

Aid Effectiveness

Can Aid Agencies Be Smarter Than the Invisible Hand?

Private financial flows such as foreign direct investment seem to encourage economic growth and relieve poverty in part because they create excellent incentives for transferring know-how and in part because they are subject to a stern market test that ensures they are allocated and monitored carefully. For aid flows, not automatically subject to these disciplines, it is difficult to be as effective. This Note argues that aid agencies, by learning what makes private flows so effective, can bring better aid to the poorest.

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This Note is part of a series exploring trends in the aid industry, including patterns of aid flows, competition, and the effectiveness of different types of aid.

Aid is no longer the major source of money flowing into developing countries, which now enjoy inward foreign direct investment, remittances from migrant workers, loans from banks and the bond markets, and substantial grants from nongovernmental organizations (see Note 290 in this series). These diverse sources of money are certainly not perfect substitutes for aid. They flow to different countries and to different people within countries, on different cycles, bundled with different ideas and with different aims—and, not surprisingly, have different results. What do they teach us about smarter aid?

Private finance and growth

First consider results. A large body of research argues that private-to-private flows directly boost economic growth. Djankov, Montalvo, and Reynal-Querol (2004), in a new study of both pri-

vate and official flows to developing countries, assess the indirect impact on growth, through government spending. They look at private loans and equity flows to the private sector, government borrowing from the private sector, and remittances—and the results look encouraging. The private flows do not raise government consumption (which is good, since high government consumption dampens growth), but they seem to increase total investment, which accelerates growth.

This is not surprising. Ever since Adam Smith conjured the image of the “invisible hand,” the ability of private enterprise to generate wealth for all has been widely appreciated. So should we abandon official aid and rely on private finance? Of course not, for several reasons:

- Private finance flows only to where money is to be made (see Note 290). That inflows of portfolio equity increase economic growth



or that foreign direct investment can be a superb way to transfer technology is no comfort to the victim of a tsunami or a civil war.

- The technology transferred by private finance is focused only on increasing the productivity of particular supply chains. Private investors have little interest in building rural roads or helping to design a legal system.
- Even if private finance worked superbly, we would always hope to do more to reduce poverty.

Why does aid fall short?

But matching the benchmarks carved by the invisible hand of private finance is difficult for official aid. One problem is that aid flows may weaken governance in developing countries, for example, by triggering a political struggle to control the cash (see Note 291 in this series).

A second problem is that official aid does not seem to boost economic growth, at least not as irrefutably as private finance does. Djankov, Montalvo, and Reynal-Querol (2004) find that official development assistance as a whole directly reduces economic growth and also indirectly retards growth by increasing government consumption and reducing total investment as a share of GDP. This finding is broadly consistent with recent research on aid effectiveness, which fails to find a strong positive effect of aid on economic growth. Djankov and his co-authors also find that when a recipient's aid is mostly in the form of grants, the negative effects on growth are more severe.

These findings come from cross-country regressions, always treacherous. One possible complication is that bilateral agencies in the past tended to hand out mostly grants, while multilateral agencies typically used loans—so the apparent superiority of loans may result in part because multilaterals give more effective aid, whether grants or loans. Moreover, what was true in the past, especially during the cold war, may not be true in the future. And of course economic growth is not the only measure of development results, nor the aim of all development assistance. Nevertheless, the results are intriguing and consistent with earlier research (see Note 287 in this series).

Why does aid seem to be falling short of its potential? The answer may be macroeconomic. For example, foreign aid may damage the competitiveness of the industries that developing countries would most expect to fuel growth. Rajan and Subramanian (2005) provide innovative evidence for this explanation.

An alternative explanation is that the failure of aid to promote growth is a statistical illusion: private for-profit flows seek successful economies, aid flows seek struggling ones, and statistical analysis has failed to fully control for this.

Benevolent, monitored, and “smart”

A possibility equally worth considering is that some private flows outperform aid because they generate the right incentives for those sending and receiving the money, incentives that are key to producing development results. At the risk of some simplification, it could be speculated that the development results of financial flows into developing countries depend on three qualities (table 1):

- *How benevolent is the finance?* The most benevolent finance would flow to the poorest people in the poorest countries exactly when they need it and would never need to be repaid.
- *How well is the finance monitored?* Perfectly monitored financial flows would go exactly where their owners want them to go. Imperfectly monitored flows might be spent on pet projects, stolen, or wasted.
- *How much knowledge flows with the finance?* Knowledge matters, whether provided as stand-alone advice or alongside financial flows. Much official aid is bundled with technical advice, but some private flows like foreign direct investment also come with advice and training.

The ideal development assistance would be benevolent, monitored, and “smart” in the sense of providing valuable know-how, but finance that falls short of this ideal can still be hugely useful. For example, the bond markets provide developing countries with finance that is indifferent to development results and contains no advice but without which the borrowers would surely be poorer. Workers' remittances are “dumb” too, but since they are well meaning and well aimed, small wonder that development professionals are beginning to be excited by

their potential to relieve poverty. Foreign direct investment is entirely indifferent to the development results it may produce—but those results often materialize where the investment is packaged with cutting-edge technological know-how. The question is, how to provide aid agencies and recipients with the same incentives to teach, learn, and achieve results as are automatically created by the invisible hand?

Can aid flows be monitored as well as private flows?

It could be argued—though it’s hard to prove—that many private flows are monitored better than official aid flows. In some cases the monitoring is inherent: a migrant’s remittances to his family back home can be monitored because the personal relationship is so close. (And some Mexican migrants open store credit accounts for their relatives rather than sending cash, so they can check that the money is spent prudently.)

But most financial flows are flows of other people’s money. Aid agencies spend taxpayers’ money. Private banks lend depositors’ money. Multinational companies invest shareholders’ money. Inevitably, such money will be assigned with less care than the personal income of those who manage these flows—the bureaucrats, bankers, or managers.

What stops complete chaos? Competition and good governance.

Is an organization like the World Bank or United Nations Development Programme governed less well than a publicly listed private company? Evidently not, if the company is Enron or Parmalat. Yet companies will always have a governance edge over governmental organizations: investors and depositors have a wide choice on where to put their money, which sharpens the pressure to offer excellent corporate governance and increases the returns to analysts and rating agencies that review that governance. Given sufficient competitive pressure, the market should deliver good corporate governance: Enron went bankrupt; aid agencies never do. Since aid agencies are subject to neither intense competitive pressure nor scrutiny from analysts and rating agencies, maintaining the highest standards of corporate governance therefore requires all the more effort and goodwill.

Table Which financial flows have the key qualities?

Qualities	Example
Benevolent, monitored, smart	Ideal development assistance
Indifferent, monitored, smart	Foreign direct investment
Benevolent, unmonitored, smart	Careless development assistance
Benevolent, monitored, dumb	Workers’ remittances
Indifferent, monitored, dumb	Bond market finance
Benevolent, unmonitored, dumb	Populist emergency aid

Can aid flows be as smart as foreign direct investment?

The smartest finance, in the right circumstances, is foreign direct investment. Many studies confirm this. Consider the manufacturing of car seats. Sutton (2005) finds that multinational joint ventures in India can bring error rates down quickly: one new factory moved from 2,085 errors per million to 65 in just three years. Domestic firms in India, emulating the multinationals and using knowledge gained as their suppliers, can also make dramatic progress: one manufacturing firm eliminated 99 percent of errors within five years of adopting cutting-edge techniques.

There is no mystery why foreign direct investment sometimes provides such tremendous expertise:

- The investing firm has strong incentives to improve the expertise of local workers, suppliers, regulators, and partners.
- Workers and suppliers have a lot to gain (high salaries, lucrative contracts), and multinational auto manufacturers are careful to monitor closely and reward excellence.

The largest alternative source of smart finance is development assistance coupled with technical assistance, largely advisory services and training. For example, a loan to fund construction of a new electricity grid and power stations would come with advice on the scale and design of the new grid and on the regulatory framework needed to make it run efficiently. The potential of smart, well-monitored, and benevolent development assistance is huge. But development assistance may not create the same incentives as foreign direct investment—for the recipients or the technical experts—to make the lessons stick.

The strongest incentives to learn arise if the flow of money will be cut off for those who fail to do so. This condition may apply for a supplier of a multinational corporation, but not typically for an aid recipient. Foreign direct investment is automatically subjected to a tough market test, but aid projects are not. If aid agencies want a tough test, they have to create it themselves using more rigorous evaluation (such as the randomized trials done by the pharmaceutical industry) or rigorous benchmarks of the quality of a country's governance (such as the World Bank's Country Policy and Institutional Assessment, or CPIA).

The strongest incentives to teach arise if repayment is impossible unless the technical assistance works (or if recipients pay directly for the advice). This condition may apply for aid agencies that make nonsovereign loans and equity investments or stand-alone consulting arrangements, but an aid agency making a sovereign-guaranteed loan knows that the likelihood of repayment has little to do with the success of the project.

Remedies

Aid agencies strive to provide aid that is carefully monitored and bundled with high-quality technical assistance, but more can always be done. Aid flows could be as well motivated and as tightly monitored as the remittances workers send back to their families—and could carry the expertise of foreign direct investment, the kind that can induce a hundredfold reduction in errors in just a few years in India. How could that happen?

Aid agencies should learn from the distinctive advantages of different private flows. Remittances seem to be well aimed and well timed. Radical proposals to give aid vouchers to the poor are usually dismissed—but these aim at providing purchasing power and choice to those who need it most, when they need it, with a minimum of waste and misdirection.

Foreign direct investment has even more to teach aid agencies. First, the standards of governance required to make such investments work are high and rising. Foreign investors are mercilessly unforgiving of poorly governed countries and partners. Aid agencies, if they wish to help the poorest, cannot be so choosy, but they can seek the highest standards of governance

for themselves—which implies embracing growing competition in the industry (see Note 277 in this series) and encouraging searching evaluations by disinterested rating agencies.

Second, foreign direct investment often creates projects dependent on rapid technology transfer. Everyone involved has a strong incentive to learn or to teach as appropriate, and a stern market test weeds out those who do not. Aid projects are not subject to any such test unless the agency decides to use rigorous evaluation. Sovereign loans for aid projects are typically repaid regardless of the quality of the technical assistance; nonsovereign loans and equity investments provide sharper incentives to ensure that appropriate lessons are learned.

Unfortunately, the most desperate situations, where we would want to help the poorest with grants and free advice, are also those where it is most difficult to maintain the appropriate disciplines and make aid effective. But one possibility is to give performance-based grants (see Note 270).

In all cases aid agencies can raise their game by providing better information about how aid is being spent and embracing competitive pressures. High-quality evaluation of projects and of aid agencies, combined with the political will to deliver better aid, should in a competitive environment improve the governance of aid agencies and the quality of the aid they deliver. In a well-functioning market for aid, aid agencies can perform their roles even better than the invisible hand.

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