# The Economics of International Aid[*]

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## Contents



## Abstract

This paper presents an overview of the economics of international aid, highlighting the historical literature and the contemporary debates. It reviews the "trade-theoretic" and the "contract-theoretic" analytical literature, and the empirical and institutional literature. It demonstrates a great degree of continuity in the policy concerns of the aid discourse in the twentieth century, and shows how the theoretical, empirical and institutional literature has evolved to address specific policy concerns of each period.

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# 1. Introduction

"[T]he decade of the 1990s was marked by a strong and lingering case of 'aid fatigue' influenced by the rising fear that foreign assistance was generating aid dependency relationships in poor countries. The issue of the effectiveness of aid conditionality was also critically debated." (Thorbecke, 2000, p47).

"Foreign aid programmes for providing economic assistance to less developed countries have fallen on hard times. The nominal amounts of aid pledged by developed areas have recently been falling and the real values of economic assistance have fallen even further. This is due in part to the diversion of attention of the donor countries to other foreign policy issues. It is due partly to their increased pre-occupation with their own domestic problems. There has, however, also been a growing disenchantment with the potential for development in the poor countries and also with the role which foreign aid can play in development. Optimistic expectations of rapid growth in less developed countries have given way to skeptical evaluations of their actual performance. The contribution of foreign aid to development has also been evaluated more skeptically and its possible disincentive effects are now emphasized." (Bhagwati and Eckhaus, 1970, p 7).

"The foreign aid program, as an instrument of United States foreign policy, is now ten years old. To it has been committed upwards of 70 billion dollars, a sum representing around 25 percent of the national debt, and the annual appropriations have been a major factor in the recurring budgetary deficits of the federal government. Despite this massive effort, its success is questionable….In consequence, the Administration's budget for foreign aid has met increasing criticism. Congressional support, at one time overwhelming, has steadily diminished. Disclosures by investigating committees of waste and extravagance in the administration of the program have added distrust, and it is not surprising that the whole concept of foreign aid has aroused anxiety among the electorate." (Groseclose, 1958, p 25).

International aid, or development assistance, is defined by the OECD to "include grants and loans to developing countries and territories which are: (i) undertaken by the official sector of the donor country, (ii) with the promotion of economic development and welfare in the recipient country as the main objective and (iii) at concessional financial terms (i.e. if a loan, have a grant element of at least 25 percent)" (Hjertholm and White, 2000, p100).[1] Whatever the definition, it might surprise the reader to see the similarity in the three assessments given above of international aid, or "foreign aid," over a period spanning four decades. But ever since its modern inception after the Second World War, international aid has raised a number of constant themes in the policy arena, in particular its underlying rationale and its actual effectiveness in aiding development in recipient countries. Moreover, international aid looms larger in public discourse than its magnitude would seem to justify. An indication of this is that polls in rich countries often show people to believe foreign aid to be several multiples of its actual level.[2]

[1] While this definition is generally accepted, there are of course many nuances to these criteria, and analysts do deviate from them as they need to. Thus Krueger, Michalopoulos and Ruttan (1989) include in their definition the non-concessional loans by the World Bank, and some include loans from the IMF (concessional or not) also in this category.
[2] Raffer and Singer (1996) refer to US polls showing that people believe the share of development assistance in the federal budget to be of the order of 15 percent, when the actual figure is less than 1 percent.

Associated with these policy themes have been a number of recurring analytical issues that essentially boil down to two basic questions:

(i) What does a transfer of resources do to the well being of donor and recipient?

(ii) How can and should resource transfer be conditioned to enhance the objective function of donor and recipient?

These two questions run through this overview of the economics of international aid. The paper will consider the history of aid and aid making institutions (Section 2), the theoretical analysis of aid (Section 3) and, the empirical analysis of the impact of aid (Section 4); Section 5 concludes.

## 2. The History of Aid

### 2.1 The Origins of Modern Aid

There is no doubt some evidence of international aid in antiquity. But in the modern era the issue of aid began to surface in the 19th and early 20th centuries as the western powers considered their colonies and other poor countries. In Britain the Colonial Development Act of 1929 was the culmination of a long process of moving from laissez faire in the economic operation of the colonies to assistance, but it was of a restrictive kind:

> "From about the turn of the century, the UK Government began to take a slightly more active interest in colonial economies, and a variety of committees studied education, the use of natural resources, and similar topics in selected colonies….In 1929, for the first time, provision was made for assisting colonial governments to develop their economies by means of grants and loans for what is now called 'infrastructure'; for improving transport, research, power and water supplies, land surveys, and so on. Education was excluded, and a strong subsidiary aim of the new Colonial Development Act of 1929 was to promote employment in Britain by stimulating the colonial economies and their demand for British exports. Funds therefore had to be spent on British products as far as possible." (Little and Clifford, 1965, p31).

The 1940 and 1945 Colonial Development and Welfare Acts went further and included education, and also allowed recurrent costs to be paid for under the provisions of the acts, and the 1948 Overseas Resources Development Act, the last in this sequence, set up the Colonial Development Corporation.

It is interesting to see that "tied aid" was already a key feature of British development assistance right from the beginning. The same is true of American aid in the 1930's and 1940's to Latin American countries, made under the "Good Neighbor Policy" of the Roosevelt Administration. In fact, such assistance goes back to the 19th century (Mikesell, 1968). As early as 1812 Congress passed an Act for the Relief of the Citizens of Venezuela, and from the late 19th century onwards food surpluses began to be deployed for tied aid (Hjertholm and White, 2000). In their fascinating account of US technical assistance overseas, Curti and Birr (1954, pp41-42) trace the following story a few years after Commodore Perry's fateful arrival in Japan:

> "When the new Meiji government undertook the colonization of the northern island of Yezo, or Hokkaido, it turned to the United States for technical aid… [T]he government, late in 1870, sent General Kuroda Kiyotak to America instructed to choose a chief advisor in agriculture….When Kuroda sought the counsel of President Grant on personnel, he was referred to Horace Capron, Commissioner of Agriculture….Capron outlined his terms. Kuroda met them…He was to have his expenses paid to and from Japan and to be given a house, guards, and servants—and to get $10,000 a year. This was a handsome salary for an American public official and considerably more than that of the prime minister of Japan."

To those familiar with the current state of technical assistance aid, it will indeed seem like very little has changed!

But the real expansion and crystallization of an aid doctrine, in the US but also elsewhere, came in the aftermath of the Second World War. Table 1, reproduced from Hjertholm and White (2000), provides a useful overview of the evolution of the history of aid in the post-war period. By common consent there were two major events in the evolution of aid in the 1940's. The Marshall Plan symbolized bilateral assistance, from the United States to countries of Europe. The setting up of the United Nations, and the Bretton Woods conference that set up the World Bank and the International Monetary Fund (IMF), represented the multilateral tendency in development assistance. The issues raised in the1940's during the setting up and operation of these initiatives are still present with us today—indeed, one often hears the call that what Africa needs is a "New Marshall Plan."

Of course, for both the Marshall Plan and the World Bank, the objective was reconstruction of a war-ravaged Europe, not the development of the non-industrialized world. But attention began to turn to the developing countries very soon after. President Harry Truman's inaugural address of 1949 contained the famous Point Four Program, with the objective of "making the benefits of our scientific advances and industrial progress available for the improvement and growth of underdeveloped areas." The Act for International development of 1950 followed up by establishing "the policy of the United States to aid the efforts of the peoples of economically underdeveloped areas to develop their resources and improve their living conditions." (Quoted in Ohlin, 1966, p.25). The modern era of international aid was thus launched with great ceremony more than half a century ago. How did it evolve?

### 2.2 Evolution of the Aid Doctrine Before and After the Cold War

As the large and still growing literature on aid has documented, the history of development assistance since the second world war has been determined by two key factors—the evolution of geopolitics, and the evolution of development thinking. The central geopolitical factor determining aid was the cold war in the first 40 years, and its absence since then. But the evolution of development thinking has been more complex and non-linear in nature.

While the need for foreign aid as a moral obligation of the rich to the poor was ever present in the discourse of the 1940's and 1950's it is now widely accepted that the main ultimate objective of western aid during the cold war was to stop developing countries going over to "the other side". Of course, that was the objective of aid from the Soviet bloc as well. Indeed, some of the analytical critiques of aid in the 1950s stemmed from a perceived disconnect between this objective and the modalities of aid. As Milton Friedman (1958, pp 63, 77-78) observed at the time:

> "Foreign economic aid is widely regarded as a weapon in the ideological war in which the United States is now involved. Its assigned role is to help win over to our side those uncommitted nations that are also underdeveloped and poor….The objectives of foreign economic aid are commendable. The means are, however, inappropriate to the objectives….The proponents of foreign aid have unwittingly adopted a basic premise of the Communist ideology that foreign aid is intended to combat. They have accepted the view that centralized and comprehensive economic planning and control by government is an essential prerequisite for economic development….An effective program must be based on our ideology, not on the ideology we are fighting." (Friedman, 1958, pp 63, 77-78)

Another influential economist at that time, Ian Little, wrote:

> "We believe that we—the West—should be interested in the development of most underdeveloped countries which aspire to a neutral or Western-committed existence, and as much interested in the neutrals as the committed. Our interest derives from the probability that some considerable economic progress has become essential to the continued long term existence of governments, or succeeding governments, which are likely to preserve neutrality or remain favorable to the West….The anti-communist objective which aid is given in the above account is nothing to be ashamed of. We, after all, believe that Communism is a major menace to the ideals in which we believe." (Little and Clifford, 1965, pp 115-116).

While the cold war positions above are perhaps unusual in their clarity and openness, there is no question that these were the views held by western policy makers throughout the cold war period, and indeed by many economists of a less conservative outlook. But what is interesting in both Friedman's and Little and Clifford's statements is the central role they place on the role of economic development—for them, then, the real question was the conditions under which aid actually led to development. This cannot of course be disentangled from the debates on development doctrine. Economists could, and did, differ in their views of what caused development, and therefore what role aid should play in it.

In fact, of course, Friedman's views on the inefficacy of central planning etc were in the minority at that time. This was the time of Rosenstein-Rodan (1943, 1961) and the "big-push", of Rostow (1960) and the "stages of economic growth", and of Chenery and Bruno (1962) and the "two-gap model". In their different ways, these authors and their followers argued that the main constraint to economic development was capital accumulation, and supplementing domestic savings was the role of aid. At the same time, as even the very term "big-push" signified, there were sufficiently strong market failures and externalities that the government and central planning had to play a key role in managing the investment and aid process in the recipient country. It was believed that "infant industries" needed to be protected from external competition in the early stages. These doctrines were amply illustrated in the India's first and second five year plans—even the phrase "five year plan" has a period feel to it. Thus throughout the 1950's and

1960's western aid was helping to finance these plans, with the objective of keeping India out of the clutches of communism, based on an argument that economic development was what would keep developing countries in the western camp, and the further argument that aid for centrally guided capital accumulation would help economic development.

During the 1960's and 1970's, bilateral assistance expanded, as did the assistance from multilateral organizations, particularly the World Bank. Since resources for the reconstruction of Europe and Japan were largely not needed by the 1960's, the attention of the multilaterals turned increasingly to developing countries. The "soft loan" window of the World Bank (the International Development Association—IDA) was opened, and Regional Development Banks were started in Asia, Africa and Latin America. These new multilateral arrangements reflected a general sense that "consortia" of donors would overcome the coordination and other problems of a multitude of individual aid programs (Rosenstein-Rodan, 1968).

In keeping with the development doctrine there was support for state led initiatives, but the doctrine itself evolved during this period. Instead of just focusing on growth of overall national income, the attention shifted to poverty and the social sectors. The experience of fast growing countries like Brazil, where inequality increased so fast that poverty gains from growth were eroded, brought a note of caution to the earlier growth through capital investment optimism (Fishlow, 1972). Under the catch all heading of a "basic needs" strategy, the development doctrine moved to emphasize direct beneficial outcomes for the poor, as opposed to the "trickle down" from general growth. India's five year plans reflected the change. And the aid doctrine itself moved, still within the overall policy framework of combating Communism, to stressing poverty reduction with a focus on agriculture and the social sectors like education and health. The World Bank's President, Robert McNamara, called for change to the strategy. With the World Bank's growing influence in aid, and backed up by other UN agencies, this became the new orthodoxy of the development doctrine and the aid doctrine.

Throughout the 1950's, the 1960's and the 1970's, through the different development and aid doctrines, one issue was constantly alluded to and criticized by both left and right in the west. This was the practice of tied aid, a practice with a tradition going back to the earliest origins of aid, where the recipient country was given the money conditional on spending it on the products of the donor country. Economic analysts pointed to the inefficiency of this method of transferring resources (Bhagwati, 1970). Other analysts focused on the issue of transferring agricultural surpluses in the west, particularly US surpluses as the result of farm price supports, as aid to recipient countries. Apart from perpetuating the inefficiency of domestic policy in the donor country, it was argued that such "food aid" actually harmed the recipient countries by hitting their agricultural production (Schultz, 1960). Relatedly, there was discussion of aid for specific projects versus overall budgetary support for the country--so called "program support" (Singer, 1965). Once this issue had been broached then the question of conditionality could not be far behind. A project has its own implicit conditionality—the money only flows as the project is completed. But with overall budgetary support it is the broad policies of the country that have to be conditioned on. As we shall see, program support conditioned on policy was about to become prominent in aid debates.

The 1980's were a turbulent decade for the development doctrine and the aid doctrine. They were introduced by the OPEC oil shocks of 1973 and 1979, and ended with the fall of the Berlin wall and the effective collapse of the Soviet bloc and hence the end of the cold war. In many ways the decade represents the peak of the cold war, albeit in its final stages. This was also the decade in which electorates in the North moved towards conservative administrations such as those of Ronald Reagan in the US, Margaret Thatcher in the UK and Helmut Kohl in the Germany. With this background, there was a decided move away from the statist approach of the earlier aid doctrine towards supporting market based routes to development. The statist and inward looking "import substitution" strategies of the earlier era came under attack from policy makers and analysts alike, and the financial crises of the late 1970's and early 1980's, in the wake of global economic instability, provided the leverage for those who could finance or refinance developing country debts. The era of "structural adjustment" was upon us.

Analytical criticism of the statist and inward looking development strategies of the 1960s and 1970s had been building for some time. Scholars such as Ian Little, Anne Krueger, Jagdish Bhagwati and Bela Balassa had been building up a case for openness throughout the 1970's in particular. A good summary of this line of thought is provided in Krueger (1978). Anne Krueger became Vice President and Chief Economist of the World Bank in the early 1980's, replacing Hollis Chenery. The change was symbolic and substantive. Since the 1980's the World Bank has remained a staunch supporter of free trade arguments. It is not surprising that in the 1980s the development doctrine and the aid doctrine melded into one. Overall country policy was regarded to be the key determinant of development, market oriented policies were regarded to be the best. Thus the 1980s saw the peak of the "structural adjustment" aid doctrine where transfers were made increasingly in the form of budget support, conditioned on policy reform that conformed to the tenets of the "Washington Consensus." (For a history of this term, see Williamson, 1999).

The Latin American debt crisis of the early 1980's was very much a part of the development and aid discourse in the 1980's. Support for debt relief, or in the aftermath of debt default, was conditioned on policy reform. The same was true for Africa. These conditions, and their supposed outcomes, led to a massive debate, with civil society becoming vocal and involved at the highest policy making levels. Some of these argued for "adjustment with a human face" (Cornia, Jolly and Stewart, 1987), while others argued that the aid and development doctrine of the 1980's was solely in the interests of the creditors of the North and should be rejected. They called for outright debt cancellation or major debt relief. These interventions undoubtedly altered the terms of the debate as the 1990s rolled around.

The 1990's are perhaps too recent to get a clear view of the evolution of the aid and development doctrine. But there are some clear difference between the first half and the second half of the decade. In the early part of the decade the 1980's doctrine continued to hold sway, especially as concerned to the transition of the formerly communist economies of Eastern Europe and the successor states of the Soviet Union. It was held by many in official circles that a rapid transition was best, and the term "shock therapy" was coined in this context. But by the second half of the decade the disastrous consequences of the transition in many countries ("more shock than therapy") could no longer be ignored, and a reassessment started (Stiglitz, 2000).

Apart from the transition to market economies of the formerly centrally planned economies, the major event of the decade of the 1990s was the East Asian financial crisis in 1997, and the subsequent crises in Latin America and in Russia, with considerable spillover effects to most poor economies. Many critics pinned the crisis on too rapid a liberalization of capital accounts, itself thought to be the result of the over-confidence in market forces that ruled in the 1980s and in the first half of the 1990s (Sakakibara, 2001). Increasingly, the international financial institutions, the World Bank and particularly the IMF, were held to be responsible directly or indirectly as conduits of the policies of the rich countries. Partly as a result of the strong criticisms of the market based approaches of the 1980's and the early 1990's, the development doctrine in the 1990's moved back to emphasizing poverty reduction as the ultimate objective of development, and supporting specific interventions to this end. The World Bank's two World Development Reports of 1990 and 2000/2001 are illustrative of this shift in the aid agencies, and this takes us right up to the current state of the aid and development debate.

The current state of the aid discourse, in the first years of the 21st century, reflects its evolution over the last fifty years or more. It also reflects the current state of the development doctrine. This doctrine appears to be at a high state of synthesis, with most of the elements of the previous debates being present (Kanbur and Vines, 2000). While there is no strong move to return to the highly statist and inward looking regimes of the 1950's through the 1970's, the "market fundamentalism" zeal of the 1980s and early 1990s has been tempered considerably (Kanbur, 2001). The role of government is more clearly recognized, as is the importance of accountability of these governments. Overall macroeconomic policy is important (although there continue to be debates on exchange rate regimes or on trade liberalization), but specific interventions to help the poor benefit from overall policy and growth are very much on the agenda. Thus intrahousehold and gender issues are emphasized, as are environmental degradation and its effects on the poor. The role of institutions, national and global, in determining the outcomes of policy is thought to be central. One factor that is emphasized more strongly than ever before is global interdependence and the need for strong management of international spillovers, be they through infectious diseases, civil war, or financial contagion.

The aid debate similarly has a rich set of issues that engage it. Some of these are very familiar from the earliest period of the origins of aid, and from how the doctrine has evolved since then: What benefits does aid confer on the donors? Do transfers actually benefit economic development and welfare in recipient countries? What sort of conditioning of transfers can improve the performance of aid in helping economic development in and welfare in poor countries? But some new issues, such as the role of aid in supplying various "international public goods" have also appeared no the horizon.

The analysis underlying these and related questions will be reviewed in the sections that follow.

## 3. The Theory of Aid

### 3.1 Unconditional International Transfers

The policy debates on aid are influenced by, and in turn influence, the theoretical analysis of transfers between countries. There are two broad strands of the theory. One considers the consequences of unconditional transfers, and is trade-theoretic in construct. The other focuses on conditional transfers, and is contract-theoretic in nature. Each of these will be discussed in turn.

Start from the general equilibrium of a standard neo-classical competitive model, and consider a comparative static transfer of endowment from one agent (the donor) to another agent (the recipient). What will be the consequences for the welfare of the donor and of the recipient? If the transfer is small enough that it does not disturb the equilibrium prices, and there are no distortions so that we really are in classically first best competitive market framework, then the result is clear. The transfer makes the donor worse off and the recipient better off. Clearly, the recipient prefers the transfer. The theoretical question, however, is why the donor should ever make such a transfer?

There are several ways to address this question. One is to say that the donor has no choice. The donor is told to make this transfer by a "world government" and that is that. But this is unsatisfactory since international transfers are voluntary, thinking of each country as an agent. When can a transfer be to the advantage of the donor? One answer is that the donor has the interests of the recipient at heart and the wellbeing of the recipient enters the utility function of the donor. Such consumption externalities violate the basic assumptions of the standard model, but they are well recognized in economics, and can indeed provide an argument as to why a donor might wish to make a transfer[3].

There may be economies of scale in making transfers, making it efficient for individuals in a country to band together and for the country as a whole to make the transfer. We can then construct an argument for the sort of aid system we have, of government-to-government transfers:

> "It is clearly wrong in most people's judgment that most people in the rich countries should be able to lead lives of considerable luxury whilst a thousand million people—a quarter of the world's population—do not even get enough food to eat. But individual taxpayers in these countries, because of selfishness or ignorance, may not recognize this moral imperative; if they recognize it they may not know what they can do about it as individuals; if they do know what they can do, namely give to voluntary agencies, they may be reluctant to give unless assured that others will also contribute their share. Lacking an assurance, they look to governments to provide on an international basis, through aid, the same functions

[3] Many of the chapters in this volume are focused precisely on a detailed analysis such motives as pure altruism. We accept such motives as part of the rationale for aid, but we do not analyze them any further.

of income redistribution which they supply on a national basis through the progressive income tax and the various institutions of social security."[4] (Mosley, 1987, p 3).

However, opening up such departures from the standard competitive equilibrium naturally leads to considerations of other departures as well. What if the terms of trade are not given but could change as the result of a transfer between donor and recipient? Changing terms of trade as the result of a transfer will still leave the donor worse off and the recipient better off if there are no other distortions and the donor and the recipient are the only two agents in the model, provided certain standard stability assumptions are satisfied. But when there are more than two parties both donor and recipient can be made better off when the post transfer equilibrium terms of trade are different, even if there are no other distortions. The classic contribution is that of Gale (1974), and this led to a large literature and generalizations (see Bhagwati, Brecher and Hatta, 1983, and Kemp and Kojima, 1985).

Once the standard competitive model is abandoned, then other channels emerge for a benefit to the donor of the transfer. If, for example, the rate of return to capital is higher in the recipient country than in the donor country, the donor can charge an interest higher than the domestic rate but lower than the recipient rate. This is concessional lending from the point of view of the recipient, but a good proposition from the point of view of the donor. Similarly, if the marginal propensity to consume is higher in the recipient country in a situation of generalized deficient aggregative demand, on Keynesian grounds one can make a case that it would be in the donor's interest to make a transfer to the recipient. (Mosley, 1987). The Keynesian argument illustrates the spillovers from recipient to the donor that go beyond the simple "warm glow" of altruism. In an interdependent world, it is argued that negative outcomes in one country quickly spillover to others. Thus rich countries have an interest in assuring that these negative outcomes do not happen. These cross-border externalities will be taken up in a later section.

Thinking of a donor country as many agents can motivate aid as the national coordination of individual giving. But the many agents scenario also opens up other aspects of political economy, namely the tying of aid. Clearly, the tying of aid reduces the value of the transfer to the recipient. If this value to the recipient is the reason for giving, why would we ever observe the practice of aid tying? The answer is that some agents in the country benefit directly from aid tying. It is, in fact, a way of redistributing income within the donor country, if aid is raised from general taxation but spent, effectively, on purchasing the output of a particular sector or a particular area:

"Northern politicians openly stress employment effects of ODA to their own constituencies. The Federal republic of Germany (FRG) even introduced a law demanding that employment effects in Germany must be proved for each German project….. Commercial pressures on aid are not new but—as the DAC itself acknowledges—they 'have been growing in recent years' (OECD 1995, p28). In defence against Republican plans to slash aid substantially, US-AID 'distributed fat folders of documents showing that

[4] The focus of this paper is solely on official, government-to-government transfers. Transfers through non-governmental organizations are not discussed here.

nearly 80 percent of its budget is recycled to the United States' (*Time*, 29 May 1995)." Raffer and Singer (1996, p 6).

Added to the above cases is the disposal of farm surplus in the US and in Europe, which arises from policies to protect farm income, as foreign aid (Schultz, 1960). While there has been a considerable amount of analytical work on the consequences of such disposal or tying of aid for the recipient countries, and there is a basic understanding that it is driven by the donor's domestic political economy, there is little recent analysis of such tying using the methods and models of the new political economy literature (for a recent survey, see Barrett, 2002).

So much for the benefits to the donor. But does the transfer actually benefit the recipient? The theoretical literature delivers a highly ambiguous answer, except in the special case where there are no terms of trade effects and no distortions anywhere, in which case the recipient does indeed benefit. But if terms of trade change and there are more than two agents, there are conditions under which the recipient can in fact be made worse off because of the general equilibrium repercussions of the transfer. In general, these terms of trade arguments, while theoretically plausible, seem a little stretched when one considers that the flow of aid, around $100 billion a year, is dwarfed by global trade flows. It is unlikely that such a small tail can wag the global terms of trade significantly.

However, while the total flow of aid is small compared to global trade flows, it can be large for individual recipient countries. If there are distortions in the recipient country itself, then an inflow of capital could end up leading to immiserization. This argument is made for projects by Bauer (1971, pp 99-100):

> "[It] is by no means unusual for projects to absorb domestic inputs of greater value than the net output, especially when the cost of administering the projects and the explicit or implicit obligation to maintain and replace fixed assets originally donated is also considered. Large losses in activities and projects financed by aid have been reported in many poor countries."

The key here is the value of domestic inputs absorbed relative to the net output, measured at shadow prices. A more general form of this argument is made in trade theory (Brecher and Bhagwati, 1982). The basic intuition can be stated quite simply. Suppose the inflow of capital changes domestic demand patterns in such a way that production shifts towards a sector that is distorted. Then the social value of national output could fall even though total resources have gone up.

There are many specific cases of this general phenomenon, including the famous "Dutch disease" syndrome that arises upon the discovery of a natural resource. The argument here is that the increased wealth is spent partly on non-tradable goods. The domestic production pattern is then changed in this direction. If we further postulate that the non-tradable sectors are less capable of undergoing productivity increases (because, among other reasons, they are less exposed to competition and influences from abroad), then the detrimental effects are clear. Indeed, some authors have analyzed the effects of aid precisely in terms of the Dutch disease (Younger, 1992).

This distortion induced immiserization is most easily amenable to trade theoretic economic analysis. There is another line of argument that is more suitable for a political economy treatment. This is that aid does not just flow neutrally into the recipient economy as postulated in trade models. Rather, it flows to the government of the recipient country, and as such is controlled and disposed of by the elites:

> "While the former Zaire's Mobutu Sese Seko was reportedly amassing one of the world's largest fortunes personal fortunes (invested, naturally, outside his own country), decades of large-scale foreign assistance left not a trace of progress. Zaire (now the Democratic republic of Congo) is just one of several examples where a steady flow of aid ignored, if not encouraged, incompetence, corruption, and misguided policies." (World Bank, 1998, p 1).

The combination of policy based distortions that might lead to aid becoming immiserizing, and worries about misuse of aid by local elites, leads naturally to the argument that if the flow of aid could be conditioned on these things being put right, then gains to the recipient could be better ensured.

### 3.2 Conditionality

The case for conditionality is well stated by Little and Clifford (1965). Addressing the motivation for aid based on redistribution from rich to poor, they argue as follows:

> " The weakness of such arguments is that they assume that if income is redistributed from rich to poor countries, redistribution of income from rich to poor people—which is the only morally desirable form of redistribution—will automatically be achieved. This assumption is far from justified, unless steps are taken to ensure that governments receiving aid use it in certain clearly specified ways. The right of a poor country's government to receive aid must depend on this condition. If the strings attached to the use of money within developing countries were, in part at least, development strings…[this] would, we think, be considerably more appealing to the electorates of donor countries, to whom many stories of the luxurious living of minorities in the underdeveloped countries would filter back." (Little and Clifford, 1965, pp 93-94).

It is not surprising that conditionality has been an ongoing theme in the aid discourse ever since the beginning. Of course, when aid is given for strategic reasons—to induce a country's government to vote with the West in the United Nations during the cold war, for example—the conditionality is self-evident. But when the ostensible purpose of aid is to help economic development and especially the welfare of the poor, the issue of conditionality is considerably more delicate, as we shall see.

The basic idea behind conditionality is straightforward. All of the discussion in the previous section assumes that the transfer takes place unconditionally. The responses of the two agents follow the transfer of resources, and are undertaken in unconstrained manner. Suppose now that instead of just the transfer of resources, there is a simultaneous undertaking of some other action or set of actions, (typically by the recipient but it could in general include actions by the donor). If a "world government" had the choice, it would always avail itself of the broader set of instruments, since a subset of the available instruments would still be unconditional aid. It is easy to see that with the right broadening, some of the seemingly perverse effects of transfers could be mitigated. For example, suppose that it was production distortions that led to the immiserizing effects of incoming transfers. Then transfers combined with, or conditional on, removing those production distortions would obviously make the recipient better off.

Conditionality is also important when we move from a "world government" view of international aid to a more direct "principal-agent" framework, where the donor is the principal and the recipient is the agent. In this framework it is assumed that the donor will only make the transfer of resources if it improves the donor's objective function. However, in addition, if the donor can make the transfer conditional on further action by the recipient, these actions can be chosen judiciously to make the donor even better off and perhaps, relatedly, the recipient better off as well. Thus, in the example given above, if the donor can insist that the recipient remove certain distortions, the transfer would make the recipient better off and then, since it is assumed the donor values this, the donor is made better off as well. On this line of argument, conditionality again simply expands the instrument set and cannot make the donor worse off—it will also make the recipient better off and thus, since it is assumed that this is what the donor wants, the donor is better off as well.

The above line of argument has been explored at length in the aid literature (see, for example, Murshed and Sen, 1995; Mosley et. al. 1995; Hopkins et. al. 1997; Killick 1997; White and Morrissey, 1997; Adam and O'Connell, 1999; Kanbur 2000; and Svensson 2000, 2002). It is also central in the literature on debt relief and cancellation, where it is argued that making the cancellation conditional on adoption of good policies increases the value of the relief (see, for example, Sachs 1989, 1990; Iqbal and Kanbur, 1997). The basic contract-theoretic answer seems straightforward—just apply the conditionality that ensures that the poor in the recipient country will be better off with the transfer. But there are at least two problems, which belie the clear-cut conclusions above. First, which conditionality to apply, to ensure that the poor do indeed benefit? Here we come up against the state of the development doctrine. As we saw in Section 2, this has cycled from one view to another. In the 1950's the conditionality would have been, indeed was, to have large-scale industrial development plans and inward looking import substitution strategies. In the 1960's and 1970's this would have remained intact, but additional conditionality would have been introduced to ensure adequate expansion of the social sectors and of agriculture, especially small-farmer agriculture. In the 1980's the conditionality swung to insist on "market-friendly" reforms, including opening up the economy to imports and foreign direct investment, privatization of state owned enterprises, opening up of the international capital account, and maintaining fiscal balance through austerity in public expenditures. In the 1990s the debate focuses on which of these elements could form part of a successful development strategy, which would include a broader set of conditions, for example on public expenditure restructuring, governance, etc.

But there is a second problem that is in many ways deeper. It is that conditionality simply does not seem to work. It is indeed part of many aid agreements. It is not met, but the aid flows anyway. The interesting point about the Mobutu Sese Seko case quoted in the previous section is that it happened despite the fact that the World Bank and the IMF had strongly conditioned assistance programs. Using data from 200 structural adjustment programs, Svensson (2002, p3) finds "no link between a country's reform effort, or fulfillment of 'conditionality', and the disbursement rate" of aid funds. The World Bank's own internal evaluations find a similar disconnect between disbursement and conditionality fulfillment (World Bank 1992a). Why does this happen? The following account from Kanbur (2000) provides some hints:

> "….in 1992 Ghana consummated its transition to democracy and, in the process, the government gave in to pressures to grant enormous pay increases to civil servants and the military. In late 1992, in advance of the elections, an 80% across the board pay increase, backdated, was announced. As a result, the budgetary conditionality in the World Bank's then current Structural Adjustment Credit was violated, and the impending tranche release was suspended. Through its own tranche, and through co-financing tied to it, the World Bank found itself holding up as much as one eighth of the annual import bill of the country.
>
> One would think that holding one eighth of the annual import bill of a poor cash strapped economy would give enormous leverage to the World Bank and the donors to dictate terms to the Ghanaians. In fact, as the representative of the World Bank on the ground, I came under pressure from several sources, some of them quite surprising, to release the tranche with minimal attention to conditionality. There was a steady stream of private sector representatives, domestic and foreign, arguing for release of the tranche both because of fears of what macroeoconomic disruption would do to the business climate in general, and also because some of them had specific contracts with the government which were unlikely to be paid on time if the government did not in turn get the money from the World Bank and other donors. Next in line, were the bilateral donors--even those who had tied themselves to the presumably greater discipline of the World Bank by co-financing. Some of these had "fiscal year" concerns--they feared the consequences within their agencies of not releasing the funds in the fiscal year for which they were slated. Others worried about a melt down of the economy if the tranche was not released. Yet others found their projects slowing up because government counterpart funds were not available, and many project agreements stipulate that donor money flows in a fixed relationship to government contributions. Rather like private sector contractors, these aid agency personnel were dependent upon the government releasing enough resources for the success of their specific projects, and this money would not come, or not come soon enough, if the tranche release was delayed. I include in this list of donors the World Bank itself--implementation of old projects, and development of new ones, would be severely affected so long as the impasse lasted." (Kanbur, 2000, pp 414-415).

This account highlights the many different dimensions of why conditionality fails. Some of these are similar to the reasons for tied aid discussed earlier. The steady flow of aid is a source of income to many interest groups in the donor country. Their dominant concern is their income, not necessarily the wellbeing of the aid recipients. If conditionality is violated, the short term interest of these groups is for the aid to flow in any case (at least, that part of the aid which flows back to them). What this suggests is a more complicated game than the simple principal-agent framework that rationalizes conditionality. There is now (at least) a triadic relationship between (say) the company in the donor country which depends on contract payments from the developing country, the developing country government, and the donor government or agency. Such a model is developed by Villanger (2002). Another line of argument focuses on the incentives facing bureaucrats in aid agencies:

> "Both donor and recipient have incentive systems which reward reaching a high volume of resource transfer, measured in relation to a predefined ceiling….In many administrations, both bilateral and multilateral, the emphasis is on disbursements and country allocations. Non-disbursed amounts will be noted by executive boards or parliamentary committees and may result in reduced allocation for the next

fiscal year….results are measured against volume figures, with no regards for the quality….besides, when the time has come to evaluate the actual outcome, most of those responsible for the project on both sides will have been transferred." (Gus Edgren, former Chief Economist of the Swedish aid agency, quoted in Svensson, 2002, p 1).

At the same time as these "selfish" interests, there is a real "Samaritan's dilemma" even for those whose objectives really are to help the recipient. Enforcing conditionality will inflict short term pain on the very people the aid is meant to help. Of course such "tough love" may be best in the long run, but this does not mitigate the short term temptation to overlook the violation of conditionality (this argument is developed in a different context, by Coate and Morris, 1995).

Most analytical modeling of the problems of conditionality focuses on the problem of time inconsistency. Thus, for example, Svensson (2000) models the game between donor and recipients as follows. In the first period, recipients choose a set of actions ("reform"). In the second period these actions interact with the state of nature to produce outcomes with uncertainty. Given these outcomes, in the second stage the donor allocated aid funds. If there was a "commitment technology" such that the donor could stick to a disbursement rule conditional on reform actions, even though disbursement takes place in the second period, then it can be shown that the reform effort is greater than the case where there is no aid. But when such commitment is not possible, and aid disbursement can be decided after the state of the world is declared in the second stage of the game, then the incentives to reform are reduced, leading to a worse outcome for all concerned. Such outcomes are very familiar from the literature on time inconsistency in macroeconomic policy, and the aid conditionality literature is a development of the policy commitment literature in general (Coate and Morris 1999, Drazen, 2000). Indeed, some authors have taken the failure of conditionality seriously enough that they have begun to analyze aid allocations when aid can only be unconditional, in the manner of the earlier trade theoretic literature, explicitly eschewing the assumption in the contract-theoretic literature that recipient government policy can in fact be changed by conditionality (Kanbur and Tuomala, 2001).

## 4. Empirical and Institutional Analysis of Aid

Given the great ideological divides in development doctrines and in aid policy, and given the ambiguities in the theoretical analysis of the impact of aid, it is not surprising that the empirical literature on aid evaluation—assessing "aid effectiveness"—has taken on special significance. This has been the case throughout its fifty-year history. Apart from ongoing evaluations within each agency (the World Bank's Operations Evaluation Department produces an Annual Review of Development Effectiveness, and most other agencies produce similar assessments of their own operations), there are some periods when assessing aid effectiveness becomes particularly intensive. These coincide with cycles of doubt on the efficacy of aid as an instrument of foreign policy or as an instrument of economic development:

"….[It] was not until 1956-7, after a series of foreign policy set-backs and the appearance of the Soviet Union in the foreign aid field, that the United States foreign aid programme was suddenly subjected to the most intensive study and publicity it had yet received. Reports were prepared by a Presidential Committee of Citizen Advisers, by the International Development Advisory Aboard appointed under the Point Four programme…., and by a Special Committee to Study Foreign Aid set up by the Senate. The Special Committee contracted for eleven studies on different aspects of the foreign aid programme by private research organizations and also dispatched ten individuals to survey foreign aid programmes in different parts of the world." (Ohlin, 1966, pp 26-27).

In fact, the quote from Ohlin is itself taken from a retrospective on aid done by the OECD ten years after the major US effort. Such evaluations continued over the next two decades. In the mid 1980s a major evaluation was commissioned by the international community. Its findings were published under the title "Does Aid Work?" (Cassen 1986). The answer given there can be summarized as "by and large, yes." In the early 1990's much discussion was occasioned by a World Bank report (the "Wapenhans report", World Bank, 1992b) that questioned the success of many of its own projects. Another major study at the end of the decade (World Bank 1998) questioned the efficacy of aid disbursed into poor policy environments. And Tarp (2000) maintains the tradition of assessments of aid by collections of analysts. So where does all this evaluation leave us?

### 4.1 Development Impact of Aid

Throughout the assessments of aid that have been carried out over the last few decades, there seems to have emerged a "micro-macro" paradox. This is that micro level evaluations of specific projects give a much better picture than do macro level assessments of the impact of aid on economic development, specifically on growth. It is easy to see how such a disconnect could arise in principle. For example, if there are distortionary policies in place and projects are evaluated taking these as given, each project in isolation could be assessed positively while the overall impact could be negative. Of course, this problem could be overcome if the projects are evaluated at "shadow prices" that take account of the macro level distortions, but this is not actually done (see Little and Mirrlees, 1990). In any event, it is the overall impact of aid on economic development that should be our concern, not the success of this or that project. For this reason, this section will focus on the macro analysis of the impact of aid, primarily on economic growth.

Hansen and Tarp (2000) review 131 cross-country regressions of the impact of aid on growth, from a thirty year period starting in the late 1960's to the late 1990's. They divide the studies into three "generations." Corresponding to the development and aid doctrine at the time, the first generation of studies focused on the impact of foreign aid on domestic savings and investment. The early optimism (e.g. Rosenstein-Rodan, 1961) of a one for one link between aid and investment was challenged by authors such as Griffin and Enos (1970). Indeed, Griffin and Enos (1970) found a negative association between aid and growth, and put this down to a negative relationship between aid and savings, which had also been found in other studies. Papanek (1972) and Newlyn (1973) were among those who in turn challenged the overly pessimistic conclusions drawn from these studies. While it was true that aid did not increase recipient savings and investment one for one, so long as there was some increase then the net effect would be to increase total investment. Based on their comprehensive survey of studies over thirty years, Hansen and Tarp (2000, 109-110) concur:

> "Neither extreme view of the aid-savings-growth link is valid. There is no evidence for a positive impact, and in only one study does aid lead to lower total savings. The overwhelming evidence from these studies is that aid leads to an increase in total savings, although not by as much as the aid flow. Given the underlying Harrod-Domar growth model, the implication is that aid spurs growth."

But this well established relationship between aid and total savings then raises another question—has aid in fact led to increased growth? Mosley et. al (1987, 1992) are among a number of "second-generation studies" that find no significant relationship between aid and growth. However, as Hansen and Tarp (2000) point out, in these studies the effect of savings on growth is insignificant as well. They argue that among reduced-from regression studies, in those that the identifying assumption (that savings impacts growth positively) holds, the vast majority do in fact find that aid does benefit growth as well.

The last five years have produced a "third generation" of studies that are more sophisticated in that they attempt to take into account the endogeneity of aid and also the policy and institutional environment in the recipient country. The key paper is that by Burnside and Dollar (2000). Although published in 2000 the paper was first circulated as a World Bank discussion paper in 1997 and immediately made an impact because of a novel claim. Although the simple correlation of aid and growth in the data may be zero, this was confounding two types of countries, those with "good" policies and those whose policies were "bad". In fact the impact of aid on growth was positive in good policy environments, identified as a significant and positive coefficient on an "aid x policy" interaction term in a growth regression, after taking into account the endogeneity of policy and aid. In fact, Burnside and Dollar (2000) find that there is no effect of aid on policy, but there is a positive effect of aid on growth when the policy environment is "right". The first of these findings has been little noticed, but it is clearly an indictment of policy conditionality. The inference, rather, is that countries choose their policies because of domestic reasons uninfluenced by aid. But if this internal process does lead to good policies, then aid will have a positive impact on growth.

The Burnside and Dollar (2000) findings underpin the World Bank's (1998) report on aid, where the implication was drawn that there should be aid selectivity. Aid should flow to those countries that have good policies rather than, as seems to be the case, a system where aid allocation takes place on other criteria altogether, like former colonial ties or political allegiance of the regime during the cold war era (Alesina and Dollar, 2000). These findings have in turn sparked a debate on selectivity, where for many people simply abandoning the poor in bad policy regimes seems too harsh a policy. One compromise is that official aid should cease in such situations, but unofficial aid, through non-governmental organizations, should continue.

However, the Burnside and Dollar (2000) findings have been questioned by Hansen and Tarp (2000), who argue that not taking into account non-linearities in the aid-growth relationship may bias results. They find that once a quadratic term in aid is introduced into the standard regressions, the coefficients show a diminishing marginal growth return to aid, but the "aid x policy" interaction term becomes insignificant. This result survives taking into account the endogeneity of aid through instrumental variables estimation. The general point is that non-linearities have to be addressed carefully in this empirical literature, to make sure that spurious relationships are not being picked up as proxies for underlying non-linearities. Even more recently, Easterly, Levine and Roodman (2003) have questioned the robustness of the Burnside and Dollar (2000) findings to the use of more up to date data.

### 4.2 Aid Dependence

The macro-econometric investigation of aid-growth regressions will no doubt continue into the next century. There are sufficient issues of data (how exactly is "aid" defined?), of econometrics (how can the truly independent effects of aid be identified from a mix of interdependent relationships?) and of development doctrine (what is "good policy"?) to keep the debate alive. But parallel to the econometric literature is a literature that looks at how the "aid business" works in practice, and lays much of the blame for the failure of aid on institutional features. Many in this literature charge that the system creates a syndrome of "aid dependency" that perpetuates itself and undermines the development effort.

Nowhere is the phenomenon more discussed than in the area of "technical assistance." This is assistance provided by donor country professionals in a wide variety of fields, financed by the aid budget of rich countries. It is, in effect, a form of tied aid—giving assistance in the form of the time of a professional, or giving financial assistance with the condition that it be used to purchase the expertise of a donor country national. Review upon review of technical assistance (see, for example, Berg, 1993) has highlighted its ineffectiveness. Chief among these is the fact that the incentives in the system are all geared towards continuing the technical assistance rather than local capacity building. For the expatriates, the continuation provides a source of income. For the hard pressed local officials in the recipient country, it provides short term assistance that they can use. Thus the form of the assistance turns out to be not one that builds local capacity to carry on, but that keeps the need unsatisfied.

Related to the technical assistance issue is that the aid flows, and the mechanisms donors adopt to track and monitor them, are very intensive in terms of recipient capacity. Each donor agency has its own reporting system. In a typical African country, there can be upwards of 20 aid agencies from different countries and multilateral agencies. The hard-pressed civil servants spend much of their time managing the paper flow. At the political level, ministers have to spend a considerable amount of time in turn meeting with donor delegations. But perhaps as important than the sheer time use is that these senior technocrats and politicians become oriented towards convincing the aid agencies to keep the aid flow going, rather than towards listening to the domestic population and the local development agenda.

A key problem that the above fragmentation of the aid flows between myriad donors is that of lack of coordination, which interacts badly with tied aid. Thus there can be equipment of incompatible specifications supplied by different donors for a water supply project. Or there can be "experts" from different aid agencies giving different advice—and this can cause real difficulty if it crystallizes into inconsistent conditionality. The lead given to the IMF on macroeconomic conditionality, and to the World Bank on sectoral and microeconomic conditionality, was a response by the donor community to such potential inconsistency. But this leads to another problem—a donor cartel behind a particular aid doctrine which suppresses innovation. The design question is how to balance the twin extremes of fragmentation and a donors' cartel. Relatedly, there is the question of the enormous burden on domestic capacity of managing the aid relationship, and the fact that as a result of this relationship the projects and programs tend to reflect donor views more than recipient priorities.

It is to address these sorts of issues that Kanbur, Sandler and Morrison (1999) have put forward the concept of the "common pool". The objectives are (i) to reduce day-to-day donor interference in the management of the aid program, (ii) reduce fragmentation within and across projects and policies, (iii) improve "ownership" of the development strategy by the domestic political economy of the recipient country, and (iv) still give donors the right to modulate their funding based on recipient characteristics. The concept works as follows. Aid flows support the overall program of the government, rather than this or that project. After a period of dialogue, with the donors but more importantly with its own population, the government puts forward an overall program of expenditures, with alternative scenarios based on different levels of aid flows. The donors look at this, and put into a common pool resources that will finance the overall program along with domestic and other resources. At no time is a particular part of the program identified with a particular donor. All aspects of aid are folded into this structure.

The theory and practice of this common pool framework needs to be worked out more fully. How exactly are the different donor preferences and aid doctrines "aggregated' through this mechanism? Will there not be free rider problems through the common pool? And what exactly is the nature of the game between recipient and donors in this framework? In fact, these questions apply equally well to another major institutional question in the aid debate—the balance between bilateral and multilateral assistance. The issue is as old as aid itself (see Rosenstein-Rodan 1968). One of the strongest arguments for moving to multilateralism was to reduce the influence of vested interest in each donor country. The idea is that when faced with a demand from a domestic constituency to skew aid away from a generally accepted development doctrine, the government could use the fact of an international agreement as a check. In effect, through the multilateral agreement they would tie their own hands. But what if the domestic constituencies could lobby their government to in turn lobby the multilateral agency? This clearly happens (see the quote above from Kanbur 2000). Yet there is very little economic analysis of this type of problem (for a start in this direction, see Villanger, 2002).

### 4.3 International Public Goods and Aid

An emerging policy and institutional issue, requiring analytical foundations, is that of cross-border externalities and international public goods, and the role of aid from rich to poor countries in addressing these problems. This discourse has brought together two venerable literatures in economics—that on aid and transfers, and that on externalities and public goods, the latter being suitably "internationalized" by interpreting agents as nations rather than individuals.

A cross-border externality occurs when events and developments in one country, whether policy induced or exogenous, spill over into other countries and have consequences that are not mediated by classically competitive markets. Thus technical progress that makes the exports of one country cheaper and thereby benefits another country through a decline in the price of its imports, is not an externality. But there are many other cases where such an externality occurs. Civil war in one country can lead to an influx of refugees to a neighboring country. Carbon emissions from the industry of one country can pollute the global atmosphere. Underground water extraction by one country for its agriculture lowers the amount available for another country sharing the same water table. Poor control of infectious diseases in one country leads to spillover effects in other countries. Financial contagion, as the name suggests, spreads from one country to another. These are all examples of negative externalities from one country to another. Competitive markets will see an oversupply of these activities, because in such markets no single agent will take account of the negative spillovers for other agents. Managing this inefficiency requires mechanisms of coordination between agents.

A pure public good is defined as one whose benefits are non-rival and non-excludable across agents. By non-rival is meant that consumption by one agent does not diminish the consumption of another. By non-excludable is meant that no agent can be excluded from enjoying the benefits of such a good. It is well known that such goods will be undersupplied by competitive markets because of the free rider problem—no single agent will take into account the positive benefits to other agents of supplying this good.

Notice first of all that if there is an international mechanism of coordination that addresses cross-border negative externalities, then this mechanism is an international public good—by definition, its benefits are non-rival and non-excludable for those agents being coordinated. However, in addition to such coordination mechanisms there are other examples of international public goods. Basic medical research in one country can benefit citizens of another as the knowledge spreads. An international institution that allows economies of scale and scope in a particular activity to be reaped coveys benefits to all member countries in non-rival and non-excludable fashion.

What, then, is the connection between the undersupply of international public goods and development assistance? Recall that the latter is a transfer from wealthier countries, intended to benefit poorer countries. In section 2 we focused on the case where the transfer is made directly to the poorer country, unconditionally or conditionally. However, if international public goods are undersupplied, and if increasing this supply would benefit poorer countries, then international public goods of this type would be legitimate targets of development assistance funds. But such transfers will typically not be from a rich to a poor country directly. Rather, they will finance the public good. For example, they could finance basic research in the rich country, the results of which will then be made available to the poorer countries. Or they could finance a coordination mechanism which resolves a cross-border negative externality among a group of poor countries. Or they could finance a coordination mechanism that cuts across rich and poor countries, thereby benefiting poor countries. Let us take each of these three types of international public goods in turn (the topic of international public goods and development assistance is taken up in greater detail in Sandler, 1998; Kanbur, Sandler and Morrisson, 1999; Kaul, Grunberg and Stern, 1999; Gerrard, Ferroni and Mody, 2001; Sagasti and Bezanson, 2001; Arce and Sandler, 2002; Ferroni and Mody, 2002; Kanbur, 2002, 2003, 2004).

Basic research into tropical agriculture or medicine that is undertaken in rich countries clearly helps poor countries, provided its findings are made widely available. Having the activity take place in the donor countries avoids the problems of conditionality discussed in section 2, since the interaction between donor and recipient is minimized, but it is not without problems of is own. The general problem is common to all issues of basic research, and resides in the tension between the generally greater efficiency of the private sector in conducting research, and the need to make the output of the research available as a public good. A recent attempt to resolve this tensions is seen the proposed Vaccine Purchase Fund (VPF). With this arrangement, private companies are guaranteed purchases of the vaccine, provided it is developed to a certain pre-specified standard. Thus aid resources are used not in direct support of poor countries, but in creating a demand for basic research into their problems. If the institutional arrangements can ensure adequate input of poor countries into defining the problems, this seems like an attractive mechanism to be explored.

Consider a cross-border externality problem that cuts across a number of contiguous countries in Africa. There are many examples of these: including water rights, infectious diseases, forest cover, transportation between inland areas and coastal ports. By definition, the response to these problems will be inadequate without coordination, since no single country will fully take into account the benefits of a coordination mechanism. Such a coordination mechanism will be beneficial to the poor countries, but it is not costless. There will be the costs of the actual act of coordination, and the costs of possible compensation that might need to be paid to individual countries who may lose in the short term, if it proves impossible to convince the gainers to provide the compensation (if there are no gainers at all from the coordination mechanism, or if the gains do not exceed the losses, the mechanism is not worth pursuing). If these costs are not met, the coordination will not take place and the poor countries will be worse off. Hence, the financing of such activities is a prime candidate for the use of aid resources.

Finally, consider a cross-border externality that cuts across developed and developing countries. Coordination of global carbon emissions, mechanisms to control financial contagion, or the coordination and channeling of bilateral aid through international institutions to reap the benefits of economies of scale and scope, are all examples of this type of international public good. Since these mechanism involve both rich and poor countries, and since the objective of aid is (or should be) to help poor countries, the central question to be asked in these sorts of arrangements goes beyond the efficiency of the arrangement, in the sense of having a positive gain overall, but is rather about how much of the gain accrues to poorer countries. An arrangement which leads to gains for the rich countries and losses for the poor would still be efficient in the standard economic sense if the gains outweighed the losses, but would not have claim on aid resources, unless the aid was effectively compensation from the rich to the poor for the losses they suffer as a result of the coordination mechanism. Hence the issue turns on the precise nature of the coordination mechanism, particularly its distributional consequences.

The above arguments have strong implications for international institutions, who are increasingly putting themselves forward as the suppliers of international public goods of different types. For the first category of international public goods, there is a strong argument for international institutions to play a convening role in developing instruments such as the Vaccine Purchase Fund, and to help finance them. For the second category, there remains the issue of the comparative advantage of global versus regional institutions in financing and managing coordination mechanisms across closely contiguous countries within a region such as Africa, and there remain questions about the development of new transfer instruments, going beyond the clearly inadequate sovereign loan instruments of the World Bank and the Regional Development Banks, to address these multi country problems. For the third category of international public goods, which cross rich and poor countries, and include the international institutions themselves as international public goods, there is the central issue of how to ensure appropriate governance mechanisms so that the benefits are sufficiently skewed in favor of poor countries, and hence aid resources can reasonably be justified in financing their supply. Each of these policy issues leads to a detailed discussion and debate, as reported in the papers listed above.

## 5. Conclusion

As the quotes at the start of this paper make abundantly clear, the fundamental policy issues in aid have remained unchanged for half a century. The search has been for mechanisms of transfer from rich to poor countries that benefit the poor countries while meeting a host of other objectives and constraints. The competing objectives in the past have included shoring up support from poor countries in the geopolitics of the cold war. While the cold war has ended, other emerging trends in geopolitics, for example the "war on terror", mean that rich countries will always need allies among poorer nations, and transfer of resources will be one way to achieve this.

Of course, as in the past, there is a strong strand in the policy discourse that at least some geopolitical alignment is to be had through encouraging development in poor nations, which then leads to the ongoing debate about the effectiveness of aid in promoting development. Closely entwined with effectiveness of aid is the effectiveness of conditionality, where the policy discourse seems to have come full circle. Attempts at intensifying the conditionality of aid in the 1980s are now recognized to have failed, and there is growing acceptance that while aid effectiveness is clearly helped by appropriate domestic policies in recipient countries, ensuring these policies by the carrot of aid flow and the stick of aid withdrawl does not seem to have been possible. The domestic political economy is too strong to be influenced by aid flows, at least in anything beyond the very short run. These fundamental concerns are equally present in the current debate on use of aid resources to provide debt relief to poor countries.

Where then does this leave the current policy thrusts on the uses of aid resources? First, there is a growing consensus that official assistance should only flow to those countries that are likely to use it well, as judged by their policies and institutions. Second, aid can assist in the domestic dialogue on these policies and institutions, but it cannot make them come about through conditionality. Third, in view of the experience with country-specific aid, and in view of the emerging problems of cross-border externalities, there should be some orientation of aid resources towards the supply of international public goods. Fourth, there is considerable discussion on the many and varied mechanisms of aid delivery, bilateral and multilateral, and how, if at all they should and can be rationalized. Indeed, some have argued that aid should flow not through official channels at all, but should use non-governmental organizations, and the allocation mechanisms should be more market oriented.[5]

As shown in this paper, the policy conjuncture has influenced developments in the economic analysis of aid. In the middle of the twentieth century the focus was on a "trade-theoretic" analysis of the welfare effects of transfers on donors and recipients. Tied aid, a feature of aid since its modern emergence in the lat e19th and early 20$^{th}$ centuries, was subjected to carefully theoretical scrutiny, and was criticized by mainstream economists as an inefficient transfer mechanism, whatever its political economy rationale. Empirical work focused on whether transfers did in fact improve the situation of the recipient in the terms of investment and growth. With the emergence of policy conditionality in the latter part of the 20$^{th}$ century, a "contract-theoretic" analysis developed to explain why such conditionality was superior to unconditional transfers, and to analyze different types of conditionality. Principal-agent models were used to good effect in illuminating the basic considerations. Corresponding to these theoretical developments, empirical work focused on what combination of aid flows and policies was best for development. Most recently, the upsurge of policy interest in international public goods has led to a spate of analytical contributions at the intersection of two great literatures in economics—that on aid and transfers and that on externalities and public goods. This literature has illuminated the subtleties of the arguments for using aid resources to finance international public goods, and, treating aid delivery institutions as public goods, has begun the discussion of a rational arrangement of the functions of these institutions.

If the historical evolution of the aid literature experience is anything to go by, it is unlikely that a survey of international aid in ten years time will have entirely and dramatically new policy issues from the ones highlighted here. The fundamental themes

[5] Such an argument is made recently by Easterly (2003).

will recur, perhaps modified somewhat by context. But analysis will not doubt advance, as it has done at every stage in the last century, by trying to provide a framework for answering the specific questions raised by the policy discourse.

***Table1* Schematic overview of main developments in the history of foreign aid**

| | *Dominant or rising institutions* | *Donor ideology* | *Donor focus* | *Types of aid* |
|---|---|---|---|---|
| 1940s | Marshall Plan and UN system (including World Bank). | Planning. | Reconstruction. | Marshall Plan was largely programme aid. |
| 1950s | United States, with Soviet Union gaining importance from 1956. | Anti-communist, but with role for the state. | Community Development Movement. | Food aid and projects. |
| 1960s | Establishment of bilateral programmes. | As for the 1950s, with support for state in productive sectors. | Productive sectors (e.g. support to the green revolution) and infrastructure. | Bilaterals gave technical assistance (TA) and budget support; multilaterals supported projects. |
| 1970s | Expansion of multilaterals especially World Bank, IMF and Arab-funded agencies). | Continued support for state activities in productive activities and meeting basic needs. | Poverty, taken as agriculture and basic needs (social sectors). | Fall in food aid and start of import support. |
| 1980s | Rise of NGOs from mid-1980s. | Market-based adjustment (rolling back the state). | Macroeconomic reform. | Financial programme aid and debt relief. |
| 1990s | Eastern Europe and FSU become recipients rather than donors; emergence of corresponding institutions. | Move back to the state toward end of the decade. | Poverty and then governance (environment and gender passed more quickly). | Move toward sector support at end of the decade. |

*Note*: Entries are main features or main changes, there are of course exceptions.

**Source: Reproduced from Hjertholm and White (2000), p 81, Table 3.1.**

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