A Survey of Aid Effectiveness: Foundations and New Challenges

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Table of contents

Résumé

Cette réédition de l'étude « Efficacité et allocation de l'aide : revue des débats » reprend, en les actualisant, les fondements et les critiques des travaux de Burnside-Collier-Dollar sur l'allocation optimale de l'aide. Les implications politiques récentes de ces travaux sont également présentées, notamment l'évaluation du degré de sélectivité de l'allocation des pays donneurs et la question des États fragiles, « orphelins de l'aide ». Cette dernière est intimement liée à l'application du principe de sélectivité en fonction des performances économiques et institutionnelles. Par ailleurs, l'engagement de la communauté internationale à doubler l'aide pour financer les Objectifs du Millénaire pour le Développement a soulevé de nouvelles questions par rapport à la problématique de Burnside et Dollar. Deux d'entre elles attirent particulièrement l'attention des bailleurs de fonds : la capacité d'absorption des flux d'aide supplémentaires et la volatilité de l'aide qui risque d'accompagner sa forte augmentation. Cette étude examine les conclusions de plusieurs travaux proposant une typologie des contraintes pesant sur la capacité d'absorption des pays bénéficiaires d'aide. Parmi celles-ci, sont identifiées les contraintes macro-économiques, les contraintes politiques et institutionnelles et les contraintes engendrées par le comportement des bailleurs de fonds. Enfin, sont discutées les implications de la volatilité de l'aide dans le cadre d'un doublement des flux, en particulier les risques liés à l'imprévisibilité de l'aide.

Abstract

This new edition of "*Efficacité et allocation de l'aide: revue des débats*" (*Aid Effectiveness and Selectivity: a Survey)* revisits and updates the underlying principles and critiques of Burnside, Collier and Dollar's work on optimal aid allocation. The recent policy implications of this work are also presented, particularly the assessment of the selectivity of donors' allocations and the issue of fragile States, or the so-called "aid orphans", the latter being closely linked to how the principle of selectivity based on economic and institutional performance is applied. In addition, the international community's commitment to doubling aid flows to further the Millennium Development Goals has raised new questions regarding the Burnside-Dollar debate. Among these, two have particularly caught the attention of donor agencies: the absorptive capacity for additional aid and the aid volatility that may accompany a large scaling-up of aid. This study examines the findings of several works that posit a typology of constraints weighing on the absorptive capacity of recipient countries. These include macroeconomic constraints, political and institutional constraints and constraints generated by donor behaviour. To conclude, the implications of aid volatility are discussed in the context of the doubling of aid and, more specifically, of the risks linked to the unpredictability of aid flows.

Introduction

In 2005, we published a first version of this survey of the literature on the allocation and effectiveness of aid. It was an opportune time to take stock of several years of intense debates around these questions, which had been sparked off by the publication of the World Bank's 1998 report, *Assessing Aid.* The purpose of the report was to relaunch the debate on aid effectiveness at a time when this issue was exposed to an unprecedented crisis of legitimacy, due in part to the conjunction of political and economic factors. Changes in the political environment, marked by the end of the Cold War, had transformed the foundations of bilateral aid policies, long designed as instruments for promoting the donor countries' own political and geostrategic interests. In parallel, the economic rationales and justifications of development aid had come under attack with the publication, in the late 1980s and early 1990s, of studies that were highly critical in regard to the ineffectiveness of aid on a macroeconomic level (Mosley *et al.,* 1987, 1992; Boone, 1996), to the potentially perverse effects of foreign aid on incentives for the economic actors in developing countries (Bauer, 1993; Berg, 1993; Thiel, 1996), to the social and human costs of structural adjustments (Cornia *et al.,* 1987) and to the failure of the conditionality regime (Guillaumont and Guillaumont Jeanneney, 1995; Berg, 1997; Collier, 1997; Collier *et al.,* 1997).

This questioning of the rationale behind development aid, linked to the pressure of economic crises and heavy budgetary constraints in many donor countries, led to a sharp drop in aid flows to developing countries from 1992 onwards. It was thus within this unfavourable context for international aid that Burnside and Dollar's research findings (1997, 2000), on which the *Assessing Aid* report was based, were published. Their results maintain that aid effectiveness in terms of growth depends on the quality of the economic policies of developing countries, thus laying the ground for the principle of selecting recipient countries on the basis of this performance criterion. Much along this line of thought, Collier and Dollar (2001, 2002) propose an optimal aid allocation model in which poverty reduction is higher if aid is targeted at very poor countries with sound economic policies and institutions.

The message of the Burnside-Collier-Dollar analyses, which has been relayed by the World Bank and used by some bilateral donors as a basis for aid policy reform, has been the subject of intense debate in both institutional and academic spheres. Several critiques have been levelled at these studies: some have pointed up methodological weaknesses, whilst others query the arguments put forward by the authors. The essential questionings of the Burnside-Collier-Dollar studies, however, relate to alternative determinants of aid effectiveness, which weaken the very foundations of an allocation regime that reflects institutional and economic performance. In particular, we shall see that aid effectiveness can depend on other factors such as vulnerability to external shocks or conflict and post-conflict situations. Furthermore, allocation based on economic and institutional performance raises the issue of fragile States or, in other words, countries that do not fulfil the conditions for aid allocation and which are nonetheless among the least advanced.

The first three chapters of this document review the analyses of Burnside-Collier-Dollar and the critiques addressed to them. The new version of this survey has, however, enabled us to more fully explore two new aspects of the debate on selectivity.

First, despite the lack of consensus, the dominant paradigm that aid should be allocated first and foremost to poor but well performing countries has gradually imposed a model of 'good practices' across donor countries. As a result, indicators have been developed to assess the extent to which donors actually adhere to these practices. This new version thus contains a detailed presentation of these indicators and their limitations. Secondly, putting the selectivity principle into practice has highlighted the case of the so-called "orphan States": countries that are excluded from the international aid system because of their weak economic and institutional performance. These countries, often considered as fragile States, are also perceived as a threat to international security (pandemics, terrorism…). The question of what intervention methods should be used in these countries is the focus of the third chapter.

Finally, this new version includes an additional chapter showing how the international community's concerns have shifted since 2004 in light of mobilisation around the Millennium Development Goals (MDGs). Various studies have recently shown that these objectives cannot be attained by 2015 without additional input of external resources to enable the least advanced countries to break out of the poverty trap. They all concur that this would require a doubling of development aid. As a result, issues linked to reallocating aid flows have since been supplanted by those concerning mobilisation of resources and the implications of doubling aid flows. This prospect of doubled aid flows has refocused attention on two older issues related to aid effectiveness—flow volatility and absorptive capacity constraints—which are examined in detail in the fourth chapter.

Aid effectiveness and growth: the role of economic policy

1

Burnside and Dollar's (1997, 2000) analysis is at the heart of the aid effectiveness debate that animated the international community during the 1990s. In this first chapter, their works and the surrounding debates are examined in depth for two reasons. First of all, their analysis marks a turning point in the research on aid effectiveness, as it broaches the question of the *macroeconomic conditions* conducive to greater effectiveness—thus opening the way to a vast and hitherto unexplored field of research. Secondly, the academic research pioneered by these authors has had very important political implications, since it underpinned the recommendations formulated in the World Bank's 1998 report, *Assessing Aid*.[1] This research also represents a major advance in the thinking led by the World Bank about selective performance-based aid allocation (presented in the second chapter), and has since driven the shaping of some bilateral donors' development assistance strategies.

1 Since 1995, the World Bank has recommended applying a principle of selectivity, notably in the case of sub-Saharan African countries (World Bank, 1995).

1.1. Burnside and Dollar's analysis

The work by Burnside and Dollar (1997, 2000) was undertaken at a time when international foreign aid had been in decline since the early 1990s and was going through a crisis of legitimacy linked chiefly to the end of the Cold War and to a resurgence of studies critiquing aid effectiveness. Pessimistic conclusions of studies on the macroeconomic effectiveness of aid,[2] the "micro-macro paradox" formulated by Paul Mosley—according to which the positive conclusions of microeconomic studies on project evaluation contrasted with the somewhat negative conclusions of macroeconomic studies,[3]—and the light shed on the human and social costs of structural adjustment programmes[4] led the World Bank to relaunch the debate on aid effectiveness.

The idea developed by Burnside and Dollar and defended by the World Bank in its *Assessing Aid* report is that aid effectiveness in terms of growth[5] depends on the quality of the economic policies implemented by developing countries. This conclusion is grounded in an econometric study in which Burnside and Dollar assess growth equation coefficients including an aid variable and an aid term interacted with an economic policy index.[6] The quality of macroeconomic policy is captured by the control of inflation, budget equilibrium and trade openness.[7] By evidencing a significantly

2 Developed particularly by Mosley *et al.* (1987, 1992) and Boone (1996).

3 Mosley *et al.* (1987).

4 Cornia *et al.* (1987).

5 Since 1950, studies on macroeconomic aid effectiveness have essentially focused on growth issues. It was not until the early 1990s that the first studies integrating alternative aid effectiveness indicators (infant-child mortality, human development indicators, etc.) appeared.

6 This term implies that the marginal effect of aid on growth depends on the quality of economic policy.

7 The authors innovatively aggregate these three variables into a composite indicator, weighting them by their respective impacts on growth (see Appendix 1).

positive effect of the aid term interacted with the policy indicator in growth estimations, they conclude that aid effectiveness depends on sound economic policy.

This econometric result, pivotal to the aid effectiveness debate, is reproduced in equation (1) and detailed in Appendix 1.

(1) $Growth = -0.60.(\text{Initial income per capita}) + 0.71^{**}.(POL) - 0.021.(Aid/GDP) + 0.19^{**}.(Aid/GDP \times POL) + \gamma X.$

$R^2 = 0.36$, N = 270, **: significant at 5%.

In this equation, *POL* represents an aggregate indicator for macroeconomic policy (see Appendix 1) and γX is a set of control variables (institutional quality, financial depth, ethnic fractionalisation, political assassinations).

The policy implications of the Burnside and Dollar analysis are paramount. Indeed, if aid is more effective within a sound macroeconomic environment, it should target those poorest developing countries that have taken on board "good" economic policies. A principle of *selectivity* across recipient countries then emerges out of a logic of *ex-ante* conditionality based on economic policy quality.

Perhaps because of its strong implications for policy, the Burnside and Dollar analysis has been subject to much criticism of two main types. The first type, presented in the following sections, is exclusively centred on their academic work, addressing: (i) the arguments they use to justify the selectivity approach to recipient countries (section 1.2.), (ii) the policy indicator used by the authors (section 1.3.), and (iii) the robustness of their econometric results (section 1.4.). The second type of criticism proposes a broader concept of macroeconomic conditions for aid effectiveness, which sometimes oppose and sometimes complement Burnside and Dollar's concept. The debate on the conditions for aid effectiveness—which, as we shall see, shape the very diverse policy recommendations for the criteria to be used for aid allocation—is presented in the third section.

1.2. Arguments under debate

To justify the idea that aid should be concentrated on countries with good economic policies, the *Assessing Aid* report advances two arguments: aid is fungible and it has no impact on economic policy.[8]

1.2.1. The fungibility of aid

The concept of the fungibility of aid refers to the fact that a recipient government is able to reduce its own expenditure on the sector targeted by aid and thus transfer funds to other sectors. The fungibility of aid thus means that budgetary constraints in the recipient country can be relaxed, with the aid simply supplementing the State's overall resources. As fungibility prevents donors from targeting aid as they wish, it is cited in the *Assessing Aid* report to argue for a more selective allocation of aid: "In countries with sound policies, […] donors can provide large amounts of assistance as general budget support, knowing the resources will be well used. […] Where donors and governments do not agree on the allocation of expenditures and spending is not likely to be effective, the best approach is to reduce funding and increase support for policy dialogue and institution building—until donors are convinced that their funds will contribute to development." (World Bank, 1998: 61).

8 A third argument, which is not cited in the *Assessing Aid* report, is the potentially incentive nature of a policy-based selectivity approach.

The *Assessing Aid* report concludes that aid is fungible primarily on the basis of the econometric analysis conducted by Feyzioglu *et al*. (1998). The study broaches three questions that reflect three aspects of fungibility. First of all, the authors attempt to determine whether aid increases government spending or, on the contrary, allows countries to reduce taxes or public deficit. In a sample of 38 countries, the study shows that USD 1 of aid increases government spending by only 33 cents, suggesting a high degree of fungibility.[9] The authors then examine whether aid finances capital expenditure or government consumption expenditure. The assessment of a sub-sample of 14 developing countries highlights that only 29 cents of every dollar is channelled into capital expenditure, the remainder going towards government consumption. Finally, Feyzioglu *et al.* verify whether the sector targeted by the donor country is the one that actually receives the aid. As the breakdown of grants is not available at sector level, the authors were only able to examine the fungibility of concessional loans. In their 14-country sub-sample, it appears that concessional loans earmarked for the transport and communication sectors are not fungible, while the contrary is true for education, agriculture and energy.

This study has nonetheless received much criticism:[10] the country sample is very limited, the sector analysis considers only concessional loans, the explanatory power of the econometric model is very weak, and the meaning of the coefficients is questionable. Furthermore, cross-country studies on fungibility do not reveal the marked differences that exist across developing countries. Thus, for example, Pack and Pack (1990, 1993) underline the importance of the characteristics of each country's budget process by showing that aid is fungible in the case of the Dominican Republic, but not in the case of Indonesia.

9 Effectively, in this case, 67% of aid flows are in fact used to reduce budget deficit and/or taxes. Nonetheless, for a more restricted sample of 14 countries, the results evidence a lower degree of fungibility, since one dollar of aid increases expenditure by 95 cents.

10 See notably Lensink and White (2000); McGillivray and Morrisey (2000); Beynon (2001); Berg (2002).

More generally, the conclusions of the *Assessing Aid* report reflect no more than a partial review of the literature on aid fungibility, bypassing, for example, the fiscal response literature (McGillivray and Morrissey, 2000).[11] Fiscal response models examine the mechanisms through which aid can engender forms of government behaviour that may even undermine the effect of aid on growth.[12] The models have given rise to econometric applications that suggest overall a certain extent of fungibility in aid flows, but in varying degrees. For instance, the estimations of Franco-Rodriguez *et al*. (1998) evidence that in Pakistan between 1965-1995, half of the aid was allocated to government consumption and that it had a slight but positive effect on public expenditure and a negative impact on taxation. A detailed survey of these studies is proposed by Amprou and Cottet (2007).

Finally, the most recent critiques underline the fact that fungibility does not necessarily constitute a problem: "If the aid recipient has more knowledge about how to maximise the impact of aid, then fungibility may in fact be growth-enhancing, assuming of course, that the aid recipient pursues the growth and development objectives in an efficient manner. Thus, whether fungibility should be seen as a positive or negative feature of aid depends upon country-specific circumstances and the interplay between donor and aid recipient objectives."[13]

1.2.2. Aid has no impact on reform

The second argument developed in the *Assessing Aid* report in favour of greater policy-based selectivity across recipient countries is that aid has no impact on the quality of policy.

11 For the bases of fiscal response models, see Heller (1975).

12 See notably Mosley *et al*. (1987); Gang and Khan (1991); Binh and McGillivray (1993); Franco-Rodriguez *et al*., (1998).

13 In Hjertholm *et al*. (2000, p.356). See also McGillivray and Morrissey (2000).

Many theoretical arguments have been put forward as to what effect aid has on economic policy reform. In the first place, aid can help a government to initiate reforms while enabling it to offset its adjustment costs, especially if these are borne by a specific segment of the population.[14] In effect, stabilisation and adjustment measures impose immediate costs that are often concentrated on sectors of population that are easy to identify and mobilise, while the benefits expected from these measures are deferred, uncertain and diffuse. At the other end of the scale, some observers emphasise that this argument can backfire against aid, since "external resources reduce the costs both of reforms and of doing nothing—that is, avoiding reform".[15]

The World Bank observes that aid has not contributed to policy reform in those countries that have not taken on ownership for such reform. The most obvious symptoms of this failure are seen in the dysfunctioning of the aid instrument designed to influence the orientation of economic policy: conditionality tied to disbursements. There is agreement from all donors and analysts on this diagnostic, but different strategies are used to remedy it.

Whereas the European Commission opts for a reform of conditionality that takes into account performance indicators (cf. Box 1.), the World Bank advocates an *ex ante* principle of selectivity across recipient countries based on policy quality (instrument indicator). It considers that, prior to serious commitment with those countries to be reformed, donor countries must focus on technical assistance without resorting to substantive budget support. If a reform process is set in motion, then funding can be increased accordingly as policies improve. Consequently, when economic policies are poor, financial aid should be replaced by dialogue about the choice of policies and

14 Sachs (1994); Dessus *et al*. (1998); Alesina and Drazen (1991); Nelson (1990); Waterbury (1989); Amprou and Duret (2000).

15 In Rodrik (1996, p.30); see also Berg (1993 and 1997).

technical assistance, summed up by the *Assessing Aid* report as: “If commitment, money—if not, ideas” (World Bank, 1998: 58).

The next two sections provide an in-depth examination of the Burnside and Dollar argument, which states that aid does not impact on reforms. This argument is analysed first in the light of the difficulties encountered within the practice of conditionality, and then of the lessons learnt from cross-country studies, which do not unanimously find that aid is ineffective in promoting reforms.

1.2.2.1. Dysfunctions of conditionality

Conditionality enables donors to deliver aid in return for reform. Donors thus become a sort of “paying advisor”.[16] Yet, twenty years’ experience of macroeconomic conditionality suggests that it has not been a very high-performing instrument for furthering economic policy reform. Certainly, the difficulties in applying conditionalities and the often contradictory goals (rapidly releasing the agreed aid amount and conditioning its disbursement to reforms that foster sustainable economic growth) have continued to create perverse effects within the system.[17] There seem to be two main factors underlying these dysfunctions: (i) in the long run, government policy is determined by domestic political forces and (ii) conditionality terms are not suitably formulated (Collier, 1997).

Policy choices are basically influenced by internal considerations, that is to say, the political doctrines of those in power and the behaviour of interest groups, notably through obstructing reform measures liable to jeopardise rent-seeking practices.[18]

16 Guillaumont,1995.

17 Guillaumont, 1995.

18 See notably Williamson (1994); Waterbury (1989); Stiles (1990); Rodrik (1996); Haggard, Lafay and Morrisson (1995).

During the crafting of policies that are subject to conditionality, both of these aspects hinder reform and prevent recipient governments from taking on ownership for aid-funded programmes. Although the actual principle of assisting structural adjustment implied that the recipient government commit to implementing reforms, it has clearly often been the case that economic policy conditions are accepted with little conviction, simply due to the pressing need to obtain funds. In this perspective, the formal commitment to undertake reform has become the price to pay in order to receive funds (Guillaumont, 1995). In other words, reform is perceived as a cost and not as a benefit. Faced with the recipients' reticence, the resulting lags in reform and the failure of many programmes, donor confidence has been severely eroded. This has led donors, now in the position of programme buyers, to formulate increasingly specific conditions and become more involved in reforms so as to make sure they are implemented. As a result, development programmes are now a concern for donors more than one for recipient governments.

Dollar and Svensson's (2000) study is interesting in this respect. The authors estimate the probability of the success or failure of structural adjustment programmes implemented by the World Bank on the basis of aid recipients' policy characteristics (democratic government, political stability, ethnic fractionalization) and of variables under the control of the World Bank (administrative costs linked to programme preparation and supervision)[19]. Their econometric analysis suggests that the success of reform programmes depends primarily on the institutional and political characteristics of recipient countries, with the World Bank variables not being significant.

Conditionality formulation is the second factor likely to cause dysfunctions in the aid system. Most financing agreements carry several conditionalities relating to different

19 These costs are measured by the number of weeks of preparation and supervision required by each project.

aspects of a single reform and attached to the disbursement of different loan tranches. It may happen that a country accept a loan and its conditionalities in order to obtain the first tranche of funding, even though release of the second is subject to completion of a condition that it has no intention of fulfilling. A frequently occurring situation with IMF agreements is that an increase in fiscal revenue is forecasted, yet this is impossible without profound changes in tax and customs and excise administration. Recipient countries can also negotiate agreements in such a way that the conditions attached can easily be emptied of their substance. This is particularly frequent with respect to the liberalisation of trade and prices.

The tendency to only partially implement agreed reforms has sometimes been substantially reinforced, as sanctions have not in fact been applied: in other words, disbursements are continued even though the prescribed conditions have not actually been met. Certain international institutions are not unfamiliar with this practice. Following a bureaucratic logic of success,[20] they have acted as if conditions had been fulfilled when this was not the case. Bilateral donors have also sometimes adopted the same attitude because of their political ties with recipient States.

It thus appears that macroeconomic conditionality, which today is the main mechanism allowing donors to promote or 'buy' policy reforms in recipient countries, suffers from numerous dysfunctions. These are in fact one of the factors that put into question the effectiveness of aid in furthering reform. In light of this, two approaches have emerged: the World Bank's approach, as outlined in the *Assessing Aid* report, and that of the European Union, which involves replacing traditional instrument-based conditionality with conditionality based on results, or more precisely, on "performance" (cf. Box 1).

20 The performance of development agencies is most often measured using the disbursement rate of committed donor funds.

Box 1.

European Commission: introduction of results-based indicators in managing structural adjustment programmes in ACP countries.

Since 1999, the European Commission has signed financing conventions within the framework of its budget support to ACP (African, Caribbean and Pacific) countries, enabling performance-based conditionality to be put to the test. This reform involves modulating structural adjustment support, which is no longer conditioned on implementing specific policy measures, but rather on country performance in jointly agreed economic or social sectors. This new conditionality must: (i) raise government ownership of reforms, given that the choice of instruments devolves entirely upon the country in question, (ii) avoid arbitrary assessment of multiple heterogeneous policy measures, (iii) facilitate graduated, progressive support contingent on performance assessment and (iv) facilitate co-ordination, since there should be no more discord over the measures to be taken.

Between 1999 and 2001, around thirty programmes including one or more variable tranches, the disbursement of which depends on performance-based indicators, were adopted with nineteen ACP countries. The principal areas targeted are public sector finances and the social sectors (education and health).

The choice of performance indicators

The indicators of budget or public finance management fall into three categories: budget consistency (e.g. share of budget allocated to the social sectors), budget execution (e.g. budget execution rates) and efficiency (e.g. time taken for government procurement). Certain aspects of these indicators have elements in common with traditional conditionality, as the same economic policy instruments are used.

In the education and health sectors, for instance, four traditional categories of public-service delivery indicators are used depending on the progress made towards the final result: the indicators involving actions undertaken by the government or *input* indicators (e.g. amount spent on the construction of schools or health centres); the indicators for execution or *output* indicators (e.g. number of school or health centres opened in rural zones or number of school books per pupil); the intermediary result indicators or *outcome* indicators (e.g. pass rate from primary to secondary education or visit rates to health services) and the final result or *impact* indicators (e.g. literacy rates or infant-child mortality rates).

The new European conditionality lays emphasis on the intermediary outcome and output indicators, rather than impact indicators, although the latter give a truer reflection of the progress made towards poverty reduction. In other terms, the new European conditionality is based more on usage rates of health and education services (school enrolment rates) and on the factors aimed at increasing usage, than on the levels of health and education themselves. Three reasons are given for this choice. First, the indicators used allow policy shortcomings in education and health to be pinpointed. Second, the data can be collected by the administration somewhat more easily than those for impact indicators. Finally, they are considered less dependent on exogenous factors beyond government control.

Evaluation and lessons to be learned from this initiative

Firstly, the evaluation of this initiative has revealed the limited scope of the conditionality reform, as the proportion of variable tranches in total European budget support between 1999 and 2001 was small. Overall, these tranches represented 20% of commitments for budget support programmes in the nineteen countries concerned. The impact of disbursement of these variable tranches on total European aid flows is still more limited. In Burkina Faso, for example, the non-disbursed amount of the variable tranche of the first convention (PAS 1999-2000) accounts for around only 2% of total European aid.

Nonetheless, a certain number of lessons and recommendations can be drawn from this initiative:

1. The impact indicators are preferable to intermediary indicators as a basis for the new conditionality and for modulating aid, since they unambiguously reflect developmental change and leave recipient countries full responsibility for their choice of strategies. A small number of summary impact indicators suffice to assess health and education development. These indicators either exist or can be established at a relatively moderate cost. For health, this mainly involves the infant-child mortality rate (these

data are collected in the Demographic and Health Surveys). For education, it entails measuring basic skills acquisition, for which test methods are continuously improving and which could complement the primary education completion rates.

2. Intermediary indicators, widely employed in the European system, are also helpful, but they should not be used to graduate the amount of aid. Their role is to enable national policy-makers to monitor the implementation of the policy they have freely chosen, and to keep donors informed.

3. These two types of indicators can be combined into a two-step procedure that reconciles both long- and short-term objectives. The emphasis laid on the final result or impact places the European system within a long-term perspective. Even if the corresponding indicators show appreciable changes over a few years, it is justifiable and possible in cost terms to measure them every three years. This three-yearly interval makes it possible to assess the actual results achieved by a country in the fight against poverty. The evaluation of these results will then be used to fix the annual allocations of the variable tranche for the three ensuing years. However, a set of medium-term indicators chosen by the country will be fixed and carried over annually according to a pre-established calendar, and will condition annual payments at the level agreed on at completion of the triennial impact-based evaluation.

4. The corollary of the above proposal is that assessment should serve to define the commitments of previous years and not the current year's disbursement. By nature, this type of system ensures better short-term predictability and inter-year scheduling of payments.

Finally, assessing results implies a need to correct them, keeping in mind the impact of exogenous factors, *i.e.* factors independent of political will (climatic or external shocks, etc.). This is precisely the meaning given to "performance" in that results are adjusted or corrected taking into account the impact of these factors.

Source: CERDI (2002).

1.2.2.2. Aid has no impact on reform: an argument under debate in the empirical literature

Voluminous literature exists on the linkage between aid and reform. The first generation of studies[21] on structural adjustment loans and their effects on policy reached a hesitant conclusion about the capacity of aid to promote reforms in countries where strong commitment to their implementation is lacking. In 1994, the World Bank ranked 26 sub-Saharan African countries according to changes in the quality of their economic policy and to the evolution of aid flows. This study shows that, for most of the African countries having benefited from increased aid flows, policy quality had deteriorated, whereas policies had improved for a majority of countries whose aid inputs had been reduced.

The debate on whether aid is effective in promoting reform has taken on new proportions as cross-country econometric studies have developed. Thus, an empirical test of how aid impacts on the quality of economic policy is proposed in the 1997 version of Burnside and Dollar's article. The authors estimate the coefficients of an economic policy equation based on a country's structural and political characteristics. While the quality of economic policy seems to depend on the characteristics of recipient countries, the aid variable itself has no effect.

Alesina and Dollar (1998, 2000) examine the effect of aid on changes in economic policy. For a sample of 60 countries, they identify a hundred or so episodes of significant increases and reductions in the amount of aid and analyse the patterns (before, during and after) of opening up both politically (captured by a democracy indicator) and economically (captured by a trade openness indicator). Comparing these variables, the

21 Mosley, 1987; Mosley *et al*., 1995 and Thomas *et al*., 1991.

authors conclude that significant variations in aid amounts do not seem to precede political or economic reforms.[22]

The cross-country econometric studies would thus seem to suggest that the link between international aid and the quality of economic policy is a tenuous one.[23] These studies, however, conceive this linkage as being static. Yet, if aid can indeed incite a country to take on board better economic policies, the poorer the quality of the policies at the outset, the greater their aid-driven improvement is likely to be. This idea is defended by Chauvet and Guillaumont (2004a). Using a different econometric specification,[24] they evidence a positive impact of aid, whereby the poorer the initial policy, the stronger the impact. In this case, the marginal contribution of aid to growth is likely to be even greater when the policies are initially very poor, since the prospect of aid-induced improvement is greater. Chauvet and Guillaumont (2004a) test this hypothesis through growth estimations. Their econometric analysis suggests that what determines aid effectiveness is less the initial quality of policy than the *potential for improvement* through aid.[25] Chauvet and Collier (2005, 2006) defend a similar idea but assign a specific definition to the weakness of initial conditions. Their analysis deals with so-called "fragile" States, which are primarily characterised by the weakness of their economic policies. The impact of aid in this context depends crucially on synchronising aid intervention with the sequence of reforms. Their analyses are presented in detail in section 3.4.

22 On the other hand, they show an aid response to episodes of democratisation (but not economic openness).

23 Sachs (1994) underlines, however, that cross-country studies are likely to "wipe out" the effect of aid if this aid has simultaneously supported reforms in some cases and allowed poor policies to continue in others. The average effect of aid on reforms is therefore zero.

24 In economic policy equations, they introduce an aid variable and an aid variable interacted with initial economic policy quality.

25 Alongside the aid term interacted with the economic policy indicator (*Aid x POLt*), they introduce an aid term interacted with the initial quality of these policies (*Aid x POLt-1*). Whilst, in accordance with the Burnside and Dollar analysis, the crossed variable *Aid x POLt* is significantly positive, the second interaction term *Aid x POLt-1* is significantly negative.

Some econometric studies have also shown that aid helps to promote reforms by making them politically sustainable in the sense that it can assist in neutralising interest groups with a capacity to resist them. It can partially and temporarily compensate these groups for any prejudice they experience due to discontinued rent-related income, and thus help facilitate the reform process (Amprou, 2001).

Finally, we note that the case studies concerning the impact of aid on the quality of policy and promotion of reforms exhibit more nuanced results than the econometric analyses. The World Bank has launched a series of studies on the aid-reform linkage in ten African countries (Devarajan *et al*., 2001). The overall findings of these studies suggest that aid has played a significant and positive role in two reform-oriented countries (Ghana and Uganda),[26] but that the donors have not adequately distinguished between the different types of recipient countries and the different phases of the reform process. More specifically, Devarajan *et al.* consider that the "large amounts of aid to countries with bad policy sustained those poor policies. The funding allowed the delay of reform." In countries that are "mixed reformers", the case studies nonetheless suggest that aid was sometimes able to impact on reform. For example, in Côte d'Ivoire prior to the 1994 CFA Franc devaluation, many reforms in favour of trade liberalisation were implemented under pressure from the principal donor countries (Berg *et al*., 2001).

The argument that aid has no effect on macro-economic policy is presented in the *Assessing Aid* report in order to justify the need for a degree of selectivity across recipient countries. Nonetheless, whilst it is unanimously agreed that traditional conditionality practices have failed, the idea that foreign aid has absolutely no impact on policy improvement has been put into question by some empirical studies, suggesting that aid can influence policy in ways other than through conditionality.

26 In the case of Ghana, see also Lloyd *et al*. (2001) who reach the same conclusion concerning the effect of aid in supporting reform in these countries.

1.3. Discussions on economic policy indicators

Certain authors have queried the concept of “good” economic policies used by Burnside and Dollar and the way in which they are measured. It should be recalled that these two authors assess the quality of developing countries’ economic policies on the basis of inflation control, budget equilibrium and trade openness. Critiques of this indicator refer not only to the problems of what it encompasses, but also to the way in which the three variables are combined.

Trade openness is measured by the Sachs and Warner (1995) indicator of openness to trade. A country is considered to be “closed” if any one of the five following conditions is met: (1) the average tariff rate exceeds 40%; (2) non-tariff barriers cover more than 40% of imports; (3) the country has a socialist economic system; (4) there is a State monopoly on principal exports; or (5) the black-market premium on the official exchange rate was higher than 20% during the 1970s or 1980s.

However, this measure of trade openness, which is at the heart of Burnside and Dollar’s analysis, is the subject of a debate that is worth mentioning briefly. Rodriguez and Rodrik (2001) underline, for example, that a high-black market premium, over a prolonged period of time, is more revealing of a set of economic and political imbalances (high inflation rates, high debt-to-exports ratio, war and poor institutional quality) than of effects solely attributable to trade policy. Furthermore, the State monopoly variable for exports is constructed on the basis of a World Bank (1994) study that implies, according to Rodriguez and Rodrik, a double bias in the selection of countries: non-African countries are excluded from this study, as are all those that did not follow a structural adjustment programme at the end of the 1980s. The authors show that the black-market premium and State monopoly variables largely explain the effect of the aggregate trade openness variable on economic growth. In effect, the other three characteristics taken into account in this indicator (two of which are restrictions on external trade variables) do not significantly influence growth when they are entered jointly with the black-market premium and the State monopoly variables.

The *budget surplus* and *inflation* variables are not exempt from criticism. Inflation is not in itself a measure of economic policy and its relation to growth is probably non-linear (Lensink and White, 2000): if a high inflation rate is bad for growth, the same is true for policies aimed at reducing an already very low inflation rate. Budget surplus can be improved by reducing expenditure or by increasing revenue, two measures that are likely to have differing effects on growth. Furthermore, some authors have pointed out that this variable is not a significant determinant of growth,[27] which seems to be confirmed by the first version of the Burnside and Dollar (1997) article, in which budget surplus has no effect on growth.

Their aggregate index combines three economic policy variables weighted by their respective impacts on economic growth. These weights, however, may vary for certain countries or groups of countries,[28] a point that Burnside and Dollar do not take into account. Furthermore, the actual construction of a composite indicator is queried by Lensink and White (2000), who conclude that aid effectiveness may be a function of only certain aspects of economic policy.

In the research that has followed Burnside and Dollar's study, the concept of "good" economic policy has progressively been extended to include that of economic and institutional performance, most often measured by the *CPIA (*Country Policy and Institutional Assessment*)*. In the second chapter, which focuses on what selective aid allocation implies in the fight against poverty, we shall take a closer look at the debate on performance measures for developing countries.

27 See, for example, Levine and Renelt (1992).

28 Lensink and White (2000) point out that Berthélemy and Varoudakis (1996) have shown that policies promoting trade openness only have a positive effect in countries that have a developed financial system.

1.4. The fragility of Burnside and Dollar's econometric results

The robustness of Burnside and Dollar's econometric results has been queried on several levels: the heterogeneity of the dependent variable, the specification of the aid-growth relationship and the sample of countries selected.

Generally, the inherent weakness of cross-sectional studies on economic growth—a weakness linked to the unobservable heterogeneity of countries and to omitted variable bias—has been underlined by numerous studies.[29] Added to this is the problem of measuring aid, which encompasses different types of aid (budget support, physical infrastructure projects, human development projects) that impact growth at different time horizons. Clemens *et al.* (2004) investigate what effect this heterogeneity of aid has on its effectiveness, according to the chosen time horizon. The authors thus distinguish budget support and aid to transport infrastructure, which can influence short-run growth, from aid channelled to social sectors and more likely to influence medium- or long-run growth. In their view, a third category, humanitarian aid, does not have as its primary aim to increase growth. They disaggregate aid into so-called "short-impact" aid, "long-impact" aid and humanitarian aid on the basis of sectoral data for aid commitments supplied by the OECD-DAC.[30] The inclusion of the "short-impact" aid variable in growth estimates suggests that this type of aid positively impacts growth, regardless of policy quality. In the Clemens *et al.* (2004) study, however, the argument that taking the type of aid into account shows a positive influence of "short-impact" aid is weakened by the equally positive influence of "long-impact" aid.

Other authors have contested the specification of the relationship between aid, economic policies and growth used by Burnside and Dollar. In fact, when a

29 On this point, see particularly Lensink and White (2000) and Hansen and Tarp (2001).

30 The authors calculate the disbursements by sector by applying the sectoral commitments portion of total commitments to the aggregate disbursements.

supplementary variable is introduced into the initial specification, this causes the link between economic policies and aid effectiveness to disappear (Hansen and Tarp, 2001; Guillaumont and Chauvet, 2001).[31] These different studies will be presented in detail in the third chapter.

Others still have inclined towards questions about the country sample used. Effectively, the robustness of Burnside and Dollar's results relies on the exclusion of five observations that they consider outliers in their data set (cf. Appendix 1). However, depending on the criterion chosen, the five observations are not always outliers and others could have been included in this list. The multiple configurations concerning the country sample chosen (explored by Dalgaard and Hansen, 2001) lead to differing conclusions about the influence of economic policy quality on aid effectiveness, since depending on the sample, the significance of the aid-policy interaction term sometimes disappears.

The sample also proves to be very important in Easterly, Levine and Roodman's study published in the *American Economic Review* in 2004. For their analysis, these authors expand the Burnside and Dollar data set to include not only a four-year sub-period from 1993 to 1997 (the initial study by Burnside and Dollar stopped at 1993), but also a greater number of countries. The sample thus increases from 56 countries and 275 observations to 62 countries and 356 observations. The Easterly *et al.* study is original in that it focuses on questions relating to the sample: except for the new observations introduced, the econometric specification is completely identical to that used by Burnside and Dollar. The findings of this purely statistical exercise show once again that the econometric relationship between aid, policy and growth lacks robustness. Whether the outliers are taken into account or not, the non-linear relationship between aid and growth is no longer

31 Hansen and Tarp (2001) add an aid squared variable, and Guillaumont and Chauvet (1999, 2001) add a variable for the structural vulnerability of developing countries.

significant in the Easterly *et al* analysis. In reply to these authors, Burnside and Dollar (2004) contend that the changes in the results obtained stem from the characteristics of the countries added to the sample: of the eleven observations that negatively influenced the aid coefficient interacted with economic policy, seven come from additions made by Easterly *et al*. However, very few arguments allow them to question the statistical results obtained by Easterly *et al*. Burnside and Dollar thus cite certain stylised facts from country case studies to reiterate their support for the hypothesis that economic policy has a positive effect on aid effectiveness. It is also interesting to note that the *Assessing Aid* report recognises the fragility of the econometric results underpinning its conclusions, but also maintains that the link between economic policy and aid effectiveness is confirmed by country case studies.

At a time when development assistance was going through an unprecedented crisis of legitimacy, Burnside and Dollar's study and the *Assessing Aid* report provided a response to the detractors of aid: certainly, aid is not always efficient, but when the economic policies implemented by developing countries are sound, aid has a positive impact on growth. The core policy implication of this analysis, and one advocated by the World Bank in its *Assessing Aid* report, is the setting up of a selectivity principle that would aim to allocate financial resources only to those countries pursuing " good" economic policies. Burnside and Dollar's research has been taken further by Collier and Dollar, who attempt to identify the implications for poverty alleviation of reallocating aid according to the quality of policy and the poverty levels in developing countries. The Collier and Dollar study is presented in the following chapter.

Aid effectiveness and poverty reduction: the role of performance-based allocation

2

Since the 1960s, the debate on the macroeconomic effectiveness of aid has above all focused on its impact on economic growth. Of course, research into its effect on growth has evolved over time—there have been changes in the conceptual framework, the econometric methods used and, more broadly, the policy issues addressed to the international community. Yet, since the early 1990s, official development assistance has progressively renewed its focus on the objective of reducing poverty, a shift materialised by the commitment made by 189 countries to the United Nations to halve global poverty by 2015. Thus, in view of achieving the MDGs, Collier and Dollar's analysis (2001, 2002) poses the following question: what criteria must donor countries use for allocating their aid in order to obtain a maximum impact on poverty reduction?

Building on the conclusions of Burnside and Dollar's study, they defend the idea that poverty reduction would be maximised by an allocation system based on the performance and institutional quality of recipient countries. In this sense, Collier and Dollar's analysis explores what the conclusions of Burnside and Dollar's study—which contends that aid is more effective in a good policy environment—imply for the way in which aid is allocated.

The first section presents Collier and Dollar's approach, their study's main findings and the critiques it has received. The second section looks at the International Development Association's (IDA) experience of performance-based aid allocation. Finally, the third section discusses assessments of the quality of geographic allocation—and thus the selectivity effort—of different donors.

2.1. Optimal allocation to reduce poverty

The normative implications of Burnside and Dollar's study with respect to aid allocation have been formulated by Collier and Dollar (2001, 2002). The cornerstone of Collier and Dollar's analysis can be summarised as follows: "to maximize the reduction in poverty, aid should be allocated to countries that have large amounts of poverty and good policy" (Collier and Dollar, 2002, p.1482). Their analysis proposes optimal aid allocation based on a poverty-efficiency principle: at equivalent levels of poverty, aid must be allocated first and foremost to those countries where it will be most effective.

2.1.1. The Collier and Dollar optimal allocation model

Collier and Dollar develop an aid allocation model aimed at maximising poverty reduction. Their model is grounded in two ideas: (i) aid has a positive effect on growth in countries with good economic policy (Burnside and Dollar, 1997, 2000) and (ii) growth brings about a reduction in poverty (Ravallion and Chen, 1997; Dollar and Kraay, 2000).

The allocation of aid that allows maximum poverty reduction is obtained by equalising, across all recipient countries, the number of persons lifted out of poverty through an additional dollar of aid. In order to derive the conditions for maximising poverty reduction through aid allocation, Collier and Dollar measure both the marginal effect of aid on growth and the effect of growth on poverty reduction.

Following the logic of Burnside and Dollar's analysis, the effect of an extra dollar of aid on growth depends on the quality of the policy environment and on the amount of aid itself. Collier and Dollar therefore estimate a growth equation of the following type:

$$(1) \quad g = \beta_0 + \beta_1 X + \beta_2 P + \beta_3 A + \beta_4 A^2 + \beta_5 AP$$

where *X* is the ensemble of exogenous conditions, *P* is the policy variable and *A* is aid as a percentage of GDP. The marginal contribution of aid to growth, g_a, can be expressed as:

$$(2) \quad g_a = \beta_3 + 2\beta_4 A + \beta_5 P$$

The notion of "good" economic policy used by Collier and Dollar is markedly different from that used by Burnside and Dollar, and is more akin to the broader notion of the quality of the institutional environment. The authors, in fact, use the CPIA tool built by the World Bank to capture, in addition to aid recipients' macroeconomic policies, their institutional arrangements and public sector management (or governance). The CPIA tool is presented in detail in paragraph 2.2.2.; it comprises twenty distinct and equally weighted components rated on a scale of 1 to 6.

The presence of the aid amount in the marginal contribution of aid to growth is linked to the aid-squared term in the growth equation. Collier and Dollar (2001, 2002) introduce this variable in order to test the hypothesis of diminishing marginal returns to aid, which is key to their analysis. Certainly, without this hypothesis, optimal aid allocation would first of all mean allocating all of the aid to the country in which it would be most efficient until there were no more poor people in the country. It would then be channelled to the next country. This type of allocation, however, would come up against the question of political realism.

To calculate aid allocation that maximises poverty reduction, the level and elasticity of poverty in relation to revenue growth need to be measured. Collier and Dollar measure poverty by the proportion of population living on less than two dollars a day (Headcount Index). They also construct a hypothesis for a constant elasticity of poverty with respect to growth, which is identical across all the countries and equal to 2 (the average elasticity estimated by Ravallion and Chen (1997) for the countries in their sample).[32]

The results of the simulations run by Collier and Dollar are shown in Table 1.[33] The last column of the table gives the estimated poverty-efficiency of aid allocation in 1996. This estimation suggests that, for countries receiving large amounts of aid, the marginal efficacy of aid—that is to say, the number of people lifted out of poverty through the allocation of one million dollars—is sometimes negative.[34] On the other hand, in India, Ethiopia and Uganda, the amounts of aid received in 1996 were low despite an increased marginal productivity of aid—reflecting the fact that these countries are characterised by high levels of poverty and relatively sound economic policy.

To calculate the optimal allocation of aid, Collier and Dollar constrain the amount of aid received by India to its actual level in 1996, as the country's size implies that it would otherwise attract two thirds of total aid. In the optimal allocation regime obtained

32 Collier and Dollar test the sensitivity of their results with respect to the measure of poverty and to their chosen elasticity value using other country-specific measures of poverty and elasticities. However, they obtain highly correlated optimal allocations whatever measures are used. Beynon (2003) remarks however that the high correlations between the different allocation regimes are in part linked to the large number of zero allocations in the optimal aid scenarios.

33 For these simulations, the authors measure poverty by the number of people living on less than USD 2 per day. The elasticity of poverty with respect to growth is equal to 2.

34 See, for example, Rwanda and Guinea-Bissau.

Table 1.
Collier and Dollar Results (2002)

	Optimal Allocation *(Poverty-Efficient Aid)*		Actual Allocation	
	Reallocation (% GDP)	Marginal Efficiency (persons / $1 million)	1996 Allocation (% GDP)	Marginal Efficiency (persons / $1 million)
Uganda	11.4	285.1	3.34	1001.5
Ethiopia	10.7	285.1	2.90	1654.8
Zambia	8.8	285.1	7.53	421.6
Tanzania	7.0	285.1	4.46	449.4
Lesotho	6.1	285.1	3.09	416.8
Rwanda	6.0	285.1	15.75	-1071.1
Senegal	5.6	285.1	4.03	358.0
Niger	5.0	285.1	2.97	484.0
Guinea-Bissau	4.9	285.1	15.67	-700.8
Madagascar	4.7	285.1	2.84	470.3
Kyrgyz Republic	4.0	285.1	2.45	325.4
Honduras	3.8	285.1	2.82	318.3
Vietnam	3.5	285.1	0.78	414.9
Mauritania	3.4	285.1	6.15	185.8
Kenya	3.3	285.1	1.91	380.2
Pakistan	3.0	285.1	0.41	376.2
Nicaragua	2.9	285.1	10.21	23.7
Côte d'Ivoire	2.8	285.1	3.91	250.5
Nepal	2.5	285.1	1.70	347.3
Nigeria	2.4	285.1	0.19	430.9
India	0.13	670.6	0.13	670.6
Algeria	0.0	33.5	0.22	32.7
Republic of Belarus	0.0	3.0	0.16	2.8
Botswana	0.0	134.9	0.71	129.2
Brazil	0.0	89.5	0.04	89.2
Bulgaria	0.0	34.1	0.46	31.7
Chile	0.0	67.4	0.12	67.0
China	0.0	237.4	0.06	236.3
Colombia	0.0	47.2	0.10	46.9
Costa Rica	0.0	98.7	-0.03	98.9
Czech Republic	0.0	77.8	0.11	77.3
Equator	0.0	63.2	0.44	57.6
Egypt	0.0	214.3	1.31	190.6
Estonia	0.0	119.3	0.91	113.0

Table 1. *(cont.)*
Collier and Dollar Results (2002)

	Optimal Allocation *(Poverty-Efficient Aid)*		Actual Allocation	
	Reallocation (% GDP)	Marginal Efficiency (persons / $1 million)	1996 Allocation (% GDP)	Marginal Efficiency (persons / $1 million)
Guatemala	0.0	227.2	0.51	217.2
Guinea	0.0	247.4	2.45	178.9
Hungary	0.0	27.8	0.26	27.4
Indonesia	0.0	144.3	0.16	141.5
Jamaica	0.0	68.1	0.66	63.5
Jordan	0.0	81.9	3.26	61.0
Kazakhstan	0.0	45.1	0.23	44.3
Lithuania	0.0	58.1	0.54	55.8
Malaysia	0.0	35.6	-0.20	36.1
Mexico	0.0	61.4	0.04	61.2
Moldavia	0.0	148.0	0.59	135.8
Morocco	0.0	71.7	0.70	67.7
Panama	0.0	102.6	0.46	99.6
Philippines	0.0	260.9	0.36	254.2
Poland	0.0	44.9	0.36	44.0
Romania	0.0	118.1	0.21	114.9
Russia	0.0	18.9	0.00	18.9
Slovak Republic	0.0	151.9	0.35	147.9
South Africa	0.0	98.2	0.13	97.4
Sri Lanka	0.0	222.8	1.16	202.2
Thailand	0.0	44.0	0.20	43.3
Tunisia	0.0	80.0	0.29	78.6
Turkmenistan	0.0	8.7	0.26	5.4
Venezuela	0.0	34.7	0.02	34.6
Zimbabwe	0.0	266.1	1.45	223.3

Source: Collier and Dollar (2002), p. 1488.

by Collier and Dollar (2002), marginal efficiency of aid (in those countries receiving it) in terms of poverty reduction is defined as 285 people being lifted out of poverty through an allocation of one million dollars. The countries that do not receive aid are those where the marginal productivity of aid is below this threshold.

For 1996, the correlation between poverty-efficient allocation and actual allocation of aid is equal to 0.57. The authors estimate that optimal reallocation of the total amount of aid in 1996 would have made it possible for a further 9.1 million people to be lifted out of poverty. This corresponds to a doubling the productivity of international development aid in terms of poverty reduction, compared to that of 1996.

A considerably different version of this model has been proposed by Collier and Dollar (2001). The authors introduce into the preferences of donor countries a bias in favour of small countries. They then analyse ideal aid allocation with specific reference to the Millennium Development Goals of halving poverty by 2015. Projections based on the current trend in growth rates suggest that these objectives have a good chance of being reached, but with uneven regional results, as poverty is decreasing only marginally in Africa. On the basis of their optimal allocation model, the authors estimate that policy reform allied with more efficient aid allocation would nevertheless enable poverty to be reduced across all the regions of the world.

2.1.2. Assumptions open to critique

Although Collier and Dollar's study holds a very strong and appealing message for policy-making, their analysis nonetheless raises a number of questions. As we have already underlined, the analysis rests on high assumptions (Guillaumont, 2000): (i) aid effectiveness in terms of growth is stronger in countries pursuing sound policies, (ii) aid has diminishing marginal returns, and (iii) the impact of aid on poverty reduction is vehicled by growth. If these assumptions were withdrawn or amended, the optimal allocation model obtained would be very different.

The point of departure, which states that the effect of aid on growth depends on policy quality, has been subject to a great many critiques, some of which have already been mentioned in the first chapter. These critiques notably underline that the coefficient

β_5, the cornerstone of optimal aid allocation, is likely to be biased for a number of reasons: poorly adapted evaluation methods, the presence of outliers and poor specification of the model. This last point is detailed in the third section. Indeed, following on from Burnside and Dollar's work, a voluminous literature has emerged attempting to identify the different conditions for aid effectiveness. The optimal allocation proposed by Collier and Dollar reflects both poverty levels and policy quality in recipient countries. Conditioning aid effectiveness through characteristics other than economic policy would of course lead to a different allocation rule. Some authors have inclined towards the problems of the absorptive capacity for aid (related to its diminishing marginal returns), others towards the question of the external shocks and civil conflicts experienced by developing countries.

Nor is there a consensus on the diminishing returns to aid. The empirical robustness of the aid-squared variable has been queried by a good many authors[35] (this debate is detailed in section 3.1., and again in chapter 4). The specification of the aid-growth relationship also poses certain problems even within Collier and Dollar's own analysis: although the authors show a significant negative effect of aid squared, the aid coefficient itself is not *significant*. This result puts into question the assumption of diminishing returns, which simultaneously requires a positive effect of aid and a negative effect of its square—both of which need to be significant.

The third assumption—the impact of aid on poverty through growth—elicits several critiques, the major one being directed at the growth-poverty relationship. There does, in fact, seem to be relative consensus as to the positive influence of growth on poverty reduction. Yet, the extent to which growth is pro-poor has not been established. Box 2. presents the main conclusions of the literature on the linkage between growth and poverty reduction.

35 In their debate with Hansen and Tarp, Burnside and Dollar themselves defend the idea that the aid-squared term is not significant in their estimations.

This overview brings to light the fact that poverty elasticity with respect to growth is far from identical across all countries. The assumption formulated by Collier and Dollar of a constant elasticity equal to 2 would thus seem over-simplified. Moreover, it tends to favour highly unequal countries (Beynon, 2003)—with higher poverty rates for any given level of per-capita income. Some authors have in fact shown that the absolute value of this elasticity varies positively with per-capita income and negatively with the initial income inequality (Bourguignon, 2000; Heltberg, 2001). Yet, if poverty elasticity with respect to growth is lower in very unequal countries, these should receive relatively less aid, since aid is less effective in alleviating poverty.

Box 2.

Growth and poverty reduction: what relationship?

The late 1990s saw the emergence of relative consensus on the positive contribution of growth to poverty reduction. A number of recent studies have thus attempted to determine to what extent the benefits of economic growth actually reach the poorest populations. This question has been the focus of a great deal of literature and, here, we follow the method used by Foster and Székely (2001), who differentiate studies according to the concept of poverty adopted.

A first approach espouses the concept of *relative poverty* and estimates the per-capita income elasticity of the bottom quintile of distribution with respect to average income. Numerous studies have demonstrated an elasticity that is practically equal to 1—growth of average income brings about an equivalent increase in income among the poorest.[36] Some results however are more pessimistic; for example, Timmer (1997) obtains an elasticity of 0.8.

The second approach is to examine the elasticity of *poverty defined in absolute terms* compared to income growth. Ravallion (2000), Ravallion and Chen (1997) and Bruno *et al*. (1998) find an elasticity close to 2 for the proportion of population living below the poverty

36 See notably Birdsall and Londono (1997), Roemer and Gugerty (1997), Gallup, Radelet and Warner (1999) and Dollar and Kraay (2000).

line, suggesting that a 10% increase in average income is accompanied by a 20% decrease in the number of people living below the poverty line. However, de Janvry and Sadoulet (2000) calculate lower elasticities (close to 1) in the case of Latin America.[37]

We note that certain structural or initial conditions are likely to affect the contribution of growth to poverty reduction. Thus, for example, the importance of initial inequalities has been underlined by Bourguignon (2000), de Janvry and Sadoulet (2000) and Heltberg (2001). Furthermore, agricultural GDP, along with demographic characteristics (population growth rates, population distribution between rural and urban sectors) can affect what contribution growth brings to the fight against poverty. Finally, the quality and characteristics of income growth may also come into play: Ravallion and Datt (1996) have demonstrated that in India, for example, growth reduces poverty less in the secondary sector than it does in the primary and tertiary sectors.

Finally, although it is widely accepted that growth has a positive impact on poverty reduction, there is still considerable debate on how it interrelates with inequalities. Psacharopoulos *et al.* (1995) have evidenced, in the case of Latin America, that inequalities such as poverty respond to growth counter-cyclically. However, other studies are less optimistic. For example, Ravallion and Chen (1997) analysed 42 countries but were unable to demonstrate any influence of income growth on the level of inequality. Similarly, for 12 Latin American countries, de Janvry and Sadoulet (2000) conclude that income growth has indeed helped to reduce poverty, but not inequalities.

In addition, Collier and Dollar's analysis hypothesises that poverty elasticity in relation to growth does not depend on aid itself and that aid does not have a direct effect on poverty—that is to say, aid is neutral in terms of income distribution. It may seem paradoxical to try to reduce poverty by allocating aid on the basis of a method that assumes aid has no real effect on income distribution and poverty—other than that vehicled by income growth. This point is underlined by Guillaumont (1999, 2000).

37 Whichever criterion is used to define poverty, the growth-poverty relationship is conceived as a linear one, even though a non-linear relationship would be more adapted. We thank Jean-David Naudet for this observation.

A number of studies have evidenced a direct effect of aid on human development indicators, as well as an indirect effect through channels other than growth. Burnside and Dollar (1998), for example, have analysed the effect of aid on lowering infant mortality, which is not only an indicator of population well-being very strongly correlated with poverty levels, but also one for which data are available on many countries. Their econometric study suggests that, in a good policy environment, aid contributes to reducing infant mortality.[38] More recently, Gomanee *et al.* (2003) have shown that aid positively influences this human development indicator and the reduction of infant mortality by financing public expenditure in favour of the poorest populations. It should be recalled, however, that contrasting results have been obtained by Mosley *et al.* (1987) and Boone (1996), whose econometric analyses suggest that aid has no effect on infant mortality. Kosack (2003) emphasises that aid impacts on the human development indicator only in countries with democratic regimes. More recently still, Fielding *et al.* (2006) have shown the positive influence of aid on variables linked to the MDGs (access to water, education, etc.). However, this globally positive influence of aid is shown to be of little advantage to the poorest, since the sub-group of poorest people does not seem to be the main beneficiary of aid flows.

2.1.3. Effectiveness or equality of opportunity: what are the foundations for optimal allocation?

Despite the fact that some assumptions are open to critique, the optimal allocation model posited by Collier and Dollar represents a seminal step forward. Over and above the models they adopt, their main contribution is to propose an allocation *rule*, as opposed to a *discretionary* system. Following a rule not only allows donor countries to commit to achieving objectives in a credible manner, but also makes aid flows more predictable.

38 However, the analysis of Hudson and Mosley (2001) suggests, on the contrary, that the marginal contribution of aid to the reduction of infant mortality is more significant in a bad policy environment.

The optimal allocation rule proposed by Collier and Dollar is founded on a principle of effectiveness: aid should be allocated according to its degree of effectiveness in achieving certain goals. Without challenging the idea of setting a rule, some authors have strongly criticised the effectiveness principle underlying Collier and Dollar's optimal allocation of aid. Llavador and Roemer (2001) and Cogneau and Naudet (2005, 2007) argue for optimal allocation based on the principle of equal opportunity. The idea of structural disadvantage thus becomes pivotal, since optimal allocation based on a principle of equal opportunity aims to offset structural handicaps whilst rewarding efforts, particularly in the area of economic policy. The allocation rule proposed by Cogneau and Naudet (2005, 2007) takes into account growth perspectives that reflect structural disadvantages. Interestingly, Wood (2006) has very recently proposed an optimal allocation model based on an effectiveness principle that also takes into account the time horizon and future objectives of donor countries. This leads the author to introduce the perspectives for future growth into his analysis in a similar manner to Cogneau and Naudet, but for completely different reasons.

2.2. An example of performance-based allocation: the IDA experience

For over 20 years, the International Development Agency (IDA)—the World Bank Group's agency for specialised loans to the poorest countries—has applied a performance-based aid allocation model. Within the framework of IDA 14, each eligible country[39] is automatically attributed 3.3 million special drawing rights (SDR), to which

39 Three criteria are used to determine which countries are eligible for IDA resources:
- relative poverty defined as GNI per capita below an established threshold and updated annually, currently USD 1 025 (from 1st July 2006);
- lack of creditworthiness to borrow on market terms and therefore a need to find concessional resources;
- good policy performance, defined as the implementation of economic and social policies that promote growth and poverty reduction.

is added a grant component determined by the model. The principal criterion for this type of allocation is a country's performance in implementing policies that foster economic growth and poverty reduction. IDA aid modalities (grants or loans) depend on the capacity of beneficiary countries to restore or maintain their external debt sustainability level.[40] The choice of aid modalities for a country has no bearing on the amount allocated, because this only happens after allocation of the amount (per capita) on the basis of the country's performance and needs.

2.2.1. The IDA allocation model

The IDA performance-based allocation model allows the annual allocation of available IDA funds for an upcoming three-year period. This comprises three stages. The first stage involves rating a country's performances (Country Performance Rating). The second stage involves integrating this rating into a formula that determines a triennial allocation for each IDA-eligible country and the last stage adjusts this indicative allocation according to the development assistance strategy adopted for the country in order to determine the final allocation amount.

The Country Performance Rating

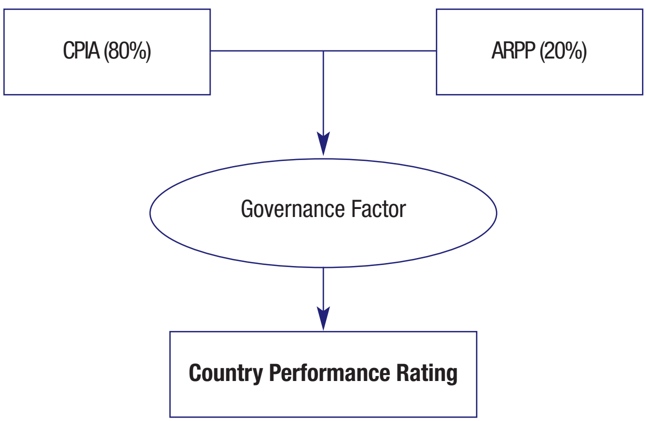
The evaluation of the recipient's performance is based on the ratings of two World Bank internal assessments: the Country Policy and Institutional Assessment (CPIA) and the Annual Report on Portfolio Performance (ARPP). The CPIA is a tool for measuring the quality of policies judged by the World Bank to "foster economic growth and

40 Contrary to the IDA 13 system, which had stipulated multiple admission criteria, this new framework envisages a single eligibility criterion for giving grants: a country's risk of debt distress. This risk is assessed on the basis of the methodology proposed in a joint World Bank-IMF debt sustainability framework for low-income countries. Accordingly, the level of grant allocation is established according to the level of estimated risk, using a colour scale inspired by the traffic light system: 100% grants in the case of high risk ("red light"), 50% for an average level ("amber light") and 0% grants for a low level ("green light").

poverty reduction". As well as being an internal World Bank tool made public only since 2006, the CPIA has been widely used in the Bank's studies on performance-based aid allocation. Section 2.2.2. revisits these calculation methods and their limitations. As for the ARPP, this measures the performance of current IDA operations in recipient countries, according to the concept of "projects at risk".[41] The percentage of projects at risk is converted into a rating on a scale of 1 to 6, corresponding to the scale used for the CPIA[42] (see details in Appendix 2).

These two indicators (CPIA and ARPP) are then aggregated into a single indicator, using an 80-20 weighting in favour of the CPIA, which automatically becomes the dominant component of the Country Performance Rating (CPR). To further reinforce the

Figure 1.
The Country Performance Rating



41 For CPR calculations, discussions are underway with a view to replacing the ARPP rating, given by the operational departments for projects in progress, with the *ex post* rating given by the Operations Evaluation Department (OED) to projects completed within the fiscal year.

42 IDA has recognised the problems posed by this indicator, notably those linked to the scaling-up of programme aid in the form of budget support, as opposed to project aid. For the moment, the ARPP calculation has not been modified to take into account IDA's gradual shift towards the programme aid approach.

focus on good governance in country performance assessments, the final stage in calculating the CPR involves multiplying the aggregate indicator by a "governance factor" (Figure 1.).

Taking account of a country's needs

On the basis of the CPR, IDA calculates an indicative amount of aid for each eligible country (Figure 2.), which takes into account (i) the country's level of income, meaning that allocations to low-income countries can be scaled up, (ii) the population size (linear relationship) and (iii) a set of corrections that makes it possible, for example, to increase aid to countries in post-conflict situations[43] or, conversely, to fix a maximum amount for borrowers also eligible for IBRD funds (the World Bank's non-concessional loan desk). The adjustment for level of income is an important point of this allocation model, since it is the only element that takes into account a recipient country's needs (rather than its performance), which thus introduces a bias in favour of poorer countries. Nonetheless, the trade-off between performance and need very heavily favours the former, as the CPR has an impact on the allocation amount sixteen times greater than the level of income.

The final IDA allocation formula according to the CPR and the average per-capita income level is the following:

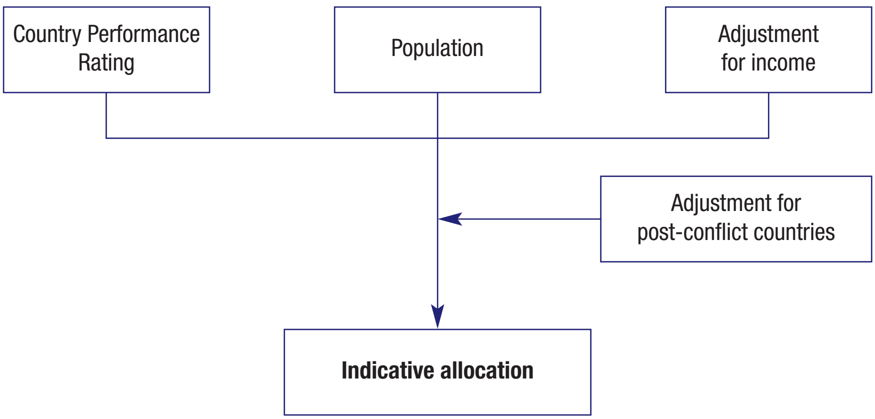
Allocation = f ($CPR^{2.0}$, $Pop^{1.0}$, *per capita* $GNI^{-0.125}$)

This indicative allocation thus becomes an anchor point for the IDA "country assistance strategy" (CAS), which determines the final loan programme for beneficiary countries. Two scenarios (high and low assumptions) are proposed and, depending on

43 For post-conflict countries where absorptive capacity is sufficiently high, allocation is more or less doubled during the first three years following the end of the conflict.

how a given number of indicators outlined in the CAS evolve, one of the two scenarios will finally be selected. This procedure injects a dynamism into IDA's funds allocation process and encourages the beneficiary country to improve its performance during the lifetime of the funding. The difference between actual allocation by country and the model's indicative allocation is substantial, averaging around one third.

Figure 2.
Indicative allocation based on Country Performance Rating



2.2.2. The CPIA: a performance indicator?

The purpose of the CPIA is to assess government-monitored policy instruments that determine growth and poverty reduction. This evaluation tool has been used for some twenty years and serves to rate IDA- and IBRD-funded countries. The rankings are confidential and communicated only to the country concerned.[44] The process is conducted by World Bank staff each year and is based on a questionnaire so as to ensure a degree of consistency across countries and time periods.

44 As of 2006, under pressure from the academic community in particular and because it used the CPIA in many econometric works, the World Bank agreed to disclose the CPIA index for those countries eligible for IDA.

The indicator is made up of 16 equally weighted categories grouped into four main clusters: macroeconomic management, structural policies, policies favouring poverty reduction, and public sector management and institutions (Table 2.). Each country receives an individual rating on a scale of 1 to 6.

Table 2.
Country Policy and Institutional Assessment (CPIA)

A. Economic Management
1. Macroeconomic management
2. Fiscal policy
3. Debt policy
B. Structural policies
4. Trade
5. Financial sector
6. Business regulatory environment
C. Policies for social inclusion
7. Gender equality
8. Equity of public resource use
9. Building human resources
10. Social protection and labour
11. Policies and institutions for environmental sustainability
D. Public sector management and institutions
12. Property rights and rule-based governance
13. Quality of budgetary and financial management
14. Efficiency of revenue mobilisation
15. Quality of public administration
16. Transparency, accountability and corruption in the public sector

Source: World Bank.

There is relative consensus on clusters A and B (macroeconomic management and structural policy), which are relatively easy to assess. Their inclusion in the CPIA aims to capture the impact on growth of economic policy and institutions. Nonetheless, taking as a starting point that growth is a necessary but insufficient condition for poverty reduction, clusters C and D were added (pro-poor policies; public sector management and institutions). The World Bank recognises, however, that certain clusters overlap, notably those linked to governance.

This indicator has received several critiques. The first is that none of the clusters refers to outcomes (for example, growth) as these may be influenced by exogenous factors beyond the control of government policy. In this sense, the CPIA represents an evaluation of instruments (policy and institutions), rather than an assessment of country performance.

Moreover, it is expected that evaluations be carried out consistently, without taking a country's level of development into account. This tends towards an evaluation of effort (liable to subjectivity) rather than of outcome. Nonetheless, despite the importance given to effort, the CPIA index still measures the quality of existing policy and institutions, rather than intentions or projects for improvement. In this respect, the CPIA is a static measure of policy and institutional environment. Furthermore this ranking system is not able to capture possible impediments that some countries may encounter when adopting and implementing certain policies.

Over the past decade, the CPIA ranking process has continued to evolve. A think-tank has been set up to make proposals for minimising the use of highly intercorrelated indicators, so as to ensure the neutrality of development levels and to avoid a strong bias in favour of average scores. More recently, efforts have been made to align CPIA indicators with the SFFP (Strategic Framework for the Fight against Poverty) objectives, particularly for categories 8 and 13.

In spite of these developments, a report published in 2001 by the World Bank Operations Evaluation Department (OED)[45] expressed reservations about some aspects

45 Today, the IEG *(Independent Evaluation Group)*.

of the process.[46] These pinpoint (i) the fact that rankings tend to be influenced by current growth rates, (ii) the static character of rankings that remain average over time despite substantial policy improvements in countries assessed,[47] (iii) potential regional biases, and (iv) the high correlation of the "public sector management and institutions" cluster (introduced in 1998) with other clusters. On this point, OED expresses doubts as to whether World Bank staff has the capacity to assess "governance" in client countries.

2.2.3. Limitations of the IDA model

Clarifying and simplifying the governance factor

In 2003, the Mid-Term Review of IDA 13 funding recognised that governance had become a central element in the IDA funds allocation system, particularly following the introduction of a governance factor. The review also underlined the fact that a slight change in governance ranking caused a substantial change in the allocation of funds. This raised the question of whether an effective weighting of 67% for governance as compared with 33% for "macroeconomic management" and "structural and social policies"[48] was not too high.

Alongside the question of weighting as applied to governance in the allocation model, there is the issue of the transparency of the calculation. Currently, the governance ranking appears twice in the model: firstly in the CPIA calculation and secondly though the governance factor, which is itself derived from certain CPIA and ARPP categories. Simplifying the allocation formula would make the IDA ranking system easier to

46 World Bank (2001)

47 Easterly (2000)

48 For details of weighting calculations, see World Bank (2004a).

understand, given that it is increasingly being discussed with other development partners.

The World Bank is currently revising the modalities for capturing governance in its allocation process. The new modalities must allow three objectives to be attained: (i) maintain a strong linkage between performance and allocation, whilst still conserving governance as an essential aspect of performance, (ii) avoid unwarranted annual volatility due to variations in governance ranking and (iii) increase the transparency of the role of governance within the system.

Taking the poverty level into account

IDA was entrusted with the mandate of assisting the least advanced among the World Bank member countries. Consequently, IDA applies a two-step selectivity rule, taking per-capita income as an indicator of the level of poverty: (i) to be eligible for IDA resources, countries must have a per-capita income below USD 1 025[49] and (ii) the allocation formula for eligible countries incorporates GNI per capita using an exponent of -1/8. Yet, as noted in section 2.2.1., the poverty level plays a minor role in the allocation process compared to performance. In 2004, during the preparatory work for the fourteenth replenishment of the IDA fund, voices were raised in favour of more consideration being given to poverty.

The first issue is which poverty indicator to use. The indicator used by IDA—and the one most widely used in the literature to quantify poverty levels—is per capita income. Statistical studies show a high correlation between poverty indicators, such as the number of people living on less than 1 dollar a day, and the level of average per-capita income.[50] In addition, direct measures of poverty (such as the number of people

49 Before 1st July 2006, this threshold was fixed at USD 865.

50 The differences identified for some countries are due either to different income distribution, in which case the headcount indicator is more appropriate, or to errors arising from household surveys, reputedly less reliable than national accounts.

living below the poverty threshold: headcount index) are difficult and costly to obtain since they are based on periodic household surveys. Consequently, the consensus is that the most appropriate indicator is per-capita income, as it is readily available in practically all countries on an annual basis, has a low error rate, and is simple and transparent.

The second issue concerns the weight given to poverty in the allocation formula. Should the per capita income weighting be increased to the detriment of the performance weighting? The World Bank is not in favour of this idea and, to justify its stance, contends that privileging the level of development as the main allocation criterion would simply penalise countries engaged in a growth dynamic.[51] Indeed, a country with a very low initial income level and which is experiencing sustained growth must address the need for growing public investment in infrastructure and social services.

Box 3.
The Millennium Challenge Account

The American Millennium Challenge Account (MCA), set up by the Bush administration in the wake of the 2002 Monterrey conference and managed by the Millennium Challenge Corporation (MCC), is an experiment in performance-based aid selectivity. It is presented as the new financial tool of American aid policy for the least developed countries. Initially endowed with USD 5 billion per annum (before Congress authorised only USD 1 billion in 2004, 1.5 billion in 2005 and 1.75 billion in 2006 and 2007), the MCA is the most visible manifestation of the new American approach to official development assistance. The approach can be summarised as follows: select a limited number of countries that have demonstrated their commitment to good economic and political governance; allocate significant aid amounts to them in the form of grants to finance projects that they themselves have identified; and hold them accountable for the use of these funds and the results obtained.

51 The negative exponent of 1/8 applied to the per capita income variable is comparable to a growth tax.

The important innovation brought by this tool is its method for selecting eligible countries, which is based on *ex ante* performance criteria. In concrete terms, if a country wishes to benefit from MCA funding, it must satisfy 16 performance criteria, which are divided into three categories:

(i) Ruling Justly: respect for civil liberties, political rights, voice and accountability, government effectiveness, rule of law, control of corruption;
(ii) Economic Freedom: low-risk countries and inflation, balanced fiscal policy, openness of trade policy, regulatory quality, days to start a business;
(iii) Investing in People: public expenditure on health and primary education, immunisation rates, girls' primary education completion.

Currently, a working group is considering the addition of further criteria relating to natural resource management.

The criteria for performance-based allocation have been defined on the basis of indicators measured by independent bodies. The objective of this approach is to provide, in theory, an objective and transparent procedure for selecting countries.

In addition to the performance criteria, eligible countries must also meet income-related criteria, since the MCA's mission is also to serve as a tool in the fight against poverty. Nonetheless, as with IDA, this last criterion is not the most important, since lower middle-income countries (with less than USD 3 465 per capita) are among those eligible. For 2006, 25 countries were declared eligible for MCA funding. Among the 25 eligible countries, there are 13 African, 4 Latin American, 3 Asian, 4 East European and 1 Pacific country.

However, an increase in weighting for per capita income (with a negative exponential) in the allocation formula would result in a gradual decrease in IDA resources to this type of country. The World Bank bases its position on the findings of Collier and Dollar (2002), who conclude that poverty-efficient aid allocation means scaling up aid volumes as per capita GDP increases, up to a threshold estimated at approximately USD 800.

The central idea is that the absorptive capacity for aid in the least developed countries (LDCs) increases with income growth.

2.3. Assessments of donor selectivity

Since aid selectivity is defined as the quality of its geographic allocation, any assessment of selectivity implies comparing actual aid allocation to what optimal allocation would be. Various studies have sought to assess the degree of donor selectivity and, here, we present three of them: the first two are based on Burnside and Dollar's analysis and give a preponderant place to the quality of economic policy (Dollar and Levin, 2004; Roodman, 2004, 2005 and 2006), while the third study diversifies the selectivity criteria for assessing foreign aid.

2.3.1. Two measures of selectivity

McGillivray (1989, 1992), who was the first to undertake a comparative analysis of different donor agencies' selectivity, used the relative per capita GDP of recipient countries as a selectivity criterion. A further step was taken by Dollar and Levin (2004, 2006) and Roodman (2004), who extended the selectivity criteria. Dollar and Levin start from a model of allocation by donor (calculated using annual data from 1999 to 2002 and thereafter five yearly averages) which contains only those explanatory variables that correspond—in their view—to "good criteria": i.e. the level of GDP per capita (negative coefficient expected), economic policy measured using the CPIA (positive coefficient expected), as well as population. The per capita income elasticity of aid is intended to represent each donor's sensitivity to the level of poverty, and the CPIA elasticity its response to the quality of the recipient's economic policy. The simple average of the absolute values of these two elasticities is taken as the indicator of each donor's aid selectivity (cf. Table 3).

Table 3.
Dollar and Levin's Selectivity Index

Indicator	Policy Selectivity (performance)	Poverty Selectivity (need)	Overall Selectivity
Total aid	1.76*	-0.49*	1.12
Bilateral aid	0.63	-0.38*	0.5
Multilateral aid	2.57*	-0.83*	1.7
Five largest donors			
USA	0.66	-0.76*	0.71
Japan	1.9	0.01	0.94
France	-0.07	-0.28	0.1
Germany	2.06*	-0.47*	1.27
UK	3.66*	-1.06*	2.36
Good practice examples			
Denmark	4.77*	-1.11*	2.94
IDA	4.23*	-4.20*	4.22

Source: Dollar and Levin, 2004
* Elasticity different from zero at 10% significance level

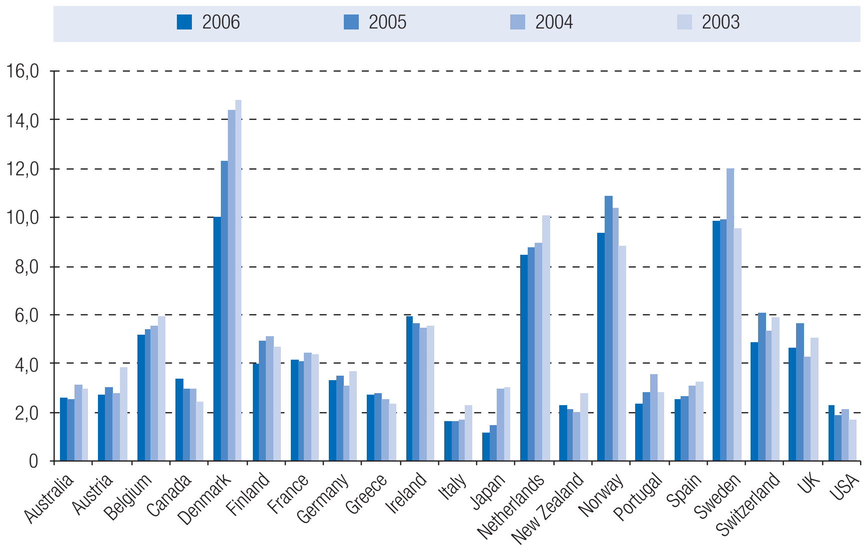
The indicator proposed by Roodman (more directly inspired by the work of McGillivray) differs from Dollar and Levin's in that it is not based on econometrically estimated functions of aid allocation. In a simpler approach, he uses a performance indicator that corresponds to the volume of aid adjusted to take into account the "quality" of aid, particularly the selectivity of aid (in fact, the volume of aid is lowered according to the "bad" quality of aid selectivity).[52] Aid selectivity is itself measured on the basis of per capita income and the world governance indicators (WGIs) constructed by Kaufmann and Kraay (2003).[53] Adjustment according to selectivity is not applied to emergency aid (thus favoured), and project and programme aid are also treated differently. In line with Radelet (2004), David Roodman considers that project aid is more

52 Among other factors of aid quality, Roodman includes the extent to which aid flows are tied and fiscal policies that support private charitable giving.

53 The Kaufmann and Kraay WGI indicator is a composite indicator encapsulating six dimensions, "Voice and Accountability", "Political Stability", "Government Effectiveness", "Regulatory Quality", "Rule of Law" and "Control of Corruption", and measured using a hundred or so variables from 24 different sources. This indicator is published annually within the World Bank's World Governance Indicators.

efficient than programme aid in countries with weak governance. The Roodman index, presented in Figure 3, shows the performance of the main donors, taking into account both the volume and quality of aid. Denmark, although it has a relatively limited ODA budget (less than 10% of the total American aid budget), thus ranks in top position due to the better quality (with better selectivity) of its aid and its higher level of aid in terms of share of gross domestic product.

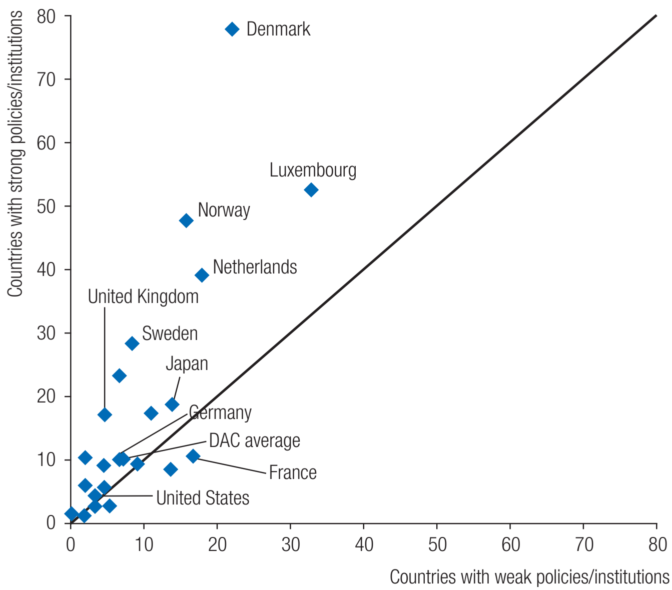
Figure 3.
Roodman's index and quality-adjusted aid volume



Source: Center for Global Development, 2006.

Inspired by the work of Dollar and Levin (2004), the World Bank's *Global Monitoring Report 2004* gives its summary analysis of the volume and quality of aid of different States and international institutions, in the chapter "Providing More and Better Aid". Recipient countries are divided into two equally sized groups on the sole basis of the CPIA: those with "good" policies and those with "bad" policies (or institutions). The graph maps each donor according to the amount of aid (per donor country citizen) it provides to both categories of recipients (represented along the two axes. cf. Figure 4.). The donors below the bisectrix are designated as being less selective and conversely. It is the angle formed with the horizontal axis that indicates the degree of selectivity and not the distance from the diagonal. The further donors' distance from the start-point due to large volumes of aid, the more they visually deviate from the diagonal (e.g. France, which thus appears in a rather unenviable position).

Figure 4.
DAC countries' selectivity of aid according to the CPIA



Source: World Bank, 2004c.

The position of the donors above or below the diagonal obviously depends on the cursor chosen to classify recipient countries as either "good" or "bad". Here, the cursor is the median of the CPIA—although many of the countries are in fact grouped around this median.[54] Even though the *Global Monitoring Report* recognises that shocks and post-conflict situations should evidently be taken into account for allocation of aid, only

54 As has already been pointed out by Berg (2003, p.22) with regard to the aforementioned Collier and Dollar study.

the quality of the economic policy measured by the CPIA is visualised in the graph. Far from highlighting the limits and relativity of Dollar and Levin's method, the authors of the report present the conclusions of the analysis that they use as their starting point in a simplified form with no reserves.

2.3.2. The limits of these selectivity measures

Amprou *et al*. (2007*a*) have observed that optimal allocation of aid is undoubtedly not independent of the allocation modalities, notably the purpose (project, programme, emergency), the conditionality attached, and the type of financing (grants or concessional loans). The authors thus underline that aid effectiveness does not depend only on the behaviour of recipient countries but also on the donors' behaviour. Whereas Roodman takes into account the type of aid in order to assess donor selectivity (which is in fact debatable), Dollar and Levin, on the other hand, address the issue of selectivity independently of the modalities used, which constitutes a first limit to their measure of selectivity.

Aid selectivity studies also have a second limit. It is difficult for them to take into account the diversity of the donors' goals. They thus focus on poverty reduction resulting solely from the effect of aid on economic growth. Selectivity is a fundamentally relative concept, as it signifies optimal allocation of aid with respect to its effectiveness, which is necessarily contingent on its objectives, and these can logically differ from one donor to another. Traditionally, this involves economic growth or development, but since the adoption of the Millennium Development Goals, aid objectives have become multidimensional, even though poverty reduction is their common aim. Over and above the MDGs, foreign aid can target other goals that should be assessed in terms of effectiveness. These may include the promotion of democracy or the respect of human rights, neither of which have a clearly established link with growth and poverty reduction. Aid can also be used to finance global public goods, which generate positive externalities to non-recipient countries (e.g. the control of pollution or pandemics) or it can focus on countries that are emerging from protracted internal or external conflicts and rebuilding their economies. Collier and Hoeffler (2004) have in fact shown that aid promotes growth in these post-conflict countries more than elsewhere. Finally, some countries, notably France, assign specific objectives to their aid policy, such as supporting former colonies or countries that share their language. These objectives can be deemed legitimate in themselves as they express a specific solidarity; they can also be justified with regard to the criterion of aid effectiveness in promoting development. The ties created through a colonial past or a common language certainly facilitate understanding between partners when aid involves dialogue about actions implemented or the transfer of knowledge, which is the case of most forms of aid to some extent or another (Amprou *et al.*, 2007*a*).

2.3.3. An alternative measure of selectivity: average donor profile

Amprou *et al.* (2007*a*) propose an alternative method for measuring selectivity, which has the advantage of not being based on modelling (open to critique) determinants of each donor's geographic allocation of aid. This method is close to the one used by McGillivray and by Roodman, and involves calculating an "average profile" of the aid recipients of each donor, weighted by the proportion of aid received by each country. This average profile can be calculated from as many recipient's characteristics as wished.

Initially, the average profile is calculated from four characteristics: the level of income (per capita GDP), the quality of governance (KKZ, Kaufman and Kraay's index), the vulnerability (EVI) and the level of human capital (HAI). For each donor *i*, the calculation is made of the average per capita GDP of its aid receivers, weighted by the share of the donor's *i* aid to each recipient country *j*, as well as an average HAI, and average EVI and average KKZ, which are weighted in the same way:[55]

55 To give an equal weight to each component, GDP, EVI, HAI and KKZ have been calibrated on a 0 to 100 scale, and so that the four components evolve in the same direction, GDP and HAI have been reversed.

$$w_{ij} = A_{ij}/A_i$$

$$GDP_i = \Sigma w_{ij} * GDP_{ij}$$

$$HAI_i = \Sigma w_{ij} * HAI_{ij}$$

$$EVI_i = \Sigma w_{ij} * EVI_{ij}$$

$$KKZ_i = \Sigma w_{ij} * KKZ_{ij}$$

The average profile for each donor's recipients is then given by the sum of these four components, which gives an indicator of aid selectivity and makes it possible to rank the donors.

$$I_i = \Sigma\ (GDP_i\ ;\ HAI_i\ ;\ EVI_i\ ;\ KKZ_i).$$

A higher index I for donor *i* thus means that, compared to other donors, donor *i* allocates aid to countries that are either poorer, or more vulnerable, or with better governance, or with a lower human capital, or a combination of these four characteristics. On the basis of I_i, it is therefore possible to rank donors according to the degree of aid selectivity and clearly distinguish each donor's preference criteria. France, for example, is seen to attach more importance to countries' poverty levels, captured by per capita GDP, and to human capital (HAI) than to the governance or vulnerability. On the other hand, Japan, Denmark, Spain and Luxembourg focus primarily on governance, while the USA does not seem very sensitive to any of the four criteria (cf. Table 4).

Amprou *et al.* have underlined that assessing aid selectivity should take into account the fact that bilateral donors may logically have preferences for certain countries, mainly due to historical or cultural ties or because they feel a special responsibility with regard to post-conflict countries. Accordingly, the former colonial powers, France, the Netherlands, Portugal and the United Kingdom, may understandably give their former colonies more aid (in a proportion the authors arbitrarily fix at 20%). They also consider the possibility of preference given (in the same proportion) to countries that share their

Table 4.
Ranking of 22 bilateral donors according to the Amprou *et al.* selectivity index

	Selectivity focusing on poverty (GDP)	Selectivity focusing on MDGs (HAI)	Selectivity focusing on vulnerability (EVI)	Selectivity focusing on governance (KKZ)	Overall selectivity
Australia	8	15	5	6	6
Austria	20	16	19	13	19
Belgium	1	2	4	21	5
Canada	12	6	8	14	9
Denmark	3	4	7	2	2
Finland	16	9	13	5	11
France	6	13	15	17	13
Germany	9	17	18	9	16
Greece	22	22	22	22	22
Ireland	2	1	2	7	1
Italy	15	11	12	20	18
Japan	10	21	21	1	17
Luxembourg	4	12	3	4	4
Netherlands	7	8	11	12	7
New Zealand	21	20	6	19	20
Norway	18	5	10	15	12
Portugal	17	3	1	16	3
Spain	14	19	14	3	15
Sweden	11	10	9	11	10
Switzerland	13	14	17	10	14
UK	5	7	16	8	8
USA	19	18	20	18	21

Source: Amprou *et al.*, 2007a.

language, because of the desire to defend a minority language by promoting the economic development of these countries.[56]

The indicator adjusted for the preference given to former colonies was constructed by multiplying each of the four components (w_{ij}*GDP_{ij} ; w_{ij}*HAI_{ij} ; w_{ij}*EVI_{ij} ; w_{iz}*KKZ_{ij}) by

56 Which leads them to distinguish Spanish-, Portuguese- or French-speaking recipient countries. On the other hand, they do not consider that the United Kingdom or United States could have the same concern about defending the use of English.

1.2 when the donor *i* allocates aid to a recipient *j* which is a former colony. The same was done independently for the indicator adjusted for linguistic preference.[57] Not surprisingly the rankings thus obtained place donors that are former colonial powers in a better position, particularly Portugal, the United Kingdom and France. A similar

Table 5.
Ranking of 22 bilateral donors according to the Amprou *et al.* selectivity index adjusted for donor linguistic preference

	Selectivity focusing on poverty (GDP)	Selectivity focusing on MDGs (HAI)	Selectivity focusing on vulnerability (EVI)	Selectivity focusing on governance (KKZ)	Overall selectivity
Australia	9	15	5	7	8
Austria	19	16	19	15	19
Belgium	1	1	2	21	4
Canada	11	4	8	12	6
Denmark	5	5	7	5	5
Finland	17	11	15	6	13
France	3	9	13	17	7
Germany	12	17	18	11	16
Greece	21	22	22	22	22
Ireland	4	2	4	9	2
Italy	16	13	14	20	18
Japan	13	21	21	4	17
Luxembourg	2	7	3	3	3
Netherlands	8	10	12	14	10
New Zealand	20	20	6	19	20
Norway	18	6	11	16	15
Portugal	6	3	1	2	1
Spain	10	19	9	1	9
Sweden	15	12	10	13	12
Switzerland	14	14	16	8	14
UK	7	8	17	10	11
USA	22	18	20	18	21

Source: Amprou *et al.*, 2007a.

57 The selectivity index is adjusted to take into account the fact that:
France, Canada, Belgium, Luxembourg and Switzerland release ODA to a recipient country where more than 33% of children attend school within the French-speaking system;
Spain releases ODA to a country that has Spanish as its official language;
Portugal releases ODA to a country that has Portuguese as its official language.

increase in ranking occurs when linguistic preference is taken into account. Thus, Portugal, which gives priority to Portuguese-speaking countries, and France, Belgium and Canada (but not Switzerland), which give preference to French-speaking countries, and Spain have a better ranking (cf. Table 5.).

This analysis shows that it is not possible to uniformly apply quality criteria in order to measure the selectivity of different types of bilateral aid, since donors legitimately have both specific preferences stemming from specific solidarities, and also a comparative advantage in assisting certain countries. Furthermore, a donor's selectivity can logically aim to offset other donors' selectivity criteria, which espouse different preferences. Amprou *et al.* conclude that, in order to compare selectivity of aid to developing countries, a consensus should be found as to how particular bilateral donor preferences are to be taken into account, while still applying common criteria.

Collier and Dollar's study now occupies a particular place in aid effectiveness literature. It recommends allocation criteria that of course take into account recipients' poverty levels, but also the quality of their economic policies. The principles of allocation identified by Collier and Dollar have been implemented in part by certain aid agencies, such as IDA and the MCC. The overview of various experiences of selectivity based on economic and institutional performance has made it possible not only to shed light on its rationale, but also on its limits.

The Burnside-Collier-Dollar analyses give a paramount place to the quality of economic policy. Yet, a large strand of the debate raised by these studies involves alternative or complementary determinants of aid effectiveness. These will be presented in the following chapter.

Problems not resolved by performance-based aid allocation

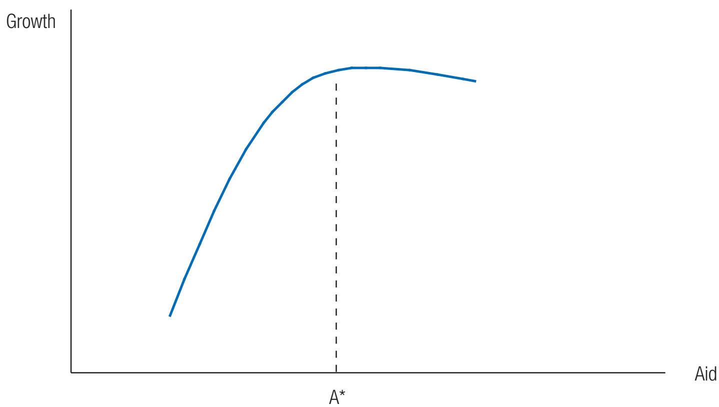
3

The Burnside-Collier-Dollar analyses have given rise to intense debate as much on the methodology and robustness of their results as on the place and role that economic policies should play and, more generally, on the performance of recipient countries in view of more efficient aid allocation. Numerous authors have more specifically defended the idea that other factors are likely to influence aid effectiveness: diminishing marginal returns, the vulnerability of developing countries to external shocks, and socio-political instability. Furthermore, performance-based allocation raises new issues such as that of orphaning fragile States, or in other words the very poor and under-performing countries. This third chapter presents different aspects of the debate and their implications for optimal aid allocation.

3.1. Diminishing returns to aid?

The hypothesis of diminishing marginal returns can be argued on several theoretical grounds: (i) the economic impact of aid may depend on the absorptive capacity of recipient countries; (ii) aid may have a negative impact on the recipient country's competitiveness—the so-called Dutch Syndrome; (iii) aid may undermine alternative sources of finance for public expenditure and (iv) the risk of corruption may increase with greater amounts of aid, etc. The various limits on the absorptive capacity for aid are presented in detail in the fourth chapter. The hypothesis of diminishing returns, whatever its theoretical justification, posits that over-high volumes of aid are relatively less productive than lower volumes: that is to say, beyond a certain level of aid, one extra euro of aid received is relatively less productive (see the simplified illustration in Figure 5).

Figure 5.
The hypothesis of diminishing marginal returns to aid



Classically, diminishing returns to aid are tested empirically by incorporating an aid-squared term into the growth estimations. Within this hypothesis, aid would have a positive effect while its square would be negative, suggesting an inverted-U relation between aid and growth as illustrated in Figure 5.

The central question raised by the hypothesis of diminishing marginal returns is beyond what threshold does aid become relatively less productive (*A** in graph 5). Hadjimichael *et al.* (1995) and Hansen and Tarp (2001) identify diminishing returns for aid amounts of around 25% of GDP, as against 40% for Durbarry *et al.* (1998). Lensink and White (1999, 2001) have also attempted to determine this turning point in the aid-growth relationship more precisely and to test its econometric robustness.[58] Their findings indicate that the optimal amount of aid, beyond which the yield becomes negative, lies somewhere between 40% and 50% of GNP. This amount is high, suggesting that a recipient's absorptive capacity is not in fact a constraining factor except in the case of a very few developing countries. Over the period 1960-2002, those countries that occasionally received aid in excess of 40% of their national income are mostly small countries (Cook Islands, Falkland Islands, Guinea-Bissau, Saint Helena, São Tomé e Principe, Tuvalu) or countries in a crisis or post-conflict situation (Eritrea, East Timor, Mozambique, Nicaragua, Sierra Leone, Somalia).

According to Hansen and Tarp (2000, 2001), the existence of diminishing returns to aid calls into question the econometric results of Burnside and Dollar (2000). By simultaneously introducing an aid-squared term and aid interacted with policy into their growth estimation, Hansen and Tarp in fact show that only the aid square has a significant effect. Thus, according to them, in Burnside and Dollar's estimations, the aid-policy interaction term only took into account non-linearities in the aid-growth relationship—non-linearities that are more appropriately captured though the aid-squared term. The implications of this result are important since it suggests that the effectiveness of aid to developing countries depends more on their absorptive capacity than on the quality of their economic policies.

However, Gomanee *et al.* (2003) have recently arrived at results that oppose those of Lensink and White (2001) and Hansen and Tarp (2001). Gomanee *et al*. do not include an aid-squared term in their models, but use a more elaborate econometric

58 They use extreme-bounds analysis (Leamer, 1983; Levine and Renelt, 1992; Sala-i-Martin, 1997).

method.[59] It appears that aid becomes efficient in terms of growth only beyond a critical level (2% of GDP), suggesting that it must reach a certain critical mass in order to be efficient. Furthermore, their study finds little evidence of diminishing returns to aid.

3.2. Vulnerability to external shocks: a compensatory role for aid?

Beyond the quality of economic policies and problems of absorptive capacity in developing countries, other factors are likely to influence aid effectiveness. Certain authors have thus defended the idea that aid could help alleviate the adverse effects of vulnerability to external shocks experienced by many developing countries.

The economic vulnerability of developing countries presents three dimensions:[60] the possible magnitude of the shocks experienced, the countries' degree of exposure to shocks and their capacity to react to these shocks (or resilience). The principal sources of vulnerability for the poorest countries are climatic, natural and trade shocks, with trade openness and population size reflecting the degree of exposure to shocks (Guillaumont 1999, 2001). The vulnerability of developing countries is likely to have a negative effect on their growth both directly and through its influence on the quality of their economic policy.[61] If aid helps to protect economic growth from external shocks, then it will be more effective in those countries that are vulnerable to external shocks.[62]

59 Developed by Hansen (2000).

60 This definition comes from Guillaumont (1999), p.6.

61 Guillaumont and Chauvet (1999, 2001).

62 Guillaumont and Chauvet (1999, 2001).

In the following sections, we first present all the effects of external shocks, particularly export instability, on the growth of developing countries. Next, we analyse the influence of structural vulnerability and price shocks on aid effectiveness in terms of growth, and then the implications of taking into account the vulnerability of developing countries for aid allocation.

3.2.1. The effect of external shocks on growth: overview of the literature

The effect of external environmental or trade shocks on growth has been extensively analysed by the aid-growth literature. Until the early 1990s, this literature came up with vastly differing econometric results with respect to the specific influence of export instability linked to shocks. The impact of export instability was variously shown to be either positively significant,[63] not significant[64] or negatively significant.[65] The argument advanced for a positive effect of this kind of instability on growth is that developing countries respond to export instability by reducing consumption, which on a repeated basis generates an increase in savings and investment rate.[66] Those authors who observe that export instability has no effect on growth argue that developing countries anticipate fluctuations in their export receipts and plan for this in such a way that they do not impact growth. Finally, those authors that show a negative relationship between export instability and growth underline that this instability creates shortages of inputs and uncertainties that are detrimental to production.

Recently however, the use of more suitable growth models seems to have allowed the emergence of a relative consensus on the negative effect of export instability on

63 Yotopoulos and Nugent (1976).

64 Kenen and Voivodas (1972).

65 Glezakos (1973); Voivodas (1974); Deméocq and Guillaumont (1985); Ozler and Harrigan (1988).

66 Yotopoulos and Nugent (1976) show a positive effect of export receipts instability on savings. See Gyimah-Brempong (1991) for a review of this literature.

economic growth.[67] Ramey and Ramey (1995) distinguish between the foreseeable and unforeseeable factors of growth volatility, with the unforeseeable factors being assimilable to a measure of risk. The authors thus show that this measure of risk negatively impacts on the growth rate of their cross-country sample. Guillaumont *et al.* (1999) differentiate between "primary" instabilities (climatic and terms of trade), which are structural rather than the result of economic policy, and "intermediate" instabilities (real exchange rate and the rate of investment rate), which, on the contrary, are linked to economic policy. Their estimations suggest that primary instabilities influence growth through intermediate instabilities.

More generally, Easterly *et al.* (1993) suggest that shocks, particularly terms-of-trade shocks, represent a determining factor of growth variations. Basing his argument on this analysis, Rodrik (1998) highlights the negative effect of external shocks on the growth rate differential between 1960-1975 and 1975-1989. Interestingly, the main thrust of his analysis underlines the fact that interaction between social conflicts and external shocks has an adverse effect on growth.

3.2.2. The impact of vulnerability on aid effectiveness

Structural vulnerability introduced into the analysis of aid effectiveness

Alongside policy quality, other factors are likely to influence aid effectiveness. Developing countries experiencing external economic and climatic shocks may need more foreign support, and if this aid can offset the harmful effect of such shocks on growth, it could then be more efficient in these countries. Countries vulnerable to external shocks may indeed need a form of insurance against shocks, so as to avoid

67 Gyimah-Brempong (1991); Guillaumont (1994); Dawe (1996); Combes and Guillaumont (2002).

interruptions or marked decreases in economic growth. In this case, the contribution of aid to growth would be greater in countries facing such shocks.

This hypothesis has been tested by Guillaumont and Chauvet (1999, 2001). Following Burnside and Dollar's growth equations, they introduce an aid term interacted with the structural vulnerability of countries, thus attempting to test for a potential cushioning effect of aid with respect to external shocks. Their vulnerability variable is made up of climatic instability,[68] long-term trade shocks[69] and short-term trade shocks.[70] Finally, population is introduced as a proxy for structural exposure to trade shocks, large countries being less vulnerable to these types of shocks.[71]

The econometric estimations of Guillaumont and Chauvet suggest that the economic vulnerability of countries has a negative impact on growth. Furthermore, it would seem that the greater the vulnerability, the greater the effectiveness of aid—the negative effect of vulnerability on growth is mitigated by foreign aid. In addition, and contrary to Burnside and Dollar's results, the aid-policy interaction term loses its significance when vulnerability is taken into account. Finally, the estimations of economic policy suggest that structural vulnerability significantly decreases the quality of these policies. These findings underline the importance of taking into account the structural vulnerability of developing countries when evaluating their economic performance, particularly in view of a more selective aid allocation on the basis of this criterion.

68 Captured by the instability of agricultural value added weighted by the ratio of agricultural value added to GDP.

69 Taken into account by the trend of terms of trade.

70 Captured by instability of exports, weighted by the ratio of exports to GDP.

71 The composite indicator for vulnerability is constructed by weighting these four variables according to their impact on growth.

A study by Guillaumont and Laajaj (2006) proposes a meso-economic analysis of the link between aid effectiveness and vulnerability to external shocks. Using the evaluations of World Bank projects carried out by the Independent Evaluation Group (IEG), the authors show a negative effect of the level of aid (aid has diminishing returns) and of exports instability (external shocks have a tendency to lower the probability of projects succeeding). However, the aid term interacted with exports instability has a positive influence on the probability of success of World Bank projects, suggesting that aid dampens the negative impact of this source of instability.

The case of price shocks

Collier and Dehn's (2001) analysis focuses more specifically on the links between aid effectiveness and export price shocks—which are a component of vulnerability. The authors identify extreme negative or positive shocks on the basis of an export price index. When introduced into a Burnside-Dollar-type econometric estimation, they show a negative effect of negative price shocks (according to the authors, positive shocks have no effect).

Much like Guillaumont and Chauvet, these authors test the capacity of aid to offset the effects of price shocks on growth. They note that a persistently high level of aid can cushion price shocks, since in this case variations in foreign currency inflows seem proportionately lower. The cushioning role of aid can also operate when aid flows fluctuate in a counter-cyclical manner, as this may offset export price shock effects by reducing the absolute change in foreign currency inflows. The interaction of negative price shocks with the initial level of aid is not significant. On the other hand, negative shocks interacted with fluctuating amounts of aid are significantly positive, suggesting that aid has a counter-cyclical effect that are likely to mitigate these negative price shocks.

3.2.3. Implications for aid allocation: an alternative concept of performance?

If foreign aid is more efficient in countries that are vulnerable to external shocks, then it would appear that aid allocation targeting poverty reduction should take this criterion into account. Certainly, delivering aid to the most vulnerable countries can not only offset a deterioration in well-being, but also increase the contribution of aid to growth, and thus help reduce poverty (Combes and Guillaumont, 2002).

If performance-based allocation is viewed from the perspective outlined in the previous section, it then becomes possible to define a concept substantially different from that of the CPIA (the one traditionally used in literature to analyse recipient countries' performance). Economic performance would be captured by country results (for growth and poverty reduction) that are purged of the influence of exogenous structural factors (initial conditions and external environment). This measure of economic performance would then shed light on the effectiveness of economic policy, independently of the policy instruments chosen. This concurs with the proposal made within the framework of the European Commission initiative, which aims at introducing performance indicators for managing structural adjustment programmes in ACP countries (Box 1.).

3.3. Political instability and conflict: what role for aid?

Given that many developing countries are facing high instability linked to political events, the debate on the conditions for aid effectiveness now encompasses various forms of socio-political instability (violent or not, on a mass scale or at government level, national or international). In the following section, we present the literature that examines the links between aid, growth and the various forms of political instability.

3.3.1. Socio-political instability, conflicts and growth

The effect of political instability on growth

There seems to be broad consensus that socio-political instability in developing countries has a negative impact on growth. Certainly, socio-political instability hinders growth insofar as it creates an uncertain environment little conducive to investment. Some authors have shown interest in an overarching concept of socio-political instability and take into account multiple dimensions of political phenomena: demonstrations, riots, strikes, political assassinations, armed attacks, political executions, coups d'état.[72] Other authors, however, have inclined towards the notion of political risk, captured by the probability of socio-political unrest occurring.[73] Finally, some authors have examined more specific notions of political instability, most frequently instability at executive level of government.[74] Whatever the form or nature of the instabilities studied in the econometric literature, their impact on growth or investment appears to have a highly negative effect.

Internal economic and social consequences of civil conflicts

Among the various forms of socio-political instabilities, civil wars are the most violent and devastating. For this reason, they have been the subject of specific analysis and, since the late 1990s, have held a key place in the literature. For developing countries, civil wars have dramatic human and social repercussions (conflict victims,

72 Alesina and Perotti (1996); Guillaumont *et al,* (1999).

73 Azam *et al.* (1996) estimate the probability that socio-political unrest occurs in correlation with military and health expenditure, education enrolment rates and regional variables. When introduced into a growth equation, this probability has a significantly negative effect.

74 Fosu (1992) and de Haan and Siermann (1996) show that *coups d'état* and turnover of the executive have a significantly negative effect on growth in Africa. De Haan and Siermann (1996) underline however that this effect is not significant in the case of Latin America and Asia. Alesina *et al.* (1996) estimate the probability of turnover in the executive and show that this negatively influences growth.

displacement of refugees), the effects of which persist and translate into increased mortality (Collier *et al.,* 2003).

The economic consequences of civil conflicts are equally very important. Murdoch and Sandler (2002) evidence a highly negative impact of civil wars—captured by the number of months of war or number of deaths—on the short-term growth of developing countries. Collier *et al.* (2003) underline that civil wars cause a drop in national output because they not only destroy infrastructure and physical capital, but also divert resources towards the non-productive sector of military expenditure.[75] Wars cause the loss of holdings and assets for households, as well as the destruction and transformation of social capital. Furthermore, in developing countries on a whole, these effects persist when peace returns: military expenditure continues to be high, capital flight remains sizeable, and social capital recovers only very slowly.

Regional and global externalities of political instabilities

Beyond their internal economic and social consequences, socio-political instability and civil wars in developing countries produce a large spill-over of externalities onto their neighbours. Regional political instability can influence the growth of developing countries in different ways. First of all, it weighs negatively on trade exchanges by causing disruptions in cross-border trade. It can also give rise to increases in military spending and lessen the share of government expenditure earmarked for education.[76] Ades and Chua (1997) explore the negative externalities for growth created by regional political instability—defined as the average number of revolutions and *coups d'états* in

75 On this point, see also Collier (1999).

76 Through econometric estimations, Ades and Chua (1997) evidence the harmful effect of regional political instability on trade exchanges and education expenditures. They also show that instability causes an increase in internal military expenditures. On this point, see also Collier and Hoeffler (2001), whose estimations suggest the existence of a predominant effect of external threats on the amount of military expenditure (the risk of internal rebellion having no effect on the amount of military expenditure).

the neighbourhood. The impact of this type of regional instability is significantly negative and of a similar extent to that of internal political instability.

Even more than regional political instability, violent civil conflicts create very strong negative externalities for economic growth in neighbouring countries (Murdoch and Sandler, 2002). The neighbours of countries at war may suffer from collateral damage and the destruction of infrastructure and physical capital. Similarly, a civil war can result in large flows of refugees, which are often a source of poverty and instability. In addition, the closeness of war and the risks of contagion create a feeling of uncertainty that harms investment, and more particularly foreign investment. Conflicts can also disrupt trade exchanges and cause short supplies of inputs. In the framework of an arms-race model, Collier and Hoeffler (2001) have studied the negative externalities of civil wars for neighbouring countries. They identify two mechanisms that transmit these effects: the increase in military expenditures and the contagion of rebel movements.[77] Finally, the repercussions of civil war in developing countries not only affect their neighbours, but can also reach developed countries. Collier *et al.* identify many forms of global externalities of civil wars, such as the production and distribution of hard drugs and the spread of disease or international terrorism.

3.3.2. Aid effectiveness in the context of political instability and war

Aid effectiveness in post-conflict situations

Whilst the negative impact of political instability and civil war on the growth of developing countries seems well established, few studies have attempted to analyse their influence on aid effectiveness. Recently however, Collier and Hoeffler (2002) have

77 On the risk of regional contagion of ethnic wars, see also Sambanis (2001).

examined the effect of aid on growth in a post-conflict period. There are no theoretical grounds for determining whether aid is more or less productive in post-conflict situations. In effect, the need for reconstruction, combined with the collapse of national income, is likely to create an environment in which aid is particularly effective. However, the opposing argument may also be put forward that societies having experienced civil war face persistent corruption, which, together with weak governance and institutions, can render aid less effective.

To assess the effect of aid in post-conflict situations, Collier and Hoeffler (2002) use a step approach and try, first of all, to identify whether a higher growth potential exists during a post-war period—independently of aid and policy quality. Their econometric study suggests that during the first post-conflict decade, there is a peak phase for growth between the fourth and seventh year.[78] Aid is also more effective during this peak growth period, with the absorptive capacity for aid being at about twice its normal level. This capacity depends on the economic policies that have been implemented. Nonetheless, aid is shown to be more effective in post-conflict societies despite the poorer quality of these policies.

Collier and Hoeffler thus note that "post-conflict societies constitute an important exception to the proposition that, for given levels of poverty, aid should be lower in societies with worse policies" (Collier and Hoeffler 2002, p.8). In their view, aid should be directed primarily to post-conflict zones and augmented during the first years of peace, then progressively scaled down up to the end of the seventh year. However, the actual allocation patterns observed in post-conflict countries do not match this recommendation: aid increases sharply during the first two post-war years, then falls and rapidly returns to a normal, if not lower, level.

78 They explain the lowest growth of the first three post-war years as resulting from the weakness of the State and the high uncertainty linked to this period.

Internal political instability—a determing factor for aid effectiveness

On a broader level, internal socio-political instability may also influence the effectiveness of aid in the area of economic growth. As in the case of post-conflict countries, this effect can play out in two opposite directions. On the one hand, political instability may be considered as being akin to economic vulnerability or, in other words, as a negative exogenous shock that aid is likely to offset or cushion. In this case, aid effectiveness would be higher in politically unstable countries. Guillaumont (2001, p.6), on the other hand, underlines that, insofar as socio-political instability is endogenous and linked to a country's political will, it is likely to be of a different nature to that of structural economic vulnerability. Thus, a politically unstable environment with frequent changes of government and political violence can, on the contrary, negatively impact aid effectiveness in terms of growth.

The impact of internal socio-political instability has also been examined by Chauvet and Guillaumont (2004a). Their instability indicator captures the number of demonstrations, *coups d'état* and months of civil war. In line with the literature on this topic, the authors evidence a strongly negative effect of political instability on growth. More interestingly however, in their growth estimations, their socio-political instability indicator is interacted with the aid variable (as in the framework of Burnside and Dollar, 2000). Their interaction term proves to be significantly negative, suggesting that aid is more productive in politically stable countries. It thus seems that a politically unstable environment, with frequent changes of government and political violence, negatively impacts the effect of aid on growth.

Can foreign aid dampen external political shocks?

In the above sections, we have presented a group of studies showing that developing countries' economic growth is negatively impacted by regional political instability or civil war in neighbouring countries. Although these "external political shocks" have a negative impact on economic growth, few studies have explored their impact on aid effectiveness. Growth estimations carried out by Chauvet and Guillaumont (2004*b*) and Chauvet (2006) suggest however that aid is more effective in countries surrounded by neighbours at war.[79] Aid effectiveness may thus be greater in countries experiencing "external political shocks", suggesting that aid has a cushioning effect with respect to the regional political instability faced by numerous developing countries.

3.4. State fragility: how is it to be taken into account?

Aid allocation based on the economic performance of developing countries raises the question of which strategy to adopt in the case of poor under-performing countries, also called fragile States. Certainly, excluding these countries from the international aid system carries the risk that poverty problems could worsen, and also that these countries' State structures might collapse—which would not only have disastrous internal implications, but also regional, if not global, consequences.

3.4.1. Concept(s) of the fragile State

Although the term "fragile States" is now widely used, the designation has varied over time and from one institution to another. The consensual term of fragile State has followed on from "failing", "failed" or "collapsed" State, which all suggest a profound failure of State institutions. Similarly, the OECD refers to "difficult partnerships", underlining the difficulties that bilateral and multilateral donor agencies have to intervene in these countries. The World Bank speaks of "LICUS" (Low-Income Countries Under Stress) to designate such under-performing poor countries.

79 The authors follow a Burnside-Dollar-type approach by introducing an aid variable interacted with the number of months of civil war in neighbouring countries.

In fact these different terms cover different notions of “fragility”. Moreno Torres and Anderson (2004) have classified the various approaches used by different development actors to define fragile States, and have come up with three main categories:

(i) fragile, failed or crisis States: this category is based on the State’s capacity to provide basic services and ensure the security of its population. According to Moreno Torres and Anderson (2004), this approach is adopted by USAID and the European Council, among others;

(i) poor-performing countries: this category is based on the assessment of a country’s performance in terms of development outcomes, while taking into account the quality of governance and the choice of economic policies. This approach to fragile States is used mainly by the World Bank, the Australian aid agency (AUSAID) and the UNDP;

(i) difficult aid partners: this approach to fragility refers to difficult donor-recipient relationships, in which the recipient country has development objectives that diverge from those of the international community and a weak institutional capacity to implement policy. The OECD Development Assistance Committee has developed this approach, which has also been adopted by the European Commission and the DFID.

3.4.2. Aid to fragile States: Chauvet and Collier’s analysis

Fragile States are at the heart of the debate on performance-based aid allocation. Characterised by weak institutions and policy, they are doomed to exclusion from a performance-based aid system despite the great poverty that their populations are facing. Thus alongside the question of an aid allocation system grounded on performance, the question of aid orphans also arises. Dollar and Levin (2005) show that difficult partners receive 40% less aid than countries with equivalent economic performances.

Beyond the moral considerations, abandoning fragile States to their fate has a considerable cost, which at an economic level argues for modes of intervention adapted to their specific problems. This cost is not only linked to the internal cost of a State's fragility borne by the populations enduring it, but also to the strong negative externalities of fragile States for their neighbours (Chauvet and Collier, 2005, Chauvet, Collier and Hoeffler, 2006a).

A core hypothesis in the performance-based allocation model is that aid has no effect on the quality of institutions and policy (this is discussed in Section 1.2.2.). This hypothesis is queried by the central strand of Chauvet and Collier's research on fragile States. They argue that, in the particularly difficult context of such States, aid helps to implement reforms that improve the quality of institutions and economic policy. However, if aid to fragile States is to be effective, the modes of delivery need to be different from those traditionally used.

Chauvet and Collier (2005, 2006*a*) analyse the influence of aid on reforms in fragile States, and focus on substantial reforms likely to lift these countries out of the "fragile State" category. After defining substantial reforms on the basis of improvements in the CPIA,[80] the authors identify the determinants of these improvements, as well as the respective roles of financial aid and technical assistance.

One of the striking findings of their research is the persistence of the "fragile State" status. To explain the absence of turnaround in these countries, Chauvet and Collier identify an ensemble of impediments blocking reform: the ruling elite's lack of political will to implement reforms, the power structure (democratic or not), the risk of choosing the wrong development strategy, and, the insufficient capacity of institutions, or sometimes even public services, to put reforms into practice. Using econometric

80 See section 2.2.2. for a critical reading of the CPIA. The authors also use the composite ranking of at-risk countries proposed by the *International Country Risk Guide* for the period 1984-2002.

estimations, the authors identified the most significant constraints in fragile States. The role of the ruling elites and the weakness of institutional capacity appear as the two main reasons for the lack of change in fragile States.[81]

Different forms of aid (financial aid and technical assistance) are expected to have different impacts on constraints. The econometric analysis of this question suggests that technical assistance influences the public sector's capacity to initiate reform, whereas financial aid influences the ruling elites' political will to reform. More importantly, their econometric study suggests that, in order to achieve sustainable reform in fragile States, aid should be specifically adjusted to the windows of opportunity for action.

These windows of opportunity can be identified in two complementary ways: (i) through economic indicators such as an observable sign of reform (a slight improvement of the CPIA); or (ii) through political signals such as a change in the ruling elite. When such windows of opportunity open, there are converging results with respect to the appropriate intervention sequence no matter which criterion is used to define these "windows". It seems that in the case of incipient reform, financial aid discourages the elite from pursuing the reform process. This finding is consistent with the disincentive effect of a positive export price shock with respect to reform. These results tend to suggest that, in fragile States, the sources of financial rents finance the *status quo* rather than change.

On the other hand, technical assistance for incipient reform strongly increases the chances of bringing about substantial reform. Once started, the reform process may be blocked if the public sector has insufficient capacity to take it through to completion. Technical assistance helps to ease this constraint. After several years of reform, however, financial aid becomes favourable to the process, while technical assistance

81 See Chauvet and Collier (2006*b*) for a detailed presentation of these results.

loses its impact. Finally, if no window of opportunity opens, any intervention seems to be useless or even counter-productive.

In addition to synchronising the release of aid with the reform process and choice of instrument (technical assistance, etc.), Chauvet *et al.* (2006b) have also analysed the donors' margin of manoeuvre for implementing development projects. Their study seeks to identify whether the supervision effort by the World Bank can ensure greater success for projects in fragile States. A key hypothesis in their study runs as follows: in "difficult partnership" countries, the interests of the ruling elites do not coincide with those of donor countries—elites do not necessarily pursue the development objectives advocated by the international community. The purpose of the study is thus to identify whether donor supervision of projects is an effective substitute for congruent donor and recipient objectives. Drawing on the extensive data base of the Independent Evaluation Group, which evaluates World Bank projects, the authors show that supervision has a positive impact, and one that is relatively more significant in fragile States—or difficult partnerships—than in other developing countries. Their findings thus argue in favour of increased supervision in these countries, contrary to what seems to be current practice.

3.4.3. World Bank strategy in LICUS countries

The Task Force on Low-Income Countries Under Stress (LICUS) was set up by the World Bank to analyse and identify the best aid strategies for these poor-performing countries. While LICUS countries are all characterised by high levels of poverty and poor economic performance, this group does in fact cover widely varying situations. For example, some LICUS countries have considerable natural resources, others are emerging from very violent conflict situations, and some have particularly weak institutional capacities. Consequently, the Task Force is not advocating a single cross-the-board strategy for these countries, but rather one that takes into account their socio-economic environment and their economic policy constraints.

However, according to the World Bank,[82] aid strategies for LICUS countries should pursue two key objectives: (i) to significantly improve economic policy, institutions and governance; and (ii) to improve basic social services delivery (health, education).[83]

Concerning the first objective, the World Bank proposes that the donor community play a catalytic role in order to foster greater country ownership of reforms in LICUS countries. This would first involve identifying a "Zero-Generation" reform agenda. This would include two or three reforms that not only have important economic implications and a rapid pay-off, but which are also feasible in socio-political terms, or in other words, supported by a broad coalition. During a second phase, the catalytic role of the donor community would facilitate the development and enlargement of this first reform agenda. To achieve this, donor countries must work to build the institutional capacities of LICUS countries and identify ways of reducing the bottlenecks that limit their absorptive capacity.

As for the second objective of the development strategy in LICUS countries—to improve the provision of basic social services—the World Bank proposes developing and using service delivery channels other than those of government. Several options can be envisaged: using existing partial solutions for certain targeted objectives (vaccination through agencies such as the Red Cross or Red Crescent), setting up social funds or even go as far as creating independent authorities for social services delivery. The World Bank emphasises that these supplementary channels must play a transitional role designed to reinforce government capacity-building.

The LICUS Trust Fund received USD 25 million in January 2004, revised in January 2006 to around USD 26 million. In December 2006, the second revision of USD 30 million

82 World Bank, 2002.

83 The specificity of LICUS countries is the fact that other objectives should be suspended until there is sufficient capacity to advance with reform (World Bank, 2002).

was approved by the World Bank's Board. So far, 80% of available financing has been allocated to African countries. However, the disbursement rate remains relatively weak (44% of committed funds).

Although the Burnside-Dollar-Collier findings have given rise to considerable debate, it leaves unanswered a good number of questions about optimal allocation of aid. In the rules for optimal allocation, little or no account is taken of the issues of diminishing returns to aid, the external vulnerability of countries, political instability and institutional fragility, even though these are core determinants for effective development assistance.

In the following chapter, we shall see that an aid allocation strategy, even when poverty-efficient, cannot alone help to lift certain countries out of the poverty trap. Some authors have defended the idea that, in particularly difficult environments, a massive foreign capital inflow or "big push" is necessary to unblock the situation and stimulate an economic take-off. In this fourth chapter, we also return to the "doubling of aid" strategy and review the recent debate that has accompanied it.

Double rather than reallocate? The issues of absorptive capacity and aid volatility

4

The principle of performance-based allocation aims at allocating aid so as to maximise certain objectives (growth, poverty reduction) within a context of strong budget constraints. The underlying idea is to use constant, or even diminishing resources as effectively as possible.

Mobilisation of the international community around the MDGs has revealed that extremely low levels of aid are no longer sustainable. Some studies, such as the United Nations' Millennium Project, have shown that some countries, because they are caught in a poverty trap, will not achieve the MDGs by 2015. Extreme poverty leads to very low domestic savings, which are not offset by inflows of foreign capital and/or foreign investments given the scarcity of physical infrastructure and the weak human capital in these countries. This combination of factors locks them into a situation of near-zero, or even negative economic growth, as they are unable to finance necessary investments. A reallocation of aid to support strategies for the fight against poverty would not in itself be sufficient to lift countries out of the trap; the only way to break out of this situation would involve a massive injection of capital (big push) to increase total savings.

Various studies (Zedillo, 2001; Sachs, 2004; Commission for Africa, 2005) that have attempted to evaluate the level of aid required reach the conclusion that aid volumes should be doubled (i.e. approximately USD 50 billion in 2004). International consensus has thus emerged on the need for a massive scaling up of aid flows (Monterrey Conference in 2002, G8 in Gleneagles in 2005). These commitments have translated into a substantial increase of donor efforts since 2002 and into various initiatives to mobilise additional ODA resources (cf. Box 4.). Furthermore this strategy to increase aid flows does not rule out application of the optimal allocation principle. The Millennium Challenge Account (cf. Box 3.) is one example of initiatives to increase American aid while still reallocating aid on the principles grounded in optimal allocation.

This commitment to doubling aid has raised new questions regarding the issues of Burnside and Dollar's approach. Two questions in particular have attracted donor attention: the recipient country's capacity to absorb additional aid flows and the aid volatility that might accompany the large increase of flows. Although related research is still inconclusive, several studies (Heller and Gupta, 2002; Clemens and Radelet, 2003; World Bank, 2004b) propose a typology of the obstacles that generate decreasing returns to aid, thus limiting the aid recipients' absorptive capacity. These include macroeconomic, institutional and policy constraints, as well as constraints generated by donor behaviour.[84] The first three sections of this chapter present in turn these three constraints. The fourth section discusses the implications of aid volatility within the context of doubled flows, laying emphasis on the risks linked to aid unpredictability.

84 It is also possible to add technical and managerial constraints to this list. Numerous recipient countries have a human capital deficit, since it can be difficult to recruit, train and keep qualified personnel. In Africa, this phenomenon is further aggravated by the effects of the HIV/AIDS pandemic.

Box 4.
Promises kept?

In accordance with the 2002 Monterrey Conference declarations and the objective of doubling aid in order to achieve the MDGs, official development assistance has been increasing since the end of the 1990s (see graph below). The average aid effort of the Development Assistance Committee (DAC) countries, which stood at 0.22% of national income in 1997, rose to 0.33% in 2005 and should reach 0.36% by 2010. This nonetheless remains well below the target of 0.7% that was fixed by the United Nations in the 1970s. Although the funds allocated to core development programmes were scaled up by 8.6% between 2004 and 2005, most of this increase benefited two countries only: Afghanistan and Iraq. Setting aside these two countries, the increase totalled 2.9%. The aid increase in 2005 was basically in the form of debt relief grants, which tripled, while humanitarian aid rose by 15.8%.

Source: OECD-DAC, 2006.

Over the last two years, several innovative financing mechanisms have also been created, notably the International Solidarity Contribution (ISC) and the International Finance Facility (IFF). Important steps in implementing both of these were taken in 2005. France decided to establish an ISC on plane tickets from 1st July 2006 and should be joined by

Chile and the United Kingdom. In the same year, Spain, France, Italy, the United Kingdom and Sweden officially launched the project IFF for Immunisation (IFFIm).

Within the framework of the IFFIm, the total amount envisaged is USD 4 billion over 10 years, destined for the Global Alliance for Vaccines and Immunisation (GAVI). The United Kingdom has committed to USD 130 million per year, France USD 100 million, Italy USD 30 million, Sweden USD 27 million and Spain USD 12 million.

The IFF mechanism involves leveraging international capital markets in order to disassociate ODA flows received by recipient countries from ODA flows disbursed by donor countries. More precisely, the IFF would "frontload" the funds received, which would be entirely disbursed within the first 14 years (between 2006 and 2019), while donor disbursements would be spread out over a period of 26 years (between 2006 and 2031). This mechanism would help to reconcile realistic levels of donor contributions with the Millennium Development Goals.

The IFF therefore aims to anticipate the future increase of development aid over time and use financial markets to this end. It periodically collects multi-year, legally-binding commitments for future contributions from member countries. On this basis, the IFF issues bonds with repayment being guaranteed by donor pledges (thus with the highest possible credit rating). The proceeds from the bond issuances are then used to finance development, largely in the form of grants. If the mechanism functions satisfactorily, it produces a stable resource, since the rhythm of disbursement is not tied to donor payments.

The *solidarity contribution on plane tickets* is a fiscal instrument. A fixed-rate contribution is levied on every ticket for a journey from one of the countries participating in the scheme. In France, ceilings have been fixed at 1 euro for economy class and 10 euros for business and first classes. This rate is multiplied by four for extra-community flights. France expects to raise revenues of 200 million euros per year. This is not strictly speaking an international tax since the contribution is implemented individually at sovereign level. However, it is internationally co-ordinated in order to channel the revenue raised in the different countries and to maximise the impact on development. France has proposed that the revenue levied by the new contribution be allocated to the Global Fund against AIDS, Tuberculosis and Malaria, in the pursuit of a specific objective such as joint purchasing of antiretroviral drugs (Mentré, 2006).

4.1. Aid increases and Dutch Disease: a real risk?

The appreciation of a country's real exchange rate (a handicap for the export sector) linked to a rapid scaling-up of foreign currency aid inflows has been identified in the literature as a major constraint for absorptive capacity (Arellano *et al.*, 2005; Heller, 2005; Gupta *et al.*, 2006; Rajan and Subramanian, 2005; World Bank, 2005 and 2006; Adam and Bevan, 2004; Adam, 2005; Bevan, 2005; Gunning, 2005).[85] These studies describe the well-known phenomenon referred to as "Dutch Disease": by causing the real exchange rate (RER) to appreciate, massive aid inflows reduce competitiveness in the tradables (exports) sector. This syndrome occurs when local prices for non-tradables increase under a fixed exchange rate regime, or through an increase in the nominal exchange rate under a floating exchange rate regime.

Although the theoretical arguments are clearly established, the empirical evidence corroborating that this syndrome coincides with the presence of aid flows appears mitigated (Guillaumont *et al.*, 2006; Berg *et al*., 2005). Gupta *et al.* (2006) review a sample of econometric studies showing contradictory results: some authors find a positive link between aid inflows and the real exchange rate (Younger, 1992, for Ghana; Kasekende and Atingi-Ego, 1999, for Uganda), while others find a negative link (Nyoni, 1998; Sackey, 2002). Even IMF studies (Rajan and Subramanian, 2005) do not formally test the hypothesis that foreign aid impacts the evolution of the RER. They simply demonstrate that aid has a negative impact on the share of the labour-intensive, tradables industries, and only suggest that this negative impact might be due to an increase in the RER.

Guillaumont *et al.*, (2006) explain this lack of empirical evidence by the fact that, in the short term, the price of non-tradables only increases if the tradables sector is

85 Numerous studies (cf. Van Wijnbergen, 1984, 1986) were published in the 1980s on this topic, which recently has once again become a centre of interest.

producing at full capacity. If, on the contrary, capacities are underused, for example in the case of high urban unemployment, the supply elasticity may be high and thus prevent non-tradables prices from increasing. This is frequently the case in countries that are highly dependent on foreign aid, notably in sub-Saharan Africa.

Furthermore, according to Guillaumont *et al.* (2006), the negative consequences of RER appreciation could be overestimated. Indeed, in the long term, an increase of productivity in the tradables sector should by nature compensate the effect of an increase in non-tradables prices on the levels of competitiveness.

Finally, if, as the Balassa-Samuelson theorem posits, income per capita increases more than in the rest of the world and causes RER to appreciate, a big push should give rise to the same phenomenon. In other words, if additional aid inflows do indeed generate the intended big push, they will automatically cause a real currency appreciation. This appreciation no longer represents a problem, but rather a sign of the development strategy's success.

What are the implications in terms of economic policy? In the short term, macroeconomic management of increased aid flows can help to prevent the relative price of non-tradables from increasing too rapidly. For example, a policy of "sterilising" foreign exchange reserves can be applied to limit an increase in demand, but this strategy can only be partial and transitory (Heller, 2005). In the longer term, the risk of Dutch Disease has important implications where sectoral aid allocation and public expenditure are concerned. In as much as growth in productivity automatically compensates the appreciation of the RER, it seems necessary to maintain a balance between aid allocated to productive sectors and aid allocated to social sectors. Aid to improve the health and education of children will only impact productivity in the long term, whereas aid in the form of investment in the productive sector will have a more short-term impact.

According to Collier (2006), even if the impact of aid flow increases is not totally comparable to that of an oil boom, the risks of Dutch Disease necessitate a radical reform of the aid modalities.

4.2. The institutional constraints weighing on absorptive capacity

The transparency and effectiveness of the budgetary system, the structure of public expenditure, the mechanisms for defining policy priorities and the system of accountability engaging government responsibility are all political and institutional factors influencing the State's capacity to implement an efficient development strategy. Many countries, however, do not have the institutional capacities required to absorb high volumes of aid without increasing the risks of embezzlement and corruption. Whatever modalities are used for programme implementation in the context of a doubling of aid (project or budget support), the fungibility of resources implies that donors need to pay attention to public policies and the means of implementing them, notably through the State budget.

Over and above budgetary trade-offs, the quality of execution procedures and the control of public expenditure (including public procurement) is key to effective absorption of the overall resources available to government. The quality of the public expenditure chain and the control systems exert a decisive influence through two channels: the expenditure execution timetable (for earlier benefit of the effects of expenditure) and the value for money principle for public purchases with respect to the goods and services supplied (over-billing, phantom agents, etc.). The budget losses linked to a deficient chain of expenditure are ill-known, but it is not inconceivable that, in certain cases, they exceed the volume of allocated aid or the annual debt burden of certain countries (Amprou and Cottet, 2007).

Box 5.
The PEFA initiative

The "Public Expenditure and Financial Accountability" (PEFA) programme is a multi-donor initiative[86] aimed at enhancing co-ordination of the joint efforts of numerous stakeholders to assess and develop public finance management (PFM) systems. The partners have created a performance measurement framework for PFM designed to (i) provide reliable data on system performance and PFM procedures and institutions over time; (ii) follow up government reform process and determine to what extent the reforms improve the functioning of the system; (iii) facilitate the harmonisation of dialogue between government and donors around a common framework for measurement of PFM performance, which contributes to reducing transaction costs for partner countries.

The framework includes a PFM performance report as well as a set of indicators for measuring six critical dimensions of an open and orderly system of public finance management:

1. **Credibility of the budget —** The budget is realistic and is implemented as intended.
2. **Comprehensiveness and transparency —** The budget and the fiscal risk oversight are comprehensive, and fiscal and budget information is accessible to the public.
3. **Policy-based budgeting —** The budget is prepared with due regard to government policies.
4. **Predictability and control in budget execution —** The budget is implemented in an orderly and predictable manner and there are arrangements for the exercise of control and stewardship in the use of public funds.
5. **Accounting, recording and reporting —** Adequate records and information are produced, maintained and disseminated to meet decision-making, control, management and reporting purposes.
6. **External scrutiny and audits —** Arrangements for the scrutiny of public finances and follow-up by executive are operating.

86 Including the World Bank, the IMF, the European Commission, the United Kingdom, France, Norway, Switzerland and the Strategic Partnership with Africa.

With respect to the six core dimensions, a set of indicators measures the operational performance of the key elements of the PFM systems, the processes and the institutions of a country's central government, legislature and external audit.

The repeated application of the indicator tool should provide information on the extent to which country PFM performance is improving or not. In addition, the PFM performance report recognises the efforts made by government to reform its PFM system by describing recent and ongoing reform measures, which may not have yet impacted PFM performance. The report does not, however, include any recommendations for reforms that should be carried out, nor does it formulate any assumptions as to the potential impact of ongoing reforms on PFM performance.

Source: PEFA Public Financial Management Performance Measurement Framework, 2005.

Donors have designed a number of instruments for monitoring expenditure policy, such as public finance management (PFM). Recently, a new performance measurement framework for public finance management systems, *Public Expenditure and Financial Accountability* (PEFA), has been developed by a small group of donors, including France. This aims to achieve (i) greater co-ordination of partners, (ii) sustained dialogue between donors and aid recipient countries, and (iii) greater latitude for national governments to define and implement reforms promoting a reliable and sustainable public finance management system that is transparent and efficient (cf. Box 5.).

4.3. Donor behaviour: an obstacle to aid absorption?

The way in which aid agencies operate can also be an obstacle to the absorptive capacity of recipient countries. The multiplicity of actors and the dispersion of projects make managing external interventions complicated for recipient country governments, as their capacities are financially and humanly limited. Although this observation is widely referred to in the Paris declaration on Aid Effectiveness,[87] poorly harmonised procedures and certain disbursement modalities [88] continue to increase civil servants' workloads and divert government administrations from their core functions.

The problem of the proliferation of donors and projects is well described by Acharya *et al.* (2004). This situation naturally generates high transaction costs. Each project needs to be negotiated separately and individually managed by the recipient country's civil servants, which makes the workloads of already weak public administrations much heavier and also reduces the attention they can give to their own projects. The situation is also exacerbated by the fact that the projects are often led by different donors, who require that the local civil servants adapt to their specific processes and timeframes. In the current system of aid, the cost of proliferation is borne by the recipient country.

The weakness of recipients' public administrations, linked to the fact that civil servants are busy managing a large number of projects, leads some donors to employ local labour (often civil servants), so that their own projects receive attention, to the detriment of all the others. This practice could weaken the public expenditure chain even further. Knack and Rahman (2004) thus observe that, during the period 1982-2001, higher fragmentation of donors is associated with lesser bureaucratic quality. This result is confirmed for many different measures of bureaucratic quality. The authors suggest that this phenomenon results from a deliberate donor practice of bypassing local institutions.

87 The Paris Declaration text (2005) is available at the following address: http://www1.worldbank.org/harmonization/Paris/ParisDeclarationFrench.pdf

88 These modalities are not unrelated to the donors' desire to bypass the institutional weaknesses of recipient countries.

Finally, the proliferation of aid agencies intervening in a country increases the risk of creating a “tragedy of the commons” phenomenon. The different donors, taken individually, not only do not feel responsible for the overall budget consequences of their own projects, but neither do they take into account the budget implications of other donors’ projects. For most of the projects implemented, it is assumed that complementary financing will be provided by the aid recipient, so as to allow, for example, recurrent costs to be covered once the project is completed. If the recipient is not in a position to refuse the donors’ offers, as is often the case (Bräutigam, 2000, p.45), the number of projects financed may prove unsustainable for the recipient countries’ budget capacities. The burden of recurring expenditure thus becomes too heavy. Projects, even if well-designed, can, in the long run, become non-viable due to the proliferation of donors and projects in the country.

Donor fragmentation imposes high transaction costs on governments with already weak capacities. Even though their impact is not yet clearly established, recent developments in favour of “programme approaches”, such as global or sectoral budget support, are attempting to remove these obstacles to absorptive capacity.

4.4. Aid doubling and volatility: how can uncertainty be reduced?

Aid volatility is often cited as a major source of instability in developing countries and the perspective of doubling aid flows has raised widespread debate about the risk of such volatility. These concerns have been amplified by the prospect of a substantive increase in aid in the form of budget support, which is traditionally recognised as being more volatile than project aid.

4.4.1. Aid volatility in question

Stylised facts

Several studies have evidenced the significant volatility of aid flows. Bulir and Hamann (2001, 2003, 2006) show, for a sample of 72 countries, that annual aid variance is seemingly higher than that of domestic government revenue. In the case of the 33 most aid-dependent countries, the variance of aid (as a percentage of GDP) is more than seven times greater than that of domestic revenue. Bulir and Hamann also show that aid volatility is greater in those countries whose domestic government revenue is the most volatile. According to the authors, countries suffering from unstable domestic revenue also suffer from unstable access to aid, which then tends to accentuate rather than offset the variability of other sources of revenue.

Pallage and Robe (2001) reach similar conclusions: aid is more volatile than the revenue of developing countries. These authors also highlight that multilateral aid is more volatile than bilateral aid as commitments are more volatile than disbursements. Finally, according to Fielding and Mavrotas (2005), programme aid is more volatile than project aid. Their study differs, however, from the preceding ones, since the econometric estimations of the determinants of volatility lead them to conclude that volatility is higher in countries receiving less aid.

Even though volatile, aid can have a stabilising impact

If, as the studies presented in section 3.2, suggest, aid helps to cushion economic growth from the external shocks experienced by developing countries, it can also be expected to be relatively volatile. Yet, the high volatility of aid may be merely a signal of a counter-cyclical action with respect to the external shocks experienced by developing countries, as suggested by the econometric results of Guillaumont and Chauvet (2001) and Collier and Dehn (2001).

However, some authors have evidenced contrary findings: aid is pro-cyclical, increasing when the external environment is favourable and decreasing when difficult conditions create a greater need for external financing, thus aggravating the harmful effect of external shocks (Pallage and Robe, 2001; Bulir and Hamann, 2001, 2003). Several reasons go to explain the pro-cyclicality of aid.[89] For example, those countries with good economic performances find it easier to implement donor conditionality and thereby attract donors. Inversely, difficult economic circumstances require adjustments to the reform programme, which leads to interruptions in aid payments.

These studies, however, may be criticised for their choice of the economic aggregates against which they compare aid cycles. They, in fact, compare aid cycles to cycles of national income or fiscal receipts. Yet, as Chauvet and Guillaumont (2006) note, revenue and receipts are endogenous with respect to aid and do not therefore represent a satisfactory reference point for assessing the pro- or counter-cyclical properties of aid. The authors instead propose a comparison of aid cycles with export cycles. They thus show that aid has been both counter-cyclical and pro-cyclical in an equivalent number of countries.

However, even when pro-cyclical, aid can nonetheless have a stabilising effect. The extent to which aid has a stabilising impact depends on its cyclical properties, but also on the level and volatility of aid with respect to exports. Taking into account these three dimensions, Chauvet and Guillaumont (2006) construct a synthetic indicator in order to measure the stabilising character of aid with the difference between (i) the volatility of exports and (ii) the volatility of exports plus aid. The authors then show that this stabilising character has a positive influence on the growth of African countries. This result confirms the conclusions of the previous studies presented in the third chapter:

89 See Foster (2003, p.93).

aid is more effective in countries that are vulnerable to external shocks (Guillaumont and Chauvet, 2001; Collier and Dehn, 2001).

4.4.2. Uncertainty and unpredictability of aid flows

Unpredictable aid …

The unpredictability of aid flows is likely to accentuate the potentially negative impact of their volatility (Foster, 2003). Certainly, if a government is able to anticipate future levels of aid, it can then manage the economy and the budget so as to minimise the negative consequences of significant aid variations from one year to the next (Eifert and Gelb, 2005). Bulir and Hamann's study, however, suggests that aid flows are highly unpredictable. Their econometric estimations evidence that donor aid commitments do not have a significant impact on disbursements for the ensuing period (moreover, these commitments are on average about 20% higher than actual disbursements).

… has a negative impact on economic performance

Faced with the uncertainty of aid receipts, the government can postpone or even cancel its investment decisions. This uncertainty can, more generally, have harmful effects on its fiscal behaviour. Lensink and Morrissey (1999) maintain that it is not the level of aid *per se* but the uncertainty associated to aid inflows that determines the impact of aid on growth. Indeed, by dissociating the impact of the volume of aid from the impact of the uncertainty of this aid on growth in a growth equation, the authors show that uncertainty has a negative impact on growth, while volume has a positive impact.

The Lensink and Morrissey analysis is also interesting in that it proposes a comparison between the impact of instability and uncertainty of aid inflows on growth.

The authors distinguish the instability of aid (measured as a simple deviation from the trend) from the uncertainty of aid inflows (or unanticipated instability, measured as the deviation with respect to the trend and to past amounts of aid received). While the uncertainty of aid has a negative impact on growth, its instability is, on the other hand, never significant. This result suggests that it is not aid volatility but its unpredictability that is detrimental to growth in developing countries.[90]

How can aid be made more predictable?

The idea developed by Collier and Dollar (2001, 2002) of an optimal allocation rule was partly intended to respond to the concern of making aid more predictable. Eifert and Gelb (2005) underline however that there is a balancing out between effectiveness and predictability. Certainly, optimal performance-based allocation—such as proposed by Collier and Dollar—tends to maximise aid effectiveness with respect to a given objective (poverty reduction, etc.). Yet, this type of system gives rise to very volatile aid flows, since allocation follows the recipient countries' year-by-year economic performances—which themselves are very volatile. Fixed multi-year allocation, on the contrary, implies total predictability and thus no volatility. However, it is much less effective, as it does not allow variations in recipient country performances to be taken into account for allocating aid flows. Eifert and Gelb (2005) propose a system of "flexible pre-commitment" for donors, functioning like a flexible aid allocation rule that would attempt to avoid the pitfalls of an over-rigid multi-year commitment. The authors therefore propose a median path that combines a medium-term commitment with a system for adjusting aid according to the quality of policy and institutions. Thus, initial commitments would be revised upwards or downwards on the basis of a pre-established rule. This system of flexible pre-commitment ensures a certain degree of aid effectiveness while still allowing better predictability.

90 This point is also raised by P. Guillaumont.

Following the commitment to the MDGs and the estimations of the amount of aid required to achieve them, the question of reallocating aid flows, as we have just seen, has been neglected in favour of the issue of mobilising resources. In the context of the prospective doubling of aid, the most recent literature has examined the problems of absorptive capacity and aid volatility.

Conclusion

This study has presented the overarching debates that have driven the research literature on official development assistance since the works of Burnside-Collier-Dollar, with a focus on policy implications. By analysing which conditions promote aid effectiveness, Burnside and Dollar formalised a concept of selectivity of recipient countries according to the quality of their policies. They then extended this analysis to the question of poverty reduction, proposing an optimal distribution of aid grounded on the poverty levels of recipient countries, as well as on the quality of their policies and institutional environment.

The rationale underpinning aid allocation based on the economic and institutional performance of recipient countries has come up against substantial critiques, which have been reviewed in this document. The main focus, however, has been on those critiques relating to alternative conditions for aid effectiveness, with a reminder of their implications for poverty-efficient aid allocation. It has thus been underlined that marginal returns to aid are diminishing, which brings to light problems of the absorptive capacity of recipient countries, even those with sound economic policies. Similarly, an alternative source of aid effectiveness would involve using aid to compensate external trade- and climaterelated shocks experienced by developing countries. Other authors have brought up socio-political instability and civil wars as factors that also impact on aid effectiveness. Aid is less productive in unstable countries, whereas its effectiveness increases during post-conflict periods.

Donor reactions to this academic debate and the resulting recommendations have been varied. For example, this debate has seemingly had only a limited impact on the way French ODA is managed. A series of evaluations of the quality of French aid actually points up a lack of selectivity. These evaluations are based on Burnside and Dollar's effectiveness principles, which do not however always enjoy unanimous acceptance (Dollar and Levin, 2004; World Bank, 2004 and 2005; Center for Global Development, 2003, 2004, 2005, 2006; Roodman, 2006). With the creation of the Millennium Challenge Account, the United States have widely taken on board the principle of *ex ante* selectivity based not only on criteria of need, but also on quantitative, performance-related criteria. This innovative approach has not yet translated into improved assessment of American development aid. Yet, it is interesting to point out that, whatever their methodological limitations, these new systems of joint donor assessment and benchmarking have had a positive echo within the donor community.

Although geographic selectivity remains a crucial issue, new concerns have surfaced within the international community. Initiatives in pursuit of the MDGs have again raised the question of scaling up the overall resources made available to developing countries. The doubling of aid has rapidly established itself not only as a pre-condition for attaining the MDGs, but also as a source of risks—for example, Dutch Disease, volatility and unpredictable aid flows.

Since 2002, donor commitments have resulted in an observable increase of aid flows. Even though the objective of 0.7% of gross national income earmarked for aid is far from being met, sizeable efforts have been made. In parallel, initiatives such as the contribution on air tickets and the IFF have been launched to mobilise additional resources. There is also mention of counter-cyclical loans (aimed at countries that have returned to a sustainable level of indebtedness), which would enable recipient countries to avoid jeopardising their financial future, while still funding the expenditures required to achieve the MDGs. Even in the light of these innovations, doubts persist as to the donors' capacity to respect their financial commitments. The strong budget constraints facing donor countries and the completion of debt rescheduling programmes create an element of uncertainty as to the sustainability of the aid levels attained over the last few years.

Appendices

Appendix 1. Burnside and Dollar's (2000) econometric results

The three economic policy variables (inflation, budget surplus, trade openness) are aggregated in a composite indicator by weighting their coefficients in a growth regression (Burnside and Dollar, 2000: 855):

POL = 1.28 + 6.85 x budget surplus - 1.40 x inflation + 2.16 x trade openness

This indicator is then introduced into growth estimations, both in a linear manner and in interaction with the aid variable. The following table summarises the econometric results of Burnside and Dollar (2000), based on a sample of 56 countries for sub-periods of four years from 1970 to 1973.

Burnside and Dollar (2000) growth estimations

Estimation method	OLS (1)	2SLS (2)	OLS (3)	2SLS (4)
Initial GDP per capita	- 0.56	- 0.71	- 0.60	- 0.90
	(0.56)	(0.60)	(0.57)	(0.65)
Ethnic fractionalisation	- 0.42	- 0.47	- 0.42	- 0.73
	(0.73)	(0.83)	(0.72)	(0.81)
Political assassinations	- 0.45*	- 0.44**	- 0.45*	- 0.41
	(0.26)	(0.26)	(0.26)	(0.27)
Ethnic fractionalisation x assassinations	0.80*	0.75	0.79*	0.71
	(0.44)	(0.45)	(0.44)	(0.45)
Institutional quality	0.67**	0.68**	0.69**	0.66**
	(0.17)	(0.19)	(0.17)	(0.18)
Financial depth (M2/GDP), t-1	0.016	0.025	0.012	0.017
	(0.014)	(0.017)	(0.014)	(0.016)
Dummy for sub-Saharan Africa	- 1.84**	- 1.71**	- 1.87**	- 1.29
	(0.74)	(0.82)	(0.75)	(0.84)
Dummy for East Asia	1.20**	1.27**	1.31**	1.15**
	(0.58)	(0.63)	(0.58)	(0.56)
Policy index (POL)	0.78**	0.65**	0.71**	0.74**
	(0.20)	(0.30)	(0.19)	(0.20)
Aid / GDP	0.49	- 0.10	- 0.021	- 0.32
	(0.12)	(0.21)	(0.16)	(0.36)
(Aid / GDP) x POL	0.20**	0.37	0.19**	0.18*
	(0.09)	(0.33)	(0.07)	(0.10)
(Aid / GDP)2 x POL	- 0.019**	- 0.038		
	(0.008)	(0.038)		
Observations	275	275	270	270
R^2	0.36	0.34	0.36	0.35

The dependent variable is the per capita income growth rate. Regressions (1) and (3) are ordinary least squares (OLS) estimators, while regressions (2) and (4) are two-stage least squares (2SLS) estimators. In this case, aid, which is supposed endogenous, is instrumented. Standard errors are in brackets.
*: significant at 10%, ** : significant at 5%.

In columns (1) and (2), Burnside and Dollar also introduce an aid-squared variable interacted with the economic policy index. The authors justify this for two reasons: (i) this term allows the capture of diminishing marginal returns to aid; and (ii) this specification seems better adapted to the data. We note however that the estimation that takes account of the endogeneity of aid (regression 2) does not show a significant effect on the aid-policy interaction term.

The authors suspect that there are five outliers in their sample of 275 observations (Gambia 1986-1989, 1990-1993, Guyana 1990-1993, Nicaragua 1986-1989). Once these are eliminated, the quadratic term $(Aid / GDP)^2 \times POL$ is no longer significant. On the other hand, the term (Aid / GDP) x POL becomes significantly positive in both the OLS and 2SLS computations.

Appendix 2. The ARPP (Annual Report of Portfolio Performance) indicator

The *Annual Report of Portfolio Performance* (ARPP) is used to measure the degree of success of current IDA operations in borrower countries. The assessment involves rating the portfolio of World Bank country projects according to the number of so-called "at risk" projects. The percentage of "at risk" projects is converted into a single rating on a scale from 1 to 6, broken down as follows:

% of "at risk" projects	Rating
0% during 3 years or more	6.0
0%	5.0
1-5%	4.5
6-15%	4.0
16-25%	3.5
26-40%	3.0
41-65%	2.5
66-100%	2.0
100% during 3 years or more	1.0

A project is considered "at risk" if there is a non-zero risk that it will not meet its development objectives. The project may have actual problems or be one that the World Bank anticipates will "have problems" in the near future. A project is assigned to this last category if at least three of the eleven criteria listed below present a risk:

1. Compliance with legal covenants in the loan contract
2. Environmental/resettlement rating (if applicable)
3. Counterpart funds
4. Monitoring and evaluation
5. Financial performance

6. Procurement progress
7. Management performance
8. Critical Risk
9. Elapsed time between Board approval and effectiveness
10. Disbursement delays
11. Located in a country with a series of problem projects, as rated by the Operations Evaluation Department (OED) for recently closed projects.

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