CAN AID CATALYZE DEVELOPMENT?

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Executive Summary

Aid projects seem to work, but they do not aggregate into major development breakthroughs. If aid effectiveness is to be linked more firmly to development strategies, the balance of today's aid allocations must change. The role of official aid must focus on finding ways to organize and encourage new partners—public and private, for-profit and nonprofit—in the most productive fashion. Four strategies are urgently needed:

- A new multilateralism.
- A more transparent aid system.
- A differentiated, adequately resourced strategy for each recipient country.
- A longer-term focus for aid.

The Group of Twenty has indicated its willingness to include development issues on its agenda. It could provide the leadership required at the international level to integrate the aid and development agendas.

What Is the Issue?

At a macroeconomic level, there is little relationship between aid and growth or other development outcomes, which has led analysts like William Easterly and Dambisa Moyo to dismiss the effectiveness of aid. At a microeconomic level, there is considerably more evidence about aid successes, with increasingly specific recommendations thanks to randomized trials pioneered by the MIT Poverty Action Lab. This forms the heart of the micro/macro paradox that the development economist Paul Mosley recognized more than 20 years ago. Aid projects seem to work but do not aggregate into major development breakthroughs. At issue is the fact that aid strategies are not driven in the same way as an evidence-based development strategy. Although there has been considerable progress, evinced by the rapid growth in Africa and better leadership in many poor countries, an acceleration framework, like that being developed by the United Nations, is desirable. According to the World Bank, most developing countries are off track to meet most of the UN Millennium Development Goals, a sober assessment at the halfway point of one of the most important global development challenges in history.

What can be done to enable aid to better promote development outcomes? There are three main steps.

The first step is to improve aid quality. The OECD's Development Assistance Committee (DAC) suggests that the benefits of aid are sharply reduced because of the way it is given. Aid is volatile and, like any stream of financial flows, its lack of predictability makes it much less valuable. Some research suggests that the deadweight losses from the volatility of official development assistance in 2008 amounted to 9 percent, or $7 billion. Further, this assistance is now provided in the form of 80,000 new projects each year financed by at least 42 donor countries, through 197 bilateral agencies and 263 multilateral agencies. Aid is fragmented into ever-smaller projects; the mean project size fell from $2.01 million to $1.46 million between 2000 and 2008 (in real terms).

In a project, "small" can be good if it is innovative and later results in scaling up, but each project also has fixed costs of design, negotiation and implementation. Recipient countries each received an average of 263 donor missions in 2007. Their senior finance officials spend from a third to half of their time meeting with donors and, in the case of countries like Kenya and Ghana, governments have resorted to "mission-free" periods to allow officials time to handle their domestic obligations. The deadweight losses from this set of transaction costs are estimated at $5 billion by the OECD, prompting calls for more serious attention to be paid to issues of division of labor among donors. A better division of labor would result in larger aid flows between a given donor and recipient but would reduce the number of donor–recipient aid relationships, because some donors would exit from some countries. In fact, the DAC estimates that if half the smallest donor–recipient relationships were abandoned, only 5 percent of country program aid would have to be rechanneled.

The second step is to link aid to other development policies, like trade, investment and migration. Although aid policy has increasingly stressed the benefits that accrue to recipient nations, other elements of economic policy seem to negatively affect developing countries. Sub-Saharan Africa accounts for less than 2 percent of global exports today, a share that has fallen by half since 1980. The poorest countries still do not have meaningful duty-free, quota-free access to trade. Efforts to expand African exports through preferences, like those afforded by the African Growth and Opportunity Act, have not had the desired results; more than 90 percent of U.S.

imports from AGOA countries is in the form of crude petroleum, not the manufactured goods for which the AGOA proponents had hoped. Even in Haiti and Pakistan, two countries where the U.S. has a significant stake in economic growth, trade restrictions on textile and garment imports (men's T-shirts in Haiti) restrict growth opportunities.

Comprehensive approaches are still lacking in leveraging private capital investment to provide infrastructure to connect producers to markets, in access to debt and equity for small and medium-sized enterprises and in devising insurance products relevant to the political risks in development. Meanwhile, although the share of migrants in developed regions has risen to about 9 percent of their populations, most of this human mobility takes the form of migration from one OECD country to another. Further, most of the low-skilled migrants from developing countries, those who can make the most difference to reducing poverty in their country of origin, come from middle-income economies in Latin America and Eastern Europe. Only 3 percent come from Sub-Saharan Africa.

The third step is to use aid to catalyze the private sector. It is now well understood that the private sector is the main driver of development, even in poor countries. But aid is still largely oriented toward the public sector. Furthermore, during the past decade, the focus of aid has shifted from the productive to the social sectors. This may provide a more solid foundation for future growth by improving human capital in the long run, but it has possibly come at a cost to short-term growth. The World Bank estimates Africa's infrastructure deficiency at $31 billion a year, mostly in the power sector, even after accounting for efficiency gains. The share of aid devoted to agriculture has fallen from 20 percent to about 4 percent in the last 30 years. Aid to cities, where most growth originates, is only $1 to $2 billion a year, a paltry sum when there are an estimated 1 billion slum dwellers in the urban areas of developing countries. The history of aid suggests that it is hard to identify the critical bottlenecks to development. Development keeps reinventing itself, so there must be a premium on being flexible and agile, not wedded to rigid ideas.

Why Does It Matter?

Does it really matter if we study aid or development effectiveness? Yes. The crux of the issue is one of branding and strategy. "Aid" has a connotation of humanitarianism or altruism. It can respond rapidly in the face of disaster. For example, more than half of all U.S. families have donated money to Haiti. Private giving to poor people in developing countries, principally from foundations, NGOs, religious groups and the like, amounts to $30 billion a year (excluding corporate donations). When aid is given directly to help people in distress, the results are immediately visible in the short term. Donors can see the difference made by their contributions.

But the developing countries who receive aid are more focused on growth than charity. When the international community introduced the "poverty reduction strategy" paper in 1998 as the principal document on which to base aid, most developing countries changed the name to "*growth and* poverty reduction strategy" in an effort to emphasize the broader nature of development and the primacy of income growth as a driver of development. But given recipients' limited influence over the allocation of donor resources, this change was mostly cosmetic. Donors have shied away from growth objectives because they take longer to achieve; and the results chain from their development assistance to outcomes is longer and more tenuous.

In Africa, leaders are seeking to rebrand the continent as the land of opportunity rather than the land of deprivation. Ngozi Okonjo-Iweala, managing director of the World Bank and former finance minister of Nigeria, asked in a speech to the John F. Kennedy School of Government at Harvard earlier this year: "What trillion-dollar economy has grown faster than Brazil and India between 2000 and 2010 in nominal dollar terms and is projected by the IMF to grow faster than Brazil between 2010 and 2015? The answer may come as a surprise to some: It is Sub-Saharan Africa!" Africa can serve as a new source of global demand. It's only a matter of time before its population rivals that of China and India. At a time when Asian and developed-country equity and debt markets are saturated and no longer offer substantial returns, Sub-Saharan Africa could be poised to provide the best global risk/return profile.

This is more than a branding issue—although branding is important in attracting foreign investment and business interest to Africa. It is about strategy. Should development dollars go into infrastructure, better cities and productive activities like agriculture, with an emphasis on science and technology as development game changers, or into health, basic education and equal opportunity for disadvantaged groups? Should aid be focused on countries with good governance where growth has a chance for taking off or on failed states where the humanitarian need is greatest? Should trade, investment and migration policies be combined into specific policy packages to promote growth in key countries or regions?

If aid effectiveness is to be linked more firmly to development strategies, the balance of today's aid allocations must change, and aid agencies—those in charge of the flows of financial and technical assistance—must work cooperatively with policy instruments in the hands of other agencies to spur sustainable growth. This is already the case in the growing civilian–military coordination efforts in fragile state engagements, but it is necessary for all aid-recipient countries. The pendulum should perhaps shift toward the development and growth agenda in some countries.

Given the diversity of countries, it is getting harder to put a single frame on development; a combination of interventions at the micro and macro levels is needed. But this would require a changed narrative for aid, one that goes beyond the UN Millennium Development Goals (MDGs). This narrative is harder to communicate to the public because of the complexity of development and because it must rely on the often-messy and corrupt political environments in both recipient and donor countries. Developing-country stakeholders would need to raise their game in utilizing aid resources effectively.

What Strategies Are Needed?

Although there is aid fatigue in some circles, aid remains popular among the citizens of developed countries, and there is grassroots support for more and better aid. At the same time, the corporate sector in developed countries sees the expansion of opportunities in developing countries as the best hope for their own growth. Infrastructure investment and consumer spending by an emerging middle class in developing countries are the two brightest spots in global aggregate demand. Both can be catalyzed by aid.

The willingness and eagerness of new partners—public and private, for-profit and nonprofit—to engage in development is a strong potential force for development. The role of official development assistance must focus on finding ways to organize and encourage this force in the most productive fashion to promote a "logic of participation" rather than a "logic of compliance." The newest player in development, the private sector, offers new ideas, new technologies, new management practices and new business models that can be game changers for development. Five strategies are badly needed, in addition to the ones articulated through the Paris Declaration, to improve aid effectiveness and meet the MDGs.

The first strategy is to pursue a new multilateralism. Multilateral development agencies are more technocratic and specialized than most bilateral aid agencies. But they do not receive full support from their members, and their leadership of the aid agenda has declined. Though most countries provide one-third of their aid through multilateral channels, the multilateral share of U.S. aid has fallen by half, to just 11 percent in the last decade, in favor of new U.S. agencies like the President's Emergency Plan for AIDS Relief and the Millennium Challenge Corporation. Strong U.S. support for and leadership of the multilateral system are vital.

The second strategy is to pursue a more transparent aid system. A lack of transparency is the biggest obstacle to greater engagement and harmonization. Without real-time information as to who is doing what where, it becomes impossible for different development partners to pursue effective strategies based on an efficient division of labor. Overlap and waste cannot be reduced. Development partners cannot be held accountable for their activities, and new development partners cannot easily identify critical gaps where their engagement can make a difference. Evaluation systems and learning from innovation are hampered.

Third is to pursue a differentiated strategy for each recipient country. Aid destined for fragile states needs to be implemented with quite different modalities than aid to well-governed countries. Yet the characteristics of recipient countries—on governance, geography, capabilities, political will, strength and the dynamism of the private sector—are not systematically addressed by donors with clarity on the conditions under which recipient countries' systems and preferences will be fully respected by donors. Instead, each donor uses systems designed for its own convenience and governance accountabilities. At times, aid agencies are too slow and need to be more nimble.

Fourth is to pursue an adequately resourced strategy for each targeted country or global objective. Resources are not commensurate with needs. Indeed, the actual cross-border flow of resources to developing countries is only a fraction of total aid. The DAC estimates that country program aid—the amount of aid that is potentially given by a donor to a recipient and entails an inflow of resources to the recipient country—is only 54 percent of all bilateral aid, varying from a low of 10 percent for some donor programs to a high of 81 percent in 2008. It is this portion of aid—not the headline totals—that is potentially available to address development challenges and that better reflects the intensity and coherence of donor efforts at the country level. For global challenges, like the MDGs, the costing exercises done by countries have not been translated into specific resources available to meet each goal. Only in a few exceptions, such as malaria and HIV/AIDS, are the resources specifically linked to requirements rather than being determined on a best-effort basis.

Finally, the fifth strategy is to pursue a longer-term focus for aid. Development challenges are addressed over decades of continuous engagement. Aid is less effective when it is swayed by changing development fashions, either in terms of countries (creating so-called donor orphans) or sectors (note the premature exit from support for agriculture). Proven models cannot be scaled up, partly because aid remains excessively project oriented. Market mechanisms, incentives and partnerships could be better used to allocate aid resources. More stable aid relationships would also provide a more conducive environment for private businesses. Most foreign direct investment is not driven by short-term profits but reflects a long-term strategic move by a corporation.

Is There a Change Management Strategy for Aid?

When there is a financial crisis in the developing world, the International Monetary Fund takes on the leadership role in crafting the global response. When there is a humanitarian crisis, the United Nations, through its office for the coordination of humanitarian affairs, provides the accepted leadership. But for long-term development, there is no leadership at the international level and sometimes not even at the national level. This situation has several particularly troublesome aspects:

- Multilateral aid is a dwindling share of total aid, and multilateral leadership at the country level has become weakened. But multilateral reform, which is a prerequisite to enlarged multilateral resources, moves at glacial speed.

- No international body coordinates the 500 official agencies—bilateral and multilateral—dispensing aid and establishes rules and standards that recipient countries could support. The UN Development Cooperation Forum is strong on representation but weaker on effectiveness. The OECD's DAC has the reverse characteristics. Neither organization oversees multilateral agencies. It is unlikely that any single organizing body could satisfy the broad debate that is needed. Instead, a variable-geometry approach to development solutions may offer more hope. Regional development groupings offer one avenue to help the communication flow and dialogue between recipient countries and international bodies. But there are gaps in the architecture—aid agencies in recipient countries do not regularly meet to exchange experiences; South–South cooperation does not have a forum to match needs and offers of help. No forum exists to assess whether the division of labor among multilateral agencies is optimal, leaving each agency to advocate for itself with its political allies, reinforcing the political nature of aid. Equally, there is no exit mechanism for failed ideas.

- No individual or specific agency is accountable for achieving global targets like the MDGs. With small exceptions, like the UN special envoy for malaria, no individual or agency is tasked with ensuring progress on actual development outcomes, with raising the necessary resources and developing global strategies. At the country level, targets are better defined and sector strategies have been elaborated in many cases, but resources and responsibilities remain highly fragmented. Country coordination mechanisms, with recipients in the lead, need far greater support, both financially and technically. Aid could better support proven winners and growth sectors.

- A communication strategy is needed to help people understand the channels through which aid works. The route from aid to development is too long and complex, and it passes through too many agencies in both donor and recipient countries to be easily communicated. There is little understanding of the key role played by the local staffs of development agencies in recipient countries and the impact that aid can have in leveraging their efforts. Highlighting the aid worker, not the poverty victim, as the main development actor would be one way to promote a sense of engagement in solving the challenges of development.

In seeking to enable aid to better catalyze development, perhaps the Group of Twenty, with its broader representation of both developed and developing countries and its focus on global economic growth, could provide the required international leadership. Its willingness to take on the development agenda in Seoul in 2010 is to be welcomed. But to lead effectively, the Group of Twenty must reach out beyond its membership to the poorest countries and seek to understand their priorities. Through such processes, it may learn how best to tackle the pressing political problems that still hinder aid's effectiveness and how to lay the groundwork for a more coherent global development strategy.