Virtue should be granted its reward;

DEBATE/Instead of reducing foreign aid to an all-time low, donors should target it at developing world's well-governed countries, argues Joseph Stiglitz

BYLINE: Joseph Stiglitz

FOREIGN aid is at an all-time low. More than 50 years after the "aid era" began with the Marshall Plan in 1947, development assistance has tumbled to less than a quarter of 1 per cent of major donors' GNP, the smallest share ever.

Among the reasons for this drop, one stands out: the assumption that aid does not work very well.

It is true that aid has been an unmitigated failure under some conditions, but it has been a spectacular success in others.

A new World Bank report, Assessing Aid, aims to show how development assistance can be used more effectively, by understanding why aid works well in Bolivia or Uganda, for example, but has little or no impact in Nigeria or Zambia.

Rather than starting with the question "does aid work?", Assessing Aid begins with "when does aid work best?" The answer is needed urgently. Despite great strides in poverty reduction in the past 50 years, more than a billion people still live in extreme poverty - on less than $ 1 a day. Even more lack basic services such as clean water, sanitation, electricity and schooling.

This new focus on the circumstances under which aid works changes the nature of the debate. Rather than arguing for more aid or less assistance, Assessing Aid suggests that donors should concentrate on providing more effective aid.

Defining effective development has become more complicated in recent years. At the same time that our aid budgets have diminished, our aspirations for aid have expanded. Fifty years ago, development focused on one objective: increasing gross domestic product. Today, we set broader goals. We seek to increase living standards, improve health and education, and maintain a healthy environment. We also want development to
be equitable and democratic, so that all of society can participate in decision-making and all groups can reap the fruits of development.

Assessing Aid finds foreign aid has the strongest impact on growth in developing countries with sound policies and institutions - for example, macroeconomic stability, openness to trade, secure property rights, absence of corruption, to name a few important ones. In countries with poor policies - that is, with poor incentives for production - financial aid has a much weaker impact. To maximise poverty reduction, financial aid should favour countries such India, Ethiopia and Uganda, which are poor and have sound economic policies. Because nearly 7 per cent of the world's poor live in countries with sound policy environments, targeting assistance to these countries would have a tremendous impact on global poverty.

Yet in 1996 donors gave only small amounts of assistance to countries with good policies. Reformist countries such as Ethiopia or Uganda received less aid per capita than poor countries with weak policies. Rather than rushing in alongside policy reforms, aid seems to taper out as reforms are adopted.

OPPONENTS of foreign aid may argue that Assessing Aid, by exploring how to use aid more effectively, gives licence to donors to decrease their aid budgets. In fact, the report encourages donors to contribute more aid where it will have the most impact. Increasing aid to countries which can use it effectively has very real consequences for the poor. For example, allocating £6 billion in aid under the current system would lift about 7 million people per year out of poverty. But if the same amount of money were targeted at poor countries with sound economic policies, the number of people to leave the ranks of the poor would be about 25 million. In good-policy environments, aid is a high-return investment which permanently raises income and reduces poverty.

So why don't countries end foreign aid to poor countries with bad policies? One reason is that donors hope that aid will induce policy reform. Unfortunately, money has proved to be ineffective in generating reform. Zambia is a typical example. Foreign aid increased steadily - reaching 11 per cent of real GDP in the early 1990s. Policy, however, got worse throughout this period. Despite a series of loans from the World Bank and the IMF, there was no substantial improvement in policy until a new government came to power in the early 1990s.

The message that aid has the greatest impact in countries with good policies should not be interpreted to mean that donors cannot or should not help countries with less than perfect policies. On the contrary, there is a great deal the donor community can do to help the poor and to spur reform.

IN THESE difficult environments, effective assistance must encompass more than just money or projects. It must also focus on ideas or knowledge creation. The ideas side of aid is critical for helping countries reform and helping communities provide most effectively public services such as education, health, and water.
The challenge for donors is how to design the best combination of money and ideas for individual countries.

Vietnam is one success story. It initiated a homegrown reform programme in the 1980s. Sweden and the United Nations Development Programme provided policy advice and by 1998 the poverty rate had fallen to 30 per cent of households from 55 per cent in 1992.

The country's experience is part of a worldwide trend in the 1990s toward economic reform that has enabled a large number of countries to use financial assistance to reduce poverty. It is tragic that the volume of aid is declining at precisely the time that the environment for effective aid is improving. On the other hand, it remains true that donors could do a better job of allocating aid.

Aid cannot accomplish goals by itself. It can only help governments and societies to pursue their objectives. Even the best designed assistance cannot succeed if it is being given to governments indifferent to, or incapable of, helping the poor.

But aid can spur development. When aid is used to champion reform at the local and national level, to create the knowledge necessary for effective development and to engage civil society in the reform process, it can improve dramatically the lives of the poor.

*Joseph Stiglitz is senior vice-president and chief economist of the World Bank in Washington, DC*