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Targeting aid: what the World Bank has (not) achieved

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revised
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**Targeting Aid: What the World Bank Has (Not)
Achieved**

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Targeting Aid: What the World Bank Has (Not) Achieved

Abstract

In a report presented at the UN Conference on Financing for Development in March 2002, the World Bank claims that the effectiveness of its financial aid has improved substantially by targeting aid at poor developing countries pursuing sound economic policies. This paper argues that the World Bank's success story rests on a weak empirical foundation. The evidence does not support the view that poverty concerns and policy assessments dominated the distribution of World Bank financing in the 1990s. We conclude that the task of improving the allocation of aid is far from being accomplished. Finally, we discuss some implications of our findings for the future role of the World Bank in development financing.

Keywords: financial aid, World Bank, International Development Association

JEL classification: F35

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I. INTRODUCTION

A recent World Bank report on the role and effectiveness of foreign aid (World Bank 2002), presented at the UN Conference on Financing for Development in Monterrey, Mexico, in March 2002, seems to have turned the tide in favor of more aid. Prior to this conference, the US administration, notably treasury secretary Paul O'Neill, insisted on aid having helped little to spur economic growth and alleviate poverty in recipient countries; calls for more aid were sharply rejected (*The Economist* 2002a). The World Bank confronted the sceptics with empirical evidence showing that, in contrast to generalized verdicts, foreign aid has worked when allocated to poor countries pursuing sound economic policies.¹

Yet, it came to almost everybody's surprise that President Bush, in his address delivered at the Monterrey meeting, outlined a new approach of the United States to foreign aid which is largely in line with the World Bank's reasoning. President Bush announced to increase US aid by US\$ 5 billion per annum (i.e., by 50 percent) until 2006, "exclusively for countries with good governance, investing in health and education and encouraging

¹ The report draws on earlier research, e.g. by World Bank (1998), Burnside and Dollar (2000) as well as Collier and Dollar (2001).

economic freedom" (*The Economist* 2002b). Shortly before, EU ministers had agreed to raise European aid from an average of 0.33 percent of GNP to 0.39 percent of GNP. The World Bank report appears to have prompted politicians to join in "a feast of giving" (*The Economist* 2002b).

Unexpected generosity of aid donors was probably not only because the World Bank could draw on previous findings suggesting that aid works under favorable circumstances. The report went an important step further and claimed that recent aid has actually been spent in accordance with these findings. It is pointed out that the donor community as a whole has improved the targeting of aid; in contrast to the early 1990s, countries with better policies received substantially more aid per capita (US\$ 29) in the late 1990s than countries with poor policies (US\$ 16). Moreover, the report portrays the World Bank as a frontrunner in allocating its own aid to where effectiveness is reasonably expected to be high:² "Even in 1990, much more IDA funding went to the good-policy countries (\$ 4.7 per capita) than to the poor-policy countries (\$ 2 per capita). By the late 1990s, targeting had improved still further: good-policy countries now receive \$ 6.5 per

² Note that overall financing by the World Bank consists of highly concessional funding by the International Development Association (IDA) and of lending at market related terms by the International Bank for Reconstruction and Development (IBRD).

capita, compared with \$ 2.3 per capita in poor-policy countries ... IBRD (nonconcessional) lending also goes primarily to countries with good policies and institutions" (World Bank 2002: xix).

The contention that "aid allocation has improved dramatically in recent years" (World Bank 2002: 70) may have convinced previous sceptics that it was high time to offer more aid. However, the few observers who remained reluctant to take official numbers for granted³ may have a point. As shown below, the World Bank's success story rests on weak empirical foundations. The widely quoted figures on per-capita aid are highly sensitive to the treatment of outliers (Section II). The distribution of World Bank financing in the 1990s was largely driven by the institution's contribution to financial rescue packages for some emerging markets, rather than having been dominated by poverty concerns and policy assessments (Section III). Regression results suggest that little has changed so far in targeting aid at poor countries with good policies (Section IV). All this leads to the conclusion that the task of improving the allocation of aid is far from being accomplished, which has important implications for the future role of the World Bank in development financing (Section V).

³ For example, Republican Congressman Jim Saxton announced that the World Bank's allegations will be checked with scrutiny in US Congress (Elliesen 2002: 125).

II. MISLEADING AVERAGES OF PER-CAPITA AID

The World Bank is rather imprecise in spelling out the statistical details of its calculations. The sample of countries is not given, and it is not specified whether the report refers to (gross) disbursements or net flows (disbursements minus principal repayments) of concessional IDA financing and market-related IBRD lending. In the following, we principally use net flows. In addition, we present calculations based on gross disbursements where net flows may provide a distorted picture. This applies to IDA in particular. Various developing countries which are relatively advanced and, hence, no longer eligible to IDA financing, report negative net IDA flows due to principal repayments of earlier IDA loans. These countries are excluded from the sample when assessing the distribution of gross disbursements. We follow the World Bank in taking its Country Policy and Institutional Assessment (CPIA) as a yardstick of good versus poor policy.⁴ The income status of recipient countries and the incidence of absolute poverty is measured by GNP per capita (purchasing power parity)

⁴ The range is from 1 (very poor) to 5 (very good). We use the classification as published in Collier and Dollar (2001: Table 3). The fact that only one CPIA observation was available to us limits the subsequent evaluation in some respects (see below).

and the share of the population living on less than US\$ 2 per day, respectively.⁵

The World Bank considers aid flows to recipient countries in per-capita terms, in order to show that its financing patterns have increasingly been shaped by poverty concerns and policy assessments. However, it proved impossible to figure out exactly how the World Bank arrived at the result that "good-policy countries now receive \$ 6.5 per capita, compared with \$ 2.3 per capita in poor-policy countries" (World Bank 2002: xix) from IDA. Apart from not providing information on the sample and flow items on which calculations are based, it is unclear what exactly is meant by "the late 1990s". We interpret this as 1997–1999, and relate the annual average of IDA disbursements in this period to the recipient countries' population in 1998. In this way, we arrive at a sample of 58 IDA clients, for which per-capita flows in 1997–1999 and the CPIA-classification are listed in the Appendix Table.

⁵ GNP per capita is from World Bank, World Development Indicators, CD-RoM; poverty incidence is taken from Collier and Dollar (2001: Table 3).

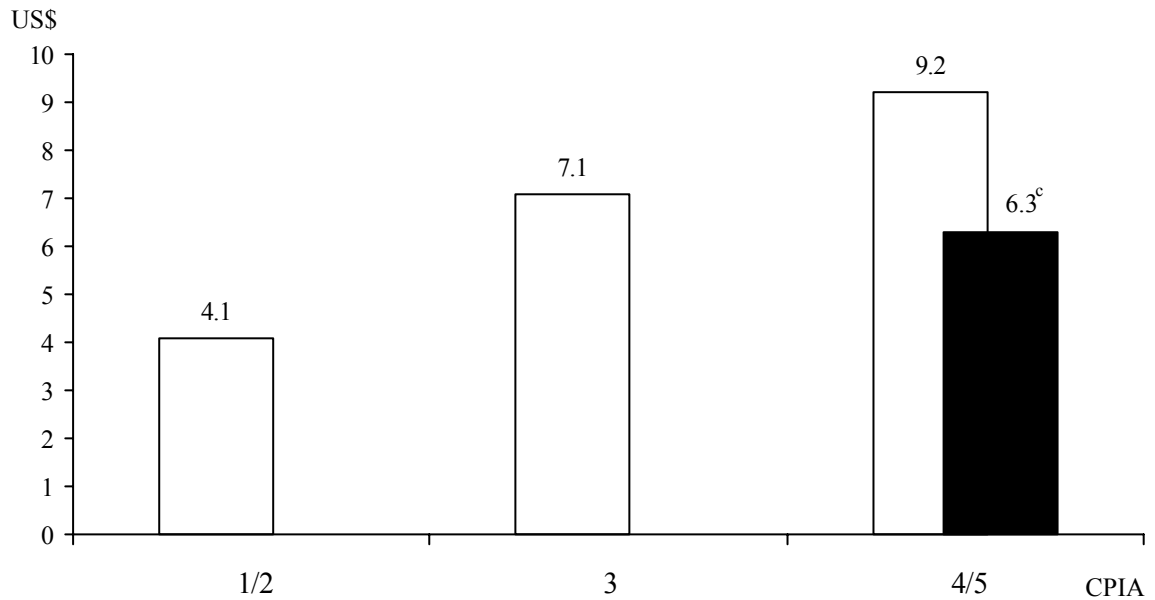
Average per-capita flows for countries belonging to different policy categories are presented in Figure 1.⁶ The averages given there are higher for both, poor-policy countries and good-policy countries than the above mentioned averages in World Bank (2002: xix).⁷ However, this difference has no major bearing for the World Bank's essential message that IDA financing favors good-policy countries by a wide margin over poor-policy countries.

The reason why the World Bank's contention of an appropriate targeting of IDA financing is rather shaky is that group averages as reported above are seriously misleading, independent of whether averages are based on gross disbursements or net flows. Some outliers with extremely high per-capita aid from IDA in the late 1990s (see Appendix Table) distort the picture, a problem ignored by the World Bank. Cape Verde and Honduras clearly

⁶ Countries with very poor and poor policies (CPIA 1 and 2) are grouped together, as only three countries belong to CPIA 1. For the same reason, we combine CPIA categories 4 and 5 (see Appendix Table).

⁷ This difference may be because the World Bank considers net flows, instead of gross disbursements. However, we could still not reproduce the World Bank figures when we calculated averages on the basis of net flows. This suggests that our sample differs from the World Bank's. For example, the World Bank may have included countries with low or zero flows from IDA, which we had to exclude due to lacking observations on CPIA.

Figure 1 — Higher Per-capita Aid from IDA to Good-policy Countries?
(average gross IDA disbursements^a per capita according to
policy rating, 1997–1999^b)



^aBy considering gross disbursements, we exclude countries no longer eligible to IDA financing. – ^bPeriod averages. – ^cExcluding Cape Verde and Honduras.

Source: Appendix Table.

stand out with per-capita flows of US\$ 44 and US\$ 23, respectively.⁸ If only these two countries are excluded from the sample, the group average for countries in CPIA 4 and 5 declines from US\$ 9.2 to US\$ 6.3. Countries with good policies (CPIA 4), except Cape Verde and Honduras, received only US\$ 5.2 on average in 1997–1999. This was significantly less than the average for countries with moderate policies (CPIA 3), and just 27 percent more than the average for countries with poor and very poor policies (CPIA 1 and 2).

Group averages are still more sensitive to the treatment of outliers, if calculations are based on annual observations (as done by the World Bank in some instances at least). The distribution of IDA disbursements in the latest available year, 1999, is in line with the World Bank's success story only if outliers are ignored: All recipients in CPIA category 4 (good policy) got 2.3 times as much per-capita aid as recipients in CPIA category 2 (poor

⁸ Due to Cape Verde's small population (0.4 million in 1998), per-capita aid was extremely high even though absolute annual flows hardly exceeded US\$ 20 million at the end of the 1990s. Aid to this country was mainly in three areas: energy and water sector reform, privatization and regulatory capacity building, and education and training (see the project documents on Cape Verde available from <http://www.worldbank.org/html/extdr/regions.htm>). Honduras received exceptionally high aid from IDA in 1999 (US\$ 273 million). This was primarily a reaction to the hurricane Mitch in October 1998, which hit Honduras particularly hard (see World Bank Report No. PID 7193 under the above internet address). It can safely be assumed that emergency relief to Honduras would also have been granted if the country's policies had not been rated good.

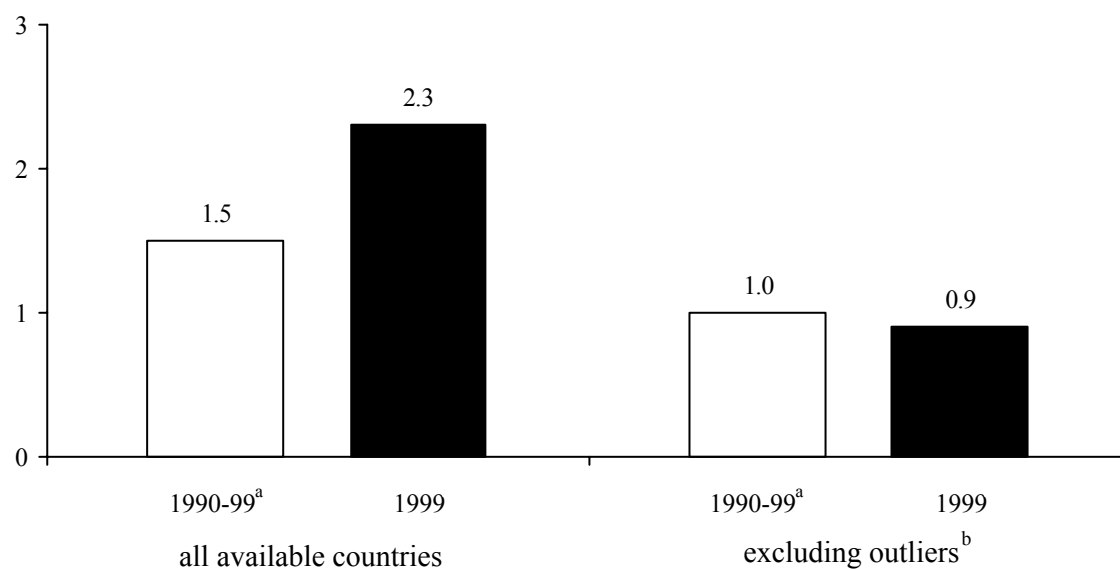
policy). Once Cape Verde and Honduras are excluded, the remaining (13) countries with good policies, on average, received just US\$ 3.8 per capita in 1999. This was about half the per-capita aid granted to countries with moderate policies (US\$ 7.3), and even less than the average for countries with poor policies (US\$ 4.3).

Furthermore, the World Bank's contention that the targeting of IDA financing has improved most recently rests on a weak foundation. True, the ratio of per-capita aid received by countries with good policies (CPIA 4) to per-capita aid received by countries with poor policies (CPIA 2) was significantly higher in 1999 than before, if group averages are not corrected for countries with exceptionally high disbursements (Figure 2). Once this correction is made, the ratio drops dramatically; and it is no longer true that the ratio increased in the course of the 1990s.

In summary, the World Bank's success story is extremely sensitive to the treatment of a few outliers in terms of per-capita aid from IDA. Success or failure in targeting aid should not be judged on arbitrary averages of per-capita aid. In order to avoid such distortions, we turn to the distribution of World Bank financing in absolute terms in the subsequent section. Moreover, we extend the discussion by analyzing World Bank lending at

market related terms in addition to IDA disbursements.

Figure 2 — Good-policy Countries Favored at the End of the 1990s?
(ratio of gross IDA disbursements per capita, CPIA 4-countries to CPIA 2-countries)



^aPeriod averages. — ^b1990-1999: Cape Verde and Guyana; 1999: Cape Verde and Honduras. All three countries belong to CPIA 4 and received exceptionally high IDA disbursements.

Source: World Bank, Global Development Finance 2001, CD-ROM; Collier and Dollar (2001:Table3).

III. WHAT EXPLAINS THE DISTRIBUTION OF WORLD BANK FINANCING?

In the following, we evaluate the allocation of absolute aid flows in the 1990s. The proposition that World Bank aid has been focused increasingly

on poor recipient countries pursuing development friendly policies is checked by comparing annual averages of aid in the first half and in the second half of the 1990s. This exercise reveals that recent changes in the distribution of World Bank financing were primarily due to the institution's involvement in providing emergency loans to some major emerging markets in financial distress, rather than poverty concerns and policy assessments.

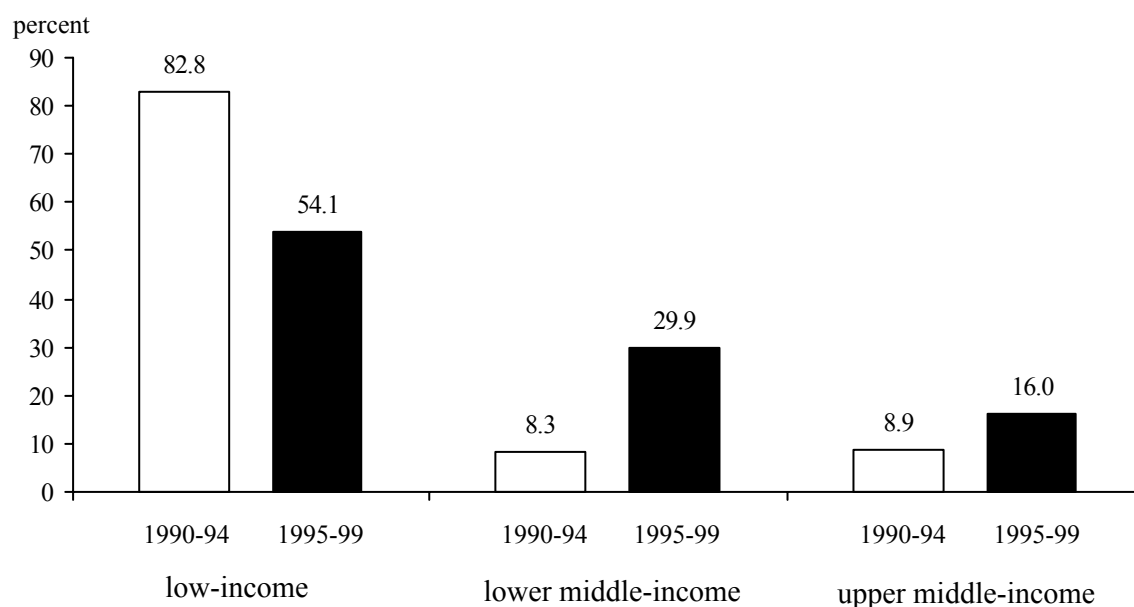
Figure 3 shows that low-income countries received a substantially lower share of total (net) World Bank flows (IDA plus IBRD) in the second subperiod than in the first. The corresponding increase in the share of middle-income countries is mainly because of heavy IBRD lending to some crisis countries.⁹ It is only when net flows to seven emerging markets suffering financial distress in the 1990s¹⁰ are excluded from the sample that the bulk of World Bank financing (93 percent) was allocated to low-income countries in 1995–1999.

⁹ For example, IBRD lending (net flows) to Russia in 1995–1999 summed up to US\$ 6.2 billion. Korea received US\$ 6.5 billion in 1997–1999.

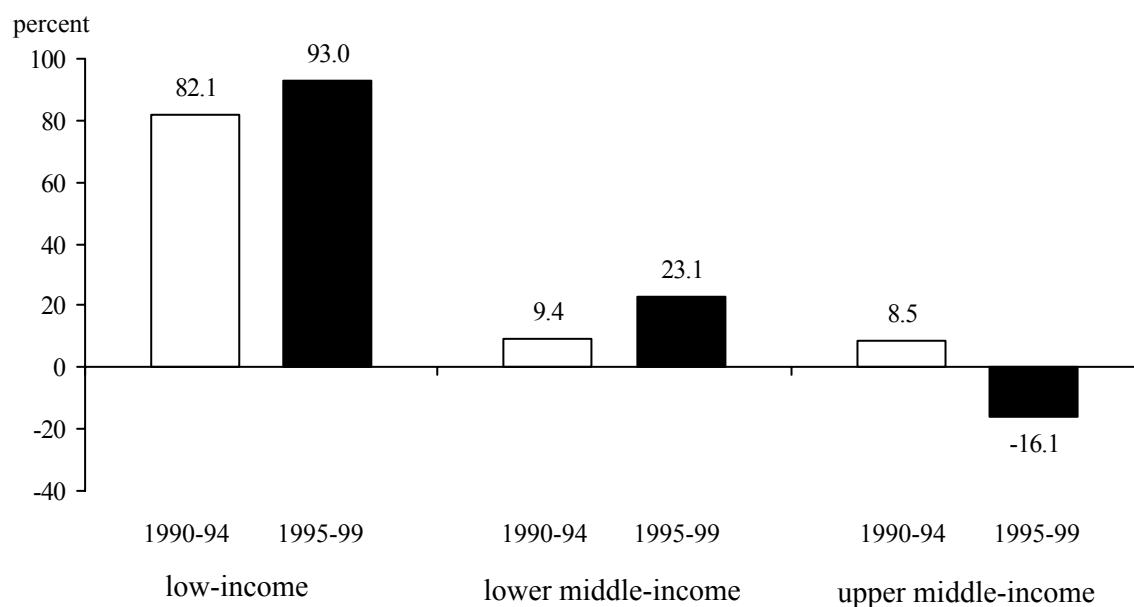
¹⁰ In addition to Korea and Russia, the list includes Argentina, Brazil, Indonesia, Mexico and Thailand; Malaysia is not considered here as no significant crisis financing was provided.

Figure 3 — Better Focus on Poor Countries?
(distribution of total net World Bank flows according to per-capita income^a)

a) all sample countries



b) excluding 7 emerging markets with financial crises



^aPeriod averages of net flows; classification of low-income, lower middle-income and upper middle-income countries according to World Development Indicators.

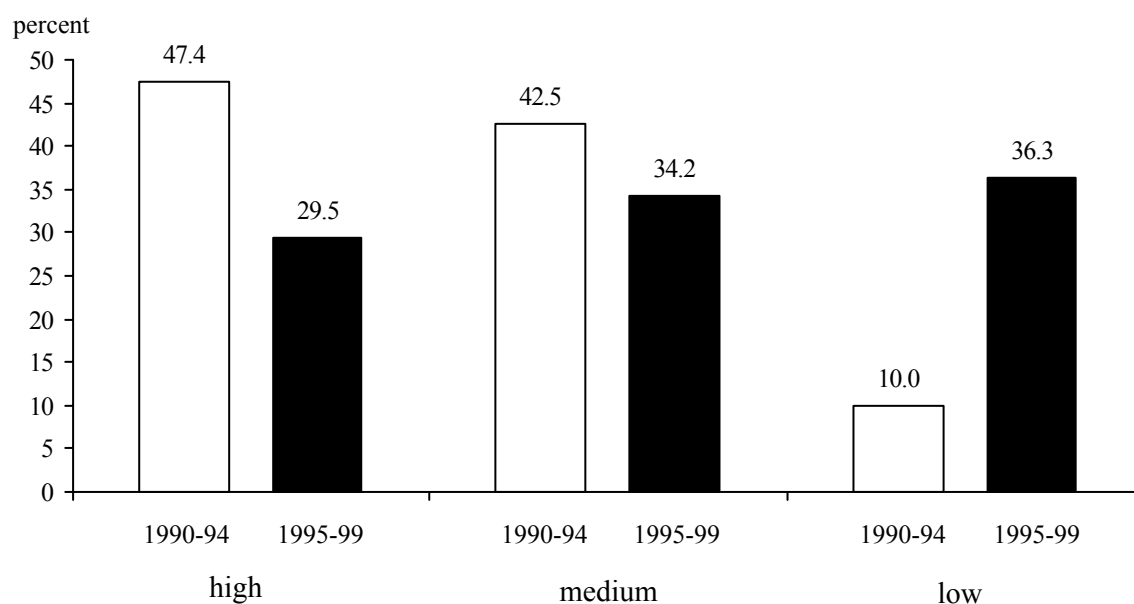
Source: World Bank, Global Development Finance 2001, CD-ROM; World Bank, World Development Indicators, CD-ROM.

It is debatable whether the World Bank should play a major role in crisis financing. This issue is taken up in Section V below, as it would be fairly heroic to assume that recent financial crises were exceptional and similar crises are unlikely to occur in the future. Here, it is important to note that World Bank financing in the second half of the 1990s hardly reveals a stronger focus on recipient countries with high incidence of absolute poverty, even when the above mentioned crisis countries are left out of account. According to Figure 4, countries with pervasive poverty received about half of total (net) World Bank flows in both subperiods. It is no longer surprising that their share declined significantly, if the overall sample is considered.

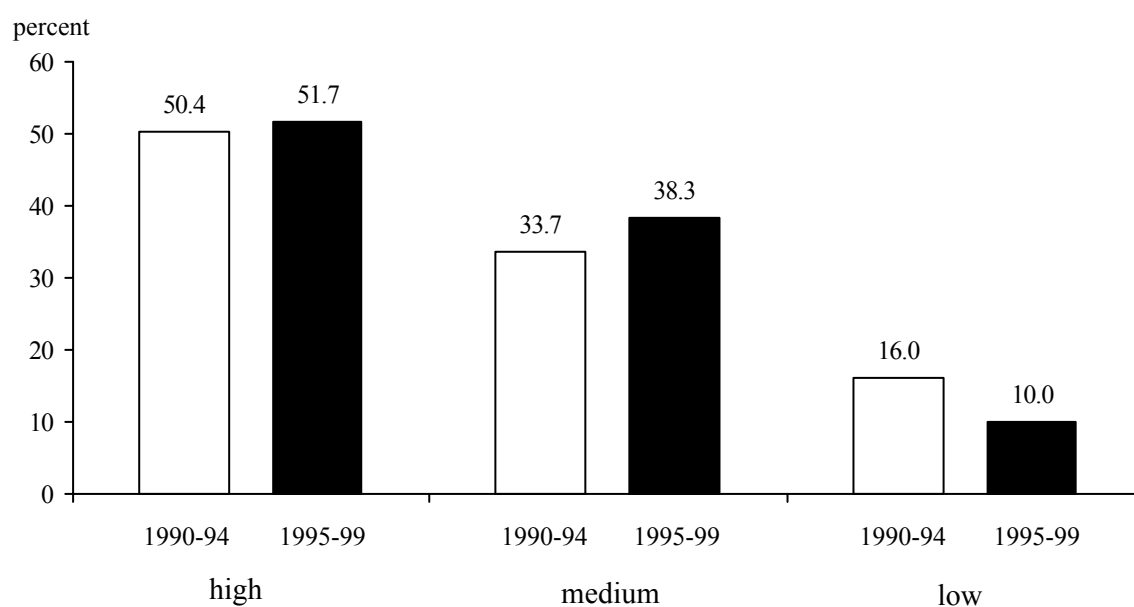
Given the aforementioned constraints on data availability concerning CPIA, we cannot compare the second half of the 1990s with the first half when it comes to the distribution of World Bank financing among recipients in different policy categories. Nevertheless, the evidence

Figure 4 — Better Focus on Absolute Poverty?
(distribution of total net World Bank flows according to poverty incidence^a)

a) all sample countries



b) excluding 7 emerging markets with financial crises

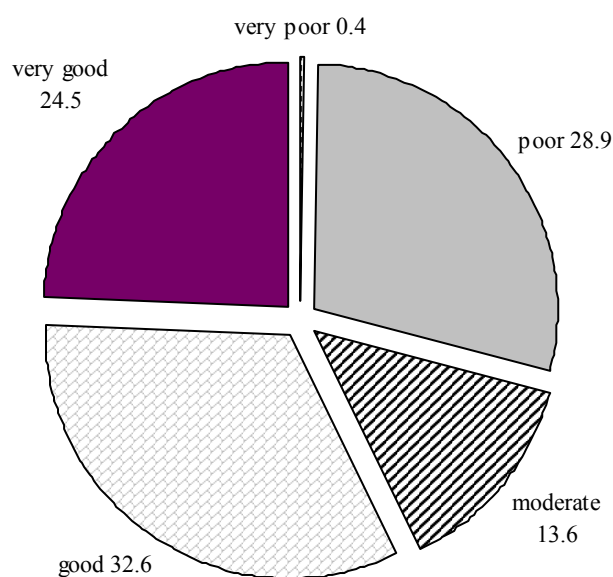
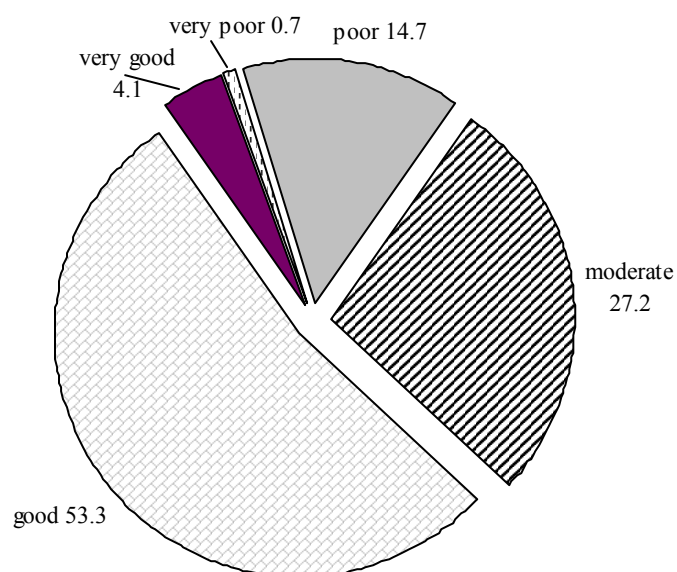


^aPeriod averages of net flows; poverty incidence, i.e. percentage of population living on less than US\$ 2 per day, as in Collier and Dollar (2001); low: up to 33 percent; medium: 34-66 percent; high: more than 66 percent.

Source: World Bank, Global Development Finance 2001 CD-ROM, Collier and Dollar (2001:Table3).

presented in Figure 5 indicates that there remains considerable room for improving the allocation of aid. Almost 30 percent of total (net) World Bank flows in 1995–1999 went to countries whose policies were rated poor or very poor.

Substantial financing of Russia was partly responsible for this high share. If all seven emerging markets with financial crises are excluded, the combined share of countries in policy categories 1 and 2 declines to 25 percent of World Bank flows to all remaining sample countries. At the same time, however, the combined share of countries in policy categories 4 and 5 (good and very good) declines from 57 percent to 52 percent; World Bank financing to countries with very good policies turns even negative. Hence, the allocation of World Bank financing still leaves much to be desired if emergency financing is left out of account.

Figure 5 — Focus on Countries with Good Policies^a?a) distribution of total net World Bank flows, 1995-1999^b (percent)b) distribution of gross IDA disbursements^c, 1995-1999^b (percent)

^aPolicy categories as in Collier and Dollar (2001). — ^bPeriod averages. — ^cWe use gross disbursements, rather than net flows, for IDA, in order to exclude countries no longer eligible to IDA financing.

Source: World Bank, Global Development Finance 2001, CD-ROM; Collier and Dollar (2001:Table3).

The combined share of countries with good and very good policies is very much the same (about 57 percent) for total (net) World Bank flows on the one hand, and IDA disbursements on the other hand (Figure 5).¹¹ Nevertheless, IDA disbursements appear to be better targeted than World Bank lending at market related terms, as the share of countries with poor and very poor policies in overall IDA disbursements is considerably lower. It is thus mainly with regard to World Bank lending that the distribution of aid conveys two related insights: First, the institution's participation in funding rescue packages for some emerging markets had an important impact on recent World Bank financing. Second, taking the World Bank's rhetoric on poverty and policy orientation seriously, the effectiveness of its financing could still be improved considerably by reallocating available funds.

IV. THE TARGETING OF AID: REGRESSION RESULTS

In order to better assess the targeting of World Bank aid, it seems appropriate to run some simple regressions in which both, the income status and the policy rating of recipient countries enter as independent variables. We use four

¹¹ For reasons stated above, Figure 5 relates to gross IDA disbursements. Yet, the distribution of net IDA flows is very similar to gross disbursements. Countries with poor and very poor policies received 15.4 percent of net flows, countries with moderate policies got 28.8 percent, and countries with good and very good policies received 55.8 percent.

different dependent variables: total net World Bank flows in per-capita terms and, alternatively, as percentage of the recipient countries' GNP, as well as gross IDA disbursements in per-capita terms and, alternatively, as percentage of the recipient countries' GNP.

The regression approach may be flawed in two respects. First, the two right-hand variables, the income status and the policy rating of recipient countries, may not be independent of each other. Collinearity might be expected if minimum standards of economic development were required to pursue sound economic policies. More plausibly perhaps, collinearity may result from poor policies going along with poor economic performance and, thus, lower per-capita income. As a matter of fact, the correlation between per-capita income and policy ratings turns out to be significantly positive. However, the correlation coefficient of 0.55 across all 106 sample countries is clearly below the "commonly used rule of thumb [which] is that a correlation coefficient between two explanatory variables greater than 0.8 or 0.9 indicates a strong linear association and a potentially harmful collinear relationship" (Hill et al. 1997: 173). A still lower correlation coefficient of 0.49 is achieved, if per-capita

income and policy ratings of the 57 recipients of IDA disbursements are considered.¹²

Second, for evaluating whether targeting improved in the course of the 1990s, the optimal approach would have been to run the regressions for the first half of the 1990s on the one hand, and for the second half of this decade on the other hand. We could not take this preferable route as the World Bank's policy rating (CPIA) in the first half of the 1990s was not known to us. This is why Table 1 compares regression results achieved for average flows throughout the 1990s with results achieved for average flows in the late 1990s (1997–1999). For both periods, we had to apply the CPIA rating as provided by Collier and Dollar (2001: Table 3).¹³ Consequently, we tend to underestimate the effect of

¹² It may also be noted that the R^2 s of various regressions reported below are fairly low. By contrast, serious collinearity is typically indicated by the combination of high R^2 s and low t-values. Furthermore, skipping the income variable in the regression does not result in significantly positive coefficients of the policy variable.

¹³ By contrast, per-capita income of recipient countries in 1995 entered regressions for 1990–1999, while per-capita income in 1998 entered regressions for 1997–1999.

Table 1 — World Bank Aid, Per-capita Income, and Economic Policy of Recipient Countries: Regression Results^a

Dependent variable ^{b/} time period ^c	Constant	Income ^d	Policy ^e	\hat{R}^2	number of observations
total World Bank financing					
- per capita, 1990-99	3.67* (2.26)	-0.00038 (-1.55)	0.47 (0.87)	0.004	105
- per capita, 1997-99	2.00 (0.77)	0.00008 (0.21)	0.68 (0.75)	-0.007	104
- percent of GNP, 1990-99	1.59** (5.50)	-0.00027** (-6.13)	0.08 (0.79)	0.30	103
- percent of GNP, 1997-99	1.18** (4.15)	-0.00023** (-5.43)	0.14 (1.46)	0.24	104
IDA financing					
- per capita, 1990-99	2.34 (1.27)	-0.00028 (-0.96)	1.54* (2.42)	0.07	56
- per capita, 1997-99	0.96 (0.38)	0.00018 (0.46)	1.51 (1.66)	0.07	54
- percent of GNP, 1990-99	1.86** (3.70)	-0.00032** (-4.06)	0.32 (1.82)	0.21	56
- percent of GNP, 1997-99	1.31** (2.81)	-0.00027** (-3.84)	0.41* (2.48)	0.19	54

^at-statistics in parentheses; ** (*) significant at 1 (5) percent level (two-tailed). – ^bNet flows in the case of total World Bank financing; gross disbursements in the case of IDA; both variables related to either the recipient countries' population (per capita) or the recipient countries' GNP (percent of GNP). – ^cPeriod averages. – ^dPer-capita income (PPP) of recipient countries in 1995 (for flows in 1990-1999) or 1998 (for flows in 1997-1999). – ^eAccording to the World Bank's Country Policy and Institutional Assessment as given in Collier and Dollar (2001); range from 1 (very poor) to 5 (very good).

Source: World Bank, Global Development Finance 2001, CD-RoM; World Bank, World Development Indicators 2000, DC-RoM; Collier and Dollar (2001: Table 3).

CPIA on average flows in 1990-1999, if the rating changed during the 1990s. Such a bias would work in favor of the World Bank's claim that the policy orientation of its financial aid has become stronger since recently.

Nevertheless, the regression results in Table 1 suggest that little has changed in the late 1990s as concerns the allocation of aid. Results turned out to be particularly weak for total World Bank financing:

- Measured in per-capita terms, all coefficients remain insignificant if the regression is run across all sample countries. In additional regressions, not reported in Table 1, we excluded the seven emerging markets with financial crises. For the restricted sample, the coefficients of the income variable become significantly negative, but the coefficients of the policy variable are still insignificant at the 5 percent level.
- As percentage of the recipient countries' GNP, total World Bank financing favored lower-income countries. But this relation did not become stronger in the late 1990s. The policy variable CPIA is insignificant for both periods considered.¹⁴

¹⁴ If World Bank financing is related to the recipient countries' GNP, regression results for the restricted sample (excluding the seven crisis countries) hardly deviate from regression results for the overall sample.

As concerns IDA disbursements, the coefficients of the income variable are similar to results for total World Bank financing. By contrast, IDA disbursements have at least some relation to the policy rating of recipient countries. Two out of four coefficients of CPIA are significant at the 5 percent level. The proposition of a stronger policy orientation of IDA aid in the late 1990s cannot be rejected, if disbursements are measured as percentage of the recipient countries' GNP.¹⁵ However, results achieved for IDA disbursements in per-capita terms are in conflict with this proposition. Taken together, the regression results underscore our earlier reasoning that the task of improving the allocation of financial aid is far from being accomplished.

V. THE FUTURE ROLE OF WORLD BANK FINANCING

In the report presented at the UN Conference on Financing for Development in Monterrey in March 2002, the World Bank contends that the effectiveness of its financial aid has improved dramatically by a redistribution of aid in favor of poor developing countries pursuing sound economic policies. A critical evaluation reveals that the World Bank's success story rests on a rather weak

¹⁵ The coefficient of CPIA is smaller, and significant only at the 10 percent level, when the regression is run for 1990-1999.

empirical foundation. In particular, our findings do not support the World Bank's claim that its financial aid has been well targeted at countries with good policies.

With regard to World Bank lending, poverty concerns and policy assessments seem to have taken second place to the institution's role in co-financing rescue packages for emerging markets. This raises a first question concerning the future of World Bank financing, namely whether this institution should continue to play this role.¹⁶ The major argument suggesting an affirmative answer is that financial crises have frequently aggravated poverty. The World Bank (2000b: 6) notes with respect to Asia that "the deep recession had pushed millions of East Asians below the poverty line." However, the findings of Dollar and Kraay (2000) are in contrast with the widely held belief that incomes of the poor fall more than proportionally during economic crises. Furthermore, it can be questioned on several grounds that emergency financing has been effective in alleviating poverty:

- Among the Asian crisis countries, for example, the incidence of absolute poverty in Indonesia was twice as high as in Korea (59 versus 30 percent of

¹⁶ Given the focus of our analysis in the preceding sections, the subsequent discussion is restricted to financial World Bank support granted to individual developing countries. Issues related to technical assistance and the financing of international public goods, in which the World Bank may play a relevant role in the future (Sachs 1999; Nunnenkamp 2002), are not addressed.

the population living on less than US\$ 2 per day). Nevertheless, Korea received World Bank funds of US\$ 6.5 billion in 1997–1999, compared with US\$ 0.9 billion in the case of Indonesia. The Philippines, where the incidence of absolute poverty was still higher than in Indonesia, reported negative net flows from the World Bank in 1997–1999, even though policies of the Philippines were rated good.

- Crisis-induced increases in absolute poverty in emerging markets notwithstanding, the available data suggest that poverty problems were much more serious in developing countries with lower per-capita income. The average share of the population living on less than US\$ 2 per day amounted to 72 percent in all sample countries with a per-capita income of less than US\$ 760 in 1998. The corresponding average for the seven emerging markets with financial crises was 35 percent. Hence, the World Bank's contribution to emergency financing involves a trade-off and may come at the cost of effective poverty alleviation. Assuming that World Bank resources are limited, emergency financing tends to divert resources away from where they are most needed.
- Another concern is that emergency financing runs the risk of bailing out the private creditors of crisis countries, rather than helping these countries to mitigate income losses. This remains a valid concern unless reforms of the

international financial architecture prevent private creditors from rushing to the exits in crisis situations, which renders it almost impossible to achieve a fair burden sharing.¹⁷

The issue of bail-outs concerns emergency financing, independently of whether supplied by the IMF or the World Bank. Yet, this problem strengthens the case for a clear division of labor between these two institutions. It is the IMF which has the mandate to provide bridging finance in order to overcome temporary payments problems of member countries. At the same time, the IMF is better equipped than the World Bank to limit moral hazard of borrowers and their private creditors. Borrowers can be discouraged from drawing extensively and permanently on IMF financing by relatively high interest rates and relatively short maturities of IMF loans. Bail-out expectations of private creditors may be reduced by pending reforms of the international financial architecture, a task in which the IMF is closely involved.¹⁸ Hence, we support the conclusion of the Meltzer Commission (2000:8) that development agencies such as the World Bank "should be precluded from financial crisis lending."

¹⁷ On this issue, see Nunnenkamp (2001: 141) and the literature given there.

¹⁸ See, for example, the proposal by the First Deputy Managing Director of the IMF on a new approach to sovereign debt restructuring (Krueger 2001).

On the other hand, the request for a clear division of labor between the Bretton Woods institutions implies that the Poverty Reduction and Growth Facility should be transferred from the IMF to the World Bank, whose concern should be long-term development financing. This invites a second question related to the World Bank's future role, namely whether this institution should provide financial support exclusively to low-income countries, as recommended by the Meltzer Commission (2000). The arguments frequently advanced against this proposition are not convincing. It is of course true that absolute poverty is not restricted to low-income countries. However, as indicated already, the incidence of absolute poverty is typically much lower in middle-income countries. Moreover, except for periods of international financial turmoil, more advanced developing countries command over more domestic resources and have easier access to private foreign capital in order to fight poverty.

This is not to ignore that abruptly ending World Bank lending to middle-income countries may add significantly to the burden of repaying outstanding loans in countries which are already net debt repayers to the World Bank. However, an unmanageable repayment schedule can be avoided by phasing out the provision of new loans gradually. It may also be noted that phasing out financial aid to relatively advanced developing countries would not preclude the World Bank from offering technical assistance to middle-income countries. For example,

governments of middle-income countries may draw on World Bank advice in setting up a social infrastructure which may help alleviate poverty.

Once the World Bank focuses financial support more strongly on low-income countries, a third question comes to the fore, namely how to improve the effectiveness of aid granted to these recipients. While a detailed discussion of this issue goes beyond the scope of this article, important aspects shall be addressed shortly. The most important lesson from experience with aid seems to be widely accepted by now: The idea that aid buys reform (i.e., induces governments to adopt growth-enhancing and poverty-reducing policies) has utterly failed (Collier 1997: 56). Rather, "ownership" of reform programs by governments is critical for the effectiveness of aid. This implies that stricter conditions attached to financial aid by donors are unlikely to result in better policies and significant poverty alleviation. For aid to be effective, the initiative for policy reforms aiming at poverty alleviation has to come from the recipients themselves.

The donor community, including the World Bank, would have to support such initiatives by directing aid to reform-minded countries. This is basically what characterizes the so-called common pool approach to development assistance (Kanbur et al. 1999). In a similar vein, the Meltzer Commission (2000: 7) recommends performance-based support of poverty related projects, e.g. in

health care, primary education and physical infrastructure: "In poor countries without capital market access, poverty alleviation grants to subsidize user fees should be paid directly to the supplier upon independently verified delivery of service."

If aid flows were clearly linked to the recipients' "ownership" of poverty related reforms and projects, the current discussion on whether aid should be provided in the form of (subsidized) loans or outright grants would become considerably less relevant. In contrast to the United States administration, various European donors resist grant financing and favor loans, in order to impose discipline on the borrowing country and to replenish the World Bank's pool of loanable resources with repayments from previous borrowers. The disciplinary effect of repayment obligations stretching over decades appears to be fairly weak, however. A stronger commitment could be achieved if aid recipients were required to co-finance poverty alleviation programs supported by grants from the World Bank. Finally, refinancing of the World Bank may become less arduous once this institution can present convincing evidence to major shareholders on the effectiveness of its financial aid.

Appendix Table — Gross IDA Disbursements to 58 Developing Countries, 1997–1999^a (US\$ per capita)

	CPIA	US\$ p.c.		CPIA	US\$ p.c.
Angola	1	2.85	Bangladesh	4	2.82
Congo, Dem. Rep.	1	0.00	Cape Verde	4	44.16
Equatorial Guinea	1	1.31	China	4	0.47
Burundi	2	2.58	Côte d'Ivoire	4	8.82
Central Afr. Rep.	2	0.71	Egypt	4	1.34
Chad	2	5.47	Ethiopia	4	1.58
Comores	2	5.21	Ghana	4	12.94
Congo, Rep.	2	0.11	Guyana	4	13.31
Guinea	2	9.61	Honduras	4	23.39
Guinea-Bissau	2	7.20	India	4	0.85
Haiti	2	4.04	Lesotho	4	5.85
Indonesia	2	0.02	Mongolia	4	8.35
Kenya	2	3.25	Philippines	4	0.11
Lao PDR	2	5.86	Senegal	4	7.18
Madagascar	2	6.62	Sri Lanka	4	3.97
Moldova	2	5.94	Kyrgyz Rep.	5	10.90
Nepal	2	2.40	Maldives	5	12.95
Niger	2	4.12	St. Lucia	5	8.11
Nigeria	2	0.81	Uganda	5	7.35
Rwanda	2	7.76	average (4+5)	–	9.18
Sierra Leone	2	3.95			
Solomon Islands	2	10.01			
Tajikistan	2	5.22			
Vanuatu	2	2.73			
average (1+2)	–	4.07			
Azerbaijan	3	5.75			
Benin	3	4.93			
Burkina Faso	3	4.86			
Cameroon	3	6.15			
Malawi	3	10.29			
Mali	3	5.65			
Mauritania	3	10.21			
Mozambique	3	7.05			
Nicaragua	3	19.15			
Pakistan	3	1.63			
Tanzania	3	5.02			
Togo	3	6.24			
Vietnam	3	2.58			
Zambia	3	12.69			
Zimbabwe	3	3.78			
average 3	–	7.07			

^a Annual average, divided by population in 1998.

Source: World Bank, Global Development Finance 2001, CD-RoM; World Bank, World Development Indicators 2000, DC-RoM; Collier and Dollar (2001: Table 3).

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