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2004

Online at https://mpra.ub.uni-muenchen.de/29823/
MPRA Paper No. 29823, posted 6 March 2015 08:43 UTC
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ABSTRACT

Over the last five decades, development assistance has evolved dramatically in response to an equally mutable global political and economic landscape. In this paper, we examine this evolution and discuss how the effectiveness of aid has been and will be seen in the eyes of donors, intended beneficiaries, and outside observers. From an historical perspective, we note that the effectiveness debate has been confined by preoccupation with macro institutions and outcomes. We also discuss how the relative importance of aid has changed with the rapid growth of trade and private capital markets. Looking ahead, we argue that great care should be taken when applying macro performance evaluation to development assistance. This approach increases the risk that aid will be politicized and allocated inefficiently. Rationing credit in whatever form it takes by macro-criteria inevitably screens out credit- or need-worthy recipients, while many beneficiaries in attractive macro settings may be less deserving. Simplistic macro rules-of-thumb not only compromise more rigorous credit and need standards; they reinforce the adversity of people living under substandard governance. In reality, aid and lending relationships involve complex contractual and agency relationships that are essentially microeconomic in nature. We therefore discuss how conceptual innovations in modern economic theory might be enlisted to improve aid effectiveness. In passing, we also review some implications for public donor institutions of another globalization phenomenon, rapidly emergent private policy agencies in the form of NGOs.

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1 Introduction

Foreign aid has undergone many fundamental shifts since the middle of the last century. During the 1960s and 1970s, a multilateral agenda of development goals, institutions and procedures was added to traditional bilateralism. Thinking about development policy was drastically modified from the early 1980s onwards; and the evolving donor-recipient relationship today can best be described as deeply uncertain and circumspect. In parallel, the global economic context in which foreign aid is implemented has been transformed in ways unimagined at the time of Bretton Woods.

Emerging from debates about the ‘micro-macro’ paradox from the 1980s, the analysis of aid effectiveness became dominated by macro-econometric approaches during the 1990s. Convincing evidence emerged that aid works at both the macro and micro level, but the putative lessons learned from this vary greatly, and disagreements persist about both necessary and sufficient conditions for effective economic aid. This is so both with reference to more narrow debates about appropriate economic policy and to the wider institutional context within which aid is implemented. The donor-driven nature of many aid programs has since the mid-1990s led to repeated calls for a change in the balance in donor-recipient relations and the need for a new kind of partnership.¹ One response has been the increased use of the concept of ‘ownership’ in the aid rhetoric, but what this means in theory and practice is less clear.

After an historical survey in Section 2 of the aid effectiveness literature, we provide in Section 3 a brief empirical narrative on the changing relative importance of aid in the present era of globalization. Rapid and sustained growth of trade and international capital flows have essential implications for both the appropriate role and the effectiveness of development assistance, and historical trends indicate that aid should best be focused on its core mission of assisting the most disadvantaged and helping to correct those market failures that most critically affect basic human needs such as public health, subsistence, and livelihood. Beginning from this more restrictive context, there are still

¹ See Helleiner (2000).
many areas for broadening and deepening the commitment to development priorities. With the diminution of aid’s relative size in the multilateral economic environment, we see ourselves entering an Age of Complementarity, where private sector interests can and must be leveraged by donor institutions in pursuit of more socially beneficial policy objectives.

As an attempt at contributing to the reshaping of existing perspectives on development assistance, the fourth section of this paper puts forward a series of ten hypothetical percepts, or operational principles, for guiding more effective aid relationships in the future. In particular, we argue that great care should be taken when applying macroeconomic or (worse) macro-political performance evaluation to development assistance. These approaches increase the risk that aid will be allocated in both economically and socially inefficient ways. Rationing credit by macro-criteria inevitably screens out credit- or need-worthy recipients, while many beneficiaries in attractive macro settings may be less deserving. Simplistic macro rules-of-thumb not only compromise more rigorous credit and need standards; they reinforce the adversity of those living under substandard governance. In reality, aid and lending relationships involve complex contractual and agency relationships that are essentially microeconomic in nature. This is so both at the level of national donor-recipient interaction and when microeconomic actors are in focus. We suggest that real ownership will remain elusive unless this is recognized throughout; and in this paper, we start discussing how conceptual innovations in modern economic theory might be enlisted to overcome imperfections in the underlying microeconomics of aid relationships, thereby improving aid effectiveness.

A fifth section of the paper briefly reviews an important institutional phenomenon associated with globalization, the rapid emergence of Non-governmental Organizations (NGOs) and the implications of this emergence for the pursuit of effective development assistance. While this discussion is only relevant to a subset of NGOs, these institutions have arisen to meet a manifest desire on the part of (mainly OECD) higher income individuals to participate in the design and conduct of global development assistance. Seen in this way, the NGO movement is a force and not only must – but should – be more constructively reckoned with by established bilateral and multilateral aid institutions.
Again the issue for the latter group is complementarities, how best to leverage the intentions and energies in pursuit of *bona fide* development objectives. To do this, and especially to do it with a minimum of politicization, is a great challenge, but it is one that must be met if the full promise of North-South cooperation is ever to be realized.

2 Retrospective

Economic development since the middle of the last century has been spectacular. There are many encouraging examples of development successes. There is also evidence of a widening gap between the most and the least successful. Too many countries lag behind, particularly in Africa, and around 1.2 billion people have to manage their lives with an income of less than a dollar a day. Political leaders have over and over again asserted that widespread poverty and existing imbalances in socio-economic conditions are unacceptable and should be corrected through urgent and concerted action. Yet, foreign aid is under pressure and its usefulness was widely questioned during the 1990s.

The roots of foreign aid can be traced back to at least the 19th century, but the economic and social development of the third world, as such, was clearly not a policy objective of the colonial rulers before the Second World War. Such an objective would – as argued by Erik Thorbecke – have been inconsistent with the underlying division of labor and trading patterns within and among colonial blocks. Thorbecke goes on to outline how the concept of foreign aid as a contributing factor to development evolved within the broader framework of development theory and strategy during the last five decades of the 20th century. He highlights that while recognizing the role that non-developmental goals play in the allocation of aid, it would be overly cynical to dismiss the developmental benefits of aid – whether they resulted directly from the developmental motivation by donors or indirectly, as a side-effect of politically motivated resource transfers.

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2 In what follows we draw upon many of the papers published in Tarp (2000). This volume synthesized contributions from some 29 authors who are cited in what follows by name only.
In the immediate post-war period, the problem in Europe was lack of capital. The response was the Marshall plan, implemented from 1948 to 1953 and driven in part by fear of communism and the desire of the USA to secure American hegemony in global trade and investment. The plan was massive even by today’s standards. It was also very effective. It helped diminish the acute scarcity of foreign exchange in Europe, and it gave rise to many of the elements of the existing system of aid delivery. However, the needs of the developing areas of the world per se were not yet in focus. The International Bank for Reconstruction and Development (IBRD), established at the Bretton Woods Conference in 1944, was originally concerned with reconstruction elsewhere, and the International Development Association (IDA) was only created in 1960 to channel resources to the poorest countries on ‘soft’ conditions. Developing regions did receive support from the colonial powers before 1960, notably from Britain and France, and the volume of French aid as a share of GNP actually increased to more than 1% by the early 1960s. A major part of the rapidly increasing bilateral flows during the 1950s came from the USA, whose aid/GNP share grew to well above 0.5%; but considerable continuity from colonial to post-colonial institutions was characteristic, as described by Peter Hjertholm and Howard White. Colonial ties were strong and influential.

After the success of the Marshall Plan, attention increasingly turned to developing countries, many of which became independent around 1960. Hjertholm and White note that this created a constituency for aid, and they go on to explain that the first meeting of the nonaligned movement in 1955 gave a focus to this voice, as did the various organs of the UN, notably the United Conference on Trade and Development (UNCTAD). The evolution from symbiotic to inward looking growth and from dependent to a somewhat more independent relation, vis-à-vis the ex-colonial powers, was beginning to emerge as noted by Thorbecke. In parallel, the 1960s saw a distinct increase in the share of multilateral aid; and the role of aid started shifting towards a broader agenda of socio-economic goals that clearly went beyond the exclusive focus on promoting economic growth, characteristic of the 1950s. The Economic Commission for Africa (ECA) came into being in 1958, and as the first of the three regional development banks, the Inter-American Development Bank (IDB) was established in 1959. The multilateralism of aid became even more pronounced in the 1970s, which saw an increased focus on
employment, income distribution and poverty alleviation as essential objectives of development and indeed aid.

Economic progress was visible during much of the third world during the first two decades from 1960. Irma Adelman refers to this as the golden age of economic growth, but this era came to an abrupt end when crisis set in at the beginning of the 1980s. It soon became evident that the downturn was of a more permanent nature, not temporary as in 1973; and it was gradually recognized that the development strategies of the previous decades were no longer sustainable. Economic circumstances in developing countries and the relations between North and South were radically different from before, so adjustments had to be made in economic policies. Achieving macro-economic balance (externally and internally) appeared as essential pre-requisites for renewed development; and macroeconomic stabilization and adjustment became important and in much of the rhetoric of the day almost synonymous with economic transformation and development. Reliance on market forces, outward orientation and the role of the private sector, including NGOs, came into focus, whereas poverty alleviation somehow slipped out of view in mainstream approaches to economic reform.

In parallel, bilateral donors and international agencies such as the World Bank grappled with how to channel resources to the developing world. Net aid flows were seriously affected by flows related to indebtedness, and by the late 1970s it had become increasingly difficult to channel resources in the form of discrete projects to many developing countries. The various kinds of macro-economic program assistance (such as balance of payments support and sector budget support, which were not tied to investment projects, and which could be justified under the headings of stabilization and adjustment, appeared an ideal solution to this dilemma. Financial program aid and adjustment loans became fashionable and ‘policy conditionality’ widespread. 3 Maintaining the flow of resources had found a rationale, which corresponded well with the major tenets of the on-going ‘neo-classical counter-revolution’ and the guidelines for ‘good policy’ summarized under the heading of the ‘Washington consensus’. All in all, aid continued to grow in real terms until the early 1990s and actually represented a

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3 Paul Mosley and Marion Eeckhout describe in detail the movement from project to program assistance and Ole Mølgård Andersen provides a sector perspective on these issues.
relatively constant share of the growing GNP of the donor community during the period 1970-1990. This is so even if US assistance started falling already in the mid-1960s as a share of GNP to less than 0.2% at the end of the century. However, after 1990, total aid flows started to decline both in absolute terms and as a share of GNP.

There are many reasons for the decline in aggregate flows, including first of all the fall of communism and the end of the cold war. Weakening patron-client relations among the developing countries and their former colonial masters certainly also played a role, and the traditional support of development aid by vocal interest groups in the developed countries became eroded. Other concerns, notably the environment, and distrust of bilateral and multilateral agencies made an impact. These institutions have been subjected to criticism and at times characterized as blunt instruments of commercial interests in the developed world or as self-interested, rent-seeking bureaucracies. In any case, the widespread perception that aid is at best ineffective in fostering growth at the macro level no doubt also had an important role to play. A superficial look at available data does indeed seem to suggest that aid is ineffective in promoting growth, and anecdotes about failed projects at the micro level contributed to an increasing sense of aid fatigue in donor countries. Finally, the acute awareness of examples of bad governance, corruption and ‘crony capitalism’ led during the 1990s, in particular, to skepticism about the sincerity and credibility of aid receiving governments.

Raymond Hopkins points out that the use of governments to transfer resources has become less legitimate as governments are less trusted (on both the donor and the recipient side). A sense of failure certainly spread during the 1990s, and such perceptions obviously represent a serious challenge to any economic development rationale for aid. To the extent they are correct and nullify the potential impact of aid transfers (in whatever form they take), humanitarian aid seems to be the only justifiable road left to follow. It is therefore well justified to speculate about and examine the effectiveness of aid. After all, while aid has generally fallen in relation to other resource flows (as further described in Section 3), aid still represents a sizeable amount of resources, the impact of which should be maximized.
Foreign aid has throughout its history been subjected to close scrutiny both by academic researchers and others interested in the topic. A massive outpour of studies over several decades bears witness to this, and it is characteristic that the boundary between policy advocacy (one way or the other) and research has not always been clearly delineated. Be that as it may, most development economists and aid practitioners have at one stage or the other come across the so-called ‘micro-macro’ paradox, formulated by Mosley (1987). This thesis suggested that while aid seems effective at the micro-level, it is harder – or actually impossible – to identify any positive impact of aid on the macro-economy. Much of this was spurred by the focus of the 1980s in uncovering the impact of the stabilization and structural adjustment packages. As a corollary of the adjustment programs in many countries, the use of a wider variety of analytical tools in aid impact assessment became common. Evaluation methods such as the internal rate of return of projects came under severe criticism as the perception that aid (channeled through sovereign governments) is fully fungible spread. In parallel, the difficulties of macroeconomic evaluation summarized under headings such as ‘before-and-after’ and ‘with-and-without’ were the topic for many discussions, and methodological issues gradually came to play an important role in the aid effectiveness debate.

In spite of all this, aid fatigue lingered on. The strong faith in the operation of markets and skepticism regarding governments, including both recipients and donors, were formidable barriers. After all, foreign aid has to a large extent always been a state-to-state relationship. Fatigue was also influenced by the fear that foreign aid was generating aid dependency relationships and as such would have negative incentive effects. The increasing perception that ‘conditionality’ was in effect failing to promote policy reform started to creep in at the turn of the century, and it became clear that the relationship between donors-and-recipients left much to be desired. Ravi Kanbur argues that the accounts of failure are legion, and he has provided a fascinating summary of both the background and the present state of affairs. He notes that while there is reason to view the donor-recipient relationship as one of unequal power, imposing conditionality is in practice much more subtle. In fact, there is strength in the weakness of the recipients, and above all, weakness in the strength of the donors. The basic reason is, Kanbur argues, that donors and recipients are so enmeshed, at the level of governments, agencies and
individuals, that it is actually not clear where the strengths and weaknesses lie. Conditionality was no doubt ‘imposed’ on unwilling recipients at the time of signing adjustment documents, but ‘the recipients know, the donors know, and in fact everybody knows, that these are paper conditions; the outcome will be driven by the need of both sides to maintain normal relations and the flow of aid’.

All of this motivated a renewed interest in coming to grips with the need for new kinds of donor-recipient relationships and with the effectiveness of aid. In response, calls were made for increased national ownership of aid programs, and both World Bank researchers and others started digging into the aid-growth relationship. This was facilitated in part by the availability of much better data and in part by insights emerging from new growth theory and the rapidly increasing number of empirical studies of growth. Early work in this vein by Boone (1996) suggested that aid does not work. Aid is a simple waste of resources. This was followed-up with an analysis by Burnside and Dollar (1997, 2000), originally put out as a World Bank policy research working paper. They argue that some aid does work, and provided an attractive and seemingly self-evident solution to the ‘micro-macro’ paradox. Aid works, but only in countries with so-called ‘good policy’. They based this on an aid-policy interaction term that came out statistically significant in their macro-econometric analyses of the aid-growth relationship.

Burnside and Dollar, and more recently also for example Collier (2002), have used the above framework as basis for suggesting that aid should be directed to ‘good policy’ countries to maximize aid’s impact on poverty alleviation. This is in part justified by reference to the seeming inability of aid to change policy, emerging from other Bank funded research, edited by Devarajan, Dollar and Holmgren (2001). While the policy recommendations were considerably toned down in the Bank’s Monterrey document (World Bank 2002), the basic thrust somehow remains. Macroeconomic performance evaluation and policy criteria (established by the World Bank) should play a key role in aid allocation. Collier refers to this as aid effectiveness – 101. In parallel, the World Bank

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President has on many occasions asserted that a development program must be country-owned, not owned by donors or the World Bank.

The Burnside-Dollar and Collier work has not gone unchallenged. Heated discussions about what constitutes ‘good policy’ have taken place. They are in many ways extensions of more general debates and views about development strategy and policy, and it is characteristic that the concept of ‘good policy’ has been gradually expanded by the World Bank to include a much wider and much more complex set of characteristics than originally considered. Other discussions have centered around what can be learned from the kind of cross-country growth regressions that underlie much of the recent empirical work on aid effectiveness. Reflections such as those of Robert Solow (2001) can be referred to. Solow suggests, for example, that there is a case for focusing more directly on TFP or factor augmentation functions as the proper left-hand-side variables in empirical work and thinking more seriously about legitimate right hand side variables. Current practice is in his view much too haphazard. Academic debate on aid effectiveness has finally covered new and important territory when it comes to issues of empirical methodology and interpretation, and it has been reiterated that robustness is an issue that should not be taken lightly when research is used for formulating policy.

There are many thought provoking contributions to this debate, which cannot for reasons of space be reviewed here. Dalgaard, Hansen and Tarp (2002) offer new theoretical and empirical insights and provide an up-to-date account. They note that the single most common result in recent empirical studies is that aid has a positive impact on real GDP per capita growth, but displays diminishing returns. They go on to conclude that the recent empirical evidence that aid works is convincing, and that political decisions on curbing aid cannot be justified, arguing that aid has no impact on growth. This is encouraging, and it suggests that it is now time to move on to consider how the

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7 See for example Hansen and Tarp (2000, 2001) and a special ‘Policy Forum on Assessing Aid’ (organized by Oliver Morrissey) in the *Journal of International Development* (Vol. 12, No. 3). Interested readers may also want to examine the August 2001 (Vol. 37, No. 6) special issue of the *Journal of Development Studies* with contributions by many authorities in this area. Draft versions of many of these contributions were originally put out as University of Nottingham CREDIT working papers at the following web-site: www.nottingham.ac.uk/economics/research/credit. A recent paper by Mosley and Hudson (2001) looks at the impact on aid on poverty rather than on growth in per capital income.
effectiveness of aid can and should be improved – rather than focusing on whether aid works. In trying to move forward, it is hard not to be struck by fact that the putative lessons learned from the past 5-10 years vary greatly. Disagreements persist about necessary and sufficient conditions for effective economic aid. What we have learned about what aid can do, what aid should do, and how to do it remains clouded; and the gap between rhetoric and practice when it comes to aid relations continues to be a matter of concern for many independent observers and analysts.8

In sum, while the last 50 years of the 20th century saw a move away from colonial to post-colonial aid and increasing multilateralism, the early 21st century is best characterized as an era of uncertainty. The evolving donor-recipient relationships are unclear and circumspect. In his reflections on this, Hopkins lists a variety of possible motivations for sustaining aid in the future, and he identifies three targets that may be useful to keep in mind as having wide appeal among diverse elements in the donor and recipient communities. They include: (i) state strengthening, (ii) improved market management, and (iii) emergency safety nets. Hopkins recommends these targets as problems for promoting future aid. There are by now several such lists in existence, and they certainly do signal the need to try to work out more clearly what roles aid should assume in the future in the emerging context of globalization and market-oriented growth.

3 Aid and Globalization

Over the period discussed in the previous section, the world economy has changed in ways that every educated person knows are unprecedented and irreversible. Most notable in the present context is the rapid proliferation of international trade relations that have been built upon a stratum of open multilateralism. Regional and global agreements to liberalize international commerce have changed the landscape of economics and nearly every agenda for economic policy in ways that are pervasive and

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8 In discussing present aid modalities, Helleiner (2000) notes that there “is still a curious ‘disconnect’ between donors’ general rhetoric on these issues and actual practice on the ground.”
still only partially understood. In the present context, it is reasonable to ask: How can the
mission of aid best be pursued in an era of globalization? Without offering any definitive
answers, this section provides a brief historical narrative to elucidate this question.

The growth of trade, growth of economies, and their interaction over recent
decades have filled volumes with statistical tables, policy analysis, and academic
research. Our purpose here is to focus more narrowly on the components of economic
change that might be more relevant to aid’s place in the global economy. Even though
there has been much work on this topic, we believe that a new perspective on the facts
and prior analysis might be beneficial.

Consider for example the very animated debate about absolute levels of global
development assistance. While we believe that greater levels of commitment to the
world’s poor are necessary to secure sustainable progress for them and for the rich,
historical data indicate that global aid levels have kept pace with both incomes and
population in the developing world. Figure 3.1 presents ratios of total aid to Trade, GDP,
and Population, respectively, of non-OECD countries for the period 1971-1999. Aid,
Trade, and GDP are measured in constant dollars and the ratios normalized to unity in the
initial year.

**Figure 3.1: Aid to Trade, GDP, and Population Ratios**
(normalized to unity in 1971)
These series show total aid rising steadily in relation to income and population until the early 1990s, but stagnating thereafter. While it might seem appealing to some that Aid/GDP is now twice what it was in 1971 and Aid/Capita has increased threefold, it should be borne in mind that the international composition of these ratios vary tremendously between high and low growth economies of the South. Perhaps the most revealing aspect here is the complete lack of net progress over the last two decades. The reversion to complacency that might be inferred from these numbers is certainly not justified by dramatic progress in global poverty alleviation during the late 1990s.

How does all this relate to globalization? The third series, measuring Aid relative to total world exports and imports, reveals the implications of a well-known fact, that trade has been growing faster than GDP and, despite a recent upturn, aid flows are about the same magnitude relative to trade as they were in the 1970s. Obviously these two economic entities have little or no causal relationship, but this trend does indicate that flourishing international commerce has not been associated with a boom in charitable activity, a linkage that one often observes in domestic economic cycles. Put a little differently, the sense of public humanitarian mission that animated development assistance programs in the early decades has not been sustained by the dramatic growth of private sector commercial interest in the international economy.

Although trade can facilitate poverty alleviation, it operates in very different ways, and with a different mission, than aid. The primary impetus of aid is real and social investment, and its putative mission can generally be characterized as an effort to facilitate better human living standards by direct transfers, investments, and overcoming institutional and market failures. From this perspective, aid more closely resembles activities on the capital account, including one dramatically emergent phenomenon, foreign direct investment (FDI). While FDI is a private sector activity, and thus is animated by very different primary objectives, it has been known to confer many benefits on developing economies that are consistent with aid objectives, including human resource development, technology diffusion, and, ultimately, poverty alleviation and more sustainable growth. In this sense, it has long been recognized that there may be
essential complementarities between private and public foreign investment in developing countries, where the latter means aid.

The extent to which the complementarities matter is of course dependent upon their potential and real significance. To get an idea of the former, look at the trends presented in Figure 3.2 below. These depict, for non-OECD countries, levels of GDP, Trade, Aid, and inbound FDI for the period 1971-1999, normalized from constant US dollars to unity in 1971. The most arresting feature of this data is of course the meteoric rise in inbound FDI, which has increased almost exactly one hundredfold over the last three decades.9 This trend must inspire reflection on the appropriate strategy to public foreign investment, or development assistance, going forward.

To depict this issue in even higher relief, Figure 3.3 presents ratios of aid to non-OECD inbound FDI, accompanied by the aid to trade ratio of Figure 3.1. The series of Aid/FDI depicts the ratio of absolute (constant USD) levels for each year. In relative

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9 Needless to say, this distribution of these private capital inflows has been very unequal across the developing countries.
In dollar terms, private capital inflows were about four times the level of development assistance by 1999, and forward commitments by both public and private interests imply that this disparity can only widen. That being the case, we believe we have already entered what might be termed the Age of Complementarity in development assistance. This is a new era where aid strategies must be focused upon their core missions, paring away many components of the grander aid agendas of the 1960s and 1970s. At the same time, aid institutions must allocate new resources to more strategic partnership that can leverage a significant component of private financial resources to further socially beneficial objectives in recipient countries.

**Figure 3.3: Aid to Trade and Inbound FDI Ratios**

*(Aid/Trade normalized to unity in 1971, Aid/FDI ratio of constant USD levels)*

We believe that perspectives on aid must change in two ways to deal with this situation. First, there must be broader and more refined awareness of the implications of coexistence between public and private investment in developing countries. Several topics related to this will be covered in the next section, but of particular importance will be a better understanding of the primary behavioral drivers and mechanisms behind private investment, particularly ownership and contracts. Institutions like the World Bank
have as already noted drawn increased public attention to the concept of ownership, but the real microeconomics of property rights and entitlement, as these are implicated in the marketplace, is more complicated than rhetoric about stake holding and community participation.

A second priority for more effective aid complementarity would be official multilateral initiatives to improve public/private communication on development priorities. Obviously, institutions like the IMF and others have been contending with this ‘partnership’ for a long time, but it is not clear the more traditional bilateral and multilateral aid agencies have awakened to the realities of aid and globalization or made the strategic adjustments necessary to more fully exploit complementarities with private capital markets. Indeed, official international coordination of public aid alone is still a significant challenge. Public-private coordination has until now remained primarily a domestic policy matter, with trade and commerce ministries simply working to promote market access abroad.

Detailed examples of how this strategy might develop are too numerous for the present discussion, but two might be illustrative. Consider one of the primary missions of development assistance in its earliest days, to provide liquidity for public investment in the absence of well-developed international capital markets. Obviously, the issue of capital market failure is very different today, but it has not disappeared. While investment resources are available today for an enormous spectrum of investment activities in the developing world, there are still areas where the public must take initiative. These are the traditional social investment and long term infrastructure projects like public health in rural areas, but they remain essential to the most economically disadvantaged. This is what we mean by refocusing on the core mission of assistance.

At the other extreme, we see private entities stampeding into infrastructure investments like media, telecoms, and energy. In situations like this, private markets appear to be delivering technological progress to developing countries rapidly and efficiently, and one might reasonably question the need for public assistance. To do this is to underestimate the potential of complementarity. In the case of media, example, OECD countries have long histories of regulatory evolution that can be conferred to
developing countries, helping them to better use the resources of private sector development for socially beneficial ends. In this way, bilaterals and multilaterals can have an essential influence on the quality, if not the quantity, of inbound investment and its ultimate social impact. The same logic applies to public and private health, pharmaceuticals, food safety, etc.

4 Ten Percepts for Aid Effectiveness

From the discussion of the last two sections, it is clear that the role of aid has evolved rapidly in recent years, in response to a combination of political and economic forces. Although aid no longer serves the same objectives or enjoys the prominence it once did, it can still be a potent catalyst for poverty alleviation around the world. John Healey and Tony Killick argue that aid can be used to reduce poverty, and we agree. In fact, poverty is very much a micro-economic phenomenon, and while growth should be promoted, it is seldom enough to cure poverty. Similarly, aid can be used to promote integration in global markets as discussed by Oliver Morrissey. Yet, given its diminished political and economic significance on a global scale, the effectiveness of aid design and implementation is more important than ever. In this section, we survey ten areas where more insight can be gained. While these topics only cover a subset of the issues relevant to aid effectiveness, we hope they will offer fresh perspectives to renew the energies of those who want aid to work better for all its direct and indirect beneficiaries.

Macro and General Equilibrium Perspectives

We begin by looking at aid issues from an economy-wide perspective. This includes traditional macroeconomic topics and performance criteria and those related to general equilibrium linkages transmitting effects between actors in the economy. The former, reviewed by Hansen and Tarp (2000), have received much attention in the aid effectiveness literature over the five past decades, while the latter is often relegated to academic research and absent from policy dialogue.
4.1 Macro criteria, misallocation, and rationing

Macro performance generally, and aggregate real income growth in particular, are certainly high priorities for development policy. Yet, we are convinced that macro criteria cannot – and should not – stand alone in evaluating the effectiveness of most development assistance efforts. Whether or not, and under whatever circumstances, macroeconomic growth and poverty alleviation might be correlated; poverty is a microeconomic phenomenon and needs to be addressed as such with a significant component of development assistance. More importantly, macro characteristics can be dangerously misleading as criteria for aid allocation. With the exception of short-term macroeconomic assistance, using macro criteria for aid eligibility is likely to lead to serious misallocation. Ultimately, the target beneficiaries of aid intended for poverty alleviation are microeconomic institutions: small enterprises, households, and individuals. Their credit-worthiness and need-worthiness cannot be effectively assessed with macroeconomic metrics, let alone with heuristic and quasi-political rules-of-thumb like ‘good’ or ‘bad policies.’ In countries with poor macro conditions, including adverse business cycles and weak or compromised policy institutions, many credit- and need-worthy candidates would be ineligible for credit they might use effectively. At the same time, a macro bias in favor of other countries would lead to substandard credit allocation at the micro level. In other words, rationing credit by macro-criteria inevitably screens out credit- or need-worthy recipients, while many beneficiaries in attractive macro settings may be less deserving.

It is clear from the literature on aid effectiveness, as well as the institutions supporting much of this research, that a macro bias is reinforced by sovereign credit relationships. Bilateral and multilateral institutions are generally entering aid relationships with national entities, and therein arises the preoccupation with quantitative and qualitative macro policy criteria. Our essential argument is that that care should be
taken when applying macroeconomic performance evaluation to development assistance. This approach increases the risk that aid will be politicized and allocated inefficiently. Assessing economies with generic government policy ratings carries similar misallocation risks. Simplistic macro rules-of-thumb not only compromise more rigorous credit and need standards, but reinforce the adversity of those living under substandard governance. It is a regrettable fact that many of the world’s poorest people live in conditions of substandard national, regional, and/or local governance and, unlike their enfranchised counterparts in OECD countries, lack any tenable means of changing these institutions.\textsuperscript{11} It would be gravely ironic for aid agencies to compound the misfortunes of these people with discriminatory aid allocation.

Finally, we would argue that the use of the ownership concept is often misplaced in the national (government) macro-context. There is of course nothing wrong with ‘ownership’ \textit{per se}, on the contrary. But governments have varying degrees of ownership over policies and some are not ‘owned’ at all. In fact, many governments do not have a single policy line. Different parts of government adhere to different policy lines, depending on how close they are to donors and on the preferences of state actors in each ministry. What genuine ownership means is therefore not that evident, particularly when microeconomic actors are omitted. As we argue later in this section, it is precisely those actors whose incentives and interests will determine much of aid’s real effectiveness.

\section*{4.2 Foreign exchange risk, local currency credit, and macro moral hazard}

Having argued against excessive reliance on macro criteria for aid appraisal and allocation, we want to emphasize what we consider to be the two critically important focal points in the context of sustained development assistance (as opposed to short term macro stabilization): quality of contracts and microeconomic appraisal. Both these issues will be discussed in more detail from a micro perspective below. But the fact of sovereign relations makes contract quality just as important at the macro level. Better contracts,

\textsuperscript{11} Readers, interested in cross-country empirical approaches, may wish to consult Dalgaard, Hansen and Tarp (2002) for an elaboration of why the endogeneity of policies and institutions should be taken more seriously than in much of the existing analytical work.
particularly those that capture the realities of incentive problems and principal-agent relationships, can improve aid effectiveness at both macro and micro levels. And they can potentially help furnish the ownership concept with real meaning. It would also facilitate the truly independent monitoring of aid relations advocated by for example Helleiner (2000).

As a macro example, consider the currency of loan denomination. Many critics of foreign assistance have argued that dollar or other ‘hard currency’ denominated credit has conferred excessive foreign exchange risk upon poor borrowers. Some have even asserted that this risk constitutes a de facto subsidy to for example the U.S. as borrowers are obliged to hold dollar reserves, effectively financing the lender’s current account deficit. In response to this and other initiatives, there is significant emergent interest in promoting local currency aid and other commercial finance. At its most recent annual meetings, for example, the Asian Development Bank (ADB) floated the idea of converting its future assistance to local currency bond finance. This would achieve at least two objectives, transferring foreign exchange risk to the lender and promoting the development of local financial markets.

While the objectives behind local or domestic currency finance seem quite laudable, they ignore a serious problem of moral hazard, one that actually does arise in the macro management context. Countries with substantial aid obligations of this type would suffer great temptation to mitigate these liabilities with inflationary policies. With this in mind, it might be advisable to develop a middle ground for aid finance, using a weighted basket of currencies to overcome both lender and borrower incentive problems.
Policy coherence in bilateral relationships

The emergence of multilateral aid agencies has done much to remove historical biases in the aid allocation process, but bilateral assistance remains very important to poor countries. Because of their sustained commitments in this area, it is therefore particularly regrettable that donor countries often pursue economic policies that partially or completely contradict the principles of their assistance programs. We believe that the cause of aid effectiveness could be advanced dramatically if bilateral donors would simply improve their own policy coherence, better harmonizing their agendas for domestic economic management, trade policy, and development assistance. Two areas where this is particularly important are agriculture and tied aid.

4.3 Richer farmers, poorer farmers: OECD agricultural support and global immiserization

It is now well understood that domestic agricultural support programs in OECD countries represent a huge implicit tax on rural households in developing countries. Chronic upward trends in this assistance have sustained excess agricultural supply in rich countries, leading to long-term downward pressure in global food prices and the real incomes for farmers in unsubsidized, largely poor countries.

Recent estimates (Beghin, Roland-Holst, and van der Mensbrugghe 2002) indicate that current OECD farm programs reduce rural incomes in poor countries by $62 billion annually. This figure is over 20% greater than even the most ambitious goals for increased development assistance presently under discussion. Moreover, these benefits would go directly to the poorest households in the developing world, conveniently bypassing bilateral and multilateral agencies, national, regional, and even local governments. Even more ironically, these estimates show that taxpayers in OECD countries essentially pay twice for every dollar of development assistance, once to reduce the incomes of the rural poor and once in an effort to offset this immiserization.
Clearly, the agricultural support and development assistance agendas arise in different policy contexts. However, it cannot be denied that they arise in the same governments and, thanks to general equilibrium effects, in the same global economy. For this reason, it is perhaps even more important to heed the initiative of the Doha trade round and improve the coherence between national farm agendas, global poverty alleviation, and open multilateralism. The Doha trade round does deserve to become a genuine development round where developing countries become actors, and where negotiated results reflect developing country interests. A major challenge to the international society is to ensure, in practice, that also the poorest countries are integrated in the global economy. Allowing narrow-minded domestic interests in developed countries to stand in the way for achieving this goal is, to put it plainly, hypocrisy.

4.4 Tied aid, market reform, and the WTO

Much development assistance in recent decades has been administered with a strong dose of free market ideology. Despite high-minded liberalism, however, donor countries often revert to anti-competitive practices that could be challenged in their own domestic jurisdictions and intra-OECD commercial agreements. The persistent use of sole-source expenditure or tied aid practices represents a post-colonial anachronism that contradicts the efficiency principles of both aid effectiveness and (domestic and external) market liberalization.

From a general equilibrium perspective, tied aid constitutes not only a monopolistic practice. It is an anti-competitive export promotion technique. Indeed, it may only be a matter of time before the WTO hears a complaint about this practice, but would it not make more sense for bilateral actors to take the initiative and improve the coherence of their own policies in this context?

4.5 Aid versus strategic assistance

A number of bilaterals have been accused of misallocating development assistance in pursuit of strategic objectives, either because they are distorting the
definition of eligible activities or because beneficiary governments compromise their aid programs. While geopolitical aspirations are endemic to most national policies, it does little service to the cause of aid effectiveness to implicate military and other strategic assistance into aid budgets. For this reason, we would argue for a set of international standards about what constitutes \textit{bona fide} development assistance. While it would be difficult to agree on a restrictive list of aid activities, agreement would be desirable at least with respect to a set of concrete objectives such as poverty alleviation or other international development goals. A more concerted multilateral approach like this could help reduce aid misallocation, arbitrage, and other problems such as fungibility and rent-seeking.

\textbf{Micro perspectives: Contracts, incentives, and sustainable credit mechanisms}

In reality, and in spite of all the rhetoric of the aid community, aid and lending relationships involve complex contractual and agency relationships that are essentially microeconomic in nature. Even though the beneficiary signatories to aid agreements or contracts often have macroeconomic authority, they behave as microeconomic agents and their strategic environment is often partially in conflict with that of the donor/lender. Nowhere is this incentive paradox more apparent than in lending for development assistance.

In this section, we discuss aspects of contract theory that may contribute to overcoming these incentive problems. In many cases, we place special emphasis on the idea of ownership, particularly localization of ownership. By this we do not mean abstract or rhetorical ideas of stake holding or community participation, but contractual ownership with its appurtenant real entitlements and responsibilities. Whether because of its paternalistic bilateral tradition or the bias of sovereign lending arrangements, the aid relationship has been relatively weak in recognition of ownership principles. We believe this has been detrimental to aid effectiveness for many reasons, not least of which because it has diluted accountability and promoted such practices as rent-seeking, fungibility, and aid arbitrage.
4.6 Decentralizing sovereign credit

Bilaterals and particularly, multilaterals often find themselves in the dilemma of extending 15-30 years credit to governments that are clearly influenced by short-run (3-5 year) policy priorities and needs. This reinforces the macro/heuristic rule biases discussed earlier. Sovereignty is obviously not negotiable, but there may be ways to restructure lending agreements that limit the uncertainty associated with political transition. The most attractive of these is decentralization, where contracts for loans and grants enlist agency at regional and local levels. Ideally, this would include both performance criteria and direct financial responsibility such as co-payment provisions. Most decentralization entails parallel conferral of local authority and, in the case of co-payment, might require new domestic entitlements.

For example, an upland water retention scheme would be coupled with local water resale rights to finance co-payment. National and even regional governments might not be congenial to these statutory reforms, but provisions of this kind have two important virtues. They help overcome the primary aid incentive problem and improve domestic policy coherence, better aligning real entitlements with financial responsibility and performance. Lenders and donors might complain that regional and local governments are even more unpredictable than national ones. To this we would reply that credit- and need-worthiness should be assessed at the beneficiary level and, despite its relative convenience, national accountability often fails to meet this standard. Consider instead the most extreme form of decentralization, micro-credit, about which we have more to say next. The much-touted success of this approach is a direct result of the attributes we emphasize, local eligibility and accountability.

4.7 Micro-credit reconsidered

As was just mentioned, micro-credit can be viewed as one of the most extreme forms of aid decentralization, extending assistance and fiduciary responsibility directly to the microeconomic level. Moreover, we argue that the success this approach has enjoyed
is directly adducible to the microeconomic nature of the contract underlying this form of assistance. Individuals are the atomic unit for eligibility, evaluation, and financial accountability (as well as ownership), and this aligns incentives to produce superior performance characteristics. There are lessons in this experience for designing aid contracts at the local community, regional, and national levels.

Having said this, the experience with micro-credit has not been uniformly positive. Indeed, recent experience in Bangladesh and a few other areas has revealed substandard loan portfolios and serious risks beyond recognized loan loss provisions. We believe these cases justify a reconsideration of the appropriate role and design of micro-credit schemes. Like many forms of aid, micro-credit is best suited when designed to overcome market failure. The failure in question here is the local capital market, with the effect of credit rationing. In most applications of micro-credit programs, however, the remedy is two-fold, credit provision and interest rate mitigation. This creates a new source of policy risk. While credit is often rationed at the local level in developing countries, there is not much empirical evidence on what is or should be the real risk premium or market rate of return. For this reason, it may not make sense to assume – as often done – that local lending rates are too high. Thus, well-intentioned micro-credit schemes may over-allocate credit and accumulate loan losses at unsustainable rates. In this context, it is worth noting that non-performing loan rates are not by themselves a problem, it is the pricing of risk that is critical. A financial aid scheme that presumes to increase credit allocation and fix prices at the same time is assuming a great deal about the quality of its own expectations. We believe that micro-credit policies should be refocused on facilitating market-based financial intermediation, as is currently being done by promoting commercial bank participation in the remittance market.12

4.8 Grants versus negative interest rates

There has been much discussion recently about increasing the grant proportion of development assistance, both in terms of converting future aid from loans to grants and to

12 IDB (2001) provides details on this.
forgive outstanding loans. While loan forgiveness has many advocates, particularly on behalf of the poorest and most (per capita or per dollar of GDP) indebted countries, there is a significant and influential opposition to large-scale loan-to-grant conversion. The main objection here is that development assistance funds represent a kind of global commons, or community credit pool that should be managed on a renewable basis.

We instinctively side with the opponents of large-scale conversion, sharing their reasons about sustainability of assistance, but feel that both sides in this debate are ignoring behavioral fundamentals. As long as we maintain an artificial dichotomy between grant and loan aid, there will be significant inefficiencies in global aid allocation. A better long term approach would be a comprehensive and relatively standard set of guidelines for concessional assistance, supported by a continuous spectrum of assistance plans ranging from outright grants to commercially rated credit. This can best be achieved by standardized aid contracts that stipulate interest rates varying from -100% (that is pure grant aid directed to those with no repayment ability whatsoever) to LIBOR plus some commercial margin. Negative interest rates are an obvious efficiency refinement of the concept of concessional credit, while contract standardization would help to harmonize public and private credit instruments and, eventually, facilitate interaction between the two (as will be discussed next). Moreover, such transparency might actually help clarify the respective roles of different donors. In practice, their operations often overlap in ways that are seldom easy to relate to the underlying differences in aid and lending instruments and conditions.

4.9 Public goods in poor countries, a more emphatic case for grants

The idea of continuous aid pricing (positive and negative interest rates) can easily be defended on efficiency grounds, but in itself provides no guidance about what kind of projects should qualify for which interest rates. To close this list of ideas for more effective aid allocation, we want to highlight the argument for public goods in very poor countries. In this situation, we believe that outright grants clearly dominate subsidies.

Consider the diagram below, with aggregate private goods measured on the vertical axis and aggregate public goods on the horizontal axis. Most empirical evidence suggests that social preferences for the two types of goods are related to average per
capita income, where low income groups strongly prefer (essential) private goods and higher income groups have more balanced preferences. In such a situation, subsidizing public goods (budget line A’C) will be more beneficial to the wealthy (UW), while grants (budget line A’B) will be more beneficial to the poor (UP2). If the objective of aid is income progressive (such as poverty alleviation) grant support of public goods provision would appear to be more appropriate.

Figure 4.1: Grants versus Subsidies
4.10 Privatization contingency and aid contracts

It is well known from game theory that principal-agent relationships, such as those between lenders and borrowers, require contingent contracts to overcome moral hazard arising from incomplete information. We have already discussed the information problems endemic to aid relations in several contexts and, despite wide recognition of these; contingencies in aid loans are still relatively simplistic. Generally speaking, these confine themselves to mutual exclusion and renegotiation clauses, and offer little recourse to the already imperfect bilateral relationship between lender and borrower.

As a partial, even an experimental step toward more efficient aid contracts, we would like to propose a privatization contingency. In particular, a clause of this kind would stipulate that, in previously agreed circumstances of nonperformance, part or all of the outstanding loan would automatically be resold into the commercial credit market.\textsuperscript{13} Clearly, this could induce significant short-term write-downs for public lenders, but long-term real renegotiation and rescheduling costs can be quite high. More importantly, however, partial remarketing could have a very tonic capital market discipline effect, attenuating both (lender) loan loss and (borrower) liability accumulation and reducing the likelihood of boom and bust credit cycles.

5 Nongovernmental Organizations and “Cohabitation”

Beneath the veneer of official facilitating agreements and institutions, globalization is largely about the proliferation of multilateral private agency. This is represented not only by international private commerce, via trade and financial linkages, but also in the rapid emergence and extension of Non-governmental Organizations (NGOs). While this discussion applies only to a subset of NGOs, a significant proportion of these institutions have arisen to meet manifest desires on the part of (mainly OECD) higher income individuals to participate, directly or indirectly, in the design and conduct of global

\textsuperscript{13} There is a clear role here for monitoring by independent assessors as discussed by Helleiner (2000). See also Section 5 below.
assistance activities, most of which are relevant to economic development. Seen in this way, the emergence of NGOs has pervasive implications for the pursuit of development assistance. To put it more bluntly, the NGO movement is a force and not only must, but should, be reckoned with by established bilateral and multilateral aid institutions.

For this reckoning to be a constructive and beneficial experience, the principles of complementarity need to be recognized by all parties. For aid agencies, the question is again one of appropriate division of labor and strategic leverage. What can NGOs accomplish in the stead of public agencies, and how best can their intentions and energies be leveraged, both in pursuit of bona fide development objectives. To meet this challenge, and especially to do it with a minimum of politicization, is not easy, but it must be met if the full promise of North-South cooperation is ever to be realized.

Given the differences in jurisdiction and policy accountability between public aid agencies and NGOs, there are substantial limits to joint activities, but this should not rule out, at minimum, real commitments to improved communication, coordination, and case-by-case collaboration. In particular, we would like to encourage examination of more coordinated effort in three areas.

1. Coordinated and regular consultation in the formulation and discussion of global development priorities, including joint public dialogue, research, and dissemination. Standards for participation in activities of this kind would obviously be subject to public agency authority and careful negotiation. We believe that democratic voices within the NGO movement need to be elevated from the sidewalk to more constructive venues for policy dialogue, but only on a basis qualified by their constituency.

2. Collaboration and secondment to official aid activities. Over the last few decades, NGOs have demonstrated remarkable commitment and resourcefulness in areas where human needs are most acute. Just as we have argued that public aid agencies should be refocusing their activities on the most essential development priorities, the expertise, resources, and tenacity of NGOs offers valuable opportunities for collaboration at the operational level. The World Bank, for example, now finds itself to be the largest financier in the war against HIV/AIDS, while NGOs such as Medecins sans Frontieres have developed a well recognized capacity to deliver primary and urgent health care in
the epicenters of this public health crisis. Some bilaterals have already made much progress in this kind of collaboration, but it would be desirable to extend these lessons to a broader agenda of development policy and priorities.

3. Assessment, auditing, and evaluation. There has been an animated discussion of aid review and performance accountability in recent years, particularly with reference to the World Bank. The most stubborn aspect of this debate is neither standards nor, ultimately, the results so far. What most polarizes the debate in this area is the question of independence.

Even as private sector auditing standards are being re-examined in the OECD countries, the World Bank and many other public aid agencies are operating with evaluation models that ignore minimum standards of objectivity and independence. Performance auditing with internal staff, who are obliged to review offices and people who may some day have authority over them, has been discredited by most authoritative observers. The insistence on this approach is a regrettable kind of institutional denial, merely postponing an inevitable acceptance of more ethically defensible standards and a very (economically and perhaps politically) costly re-appraisal later on.

When the time does come for more objective program evaluation, not only independent auditors (firms and individuals) and NGOs have a vast well of experience to draw upon. The fact that some NGOs are less than congenial to the institutions in question may actually be advantageous, since this will stimulate diversity of thinking in review and, ultimately, formulation. What is needed is responsible orchestration of these independent and partially discordant voices, meaning that review of this kind is best done collectively, perhaps with anonymity.
6 Conclusions

This paper was originally motivated by informal discussions about how changes in the global economy have influenced the development process and, inevitably, must influence the strategies of those who seek to facilitate development. A searching examination of the literature on historical aid practices has revealed many insights about what has been accomplished. Aid did promote growth, but aid could have been made more effective. The second section of this paper gave an overview of these issues.

Rather than dwelling upon aid effectiveness in retrospect, however, we have sought to use the lessons of the past and embed them in a vision of a rapidly changing global economy. In that context, we observed that the relative significance of public development assistance is much smaller than in the past and it is likely to continue shrinking. At the same time, there are important new agents on the international scene that affect the developing world’s prospects. To be effective as a smaller player in this new environment, we have argued that aid agencies must sharpen their implementation skills, focus on core priorities, and develop new strategic capacity for complementary relationships with, among others, private capital markets and NGOs.

It should be noted that the ideas presented here are part of a work in progress. We are relatively agnostic about the political implications of our analysis and recommendations, striving foremost for intellectual honesty and objectivity. Having said this, a few salient aspects of this work seem worthy of emphasis. Firstly, we have noted a tendency in the aid effectiveness literature, and by extension in aid policy, toward excessive preoccupation with macro performance criteria and outcomes. While the correlation of these with material living standards in developing countries is an interesting empirical question, poverty and its attendant experiences are microeconomic phenomena. For this reason alone, we believe that most aid research and resources should be focused at this level. Moreover, we argue repeatedly that more attention to the microeconomic properties of development aid will improve its effectiveness. In this context, another important issue we emphasize is the decentralization of economic
accountability, including ownership in the literal sense of contractual entitlement and responsibility down to the local level. We believe this more concrete approach to ownership will significantly improve the incentive characteristics of development assistance.

In order to stimulate discussion and a renewal of thinking in this area, we have put forward a set of ten percepts for design and implementation of development assistance. In addition to what has already been mentioned, we suggest that bilateral donors make greater effort to achieve policy coherence, reconciling or at least clarifying many policies that are be in partial or direct conflict with generally accepted principles of development aid. These include, among other things, domestic agricultural support, tied aid, and strategic assistance.

At the microeconomic level, we advocate a more flexible approach to the grant/loan dichotomy, more generous granting for public goods provision in the poorest countries and, finally, a privatization contingency in development lending agreements. This last idea might seem controversial, but we believe it to be a vital step in reforming the lending relationship and, more profoundly, an essential example of the complementarity we advocate throughout this paper, linking development assistance directly with emergent private capital markets. If the ideas presented here are allowed to evolve in the aid policy environment, we expect to see more robust and dynamic linkages between public and private finance in the developing world. Aid agreements with better private incentive (ownership) characteristics, coupled with the tonic influence of private capital market discipline, may bring us closer to the dual goals of social and economic efficiency. If this happens both the developing and the developed world will be beneficiaries.
References


