the contrary, in cases where the negative external shocks have caused the LDC Government to be unable to fulfil the IMF conditionality, the negative signal to the donor "community" at large has often caused a partial withdrawal or delay of funds at a time of need (Sachs et al., 1999). Furthermore, the complementarity of much of bilateral aid with the domestic currency resources of the recipient Government introduces an additional pro-cyclical tendency in the aid delivery system; negative external shocks lead to the recipient Government not being able to provide domestic counterpart financing and hence delaying the disbursement of aid. The overall logic of the aid delivery system, therefore, entails aid's pro-cyclical behaviour vis-à-vis external shocks rather than a compensatory role.

Despite the growing emphasis on programme aid during the past two decades, the logic of the international aid delivery system has essentially worked against the potential role of aid in short-term liquidity provision.

This phenomenon has had profound implications for aid effectiveness, and for investment and growth and the overall efficiency of resource use in the LDCs. The volatility of the aid flows has contributed to macroeconomic instability. Ironically, the community of donors has treated macroeconomic stability as a key component of policy reform conditionality since the early 1980s. This may be one reason why as soon as measures such as overall volatility or aid uncertainty are introduced into cross-country regressions of aid effectiveness the macro-policy index loses its significance (see, for example, Lensink and Morrissey, 1999, and Guillaumont and Chauvet, 1999). As pointed out by Lensink and Morrissey, "It appears reasonable to claim that aid will be more effective under certain policy environments, notably those that are themselves conducive to growth. It is less clear that conditional aid promotes such policy environments. If conditionality leads to greater uncertainty (and/or lower investment), and there are reasons to believe it does, then it may actually reduce the effectiveness of aid. The links between aid, policy and growth are more complex than simply stating that aid works if the right policies are present"

The volatility of the aid flows has contributed to macroeconomic instability.

(p. 22). As appears from the above discussion, not only conditionality but also, and perhaps more importantly, the diversity of the aid delivery system seem to have undermined macroeconomic stability and hence aid effectiveness.[10]

F. Macro effectiveness of foreign aid: (2) the erosion of state capacities

There are, however, other more important factors associated with the diversity of the aid delivery system which have contributed to the undermining of the macro effectiveness of aid in the LDCs. These factors can be grouped under the generic title of externalities arising from lack of coordination and integration of the aid delivery system. Foreign aid provides additional resources for the recipient countries, which can lead to the generation of new capacities and better utilization of the existing capacities in those countries. The productive use of aid funds, however, always requires complementary domestic resources in various forms, e.g. manpower, local government funds and public services, and services from other local institutions. Where the return on aid-related projects is higher than the return on the uses to which these complementary domestic resources were hitherto applied, the overall productivity in the economy will rise. In addition, aid-funded projects, when well coordinated and integrated into the domestic economy, can produce additional positive synergies in the economy through the transfer of new technology and know-how, learning and other positive externalities, which could bring about additional productivity increases. Even if the immediate returns on aid-funded investments are relatively low, they can still help increase overall productivity in the economy through their technological and learning effects.

The productive use of aid funds always requires complementary domestic resources in various forms, e.g. manpower, local government funds and public services, and services from other local institutions.

During this process, along with productivity growth the wages and prices of the local services rise relative to the prices of internationally traded goods. This process of productivity growth with its attendant real-wage and relative-price changes, which is the very essence of economic development, is sometimes mistaken for the so-called "Dutch Disease" phenomenon. This phenomenon, however, is relevant to the situation of developing countries subject to sudden capital inflows or temporary export booms. It is of little relevance to the analysis of the impact of aid in the case of LDC economies with their severe capital shortages, to the extent that aid funds are productively employed in developmental activities.[11]

However, when the activities of the various donors are not coordinated and the aid delivery system is not integrated into the domestic economic processes, aid would not only fail to generate the expected positive externalities, but might also give rise to considerable negative effects. Under these circumstances, aid can swamp the capacities of the local institutions, weaken the ability of recipient Governments in the provision of vital public services, and distort the overall allocation of resources away from the strategic priorities of development. While each aid project may be well designed and well implemented, and address some vital economic need from the micro perspective, the aggregate outcome would be much less than the sum of the parts. The problem here is not the size of foreign aid per se, or what in the classic aid literature has been referred to as the lack of absorptive capacity in the recipient countries. On the contrary, as pointed out in other chapters of this report and as is almost unanimously agreed by analysts, economic development in the LDCs in fact requires much higher amounts of foreign aid than they currently receive (see, for example, ESCAP, 1999; Collier, 1999; UNCTAD, 2000; World Bank, 2000a: 243). The main

problem is rather the lack of coordination of the aid delivery system, and the low degree of integration of the aid system into the local economic and administrative structures.

This lack of coordination and integration of the aid system can lead to a fragmentation of decision-making and a proliferation of projects and procedures which put increasing pressure on the meagre resources of the recipient Governments. Over time it can lead to a gradual erosion of the capacity of the recipient Government even to meet its basic recurrent expenditures – a situation which can be referred to as extreme "aid dependence". There are normally various mechanisms at work to bring about this situation. Foreign aid projects in the LDCs, though nominally in the public sector, have been controlled by the donors, at least until the completion or the "exit" date when the projects are expected to be handed over to the recipient Government. Wages and salaries in these projects are also usually set by the donors, often not in conformity with public sector pay scales. A prolonged adverse external shock, as for example happened in the late 1970s and early 1980s, followed by a relatively large increase in aid and at the same time a tightening of the recipient government's resources, can set the process going. There would be a proliferation of donor projects, increasing the demand for professional staff at a time when the tightening government budget is leading to increasing wage erosion in the government sector. Those parts of the Government that do not receive donor funds gradually lose their key staff as they lose the ability to pay competitive salaries. The gradual decline in public services leads to the erosion of its ability and capacity to raise revenues.

Those parts of the Government that do not receive donor funds gradually lose their key staff as they lose the ability to pay competitive salaries. The gradual decline in public services leads to the erosion of its ability and capacity to raise revenues.

A number of other factors, in-built in the international aid delivery system, further contribute to the implosion of State finances. The increasing GDP share of donors' expenditures, which normally benefit from various tax and duty exemptions, further reduces the capacity of the Government to raise revenue. Over time the government budget may be also increasingly burdened by the debt service obligations on foreign aid. While the projects and programmes being implemented are by and large controlled by the donors, the debt service on aid funds is very much "owned" by the central government budget.[12] A growing proportion of the meagre government resources is also increasingly spent on negotiations with various donor agencies with a variety of procedures and principles, and on debt rescheduling negotiations (see, for example, Killick, 1993, and Wuyts, 1996).

Furthermore, the currency devaluations accompanying the adjustment policies substantially increase the command of the aid funds in domestic currency, while at the same time increasing the domestic currency denomination of the debt service obligations for the recipient government. The governments' room for maneuver can be particularly restricted under the IMF ESAF-funded programmes where budget deficit targets are set with the exclusion of grants. In addition, the problems can be magnified when the bias of such programmes is towards cutting the recurrent expenditure (mainly the wage and salary bill) rather than the capital expenditure, as has been the case in the ESAF programmes. And even more so when the outcome of the programmes is by and large to reduce the wage and salary rate rather than public sector employment, as has also been the case in the ESAF programmes (see IMF, 1998: 4-5).

The downward spiral is complete when the donors increasingly realize that the national governments are no longer in a position to run the completed aid projects – the well-known recurrent cost problem. For the projects to survive, the donors find themselves increasingly enmeshed in continued support of

recurrent costs, and the cash-strapped recipient Governments, in order to comply with the terms of policy conditionalities, increasingly resort to imaginative accounting procedures whereby recurrent expenses are allocated under development finance (Wuyts 1996). Ironically, the recurrent cost problem has become particularly acute not during the investment support era of the 1960s, but during the programme aid era of the 1980s and the 1990s.

Most of the above processes have been at work in most LDC economies, albeit with differing degrees of intensity. The most intense cases are perhaps to be found amongst the sub-Saharan African LDCs, where the initial conditions in terms of the government administrative capacities and aid coordination capabilities were most fragile. The following excerpt from a recent study of aid and capacity building in sub-Saharan Africa paints a graphic picture:

> Many of the institutions [that] donors have supported in Africa cannot continue to operate without external support. Most African states lack the resources to run the institutions on their own – they cannot, or do not want to allocate scarce state funds to them. In some cases the ‘output’ from the organizations is, however, so valuable to the country that donors and recipients agree to run the institutions – i.e. to provide for their recurrent costs – for some time. During the 1990s this has increasingly been the case when the state finances have imploded in country after country. A number of roundabout ways have been invented to hide the fact that payments are for salaries, but donors and recipients have rarely admitted that topping-up allowances etc. are in fact carried out just because normal salaries are too low to keep the organization together… The financial collapse of the states has eroded the real value of the salaries to a fraction of what they were ten years ago. The institutions are deserted, not in the number of staff, but in capacity and knowledge. Professional staff are forced to have several occupations, and they spend less and less time at the institutions… A catastrophic destruction of knowledge and competence is occurring in Africa (Hesselmark, 1999: 2-3).

This picture is not very different from what individual country studies in the case of some sub-Saharan African LDCs portray (see, for example, Wuyts, 1995, 1996; OECD/UNDP, 1999; Helleiner et al., 1995; ESCAP, 1999). For example, the OECD/UNDP Mali aid review has the following to say on the links between aid and the system of governance in that country:

> In particular, the civil service underwent a marked decline in the 1980s, which still does not seem to have been really reversed. Handicapped by a failure to renew structures and an aging, de-motivated workforce, the public sector is withering away, while its managers grasp job opportunities in the development projects and programmes financed by donors. The root cause seems to be the lack of effective human resource management in the public service, rather than a lack of competencies. The on-going emergence of civil society and the decentralization process under way make the challenges facing the civil service all the greater. Increasingly it is required to behave as a partner in, rather than a manager of, development. Also, some of the development partner practices, especially overuse of conditionality and the creation of parallel management structures for projects, have helped to exacerbate the decline of Malian civil service (p. 20).

The above quotation points to a very important fact about the role of the LDCs and other young post-colonial States which is often forgotten in some of the more technocratic and economistic approaches to development policy. The role and the position of the State in such societies are different from what they

are in advanced industrialized States, where centuries of modern economic development has created a well-integrated web of appropriate institutions, rules, laws and strong civil society organizations, within which the markets play an important integrating social function. In many post-colonial LDCs such institutions did not exist, markets were not all-encompassing and integrative on a national scale, and in some countries even the basic institutions of private property were not yet in place in a large part of the economy. In such societies the States themselves play an important integrative and institution-building role. The move to the more market-based strategy of development, since the early 1980s particularly, actually involved *additional* administrative and organizational functions for these States in order to create the preconditions for the proper functioning of the markets and the strengthening of civil society organizations and institutions. During such reform periods, an increase rather than a decline in the financial and administrative resources of the Government is required. The erosion of those resources of Governments during this critical period would affect not only aid effectiveness but also the efficiency of resource use in the economy as a whole, and in extreme cases could lead to the unraveling of the social cohesion and national integrity of the country. It is not surprising that more than a quarter of LDCs during the 1990s have been subject to disruptive civil wars or serious armed conflicts, and an increasing amount of aid to these countries has been absorbed by humanitarian, peacekeeping and post-conflict reconstruction assistance.[13]

G. Macro effectiveness of foreign aid: (3) aid and budgetary squeeze in the LDCs

Although the experience of different LDCs with regard to aid coordination and government budgetary procedures and developments has varied, it would nevertheless be instructive to examine some of the overall tendencies in the fiscal structures of those economies as compared with other developing countries during the past few decades. Table 41 compares the overall fiscal structure of the African and Asian LDCs with that of other developing countries, and of other low-income countries, for the period 1970-1998.[14] Due care must be taken in comparing the average figures for different variables, as the sample of countries varies depending on the availability of data for each variable. The table, however, highlights some interesting overall tendencies in the fiscal structure of the LDCs as a group in relation to the above discussion on aid dependence and fiscal squeeze.

The first outstanding feature of the fiscal structure of the LDCs is that the GDP share of tax revenues and current revenues (excluding grants) seems to be on average significantly lower than that of other developing countries, including the other low-income economies.

The first outstanding feature of the fiscal structure of the LDCs highlighted in Table 41 is that the GDP share of tax revenues and current revenues (excluding grants) seems to be on average significantly lower than that of other developing countries, including the other low-income economies. There appears to be some debate on the policy implications, particularly in the context of African LDCs. On the one hand, the IMF in the context of its ESAF programmes, by targeting the fiscal deficit excluding grants, maintains that government budgets cannot rely on the unstable flow of external grants, and hence in addition to current expenditure cuts, improved tax performance is essential. On the other hand, Collier (1999) and a number of papers emanating from the World Bank's research department maintain that higher taxes in such economies would be distortionary and hence in the medium term greater reliance should be placed on foreign aid to bridge the fiscal gap.

Table 41: Comparative aspects of fiscal structures in the Asian and African LDCs, 1970–1998

	Current revenue (% GDP)			Tax revenue (% GDP)			Total expenditure (% GDP)			Current expenditure (% GDP)		
	1970-80	*1980-90*	*1990-98*	*1970-80*	*1980-90*	*1990-98*	*1970-80*	*1980-90*	*1990-98*	*1970-80*	*1980-90*	*1990-98*
Group averages												
LDCs	14.6	14.9	15.0	11.3	12.1	12.3	18.2	22.4	22.3	13.5	14.8	14.6
Other developing[a]	21.9	23.0	22.5	16.6	18.5	18.5	24.5	27.7	26.8	18.2	20.5	20.7
Other low-Income[b]	20.6	22.3	20.7	15.9	17.6	15.9	24.5	28.4	25.3	18.3	21.4	20.9
t-test for the significance between the means												
LDC and other developing	-3.87*	-3.60*	-3.20*	-4.50*	-3.11*	-2.44*	-2.51*	-1.35	-1.25	-2.49*	-1.93*	-2.14*
LDC and other low-income	-2.25*	-2.32*	-1.97*	-2.34*	-2.10*	-1.18	-1.66	-1.18	-0.74	-1.58	-1.69*	-1.87*
Number of LDC observations	21	21	21	16	16	16	12	12	12	10	10	10

	Current education expenditure (% GDP)			Capital expenditure (% total exp.)			GNP per capita, PPP, 1980-90
	1970-80	*1980-90*	*1990-99*	*1970-79*	*1980-90*	*1990-98*	*current international $*
Group averages							
LDCs	2.8	3.0	2.8	23.7	34.9	32.3	1 034
Other developing	3.3	3.6	3.8	24.4	21.1	18.4	2 800
Other low-income	3.2	3.3	3.4	22.5	23.6	18.3	1 172
t-test for the significance between the means							
LDC and other developing	-1.59	-1.69*	-2.59*	-0.28	3.57*	3.69*	-7.62*
LDC and other low-income	-1.59	-1.66	-1.98*	0.32	2.16*	3.25*	-1.05
Number of LDC observations	24	24	24	15	15	15	38

Source: World Bank, *2000b*; UNCTAD calculations.

Notes: * Significant at 5 per cent level, one-tailed test. t-tests are based on non-pooled group variances.
a Other developing countries consist of all developing countries excluding oil-exporting countries and former centrally planned economies in Eastern Europe and the Soviet Union.
b Other low-income developing countries consist of all developing countries whose average per capita GDP over the 1980s did not exceed maximum LDC per capita GDP.

Both these positions are in some respects correct and in other respects mistaken. The IMF's position is correct in that the flow of aid is indeed very volatile and in some cases pro-cyclical, as noted above. There appears also to be much room for improving the tax performance of the LDCs, where tax rates at the average level of 12 per cent of GDP for the 16 countries shown in table 41 are significantly below the prevailing levels even in other low-income countries. However, in order to improve tax performance, there is a critical need for reconstruction and rationalization of public administration in these economies, not only with regard to their tax and customs administration but also with a view to better provision of public services. More efficient and effective taxation requires not only improved taxation capacities resulting from a more effective and better-designed taxation machinery, but also better provision of public services in order to make the "institution" of taxation socially acceptable and, so to speak, to "legitimize" higher taxes. This is the reason why those who criticize the IMF's position are correct in pointing out that the LDCs need to rely on substantially increased foreign aid in the medium term in order to bolster State finances. This is necessary in order to rebuild the public sector administration, and improve the morale of civil servants and the quality of public services, all of which are important preconditions for more effective and efficient taxation. But where these critiques are mistaken is in maintaining that aid is less volatile and negatively covariant with government revenue and that increased aid within the current delivery system will be effective in alleviating the fiscal bind of the LDCs. As argued above, the assumption about aid volatility is not supported by the existing evidence, and the effectiveness of increased aid is not guaranteed under the current delivery system. To see this more clearly, we need to examine the expenditure side of the LDCs fiscal structure.

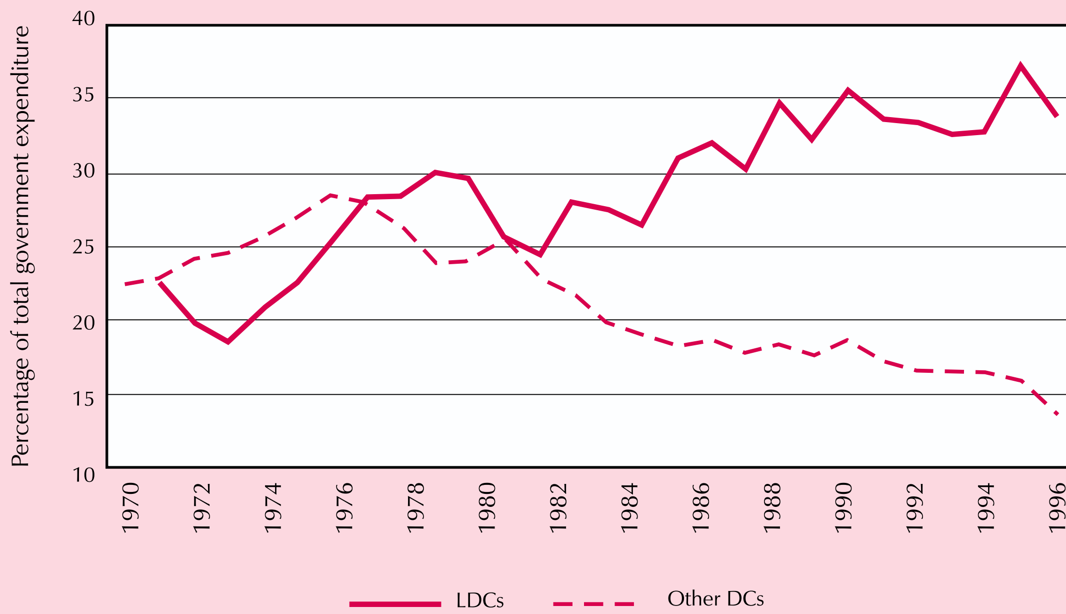
In order to improve tax performance, there is a critical need for reconstruction and rationalization of public administration in these economies, not only with regard to their tax and customs administration but also with a view to better provision of public services.

As can be seen from table 41, the total government expenditure share of GDP in the LDCs does not on average seem to be significantly different from that of other developing countries or other low-income countries. But the current expenditure share is considerably and significantly below that of other developing countries, even when one controls for the level of per capita income. This anomaly is even more starkly evident when one compares the share of capital expenditure in total between the LDCs and other country groupings. As can be seen from table 41, the average share of capital expenditure in the LDCs increased from about 24 per cent during the 1970s to over 30 per cent during the 1980s and the 1990s as foreign aid as a share of GDP increased in these countries. This is in sharp contrast with the declining capital expenditure share in other developing country groupings. To have a clearer picture of the trends in capital expenditure shares we have plotted the median of capital expenditure shares for the LDCs and other developing countries in chart 49. The capital expenditure share of the LDCs, starting from levels more or less similar to those of the other developing countries in the early 1980s, follow a steep upward trend, sharply diverging from trends in other countries, with the proliferation of aid projects in the 1980s and the 1990s. By the late 1990s, the gap between the LDCs and other developing countries in the share of capital expenditure reaches about 20 per cent.

With the proliferation of aid projects the share of capital expenditure in total government expenditure increases beyond any rational bounds.

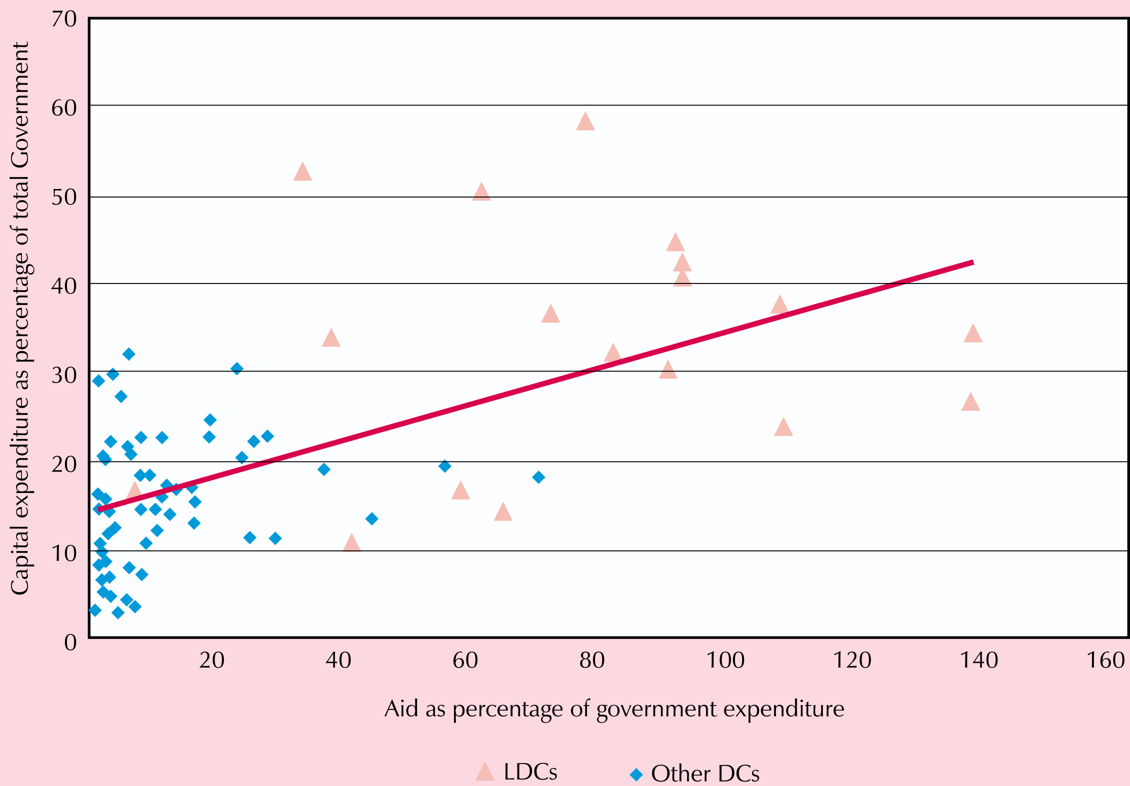
To see more clearly the link between the capital expenditure share and foreign aid, we have also plotted the capital expenditure share against the ratio of foreign aid to government expenditure in chart 50. The figure clearly shows the divergent behaviour of the LDCs as compared with other developing countries with respect both to the capital expenditure share and to the aid ratio. With the proliferation of aid projects the share of capital expenditure in total government expenditure increases beyond any rational bounds. Of course, one should be careful in interpreting what is meant by capital expenditure in LDC

CHART 49: CAPITAL EXPENDITURE SHARE OF TOTAL GOVERNMENT EXPENDITURE IN LDCS AND OTHER DCS, 1970–1997



Sources: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 1999*.

CHART 50: THE RELATIONSHIP BETWEEN AID AND GOVERNMENT CAPITAL EXPENDITURE, 1990–1995



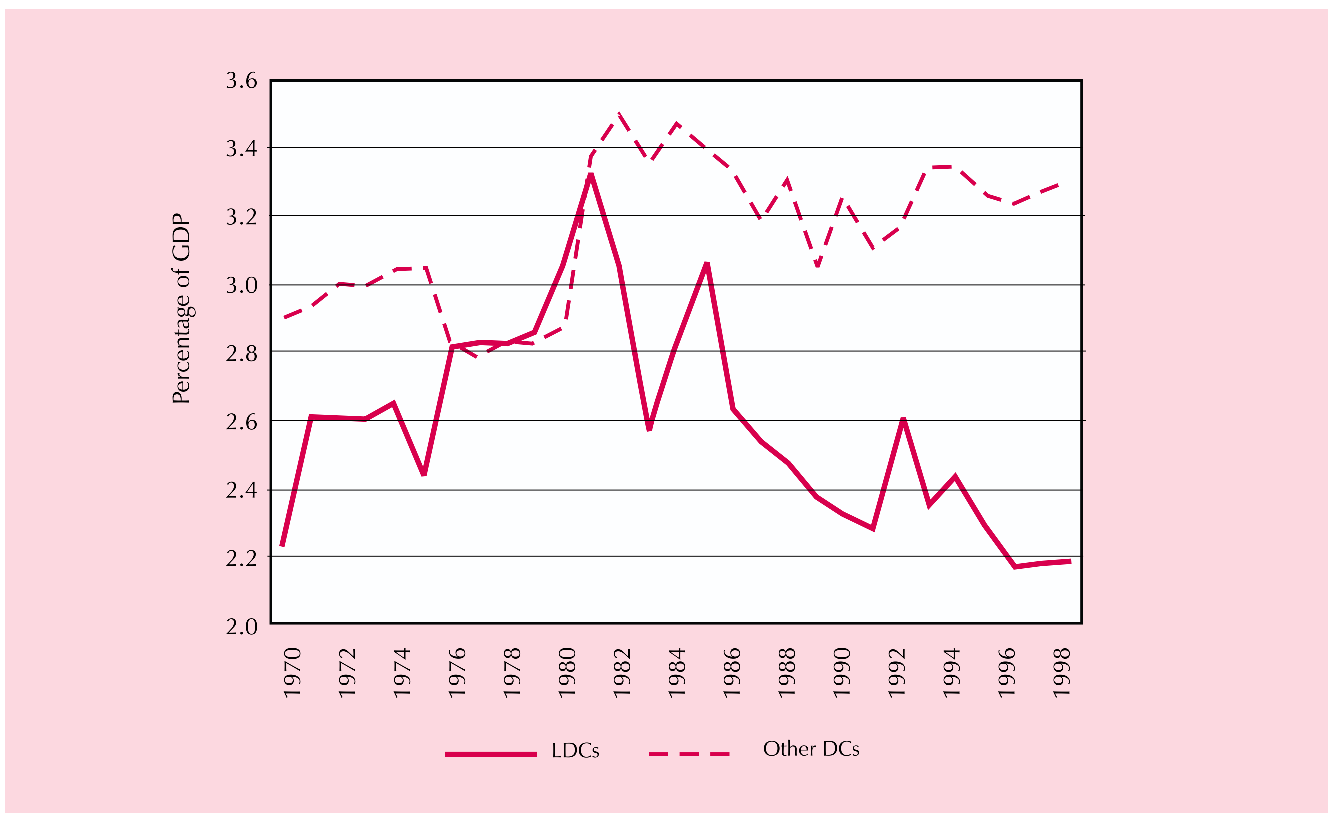
Sources: Same as chart 49.

budgets. Expenditures associated with aid projects are by and large regarded as development expenditure, which is likely to give an inflated figure for what is recorded as capital expenditure in the budgets.[15] As pointed out in chapter 1, this is one reason why the investment data in the case of these countries may contain a large overestimation error.

A more appropriate interpretation of the picture emerging from charts 49 and 50 is that as aid projects proliferate, the share of the budget financed by donor-controlled aid funds increases at the expense of the share of the regular budget directly controlled by the recipient country. The outcome, as argued above, is the squeeze in the recipient Government's command over real resources and a declining quality of public services. This cannot be better demonstrated than in chart 51, which compares the trends in the median GDP share of current expenditure on education in the African and Asian LDCs with those in other developing countries. As can be seen, during the 1970s the median LDC, starting from expenditure shares below those of other developing countries, follows a steeper trend and catches up with the median developing country group by the end of the decade. During the programme aid and adjustment era of the 1980s and the 1990s, however, the current education expenditure share of the LDCs experiences a precipitous decline, while other developing countries on average manage to maintain their current expenditures as a share of GDP. It is remarkable that the picture revealed in chart 51 regarding educational expenditure looks like an exact mirror image of the behaviour of capital expenditure (i.e. aid-financed expenditure) shown in chart 49.

During the adjustment era of the 1980s and the 1990s, the current education expenditure share of the LDCs experiences a precipitous decline.

CHART 51: CURRENT GOVERNMENT EXPENDITURE ON EDUCATION, 1970–1998



Sources: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 2000*.

Of course, it may not be surprising if one finds that total educational expenditure (including capital expenditure on education) as a share of GDP has followed a different trend from that of current expenditure in some LDCs. However, what matters from the point of view of delivery of effective educational services is current expenditure. Aid-funded schools without teachers and books, or with low-paid, demoralized or badly trained teachers and dilapidated structures, do not deliver effective education. This is an important part of the explanation of why LDCs are rapidly falling behind other developing countries in education, health and other social aspects of development, as indicated by the data discussed in part I of this Report.[16]

It appears, therefore, that the government finances of the African and Asian LDCs have been adversely affected by the double squeeze of uncoordinated and non-integrated aid on one hand, and by policy conditionalities of adjustment programmes on the other. Rising debt service obligations, the increasing amount of time spent on aid coordination and debt negotiations, and a continuous haemorrhage of experienced personnel to rapidly proliferating aid projects formed the various elements of the squeeze resulting from the diversity of the aid delivery system. The targeting of the domestic budget deficit (excluding grants) and within that the current expenditure of the government by the Bretton Woods institutions formed the other side of the bind. This indicates that at least in the case of the African and Asian LDCs, the *lack* of fungibility of aid has been one of the reasons for reduced aid effectiveness, rather than the much discussed fungibility of aid.[17] Had the aid delivery system been more integrated into the budgetary processes, or in other words had the recipient governments exerted more control (ownership) over aid funds, the resulting fungibility might have helped alleviate the demise of public administration and public services in the African and Asian LDCs.[18]

The government finances of the African and Asian LDCs have been adversely affected by the double squeeze of uncoordinated and non-integrated aid on one hand, and by policy conditionalities of adjustment programmes on the other.

One strategy to increase the fungibility of aid, which the LDC Governments seem to have followed during the pre-adjustment era, was to resort to inflationary finance and highly overvalued currencies. Although these proved to be distortionary and self-defeating policies in the long run, in the short run they boosted State finances at the expense of the command of the donors' funds over domestic resources and, of course, also at the expense of the rest of the economy. With the strengthening of stabilization programmes, this option became by and large closed to Governments, while at the same time the large currency devaluations further tilted the balance by squeezing the part of the regular budget under the Governments' direct control and increasing the domestic currency value of the donor-controlled funds. The proliferation of unsustainable aid projects was almost an inevitable outcome of this situation, as the cash-starved line ministries scrambled for new aid projects and the disbursement-driven donor agencies competed to download their funds, with little time to worry about the recurrent cost quagmire they were creating. One of the enigmas of this whole situation is why under these circumstances, and with the admittedly low rates of sustainability of aid-funded projects, the IMF insisted on increasing the share of government investment expenditure in this period and cutting the current budget. It was precisely at this time of economic reform that the donors needed to address the problem of lack of coordination and integration of the aid delivery system in order to prevent the demise of public finances and the deterioration in public services in the reforming countries. The failure to address this problem adequately and effectively has played an important part in the lack of success of reform programmes in a large number of Asian and particularly African LDCs.

A good deal of effort has, of course, been expended on public sector management reform under the World Bank adjustment lending programmes. The Bank's public sector reform programmes have addressed issues such as public expenditure management, civil service reform, capacity building, public enterprise reform and, more recently, general governance issues. According to the World Bank's own evaluations, these attempts at least in the case of low-income countries have remained by and large unsuccessful. In a recent review of such evaluations, Berg (2000) concludes, "The substantial donor efforts to reform public sector management in low-income countries during the past 15-20 years can justifiably be called failures. And a significant share of the responsibility for these dismal results has to be attributed to donor deficiencies as reformers" (p. 493). One cannot but agree with Berg's assessment because, although it may be tempting to try to explain this lack of success in terms of the administrative deficiencies and political peculiarities of the low-income countries, it is precisely because of such deficiencies and pecularities that public management reform programmes are called for in the first place. In this respect, Berg points out that in general the donors failed to adapt programmes and practices to the circumstances of low-income countries with weak administrative institutions, and that their response to implementation problems has been generally inadequate. "In these senses they [the donors] have been unimpressive architects and implementers of public sector management reforms" (p. 493).

With regard to the deficiencies of the public sector reform programmes proposed and implemented by the World Bank, Berg's study (pp. 495-498) makes the following observations:

> One factor is the well-known organizational inclination in the World Bank to give much greater weight to analytic issues than to the softer matters of process such as concern with ownership and nurturing of local capacity… Related to this is the World Bank staff discomfort with institutional matters. Awareness of institutional weakness should permeate all reform activities in low-income countries. But sensitivity to country specific institutional constraints has never been a strong point in World Bank operations. The 1998 evaluation of PER [public expenditure reviews]… found neglect of institutional issues to be a major failing… Another factor is the natural tendency to resort to off-the-shelf solutions. Confronted with extremely difficult and complex problems, crafters of reform almost never have the time or the specialized skills and experience needed to develop customized approaches. They rely on what is available – 'best practices' or what other countries are doing… Then there is the inadequacy of communication, learning failures, within the World Bank…

Local ownership is necessary for the design of correct policies in the first place.

The above points, of course, are known to the World Bank (since Berg's study largely relies on the World Bank's own evaluations), and the second-generation reform programmes since the latter part of the 1990s have apparently moved on to emphasize institutional issues as well as the question of "ownership" of policy reform within the new Comprehensive Development Framework. What the above quotation helps to highlight however, are the intricate inter-relationships between institutional specificity, ownership, design, and implementation of aid policy. Institutional specificity necessitates policy ownership, not just because policies that are not locally owned are unlikely to be implemented effectively. More importantly, in the context of institutional specificity, local ownership is necessary for the design of correct policies in the first place. In the absence of local ownership, inappropriate "off-the-shelf-solutions" are imposed by the force of conditionality, and when these solutions inevitably fail, the recipient country is doubly punished by the cutting off the

assistance. This has the additional effect of killing off learning, both in the recipient country institutions and in the donor agency.

H. Ownership, partnership and selectivity

1. Ownership and partnership

This analysis of aid effectiveness has important implications for the rethinking of international aid which is currently underway. It is widely agreed that the conditionality paradigm has failed and that new ideas and systemic changes in the old way of thinking are urgently needed. But the current position, as noted earlier, is that aid will work if the national policies are right and when these policies are truly domestically "owned". From this perspective, Governments should not have policies in which they do not believe foisted on them from outside. Aid effectiveness can be increased by putting the Government, in tandem with domestic civil society, in the driving seat in the preparation and implementation of policies. Creditor-donors should key their assistance in their respective areas of comparative advantage to a strategy document produced by the Government, and performance conditions, which must be achieved in order to justify continued assistance, should be drawn from this and monitored by creditor-donors. Donors should practise selectivity, targeting their aid flows at countries in which the right policies are in place and are domestically owned.

Effective "ownership" of policies, therefore, in the case of LDCs requires not simply preparation of the strategies, but also effective control over the allocation of aid funds within a coherent and integrated budgetary process.

The analysis in this chapter shows that the multi-donor-driven resource allocation processes in the LDCs interfere with effective policy-making in these countries in various ways. The problem with the policy conditionality during the adjustment period was not that conditionality invariably failed to influence policies. In many instances the policies were implemented, but the main problem was that the policies were inappropriate for the contexts in which they were applied, and they were combined with the uncoordinated and the largely donor-driven resource flows. As a consequence, the outcomes were contrary to what was expected.[19] Effective "ownership" of policies, therefore, in the case of LDCs requires not simply preparation of the strategies, but also effective control over the allocation of aid funds within a coherent and integrated budgetary process.

As the example of Botswana shows, once aid is integrated in such a coherent national framework, there is no reason why the LDCs cannot make effective use of aid (see box 10). What distinguishes the management of aid in Botswana, which is in fact the only country to have graduated from LDC status, from the case of other LDCs discussed in the previous section is that in Botswana the management of aid and relations with donors has been an integral part of the national planning process. Projects that were not included in the National Development Plan as approved by the Parliament were not accepted, all aid funds and local revenues were integrated into a unified national budget, and technical assistance personnel were under strict national control.[20] Most other LDCs, particularly in sub-Saharan Africa, relaxed their control over aid flows in the latter half of the 1970s, and with the end of the planning era and the beginning of the adjustment era in the 1980s they became increasingly enmeshed in the uncoordinated, donor-driven system of resource allocation. While the loss of control in the sub-Saharan African LDCs looks most acute, aid effectiveness in all the LDCs is held back by the lack of coordination of the aid

Box 10: Aid management and economic performance in Botswana

Botswana is a country that has applied principles consistent with national priorities for efficient aid administration for over 20 years. After the establishment of a budget and planning system that operationalizes the national priorities in a transparent fashion within resource realistic ceilings, the country's public management system has both legitimacy and credibility.

Botswana has created a strong Ministry of Finance and Development Planning (MFDP), which draws up the country's six-year development plans, prepares projects as needed (together with the appropriate line ministry), and only then matches projects with appropriate donors. Line ministries do not negotiate directly with donors. All projects and programmes must be approved by the Parliament. All aid money and local revenues are integrated together into the budget. Most important of all, Botswana has the political will to reject donor proposals that are not part of national plans.

To reinforce the local ability to manage aid resources, the Government decided to make use of expatriate personnel in line positions in the ministries, replacing them only when local people were adequately trained to take over those positions. Expatriates generally occupy mid-level advisory and analytical positions, but not the high-level decision-making ones. Technical assistance is assessed and used not on a project-by-project basis, but according to manpower development plans prepared sector by sector for the economy as a whole.

Principles of Botswana's aid management:

- The management of aid and dealings with donors is an integral part of the national planning process. Only MFDP has the authority to negotiate and secure aid.
- No project will be accepted if it is not included in the National Development Plan as adopted by Parliament. New programmes can be included, but only with parliamentary approval.
- No separate procedures or standards are applied to aid-funded as opposed to nationally funded projects. Projects must be carried out by available staff, and the Government has consistently refused to create additional posts in order to implement donor-funded projects.
- Technical assistance personnel are placed under national control, often in line rather than in advisory positions.

As an LDC until 1995, Botswana has achieved impressive economic growth over the last 20 years and is now classified as an upper-middle-income country. It's real GDP per capita grew from US$ 1678 in 1980 to US$ 3611 in 1998, that is a 4.3% annual growth rate as compared with -1.3% for the group of African LDCs. Botswana's aid dependency ratio to GDP declined steadily from 7% in 1980 to less than 2% in 1995, whereas that of the African LDCs increased from 8% to over 15% during the same period. Following the sharp increase in diamond production from the mid-1970s onwards, Botswana has built up strong budgetary and current account surpluses. The authorities have invested part of the mineral revenues in domestic infrastructure and social services. Spending on education and health increased by 170% in real terms between 1980 and 1998.

Sources: Brautigam and Botchwey, 1998; ECON, 1999.

system with the national development processes. And this lies at the heart of the question of policy "ownership".

Three basic requirements have to be fulfilled for genuine policy ownership to become a reality in the LDCs. First, there must be a serious effort by the countries themselves to establish comprehensive and coherent budgets and medium-term expenditure plans which have the transparency, accountability and realism required in order for them to be taken seriously by the donors and their own domestic constituencies. Second, the donors need to provide the necessary information about their current activities and future plans in order to make the first task possible. They should be also prepared to coordinate their procedures with the local requirements and integrate their activities within the national budgets and expenditure plans – in other words, genuinely to put the recipient country in the "driver's seat". Third, a realistic assessment of the immediate financial requirements to jump-start the process needs to be made, and the necessary funds need to be made available in order to get the countries

out of the downward spiral discussed in the previous section. We shall discuss these three requirements briefly in turn.

Meeting the first requirement for genuine policy ownership depends firstly on adequate human resources. By now many LDCs should have the necessary personnel and expertise to start putting the government accounts in order, producing credible and consistent expenditure plans within realistic macroeconomic frameworks, and introducing effective accounting and auditing systems. After all, when Botswana began its development planning process the country had only 22 college graduates (Brautigam and Botchwey, 1998). In any event, there is no dearth of technical experts that the countries can draw on if the need arises, as long as they are used judiciously, as in the case of Botswana. However, a major difference between Botswana and some of the less successful LDCs, particularly in sub-Saharan Africa, is that in the latter, low salaries and adverse working conditions in public administration have made it difficult to attract and retain well-qualified personnel.

The setting up of the necessary public sector auditing and accounting systems is a basic precondition for genuine policy ownership.

One important technical capacity for effective policy which requires strengthening in many LDCs is financial auditing and accounting. In many sub-Saharan African LDCs, technical capacity for auditing and accounting, which is the backbone of government accountability, is extremely weak (Schacter, 2000; Johnson, 1995, 1996). The setting up of the necessary public sector auditing and accounting systems in such countries is thus a basic precondition for genuine policy ownership.

The political processes underlying the formulation and implementation of the budgets are, however, at least as important as the financial and accounting technicalities. Due consultation with all the relevant line ministries, and open discussion by relevant stakeholders of the strategic development visions and the means to implement them, are essential preconditions for transparency, accountability and credibility of government efforts, which in turn are necessary in order to convince the donors to integrate the financial management of their projects and programmes within the government budget.

However, without simultaneous support by the donors, and without an effort by them to coordinate their aid with one another *and* with the domestic economic processes, the efforts by the recipient Governments in aid-dependent economies are likely to remain ineffective. This is the second precondition for genuine policy ownership. The internal processes of consultation, transparency and consensus building around the budget would be rendered futile without timely and accurate financial information from the donors. The lack of synchronization of donors' and recipients' budget cycles, the use of different accounting conventions and classifications, provision of incomplete data on aid disbursement, and lack of information on aid strategies and future expenditure plans of the donors are well-known deficiencies of the aid delivery system, which have made the task of financial management in the recipient countries difficult, if not impossible. As we have seen in the previous section, rather than alleviating the vulnerability of the LDCs, the prevailing aid delivery system appears to have added to the volatility of most of these economies. However, the most important impediment to comprehensive medium-term public sector expenditure planning and financial management in the LDCs, is that a large part of the donor-funded projects and programmes indeed bypass the central government budget.[21] Under these circumstances, it should not be surprising to find that over time some aid-dependent Governments have lost confidence in their own budgetary processes and also the capacity, discipline and institutions necessary for good public sector management.

The internal processes of consultation, transparency and consensus building around the budget would be rendered futile without timely and accurate financial information from the donors.

The lack of correspondence between policy conditionality and the aid delivery system, as discussed in the previous section, has had further debilitating effects by weakening governance and undermining public service delivery. The double squeeze on public sector funding through the proliferation of "stand-alone" donor-funded projects on the one hand, and the current spending controls imposed by policy conditionality and the debt service burden on the other, has created a demotivated and demoralized civil service and has undercut vital public services such as education. Under these circumstances, the imposition of practices such as cash budgeting in some LDCs has further undermined the institutions of good governance, for example respect for the budget document as a mutually agreed and binding document amongst different line ministries and public agencies. Naturally, cash starved central governments with a demotivated civil service suffering from a long process of "brain drain" to the more highly paid donor-supported institutions do not make good development "partners".

An important precondition for the much-discussed public sector reform in the LDCs is a more cooperative and trustful attitude on the part of the donors. During the process of reforming public sector pay structures, the donors need to end their prevalent practice of parallel staffing and remuneration arrangements on stand-alone projects, which has undermined recipient governments' ownership, accountability and capacity. Donor funds should increasingly take the form of budget support or collaborative sector-wide programmes administered by recipient governments in accordance with objectives and priorities agreed with the donors. New forms of aid which bypass the budgetary and monitoring scrutiny of reformed government administration, and are uncoordinated with national priorities, need to be restrained. Practices such as tied aid, tax exemptions, and restrictive import controls by donor countries, which work against the efficient operation of market forces in the reforming LDCs, should end.

Donor funds should increasingly take the form of budget support or collaborative sector-wide programmes administered by recipient governments in accordance with objectives and priorities agreed with the donors.

These reforms by the donors, which constitute the basic elements for the establishment of good "partnership", have of course been emphasized for a long time in various DAC reports on effective aid (see, for example, OECD/DAC, 1992, 1996, 1999).[22] The 11-point checklist for partnership by OECD/DAC, shown in box 11, is a good example of not only the principles but also the practicalities of establishing good partnership and effective local ownership. Although recent enthusiasm for recipient country ownership may hasten reform of the aid delivery system, this process of change is likely to take some time. Helleiner (2000) has also proposed a list of necessary reforms of the aid delivery system – similar to OECD/DAC's list – and an international monitoring scheme which may help hasten the pace of reform (see box 12). In the meantime the reform of public sector management in the LDCs is urgent. New challenges are putting the weak public sectors in these countries under increasing stress. Under the new ownership initiatives, not only are the existing weak structures supposed to function better, but also new tasks are being added (ECON, 1999).

This extended agenda, in addition to making a more focused and efficient use of the financial and human resources in the public sector essential, implies the need for additional aid in order to relax the financial bind on Governments, created by a dysfunctional aid system during the past two decades. That is the third requirement for effective domestic policy ownership. This should not be regarded as aid-funded current government consumption with an open-ended outlook, but rather as an initial investment needed to create a more trim and efficient, and better remunerated and motivated, civil service. This is necessary for the success of other reform programmes, which in due time would lead to increased government revenues and the gradual end of aid dependence.

Box 11. OECD/DAC: a working checklist for partnership

1. Donors should encourage recipient partners to formulate their own development strategies – setting out the local priorities, plans and instruments for implementing such strategies. This process should systematically involve civil society, as well as consultation with external partners. Where such locally owned strategies are compatible with internationally agreed goals, donors should work to implement their aid programmes in a coordinated manner on the basis of those strategies and accept their discipline.
2. Donors should stimulate and help strengthen recipient partner-led coordination of development cooperation. The capacity for local coordination (which can and should also strengthen the international process) may be improved by donors' own delegation of decision-making authority from headquarters to field missions. At the international level, the possible advantages and disadvantages of organizing consulting group (and Round Table) meetings in the capitals of the recipient partners concerned should be further tested in practice.
3. The transparency of donor and recipient partner interests and mutual trust should be increased through continuous dialogue, both informal and through systematic work on themes and sectors through standing sub-groups, preferably led by the host Government.
4. External partners should agree in principle to adjust more to local procedures, where necessary helping recipient countries to bring their procedures and management capacities up to international standards. There may be useful DAC roles in identifying best practices and helping organize pilot exercises to move towards the simplification and harmonization of procedures.
5. Practices involving tied aid are permanently identified among procedures that can impair local ownership and capacity building, with substantial economic and credibility costs. The proposal for a DAC recommendation to start with untying aid to least developed countries could be a step towards improved partnerships in this area, yielding additional tangible benefits for partners from competitive bidding and from local procurement.
6. Donors share the objective of ending the proliferation of projects and providing their aid increasingly in forms of programme and budget assistance to support country's strategic priorities for development. To this end, they need to help strengthen partner countries' capacities to manage such aid, and further test the various approaches and conditions under which they can pool their contributions in country funds for major sectors or key goals, e.g. poverty eradication. The integration of aid spending into the overall budget context may [encourage] donors to manage their own significant inputs differently to help strengthen local revenue pools.
7. There is a widely felt need to support local capacity building by changing the existing modalities for providing technical cooperation, which often appears expensive and excessive, hampering true ownership and the use and development of local capacities.
8. The practices of joint monitoring and evaluation of development programmes by donor and recipient partners should be further developed and applied, with a view to learning together the lessons of achievements and failures.
9. Improving the coherence between external partners' development cooperation policies and their other policies (such as those affecting trade and investment) affecting recipient partners is clearly seen as increasingly important to help the developing countries concerned move towards reduced dependence on aid.
10. Innovative ways of financing should be constructed so as to have ODA play a catalytic and leverage role in generating and attracting other forms of domestic and foreign investment. The roles of grants, loans, forms of support for the local private sector and "matching" contributions by beneficiaries merit further careful assessment and coherent policies.
11. External partners should continue to help lessen the debt burden of recipient partners; in this context, among others, the modality of various types of "debt swaps" should be considered.

Source: ECON, 1999.

Box 12. Recent suggestions for aid performance monitoring

1. *Recipient country specificity of data*. The most important consideration for aid recipients is that data and evaluation systems relate to their own budgeting and planning needs, as well as their own country-specific statistical categories and decision-making timetables. To be useful to the recipients, donor performance monitoring and evaluation must take place at the level of activities within the host countries, activities over which, at least in principle, they can have jurisdiction and exercise their sovereignty. Such recipient country-level systems do not exist.
2. *Compliance with recipient requests for information*. The economic decision-making in the more aid-dependent of the low-income countries is severely constrained in terms of critical data. The degree of donor compliance with recipient government requests for standardized and timely aid data should therefore be an important performance indicator for donors.
3. *ODA expenditures and recipient budgetary system*. A common misconception about ODA is that it is all passed through a recipient government system, even through its budget. This is typically not the case. In Mali and the United Republic of Tanzania, for example, only 20 to 30% of ODA is estimated to flow through the government budget. Needless to say, decisions as to the uses and recipients of the remaining part are made exclusively by the donors. The proportion of each donor's ODA expenditures that finds its way into the national budget is another good performance indicator for donors.
4. *Integration and coordination with national plans and priorities*. A related issue is the degree to which donor projects and expenditures are coordinated and integrated into national and sectoral plans and/or recognize the declared priorities of the recipient Government. The clearest manifestation of this is the degree to which donors are willing to contribute to sectoral or cross-sector "basket funds", administered by recipient Governments in accordance with objectives and priorities agreed with the contributing donors. Donors who may be constrained by their own national legislation from pooling their resources in basket funds should tailor their activities to recipient priorities, and attempt to coordinate their support, standardize their accounting and reporting systems, and reduce transaction costs to recipients. A quantitative donor performance indicator, where feasible, may be the percentage of funds allocated to stand-alone projects (as a "negative" indicator).
5. *Shortfalls from ODA promises*. Aid donor announcements and even formal commitments often bear little relationship to subsequent actual disbursements. For effective policy-making one must have reasonably accurate resource projections. There must be a presumption that where general macroeconomic management remains sound, and particularly in the case of sectoral or budget support, the primary responsibility for exceptionally large shortfalls rests with the relevant donors. Their actual disbursements should therefore be monitored in the context of their own prior commitments.
6. *Compensatory and contingency financing*. It is important to recognize the exceptional need for liquidity and contingency finance in the poorest and least developed countries, because of their high degree of vulnerability to external shocks. Because of the conditionalities attached to its lending to LDCs, the IMF can no longer be described as a source of increased "liquidity". Bilateral donors, who collectively disburse far greater amounts in support of poor countries than the IMF or the World Bank, could alter the time profile of their disbursements for budget or balance-of-payments support in response to an individual recipient's shock-generated need for liquidity. Those able to perform such a role should obviously be favourably recognized for doing so rather than recorded as offering unstable and unpredictable finance.
7. *Tying of procurement*. The tying of aid is very costly to the recipients, particularly when it relates both to its use and to its procurement source. Despite years of effort, DAC OECD members have still not been able to collectively agree to untie all aid to LDCs. Another obvious donor performance indicator, then, is the percentage of ODA which is provided on an untied basis with respect to country of procurement.
8. *Role of technical cooperation*. The emerging consensus among aid analysts is that, as great as the need for technical expertise may be in most of the poorest countries, traditional technical assistance/cooperation activities have been signally ineffective in sheer cost-benefit terms. One suitable donor performance indicator may be the percentage of aid spent on donor-country-tied technical assistance. One could also conceive some positive indicator of contributions to long-term capacity building as a complement to this "negative" indicator, but this would have to be somewhat subjective and hence would be more difficult to devise.
9. *Qualitative assessments of ownership*. On other dimensions of the aid relationship there might also have to be resort to more qualitative assessments, undertaken by independent evaluators, of individual and collective donor performance. In one recent such exercise, an independent assessor assigned letter grades to the collective performance of donors with respect to the variety of promises they had made regarding the transfer of "ownership" of development programmes (together with relevant commentary) (Helleiner, 1999).
10. *Time horizon for ODA commitments*. Some attempt must be made to record systematically the degree to which donors have been able to make longer-term commitments, e.g. within the framework of a medium-term expenditure plan.
11. *Individual and collective donor performance indicators*. All of these indicators should be recorded at the recipient country level both for individual donors, at least the more significant ones in the particular country, and for the donor community as a whole.
12. *Independence of monitoring authority*. Fundamental to the credibility and effectiveness of any performance monitoring is the independence of the evaluator. Neither the DAC OECD nor the Bretton Woods institutions can be trusted to be neutral and apolitical in their assessments of donor performance (there is room for doubt about their record of neutrality regarding the performance of recipients as well). Perhaps some more independent UN agency could serve as an appropriate financier and organizer of independent donor performance assessments via contracting with private individuals, teams of individuals (panels) or consulting firms to provide these services. Whoever the financiers/organizers are, it must be clear to all that the assessors retain absolute independence.
13. *Frequency of performance assessments*. Since change in aid relationships is likely to take some time, in any case, every effort should be made by donors to reduce recipient transaction costs and to take a longer view. The current one-year cycle for donor consultations and Consultative Group (CG) meetings is too short. The more balanced assessment of donor and recipient performance recommended here, and perhaps CG meetings themselves, need not take place so frequently. A two-year cycle might be most appropriate.

Source: Helleiner, 2000.

The debt reduction strategies under the HIPC Initiative should also alleviate the immediate cash flow problems of the budgets in poor countries. It is telling in this regard that many observers argue that the relaxation of the criteria which are used to judge both eligibility for, and the extent of, debt relief should focus on fiscal indicators. This is not surprising, given that aid flows generally do not go into the government budget whilst debt service generally has to come out of it. For example, it is estimated that in Africa in 1998, donors' gross disbursements (including grants) for projects were about $13 billion, and for general budget support about $3 billion. Debt service paid from the budget was about $9 billion. Thus, including debt repayments, governments on average in Africa had to finance a net negative transfer from their budget of $7 billion (Birdsall, Claessens and Diwan, 2000: 6). Under these circumstances, to load the debt relief process with too strict policy outcome conditionalities would be both unfair and impractical. It would be unfair because, as we have seen, the debt situation is partly the outcome of two decades of donor-driven and dysfunctional aid strategy, during which, as pointed out by the World Bank, the donors "assumed to have all the answers". It would be impractical because, as we have argued above, government policies in the LDCs are very much constrained by the prevailing aid delivery system, and an important precondition for greater local ownership is an immediate reform of public sector management, which is made difficult by the severe financial constraints facing the governments, the most important element of which is the debt service obligations.

To load the debt relief process with too strict policy outcome conditionalities would be both unfair and impractical.

2. Inclusive ownership and selectivity[23]

Within the current rethinking of international cooperation, good policies are seen to lay the foundations for partnership, but they should ideally be made by Governments that are accountable to their citizens through some form of democratic governance. The quest for increasing government accountability and local choice has many merits. If successful, it can undoubtedly enlarge the stake of the public in economic policies through political checks and balances, a free press, and open debate on the costs and benefits of government policy. But the double accountability, whereby the recipient Government is accountable not just to donors for the use of aid finance but also to its own electorate, may create tensions.

This point may be analysed within the framework created by Ndulu (2000), based on partnership involving greater *inclusiveness* of local political processes. Rather than looking at the aid relation as a principal-agent problem involving one principal (the donor) and one agent (the recipient Government), he argues that there are in fact two principals: the donor community on the one hand, and the local electorate and civil society on the other.[24] Consequently, for the aid relation to be inclusive, the recipient Government has to be responsive to both these principals. Moreover, he argues, partnership is essential in order to prevent the preferences of one principal from being overridden by the other, or the recipient Government from finding itself in a position of multiple (and perhaps conflicting) structures of accountability. *Consensus building* through partnership, he argues, is necessary in order to arrive at a single structure of governance, transparency and accountability.

This argument provides an answer to one of the persistent stumbling blocks that prevent many donors from pooling aid resources under the control of the recipient Government rather than channelling them to project aid or to NGOs.[25] Consensus building, jointly with capacity building in development management,

can provide the foundations for enhancing accountability and transparency and hence reduce donors' objections to handing over control of finance to the recipient Government. As Helleiner (1999) has shown, for example, the recent Tanzanian experience with the move towards consensus building through inclusive partnership has produced significant advances in managing public expenditures in general, and aid finance in particular. But the process has not been without difficulties and setbacks. For example, one particular measure, taken in 1997, to improve the aid relationship between donors, recipient and beneficiaries was to move the Consultative Group meeting to Dar es Salaam rather than from Paris. The meeting took place in December 1997 and provided greater scope for wide-scale involvement not just of all members of the Tanzanian Government and government officials, but also of business, trade-union and NGO representatives. The next year, however, the donor community voted in favour – albeit by a small margin – of holding the next meeting in Paris so as to guarantee the attendance of senior officials from their national capitals. This example – trivial as it may be in terms of content, but not of process – shows that the aid relation is essentially asymmetrical and unequal in nature.

One aspect of this asymmetry is that it is up to the donor to decide which partners are eligible, or not. Adherence to "good policies" plays a key role in this respect. But this question is often seen as unproblematic – that is, as part of an already existing *international consensus* on development and structural adjustment policies. But this ignores the question whether the same set of good policies *fits all*, or whether context and specificity matters. As Mkandawire (1994: 165-169) has argued, there is no reason to believe that the policies adopted within democratic processes would, of necessity, converge with the views of the donor community at large, and of the multilateral financial institutions in particular. Unless, of course, the assumption is made, explicitly or implicitly, that there is only one "right" theory and practice around which a consensus can readily be built and no scope for conflict regarding what is desirable for society arises (p. 168).

Genuine partnership must allow for differences in perspectives and leave room for partners to learn from mistakes.

However, the question is whether policy does not have to address the concrete circumstances in which developing countries in general, and each country in particular, find themselves. History shows that successful experiences in economic growth, poverty alleviation and social development often pursued quite varied economic and social policies, which by no means always converged with present-day doctrine (Taylor, Mehrotra and Delamonica, 1998). Sen (1999), for example, contrasting Western Europe and the United States, points out that, while Western Europeans find it hard to accept the lack of social provisioning in the United States, the citizens of that country would find the double-digit levels of unemployment in Europe quite intolerable (p. 95). The interesting point here is the significant divergences in policies and in their effect on livelihoods that exist between Western European countries and the United States, reflecting clear path dependencies in their respective developments.

A critical issue, as noted in the last chapter, is whether there is room for manoeuvre left to less developed countries under structural adjustment for similar divergences in policy choices to tackle poverty alleviation and social development. Will divergence from the prescribed economic policies be acceptable, or will it be identified as manifestations of "distortionary" practices of a predatory State? Genuine partnership must allow for differences in perspectives and leave room for partners to learn from mistakes. It will be easy for selectivity, which functions as a threat of withdrawal of concessional finance if the policies are not right, to act as a mechanism which guides policies to those that fit the donors' preferences.

The argument put forward here is not that donors should not be selective with respect to which countries to support. Principles such as democracy, human rights, and pro-poor development are important. But the way in which the concept of partnership is used often leaves considerable vagueness about whether most donors merely see partnership as a disguised form of *ex-ante* conditionality inasmuch as recipient Governments should adhere to and own the policies prescribed by donors, or whether partnership actually provides scope for the recipient Government to develop its own responsible policies, based on democratic and inclusive principles. In the former case, the new aid paradigm may well become a variant of what Mkandawire (1994: 173) has described as "the usual meddlesome condescension", while in the latter case, it may signify a significant move towards establishing a less unequal and less asymmetrical relation between donors and recipients.

Finally, it is necessary to address the question of "outcome selectivity", or *ex-post* conditionality, which is being discussed as a new instrument for increasing aid effectiveness during the "partnership" era. Although monitoring of both government policies and outcomes is essential for aid effectiveness, simplistic approaches such as macroeconomic simulations or the use of *ex-post* growth regression models should be avoided.[26] Furthermore, it is important to keep in mind the lessons learned from experience – most notably, that as long as Governments are not in control of aid funds, in a fragmented and uncoordinated aid delivery system, they cannot be held totally responsible or accountable for the policy outcomes or even the success or failure of policy implementation. In this context, as suggested by Helleiner, independent monitoring of the donors as well as of the recipients is essential (box 12).

Monitoring of outcomes and setting appropriate performance criteria are likely to be best achieved if research, design, implementation, financing and evaluation of programmes and policies are not all combined within the same institutions, and if recipient countries have a greater voice in the formulation of the policy agenda and the monitoring of outcomes.

Selectivity also raises important but more general questions about the architecture of international development assistance. As indicated in point 12 in the list of Helleiner's recommendations, independent agencies other than the existing international donor agencies such as OECD/DAC, the World Bank and the IMF are necessary for effective monitoring of the donors. In the context of selectivity, however, this issue becomes even more critical and assumes wider dimensions. Selectivity involves not only monitoring of outcomes, but also setting performance criteria based on independent research which takes into account the constraints and institutional specificities of the recipient countries. This is likely to be best achieved if research, design, implementation, financing and evaluation of programmes and policies are not all combined within the same institutions, and if recipient countries have a greater voice in the formulation of the policy agenda and the monitoring of outcomes.

Another pitfall to be avoided as the idea of selectivity gains ground is the temptation to set three-year, or even worse, annual quantitative targets, and to try to achieve these under the threat of cutting off aid. This approach, apart from increasing uncertainty and creating a wait-and-see mentality for private sector investors, misses a key point regarding what the process of development is all about. As the experience of centrally planned economies over a good part of the last century showed, economic development is not about setting quantitative targets and trying to achieve them. It is rather a long and complex process of learning at the level of society and polity, strewn with social conflict and frequent reverses. It may not be inappropriate to conclude this brief discussion of "selectivity" with the following sobering thought:

> A difficult policy environment should not be taken as purely negative, as donors sometimes seem inclined to interpret it as. *Conflict* and *power* are key concepts to understanding priority setting in industrialized societies,

yet there seems to be a view that in emerging societies, "ideas matter" and that once good ideas have been presented, national consensus and harmony will emerge around them. Allowing a political system to work through the conflicts and contradictions is necessary if the overall system is going to develop and gain legitimacy, and stepping back and letting national politics work out the compromises necessary for coalition building may require time (ECON, 1999: 29).

I. Conclusions and policy implications

This chapter has argued that the lack of aid effectiveness in the LDCs is a consequence of the nature of the international aid delivery system and the impact of policy conditionality under this system. In common with OECD/DAC's own evaluations of how aid works, this chapter finds that the diversity and the fragmentation of the aid delivery system are a critical problem. Although the LDC economies clearly need foreign aid, the multi-donor-driven and fragmented aid delivery system has seriously disrupted the resource allocation mechanisms in these countries. Foreign aid flows are too volatile and unpredictable. Aid flows are also by and large non-covariant, or positively covariant, with exports and government revenues, thus adding to the economic vulnerability of most LDCs. Furthermore, the lack of coordination of the activities of various aid agencies and the lack of integration of their projects into domestic economic and managerial structures has undermined the sustainability of aid projects. The combination of these factors have substantially reduced aid effectiveness. More importantly, given the predominance of aid flows as major sources of development finance and foreign exchange revenue in the LDCs, this has had important consequences for economic management, the overall efficiency of resource use, and economic growth in general.

Although the LDC economies clearly need foreign aid, the multi-donor-driven and fragmented aid delivery system has seriously disrupted the resource allocation mechanisms in these countries.

The combination of this dysfunctional aid delivery system and policy conditionality since the early 1980s, during the adjustment era, has particularly undermined economic progress in the LDCs by eroding State capacities and undermining the quality and quantity of vital public services such as education and public administration. This has occurred because of a double squeeze of public finances by the uncoordinated and non-integrated aid delivery system on the one hand, and the policy conditionalities of adjustment programmes on the other. Rising debt service obligations, the increasing amount of time spent on aid coordination and debt negotiations, and a continuous haemorrhage of experienced personnel to the proliferating aid projects formed the various elements of the squeeze resulting from the diversity of the aid delivery system. Measures to reduce the domestic budget deficit and within that the current expenditure of the Government, which have been central elements of stabilization and structural adjustment policies, have formed the other side of the bind. According to most accounts, capacities in most of the LDCs in sub-Saharan Africa are now below the levels of two decades ago. As discussed in *The Least Developed Countries 1997 Report* (part three), the weakness of the State in many LDCs has become a major impediment to economic progress in these countries.

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The findings of this chapter have important policy implications at the national and international levels. In any discussion of development policy it is important to distinguish between policy *objectives*, and the ways and means of achieving these objectives under empirically given conditions in the countries concerned. For example, the desirability of most of the *objectives* that formed the components of policy conditionality during the adjustment period remain

undisputed - for example, the objectives of achieving macroeconomic stability, pursuit of internal and external balance, and creation of an efficient market economy. But the *policies* that have been advocated in the shape of ready-made blueprints to achieve these *objectives* are inadequate. Policy-making in the context of the LDCs is about finding the ways and means to develop sustainably, in conditions where economies are subject to large shocks in relation to domestic resources available to cope with them. Policy design needs to be specific to the circumstances of the country concerned, signifying the importance of the recipient country "ownership" of policies and programmes. The general policy implications of this chapter, as discussed below, are in effect some of the preconditions for the recipient country "ownership", rather than being a new set of blueprints.

A fundamental prerequisite for recipient country ownership is to reinstate countries' lost capacities, which is a particularly demanding task in the sub-Saharan African LDCs. In some of these countries public sector accounting and auditing capabilities, which are the essential ingredients of government accountability, have been seriously eroded. Low levels of remuneration in the public sector and the inability of the Governments to attract competent and motivated staff are a major obstacle to rebuilding these structures in most countries. A major constraint on the creation of a more effective public sector administration in these economies is the lack of funds. The possibilities of reliance on domestic sources of finance to mobilize sufficient resources for this task are, at least in the short run, very limited. This emphasizes the need for additional aid in the form of budget support or sector-wide programmes in order to relax the financial bind on the governments. This should be regarded as an initial investment, necessary for creating a more effective civil administration, rather than an open-ended commitment to financing government consumption expenditure. Such capacity-building measures are necessary for the functioning of an efficient market economy and improved economic growth, which in due course should increase government revenues and end aid dependence.

A major constraint on the creation of a more effective public sector administration in these economies is the lack of funds.

A mistake that is often made by economists not familiar with the LDC economies is to treat foreign aid and debt service obligations, together with other revenue and expenditure sources, as equivalent entries in a general government budget constraint. Aid funds under the current aid delivery system, however, are by and large non-fungible. It is therefore important that the flexibility which Governments have in the use of aid be increased, so that funds can be allocated in accordance with national developmental priorities, transcending the current artificial boundaries in the LDC context between what is regarded as developmental and what is seen as recurrent expenditure.

In this context, it should also be recognized that under the current aid delivery system, increases in net transfer from debt reduction play a developmental role that is different from that played by increases in new loans and grants. Debt service obligations are a direct burden on government budgets, while aid flows under the current system only marginally increase foreign exchange resources under the control of LDC Governments. As a consequence, the result of the prevailing aid-debt service system has been a substantial net drain on public sector resources. This needs to be an important consideration in the design of any debt reduction strategies in the case of the LDC economies, with the requirement that debt reduction be aimed at alleviating the immediate budgetary constraints in poor countries. Under these circumstances, to load the debt relief process with the type of conditionalities currently imposed under the HIPC Initiative would be counter-productive and self-defeating. As shown in this chapter, the objective of macroeconomic stability, for example, is likely to fall

beyond the capacity of the LDC Governments under the prevailing aid delivery system.

The policy implications of the findings of this chapter at the global level are by and large in line with OECD/DAC's recommendations on good partnership (box 11). A step towards the effective implementation of these recommendations may be taken by giving effect to the proposals for donor monitoring set out in box 12. As discussed in the last section, the issue of partnership, based on inclusive ownership, also raises serious questions not simply about national institutions but also about international institutions. New global goals in the era of partnership require new global institutions. Whether the new vision of "partnership" will lead to a genuine change in the aid relationship and improved aid effectiveness depends on the extent to which it can be transformed from a one-way dialogue between the donors and the recipients and enlist the genuine participation of the recipient countries in materializing the new vision.

In the LDC context, more aid is a precondition for effective aid, and effective aid is necessary for economic growth, poverty reduction and sustainable development.

It is important finally to stress that the present diagnosis of the ways in which the workings of the aid delivery system have undermined aid effectiveness should not lead to the conclusion that there is no need for more aid. The contrary is rather the case, for the current limits to domestic resource mobilization and to attractiveness to private capital inflows mean that aid is essential to LDC development. It implies that a proper analysis should be made of the constraints on effective aid and of ways of overcoming them. In the LDC context, more aid is a precondition for effective aid, and effective aid is necessary for economic growth, poverty reduction and sustainable development.

Notes

1. This discussion partly draws on Wuyts (2000).
2. This proposition is based on econometrics results of Burnside and Dollar (1997), who use a composite policy index based on government budget deficits, inflation and openness. Others have challenged the robustness of Burnside and Dollar's results (see, for example, Hansen and Tarp, 2000, and Lensink and Morrissey, 1999). In this chapter we are concerned with a more basic question - namely, to what extent these supposed policy variables in the LDCs are under the control of the Government, and how the aid delivery system constrains independent policy-making by recipient Governments.
3. Economists have conventionally assumed that aid is "fungible", that is, it relaxes the overall government budget constraint. Aid is "fungible" when the projects that it finances would have been undertaken by the Government in the absence of aid, hence releasing resources which are used by the Government to finance other activities. For example, with the assumption of fungibility, Mosely et.al. (1987: 617) maintain, "Our point of departure is that the government of a developing country will attempt to maximise its welfare in the face of budgetary constraints, and will use aid inflows from overseas as an instrument in the pursuit of that objective". When aid constitutes the entire development expenditure of a Government that is cash-starved even for its requirements for running its daily administration, as is the case for many LDCs, the idea of fungibility in this sense is difficult to support. This position is made more problematic by IMF conditionalities under ESAF, which impose restrictions on domestic budget excluding grants. This theme is elaborated below.
4. These figures are much higher than figures reported in Malian statistics on aid. According to the OECD/UNDP report (1999: 6), "The aid flows given in Malian statistics represent only between one- and two-thirds of the official figures published by the OECD and UNDP in their development co-operation reports."
5. See, for example, Helleiner et al. (1995), van de Walle and Johnston, (1996), and Bagachwa et al. (1998), for studies of the aid delivery system in the United Republic of Tanzania, and ESCAP (1999) for a discussion of aid delivery systems in the Asian LDCs.
6. It is interesting that this point is made by the World Bank's Operations Evaluation Department. Much work on aid effectiveness makes no mention of this important point

and starts from the basic premise of a benevolent donor versus a corrupt or rent-seeking recipient Government that is assumed to have total control over aid funds.

7. In the words of OECD/UNDP (1999: 11), "one of the most striking findings in the Mali aid review was the contrast between the relatively satisfactory results of project and programme evaluations and the far less encouraging overall assessment of aid activities, which for instance were said to have little noticeable impact on living conditions".
8. The countries included in Table 40 are those where data are available for all the variables for at least 10 years over the period 1970-1998. Export revenues in the table refer to total exports of goods and services, including net factor income from abroad in dollar terms at current prices as registered in balance-of payments-accounts. The exercise was repeated using other export revenue notions, e.g. exports of goods and services excluding factor incomes, and exports of goods and services deflated by the import price index. Other measurements of variability such as the standard deviation of annual growth rates and the coefficient of variation of annual absolute changes were also made. However, as the results were not different from those in the table, they are not reported here.
9. For example, Gemmell and McGillivray (1998) provide similar results regarding aid and the different categories of government revenue and expenditure with respect to a broader sample of 48 developing countries. The only exception in the literature seems to be Collier (1999), who claims that aid in the case of sub-Saharan Africa has been less volatile than, and negatively covariant with, government revenue. There are, however, some serious problems with Collier's statistical analysis, notably that it uses the variance and covariance of trended variables, such as aid and revenue levels, as indicators of annual variability and co-movement. Even so, the individual country estimates by Collier (table 1, p. 541) do not appear to support his conclusions made in the text.
10. This also may go some way in explaining two of the perhaps less spurious regression results from Burnside and Dollar (1997), namely, that (i), aid does not flow to countries with good policy environments, and (ii), aid does not cause good policy environments to emerge. Macroeconomic stability is a component of the policy environment index used by Burnside and Dollar. However the wide-ranging experience of countries with respect to correlation between aid and external shocks, as shown in figures 6.1 and 6.2, clearly shows one aspect of the problem of omitted heterogeneity in panel regressions of the type conducted by Burnside and Dollar.
11. Of course, when aid flows are subject to large short-term fluctuations and do not contribute to productivity growth in the economy they can also lead to similar Dutch Disease symptoms. However, in that case, as we shall argue, uncoordinated aid can give rise to much more serious problems than just an overvaluation of the exchange rate.
12. For example, it is estimated that in sub-Saharan Africa in 1998 debt service minus the amount of aid that took the form of budget support drained the government budgets by about $7 billion (Birdsall, Claessens and Diwan, 2000).
13. Among the LDC's, serious conflicts and civil wars occurred in Afghanistan, Liberia, Sierra Leone, Sudan, Eritrea, Ethiopia, Haiti, Somalia, the Democratic Republic of the Congo, Angola, Rwanda and Burundi in the 1990s.
14. Other developing country group in table 41 and elsewhere in this chapter encompasses all the developing countries listed in World Bank (2000b) as developing countries, excluding the former Soviet bloc countries in Central and Eastern Europe and Central Asia, and the OPEC member countries. The other low-income country group consists of all other developing countries whose per capita GDP in purchasing power parity terms (at current international dollars) during the 1980s was below the maximum per capita income in the LDC group in the same period. The sample of countries for different variables varies depending on the availability of data, but the numbers are consistent over time.
15. As mentioned earlier, there is also much evidence to suggest that donors have had increasingly to support the recurrent cost of some of the projects, and that the recipient Governments, in order to by-pass the IMF - imposed ceiling on current expenditures, and have labelled part of their recurrent expenditure as development expenditure. On estimates of the recurrent cost component of aid projects in Mozambique, see Wuyts (1996).
16. Considering that the LDCs have had higher population and school-age population growth rates, as well as lower per capita GDP growth, than other developing countries over the past two decades, in terms of real educational expenditure per student the widening gap between the LDCs and other developing countries is much worse than the situation revealed by expenditure shares in figure 5.5.
17. For a definition of the term "fungibility", see endnote 3.
18. On the revenue side, whether the low tax rates in the LDCs are due to "fungibility" of aid or structural and administrative shortcomings of the LDC economies depends on how far one is prepared to stretch the concept of fungibility, since it can be argued that

such structural and administrative shortcomings are themselves due to fungibility of aid. Standard fungibility tests, however, suggest that at least with respect to the sub-Saharan African economies aid is not fungible vis-à-vis government taxation (Devarajan, Rajkumar and Swaroop, 1998).

19. In the aid policy debate, outcomes and policies sometimes are confused. For example, various tax rates and government expenditures within the regular government budget can be regarded as policy variables, even within the constraints of underdeveloped structures of the LDCs. But the budget deficit, even when we exclude donor-funded investments and grants, though it can be a target of policy, is not in itself a policy variable. Fluctuations in aid funds can exert an overwhelming influence on the outcome even when they are excluded from the measurement of the deficit. Similar considerations apply to monetary policy, as compared with outcomes such as domestic credit expansion and inflation, and to exchange rate policy, as compared with real exchange rate outcomes.
20. This is not, of course, to deny that there have been with other important enabling conditions in the case of Botswana which are absent in many other LDCs.
21. For example, as Helleiner (1999: 3) points out, "in Tanzania, where efforts have been made to transfer 'ownership' of development programs from aid donors to the government, only 30 per cent of ODA was estimated to flow through the government budget in fiscal year 1999". And the figure for fiscal year 2000 is apparently unchanged (ibid).
22. In fact, the principles of partnership, i.e. the critical role of the recipient Governments in giving direction and strategic guidance to aid coordination, and the donors' roles in harmonizing their activities as *partners* in development, were set out more than 30 years ago in the Pearson commission's report on international development (Pearson et al., 1969: 127).
23. This discussion partly draws on Wuyts (2000).
24. An arguably more appropriate framework would be one where there are two principals, namely the voters and the tax-payers in the recipient and the donor countries, and two agents, namely the recipient country Government and the Government or aid agencies in the donor countries. As shown in this chapter, the reasons for lack of aid effectiveness have to do with agency problems on both sides. However, Ndulu's framework (Ndulu, 2000) is adequate and more parsimonious for the study of issue of inclusive ownership.
25. This preference for NGOs, however, is not always clearly spelt out since many NGOs (particularly international NGOs relying on co-financing out of aid funds) are by no means accountable to the ultimate beneficiaries.
26. This may appear too superficial a point, but there are a number of influential advocates of this type of selectivity (see, for example, Collier, Guillaumont and Gunning, 1997, and Gunning, 2000), proposing the use of cross-country growth accounting regressions. The latest topical issue in this debate is whether to include policy variables in the regression equation and, if so, how to adjust the error term in order to find the right formula for effective aid allocation (see Gunning, 2000). But too much confidence should not be placed in the residuals from cross-country panel regressions, owing to various statistical problems, notably those arising from omitted heterogenity..

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