

private sector

The Market for Aid

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



Understanding Aid by Looking Forward and Looking Back

The market for aid is changing. These days donors use a far greater array of instruments than in the past, and operate in a context of far larger private financial flows. Poor countries are growing richer, but there are legitimate doubts about whether the aid industry deserves credit. Measurement of the effectiveness of aid has not yet produced some of the results that would really help, such as credible ratings of aid agencies or rigorous randomized trials of specific programs. This information might pull the aid debate away from minimizing the costs of aid competition and toward trying to maximize the benefits: widespread experimentation and innovation.

The aid industry faces a very different task today than it did in the reconstruction efforts following World War II. The complexity of development policy has grown as more players have become involved, the focus has shifted from the state to the market, and development thinking itself has grown more subtle and less sure of itself.

The industry has gone through many changes of ideology. Yet as ideas have waxed and waned, one thing has remained constant: new aid agencies are always being established, while old ones are never shut down (see Note 277 in this series). The new agencies have appeared for three reasons: because of a new perceived need (Global Fund to Fight AIDS, Tuberculosis, and Malaria), because of new recipients (European Bank for Reconstruction and Development),

and because of new donors (China, Slovenia, and Thailand). The reputations of these disparate aid agencies vary, but efforts to measure their performance have so far been rudimentary (see Note 278).

The proliferation of aid agencies creates a challenge for each to find a useful niche. This challenge is intensified by the fact that many of the aid industry's clients are no longer suitable for the traditional lending operations of the World Bank and similar agencies. Some, like the Republic of Korea, have become too rich for aid to be appropriate. Others, like India, have excellent access to capital markets but millions of poor people in isolated areas who are not fully benefiting. And still others, like Haiti, are under such stress that it is hard to know how to give aid

effectively. Market-rate loans to central governments no longer seem to be the right tool for such cases. The industry is under pressure to respond.

No doubt this headache for the aid industry is in part a symptom of good news: economic growth has been far higher than predicted in 1945, the share of the world's population living in extreme poverty fell by nearly half between 1981 and 2001, and there is no obvious sign that these trends are stopping.

Part of the headache, however, is caused by the troublesome cases. Africa presents the big task for the aid industry—plagued by seemingly innumerable problems. Yet even here there is some hope, as democracies have been established in Nigeria, South Africa, and many smaller countries too. And while poverty reduction remains a key focus for the aid industry, new challenges are appearing in places like the Middle East, the Caspian, and Latin America: fragile democracies, failed states, drugs, crime, and terrorism variously afflict different countries in these regions.

The private sector and poverty reduction

The success of China, India, and the East Asian tigers, coupled with the failure of the Soviet Union, has helped build a consensus that private firms produce the new jobs and economic growth essential for poverty reduction. So, if the aim is pro-poor growth (and it is), there is no substitute for bringing a better business climate to places where poor people already live or can easily move.

Yet free trade, sound money, privatization, and deregulation are helpful but not sufficient to promote growth. The private sector will struggle without supporting institutions, including the protection of property rights. The consensus supports a good investment climate, but defining exactly what that means or how to get there still poses a challenge.

To add to this complexity, the development industry and investors confront an increasingly long list of demands for better social and environmental standards. These demands come both from Western nongovernmental organizations (NGOs) and from workers, governments, and NGOs in developing countries. The grow-

ing demands are not surprising, in part because globalization generates a sense of connection to what is happening elsewhere in the world, and in part too because rich and poor countries alike are getting richer and so demand more than the simple satisfaction of basic needs.

So we should not be too surprised to see a “race to the top,” contrary to popular expectations. That is indeed what seems to be happening. Air quality standards in China, Brazil, and Mexico are improving—and that matters, since these countries together account for nearly two-thirds of foreign direct investment into developing countries (Dasgupta and others 2001). But the “race to the top” poses dilemmas for investors and aid agencies alike: to respond to competing, even conflicting demands is no simple matter (see Note 271).

More choices for funding

Aid agencies no longer offer the basic package of loans and grants to governments that they did in the 1950s. The range of instruments has expanded to cover concessional loans, dispute resolution, performance-based grants, loans to the private sector, insurance and guarantees for private investors, equity investments in the private sector, loans to subnational governments such as municipalities, and an array of stand-alone technical assistance. The most notable trend in recent times has been a shift from concessional loans to grants, mostly from bilateral agencies but increasingly from multilateral ones (see Note 276). All this adds up to a much richer menu of choices for development finance, with more options for sharing risk and more effective operations.

The choices do not end there. There are plenty of financing options beyond the new offerings of the established aid agencies. We can expect aid agencies to proliferate further, with the new agencies offering innovative new approaches or pursuing new priorities. The private sector can provide sovereign debt at a cost similar to that of official debt, though developing countries appear to prefer the long maturities of official debt (see Note 289). In any case much of the money flowing to poor countries is no longer sovereign debt (see Note 290). Gross unofficial flows to developing countries, at

US\$380 billion in 2002, are more than twice the flows to governments. Some of these flows are not investments but gifts: in 2002 remittances from migrant workers were US\$98 billion and even private charitable giving was around US\$15–20 billion. These numbers are substantial when set alongside official development assistance of US\$70 billion.

Is fragmentation of aid a problem?

Developing countries today have many advantages compared with those of 30 or 40 years ago, with more market access, better risk sharing instruments to entice capital, and many more choices of loans, equity, and grants. Yet the aid industry is increasingly concerned about the costs of a fragmented industry.

For some countries these costs are illusory. India, for example, has chosen to work with six preferred partner agencies. Some countries prefer to use private capital markets. Others have taken advantage of multilateral lending to restructure their debt portfolios. For these countries choices simply mean opportunities.

But for other countries competition between aid agencies has not brought opportunity. Some “donor darlings” have been swamped with grants, often in the form of dozens or even hundreds of different projects (see Djankov, Montalvo, and Reynal-Querol 2005 for preliminary analysis of how this might reduce the effectiveness of aid). The institutions of such countries may even have been damaged by these aid flows (see Note 291). Fragile and failed states too are likely to make choices that fail to benefit their people—if they have any government to make choices. Here, competition does not seem to have the beneficial effects we would expect.

With some countries graduating from any need for aid and others faltering so badly that it is hard to provide aid, fewer clients are being pursued by more competitors. How do we make the most out of the situation? While many policy approaches have focused on minimizing the costs of competition, we should not forget to try to maximize the benefits.

For a market for aid to work well, we need better information about what works. The response to the Asian tsunami at the end of 2004 showed that there is no lack of willingness to help; what

holds back donors, both private and public, is a lack of conviction that the money will be well used. Better evaluation of projects and agencies would help make that case. At least as important, it would improve the quality of the aid we give, by allowing us to do more of what works and less of what does not. Informed choice, exercised by donor governments and individuals, and by recipients, may turn out to be a powerful force for raising the quality of aid. Without information, mere choice will not be enough.

Recently researchers have been asking questions about donor performance and aid effectiveness (see Notes 278 and 292). But research has not yet produced some of the results that would really help. The innovations in evaluation seem to be coming from NGOs or foundations, but these institutions are unlikely to take on the task of evaluating the aid industry. Some NGOs publish ratings of donor performance, but they do not provide the detailed assessment of individual agencies required to make competition work well. This lack of independent, rigorous evaluation is very worrying.

Of course, one reason for the limited appetite for evaluation is that geopolitics still matters: aid to many places is determined by political considerations, not development needs. This will continue to be true as new donors such as China enter the aid industry. Nevertheless, it seems certain that with more choices available, taxpayers, private givers, recipients, and others are all going to ask increasingly keen questions about the performance of different aid agencies.

Getting the best out of competition

The world is a complicated place politically, socially, and economically. It is not about to become simpler. The aid industry too is growing more complex, more fragmented, and more competitive. That is frightening to some, but we should not be frightened. A simplistic, monolithic aid industry, however “harmonized,” cannot deal with a complex world. The challenge is to get the best out of both harmonization and competition.

In some ways the tension between harmonization and competition is reminiscent of the old development debate between “balanced

growth” and “unbalanced growth.” Advocates of balanced growth argued for coordinating infrastructure, education, and complementary industries in a “big push” to achieve growth. That sounds reasonable, of course—the challenge is to make it happen without the big push becoming a big flop. The bigger the push, the bigger the risk.

Unbalanced growth is a chaotic process in which shocks are painful but shake up the established economic order and allow unexpected new businesses to thrive. Since chaos is what we can expect anyway, one should work out how to take best advantage of it.

Harmonization, like balanced growth, is appealing but very hard to get right. A competitive aid industry will be chaotic and will always be trying out new things, and in the process aid agencies will make many mistakes. But if the market for aid works well, with rigorous testing of new ideas and a willingness to pull the plug on failures, it will be productive chaos. In fact, freedom to fail should ideally be built into the structure of aid projects and aid contracts.

Imagine a messy world of new experiments and many small failures, overshadowed by the ability of good ideas to flourish. That is a description of any successful economy in the modern world. It could, and should, describe the aid industry too.

References

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